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FEATURES

ARTICLES

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This article continues a discussion of shopping center insurance clauses from the previous issue.

People and Property: Insurance Clauses Revisited—Part II

Emanuel B. Halper

WHY WAS I SITTING in a crowded bus on Friday evening, March 14 and traveling from Bradley Field Airport in Windsor Locks, Connecticut to a "popular-priced" hotel in Hartford?

I was not with my family, and my only acquaintances on the bus were people I met only a few hours ago on an airplane en route to Kennedy Airport from Atlanta, Georgia. I was returning home from a lease negotiation that took place aboard a yacht in Howe's Bayou, Louisiana.

Returning from a lease negotiation is not an unusual experience in my life. Because I am sure you are interested, I will summarize my last three tales and remind

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you of all the trouble I had going to and from this negotiation.

My most important and most demanding client, Harry Paine, had insisted that I arrive at the yacht on Thursday morning, March 13, to negotiate the insurance clauses for a group of twenty small store shopping center leases. Normally, I am eager to please Harry, but this time his demands conflicted with a commitment I had made to Dean Mitchell Halderlich, the well-known political figure and supporter of the presidential campaign of Louisiana Senator Beauregard Whitehood. I had promised Halderlich that I would attend a mammoth formal banquet honoring Whitehood on the evening of March 12.

So I ended up attending only the cocktail party before the banquet and rushing off in my tuxedo at 8:30 to board a plane. But I did sit at the dinner table long enough to meet Senator Whitehood. Before I left, he insisted that he would drop by my house during a tour of Long Island that he was planning for Sunday, March 16.

My return trip from the Howe's Bayou yacht was more eventful than the trip there. The flight I boarded in Atlanta flew into a snowstorm that was so ferocious that planes bound for New York were rerouted to Bradley Field. We remained in the plane on the Bradley Field runway for an uncomfortably long period. Finally, the airline rented a bus to bring us to the hotel in Hartford where they would keep us until they were able to fly us into New York.

When the bus stopped, we found ourselves entering the local franchise of one of the nation's best-known, popularly priced, family-style hotel chains. The place looked as if it had been abandoned by the local slumlord.

We all crowded around the desk to get keys to our rooms.

When I got my key, I deposited my bags in my room and went down to dinner. Naturally, there was a line. The hotel restaurant had not had so much business since the day it opened in 1953 and offered meals at 1933 prices. So I waited. Conversations began, and friendships were started. I met a French chemist whom I tried to impress with my high school French.

When a table became available, the two of us were seated with six Tunisian soldiers. They were impressed that I admired Habib Bourguiba, but the Frenchman denounced Bourguiba for his disloyalty to the French nation. I led them through discussions of the recent wars in the Sahara, Lebanon, Iraq, and Chad.

Back in my room, I opened my luggage. It was freezing. Cold air rushed through the window frames, and layers of frozen moisture collected at the edges of the windows. To preserve my body warmth, I climbed into bed and covered myself with three blankets and the bedspread.

The morning of Saturday, March 15 was spent idling in the hotel. The airports were still closed. Everything in Hartford was also closed. To pass the time, I completed a memorandum on shopping center lease insurance clauses to enable my client, Harry Paine, to evaluate the clauses agreed to at the meeting in Howe's Bayou. As living proof of my enterprise and devotion to my work, I present to you the balance of the memo.

FACTORS AFFECTING INSURANCE PREMIUM COSTS

The cost of a shopping center's insurance premiums is expected to rise over the years. One reason is that the cost to replace an existing building is constantly rising, and a prudent businessman must make certain that the insurance proceeds will be adequate to repair or replace damage caused by fire or other catastrophe. Moreover, both the coinsurance clauses of fire and other property insurance policies of his mortgagee force a property owner to act prudently.

Not only does the cost of construction continue to rise, but premium rates sometimes rise too. The only things that a shopping center owner can do to reduce insurance premiums are things that he should have considered when the shopping center was initially designed and constructed.

Reduced Premium Carriers

Insurance carriers that belong to the Factory Mutual Group and carriers known as Industrial Risk Insurers and Improved Risk Mutual, all of which write highly protected risks, are able to charge much lower premium rates than average because they have a superb loss record. This record is made possible by the application of strict standards in selecting insureds and careful precautions against fire hazards in the original engineering and design of buildings.

Factory Mutual, Industrial Risk Insurers, and Improved Risk Mutual encourage fire-resistant construction, the installation of central station communications to report fires in their early stages, the installation of automatic fire and smoke detection equipment, and the installation of sprinkler systems.

Successful sprinkler systems involve a surge of a great deal of water under high pressure. That's why a significant part of a developer's early site investigation should be devoted to determining whether a public utility or municipal water supply can supply water in the appropriate volume under sufficient pressure. If there is no such supply of water, the developer must either bear the expense of creating the pressure and volume or abandon the possibility of buying reduced premium

insurance from Factory Mutual, Industrial Risk Insurers, or Improved Risk Mutual.

