PILLSBURY WINTHROP LLP

on real estate

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BUILDING UPON SUCCESS: YMCA OF GREATER NEW YORK

By Max Friedman

The YMCA of Greater New York ("YMCA-GNY") is one of New York City's leading not-for-profit organizations, with a 150-year history of promoting programs to build the human spirit, mind and body. As part of a broad national and international network, the YMCA-GNY is one of the oldest and largest YMCAs in the United States. It is a leader in creating programs and policies that are followed by other YMCAs throughout the country.

The success of the YMCA-GNY in serving the youth of New York City is demonstrated by the fact that its programs in academic enrichment, health/wellness and values serve almost 165,000 young people annually. The YMCA-GNY's vision is to serve one out of every ten New York City youth by the year 2005.

As part of the YMCA-GNY's vision -- and to address the ever-increasing demands on its programs and services -- the YMCA-GNY has embarked on an ambitious program to upgrade and, where appropriate, redeploy its physical assets by:

- maximizing unused facilities and seizing real estate opportunities;
- selling facilities that cannot be retooled successfully and economically to serve 21st century needs; and
- building new facilities better suited to the diverse needs of the many communities and constituencies served by the YMCA-GNY.

Pillsbury Winthrop LLP is proud to partner with the YMCA-GNY in pursuing these goals, not only by serving as outside counsel to the YMCA-GNY on a daily basis, but also by orchestrating complex and creative transactions that enhance the YMCA-GNY's ability to do what it has done so successfully for the last one-and-a-half centuries. Two of the recent projects in which Pillsbury Winthrop LLP assisted the YMCA-GNY in achieving its goals were the West Side YMCA project and the McBurney YMCA project.

The West Side "Air Rights" Project

The West Side YMCA is one of the largest, and most heavily used, of the YMCA-GNY branches, offering diverse programs and hosting the largest elderhostel program in New York State. In need of new and refurbished space to house its many programs, the West Side YMCA sought to leverage "excess" development rights for the construction of a forty-story residential tower that would be cantilevered, in part, over the existing West Side YMCA and would command unobstructed views of Central Park to the east.

Pillsbury Winthrop LLP guided the YMCA-GNY through the entire process: from the development of a request for proposals (the "RFP") through the condominiumization of the new building. Since one of the YMCA-GNY's principal objectives was the development of new, and enhanced, space for the operation of the West Side YMCA, the RFP was structured to require that the designated developer not only make a cash payment to the YMCA-GNY, but also construct, in the first five stories of the new building, 25,000 square feet of additional program space for the West Side YMCA.

When a real estate transaction for a tax-exempt entity involves both "commercial" and "exempt" components, the transaction must be carefully structured to preserve the tax-exempt treatment of the portion of the project that will be occupied by the non-profit entity. The challenge facing the West Side YMCA was how to do so in the context of a single, integrated development project. The legal solution was to lease to the developer, during construction, just the "for profit" portion of the development site -- above a "line in the sky" -- leaving the lower

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ALSO IN THIS ISSUE

SURVIVING A SUBLANDLORD'S BANKRUPTCY

By Jackie K. Park

By Andrea H. Slutske

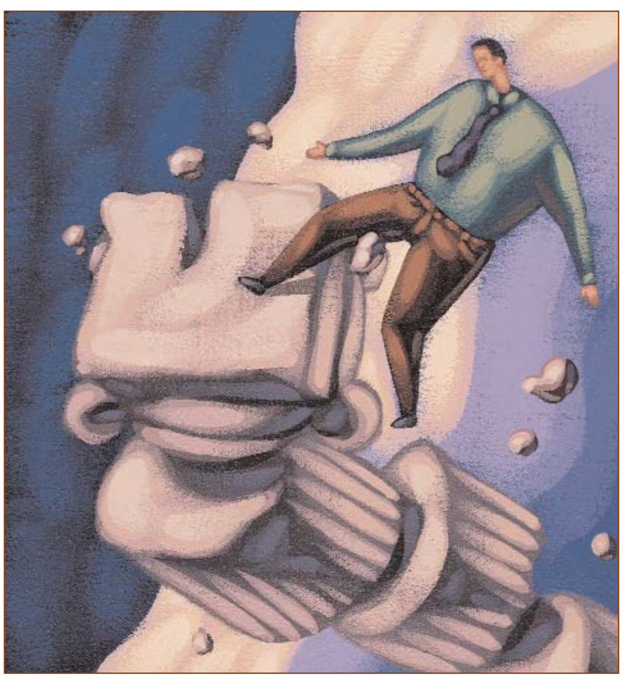
When a party to a lease files for bankruptcy protection, the effect of bankruptcy laws upon the party's lease can be significant. It is essential for one involved in the leasing of real property to understand the impact of certain bankruptcy laws upon a lease transaction. This is especially true for a subtenant in the context of a sublandlord's bankruptcy. While a subtenant's rights in this circumstance typically are tenuous, a subtenant may employ mechanisms to protect the subtenant's interests.

