Don’t Become A Casualty Of Lease Casualty Clauses

Eric D. Sherman

Law360, New York (January 06, 2015, 6:13 PM ET) --

What happens when commercial premises are rendered “wholly unusable” as a result of a fire, flood or other casualty?

The answer typically is found in Article 9 of the Real Estate Board of New York’s widely used standard form commercial lease, but to date the clause has received scant judicial attention. Worse yet, the few published cases invite some confusion about how to interpret the clause. The resulting lack of clear guidelines should be highly concerning.

As Hurricane Sandy made clear, one casualty event can render thousands of commercial properties “unusable” for at least some period of time. And when faced with such circumstances, both landlords and tenants should have a clear understanding of the operative ground rules.

With all this in mind, and as discussed here, only one reading of Article 9 makes sense both in terms of the rules of contract interpretation and on public policy grounds. Both practitioners and courts should be guided accordingly.

Article 9: Questions Raised

In relevant part, Article 9 reads as follows:

9. (a) If the demised premises or any part thereof shall be damaged by fire or other casualty, Tenant shall give immediate notice thereof to Owner, and this lease shall continue in full force and effect except as hereinafter set forth. (b) If the demised premises are partially damaged or rendered partially unusable by fire or other casualty, the damages thereto shall be repaired by and at the expense of Owner, and the rent and other items of additional rent, until such repair shall be substantially completed, shall be apportioned from the day following the casualty according to the part of the demised premises which is usable. (c) If the demised premises are totally damaged or rendered wholly unusable by fire or other casualty, then the rent and other items of additional rent as hereinafter expressly provided shall be proportionately paid up to the time of the casualty and thenceforth shall cease until the date when the demised premises shall have been repaired and restored by Owner (or sooner reoccupied in part by Tenant then rent shall be apportioned as provided in subsection (b) above), subject to Owner’s right to elect not to restore the same as hereinafter provided. (d) If the demised premises are rendered wholly unusable or (whether or not the demised premises are damaged in whole or in part) if the building shall be so damaged that Owner shall decide to demolish it or rebuild it, then, in any such events, Owner may elect to terminate this lease by written notice to Tenant given within 90 days after such fire or casualty or 30 days after adjustment of the insurance claim for such fire

or casualty, whichever is sooner, specifying a date for the expiration of the lease, which date shall not be more than 60 days after the giving of such notice, and upon the date specified in such notice the term of this lease shall expire as fully and completely as if such date were the date set forth above for the termination of this lease and Tenant shall forthwith quit, surrender and vacate the demised premises ...

This cumbersome language raises two practical questions that have the potential to become critically important in the event of a casualty event. Specifically, at what point do premises become "wholly unusable" such that a landlord will have the option to terminate the lease? And even if premises are rendered "wholly unusable," in what instances will a landlord nonetheless be precluded from terminating? For instance, what if a landlord already has elected to "restore"?

Judicial Confusion

With regard to the first question, some courts have suggested that premises need only be unusable in their "present condition" to be "wholly unusable" for purposes of Article 9, such that a landlord may terminate.[1] But this reading would have absurd implications, given that it is easy to imagine very temporary events, i.e., a blackout, that could render premises "wholly unusable." The suggestion that a landlord could terminate in such circumstances defies common sense, and fortunately, is not supported by broader case law.

Courts also have demonstrated some confusion in addressing the question of whether a landlord may terminate even if it has elected to "restore."[2] To the extent that some decisions suggest an answer in the affirmative, they fail to reconcile Article 9(d) with Article 9(c). Moreover, such a rule would allow landlords to engage in commercial bad faith, which courts generally abhor. Fortunately, the broader authorities again suggest a more logical approach that comports with public policy considerations.

A Legally Defensible and Policy-Based Reading

Any confusion that currently exists concerning Article 9 should be resolved as follows.

First, there is a large body of authorities supporting the proposition that premises are rendered "wholly unusable" only where the damage caused by casualty is catastrophic and structural in nature.[3] For instance, in New Henry & John Corp. v. Rainbow Rest. Inc.,[4] the court recognized that the analogous term "'wholly untenantable' contemplates circumstances where the ... damage was so extensive that it consumed and totally destroys a substantial part of the building itself, or the subject premises, and the premises no longer existed … for the purpose for which it was intended by the parties."[5]

And the leading treatise, Friedman on Leases, adds that "structural damage is essential to untenantability."[6] This of course makes sense, as premises are rendered temporarily "unusable" on a regular basis (consider, for instance, a burst pipe). Neither law nor public policy should enable landlords to terminate a tenant in the absence of damage that is truly catastrophic in nature. And fortunately, neither do. Both the history of "fire clause" cases and common sense strongly suggest that "wholly unusable" equates to "total or substantial destruction."

