COX CASTLE NICHOLSON

# RETAIL PERSPECTIVES

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## THE TOP 10 CONCEPTS TO UNDERSTANDING INSURANCE IN RETAIL LEASES

It goes without saying that most people find the arcane world of insurance to be difficult to fully understand. It is always easier to let the "insurance brokers" or "in-house insurance gurus" negotiate the insurance provisions of a lease. However, a basic understanding of the most common insurance concepts is very helpful in negotiating a letter of intent or a lease. It is the goal of this article to provide a simple "primer" on the ten most common insurance concepts encountered during lease negotiations.

1. ***First Party Insurance:***

First party insurance is the insurance obtained by a party to protect itself from loss to its own property. For a landlord, this insurance typically takes the form of "all-risk" coverage, "special form-causes of loss" coverage or "fire and extended" coverage. In the event of a casualty to the property covered by the insurance policy, the party insured receives insurance proceeds to rebuild the property damaged or destroyed. This insurance is referred to as "first party" insurance because it covers damage to the insured (*i.e.*, the "first party").

2. ***Third Party Insurance:***

Third party insurance is commonly referred to in a lease as "comprehensive" or "commercial general liability" insurance. In the case of the landlord, this insurance covers losses suffered by "third parties" as a result of the acts, conduct, negligence or gross negligence of the landlord. A common example of a covered loss would be when a customer of one of the tenants in the shopping center slips and falls in the parking lot because of a pothole or crack. The landlord typically maintains third party insurance

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## WHAT TO DO IF A TENANT CRIES CO-TENANCY FOUL

When negotiating shopping center leases, landlords sometimes grant to tenants certain "co-tenancy" rights, often as an added incentive to lure certain tenants to a project. Generally stated, a co-tenancy provision provides a tenant with certain remedies if one or more select tenants, or a certain percentage of tenants, leave(s) a shopping center. Such remedies often include the payment of reduced rent for a certain period, the payment of a percentage of sales in lieu of base rent, or lease termination.

In the current economy, with shopping center vacancies on the rise, some landlords are in the position of having to deal with co-tenancy violation claims. Such co-tenancy violations may result from the departure of one or more "anchor" tenants (such as Circuit City, Linens 'N' Things, Mervyn's and/or Home Depot Expo), or the cessation of operation by tenants formerly occupying a significant square footage of the shopping center (*i.e.*, a shopping center where 40% of the gross leasable floor area is now unoccupied due to tenants shuttering their businesses).

Any landlord that receives a notice from a tenant claiming a co-tenancy violation should address the situation immediately and consider the following:

**Confirm the alleged violation.** Not surprisingly, the landlord should review the applicable lease and other relevant documentation to determine whether the current situation at the shopping center

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on the common areas so that it has insurance coverage to pay the losses suffered by such a customer.

3. ***Additional Insured vs. Named Insured:***

A tenant will often desire to be named as an additional insured on the landlord's third party insurance policy in connection with the common area. Likewise, the landlord will usually want to be named as an additional insured on the tenant's third party policy of insurance in connection with the premises. By doing this, the party named as an additional insured receives the benefit of the third party insurance policy. In addition, the additional insured will receive notices regarding changes or cancellation in coverage.

4. ***Loss Payee:***

Sometimes a landlord (or its lender) requires the tenant to name it as a "loss payee" on the first party insurance maintained by the tenant on the tenant's building or leasehold improvements. By being named a "loss payee", the landlord would have to be named on any check made payable by the first party insurer to the tenant.

5. ***Waiver of Subrogation:***

The terms "subrogation" and "waiver of the right of subrogation" are some of the most misunderstood concepts in the insurance provisions of a lease.

