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Expert Analysis

Keeping Up With Escalation Clauses

A recent decision by the Appellate Division, First Department, *Murray Hill Mews Owners v. Rio Restaurant Associates*,[1] evidences the importance for commercial tenants, with annual rent escalation provisions in their leases, to review and analyze their leases and the landlord's billing statements when annual increases go into effect.[2] Likewise, to avoid long-term uncertainty and potential litigation years into a tenancy, commercial landlords must carefully review and analyze their rent escalation provisions—and then re-review and re-analyze them—well before execution of the lease. Recycling such provisions which worked (or were fortunately not challenged) in the last decade, will no longer work today when there is a whole industry specializing in auditing escalations. And boilerplate provisions lifted verbatim from other leases or from real estate treatises—while ostensibly a cost-saving device—is surely a recipe for litigation.

This need for re-examination, re-review and re-analysis is made more manifest by the history of this recent decision where the lower court, on landlord's motion for summary judgment, ruled in favor of the landlord as to its application of the annual rent escalation provision for more than seven years. The Appellate Term reversed and ruled that there was an issue of fact—an ambiguity—in the application of the rent escalation provision which had to await a trial. The Appellate Division reversed the Appellate Term, reinstated the lower court, and ruled that the landlord's application of the unambiguous rent escalation provision was the proper one without the need for a trial.

All of this could have been avoided before the lease was executed or, at the very least, early on before establishing a course of dealing between the parties.

Furthermore, the need for continuing annual examination both by landlords and tenants is all the more brought to the forefront when there is a looming statute of limitations that may preclude any claims by the tenant for recoupment of overpayments or for reformation of the lease to cover any rent increase issue in the future.

By **Menachem J. Kastner**

'Murray Hill Mews'

In *Murray Hill Mews*, in which the author was counsel for the landlord, there was a rent escalation provision which provided for two different methods of calculating annual rent increases. In short, the landlord could increase the rent by the greater of either 3 percent of the last lease year rental or by half of the Consumer Price Index (CPI) percentage increase over the base year. Thus, if the CPI increase was above 6 percent, the landlord would naturally apply the CPI formula because half of that was greater than the flat 3 percent formula.

> Rent escalation provisions in a lease must, in the first instance, be carefully drafted and reviewed to ensure their clarity and precision.

The issue before the court was, under the terms of the rent escalation provision, whether the CPI increases were to be added to the original base year rental (without any intermittent CPI increases) or whether they were to be cumulative and added to the prior lease year which already included prior CPI increases. Clearly, the difference in application would greatly affect the annual rents. In the second application, the increases would be exponentially greater than under the first application. Furthermore, in the case before the court, the landlord had billed the tenant for more than seven years at its calculation of the annual increases, to wit, adding the CPI increase to the prior year's rental, and tenant paid the amounts billed by the landlord without comment or objection.

In addition, as the lease was approaching its expiration date, the tenant requested a five-year extension. In entering into the extension agreement, the tenant was required to provide an increased letter of credit reflecting a certain number of months at the then current rental. The amended letter of credit was calculated by the parties at the annual rental as had been billed and determined by the landlord. Thus, in providing an amended letter of credit in connection with the five-year extension, the tenant implicitly conceded the landlord's long-term cumulative calculations.

After the five-year lease extension had been executed, the tenant, after seven years of rent payments according to the landlord's calculations, voiced its objection to the landlord's method of calculation and refused to pay the higher rent, recalculated the rent increases and started paying rent on a non-cumulative basis. The landlord brought a nonpayment proceeding in the Civil Court; the tenant answered, asserting that the landlord's method of calculation was incorrect and that it was entitled to an offset against current rents in the amount overpaid over the years. The landlord moved for summary judgment on its claims, arguing that its method of calculation of the annual escalations was according to the express terms of the lease, as acknowledged by the parties' long course of conduct.