The *Syufy* Case

In the recent case of *Syufy Enterprises, L.P. v. City of Oakland*, 104 Cal. App. 4th 869 (2002), the court held that when a master lease is deemed rejected in a bankruptcy proceeding, a subtenant may lose possession of the subleased premises. *Syufy* serves as a blaring warning to a subtenant whose sublandlord has severe financial problems and files for bankruptcy.

In *Syufy*, the master landlord ("Master Landlord") gave its tenant ("Sublandlord") consent to sublease a portion of the premises to a subtenant ("Syufy"). The Master Landlord and the Sublandlord amended the master lease to state that the Master Landlord "understood and agreed" that the Sublandlord was permitted to enter into a sublease with Syufy and that the Sublandlord intended for Syufy to construct improvements on the subleased premises. After Syufy and the Sublandlord executed the sublease, Syufy expended significant funds to construct a movie theater on the site. A few years later, Syufy substantially remodeled the facility. Eventually, disputes arose between the Master Landlord and the Sublandlord because the Sublandlord was in default under the master lease.

While Syufy received copies of notices served upon the Sublandlord relating to the Sublandlord's default, the Master Landlord assured Syufy that it did not intend to disturb Syufy's tenancy. Eventually, the Master Landlord filed an unlawful detainer action against the Sublandlord and the Sublandlord filed for chapter 11 bankruptcy protection. In the bankruptcy proceeding, the Sublandlord's bankruptcy trustee filed a motion to assume the master lease. The bankruptcy court denied the motion based on events that had occurred in course of the unlawful detainer action and ordered the Sublandlord to vacate the premises. The failure to assume the master lease amounted to a "deemed rejection" of the master lease in the bankruptcy proceeding.



Syufy was unaware of the Sublandlord's bankruptcy proceeding until it received a letter from the Master Landlord regarding the bankruptcy court's order for the Sublandlord to vacate the premises. The Master Landlord explained in its letter that the master lease had been terminated and that Syufy's sublease had also been effectively terminated, but the Master Landlord also assured Syufy that Syufy could continue to occupy the premises on a month-to-month basis. The Master Landlord subsequently informed Syufy that it did not intend to disturb Syufy's tenancy and that it planned to formalize a new, direct lease with Syufy. Although the Master Landlord did not prepare a new lease for Syufy, Syufy relied on the Master Landlord's assurances and continued to operate the theater.

Approximately two years later, the Master Landlord decided to market the site and delivered to Syufy a notice of termination, ordering Syufy to vacate the premises within thirty days. In response, Syufy filed suit against the Master Landlord for damages and other redress. The Master Landlord filed a pretrial motion in that proceeding, seeking adjudication of whether the Sublandlord's deemed rejection of the master lease in the bankruptcy proceeding effectively terminated Syufy's rights under the sublease. The trial court decided this issue in the Master Landlord's favor and dismissed Syufy's complaint. On appeal by Syufy, the California Court of Appeal analyzed whether Syufy had a right to remain on the premises despite the deemed rejection of the master lease in bankruptcy. The Court of Appeal's analysis in *Syufy* hinged upon principles of federal bankruptcy law and California landlord-tenant law.

"Deemed Rejection" in Bankruptcy

United States Bankruptcy Code Section 365 enables a bankruptcy trustee or a debtor in possession in a chapter 11 bankruptcy case to assume or reject an unexpired lease held by a debtor as lessee. However,

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From the Chair

By Mary B. Cranston

We live in interesting times. With international, financial and legal turmoil all around us, the personal and professional challenges have never been greater. Real estate practitioners in particular are facing a myriad of challenges: aging infrastructure, changing demographics, dwindling revenue sources and a poor economy.

Well, as they say, the only way out, is through.

At Pillsbury Winthrop LLP, we are devoted to helping our real estate clients through these interesting times by recognizing and capitalizing on the opportunities that are inherent in every challenge. And *Pillsbury Winthrop LLP on Real Estate* is one of the many tools that our Global Real Estate Practice Section utilizes in that pursuit. This edition features four articles about challenges -- and opportunities -- that may present themselves to real estate practitioners in the months and years ahead.