Second, the better-reasoned authorities also support the proposition that a landlord cannot terminate a tenant pursuant to Article 9 where it has elected to "restore" the demised premises.[7] This is the only proper reading of Article 9 in its entirety, considering that both

Articles 9(d) and 9(c) address situations in which premises are rendered "wholly unusable." Importantly, it is black-letter law that a written contract must be read as a whole, and every part interpreted with reference to that whole.[8]

In particular, 9(c) provides that rent shall be proportionately paid up to the time of the casualty and thenceforth cease until the demised premises have been repaired and restored, "subject to Owner's right to elect not to restore the same as hereinafter provided." Article 9(d) in turn provides in relevant part: "If the demised premises are rendered wholly unusable or (whether or not the demised premises are damaged in whole or in part) if the building shall be so damaged that Owner shall decide to demolish it or to rebuild it," then the landlord may elect to terminate.

Thus, in short, these provisions give landlords a choice in the event that premises are rendered "wholly unusable" by casualty. If a landlord elects to "restore" the premises, then Article 9(c) governs and there is no option to terminate the lease. If, on the other hand, a landlord decides not to restore "wholly unusable" premises, or alternatively, to "demolish" or "rebuild" damaged premises, it may elect to terminate.

But a landlord cannot have its cake and eat it too. If it opts to restore, it cannot use a casualty as an excuse to terminate a lease. Any alternative reading renders Article 9(c) — in particular, the "subject to Owner's right to elect not to restore the same as hereinafter provided" language — completely superfluous. Such a reading flies in the face of black-letter law, and from a policy perspective, would have the undesirable effect of inviting landlords to literally profit from disaster when they choose to restore a partially damaged premises and nonetheless are able to terminate preexisting tenants.

Indeed, courts have made clear that terminating a tenant that pays below-market rent is the very definition of consummate bad faith.[9] Landlords always will have economic reasons to terminate such tenants, and Article 9 seems particularly treacherous in this regard (for both landlords and tenants) because of the aforementioned judicial confusion concerning its terms. As courts have admonished, "the discretion conferred by Paragraph 9(d) of the printed Lease is not unfettered, and the Owner's right to elect is subject to a consideration of whether he is acting reasonably and in good faith."[10]

Conclusion

Cases addressing Article 9 historically have been confined to relatively small landlord-tenant disputes concerning isolated commercial properties. But the resulting lack of judicial attention could be costly going forward due to existing judicial confusion concerning an admittedly complex contractual provision.

In this age of increased major weather events, Article 9 will take on increased importance. And when one storm can flood literally thousands of properties, and knock out critical infrastructure for weeks or even months at a time, both landlords and tenants will be forced to evaluate their options. Both practitioners, and ultimately courts, should adhere to the reasoning set forth above. Any other reading of Article 9 either ignores case law or common sense, or quite possibly both.

—By Eric D. Sherman and Eric D. Dowell, Pryor Cashman LLP

Based in New York, Eric Sherman is a partner in Pryor Cashman's real estate litigation group and Eric Dowell is a litigation associate.

The authors thank Pryor Cashman associate Andrew M. Goldsmith for his research assistance in preparing this article.

[1] See, e.g., Mawardi v. Purple Potato Ltd., 187 A.D.2d 569 (2d Dep't 1992).

[2] See, e.g., Pig Rest. v. Odelia Enters. Corp., 244 A.D.2d 196 (1st Dep't 1997).

[3] See, e.g., Barrow v. Lenox Terrace Dev. Assocs., 79 A.D.3d 457 (1st Dep't 2010); Ji-Jae Corp. v. Agyeman-Duah, 189 Misc. 2d 595 (App. Term 2d Dep't 2001); New Henry & John Corp. v. Rainbow Rest. Inc., No. (L&T) 55720/06, 2006 N.Y. Misc. LEXIS 1696 (Civ. Ct. Queens Co. June 29, 2006).

[4] 2006 N.Y. Misc. LEXIS 1696, at ***9-10.

[5] Id.

[6] 1 Friedman on Leases § 9.5 (5th ed. 2014).

[7] See, e.g., Adams Drug Co. v. Knobel, 64 N.Y.2d 768 (1985); McKinsey v. Calla, No. 021211/06, 2006 N.Y. Misc. LEXIS 3217, at *14 (Civ. Ct. N.Y. Co. 2006).

[8] See, e.g., Westmoreland Coal Co. v. Entech Inc., 100 N.Y.2d 352 (2003).

[9] See, e.g. Cross County Savings v. Jakubek, 41 Misc. 3d 1239(A), 2013 N.Y. Misc. LEXIS 5758, at *5-6 (Sup. Ct. 2013); McKinsey, 2006 N.Y. Misc. LEXIS 3217, at *20.

[10] Cross County Savings Bank, 2013 N.Y. Misc. LEXIS 5758, at *14-15; see also Adams Drug, 64 N.Y.2d at 770; 57 E. 54 Realty Corp. v. Gay Nineties Realty Corp., 71 Misc. 2d 353 (App. Term 1st Dep't 1972).

D