# SEVEN WAYS TO HANDLE FREQUENT DEFAULTS UNDER RESTAURANT LEASES

*February 2019*

Itkowitz PLLC
itkowitz.com

# Seven Ways to Handle Frequent Defaults Under Restaurant Leases

By Michelle Maratto Itkowitz, Esq.
ITKOWITZ PLLC
26 Broadway, 21st Floor
New York, New York 10007
(646) 822-1805
**www.itkowitz.com**
**mmaratto@itkowitz.com**



## TABLE OF CONTENTS

## I. INTRODUCTION

You and your friend are walking down the street in New York City. She says to you, *"Hey look, that store, which has been empty for so long, has a new restaurant in it!"* You stop into the new restaurant. The food is nice. The service is great. The chef comes out and introduces herself to you. You see the first dollar they earned taped to the wall by the door. You wish them luck as you leave and promise you will be back.

What are the chances that, if you are walking down that same street and you look at that same corner in a year, that the new restaurant will still be there? What about in two years? In four?

Restaurants frequently do not make it. Business Insider magazine says 80% of restaurants don't make it to five years[1].

This continuing legal education seminar explores seven options for dealing with frequent defaults under restaurant leases.

The author represents both landlords and tenants. Sometimes this material may *seem* to be directed towards an audience of landlords' lawyers. That is simply because it is the landlord who is prosecuting in the event of frequent defaults (the landlord is the driver of the action), so the instructions are theirs to follow. BUT – every section of this material is valuable for tenants' counsel because here you will find your most powerful defenses and strategies. If a landlord is instructed to do something and landlord does not follow the instruction, tenant may well have a potent defense. I will take extra care, however, to highlight strategy for tenants' lawyers.

For all of the options, I am going to:

- Explain the law underlying the option
- Examine the option's pros
- Examine the option's cons

Options one through five are litigation options. Options six and seven deal with settlement.

[1] https://www.businessinsider.com/why-restaurants-fail-so-often-2014-2.

## II. OPTION 1: DO A SUMMARY NONPAYMENT PROCEEDING PURSUANT TO STATUTE

### A. Summary Proceedings

In most instances when a landlord finds it necessary to sue a tenant to recover rent or possession of a premises, the proper vehicle is a summary proceeding for the recovery of real property. A summary proceeding for the recovery of real property ("summary proceeding") is an expedited lawsuit, for the recovery of rent and possession of a premises, created by the New York State Legislature and governed by Article 4 of the Civil Practice Law and Rules ("CPLR") and Article 7 of the Real Property Actions and Proceedings Law ("RPAPL"). Summary proceedings are expeditious because the parties' procedural rights and remedies are VERY limited. Among other things, for example, the tenant's time to answer the lawsuit is accelerated and, absent leave of court, there is no discovery.[2]

Due to the accelerated nature of a summary proceeding and the limits on pre-trial discovery, a landlord prosecuting such a proceeding is held to a higher standard with respect to complying with the technical requirements of the RPAPL. In general, even though courts have adopted more liberal standards in recent years, technical defects that might have no effect on a plenary action will mandate dismissal of a summary proceeding.[3]

There are two types of summary proceedings: nonpayment proceedings ("nonpayment") and holdover proceedings ("holdover"). We will discuss holdovers in the next section.

---

[2] *See, e.g.,* CPLR § 408; RPAPL § 701; *NYU v. Farkas*, 121 Misc.2d 643 (Civ. Ct. N.Y. Cty. 1983) (defines "ample need" test for discovery to be allowed in a summary proceeding).

[3] *Clarke v. Wallace Oil Co.*, 284 A.D.2d 492 (2d Dept. 2001). ("[F]ailure strictly to comply with the statutes governing summary proceedings deprives the court of jurisdiction and mandates dismissal. '[A] summary proceeding is a special proceeding governed entirely by statute and it is well established that there must be strict compliance with the statutory requirements to give the court jurisdiction'.") citing *MSG Pomp Corp. v. Jane Doe*, 185 A.D.2d 798, 799-800 (1st Dept. 1992), quoting *Berkeley Assocs. Co. v. Di Nolfi*, 122 A.D.2d 703, 705) (1st Dept. 1986)); *but see 17th Holding LLC v Rivera*, 195 Misc.2d 531 (2d Dept. 2002) (distinguishing *Clarke* by limiting the case to its own facts and stating that "First Department has now adopted the more liberal rule of construction [*433 Assocs. v. Murdock*, 715 N.Y.S. 2d 6 (1st Dept.)] and has stated that a rule of strict construction was applied in *MSG Pomp Corp. v. Doe*…only as a matter of equity."); *Elul Realty Corp v. Java New York LTD*, 125 Misc. 3d 336 (Civ. Ct. Kings Cty. 2006) (distinguishing *Clarke* on its facts, while holding the petition in the summary proceeding defective on different grounds pertaining to the vague/incomplete description of the premises in the petition.)

A nonpayment is a lawsuit for the recovery of rent due and, in the absence of full and timely recovery of rent due, possession of the premises.[4]

## B. Predicate Notice When Suing For Rent –– Rent Demands

A rent demand on at least three days' notice is a required predicate of a summary nonpayment proceeding.[5]

The three-day requirement may be lengthened by the lease.[6] In addition, the lease may require more stringent service requirements than those promulgated in the RPAPL.

A rent demand must set forth a good faith approximation of the rent believed to be due and owing. This contrasts with the often highly exaggerated damages asserted in a typical civil action.[7]

A rent demand must state that the tenant has the alternative of paying the arrears or surrendering the premises.[8]

A rent demand may include legal fees, late fees and other "additional rent" if the lease allows such.[9]

---

[4] RPAPL § 711(2).

[5] RPAPL § 711(2).

[6] *Hendrickson v. Lexington Oil*, 41 A.D.2d 672 (2d Dept. 1973).

[7] *Brusco v. Miller,* 167 Misc.2d 54 (App. Term 1st Dept. 1995).

[8] *J.D. Realty Associates v. Jorrin,* 166 Misc.2d 175 (Civ. Ct. N.Y. Cty. 1995) (Service of the three-day notice serves two important functions. It is the statutory predicate for a summary non-payment proceeding. RPAPL 711(2). Accordingly, if a proper notice is not served, the subsequently commenced proceeding must be dismissed. Moreover, it informs the tenant of the amount of rent claimed due and what the tenant must do to avoid litigation which could result in eviction. In order to serve both functions, the notice must allege the approximate dollar amount which the petitioner believes, in good faith, is due and owing, [citations omitted]. It must demand payment of that sum, or surrender of the premises; if the tenant does not comply, only then may the owner commence a summary non-payment proceeding to evict the tenant. RPAPL 711(2). In order to comply with the statute and give notice, the written demand must state facts, present the alternatives and convey the consequence of non-compliance. Accordingly, the demand must be definite and unequivocal.).

