

Considerations for New York City Commercial Leases

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This article was published in the Fall 2017 issue of Real Estate Finance Journal. © 2017 Thomson Reuters. Reprinted with permission.

New York City is home to Broadway, Times Square, the New York Yankees — and some of the most expensive real estate in the country. As a result, commercial leases in New York City tend to be difficult to navigate and negotiate for tenants — particularly for startups and small companies. This article will discuss several common pitfalls for tenants to avoid, and some local nuances for tenants to be aware of, when negotiating New York City commercial leases.

REBNY Form

Depending on the landlord and the size/type of the building, some landlords use an antiquated standard form of office lease, loft lease or store lease prepared by the Real Estate Board of New York (the REBNY Form).

This dual-column “boilerplate” form is rarely, if ever, used on its own and is often supplemented by a lease rider that amends and supersedes most, if not all, of the provisions in the REBNY Form. This begs the question of why the REBNY Form is still used. Nevertheless, many landlords in New York City continue to prepare leases using the REBNY Form. If a tenant is presented with the REBNY Form, there are several provisions to look out for, including:

- **The obligation to remove all tenant improvements and alterations in the leased premises at the end of the lease term.** As drafted, all fixtures, paneling, partitions, railings and other like installations shall, upon installation, become the property of the landlord and shall be surrendered with the leased premises at the end of the term “*unless Owner, by written notice to Tenant no later than twenty days prior to the date fixed as the termination of this lease, elects to relinquish Owner’s right thereto and to have them removed by Tenant, in which event the same shall be removed from the demised premises by Tenant prior to the expiration of the lease, at Tenant’s expense.*”

This restoration obligation could result in a tremendous expense and burden on a tenant at the end of the term and should be removed, if possible. As an alternative, most landlords will agree to either (1) notify the tenant at the time the landlord approves an alteration whether the alteration will need to be removed at the end of the term (as opposed to notifying a tenant shortly before the end of the term), which would give a tenant the opportunity to decide if the alteration is worth installing if it must then be removed at the end of the term, or (2) limit the restoration obligation solely to “specialty alterations” or alterations that are nonstandard alterations for an office space, such as internal staircases, raised flooring and supplemental air conditioning units, and which may cost more to remove than ordinary office installations.

- **The obligation to comply, at the tenant's sole cost and expense, with all present and future laws which shall impose a violation, order or duty upon the landlord or tenant with respect to the demised premises, "*whether or not arising out of tenant's use or manner of use thereof (including tenant's permitted use)*."** This seemingly innocuous provision can have tremendous ramifications if not revised properly. For example, if a new law requires an owner to install a sprinkler system in a building that, when initially constructed, predated the city's sprinkler code, then, based on this provision, a tenant could be required to install, at its expense, a sprinkler system within the premises.

Instead, tenants should only be required to perform such alterations within the premises or to the building necessary to comply with law if such compliance is required by reason of their *specific or particular manner of use* in the premises, as opposed to the permitted use under the lease (which, in most cases, is general office use). The theory here is that tenants should not be responsible for compliance obligations merely based on being a tenant in a building, but rather they need to be doing something (other than simply leasing the space) that results in such violation, order or duty.

- **The prohibition on assignments, subleases and transfers of stock or other ownership interest in the tenant.** Without any modifications to this provision, a tenant would be hamstrung in its ability to find other space (whether to downsize or grow its business), to sell or transfer control of its business, or to undertake other corporation transactions because any of these transactions would be prohibited without obtaining the landlord's consent. Therefore, it is important to make sure that this provision is modified to permit assignments, subleases, licenses and other occupancy arrangements with the landlord's prior consent, not to be to unreasonably withheld. Further, tenants should also negotiate the right to transfer the lease in connection with certain corporate transactions **without** the landlord's consent, such as (1) assignments or subleases to affiliates or subsidiaries of the tenant (or the parent of the tenant, as the case may be), (2) mergers, consolidations or reorganizations of the tenant and (3) the sale of all or substantially all of the tenant's assets, stock or other ownership interest. Most often, landlords will permit these corporate transactions without their consent provided that certain conditions are met, which may include a net-worth test and prior notice of such transactions.
- **Default for the nonpayment of rent.** As drafted in the REBNY Form, if a tenant fails to pay any rent required under the lease when due, the landlord may, **without notice**, *reenter the demised premises either by force or otherwise and dispossess the tenant by summary proceedings*. While this rarely, if ever, happens in practice, a landlord is still entitled to terminate the lease if the rent is not received when due. Generally, landlords are amenable to giving some period of written notice to the tenant before nonpayment of rent is deemed to be a default under the lease entitling the landlord to terminate the lease. At the very least, landlords may agree to give one or two written notices per year or lease term as a courtesy so that a tenant is not facing eviction if they are late in paying rent on occasion.

