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publication in the New York Reports.

1 No. 59
P.A. Building Company,
 Respondent,
 v.
City of New York,
 Appellant.

Ronald E. Sternberg, for appellant.
Donald M. Bernstein, respondent.

READ, J.:

 In this protracted landlord-tenant dispute, we are asked to decide whether asbestos abatement costs incurred by the landlord were operating expenses under the terms of the relevant commercial leases. We conclude that they were not. As a result, the landlord improperly billed these costs to the tenant as

additional rent under the leases' escalation clauses. Further, we conclude that interest on the award of additional rent due the landlord from the tenant for 1993 and 1994 should run from January 13, 1997, when the audit resisted by the landlord was finally commenced.

I.

From mid-1973 through early 1998, P.A. Building Company (PA) owned a 16-story commercial office building located at 111 Eighth Avenue in Manhattan.¹ Built in 1932, this 2.3 million square-foot building occupies an entire city block, bounded by 8th and 9th Avenues, and West 15th and West 16th Streets. Between August 17, 1978 and November 15, 1994, PA leased space in the building to the City of New York pursuant to long-term leases executed in 1978 and 1980, which were amended several times during their terms to add space (collectively, "the leases").

As relevant to this appeal, the leases obligated the City to pay PA monthly base rent and, as additional rent, a pro rata share of any increase in the building's annual operating expenses "as audited by the Comptroller" over those incurred in a specified base year. The leases defined "operating expenses" to include costs charged to PA "for services, materials and supplies furnished in connection with the operation, repair and maintenance of . . . the Building." In 1985 -- seven years

¹PA was a partnership between Sylvan Lawrence Company, Inc., which managed 111 Eighth Avenue, and Sylvan Lawrence's co-founder and chairman.

after the initial lease was drafted and signed -- New York City enacted Local Law No. 76 "to safeguard the public health by requiring that renovation or demolition projects which disturb asbestos be conducted in accordance with procedures established pursuant to [its] provisions" (Local Law No. 76, § 1 [1985]).

In June 1992, the City issued a request for proposals (RFP) "for the review and audit of additional rent payments made by City agencies . . . to private landlords pursuant to leases containing cost escalation clauses." In December 1992, the successful bidder entered into a contract with the City to perform the services sought by the RFP. Consequently, on July 30, 1993, the City informed PA that it "intend[ed] to exercise its right to audit" PA's statement of operating costs for the years 1978 to 1993 to "verif[y] [its] escalations."

On August 6, 1993, PA notified the City that it would not cooperate with the audit on the grounds that "the City [could] not suddenly seek a retroactive audit" and that "no audit by anyone other than the Comptroller's office is ever authorized." As a result, the City informed PA on August 30, 1993 that it would "withhold payment of all operating expense . . . escalations until [PA's] consent [was] obtained to perform an audit and such audit [was] completed," but that "[a]t the conclusion of the audit, all valid charges [would] be paid."

In March 1994, PA sued the City for breach of contract to recover escalation charges withheld by the City for 1993 and

1994, and to block the audit. The City answered and counterclaimed for a declaration that it was entitled to an order directing PA to submit to an audit and also asking for judgment in an amount to be proven at trial, representing the rent overcharges that the City expected the audit to reveal. PA moved and the City cross-moved for summary judgment.

In a decision and order filed March 2, 1995, Supreme Court denied PA's motion and granted the City's cross motion for summary judgment, and also granted the City's counterclaim to the extent of declaring that the City was "entitled to audit [PA's] books through its agent" and directing PA "to submit to such audit." Supreme Court reasoned that "because the Lease clauses establishing the City's right to audit the escalation charges and the obligation to pay them are mutually dependant covenants, [PA's] failure to allow the audit suspended the City's obligation to pay those charges"; and declared that "[a]s a matter of law, the City has not breached its contracts with [PA] by withholding payment of the escalation charges."

