

The Laundromat Lease Trap

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Our agency specializes in Laundromat Insurance. We protect over 1,000 Laundromats nationwide. A vast majority of those are leased spaces where there is a landlord/tenant relationship. Believe it or not your lease can have a dramatic effect on what is and what is not covered on your Laundromat policy. A poorly written lease can unintentionally put you, the Laundromat owner on the hook for things that no insurance can cover. In this **White Paper** we are going to focus on the real property lease and the things in that lease that negatively impact on insurance.

In the 1st part of this discussion I'd like to focus on 3 main objectives:

1. Identify provisions found in leases of **real property** that may impact how property insurance should be written.
2. Discuss when and under what **conditions subrogation may be waived**
3. Review the impact of a "**Mutual Waiver of Subrogation**" clause found in property leases

Are you bored yet? I implore you to read on. It could save your Laundromat. Over the years, many of our clients have faced business threatening situations with a poorly written lease. Here is a real life scenario. The names have changed to protect the innocent

Tom's Lucky Laundromat Emporium is renting space in a local strip center that is owned by Strip Centers, Inc. Tom has signed a ten (10) year lease at a reduced rate because Tom is making improvements to the building valued at \$250,000. Tom (like many of our clients) was so pleased to get this prime location that he signed the lease without reading the fine print. We have written Tom's insurance covering his personal property in the amount of \$1,000,000. (750,000 in contents and 250,000 in tenant improvements)

Situation #1 – The Real Property Lease

Question #1 — Four years into the lease the roof collapses in the strip center and damages \$200,000 of Tom's personal property. The damage to the roof is \$50,000. Your lease states:

Under the **insurance clause** of the lease, it states that the landlord will supply insurance for the building and the tenant will supply insurance for his contents and tenant improvements.

Unfortunately, many leases have a maintenance clause. This states what the tenant is responsible for maintaining during the course of a lease. Here is a typical clause:

Maintenance: The renter shall during the term of the lease keep and maintain the property in good working condition and repair and shall be responsible for any loss, casualty, damage or destruction to said property notwithstanding how caused and **Renter agrees to return said property in its present condition, reasonable wear and tear excepted.**

Notice what they did here. They passed on some of the responsibility to the tenant. In layman's terms, this means that the tenant will take care of this building as if it were your own. If anything goes wrong, it's on you!

The good news is the claim gets paid. Tom gets 200k from his insurance company for his loss and the landlord gets 50k from his insurance company for the roof. **Life is good!**

Sadly, Tom's poorly written lease is rearing its ugly head and is going to do some damage to Tom and his Laundromat. Here's what happened

Four (4) months after the loss was settled, Tom receives a letter from Strip Centers, Inc. Insurance Company stating: "It has come to our attention that the damage to the roof of Strip Centers, Inc. was due to a water back-up on the flat roof. Our structural engineer has indicated that the collapse was a result of the gutters not being cleaned out in four (4) years. **Please find enclosed a bill in the amount of \$50,000.** Please pay at your earliest convenience."

Needless to say, Tom is very upset. He speaks to the landlord and the landlord wanting to keep Tom as a tenant, writes a letter to the insurance company asking them to leave his tenant alone. I don't want you to "Subrogate" against Tom!

It's time to take a closer look at the insurance policy. There is a clause in almost every property policies called the "Subrogation Clause". Here is an actual Subrogation clause:

TRANSFER OF RIGHTS OF RECOVERY AGAINST OTHERS TO US

If any person or organization to or for whom we make payment under this Coverage Part has rights to recover damages from another, those rights are transferred to us to the extent of our payment. That person or organization must do everything necessary to secure our rights and must do nothing after loss to impair them. But you may waive your rights against another party in writing:

In English this means if the insurance company writes a check on behalf of an insured, than the rights to recover (subrogation) are no longer the insured's (in this case the landlord), but are now the insurance company's. The insurance company wants that right so they can go after the at fault person (Tom). However, look at the last sentence.

You may waive your rights against another party in writing

By writing a letter to the insurance company didn't the landlord waive his rights in writing? (Hint: it's a trick question)

The answer sadly is no. If you go back to the insurance clause above look at this sentence: *But you may waive your rights against another party in writing:* The problem is that they are no longer your rights. Once the claim is paid the insurance company now owns the rights to recovery not the landlord.

In the above scenario, there is no insurance that would ever cover Tom for the \$50,000 bill Strip Center's Inc. insurance company sent him. So what is the answer? How do we protect Tom and many of our clients like him?

The answer comes in the lease. It is a clause called Mutual Waiver of Subrogation. Let's look at an actual clause in a lease:

*Lessee shall provide Lessor with a Certificate of Insurance showing Lessor as additional insured. The Certificate shall provide for a ten-day written notice to Lessor in the event of cancellation or material change of coverage. **To the maximum extent permitted by insurance policies which may be owned by Lessor or Lessee, for the benefit of each other, waive any and all rights of subrogation which might otherwise exist.***

Does this qualify as "In writing prior to a loss?" Yes. If this clause was in the lease, than Strip Center's Inc. insurance company would never be allowed to subrogate against Tom. This clause in realty protects both the landlord & tenant.

Your homework is to go and check your lease and see if you have this clause. There are many leases that don't have this clause. They may have been written by an attorney that doesn't specialize in commercial leases or one of those online documents like Legal

Zoom. If you don't have this clause, there are still ways to protect yourself, but only prior to the loss. Also, check the maintenance clause of your lease. What are you responsible for as respects to the maintenance of the building?

