Tax Escalation

Issues Arise When a Building Changes

Rent escalation clauses are frequently found in commercial leases. They are often the subject of controversy because they can be a significant source of additional revenue for the landlord and, conversely, a major burden to the tenant not calculable upon the initial signing of the lease.

A recent decision by the New York County Civil Court (Paul G. Feinman, J.) in *1152 First Avenue, LLC v. MNY Holdings Associates, LLC*[1] illustrates the kind of dispute that can arise concerning a real estate tax escalation provision and highlights some legal principles relevant to such a provision. This article discusses the reasoning of that case and the legal precedent it cites.

The case was a non-payment proceeding concerning the building at 1152 First Avenue. In August 1995, petitioner's predecessor leased the subject premises to respondent's predecessor. On or about July 2002, respondent acquired the lease at a bankruptcy auction.

On about April 22, 2001, petitioner converted the building to a condominium consisting of a residential unit with multiple apartments and a commercial unit occupied by respondent. Before that, the building was considered a single unit with a single landlord and was designated as a single tax lot. The condominium declaration apportioned the interests in the common areas as 24 percent to the commercial unit and 76 percent to the residential unit. In June 2001, petitioner sold the residential unit to a non-profit, tax-exempt corporation. It remained the owner of the commercial unit, where respondent is its tenant.

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The Lease

Article 15 of the lease pertains to real estate tax payments. As quoted in the court's decision, it provides in relevant part:

"Tenant agrees to pay seventy-five percent 75% of any and all increases in the real estate taxes assessed and levied against the Building and the land appurtenant thereto above the taxes paid for the year 1995-1996 (as well as any assessment(s) imposed upon the Premises for any purpose whatsoever during the term), whether the increase in taxation results from a higher tax rate or an increase in the assessed valuation of the Premises, or both ... "

The base year was changed to 1996-1997 by another article of the lease.

The amount of the real estate tax payments by petitioner was not disputed. In the base year of 1996/1997, it paid $44,740.96. Now owning only part of the building, petitioner paid $15,123.04 in real estate taxes in the tax year 2002/2003 and for 2003/2004, it will pay $22,684.76.

Respondent emphasized that petitioner's real estate taxes for 2002/2003 and 2003/2004 were less than the taxes petitioner paid in 1996/1997. Accordingly, respondent contended, it could not be charged for any real estate taxes because Article 15 of the lease provides that the tenant must pay 75 percent of all increases in taxes above the base year. Respondent moved to dismiss the petition on the ground that petitioner's claim that real estate taxes were due and owing was erroneous as a matter of law.

In opposition, petitioner contended that Article 15 of the lease "was drafted with the contemplation that the building would remain a single unit owned by a single landlord." Although admitting that the real estate taxes charged to it for the 2002/2003 and 2003/2004 tax years were less than the taxes paid in 1996/1997, petitioner argued that such a result was because the amount charged in 1996/1997 was for "a different property" than what petitioner was being charged for in the later years. Petitioner argued that the assessed value of the building continued to rise, as reflected in annual tax increases, and the intent of Article 15 of the lease was to pass along 75 percent of such tax increase to the tenant.

Petitioner further asserted that there must be a "reasonable and equitable" determination of the amount of real estate taxes owed by the tenant which would reflect that the space was escalating in value even though, given what transpired, petitioner was only taxed for 24 percent of the space. Petitioner computed what it claimed due from the tenant by assessing 24 percent of what was owed in the base year of 1996/1997 ($10,737.83), comparing that amount to the total amounts actually owed in 2002/2003 ($15,123.04) and 2003/2004 ($22,684.76) and taking 75 percent of the difference of each of those amounts.

Thus, for example, for 2002/2003, the real estate taxes were $15,123.04. Petitioner subtracted the base year amount ($10,737.83) from that, resulting in a difference of $4,305.21. It then took 75 percent of that difference, totaling $3,288.90. Applying the same methodology to the 2003/2004 year, petitioner calculated the real estate taxes due from the tenant for that year to be $8,960.20, making an aggregate for the two tax years of $12,249.10. (In its decision, the court noted that these amounts "differ greatly from the total amount of $32,991.16 claimed in the petition as being owed.")

Petitioner also argued that at the time of entering into the lease, neither party contemplated that the original building, assessed as one unit, would become in essence two parcels, with the petitioner responsible for taxes only on the smaller portion and thus with a proportionately reduced tax burden. Petitioner urged the court to reinterpret the real estate tax escalation clause "to reflect these changed circumstances."

The court found petitioner's argument for reinterpreting the lease terms to be "unpersuasive" and granted respondent summary judgment dismissing the petition. Judge Feinman commented that "[i]t is not the role of the court to remake a bargain entered into because of mistake, nor does the Civil Court have jurisdiction to reform a lease agreement (CCA §203)."