PA appealed, and the Appellate Division affirmed, observing that PA's "refusal to submit to an audit by [the City's agent], which impaired the City's ability to protest overcharges, cancelled the City's obligation to make additional payments for rent escalations" (P.A. Bldg. Co. v City of New York, 217 AD2d 417, 417-418 [1st Dept 1995], appeal denied 86 NY2d 708 [1995] [quotation marks omitted] [emphasis added]). As a result, "the

City did not breach its contract with [PA], and [PA] must submit to an audit by the City's agent" (id. at 418).

PA continued to fight a rearguard action against the audit (see P.A. Bldg. Co. v City of New York, 236 AD2d 275 [1st Dept 1997] [detailing PA's further objections and the resulting legal skirmishes]). PA's resistance, however, had given way to compliance by January 13, 1997, when the auditor began to review PA's books and records. The City presented PA with a draft audit report in May 1997. The final audit report, dated September 12, 1997, concluded that PA had overcharged the City almost \$1.2 million in escalation charges for operating expenses (out of about \$2.5 million billed) for the years 1988 through 1994. The City had paid PA at least \$1.7 million in escalation charges over the same time period. Thus the City claimed about \$448,000 in overcharges (the difference between the \$1.7 million actually paid and the \$1.3 million found to be allowable after audit).

By letter dated September 5, 1997, PA billed the City retroactively for roughly \$330,000 in additional operating expenses for the years 1988 through 1993. These charges were based on revised accounting statements issued in August 1997, which reclassified certain capital expenditures as operating expenses.² After the City refused to pay this invoice, PA

²Under the leases' terms, capital expenditures are generally excluded from operating expenses. An exception is made, however, for "replacements of building equipment and property" in need of repair, where the costs to repair are "such as to warrant in

brought an action in January 1998 to recover escalation charges for the years 1988 to 1994 (i.e., both the escalation charges withheld by the City beginning in the summer of 1993, pending completion of its audit, and those billed retroactively by PA), while the City answered and counterclaimed for overcharges.³ PA moved for summary judgment, and the City cross-moved for summary judgment dismissing the complaint and granting its counterclaim.

With respect to the counterclaim, the City contended that PA had improperly billed as operating expenses more than 20 separate categories of charges, including expenditures for asbestos abatement undertaken by PA. According to the final audit report, the "total charges disputed relating to this asbestos abatement project" amounted to roughly \$4.6 million over the period from 1988 to 1994. Further, "[t]he majority of" the work was carried out

"to remove insulation throughout the building which contained asbestos (ACM).⁴ The project essentially had three distinct parts, generally performed by different vendors. First, a consultant was retained to monitor the asbestos project. Second, a firm was hired to actually remove and cart away the ACM, and in some cases, a third company was engaged to re-insulate the piping throughout the building."

Landlord's good judgment" replacement instead.

³PA's 1994 and 1998 actions were subsequently consolidated under the index number for the 1994 action.

⁴"Asbestos containing material" or "ACM" is defined as "asbestos or any material containing more than one percent asbestos by weight" (see Administrative Code of the City of New York § 1403.2-9.12[a][4]).

As Sylvan Lawrence's Director of Operations and Construction subsequently testified at his deposition, the asbestos removed at 111 Eighth Avenue "was largely pipe covering," and "[a]lmost the entire building had pipe covering in the systems that existed in the building." Further, asbestos-containing pipe covering was taken out "as tenants would vacate the space or in other instances where it was necessary to remove the asbestos in mechanical areas that people inhabited." When asked if there was ever "any conversation of encapsulating the pipe covering" in lieu of removing it, he replied "No, I don't think there was -- no."

In a decision and order filed December 21, 2001, Supreme Court denied PA's motion for summary judgment, and awarded summary judgment to the City to the extent of dismissing the complaint in its entirety, principally based on what it believed to be the law of the case "holding that the City did not breach its contract with plaintiff, as [PA]'s refusal to submit to the audit 'canceled the City's obligation to make additional payments for "rent escalations"' in 1993 and 1994 (quoting P.A. Bldg. Co., 217 AD2d at 417-418).

