

# Real Estate Board of New York

Monday, January 13, 2003

## *A New Era for Lease Negotiations*

Issues Previously Skimmed Over Now Assume a Prominent Place at the Bargaining Table

BY DAVID M. RUBIN

**I**F HISTORY is demarcated in the civilized world as those events coming before the common era and those events after the common era, then the defining moment in the history of modern office leasing must be Sept. 11, 2001. On that date, the world changed and with it changed the New York City office leasing market. Not only did that tragedy cause the destruction of 11 million square feet of office space at the World Trade Center alone, it cast a pall on the lower Manhattan market and contributed to one of the slowest leasing markets in recent history. The tragedy raised complex and contentious issues that were previously skimmed over by both landlords and tenants with the disinterest of a real estate broker reading a condemnation clause of an office lease. Until now.

Now, insurance, tenant security, financial strength of the tenant, force majeure, real estate taxes and exit strategies occupy a far more prominent place in lease negotiations than ever before. Since Sept. 11, the two major forces in the real estate market have been subleasing and tenant retention. And if subleasing was last year's signature color, then tenant retention is this year's black. The challenge for the tenant is to use this market opportunity to recast those lease provisions which have, to date, been set in stone, and the challenge for the

**David M. Rubin** is a partner in the real estate department of Golenbock, Eisman, Assor, Bell & Peskoe.

landlord is to hold onto the tenant without losing ground.

### **A Different World**

No longer do landlords simply ask for a copy of a binder with the limits and the additional insureds typed in. Some prudent landlords ask to see verified copies of the policies and include that specific language in their leases.

Insurance carriers have renamed their policies to reflect their limited coverage. No longer do carriers issue "comprehensive

---

*Since Sept. 11, the two major forces in the real estate market have been subleasing and tenant retention.*

---

liability policies," as the coverage is not comprehensive. Carriers issue commercial general liability coverage which has explicit limitations. No longer do carriers issue all risk policies, as the policies exclude a great many risks. Such all risk policies are now called special form coverage.

Public liability insurance is no more. It is now called general liability with general aggregate amount, and per occurrence limit is the new proper name for the traditional public liability coverage.<sup>1</sup> And, perhaps most important, tenants and landlords can now secure terrorism insurance, and each can demand it of the other, by reason of the passage of recent legislation in which the government becomes the

insurer of last resort.<sup>2</sup>

Force majeure, as a defense to a landlord's performance or failure to perform, is now the subject of intense negotiation. Following Sept. 11, tenants sought to recover rent abatements on various theories, including constructive eviction, condemnation and failure to deliver services. But, landlords countered with a force majeure exclusion. A typical force majeure provision excludes a party from responsibility caused by circumstances "beyond the parties' reasonable control, including without restriction, governmental regulations, acts of God, enemy action, epidemics, nuclear emergency, fires, floods...."

This provision may very well protect a landlord against losses by reason of a terrorist attack, police action or contamination, but it could also be significantly narrowed to protect the tenant as well. After all, in the event of a force majeure, the landlord and the tenant are, presumably, equally blameless. Of course if a force majeure happened by reason of the landlord's failure to plan, or by its negligence or failure to take prudent action in anticipation of the external event, the tenant might be able to overcome a force majeure defense and recover its losses from the landlord. But it must carve out exceptions in the lease itself.

Perhaps a tenant might succeed in providing that in the event a tenant cannot gain access due to a terrorist act, police activity or other government action, the loss should be shared. A landlord would counter with the fact that a tenant may secure business interruption or business income insurance. But, then, perhaps a fair

compromise is the assumption of the expense by the tenant solely to the extent of the agreed upon insurance coverage. Such a compromise shifts the risk to the carrier or at least quantifies the expense to the parties.

A modification to the force majeure language might, as well, better protect a tenant in the event that the landlord's completion of tenant improvements is delayed due to a strike or shortage of materials. By requiring that a landlord use best efforts or anticipate certain circumstances, including shortages, a tenant might very well further its ability to overcome a force majeure defense.

Concern for air quality, environmental safety and, more recently, mold, have been issues of concern to savvy lease negotiators, but Sept. 11 catapulted these concerns to the forefront. The contamination of the air and materials flowing from Sept. 11 again caused certain office buildings in lower Manhattan to be unusable for a period of time; and even today, some buildings in lower Manhattan stand empty and fallow.

The contamination was, again, neither the fault of the landlord nor the tenant, but without protection, the risk of loss arising from contamination may fall upon the tenant unless the tenant gives careful attention to the provision. As a result of a heightened concern, tenants may now attempt to impose upon landlords an affirmative obligation to maintain the air quality and environmental safety of a building and the interior office space, including heating, ventilating and air conditioning systems; and with that obligation, a lease may impose upon the landlord the risk of maintaining the air quality, except, of course, if the lack of air quality is caused by the tenant's acts.