We hope that you find these articles, well, interesting, and that your future is defined by success and contentment, both personally and professionally.

TERRORISM INSURANCE:

Congress to the Rescue?

As the cost of terrorism insurance soared, many borrowers found it difficult to secure insurers willing to provide coverage for terrorism at reasonable rates.

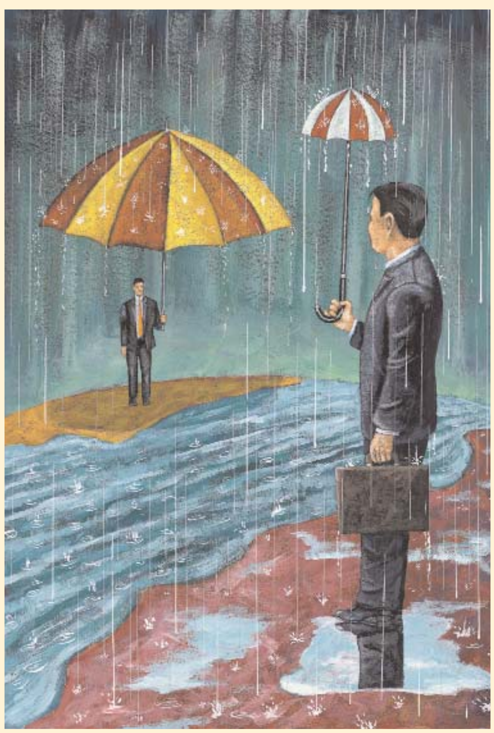
By Laura E. Hannusch

By Suneil M. Thomas

Prior to September 11, 2001, insurers and reinsurers did not deem the risk of terrorist attacks material enough to fashion exclusions for such events in all-risk insurance policies covering high-rise office buildings. The state of the insurance industry, however, underwent a dramatic change following the destruction of the World Trade Center. Due to the scale of damages and the unpredictability of future terrorist attacks, many reinsurers began refusing to renew coverage for terrorist attacks. In response, as primary all-risk policies came up for renewal, almost all primary property and casualty insurance carriers began to exclude terrorist acts from coverage. This exclusion forced commercial property owners to look to stand-alone terrorism coverage.

As a result of the broad exodus of insurance carriers from the terrorism insurance market, stand-alone terrorism insurance became extraordinarily expensive and, in the case of some high-profile properties, simply unavailable. The few companies willing to provide terrorism insurance limited the amount of coverage they were willing to underwrite, which made obtaining coverage for the most valuable properties even more difficult. In addition, stand-alone coverage suffered from many drawbacks that standard all-risk policies did not, including that it was often prohibitively expensive, usually offered on an aggregate rather than a per-occurrence basis, and typically subject to a 30-day cancellation clause. Moreover, exclusions from coverage were numerous. The uncertainty surrounding the availability of terrorism insurance undermined the recovery of the commercial real estate market that had been battered by the terror attacks and the general economic slowdown.

As the cost of terrorism insurance soared, many borrowers found it difficult to secure terrorism coverage at reasonable rates. Some lenders, relying on mortgage provisions requiring standard all-risk policies or other "commercially reasonable" insurance, attempted to use "lock box" funds to secure terrorism coverage for their borrowers. Litigation between borrowers and lenders ensued over the scope of "all-risk" insurance, as well as what constituted "commercially reasonable" policies. Borrowers argued that all-risk policies covered losses due to a fire regardless of the cause and that



specific terrorism coverage was therefore unnecessary (the "fire-following doctrine"). A Minnesota court upheld the fire-following doctrine and found that additional terrorism coverage (stand-alone or otherwise) offered little protection beyond what all-risk policies with terrorism exclusions already provided. However, the New York Supreme Court reached a contrary conclusion about the scope of coverage provided by standard all-risk policies. That court found that the fire-following doctrine might not apply in all cases because the damage from a terrorist attack could take many forms, including chemical, biological or nuclear damage. The conflicting outcomes of these two disputes created additional uncertainty for lenders and borrowers as they struggled to adjust to the post-September 11th climate.

Congress Steps Up

Recognizing this new reality, the real estate and insurance industries looked to the federal government for relief. On November 26, 2002, President George W. Bush signed the Terrorism Risk Insurance Act of 2002 ("TRIA") into law. TRIA is designed to ensure that all-risk policies include terrorism coverage at affordable rates by obligating the federal government to share the risk of losses in the event of future terrorist attacks. TRIA seeks to temporarily stabilize the volatile insurance market until the insurance industry develops the programs necessary to create a viable financial services market for private terrorism insurance.