A recent decision in New York County Civil Court illustrates the disputes that can arise over a real estate tax escalation provision, and some of the relevant legal principles.

The Civil Court found the cases relied on by petitioner to be distinguishable, referring specifically to *Bryant Park Building, Inc. v. Acunto*,[2] *Credit Exchange, Inc. v. 461 Eighth Avenue Associates*[3] and *Blackstar Publishing Co. v. 460 Park Associates*.[4]

In *Bryant Park*, a 1928 case, the Municipal Court of New York, Borough of Manhattan, held that the tenant was not required to pay real estate taxes resulting from an increased assessment arising out of the landlord's addition of nine stories to the building. The court stated that "[i]t would certainly be distorting the intent of the parties to hold that they contracted with anything other in view than the building as it then existed [at the time of lease execution]."

In *Credit Exchange*, the tenant leased one floor of what was then a 22-story building. The lease included a provision for the tenant to pay 41/2 percent of any increase in taxes on the land and building beyond $203,342.50 annually. Faced with a real estate tax bill that had increased by more than 100 percent from 1984/1985 to 1985/1986, and believing that the increase was due to the addition of two floors rather than to any improvements benefiting its space, the tenant commenced an action for a judgment declaring that its 1985/1986 tax obligation was limited to that of 1984/1985. The landlord sought summary judgment dismissing the complaint.

The trial court granted that relief, but the Appellate Division, First Department, reversed. It found that summary judgment was precluded because there were "issues of fact ... whether all or part of the increased assessment for 1985/1986 resulted from

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an unforeseen addition of two floors and the improvements affecting only those two floors, and to what extent, if any, the other improvements [e.g., redoing the main entrance and lobby, upgrading the freight elevators, resurfacing the exterior of the building] contributed to the assessment increase."

The Appellate Division also noted that the percentage the tenant was to pay of tax increases (41/2 percent) was determined by its occupying one floor out of 22. Accordingly, the court continued, "an issue therefore exists whether the enlargement of the building to 24 floors should decrease proportionately the percentage to be paid by the plaintiff."

The Court of Appeals affirmed the Appellate Division decision, agreeing that triable issues of fact existed whether, and to what extent, the increased assessment "was attributable to improvements made to the exclusive benefit of the landlord." The Court of Appeals stated that it is "not the aim of [a tax escalation] clause, ordinarily, to impose upon the tenant responsibility for increases in real estate taxes resulting from improvements on the property redounding solely to the benefit of the landlord."

In *Blackstar Publishing Co., Inc. v. 460 Park Associates*, after the tenant (Blackstar) had entered into its lease, the landlord negotiated a long-term lease for six floors of the building with another tenant. The landlord then implemented a major renovation program with respect to those six floors and the lobby, resulting in a dramatically increased real estate tax assessment.

The tenant claimed that the parties to the lease did not intend that increases in real estate taxes attributable to major renovations to the building that did not benefit Blackstar could be passed through to it. It paid the increases under protest, and then brought an action for a declaratory judgment that it had no liability for the tax increases, and for restitution. It moved for summary judgment, and the landlord cross-moved for summary judgment dismissing the complaint and declaring that the tenant was required to pay the real estate tax escalation.

A Rule on Lease Construction

In a 1987 decision by then-Supreme Court, New York County (and now, Appellate Division, First Department) Justice David B. Saxe, the court denied the respective summary judgment motions. It stated that a rule of lease construction "that recognizes the condition of the premises at the time that the lease was entered into and the reasonable commercial expectations of both signatories to the lease" is one that "deserves our favored attention."

Under that principle, the court concluded, it would be unfair to pass along to Blackstar any increase in real estate taxes attributable to improvements done only on another tenant's space. However, there were improvements that had been performed on common areas. As to those, the court stated that "it cannot be said, as a matter of law, that such renovations that seem to have benefited all tenants (including Blackstar) were not reasonably foreseeable" at the time Blackstar signed its lease. Accordingly, the court concluded that neither party was entitled to summary judgment.

The court in *1152 First Avenue* distinguished these three cases from the fact situation before it. In the three cases, Judge Feinman pointed out, the building owners' actions (i.e. adding floors, making extensive renovations) "resulted in sudden large tax obligations for which the tenants argued they were not responsible." By contrast, in the 1152 First Avenue case, far from increasing the value of the building in any way, the landlord "instead sold the greater portion of the premises," and its action "resulted in an overall decreased tax obligation." Under such circumstances, the court held, "if petitioner wished to continue to pass along a portion of the reduced tax assessment, it should have caused the lease to be amended to reflect this changed circumstance."

