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NYSBA

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A Message from the Section Chair

The Real Property Law Section is Hard at Work: Join Us!

1. Task Force on Adverse Possession

A9156/S5364A, which would have provided that a title claim based on adverse possession could not succeed if the claimant had knowledge of the true ownership, was opposed by our Section (RPLS Legislation Memorandum #13) because the bill contained ambiguities and raised important issues. The bill was an attempt to reverse the outcome in *Walling v. Przybylo*, 7 N.Y.3d 228 (2006). Following a conference call with an Assistant Counsel to the Governor, the Governor vetoed the bill. Our Task Force on Adverse Possession, chaired by Prof. Robert Zinman, has undertaken to study the law and recommend a better alternative.

2. Task Force on Mortgage Foreclosure

The Task Force, chaired by Steve Alden, has been asked to: (a) analyze the various mortgage foreclosure notice bills, write legislation memos on each and try to find a way to have the legislature coordinate the notice bills; and (b) analyze the impact of the Home Equity Theft Prevention Act and propose legislation to correct any problems (e.g., with deeds-in-lieu of foreclosure).

3. MERS; Subprime Lending

The Real Estate Finance Committee, Co-Chaired by Steve Alden and Victoria Grady, has been asked to study problems with MERS (i.e., *MERSCORP, Inc. v. Romaine*, 8 N.Y.3d 90 (2006) (County Clerk had duty to record and index mortgages that name MERS as lender's nominee; dissent by Kaye, J., urged legislative reform). The Committee is drafting a memo in opposition to A9295, which would grant discretion to County Clerks to reject documents. The Committee has also been asked to study proposals in response to the subprime lending problems (e.g., A8972 Responsible Lending Act, which tries to define and regulate subprime loans).

4. Title Agents and Upcharges

The Section successfully negotiated an exclusion from the controlled business prohibition for attorney title agents and examining counsel in the title agents registration bill (A1743/S877) and consequently supported the bill. The bill's failure to pass is something of a mystery, but the New York State Land Title Association (NYSLTA) intends to try again next year.

5. Section Blog

As I hope you know, we have established a "blog" for the Section, which can be accessed from the RPLS portion of the NYSBA Web site (www.nysba.org). To further communication with our members, we would like to see blogs written on each significant *new case* in our field (especially from the Court of Appeals) and each significant *new statute* enacted. Any volunteers? Please check out the Web site and send your blogs to Mike Berey at mberey@firstam.com.

6. NYSLTA Annual Meeting

At the request of NYSLTA, I attended the NYSLTA Annual Meeting in Halifax in August and gave a CLE lecture on recent Property Condition Disclosure cases. At my request, I had a meeting with the NYSLTA officers to discuss RPLS projects of interest to NYSLTA: (1) title agent licensing; (2) audits of title agents; (3) bill on disclosure of upcharges; (4) RPLS mortgage foreclosure task force; (5) RPLS adverse possession task force; and (6) RPLS recorded documents task force. The meeting was very positive and we agreed to work together.

7. Bill on Disclosure of Upcharges

In a discussion with the sponsors of the title agents licensing bill, we proposed that a requirement of disclosure of upcharges in connection with a title search or title insurance be added. They declined to do so, but said they would be willing to sponsor a separate bill. The bill would separately identify (a) payments to governmental entities, recording officers and any other third parties and (b) the portion of the charge being made for services rendered. The Title & Transfer Committee Co-Chairs, Jerry Antetomaso, Joe DeSalvo and Tom Hall, are finalizing a draft.

8. Guardian Ad Litem Defense and Indemnification Act

The Executive Committee has approved a draft bill to amend the N.Y.C. Civil Court Act to grant defense and indemnity to Guardians ad Litem appointed by that Court. Dov Treiman was the author.

9. Uniform Fraudulent Transactions Act

The Executive Committee has voted to support S5269, which would enact the UFTA, but took no position on three non-uniform provisions: (i) burden of proof for intentional fraud; (ii) mandated attorney's fees; and (iii) money judgment executions. Prof. Robert Zinman is our expert.