Need help? Let us look at the lease. We've seen hundreds of them and can pick out the clauses that have insurance implications. Of course we are not attorneys and you should consult one prior to making any changes in your lease.

Part 2-Tenant Improvements and Betterments

The next part of our discussion involves a topic that is very important to Laundromat Owners. It's called Tenant Improvements and Betterments. To illustrate what this means and how you can be protected let's look at another example:

Situation #2 – Tenants Improvements and Betterments

Tom has installed at his own expense \$250,000 of improvements and betterments that were needed in the strip center to make his Laundromat functional. The improvements are a permanent part of the building and cannot be removed at the termination of the lease. Tom certainly wants his investment protected for the duration of the lease.

Question #1 – What is a Tenant Improvement and Betterment? Who has the right and/or responsibility to insure them? Can the lease affect this issue?

Tenant Improvement and Betterment are improvements you pay for as the tenant but you made part of the building you don't own and are permanently installed. In other words, you can't take them with you when you leave.

In the absence of direction of the lease the general rule of thumb is if the tenant makes the investment, it should be covered by tenant's insurance policy.

Let's walk thru a few claims to illustrate further:

Fire totally destroys the building and Strip Centers, Inc. notifies Tom's Lucky Laundromat Emporium that they plan to rebuild as soon as possible. How will Tom's Insurance respond for his use interest in Tenants Improvements and Betterments?

In this case, since they plan to rebuild than Tom's Laundromat insurance policy will pay for the tenant improvements.

But what happens if the landlord advises Tom he does not want to rebuild. In a standard lease, there are triggers that a lease can be terminated. Many leases state that if 1/3 or more of the building is destroyed, lessor may elect to terminate the lease.

In this case does Tom have any recovery for his Tenant Improvements and Betterments? Here's where it get complicated.

Look at the formula below: Multiply the original cost of tenant improvements (250k) by the Number of days from date of loss to the expiration of the lease divided by Number of days from date of installation to the expiration of the lease

$$\text{Original Cost X } \frac{\text{Number of days from date of loss to the expiration of the lease}}{\text{Number of days from date of installation to the expiration of the lease}}$$

Let's say the loss happened exactly half way thru a 10 year lease.

$$\mathbf{\$250,000 \times 1/2 = \$125,000}$$

That hardly seems fair. Tom bought and paid for \$250,000 worth of insurance. What gives them the right to do this? Let's go back to the definition of Tenant Improvements and Betterments. It says your "use interest" remaining as a tenant in improvements and betterments. That means that in this case it is only for the 5 years remaining on the lease or half!

So why did Tom pay the premium for 250,000. Shouldn't I, as his trusty agent, lower his Tenant Improvement and Betterment coverage by 10% each year? The answer is no. Here's why. We have to insure for a worst case scenario. What if the landlord rebuilds? Won't you want the maximum coverage?

Here's a chart of How and When Tenant Improvements Will Be Paid

Damage to Tenants Improvements & Betterments	Value for Payment Under Tenants Insurance
Tenant Repairs	Actual Cash Value (Replacement cost if repaired)
Landlord Repairs	Nothing Paid
Cannot Repair or Rebuild	Proportional on original cost

One final scenario and this one could be a nightmare! Read on...

Fire destroys one-half of the strip center owned by Strip Centers, Inc. where Tom is a tenant. However, Tom's Lucky Laundromat Emporium has not suffered any loss. What if the landlord exercises his right to terminate the lease and sends Tom a letter giving him his 60 day notice. Can the landlord do this? See the portion of the lease below that states the landlord can indeed terminate the lease. The lease states:

*Destruction of Premises: In the event of a **partial destruction of the premises** during the term hereof, from any cause, Lessor shall forthwith repair the same, provided that such **repairs can be made within sixty (60) days** under existing governmental laws and regulations, but such partial destruction shall not terminate this lease, except that **Lessee shall be entitled to a proportionate reduction of rent** while such repairs are being made, based upon the extent to which the making of such repairs shall interfere with the business of Lessee on the premises.*

*...in the event that Lessor shall not elect to make such repairs which cannot be made within sixty (60) days, this **lease may be terminated at the option of either party**. In the event that the building in which the demised premises may be situated is destroyed to an extent of not less than **one-third** of the replacement costs thereof, Lessor may elect to terminate this lease whether the demised premises be injured or not. A total destruction of the building in which the premises may be situated shall terminate this lease.*

So Tom put \$250,000 in tenant improvements and is asked to vacate the premises. Fair? No. Legal? Yes! Will it be covered by insurance? The answer is generally no. There was no damage sustained and therefore there was no triggering event for coverage to respond and most policies will not provide coverage.

There is one potential answer to this, but it is expensive. It is called Lease Hold Interest Coverage Form. This will cover Tom in the above scenario however, it is generally not available on a Business Owner Policy (99% of my Laundromats are written on a **Business Owner** form). It is available only on a **Commercial Property** form. This form is far more costly than the Business Owner Policy and not always readily available.

To recap. What have we learned? The 1st lesson is that insurance is very complicated and not always fair. Also, your lease provisions can have a profound impact on your insurance. The bottom line is to look at your lease. If you are negotiating a new lease, consult with insurance professionals such as Brooks Waterburn as well as your attorney. As a service to our clients, I offer to look at any of your leases to review the insurance provisions.

If you have any questions on this topic or any Laundromat insurance topic I can be reached at 888-997-9801 or email me at ltrapani@brookswaterburn.com