

To Lease or Sublease, That is the Question

By: Thomas A. Neufeld

The current economic downturn has forced many business tenants to downsize, restructure, or relocate, and in the process they must dispose of a part, if not all, of their leased space. Sometimes a landlord will take back the leased space by exercising a right of recapture contained in the lease or by negotiating a surrender of the lease by the tenant, however in a weak market the landlord is usually not inclined to do so. A tenant may seek to assign its entire lease to someone else who is willing to take it over. As an alternative to giving up all of its lease rights, a tenant may seek to sublet all or part of the leased premises, but for a term shorter than the balance of the lease term. This creates opportunities for other companies who are in the market for commercial space and who can choose between a direct lease from the property owner or a sublease from an existing tenant.

Save Money by Subleasing

The new occupant can save substantial money by choosing a sublease rather than a direct lease because generally the rent is less under a sublease than a new direct lease. Before selecting a bargain sublease rent, several matters must be carefully considered. A prospective subtenant must determine that the sublandlord and the property owner are in good financial health, although frequently the space becomes available for sublease as the result of the financial distress of the sublandlord. All of the occupants of a building are concerned that the property owner is financially able to, and in fact does, provide the required services and keep the property maintained and repaired in a satisfactory condition. If there is a problem with building services, maintenance or repairs, a subtenant has a special problem in that it is relegated to asking the sublandlord to ask the property owner to correct the problem. The property owner's timely payment and observance of its obligations under its mortgage on the property are essential, or else the leases and subleases may be terminated.

"To Lease or Sublease..." continued page 2

The Terror of Terrorism Insurance Coverage

By: Jody L. Googel

After September 11th most insurance companies eliminated the coverage of terror acts from "all risk" insurance policies on commercial properties. As a result, the burden has been placed on property owners to purchase separate insurance policies for terrorism. For owners of large skyscrapers and landmark buildings in major city business districts, the cost of obtaining such insurance is exorbitant, costing as much as 10 times more than the premium on an all-risk blanket coverage policy. This has created a heated debate between property owners and lenders in that property owners do not want to pay large premiums for terrorism insurance and lenders are demanding financial security on their investments.

Four Times Square

Recently, in the case of *Four Times Square Associates, L.L.C. v. Cigna Investments, Inc. et al.*, ("Four Times Square") the New York Supreme Court addressed this issue and determined that, for the time being, a property owner must purchase terrorism insurance upon

"The Terror of Terrorism..." continued page 3

"The Terror of Terrorism..." continued

demand of its lenders. In this case, Four Times Square Associates, L.L.C. ("Plaintiff") owns a forty-seven story building, Four Times Square (the Conde Nast Building), in the heart of midtown Manhattan, with a value of approximately \$877,000,000. Cigna Investments, LaSalle National Trust, Bank of New York and BNY Asset Solutions ("Defendant") sought to hold Plaintiff in default under the mortgage and thereby use funds held as security under the mortgage agreement to purchase insurance on behalf of Plaintiff. The Court denied Plaintiff's request for an injunction against Defendant.

Defendant claimed that Plaintiff was in default under the terms of the mortgage (the "Mortgage") when Plaintiff failed to obtain terrorism insurance at the request of Defendant. Plaintiff argued that it complied with the terms of the Mortgage and was not in default, by obtaining an all-risk policy on April 18, 2002. Plaintiff claimed it was not required to obtain terrorism insurance under the Mortgage.

The Mortgage provided that plaintiff is responsible to maintain in full force and effect, at its "sole cost and expense" an all-risk policy and such other insurance, reasonably requested by lender, against loss or damage of the kinds customarily insured against at commercially reasonable premiums, generally required by institutional lenders with respect to loans secured by comparable properties located in the New York metropolitan area.

Are All-Risk Policies Enough?