10. NYSAR Bill on PCDA

At the request of the New York State Association of Realtors (NYSAR), I attended their meeting on August 20 with Assemblyman Brodsky, who agreed to sponsor their

PCDA/PCDS revisions (previously approved by the RPLS Executive Committee). Senator Libous had already introduced an earlier version (S5361). The bill would do the following: (a) Set forth the $500 credit in all caps in bold face type on the first page and add a new "Note to Buyer" emphasizing that the PCDS is not a warranty or a substitute for inspection. (b) "Unknown" has been deleted as an option. The questions are revised to ask "Do you know . . ." Yes/No/Not Applicable. (c) Any certificate of occupancy is to be listed or attached (Q4). (d) New question: If improvements have been made, do you know if they required a permit? (Q5) (e) The "working order" test will now apply to eleven systems (as we requested), rather than the "material defect" (still undefined) test. (f) RPL 464 will be revised to make clear that the seller need not send a revised PCDS solely because of receipt of an inspection report from the purchaser's inspector. (g) RPL § 465 will be revised to require a $500 credit if the buyer does not receive a "complete" PCDS. (h) Statutory disclosure requirements (electric service, utility surcharges, agricultural district, and uncapped natural gas wells) are moved to the end of the form.

11. Legislation Conference Call

Legislation Committee Co-chairs Spencer Compton and Kathleen Lynch and I participated in a NYSBA telephone conference call on legislation procedures and policies, which provided lots of good guidance. We appreciated it when Ron Kennedy singled out our Section for: (1) RPLS efforts to establish ourselves as a resource to the legislature and the Governor and (2) the RPLS pending legislation site on our Web site. It is really nice to see our Section getting recognition from NYSBA.

12. New Laws Enacted that Affect Real Estate:

- Chapters 73 and 616 (A3386/S1922; A9244/S6351) Add RPL § 227-c allowing victims of domestic violence to terminate residential leases.
- Chapter 458 (A8630/S4210) Amends RPAPL § 1320 to require additional notice of foreclosure to mortgagors.
- Chapter 549 (A8326/S5085) Amends RPL § 443 re: disclosure of dual agency by real estate brokers.
- Chapter 553 (A8793/S5620) Amends Banking Law 599-a re: certification of mortgage loan originators.
- Many Chapters enacted transfer and mortgage recording taxes.

13. Mission Statements

Each committee of the Section has been asked to update or adopt a mission statement describing their goals and activities. Those received so far have been posted on the RPLS Web site. Check them out to see which committee you would like to join.

14. 2007 and 2008 Summer Meetings

Thanks to First Vice Chair Peter Coffey for a successful and enjoyable summer meeting for our Section last July at the Equinox in Manchester, Vermont. Next July the RPLS will meet in Hershey, PA., with Second Vice Chair Joel Sachs in charge.

15. Section Web site

The RPLS Web site at www.nysba.org/realprop has several features:

- *N.Y. Real Property Law Journal*: issues back to 1998
- Real Property Committees: rosters and mission statements
- Minutes: minutes of Executive Committee meetings
- Upcoming Events: schedule of RPLS CLE and committee meetings
- Join the Section Listserv: access to the Real Property Forum discussion group
- RPLS Blog: postings to the Blog
- Status of Pending Legislation: listing of bills of interest in the Senate and Assembly
- 2007-2008 Legislative Memoranda: memoranda on bills prepared by the RPLS
- Useful Links for the RPLS: to other sites

Check out our site!

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New York's RPTL § 581-a: The Missing Link to Rental Housing Affordability?

By Brian E. Lawlor and Brian P. McCartney

In an effort to facilitate the development and operation of affordable rental housing by injecting a measure of consistency and predictability into the otherwise problematic task of assessing such properties for *ad valorem* taxation purposes, New York State amended its Real Property Tax Law ("RPTL") by adding a new section 581-a, which addresses the assessment of restricted income rental developments and is applicable to taxable status dates occurring on or after January 1, 2006. This article will: (1) discuss the significance and complexity of the issues facing assessors charged with equitably valuing such properties, (2) present a brief overview of how the New York State Legislature and its judiciary have treated this topic historically, and (3) examine the Legislature's recent attempt, in enacting RPTL § 581-a, to provide a standard methodology for assessing low-income rental housing.

The stakes at risk in the assessment of subsidized housing are high. Being an *ad valorem*—i.e., percentage of value, form of taxation—real property taxes are a direct function of assessed value, and "may well be the largest single expense line item in the [project's] operating statement. . . ."[1] The likely result of full valuation is that low-income units will be taxed at a rate that cannot be supported by the project's restricted rental income, thereby jeopardizing its economic viability. Moreover, "[e]xcessive real estate valuation can discourage the development of needed affordable housing and contribute to mortgage defaults or poor maintenance."[2]

The assessment of affordable housing is a complex subject which presents special challenges to assessors. The value of such housing is impacted by several elements that are unique to these properties, differentiating them from unrestricted multifamily developments. To minimize capital costs in order to make housing affordable to low- and moderate-income residents, governmental subsidies, such as below-market financing, rental assistance, or tax credits, are often necessary to make such projects economically feasible. These subsidies come with significant strings attached.