"Subrogation" means to "stand in the shoes" of another. For example, if a landlord maintains insurance on a tenant's premises, and the premises are burned down by the negligence of one of the tenant's employees (*e.g.*, a lit cigarette butt is accidentally thrown in a waste basket), the landlord would still be insured for such casualty, and would still have the right to receive insurance proceeds from its first party insurer to pay for the rebuilding of its premises. However, in this situation, the landlord may have a legal claim against the tenant for the negligent actions of its employee in burning down the premises. Because the landlord has insured for such an event through its first party insurance, it would not bring a legal claim against the tenant. However, as part of its insurance policy with the first party insurer, the landlord will have assigned to its insurer its rights to bring this legal claim against its tenant. Therefore, the insurer will have the right of subrogation (*i.e.*, the right to "stand in the shoes" of the landlord) in connection with this claim and have the right to sue the tenant to recover the insurance proceeds paid to the landlord (its insured).

6. ***Self Insurance:***

In essence, when a party self insures a particular risk that is otherwise covered by insurance, the party providing the self insurance agrees to pay (out of its own pocket) any claims that would have been covered had the party maintained the subject insurance.

7. ***Rental Loss Insurance:***

Rental loss insurance is often maintained by landlords. It is often required by the landlord's lender. Rental loss insurance protects the landlord from the loss of income from its tenants in the event of a casualty covered by its first party insurance.

8. ***Business Interruption Insurance:***

Business interruption insurance is often maintained by the tenant so as to provide it with the necessary funds to pay its rent to the landlord in the event of a casualty to the premises. As with rental loss insurance, business interruption insurance is only available for those casualties typically covered by the first party insurance insuring the premises.

9. ***Best's Key Rating Guide:***

People are often confused by lease provisions which require policies of insurance maintained by a party to be issued by insurance companies with a general policy holder's rating of a certain level (such as "A") and a financial rating of another level (such as Class "X"), as rated in the most current available "Best's Key Rating Guide". These are simply ratings that shed light on the financial capabilities and performance levels of insurance companies.

10. ***Blanket or Umbrella Insurance:***

Blanket or umbrella insurance typically refers to one insurance policy that covers many locations. The benefit of this type of coverage is that it is usually less expensive than insuring each property with separate insurance coverage.

The foregoing is a summary of some of the most important and commonly negotiated insurance-related concepts in retail leasing. Understanding these concepts will greatly enhance your ability to negotiate these principles in your upcoming lease transactions.

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indeed results in a co-tenancy violation. In doing so, the landlord will want to consider several issues, including the following:

- In the event the alleged co-tenancy violation is not site or tenant specific (e.g., if the lease requires that at least one national or regional soft goods retailer is operating from the shopping center at all times, as opposed to requiring that Kohl's (or a tenant in a specific location (usually in close proximity to the co-tenancy holding tenant)) is continuously operating from the shopping center), the landlord should determine whether another tenant at the shopping center who is operating can satisfy the requirement. The landlord may also be able to take advantage of ambiguity in the co-tenancy provision to argue that the requirements of the lease continue to be satisfied, despite vacancies by one or more tenants.

- If the alleged co-tenancy violation is based on the total square footage of the shopping center, the landlord should confirm that the numbers used by the tenant are accurate. For example, if the lease provides that a co-tenancy violation occurs if, at any time, less than 60% of the square footage of the shopping center is occupied, and the tenant claims such a violation, the landlord should calculate carefully the unoccupied square footage to determine whether the tenant's claim is valid. The landlord likely has more accurate information regarding the square footages of all of the spaces at the shopping center and may be able to argue that the tenant's calculations are incorrect.

**Review the conditions attached to a claimed violation**. The landlord should also determine whether the tenant has satisfied any conditions set forth in the lease which need to be met in order for a co-tenancy violation to exist. For example, the lease may provide that a tenant may claim a co-tenancy violation only if the tenant is not in default and is operating from its premises at the time the claim is made. Or, there may be language that states that the right to invoke a remedy for a co-tenancy violation is personal to the original tenant that signed the lease, in which event the landlord should confirm that the tenant making the claim is not in possession of the premises following an assignment or sublease. In addition, the co-tenancy provision may require that a tenant show a drop in sales during the co-tenancy violation period as compared to the period prior to the violation. In such an instance, the landlord should require the appropriate documentation (delivered in satisfaction of the requirements of the lease), and should scrutinize the same carefully to determine whether the applicable thresholds are met.