The Civil Court granted summary judgment to the landlord, holding that the terms of the lease were clear and unambiguous in their application and that the tenant's method of calculation would render meaningless various provisions of the lease. The court went on to say that, even if there were an ambiguity in the provision of the lease, the course of conduct of the tenant paying rent for more than seven years as calculated by the landlord and in then entering into a lease extension agreement adopting landlord's method of calculation, resolved any ambiguity and that the parties' long course of conduct established the proper reading of the lease to be that of landlord's. There were other issues involved that are not germane for the purpose of this article.

Appeals

The tenant appealed to the Appellate Term, First Department. That court, contrary to the Civil Court, found that the terms were ambiguous and that a trial was necessary to resolve any

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open issues of interpretation. Furthermore, the Appellate Term found that the long course of conduct of the parties did not definitively resolve any ambiguity and, thus, a trial was necessary.

On appeal by the landlord, the Appellate Division, First Department reversed the Appellate Term and reinstated the Civil Court decision, sending the case back to the Civil Court for a determination of the amount of rents due to the landlord. The Appellate Division found that the rent escalation clause at issue was not ambiguous and that landlord's reading was correct.

Furthermore, the First Department found that the parties' long course of conduct, including the lease extension, resolved any purported ambiguity. The case was ultimately settled prior to any determination by the Civil Court on remand.

Lessons Learned

The case should make evident to every commercial landlord and tenant (and their counsel) that rent escalation provisions in a lease must, in the first instance, be carefully drafted and reviewed to ensure their clarity and precision. And, in the second instance, after execution, they should be re-reviewed, preferably annually when rent bump-ups go into effect. Typically, rent escalation provisions span various pages of a lease rider with convoluted and complex language, defined terms that are not so well defined, and references back to other provisions of the lease, making a reading of these clauses a minefield for the inexperienced.

When tenants receive monthly rent statements immediately after a rent escalation increase, they must read and re-read these clauses as to their intended and executed application. This is true especially where the rent escalation clauses provide various alternate formulae in calculating such increase (as in the case under discussion) with the landlord having the right to choose which formula gives the landlord higher increases. Simply writing the check month after month, year after year, will establish, as was established in *Murray Hill Mews*, a course of conduct of the parties which may resolve, against the tenant, what may seem to be an ambiguity.[3]

Notably, many law firms have a practice of having a real estate litigator review pivotal lease provisions—such as the alteration, default, remedies, security, renewal, purchase option, and rent/operating expense escalation provisions—before finalizing leases for execution (or becoming part of the firm's "form" leases). Such "preventative" review by one experienced in litigating the nuances of lease construction and interpretation can prevent unnecessary (and embarrassing) litigation years down the road.

Recommendations

A few pointers for both landlords and tenants are the following.

Pre-Execution Due Diligence

• Before tenant signs the lease, it should ask for a history of operating expenses and real estate escalations or determine the pattern of CPI escalations and compute the escalations based upon such history to eliminate surprises.

• If the escalation clause is complicated, examples of various scenarios should be included in the lease to demonstrate how the escalation clause works. These examples will be helpful in resolving ambiguities in the actual provisions and will establish by example whether or not an escalation was meant to be compounded. There are many court decisions that have looked to such examples in disposing of alleged ambiguities.[4]

Landlord Provisions

• Landlord should include a "binding and conclusive" provision, which provides for a cut-off date—e.g., 30 days—by which the tenant must object to landlord's escalation statement. And, if tenant does not object within 30 days after receipt of the statement, the escalation statement is closed out—deemed conclusive and binding—and no further objections are allowed. The courts have repeatedly upheld such binding provisions.[5]

• Landlord's failure to bill or make demand is not a waiver of any right to subsequently bill omitted items or to correct improperly billed amounts.

Tenant Provisions

• A sunset provision is the converse of the landlord's "binding and conclusive" clause. Thus, if landlord does not bill or underbills, then, after a certain period of time, the sun goes down and the landlord cannot collect those escalations. This should be drafted so as to override the boilerplate no-waiver provisions found in most leases.

• Caps. Tenants can provide for a cap on increases such as "Under no circumstances will the annual increases exceed the prior year's payment by more than [__] percent." Nice and simple. No surprises.

