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New York Residential Landlord-Tenant Law and Procedure*

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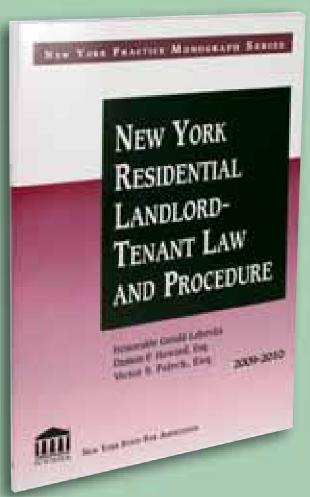

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New York residential landlord-tenant law is daunting to newcomers and the experienced alike, given its patchwork statutory framework, discordant case law, and emotion-laden disputes involving homes, money, and the charged landlord-tenant relationship. This greatly expanded monograph introduces the fundamentals of residential landlord-tenant law and offers a guide to the procedural mechanics practitioners face in landlord-tenant disputes.

The 2009-2010 release is current through the 2009 New York State legislative session.

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Message from the Section Chair

It is hard to believe that it has been three years since the nominating committee announced that I would be taking minutes for the next year. Those three years have flown by. I learned so much from my predecessor Chairs, Joel Sachs, Peter Coffey and Karl Holtzschue. Clearly I have large shoes to fill!

Joel Sachs has been tremendous in his support of me during the Vice Chair year. We worked beautifully as a team. Joel has promised to remain active so that we will continue to have the benefit of his good counsel.

We have a great leadership team this year in Ed Baer, Heather Rogers and Steve Alden. Spencer Compton will continue as our faithful finance officer. We are so grateful that he is willing to continue to manage our budget. It takes so long to become familiar with the mysterious inner workings of the finances that we would hate to lose his services.

This year will continue to be a busy one. We begin with an interesting and informative Summer Meeting at the Dolce Seaview Inn in New Jersey which Ed Baer, in conjunction with Pace University Law School, has developed. This is a collegial group. Bring a friend or two to the Summer Meeting.

Our many committees and task forces will continue their efforts to help improve the practice of real property law in the State of New York. Sam Tilton has agreed to partner with Karl Holtzchue on the Legislation Committee. This should reprise their great efforts from Title and Transfer!

We will continue our liaison with St. John's Law School and Pace University Law School. These have been very beneficial relationships for all involved.

Our district representatives will continue to work with the membership committee to build our strength through district social events and mini-CLE programs. Heather Rogers is taking on the task of organizing and supervising the District Representatives. Nancy Connery (1st District) planned a cocktail party which was held in May. The combined 3rd and 4th Districts will have a day at the Saratoga Race Track planned by Michelle Wildgrube and Frank Sarratori.

Our *Journal* is the finest among all Sections of the bar. This is due to the articles written by you and the strong leadership of our editors, Vincent Di Lorenzo, Bill Colavito, Marvin Bagwell and Bill Johnson.

Our CLE committee will need all of us to continue to present the finest CLE programs in NYSBA.

Surely there will be challenges as we recover from this recession. With your help and participation, we will resolve these challenges. I look forward to working with all of you.

All the best,
Anne Reynolds Copps

New York Residential Landlord-Tenant Law 101 for the Transactional Attorney

By Margaret B. Sandercock and Gerald Lebovits

Introduction

A transactional attorney whose client wants to acquire a building occupied by residential tenants must have answers to many important questions. These questions include whether existing tenants have rights of continued occupancy and to the issuance of renewal leases; whether the tenants' leases are enforceable and whether other enforceable agreements with the tenants, apart from their leases, will bind the purchaser; whether there are impediments to collecting rent; whether the purchaser will face financial liability for the prior owner's actions, such as rent overcharges; and whether the purchaser will be able to continue any landlord-tenant proceedings the prior owner commenced.

The building's suitability for the purchaser's purposes and the fiscal advisability of the purchase might hinge on the attorney's answers to these questions. The parameters of pre-purchase due diligence, the contract provisions necessary to protect the purchaser's interests, and the steps the purchaser should take at the closing and immediately post-closing will require a basic knowledge of landlord-tenant law.

This article spots some of the most common landlord-tenant issues that transactional attorneys should recognize so that they can assess the proposed purchase, consult with a landlord-tenant specialist if necessary, and take action required at closing. The attorney's pre-purchase research, which may be conducted pre-contract or during a due-diligence period with a right of cancellation after the contract is signed,[1] should be conducted simultaneously with other due diligence and will supplement an engineering report and physical inspection of the entire building.[2]

Due Diligence Issue #1: Do the Tenants Have the Right to Stay?

Customarily, the contract of sale for an occupied residential building will contain a schedule of the unit numbers, the rent amounts, and the security deposits, if any. Leases to which the contract is subject (those that will continue after closing) may be attached to the contract or provided during a post-contract due-diligence period. The purchaser's attorneys should seek a contract representation that the leases the seller provides are the only written agreements with the tenants.

"This article spots some of the most common landlord-tenant issues that transactional attorneys should recognize so that they can assess the proposed purchase, consult with a landlord-tenant specialist if necessary, and take action required at closing."

Absent an option to renew, a lease provision terminating the lease on sale of the building, or some other written agreement with the prior owner, residential tenants not subject to New York's rent-regulatory laws may remain for the balance of their lease but need not be given a renewal lease.[3]

A rent-regulated tenant, however, has the right to continue in possession with successive renewal leases, in the case of rent-stabilized status, or as a statutory tenant without a lease, in the case of rent-control or interim multiple dwelling (Loft Law) status.[4] These tenants' occupancy rights may not be terminated without a showing of good cause.[5] Some rent-regulated tenants' successors in interest also have the right to continued occupancy.[6] Tenants who meet the following requirements are rent-regulated.

Rent-Stabilized Tenants

Rent-stabilized tenants in New York City are those who live in buildings with six or more units built before January 1, 1974, and which are not subject to rent control, as well as the tenants of some newer buildings that became subject to rent stabilization because the owner participated in a real estate tax-abatement program.[7] Some localities in the counties of Nassau, Westchester, and Rockland also adopted the Emergency Tenant Protection Act (ETPA).[8] In those localities, a building with six or more units built before January 1, 1974, and which is not subject to rent control is subject to rent stabilization.[9]

Purchasers of cooperative or condominium units occupied by rent-stabilized and rent-controlled tenants must be alert to a tenant's right of continued occupancy. If the building was converted under a non-eviction plan,[10] rent-regulated tenants who do not purchase their units retain their statutory rights.[11] Even if the building is converted under an eviction plan, rent-regulated tenants are entitled to continued occupancy for at least three years after the offering plan is declared effective.[12] The three-year limitation does not apply to senior citizens[13] (over sixty-two) and the disabled,[14] who retain their statutory rights indefinitely.[15]

Courts in the First and Second Departments have recently recognized, in addition, that tenants who live in a commercial building with six or more residential units not subject to the Loft Law[16] and located in an area where residential occupancy is permitted by zoning might be subject to rent stabilization.[17]

To be rent stabilized in the First Department, a residential tenant in a commercial building must demonstrate that zoning requirements are complied with, that the building has six or more residential units, that the landlord knew or should have known of the residential occupancy, and that the unit is capable of being legalized.[18]

> *"An exception to rent stabilization coverage exists if the landlord, at the landlord's expense, substantially rehabilitated the property after January 1, 1974, without receiving a real estate tax benefit."*

The standards are stricter in the Second Department, which has indicated its intent to limit rent-stabilized tenancies in commercial buildings.[19] In the Second Department, a residential tenant in a commercial building must establish not only compliance with zoning, that the building has six or more residential units, and that the landlord knew or should have known of the residential occupancy, but also that residential amenities were installed at the occupants' expense and that the landlord took affirmative steps to convert the premises to residential use during the pendency of litigation in which the tenants sought rent-stabilization protection.[20]

A count of six or more residential units, which invokes rent stabilization, may be arrived at in a number of ways: if there were six or more units when the building came under rent stabilization;[21] if six or more units are on the certificate of occupancy (C of O) of a building otherwise qualifying for rent stabilization, even if the building, as used, has less than six separate units;[22] or if the number of residential units in a building otherwise qualifying for rent stabilization is increased to six or more.[23] On the other hand, a building remains rent stabilized if it has six or more units and the number of units is subsequently decreased to five units or fewer.[24]

In some instances, a building might contain six or more units and be subject to rent stabilization even though it is not initially obvious that the requirement of six or more units is met. For instance, garden apartments in New York City are covered by rent stabilization.[25] Even if an individual building in the complex has fewer than six units, but so long as the complex in total has six or more units, the complex is covered by rent stabilization if it meets the other statutory requirements. Sometimes two or more physically adjacent buildings, none of which contains six or more units, will collectively be declared a horizontal multiple dwelling subject to rent stabilization if the buildings meet the other requirements of rent stabilization and are operated as a single enterprise under common ownership and share common facilities such as a boiler or water supply.[26]

An exception to rent stabilization coverage exists if the landlord, at the landlord's expense, substantially rehabilitated the property after January 1, 1974, without receiving a real estate tax benefit.[27]

Some units that would presumptively be subject to rent stabilization are, on investigation, deregulated. One reason this might be the case is that the unit has consistently been owner-occupied.[28] Another reason is that the legal regulated rent rose to a figure exceeding $2,000 a month, either at a vacancy or if the tenant's annual income exceeded $175,000 for two years in a row.[29] This deregulation is called "luxury decontrol."

With the exception of residentially occupied commercial buildings that are rent stabilized due to case law and not by statute or regulation, a building's rent-stabilized status and the number and identity of registered units can be ascertained from the Department of Housing and Community Renewal (DHCR), the regulatory agency, by making a request to the DHCR's Public Information Unit. The seller's cooperation is required for all pre-closing DHCR investigations; the contract should require that cooperation. A DHCR investigation must be conducted on the purchaser's behalf of any building of six or more units in New York City, Nassau, Westchester, or Rockland counties. The purchaser's attorney should assume that all buildings in these areas meet the basic criteria for rent stabilization and that all units in these buildings should be registered, and should ask the seller to explain unregistered buildings and units.

Single Room Occupancies

Permanent tenants of single room occupancy facilities (SROs) in New York City are protected under rent stabilization if the building was erected before July 1, 1969, contains six or more units, and the rent charged was less than $88 a week or $350 a month on May 31, 1968.[30] Rent-stabilization protection for SRO tenants can also accrue because the building received a tax abatement.[31] Permanent tenants are those who have been in occupancy for six months or more[32] or who have been in occupancy for at least fifteen days and have requested a lease.[33]

The New York City Department of Housing Preservation and Development (HPD) regulates New York City's SRO facilities. The New York City Department of Buildings (DOB) will not issue a building permit for a building known to it as an SRO if HPD does not issue a Certificate of No Harassment.[34] The "look back period" for a Certificate of No Harassment is three years.[35] Even if the building is vacant when the purchaser acquires it, HPD requires assurance that the former owner, in preparation for selling the building, did not harass the tenant to vacate. The purchaser's attorney for any building that, by its age and physical configuration, could possibly have been used as an SRO facility must review the DOB's records and contact the HPD to see whether city records reflect it as an SRO. If so, existing single-room tenancies meeting the rent-stabilization requirements might have to be continued. The seller should also be contractually bound by a condition of closing to obtain a Certificate of No Harassment if one is required.

Loft Law Tenants

Loft Law tenants are residential tenants who lived, between April 1, 1980 and December 1, 1981, in formerly commercial buildings, zoned legal for residence. These buildings must contain three or more residential units and these tenants' lawful successors.[36] The Loft Law covers tenants in these buildings located in areas not zoned legal for residence if they can show that the building contained three or more residential units from April 1, 1980 through May 1, 1987.[37] Loft Law buildings are regulated by the New York City Loft Board, located at 100 Gold Street, New York, New York 10038, and must be registered with the Loft Board,[38] which maintains a website listing the buildings currently under its jurisdiction. In addition to the Multiple Dwelling Law's statutory provisions enacting the Loft Law, the Loft Board has a body of its own regulations and decisions, or Loft Board orders.[39]

The Loft Law is a transitional statute[40] under which landlords of rent-regulated buildings are statutorily required to obtain a Class A C of O for residential use,[41] a significant financial commitment. There are statutory time limits within which a C of O must be obtained, although under Loft Board regulations, a new owner may obtain a one-year extension if it misses a deadline.[42] When the C of O is obtained, Loft Law tenants become rent stabilized.[43] Some rent-stabilization provisions like luxury decontrol do not apply to Loft Law tenants.

The Loft Board website listing does not include buildings that have obtained their C of O or buildings in which all the Loft Law tenants have vacated. This is significant because if a building or unit is vacated pre-C of O and the landlord does not buy the Loft Law tenants' tenancy rights as statutorily permitted,[44] the unit remains subject to the Loft Law. If a Loft Law unit is vacated pre-C of O with a payment for tenancy rights, the sale must be reported to the Loft Board with a statement concerning the unit's intended future use. If the unit will be used residentially, the landlord is required to obtain a residential C of O.[45] If the Loft Board is advised that the unit will be used commercially but it becomes reoccupied residentially, the unit becomes rent stabilized.[46]

The prospective purchaser's attorney for a building known to have been subject to the Loft Law should make a Freedom of Information Law (FOIL) request to review all records concerning the building or arrange for a knowledgeable Loft Law practitioner to do so. If the Loft Law status is unknown but the building's appearance and history suggest that it might have been subject to the Loft Law, a contract representation should be sought that the building and its units are not, and never have been, subject to the Loft Law.

Rent-Controlled Tenants

Rent-controlled tenants live in buildings containing three or more residential units, residentially occupied since February 1, 1947, or earlier and occupied by the current record tenant or lawful successor since at least July 1, 1971. Rent-control laws are effective in New York City, more than 50 municipalities throughout the state, and the counties of Albany, Erie, Monroe, Nassau, Oneida, Onondaga, Rensselaer, Schenectady, and Westchester. Rent control also applies to buildings of fewer than three units if the tenant or lawful successor has been in residence since at least April 1, 1953.[47]

Rent-controlled tenancies are registered with DHCR. Because of the age of many of these tenancies, DHCR's records are not always complete or accessible. Complicating the investigation of rent-controlled tenancies is that renewal leases are not issued. They need not be issued: rent-controlled tenants are statutory tenants. In any transaction concerning a residential building built before 1947, the attorney should seek a contract representation that there are no rent-controlled tenancies. Investigating this issue independently can prove difficult.

Immediate family members may succeed to the tenancy rights of rent-controlled and rent-stabilized tenants. To succeed to a rent-controlled or rent-stabilized tenancy, the family member seeking succession has the burden of proof to show by a fair preponderance of the credible evidence[48] that the protected tenant vacated due to death or permanent departure and that both the protected tenant and the family member seeking succession primarily resided in the unit together for two years (or one year where the tenant or spouse is over age 62 or disabled).[49] The following are immediate family members under rent stabilization and rent control: the protected tenant's husband, wife, son, daughter, father, mother, grandfather, grandmother, grandson, granddaughter, sister, brother, stepson, stepdaughter, stepfather, stepmother, father in law, mother in law, son in law, and daughter in law.[50]

The Court of Appeals in *Braschi v. Stahl Associates Co.*[51] expanded the concept of family to include nontraditional family members like homosexual couples. Regulations governing both rent-controlled and rent-stabilized tenants later adopted the *Braschi* standards. The New York City Loft Board issued an order that likewise adopted *Braschi*.[52] To succeed to a regulated tenancy, the nontraditional family member must satisfy the requirements for traditional family members (permanent vacatur of the regulated tenant and primary residence of the regulated tenant and the succeeding tenant for one or two years) and, in addition, demonstrate that the relationship was one of emotional and financial commitment and interdependence. This is a litigious area with numerous fact-specific precedents. A prospective purchaser or new owner who wishes to investigate tenancies that might fall under *Braschi* should seek specialized legal assistance.