What about the presence in an office building of a volatile and controversial tenant? Can a tenant impose upon a landlord a requirement that the landlord not lease, for example, to the Iraqi Mission to the United Nations or to a group on a terrorist watch list? Of course, in attempting to restrict the character of one's office neighbors, one must be careful not to run afoul of the multitude of discrimination laws on the city, state and federal level. But could a tenant, through a lease provision, preclude a landlord from leasing space to a governmental agency, a foreign government or nongovernmental organization

which, by its character, requires extraordinary security services?

Certainly, landlords can and do prohibit tenants from subleasing to a certain type of subtenant such as employment agencies, schools, government instrumentalities and, even, reproductive rights clinics or persons prohibited from doing business with the City of New York. Why not require that the landlord follow the same prohibitions?

Tenants may base their position requiring a landlord to limit the character of the other building tenants on the same reasoning. The presence of a foreign government or even domestic government agency in an office building may result in excessive security costs which a landlord most likely would attempt to pass on to the tenants in general. Moreover, the presence of certain tenants in a building may further

---

*Force majeure, as a defense to a landlord's performance or failure to perform, is now the subject of intense negotiation.*

---

interrupt the ability of neighboring tenants to do business.

In certain buildings, when the head of a delegation of a foreign government is present in the building, the applicable governing security force (i.e., U.S. Department of State) may order the closing of freight elevators, or the closing of entrances or the imposition of additional screening procedures, thereby substantially interfering with the ability of the other tenants to experience the full beneficial use and enjoyment of their offices. Yet, without protection set firmly in a lease, a tenant may have no recourse against the landlord, particularly if the restrictions are imposed by a governmental authority.

One landlord recently attempted to pass on these very additional security costs to the League of Arab States, a tenant in its office building in Manhattan; but its efforts were unequivocally rebuffed by the New York County Supreme Court.<sup>3</sup> The court held that the landlord could not, without authority in the lease, impose the cost of additional security on the tenant, although, the court observed, the landlord could pass

on real estate taxes and other expenses that were provided in the lease. But what if the lease had had a provision that required the tenant to pay for any additional security charges due to the tenant's occupancy or use of the office premises? Such a provision might be easily enforceable. When a tenant consumes more electricity than is customary for an office tenant, the tenant agrees to pay for that additional consumption. Similarly, why shouldn't a tenant that consumes more security services than the average tenant pay for those services as well.

The tenant might be protected, in part, by taking a less aggressive position with respect to security charges. A tenant might insist that any operating expense which the tenant is to pay under the lease exclude extraordinary security services necessitated by the presence in the building of a neighboring tenant. Thus, the tenant could protect against the imposition of additional security costs without dictating to whom the landlord can lease space.

## Security

Current leasing issues are not limited to the obvious Sept. 11 concerns. At the same time as the World Trade Center tragedy befell us, many dot com businesses cratered, and landlords were faced with another challenge: to hold onto their tenant security after the tenant breached its lease. It was not uncommon for landlords to hold 12 months rent as security for their leases to Internet start-up companies. But that wonderfully soft cushion which was intended to protect the landlord against a hard tenant hit quickly became the focus of competing interests as the dot com tenants fell into insolvency.

The security, itself, was quite threatened by the reach of the bankruptcy court or even the threatened reach of the bankruptcy court. Where the security was held in cash in a denominated security account, in some cases, the security was brought back into the estate and the landlord left with its remedies under the Bankruptcy Code. Where a landlord held a letter of credit in lieu of cash security, it was better served.

Some landlords overcome the desire to hold onto hard cash, and take, instead, a letter of credit; and they are the wiser for it. The proceeds of a properly drawn letter of

credit may possibly escape the reach of the bankruptcy court provided that drawing on the letter of credit does not adversely impact the debtor's estate and provided further that the landlord can draw on the letter of credit without making a demand on the debtor tenant.

Thus, a landlord should resist a seemingly reasonable tenant request that, as a condition of drawing on a letter of credit, the landlord must first make a demand for payment on the tenant. Perhaps, that condition might be included in a lease, but suspended upon the filing of a bankruptcy. But, a tenant in bankruptcy might successfully argue that such a provision is contrary to the intent of the Bankruptcy Code to protect the interests of the debtor's estate. Thus, if the parties agree upon a letter of credit as security in lieu of cash, the landlord should provide that the letter of credit can be drawn on with the presentation of a site draft only, dispensing with any requirement of affidavits of no default, notice or demand for payment by the tenant.