Other Cost Factors

Many other factors determine fire insurance rates for a shopping center. One of these factors, obviously, is location. In a troubled area in which the local teenagers are prone to arson, fire insurance premiums are bound to be a bit higher. The distance of the shopping center from the closest fire department and fire hydrants affects rates. The use to which a building is put also affects its fire insurance rate. Dry cleaning establishments which use volatile fluids and restaurants which include kitchens, usually are charged higher rates than candy stores.

WHO SHOULD CARRY THE INSURANCE?

When shopping center owners submit leases to small store owners, the leases frequently say nothing about insurance. Why should they? Almost everyone expects that the landlord will carry the property insurance. Consequently, landlords usually avoid the issue and leave property insurance clauses out of their form leases. They know that they must answer to the mortgagee about insurance. Why invite more trouble by establishing a similar obligation to the tenants?

But the tenant's lawyer in a gross lease negotiation should never forget to insert a provision that requires the owner to carry appropriate property insurance for the entire shopping center. If insurance proceeds are inadequate, the party required to repair or replace damage caused by fire or other catastrophe (usually the landlord in the case of a gross lease) might not have enough money to finance the repair or replacement.

On the other hand, there is no immutable rule that the landlord, and only the landlord, should carry the necessary insurance. It's a question of arithmetic. Many tenants would prefer to have a lower rent and provide the insurance coverage themselves.

When the demised premises are a 2,000 square feet store in a row of 2,000 square foot stores, it is best that the landlord carry the property insurance. The cost of this insurance should be borne by the tenants either as a part of regular minimum rent payments or as separately stated charges. If a fire were to damage the whole row of stores, it would be foolish for the landlord or the mortgagee to have to negotiate with twenty or thirty different insurance companies. Suppose the fire started in one store and spread to another. Which fire insurance company would be responsible for the party wall or any other facilities used in common? The insurance companies would fight with each other and would probably battle with the landlord and tenants as well.

On the other hand, when the demised premises are a free-standing building, it makes sense for the tenant to carry the insurance and to cover the interest of the landlord. A chain department store or supermarket may carry insurance under a blanket policy which covers all or many of its stores. Its blanket policy may be cheaper than any policy the landlord could buy.

If a lease requires a department store or supermarket tenant to insure the real estate, the tenant is in a position to choose a single carrier to cover the demised premises, the leasehold improvements, and the fixtures and merchandise in the demised premises. There are several advantages to selecting the same carrier to insure the real estate and the store's personal property (contents). One is that the combined premium may be lower than the separate premiums. The other is the avoidance of disputes. When the real and personal property are separately insured, insurance companies fight with each other over whether damaged property is real property and insured by the landlord's policy, or personal property insured by the tenant's policy.

Even if the lease requires the landlord to insure the building, the tenant may be able to persuade its own insurance company to insure the leasehold improvements whether these improvements are the landlord's or the tenant's property. There's a good chance that the company that insures the "contents" of a building, if asked in advance, will also agree to extend its coverage to the leasehold improvements even if the improvements are technically the landlord's property.

REQUIREMENTS AS TO TYPES OF INSURANCE

When the tenant is expected to carry the insurance, the lease is often called a "net lease." In a net lease the landlord wants to make certain the tenant covers each peril for which the landlord's mortgagee requires coverage. Regrettably, shopping center mortgages often include only the vague statement that the landlord must carry *such insurance as the mortgagee may require from time to time.*

When the landlord tries to pass on this obligation to the tenant (that the tenant carry all the insurance that the mortgagee may require), the tenant's negotiators cry out that this is a preposterous notion. Suppose the mortgagee decides the tenant should carry insurance against the prospect that its employees will contract venereal disease. If social attitudes continue on their current path, the premiums would be phenomenal.

A tenant's lawyer may get away with refusing to give the mortgagee unrestricted power to specify the kind of insurance the tenant must carry. But the landlord's lawyer probably can't persuade the mortgagee to change the insurance clause in the mortgage. Few mortgagees will concede that their favorite clauses are unfair. They'll just lend their money to someone else.

Mortgagees' Requirements

So when the leasing arrangement calls for the tenant to carry insurance, the landlord's negotiator may simply have to guess what the mortgagee's requirements will be.

Many institutional lenders to shopping centers make the fire insurance policy the centerpiece of their property insurance coverage requirements. When fire insurance is the base of the insurance program, an extended coverage endorsement is almost always required as well. If a mortgagee is aware that vandalism and malicious mischief are not covered by customary extended coverage endorsements, it may demand a separate vandalism and malicious mischief endorsement. Many mortgagees also require sprinkler leakage insurance.

An increasing group of mortgage lenders prefer the comprehensive approach of "all-risk" or "difference-in-conditions" coverage.

All-risk policies say that they insure against "all direct risks" or "direct risks," but they exclude a long list of specific risks from the coverage.

A difference-in-conditions policy is a companion to a package that includes fire, extended coverage, vandalism and malicious mischief. When you add difference-in-conditions coverage to the package, you get the same deal as you would with all-risk—perhaps with a lower premium. Some mortgage lenders require boiler and machinery, flood, and earthquake coverage to fill the gaps not covered by all-risk insurance or a package of endorsements that includes difference-in-conditions.