[9] *Meyers Parking v. 475 Park Ave. So. Co.*, 186 A.D.2d 92 (1st Dept. 1992).

Pursuant to RPAPL § 711 (2), written rent demands must be served upon a tenant in the same manner set forth in RPAPL § 735 for service of process of summary proceedings for the recovery of real property. The requirements of RPAPL § 735 service are discussed in greater detail later in these materials. It is important to note that the lease itself may contain more stringent service requirements.

## C. Additional Rent

In addition to regular monthly rent, the restaurant tenant frequently owes "Additional Rent", charges for things priced outside of the rent because they are changeable and unpredictable. For example, electricity, real estate tax escalations, and/or late fees.

When I see that I am being instructed by a landlord client to sue for Additional Rent[10], I have three questions.

### *1. Is the additional rent really due?*

Is the additional rent really due? For example – I have seen landlords try to bill tenants for things landlord should not be entitled to. For example, trying to bill building-wide architectural fees to a tenant as "repairs." You need to check the lease for the authority to bill an item as additional rent.

### *2. If the additional rent is really due, was it calculated in a defensible way?*

If the additional rent is really due, was it calculated in a defensible way? Many of these items require a little math. For real estate tax escalations, for example, the lease usually says to subtract the base year from the current taxes and then the tenant pays a percentage of the marginal increase, usually commensurate with their percentage of the building's total floor area. I like to make sure landlord did the math right.

[10] In the commercial context, unlike the residential, there is regular monthly rent, and then there is also "Additional Rent" – payments that the tenant has to make the landlord for all kinds of other items. Usually these things are priced outside of the rent because they are changeable and unpredictable. For example, electricity or real estate tax escalations. If the taxes on the building go up over the years, commercial tenants agree to shoulder a portion of the increase. Extra charges for repairs and key cards are also additional rent.

### *3. Was the additional rent billed correctly?*

Was the additional rent billed correctly? Unlike regular monthly rent, which is usually due without demand as per the lease, additional rent does, indeed, need first to be billed. How else would the tenant even know it was due? Thus, tenant needs to be billed in accordance with whatever the lease says about such things. Many leases require landlord to present tenant with a bill for additional rent, and tenant gets ten days to pay. Some leases even dictate how that bill has to be sent and to whom.

## D. Notice of Petition and Petition and Who to Sue

If, in response to the Rent Demand, tenant pays in full the amount demanded, then landlord must accept payment and cannot proceed to a summary nonpayment proceeding, since payment is a complete defense in such cases. If, however, tenant fails to pay the full amount demanded in the Rent Demand, landlord can initiate a summary nonpayment proceeding.

A very important and often overlooked aspect of drafting a petition is who to name as a respondent.

Subtenants – both authorized and unauthorized – should typically be named as respondents. In order to obtain complete relief (i.e. possession), any person or entity that claims an interest in the premises must be named. You can sail through an entire summary proceeding against tenant Olga's Sushi Palace ("Olga's") and be successful every step of the way, but on eviction day the marshal can show up to evict tenant Olga's and find subtenant Greta's Taco Heaven ("Greta's") in possession of the space. If the judgment and the warrant were not for Greta's, then Greta's does not get evicted.

Note, however, that a subtenant is not a necessary party. The litigation can go forward without a subtenant, but in order for landlord to gain complete relief for your landlord-client, you must get a warrant against the subtenant.[11]

[11] *See e.g.*, *New York Railways v. Savoy*, 239 A.D. 504, 508 (1st Dept. 1933) ("The failure to make the subtenant a party to the first dispossess proceeding could not affect the character of its estate after the overlease fell for non-payment of rent."); *First Federal Savings & Loan Association of Rochester v. Moore*, 157 Misc.2d 877, 878 (Civ. Ct. N.Y. Cty. 1993) ("It is also axiomatic that subtenants are not necessary parties to a summary proceeding and are joined in the proceeding at the discretion of the landlord in order to assure that any warrant which may be issued by the court is effective against the subtenant as well as against the prime tenant.").

Do not name guarantors to the lease. Guarantors need to be sued separately in a plenary action. See the below section on Guarantor actions.

## E. Service of Process

Real Property Actions and Proceedings Law § 735 is the section that covers the service of rent demands and other predicate notices and of notices of petition and petitions. Service of process for non-landlord and tenant matters is governed by Civil Practice law and Rule Article 3. Note that RPAPL § 735 service is somewhat different than regular CPLR service.

There are FIVE elements to RPAPL service of process:

(1) Delivery of the papers
(2) GPS-ing the service[12]
(3) Mailing the papers
(4) Filing proof of service with the court
(5) Completing and maintaining the process server log book[13]

All five aspects of service of process are important, but it is beyond the scope of this program to examine all of them. Below I offer an important tip on the delivery and mailing aspects of the service.

Delivery options set forth in RPAPL § 735 include:

(1) Personal Service on an Individual. Personal delivery to respondent who is an individual.

(2) Personal Service on a Corporation. Personal service on a corporation must be made on an officer, director, managing or general agent, cashier or other person authorized to accept service on behalf of the corporation, in compliance with CPLR § 311 (a)(1). RPAPL does not permit service on a corporation via the secretary of state.

[12] Subchapter W of Chapter 2 of Title 6 of the Rules of the City of New York § 2-233b.

[13] General Business Law § 89-cc(1).

(3) Substituted Service ("Suitable Age and Discretion"). If respondent is not able to be personally served, a copy of the papers may be left with a person of suitable age and discretion who resides or is employed at the premises sought to be recovered. Substituted service must be made at the premises sought to be recovered.

(4) Conspicuous Place Service ("Nail and Mail"). Only after reasonable application to serve respondent(s) by personal or substituted service fail, a copy of the notice and petition may be "affixed" to the door or a conspicuous place on the premises. There is a plethora of law on this topic. For commercial evictions, reasonable application means the process server makes at least two attempts to find the tenant at the premises, during two different times of day (or night) which encompass tenant's regular business hours. For example, the process server should go to a breakfast-oriented restaurant during regular business hours; but the process server should go to a dinner-oriented restaurant during the evening.

