

H G & G U P D A T E

Hofheimer Gartlir & Gross, LLP

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Keeping Your Priorities Straight: Drafting a Lease for Maximum Protection

Although a landlord of commercial property has several options when a tenant defaults, none can ensure that the landlord will not suffer losses from the default.

Since a security deposit may not cover the full amount of the unpaid rent, a landlord may further protect itself by obtaining a lien against the tenant's personal property, including equipment, inventory, movables and trade and domestic fixtures. The lien should also cover non-trade fixtures so that there can be no dispute between the

parties as to whether the chattel was so permanently attached to the building as to become part of it and hence a fixture belonging to the landlord. By adhering to the following suggestions, a landlord may be spared a certain amount of time and money that otherwise would be expended in attempting to recover losses incurred by a tenant's default.

excludes "landlord's liens" from the categories of protected security interest under the UCC (which has been interpreted by the courts to apply only to statutory landlord's liens, but not landlord's liens contractually set forth in a lease or a side agreement). In New York, a landlord has no statutory protection with respect to the tenant's movable property. Moreover, absent a written agreement to the contrary, in the event of a tenant's default, under the common law, the chattels or movables of a defaulting tenant continue to belong to the tenant, so that a landlord cannot seize those chattels as a set-off to unpaid rent without risking a claim of conversion brought by the tenant.

However, under the proper circumstances, a landlord should consider adding a lease provision creating a contractual landlord's lien that would constitute a protected security interest under the UCC. In order to "perfect" its security interest in the tenant's property, the landlord should record this lien by filing a UCC financing statement (a "UCC-1") at the time the lease is executed, which would provide the landlord with the protections afforded by Article 9 of the UCC, governing security interests in personal, non-real estate property. The filing of a UCC-1 serves to provide notice to potential purchasers, transferees, creditors and other potential encumbrancers of the property described therein. A landlord or creditor who files a

In This Issue:

Keeping Your Priorities Straight: Drafting a Lease for Maximum Protection

•
Insurance Coverage for Intentional Acts by Third Parties

•
Advertising Requirements in the Fair Housing Act

•
Managing Partner

•
New Associates

In New York, a commercial landlord has no statutory protection with respect to a tenant's personal property.

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Contractual Landlord's Liens

New York statutory law does not provide for a landlord's lien on a tenant's personal property or movables and the Uniform Commercial Code ("UCC") specifically

UCC-1 also receives protection by gaining an interest in property that the debtor or tenant receives as replacement for the encumbered property.

This recorded or “perfected” contractual landlord’s lien is governed by Article 9 of the UCC, and the rules of priority specified therein determine the priorities of more than one security interest in the same collateral. This contractual landlord’s lien should attach either at the time the chattels are placed on the property or at the beginning of the tenancy and would constitute a perfected security interest in the tenant’s property as long as the landlord properly files a UCC-1 contemporaneously with the lease signing. In addition, the landlord retains an interest in the tenant’s personal property, and such interest entitles the landlord to take possession of the property upon the tenant’s default under the lease.

Under the UCC, a contractual landlord’s lien on the personal property of its tenant, created by and provided for in the lease, will be superior to a subsequently filed security interest in the same property if the lease expressly provides for the landlord to have such a lien and if, as stated above, the landlord files a UCC-1 upon the signing of the lease. Conversely, if the contractual landlord’s lien is not perfected timely by the filing of a UCC-1, then a subsequent security interest in that same property which is perfected by the filing of a UCC-1 will be superior to the landlord’s lien, even if the subsequent lienholder had actual knowledge of the landlord’s prior unrecorded contractual lien.

A 1999 decision of the New York Court of Appeals, New York’s highest court, acknowledged the contractual landlord’s lien discussed in this article. In that case, *Badillo v. Tower Insurance Company of New York*,¹ the tenant of a supermarket provided

its landlord with a security interest in connection with its lease of the premises. The landlord had filed a UCC-1 which described the premises and covered all “personal property, goods and chattels now present or after acquired . . . [and] all insurance proceeds and leasehold at [the supermarket]” Less than one year after the commencement of the lease, the supermarket was destroyed by fire and the tenant received insurance proceeds from its insurance carrier. The landlord notified the carrier of its security interest in the insurance proceeds after the carrier had paid the insurance proceeds to the tenant. Upon learning of the prior payment of the proceeds to the tenant, the landlord brought an action against the carrier for conversion. The Appellate Division of the Supreme Court held that the insurance carrier was liable to the landlord because the UCC-1’s provided the carrier with constructive notice of the landlord’s security interest in the loss proceeds. The New York Court of Appeals reversed, holding that since the insurance contract was between the tenant and the insurance carrier only, the carrier’s only obligation was to pay the proceeds to the tenant. The landlord’s UCC filing was held to have no effect on the carrier’s obligation, because the carrier had no obligation to conduct a search for third parties, unnamed in the policy, who may have had an interest in the covered property. Although the Court explained that the landlord, under Article 9 of the UCC, had a right to bring a claim against the tenant for the insurance proceeds, the landlord had no right to a judgment against the insurance carrier, absent actual notice to the carrier. The Court reminded the bar that the landlord could have protected itself by requiring that it be named as the loss payee or as an additional insured on the risk under the policy.