Some mortgagees have eccentric requirements. They may require sprinkler leakage and vandalism and malicious mischief endorsements in addition to all-risk coverage; these endorsements are unnecessary when a developer carries all-risk coverage. I've seen insurance clauses in mortgages that require the borrower to carry an extended coverage endorsement *and* a special extended coverage endorsement despite the fact that a special extended coverage endorsement includes all the coverage you get from the combination of an extended coverage and a vandalism and malicious mischief endorsement. If a lender's attorney likes to make long lists to impress both the borrower and his client, he may specify boiler and machinery coverage. However, boiler and machinery coverage is usually not needed if the building does not have a steam boiler or other pressure vessel.

In anticipating what coverage the mortgagee may require, the owner's negotiator should bargain for a clause that provides that, if other insurance coverage becomes customary for similar kinds of property, the tenant will add that type of coverage. Conversely, a party that agrees to carry insurance should insist that he not be obliged to carry any particular kind of insurance unless it is customarily carried by owners or lessees of similar types of property.

Tenant's Requirements

When a lease requires that the landlord carry the insurance, the tenant doesn't care what kind of insurance the mortgage lender may require, but the tenant does want to make sure that the landlord insures the premises against the perils that are most likely to happen so that the landlord has the funds to pay for the repair or replacement of the damage.

A tenant should find comfort from requirements that the landlord carry an all-risk policy or a package of fire insurance with extended coverage, vandalism and malicious mischief, and difference-in-conditions endorsements. Boiler and machinery should be added if a steam boiler or other pressure vessel is used on the premises. Flood insurance, earthquake insurance, or both should be considered if either the property owner or lessee has a realistic concern about these risks.

GETTING THE RIGHT INSURER

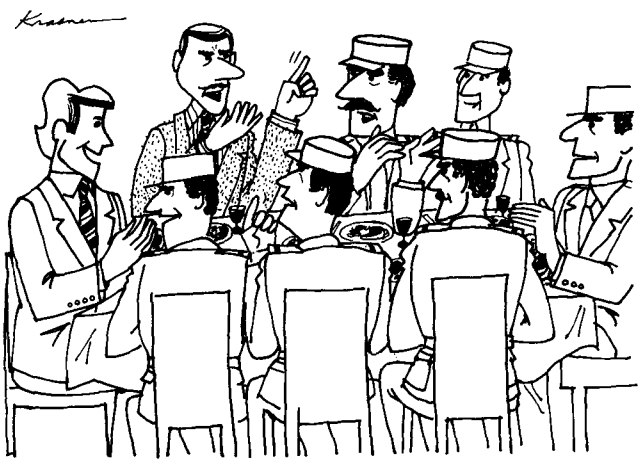
The financial stability of insurance companies varies considerably. Landlords, tenants, and mortgagees who rely on an insurance company's promise to provide a fund to finance the cost of restoration after a fire or catastrophe should worry about whether the insurance company will be able to meet its contractual obligation under the policies it issues. (Insurers routinely subject themselves to liabilities that are many times greater than their net worth. In part, insurers cushion themselves by reinsuring with each other. Accordingly, a loss covered by a single insurance policy may actually be shared by several companies pursuant to reinsurance arrangements.)

To deal with the risk that an insurance company may have insufficient resources to meet its obligations, shopping center leases and mortgages include provisions governing the identity of insurance companies. In the early days of the industry when we attorneys knew even less about insurance than we know now, provisions concerning insurers were rudimentary. Mortgage lenders required that the choice of the insurer be a decision solely within their discretion. Many shopping center mortgages still say no more about the identity of insurers except that they are to be satisfactory to the mortgagee. Not unexpectedly, chain store tenants' form leases required (and still require) that the insurance companies are to be satisfactory to the tenant. But suppose the only insurance company that is satisfactory to the mortgagee is unsatisfactory to the chain store tenant. What is the poor landlord supposed to do?

Objective Requirements

Another approach to the problem is to require that the insurer be qualified to do business in the state in which the shopping center is situated. This requirement may be adequate to assure all parties about the insurer's financial stability because many states have tough requirements as to the financial strength of insurance companies that do business within their borders.

A bolder route requires that the insurance be carried with insurance companies "of recognized responsibility." This phrase creates an "objective" guideline that protects a landlord from being subjected to arbitrary treatment by mortgagee and tenant. Unfortunately, it's not easy to figure out what the phrase "of recognized responsibility" means. A thoughtful person might ask these questions: What kind of responsibility? How much responsibility should there be? Who should do the recognizing?



Still another possible solution to the problem is to provide that the insurer be reasonably satisfactory to the landlord or the tenant, to both, or to both and the mortgagee. The advantage of this method is that nobody has the right to reject an insurer; the disadvantage is that if the parties disagree, a court may be the only place to find out what is reasonable.

There are some truly objective criteria to which the parties can look for guidance. A clause may provide that a "captive insurance company" is not acceptable. A captive insurance company is a company that is owned or controlled by the landlord or the tenant and which principally insures the property of the company that owns or controls it. Using a captive company is very much like self-insuring the entire risk because the insured really bears the entire risk itself under both circumstances.