Personal service and substituted service are EQUALS. Conspicuous place service is inferior – in that you may NOT use conspicuous unless you have tried for either personal or substituted. My policy is to SKIP personal service on a corporation and go straight for suitable age and discretion service. Why? Because personal is harder to get than suitable age and discretion. If the restaurant is a corporation, then personal service on a corporation requires reference to another statute (the Civil Practice Law and Rules). And the CPLR statute requires you to find an officer, director, cashier, or person authorized to accept service. I do not want to have a traverse over whether someone was an officer or was authorized by the restaurant corporation to accept service. Under suitable age and discretion, all I need to find is a person of suitable age of discretion to accept service. It has nothing to do with "officer, director, authorized, etc." And it is just as good in the first instance as personal service.

Here is a funny (and sad, but true) story to illustrate this point. My process server did an emergency service for me on a bar, way out in Queens. He took it upon himself to NOT mail the papers as well as deliver them. I asked him why. He told me that it was "personal service on a corporation" and, therefore, he did not need to mail the papers. I asked why he thought he had achieved "personal service on a corporation". He informed me that he served the bartender, and she was taking money from people and putting it into a cash register. That made her a "cashier", who is, as per the CPLR, a person to whom personal service on a corporation may be delivered. I asked him, "Do you know that a bartender is a 'cashier' for purposes of CPLR § 311?" And he told me, "Well, it must be." *Oh really?* I checked. I found only one case on the topic of whether a

bartender was a "cashier" for service of process purposes. And it says that a bartender is NOT a "cashier" for purposes of the relevant service statute.[14] You can't make this stuff up. Thus, I strongly favor substituted service on a corporation.

### F. Pros and Cons of Nonpayment Proceedings

#### *1. Pros*

- Nonpayment proceedings are easier, cheaper, and faster than terminating the tenancy for nonpayment of rent (Option 2) or a Guarantor Action (Option 5).

- For these reasons, nonpayment proceedings are the most common choice for landlord practitioners when a tenant defaults.

#### *2. Cons*

- As we saw above, if tenant pays, the proceeding is over. If tenant pays in response to the rent demand, then the proceeding is over before it starts. This is a great result if landlord just wants to get paid. If, however, landlord's goal was to recover the space, then a nonpayment proceeding might not be the best option.

- Not the most aggressive option.

## III. OPTION 2: TERMINATE THE LEASE UNDER THE CONDITIONAL LIMITATION CLAUSE OF THE LEASE, ASSUMING RENT IS SPECIFIED AS A DEFAULT

### A. Conditional Limitations

One of the landlord's most powerful remedies, a default subject to a conditional limitation pursuant to the lease, permits the landlord to terminate the lease by following certain procedures.

Although many leases specifically exclude such, a lease may provide a mechanism whereby the landlord may terminate the lease, after default in the payment of rent, in the commercial

[14] *People v. Alrich Restaurant Corp.*, 53 Misc.2d 574 (Dist. Ct. Nassau Cty. 1967).

context. Properly drafted, a conditional limitation clause for the nonpayment of rent in a commercial lease will be enforced by the courts and is, perhaps, the landlord's most powerful remedy. A properly structured conditional limitation for the non-payment of rent should utilize the language cited approvingly by the court in *Grand Liberte Co-op Inc. v. Billhaud*[15], expressly making the conditional limitation applicable to rent defaults and stating that "it [is] the intention of the parties hereto to create hereby a conditional limitation."[16]

## B. Notice to Cure

In many commercial leases, the landlord must first notify the tenant of the default and set forth a time period in which the tenant must cure the default; or, if it is impossible to cure within the time period, it must set forth a time period in which the tenant must begin curing the default. The cure period in many commercial leases is fifteen (15) days. This notice is commonly referred to as a "notice to cure".

## C. "Yellowstone" Injunctions and Tolling Time to Cure Defaults

Giving a notice to cure may force the commercial tenant to initiate a proceeding in Supreme Court commonly referred to as a " *Yellowstone* Injunction," so called after the case of *First National Stores v. Yellowstone Shopping Center*.[17] The essence of a *Yellowstone* application is a declaratory judgment complaint accompanied by a stay application (which is routinely granted, at least in the form of a temporary restraining order, pending a hearing on a preliminary injunction), which seeks a trial on the issue of whether the tenant is, indeed, in violation of the lease. This procedure is designed to toll the time the tenant would ordinarily have to cure a lease violation while the court resolves the issue of whether the tenant is indeed in violation and/or has cured the violation. If the court finds the tenant in violation, then by virtue of the stay of the notice to cure, the tenant still has the opportunity to cure the violation before the cure period ends.

---

[15] *Grand Liberte Co-op Inc. v. Billhaud*, 126 Misc.2d 961 (App. Term. 1st Dept. 1984).

[16] Note, however, that this strategy will not work in a residential context. A conditional limitation regarding the nonpayment of rent in a residential lease has been held to violate public policy as it would provoke a forfeiture, and the law disfavors automatic forfeitures of residential tenancies. *Semans Family Ltd. Partnership v. Kennedy*, 177 Misc.2d 345 (Civ.Ct. N.Y. Cty. 1998).

[17] *First National Stores v. Yellowstone Shopping Center,* 21 N.Y.2d 630 (1968), *rearg. denied*, 22 N.Y.2d 827 (1968).

This process in itself can buy the tenant significant time as the resolution of the proceeding can take months, if not years.

The purpose of a *Yellowstone* injunction is to maintain the *status quo* by means of a temporary stay while the tenant challenges the landlord's notice to cure.[18] Thus, the *Yellowstone* injunction tolls the cure period set forth in the landlord's notice of default until there is a judicial determination of the parties' rights.[19]

To demonstrate one's entitlement to a *Yellowstone* injunction, a tenant must demonstrate that he/she: (i) holds a valuable commercial lease; (ii) has received a notice to cure; (iii) has requested injunctive relief prior to the expiration of the applicable cure period; and (iv) is prepared and maintains the ability to cure the alleged default by any means short of vacating the premises.[20] "These standards reflect and reinforce the limited purpose of a *Yellowstone* injunction: to stop the running of the applicable cure period."[21]

The First Department has held that commercial tenants have a right to a virtually automatic issuance of a *Yellowstone* injunction[22] and has held that, in order to obtain a *Yellowstone*, rather than requiring the tenant to prove on his application that he can cure the alleged default, a tenant must merely state his desire and ability to cure the default by any means short of vacating the

[18] *See e.g.*, *Jemaltown of 125th Street, Inc. v. Leon Betesh/Park Seen Realty Assocs.*, 115 A.D.2d 381 (1st Dept. 1985); *Fratto v. Red Barn Farmers Market Corp.*, 144 A.D.2d 635 (2nd Dept. 1988).