• Right to Audit. Tenants can provide for an ongoing right to review and dispute escalations statements and specific methods for disposing of such disputes (arbitration or courts), whether increased disputed payments are to be made until the dispute is resolved or to be made only after the dispute is resolved, whether the increase goes into effect upon the arbitrators issuing an award or upon confirmation by the court, what interest is to be paid on over or under payments, and the like.

Another reason why annual vigilance is necessary in reviewing these leases is because of a looming statute of limitations. In this regard, in New York, there is a six-year statute of limitations for suing for a breach of contract, including a lease. Thus, where there have been annual breaches of a lease whereby a tenant is being overcharged every year, the general statute of limitations provides that a tenant can only sue for the last six years of overcharges and cannot go back for any earlier years.

However, in the area of landlord/tenant law applicable to leases, there is appellate authority which holds that where a landlord has continuously used an incorrect formula in calculating various escalations under a lease for a period of more than six years, the tenant is barred from recovering any of those improper overcharges even if the bulk was within the last six years. In effect, the statute of limitations was triggered by the first overcharge more than six years before and bars any recovery—even of payments made within the last six years.[6] Thus, for example, if a tenant's proportionate share of real estate taxes is 1.5 percent of the total real estate taxes, and where the landlord has been charging the tenant 3 percent for the last 10 years and the tenant has paid that 3 percent, under this decision, the tenant is precluded from recouping even those overcharges within the six-year period.

The court held that the statute of limitations began when the first overcharge occurred and if the very same mistake (i.e., method of calculation) occurs for more than six years, there is no recoupment at all. This further evidences the need for constant review of the applicable lease provisions governing rent increases, as well as reviewing the landlord's annual true-up statements and monthly rent bills.

Conclusion

Escalation provisions are complex in form and very dry reading. However, as demonstrated above, the failure to carefully read and understand such provisions can be costly. In the end, the time expended to understand these clauses will be well worth it. As the court in *Murray Hill Mews* stated: "Even if the result of this construction is economically harsh, where, as here, the lease is entered into at arm's length between two sophisticated parties, the courts will not interfere."

1. *Murray Hill Mews Owners v. Rio Restaurant Associates*, 26 Misc.3d 1224(A)(Civ. Ct. N.Y. Co. 2010), reversed, 30 Misc.3d 129(A) (App. Term 1st Dept.), reversed, __A.D.3d__ (1st Dept. 2012).

2. While this article focuses on rent escalations, it is equally applicable to other escalations such as operating expense, real estate taxes, etc.

3. The appellate courts have frequently looked to the parties' course of conduct in resolving any ambiguities in the parties' agreement. See e.g. *Ins. v. Dutcher*, 95 U.S. 269, 273 (1877) ("The practical interpretation of an agreement by a party to it is always a consideration of great weight. The construction of a contract is as much a part of it as anything else. There is no surer way to find out what parties meant, than to see what they have done"); *One Hundred Grand v Chaplin*, 70 A.D.3d 513 (1st Dept. 2010); *Waverly Corp. v. City of New York*, 48 A.D.3d 261 (1st Dept. 2008); *Citibank v. 666 Fifth Ave.*, 2 A.D.3d 331 (1st Dept. 2003).

4. See *Milt Holdings v. 181 PM,* 27 Misc. 3d 136(A) (App Term 1st Dept.).

5. See e.g. *Home Ins. v. Olympia & York Maiden Lane,* 219 A.D.2d 469 (1st Dept. 1995); *Salomon Smith Barney Holdings v. 7 World Trade*, 278 A.D.2d 63 (1st Dept. 2000); *115 E. 9th St. Retail v. STA Travel,* 18 Misc.3d 133(A) (App. Term 1st Dept. 2008).

6. See *Goldman Copeland Associates v. Goodstein Bros. & Co.,* 268 A.D.2d 370 (1st Dept. 2000); *Kramer Levin Naftalis & Frankel v. Metropolitan 919 3rd Ave.,* 6 Misc.3d 796 (Sup. Ct. N.Y. Co. 2004).