Best's Ratings

Probably the most objective guideline for the selection of an insurance company is a requirement that the insurer be a company with a specific "Best rating" or "Best rating and financial category" or a company with equivalent financial strength and reputation. Best ratings appear in the publications of A.M. Best Company of Oldwick, New Jersey. *Best's Key Rating Guide* contains financial information about insurance companies and rates the companies according to their financial stability.

Best's opinion as to a company's overall ability to fulfill its obligation is called its "policyholders' rating" and is expressed as a combination of letters and symbols. A+ is the highest policyholders' rating. Best also groups the companies into categories in accordance with their reported financial information. The categories are expressed in Roman numerals and XV is the highest.

Consequently, you might conclude that a company in Best's financial category XV and rated A+ by Best's is the greatest. On the other hand, the policyholders' ratings are more significant than the financial categories, and companies rated A or better are well respected in the industry.

Best's has changed its rating system in the past and might do so again. Consequently, a lease or mortgage clause should not refer to a company's rating pursuant to the existing system without a proviso to deal with the possibility that the rating system might be changed or that Best's will stop rating insurance companies altogether.

HOW MUCH INSURANCE SHOULD THE LEASE REQUIRE?

As we indicated, when the parties decide that the tenant should carry the insurance, the landlord must get the tenant to satisfy the needs of his mortgagee. Mortgagees usually insist that insurance protection against fire and other catastrophes be in an amount which is not less than the original mortgage debt.

The minimum amount of insurance that the lease should require is the higher of 80 percent of actual cash value or an amount sufficient to require the insurance company to pay the entire loss up to the face amount of the policy.

Because the replacement cost of buildings has been rising constantly, the lease should provide that the amount of required insurance be reviewed every year. The lease should specify that replacement cost or actual cash value be established annually by an appraisal organization approved in advance by the insurance company.

The best way to deal with a co-insurance clause in a property insurance policy is to get an agreed amount endorsement, and insurance companies are willing to issue agreed amount endorsements on the basis of an appraisal by an approved appraisal organization.

Endorsements

It's in the best interests of mortgagees, landlords, and tenants to make sure that the party obliged to carry insurance under a lease carries enough insurance to pay for the entire cost of the repair or replacement of the damage. To this end, a shopping center lease should require a replacement cost endorsement, a demolition cost endorsement, and an increased cost of construction endorsement.

Replacement cost endorsements increase the coverage so that it is possible for the insured to recover the cost of replacing the building that was damaged with new materials of like kind and quality. However, replacement cost endorsements don't cover the cost of demolishing a part of a damaged building that can't be rebuilt because of the operation of building laws. You buy a demolition cost endorsement to cover that contingency. The increased cost of construction endorsement covers the cost of construction of building elements that are required by current laws but that were not legally required at the time of the original construction (and therefore are not covered by the replacement cost endorsement).

Although some self-insurance is required for many policies and is customary for most of them, few shopping center leases permit any self-insurance. New shopping center leases should provide for self-insurance for small losses and should fix the extent of losses for which a party to a lease will substitute its own liability for insurance.

ADJUSTMENT OF INSURANCE PROCEEDS

Although only two parties execute a lease, three parties are interested in what happens to the insurance proceeds: the landlord, the tenant, and the mortgagee. All three are suspicious that one will make a deal with the insurance company that won't protect the interests of the others.

Even when the tenant carries the insurance, the landlord usually insists that insurance claims be adjusted by the mortgagee. That's because the landlord anticipates that the mortgagee will insist on this right in the mortgage. A department store tenant in a strong bargaining position or a tenant of a free-standing store building may refuse to give the mortgagee the sole right to adjust insurance proceeds. If the tenant has the obligation both to carry the insurance and to rebuild the building, this issue can be compromised by allowing the tenant to adjust insurance claims subject to the approval of the mortgagee. If the tenant is carrying the insurance and the landlord is required to rebuild, it would be appropriate for insurance claims to be adjusted by the mortgagee, but the adjustment should be subject to the approval of the tenant and the landlord. It would be a good idea to require any party that has the right to approve the adjustment of insurance claims to agree not to withhold approval unreasonably.

When a landlord is required both to carry insurance and to repair any damage caused by fire or other catastrophe, the tenant need not get involved in the insurance adjustment. However, even in these circumstances, some tenants insist upon a right to approve the adjustment of insurance claims because they are afraid that there won't be enough money to pay for the repairs.

TO WHOM SHOULD INSURANCE PROCEEDS BE PAID?

Mortgagees would like to have the right to decide whether insurance proceeds will be applied to the unpaid balance of their debts or be used to restore the buildings.

If the catastrophe caused a partial loss and the unpaid balance of the debt is much greater than the insurance proceeds, the mortgagee normally does not grab the insurance proceeds because there may not be sufficient value left in the half-destroyed building to cover the balance of the debt.

However, if the loss is total or if the insurance proceeds are greater than the unpaid balance of the debt, the mortgagee may be tempted to apply the insurance proceeds to the debt—that is to keep them. If that happens, and there isn't enough money left to pay for the repair of the damage, the tenant's perhaps prosperous retail operation may die for lack of a place in which to do business.