Federal and state subsidy programs impose extensive rental and disposition restrictions designed to ensure that the housing is affordable to persons financially unable to pay market rent, and remains affordable for an extended period of time, upwards of thirty years or more.[3] Subsidies are generally held to have a positive influence on value while governmental restrictions, which act to foster illiquidity in the marketplace, are considered a negative factor.[4] Both of these special features of affordable housing must be appropriately considered when conducting a valuation analysis.

After the enactment of the federal Low-Income Housing Credit ("LIHC") program[5] in 1986, the complicated financing and organizational structure of these developments made the assessment of subsidized housing particularly challenging. The LIHC program has facilitated the development of affordable housing nationwide by minimizing the need for debt financing through its encouragement of private equity investment to fund construction and operational costs. Such equity is raised by an LIHC developer selling the rights to a project's future tax credits to investors who must hold an ownership interest, usually as a limited partner, in the project in order to qualify to use them to offset taxable income.[6] Only ten percent of the tax credits can be claimed annually by the owners over a ten-year period.[7]

Generally, LIHC units can only be rented to individuals and families earning no more than sixty percent of the median income, adjusted for family size, for the area in which the project is located.[8] Furthermore, the rents are restricted in such a way that even if a tenant's income during his or her tenancy exceeds sixty percent of the area median income ("AMI"), the maximum collectible rent is limited to approximately thirty percent of sixty percent of the AMI.[9]

Assessors who may not be fully familiar with how LIHC properties function often assume that, notwithstanding the rental restrictions and limited cash flow such properties operate with, there is additional ongoing supplemental income or other value flowing to the owner. Consequently, it is not unheard of for LIHC housing to be given market rate assessments which can not be supported by their restricted incomes.

In the past, New York's real property tax policy has been primarily focused on the provision of real property tax exemptions and abatements to expand and preserve its affordable housing inventory. The City of New York has been particularly progressive in this regard, employing a number of tax incentive programs structured to stimulate production and preservation of subsidized housing. For example, the City's 420-c tax incentive program[10] provides a total exemption for low-income projects that are owned by specific nonprofit entities formed for the purpose of providing such housing, and are developed in conjunction with the LIHC program. Housing programs instituted decades ago, such as the Mitchell-Lama program (1955),[11] have also utilized tax exemptions as a tool to encourage the growth of New York State's affordable housing stock.

Subsidized housing developments that are not eligible for a tax exemption and have not entered into a payment in lieu of taxes ("PILOT") agreement with the local taxing authority must pay real property taxes based upon their assessed valuation, which brings us to the issue of assessment methodology.

The three conventional real property appraisal methods, which assessors may pick from as they deem appropriate, are: cost, comparative sales, and income capitalization.[12] Of these, the income capitalization approach is generally recognized by assessors and the courts as being "the preferred method to determine the value of income-producing property such as petitioner's [low-income housing project]."[13]

Income capitalization has been described as:

> the process of converting a series of anticipated future payments (income) into present value. It relates net income produced by a property to the property value. The capitalization process, or the income approach, restates market value by converting the future benefits of property ownership into an expression of present worth.[14]

Although a detailed discussion of the mechanics of the income approach is beyond the scope of this article, in its simplest form it is an assessment methodology whereby a given property's estimated net operating income is divided by a capitalization rate to arrive at its present value.[15] Essentially, the capitalization rate is meant to "reflect what investors generally are expecting from an investment in a particular type of property."[16] Since a relatively minor difference in the capitalization rate can dramatically affect the final valuation, the calculation of the rate is of utmost importance.[17]

Courts have struggled with two fundamental questions when reviewing the application of the income capitalization approach to subsidized housing, the answers to which can have a significant influence on valuation for assessment purposes.[18] The first question is whether the property's restricted rents, as opposed to the prevailing market rents, should be used in calculating net income.[19] In New York, prior to the enactment of section 581-a of the New York Real Property Tax Law ("RPTL § 581-a"),[20] case law regarding the assessment of projects subsidized by the United States Department of Housing and Urban Development in the form of direct rental payments to the owner holds that restricted, also referred to as actual, rents may be disregarded when determining net income if they are lower than market rents,[21] which places New York in the minority of state courts that have ruled on this topic.[22]