Base Years for Real Estate Taxes and Operating Expenses

In addition to base rent, most landlords will require tenants to pay additional rent in the form of real estate tax and operating expense escalations. Instead of annual percentage increases in base rent, tenants may be obligated to pay their proportionate share (*i.e.*, the ratio that the rentable square footage of the premises bears to the total rentable square footage of the building) of the real estate taxes and/or operating expenses for the building. Often, the tenant's proportionate share is based on the excess of the building's real estate taxes and/or operating expense over the real estate taxes and/or operating expenses for an agreed-on "base year."

For example, if operating expenses for the building are \$200,000 during the “base year” and \$250,000 during the subsequent lease year, then a tenant who occupies 10 percent of the building would be required to pay its proportionate share of the increase in operating expenses over the base year, or \$5,000 (*i.e.*, \$50,000 x 10 percent). It is important to negotiate for the most current base year (or even a future base year) in order to realize the most savings over the life of a lease. In addition, payments for real estate taxes and operating expenses should not begin until the year following the base year — or, if possible, for a year after the lease commencement date.

- **Real Estate Tax Base Years:** Tenants in a newly constructed building or a building that is currently undergoing (or recently underwent) substantial renovations must be careful that their base year properly reflects a fully assessed building, as these buildings will be reassessed to reflect the value of the construction or renovations. If the base year is artificially low (*i.e.*, the increased value is not reflected in the base year), tenants could be exposed to enormous increases in real estate tax escalations when the building is reassessed in later lease years. Therefore, it is critical that real estate taxes are based on the building as if it were fully leased and assessed or to select a later base year when the construction or renovation is completed and the building is fully assessed.
- **“Gross Up” for Operating Expenses:** Similar to protections for real estate tax escalations, tenants must also protect themselves against potentially large operating expense escalations by negotiating “gross up” provisions in the lease. If the building has a low occupancy rate during the tenant’s base year, then, as the occupancy rate increases, the tenant’s operating expense escalations may increase exponentially. However, if the lease states that the operating expenses for the building are based on a fully occupied building (*i.e.*, 95 percent or 100 percent occupancy rate) and the amount by which operating expenses *would have* increased had the building been fully occupied and operational and had all services been provided to all tenants, then the operating expenses will be regulated in an equitable manner for the tenant and the landlord. To fully benefit from this concept, the “gross up” language must apply to the base year, as well as to all future lease years.

Security Deposits

Depending on the creditworthiness of the prospective tenant, a landlord may require a security deposit equal to several months of base rent. If a landlord is requesting a high security deposit to overcome financial solvency issues, a tenant should try to negotiate for a reduction or a “burn down” in the amount of the original security deposit after a certain period of time, provided the tenant has been current in its rental payments.

