

Who Must Restore Tenant Improvements After a Fire?

by Richard E. Strauss

Every lease contains clauses dealing with damage to the premises by fire and other casualty. These clauses typically provide for the repair and restoration of the premises by the landlord, a rent abatement until the damaged portion of the premises is restored and a right on the part of the landlord, and sometimes the tenant, to terminate the lease when there is substantial damage or lengthy restoration.

However, the typical fire clause makes no attempt whatsoever to clarify the nature of the premises which the landlord must repair. Are the premises the unfinished raw space in its condition upon lease execution or, after a catastrophic event, required to be gutted by the landlord? Or does the landlord's obligation to repair and restore extend to the initial leasehold improvements such as hung ceilings, partitions, lighting fixtures and doorways, as well as the distribution system for heating, ventilation and air conditioning, electrical and telephone wiring, not to mention the wall finishes and hardware, all of which are needed by the tenant to use the space for its business? Moreover, what if the initial installation has later been substantially altered by the tenant?

At the negotiation of the lease, the party which is obligated to build out the initial tenant installation, and the allocation of the cost, is always clear. However, should there later be a fire which damages these installations, the parties in the lease often have not addressed which of them is obligated to make required repairs or restorations. This is demonstrated by the "Standard Form of Office Lease" published by the Real Estate Board of New York and utilized by the majority of landlords in New York City. Paragraph 9 of that lease form states:

If the demised premises are . . . damaged or rendered . . . unusable by fire or other casualty, the damages thereto shall be repaired by and at the expense of the owner and the rent, until such repairs shall be substantially completed, shall be apportioned from the day following the casualty according to the part of the premises which is useable. . . .

Typically the lease merely states that the landlord leases to the tenant the "demised premises," which is described only by reference to a cross-hatching on a drawing of the floor plan of the building. This omission can lead to wasteful and expensive disputes and litigation. Instead, what should occur is a prompt and certain response from the landlord, the tenant and their insurers, understanding their respective responsibilities, in order to swiftly repair what has been damaged so that the landlord's building can be put in good order and the tenant can resume its business operations.

As an example of the needless controversy which can result, the New York case of *Viacom International Inc. vs. Midtown Realty Co., et al* is instructive. There, a fire in leased space occurred in 1988, but litigation was still pending among landlord, tenant and their respective insurers through 1997. The fire clause in the lease was exactly as quoted above. The courts interpreted the lease so that the "demised premises" which the landlord must restore included the leasehold improvements. To come to this conclusion the courts relied on a provision found in the alteration clause, where it was stated, in accordance with the text of this standard lease form, that all fixtures installed in the premises shall, upon installation, become the property of the landlord. Because the leasehold improvements were the landlord's property, the courts held that they must be repaired and restored by the landlord.

When a similar issue arises under another lease, this provision for ownership of alterations may very well be different, especially because the parties and their attorneys rarely focus on its implications in the fire clause, and often the alterations clause is driven by income tax depreciation questions. For example, the lease may provide that any alterations, including the initial tenant improvements—whether installed by the landlord or the tenant—are the property of the tenant. Should the resolution of parties' responsibilities in the fire clause turn on the particular negotiation of the alteration clause? Furthermore, there may be other clauses in the lease bearing on this issue, such as which party installed the leasehold improvements and paid for them, or which party has the obligation of repair generally or whether the tenant must surrender the leasehold improvements at the end of the term. Unfortunately, these various clauses often point to different conclusions.

Again, in reality the parties never intended that these other clauses should have an immediate bearing on the interpretation of the fire clause. For example, by the time of the final appeal by the landlord in the *Viacom* case, the landlord's principal owner still argued that:

I have negotiated hundreds of lease agreements. As a landlord, it has always been my position that under a standard lease the landlord does not assume or accept any responsibility or liability or obligation with regard to the improvements that a tenant undertakes to construct or place within the demised premises.

Interestingly enough, leasehold improvements are a type of property in which both the landlord and the tenant have insurable interests which may be covered under their separate fire insurance policies and each might be the subject of a claim. Therefore, although each party may be covered for some loss, both of them, and their respective insurance carriers, may have an interest in shifting the final economic obligation for the repair and restoration to the other and its insurance carrier.

Accordingly, it is incumbent on the landlord, the tenant and their attorneys to resolve these issues in the fire clause. The lease, obviously, should expressly provide either that the landlord shall make such repair or restoration or that the landlord shall have no obligation to do so.