In all cases it is advisable to obtain a contract provision stating that no litigation is pending in any court or administrative agency concerning the building or, in the alternative, listing all litigation so that it can be investigated.

Due Diligence Issue #2: Lease and Rent Issues

After determining whether any residential tenant has a right of continued occupancy, the purchaser should ascertain whether the leases claimed to be in effect are enforceable;[53] whether rent can be collected; and whether the rent amounts in the leases are legally permitted.

Are the Leases Enforceable?

For residential tenancies, regulated and deregulated alike, courts will not enforce leases that are unconscionable[54] or against public policy. For instance, rent-stabilized leases giving unrestricted rights to sublease and assign, or waiving the obligation of primary residence at the premises, are unenforceable as against public policy.[55] Other examples of unenforceable leases include those that permit the landlord to breach the warranty of habitability[56] and in which rent-stabilized and rent-controlled tenants waive their rent-regulatory rights.[57]

Agreements between the prior landlord and a tenant conferring rent-stabilized status are enforceable[58] and bind successor landlords even if the agreement did not so provide, because these agreements run with the land.[59]

Can Rent Be Collected?

Even if the residential tenants are not rent regulated, rent may not be collected if the building does not have a C of O for residential use if a C of O is required.[60] This rule equally applies in the Second Department to situations in which residential tenants live in commercial buildings but do not qualify for rent-stabilization protection.[61] Rent may also not be collected from the residential occupants of portions of the building not covered by the C of O, such as extra units not reflected on the C of O.[62]

New York City buildings containing three or more residential units must be registered as multiple dwellings with HPD; this registration is known as a Multiple Dwelling Registration statement, or MDR. The consequence of failure to register is that rent may not be collected until registration.[63] This is true whether or not the occupants are rent-regulated and whether or not the residential occupancy is legal.[64]

Rent-regulated buildings must be registered with the proper regulatory authority, whether the DHCR or the Loft Board,[65] or rent may not be collected. If the registration for a stabilized unit is not kept current, the landlord may not charge in excess of the last registered rent. Rent may not be collected from Loft Law tenants in buildings in which the landlord has not complied with the code-compliance timetable set out in Multiple Dwelling Law § 284.[66]

Are the Claimed Regulated Rents Correct?

It is the nature of a deregulated tenancy that as long as the C of O corresponds with the use of the building and the building is registered if registration is required, the landlord may charge and collect any rent the tenant agreed to. A hallmark of a regulated tenancy is that although the landlord may charge the tenant less rent than the law permits, the rent may not exceed the regulated rent.

A rent-stabilized tenant's rent, which is less than the law permits, is a preferential rent. For leases post 2003, a preferential rent reflected as such in the tenant's lease need not be continued in lease renewals absent an agreement between the landlord and the tenant that the preferential rent will continue permanently throughout the tenancy.[67]

The rents paid by rent-stabilized tenants must be registered with DHCR. Unless the stabilized tenant is paying a preferential rent, the legal regulated rent is calculated as follows: the initial legal registered rent (generally the first rent registered by the landlord after April 1, 1984);[68] plus the increases permitted for a one- or two-year lease;[69] plus any vacancy allowances that have accrued during vacancy between tenants;[70] plus any other permitted increases by virtue of Major Capital Improvements (MCI) or other improvements;[71] less any rent-reduction orders in effect for failure to provide required services.[72]

A landlord might be entitled to MCI increases for work to operate, preserve, or maintain a building, but not for ordinary repairs.[73] The work must be building-wide, benefitting all tenants.[74] Building systems such as heating or intercom can result in an MCI increase only after they exceed their useful life as determined by a DHCR schedule.[75] MCI increases may not exceed the tenant's regulated rent by six percent a year.[76]

MCIs require an application to DHCR before the appropriate rent increase may be collected.[77] MCI applications must be supported by at least one of the following: cancelled checks for payment of the work; invoice receipts marked "paid in full"; a signed contract for the work; or a contractor's affidavit that the work was completed and paid in full.[78] DHCR might require additional proof if the relationship between the contractor and the landlord is not at arm's length.[79]

Work on an individual unit can result in what is known as a "1/40th increase."[80] Examples of work that might qualify for that increase include new kitchen cabinets and windows, but ordinary maintenance such as painting and finishing floors is ineligible.[81] Landlords most often perform the work between tenancies, with the cost passed along to the new tenant, who has the opportunity to file a Fair Market Rent Appeal (FMRA) to grieve the rent for a period of four years, if the landlord notified the tenant that work was done and that the rent increased in consequence.[82]

If a building is rent stabilized, the purchaser should require the seller to provide at least four years of leases and compare them with the rent registrations filed at DHCR for the same period. The purchaser should obtain a contract representation concerning all pending applications before DHCR and compare it with a printout that can be obtained from DHCR indicating open matters. The attorney should collect proof of performance of all work leading to 1/40th increases for at least the past four years as well as notice to the new tenant a rent increase was based on this work. Likewise, the attorney should obtain all proof associated with MCI work for at least the past four years, together with an agreement to assist post-closing on pending MCI applications.

Rent-controlled rents are comprised of the initial base rent plus annual increases.[83] The DHCR annually sets rent increases for rent-controlled tenants outside New York City.[84] In New York City, since 1972, a procedure called the Maximum Base Rent (MBR) system allows rent-controlled rents to be increased.[85] Every two years, DHCR sets an allowable increase in the MBR for each rent-controlled apartment.[86] Rents can be increased by a maximum of 7.5 percent each year, but they are limited to the amount needed to reach the MBR.[87] To obtain an MBR increase, the landlord must apply to DHCR six months in advance for an order of eligibility, which requires the landlord to represent, among other things, that rent-impairing violations have been cleared, corrected, or abated.[88]

Senior citizens in both rent-controlled and rent-stabilized apartments may apply for a SCRIE exemption from future rent increases if the head of household is over 62, the family income is $29,000 a year or less, and the rent exceeds one-third the gross household income.[89]

Loft Law tenants do not pay regular, periodic rent increases.[90] The tenant's base rent under the Loft Law, which in almost all cases was established twenty or more years ago, is derived from a complex Loft Board formula that takes into account the date and percentage of the tenant's last rent increase.[91]

The only increases from the base rent for Loft Law tenants are associated with progress toward obtaining a C of O: for filing an alteration application (six percent), obtaining a building permit (eight percent), and achieving temporary C of O standards (six percent).[92] After a C of O is obtained, the landlord may apply to the Loft Board to pass along to the tenants, as a temporary rent increase over ten or fifteen years, the reasonable costs of obtaining the C of O,[93] as well as the New York City's Rent Guidelines Board-permitted loft increase for that year.[94]

There are no SCRIE rent adjustments for Loft Law tenants, nor is there a Loft Law analog to a rent-reduction order.[95]

Loft Law tenants who believe they are being charged the incorrect rent because unpermitted increases were added to the rent in the past may apply to the Loft Board for a rent adjustment[96] or may advance the defense of rent overcharge in a nonpayment proceeding.[97] Unless a Loft Law tenant has disputed the rent at the Loft Board, in which case there will be a Loft Board order stating the outcome of the dispute, the Loft Law tenants' rents are not registered with the Loft Board and usually cannot be ascertained from Loft Board records. In purchasing a Loft Law building, therefore, the seller's contractual representations of permitted rent levels are particularly important.

What are the Consequences of Collecting Rent When the C of O Does Not Match the Building's Use; When No MDR or Loft Law Registration Is Filed; or When Excessive Rent Is Collected from a Rent-Regulated Tenant?

A tenant may not recoup past-paid rent when the tenant paid rent not otherwise collectible because the building occupancy did not conform with the C of O; when the building was required to have an MDR but did not; or when the building was required to be registered with the Loft Board but was not.[98] The purchaser has nothing to fear if a predecessor collected rent under any of these circumstances.

This is not the case if a rent-stabilized or rent-controlled tenant has been overcharged. A rent-stabilized tenant may file an application with DHCR to recoup up to four years of rent overcharges[99] or may assert an overcharge defense in a nonpayment proceeding. The tenant may be awarded treble damages for up to two years before an overcharge application if the overcharge is willful. The landlord has the burden to disprove willfulness.[100]

Rent overcharges that do not concern the initial rent charged for the premises may be recaptured from a new landlord.[101] Court decisions anticipate that purchasers investigate the building's rent history and pending DHCR applications, negotiate a purchase price that reflect a potential overcharge liability, and, possibly, negotiate contract provisions for indemnification by the seller in the event of a determination of overcharge.[102] Treble damages are not awarded against a new owner who cannot produce rent records prior to the new ownership.[103] The tenant may recoup the overcharge either by means of forgiven past or future rent or by a cash payment.[104]

Rent overcharges stemming from the initial rent paid by the tenant may not be collected from a new owner.[105]

Although Loft Law tenants are subject to the four-year statute of limitations in collecting rent overcharges,[106] Loft Board regulations do not provide for treble damages in rent disputes with the landlord.[107]

Due Diligence Issue #3: Is Owner-Occupancy Possible?

Purchasers who want to occupy their own building may do so by declining to renew a deregulated tenant's lease.[108] If there are no deregulated units or if the deregulated units are unsuitable for the purchaser, one or more rent-stabilized or rent-controlled units can be taken for owner occupancy.[109] A nonrenewal notice must be served on the tenant between 90 and 150 days before the lease expires.[110] Assuming that the tenant does not vacate as the notice requires, the owner must bring a summary holdover proceeding.[111]

An owner-occupancy, or owner's-use, proceeding can be maintained only by an individual owner or one partner of a partnership.[112] The landlord bears the burden of proof to demonstrate a good-faith intent to occupy the unit taken as the owner's primary residence or the primary residence of an owner's immediate family member.[113] To prevail in an owner-occupancy case, the owner must offer the tenant moving expenses and comparable housing in the immediate vicinity[114] if seeking a unit of which the tenant or tenant's spouse is over the age of sixty-two or disabled.[115] If a rent-controlled tenant or household member has lived in the building for twenty years or more, an owner-occupancy eviction may not be maintained.[116]

The Loft Law and Loft Board regulations do not provide for owner occupancy.[117] An owner-occupancy case may not be brought in a Loft Law building until it passes into rent stabilization and the tenant's first or subsequent stabilized lease is ending.[118]

Issues Arising at Closing and After

If all goes well during the building investigation, the client decides that the building will suit the client's needs, and a contract is signed, it will soon be time to prepare a closing checklist and a "to do" agenda for the first days of ownership. Along with pro-rated rents for the month of the closing, security deposits for the existing tenants must be collected and handled properly after the closing. The purchaser should also be counseled about an owner's lead-paint responsibilities. There might also be existing landlord-tenant proceedings that the purchaser may continue in many, but not all, cases.

"Purchasers who want to occupy their own building may do so by declining to renew a deregulated tenant's lease."

What About Security Deposits?

When property is conveyed from one owner to another, the security deposits must be transferred to the new owner, which is responsible for maintaining the deposit and returning it to the tenant.[119] The seller is no longer liable to the tenants for their deposits.[120] Even if a purchaser fails to receive the tenants' security deposits from the seller, the purchaser will still be liable to the tenants.[121]

Tenant security deposits may not be commingled with the landlord's funds.[122] If the building contains six or more rental units, security deposits must be held in an interest bearing account.[123] The tenant is entitled to receive the interest annually, less a one percent administrative fee.[124]

Statutory rights concerning security deposits pertain whether or not the tenant is rent-regulated.[125] Tenants subject to rent stabilization may not, however, be required to post a security deposit exceeding one month's rent.[126]

What Are the Obligations Concerning Lead Paint?

A landlord who has actual or constructive knowledge that a child under age seven resides in a unit is charged with notice of any hazardous lead condition in the unit.[127] A letter should be sent to all tenants to identify those units with children under seven.[128] The new landlord should schedule an inspection of all units from which a response is received and of any others of which the purchaser is aware, or becomes aware, that children are in residence.[129]

May the New Owner Maintain Landlord-Tenant Cases the Seller Began?

In general, landlord-tenant proceedings may be brought only by the building's landlord and owner. A prospective purchaser or contract vendee may not properly serve the predicate notices required before most summary proceedings may be brought or commence summary proceedings until after closing.[130]

Sometimes, however, at the time of closing the seller has already commenced one or more summary proceedings. In general, a new owner can be substituted, on consent or on motion, for the predecessor in a summary proceeding previously filed.[131] This is especially advantageous in cases such as primary-residence holdovers against rent-stabilized tenants, in which the predicate notice must be served 90–150 days before lease expiration and in which discontinuing a previously filed case will result in a long delay or recapture an appellant.[132]

If consent to the substitution cannot be obtained, the purchaser should demonstrate building ownership by a certified copy of the deed; registration of the property (MDR, DHCR, or Loft Board, as appropriate) in the new owner's name; and, in a proceeding involving rent, an assignment of rents.[133]

A new owner may not continue an owner-occupancy proceeding against a rent-regulated tenant.[134] Maintaining an owner-occupancy case is based on the qualifying person's good-faith intent to occupy the premises.

Conclusion

For most purchasers, acquiring a residential property designed for multiple occupancies is a major investment. There are some restrictions on the landlord's rights with respect to a residentially occupied building, even one not rent regulated. Occasionally a purchaser inadvertently acquires a property occupied by one or more rent-regulated tenants, and therefore subject to greater controls, through misunderstanding or lack of pre-purchase investigation. The landlord's rights are more limited than contemplated, and the financial implications might be disastrous. More frequently, the purchaser knows that tenants with leases occupy the property, or even that the tenants are rent regulated, but is not fully aware of the tenants' rights and the new owner's responsibilities to them.

Even if money is no object and the best and consummate experts conduct full due diligence, the purchaser and its representatives are often unable to speak with the tenants until after the closing. Where this article suggests obtaining contract representations, the purchaser and counsel might wish to request that certain contract representations by the seller survive closing, at least for a few months. This burden to the seller must be used sparingly and be tailored to the building in question (might it be a Loft Law building, an SRO, or something else?), and not to substitute for available due diligence.

Endnotes

1. *See generally* Bea Grossman & Ram Sundar, *The Importance of Due Diligence in Commercial Transactions: Avoiding CERCLA Liability*, 7 Fordham Envtl. L.J. 351, 377 (1996) (discussing the importance of the due diligence inspection team, both financially and legally). The attorney should try to obtain a post-contract due-diligence period. The required investigation for any given building might involve a great deal of work. But the purchaser might prefer to incur due-diligence costs post-contract when seller is under an obligation to the purchaser and the expense is less likely to be wasted.
2. *See 52 Riverside Realty Co. v. Ebenhart*, 119 A.D.2d 452, 453, 500 N.Y.S.2d 259, 260 (1st Dep't 1986) (citing *Phelan v. Brady*, 119 N.Y. 587, 591, 23 N.E. 1109, 1110 (1890)) (explaining that the transferee of real property takes the premises subject to the conditions as to tenancy, including any waiver of rights that his predecessor has established if the transferee has notice of the existence of the leasehold; possession of the premises constitutes constructive notice to a purchaser of the rights of the possessor).