TRIA coverage is triggered when the Secretary of the Treasury (the "Secretary"), in concurrence with the Secretary of State and the Attorney General, certifies an event causing losses of at least $5,000,000 as a foreign terrorist act, which is defined as an act that has been "committed by an individual or individuals acting on behalf of any foreign person or foreign interest, as part of an effort to coerce the civilian population of the United States or to influence the policy or affect the conduct of the United States government by coercion." The Secretary's decision is not subject to judicial review.

Each participating insurance company will be responsible for paying out a certain amount in claims resulting from certified terrorist acts as a deductible before federal assistance becomes available. The deductible is based on a percentage of direct earned premiums from the previous calendar year, and rises from 7% during year one to 10% in year two and 15% in year three. The phrase "direct earned premiums" refers to any premiums that are earned for property and casualty insurance issued by any insurer against losses occurring in the United States or to a United States air carrier or flagged vessel. For losses above an insurance company's deductible, the federal government will cover 90% of such losses, while the insurance company contributes 10%. Losses covered under TRIA will be capped annually

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California's Budget Solution: An Affordable Housing Problem?

By Lewis G. Feldman

By Douglas A. Praw

It has been said that as California goes, so goes the nation. Unfortunately, this seems to be holding true for the fiscal affairs of many states throughout the country. Like California, many states are facing unprecedented budget deficits. The numbers are staggering and, not unexpectedly, so too are the solutions being proposed to overcome the crises. With radical proposals come devastating unintended consequences.

Gray Davis, Governor of California, recently made a proposal to solve part of the state's budget crisis which could potentially impact the low-income housing market in California to the tune of $100 million. Naturally, the reaction by California's development community has been charged. And, if California is truly a trend-setting state, then the development communities in other states should pay close attention to the California example so that they are prepared if -- or, perhaps more accurately, when -- a similar proposal is suggested in their state.

California's Budget Crisis

Faced with a $35 billion budget deficit, California's Governor Davis has announced that the California Legislature will have to make sharp cuts in spending, but the Governor is also considering several alternative revenue sources. One proposed measure is to shift $500 million in unencumbered tax increment from 400 redevelopment agencies ("RDAs") to California's General Fund. The effect of this reallocation on the availability of affordable housing could be dramatic.

Redevelopment, including the provision of safe, sanitary housing, is funded in part by so-called tax increment financing. In general, the amount of tax increment allocated to an agency is equal to the difference between property taxes generated from a specific geographic area in a given year and property taxes that were generated in the same geographic area in the "base year" during which the redevelopment plan was adopted.

In addition to the overall goal of eliminating social and economic blight, the California Legislature has declared that RDAs are to use their tax increment revenue to expand the supply of low- and moderate-income housing. Consequently, the Community and Redevelopment Law, as amended, constituting California Health and Safety Code Section 33000 et seq. (the "Redevelopment Act") requires that RDAs spend at least 20% of their property tax increment revenue on affordable housing for seniors, people with disabilities and low- or moderate-income families within the territorial jurisdiction of the RDA. These funds help developers and RDAs to provide housing, finance repairs, subsidize rents, improve infrastructure and assist with home ownership for low- and moderate-income individuals.

By seeking a reallocation of $500 million in tax increment, Governor Davis' proposal would reduce the available funds for low- and moderate-income housing by $100 million. Affordable housing constituents estimate that reallocating $500 million from the RDAs to the General Fund could cause the loss of up to 15,000 affordable housing units statewide. The City of Los Angeles alone could lose one-third of its affordable housing budget.

Responding to the Threat

Despite the apparent threat to the availability of funding for affordable housing, strategies on both the local and the state level can be implemented to mitigate the potential damage.

On the local level, developers need to be proactive, signing contracts with the applicable RDAs earlier in the development process because the State of California may only reallocate "unencumbered funds." Once moneys are earmarked for a specific purpose, they may not be reallocated for another purpose.

Moneys are deemed encumbered if they are committed for appropriate expenditures pursuant to a legally enforceable contract. Appropriate expenditures under the Redevelopment Act include, but are not limited to, the acquisition of real property or building sites, and the acquisition, construction and rehabilitation of buildings or structures.

Although each RDA may possess its own policies and procedures, the redevelopment process generally begins with a developer supplying the applicable RDA with a letter of interest, wherein the housing assistance is proposed. Thereafter, the RDA and the developer negotiate the details of the assistance in a legally binding contract. If the RDA owns property upon which the developer proposes to build the to-be-assisted project, the RDA and the developer enter into a Disposition and Development Agreement ("DDA"). If the developer owns the property, then the form of agreement is called an Owner Participation Agreement ("OPA"). Once the RDA has committed tax increment funds to the developer through either the OPA or the DDA, the funds become encumbered for the designated purpose.