[19] *See, Finley v. Park Ten Associates*, 83 A.D.2d 537 (1st Dept. 1981); *South Ferry Building Co. v. J. Henry Schroder Bank & Trust Co.*, 91 A.D.2d 963 (1st Dept. 1983).

[20] *Garland v. Titan West Assocs.*, 147 A.D.2d 304 (1st Dept. 1989).

[21] *Graubard Mollen Horowitz Pomeranz & Shapiro v. 600 Third Avenue Associates*, 93 N.Y.2d 508 (1999).

[22] *See Herzfeld & Stern v. Ironwood Realty Corp.*, 102 A.D.2d 737 (1st Dept. 1984); 34 N.Y.Jur.2d § 261 ("where a tenant denies any default and demonstrates that the landlord has given notice of default, and where a period of time remains within which to cure, the tenant is entitled to a grant of preliminary relief in the form of a *Yellowstone* injunction; since the law does not favor forfeitures, the tenant is not required, as a prerequisite to such relief, to demonstrate a likelihood of success on the merits or an ability to cure, and the proper inquiry instead is whether a basis exists for believing that the tenant desires to cure and has the ability to do so through any means short of vacating the premises").

premises.[23] Furthermore, a tenant is entitled to a *Yellowstone* injunction when the tenant argues that he is not in violation of the lease, and that if he is, he concedes to cure any such violations.[24]

If a tenant's position is that it refuses to cure the default, Tenant cannot have the *Yellowstone*.[25]

A *Yellowstone* injunction can provide a modicum of protection to landlords as well as tenants, because they are often conditioned upon the tenant's ongoing payment of rent and/or the posting of a bond to protect the landlord from a wrongfully issued injunction.

If the tenant is successful in having the *Yellowstone* injunction implemented, then the landlord must answer the Supreme Court action and counterclaim for termination of the tenancy.

## D. Notice of Termination

If no *Yellowstone* proceeding is commenced and the default is not cured or being cured by the date specified in the notice to cure, or if the default is not curable (see chart below), then the landlord may notify the tenant that the lease will be terminated in a certain number of days prescribed by the parties' lease. Many commercial leases allow termination in five (5) days. This notice is commonly referred to as a "notice of termination." After the expiration of the notice of termination, the landlord may commence a summary holdover proceeding against the tenant to recover possession of the premises.

Notices to cure and notices to terminate pursuant to the terms of a lease are served on the tenant in accordance with the lease. No statute specifies other methods of service for notices given strictly pursuant to a lease.[26] If the lease is silent on a method of service, the method used must be "reasonable."

---

[23] *Id.* at 738.

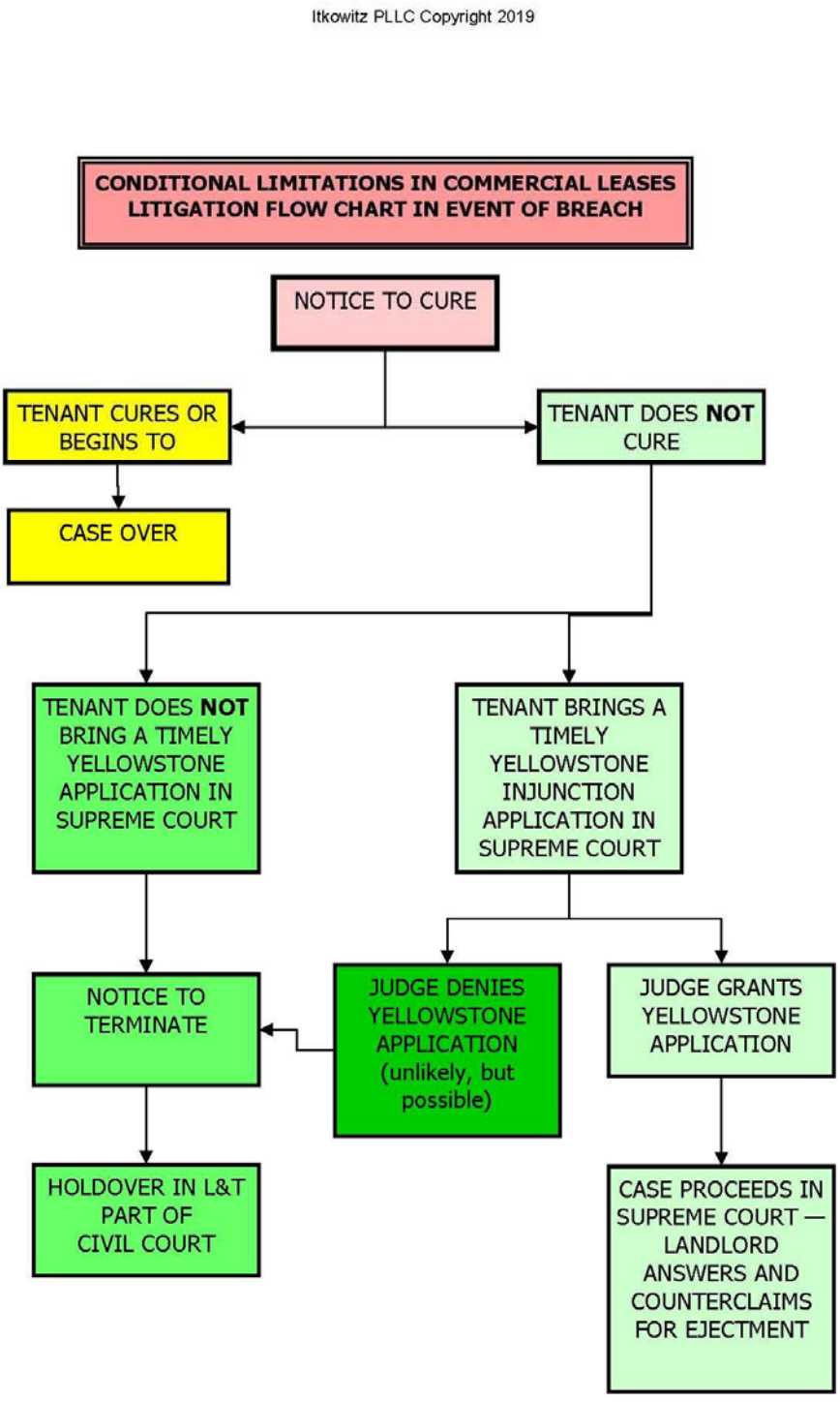
[24] *See Empire State Building Assocs. v. Trump Empire State Partners*, 245 A.D.2d 225 (1st Dept. 1997) (where a tenant can show that it is able and willing to bring itself into compliance with the lease absent vacating the premises, forfeiture is inappropriate); *Garland*, *supra,* at 38.