A commercial lease
may contain a
contractual
landlord’s lien.

¹92 N.Y.2d 790, 709 N.E.2d 104, 686 N.Y.S.2d 363.

Priorities Where There Is More Than One Security Interest in the Tenant's Property

The Uniform Commercial Code determines issues of priority with respect to different security interests in the same collateral. When determining the priority of a contractual landlord's lien as opposed to another security interest in the tenant's property, a subsequently filed landlord's lien will be subordinated to a security interest previously filed on the same property. For example, a tenant operating a restaurant enters into a lease providing the landlord with a security interest in the restaurateur's personal property located on the premises, including equipment such as the refrigerators and stove ventilation system, trade fixtures such as the bar, chattels such as the chairs and tables, and the supplemental air-conditioning system, which may or may not be an actual fixture. The landlord files a UCC-1 on such personal property which explicitly describes the equipment covered by the UCC-1. However, if that equipment is encumbered by a third-party's prior recorded (and hence "perfected") security interest in that equipment (e.g., if the tenant had leased the equipment from a third-party lessor which had perfected its interest by filing a UCC-1), then under the UCC rules of priority, the landlord's subsequently filed security interest in that equipment would be subordinated to the prior interest of the third-party lessor. Upon the tenant's default under the lease with the landlord, the landlord's rights to possess the equipment would become secondary to the rights of the first encumbrancer, despite the explicit reference to such equipment in the lease and the landlord's filing of a UCC-1.

Another potential conflict arises when, although a landlord has a contractual lien on the personal property of its tenant, the

tenant subsequently leases equipment in connection with the operation of its business. The lessor of such equipment may insist on the retention of a security interest in the equipment, and upon learning of the landlord's prior recorded, perfected security interest in the tenant's personal property, the lessor may decide not to lease the equipment to the tenant unless the landlord agrees to subordinate its prior interest. It may be in the landlord's economic interest to subordinate its security interest so that the tenant can lease the equipment necessary for the successful operation of its business. In the case of a landlord who receives percentage rent, a tenant's lease of new or additional equipment may result in an increase in the tenant's sales and thus increase the amount of rent paid to the landlord.

Protecting the Landlord Through Careful Lease Drafting

When the circumstances permit, a lease drafted on behalf of a landlord should specify not only the landlord's right, at its option, to sell fixtures, trade fixtures, movables and chattels in the event of the tenant's default or abandonment of the premises, but it also should specify the property in which the landlord is taking a security interest. Depending on the circumstances of the particular tenant, the lease also may provide that the landlord has a lien on all proceeds and accounts receivable collected from the sale of the tenant's inventory, merchandise, fixtures and equipment.

The landlord should make sure that no other liens exist on the property prior to entering into the lease. The lease should specifically set forth the rights of the landlord to enter the demised space upon the tenant's default in order to sell the property at either a private or public sale.

It may be in a landlord's interest to subordinate its security interest.

Conclusion

When entering into a lease agreement, depending on the amount of the security, the economic viability of the tenant and other specific circumstances of the transaction, a landlord may require the following:

- (1) that the lease expressly provide that in the event of a default under the lease, the landlord has a lien against the tenant's personal property located on the leased premises, and
- (2) that the tenant sign a UCC-1 financing statement covering such property, which is

to be immediately filed by the landlord so that the contractual landlord's lien which has been created constitutes a "perfected" security interest under Article 9 of the UCC.

The use of these techniques must, by necessity, vary with the particular circumstances of the property, the parties to the lease, and other obligors of the tenant. For more information particular to your circumstances, please consult one of the partners of our firm.

Insurance Coverage for Intentional Acts by Third Parties

Hofheimer Gartlir & Gross, LLP filed an *amicus curiae* brief in a case before the New York Court of Appeals (settled immediately before argument) that delineated the reasons why an insurance company had a duty to defend and indemnify a property owner or manager in an action arising out of the intentional act of a third party, whether an employee or a stranger to the premises. We argued that the intentional act was neither expected nor intended from the landlord's point of view and therefore was an accident and an "occurrence" under the terms of the insurance policy.

