

Avoiding Expensive Drafting Mistakes in Commercial Leasing

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It is no surprise that ambiguous provisions in a commercial lease can be very costly to an owner. Clarity of drafting is particularly important in the financial provisions of leases, especially rent escalation clauses. An owner unable to recover expected escalations due to sloppy drafting will be justifiably critical of his counsel: In this case ambiguity breeds contempt.

The importance of accurate and precise drafting in determining landlord and tenant obligations is even more critical in challenging economic times. Lease audits have become more prevalent as corporate tenants look to cut expenses. Ambiguous clauses can provide a predicate for a tenant's overcharge claims, or defenses against owner's efforts to collect additional rent, or even base rent.

Even if those claims or defenses are ultimately proven unfounded, the cost of collection can be substantial, particularly in attorney's fees. The problem is exacerbated when a drafting ambiguity is repeated in numerous leases for the same property, and multiple tenants mount challenges to the enforceability of the rental clause.

'Citibank'

Such a situation arose in *Citibank, N.A. v. 666 Fifth Avenue Limited Partnership*, (___ A.D.2d___, N.Y.L.J., Nov. 20, 2002, p.23, c. 1).

The main issue in *Citibank* was whether the escalation provisions allowed for a reduction in the tenant's fixed rent when the real property taxes were reduced below the base-year amount.

Citibank entered into two leases for office space at 666 Fifth Avenue in 1989. The leases contained similar terms and included an "escalation" (paragraph 1) stating that the fixed rent would be adjusted to reflect fluctuations between annual real estate taxes and comparable taxes for the base-year .

The lease provided:

"If the Taxes payable for any Tax Year . . . shall represent an increase above or decrease below the Base Taxes then the Fixed Rent for such Tax Year and continuing thereafter until a new Tax Statement is rendered to Tenant, shall be increased or decreased, as the case may be, by Tenant's Share of such increase or decrease."

The tax escalation adjustment formula was further addressed in the following paragraph (paragraph 2):

"[If] as a result thereof a refund of Taxes is actually received by or on behalf of Landlord, then promptly after receipt of such refund, Landlord shall send Tenant a Tax Statement adjusting the Taxes for such Tax Year and setting forth Tenant's Share of such refund and Tenant shall be entitled to receive such Share by way of a credit against the Fixed Rent next becoming due after the sending of such Tax Statement; provided however that Tenant's Share of such refund shall be limited to the amount, if any, which Tenant had theretofore paid to landlord as increased Fixed Rent for such Tax year."

Citibank cited paragraph 1 in arguing that the parties specifically contemplated and intended an actual reduction in fixed rent when taxes fall below the base-year amount. The landlord countered that paragraph 1 could not be read alone. When considered in context with the limiting clause in paragraph 2, Citibank could only be entitled to a credit against escalations that it had previously paid and the base rent was never intended to be decreased.

Ambiguous Language

In denying each party's summary judgment motions, the court decided that the lease language was ambiguous at best and it could not conclusively determine the parties' intent regarding whether a credit against fixed rent was intended as a result of the reduction in taxes.

To resolve the issue, the court looked outside the four corners of the lease and examined extrinsic evidence. It noted that it would be important to examine prior drafts of the lease to ascertain the intent of the parties. However, neither party produced earlier drafts of the lease. Testimony at

trial also failed to offer any indication of the intent of the parties as to a fixed rent reduction.

There was only one witness noted by the court who testified about the current norms in the New York City commercial leasing market. Consistent with the general lack of clarity of the facts presented to the court, one witness' testimony was actually cited by both sides in support of their respective positions. On one hand, the witness stated it was not common for a tenant to be granted a credit against fixed rent when taxes are reduced below the base-year amounts. The same witness later testified that he has a number of clients whose leases contain such clauses. Due to the inherent inconsistencies, the court apparently discounted the evidentiary value of the witness' testimony.

Ultimately, the most compelling factor in the court's decision was the conduct of the parties. The court found that Citibank had been a party to countless commercial leases in New York City and Citibank could not identify one instance where it would be entitled to reduction in fixed rent by virtue of a reduction of taxes below the base-year level. A longtime employee responsible for administering leases testified that he "never sought to insert a clause in a lease providing for a reduction in the fixed dollar amount rent based upon a lowering of the real estate taxes below that paid in a base period." It was clear that based on its past lease negotiations, there was no expectation on the part of Citibank that it would be entitled to a fixed rent reduction under these facts.

Delay Critical

The delay in asserting Citibank's claim also was critical to the court's decision.

The lease was executed in 1989. Throughout the term of the lease, Citibank had received numerous copies of tax bills and statements reflecting tax escalations. Citibank had retained numerous employees to examine and review the escalation provisions in the hundreds of commercial leases to which Citibank was a party.