On the state level, redevelopment leaders are lobbying to see the definition of "encumbered" relaxed to include mere allocations to redevelopment projects that are in early planning phases. The hope is that the state will recognize housing funds as earmarked by an RDA for a project even though no formal agreement has been executed with a developer. One variation of this effort is AB 1058, which was referred to the Committee on Housing and Community Development on March 13, 2003. AB 1058 proposes that an RDA that incorporates certain community benefit standards into a redevelopment project is exempt from any transfer of tax increment funds to the General Fund. Even though the terms of a project are not formally agreed to through a DDA or OPA, a project that includes identifiable benefits to the community, such as providing a sufficient number of affordable housing units, generating additional tax revenue and increasing economic activity within the project area, is saved from a possible gubernatorial reallocation of redevelopment funds.

Additionally, developers may find themselves looking for alternatives to tax increment such as those found in Proposition 46. Passed in November 2002, Proposition 46 will bolster the number of affordable housing units in the State of California through the issuance of $2.1 billion of general obligation bonds, with more than half of the proceeds funding a variety of housing programs aimed at the construction of rental housing. These programs generally provide low-interest loans to developers in order to fund part of the construction costs. In exchange, the developer must commit a portion of the units in the project to low-income households for a period of 55 years.

More Work To Do

Opportunities exist to minimize the harsh effects of any proposal to reallocate moneys for redevelopment to California's General Fund. Developers must work earnestly to execute agreements with the RDAs for existing projects to encumber RDA funds early in the redevelopment process. Developers should also track AB 1058, and similar legislation, which if passed will protect millions of dollars of unencumbered redevelopment funds from reallocation. Developers should never stop looking for alternatives to tax increment financing of low-income housing, such as the public-private partnership embodied in Proposition 46. Unfortunately, whatever the fate of the Governor's proposal, the development community has much more work to do to ensure the availability of low-income housing -- both in California and across the nation.

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portion (in which the new West Side YMCA program space would be built) in uninterrupted ownership by the exempt entity. A development agreement linked the developer's obligation to construct the "Y" portions and the "for profit" portions of the building, bridging the two vertical halves of the development site. To continue the real property tax exemption on the "Y" portion upon completion, Pillsbury Winthrop LLP created a condominium structure, permitting the YMCA-GNY's ongoing ownership of its portion of the completed project. Further condominiumization of the upper portion of the project permitted the sale of individual apartment units to the general public.

The McBurney YMCA

The McBurney YMCA, located in New York City's Chelsea neighborhood, presented other challenges. The building was no longer well-suited to the purposes of the McBurney YMCA, as the excessively "vertical" space required that too much of the building be devoted to hallways, stairways and elevators. In addition, the building required significant capital investment.

The YMCA-GNY determined that a sale strategy was the most sensible course, with the proceeds to be applied to the construction of a new and more appropriately configured YMCA facility elsewhere in the neighborhood. But the sale of a building with two diverse functions -- a community facility on 23rd Street and a residence on 24th Street -- was challenging. The business solution was to "sell" the building in two halves: the residential facility to another not-for-profit entity that would use it to provide supportive housing, and the community facility to a developer for adaptive reuse. To further complicate the transaction, the YMCA-GNY wanted to retain the community facility portion of the building until it opened its new branch, which it expected to do nearly two years after the sale of the residential facility. The YMCA-GNY also wanted to effectuate the sale without incurring the significant obligation of splitting the building for separate ownership.

The legal solution was to enter into concurrent contracts for the sale of the two halves of the building, one contemplating a near-term closing and the other a closing to coincide with the completion of the new McBurney YMCA facility nearby. Along with its execution of the two contracts of sale, the YMCA-GNY entered into a zoning lot development agreement (which was approved by each of the purchasers) to serve as a blueprint for the legal and physical separation of the two halves of the building. The purchaser of the residential facility agreed that, once it acquired fee title, it would undertake its obligations in connection with the division of the building. The purchaser of the community facility committed to do the same, even though it would not get actual title for several years. In addition, both purchasers committed to perform the work in a manner that would not disrupt the ongoing occupancy of the existing McBurney YMCA.

