

## TRENDS IN REAL ESTATE & TITLE INSURANCE

### Bearing Risks Under a Cloud of

BY DAVID M. RUBIN

**T**HE INCESSANT battle between landlord and tenant to shift the burden of rising costs and the risks of unanticipated expenses from one to the other, as if both the landlord and the tenant were parties to a game of disappearing musical chairs, has suddenly become far more complex as the battle now proceeds under the threats of terrorism. And, yet, just as some claim those who were charged with protecting us before 9/11 may have been sleeping, those persons charged with negotiating leases continue to fail to address adequately the material impact that issues of terrorism have on the expense of one's tenancy, the management of one's building and the ability of a tenant to conduct its business in a leased premises.

Terrorism issues impact not just the costs of a lease and the costs of operating a building, but the manner in which a building is run and manner in which a tenant may operate its business; and the trend seems to be moving decisively in favor of taking whatever action is

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*Landlords and tenants wrestle  
over expenses arising  
from security measures.*

necessary to protect against perceived terrorist threats even if the consequence is substantial — additional cost and substantial disruption to a tenant's business. For example, in *Cipriani Fifth Avenue, LLC v. RCPI Landlord Properties, LLC*,<sup>1</sup> the operator of the Rainbow Room objected to the landlord's anticipated installation of metal detectors and inspection of all patrons. The plaintiff claimed that such security measures addressed solely to the Rainbow Room would be the death knell for the night club/restaurant with its customers coming in tails, tuxedos and gowns.

In a written opinion, the lower court acknowledged that such installation might adversely impact the success of the Rainbow Room. The court also recognized the clear conflict between freedom of access and the landlord's

obligation to protect the premises and its occupants from danger, but permitted the security installation to proceed nevertheless. The court held that the need for the landlord to address security concerns for the complex exceeded the potentially adverse impact on the tenant's business. In finding for the landlord, the court also sighted various provisions of the lease permitting the landlord to control access to the project.

#### **Color Coordinated Leases**

If leasing is like marriage, the entry into a long-term commitment where each party attempts to anticipate the needs of the other and resolve conflict, then perhaps we can look to the federal government for assistance in bringing the security expectations of landlords and tenants closer together; and perhaps, the conflict in *Cipriani* could have been avoided. The Homeland Security Advisory System established by our President and implemented by the Department of Homeland Security may provide a key to reducing conflict.<sup>2</sup>

The Homeland Security Advisory System includes five threat condition levels ranging from low (green), guarded

(blue), elevated (yellow), high (orange) and severe (red). As the color changes so does the perceived threat to security and so does the level of response undertaken by the national and local governments. A Code Green is declared when there is a "low risk of terrorist attacks," a Code Blue, when there is a "general risk," and a Code Red when there is a "severe risk of terrorist attacks." With each code level comes increasing intervention by the applicable governmental authority. For example, in a Code Red condition, the authorities may close public facilities or constrain transportation systems. In a Code Orange, government employees may be relocated to more secure locations.

How can leasing attorneys make use of the code levels in furthering the interests of their clients, be they landlords or tenants? If a tenant is concerned about ease of access to its premises, the tenant may request that the lease prohibit certain security measures unless the government has declared a particular code level, for example, a Code Orange. A garage operator may not want to inspect the trunk or underside of every vehicle that comes into its garage on a daily basis, but the operator may agree to such a heightened inspection when a certain code level is declared. An office tenant may balk at the requirement that all briefcases be inspected by all who enter an office building, and a retail tenant in a mall or a theater operator may not want their patrons to pass through a security check on a daily basis. But they might accept such burdens and expense at times of heightened security.

Without explicit language in a lease limiting the ability of a landlord to implement security measures and pass on terrorism-related security costs, courts have uniformly permitted landlords and lenders to pass on such costs to their tenants or borrowers and implement what procedures they deem necessary. Lenders successfully impose upon borrowers the obligation to pay for terrorism insurance despite the fact that such insurance may constitute almost one-half of the

borrower's cost of insurance.<sup>3</sup> The reported cases have all determined that the reference to 'other insurance' in a mortgage is a basis for securing such insurance.