"Where this article suggests obtaining contract representations, the purchaser and counsel might wish to request that certain contract representations by the seller survive closing, at least for a few months."

3. *See* N.Y. Real Prop. Law § 291 (LEXIS 2010) (explaining that every conveyance of real property, including leaseholds, for a duration in excess of three years is void against the person who subsequently purchases or acquires the real property). *See, e.g.*, *Sam & Mary Housing Corp. v. Jo/Sal Mkt. Corp.*, 121 Misc. 2d 434, 439–40, 468 N.Y.S.2d 294, 298–99 (Sup. Ct. Queens County 1983), *aff'd on other grounds*, 100 A.D.2d 901, 901, 474 N.Y.S.2d 786, 787 (2d Dep't 1984) (holding that although a lease in excess of three years is a "conveyance of real property," neither statutes nor authorities require such to be recorded); *Gemrosen Realty Corp. v. Kadarkhan*, 288 A.D.2d 64, 64, 733 N.Y.S.2d 15, 16 (1st Dep't 2001) (finding that an unrecorded lease exceeding three years may be enforceable, notwithstanding New York Real Property Law § 291, if the purchaser has notice or constructive notice by virtue of the tenant's presence on the premises and filings with the Division of Housing and Community Renewal (DHCR)).
4. *E.g.*, N.Y.C.R.R. tit. 9, ch. VIII, § 2522.5(b)(1) (LEXIS 2010) ("For housing accommodations other than hotels, upon such notice as is required by section 2523.5 of this Title, the tenant shall have the right of selecting at his or her option a renewal of his or her lease for a one- or two-year term; except that where a mortgage or a mortgage commitment existing as of April 1, 1969 prohibits the granting of one- year lease terms or the tenant is the recipient of a Senior Citizen Rent Increase Exemption pursuant to section 26-509 of the Administrative Code of the City of New York, the tenant may not select a one-year lease.").
5. *See, e.g.*, *id.* § 2524.5 (providing grounds for refusing to renew a rent-stabilized tenant's lease); *Commercial Hotel v. White*, 194 Misc. 2d 26, 27, 752 N.Y.S.2d 779, 780 (Sup. Ct. App. T. 2d Dep't 2002) (finding that rent-controlled tenants can only be evicted pursuant to one of the grounds that the rent-stabilization code provides).
6. *See generally* N.Y.C.R.R. tit. 9, ch. VII, §§ 2104.6(d)(3)(i), 2204.6(d)(2)(i), 2520.6(n), 2523.5(b)(1) (listing the immediate family members and nontraditional family members who may succeed to rent-controlled and rent-stabilized tenancies; the regulations provide identical succession rights for all rent-controlled and rent-stabilized tenants throughout New York state).
7. *See generally* Andrew Scherer, Residential Landlord-Tenant Law in New York § 4:31 (2009-2010 ed.) ("In New York City, as a general rule, residential rental units occupied as primary residences in buildings with six or more units that were built prior to January 1, 1974 and that are not subject to the Rent Control Law are subject to the Rent Stabilization Law, by operation of the Rent Stabilization Law and the Emergency Tenant Protection Act. However, many units that do not fit into this category are also governed by the Rent Stabilization Law because the owners have received certain tax benefits, loans or other assistance.").
8. *Id.* § 4:30 ("Outside New York City, Rent Stabilization applies to non-Rent Controlled housing units in buildings of six or more units that were built or converted to residential use before January 1, 1974 in localities that have adopted the Emergency Tenant Protection Act in Nassau, Westchester, and Rockland counties.").
9. *Id.*
10. *See generally* N.Y. Gen. Bus. Law § 352-eeee(1)(b) (LEXIS 2010) (defining "non-eviction plan"). Whether a conversion plan was eviction or non-eviction can be determined by examining the cover of the

offering plan or from the New York State Attorney General's Real Estate Finance Bureau, located at 120 Broadway, New York, New York.

11. *See id.* § 352-eeee(2)(c)(iii) ("Non-purchasing tenants who reside in dwelling units subject to government regulation as to rentals and continued occupancy prior to the conversion of the building or group of buildings or development to cooperative or condominium ownership shall continue to be subject thereto.").

12. *See id.* § 352-eeee(2)(d)(ii) ("No eviction proceedings will be commenced against a non-purchasing tenant for failure to purchase or any other reason applicable to expiration of tenancy until the later to occur of (1) the date which is the expiration date provided in such non-purchasing tenant's lease or rental agreement, and (2) the date which is three years after the date on which the plan is declared effective. Non-purchasing tenants who reside in dwelling units subject to government regulation as to rentals and continued occupancy prior to conversion shall continue to be subject thereto during the period of occupancy provided in this paragraph. Thereafter, if a tenant has not purchased, he may be removed by the owner of the dwelling unit or the shares allocated to such dwelling unit.").

13. *Id.* § 352-eeee(1)(f) (defining "eligible senior citizens").

14. *Id.* § 352-eeee(1)(g) (defining "eligible disabled persons").

15. *See* New York, N.Y., R.C.N.Y. tit. 26, ch. 4, § 26-511 (LEXIS 2010) (explaining that an owner shall not refuse to renew the lease of a rent-stabilized tenant who is an "eligible senior citizen" or an "eligible disabled person").

16. *See* N.Y. Mult. Dwell. Law §§ 280–286 (LEXIS 2010).

17. *See Randall Assocs., LLC v. Fylypowcyz* , 16 Misc. 3d 1107A, 841 N.Y.S.2d 828 (N.Y. Civ. Ct. N.Y. County 2007) (providing an historical analysis of the rent-stabilization protections afforded to tenants who convert commercial space not subject to the Loft Law with six or more residential units).

18. *See Duane Thomas LLC v. Wallin*, 35 A.D.3d 232, 233, 826 N.Y.S.2d 221, 222 (1st Dep't 2006) (explaining that because a temporary residential certificate of occupancy covering the unit was obtained, the unit was capable of being legalized and may be subject to rent-stabilization).

19. *See S. Eleventh St. Tenants Assn. v. Dov Land LLC*, 59 A.D.3d 426, 427, 872 N.Y.S.2d 514, 515–16 (2d Dep't 2009) (stating that Emergency Tenant Protection Act (EPTA) protections are available to tenants of illegally converted lofts not subject to the Loft Law only in very limited circumstances).

20. *See Caldwell v. Am. Package Co.*, 57 A.D.3d 15, 24, 866 N.Y.S.2d 275, 281 (2d Dep't 2008) (holding that tenants were not entitled to ETPA protection, because their assertion that the owner applied for and obtained a map change permitting residential occupancy of the building was not supported by copies of any public records or any additional evidence that the owner had taken measures to alter the permissible use of the premises during the pendency of the proceeding).

21. *See generally Fleur v. Croy*, 137 Misc. 2d 628, 629–31, 520 N.Y.S.2d 1010, 1011–14 (N.Y. Civ. Ct. N.Y. County 1987), *aff'd*, 139 Misc. 2d 885, 531 N.Y.S.2d 761 (Sup. Ct. App. T. 1st Dep't 1988) ("The current rent stabilization structure was established by the Rent Stabilization Law of 1969… which, with limited exceptions, applied to all buildings 'containing six or more dwelling units' built after 1947.").

22. *See Loventhal Mgmt. v. N.Y. St. Div. of Hous. & Cmty. Renewal*, 183 A.D.2d 415, 415, 583 N.Y.S.2d 270, 270–71 (1st Dep't 1992) (explaining that illegally converting two units into one will not exempt the premises from coverage under the Rent Stabilization Law when its certificate of occupancy and an inspection report showed that the premises were formerly comprised of six residential units).

23. *See Commercial Hotel*, 194 Misc. 2d at 27, 752 N.Y.S.2d at 780 ("Plaintiff's addition of a sixth unit…brought all the units in the building under rent stabilization….").

24. *Fleur*, 137 Misc. 2d at 630–31, 520 N.Y.S.2d at 1012–13 (holding that mere cosmetic work and a reduction in the number of units was insufficient proof of a substantial rehabilitation and thus did not destabilize a building under the ETPA).

25. New York, N.Y., Admin. Code, tit. 26, ch. IV, § 26-505 (LEXIS 2010) ("For purposes of this chapter a class A multiple dwelling shall be deemed to include a multiple family garden-type maisonette dwelling complex containing six or more dwelling units having common facilities . . . and operated as a unit under a single ownership on May sixth, nineteen hundred sixty-nine, notwithstanding that certificates of occupancy were issued for portions thereof as one- or two-family dwellings.").

26. *See* N.Y.C.R.R. tit. 9, ch. VIII, § 2520.11(d) (LEXIS 2010); *Salvati v. Eimicke*, 72 N.Y.2d 784, 791, 533 N.E.2d 1045, 1047, 537 N.Y.S.2d 16, 18 (1988).

27. N.Y.C.R.R. tit. 9, ch. VII, § 2520.11(e).

28. *See id.* § 2200.2(f)(11) (explaining that regulations of the City Rent and Rehabilitation Law shall not apply to housing accommodations rented after April 1, 1953, which were or are continuously occupied by the owner thereof for a period of one year prior to the date of renting); *see also Francis v. Rapee*, Loft Board Order #30 (Nov. 30, 1983) (stating that Loft Law owner-occupied units count toward the number of residential units required for the building to be subject to the Loft Law), *available at* http://archive.citylaw.org/loft/arch1983/LBO-0030.pdf.

29. *See* N.Y., Admin. Code, tit. 26, ch. IV, § 26-504.1.

30. N.Y.C.R.R. tit. 9, ch. VII, § 2520.11(g) (LEXIS 2010).

31. *See* Scherer, *supra* note 7, at § 4:48.

32. *See* N.Y.C.R.R. tit. 9, ch. VII, § 2520.6(j).

33. *See, e.g.*, *Nutter v. W & J Hotel Co.*, 171 Misc. 2d 302, 305–06, 654 N.Y.S.2d 274, 276–77 (N.Y. City Civ. Ct. N.Y. County 1997) ("[T]he purposes of these provisions of the rent stabilization laws indicate that the request for a lease, evincing an intent to accede to tenancy status, is what triggers the protection of the rent stabilization laws.").

34. *See* N.Y. Admin. Code tit. 26, ch. IV, § 27-2093 (LEXIS 2010) (certification of no harassment with respect to single room occupancy multiple dwellings (SROs)); *see generally* New York, N.Y., R.C.N.Y. tit. 28, ch. 10, § 10-07 (LEXIS 2010).

35. *See* R.C.N.Y. tit. 28, ch. 10, § 10-01 ("'Inquiry period' shall mean (i) with respect to an application submitted pursuant to any provision of the Zoning Resolution, the period of time therein defined as the inquiry period, and (ii) with respect to an application submitted pursuant to Administrative Code § 28-107.1 *et seq.* and Administrative Code § 27-2093, a period commencing three years prior to submission of the application and ending on the date that HPD issues a final determination on the application.").

36. *See* N.Y. Mult. Dwell. Law § 281(1)–(2) (LEXIS 2010).

37. *See id.* § 281(4).

38. *See id.* § 284(2).

39. *See generally* R.C.N.Y. tit. 29, chs. 1–2, §§ 1-01—2-12 (LEXIS 2010). Loft Board orders can be researched in a database maintained by New York Law School, *available at* http://www.nyls.edu/centers/harlan_scholar_centers/center_for_new_york_city_law/cityadmin_library (last visited Apr. 25, 2010). Old Loft Board orders not on the New York Law School website may be obtained by contacting the Loft Board, *available at* http://www.nyc.gov/html/loft/html/contact/contact.shtml (last visited Apr. 25, 2010).

40. *See* R.C.N.Y. tit. 29, ch. 2, § 2-01(m).

41. N.Y. Mult. Dwell. Law § 284 (LEXIS 2010) ("The owner of an interim multiple

dwelling . . . shall take all reasonable and necessary action to obtain a certificate of occupancy as a class A multiple dwelling for the residential portions of the building or structure within thirty-six months from such effective date.”).

42. R.C.N.Y. tit. 29, ch. 2, § 2-01(b)(1).

43. *Id.* § 2-01(m) (providing that fewer than six units in a Loft Law building does not preclude rent-stabilization coverage).

44. *See* N.Y. Mult. Dwell. Law § 286(12) (“No waiver of rights pursuant to this article by a residential occupant qualified for protection pursuant to this article made prior to the effective date of the act which added this article shall be accorded any force or effect; however, subsequent to the effective date an owner and a residential occupant may agree to the purchase by the owner of such person’s rights in a unit.”).

45. *See generally* R.C.N.Y. tit. 29, ch. 2, § 2-07 (LEXIS 2010).

46. *See 315 Berry St. v. Hanson Fine Arts*, 39 A.D.3d 656, 657, 835 N.Y.S.2d 261, 262 (2d Dep’t 2007).

47. Scherer, *supra* note 7, at § 4:26-4:28.

48. *See 1234 Pacific Mgmt. v. Jefferson*, 8 Misc. 3d 1022(A), 2005 N.Y. Slip Op. 51230(U), *3 (N.Y. Civ. Ct. Kings County 2005).

49. N.Y.C.R.R. tit. 9, ch. VII, §§ 2104.6, 2204.6, 2520.6, 2523.5 (LEXIS 2010) (“Disabled” for this purpose is defined identically to the definition in N.Y. Gen. Bus Law § 352-eeee(1)(g) set forth *supra* at note 14).

50. *Id.* §§ 2520.6(o)(1), 2204.6(d)(3)(i).

51. 74 N.Y.2d 201, 211 543 N.E.2d 49, 53–54 554 N.Y.S.2d 784, 788–89 (1989).

52. *In re Snelham*, Loft Board Order #1625 (Sept. 29, 1984), *available at* http://archive.citylaw.org/loft/arch1996/Lbo-2029.pdf.

53. The purchaser should remember that sellers that provide leases might not provide them for all occupied residential units. For example, statutory tenants—rent-controlled and Loft Law tenants—do not have current leases; no current leases will be provided for these units.

54. N.Y. Real Property Law § 235-c (LEXIS 2010) (“If the court as a matter of law finds a lease or any clause of the lease to have been unconscionable at the time it was made the court may refuse to enforce the lease, or it may enforce the remainder of the lease without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.”).

55. *See, e.g.*, *Rima 106 LP v. Alvarez*, 257 A.D.2d 201, 204–06, 690 N.Y.S.2d 40, 42–44 (1st Dep’t 1999).

56. *See* N.Y. Real Prop. Law § 235-(b)(2) (LEXIS 2010) (“Any agreement by a lessee or tenant of a dwelling waiving or modifying his rights as set forth in this section shall be void as contrary to public policy.”).

57. *E.g.*, *Georgia Props., Inc. v. Dalsimer*, 39 A.D.3d 332, 334, 835 N.Y.S.2d 41, 43 (1st Dep’t 2007) (finding that “[d]eregulation of apartments is only ‘available through regular, officially authorized means [and] not by private compact’”) (quoting *Draper v. Georgia Props., Inc.*, 94 N.Y.2d 809, 811, 701 N.Y.S.2d 71, 72 (1999))).