The second question concerns whether subsidies should be factored into the equation when assessing affordable housing.[23] Although no reported New York cases were found on point, the conclusion reached by the majority of other state courts is that governmental subsidies add value to affordable housing properties and should be reflected in their assessment.[24]

New York courts have had occasion, prior to RPTL § 581-a, to examine the effect of use and sale restrictions on low-income projects. In *78 S. First St. Hous. Dev. Fund Corp. v. Comm'r of Fin. of City of N.Y.*, the Court held that certain restrictions on the use and sale of affordable housing owned by a housing development fund company organized pursuant to Article XI of the Private Housing Finance Law were personal to the property owner and, therefore, need not be taken into account for assessment purposes.[25]

New York case law, because it permits the imputation of market rents and the exclusion of use and sale restrictions in the appraisal of restricted income projects, can be reasonably characterized as favoring local government in this area. In an attempt to counteract this judicial trend, and in recognition of the need for a consistent assessment standard that will foster the growth of subsidized rental housing, New York State enacted RPTL § 581-a.

As explained in the New York State Senate Introducer's Memorandum in Support of the bill:

> Under current law, developers who provide affordable housing in communities often have the disadvantage of having their property assessed at market value, despite the fact that the rents in such units are restricted. In effect, the income derived from such rent restrictions might be significantly less than that of a comparable building charging market rates, yet these units are assessed equally. This can result in reluctance on the part of developers to build affordable housing. This bill attempts to alleviate this problem by providing for more realistic valuation and assessment rates on rental property with restricted income.[26]

RPTL § 581-a breaks from previous New York real property tax policy, with its emphasis on exemptions and abatements, by mandating the use of a specific assessment methodology for low-income rental developments.[27] Specifically, the statute provides that the income capitalization approach, based upon actual net operating income, after deducting any required reserves, shall be used to assess residential rental properties where the occupancy of at least twenty percent of the units are restricted, pursuant to an agreement with a governmental entity, to tenants who qualify in accordance with an income test.[28] Such restricted housing would include, for example, properties developed with LIHC, state low-income housing tax credits,[29] tax-exempt bond financing,[30] the federal HOME or the Homeless Housing and Assistance[31] programs. Thus, the statute not only eliminates an assessor's discretion to choose an appraisal method for subsidized rental developments, but it also reverses the trend in New York case law by requiring that restricted rents be used in all instances, notwithstanding the fact that local market rents may be higher.

Equally significant, RPTL § 581-a addresses the subsidy issue, which had been left open to interpretation in New York, by excluding them from the calculation of actual net operating income.[32] Under the statute, this exclusion specifically applies to income tax credits, below-market mortgage financing and grants, if such subsidies are applied to development costs in order to make reduced rents economically feasible.[33]

Pursuant to the authority granted it under RPTL § 581-a, the New York State Division of Housing and Community Renewal, in consultation with the New York State Office of Real Property Services, and the primary organizations that are representative of the regulated community (i.e., the New York State Association for Affordable Housing and the New York State Assessor's Association), permanently adopted regulations, which became effective as of November 1, 2006, to clarify certain aspects of the statute. A new Part 2656 was added to Title 9 of the New York Code of Rules and Regulations to provide a definitional section,[34] as well as to delineate the financial documents property owners seeking reassessment under RPTL § 581-a must furnish the local assessing unit prior to the taxable status date.[35]

Although the intent and purpose of RPTL § 581-a is clear, the statute's language does not directly answer all of the valuation issues that have confronted assessors and owners alike. On its face, the plain language of the statute does not require a particular method for calculating capitalization rates, nor does it specifically address whether subsidies should be considered in their derivation. According to the New York State Senate Introducer's Memorandum in Support of the bill, it was the drafters' intent to "exclude the benefits of federal or state income tax credits or special financing or grants in deriving the capitalization rate or yield rate used in the valuation of real property. . . ."[36]

The issue of the role subsidies should or should not play, in determining the capitalization rate under RPTL § 581-a, has not been examined by any New York court to date. However, this question is not unique to New York and has received judicial review elsewhere. Specifically, the interplay of capitalization rates and tax credits was the issue at hand in *Holly Ridge Ltd. P'ship v. Pritchett*,[37] a Florida District Court of Appeals case where the court was faced with interpreting a statute, substantially similar to RPTL § 581-a, which required assessors to recognize a LIHC project's actual income, excluding tax credits, when utilizing the income approach, but did not address how the capitalization rate should be derived.[38]