[25] *Linmont Realty, Inc. v. Vitocarl, Inc.,* 147 A.D.2d 618 (2nd Dept. 1989).

[26] *See Rose Assoc. v. Bernstein*, 138 Misc.2d 1044 (N.Y.C. Civ.Ct. N.Y. Cty. 1988).

## E. Flow Chart of Litigation Regarding Conditional Limitations in Commercial Leases

Below is a flow chart that visually represents the litigation described in this section regarding conditional limitations in commercial leases.



## F. Holdover Proceeding

After the notice of termination expires, the next step for landlord is a holdover proceeding. A holdover is a lawsuit for possession of the premises, regardless of the payment of rent, although past due rent or a fee for using and occupying the subject premises may also be recovered in a holdover.[27]

## G. Pros and Cons of Terminating the Tenancy for Nonpayment of Rent

### *1. Pros*

- More aggressive than Option 1(a nonpayment proceeding).
- More likely than Option 1 (a nonpayment proceeding) to recover possession of the restaurant, if that is landlord's goal.

### *2. Cons*

- If you attempt to terminate the lease for nonpayment of rent as a conditional limitation, at best, tenant will not apply for or not be granted a Yellowstone injunction and you will be prosecuting a holdover proceeding. A holdover proceeding is more expensive, complicated, and time consuming then a simple nonpayment proceeding (Option 1).
- If tenant makes a *Yellowstone* application and it is granted, which it frequently is, then you are not litigating a holdover proceeding in landlord and tenant court, rather you are litigating a Supreme Court action (with discovery), *which is even more expensive, complicated, and time consuming.*

[27] RPAPL § 711 (1).

## IV. OPTION 3: CLAW BACK FREE RENT FROM THE BEGINNING OF THE LEASE

Many restaurant leases allow tenant to have a period of free-rent at the beginning of the lease. Landlords do this to entice restaurant tenants to choose their buildings over other options and to soften the difficulty of a tenant having to finance a buildout at the beginning of the lease, during which the restaurant will not have any income. Landlords rationalize the initial loss by calculating the benefit of having the full lease term.

When landlords contact me to complain of a tenant default, they often have forgotten about the free-rent period. The free-rent period, however, increases a landlord's loss. See the chart below.

| EXAMPLE = Tenant with a 5 year lease with rent at $10k per month to get first 3 months free. | | |
|---|---|---|
| Monthly Rent | $ | 10,000.00 |
| Term in Months | | 60 |
| Total rent expected over life of lease (when not considering free rent) | $ | 600,000.00 |
| Number of months of free rent at beginning of lease for build out | | 3 |
| Total amount of free rent | $ | 30,000.00 |
| True amount of rent expected over the life of the lease (when considering free rent)(and, for the sake of simplicity, assuming no rent escallations) | $ | 570,000.00 |
| **Ave annual amount expected** | **$** | **114,000.00** |
| *After getting free rent for months 1 though 3, then then defaults for months 10 through 12.* | | |
| Tenant actually paid for year 1 | $ | 60,000.00 |
| Ave annual amount expected | $ | 114,000.00 |
| **Real loss to LL (not 3 x $10k = $30k)** | **$** | **54,000.00** |

If the above example, we see that the sooner a tenant defaults, the less able the landlord is to absorb the free-rent period loss.

Landlords seldom, however, ask me to attempt to claw back the free rent. Depending on what the lease says, however, clawing back free rent may be a possibility. Let us consider three different types of lease provisions regarding free rent.

### A. Free Rent Clause Has No Conditions

In this example, the free-rent section of the lease has no conditions:

> Notwithstanding anything to the contrary herein contained, Tenant shall not be required to pay the Basic Rent until the one hundred and eighty first (181st) day from the Term Commencement Date ("Rent Concession Period").

Therefore, in this case, there would be no option to recapture the free rent because the lease provides no basis for doing so.

### B. Free Rent Clause Has Default Conditions

In this example, the free-rent section of the lease is subject to tenant not being in default:

> Notwithstanding anything to the contrary herein contained, provided Tenant is not in default under any terms, covenants or conditions of this Lease, Tenant shall not be required to pay the Basic Rent until the one hundred and eighty first (181st) day from the Term Commencement Date ("Rent Concession Period").

Here, there is an argument that you can recapture the free rent, but still it is problematic. Does "provided Tenant is not in default under any term" refer only to defaults occurring during the Rent Concession Period? Or does it refer to defaults occurring at any time throughout the life of the lease? If there is ambiguity, it is typically construed against the drafter.[28]

[28] "In cases of doubt or ambiguity, a contract must be construed most strongly against the party who prepared it and favorably to a party who had no voice in the selection of its language." *67 Wall St. Co. v Franklin Nat. Bank,* 37 N.Y.2d 245 (1975).

## C. Free Rent Clause Has Specific Claw Back Provision

In this example, the free-rent section of the lease has a specific claw back provision:

> Notwithstanding anything to the contrary herein contained, provided Tenant is not in default under any terms, covenants or conditions of this Lease, Tenant shall not be required to pay the Basic Rent until the one hundred and eighty first (181st) day from the Term Commencement Date ("Rent Concession Period"). Anything contained herein to the contrary notwithstanding, if Tenant, at any time during the term hereof after Tenant has been granted all or a portion of the rent credit provided herein, breaches any covenant, condition or provision of this Lease and fails to cure such breach within ten (10) days after Landlord's notice of such default, then, in addition to all other damages and remedies herein provided and to which Landlord may otherwise be entitled, Landlord shall also be entitled to the repayment of any rent credit theretofore enjoyed by Tenant, which sum shall be deemed additional rent hereunder and shall be due upon demand by Landlord.

Here, the lease has a specific mechanism whereby the free rent can be recaptured. I have seen this done in many ways. I like the way this lease turns the free rent to be recaptured into additional rent. This makes it easier to identify when it becomes due in the event of default. A clause similar to the one in this section was enforced in *Sheva 7 LLC v. Junnie Leigh New York, Inc.*, 2011 WL 11166376 (Sup. Ct. N.Y. Cty. 2011).

### D. Pros and Cons of Clawing back the Rent

#### *1. Pros*

If the lease provides a clear claw back mechanism, then this tactic puts more pressure on a defaulting restaurant tenant, while requiring not a lot of effort or extra legal fees.

