



# ALERT

## RIGHTS AND OBLIGATIONS OF LANDLORDS AND TENANTS WHEN LEASED PREMISES SUFFERS CASUALTY DAMAGE CAUSED BY HURRICANE SANDY

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The obligations of a landlord as an owner of a commercial property (i.e., office, retail, manufacturing facility, warehouse/distribution facility, etc.) to repair and restore casualty damage to such property are found in two documents pertaining to the property – (i) a mortgage and security agreement constituting a lien on the property when recorded in the County Clerk’s office where the property is situate and (ii) a lease between the landlord and tenant.

### **The Mortgage**

Many commercial properties are encumbered by a mortgage. Therefore, the mortgage instrument must be examined to ascertain what types of insurance coverage the mortgage lender is requiring and the amount of coverage of each type of insurance. In addition, the mortgage will contain provisions dealing with the disbursement of the insurance proceeds when a casualty loss occurs.

#### **a) Type of Insurance**

With respect to casualty damage, the mortgage will require that the owner of the property obtain and maintain (i) all-risk fire and extended coverage hazard insurance (non-reporting Commercial Property Policy with Special Cause of Loss form) covering the property in an aggregate amount not less than 100% of the agreed upon full insurable replacement value of the property, including coverage for loss of rents, (ii) during the course of any construction, reconstruction, remodeling or repair of any improvements, builders’ all-risk extended coverage insurance (non-reporting Completed Value with Special Cause of Loss form) in amounts based upon the completed replacement value of the improvements, excluding roads, foundations, parking areas, walkways and like improvements, and (iii) if

the property is required to be insured pursuant to the National Flood Insurance Reform Act of 1994, and the regulations promulgated thereunder, flood insurance in an amount at least equal to the lesser of the agreed upon full insurable replacement value of the property (less any value attributable to the land and building) or the maximum limit of coverage available.

#### **(b) Disbursement of Insurance Proceeds**

How are insurance proceeds under a fire and extended coverage hazard insurance policy disbursed? Disbursement is governed by the applicable language in the mortgage.

(i) Usually, all rights to the insurance proceeds are assigned to the mortgage lender as security for payment of the mortgage debt and in most instances the mortgage will clearly state that the owner has no claims against the insurance proceeds and is not entitled to any portion of the insurance proceeds. In this respect, the language in the mortgage will give the mortgage lender an option, in its sole discretion, of paying or applying all or any part of the insurance proceeds to: (A) reduction of the mortgage debt; (B) restoration, repair or replacement of the property in accordance with the mortgage lender’s standard construction loan disbursement conditions and requirements; or (C) the owner/landlord.

(ii) In certain other cases, due to the bargaining power of the owner, and subject to the satisfaction of the conditions enumerated below, the mortgage lender will not have the disbursement options described above. Rather, the mortgage lender will be obligated to make the insurance proceeds available to the owner for restoration, repair or replacement of the property, provided, however, the following terms and

conditions are and remain satisfied:

- (1) No default under any of the loan documents shall have occurred;
- (2) Evidence will have been provided to the mortgage lender that the property can be fully repaired and restored by a date prior to the maturity of the mortgage debt;
- (3) No lease is cancelable or terminable by any tenant occupying a material amount of rentable square foot area of the property or by the owner on account of the casualty, or if it is, the tenant or the owner, as applicable, has waived in writing the right to cancel;
- (4) The work is performed under a stipulated sum or guaranteed maximum price contract satisfactory to the mortgage lender in accordance with plans and specifications and a budget satisfactory to the mortgage lender in accordance with all applicable laws, statutes, rules and regulations;
- (5) The owner shall have deposited with the mortgage lender for disbursement in connection with the restoration the greater of: (x) the applicable deductible under the insurance policy covering the loss; or (y) the amount by which the cost of restoration of the property to substantially the same value, condition and character as existed prior to such damage is estimated by the mortgage lender to exceed the net insurance proceeds available for restoration; and
- (6) The owner has paid all of the mortgage lender's costs and expenses incurred in connection with the collection and disbursement of insurance proceeds.

#### **The Lease**

If the property is not encumbered by a mortgage, the lease, only, will need to be examined to determine (i) the rights of the tenant to cause the leased premises to be rebuilt and the obligation of the landlord to do so, (ii) the obligation of the tenant to continue to pay rent when the leased premises suffers casualty damage, and (iii) the right of either party to terminate the lease.

Under a standard and customary casualty clause in a commercial lease, the landlord will seek to have as much flexibility as reasonably possible with regard to the

utilization of casualty insurance proceeds. The standard clause will provide that if the leased premises or the building are totally or partially damaged or destroyed thereby rendering the leased premises totally or partially inaccessible or unusable, landlord will repair and restore the leased premises and the building to substantially the same condition they were in prior to such damage, provided that such damage was not caused by the act or omission of the tenant or any of its employees, agents licensees, subtenants, customers, clients, family members or guests. Until the repair work is completed, the tenant will be required to pay rent only for that part of the leased premises that the tenant is able to use while repairs are being made based on the ratio that the amount of usable rentable area bears to the total rentable area in the leased premises.

Usually, a landlord will seek to limit its obligation of repair and restoration to the requirement of not having to spend more than the net proceeds of insurance made available for such repair and restoration. In addition, the landlord will seek to include language exempting it from having to repair or restore any alteration previously installed by tenant at tenant's sole cost and expense.

In the highly unlikely situation where the lease does not address the rights and obligations of landlord and tenant if the leased premises suffers casualty damage, the applicable New Jersey statutes will control.

#### **Conclusion**

The casualty clauses described above in commercial mortgages and leases are fairly typical and customary in these types of documents. However, they are subject to negotiation and alteration. Therefore, each mortgage and/or lease implicated with commercial property that is damaged or destroyed must be carefully reviewed and examined in order to understand the rights and duties of the owner/landlord and tenant.

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