In *1152 First Avenue*, the Civil Court also emphasized that, in seeking real estate tax escalation payments from the tenant when its actual real estate taxes had decreased, the landlord was asserting a claim for real estate taxes that it did not owe. That, said the court, contravenes the legal principle that "a landlord may not collect taxes which are not actually owed."

"1152 First Avenue" is an example of a situation where a commercial tenant negotiated an attorneys' fee clause that protected both tenant and landlord.

In support of that legal principle, the court cited decisions by the Appellate Division, First Department from each of the last three decades, namely, *Fairfax Co. v. Whelan Drug Co., Inc.*[5] (1984), *S.B.S. Assoc. v. Weisman-Heller, Inc.*[6] (1993) and *Ran First Associates v. 363 East 7 68th Street Corp.*[7] (2002).

In *Fairfax*, for example, although the tax assessment had increased from the base year, the landlord's actual tax bill was reduced, due to J51 exemptions, by over 50 percent from the tax bill in the base year. The court stated that "[t]o allow a 4.95 percent payment on taxes not requiring actual payment would provide Fairfax with a windfall not envisioned by [the escalation] clause."

The following are additional points to consider in connection with the 1152 First Avenue case:

We have frequently written in this column about attorneys' fees pursuant to Real Property Law § 234. That is a statute that is applicable only in the residential context. It provides that where there is a lease provision for the landlord to recover attorneys' fees from the tenant if the landlord prevails in a lawsuit based on tenant's breach of lease, a reciprocal provision for the landlord to pay a successful tenant's legal fees will be implied.

RPL § 234 is inapplicable to a commercial tenant. Its right, if any, to attorneys' fees is based on the contractual arrangement reflected in its lease. The typical commercial lease, drafted by the landlord, only provides for the landlord to receive attorneys' fees. *1152 First Avenue*, however, is an example of a situation where the commercial tenant negotiated in the lease an attorneys' fee clause that protected the tenant, as well as the landlord.

Accordingly, having dismissed the summary proceeding, the court in *1152 First Avenue* stated that the respondent was the prevailing party and, as such, was "entitled to an award of attorneys' fees in accordance with the terms of the lease." The Civil Court severed the issue of such fees for determination at a hearing. We are informed by Richard L. Cohn, Esq., attorney for the respondent, that the attorneys' fee hearing has been stayed pending the landlord's appeal, which is scheduled for the May Term. The landlord's counsel is Rose & Rose.

As noted above, the Civil Court in *1152 First Avenue* mentioned that the amounts which the landlord argued in its opposition papers to the tenant's summary judgment motion were due for real estate taxes for the two tax years at issue "differ[ed] greatly" from the amounts claimed in the petition as owed for such taxes. While the court did not assert that discrepancy as a basis for its rejection of the landlord's claim for real estate taxes, one can speculate whether the landlord's credibility suffered in the court's eyes as a result of that discrepancy.

The landlord's apparent change in position as to the sums it was claiming due for real estate taxes raises another question. As summarized in the court's decision, the landlord was seeking $3,288.90 for the tax year 2002/2003 (i.e., July 1, 2002 through June 30, 2003). However, in the predicate rent demand, as attached to the petition, the real estate taxes sought for the 2002/2003 tax year (identified as September 2002 and March 2003 real estate taxes) aggregated $10,995.58.

Assuming, arguendo, that the Civil Court had found, as it did not, that the landlord was entitled to real estate tax escalation under the factual situation of the case, could recovery of those taxes still have been denied because the amount the landlord ultimately claimed as due was substantially less than what it had claimed in the predicate rent demand? Could an argument have been be made that there had not been a good faith rent demand? Discussion of that question is beyond the scope of this article.

1. Civil Court of the City of New York, New York County, L&T Index No. 087301/03, n.o.r.

2. 133 Misc. 225, 231 N.Y.S. 451 (N.Y. Mun. Ct., Borough of Manhattan 1928).

3. 119 A.D.2d 216, 506 N.Y.S.2d 168 (1st Dep't 1986), aff'd 69 N.Y.2d 994, 517 N.Y.S.2d 903 (1987), reargument denied 70 N.Y.2d 748, 519 N.Y.S.2d 1034 (1987).

4. 137 Misc.2d 414, 520 N.Y.S.2d 922 (Sup. Ct., N.Y. Co. 1987).

5. 105 A.D.2d 647, 481 N.Y.S.2d 366 (1st Dep't 1984).

6. 190 A.D.2d 529, 593 N.Y.S.2d 28 (1st Dep't 1993).

7. 297 A.D.2d 506, 747 N.Y.S.2d 13 (1st Dep't 2002).