When negotiating a lease provision regarding monetary obligations, regardless of whether it is a pass-through expense, there is rarely a good reason to be ambiguous as to how monetary obligations will be calculated. If separate clauses are expected to function similarly, major wording differences should be examined carefully.

- **If utilities will be invoiced on any basis other than actual cost, verify the particulars.**

The Park Place Court criticized the tenants because there was no evidence of "an independent verification" of the tenants' "assumptions" at the time the leases were negotiated. This criticism is difficult to apply in practice because assumptions are, by definition, matters that do not show up as unresolved issues on our analytical radar.

However, if there is any reason that utilities will not be invoiced to the tenant on the basis of actual costs, you may save time and money if you test your assumptions by running hypothetical numbers in written correspondence. If the lease is clear, the correspondence will not be admissible. However, if the lease remains ambiguous, and a dispute arises, the court will probably consider correspondence as evidence of the intent of the parties.

Assumptions and ambiguities regarding utility bills are usually an unnecessary risk. Negotiate for specificity and follow up by carefully examining invoices.

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## The Perils of Subtenancy; A Roadmap for Recourse When the Sublandlord Defaults Under the Prime Lease; and Some Lessons for Nonrecourse Financing

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A recent New York case on subleasing teaches sublandlords and subtenants some lessons about the risks of these transactions. Those lessons may also benefit mortgage borrowers and lenders when they interpret, apply and negotiate nonrecourse clauses. In a contracting economy, many commercial tenants need to cut back their costs and their operations, which they often do by trying to sublease unnecessary space, usually at rents (actually "subrents") below the rents they pay under their leases. As a second example of how tenants become landlords, a real estate investor may acquire an old below-market ground lease and sublease the premises (not assign the lease) to realize a profit between rent paid and subrent received.

Under any sublease, a subtenant must live with certain risks that a tenant renting directly from a property owner need not bear. (A direct lease from the property owner is sometimes called a "prime lease.") As the first such risk on a long list, a sublease generally terminates if (a) the sublandlord fails to perform its obligations under the prime lease and, (b) as a result, the landlord can terminate the prime lease.[1] Although the subtenant can usually sue the sublandlord for ruining the transaction in this way, the sublandlord will often lack assets or will prefer to allocate its limited (probably dwindling) assets elsewhere. Moreover, the sublease may contain language that tries to protect the sublandlord, as follows:

1. *Automatic Termination*. The sublease will automatically terminate if the prime lease terminates for any reason. Thus, the subtenant has no claim from any termination of the prime lease, regardless of what caused it.
2. *Limitation of Liability*. The sublease will contain an "exculpation" clause, limiting the sublandlord's liability under the sublease to its interest in the prime lease. Once that lease terminates, the subtenant loses the one asset against which it could enforce a judgment.

A recent New York case considered the plight of a subtenant that lost its occupancy rights when the sublandlord collected subrent but did not use it to make payments under the prime lease. The case suggests that if a sublandlord lets the prime landlord terminate the prime lease, the sublandlord and its principals may face more liability to the subtenant than they expected. The court was not so quick to accept the sublandlord's defenses.

Although the case considers only some rather narrow issues arising from the sublandlord-subtenant relationship, and only in a very cursory way, its analytical approach also raises issues for borrowers and lenders under nonrecourse mortgage loans.

In *Tapps of Nassau Supermarkets, Inc.* v. *Linden Boulevard L.P.*,[2] the New York Supreme Court, Appellate Division, considered claims a subtenant can make when a sublandlord willfully breaches the prime lease and the landlord evicts both tenant and subtenant. (The "Supreme Court" is the general trial court in New York State. The "Appellate Division" is the first level of appeal.) Linden Boulevard L.P. ("Linden") leased premises (the "Premises") under a prime lease from a property owner (the "Owner"). Linden sublet to Tapps of Nassau Supermarkets, Inc. ("Tapps"). Tapps agreed to pay Linden part of the escalations for the Premises (the "Escalations"). Linden agreed to pay Tapps's Escalations to the Owner toward escalations under the prime lease.

