

Baby It's Cold Outside - But Don't Tell the Markets ...

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Contracts Clause Rears Its Powerful Head for a Landlord



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In a recent case, *513 West 26th Realty LLC v. George Billis Galleries Inc.*, a New York Supreme Court addressed whether the COVID-era personal guaranty relief statute (the Guaranty Law) violated the Contracts Clause of the U.S. Constitution.

The Guaranty Law was originally passed in May 2020 by the New York City Council in response to the COVID-19 pandemic. Its aim was to prevent commercial landlords from holding personal guarantors liable for a business tenant's default in rent payments during the State-mandated closure period.

In this case, the tenant, a gallery, defaulted on its lease, and the landlord sought to enforce the personal guarantee of the tenant's principal. The tenant argued that the Guaranty Law should invalidate the guarantee. The landlord, in turn, argued that this law unconstitutionally interfered with their contract rights, claiming it violated the Contracts Clause of the U.S. Constitution by impairing the enforceability of the lease agreement retroactively.

In deciding whether a law violates the Contracts Clause, the Court applies a two-step analysis. First, whether the state law has "operated as a substantial impairment of a contractual relationship," which is determined by considering the extent to which the law undermines the contractual bargain, interferes with the parties' expectations, and prevents the parties from safeguarding their rights; and if the law operates as a substantial impairment. Second, whether the state law is drawn in an appropriate and reasonable way to advance a significant and legitimate public purpose. (*Sveen v. Melin*, 584 US 811, 819 [2018])

In considering whether the law operates as a substantial impairment of a contractual relationship, the City, on behalf of Defendant, argued that the law simply makes commercial leases less profitable, but the court rejected this argument, citing prior decisions, particularly *Melendez I*[1] and *Melendez II*[2]. These cases held that the law permanently undermined landlords' contractual rights by preventing them from collecting unpaid rent during the statutory period, and that landlords would not have entered into leases without the benefit of the guaranty. Consequently, the Guaranty Law is deemed a substantial impairment of the contractual relationship.

Next, in considering whether the law is drawn in a reasonable way to serve a legitimate public purpose, the City argued that the law was enacted to protect small business owners from personal bankruptcy, a legitimate goal given the financial impacts of the pandemic. However, the court found that while the public purpose is valid, the means used are not reasonable. The law permanently eliminates landlords' ability to collect unpaid rent, unlike temporary measures seen in past cases like *Blaisdell*[3], which allowed homeowners facing foreclosure to delay mortgage payments for up to two years to prevent the loss of their homes during the Great Depression. The City failed to justify why landlords, rather than tenants or guarantors, should bear the full economic burden. Additionally, the law lacks a need requirement and does not provide compensation to landlords for their losses, which contrasts with other relief measures that balance interests more equitably.

While the City's objective was legitimate, the Court found that the Guaranty Law was not reasonably tailored to achieve the intended objective. The Guaranty Law imposed a significant and permanent impairment on landlords' contractual rights without adequate compensation or justification for its broad application, thus violating the Contracts Clause of the U.S. Constitution.

[1] *Melendez v. City of New York*, 503 F. Supp. 3d 13 [SDNY 2020]

[2] *Melendez v. City of New York*, 16 F.4th 992 [2nd Cir 2021]

[3] *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 US 398 [1934]