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Shopping Center Ground Leases: Pitfalls and Opportunities

By Jeffrey Glen

Many American shopping centers and large stand-alone stores sit on ground that is leased, typically for substantial periods on a triple net basis. Often, the lease terms are tied economically to the costs of construction or expansion of the stores, and the expectation of both the lessor and the lessee is that the lease will run for decades.

Where the center or the single tenant fails, generally it can walk away on a non-recourse basis and the ground lessor is the beneficiary of, or is stuck with, the improvement. When the value of the center or "standalone" store has increased, the curse or opportunity of sharing the value can come up in interesting and unexpected ways.

Anderson Kill has recently represented the ground lessor in cases involving this issue.

The Michigan Case

A ground lease for a shopping center in Michigan had an original term of 20 years, with five renewal options of five years each. Each renewal option was to be exercised by a notice, given at least six months before expiration of the then-current term. During the second renewal period, the ground lessee (the "tenant") forgot to send the required notice of extension, and a few days before the end of the term the ground lessor (the "landlord") sent a letter demanding the keys. The tenant immediately went to court in Michigan, seeking a declaration that its negligence was excusable since the landlord knew that the tenant wanted to stay in possession, the landlord had suffered no prejudice, and losing the lease would give the landlord a windfall. Underlying this litigation was the fact that the tenant had negotiated a very substantial rent increase from the anchor store sublessee contingent upon the landlord extending the last extension term, which the landlord had turned down.

The landlord obtained summary judgment in the federal district court, with the court holding that failure to give the requisite written notice meant that the lease was not

"Shopping Center Ground Leases" continued page 2

How a Few Simple Insurance Tips Can Make a Big Difference to Your Business

By John G. Nevius, Esq., P.E.

Attorneys get their share of frantic phone calls. A landlord client called the other Friday. She had just received a lengthy denial letter from her insurance company. It seems the landlord had not obtained insurance for her drugstore tenant. Both the landlord and tenant were being sued by someone who had slipped and fallen in the parking lot when the store was closed. The plaintiff may have been drunk when he fell, and the case was finally set to go to trial. The insurance company was defending the landlord in the plaintiff's lawsuit, but the lease required the landlord to obtain insurance for the tenant. The tenant was supposed to clear the area of ice and snow, but asserted a claim against the landlord over the landlord's failure to procure insurance. Failure to obtain insurance is why the last-minute denial letter landed on my desk. In the end, the trial was postponed and the matter settled. The landlord likely will only have to pay a modest sum, but her insurance rates may rise. The moral of this tale: the time to think about insurance is

"Simple Insurance Tips" continued page 2

"Simple Insurance Tips" continued from p1

before there is a claim. In the case of the unfortunate tenant, there were several approaches that could have prevented this issue from arising, but those steps needed to be put in place before the loss occurred. Trying to fix a contract-based problem after a loss takes place can be very difficult.

Do You Have The Right Insurance?

Most commercial contracts, including leases, have provisions that deal with insurance. The landlord in the above case appears to simply have made a mistake. However, having the wrong insurance, or insurance that does not take into account the risks to be insured against or that does not reflect changing business realities, can be just as bad as—or worse than—no insurance at all. No company needs additional litigation over insurance coverage when a lawsuit has been brought against it for the loss itself.

How To Protect Yourself

Policyholders can do a number of simple things to protect themselves. It is very important to work closely with a broker whom you trust and who knows your specific business and is familiar with the general type of your business. Brokers have dual loyalties, however, because they earn a living from the commissions they get from insurance companies. Policyholders need to be very clear in communicating with the brokers they use. Special coverage requests or special risks identified to be covered should be communicated to the broker in writing. If the coverage obtained by the broker is deficient and a claim is denied, whether a subsequent malpractice claim against the broker is successful may depend on the documentation that exists and the evidence that the broker knew the policyholder was relying on the broker.

A good broker works with the policyholder to tailor the insurance coverage to fit the policyholder's needs. Disclosure of poten-

"Simple Insurance Tips" continued on p3

"Shopping Center Ground Leases" continued from p1

renewed, that equity would not relieve the tenant of its own negligence, and that the significant benefit the landlord would obtain by regaining possession and then dealing directly with the anchor store to increase the rent by giving a direct lease with an extended term was not an actionable windfall. The judgment was affirmed in the Sixth Circuit Court of Appeals.