Tapps paid Linden as promised, but Linden did not pay the Owner, who evicted both Linden and Tapps. Tapps sued Linden for conversion, breach of contract and misrepresentation, based on Linden's alleged misapplication of Tapps's Escalations.

The sublease stated: "any termination of the Master Lease shall cause a termination of [the sublease] . . . and [Tapps] shall not be entitled to any compensation . . . for such termination."[3] The trial court relied on this language as a basis to dismiss Tapps's complaint, finding that if the sublease were terminated, Tapps must be out of luck. The appellate court reversed, concluding that the termination language in the sublease did not insulate Linden from tort liability to Tapps where Linden's "willful actions"[4]—alleged conversion of the Escalations—led the Owner to terminate the prime lease.

The court based its decision on the covenant of good faith and fair dealing, by which each party to a contract implicitly agrees that it "will not intentionally and purposely do anything to prevent the other party from carrying out the agreement on [its] part."[5] Linden violated that covenant if it misapplied the Escalations. The court said that if Tapps and Linden had wanted to immunize Linden from liability for intentional torts, such as conversion of the Escalations, they could have drafted the sublease to provide specifically for such immunity. But they had not. Once Linden's alleged misapplication of Escalations reached the level of "conversion," it became a matter of tort law rather than contract law, and, hence, beyond the protections of the sublease termination clause.

The appellate court even let Tapps add as defendants some individual principals of Linden and its corporate general partner, based in part on the theory that they participated in, or were somehow responsible for, Linden's torts against Tapps. Although the main individual at issue was merely an officer of a corporation that was itself a general partner of Linden, the court said that the active role she took "in negotiating the lease, in meeting with Tapps's representatives about overcharges and in being the sole rent collector raised triable issues of fact regarding the existence of a reasonable belief that she participated in the control of Linden's business."[6] Such "control" could make her liable as a general partner, the court thought.

Actions like these are, however, precisely what the principals of any company do every day. The principals of any small company always "control" the entity they own, and for which they act. If a principal (e.g., officer of a corporate general partner) risks incurring personal liability by running the affairs of its entity, then every principal of every small real estate company may be at similar risk. After all, companies do not operate themselves. When a tenant negotiates a lease, the tenant deals with individuals who act for the landlord, such as officers of its corporate general partner. The landlord itself, as a legal entity, cannot sit in a conference room, attend a meeting or make a telephone call. Only its people can do those things.

Notwithstanding that logic, and even absent any reported statement that the individual principal had actually conducted business in her own name (as opposed to Linden's), the court seemed to be willing to find the individual potentially liable as a general partner for participating in Linden's misdeeds and/or running Linden's affairs. One might consider this ruling to be unusual, or perhaps driven by the court's disgust with the facts of whatever Linden had done.

Still, this branch of the *Tapps* case suggests that in the hands of a creative plaintiff and an angry judge, the corporate (or limited liability company) form may not be as reliable a shield as the business world thinks. Principals who negotiate and administer real estate transactions for their entities may want to assess this risk and mitigate it through measures like the following, another example of the familiar process in which bad facts create bad law, and bad law creates more paper:

1. *Contract Language.* If the lease or contract does not exculpate any individual employees, officers or the like from any claim arising from the lease or contract (even a tort claim), add such language and make it broad. No principal of the contracting party should ever have any liability under any circumstance or theory whatsoever (contract or tort) related to or arising from the transaction.
2. *Paper Record.* In any negotiations or other activities, the individual principals should clearly establish, on paper, that they act in a particular capacity and not as general emissaries or agents for their entity. Signature blocks may make a difference, even in routine correspondence.
3. *Titles and Arrangements.* Principals may want to act under titles that announce they have administrative functions only (e.g., "lease administrator"). They may want to create documents to show they have authority (and perhaps are paid) to perform only specific tasks but have no general authority to act for the entity.

In short, principals should avoid creating facts that might support arguments for personal liability. They should not always assume that the corporate form (or, by analogy, the limited liability company form) will protect them against a judge who wants to find someone personally liable.