Another factor that a mortgagee is likely to consider when it decides how to apply the insurance is whether the return it is receiving on the existing mortgage is as large as current market returns. But, unless the lease provides to the contrary, the mortgagee is unlikely to consider the tenant's needs in determining whether the store will be rebuilt.

It's not enough for a lease to provide that the landlord is required to rebuild in case of fire or other catastrophe. If a mortgagee grabs the insurance proceeds, the landlord may not have the money with which to rebuild.

If the lien of the lease is subordinate to the lien of the mortgage, the mortgage will prescribe the format of the insurance policy and the application of insurance pro-

ceeds. A lease is subject to a mortgage that is recorded earlier, and a lease becomes subordinate to a mortgage that is recorded later if the lease contains a subordination clause to that effect.

When a mortgage recorded before a lease provides that the mortgagee has the right to apply insurance proceeds to the debt, a tenant can protect its interest only by insisting that a direct contract be written between itself and the mortgagee that provides that the insurance proceeds be applied solely in accordance with the lease. If the lease is recorded before the mortgage, the job is easier and is accomplished in the subordination clause. The tenant can condition its obligation to subordinate the lien of the lease to the lien of the mortgage. The condition would be the mortgagee's commitment to apply insurance proceeds to the repair or replacement of the damaged parts of the building.

CANCELLATION, MODIFICATION AND RENEWAL OF INSURANCE POLICIES

Fire and other property insurance policies customarily include clauses that permit the insurer to cancel the policy on a few days' notice. Because buying new insurance coverage is time-consuming and complex and mail service is slow, the possibility that an old insurance policy will be canceled before new insurance can be purchased is frightening.

Knowledgeable insurance buyers try to increase the number of days between the delivery of a notice of cancellation and its effective date. Thirty days should be sufficient to arrange for substitute insurance, and most insurance companies will agree to grant thirty days' notice.

The insured should also require thirty days' notice in case the insurance company wants to make a material alteration to a policy. Finally, an insured should request a clause in the policy that provides that the policy will be renewed automatically on substantially the same terms, rates, and conditions as the expiring policy unless the insurer gives notice to the contrary. The term of an insurance policy is short and many people neglect to take affirmative steps to renew insurance that is about to expire.

The party to a shopping center lease who is not required to maintain the insurance also wants to know when the insurance is about to lapse or be canceled. The lease should require that the insurance policy be endorsed to provide that the insurance company give thirty days' notice to both landlord and tenant of cancellation, material alteration, or intent not to renew. The mortgagee should be entitled to notice also. The insurance company should be required to give notice by certified mail, return receipt requested.

PROOF OF COVERAGE

A shopping center lease should require the party obliged to carry the insurance to prove it has done so. Older mortgage forms require the mortgagor to deposit the insurance policy itself with the mortgagee; and older lease forms under which the tenant is obligated to carry insurance require the tenant to deposit the actual policy with the landlord. More recent forms of lease and mortgage substitute a certificate of insurance for the actual policy.

Certificates of insurance may not say enough about the contents of the policy to satisfy many parties who are concerned about the details of coverage. Therefore, a lease should provide that the party required to carry the insurance should furnish an accurate copy of the policy (called an underlyer policy) to the other party. If the policy covers more than one location, the party required to carry insurance should be permitted to submit a copy that excludes clauses of the policy relating to other locations.

BLANKET POLICIES

Blanket policies are policies that insure more than one location. A lease requirement that the tenant deliver the original policy to the landlord makes blanket policies impractical. If a tenant insures several buildings pursuant to a single blanket policy, it is obvious that it can't deliver the actual policy to more than one landlord.

DAMAGE TO PREMISES OF OTHER TENANTS

A shopping center tenant worries about more than the damage that a fire can do to the demised premises alone. He wants to know that, if most of the shopping center burns down, he will not end up operating the sole remaining store on a large empty site.

Small store tenants usually expect that they will be doing business near one or more department stores or a supermarket. They depend on these larger units to generate customer traffic. They expect to do business in a coordinated retail complex that includes many other stores and common facilities such as an enclosed mall.

The Tenants' Concern

When the stores of the anchor tenants, a significant group of small stores, or the enclosed mall burn to a crisp, the survivors of the conflagration may be worse off than the victims. Presumably, the victims have business interruption insurance to soothe their pain, but the clothing store and pizza parlor that were unscathed by the fire have big troubles. If the landlord pockets the insurance proceeds and invests them in a racehorse or

basketball team, the unscathed merchants can expect to have many fewer customers.

Consequently, sophisticated tenants ask the landlord for assurance that the landlord will rebuild significant parts of the shopping center if they are destroyed by fire or other catastrophe. The important elements are the tenant's own store, the stores operated by the anchor tenants, the enclosed mall, and other stores. A prudent tenant should also demand that the mortgagee and landlord both agree that the insurance proceeds relating to damage of *any* part of the shopping center be held as trust funds and applied solely to the repair or replacement of the damage.

The Landlord's Concern

Landlords and mortgagees usually respond favorably to such requests, but they should be aware of possible problems that may burden them when they do.