Supreme Court also granted partial summary judgment on the City's counterclaim for escalation overcharges to the extent of holding that the inclusion of the costs of asbestos abatement in rent escalation was improper; and directed a trial on the merits of the remaining claimed overcharges. The Court

considered the record sufficient to support summary judgment on asbestos abatement because it was the only category of allegedly improperly billed operating expenses raising only a legal issue, and therefore not requiring factual determinations after trial. The Court concluded that "as a matter of law . . . the cost of asbestos abatement [was] not [an] item of repair or maintenance within the meaning of the operating expense escalation clause."

Upon PA's subsequent appeal, the Appellate Division reversed Supreme Court's judgment on the law and vacated it, concluding first that "[t]he motion court erred in dismissing, in its entirety, [PA's] claim for payment of rent escalations on the basis of the law of the case doctrine" (P.A. Bldg. Co. v City of New York, 305 AD2d 244, 245 [1st Dept 2003]). As the Court explained,

"a party's failure to perform its obligation[] under a dependent covenant [here, PA's obligation under the leases to permit the audit] results in the suspension of the complying party's obligation to perform under the agreement [here, the City's obligation under the leases to make escalation payments] until such time as the defaulting party complies [here, by consenting to the audit]. The complying party's obligation is not completely nullified, but only exculpated presently . . . until such time as the noncomplying party complies" (id. at 245-246 [internal quotation marks and citation omitted]).

The Appellate Division also decided that Supreme Court had improperly "exclud[ed] the cost of asbestos abatement from [the City's] baseline operating expense for purposes of calculating the rent escalations" because the leases

"never excluded asbestos abatement costs or repair costs deemed extraordinary and structural, even after the asbestos

problem became apparent. In fact, the rent escalation clause is a covenant to partially shift responsibility for asbestos abatement from the landlord to the tenant" (id. at 246 [internal quotations marks omitted]).

At the conclusion of a nonjury trial in December 2004, Supreme Court awarded PA \$473,480.73 for additional rent due for the years 1993 and 1994, plus interest from January 22, 1995 (apparently, the date these charges were billed), and \$244,977.73 for rent due under PA's retroactive billing for the years 1988-1993, with interest calculated from September 5, 1997 (the date these charges were invoiced). In so doing, Supreme Court adopted the figures and dates advocated by PA's lawyer in his closing argument. On February 16, 2005, final judgment was entered for PA and against the City in the amount of \$1,312,960.26.

The City appealed, contending that PA had improperly included the cost of asbestos abatement in calculating rent escalations, and that Supreme Court had chosen the wrong trigger dates for calculating interest on the awards. In a decision and order dated January 25, 2007, the Appellate Division affirmed in a memorandum, which stated in its entirety that

"[t]he issue of whether, under the governing leases, costs of asbestos removal at the demised premises may be passed by plaintiff landlord to defendant tenant, has been determined by this Court on a prior appeal, and we see no reason to revisit the issue, much less revise our determination. Defendant's remaining argument respecting the trial court's calculation of interest was waived" (P.A. Bldg. Co. v City of New York, 36 AD3d 539 [1st Dept 2007] [citation omitted]).

The City subsequently moved for permission to appeal to

us. We granted the motion, and now modify to the extent of holding that PA's asbestos abatement costs for 1988 through 1994 were not operating expenses within the meaning of the leases; and that interest on the award for \$473,480.73 (1993 and 1994 escalation charges) should run from January 13, 1997, the date when the City's audit began.

II.