58. *See 546 W. 156 St. HDFC v. Smalls*, 8 Misc. 3d 135(A), 803 N.Y.S.2d 18, 2005 WL 1798344 (Sup. Ct. App. T. 1st Dep’t 2007), *rev’d*, 43 A.D.3d 7, 14, 839 N.Y.S.2d 62, 68 (1st Dep’t 2007) (reinstating the trial court’s ruling and holding that the parties’ stipulated agreement treating the premises as subject to rent-stabilization did not defeat the statutory exclusion from regulation under the Administrative Code of the City of New York and that the parties’ stipulated agreement was enforceable only to the extent that it set the rental amount and only for the duration of any lease signed by the parties).

59. *See Carrano v. Castro*, 12 Misc. 3d 5, 7, 820 N.Y.S.2d 376, 378 (Sup. Ct. App. T. 2d Dep’t 2006), *aff’d*, 44 A.D.3d 1038, 1040, 844 N.Y.S.2d 435, 436 (2d Dep’t 2007).

60. N.Y. Mult. Dwell. Law § 302(1)(b) (LEXIS 2010); *see Caldwell v. American Package Co.*, 57 A.D.3d 15, 22–23, 866 N.Y.S.2d 275, 280 (2d Dep’t 2008) (“Multiple Dwelling Law § 302 prohibits the owner of a multiple dwelling for which there is no valid certificate of occupancy allowing residential use from collecting rent or the value of the use and occupancy of the premises.”).

61. *See Caldwell*, 57 A.D.3d at 25–26, 866 N.Y.S.2d at 282 (holding that the trial court erred by not allowing the tenants to rely on Multiple Dwelling Law § 302 as a defense and therefore that the owner was not entitled to an award of the value of the use and occupancy of the premises).

62. *See, e.g.*, *Tan Holding Corp. v. Ecklund*, 33 A.D.3d 487, 487–88, 823 N.Y.S.2d 31, 31 (1st Dep’t 2006) (holding that landlord had no claim against tenant for use and occupancy when landlord and its predecessors in interest acquiesced in the illegal conversion); *O’Connor v. Gallier*, 7 Misc. 3d 1016A, 801 N.Y.S.2d 237, 2005 WL 991 http://www.nysba.org/AM/Template.cfm?Section=Entertainment_Arts_and_Sports_Law_Journal&TEMPLATE=/CM/HTMLDisplay.cfm&CONTENTID=3318 069, at *2 (Sup. Ct. Kings County 2005).

63. N.Y. Mult. Dwell. Law § 325(2) (McKinney 2010).

64. *See A Real Good Plumber v. Kelleher*, 191 Misc. 2d 94, 96, 740 N.Y.S.2d 745, 747 (Sup. Ct. App. T. 2d Dep’t 2002) (holding that the landlord was required to have registered the leased premises as a multiple dwelling if landlord knew of, and acquiesced in, tenant’s residential use of loft).

65. Loft Law buildings consisting of three or more units need not register as multiple dwellings; Loft Board registration is required instead of an MDR statement.

66. *See County Dollar Corp. v. Douglas*, 160 A.D.2d 537, 537, 556 N.Y.S.2d 533, 533 (1st Dep’t 1990) (finding that a landlord cannot bring a non-payment proceeding against loft tenants when the landlord has not complied with the legalization procedures of Multiple Dwelling Law § 284(1)).

67. N.Y.C.R.R. tit. 9, ch. VIII, § 2521.2 (LEXIS 2010); *see Aijaz v. Hillside Place, LLC*, 37 A.D.3d 501, 501–02, 830 N.Y.S.2d 283, 284 (2d Dep’t 2007) (holding that the landlord could not use the Rent Stabilization Law as an affirmative defense to tenant’s rent overcharge claim because the renewal leases at issue were entered into and expired before the Legislature amended the Rent Stabilization Law, which amendment was to be applied prospectively).

68. Emergency Tenant Protection Act of 1974, N.Y. Unconsol. Laws, ch. 5, § 8629(b); New York, N.Y., Admin. Code tit. 26, ch. 4, § 26-513 (LEXIS 2010); N.Y.C.R.R. tit. 9, ch. VIII, § 2522.3. The initial legal regulated rent for units extensively altered is not based on the 1984 rent but on the first rent set after alterations. The initial legal regulated rent for units that pass from rent-control to rent-stabilization is based on the fair market rent, a value the landlord sets and which the first tenant may contest. The Loft Board sets the initial regulated rent for a Loft Law unit passing into rent stabilization. N.Y. Mult. Dwell. Law § 286(6).

69. *See, e.g.*, Admin. Code tit. 26, ch. 4, § 26-510(b); N.Y.C.R.R. tit. 9, ch. VIII, §§ 2522.2, 2522.5(d)(1).

70. *See generally* Scherer, *supra*, note 7, at § 4:115 (“Under the statutory provision, if a vacant apartment is rented for a two-year lease, the landlord can charge a 20% vacancy increase. If a vacant apartment is rented for a one-year lease, the landlord may charge a 20% increase minus ‘the difference between (a) the two year renewal lease guideline promulgated by the guideline board of the City of New York applied to the previous legal regulated rent and (b) the one year renewal lease….’”).

71. N.Y.C.R.R. tit. 9, ch. VIII, § 2522.4(a)(2)(i); Admin. Code tit. 26, ch. 4, § 26-511(c)(6)(b), *available at* http://24.97.137.100/nyc/AdCode/entered.htm.

72. *See generally* Scherer, *supra*, note 8, at § 4:118 (“DHCR issues rent reduction orders as a penalty for failure to maintain

essential services…. A rent reduction order will offset an abatement of rent for breach of warranty of habitability.”).

73. *See generally* N.Y.C.R.R. tit. 9, ch. VIII, § 2522.4(a)(2)(i) (LEXIS 2010); N.Y. Admin. Code tit. 26, ch. 4, § 26-511(c)(6)(b) (LEXIS 2010).

74. N.Y.C.R.R. tit. 9, ch. VIII, § 2522.4(a)(2)(i); *see Garden Bay Manor Assocs. v. N.Y. St. Div. of Hous. & Cmty. Renewal*, 150 A.D.2d 378, 540 N.Y.S.2d 665 (2d Dep’t 1989) (explaining that even an item depreciable under the Internal Revenue Code will not qualify for MCI treatment unless it is building-wide and constitutes an improvement to the building).

75. *Id.*

76. *Id.* § 2522.4(e)(8).

77. *See* N.Y.C.R.R. tit. 9, ch. VIII § 2502.4(a) (LEXIS 2010).

78. Elliot G. Sander, *Major Capital Improvements/Individual Apartment Improvements Confirmation of Costs/Payments*, Division of Housing and Community Renewal (1990), *available at* http://www.dhcr.state.ny.us/Rent/PolicyStatements/orap9010.htm (last visited Apr. 25, 2010).

79. *See id.*

80. *See* N.Y.C.R.R. tit. 9, ch. VIII, § 2522.4(a)(8) (LEXIS 2010) (“The increase in the monthly stabilization rent for the affected housing accommodations when authorized pursuant to paragraph (1) of this subdivision shall be 1/40th of the total cost, including installation but excluding finance charges.”); *see also* New York, N.Y., Admin. Code tit. 26, ch.4, § 26-511(c)(13) (LEXIS 2010).

81. *See* N.Y.C.R.R. tit.9, ch. VIII, § 2522.4(a)(2)(i) (LEXIS 2010).

82. *See* N.Y.C.R.R. tit. 9, ch. VIII, § 2522.4(a)(1) (“An owner is entitled to a rent increase where there has been a substantial increase, other than an increase for which an adjustment may be claimed pursuant to paragraph (2) of this subdivision, of dwelling space or an increase in the services, or installation of new equipment or improvements, or new furniture or furnishings, provided in or to the tenant’s housing accommodation, on written tenant consent to the rent increase. In the case of vacant housing accommodations, tenant consent shall not be required.”); Admin. Code tit. 26, ch. 4, § 26-516(a) (“Where the amount of rent set forth in the annual rent registration statement filed four years prior to the most recent registration statement is not challenged within four years of its filing, neither such rent nor service of any registration shall be subject to challenge at any time thereafter.”).

83. *See Perry v. N.Y. St. Div. of Hous. & Cmty. Renewal*, 281 A.D.2d 629, 631, 722 N.Y.S.2d 556, 558 (2d Dep’t 2001) (“[T]he legal regulated rent is deemed to be the rent charged four years prior to the date of the initial registration ‘plus in each case, any [subsequent] lawful increases and adjustments.’”).

84. New York State Division of Housing and Community Renewal, Office of Rent Administration, *available at* http://www.housingnyc.com/html/resources/dhcr/dhcr1.html (last visited Apr. 4, 2010).

85. *See City of New York v. N.Y. St. Div. of Hous. & Cmty. Renewal*, 97 N.Y.2d 216, 765 N.E.2d 829, 739 N.Y.S.2d 333 (2001) (“In 1970 the City passed Local Law 30, enacting a new maximum rent formula: Administrative Code of City of NY § Y51-5.0[a], now § 26-405[a]. Like the earlier State legislation, Local Law 30 provided both for the calculation of maximum rents and for adjustments to these rents.”); *see also Mayer v. City Rent Agency*, 46 N.Y.2d 139, 385 N.E.2d 605, 412 N.Y.S.2d 867 (1978) (“Local Law No. 30… substantially revised the city rent control laws. By its provisions there was required to be established, effective January 1, 1972, a maximum base rent (MBR) ceiling for each rent controlled apartment…. The MBR was to be recalculated every two years thereafter to keep abreast of changes in operating costs.”); *see also* Admin. Code tit. 26, ch. 3, § 26-405(a)(3) (LEXIS 2010).

86. *See* Admin Code tit. 26, ch. 3, § 26-405(a)(4) (“the city rent agency shall establish maximum rents effective January first, nineteen hundred seventy-four and biennially thereafter by adjusted the existing maximum rent to reflect changes, if any, in the factors which determine maximum gross building rental under paragraph three of this subdivision…”).

87. *See id.* § 26-405(a)(5) (“[W]here the period for which the rent is established exceeds one year, regardless of how the collection thereof is averaged over such period, the rent the landlord shall be entitled to receive during the first twelve months shall not be increased by more than seven and one-half percentum over the previous rent and additional annual rents shall not exceed seven and one-half percentum of the rent paid during the previous year.”).

88. *See id.* § 26-405(h)(6) (“If at least six months before the effective date of any adjustment or establishment of rents pursuant to paragraph three or four of subdivision a of this section, the landlord has not certified to the agency having jurisdiction that (a) all rent impairing violations (as defined by section three hundred two-a of the multiple dwelling law), and (b) at least eighty percentum of all other violations of the housing maintenance code or other state or local laws that impose requirements on property that were recorded against the property one year prior to such effective date have been cleared, corrected, or abated, no increase pursuant to such paragraphs shall take effect until he or she shall have entered into a written agreement with the city rent agency to deposit all income derived from the property into an escrow or trust account pursuant to subparagraph (a) of paragraph four of this subdivision, in addition to the procedures set forth in this paragraph and all other applicable penalties and procedures under this chapter, such violation shall also be subject to repair or removal by the city pursuant to the provisions of article five of subchapter five of the housing maintenance code, the landlord to be liable for the cost thereof.”).

89. *See id.* § 26-509 (“A tenant is eligible for a rent exemption pursuant to this section if: (i) the head of the household residing in the housing accommodation is sixty-two years of age or older…and is entitled to the possession or to the use or occupancy of a dwelling unit…(ii) the aggregate disposable income (as defined by regulation of the department for the aging) of all members of the household residing in the housing accommodation whose head of household is sixty-two years of age or older does not exceed… twenty-nine thousand dollars beginning July first, two thousand nine, per year, after deduction of federal state and city income and social security taxes…(iv) (a) in the case of a head of the household who does not receive a monthly allowance for shelter pursuant to the social services law, the maximum rent for the housing accommodation exceeds one-third of the aggregate disposable income, or subject to the limitations contained within item (c) of subparagraph (i) of paragraph three of this subdivision, if any expected lawful increase in the maximum rent would cause such maximum rent to exceed one-third of the aggregate disposable income”).

90. *See* N.Y. Mult. Dwell. Law § 286(2) (LEXIS 2010).

91. *See id.* § 286(4).

92. *See id.* § 286(2).

93. *See id.* § 286(3).

94. *See id.* § 286(3).

95. *See* N.Y. Mult. Dwell. Law § 286(2) (LEXIS 2010).

96. *See id.* § 286(b).

97. *See Theoharidou v. Newgarden*, 176 Misc. 2d 97, 98, 673 N.Y.S.2d 813, 814 (Sup. Ct. App. T. 1st Dep’t 1998) (explaining that the Rent Regulation Reform Act of 1997 amended the Rent Stabilization Law of 1969 to provide that “no determination of an overcharge and no award or calculation of an award . . . may be based upon an overcharge having occurred more than four years before the complaint is filed”).

98. *See Goho Equities v. Weiss*, 149 Misc. 2d 628, 631, 572 N.Y.S.2d 836, 837 (Sup. Ct. App. T. 1st Dep't 1991) (holding that tenant who pays rent for a loft not in compliance with code-compliance timetable may not recoup rent). *See, e.g.*, *Commercial Hotel*, 194 Misc. 2d at 27, 752 N.Y.S.2d at 780 (holding that tenant may not recoup rent for premises that lack certificate of occupancy); *Soalt v. Pulisic*, N.Y. L.J., Dec. 5, 1991, at 30, col. 4 (Sup. Ct. App. T. 2d Dep't 1991) (holding that tenant may not recoup rent paid for illegal premises).

99. *See* New York, N.Y. Admin Code tit. 26, ch. 4, § 26-516(a)(2) (LEXIS 2010).

100. *See* Admin Code tit. 26, ch. 4, § 26-516(a).

101. *See* N.Y.C.R.R. tit. 9, ch. VIII, § 2526.1(f)(2) (LEXIS 2010) (providing that the treble damages the prior landlord incurs are also the new owner's responsibility).

102. *See Helfand v. Sessler*, 8 Misc. 3d 96, 97–98, 799 N.Y.S.2d 347, 348–49 (Sup. Ct. App. T. 1st Dep't 2005).

103. *Round Hill Mgmt. Co. v. Higgins*, 177 A.D.2d 256, 257, 575 N.Y.S.2d 841, 842 (1st Dep't 1991).

104. N.Y.C.R.R. tit. 9, ch. VIII, § 2522.3(d)(1); *see also Fullan v. 142 E. 27th St. Assocs.*, 1 N.Y.3d 211, 214–15, 802 N.E.2d 1105, 1107–08, 770 N.Y.S.2d 707, 709–10 (2003).

105. *See Fullan v. 142 E. 27th St. Assocs.*, 1 N.Y.3d 211, 214–15, 802 N.E.2d 1105, 1107–08, 770 N.Y.S.2d 707, 709–10 (2003).

106. *See* N.Y. C.P.L.R. 213 (LEXIS 2010).

107. *See* N.Y. Mult. Dwell. Law § 286 (LEXIS 2010).

108. *See* N.Y.C.R.R. tit. 9, ch. VIII, § 2204.5 (LEXIS 2010).

109. *See, e.g.*, *id.*; *see also, e.g.*, *id.* § 2524.4(a)(2).

110. *See* N.Y.C.R.R. tit. 9, ch. VIII, § 2204.5.

111. *See id.*

112. *See id.*

113. *See* N.Y.C.R.R. tit. 9, ch. VIII, § 2204.5 (LEXIS 2010).

114. *Burke v. Joy*, 99 A.D.2d 952, 953, 472 N.Y.S.2d 643, 644 (1st Dep't 1984).