Finding a location for the new McBurney YMCA was equally challenging. Few viable sites existed in the area served by the current facility, particularly given the need to accommodate a community facility with approximately 65,000 square feet of mostly horizontal space. When New York State determined that an old armory building on 14th Street was to be sold for redevelopment, the YMCA-GNY immediately recognized that the location, footprint and visibility would be perfect for the new McBurney YMCA. But the development potential of the site far exceeded that which could be used by the McBurney YMCA alone. When the YMCA-GNY approached the developer of the site about including a YMCA facility in any mixed use development of the site, the developer indicated that it was not interested in constructing a YMCA facility for conveyance to the YMCA-GNY. Pillsbury Winthrop LLP teamed with the YMCA-GNY to negotiate a transaction whereby the YMCA-GNY became a member of the entity owning the site, with the developer (pursuant to a separate agreement) committing to build the new McBurney YMCA facility. Upon completion of the new facility and the creation of a condominium regime for the project, the agreement with the developer gave the YMCA-GNY the right to redeem its interest in the ownership entity for direct ownership of the condominium unit. The YMCA-GNY was thereby able to obtain the facility it needed and, at the same time, satisfy the developer's structuring concerns.

As the community's needs change, the YMCA-GNY will face new and sophisticated challenges to provide and maintain the physical infrastructure that it needs to operate effectively. As the West Side YMCA and McBurney YMCA projects demonstrate, the YMCA-GNY has the proven experience and vision to meet those challenges. Paula Gavin, President of the YMCA-GNY, noted in the volume celebrating the 150th Anniversary of the YMCA-GNY: “We have to stretch and reach. And once we do, we'll see that success breeds success. Success builds upon itself." Pillsbury Winthrop LLP shares that sentiment, and is proud to be a continuing part of the organization's success.

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if the trustee or debtor in possession does not assume or reject the lease within sixty days after the date of the order of relief (or by such other date as the court may order), then the lease is deemed rejected, and the trustee must immediately surrender the real property to the lessor. In *Syufy*, the bankruptcy trustee's failure to assume the master lease unquestionably resulted in a deemed rejection of the master lease. The novel issue addressed in *Syufy* was the effect of the deemed rejection on a third party, namely a subtenant, with respect to its rights under the rejected lease.

Bankruptcy courts have developed two divergent views regarding the effect of a deemed rejection of a lease in bankruptcy. The traditional view, and that embraced by several bankruptcy courts, is that a deemed rejection results in a complete termination of the lease, extinguishing the tenant's right to possession, as well as the other covenants, rights and remedies set forth in or appurtenant to the lease. Under this view, a subtenant's rights are automatically extinguished when the lease is deemed rejected. However, the emerging view, and the current trend in Ninth Circuit bankruptcy cases, is that a deemed rejection constitutes a breach of the lease, but not an extinguishment of the tenant's other covenants, rights and remedies in or appurtenant to the lease. Under the emerging view, a third party's rights may not necessarily be extinguished by the debtor's rejection of the lease. Even under the emerging view, however, rejection terminates the tenant's right of possesion, although other covenants, rights and remedies may survive.

Syufy adopted the emerging view that a deemed rejection results in a breach rather than a termination. Under this view, despite the deemed rejection of the master lease, Syufy stood a chance of salvaging its interest in the subleased premises. However, the ultimate outcome was dependent upon state law.

Application of State Law

The *Syufy* court turned to California law to address the extent to which a subtenant retains rights in a master lease after a sublandlord's breach. Under California law, a subtenant's rights are dependent upon and subject to the sublandlord's rights. Thus, the rights of a subtenant sink or float with those of the sublandlord. Syufy, however, claimed that it was more than a typical subtenant. Specifically, Syufy asserted that it was a third party beneficiary of the master lease and that it enjoyed rights greater than those of an ordinary subtenant, particularly the right to continued possession of the subleased premises. Syufy argued that its third party beneficiary status was created by the amendment to the master lease, in which the Master Landlord expressly permitted the Sublandlord to enter into a sublease with Syufy and acknowledged that Syufy would construct improvements on the subleased premises. The Court of Appeal concluded that while Syufy may have been a third party beneficiary with respect to the amendment, the amendment did not provide Syufy with a greater right to remain in possession of the premises than was enjoyed by the Sublandlord. Essentially, the court found that Syufy's right to possession was based entirely on the master lease and its derivative sublease. Consequently, when the master lease was deemed rejected, there was a breach under the master lease pursuant to which the Master Landlord had an unconditional right under California law to regain possession of the entire leased premises, including the subleased premises.

Ultimately, even though (i) the Master Landlord expressly approved the sublease and Syufy's improvements to the leased premises, (ii) Syufy spent substantial funds to build, operate and expand the theater, (iii) the Master Landlord gave repeated assurances that it did not intend to disturb Syufy's tenancy and (iv) *Syufy* adopted the emerging view that a tenant's deemed rejection in bankruptcy does not result in a complete termination of the master lease, under California law Syufy's right to possess the subleased premises was extinguished along with the master lease.

