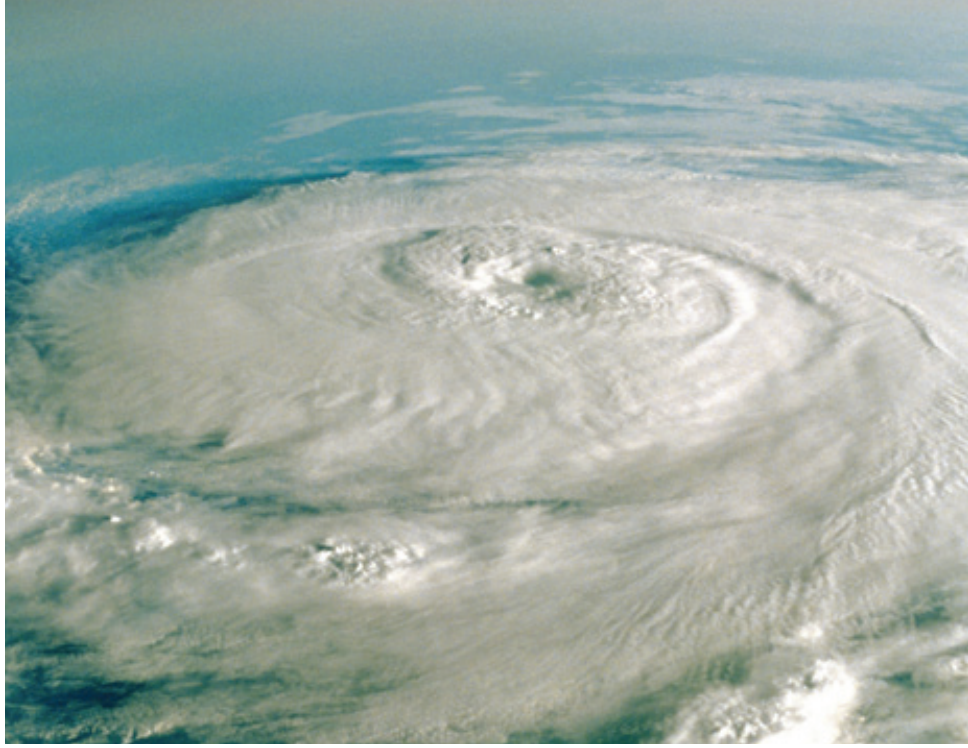
*by Thad Armstrong*
*Thompson & Knight LLP*

# Anatomy of a Casualty Clause

**Hurricane Katrina hit New Orleans on August 29, 2005. The following morning, I received a phone call from a client who owned several office buildings in and around the affected area. He told me that his buildings were either destroyed or were otherwise untenantable. His tenants had already begun to call, and his question was simple: "What are our rights?" The answer to that question, I told him, depends on the casualty provision in each lease.**

Of course, as we recently experienced with Hurricane Rita, our Gulf Coast location makes us just as likely to receive a destructive hurricane. Therefore, this article is intended to focus on the issue of casualty and a landlord's and tenant's rights associated therewith. Casualty touches and concerns many other related topics such as insurance, waivers and releases, and, in the case of a landlord, coordination with corresponding provisions of loan documents; however, the scope of this article is limited to the casualty provision itself rather than the interplay between casualty and these related topics.



## Consider the Following:

*"Subject to the other provisions of this section, if the premises or the shopping center are damaged by fire or other perils, this lease shall remain in full force and effect, and landlord shall restore the premises to a state ready for restoration by tenant of tenant's improvements. Notwithstanding the foregoing, landlord will have no obligation to restore the premises when: (i) the landlord's lender elects not to permit use of insurance proceeds for reconstruction; (ii) the damage is not fully covered by landlord's insurance; (iii) the damage occurs during the last 2 years of the term of this lease; or (iv) 30% or more of the premises or the shopping center damaged. In any such event, landlord may terminate this lease by so notifying tenant within 120 days after the date of the damage, which termination will be effective as of the date of the notice. Landlord shall not be required to make any repairs or replacement of any improvements or any other property installed in or located on the premises by tenant. Tenant shall be entitled to an abatement in minimum annual rent during landlord's restoration in proportion to the portion of the premises that is rendered untenantable by such damage; provided, however, if the damage is occasioned by the acts or omissions of tenant or its employees, there shall be no abatement of rent. The abatement shall commence as of the date of that damage and shall terminate on the date landlord completes its restoration work."*

The foregoing clause, which this article will refer to as the "Example", is being used for illustrative purposes only and not as a suggested or model provision. Indeed, this article will highlight many of its deficiencies in the paragraphs below.

## Obligation to Rebuild

As is the case in most leases, the Example obligates the landlord to rebuild the premises, but also creates certain exceptions to this obligation.

First, the landlord does not have to restore if its lender will not permit the insurance proceeds to be used for restoration. This is a typical, reasonable exception and is important to landlords because most loan documents allow the lender to choose whether the insurance proceeds will be used for restoration or applied to the debt. In other words, the landlord in all likelihood is not in control of its insurance proceeds; thus, it would be a disaster if the


landlord found itself contractually obligated to rebuild a multimillion dollar building when no insurance proceeds were available for it to do so.

