

Tenants' Rights to Share of Landlord's Insurance Pay-Out

A tenant-favourable judgment (*One Three Four Limited v JRF Holdings Limited* [2013] NZHC 938) has recently been issued by the High Court, awarding the tenant a portion of the landlord's insurance proceeds – even though the lease was clear that the tenant did not own any part of the improvements and was not entitled to any compensation for improvements on termination of the lease.

One Three Four Limited ("134 Ltd") owned a building in Christchurch, which was leased to JRF Holdings Ltd ("Fisher Galleries"). The building was irreparably damaged in the 2011 earthquakes, and was demolished on CERA's direction and 134 Ltd terminated the lease. 134 Ltd had a material damage policy, and Fisher Galleries claimed that it was entitled to payment of a portion of the proceeds of that policy.

Fisher Galleries' claim was based on the fact that it had made significant payments towards improvements on the building to make the building of a suitable standard for a central city art gallery. Ultimately Fisher Galleries paid 75 per cent of the cost of the upgrade work, and 134 Ltd paid 25 per cent. Despite these payments, the lease stated that 134 Ltd would continue to own the improvements and that Fisher Galleries would not be entitled to compensation for improvements on expiry or termination of the lease. Fisher Galleries would, however, pay below-market rent.

Unbeknown to 134 Ltd, its broker noted Fisher Galleries as an interested party on the material damage policy.

134 Ltd said that on termination following destruction, it became entitled to ownership of all the improvements and Fisher Galleries did not have any claim to compensation. Fisher Galleries said that the endorsement on the policy recognised a proprietary interest in the lease for it and entitled it to some apportionment of the insurance proceeds. Further, the lease also provided that in the event of termination resulting from destruction of the premises, termination was "without prejudice to the rights of either party against the other" (clause 26.1). There had been a partial failure of consideration as although Fisher Galleries had paid for the upgrade of the premises, it did not gain the benefit of reduced rent for the full term of the lease (potentially until 2020). Accordingly it was argued that Fisher Galleries was entitled to compensation for this.

The Court preferred Fisher Galleries' arguments. Even though 134 Ltd did not know that Fisher Galleries was named on its insurance policy, it was still bound by the effects of having Fisher Galleries named. The endorsement had been put there by the broker, who was 134 Ltd's agent in securing the insurance policy. Entering such an endorsement was within the broker's apparent authority. Accordingly 134 Ltd was bound by it. While Fisher Galleries did not have an interest in the freehold, the endorsement provided a basis for finding that Fisher Galleries had an insurable interest.

The Court then considered the lease to determine whether there was any interest to be protected by the insurance policy. It found that it had to look at the underlying commercial dynamics of the lease when determining whether the "no compensation for improvements" clause (clause 14(c)) or clause 26 prevailed. Clause 26.1 preserved whatever rights the parties might have against each other. Accordingly while Fisher Galleries was not entitled to compensation for the money it had paid towards future improvements, it might still be able to identify a separate right or interest in the insurance money to be enforced through clause 26.1. Demolition had altered the underlying commercial dynamics of the lease - 134 Ltd would be compensated for its insurable loss, including the improvements, and could rebuild and lease the new building at a commercial rent. In contrast, Fisher had lost the benefit of a long-term lease at below market rental (which it had secured through the payments for improvements).

The Court accordingly found that Fisher Galleries could assert a right to a portion of the insurance proceeds to compensate it for loss of the remainder of the term of a lease negotiated on rental terms beneficial to it. The value of the remaining term of the lease was assessed at \$225,000, and 134 Ltd had to pay this to Fisher Galleries out of the insurance proceeds.

It appears that even where tenants do not have any ownership interest in the leased premises, the Court will find that tenants are entitled to a share of insurance proceeds where the tenants have contributed towards the

cost of works carried out on the building. Accordingly landlords and insurers need to be very wary before paying out insurance proceeds. Landlords should also check who is named as an interested party on their policy.

Prepared by Mike Kerr, Frazer Barton and Taryn Gudmanz.