While *Syufy* serves as a warning that the rights of a subtenant, particularly in the context of a bankrupt sublandlord, may be quite weak, the case also serves as a guide. *Syufy* demonstrates that a subtenant cannot simply rely on assurances or other representations by a master landlord. Rather, a subtenant must be proactive and plan ahead by utilizing mechanisms available to ensure its continued possession of subleased premises in the event the master lease is terminated.

Recognition Provisions

The primary tool that a subtenant may employ to protect its interest in subleased premises is a recognition provision. Such a provision typically provides that if the master lease terminates, the subtenant will render performance to the master landlord, and the master landlord will recognize the sublease (i.e., not disturb the subtenant's possession of the premises) so long as the subtenant is not in default under the sublease. When a recognition provision is negotiated between a subtenant and a master landlord directly, it is contained in a separate agreement, typically called a consent to sublease.

Sometimes, a recognition provision is contained in the master lease itself. Therefore, when planning to enter into a sublease, it is imperative for a prospective subtenant to first look to the master lease to see if such a provision exists. If the master lease contains an appropriate recognition provision, in the event of a sublandlord's rejection of the master lease in bankruptcy, a subtenant will be construed as a third party beneficiary of the recognition provision and the subtenant's right to possess the subleased premises will be protected. In *Syufy*, the master lease contained an amendment in which the Master Landlord agreed to and acknowledged Syufy's subtenancy, but the Master Landlord never agreed to recognize Syufy's sublease in the event the master lease was terminated. This was precisely why the *Syufy* court could not construe Syufy as a third party beneficiary with rights distinct from those of the Sublandlord.

Negotiating a recognition provision generally is not a simple task and a master landlord is often unwilling to agree to such a provision. A master landlord may be very rigid with respect to the terms and conditions upon which it will recognize a subtenant. If a subtenant is subleasing only a portion of premises, the master landlord may not want to recognize the subtenant at all. This is because in the event the tenant/sublandlord vacates the premises, the master landlord may have difficulty procuring a new

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in the community

A number of Pillsbury Winthrop LLP's attorneys and staff have joined in an effort to send care packages and letters of support to relatives and friends serving abroad in the United States military. Volunteers in the firm's many offices collected items for the care packages and assembled the parcels for delivery overseas. Among the items included in the care packages were drawings from local schoolchildren, as well as toiletries, batteries, socks and non-perishable food.

A group in the Los Angeles office gathered to send well-wishes.

(*Terrorism Insurance* continued from page 3)

at $100 billion. Congress is to determine the procedures and the source for any payments above this amount.

Under certain circumstances, the federal government is required under TRIA to recoup financial assistance provided in connection with acts of terrorism. In addition, the Secretary has the discretion to recoup amounts expended. In both mandatory and discretionary cases, the recoupment will be accomplished through risk-spreading surcharges imposed on all policyholders of property and casualty insurance, which are not to exceed 3% of the policy premiums paid in a given year.

TRIA obligates all insurance companies to provide terrorism coverage to all policyholders of commercial lines of property and casualty insurance during the first two program years of TRIA. The Secretary has the discretion to determine whether coverage should be extended for the third program year. Insurance companies must disclose to policyholders the premiums that they charge for terrorism coverage and the existence of a sizeable federal backstop. Captive insurers or municipalities and other entities with self-insurance arrangements may participate in the program at the discretion of the Secretary.

TRIA provides that any terrorism exclusion provision in a contract for property and casualty insurance that is in force on the date of enactment of TRIA is void to the extent that such provision excludes losses that would otherwise be insured losses. Moreover, TRIA, like much federal legislation, preempts state law, so that any state approval of such a terrorism exclusion that is in force on the date of enactment of TRIA is also void. However, under two very limited circumstances, TRIA allows the reinstatment of terrorism exclusions that are otherwise void.

Under TRIA, the federal government is immune from any and all punitive liability as a reinsurer. In addition, with certain exceptions, TRIA creates an exclusive federal cause of action, governed by applicable state law, for suits seeking recovery for property loss, personal injury or death arising out of a terrorist event. Following the determination by the Secretary that an act of terrorism under TRIA has occurred, the Judicial Panel on Multidistrict Litigation shall designate one district court (or, if necessary, multiple district courts) to have exclusive jurisdiction over all actions for any claim relating to such act of terrorism.