In denying the injunction on June 20, 2002, the Court reasoned that since September 11, terrorism attacks are a real threat and as a result, the increase of the risk of an attack has led insurers to exclude terrorism from all-risk policies and offer separate terrorism coverage. A reasonable reading of the Mortgage requires the borrower to obtain an all-risk policy and such other insurance that the lender reasonably requests against loss

"To Lease or Sublease..." continued

The subtenant, however, has the additional risk that the sublandlord may go into bankruptcy or otherwise default under the prime lease, which can result in the termination of the sublease. Unless a property owner has agreed to do so, a property owner does not have to accept a subtenant's efforts to cure the sublandlord's default under the prime lease. A separate nondisturbance agreement obtained by the subtenant from the property owner and also from the mortgage holder can preserve the sublease, but such nondisturbance agreements are not always available, particularly for a business that is not a blue-chip subtenant occupying all or a large portion of the property for a long period of time. In some subleases a sublandlord may promise to provide certain services to the subtenant in addition to the services provided by the property owner, and those additional services may suffer if the sublandlord is experiencing financial difficulties.

Professional Property Manager vs. Sublandlord

There are differences in the negotiation process for a direct lease from a professional property manager and a sublease from a tenant whose only involvement in real estate may be the leased space. A tenant negotiates the terms of the direct lease with the tenant's own needs, not a future unknown subtenant's needs, in mind. Of course, it does benefit a tenant if it is able to obtain liberal provisions in a lease that will give the tenant the ability to negotiate a favorable sublease in the future. A subtenant inherits the terms of the prime lease, which are incorporated into the sublease, with some modifications. After the prospective subtenant reaches an agreement with the sublandlord, the deal is subject to the consent of the property owner (and sometimes the consent of the property owner's mortgage holder), a process which can take another 20-30 days or even larger. A prospective occupant does not always have the luxury of waiting the additional time to find out if the sublease will be effective. Moreover, the subtenant's financial information, assuming it is considered satisfactory by the sublandlord, will be subjected to further review by the property owner. Even if the approval of its financial condition is not a concern, a prospective occupant may not want to invest its effort and money in a proposed sublease if a property owner can arbitrarily or reasonably withhold its consent or simply exercise its right to recapture the space being offered for sublease. A property owner, as a condition to granting its consent to a sublease, may impose additional obligations, which the tenant and subtenant must observe.

"To Lease or Sublease...." continued

Get Consent Before Making Alterations & Improvements

Although a fortuitous subtenant may be able to take over some or a large part of the sublandlord's existing layout, the prospective subleased premises are usually not in a perfect move-in condition for the subtenant. The consents of the property owner and the sublandlord will be required for alterations and improvements. The obligation to restore the premises to the condition prior to the alterations or improvements must be carefully considered by the sublandlord and the subtenant.

Sublease Limitations

Finding suitable sublease space can be difficult because of the requirements in the prime lease. It is common to have limitations on the size of the space to be sublet, the number of subtenants, the permitted use by the subtenant, and the length of the sublease. A sublease to another occupant in the same building (or even a prospective occupant who recently dealt with the property owner) is usually prohibited. The property owner can even put limitations on the content of any advertisements for the subleased premises, and there may be a requirement that the property owner's managing agent be the exclusive agent for the sublandlord's marketing of the subleased premises. The property owner is usually entitled to be paid all or part of any profits from the sublease in excess of the monetary obligations under the prime lease.

Conclusion

The sublease market offers many opportunities for prospective occupants. The reduced sublease rents and other advantages must be weighed against the risks and limitations inherent in a sublease. ■



Tom Neufeld has been engaged in the practice of real estate law for over 20 years. He has a broad background in the sale, purchase, leasing and financing of commercial and residential properties, including cooperatives and condominiums.



Jody L. Googel has a broad range of experience in real estate including commercial lending, commercial leasing and commercial and residential acquisitions and sales.