While most landlords require the security deposit in the form of a letter of credit (to protect the security deposit from being clawed back into a bankrupt tenant’s estate), landlords that accept cash security deposits are permitted by law to keep up to 1 percent of the interest earned on the security deposit as an administrative fee. In some instances, such as with startups, small businesses or single-purpose entities, a landlord may also require a personal or corporate guaranty (depending on the tenant entity), which means that the guarantor will make the rent payments if the business fails. A less onerous form of guaranty is a “good guy” guaranty created to incentivize good behavior in tenants and to avoid the expensive and difficult process of remarketing the space while obtaining possession from the holdover tenant. The good-guy guaranty typically contains (1) a guaranteed period of time, (2) a limited and specified amount of payment, such as base rent and additional rent, and (3) specified scope of performance obligations other than payments. A tenant should try to limit the good-guy guaranty in the following ways:

- **Guaranty Period:** The guaranty should only cover the period of time that the tenant is in possession of the premises. Provided that the tenant has paid all rent and performed other specified obligations through the date it vacates the premises (albeit a date before the lease expiration date), then the guaranty terminates. Landlords typically require that tenants give a certain amount of advance notice before vacating the premises (anywhere between 30 and 90 days), and, if this notice is not given, the vacate date is extended for the same amount of time as the notice period. A tenant will want to limit the notice period to the shortest amount of time possible, if not eliminate the notice period entirely.
- **Guaranty Obligations:** The guaranty should only cover the payment of base rent and monthly recurring additional rent — as opposed to any and all charges and performance obligations under the lease. The guarantor should not step in the shoes of the tenant under the lease (as it would with a standard guaranty), but rather agree to be a “good guy” and pay the rent while the tenant is occupying the space. If the landlord is opposed to removing all performance-based obligations from the guaranty entirely, these obligations should be limited to very specific obligations, such as completion of work projects, removal of liens and surrender condition.

Use/Compliance With Law

Tenants leasing space in New York City must determine the permissible uses of a space under local zoning ordinances and the certificate of occupancy for the building to ensure that their intended use is permitted in the premises. For example, a financial services company leasing office space in midtown Manhattan has little to worry about in terms of using the premises for its intended use because most buildings in this area have certificates of occupancy for general office use. However, in lower Manhattan, many of the older buildings have outdated certificates of occupancy for warehouse, retail or other non-office uses or do not have certificates of occupancy at all. In these cases, a tenant will need the landlord to either amend the certificate of occupancy or represent that the tenant’s use will not be deemed a violation under the lease. In some cases, depending on the negotiating power of the tenant, a landlord may agree to give the tenant a termination right if the tenant is prohibited from obtaining work permits or conducting its business in the premises as a result of the existing certificate of occupancy or the lack thereof. Further, if the premises lies within a historic district or is in a landmarks building, a tenant may also need to comply with the rules of the New York City Landmarks Preservation Commission for certain alterations and improvements (including storefronts and exterior signage for retail tenants).

Local Taxes

Tenants may also be subject to a local use and occupancy tax on rents. Tenants leasing property for commercial activity are subject to the Commercial Rent or Occupancy Tax (CRT) if (1) the property is located in the borough of Manhattan, south of the center line of 96th Street, and (2) the annual or annualized gross rent paid is at least \$250,000, unless the tenants meet certain exemption criteria (such as short rental periods, residential subtenants, theatrical productions, not-for-profit status or properties located in the World Trade Center Area). See Title 11, Chapter 7, NYC Administrative Code.

Currently, the tax rate for the CRT is 6 percent of the base rent. All taxpayers are granted a 35 percent base rent reduction, which reduces the effective tax rate to 3.9 percent. In addition, tenants with annualized base rents between \$250,000 and \$300,000 before the 35 percent rent reduction are eligible for a sliding-scale credit that partially offsets the CRT. Tenants subject to the CRT must file annual CRT returns with the NYC Department of Finance on or before June 20 covering the prior year. Every landlord of taxable property and every tenant of

taxable property must keep the following records:

- identification of each tenant or subtenant
- the rent required to be paid
- the rent paid and received
- the location of each premises
- the period of each occupancy
- all leases or agreements that fix the rents required to be paid and/or the rights of the tenants.

Leases stating rents required to be paid should be kept for a period of three years after the expiration of the lease. Other records must also be kept for a three-year period after the annual return is filed (unless written permission is granted to destroy them before that time).

We are here to assist you in negotiating your lease in New York City to protect your interests.

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