Similarly, it is highly likely that when a landlord purchases terrorism insurance and passes it on to her tenants, the tenants will not be able to avoid paying their share of such costs unless they have explicitly negotiated either an exclusion in their respective leases or, perhaps, a ceiling on the cost of such insurance. Tenants can limit such expenses explicitly in their leases; but they must overcome the inherent, unequal bargaining power of the landlord and

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the fact that the issue of security, though looming large, does not drive the economics of a lease transaction.

### **High-Profile Tenants**

What can tenants do to avoid or limit the impact of rising terrorism costs and to avoid the necessity to undergo burdensome security procedures? Perhaps a tenant may include in a lease a provision that the landlord will not lease space to a foreign power or an entity which might generate additional demands on the building's security, much like many leases preclude tenants from subleasing to a sovereign entity or a school.

An overly broad prohibition may raise issues of constitutional dimension as well as raise questions under various civil rights laws. But, perhaps a lease could preclude a landlord from leasing space to an entity which, by its conduct might attract undue attention and therefore require additional security. Surely, it is accepted practice in leasing for a landlord

to prohibit a tenant from undertaking certain uses in an office building or a shopping center and it is accepted practice for a tenant, with some bargaining strength, to require that the landlord not lease to competitors. For example, the prohibition against leasing or subleasing to persons not found in a first-class office building is almost universal.<sup>4</sup>

But, with regard to tenants that generate unwanted attention and potential security threats simply by their mere presence in a building and not by the nature of their conduct, the ability to exclude such a potential tenant or impose additional costs on such tenant is far from clear. To preclude a tenant from a project due solely to its identity, as, for example, the Arab League, might lead to racial profiling and discrimination under the guise of a lease negotiation. Moreover, how could one determine, in advance, when a party is a potential magnet for unwanted security threats and their ensuing costs? When a small bomb was placed in front of the British Consulate on Third Avenue, who would have thought that the British Consulate would become a neighbor one would want to avoid or the cause of increased security costs?<sup>5</sup>

Notwithstanding the initial discomfort with singling out a tenant and requiring it to pay for additional security necessitated by its mere presence in an office building, is it fair to pass on to all other tenants in that building the cost of security necessitated by leasing space to a particular tenant which, by its nature, requires additional security? Landlords routinely provide in leases that a landlord may impose additional costs upon a tenant if its use generates additional cleaning services or electric usage (too much glass surface in the executive offices). Why not simply expand that requirement to security costs?

As leasing is first and foremost a creature of contract, the issue of security costs could be addressed easily in a lease provision providing that no security costs would be passed on to a tenant through operating expenses if the security costs

were necessitated by occupancy in the building of another party, such as, for example, the Republic of Iran. Why should the cost of security be any different than the cost of electricity which can be metered and adjusted throughout a lease term?

Yet, the idea of imposing additional costs on a party merely because of its identity, which is so often related to racial and religious considerations, is offensive; and when a landlord argues that the mere presence of a tenant (such as the Arab League) is, in and of itself, a nuisance, causing a risk to other tenants, a landlord raises issues which move dangerously close to discriminatory conduct — conduct the U.S. Supreme Court struck down long ago.<sup>6</sup>

In rejecting one landlord's effort to impose upon the Arab League the additional security necessitated by its presence in the landlord's building, one New York state court held that the landlord "had failed to point to any 'conduct' on the part of plaintiff which is a 'legal' cause of the threats, other than [tenant's] lawful possession of the leased premises."<sup>7</sup> That same landlord, shortly thereafter, attempted to shift security costs to another Middle East related tenant and was, again, rebuffed, this time by the U.S. Court of Appeals for the Second Circuit.<sup>8</sup>

In each of the cases just cited, the landlord had attempted to shift to the Middle East affiliated tenant the additional costs that the landlord incurred due to the tenant's occupancy in the landlord's building. Federal and state courts both rejected the landlord's efforts to pass on the security costs to the tenant where the tenant's lease had no provision permitting the landlord to pass on these costs directly to the tenant. Each court further rejected the misguided effort of the landlord to claim that the tenant was, by its mere presence, a nuisance by "causing a risk of danger to the building and its tenant..."<sup>9</sup>

The need for heightened security

measures may not be limited to tenants traditionally associated with terrorists. What about tenants that bring unwanted attention to a building by the nature of their business, such as a reproductive rights clinic, a Boston Red Sox fan club or, many years ago, the Republic of South Africa? Are landlords entitled to exclude these tenants unless they agree to absorb directly the additional costs associated with their tenancies? If unpopular tenants were compelled to assume directly the security costs associated with their tenancies, would they be able to find space within the City of New York? And what would happen if the city slowly became inhospitable to unpopular tenants? Would the diverse character of the city disappear as high-profile tenants were effectively denied the freedom to lease in quality office buildings?