A landlord's obligations regarding maintenance and repair are governed by the maintenance provisions of the relevant Building Code -- in this case, the Administrative Code of the City of New York (see Wolf v 2539 Realty Assocs., 161 AD2d 11, 14 [1st Dept 1990]), section 27-128 of which provides that a building owner "shall be responsible at all times for the safe maintenance of a building and its facilities." As the Appellate Division recognized in Wolf, covenants to keep leased premises in good order and repair do "not entail the assumption of any responsibility for an inherent characteristic of a material employed in the original construction of the premises by the owner or his [or her] agents in compliance with then-existing laws and regulations" (161 AD2d at 16). Thus, when interpreting such repair clauses, the lower courts have held

"that absent a lease covenant to the contrary, responsibility for Local Law No. 76 compliance is not shifted from the landlord to the tenant. [Where] the lease, even as supplemented, does not expressly shift this particular financial burden to the tenant, even in the context that the tenant's exit work might cause or exacerbate an asbestos condition, the burden as between the parties does not rest on the tenant" (Chemical Bank v Stahl,

272 AD2d 1, 16 [1st Dept 2000] [citations omitted, emphasis added]; see also Marine Midland Bank v 140 Broadway Co., 236 AD2d 232, 233 [1st Dept 1997]; Linden Blvd. v Elota Realty Co., 196 AD2d 808, 810 [2nd Dept 1993]).

The rent escalation clauses in the 1978 and 1980 leases are specifically intended to shift some responsibility for the costs of the building's operation, repair and maintenance from PA to the City. Indeed, we have previously recognized the risk-shifting nature of escalation clauses (see Credit Exch. v 461 Eighth Ave. Assocs., 69 NY2d 994, 997 [1987] [tax escalation clause]; George Backer Mgt. Corp. v Acme Quilting Co., 46 NY2d 211, 218 [1978] [wage rate escalation clause]). Here, both leases contain respective (and substantively identical, except for dates and numerical figures) provisions titled "Escalation" (Article 24). Paragraph (b) of Article 24 states as follows:

"(b) Tenant shall pay to Landlord, as further additional rent, [3% in 1978 lease, 2.34% in 1980 lease] of any increase in the operating expenses of the building as audited by the Comptroller of which the demised premises are a part in excess of such operating expenses for the [1978 or 1980] calendar year (the "Base Year"); and in the event of a decrease in the aforesaid operating costs below such operating costs incurred during the Base Year, the Tenant shall receive [3% in 1978 lease, 2.34% in 1980 lease] of such decrease as a credit in rent.

"Operating Expenses are defined as follows:

"A. Items included in Operating Expenses.

"(1) Labor Costs (as hereinafter defined) for the services of . . . employees performing services required in connection with the operation, repair and maintenance of the Building[, including]: [. . .]

"(vi) carpenters, engineers, firemen, mechanics, electricians, and plumbers engaged in the operation, repair and maintenance of any part of

the Building, the plazas and sidewalks around the Building, and the heating, air conditioning, ventilating, plumbing, electrical and elevator systems of the Building . . .

"[(2)-(10) Numerous types of costs associated with normal operation, maintenance and repair of the Building];

"(11) All other incurred costs and charges generally recognized as constituting Operating Expenses of a building and the land on which it is situated" [emphases added]).

These contractual provisions control, and thus our task is to determine whether asbestos abatement is the kind of financial risk that the lease expressly shifted from PA to the City. In short, is asbestos abatement an "Operating Expense[]" within the meaning of Article 24?

As the above-quoted passages illustrate, an expense generally qualifies as an operating expense if it relates to the "operation, repair and maintenance of any part of the Building" and/or was a "cost[or] charge[] generally recognized as constituting [an] Operating Expense[]" of a building and the land on which it is situated" (emphasis added) when these leases were executed in 1978 and 1980. Indeed, escalation costs are defined as the difference between operating expenses for the lease year under consideration and those incurred in a specified base year - - calendar year 1978 for the 1978 lease, and calendar year 1979 for the 1980 lease. Importantly, neither party argues that PA or the City contemplated asbestos abatement in drafting or subscribing to these leases; there is no allegation that asbestos