#### *2. Cons*

If the lease does not, however, provide a clear claw back mechanism, then this tactic may be little more than a bluff – an attempt to put greater pressure on the defaulting restaurant tenant. If the lease is not clear that the rent can be recaptured and how it should be recaptured, then this tactic may create a lot of extra litigation.

## V. OPTION 4: DRAW DOWN ON THE SECURITY OR THE LETTER OF CREDIT

The security should not be utilized unless the relationship between landlord and the restaurant tenant is ending. I hate when my landlord clients allow a restaurant tenant to use the security to ameliorate an interim default. I have often observed that security, once drawn down, whether partially or in full, is never replaced.

A landlord may not sue a restaurant tenant for security as if it is rent. Security deposits are not rent[29], and they cannot be recovered in a nonpayment proceeding[30]. Rather, the failure to give a security deposit as required by a lease is properly addressed as a breach of a substantial obligation of the lease in a holdover summary proceeding.[31] Which (as you can see from the material above) is a much more arduous legal process than a simple nonpayment proceeding.

I have also often observed that the landlord or manager then later cannot easily remember, without reference to its records and usually before it is too late, that the restaurant tenant has used

[29] General Obligations Law § 7–103.

[30] *Graham Realty Assoc. v. Peller,* 11 Misc.3d 132 (A) (App. Term, 2d & 11th Jud. Dists.).

[31] *Markowitz v. Landau,* 171 A.D.2d 564 (1st Dep't 1991).

all or part of the security in the past. Thus, in these situations, if the relationship ultimately ends with tenant in arrears, there is no security as a contingency against such default.

## VI. OPTION 5: SUE THE GOOD GUY GUARANTORS

### A. The Basic Good Guy Guaranty

The simplest and earliest iteration of the GG Guaranty provides that the tenant's guarantor remains liable for the tenant's obligations under the lease through the date that the tenant vacates the premises and delivers possession to the Landlord.

After the tenant, or anyone claiming through the tenant (*i.e.* subtenants), vacates the premises, removes all personal property, and offers to deliver possession to the landlord, the guarantor is in the clear.

GG Guaranties are "commonly understood to apply to obligations which accrue *prior to the surrender of the lease premises.*"[32] If there is a basis to hold guarantor personally liable for future rent given tenant's failure to surrender the premises in the manner prescribed by the lease and GG Guaranty, Landlord must reserve all of its rights under the GG Guaranty to pursue those claims against guarantor.[33] If landlord accepts tenant's surrender without reserving its rights under the lease and the guaranty, landlord waives any claims to future rent absent an agreement to the contrary because such acceptance terminates the leasehold.[34]

[32] *Russo v. Heller*, 80 A.D.3d 531 (1st Dept. 2011) (emphasis added).

[33] See also *James Leonard 6, Inc. v. Six & Cornelia Associates*, 2016 WL 4094712 (Sup. Ct. N.Y. Cty. 2016) ("The reletting expenses, including rent concessions, and broker's fees occurred after the Plaintiff vacated the Premises and returned the key on May 15, 2015. Defendant does not dispute that Plaintiff returned the keys and vacated the entire premises. Therefore, when [Tenant] vacated the property on May 15, 2015, [Guarantors'] liability for future rent ceased.")

[34] *See Freeman Foursome v. Cabana Carioca*, Index No. 100289/94 (Sup. Ct. N.Y. Cty. Jan. 30, 2001) *aff'd* 293 A.D.2d 964 (1st Dept. 2002) (holding that landlord's failure to reserve rights under the lease and guaranty defeated claim for future rent because acceptance of surrender constitutes termination of the leasehold).

## B. Notice and Payment Requirements in Good Guy Guaranty

Many GG Guaranties these days, however, require, among a host of other conditions, advance notice of a tenant's intent to terminate the lease early and surrender the premises in order to terminate the guarantor's liability.[35] The interpretation of the terms of the Good Guy clause are a question of law for the court, which accords those terms their plain and ordinary meaning.

The following is language from a typical condition of a GG Guaranty:

> Landlord has received at least sixty (60) days written notice from Tenant of Tenant's intent to vacate the Premises and Tenant has vacated the Premises on or before the date of delivery of possession to Landlord set forth by Tenant in such notice…

This clause has a dual effect. First, if Tenant fails to give at least 60 days' written notice by either giving less than 60 days' notice OR by giving notice orally rather than in writing, then the condition is left unsatisfied, and guarantor remains liable under the lease for past and future rent owed. Second, the effect of requiring 60 days' advance notice of a tenant's intent to surrender the premises functions as an additional two months of security! If the notice period was 180 days, it would be equivalent to an additional 6 months of security. Remember, in a basic GG Guaranty, guarantor's liability is cut off at the time of surrender. Here, the advance notice requirement must be read in conjunction with the surrender provision of that same lease:

> …at the time of such surrender, all Fixed and Annual and Monetary Additional Rental […] due under the Lease have been paid to Landlord up to the later of (a) the time of surrender, or (b) the end of the (60 day period set forth in subsection (ii) below. . .

[35] See *Fairchild Warehouse Associates, LLC v. Water Chef, Inc.*, 2014 WL 12639275 (Sup. Ct. N.Y. Cty. 2014) ("[Guarantor's] arguments are unavailing in light of the unambiguous language in the Guaranty. The Good Guy clause required tenant give landlord two months notice prior to the vacancy date. Tenant gave landlord less than 30 days notice. The rent was in arrears ($72,000) when tenant vacated the premises. Tenant was given timely Notice of Default to allow a cure of the arrears. Since the defendants have failed to satisfy the relevant conditions of the Good Guy clause, the limitation of liability set forth in the Good Guy clause is unavailable to Lazar. The guarantor is liable for damages for the full term of the lease, as it is undisputed that the conditions in the Good Guy clause were never satisfied.") (citations omitted).

By requiring the advance notice and also requiring that all fixed annual and additional rental be paid through the date of surrender or the end of the advance notice period, landlord has effectively tacked on two months that the guarantor will be liable for one way or another.