"The Terror of Terrorism..." continued

not covered by the all-risk policy. However, the risk must be customarily insured against with coverage at commercially reasonable premiums. Whether terrorism insurance is part of the new custom of business, available at commercially reasonable premiums, remains a question. The Court concluded that Plaintiff had not established as a matter of law that Defendant's actions in requiring terrorism insurance constituted a breach of their contractual obligation. Further, the cost of obtaining such insurance, 3.5-5 million dollars, did not amount to irreparable harm under the standard for granting an injunction. Plaintiff, under protest, has since purchased a \$100,000,000 policy (as opposed to Defendant's request for a \$400,000,000 policy) at a premium cost of \$500,000 and reserved its right to appeal and seek recovery. As such, the Court concluded that injunctive relief was not necessary since the premium cost could be recovered. Currently, this case is on appeal.

Although it is too early to predict how the Court will ultimately rule, for the time being, it appears that lenders will be able to require borrowers to carry terrorism insurance at the current rates. The Congressional Joint Committee in Washington stated in a report that the issue of terrorism insurance poses a threat to economic growth. Businesses are being forced to bear higher costs of insurance and those that cannot, are being prevented from purchasing or renting property. Most commentators are calling for the need for immediate legislation in this area that will provide some relief to the problem. In the meantime, the issue of terrorism insurance coverage remains in the Courts.

Conclusion

Borrowers and lenders should review carefully with their counsel the insurance provisions in mortgages, security agreements and leases, in light of this case. ■

Real Estate & Construction Advisor
Anderson Kill & Olick, P.C.
1251 Avenue of the Americas
New York, NY 10020-1182

The AKO *Real Estate & Construction Advisor* is published periodically by Anderson Kill & Olick, P.C. to inform clients, friends, and fellow professionals of developments in the real estate and construction laws. This newsletter is available free of charge to interested parties. The articles appearing in the *Real Estate & Construction Advisor* do not constitute legal advice or opinions. Legal advice and opinions are provided by the Firm only upon engagement with respect to specific factual situations.

AKO's *Real Estate & Construction Focus Group* is a group of attorneys from various AKO departments, including the Insurance Coverage, Real Estate, and Corporate departments who have an interest in legal issues in the real estate and construction fields. The *Real Estate & Construction Focus Group* meets periodically to share insights on new developments in insurance, construction and real estate law, in the belief that an inter-disciplinary approach to legal problems will often maximize client profitability or recoveries, while minimizing costs.

To subscribe to the *Real Estate & Construction Advisor* or any of the Anderson Kill & Olick Newsletters and Alerts, please go to: www.andersonkill.com/subscribe.

Copyright © Anderson Kill & Olick, P.C., 2002.
All rights reserved.

AKO Real Estate & Construction Advisor Member Information

We hope you have enjoyed this issue of the *Real Estate & Construction Advisor*. We invite you to contact the members of our Group, listed below, with your questions and concerns.

Lawrence J. Bartelemucci	(212) 278-1883	lbartelemucci@andersonkill.com
Arnold L. Bartfeld	(212) 278-1511	abartfeld@andersonkill.com
John B. Berringer, Co-Chair	(212) 278-1500	jberringer@andersonkill.com
Robert S. Cook, Jr.	(212) 278-1203	rcook@andersonkill.com
James P. Cullen, Co-Chair	(212) 278-1565	jcullen@andersonkill.com
Jean M. Farrell	(212) 278-1222	jfarrell@andersonkill.com
Robert E. Frankel	(215) 568-4295	rfrankel@andersonkill.com
Jody L. Googel	(212) 278-1815	jgoogel@andersonkill.com
Thomas A. Neufeld, Editor	(212) 278-1840	tneufeld@andersonkill.com
John G. Nevius	(212) 278-1508	jnevius@andersonkill.com
Alexander Sokoloff	(212) 278-1708	asokoloff@andersonkill.com
Mark Weldon	(212) 278-1201	mweldon@andersonkill.com