Creative Commercial Lease Negotiations Can Help Revive NYC

By **Eric Menkes and Risa Letowsky** (August 16, 2021)

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As New York City emerges from its pandemic lockdown, office building owners as well as their tenants are realizing that we can't yet revert easily into old business models. Amid empty streets and barren offices, the city adapted to not only survive but to thrive — and the rest of the nation should take notes.

Lunch-eating office workers have not returned en masse as some expected. Instead, the overwhelming majority of white collar office workers continue to work remotely. To be sure, nightlife, culture and other social aspects of city life are returning with full force — sidewalks, parks and restaurants in residential neighborhoods like the West Village are packed with stylishly dressed pleasure-seekers, both young and old.

But Manhattan's business districts — Midtown and the Financial District — remain sparsely populated, as do their fast-casual salad delis and wood-paneled steakhouses. Many of Midtown's clothing chains catering to business wear remain shuttered. And — while some may perceive this as a positive — subway traffic is nowhere near full capacity during morning and evening rush hours.

New Yorkers of a certain age understand implicitly that this too shall pass. The New York City real estate market is cyclical, and has bounced back against long odds before. The pandemic is no exception.

But the city's awakening from its medically induced coma is proceeding unevenly, so adjustments must be made to keep the business of real estate afloat in the meantime.

As such, legal practitioners must be ready to sit at the negotiating table between office owners and tenants in this novel and evolving environment in order to preserve these business districts for workers to return to in the years to come. By doing so, we are indirectly helping property owners maintain the value of trillions of dollars of real assets, and helping the city preserve its tax base.

Here are some of the novel solutions within new and amended lease terms we are seeing at the front lines of these New York City commercial real estate conversations.

Retail and Restaurants as Amenity

Pre-pandemic property owners expected their ground-floor retail space to generate revenue, much like the office spaces above. Simply put, this is no longer the case. Instead, office owners recognize the reality that, in today's market, the coffee shop adjacent to the lobby will go under if forced to pay the rent it paid in years past.

For landlords, a vacant storefront represents more than just a lost revenue stream, because, when occupied, the retail space can serve as an amenity for the office workers who they hope will soon fill the floors above. In fact, with office vacancies also on the rise, that coffee shop in the lobby can be a critical factor in leasing the office space and keeping it occupied.

Because of this, many of the restaurants and retailers that are still open today — with the notable exception of large corporate chains — are keeping the lights on as the results of concessions from, or alternative arrangements with, property owners. Landlords are offering deals that allow these retail tenants to make a profit, while also creating an exit strategy for themselves if tenants do not fulfill their obligations.

Alternative arrangements include:

- ***Percentage Rent:*** This is the most common accommodation property owners make for tenants to encourage them to stay on a lease. While the tenant retains its lease, it no longer pays the landlord a fixed monthly fee, instead paying a specified portion of sales revenue. As part of the typical deal, the tenant commits to remaining open as an amenity to the building and the neighborhood.

- ***Management Agreements:*** The landlord essentially takes over the retail business as its owner and has the retail tenant operate within the space.

  A lease is no longer a factor in this arrangement, as the landlord acts as the business owner and the tenant provides the restaurant or retail services. It is the landlord who dictates whether the space remains open or is closed, while the restaurant operator is paid a fixed fee for running the operation.

  These agreements have been particularly common among restaurants within hospitality properties.

- ***Short-Term Leases:*** Some property owners and tenants are kicking the can down the road a bit as they try to see if work-from-home will become an enduring part of office life, how extensive it will be, and whether or not it will impact space needs.

  That may take a while to sort itself out and the short-term lease extension of one, two or three years is the logical way to address it as a stop-gap measure.

Over the past 18 months, many distressed tenants have attempted to void their leases without liability under the arguments of frustration of purpose or impossibility of performance amid the pandemic.

In March, the U.S. District Court for the Southern District of New York struck the arguments down in Gap Inc. v. Ponte Gadea New York LLC, involving the retail store at the corner of 59th Street and Lexington Avenue, reasoning that you have to pay up if you are a tenant on a lease.

Yet, while the court may have held that the traditional lease can endure, that has little bearing on the realities of the retail business. In truth, most tenants and property owners found case-by-case mutually beneficial solutions, such as those listed above.

While some legal intricacies of these lease arrangements can be unique to New York City's commercial real estate industry, they don't have to be. In fact, we've found that due to the size, depth and level of sophistication of the city's commercial real estate industry, its cutting-edge industry standards, either in contract terms or anything else, tend to get adopted in other places, over time.

Given the uncertainty around return-to-work now that Labor Day is no longer seen as a turning point and new variants have put people on edge, we view the proliferation of this legal creativity as a net positive for the industry, its retail tenants, and the cities we love.

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