

KNOW YOUR LEASE

By Thad Armstrong

PART 4



Questions to Ask

This is the fourth and final entry in a series of articles following last year's *NBIZ* article titled *10 Questions You Need to Ask About Your Lease*. Each of the questions in that article touched upon an important issue facing tenants when negotiating a commercial lease agreement. This final entry will focus on the eighth, ninth, and tenth of the original 10 questions, giving you a better understanding of the critical issues controlling your and your landlord's rights and obligations under your lease agreement.

What If an Employee or Customer Slips and Falls in the Common Area?

Allocation of Risk

Both the landlord and the tenant naturally assume some liability by entering into the lease and agreement and subsequently operating their respective businesses and properties. Commercial leases typically attempt to transfer as much of the landlord's liability as possible onto the tenant. This transfer of liability is called "allocation of risk." Liability comes in two basic forms: first-party liability and third-party liability. First-party liability consists, for example, of the landlord's and the tenant's liability to each other for each other's acts, injuries, and damages. Third-party liability, on the other hand, consists of the landlord's and the tenant's liability to each other for the acts, injuries, and damages of others. First-party liability will be addressed in the next question. This question, however, focuses on third-party liability, and, more particularly, how the risks of third-party liability are allocated between the landlord and

the tenant. The answer to this question goes straight to the indemnity clause in your lease.

Indemnities

An indemnity works a lot like an insurance policy. In its most basic form, an indemnity is one person's agreement to protect another person from claims and lawsuits and to pay for the other person's covered losses. If the person entitled to indemnification incurs a loss, the person providing the indemnity must pay.

Indemnities unfortunately can be complicated and complex. Indemnities in leases often overreach, covering losses that should not be allocated to the tenant. One simple way to figure out the scope of an indemnity is to put each item of the indemnity into two buckets. First, location: where did the injury occur? Second, fault: who caused the injury? One good solution for a tenant is to propose a fair, simple indemnity that allocates risk based on these two factors. For example, the risk of injuries inside the premises could be allocated to the tenant and the risk of injuries outside the premises could

be allocated to the landlord, unless the injury was the fault of either the landlord or the tenant, in which case the at-fault party would bear its own liability. But even a straightforward allocation of risk such as the above may not fit the particular circumstances and type of lease, and landlords may reasonably expect entire risks to be allocated to a tenant. Texas law requires specific legal drafting for certain indemnities to be enforceable; tenants and landlords should seek the advice of an attorney to make sure their intentions are properly captured in the lease.

Insurance

Perhaps the most important aspect for tenants assuming risk through an indemnity is to be adequately insured. In other words, whatever liability is assumed should also be insured. It is critical to have your indemnity reviewed by your insurance company. If there are holes or gaps in your coverage, the tenant (and perhaps the personal guarantor) may be exposed to great liability without the protection of an insurance policy.

What If a Fire or Hurricane Damages the Property?

Restoration

The lease should clearly describe the landlord's obligations and the tenant's rights following a fire or in the event of hurricane damage. The landlord should, at a minimum, be obligated to restore the structure and shell of the building. Reasonable exceptions to the landlord's obligation to rebuild include lack of insurance proceeds, lender requirements, and total destruction. The tenant should pay careful attention to which party is obligated to restore the tenant's improvements. Because the tenant's improvements will become a part of the building, it is not unreasonable to ask whether they will be insured under the landlord's property-insurance policy. If so, the obligation to rebuild the tenant's improvements may reasonably fall to the landlord, or proceeds may be allocated to the tenant for restoration (much like the initial improvement allowance). But if the landlord is not required to restore the tenant's improvements, the tenant should carry sufficient insurance to cover its own restoration.

Abatement of Rent

The lease should also answer the question of whether the tenant is required to pay rent after the damage

occurs and before the premises are restored. The right of abatement allows the tenant not to pay rent under certain circumstances. It is customary in most commercial leases for rent to be abated at least to the extent that the premises are unusable by the tenant and until the restoration is complete. It is not uncommon for all rent, including operating expenses, to be abated until restoration is complete. Tenants with strong bargaining positions may be able to negotiate an extended period of abatement in order to give the tenant a period of time (e.g., 30 days) after restoration is complete in which to finish out the premises with furniture, fixtures, and office equipment. Tenants may also consider purchasing business-interruption insurance, which, in addition to other covered losses, may fill any gaps or holes resulting from limited or no rights of abatement.

Tenant's Rights

The tenant should also focus on business interruption and ask itself the following question: How long can I afford to be without space? If restoration will take or does take more time than the tenant can afford, the tenant may need the right to terminate the lease. It is common for a tenant to have the right to terminate the lease under the following scenarios: (1) restoration is *estimated*



to take longer than a certain period of time; and (2) restoration *actually* takes longer than the estimated time. These time periods are negotiable. It is also not unreasonable for tenants to negotiate for the right to terminate the lease if the damage occurred near the end of the term of the lease (e.g., in the last 12 months of the lease). If, for example, a fire occurred with six months left in the term, and restoration will take three months to complete, the tenant may have to reopen its office only to have the lease expire three months later.

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Liability

Third-party liability was addressed previously. But what about first-party liability? What if, for instance, the tenant caused the fire that destroyed the building? Could the tenant be liable to the landlord for millions of dollars? Technically, yes. But, because of risk allocation, the answer should be no. The landlord and tenant should assume the risk of property damage and waive all claims against each other for damage to each other's property, irrespective of the cause. Rather than sue each other, each party should look to its respective insurance to cover the loss. This waiver is customary in commercial leases. But it is only the first of two important steps. The second step is to obtain the same waiver from each other's insurance companies. This is called a "waiver of subrogation." Without a waiver of subrogation, if any insurance company pays a claim, the insurance company has the right to sue the person who caused the loss. Waivers of subrogation are customary. Texas law requires specific legal drafting for certain waivers to be enforceable, and tenants and landlords should seek the advice of an attorney to make sure their intentions are properly captured in the lease.

What If the Landlord's Bank Forecloses on the Property?

Under general Texas law, the lease might be automatically terminated following a foreclosure. A prudent tenant will require the landlord to provide an agreement, commonly referred to as an "SNDA," from the

landlord's bank to prevent this from happening. An SNDA—which stands for Subordination, Non-Disturbance, and Attornment—is an agreement between the tenant and the landlord's bank that, in its most basic form, will cover three things: (1) the tenant's agreement to subordinate the lease to the bank's lien; (2) the bank's agreement not to disturb the tenant's possession of the space after a foreclosure; and (3) the tenant's agreement to recognize the bank as the tenant's landlord after a foreclosure. SNDA agreements frequently contain several other clauses dealing mostly with the lender's rights, obligations, and liability following a foreclosure, much of which is reasonable, but much of which goes too far. SNDA agreements are negotiable, and tenants with strong bargaining positions may be able to demand the removal of unfavorable provisions. The tenant's goal is to leave itself in the same position and with the same rights

following a foreclosure as it bargained for under the lease. The lender's goal, however, is not to assume liability for the defaults of landlords after foreclosure. Both goals are reasonable, and a balanced SNDA agreement can accomplish both. **N**

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The information in this column is not intended as legal advice but to provide a general understanding of the issues. Readers with legal problems, including those whose questions are addressed here, should consult an attorney for advice on their particular circumstances.