

TENANTS MAY PAY THE COST OF TERRORISM

By Harris Ominsky*

The fallout of terrorism has created unintended victims. Political analysts have focused on recent Congressional election results. Real estate analysts have focused on commercial tenants.

After 9/11 the cost of insurance and building security has increased substantially. Who will pay those costs in commercial buildings? The simple answer is tenants – unless they do something to prevent it.

This issue arises under customary lease provisions that pass on operating cost increases to tenants. We see this in shopping centers and office leases – even your own law firm leases.

Insurance Premiums

We now live in a world where insurance premiums have skyrocketed. For one thing, much of the real estate community believes that insurance companies have taken advantage of the threat of terrorism to play “catch-up” with low insurance premiums that had been charged on casualty and liability policies before 9/11. Owners have reported that their renewal premiums have increased by 50 to 100% with no additional coverage. At a recent meeting of the American College of Real Estate Lawyers, one insurance expert reported that throughout the country insurance companies had been paying losses estimated at 110% of the premiums they received. Before recent down-trends in the stock market and in interest

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rates, insurance companies were able to make up these deficits from their investments. All of that changed when investment returns collapsed.

Also, consider the cost of terrorism insurance. After the World Trade Center disaster, owners and lenders started focusing on covering themselves against future terrorism attacks. Often, this coverage isn't even available, but when it is, the cost of this insurance alone could easily exceed the premium for all other building insurance. In one recent notable New York case, the terrorism insurance premium required by the lender for Four Times Square in Manhattan was reportedly \$3,200,000. When the owner refused to pay it, the lender paid the premium out of lockbox income that the owner controlled under the mortgage documents. That case is still in litigation.

Where does all of this leave the tenants of those buildings? The answer is that increases in insurance costs are passed on to the tenants, generally on a pro-rata basis under traditional pass-through provisions.

Additional Security

Another fall-out from terrorism is the increased cost of building security. Essentially, cost pass-through clauses will include the cost of increased security in buildings. What happens if the landlord decides to post security guards around the clock in a building that never had them before? You guessed it. These costs will generally be passed on to the tenants.

A more subtle issue can arise when the landlord decides to upgrade its security systems, such as installing more advanced alarm systems, automated identity checkers, state-of-the-art video surveillance systems, security gates, better locks or even exterior barriers

against motorized bomb threats. Many leases distinguish between “operating expenses” , which may be passed through, and “capital improvements,” which may not. If that distinction is not carefully defined, a tenant may even find itself paying for those costs.

Negotiating Pass-Throughs

Tenants who are “stuck” with existing pass-through provisions in their leases should carefully examine these bills in light of their leases. It is possible that some of the charges may not be appropriate. For example, under some circumstances, it may be argued that the cost of terrorism insurance is not a “commercially reasonable” operating expense. If that type of insurance is not customary in comparable buildings, but is a peculiar requirement of the lender who happens to hold the loan on the landlord’s building, tenants may argue that this is not a “normal or customary operating expense,” as that term may be defined in the lease. The argument can be made that the cost of an exorbitant insurance premium for this purpose stems from unreasonable demands of a lender selected by the landlord – and not from building operations.

Similar arguments may be made about increased costs of building security. Are these extra costs customary in comparable buildings? Are they justified by incidents that are likely to occur or, to put it in legal terms, that are “foreseeable.” Can these expenses be reasonably expected to prevent terrorism attacks on this building?

There may not be much that tenants can do with existing leases negotiated in more peaceful times. However, tenants who are negotiating new leases may have options.

For one thing, they can try to negotiate provisions that place limits, or “caps,” on these types of increases. The issue can be complicated because some landlords will require

tenants to pay even for capital improvements, if those improvements can be demonstrated to save other operating expenses. For example, if in computing a base year for determining increases, a landlord includes elevator operators, and in later years is willing to upgrade the elevators so that those employees are no longer needed, the landlord will want the tenants to pay for that type of capital improvement. That same rationale could apply to capital improvements like a video monitoring system or an ID scanner that could reduce the cost of security guards.

However, the tenant may still be able to negotiate limits. For example, tenants should resist having to pay for that capital improvement in one year. They might be able to negotiate a provision to amortize the capital improvement over the expected life of the improvement so that the payment is spread out over many years. If the lease term is shorter than that expected life, the tenant may wind up paying for only part of those costs.

In the same way, a prospective tenant may try to negotiate insurance pass-throughs. There are many ways to go with this negotiation. One way is to try to negotiate a cap on increases of insurance costs, or other costs, either each year or during the term of the lease. The tenant may be able to justify percentage limits.

Compare Buildings

Landlords will resist these efforts by tenants, particularly with those costs that are not under their control, like insurance premiums. But it doesn't hurt to ask. At least by focusing on these issues, tenants who have alternatives may be able to factor in these potential costs in making comparisons with other buildings. For example, if one building already has improved security systems and around-the-clock guards, those costs will be built into the

base year which is used for computing cost increases. It is therefore less likely that the total cost of occupancy will be jacked-up for these reasons, than in a building which does not have those items built into the operating-cost base.

Similarly if the prospective tenant will look into various buildings' insurance costs, it may find that one building has already built the increased insurance rates into its base year, while another has not. Low base-year costs lead to what is sometimes called "hidden rent."

Also, one building may not require terrorism coverage or, in the alternative, that coverage will not be part of the computation of increased costs. That, too, should be considered when a tenant compares buildings in projecting its total occupancy costs.

Tenants may also want to compare each building's policies for access in this new atmosphere of fear. If the tight security and limited access of one building is different from another, the prospective tenant should weigh the effect of these policies on its own needs. Some tenants will see that as merely expensive "window dressing" for which it has to pay extra operating costs. Others will be willing to pay the price.

Some tenants will not want to see their customers or clients delayed, photographed, questioned, or searched in the lobby of their building. What about a psychiatrist who specializes in addictions, or a law firm that concentrates in corporate bankruptcy consulting, securities fraud or highly confidential domestic relations disputes?

Others tenants may value the extra security. In any event, if building-access policies are important to the tenant, the tenant should spell them out in the negotiated lease.

None of these issues may be important enough to worry some tenants or to affect their decision of where they will spend their working life during the next five to 20 years, but

tenants should pay attention to them. As we know, it is difficult to prepare for a terrorist attack, which can visit death and devastation on a building and its occupants. But, with proper advice, the tenant can at least prepare itself for the terror of escalating occupancy costs.

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