115. *See* N.Y.C.R.R. tit. 9, ch. VIII, § 2204.5; *see also id.* § 2520.6(q) (defining "disability" as "an impairment which results from anatomical, physiological or psychological conditions…which are expected to be permanent and which prevent such person from engaging in any substantial gainful employment.").

116. *See* N.Y.C.R.R. tit. 9, ch. VIII, § 2204.5.

117. *See* N.Y. Mult. Dwell. Law § 286 (LEXIS 2010); *Axelrod v. French*, 148 Misc. 2d 42, 44–45, 559 N.Y.S.2d 918, 919–20 (N.Y. Civ. Ct. N.Y. County 1990); *165 W. 26th St. Assocs. v. Folke*, 131 Misc. 2d 867, 869–70, 520 N.Y.S.2d 355, 356–57 (Sup. Ct. N.Y. County 1986).

118. *See* N.Y. Mult. Dwell. Law § 286; *Axelrod*, 148 Misc. 2d at 44–45, 559 N.Y.S.2d at 919–20; *165 W. 26th St. Assocs.*, 131 Misc. 2d at 869–70, 520 N.Y.S.2d at 356–57.

119. *See* N.Y. Gen. Oblig. Law § 7-105 (LEXIS 2010).

120. *See id.*

121. *See id.*

122. *See id.* § 7-103.

123. *See id.*

124. *See* N.Y. Gen. Oblig. Law § 7-105 (LEXIS 2010).

125. *See id.*

126. N.Y.C.R.R. tit. 9, ch. VIII, §§ 2525.4, 2505.4 (applying the ETPA regulations to certain tenants in counties outside New York City).

127. New York, N.Y., Local Law No. 1 (2004), *available at* http://www.nyc.gov/html/hpd/downloads/pdf/lead-local-local1-2004.pdf. *See generally Peri v. City of New York*, 44 A.D.3d 526, 527–28, 843 N.Y.S.2d 618, 618–19 (1st Dep't 2007), *aff'd*, 11 N.Y.3d 756, 894 N.E.2d 1192, 864 N.Y.S.2d 802 (2008); *see also* Gerald Lebovits, HP Proceedings: A Primer (Legal Update for Judges and Court Attorneys 2007), *available at* http://ssrn.com/abstract=1299746 (last visited Apr. 25, 2010).

128. *See* Local Law No. 1; *see generally Peri*, 44 A.D.3d at 527–28, 843 N.Y.S.2d at 618–19 (1st Dep't 2007), *aff'd*, 11 N.Y.3d 756, 894 N.E.2d 1192, 864 N.Y.S.2d 802 (2008); *see also* Gerald Lebovits, *supra* note 127.

129. *Id.*

130. The converse to a new owner's being allowed to maintain a proceeding is the obligation of a new owner to correct code violations existing when the new owner closed on the building and what happens to code-violation cases (called Housing Part, or HP, proceedings in New York City) pending against the old owner. The prior owner may move to dismiss any pending code proceeding. That motion will be granted because the occupant-petitioner no longer has standing to maintain the proceeding (although the occupant-petitioner may still move for contempt against a prior owner who did not comply with a stipulation or court order to effect repairs while it still owned the building). The Department of Housing, Preservation, and Development (HPD), or in granting the prior owner's motion to dismiss the judge, will then ascertain, with the prior owner's help, who is the new owner so that the occupant-petitioner in the code proceeding may file a new proceeding against the new owner. Regardless what happens in the proceeding, the new owner always has the obligation to correct violations that arose during the prior ownership and which exist during the current ownership. For more on this complicated area, *see* Gerald Lebovits, *supra* note 127.

131. *See id.*

132. *See id.*

133. *See id.*

134. *E.g.*, *MRG Realty Co. v. Bloomberg*, 58 A.D.2d 562, 562, 396 N.Y.S.2d 24, 25 (1st Dep't 1977).

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RESPA Changes and Their Effect on Residential Closings

By Daniel M. Shlufman

As most of us are aware, as of January 1, 2010, the new Real Estate Settlement and Procedures Act ("New RESPA") went into effect.[1] As it only affects loans that are originated after said date, and closings normally take 6–8 weeks in New York (and often 12 or more for co-ops and condos in Manhattan), few if any transactions have closed under the New RESPA.

This is fortunate since the major changes detailed below will have the effect of changing the timing and, in many cases, the occurrence of closings. As a result, to mitigate this on residential real estate transactions, I strongly recommend that we make some changes to our practices on these transactions and specifically modify our closing procedures with respect to the HUD-1 Settlement Statement ("HUD-1").[2]

The intent of the New RESPA was to improve consumer protection. To effectuate this, lenders and mortgage brokers are required to provide more accurate Good Faith Estimates ("GFEs") to buyers. The effect on closings is that the charges listed on the HUD-1 will now be required to track those disclosed on the GFE.[3]

Certain charges will **not be permitted** to change **at all** on the HUD-1 from those disclosed on the GFE. These are broker and lender charges such as origination fees, application/processing fees and underwriting fees.[4] In addition, inexplicably (as many of these have nothing to do with a loan and, even those that do are set by state and local statute), government transfer fees are included as well. In New York, the mortgage tax is included, as it should be. However, so, I believe, are the Mansion Tax and the Peconic Bay Tax. Both of these are sizable amounts and might not be known to an out-of-state broker or lender, causing a closing issue if they are not disclosed on the GFE!

The second class of charges are those that may vary in the aggregate by no more than 10% over the amounts disclosed on the GFE.[5] These charges are lender-required settlement services such as bank attorney fees, title insurance and government recording charges. This limit does not apply if the borrower or, presumably, borrower's attorney selects its own provider for any of these services.

"[T]he major changes detailed below will have the effect of changing the timing and, in many cases, the occurrence of closings."

The final class of charges are those that may vary (without limit or tolerance levels) from the GFE and are for escrow reserves (*i.e.*, homeowner's insurance and real estate taxes);[6] daily interest charges and homeowners insurance itself. In addition, if the interest rate is not locked in at the time of application, the origination fees can vary until such time as the rate is locked when a new GFE will need to be delivered.

To make sure that we are best serving our clients and also to provide for quick and smooth closings, I suggest that we do the following on all new transactions:

1. **Review the GFE**: Have the client send this to you and check to make sure that all usual loan charges are listed (and that unusual ones are not). Confirm that the mortgage tax and appropriate transfer taxes are listed properly. If not, let the client and mortgage broker/lender know this as soon as possible so this can be corrected.

2. **Title Charges**: Once a contract is signed and *prior to* ordering a title insurance report (unless your practice is to order it at that time as opposed to when the mortgage commitment is issued, as many attorneys do), request a *written, binding list of all title charges* (including recording fees). The title companies are all aware of New RESPA and most of them are willing to do this. Once you receive these charges, forward them to the client's mortgage broker or lender to include in the GFE.

3. **HUD-1**: The most important change is with respect to the HUD-1 which has been traditionally an after-thought and completed at the closing. This can no longer be the case since a lender will refuse to fund a loan if these charges don't match those on the GFE. At a minimum this will cause a delay in the closing if the lender's in-house closer (*i.e.*, not bank attorney) is unfamiliar with New York practices. In the extreme, it can cause an adjournment of the closing if the issues cannot be satisfactorily reconciled quickly.

To avoid this, the HUD-1 needs to be completed, reviewed and finalized by all parties 1-2 days prior to the closing. To accomplish this, attorneys will need to provide the bank attorney with all charges including managing agent fees, real estate agent commissions, title costs (which they should have from the beginning of the transaction), adjustments, etc. once the closing is scheduled. They must also insist that a final HUD-1 be provided to them at least 1 day prior to the closing for review. My recent experience has been that bank attorneys understand this and are willing to comply.

If this occurs, the bank attorney will be able to obtain approval on the HUD-1 prior to the closing. This will not only avoid delays, but speed up the timing of closings. In the case of a problem, it will get resolved prior to the closing. If it does not, then the closing will get adjourned prior to its occurrence saving all parties time and aggravation.

I believe if we adopt these few, relatively minor changes, we will be able to easily adapt to the New RESPA and continue to protect our clients' best interests.

Endnotes

1. 12 U.S.C.S. §§ 2601–2617 (LEXIS 2010).
2. 18 U.S.C.S. § 1001 (LEXIS 2010).
3. 12 U.S.C.S. §§ 2601–2617.
4. *See* 12 U.S.C.S. §§ 2601–2617.
5. *See id.*
6. *See id.*

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Equitable Subrogation: Stepping Into Shoes That May Be Slippers

By Adam Leitman Bailey and Dov Treiman

In this era where this nation's economic stability depends, in part, on stable and unfettered real estate transfers, equitable subrogation provides a solution to some of the cracks in the system. However, as evidenced by a split between two departments of the Appellate Division, these cracks need some additional caulking to make sure that the right lien obtains priority.

All within 2009, the Second and Third Departments of the Appellate Division split regarding when and how equitable subrogation should be applied in prioritizing mortgages. Although two of the departments of the Appellate Division cite to the same Court of Appeals case for guidance when deciding equitable subrogation cases and both the First and Fourth Departments have been silent on the subject, the varying interpretations have created opposing conclusions and calls for further interpretation by the state's highest court or the passage of legislation.

Equitable Subrogation Defined

Equitable subrogation, an obscure enough doctrine silently lurking at most title closings, allows a lender whose funds are being used to extinguish an older debt to step into the priority position held by the original creditor, thus leapfrogging in priority of payment over older lenders, should the property be sold at foreclosure.

However, the question arises whether the lender can be allowed this privilege if it knows of other liens on the property older than its own, but younger than the one it seeks to pay off.

This word "knows" is the crux of the divide between the Second and Third Departments.

To understand equitable subrogation, one must be fully familiar with the idea that recordation of an item imparts constructive knowledge to the whole world not only of the actual contents of the recorded instrument, but of matters set forth in it that indicate that other things exist which could cloud title.[1]

According to the Second Department, this constructive notice of an intermediate lien is enough to disqualify the subrogation. According to both the Court of Appeals and the Third Department it is not.

To further complicate things, there have been no rulings from any of the Departments or the Court of Appeals speaking to whether or not actual knowledge of the intermediate lien disqualifies the subrogation.

The Leading Case

The leading New York case is *King v. Pelkofski*,[2] standing for the idea that equitable subrogation lies in New York *at least* where the junior liens are not actually known to the lender seeking subrogation. The quote most extracted from the case is:

> This principle has been applied to situations…where the funds of a mortgagee are used to satisfy the lien of an existing, known incumbrance when, unbeknown to the mortgagee, another lien on the property exists which is senior to his but junior to the one satisfied with his funds. In order to avoid the unjust enrichment of the intervening, unknown lienor, the mortgagee is entitled to be subrogated to the rights of the senior incumbrance.[3]

In *Pelkofski*, the lienor did have constructive notice of a junior lien. The property was originally bought with a bank mortgage. Then the owner executed an unrecorded deed of trust in favor of his wife. Then he took out two additional bank mortgages, after which the trust deed was finally recorded. Borrowing privately from someone new who did not find the trust in a title report, the owner then used the funds to discharge the various mortgages and some other debts. Thus the court had to deal with whether the last lien had the priority position of the mortgage whereby the property was bought in the first place or was junior to the trust. The court gave the youngest lien the most senior position.

So, *Pelkofski* stands for the proposition that mere constructive notice did not disqualify the subrogation.

However, the Court did not say what many assume the court meant: "Had the lienor had actual knowledge of the junior lien, the subrogation would not lie." The court only says that it is *enough* that there was actual ignorance of the junior lien; the court never said such ignorance was *needed.* One should note that *Pelkofski* approvingly quotes from the Restatement of Restitution, the leading authority for the idea that actual knowledge would itself be irrelevant, but *Pelkofski* never addresses that issue.

This enough / needed dichotomy is often expressed in formal logic as respectively a discussion of "sufficient" and "necessary" conditions. In just such language, *Ohio Savings Bank v. First Island Realty Corp.*,[4] applying *Pelkofski*, found lack of actual knowledge "sufficient" without considering whether it was "necessary," again leaving open the question of whether actual knowledge will kill the subrogation.

In *U.S. v. Baran*,[5] property was sold to a third party who financed the deal by obtaining a mortgage, the proceeds of which were used to satisfy the first mortgage on the property, but apparently not to satisfy a tax lien recorded after that first mortgage. The lender at the sale had no actual knowledge of the tax lien. The Second Circuit, applying New York law stated:

> The purpose of subrogation is to prevent a junior lienor from converting the mistake of the lender 'into a magical gift for himself'…. In effect, subrogation erases the lender's mistake in failing to discover intervening liens, and grants him the benefit of having obtained an assignment of the senior lien that he caused to be discharged…. Although other states may take a different view, New York does not require the lender to offer an excuse for his failure to discover the intervening lien.[6]

Thus, the new mortgage was put in a more senior position than the older recorded tax lien. Notably, *Baran* also never addressed the question of actual knowledge.

The Second Department

The Second Department first addressed this issue in 1997, in *R.C.P.S. Assoc. v. Karam Developers*,[7] that court, citing to *Pelkofski* denied equitable subrogation, saying "The…doctrine of equitable subrogation should not be applied here inasmuch as the evidence established that the plaintiff had knowledge of the [intervening] lien."[8]

Although not reported as such, the briefs made it clear that the so-called knowledge was in fact mere constructive notice.[9]

That the Second Department explicitly held mere constructive notice adequate to disqualify the subrogation became clear in *Bank One v. Mui*,[10] in which there were four mortgages involved. The proceeds of the youngest were used to pay off the debt of the eldest. One of the two mortgages in the middle had been recorded, but the other not. The Second Department held that the subrogation lifted the fourth mortgagee to the most senior spot with respect to the unrecorded intervening mortgage, but not with respect to the recorded one. No one claimed that the fourth mortgagee had actual knowledge of any but the most senior of the mortgagees, the one into whose shoes it was hoping fully to step.

The Second Department reiterated that view in a case not about lending money but about conveyancing, in *Roth v Porush.*[11]

The Third Department

However, the Appellate Division, Third Department in *Elwood v. Hoffman*[12] wrote:

> [W]hile Delta had constructive notice of the recorded notice of pendency, it did not have actual notice of the same. Based on the Court of Appeal's decision in *King*…the presence of constructive notice does not render the doctrine of equitable subrogation inapplicable…. We decline to follow those cases holding otherwise inasmuch as they depart from the Court of Appeals' decision in *King v Pelkofski*.[13]

Thus, the Third Department has staked out its territory, directly contradicting the Second Department's view that constructive notice disqualifies the subrogation. The Third Department bluntly says, "No. We disagree with the Second Department."

Since *Pelkofski* was explicitly a case about constructive notice, it seems impossible to agree with the Second Department. The Third Department seems to have all authority on its side. The Second Department indeed seems to be violating the fundamental rule of stare decisis by contradicting the Court of Appeals.

The Second Department Responds

The Third Department's *Elwood* criticism is solely of the Second Department, the source of the *only* cases in New York to disqualify equitable subrogation on the basis of constructive notice. *Elwood* was an implicit invitation to the Second Department to change its view. However, the Second Department ended 2009 reasserting its position in *Countrywide Home Loans v. Dombek*[14] without mentioning *Elwood*.

In *Dombek*, the owner gave a mortgage to the plaintiff. The mortgage was recorded on August 25, 2005, which was nine days after he gave another mortgage to the defendant which mortgage was recorded on September 14, 2005. The proceeds of the appellants' mortgage were used to satisfy a prior and more senior purchase money mortgage. The court denied summary judgment to the plaintiff, finding issues of fact as to whether the plaintiff had "mere notice" of the earlier mortgage.