**Review the landlord's cure rights**. If drafted favorably to the landlord, the co-tenancy provision might provide landlord with a lengthy cure period in which to rectify any co-tenancy violation. For instance, the landlord may have up to a year (or more) to replace a grocery store tenant, in which case the landlord should confirm with the tenant the trigger date on which the applicable cure period began so that the landlord knows exactly when the remedies will kick in if a replacement tenant is not found. Furthermore, the lease may allow the landlord to replace a named tenant with a "comparable replacement" tenant, and will usually grant the landlord a set period of time in which to do so.

**Be prepared to argue that the remedy is unenforceable**. While we are not aware of specific case law addressing the issue, an argument could potentially be made that an extreme remedy for a co-tenancy violation (*i.e.*, the ability to reduce rent by 50% or to terminate the lease) may be an unenforceable penalty if there is no relationship between what might be a miniscule loss in sales compared to a large rent reduction (or draconian lease termination). Such an argument may not succeed, but the merits should be considered, depending on the circumstances.

**If there is a violation, be prepared to negotiate**. If the landlord determines that a violation does exist, the landlord may want to negotiate with the tenant to scale back the remedy provided in the lease. For example, rather than accepting a 50% reduction in rent, the landlord may propose expanding the tenant's premises at a reduced rate, increasing the tenant's signage rights (to the extent the landlord is able to do so), or reducing or capping common area costs for a set period. The tenant may not be receptive to any of these alternatives, but it does not hurt for the landlord to ask, especially if the landlord had previously granted certain concessions to the tenant in question.

The foregoing discussion addresses what a landlord should do if a co-tenancy violation has already occurred, or is alleged to have occurred. Of course, as a preemptive measure when granting co-tenancy rights in the first instance, the landlord should attempt to build in a variety of protections to any co-tenancy provision. Concepts to consider include:

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(1) ensuring that a co-tenancy claim can be made only if the tenant has "clean hands" (*i.e.*, is not in default), is operating from its premises, has not transferred its interest in the lease, and/or has suffered a drop in sales as a result of the violation, (2) granting the landlord the ability to find a replacement tenant (which should be defined as broadly as possible so as to give the landlord flexibility and a plethora of options) within a set period (*i.e.*, 12 months) after the named co-tenant ceases operation, (3) providing a reasonable and lengthy cure period for the landlord to remedy the co-tenancy violation, and (4) requiring that any remedy involving the reduction of rent has a limited time frame (*i.e.*, six months), after which period the tenant must either terminate the lease (a negotiable point) or resume paying rent at the rate then called for in the lease.

The Retail Group of Cox, Castle & Nicholson LLP has extensive experience in acquiring, developing, constructing, leasing, financing and disposing of all types of retail projects, including regional enclosed malls, lifestyle community centers, neighborhood centers, and mixed-use projects. Members of the Retail Group include attorneys who are experts in sales and acquisitions, design, engineering, and construction contracts, reciprocal easement agreements, development and management agreements, and leasing.

## The Retail Group of Cox, Castle & Nicholson LLP


### LOS ANGELES OFFICE

2049 Century Park East, 28th Floor
Los Angeles, California 90067-3284
**P** 310.284.2200 **F** 310.284.2100

Gary Glick
Scott Grossfeld
Dan Villalpando
Matt Seeberger
Chris Rizza
Aimee Frank

### ORANGE COUNTY OFFICE

19800 MacArthur Blvd., Suite 500
Irvine, California 92612-2435
**P** 949.260.4600 **F** 949.260.4699

David Wensley
Bob Sykes
Hans Lauterbach
F. Julian Freeman

### SAN FRANCISCO OFFICE

555 California Street, 10th Floor
San Francisco, California 94104
**P** 415.262.5100 **F** 415.262.5199

Scott Brooks
Gregory Caligari