The tenant was disadvantaged in this particular case because we were able to show, through extensive discovery, that several years before it had missed a renewal date at a different center in another state, and had taken no effective steps to improve its record-keeping system. The landlord was fortunate as well in being under Michigan law, for in other states, the decided case law is more favorable to tenants who miss deadlines in leases.

The "Superstore" Case

Another case ended just this year, some 20 years into a very long-term ground lease, which the single store undertenant had negotiated with the ground lessee in order to turn the building into a "superstore." The ground lessee, inadvertently, had failed to give the landlord notice of the modifications in the lease to the "superstore," which notice was required under the ground lease. The ground lease contained a provision that required arbitration before three New York City realtors of any dispute as to the reasonableness of the landlord's withholding consent from any proposed lease modification.

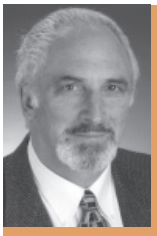
Some two years after the modified lease between the ground lessee and the "superstore," was signed the ground lessee came to the landlord with a proposal to assign the ground lease. The landlord refused and sent the ground lessee a notice of default and termination for entering into the modified lease without its consent. The ground lessee promptly sued the landlord in federal district court in Denver, pointing out that on several occasions it had sought the requisite consent, although belatedly, and that the modified lease had actually been recorded and therefore the landlord had been on public notice of the event.

Seizing on the arbitration provision in the ground lease, the landlord went to federal court in New York to compel arbitration of the entire dispute, and sought to stay the action in Colorado. The district court judge in New York agreed with the landlord and issued the relief requested. Because there is no appeal in the federal system from such an order until the arbitration is completed, the ground lessee found itself in a lengthy arbitration across the continent from Denver,

and was stymied in its efforts to assign its ground lease. Shortly after the judge in New York issued her order, the dispute was settled.

In Summary

In our experience, careful vetting of what are often very old ground leases is critical both for the owner of the fee and for the operator of the shopping center. Lease provisions that were negotiated decades ago, often between predecessor parties that are no longer in existence, can and are litigated under legal principles created when the Sheriff of Nottingham was pursuing Robin Hood and under case decisions that may be as antique in their holdings as they are quaint in their language. Because litigation in this area is infrequent, we have found that knowledge of the law across the nation is key to making an effective presentation when the cases are invariably brought suddenly, and swift resolution is needed so that commercial relationships can be finalized. The stakes are large; rental values are often vastly different from what they were when these leases were signed originally, and the length of the leases means that the financial impact of early termination is a large multiple of the reserved rent.



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This Just In

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"Simple Insurance Tips" continued from p2

tial risks and the nature of business activities will assist in conducting the insurance underwriting process. Proper disclosure can also prevent surprises, such as allegations of misrepresentation in the insurance application, when the time comes to make a claim. Along these lines, in addition to a complete application, businesses should always check the insurance certificates provided by policyholders working for them. A subcontractor may be able to produce an insurance certificate, but is it up-to-date and for the right insurance? It is always a very good idea to ask for a copy of the insurance policy. It is common for the insurance certificate to contain a legend in the upper right-hand corner warning that the certificate is for information only, that it confers no rights, and that it is not an insurance policy. In the rush to get a deal done or finalize a contract, the insurance policy may not even be issued by the closing date. Follow-up can be crucial. Insurance binders, certificates, or promised coverage may not be consistent with the final policy contract document. Simply checking the summary "declarations" page of the insurance policy when issued can avoid innumerable problems down the line. Similarly, it is often tempting to just rely on a renewal of the old insurance policy when the issue comes up a year later. This could be a problem, however, if circumstances have changed.

Using Other People's Insurance

Other people's insurance (OPI) can be a very effective way to manage risk. Contracts can require those with whom companies do business to obtain insurance on their behalf or list them as an "additional insured," etc., on another policyholder's insurance policy. Again, it is important to review the actual policy and not just the insurance certificate. Contractual indemnification provisions can also be effective in shifting the burden from a policyholder in the event of a loss, and provide a useful, belt-and-suspenders approach to

"Simple Insurance Tips" continued on p4

"Simple Insurance Tips" continued from p3

improving the policyholder's chances of actually being defended and indemnified. Many companies have written policies requiring those with whom they do business to include them in their insurance program. Such written policies can be attached to contractual documents and put business associates on notice of their obligations.

Conclusion

These simple tips for attending to insurance matters can help to ensure that insurance is available when needed. Simply having coverage may not always off-set a loss, but a business that protects itself before a loss happens is a smart business.

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