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Commercial leases and insurance claims

by the CILA Property Special Interest Group

31st May 2016

Introduction

This paper is intended as a guidance document to understanding commercial leases, particularly in the context of dealing with insurance claims involving tenanted premises. The general areas covered are as follows:-

- Purpose of a lease
- Structure of a typical lease
- Important parts in relation to insurance claims
- Claims issues

It is also recommended that reference is made to the separate paper available through the CILA* dealing more specifically with issues relative to tenants' fixtures, improvements, etc. where appropriate. This paper does not cover this complex area of the law.

**Tenants' Fixtures & Fittings by M. Weatherhead.*

Purpose of a lease

A lease is very simply a document that sets out the agreement between the landlord and the tenant as to the basis on which the former will allow the latter to occupy their premises.

It can be a simple document confined to the main points, as is often the case for small, short-term leases (typically referred to as a licence).

More often, it relates to long term (typically 5 to 25 years) agreements involving substantial sums of money and is therefore a comprehensive document that attempts to cover all aspects of the relationship and provide for all foreseeable issues and eventualities. Such leases (as are all agreements to rent property) are legally enforceable contracts and generally “contracts under seal” (now really meaning executed as a deed and witnessed) which are registered on the title deeds of the property with the Land Registry.

A long-term lease with a good quality tenant is a significant asset for the landlord, and substantially enhances the market value of the property. It is important that the lease is robust and correctly interprets and evidences the relationship between landlord and tenant. It also represents a major commitment by the tenant – often for the payment of hundreds of thousands of pounds.

Structure of a typical lease

Because they are such important documents the main structure has been largely standardised (under a Law Society template) so that nothing key is overlooked. As a result, most leases follow the same structure with the finer details bespoke to match the actual agreement the parties wish to enter into. The typical lease will therefore follow this pattern –

- The Parties
- Definitions
- Tenant’s covenants
- Landlord’s covenants
- Conditions
- Additional schedules

As most leases are following the template the wordings under the various sections above tend to be relatively similar (with appropriate variations to reflect the requirements of the individual contract) and it is often in the Additional Schedules that the more specific and bespoke aspects for the actual premises under consideration will be found.

Important parts in relation to insurance claims

There are only certain aspects of most leases that are of any interest to us in the context of a claim so it is useful to know what to concentrate on. It is however important to always go through the whole lease as many do not follow conventional lines, some are poorly drafted and strange clauses can appear that may prove important in the context of the claim under consideration.

Generally, the main areas to concentrate on are:-

Parties to the lease – make sure you are actually looking at a lease between the parties you think should be the landlord and tenant. Any anomalies should be clarified – for example you should perhaps be also looking at further documents that post-date the lease, such as an assignment; sub-lease; revised or amended version; deed of variation, etc. It is important to obtain and consider any such additional agreements.

Definitions – look for the definitions of the demise, premises or buildings, as applicable. These are important in interpreting the meaning of words in later sections of the lease.

The Demise – this will often be effectively the "operative clause" of the lease and will state the term of the lease but more importantly for us the rent. Specifically you need to look at what the rent is and what additional amounts are also payable – typically there will be mentioned an additional "rent" for landlord's insurance costs and service charges.

Tenant's Covenants – look for covenants relating to alterations made to the premises by the tenant and, less importantly, what it says about removal of alterations and additions. Of particular interest might be covenants requiring the landlord's permission or a licence to make any alterations or additions, with sometimes an additional responsibility for the tenant to advise the landlord of the cost of such works. This is important if the landlord is expected to insure such "additions" (see comments below) as, if they have not been advised of the cost as required (which is needed for the landlord to add to the sum insured) then there is an argument such additions are not the landlord's responsibility to insure.

Landlord's covenants – it is worth checking there is a covenant for "quiet enjoyment" as that may be relevant but the most important one to find is that relating to insurance. The precise wording of this needs to be considered carefully. If there is no such covenant check the tenant's

covenants again – it is unusual but it is possible the tenant has taken on the responsibility of insuring the landlord's property.

Conditions and Additional Schedules – the important thing to look for here, and it can be in either the Conditions or Schedules, is any rent cessation clause. Again the precise wording of this will be important.

As mentioned above, it is always worth going through the whole lease as there may be little surprises in there that are relevant to the case under consideration. With experience, however, many clauses become familiar and can be ignored as many relate to rent reviews, sub-letting or assignment, penalties for non-payment of rent, etc. which are unlikely to be of much interest.

Claims Issues

The biggest issues that arise are questions as to who is responsible for what, once damage has occurred. This particularly relates to things the tenant may have changed in the building and also things the tenant has brought into the building, some of which may be regarded as fixtures or additions.

A tenant's fixture remains the tenant's property, unless replacing an existing landlord's fixture, which would be the landlord's property. Additions are effectively permanent changes to the building and are also the landlord's property as they have become part of the building. It is therefore important to refer, as mentioned above, to what the landlord has covenanted to insure, and what that is defined as. For example, the landlord may have agreed to insure "the building" so you need to look at what is included in the definition of "the building". This may often refer to "the building of the landlord and any additions thereto" or it may refer only to "the building of the landlord". If the latter, the landlord has not agreed to insure anything other than the building as it stood when the lease was entered into.

Two very different definitions of "the building" from actual leases are:-

"the Building" shall be the building of the Landlord of which the Demised Premises form part…..

"the Building" shall mean the Demised Premises together with all additions and alterations thereto…

Rent cessation is another area of potential dispute. Exactly what ceases is important to determine. It may be just the base rent; it may also be the additional charges – such as service charges.