abatement costs were included as operating expenses in the base years against which the City's obligation for additional rent was measured. This is not surprising since the impetus for asbestos abatement -- Local Law No. 76 -- was not enacted until 1985, and, in any event, covers "renovation or demolition projects," not "operation, repair and maintenance." Even assuming that PA undertook abatement to address an asbestos hazard on the premises, this was "not a condition in need of 'repair' in the normal sense of the word, meaning 'fix' or 'mend.'" Corrective measures [were] not necessitated by any damage or wear which impair[ed] the effectiveness of the material" (Wolf, 161 AD2d at 15 [citation omitted]). In sum, asbestos abatement costs are not operating expenses within the meaning of Article 24 of the leases.⁵

III.

In closing arguments after trial, the City's lawyer took the position that interest on any award in favor of PA and against the City should only run from 1997 at the earliest "given [PA's] failure to comply with [the City's] requests to audit back

⁵While the dissent argues that we "overlook[] the main point of escalation clauses" (dissenting op at 2), the parties to this suit did not agree to, and we are not asked to pass upon, "escalation clauses" in general. At issue here is the particular escalation clause agreed to by PA and the City, and this clause was clearly limited in scope: only "normal operation, maintenance and repair" costs and "costs and charges generally recognized as constituting operating expenses" were subject to escalation.

in '93," and the courts' decisions holding that because "the City wasn't in breach in failing to pay the bills, any of its obligations were suspended." PA's lawyer countered that "\$244,977.22, we are seeking interest on that from the date of the retroactive billing, which is September 5, '97 . . . \$473,408.73, we seek interest from January 22nd, 1995," without spelling out why he chose the latter date.⁶ Supreme Court, in an oral decision, said that "for the reasons stated by [PA's counsel] in his final argument, the court is going to award judgment in the full amount as quoted on the record." The amounts and dates advocated by PA's lawyer were later set out in the final judgment.

Without explanation, the Appellate Division decided that the City had "waived" any argument "respecting the trial court's calculation of interest" (P.A. Bldg. Co., 36 AD3d 539). In light of the above-quoted statements made by the City's attorney in closing arguments, we disagree.⁷ The City was not required, as PA urges (and evidently likewise contended at the Appellate Division), to make a post-trial motion aimed at

⁶In its brief to us, PA merely indicates that the \$473,408.73 was "billed on" January 22, 1995. There are no invoices in the record dated January 22, 1995.

⁷In its appeal to this Court, the City seeks to tie the running of interest on the additional rent retroactively billed by PA in 1997 to the date in 1999 when the Comptroller filed an audit in response to PA's notice of claim and at the behest of the City's Department of Law. This argument was never made to the trial court, and thus is unpreserved for our review.

persuading the trial judge to change her mind in order to preserve its challenge to the interest rate calculations.

The dispositive wrinkle in this case was accurately pointed out by the City's trial lawyer: the City's obligation to pay the escalation charges for 1993 and 1994 as additional rent was "suspended" by the lower courts until such time as PA cooperated with the requested audit: the lower courts specifically held that, until PA submitted to the audit, the City was not obligated to make these payments and, in the meantime, did not breach the leases by withholding the additional rent.⁸ The parties agree that the audit commenced on January 13, 1997. Thus, January 13, 1997 is the date on which interest on the award for the 1993 and 1994 escalation charges begins to run. This comports with CPLR 5001(b), which commands that "[i]nterest shall be computed from the earliest ascertainable date the cause of action existed" [emphasis added]).

Accordingly, the Appellate Division's order should be modified, without costs, by remitting to Supreme Court for further proceedings in accordance with this opinion and, as so modified, affirmed.

⁸We do not mean to imply either approval or disapproval of the lower courts' "suspension" approach; we merely recognize it as law of the case. We further note that earlier in this long-running litigation, PA itself apparently relied on the lower courts' "suspension" holding to obtain dismissal of the City's statute-of-limitations defense.