Thus the Second Department adhered to its position that "mere notice" could disqualify an equitable subrogation without mentioning *Elwood*'s disapproval of its earlier cases.

Practical Effects

The split between the Second and Third Department and most courts' silence on the effect of actual knowledge have effects on real life. The first thing we have to realize is that at any real estate closing where a mortgage is being used to buy already mortgaged property, the proceeds of the newer mortgage are indeed being used to pay off the senior one. Without acknowledging it as such, the parties are expecting equitable subrogation.[15]

If it doesn't matter what the most junior lender knew about earlier liens, the only thing that would have to be proved would be whether the funds were indeed being used to discharge older liens.[16] This view encourages the use of title searches so the lienor can be certain that *all* of the older liens are being wiped out in refinancing. Under this theory, the funds' use determines how reliably they can be recovered by a lender/lienor.

If only actual knowledge disqualifies an equitable subrogation, the purchase of title becomes even more crucial. Once a lender receives a title report, anything in that report upgrades from mere constructive notice to actual knowledge. On one level that would seem to argue against ordering a title report. However, that knowledge is not only critical in ascertaining whether the loan is a good risk in the first place, but it enables the lender to ensure that the funds are indeed being used to discharge the elder liens and that therefore the lender will qualify for the subrogation from the use-of-funds point of view. Fortunately for the lender, any mistakes in the title report will not harm the lender or its title company. Other liens that eluded the title report cannot unseat the subrogation.

If mere constructive notice disqualifies subrogation, title insurance for the lender is absolutely essential. The lender will want all the benefits previously described, but also to require the borrower to pay the requisite insurance premium to ensure that any errors in the title report do not deprive the lender's recovery of the proceeds.

In the current atmosphere of plentiful over-financed properties and foreclosures, the rules for lien priority may make all the difference in determining how many loan defaults cause lenders to have to default on their debts as well.

Conclusion

With this split in authority between the Second and Third Departments, not knowing which sides the First and Fourth Departments will take, and not having any word on the effect of actual knowledge, it is time for the Court of Appeals to speak again or the legislature to act and let the State know what the rules of equitable subrogation are to be. In truth, any rule definitely stated is better than confusion as to what the rules are. Ideally one of the contradictory cases from 2009 should go up to the Court of Appeals to resolve the problem, but lacking that, it would be wise for the Legislature to speak. The forgiveness for error implicit in the rule allowing the subrogation in spite of constructive notice makes that rule the one most appetizing from the point of view of fundamental fairness. It is also the rule most likely to support an active real estate transfer industry as it makes secured transactions vastly more secure.

In the mean time, junior lenders discharging elder liens had better make sure they insist on paid up title insurance.

Endnotes

1. *Fairmont Funding, Ltd. v. Stefansky*, 301 A.D.2d 562, 754 N.Y.S.2d 54 (2d Dep't 2003).
2. 20 N.Y.2d 326, 282 N.Y.S.2d 753 (1967).
3. *Id.* at 333−34, 282 N.Y.S.2d at 439.
4. 14 Misc. 3d 1237(A), 836 N.Y.S.2d 501 (Table) (Sup. Ct. Kings County 2007).
5. 996 F.2d 25 (2d Cir. 1993).
6. *Id.* at 29 (internal citations omitted).
7. 238 A.D.2d 492, 656 N.Y.S.2d 666 (2d Dep't 1997).
8. *Id.* at 493, 656 N.Y.S.2d at 667.
9. Brief for Plaintiff-Appellant, *R.C.P.S. Associates v. Karam Developers*, 238 A.D.2d 492, 656 N.Y.S.2d 666 (2'd Dep't 1997) (No. 1995-11345). Actually the title report showed the defect, but the lender's lawyer did not communicate it to the lender. The Second Department never resolved whether this was actual knowledge imputed to the agent's principal or mere constructive notice. Later cases where there was pure constructive notice made the answer to that question unnecessary.
10. 38 A.D.3d 809, 835 N.Y.S.2d 585 (2d Dep't 2007).
11. 281 A.D.2d 612, 722 N.Y.S.2d 566 (2d Dep't 2001).
12. 61 A.D.3d 1073, 876 N.Y.S.2d 538 (3d Dep't 2009).
13. *Id.* at 1076, 876 N.Y.S.2d at 540 (internal citations omitted).
14. 68 A.D.3d 1041, 892 N.Y.S.2d 465 (2d Dep't 2009).
15. Or, as Molière would have it, "I have been speaking about equitable subrogation my entire life without knowing it." [In *The Bourgeois Gentleman*, II, vi, M. Jourdain, a nobility-wannabe who has just had explained to him the difference between poetry and prose, exclaims, "Par ma foi, il y a plus de quarante ans que je dis de la prose, sans que j'en susse rien." (My word, it's more than 40 years that I speak prose, without my knowing anything of it.)]
16. *Pelkofski* also dealt with what other kinds of payments would qualify for subrogation treatment, but analysis of that is beyond the scope of this article. 20 N.Y.2d 326, 282 N.Y.S.2d 753 (1967).

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Wrongful/Negligent Referral

By Abraham B. Krieger

In this age of specialists, many lawyers refer clients and potential clients to other lawyers more experienced in a given area of law. Similarly, professionals in different fields refer to other professionals. Indeed, the referral process is a productive source of new business. However, under recent case law, referring without exercising due diligence may be actionable.

Recently, New York's Appellate Divisions in the First, Second and Third Departments, and a number of other state courts, implicitly recognized negligent recommendation/referral as a potential cause of action. While New York does not yet expressly recognize "negligent referral" or "negligent recommendation" as a cause of action, such a claim may be supported by applying the tort of negligent misrepresentation. A claim for negligent recommendation/referral may also be supported by the scope of duty voluntarily taken as part of a professional's responsibility under the rules governing professional ethics, conduct and responsibility.

Historically, most jurisdictions have only recognized claims for negligent referral in the area of medical malpractice. In New York, "[i]t is generally true that the mere referral of a patient by one physician to another, without more," is insufficient to "render the referring doctor vicariously liable" for the negligent treatment of the patient by the referred doctor.[1] A Pennsylvania federal district court held that "negligent referral to a specialist, i.e. when the referring physician knows or has reason to know the specialist is incompetent, may be a basis for liability under general negligence principles."[2] However, the following year, a Pennsylvania state court refused to apply the same standards to the legal profession, ruling that Pennsylvania did not recognize a cause of action for negligent referral.[3] Nevertheless, in the same opinion, the court distinguished *Tranor*, stating that "appellant did not allege in her complaint that Appellees knew [the referred to] Attorney to be incompetent."[4] The court considered the possibility that where an attorney has actual knowledge of the referred attorney's incompetence, a cause of action for negligent referral may be recognized in Pennsylvania.

In *Tormo v. Yormark*,[5] the U.S. District Court for New Jersey addressed whether a referring attorney was negligent in transferring his client's case to a criminally indicted attorney who subsequently embezzled the client's funds.[6] The court recognized a claim for negligent referral involving the lawyers, by denying the attorney-defendant's summary judgment motion. By denying summary judgment, the court implicitly recognized a claim for negligent referral among lawyers. The court went on to state that a jury *could* find that the referring attorney had a responsibility to check the referred attorney's qualifications.[7] The court stated that the referring attorney's responsibility arose from his "duties as an agent toward his [clients] and from his affirmative conduct in bringing his clients into contact with a person of previously unknown character under circumstances affording the opportunity for crime."[8] It noted that the referring attorney, who was from New York, might not be required to know of the other attorney's indictment in New Jersey,[9] but that a jury could conclude that the referring attorney was negligent because he should have been suspicious of the other attorney's solicitation of clients in violation of the Code of Professional Responsibility.[10] The court found that the alleged negligence selecting the attorney could be a proximate cause of plaintiff's damages and allowed the negligent referral claim to proceed.[11]

Recent New York appellate cases have questioned what was previously considered settled law that "[t]he mere recommendation of a person for potential employment is not a proper basis for asserting a claim of negligence where another party is responsible for the actual hiring."[12] In *Bryant v. New York*,[13] the Second Department held that where an individual voluntarily provides a recommendation or referral, that individual must perform the duty with due care.[14] *Bryant* involved defendant Department of Labor's recommendation of prospective employees for the claimant's business.[15] The Department of Labor advised claimant that prospective employees would be recruited, screened and interviewed by the Department.[16] The court held that the Department's screening process was voluntarily undertaken and must be performed with due care.[17] It held that such duty was performed negligently, resulting in a theft at claimant's business by an employee recommended by the Department who was previously involved in thefts, and thus warranted plaintiff's recovery of damages.[18]

Of even more concern to referring parties is the First Department's decision in *Friedman v. Anderson*,[19] denying an accountant's motion to dismiss based upon the recommendation of a financial manager. In *Friedman*, the court referred to Rule 201 of the American Institute of Certified Public Accountants (AICPA), which states that accountants "shall obtain sufficient relevant data to afford a reasonable basis for…recommendations in relation to any professional services performed."[20] The court found that the AICPA promulgated ethical and practical rules and measures professional standards requiring accountants to "obtain sufficient data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed."[21] The court further held that by recommending the money manager to plaintiff, defendant accountants were required to perform professional services with due care. The potential breach of that duty and damages resulting might form a "proper basis for claims of negligence and negligent representation."[22]

Notably, ethical violations by attorneys have not yet been conclusive grounds for civil liability. Under prior rules, the New York Court of Appeals held that, even if an attorney's conduct was contrary to the standards set forth in DR 9-102 (also known as, section 1200.46 of the New York Code of Professional Responsibility), "an ethical violation will not, in and of itself, create a duty that gives rise to a cause of action that would otherwise not exist at law."[23] Nevertheless, as demonstrated in *Bryant* and *Friedman*, the First and Second Departments now recognize such independent causes of action. In making referrals, an attorney must act with due care, such as has been found for accountants.[24] At the very least, an attorney should advise clients in writing that the referral is not an express endorsement or representation of actual services to be rendered and that the client must make that decision independently.

On April 1, 2009, New York joined 47 other states by adopting ABA's "Model Rules." The new rules thoroughly regulate fee splitting. Rule 1.5(g) governs fee splitting between attorneys. An attorney must advise his / her client that fees will be split, including the share each lawyer will receive. The fee cannot be excessive and must bear a relationship to services rendered and the client must give written consent and, significantly, both attorneys are jointly responsible for the work.

More jurisdictions are expanding the duties of other professions involving referrals and recommendations. Courts in Connecticut and Ohio have recognized causes of action against real estate agents for "negligently" recommending home inspection companies. The New London Superior Court in Connecticut denied a motion to strike negligent referral as a cause of action.[25] It held that plaintiff purchasers and defendant real estate agent entered into an agreement creating a relationship, obligating defendant to exercise reasonable care in its recommendations.[26] The court held that where a real estate agent recommends a home inspector, "it is not an unfair burden to place on the party making the recommendation to do an appropriate investigation of the person recommended before the party makes the recommendation."[27] The court also noted that, although the Restatement of Torts § 323 concerning the failure to exercise reasonable care only allows recovery for physical harm, the cause of action is not defeated because defendant caused plaintiff's emotional and physical distress.[28]

Despite settled law that insurance companies are not responsible for acts of independent contractors they recommend, a claims adjuster's exaggerated recommendation can open the door to a negligent recommendation or negligent misrepresentation claim. Analogous to New York's *Bryant* case, *affirmative* referrals or recommendations can lead to liability. An Arkansas court examined whether an insurance agent who provides a list of "competent" building contractors to an insured can charge the insurer with the duty to determine the competency and qualifications of such contractors.[29] The court held that the "gratuitous undertaking to represent the competence, insured, and bonded status of contractors created a duty…to exercise ordinary care to ensure that the information it communicated was true."[30] The court remanded the case to determine whether the evidence yielded proof of a causal connection between the alleged negligent recommendation and the plaintiff's injury.[31]

The Illinois courts have also examined possible liability for negligent referral. An appellate court held that the Chicago Bar Association (CBA) was not liable for negligent referral, but presciently detailed the potential loopholes wherein an individual attorney could be impliedly liable for negligent referral.[32] Plaintiff argued that defendant (CBA) lawyer referral service acted as a "referring lawyer" under the Illinois Rules of Professional Conduct and owed plaintiff the same duty for the performance of services as the referred attorney.[33] Rejecting this argument, the Court found that the CBA was not a "lawyer" subject to the provisions of the Illinois Code of Professional Responsibility and stated, "[o]nly where the referring entity is a lawyer can such a responsibility and is such a responsibility imposed."[34] Thus, the *Weisblatt* court, like *Friedman* and *Tormo*, did not shut the door to using ethical violations as a basis for civil liability when one attorney negligently refers another. Furthermore, in response to plaintiff's argument that she had pled a cause of action for negligent performance of a voluntary undertaking, the court was constrained to limit recovery under such circumstances, based on case precedent and general tort recovery, to non-economic damages.[35] It stated that the exceptions to the general rule for economic loss recovery are permitted only when there is an "intimate nexus…by contractual privity or its equivalent."[36] Lastly, the *Weisblatt* court considered but denied liability under a negligent misrepresentation theory. Plaintiff failing to assert a statement of false information, and the single occurrence of her recommended attorney's mishandling of her case, does "not establish a lack of expertise or experience" so as to make the CBA's representations false.[37] Apparently, if plaintiff actually alleged that the CBA told her the attorney recommended actually lacked "expertise" (contrary to CBA's representations) or was deemed incompetent on other legal malpractice matters, her cause of action for negligent misrepresentation might have been recognized.

The case of *Aiello v. Adar*[38] suggests that a cause of action for "negligent referral" exists in a fee-sharing agreement. In *Aiello*, plaintiffs retained the services of attorney Issler to assert medical malpractice claims.[39] After preparing the claims, Issler referred the case to attorney Starr, pursuant to a written fee sharing agreement.[40] The attorneys agreed to share 50% of the contingency fee.[41] Starr was to have "primary responsibility," but Issler agreed to remain the attorney on record.[42] A fee dispute arose between Issler and Starr when Starr filed a petition to prevent Issler from recovering the agreed 50%. Starr argued that he performed 96% of the work and accordingly Issler should only receive his *quantum meruit* share.[43]

The court found the lawyers' agreement valid because it confirmed Issler would assume responsibility of the action and in no way limited the client's rights against Issler only.[44]

A recent case in the New York Appellate Division Third Department suggests that a cause of action for "negligent referral" for failure to supervise applies to a law firm recommending or referring its client to another attorney to perform a portion of legal services for the client.[45] Plaintiff initially retained defendant to recover her interest in a partnership against Julius Gerzof, which defendant successfully accomplished.[46] However, Gerzof died a resident of Florida before judgment was satisfied.[47] Defendants, attempting to recover from the estate, sought the assistance of Florida counsel, Scott Cagan, and the law firm of Bailey. Bailey did not file a notice of claim with the Gerzof estate during the required time period and thus plaintiff was unable to recover from the estate. Plaintiff claimed, and the court agreed, that "defendant (the referring law firm) is liable for damages resulting from Bailey's failure to file the notice of claim either on the basis that defendant had a nondelegable duty to file such notice of claim or based upon defendant's negligent supervision of Bailey."[48]

The court explained that:

> [The] general rule is that "[a] firm is not ordinarily liable…for the acts or omissions of a lawyer outside the firm who is working with the firm lawyers as co-counsel or in a similar arrangement" (Restatement Third of Law Governing Lawyers § 58, Comment *e*), as such a lawyer is usually an independent agent of the client. Here, however, defendant solicited Cagan and Bailey and obtained their assistance without plaintiff's knowledge. Although plaintiff was later advised that Bailey had been retained by defendant, she had no contact with Bailey and did not enter into a retainer agreement with that firm. Defendant concedes that plaintiff completely relied on defendant to take the necessary steps to satisfy her judgment against Gerzof. Under these circumstances, defendant assumed responsibility to plaintiff for the filing of the Florida estate claim and Bailey became defendant's subagent (*see* Restatement Third of Law Governing Lawyers § 58, Comment *e*). Therefore, defendant had a duty to supervise Bailey's actions (*see* Restatement Third Agency § 3.15; Restatement Second Agency §§ 5, 406).[49]

The *Whalen* decision supports the principle that law firms can be liable for failure to supervise and / or for the negligence of a referred attorney.