Precisely how the wording reads needs to be considered - are the other charges referred to as "additional rent" and do these fall within the meaning of what ceases in the rent cessation clause? Are service charges specifically mentioned as ceasing as well? Some leases refer to "rents" (in the plural) and reference to the lease may confirm that "rents" are indeed the base rent, additional rent for insurance and the service charges, in which case all cease.

Once you have established what ceases, there can then be disputes about the period of cessation. Clauses differ and may relate to the premises being "unfit for occupation"; some may also refer to "useful occupation" and others to "their usual occupation" or some such variation. It is important to understand what is intended here and generally a tenant will be regarded as "in occupation" as soon as they are able to access the premises again after the landlord has completed the repairs. So tenant's fit out periods are not part of the rent cessation period nor is the period between them getting the building back and being able to re-open their business – unless the clause has been worded to that effect. A typical rent cessation wording is as follows:-

"If the demised premises or any part thereof or the means of access thereto shall at any time during the term be destroyed or damaged by fire or any other insured peril so as to be unfit for occupation and use (and provided that the policy of insurance effected by the Landlord shall not have been vitiated or payment refused…..as a consequence of any act or default of the tenant…..) then the rents hereby reserved or a fair proportion thereof according to the damage sustained shall from the date of such damage or destruction be suspended until the Demised Premises shall again be rendered fit for occupation."

Note in this particular wording reference to access to the premises being affected; the use of the plural "rents" (although without a capital R) and the requirement only that the premises are "fit for occupation".

Rent free periods also cause problems, if damage occurs during this time. Check the wording of the lease but strictly speaking, if there is no rent being paid, it clearly cannot be reduced or cease any further because of damage. Some landlord's policies do however provide specific cover that recognises these problems – and protects the tenant's position, who is after all paying the premium in most cases. Do not be misled as regards the tenant's method of treating a rent free period for accounting purposes. Some accountants may advise to spread a rent free period across the terms of the lease – so reducing the overall rent. That is a matter for them and their accountants and the

lease is the document that decides the position. Is rent actually been paid by the tenant to the landlord at the time of the loss? If no rent is being paid, then there can be no reduction. Sometimes an initial reduced rent may apply, the rent reduction applies to the actual rent being paid at the time of the loss and due to be paid during the period affected. Not to any theoretical means of accounting for the reduction for the tenant's purposes.

Issues arise in relation to premium costs that might arise in carrying out insured works to the buildings following damage. These may be acceleration costs to reduce the period of unoccupancy or, more controversially, additional costs incurred in carrying repairs out, because the tenant remains in occupation and contractors have to work around this – a good example might be extensive "crash-decking", enabling re-roofing of a building whilst a tenant continues to operate a factory or warehouse beneath.

It is more than likely that premium costs to accelerate a project are something to be negotiated between landlord and tenant, if the tenant has had to move out because the damage is so severe. There is unlikely to be any requirement in the lease for the landlord to carry out repairs other than in a reasonable timescale and certainly no requirement to incur additional costs to reduce a realistic repair programme. The mutual benefits of earlier resumption of rent and restoration of the business therefore have to be weighed and considered in arriving at an equitable solution.

Where the tenant has been able to remain in occupation, however, the position is somewhat different. The existence of a "quiet enjoyment" covenant as referred to above will have a bearing on this situation. There is case law and opinion that the landlord is obliged to carry out works with the minimum possible (and practical) disruption and disturbance to the tenant's activities – so if additional costs are involved in so doing, that is only the landlord fulfilling its obligations. There is an inherent test of reasonableness here but it is far from clear where the line might be drawn and it will depend on the potential effects on the tenant's activities, the alternatives and of course some good old negotiation. Depending on the amounts involved, legal advice may well be worth considering as much will turn on the wording of the lease and the individual circumstances and costs involved. Suffice it to say, however, that any assumption additional costs incurred to accommodate a tenant's requirements to remain operational in the building whilst insured works are carried out (the same applies to uninsured works) should be met by the tenant may well be wide of the mark and indeed the exact opposite may well apply.

Finally, Berni Inns needs to be considered. In that case, an attempt by the landlord's insurers to hold the tenant responsible for damage to the demised premises arising from fire negligently caused by the tenant was defeated on the grounds the tenant was effectively a joint insured under the insurance policy, they were therefore effectively trying to sue themselves, at least in part. If the lease clearly requires the tenant to pay an additional amount, over and above the basic rent, to cover the insurance premiums then there is little doubt a Berni Inns defence can be raised. Even if no extra charge is made to the tenant, then the wording of the relevant parts of the lease may well imply the insurance is for the benefit of the tenant as well as the landlord, effectively making the tenant a joint insured. In addition in subsequent legal cases, even without the explicit extra payment by the tenant of the insurance premium, it has been found that the wording of the lease it such that it is clear the risk of damage to the premises by insured perils has been transferred to insurance for the benefit of both parties to the lease and the tenant cannot therefore be held responsible when such damage arises. Only if the actions of the tenant have voided the insurance in place, could any such recovery prospect arise – this is often specifically stated in the lease wording.

As a summary on the Berni Inns issue, it should never be assumed that the tenant cannot be held liable until the lease has been carefully considered. Even then, if there is any doubt, legal advice should be sought, especially where significant sums are involved. The matter could turn on the smallest of details in the lease wording specific to the premises in question. Assumptions are always dangerous and adjusters also need to be very careful of a conflict of interest when considering accepting instructions from both landlord's and tenant's insurers if the position is not totally clear.