

## Appellate Division Rules on Commercial Leasing

### When Sympathy Trumps Contractual Rights

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Many times, cooperatives and condominiums have commercial retail spaces connected to or below their building. These are immensely valuable as a result of the income generated by these stores and restaurants. Ergo, the importance of a new decision from the Appellate Division. Two decades ago, New York Courts allowed equity to trump the law and case precedents in many of its commercial leasing decisions. During the new millennium, the pendulum swung back to enforcing contracts and leases as they have been written no matter how painful and obtrusive the result. According to a recent commercial leasing decision by one of the Appellate Division's most reputable judges, this pendulum may be swinging back to allowing empathy and sympathy override a contractual provision.

#### Equity in Leasing?

Is "equity" more powerful than enforcing the terms of a renewal lease option in a lease between two sophisticated business entities? In *135 East 57th Street LLC v. Daffy's Inc.*, the Appellate Division, First Department, signaled that it is.

It has long been the law that a notice exercising an option to renew a commercial lease is ineffective if it is not given within the time specified in the lease between the landlord and tenant. However, since the result—termination of the leasehold at the expiration date—can be extremely harsh, over the years the courts have created certain exceptions to the rule. Thus, a commercial tenant can be relieved of its failure to timely exercise its renewal option when (i) the failure to timely renew is caused by an honest mistake or inadvertence (ii) the landlord will not be prejudiced by the renewal and (iii) the non-renewal will result in a substantial forfeiture to the tenant. Regarding the third prong, courts will usually look to whether the tenant has made any substantial improvements to the space with the intent to renew in mind.

In *Daffy's*, the lease provided the tenant with two five year renewal lease option periods. The option had to be exercised one year before the term was set to expire. The tenant provided notice four days late due to an error made by its comptroller. The landlord rejected the late exercise and immediately brought suit for a judgment declaring that the option terminated and that the lease would terminate at the expiration of its term. After a trial, where the court found for *Daffy's*, the landlord appealed to the Appellate Division, First Department.

The Appellate Division framed the issue as "whether [the lower court's] exercise of equitable authority was proper, given that the tenant did not provide that it had made substantial improvements in anticipation of continued occupancy."

The Appellate Division found that *Daffy's* had not made substantial improvements to the space in anticipation of renewal. While that should have ended the inquiry, the Appellate Division, in a ruling that is harmful to commercial landlords, nevertheless found that *Daffy's* could renew its lease.

## Tenant Engendered Goodwill

Initially, the Court found, that “the four-day delay in providing the one-year’s notice required by the lease did not prejudice the landlord.” But more important, the Appellate Division had found that “Daffy’s 57th Street store in particular had garnered substantial good will in its approximately 15 years at the location...” This conclusion was based upon evidence that the “57th Street store in particular had become highly successful and popular, that the company had searched for alternative space into which to relocate and had not identified any prospects, and that even if it found a viable site, it would require the better part of a year to open a new store.” The Court also looked to loss of jobs for the 114 employees of the location and the fact that the site was one of Daffy’s top producing rental locations.

Daffy’s is a particularly troubling decision for commercial landlords. The Appellate Division vitiated the landlord’s contractual rights under the lease because it appeared to feel “sorry” for the tenant and was angry at the landlord for bringing its declaratory judgment action almost immediately after it had rejected Daffy’s late notice of renewal. Whether Daffy’s will provide future commercial tenants with the authority to excuse their failure to timely exercise a renewal option if their “tale of woe” is found persuasive by some judge is not presently known. What is known, however, is that such a ruling leads to uncertainty in the commercial real estate market, a result to be avoided at all cost.

It will be interesting to see whether the landlord attempts to appeal to the Court of Appeals, and, if so, whether permission will be granted. The higher court has long taken the view in cases such as *Holy Props. V. Cole Productions* and *Maxton Bld’s v. LoGalbo* that in the area of real property law, certainty in an established rule trumps reliance upon another rule and that precedent should be followed.

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