An agreement to rebuild *all* of a shopping center might mean an obligation to rebuild an antiquated unit exactly in the form in which it was before the fire. The dimensions of many stores in older shopping centers don't fit the needs of modern retailers. Twenty-thousand square foot supermarkets are too small for today's supermarket operators, and old supermarkets are too deep to be converted to small stores. Theaters that contain 500 seats are often too small for the needs of today's exhibitors. Any clause that extends the landlord's obligation to rebuild stores damaged by fire should take these problems into account.

Another question for a landlord who generously promises to rebuild a shopping center is, "Who will pay rent after the rebuilding?" If other store leases in the shopping center permit the tenants to cancel because of a fire, the landlord may find a lot of pretty but vacant stores after the rebuilding is complete. So any landlord who agrees with a department store tenant that he will rebuild the supermarket after a fire should check to see whether he has not already self-destructively permitted the supermarket tenant to cancel in case of that fire.

Landlords are able to negotiate some exceptions to a tenant's demand that all damaged improvements are to be rebuilt. The tenant's legitimate concerns about rebuilding may not extend to every part of the shopping center. There may be many parts of the shopping center that could magically disappear without harming some of the merchants in the slightest. Why should a landlord be required to restore these parts?

Rent Abatement and Cancellation Clauses

Every tenant should try to negotiate a lease that provides that rent should abate if the mall is damaged to such an extent that customers can't be expected to use the mall or if an anchor tenant's store is destroyed by a fire. A tenant might also ask for a clause that would enable it to *cancel* its lease if the anchor tenants' stores are destroyed by fire or other catastrophe and not rebuilt within a reasonable period of time.

Needless to say, landlords consider rent abatements, requirements to rebuild, and cancellations to be disagreeable concepts and they resist such suggestions. There are other clauses that protect the small store tenant and that the landlord may find more palatable. One such clause provides that, if the anchor tenants' stores are destroyed by fire or other catastrophe, the tenant has the right to stop doing business until the anchor tenants' stores are rebuilt. If the tenant stops doing business, it would be permitted to stop paying rent; and if the tenant decides to continue to do business, it would get a rent concession until the anchor tenants' stores are rebuilt.

One concession that many landlords are willing to make is to waive minimum rent altogether until the repair is completed. In lieu of minimum rent, the small store tenant is required to pay a substitute rent equal to a specified percentage of its sales. Specifically, the tenant would pay the same percentage used in the calculation of percentage rent.

Here is an example of such a calculation.

Assume that the tenant of a 2,000 square foot unit has agreed to pay a minimum rent of $20,000 annually against a percentage rent of 7 percent of gross sales. Assume also that his gross sales for the first year of operation are $300,000. Percentage rent is calculated by multiplying $300,000 by 7 percent. Then the minimum rent would be subtracted from the product ($300,000 × 7% = $21,000. $21,000 − $20,000 = $1,000). Therefore, percentage rent would be $1,000, and minimum rent would be $20,000.

On the first day of the second lease year, both department stores of the shopping center burn down and are not rebuilt for the entire lease year. The lease for the small store provides that, when the department stores close because they have been damaged by fire or other catastrophe, the small store tenant is required to pay substitute rent only. In the second year, the small store's gross sales are $100,000. Therefore, substitute rent would be $7,000 ($100,000 × 7%), and there would be no minimum rent.

UNINSURED CATASTROPHE

What happens when a shopping center is damaged by a catastrophe that isn't covered by insurance? An uninsured catastrophe means big trouble. And the tenant may have bigger trouble than the landlord. Just think

about this. If the real property was damaged by an event you can't insure (or don't usually insure) against, the store merchandise was probably also damaged by the same uninsurable or uninsured event. Consequently, there is no insurance to restore either the building or the tenant's merchandise, or the tenant's trade fixtures.

Every landlord should try to avoid committing itself to repair a building that is damaged by an uninsured catastrophe. If an uninsured catastrophe actually happens, a landlord who has agreed to repair the damage will be very unhappy and probably very broke. Nevertheless, many landlords do make such commitments.

Landlords may put themselves in this position because (1) uninsured calamities don't occur very often; and (2) the exculpation clause in the lease insulates them from personal liability.

Since the exculpation clause limits the landlord's liability to his estate in the shopping center, he knows that, if the worst happens, he will lose the shopping center, but he won't lose his Cadillacs or racehorses.

Follow this reasoning a step further. If the landlord is negotiating a department store lease and the department store tenant insists that the landlord agree to repair damage by uninsurable catastrophes, the landlord may well go along because he knows that he won't have a shopping center in the first place unless the department store executes the lease.

The Mortgagee Bears the Risk

What is the attitude of shopping center mortgagees to this problem? My experience is that many mortgagees either ignore the problem or are willing to take the risk that there will be absolutely no protection against the destruction of the shopping center by a catastrophe that is uninsurable or customarily not insured against. They take this risk by agreeing that the borrower's liability for payment of the debt is limited to the security (the shopping center itself), by requiring that less than every conceivable peril be covered by insurance, and by not requiring the tenants to rebuild damage caused by an uninsured peril.