Despite the monitoring of these leases, Citibank failed to assert its claim for a fixed rent credit against the landlord of 666 Fifth Avenue until nearly ten

years after the leases were signed, and only after Citibank had engaged a lease-auditing firm.

Citibank explained that it did not assert a claim for the credit largely because it did not know it was entitled to one. The Court inferred from the action, or rather inaction, of Citibank, that since Citibank did not believe it was entitled to a reduction in fixed rent, then the parties never intended a rent reduction of the type Citibank demanded and, accordingly, the Court dismissed Citibank's action.

Similar Attempts

Citibank was not alone in its attempt to challenge the escalation provisions in leases for 666 Fifth Avenue. Several other tenants forged similar attacks to pursue rent reductions based upon the ambiguous clause.

In *Executive Office Network, Ltd. v. 666 Fifth Avenue Partnership*, 294 A.D.2d 166, 742 N.Y.S.2d 36 (1st Dept., 2002), the tenant contended that it was entitled to a reduction in the fixed rent based upon operating expense reductions below base year amounts of the operating expenses for the building. Citing similar escalation provisions to those found in *Citibank*, the lower court agreed with the tenant in *Executive Office* and awarded the tenant summary judgment for nearly \$500,000.

However, in vacating the award, the First Department reached the same conclusion in the lease interpretation as the *Citibank* court. In fact, the *Executive Office* court found the language so confusing that it labeled the lease provisions "hopelessly ambiguous" and ordered the resolution of the issues to be tried.

Another tenant of 666 Fifth Avenue suffered a similar fate.

In *Agip Petroleum Co., Inc. v. 666 Fifth Avenue Limited Partnership*, 297 A.D.2d 483, 746 N.Y.S.2d 717 (1st Dept., 2002), the tenant was awarded summary judgment for more than \$100,000 claiming that it was entitled to a reduction in fixed rent as a result of a decrease in both the taxes and operating expenses under the base-year amounts.

The First Department vacated the award and dismissed the tenant's

complaint relying on the fact that Agip failed to notify the landlord of objections to the tax and operating statements in a timely manner.

Interestingly, this time the appellate court found no ambiguity in the drafting of the lease contrary to the same court's holdings in *Citibank* and *Executive Office*.

The panel, which included two of the same judges who concurred in *Executive Office*, concluded that the subparagraphs of the escalation provision, substantially in the same form as in the *Executive Office* and *Citibank* leases, determined that the fixed rent should not be altered.

The fact that different panels in the same court had opposing views on substantially the same lease, with similar fact patterns, only further underscores the severity of the problems encountered because of the ambiguity of the lease. But what was the ambiguity that would have caused courts to award summary judgment to two separate tenants, only to have them reversed at the appellate level?

Neither the landlord nor its attorneys intended to have an ambiguous lease. They labeled it an "escalation" clause and yet two tenants were awarded substantial rent reductions that were later reversed and remanded on appeal. The landlord may ultimately prevail, but not without lengthy litigation, including appeals addressing the "hopelessly ambiguous" clause. Perhaps the landlord will be spared because the tenant presented virtually no credible evidence that the parties intended that fixed rent would be reduced due to lower real estate taxes, or that the tenant itself believed it was entitled to such a reduction, or that such clauses are customary in New York City leases. One wonders whether the next tenant who sues 666 Fifth Avenue Limited Partnership will learn from these mistakes.

Recommendations

The problem suggests the solution. The practitioner should consider the following:

Keep it clear. "Fixed rent" or "base rent" should stay fixed and immutable. Your client's mortgage lender needs to know that these amounts can never decrease. Additional rent should encompass all escalations and any credits

or refunds. Review your form leases with a critical eye, as a disinterested third-party arbiter would, to uncover potential ambiguities. If there is any conceivable interpretation of an important clause that differs from yours, clarify the language.

Use examples. Sample calculations and examples are excellent for clarifying a concept that may be difficult to follow. Remember, though, that examples are not a cure for poor drafting. They should be used to illustrate how a clause works and to help the reader follow the computation. Do not rely on a clear example to repair a problematic clause.

Get help. After finishing the lease, the landlord's administrative or financial staff should do the billing, not you. Make sure that they understand the clause, are instructed how to bill it correctly, and concur with you that it is consistent with the landlord's financial recordkeeping practices. Obviously, this should be done before the lease is signed.

Retain lease drafts to establish intent. Lease drafts can evidence intent. If the court looks beyond the "four corners" of the lease, prior drafts that covered the issue could estop a claimant from taking a variant position. Modern document imaging techniques, e-mail and retaining drafts on a CD-Rom may be more manageable than maintaining paper files for the number of years of the lease term.

Don't wait. Courts deem it important whether a party acquiesced in the interpretation suggested by their adversary. Any objection to the landlord's rent escalation statement should be raised promptly. Even though a claim is still viable within the statute of limitations period, the fact that a claimant sat on its presumed rights is given considerable weight by a court.

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