## C. Suing a Guarantor Post-Possession – Often a Huge Waste of Time

I like to say that one of the reasons I do so well practicing landlord and tenant litigation in New York City is because I spend 80% of my time talking potential litigants out of litigating. I have been at the law in this area for twenty-five continuous years, and I can say with a perfectly straight face that most plenary lawsuits[36] are simply not worth bringing. Most lawyers are not going to tell you that. It is not in their interests to do so. To a hammer – everything is a nail. To a litigator, everything is a lawsuit. In any event, I offer you the following words of wisdom regarding post-possession, tenant-guarantor actions:

### *1. Most guarantors are just as broke as the single-asset restaurant corporation that was the defunct tenant.*

Most guarantors are just as broke as the single-asset restaurant corporation that was the defunct tenant. I do not know why this is, but it has been my frequent observation. I always begin my work on a post-possession guaranty lawsuit by running a credit report on the guarantor. I cannot possibly tell you how often the report produces a long list of judgments that are ahead of my client in time and priority. Sometimes the would-be-debtor owns a family home, with a spouse by the entirety, that is heavily mortgaged. Maybe via a bank account search run by my licensed private investigator, I discover that the would-be-debtor has $212.13 in a bank account somewhere in New Jersey. I fully understand that "someday" the would-be-debtor might have attachable assets. Many things might happen someday. Personally, I question whether a landlord who has just lost a bunch of money on a defaulting restaurant tenant should incur more legal fees to obtain a worthless judgment.

[36] Black's Law Dictionary defines a "plenary action" as a "full hearing or trial on the merits, as opposed to a summary proceeding." When we use that word in New York we are referring to a regular action in Supreme Court, one that includes discovery and where the court is one of original jurisdiction, as opposed to a special summary proceeding for the recovery of real property, pursuant to RPAPL Article 7 and CPLR Art. 4, in a local court of limited jurisdiction, which we discussed at length earlier in this booklet.

### 2. *If the guarantors are not broke, the amount owed is not worth pursuing in a New York Court if it is under $100,000.*

If the guarantors are not broke, the amount owed is not worth pursuing in a New York Court if it is under $100,000.

There is no case worth bringing in a New York City or State Court for less than $100,000. Court is a black hole for resources – time, money, mental energy. You have to go back again and again and again. So even using a bad, cheap lawyer will eventually stop making economic sense for the less than 6-figure case. Actually, it is especially the bad, cheap lawyer that makes the typical morass even longer and harder.

### 3. *Questioning the Wisdom of a Post-Possession Collection Effort Against the Guarantors*

A money judgment is just a piece of paper unless you can collect on it, and collecting on judgments is very difficult.

Let's say you pursue the case with all vigor, and win. Now what do you get? You get a judgment, which is a piece of paper, unless you turn the judgment into money. How do you get the judgment debtor to pay the judgment? The answer is longer than what I have said so far. In essence, collecting a judgment is a whole other legal case - a longer and harder one. If you have done business in New York for any length of time, you know I speak the truth.

Recently, I have had several landlord clients who have had defaulting restaurant tenants, where the leases were guaranteed by European Nationals. That, in my opinion, is a useless guaranty.

Unless your guarantor is local and you are certain she has attachable assets, and you feel confident that she will remain local and continue to have such assets, then seeking to get a judgment against a guarantor is often waste of time.

## D. How a Guaranty Can Be Used Effectively

In light ofthe questionable wisdom of a post-possession collection effort against the guarantors, what utility can a guaranty have?

I like to begin collection efforts against guarantor while the tenant is still in possession and relatively early into the default. This achieves two things.

First, it puts to guarantors on notice that tenant is in default. Sometimes the guarantor is not the restaurant's principal and would not otherwise know of the default situation. Often enough, this alone gets my landlord client paid.

Second, if the restaurant tenant's principal is the guarantor, it puts intense pressure on that individual to deal with the situation. Sometimes the restaurant has trouble getting its revenue to where it wants and, as a result, lags behind on the rent. If a landlord has tolerated this for a period of time, the restaurant tenant begins to see landlord as her bank. A complacency that a simple rent demand (see Option 1) might not wake tenant's principal out of. A guarantor lawsuit, however, is a wakeup call.

I have had a lot of success in situations where I simultaneously combine a nonpayment proceeding (option 1) with a guarantor action (prospective, while tenant is still in possession).

## VII. OPTION 6: A STIPULATION OF SETTLEMENT FOR A FREQUENT RESTAURANT DEFAULT CASE – EIGHT IMPORTANT CLAUSES

The first five options are all about litigating. The final two options are about settlement. Most of these cases end with a settlement. The following are some tips for a robust stipulation of settlement for a landlord in a restaurant case. I highlight throughout what tenant's counsel should be seeking in such stipulation.

### A. Whereas Clauses

I use the WHEREAS clauses at the beginning of a stipulation of settlement for a very specific purpose – so that if someone picks up the stipulation of settlement a number of months or years from now, they can understand the exact context in which the stipulation was arrived at. No one has to guess about what was going on. The story of the case is briefly but clearly laid out. A good WHEREAS section of a stipulation of settlement of a restaurant default case should cover:

- Definition of the parties, lease, and premises

- Description of what type of proceeding this is – nonpayment or holdover, and, if a holdover, the basis for the holdover; the date the proceeding was filed
- Briefly recount the milestones of the litigation – "WHEREAS on January 15, 2015, Tenant filed a motion to dismiss this proceeding, which Petitioner opposed; Petitioner cross-moved and Tenant opposed the cross-motion; which motions were orally argued on February 17, 2015, and which the Court reserved decision on;…"
- End by explaining that the parties wish to settle this matter

## B. Judgment of Possession And Warrant Of Eviction

A landlord's attorney should always attempt to get a final judgment of possession in favor of landlord, granting legal possession of the premises sought to be recovered and the immediate issuance of a warrant of eviction with execution stayed through a certain date or pending any default by tenant as provided for in the stipulation, whichever shall occur earlier.

Where tenant is agreeing to vacate and surrender the premises, this is obvious. But even where tenant is intending to stay and pay out arrears over time, it is still prudent to get a judgment of possession and warrant of eviction so that the stipulation has real teeth if tenant does not pay or otherwise comply. Tenant's attorney, however, should resist giving a judgment of possession and warrant of eviction.

## C. Itemize Arrears –– Money Judgment –– Satisfaction Of Money Judgment

Landlord's attorney should also make sure that if part of the settlement involves tenant paying arrears that tenant admits and concedes the exact amount tenant owes landlord, and includes a breakdown of how that number is reached. Lay out everything owed in itemized fashion. Even if part of the settlement involves waiving some of what is owed, itemize everything, and then indicate which items are being waived, pending tenant's compliance. It can be important later for landlord to be able to say to the court: "look how much rent I waived!" If possible, any waiver of rent or other concession to tenant should be conditional, on full compliance with the terms of the stipulation.

Moreover, rather than merely stating in a stipulation that arrears are owed and setting up a payment schedule, a stipulation should contain a money judgment for the arrears owed. In that case, you can make a stay of enforcement of the money judgment contingent on tenant's compliance with the stipulation. This can be a very powerful tool. It can take up to six weeks for a

warrant of eviction to be issued from the Clerk of the Court. The money judgment, however, is immediately effective.