So, here is a true instance in which the tenant might take no risk, in which the landlord might take only a limited risk, and in which the ultimate risk might be taken by the mortgagee.

Shifting the Risk

Of course, there are alternatives to the proposition that this risk be borne by the mortgagee. Some landlords try to impose this risk on the tenant. Such a solution is most appropriate in sale-leaseback leases or leases executed by a tenant to accommodate a "bond type" mortgage.[1] But most tenants who negotiate shopping center leases won't swallow the idea that, if the building is swallowed by an invader from outer space, the tenant must restore the building to its original condition at its own expense. Sometimes, the issue is raised in negotiations for department store and supermarket "net leases." If the assertion that the lease is a "net lease" convinces the tenant that it should restore a building that is damaged by an uninsured catastrophe, the negotiator for the landlord has done a fine job. As a matter of fact, if the assertion that the lease is intended to be a net lease convinces a tenant's negotiator of anything except that the tenant should pay real estate taxes and fire insurance premiums, the negotiator for the tenant is pretty gullible.

I really can't suggest a "fair" way of resolving this problem, but here are some solutions that were reached in recent deals.

☐ *Deal #1*. Neither the landlord nor the tenant was responsible for rebuilding, but the tenant agreed to pay rent for the balance of the term even if the building were completely destroyed. (Note that rent insurance probably wouldn't help much here.)

☐ *Deal # 2*. The tenant agreed to rebuild, but the parties agreed that, after the current mortgage loan would be paid off, the tenant would have the right to occupy the building free of rent.

☐ *Deal #3*. The tenant agreed to rebuild, but the tenant could recoup the cost of rebuilding by keeping what it would have otherwise paid in percentage rent.

[1] Unfortunately, sale-leaseback leases and leases used in connection with bond-type mortgage financing deals are beyond the scope of this article.

☐ *Deal #4.* The landlord agreed to rebuild, and the tenant agreed to extend the term of the lease to allow the landlord to recoup the cost of rebuilding plus interest.

"Uninsurable" vs. "Uninsured"

It is important to distinguish between risks that *can't be* insured and risks that *are not* insured. If a tenant's negotiator is reviewing a landlord's form lease and notices that the landlord's responsibility for restoration is limited to insured catastrophes or to the extent of insurance proceeds, it is essential that the tenant know what insurance will be carried by the landlord.

Certainly, a lease should distinguish between risks which are uninsured because a party wishes to save a few bucks and those which, as a practical matter, are uninsurable. If the lease requires that proper insurance be carried, this problem is less pressing.

CHECKLIST OF CRITICAL ISSUES FOR A TENANT

Here's a checklist of important points for a tenant to raise when negotiating destruction and insurance clauses.

- ☐ Unless the lease is a net lease, rent should abate if the premises are damaged or destroyed.
- ☐ The lease should require that the premises be rebuilt if they are destroyed by fire or other catastrophe.
- ☐ The landlord should be required to carry appropriate insurance (except when the parties contemplate that the tenant will carry the insurance).
- ☐ The insurance policies should require that no insurance claims can be adjusted without the tenant's approval.
- ☐ The insurance policy itself should indicate that the proceeds must be used to repair or replace the damage.
- ☐ Insurance proceeds should be regarded as trust funds.
- ☐ Losses should be payable to an insurance trustee. If the tenant is a creditworthy company, the tenant itself might be the trustee. Otherwise, the trustee should be an institutional mortgagee. If there is no institutional mortgagee, the trustee should be a commercial bank that is acceptable to both landlord and tenant.
- ☐ Insurance proceeds should be paid to the party required to repair the damage as the repair progresses.
- ☐ If the landlord's estate is a leasehold, the fee owner should be required to execute a separate agreement with the tenant to provide that insurance proceeds will be applied to repair or replace the damage.
- ☐ If the premises are subject to the lien of a mortgage, the holder of the mortgage should be required to execute a separate agreement with the tenant to provide that insurance proceeds will be applied to repair or replace the damage.
- ☐ The tenant should not be required to subordinate the lien of the lease to the lien of a mortgage unless the holder of the mortgage agrees that insurance proceeds will be applied to repair or replace the damage.
- ☐ The tenant should have the right to cancel the lease if significant parts of the shopping center are destroyed and not rebuilt within a reasonable time.

THE RETURN TRIP HOME

After breakfast on Sunday, March 16, I learned that New York-bound Conrail trains were running again. A Conrail trip was not exactly convenient, but an inconvenient trip was better than no trip.

The itinerary was a bit complex. The Conrail line that stops in Hartford doesn't go directly to New York. New York-bound passengers must change trains in New Haven. From Penn Station I would be required to take the legendary Long Island Rail Road home.

The Conrail train was scheduled to leave at 12:30 P.M. and I was assured that everything was running on schedule. As companions for the trip, I recruited Joe, Willy, Carole, and Sally (you remember them from the last installment of this saga), the Tunisian soldiers, and the French chemist. My companions met me in the lobby. There was no public transportation of any sort. We checked out and began the long trek to the station. Joe, Willy, Carole, and Sally, believers in traveling lightly, had no outer garments other than topcoats. The Tunisian soldiers had been studying desert warfare and were equipped only for the Sahara. The French chemist was also unprepared.