### Statutory Concerns

While a landlord may wish to avoid leasing to certain tenants, recent legislation actually prohibits landlords and others from dealing with certain persons known as Specially Designated National and Blocked Persons (SDNs).<sup>10</sup> SDNs are those persons contained on a list prepared by the Office of Foreign Asset Control (OFAC) which is an organization within the U.S. Department of the Treasury. OFAC's lists contain thousands of names of entities and persons with whom it is a crime for a landlord or a tenant (or any person) to do business.

Yet, the amount of ink found in a lease pertaining to prohibited persons is almost nil. Despite the fact that contracting with a prohibited person may constitute a crime, the potential exposure to a landlord or tenant has generated as much concern on the leasing landscape as negotiating Y2K indemnities in 2005. Leasing attorneys ignore this risk at their peril, particularly when the insertion of disclaimer in a lease may protect both the landlord and tenant and where one might undertake simple due diligence to ascertain that a party to a lease or a

sublease is not a prohibited person. Title companies might undertake such a chore, for example.<sup>11</sup>

Ultimately, in a conflict between the landlord's decision to implement certain security measures and the tenant's desire to avoid the expense and burden associated with security, unless the lease explicitly protects the tenant, the landlord will surely prevail. Yet, by aggressive drafting, a tenant may restrain a landlord from passing on all the security costs to the tenant; and by attempting to control the tenant mix of a building, the landlord might reduce the need for costly security measures, with the ultimate result being that the interference the tenant endures may be less painful and the cost less burdensome. And if a landlord must absorb some or all of the cost of increased security and not simply pass on the cost to her tenants, the perceived terrorist threat to the landlord may suddenly seem less severe.

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1. 4 Misc.2d 850, 782 N.Y.S.2d 522 (New York Co. 2004).  
 2. See Homeland Security Presidential Directive-3, <http://www.whitehouse.gov/news/releases/2002/03/20020312-5.html>  
 3. 245 Park Co. LLC v. GMAC Commercial Mortgage Corporation, 12 A.D.2d 330, 786 N.Y.S.2d 425 (1st Dept. 2004); Four Times Square Associates LLC v. CIGNA Investments, Inc., 306 A.D.2d 4, 764 N.Y.S.2d 1 (1st Dept. 2003); Omni Berkshire Corp. v. Wells Fargo Bank N.A., 307 F.Supp.2d 534 (S.D.N.Y. 2004).  
 4. But see, *Hawkins, Delafied & Wood, LLP v. RBNB, 67 Wall Street Owner LLC*, 7 Misc.3d 753, 794 N.Y.S.2d 888 (New York Co. Sup. Ct. 2005) (Court refused to enjoin preliminarily conversion of a portion of office building to residential use despite inclusion in lease of provision that premises would be 'run as a first class office building'.  
 5. The New York Times, May 6, 2005, Metropolitan Section.  
 6. E.g., *Shelley v. Kraemer*, 334 U.S. 1 (1948).  
 7. *League of Arab States v. 4 Third Avenue Leasehold, LLC*, 194 Misc.2d 51, 53, 753 N.Y.S.2d 323, 325 (New York Co. 2002), aff'd, 2 A.D.3d 318, 768 N.Y.S.2d 604 (1st Dept. 2003), aff'd, 3 N.Y.3d 605, 785 N.Y.S.2d 21 (2004).  
 8. *4 Third Avenue Leasehold LLC v. Permanent Mission of the United Arab Emirates to the United Nations*, 2005 WL 123721 (2d Cir. 2005).  
 9. *League of Arab States*, supra, at 53, 753 N.Y.S.2d at 325.  
 10. See, International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001 (IEEPA), as amended by the USA Patriot Act.  
 11. The Office of Foreign Asset Control sets forth a list of all prohibited persons ([www.treas.gov/offices.enforcement/ofac/sdn](http://www.treas.gov/offices.enforcement/ofac/sdn)). In addition, private entities also provide such a service. See, for example, [www.attustech.com](http://www.attustech.com) or [www.psi-pay.com/payflag](http://www.psi-pay.com/payflag).

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