Second, the landlord does not have to restore if the casualty is not covered by its insurance. This is a common exception and is conceptually reasonable for the same reasons stated above – it would be a disaster if the landlord found itself contractually obligated to rebuild when no insurance proceeds were available for it to do so. However, the tenant should protect itself by requiring the landlord to obtain property insurance on an "all risks" basis (correctly termed "causes of loss - special form") in an amount equal to the full replacement value of the building.

Third, the landlord does not have to restore if the casualty occurs during the last two years of the term. This is also a common exception in that it may not be economically feasible for a landlord to restore the premises of a tenant whose lease will terminate within months after the restoration is complete. Likewise, a casualty near the end of a lease term creates a business interruption issue for the tenant; not only will its operations be interrupted during the period of restoration, but its lease will expire within months after moving back into the restored premises. Therefore, a tenant should ask for a mutual right of termination if a casualty occurs near the end of the term.

Fourth, the landlord does not have to restore if the casualty affects more than 30% of the premises or the shopping center. Again, this is a common exception and one that should not cause too much concern on either side of the table; however, a tenant should be wary if the percentage is unreasonably low because the landlord could use it as a backdoor to get out of an unfavorable lease. What's more, a tenant with good bargaining position should require a provision stating that its lease cannot be terminated in this instance unless the landlord also terminates all other leases at the property. Again, a tenant does not want its landlord to take advantage of a casualty as a means of ridding itself of unfavorable leases.

> **"Nevertheless, long periods of restoration correspondingly create a business interruption issue for the tenant; therefore, a tenant should ask for a right of termination if restoration is estimated to take longer than it would be willing to wait under the circumstances."**

A landlord may also want to add another exception to its obligation to rebuild in the event restoration is estimated to take longer than a specified period of time. This, too, is a common, reasonable exception. Nevertheless, long periods of restoration correspondingly create a business interruption issue for the tenant; therefore, a tenant should ask for a right of termination if restoration is estimated to take longer than it would be willing to wait under the circumstances. In connection with the estimated time for restoration, a tenant with good bargaining position should also require a termination right if the actual restoration exceeds an outside date for completion. An estimated 60-day restoration period could turn into a

120-day waiting period, thus causing serious business interruption issues for the tenant.

Finally, note that the Example provides that the landlord's obligation to rebuild does not include those improvements for which it was not originally responsible. This makes sense: if the tenant paid for and installed certain improvements, the tenant should look to its own insurance proceeds to pay for their restoration. The Example could be more clear, however, by (1) requiring the landlord to restore the premises to the condition they were in on the day prior to the casualty, except for those improvements, fixtures, and other items of personal property paid for and installed by the tenant, and (2) requiring the tenant to restore the improvements, fixtures, and other items of personal property paid for and installed by it.

## Notice

The Example provides the landlord with a generous 120-day period in which to decide whether to rebuild or terminate. From a tenant's perspective, every day that goes by is one more day that the tenant is not in business. The landlord needs a reasonable amount of time in which to assess the damage, coordinate the insurance adjustment, and engage architects and contractors. On the other hand, the tenant should not have to wait an unreasonably long period of time for the landlord to decide whether to rebuild or terminate. During the lease negotiation process, the parties need to recognize each other's needs and strike an appropriate balance.

## Abatement During Restoration

Like most leases, the Example grants the tenant an abatement of rent during any period of restoration. Note, however, that the Example provides an exception if the casualty was caused by the tenant, which raises several issues for both the landlord and the tenant. This, however, is unreasonable. First, the landlord should have rental insurance, which the tenant should expect the landlord to rely on; after all, tenants pay for the landlord's insurance anyway. Second, landlords are almost certainly better off granting an unlimited abatement. Otherwise, the tenant's loss of business coupled with an ongoing obligation to pay rent may force the tenant out of business altogether, leaving the landlord with a likely uncollectible claim against an insolvent tenant. On the other hand, the landlord should look to its rental insurance during the period of restoration, while the tenant should carry and look to its business interruption insurance, thereby leaving both parties in as good a position when the restoration is complete as they were before the casualty.

One last note about abatement: the Example provides that the abatement will continue until the landlord's restoration is complete. Leases often contain a free rent period at the beginning of the term in order for the tenant to outfit the space with its equipment, inventory, and furnishings. Tenants should ask for a similar free rent period after a casualty. For example, the tenant's abatement would continue until the 30th day after the landlord's restoration is complete.

## Conclusion

Parties to a lease transaction are primarily focused on the material terms of the deal – the rent, the term, build-out, and any other bargained-for rights deemed fundamental to the transaction. Casualty provisions, however, are often overlooked, frequently being referred to as "boilerplate", which to many means they are not even worth reading much less negotiating. Moreover, many reduce a casualty provision to a typical cliché – "That would never happen to me." Tell that to the people in New Orleans.

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*Thad Armstrong is an associate in the real estate and banking section of Thompson & Knight LLP, a Texas based, full service law firm with offices worldwide, including Houston, Dallas, New York, London, Paris, Algiers, Mexico City, and Rio de Janeiro. Thad can be reached via email at thad.armstrong@tklaw.com.*