Recently, some tenants have proposed a security bond in lieu of cash or a letter of credit. A lease bond operates in the same manner as a construction bond. The landlord looks to the credit of a third party bonding company to honor the security obligation of the tenant as it would look to the issuer of the letter of credit. To the extent that the conditions to collection under the bond are more demanding than the conditions to collection under a demand letter of credit, the bond becomes less attractive; and, further, to the extent the bonding company's credit is less than the credit of the bank issuing the letter of credit, the bonding option becomes even less attractive. However, if there is no alternative to a bond, then obviously the bond looks more attractive than the sole credit of the tenant.

As a result of current economic pressures, tenants are further demanding the ability to respond more quickly to the state of their businesses by shedding or adding office space. The loss of a client or the downturn of an industry or line of business may prompt a tenant to close an office or severely reduce its space needs. In contrast, particularly in this market, landlords, obviously, want the certainty of a tenant remaining in the premises for the duration

of the lease obligation. Not only do landlords wish to have the predictability of cash flow and occupancy, but their lenders may demand it as well.

Should a lease have a buy out at a point in time prior to the expiration of the lease term, the landlord's lender may very well look at the lease as if it had a term expiring on the date of the potential buyout. Thus, in this regard, as in other relationships which span any period of time, tenants may appear to come from Mars and landlords from Venus. The tenant's desire to make flexible an inherently stiff and inflexible document is confronted with the landlord's desire to have a document that is, to the extent possible, nothing more than an obligation to make monthly payments for the full term of the lease.

However, there is room for compromise. Tenants may tie the right to contract its space to the loss of revenues in general or the loss of a particular client. Indeed, landlords may appreciate the ability to terminate a lease when the tenant is about to go into bankruptcy and may want that right itself. If the parties can agree upon a buyout amount, the landlord has the flexibility of applying the buyout sum to its expenses while it finds a more solvent tenant. And the tenant can secure financial relief going forward.

### Tax Increase

One final issue of some conflict between landlords and tenants, which is destined to increase even more in contentiousness, is the recently imposed burden of the 18 1/2 percent increase in real estate taxes.<sup>1</sup> For the next year or so, tenants will demand a base tax year which includes this substantial tax increase and landlords will demand a base tax year which precedes fiscal 2003. Depending upon the strength of the market, landlords may end up absorbing all of this increase, with respect to new leases.

The impact of the recent tax assessment scandals in the New York City Department of Finance compound the contentiousness of the increase in real estate taxes as landlords who have benefitted from artificially low real estate assessments seek to pass on their tax increases to their tenants. But the pass throughs are not based upon the customary and across-the-board increases in the tax rate. These increases are due sole-

ly to the fact that such buildings benefitted from artificially low, fraudulently induced assessments.

Suddenly, the increase in real estate taxes passed through to a tenant under a customary tax pass through may include (i) not only the customary increase in real estate taxes, but (ii) the increase between what the real estate taxes should have been had there been no tax fraud (to which the tax base will eventually be increased) and what the tax base was by reason of the tax fraud.

The burden on the tenant is obvious, as a tenant may very well have agreed to a higher base rent in light of a lower tax base. Even if landlords who benefit by these low assessments were not parties to the fraud and were entirely unaware of the manner in which the low assessments were secured, a tenant might argue that the landlord and tenant were mistaken as to the true base tax year, and thus, based upon mutual mistake of fact, the base tax year should be adjusted. Why should the tenant pay for the entire adjustment to the real estate taxes by reason of the fraud, when, in fact, it was the landlord that engaged the 'tax consultant' that induced the fraud.

### Conclusion

In 2003, office tenants have an opportunity to take advantage of the market and assert their positions in ways that they could not have imagined just two and three years ago. But, to be effective, tenants must be willing to fight hard to educate landlords as to the current market realities and to push for the possibilities set forth herein, knowing that the window of opportunity is rather short; and, as with all else in life, the pendulum will eventually swing back some time soon.

(1) Commercial Law Insider, July 2000 at 7.

(2) The New York Times, Nov. 27, 2002.

(3) *League of Arab States v. 4 Third Avenue Leasehold, LLC*, (Supreme Court, New York Cty.), New York Law Journal, Nov. 25, 2002 at 1.

(4) The New York Times, Nov. 26, 2002.

This article is reprinted with permission from the January 13, 2003 edition of the NEW YORK LAW JOURNAL. © 2003 ALM Properties, Inc. All rights reserved.

David Rubin can be reached at 212-907-7371 or by e-mail at drubin@golenbock.com