TRIA is set to expire on December 31, 2005, causing some concern among those in the commercial real estate industry who have long-term loans. Presently, it is unclear what will follow once the federal backstop expires. However, not later than June 30, 2005, the Secretary must report to Congress on the effectiveness of TRIA and the likely capacity of the insurance industry to offer affordable insurance after the termination of the program. Congress will have detailed information about market conditions, enabling it to make a decision whether or not to continue the program. If the private market has not found a permanent way to address the terrorism insurance issue, there is a strong likelihood that Congress will renew TRIA or find another way to ensure that terrorism insurance remains available and affordable.

TRIA also makes it more likely that lenders will be able to successfully argue that borrowers must carry terrorism insurance because it is commercially reasonable and available.

TRIA will have a significant impact on the requirements imposed on borrowers under the terms of their loan agreements. Prior to September 11th, most "all-risk" policies were deemed to incorporate the risk of terrorist attack. After September 11th, as insurers began to craft exclusions for terrorism insurance and the price of stand-alone policies skyrocketed, many borrowers argued that the procurement of terrorism insurance was commercially unreasonable and thus not required under the terms of their agreements. After TRIA, however, such arguments are undermined by the requirement that insurers include terrorism coverage in their standard policies at a more reasonable cost. As a result, it is likelier that lenders will insist on more stringent terrorism insurance requirements in their loan agreements.

Not a Perfect Solution

TRIA solves the problem of availability of coverage (albeit with a limited scope and for a limited time) and it reduces the financial exposure of insurance companies providing terrorism coverage, but it is unclear if TRIA will have a significant impact on the cost of such coverage. Companies that have purchased or are looking to purchase terrorism insurance should consult a sophisticated insurance brokerage company in order to ensure that the rates paid for such coverage are competitive in the marketplace. Marsh, Inc., a leading risk and insurance services firm serving clients in more than 100 countries, conducted a recent survey of approximately 1,500 existing policies and found that insurers were requiring around 8% to 9% in additional premiums for terrorism coverage. Whether or not a particular state adheres to the fire-following doctrine will also impact the price of terrorism coverage. In jurisdictions where the doctrine is applicable, coverage is likely to be priced at relatively low levels because the mandated coverage does not significantly increase the perceived risk. The opposite should be true where the doctrine is not followed.

While TRIA may provide a short-term solution, borrowers still have numerous concerns relating to their long-term loans. Many loans have terms that will extend far beyond the expiration of TRIA. In this situation, borrowers should try to include provisions in their loan agreements stating that if TRIA is not renewed or an alternative is not implemented, then the borrower will be required to procure replacement terrorism insurance only if it is available at commecially reasonable rates.

TRIA also makes it more likely that lenders will be able to successfully argue that borrowers must carry terrorism insurance because it is commercially reasonable and available. Prior to TRIA, borrowers could argue that terrorism insurance was pro-hibitively expensive and thus "commercially unreasonable." TRIA, as long as it exists, could make it more difficult for borrowers to adhere to that position.

Only time will tell whether TRIA achieves its objective of stabilizing the cost of terrorism coverage and preventing future litigation or if TRIA will be merely a complex, yet ineffective, solution to a serious problem.

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tenant to rent only the vacated portion of the premises. As an example, if a tenant leases an entire floor of a commercial building but the subtenant subleases only a portion of that floor, the master landlord may resist recognizing the sublease because leasing an entire floor is usually easier than leasing just a portion of a floor.

In addition, a master landlord will often try to condition a recognition provision upon the subtenant's "stepping into the shoes" of the sublandlord and accepting the terms and conditions of the master lease, namely the rental rate. This is because, typically, a commercial subtenant's rental rate is less than that of a tenant, and a master landlord has little or no incentive to recognize the subtenant at a discounted rate. A savvy master landlord may also negotiate for an option to recognize or not recognize the subtenant in its sole and absolute discretion. A subtenant, though, may not want to pay the higher rental rate under the master lease (as opposed to the discounted sublease rate) for its own financial reasons. While a recognition provision is often difficult to obtain, a prospective subtenant should be aware that such a provision does exist and, with skilled negotiating, a subtenant may be able to protect its interest in subleased premises.

Subtenants Are Vulnerable

Ultimately, a subtenant like Syufy should be aware that it is highly vulnerable in the context of a bankrupt sublandlord. Given the risk of losing costly improvements and possession of subleased premises, a subtenant should be cognizant of the tools available to protect its interests and secure its investment in subleased premises. While tools like recognition agreements are not foolproof, they can be effective in some situations. The alternative -- extinguishment of the sublease and the right to possession -- compels meaningful consideration of such tools.

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