P. A. Building Company v City of New York

No. 59

SMITH, J.(dissenting in part):

I agree that the Appellate Division erred in its ruling on interest, but I think it decided the operating expenses issue correctly.

The lease requires the tenant, New York City, to pay its share of increases in "Operating Expenses," defined in several clauses to include expenses for "operation, repair and maintenance" of the building. (These clauses are quoted in the Appendix to this opinion.) There is no exclusion for expenses that are extraordinary in nature or amount, or that were not or could not have been contemplated at the time of the lease. Contrary to the impression given by the majority opinion, the words "operation, repair and maintenance" are not qualified by the adjective "normal," except in one clause of minor significance (see Appendix, subparagraph [4]). I believe "operation, repair and maintenance," read in context, includes the asbestos abatement at issue here.

It is immaterial, as the majority seems to recognize, that asbestos abatement is ordinarily a landlord, not a tenant, expense (Wolf v 2539 Realty Assoc., 161 AD2d 11 [1st Dept 1990]). The very purpose of escalation clauses is to shift some landlord expenses to tenants, so that increases in these expenses do not

consume the landlord's profit (see Credit Exch. Inc. v 461 Eighth Ave Assoc., 69 NY2d 994, 997 [1987]). It is also immaterial, I think, that there were no asbestos abatement expenses "in the base years against which the City's obligation for additional rent was measured" (majority op at 13). The question is whether the "operations, repair and maintenance" expenses of the building increased -- not whether the increase resulted from the addition of a new category of expenses or the enlargement of an old one.

The main ground for the majority's decision seems to be its view that the landlord's exposure to asbestos abatement expense was unforeseen, and perhaps unforeseeable, at the time the lease was entered into (see majority op at 12-13). But the majority overlooks the main point of escalation clauses: they are supposed to protect against unforeseen developments that make running a building more expensive -- including regulatory changes. If a regulatory change had required the landlord to install window guards, or to pay higher wages, the increased cost would not, under this lease provision, have been borne by the landlord alone -- and a regulatory change requiring asbestos abatement is not meaningfully distinguishable.

The lease excludes from its escalation clause certain costs "properly classified as capital expenditures," but the City does not argue that this exclusion applies here. Nor does the City seriously argue -- and the record does not show -- that the asbestos abatement expenses had the purpose or effect of

enhancing the building's value; it is essentially undisputed that the landlord had to spend this money in order to continue operating the building. The Appellate Division was right to hold that the City should pay its share.

APPENDIX TO DISSENTING OPINION

"A. Items included in Operating Expenses:

"(1) Labor Costs (as hereinafter defined) for the services of the following classes of employees performing services required in connection with the operation, repair and maintenance of the Building:

. . .

"(2) the cost of materials and supplies used in the operation, repair and maintenance of the Building;

"(3) the cost of replacements for tools and equipment used in the operation, repair and maintenance of the Building;

"(4) the amounts paid to managing agents of the Building employed by Landlord (which shall be competitive with management fees customarily paid to managing agents of first class Manhattan office buildings) or for professional fees (other than legal) normally incurred from year to year in connection with the normal operation, maintenance and repair of the Building.

"(5) amounts charged to Landlord by contractors for services, materials and supplies furnished in connection with the operation, repair and maintenance of any part of the Building, the plazas and sidewalks adjoining the Building, and the heating, air conditioning, ventilating, plumbing, electrical, elevator and other systems of the Building;"

* * * * *

Order modified, without costs, by remitting to Supreme Court, New York County, for further proceedings in accordance with the opinion herein and, as so modified, affirmed. Opinion by Judge Read. Chief Judge Kaye and Judges Ciparick, Graffeo and Pigott concur. Judge Smith dissents in part in an opinion in which Judge Jones concurs.

Decided May 1, 2008