Captain Ali Hakim of the Tunisian Army appointed himself commander-in-chief of the expedition. He lined us up in size places and led us through the streets. He did this exceedingly well and maintained that there was little difference between the snow of Hartford and the sand of Tunis. Carole and Sally complained bitterly that Ali Hakim could have walked around some mounds of snow to avoid the disagreeable feeling of stepping into snow drifts with open-toed shoes.

The Conrail station in Hartford is not a good promotional tool for the program to lure the public back to railroading. The polite ticket seller told us "Yes," the train would be on time, 12:30 P.M. So bundled in my outerwear, I waddled across the street to a Greek luncheonette that specializes in Italian hero sandwiches. I purchased two and returned to the station.

By the time I returned, the station person had announced that the train was now expected at 1:15 P.M. Unfortunately, this was not the only announcement of a postponement. We finally climbed aboard at 3:45 P.M. and had the rejuvenating feeling of moving closer to home. The rejuvenating feeling did not last long. There were many stops and starts along the way, and we did not reach New Haven until 5:30 P.M.

As I told you, we had to change trains there. As the sun set in Hartford, a small crowd of brave passengers waited for the New York train. It could have been a picture in a Siberian village. But I knew I was in New England when I looked at Joe and Willy shivering in their golfing slacks, loafers, and light topcoats.

Much, much later, the New York train deposited me in the familiar surroundings of Pennsylvania Station. There I parted from my companions and dragged myself and my luggage to the part of the station that is assigned to America's busiest commuter railroad, the Long Island Rail Road.

Over the years, I have been conditioned to deal with the LIRR as an experience that must be measured by an entirely different set of standards.

The first train to depart for any destination left in another hour. Although it was headed for the South Shore of Long Island (I live on the North Shore) and was not scheduled to connect with my line, the Oyster Bay line, I boarded anyway. All trains pass through the dilapidated junction station called Jamaica. The commuter's best strategy is to move east.

Jamaica Station is a lonely place at night. I missed being able to join militant crowds of fellow angry passengers as I cursed the railroad management. For about forty minutes no train and no person entered the station. I marched along the main eastbound platform to keep busy and keep warm. Then I noticed a train standing on Track 1, the main westbound track.

A commuter's pure instinct told me that tonight an eastbound train would be rescheduled on a westbound track. I grabbed my bags and hand truck and ran down the stairs through dingy underground passages to Track 1.

I was fortunate, and I was able to sprint through the door of the first car just before it closed. I was the only paying passenger, but there were three conductors to punch my ticket.

In about an hour, I debarked at Greenvale Station and dragged myself and my luggage through one-half mile of a snow-covered street to my home and a joyous welcome.

Of course, my wife and children were there, but there were others too. The unexpected guests were Dean Mitchell Halderlich and Senator Beauregard Whitehood. Halderlich told me that he had become chairman of People for Whitehood, a grassroots organization dedicated to Whitehood's candidacy for President. A select group of civic leaders, industrialists, real estate developers, and other luminaries were meeting on Tuesday evening March 18, 6:00 P.M. to choose a regional chairman for the metropolitan New York area.

I explained that I had not yet decided who, indeed, I favored in the race for the world's most important job. "Never fear," Halderlich said. They were not asking for a commitment to support the candidate. "By the way," continued Halderlich, "You'll be in a small room with thirty of the richest and most powerful men and women in this area, corporation presidents, labor leaders, bankers and real estate developers. What an opportunity to pick up a new client or two."

Patriotism and civic pride welled in my heart. "Of course, I will do my duty. I'll be there at 6 P.M. sharp. You can depend on me."

I opened a bottle of brandy left over from my wedding (does it improve with age?); and Whitehood and I drank to his home state, and stars and stripes, peace and security, a stable currency and full employment, and a balanced budget.

And then the phone rang. The operator asked if I would accept a collect call from Howe's Bayou, Louisiana. Of course, I accepted. It was Harry Paine, my most important client.

Harry: "Where havya been? I've been tryin' tigetya fer two days."

I: "Harry, it's Sunday night, and I've been traveling for three days!"

Harry: "Who asked ya to go travelin in the middle of a deal. What kinduv a nut are you becoming? Yuh know what happens to lawyers when they go off on a binge and don't give service. I need ya here in Howe's Bayou tomorrow."

I: "Harry, I'm exhausted! I've been traveling three days and I just made a date to go to an important meeting of civic leaders."

Harry: "What is this civic leaders business? You've been doin crazy things lately. Yuh eat like a weirdo, yuh dress like a hippie, and yuh think like an egghead."

I: "But Harry!"

Harry: "No buts. Get on a flight to Mobile tomorrow morning and I'll have a seaplane meet yuh late in the afternoon."

I: "Harry, I just can't leave tomorrow. I'm committed to go to an important meeting this Tuesday night."

Harry: "Then ya betta be here by noon on Wednesday. If ya can't be here by then, don't come at all!"