On June 20 of this year, the New York Court of Appeals decided the case of *Agoado Realty Corp. v. United International Insurance Company* in which it held that the intentional assault of a tenant by an unknown assailant was an "accident" and thus a covered "occurrence" under the property owner's insurance policy. Therefore, the insurance company could

not rely on the policy's exclusion for "expected or intended" injuries. Citing its own cases, the Court explained that "in the strictest sense and dealing with the region of physical nature there is no such thing as an accident," but to determine whether a loss is an accident under an insurance policy, the insured's viewpoint must be ascertained, and if the incident was "unexpected, unusual and unforeseen," it is a covered loss. The Court distinguished this case from an earlier case before it where the policy excluded coverage for any assault and battery "whether or not committed by or at the direction of the insured."

The Court's decision reflects the arguments we had made in the previous case and should put to rest the aberrational case law of the lower courts which had stripped insurance coverage from landlords and managing agents of real estate for intentional acts that they had neither expected nor intended.

An insurance company has a duty to indemnify for the intentional acts of a third party.

■ Advertising Requirements in the Fair Housing Act

The Fair Housing Act (“FHA”) was enacted to prevent discrimination in housing based upon race, religion, gender, familial status, national origin or handicap. The Act provides advertising standards with respect to equal housing opportunities.

Builder advertising is regulated by the Federal regulations promulgated under the FHA, the Code of Federal Regulations (“C.F.R.”). There are three methods of complying with the C.F.R.’s requirements of promoting equal opportunity in housing advertisements: a builder may use an equal housing opportunity logo, statement or slogan in the advertisement. The particular method utilized by the builder depends upon the size and category or type of advertisement.

Larger advertisements require the use of the logo or the statement, depending on whether there are other logos in the advertisement. If there are other logos, the logo must be used; otherwise, the builder may choose the logo or the statement. The equal housing opportunity logo is as follows:



The equal housing opportunity statement reads:

“We are pledged to the letter and spirit of U.S. policy for the achievement of equal housing opportunity throughout the Nation. We encourage and support an

affirmative advertising and marketing program in which there are no barriers to obtaining housing because of race, color, religion, sex, handicap, familial status, or national origin.”

Smaller advertisements require the use of the slogan: “Equal Housing Opportunity.” The size and print of the slogan is regulated by the C.F.R.

Courts have found certain advertisements to violate the FHA. Examples of these include advertisements with all-white models and advertisements that do not contain a logo, statement or slogan.

In addition to these requirements, the C.F.R. requires builders to maintain a fair housing poster (the “Poster”) to promote equal opportunity in housing projects. The Poster must be *prominently displayed* so as to be “readily apparent to all persons seeking housing accommodations or seeking to engage in residential real estate related transactions or brokerage services.” A failure to display the Poster as required by the C.F.R. will be deemed *prima facie evidence* of a discriminatory housing practice. This means that the failure to display the Poster is sufficient to support a conclusion that the builder has violated the FHA. This does not compel a court to necessarily make that conclusion, but the requisite minimum evidence required is established.

The Poster must be posted and maintained at any place of business where the dwelling is offered for sale or rental. A Poster must also be posted and maintained at the dwelling, “except with respect to a single-family dwelling being offered for sale or rental in conjunction with the sale or rental of other dwellings.” In this instance, the Poster may be posted and maintained at the model dwellings instead of at each of

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the individual dwellings. In addition, the Poster must be posted at the "beginning of construction and maintained throughout the period of construction and sale or rental."

The size and content of the Poster is regulated by the C.F.R. Posters may be obtained from the Department of Housing

and Urban Development's ("HUD") regional and area offices, or a copy may be used if the copy and the lettering within the copy are equivalent in size to the Poster available from HUD.

For further information, please contact one of our partners.

■ Managing Partner

We are pleased to announce that Gerald H. Morganstern has become Managing Partner of the firm, upon the retirement of our esteemed colleague Donald M. Weisberg from the active practice of law. Don remains "Of Counsel" to the firm, and his clients will continue to be served by our partners.

■ New Associates

We are pleased to announce that Diane L. Barretta and Zoe Freireich have become associates in our firm.

■ Visit us on our website: www.hgg.com

About Hofheimer Gartlir & Gross, LLP

The firm conducts a general commercial practice. Our principal practice areas are:

- real estate
- corporate and securities law
- general business and commercial law
- cooperative and condominium matters
- financial institutions (loan transactions, leasing, acquisitions, credit restructuring, workouts and foreclosures)
- estate planning
- trust and estate administration
- general litigation and alternate dispute resolution
- matrimonial and family law
- taxation

Clients of the firm range from major financial institutions and public corporations to closely-held businesses, individuals and families.

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