Conclusion

Although New York courts remain generally unsympathetic to causes of action for negligent referral or recommendation, given recent Appellate Division decisions, practitioners should be cautious and diligent with referrals and affirmative recommendations. Real estate attorneys may be responsible for referring clients to brokers, engineers or mortgage companies. Courts may hold the referring attorney liable under tort theories of negligent misrepresentation or where a duty is voluntarily undertaken, giving rise to an obligation to undertake such duty with due care. *Caveat advocatus.*

Endnotes

1. *Datiz v. Shoob*, 71 N.Y.2d 867, 868 (1988).
2. *Estate of Tranor v. Bloomsburg Hosp.*, 60 F. Supp. 2d. 412, 416 (M.D. Pa. 1999).
3. *Bourke v. Kazaras*, 746 A.2d 642 (Pa. Super Ct. 2000).
4. *Id.* at 644.
5. 398 F. Supp. 1159 (D.N.J. 1975).
6. *Id.* at 1170.
7. *Id.*
8. *Id.*
9. *Id.* at 1170–71.
10. *Id.* at 1171.
11. *Id.* at 1172–73.
12. *Cohen v. Wales*, 133 A.D.2d 94, 95, 518 N.Y.S.2d 633 (2d Dep't 1987) (In *Cohen*, plaintiff alleged that the board of education was negligent for recommending a former employee for a position as a grammar school teacher without disclosing that the former employee had been charged with sexual misconduct. *Id.* The plaintiff was injured by the teacher. *Id.* at 634. The court held that the common law imposes no duty to control the conduct of another or to warn those endangered by such conduct in the absence of a special relationship between either the person who threatens harmful conduct or the foreseeable victim. *Id.* The court concluded that no special relationship existed; rather a cause of action lies with the school district which had custody over plaintiff and hired the wrongdoer. *Id.* See also *Bell v. Perrino*, 490 N.Y.S.2d 821 (N.Y. App. Div. 2d Dep't 1985), where plaintiff was injured by a taxicab driver and sued the company that had dispatched the driver alleging the company was negligent in failing to supply, dispatch, and / or hire competent, skilled, and licensed drivers and knew or should have known that the driver was prone to violence and the use of firearms. The court held that since the company was an independent entity providing dispatching services to more than 20 cab companies in the

area, it was not responsible for hiring the driver. Merely recommending the driver was insufficient to hold the company accountable for the driver's actions. *Id.* at 822).

13. 805 N.Y.S.2d 634 (2d Dep't 2005).
14. *Id.* at 636.
15. *Id.* at 635.
16. *Id.*
17. *Id.* at 636.
18. *Id.*
19. 803 N.Y.S.2d 514 (1st Dep't 2005).
20. *Id.* at 516.
21. *Id.*
22. *Id.*
23. *Shapiro v. McNeill*, 92 N.Y.2d 91, 97 (1998).
24. *See Friedman*.
25. *Marx v. McLaughlin*, 2001 WL 837921 (Conn. Super. Ct. 2001).
26. *Id.* at *4.
27. *Id.*
28. *Id.* at *5.
29. *Capel v. Allstate Insurance Co.*, 77 S.W.3d 533 (Ark. Ct. App. 2002).
30. *Id.* at 543.
31. *Id.* at 542.
32. *Weisblatt v. Chicago Bar Assoc.*, 684 N.E.2d 984 (Ill. Ct. Cl. 1997).
33. *Id.* at 989.
34. *Id.*
35. *Id.* at 988.
36. *Id.* (citing *Chew v. Paul D. Meyer M.D., P.A.*, 527 A.2d 828, 832 (Md. Ct. Spec. App. 1987)).
37. *Id.* at 990−91 (Plaintiffs alleged that the CBA "provid[ed] an attorney referral service by which members of the public may obtain from this service the names of attorneys with purported expertise in specified areas of law.").
38. 750 N.Y.S.2d 457 (N.Y. Sup. Ct. 2002).
39. *Id.* at 459.
40. *Id.*
41. *Id.*
42. *Id.*
43. *Id.* at 460.
44. *Id.* at 465−66.
45. *Whalen v. DeGraff, Foy, Conway, Holt-Harris & Mealey*, 863 N.Y.S.2d 100 (3rd Dep't 2008).
46. *Id.* at 101.
47. *Id.*
48. *Id.*
49. *Id.* at 102 (internal citations in the original).

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Real Property Law Section, Report of the Task Force on Proposed "Public Option" Title Insurance Legislation

Memorandum in Opposition of Two Bills and in Opposition (Unless Amended) of One Bill

Assembly Bills A 9445-A (S 6290) and A 9441 (S 6288) (OPPOSE BOTH);

Assembly Bill A 9452 (S 6289) (OPPOSE UNLESS AMENDED);

AN ACT to amend the public authorities law, in relation to creating the New York title guaranty authority (A 9445-A and S 6290) and AN ACT to amend the workers' compensation law, in relation to directing the state insurance fund to offer title insurance or certificates of clear title (A 9441 and S 6288) (OPPOSE BOTH); and

AN ACT in relation to directing the superintendent of insurance to conduct a study and issue a report regarding title insurance premium rates (OPPOSE UNLESS AMENDED).

THE REAL PROPERTY LAW SECTION:

- **OPPOSES A 9445-A (S 6290) AND A 9441 (S 6288); AND**
- **OPPOSES A 9452 (S 6289), UNLESS AMENDED.**

SUMMARY

New York does not need a "public option" for title insurance, a private industry that works well for consumers and the real estate industry. A 9445-A (S 6290) and A 9441 (S 6288) (together, the "*Public Title Insurance Proposal*") would, at great expense, put state government in a business that is not as simple, easy to enter, or profitable as the Public Title Insurance Proposal assumes. It is not realistic to expect that a public title insurer, after paying startup expenses, operating costs, claims reserves, and claims payments, will have excess revenues sufficient to fund public purposes at any time in the medium-term future. A shortfall seems particularly likely given today's depressed real estate market. Title insurance is a volatile business, hardly one appropriate for State involvement.

All New York title insurance companies and their rate schedules are regulated by the New York State Department of Insurance ("NYSID"). That agency seeks to assure, among other things, that title insurance companies stay in business so they can pay claims. If the Legislature wishes to try to reduce charges for title insurance, a goal suggested in A 9452 (S 6289), NYSID is the proper State authority to consider the matter. NYSID already regulates the title insurance industry. NYSID's regulatory expertise and information about the industry give it the background necessary to analyze title insurance rate-setting and recommend whether and how the State can or should reduce rates. Given current laws and regulations on title insurance, there is no reason to think that a Public Title Insurance Proposal in and of itself would reduce title premiums.

We could withdraw our opposition to A 9452, and support it, if it were amended to direct NYSID to consider in the first instance whether reduction is appropriate, taking into account New York statutory standards on title insurance premiums, before recommending how to achieve a reduction.

DISCUSSION

The Current System of Private Title Insurance Works

Any decision by New York State that the State go into the title insurance business will involve far more investment, oversight, management, and complexity than the Public Title Insurance Proposal, and the statements in its support, recognize. Title insurance is a complex business, providing a range of services, which we summarize in Exhibit A. Those services are not always profitable to provide (either in any particular situation or in the aggregate), especially in today's severe cyclical downturn in both the residential and the commercial real estate markets. Title premiums help pay for all the services described in Exhibit A.

Much of what we know as the title insurance business really consists of a massive and complex customer service system that searches, collects, and organizes crucial information about real estate titles, and then closes real estate transactions in a way that gives all players comfort that they will get what they pay for. Although title insurance does compensate for title problems that may arise after a closing, it seeks primarily to prevent those problems in the first place. It does that by performing accurate title searches and then carefully analyzing and assessing the information that those title searches reveal.

The fact that claims typically consume a single-digit percentage of the title insurance industry's income does not mean something is wrong. It actually means something is right. It means the industry does an excellent job at identifying and solving title problems before the closing rather than afterwards, and gets paid for providing that service.

The lion's share of the title insurance industry's revenue traditionally goes to operate the business of closing real estate transactions. That business requires fast turnaround, the constant making of business judgments, and a commitment to client service. Title and closing problems often arise late on a Friday afternoon and sometimes on weekends. The title insurance industry routinely meets unreasonable scheduling requirements; makes business judgments about assuming certain limited risks; advises on State and City transfer and mortgage recording taxes; and takes other actions to help its customers close their transactions in a satisfactory and timely way, all as we further describe in Exhibit A. The industry does all this not only for transactions in progress but also on a consulting basis for transactions merely under discussion. We question whether any State government authority could ever act with the customer service mindset that real estate closings require.

We also note that the customers of the title insurance industry, including the real estate bar and their clients, are generally satisfied with the service and protection provided by the title insurance industry as it exists today. We hear no clamor for a reform of this industry.

We question whether a governmental entity would handle title insurance claims as well as private title insurance companies. In general, having any government agency or authority run any business function has not traditionally been a recipe for success or greater efficiency or customer service. That seems particularly true when the business function has previously been handled well by the private sector.

Financial Prospects If New York Entered the Title Insurance Business

If New York State went into the title insurance business, it would need to replicate the private sector personnel, procedures, and business model that accomplish all the tasks in Exhibit A. That process would not be easy or quick. It would require a significant capital outlay—likely equal to many years of anticipated profits that might eventually redound to the State, even on the best assumptions—and creation of a management structure and team to provide a complex package of services in 57 counties plus the largest city in the country. That same structure and team would also need to stand ready to coordinate title insurance and closing services for multistate transactions, a service that the existing title insurance industry provides and one that requires communication channels with other title insurance companies and offices from coast to coast.

Does New York State have the extra money to invest in starting up a business that private enterprise already handles well? Does the Legislature have any sense of just how much investment this would entail? We don't, but we would anticipate the required investment would be in the tens or hundreds of millions of dollars.

Moreover, we cannot readily project whether a public title insurance company could generate profits at a level that the Public Title Insurance Proposal contemplates will be available to fund various worthy expenditures. We expect, however, that it is not realistic to expect that a public entity title insurer, after paying startup expenses, operating costs, claims reserves, and claims payments, will have excess revenues sufficient to fund those public purposes at any time within the near- or medium-term future. A shortfall seems particularly likely given today's depressed real estate market.

Title insurance industry profits nationwide fluctuate widely from year to year. The year 2003 represented the best in the industry's history, producing over $1 billion of profits nationally—a tempting target for a cash-starved State government looking for new revenue streams. But the industry lost nationally $800 million in 2008, $250 million in 1990, and $100 million in 1980. These were all horrendous years for the real estate industry. Until 2002, when the real estate bubble really started to inflate, the entire industry generated annual profits of up to $250 million (never more) nationally. Profits rose dramatically in the ensuing bubble years, then crashed in 2008. It seems reasonable to expect further pain in 2009 and 2010.[1]

An industry with such high volatility hardly seems an appropriate and prudent one for New York State to enter, particularly given that the industry is already doing its job and serving its customers adequately or better.

Moreover, the Public Title Insurance Proposal says nothing about whether any State title insurance authority would have to operate subject to NYSID's regulatory authority, including compliance with NYSID's reserve requirements, pricing requirements, and so on.

If a State title insurance authority could operate free of NYSID's regulatory requirements, then it would operate at an unfair advantage as against private enterprise. If a State title insurance authority had to comply with all NYSID requirements just like any private title insurance company, then the State authority would need to charge the exact same title insurance rates as the rest of the industry unless NYSID approved a "deviation filing" by the State authority. NYSID has typically not approved such filings, although few have been submitted. Absent assurances that the State title insurance authority will in fact make a deviation filing and NYSID will in fact grant it, existence of a "public option" player in the industry would not achieve the stated goal of reducing title insurance premiums.

The magnitude and historical volatility of industry profits also suggest that the Public Title Insurance Proposal expects way too much by mandating that any New York State venture into title insurance generate:

> fifty million dollars annually for affordable housing, fifty million dollars annually to ensure that the state's roads and bridges are in a state of good repair, fifty million dollars annually for the purpose of a STAR rebate program and such other purposes as may be required by the legislature and the governor.[2]

These numbers add up to about 60% of the entire U.S. title insurance industry's maximum annual profits during all years before 2003. For many of those years, the required minimum contributions to desirable government programs exceeded the total profits of the entire title insurance industry nationally. Assuming that New York title insurance profits are significantly less than the profits of the entire national title insurance industry—which seems a reasonable assumption—the notion that a State title insurance authority could generate $150 million a year for earmarked worthy programs seems even less realistic.

Taking into account historical fluctuations in title industry profits, we can easily foresee a crisis when the State's public title insurance authority suddenly cannot contribute $150,000,000 a year to affordable housing, roads and bridges, a STAR rebate program, and other good things as the Public Title Insurance Proposal contemplates. But, because the State budget will have already factored these contributions into anticipated revenue – and will have already authorized their expenditure -- their absence will inevitably produce a further budget crisis.

We can foresee a point at which the title insurance authority, not being funded from the State's general treasury under the Public Title Insurance Proposal, runs out of money and needs more money so policy holders are not left high and dry. The only possible solution to that problem will come from the State treasury, which hardly needs exposure to crises of this type. The risk of such a crisis seems particularly high in the early years of any possible State title insurance authority, when the authority could face claims but not yet have significant reserves from which to pay them. New York's private title insurance companies, in contrast, have amassed substantial reserves during many profitable years—and given today's downturn those reserves are coming in very handy indeed to pay claims.

The Public Title Insurance Proposal contemplates that whatever State entity goes into the title insurance business will have authority to issue its own debt and raise money in the capital markets. This seems to us a move in precisely the wrong direction, at a time when the State is generally trying to better understand, rein in, and control the number of State-related borrowing entities and authorities. The last thing we need to add to the State's financial mix is another State-affiliated bond issuing authority. If that bonding authority ever cannot pay its obligations, the State treasury will as a practical matter be exposed regardless of how many times the bond offering documents disclaimed any backing by the State's general credit.

Today's private title insurance (real estate closing) industry employs thousands of taxpaying New Yorkers. Any public option, particularly if it took over a significant share of the market, would replace private sector employees with public sector employees, a potential burden for State government, for example, if title insurance turns out not to be the bonanza for New York State that the Public Title Insurance Proposal anticipates.