As another defense in the *Tapps* lawsuit, Linden argued that the sublease limited Linden's liability to its interest in the prime lease—an asset that vanished the moment the owner terminated the prime lease. The trial court accepted that argument as a second basis to dismiss Tapps's case. The appellate court again reversed, making this somewhat cryptic comment: "That Tapps may be ultimately unable to satisfy a judgment does not provide a basis for limiting [Tapps]'s ability to bring an action for conversion, breach of contract and misrepresentation. Insulation of certain assets does not immunize a party from liability."[7]

The court may have meant that Tapps could proceed with its lawsuit against Linden, even though no assets remained against which Tapps could enforce any judgment. In other words, Tapps was welcome to continue its litigation to obtain a useless judgment. Even though Tapps's potential judgment would be useless, however, Linden would still need to monitor and defend the continued litigation and fight off Tapps's efforts to reach Linden's other assets.

Reading between the lines, however, if Tapps ever obtained a tort-based judgment against Linden or its principals, the appellate court probably would have let Tapps enforce that judgment against the defendants' assets beyond the terminated leasehold. That result seems likely based on: (a) the absurdity of letting the plaintiff prosecute its litigation even if any resulting judgment would be useless; and (b) the court's approach to potential tort liability elsewhere in the decision (e.g., letting Tapps proceed against Linden's individual principals). Nowhere, however, did the appellate court directly state that it would disregard the limitation of liability clause if Tapps obtained a tort-based judgment.

Although Tapps won (at least the battle but not the war) at the appellate level, the *Tapps* case reminds subtenants of the potentially harsh effect that a nonrecourse clause can have on their ability to recover damages against a sublandlord that lets a prime lease terminate. Subtenants may accept such nonrecourse clauses in subleases because a tenant negotiating a prime lease often accepts such a clause. In the case of a prime lease, though, the landlord's interest in the leased premises may give the tenant adequate recourse, and market standards almost always let landlords limit their liability in this way. [In practice, mortgage debt usually encumbers the landlord's fee estate, to as much as 80% of its value, more in declining markets. In response, tenants: (a) analyze but get comfortable with being subordinate; (b) ask the mortgagee to grant "nondisturbance" protections (usually available only for substantial space tenants); (c) request credit enhancement for build-out contributions or other major landlord obligations; (d) negotiate offset and self-help rights; (e) anticipate that, if necessary, smart lawyers will be able to figure out how to assert a "tort" against the landlord and its principals, to "get around" he exculpation clause; and/or (f) treat the problem as a cost of doing business. In the last case, tenant's counsel may want to establish a clear record of having warned the tenant about the risks and alternatives.]

If, however, a tenant/sublandlord sublets at a loss, a nonrecourse clause that limits the sublandlord's liability to its interest in the lease effectively eliminates the subtenant's right to recover damages for the sublandlord's breach of the sublease (e.g., breach of the covenant of quiet enjoyment when the prime landlord evicts the tenant and subtenant). Even if the prime lease has not terminated, it is probably above market and, therefore, a liability—not an asset. It is not readily transferable (e.g., through an execution sale on a judgment). Overall, it hardly gives the subtenant a meaningful source to recover for damages against the sublandlord.

If a sublandlord refuses to assume personal liability for its failure to preserve the prime lease, the subtenant might first look elsewhere. (As another option, the subtenant might try to persuade the prime landlord to agree to "recognize" the subtenant's sublease and occupancy rights if the prime lease terminates—unlikely for the typical commercial space sublease entered into at a loss but enough to make most of this article moot if the subtenant can obtain it.) Otherwise, the subtenant should consider how best to preserve both the prime lease and its right to assert tort claims against the sublandlord if the sublandlord lets the prime lease terminate. The subtenant should consider some combination of these measures:

1. *Direct Payment.* Pay subrent to the prime landlord—not the sublandlord—with those payments being credited against the sublandlord's obligations to the prime landlord.
2. *Joint Check.* Pay subrent by joint check to the sublandlord and the landlord.
3. *Proof of Payment*. Require the sublandlord to give the subtenant proof from time to time that subrent payments have been correctly applied.
4. *Prepayment of Shortfall.* Require the sublandlord to prepay into an escrow account (e.g., always at least a month in advance) the "shortfall" between rent and subrent.
5. *Subtenant's Security Deposit.* If the subtenant has delivered a security deposit, place it in a dedicated account to be available to cure defaults under the prime lease (with appropriate offset rights for the subtenant).
6. *Right to Cure.* Even if the prime landlord will not cooperate, let the subtenant cure any sublandlord default under the prime lease, and have the sublandlord appoint the subtenant as agent for that purpose.
7. *Security.* Require the sublandlord to provide security for proper application of the subrent (unlikely to be feasible in most cases where it would be appropriate).
8. *"Conversion" Language.* Require the sublandlord to hold any subrent payments in trust, as a separate asset, without commingling them with other funds, and then to use such payments only to pay rent or specific charges under the prime lease. This language tries to maximize the subtenant's argument that misuse of such funds constitutes tortious "conversion," rather than a mere breach of contract.
9. *Due Diligence.* Understand the sublandlord's creditworthiness in assessing the need for any of the preceding measures. For example, if the sublandlord is a Fortune 500 company (except Enron), the subtenant may be less inclined to push.

Measures like these should make it easier for a subtenant to protect the prime lease and then assert a "tort" claim against a sublandlord, like Linden, that lets the prime lease terminate. From a sublandlord's perspective, if a sublandlord wants to preserve its "flexibility," the *Tapps* case should cause concern. It means that the sublandlord—and its principals—may incur tort liability if they let the prime lease terminate, even though (a) the sublease contains automatic termination language and supposedly limits the landlord's liability to its interest in the lease; and (b) the sublandlord's principals probably think they act in good faith in adverse circumstances—financial distress that would typically give rise at most to relatively worthless breach of contract claims—but in the best overall interests of all the "stakeholders" concerned.

A sublandlord that wants to avoid tort liability under facts like these should consider some combination of these measures:

- *Fungible Funds.* Avoid language in the sublease that requires the sublandlord to use particular elements of subrent for a specific purpose, such as to make specific payments under the prime lease. Instead, the sublandlord should covenant (as a matter of contract) to make those payments from its general assets. Subrental income should merely constitute a flow of unrestricted cash to the sublandlord. This reduces the strength of any conversion (tort) theory a subtenant might assert.
- *Exculpated Parties.* As suggested above more generally, the exculpation clause in the lease should be very broad.
- *Scope of Exculpation.* If a subtenant will tolerate any exculpation clause in the sublease, that clause should apply not only to claims arising from the sublease itself but also to any claims of any kind at all (contract or tort) arising from the parties' relationship, including any implied covenants that govern that relationship. (These implied covenants would include the "implied covenant of good faith and fair dealing," as shocking as it may sound. That implied covenant may, however, merely give judges an all-purpose justification to reach any result they want, regardless of the words on paper.)
- *Breach of Contract.* State that any claim for any breach of the sublease—regardless of the circumstances of the breach and even if it can be called a "tort"—shall constitute a claim for breach of contract only and in no event produce any "tort" liability.

- *Enforcement of Judgment.* Provide that any judgment arising from the relationship between the parties may not be enforced against any assets beyond the prime leasehold, and, in addition, the subtenant cannot bring any action of any kind against the sublandlord if the prime lease has terminated. To a subtenant, this suggestion may seem egregious and offensive. It is, however, what Linden probably expected from the "limitation of liability" clause in its sublease—if Linden noticed the clause and thought about it. Regardless of the author's view that such clauses have no place in subleases, they are somewhat common.

To the extent that any of these measures try to absolve a "tortfeasor" of liability for its misdeeds, courts might hesitate to enforce them, particularly for "intentional" torts such as conversion. That fact further motivates any plaintiff to try to convert a contract claim into a tort claim whenever possible.

With very little difficulty, many of the above suggestions for a sublandlord could easily apply to borrowers and lenders when they negotiate, interpret and enforce typical "nonrecourse" clauses in commercial mortgage loan documents. Just as Linden was surprised to learn that the language in the sublease might not save it from liability, so too have borrowers been surprised to learn about the range of theories that lenders have used, with some success, to "get around" nonrecourse clauses.