If a money judgment is going to be issued pursuant to a stipulation and there is a payment schedule in the stipulation that anticipates that tenant will pay the judgment amount, tenant's attorney should provide in the stipulation that landlord will give a satisfaction of judgment after tenant has made the last payment required.

### D. Payment Applied First To Current Rent Due

**If tenant is promising to comply with a payment schedule for arrears, it is very important that he agree that all monies received by landlord are applied first to any current rent or additional rent due, and that the balance (if any) is then applied to arrears.**

Without this clause, if tenant only pays the arrears and not the current rent as and when it becomes due, then the stipulation will be deemed satisfied, and landlord may no longer resort to the stipulation's enforcement provisions. In the meantime, tenant will have gone back into arrears for the ongoing rent it ignored in favor of satisfying the arrears in the stipulation.

### E. Security Deposit

Landlord's attorney should state in the stipulation how much security landlord is holding, especially if it has been diminished by a draw down at some point during the tenancy. The stipulation should also explain exactly what is happening to the security, i.e., maybe the security is being applied to arrears or it is still functioning as security, in which case it does not hurt to specifically establish (although the lease already covers this) that the parties intend that the security will be returned thirty days after the premises is vacated and all terms of the stipulation have been complied with. If the issue of the security deposit is not specifically addressed in the stipulation, many tenants will try to "live out the security" at the end or claim that an arrears payment pursuant to the stipulation should be met by application of the security.

## F. Sole Possession

Especially if tenant is vacating pursuant to the stipulation, it is very important that tenant represent in the stipulation that:

> (i) Tenant is the only person or entity occupying the premises; (ii) no sub-tenant, licensee, assignee, or any other individual or entity of any description who may claim any right to remain in the premises presently occupies the premises; and (iii) Tenant will not allow any such person or entity to occupy the premises between the date of the stipulation and vacatur.

## G. General Releases

It is a good idea when the tenant is vacating, especially if the litigation has been complex, for all parties to exchange general releases. Such releases should be exchanged upon satisfactory compliance with the terms of the stipulation.

## H. Default

The default section of the stipulation should be drafted with great care. It should say exactly what will happen if a party defaults. There are several possibilities for the consequences of a default, and I am going to suggest some here:

- Tenant will be charged a per diem, pre-agreed-to sum for "use and occupancy" of the premises. Setting this sum is typically accompanied by this phrase; "The parties agree that damages in such a case would be difficult to calculate and agree that this rate is fair and reasonable and is in the nature of liquidated damages and not a penalty."

- The landlord will be allowed to execute a warrant of eviction (if there is one).

- The matter may be restored to the court's calendar to obtain a judgment of possession and warrant of eviction (if these items were not previously issued).

- Any advance settlement payment received by the tenant (usually in the case of a buyout) must be returned to landlord.

- Any settlement payment in escrow for the tenant will not be given to tenant.

- Tenant will be liable to landlord for all costs and expenses, including but not limited to reasonable legal fees, incurred by landlord in connection with tenant's breach of this agreement.

- The matter may be restored to the court's calendar for further relief.

## VIII. OPTION 7: PRE-LITIGATION ALTERNATIVE – AMEND THE LEASE

Oftentimes, at the beginning of a landlord and tenant relationship regarding a restaurant, the road concerning the build-out and the opening of the restaurant will be a rocky one. Landlords, interested in the success of their restaurant tenants, will often absorb some of that pain, by agreeing to give tenant more free rent or by agreeing to reduce the monthly payments. As I draft these materials in 2019, this is a common phenomenon in New York City, because the market is soft. Landlords do not wish to lose tenants.

In such situations, an alternative to litigation altogether can simply be a lease amendment.

I strongly encourage, however, the parties to go to transactional leasing counsel and get any agreements they arrive at drafted in a formal lease amendment, as opposed to leaving their discussions as an informal agreement.

## ABOUT THE AUTHOR

Michelle Maratto Itkowitz is the owner and founder of Itkowitz PLLC and has been practicing landlord and tenant litigation (both complex-residential and commercial) in the City of New York for over twenty years. Michelle represents BOTH tenants and landlords and her core competencies include: Rent Stabilization and DHCR Matters; Rent Stabilization and Regulatory Due Diligence for Multifamily Properties; Rent Stabilization Coverage Analysis for Tenants; Sublet, Assignment, and Short Term Leasing Cases (like Airbnb!); all kinds of Residential Tenant Representation; Good Guy Guaranty Litigation; Co-op Landlord and Tenant Matters; Loft Law Matters; De-Leasing Buildings for Major Construction Projects; Emotional Support Animals in No-Pets Buildings; and Co-Living.

Michelle publishes and speaks frequently on landlord and tenant law. The groups that Michelle has written for and/or presented to include: Lawline.com; Lorman Education Services CLE; Rossedale CLE; Clear Law Institute CLE; The New York State Bar Association, Real Property Section; The Women Attorneys in Real Estate Bas Association; The Association of the Bar of the City of New York; The Long Island Chapter of the National Appraisal Institute; The Columbia Society of Real Estate Appraisers; LandlordsNY; Thompson Reuters; The Cooperator; and Argo Management University for Boards.

Michelle regularly creates and shares original and useful content on landlord and tenant law, including via booklets, blogs, videos, and live presentations. As the "Legal Expert" for LandlordsNY.com, the first social platform exclusively for landlords and property managers, Michelle answers member's questions, guest blogs, and teaches. Michelle developed and regularly updates a seven-part continuing legal education curriculum for Lawline.com entitled "New York Landlord and Tenant Litigation". Over 20,000 lawyers have purchased Michelle's CLE classes on Lawline.com (a labor of love for which Michelle gets not a dime) and the programs have met with the highest reviews. Michelle co-authors a chapter on lease remedy clauses and guaranties for the New York State Bar Association, Real Property Section, Commercial Leasing Committee's treatise.

Michelle is immensely proud that Itkowitz PLLC was awarded its NYS Women Business Enterprise Certification by the Empire State Development Corp. Michelle's eponymous law firm is one of the largest women-owned law firms, by revenue, in the State.

Michelle is admitted to practice in New York State and the United States District Court for the Southern District of New York. She received a Bachelor of Arts in Political Science in 1989 from Union College and a Juris Doctor in 1992 from Brooklyn Law School. She began her legal career at Cullen & Dykman.

Michelle Maratto Itkowitz
Itkowitz PLLC
**itkowitz.com**
26 Broadway, 21st Floor
New York, New York 10004
mmaratto@itkowitz.com