We recognize that in good years for real estate, the title insurance industry makes money. That fact alone does not mean New York State should go into the title insurance business. Profitability is not the right criterion for government activity. To the contrary, if a business makes money and does its job, that usually represents a good reason to leave it to private enterprise. State government is not an all-purpose business conglomerate standing ready to enter any marketplace where it might make a buck. If title insurance attracts State government entrepreneurs this year, why not some other apparently profitable private sector industry next year? Lots of industries make money and produce goods or services that have some "public" impact, but that doesn't mean the State should enter those industries.

Looking Ahead, and Continuing the Discussion

We recognize that a desire to reduce the cost of title insurance drives the Public Title Insurance Proposal, at least in substantial part. The idea seems to be that introducing a new player into the market will increase competition and thus reduce rates. That goal seems incompatible with the proposed requirement that the State title insurance authority generate at least $150 million a year for whatever appealing or politically attractive State expenditures the Public Title Insurance Proposal ultimately promises to fund.

Any responsible discussion of title insurance rates in New York should start by recognizing that title insurance rates do not exist in a vacuum. They have not previously been an unregulated wasteland, lying beyond any scrutiny or oversight by New York State government. As a result of legislation previously passed, all New York title insurance companies—and their rate schedules—are regulated by NYSID. Title insurance rates are established on an industry-wide basis and then submitted to NYSID. That agency seeks to assure, among other things, that title insurance companies stay in business so they can pay claims. Existing law requires that title insurance rates not be "inadequate, excessive, unfairly discriminatory, destructive of competition, detrimental to the solvency of the insurer, or otherwise unreasonable."[3]

NYSID tries, among other things, to make sure title insurance companies maintain sufficient reserves to cover "bad years" such as today's real estate downturn. That downturn has placed the industry under severe distress, resulting in massive industry layoffs statewide. Further, NYSID enforces State law that prohibits any title insurance company from selling title insurance at rates lower than those filed with NYSID. Thus, if the title insurance industry is making "excessive profits" (whatever that means), it does so in part because State law requires it. Of course, in recent years, the industry has suffered extraordinary losses.

In short, New York already has an agency charged with responsibility for title insurance premiums and the safety and stability of New York's title insurance industry. A 9452 (S 6289), as written, would require NYSID to report back to the Legislature in a year with an analysis of how title insurance premiums should be reduced. Assuming that the Legislature desires to reduce title insurance premiums, as the proposal contemplates, we think NYSID is the right part of State government to consider the question. But we do not necessarily accept the assumption that rates should be reduced. It may be that rates are at the right level today, taking into account the tremendous costs of title insurance companies, including the costs of paying claims and setting up reserves. NYSID can make that assessment. And if NYSID concludes that rates should be reduced, NYSID can recommend how. That is part of NYSID's mission.

We therefore suggest that A 9452 (S 6289) be amended so that before NYSID identifies how to reduce rates, NYSID should first determine whether any such reduction is necessary or appropriate taking into account statutory requirements.

The New York State Bar Association Real Property Law Section would welcome an opportunity to participate in any such discussion. Should the Legislature decide to initiate any other projects to revisit or reform real estate practices in New York with an eye toward reducing transaction costs, the Section would welcome an opportunity to participate in those as well.

If the Legislature does direct NYSID to review possible strategies to reduce New York title insurance rates, and by implication the workings of the industry, those discussions seem likely to consider, among other things, the experience in Iowa, where state government took over the title insurance function after the state's major title companies failed in 1947. We made a few inquiries in Iowa, but did not undertake an exhaustive study. We learned that it is difficult to get a full picture of how (and how well) title insurance works in Iowa. The state does operate some form of title insurance system, but it does not seem to offer the level of service, risk assessment, and flexibility seen in New York. The real estate market in Iowa is much smaller than in New York, and values are much lower. Parties to Iowa commercial transactions generally require ordinary title insurance from companies in other states. Iowa's residential title insurance premiums are lower than New York's, but other closing charges may be higher. Iowa's system continues to attract controversy, with the Iowa bar association generally favoring it and Iowa's real estate brokers' association generally disfavoring it.

Any assessment of the Iowa experience must also consider whether Iowa's system would work in the very different environment of New York.

As a final note, partly as a measure to reduce costs of real estate transactions, legislation has been introduced to require disclosure of service charges that title insurance companies and agents collect from their customers (A 8404, proposed by the Real Property Law Section and the New York State Bar Association). Exhibit B offers more information about this disclosure legislation. In essence, the legislation requires disclosure of service charges separately from payments made to government agencies and other third parties. Requiring the disclosure of such charges should help eliminate any hidden overbilling of customers that may now occur.

Recent federal legislation on "good faith estimates" will shed further light on title insurance and related charges, thus perhaps further reducing costs for consumers.

These and other measures—perhaps coupled with recommendations or regulatory initiatives from NYSID—constitute an appropriate response to any legislative concern about the level of title insurance premiums in New York. The notion of putting New York State in the title insurance business seems neither appropriate, necessary, nor beneficial.

Endnotes

1. Figures through 2008 come from a special report on the title insurance industry prepared in 2008 by A.M. Best. *Available at* http://tinyurl.com/yl86wva.
2. Public Authorities Law Section 3979(1), as proposed in A 9445-A.
3. Insurance Law § 2321.

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Section Chair: Joel H. Sachs

April 13, 2010

EXHIBIT A

AN EXPLANATION OF TITLE INSURANCE

Members of the New York State Bar Association Real Property Law Section represent consumers purchasing and mortgaging their homes, purchasers of commercial real estate, real estate lenders, and participants in the secondary mortgage market. For all those players and their counsel, New York's private sector title insurance industry helps assure that real estate transactions close quickly and efficiently.

Pennsylvania was the first state to authorize the issuance of title insurance in the 1870s. The enabling statute permitted corporations to insure title to real estate. This statute was enacted in response to a court decision that arose after the purchaser of certain real property rights unsuccessfully sued his title searcher. The defendant and an attorney involved in the transaction had concluded that a judgment against a former owner was not a lien against the property—a conclusion that turned out to be wrong. To reduce the risk in real estate transactions, many states followed Pennsylvania's lead. The first New York statute authorizing corporations to issue title insurance was passed in 1909.

By issuing a policy of title insurance, a title insurance company insures that real estate being conveyed or mortgaged is free of title defects and that title to the property is marketable. If a title examiner finds title defects or liens, the title underwriter and counsel for the parties (and in upstate New York the title examiner) will try to eliminate those problems. If, however, the parties simply cannot correct a title defect, the title insurance company may limit the risk by insuring against the consequences of the title defect.

A title insurance policy also protects against hidden title defects or liens not discoverable by reviewing the public record. Affirmative insurance and title policy endorsements can deliver other valuable coverage supporting real estate investment, such as by assuring that the insured has the right to enforce an easement benefiting the insured premises.

Title insurance companies and their agents, including attorney-agents, typically examine and report on the status of title in only a few days. They may hold contract deposits in escrow, help correct title defects, provide guidance on the completion of the numerous forms required for closing, coordinate multistate (or single property out of state) closings with title insurance companies and offices in other states, review other closing instruments affecting title for their sufficiency and recordability, provide guidance on transfer and mortgage recording taxes, and disburse closing proceeds if requested. They interact with surveyors and other search companies to obtain surveys and searches of municipal records for review.

A representative with ready access to underwriting staff will be available to attend the closing even if it takes place outside of usual business hours. Major commercial closings with multiple properties can require days of concentrated work, with the title company or agent expected to be available at all times, sometimes around the clock, to answer questions and resolve issues.

After closing, the party issuing the policy will assure that the closing documents are properly recorded in New York and elsewhere as needed, which can require correcting errors or persuading county clerks to cooperate. That party will also pay mortgage, transfer, and real estate taxes collected at closing. The title insurance company may need to coordinate UCC filings and, if a transaction involves a cooperative apartment, a hotel, or a mezzanine loan, or in other appropriate cases, issue UCC insurance coverage.

Real estate transactions often close under extreme time constraints. A home purchaser often must close by a date certain to keep a favorable interest rate or even an approved loan. Sellers also need to know their transactions will close smoothly and on time as they often need the proceeds of sale to purchase replacement property. The private title insurance industry has for decades served as the lubricant that enables real estate transactions to close easily. That mechanism helps protect the parties to transactions from having to litigate to determine whether title to property is marketable. A State-run title insurance company hardly seems likely to deliver the fast turnaround and reliable closings that today's real estate industry requires. That seems particularly true during the first couple of years of any State-run title insurance company.

Coverage under any title insurance policy continues as long as the insured holds its interest in the insured property. If the insured sells the property and warrants title, the title coverage may indemnify the insured forever. In exchange, the title insurance industry collects a single, non-recurring premium, based on rates that NYSID has approved.

Unlike any other line of insurance, a significant part of every title insurance premium dollar pays for the pre-closing, labor-intensive work of searching and examining title, and eliminating, or providing insurance against, the enforcement or effect of, liens and other title-related issues.

The consumer is best served when the ownership of his or her home is not questioned—i.e., when no title claim ever needs to be asserted. For lines of insurance such as life, automobile, and casualty, annual recurring premiums largely reflect the statistical probability that claims will be made. In contrast, the title insurance process seeks to eliminate and prevent all claims. That explains why claims consume such a low percentage of title premium income.

Title insurance companies and title agents use premium income primarily to pay operating expenses and overhead customary for any type of business, such as rent, personnel, utilities, sales, and marketing. The industry also pays substantial income taxes to New York City and State. In the case of title insurance companies, part of the premium income goes to pay (and reserve for) claims in addition to the costs of adjudicating title issues. Such adjudication costs, often substantial, would otherwise be borne by the insured.

At the present moment in the real estate cycle, title insurance companies are paying claims based on amounts reserved for that purpose during better times. Those accumulated reserves deliver comfort and protection for real estate purchasers, their lenders, and the secondary mortgage market. Those reserves exist in part because of NYSID's historical regulatory oversight of the industry, including its rate structure.

EXHIBIT B

NYSBA SUPPORT OF PROPOSED LEGISLATION ON SERVICE CHARGE DISCLOSURE

Title insurance providers often deliver title-related services for real estate transactions. They may charge separately for some of those services, above and beyond the title insurance premium and, in parts of the State, the title examination. For example, title insurance providers often perform or obtain from third party providers additional searches in government offices such as building departments; record instruments; order surveys; perform survey inspections; and provide numerous other services requested by buyers and lenders for purchase and refinance transactions.

Although NYSID regulates title insurance premiums, NYSID does not regulate charges for additional title-related services. Consumers often have little familiarity with these services and the appropriate charges for them. Consumers may first learn of these charges at the closing table, when they appear on a title insurance provider's invoice. The charge for each service may show up as a lump sum, covering both (a) the amount actually paid out of pocket to a governmental office or other third party; and (b) an additional charge that the service provider adds, for performing or arranging the service. This format can sometimes allow concealment of excessive charges.

Requiring disclosure of service charges separate from amounts paid to third parties would enable consumers and their attorneys to understand and question the calculation of service charges. Consumers and their attorneys could compare potential service charges when "shopping around" for a title insurance provider and negotiate these charges when they do appear. Disclosure might in itself discourage excessive charges.

A bill drafted by the Real Property Law Section and officially proposed by the New York State Bar Association, A 8404, would require that when a title insurance provider receives an application for title insurance, the provider must promptly give the applicant an estimate of service charges that the provider will seek to collect. It would also require title insurance providers to clearly and separately itemize service charges so consumers can differentiate between service charges and actual disbursements to third parties.

This proposed legislation would give consumers better information about anticipated service charges when they order title insurance. At closing, consumers could confirm that the service charges actually billed conform to the estimate issued at the time of application. The legislation would give consumers a tool to reduce costs of real estate transactions.

Bergman on Mortgage Foreclosures: Escaping from the Automatic Stay?

By Bruce J. Bergman

The lending community and their counsel well recognize that the filing of a petition in bankruptcy imposes an automatic stay upon a foreclosure action. But what if the debtor (the borrower) didn't list the mortgage holder as a creditor in its filing (so that the mortgagee didn't know about the bankruptcy) and what if the resultant continuation of the foreclosure did not prejudice the debtor-borrower? Would those factors be sufficient for the state court where the foreclosure was pending to allow the foreclosure prosecuted during the stay to be valid? Yes, said a trial court in New York; no, said the appeals court. [*Carr v. McGriff*, 8 A.D.3d 420, 781 N.Y.S.2d 34 (2d Dept. 2004)].

From the viewpoint of a mortgage lender or server, the trial court opinion was welcome and seemingly reasonable. Why it was overturned on appeal, though, was understandable. The facts and applicable law tell the story, at the same time offering a helpful primer on the sometimes perplexing rules of bankruptcy as they relate to a defaulted mortgage.

Lender began a foreclosure (upon a second mortgage) on November 2, 1995. Borrower, a one-half owner of the property, was personally served a few days later but defaulted in the action and so the case proceeded eventually to issuance of a judgment of foreclosure and sale in September of 2001. What the foreclosing plaintiff never knew was that back in March, 1996 the borrower filed a Chapter 13 petition, although that was dismissed in August, 1997. But a second Chapter 13 petition was filed in late October, 1997 with the plan confirmed and later completed, leading to a bankruptcy court discharge in November, 2002.

By February, 2003 the borrower moved to vacate the referee's appointment, the computation and the judgment, all on the grounds that each issued in violation of the automatic stay provision of the Bankruptcy Code. In denying the borrower's motion to vacate the various foreclosure stages, the state trial court concluded that the acts violative of the stay were not void, but merely voidable—an important distinction. It also ruled that continuation of the foreclosure during the stay imposed by bankruptcy filings did not prejudice the borrower and so should be allowed to stand.

In its reversal, these succinct points made by the Second Department highlight the applicable law:

- The bankruptcy code provides for an automatic stay of certain prescribed actions against a debtor's property (11 U.S.C. § 362[a]).
- Imposition of the automatic stay is one of the fundamental protections afforded a debtor by the Bankruptcy Code.
- The stay is effective immediately upon the filing of a petition without need for further action.
- The stay is not limited to the litigants, but rather extends to a non-bankruptcy court too so that the stay serves to suspend any non-bankruptcy court authority to continue any judicial proceedings which are then pending against that debtor.
- Proceedings which the Bankruptcy Code stays upon a petition filing are void if they take place after the stay begins. (Ministerial acts such as entering a judgment are not barred, but issuance of a decision by a state court judge is.)

While an action violative of a stay is void, power to validate the action is given to the bankruptcy court itself (but not the state court). As a matter of law, the bankruptcy court can terminate, annul or modify the automatic stay. Here then, the foreclosure steps taken in state court were simply of no effect. The bankruptcy court could have ratified those, but it did not. State court in effect annulled the bankruptcy stay from the inception—a power it just did not have.

It may very well be that the borrower here suffered no prejudice by the foreclosure going forward even though a bankruptcy petition had been filed. And one could argue rationally that a stay should not be imposed upon a lender who is never mentioned in the bankruptcy case and never given any notice whatsoever of the existence of the bankruptcy filing—particularly since the uninformed lender is likely to spend much time and money endeavoring to enforce its rights, blissfully unaware of any impediment to continuing. But law is to the contrary.

Mr. Bergman, author of the three-volume treatise, *Bergman on New York Mortgage Foreclosures*, Matthew Bender & Co., Inc. (rev. 2009), is a partner with Berkman, Henoch, Peterson & Peddy, P.C. in Garden City, New York, a member of the USFN and an Adjunct Associate Professor of Real Estate with New York University's Real Estate Institute, where he teaches the mortgage foreclosure course. He is also a member of the American College of Real Estate Lawyers and the American College of Mortgage Attorneys.

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