Borrowers probably did not think of nonpayment of real estate taxes as constituting tortious "waste," but some courts have said it can be, and have found borrowers personally liable despite nonrecourse language in the loan documents.[8] More recently, plaintiffs in unreported litigation have sought to use the "implied covenant of good faith and fair dealing" as a theory to sidestep a nonrecourse clause in security documents and assert a "tort" against the borrower and its principals.

A borrower concerned about these trends—as played out once again in the microcosm of the *Tapps* case—may want to follow some of the above advice for sublandlords. Similarly, a lender may want to think about applying some of the above advice that applies to subtenants. Although not all these suggestions apply directly to real estate financing, others do—at least by analogy. For example, just as a sublease can require a sublandlord to hold its subrent income in trust for particular purposes, loan documents can, and often do, impose the same obligation for rents.

In both subleases and loan documents, the suggestions offered here may help a potential plaintiff maximize its ability to assert a "tort" claim and, thus, its potential ability to "get around" nonrecourse or exculpation protections that are built into a document. Every potential defendant's goal should be to prevent that result—within the bounds of enforceability and good taste.

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[1]For more on the legal and practical issues of subleases, *see* Andrew L. Herz, "Subleases: The Same Thing as Leases, Only Different," 35 *Real Prop., Prob. & Tr. J.* 667 (2000).

[2]704 N.Y.S.2d 27; 269 A.D.2d 306 (N.Y. App. Div. 2000). This memorandum decision contained minimal factual description and discussion, but enough to raise the issues this article considers. Many New York real estate cases display the same brevity. California, in contrast, has a larger and more reasoned and analytical body of common law on commercial real estate, a characteristic of California jurisprudence that is both good and bad.

[3]704 N.Y.S.2d at 29; 269 A.D.2d at 307.

[4]704 N.Y.S.2d at 29; 269 A.D.2d at 308. If conduct is "willful," it must be really bad. Linden's action consisted of failure to pay money. If labeled as a mere breach of contract, a court would probably not call it "willful." But perhaps "willful" made the conduct tortious, which was crucial for Tapps's theory of the case.

[5]704 N.Y.S.2d at 29; 269 A.D.2d at 307 (quoting from *Patterson* v. *Meyerhofer*, 204 N.Y. 96, 100, 97 N.E. 472, 473).

[6]704 N.Y.S.2d at 28; 269 A.D.2d at 307.

[7]704 N.Y.S.2d at 29; 269 A.D.2d at 308.

[8]*See Travelers Ins. Co.* v. *633 Third Assocs.*, 973 F.2d 82, 86 (2d Cir. 1992) (borrower's willful failure to pay real property taxes on mortgaged property constitutes waste; exculpation clause does not bar lender); *Nippon Credit Bank* v. *1333 North California Boulevard et al.*, 103 Cal. Rptr.2d 421; 86 Cal. App. 4th 486 (Cal. Ct. App. 2001) (if borrower has adequate funds but does not pay real estate taxes, and this may constitute waste and justify punitive damages).

## In Practice

# Terrorism Insurance after September 11: Is Federal Assistance Needed?

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The financial losses from the terrorist attacks on September 11 are staggering, with current estimates reaching $90 billion, of which approximately $50 billion was covered by insurance. These losses are the largest in the history of the U.S. insurance industry and are far greater than the combined losses from the Northridge earthquake and Hurricane Andrew. Because a significant portion of the September 11 losses were covered by insurance, the orderly, rapid adjustment and payment of claims served to minimize disruption to individuals, businesses and the economy as a whole. Since September 11, however, the insurance available to cover terrorism losses has been significantly reduced, and, where insurance is available, premiums have skyrocketed.

Although the human tragedy of September 11 remains foremost in everyone's minds, this article will focus on the impact these attacks have had on the availability and cost of insurance in the United States for terrorist acts; the disruption to the U.S. real estate market for acquisitions, development and financing caused by the reduced availability and increased costs of terrorism insurance; and the evolving responses of the private and governmental sectors to the financial risk of terrorism in the United States.