When the lease provides that the landlord shall do so, the landlord and the tenant should at least consider the following:

- The cost of restoring leasehold improvements may be more than the economic contribution to their initial installation which the landlord undertook at the commencement of the lease. Also, the tenant may have made further alterations. This could concern the landlord if the leasehold improvements were of a type which increase its fire insurance premiums, or were special installations so that the landlord's claim under its fire insurance policy would be increased as a result of its making the repair, which in turn could result in a higher premium in the future. Accordingly, the landlord could have excluded from its obligation improvements such as kitchens, executive bathrooms, vaults, libraries, internal staircases and paneling.
- If the landlord undertakes the repair, there may be a resulting lengthening of the tenant's rent abatement as compared to simply repairing the building's core and shell and the base building of the premises. Typically, rent loss is payable by the landlord's fire insurance, so that the landlord would be made whole in any event, but its claim would be increased as the abatement period is increased.
- If some of the tenant's leasehold improvements must be specially manufactured or installed, completion by the landlord will be further delayed. In this situation, perhaps the landlord may require the rent abatement be correspondingly shortened.
- A lease which requires the landlord to restore the damaged leasehold improvements may be of little value to a tenant whose installation became outdated or no longer suitable to its business operations. In that case, such a tenant would wish to design a new installation rather than merely replace the old one. The landlord must be certain that its replacement cost insurance will cover the redesign and that any extra costs are paid by the tenant.
- The landlord should condition its obligation on the restoration being in compliance with then-building codes, should there be a change in the law. Alternatively, the lease may provide that the landlord is not responsible for repair or restoration. In this situation, the landlord and the tenant should be aware of that.
- The landlord's obligation would be limited to restoring the core and shell and base building. The tenant would use its own replacement insurance proceeds to restore the leasehold improvements and pay its own contractors for the work.
- The tenant may require a further period of rent abatement after the core and shell have been completed for it to restore the leasehold improvements. However, even if the tenant does not obtain additional rent abatement, usually the tenant will be able to claim under its business interruption insurance policy for rent paid while the premises are not suitable for the conduct of its business.
- Assuming no lease termination, the fire clause may go further to obligate the tenant to restore the leasehold improvements—and not merely relieve the landlord of this obligation. The tenant may contend that so long as it is paying the rent it should not be obligated to improve the premises, but the landlord may perceive a value in having the leased space in the building built out and occupied. A compromise might require that the premises be restored only to a condition of equal utility and/or at a cost not in excess of a then standard work letter, but that no restoration be required in the last year of the term.

As is indicated by the above discussion, both the landlord and the tenant anticipate that the cost of the restoration, whichever is obligated to do so, would be paid for by the fire and extended coverage insurance policy which each carries. Such insurance is payable regardless of fault. Accordingly, it is reasonable that the economic burden of the restoration should not necessarily depend, as between the landlord and the tenant, upon whether either or both were negligent in causing the fire.

If this principle is recognized, then the landlord and the tenant must exclude the division of risk and responsibility, which they negotiated in the fire clause, from any other potentially applicable clauses of the lease, so as not to inadvertently change the result. These include (a) a clause of the lease, or the law of negligence itself, where one party performing the repair or its insurance carrier could sue the other for the cost thereof if the damage was caused by negligence of the other, (b) an indemnity under which the other party might be responsible to indemnify the party performing the repair for costs incurred regardless of fault or (c) a breach of a covenant on the part of the tenant to surrender the premises in its condition as of the commencement date, or in good condition and repair, when the lease has terminated as a result of fire.

The question of the liability of a party for its negligence is complicated. As mentioned above, in reality each party expects this risk to be covered by insurance even if there is negligence. Thus, for example, if the tenant were obligated to and did repair its leasehold improvements after a fire and recovered the cost from its insurance carrier, but the fire was caused by the landlord's negligence, a claim could be made by the tenant's insurance carrier by "subrogation," and the landlord could be forced to pay damages. This result would be in direct contradiction to the allocation of risk set forth in the fire clause and would, in effect, make the landlord the reinsurer for the tenant's insurance company. The resolution would be for each party to release the other from claims for damage to its property which are—or should be—covered by its own fire and extended coverage insurance. However, any such release without the consent of the insured's carrier might have the effect of invalidating its insurance. In most insurance policies today it is standard for the insurer to so consent and waive its rights of subrogation.

A sensible resolution of these restoration obligations can be achieved if the parties focus on the issues during lease negotiation. Failure to do so could produce unintended and uneconomical results and also create costly delay after a fire, while the parties first attempt to resolve these questions under duress.

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