The *Pritchett* court reviewed the underlying intent of the statute, and held that although the appraiser correctly excluded the tax credits when calculating the project's actual income, he improperly considered them in determining the capitalization rate.[39] The appraiser's inclusion of the value of the tax credits into the capitalization rate was found by the Court to violate the statute's clear directive that tax credits not be considered as income to the property.[40]

> *To permit the property appraiser to use his derived capitalization rate would permit him to circumvent the requirements of section 420.5099 by indirectly considering the tax credits as income. . . . Additionally, the methodology used by the property appraiser, if permitted, would frustrate the legislative intent to utilize tax credits in order to encourage development of low-income housing*.[41]

Although the language of RPTL § 581-a may not specifically dictate each and every aspect of the assessment process for affordable rental housing, it represents a major step in providing for a uniform assessment methodology, which should, as it was intended to do, increase the confidence of affordable housing developers, investors and financial institutions in their ability to more accurately predict and maintain the economic feasibility of a proposed project.

Endnotes

1. Richard E. Polton & Julia LaVigne, *Valuation and Market Studies for Affordable Housing* 96 (2002).
2. Joseph Rosenblum, *Assessing the Value of Affordability:* Ad Valorem *Taxation of Properties Participating in the Low Income Housing Tax Credit Program*, 2 JMLS F&A Hous. Comm. 32, 39 (2006), quoting Governor's Housing Task Force, Comprehensive Strategy for Iowa 65 (2000), *available at* http://www.sppg.com/uploads/pdf/housingstrategy.pdf.
3. *See, e.g.,* Low-Income Housing Credit Act of the Internal Revenue Code 26 U.S.C. §§ 42 *et seq.*; HOME program, 42 U.S.C. §§ 12721 *et seq.*; Mitchell-Lama program, N.Y. Priv. Hous. Fin. Law §§ 10–37, 70–97 (2007); Low-Income Housing Trust Fund program, N.Y. Priv. Hous. Fin. Law § 1106 (2007).
4. 4 Polton & LaVigne, *supra* note 1, at 71.
5. 26 U.S.C. § 42, *supra* note 3.
6. Herb Stevens & Thomas Tracy, *Developer's Guide to the Low Income Housing Tax Credit* 16 (3d ed. 1994).
7. 26 U.S.C. § 42(b)(2)(B).
8. 26 U.S.C. § 42(g)(1)(B).
9. 26 U.S.C. § 42(g)(2)(D). For example, in New York City, sixty percent of the AMI for a family of four is $42,540 per year, which would result in a LIHC rent capped at $1,106 per month for a three-bedroom apartment. By comparison, in Albany the AMI for a family of four is $39,720 per year, and the LIHC rent is capped at $1,032 per month for the same sized apartment.
10. N.Y. Real Prop. Tax Law § 420-c.
11. Limited-Profit Housing Companies Law, N.Y. Priv. Hous. Fin. Law §§ 10–37 (2007).
12. Polton & LaVigne, *supra* note l, at 91.

13. *John P. Burke Apts. v. Swan*, 137 A.D.2d 321, 325, 528 N.Y.S.2d 718, 720 (3d Dep't 1988) (citation omitted).
14. International Association of Assessing Officers, *Property Assessment Valuation* 231 (1977).
15. *Id.* at 233.
16. Rosenblum, *supra* note 2, at 50.
17. International Association of Assessing Officers, *supra* note 14, at 234.
18. Rosenblum, *supra* note 2, at 32.
19. *Id.*
20. Assessment of Residential Real Property, N.Y. Real Prop. Tax Law § 581-a (2007).
21. *See e.g.*, *Conifer Baldwinsville Assoc. v. Town of Van Buren*, 115 A.D.2d 325, 495 N.Y.S.2d 869 (4th Dep't 1985), *aff'd*, 68 N.Y.2d 783, 498 N.E.2d 417 (1986).
22. Rosenblum, *supra* note 2, at 58.
23. *Id.* at 32.
24. *Id.* at 49.
25. 202 A.D.2d 115, 119, 616 N.Y.S.2d 405, 407 (2d Dep't 1994).
26. New York Governor's Bill Jacket, L 2005, ch. 714, at 5 (Oct, 11, 2005).
27. N.Y. Real Prop. Tax Law § 581-a (2007).
28. *Id.*
29. N.Y. Pub. Hous. Law §§ 21–25 (2007).
30. Exempt Facility Bond program, 26 U.S.C. § 142(d).
31. N.Y. Soc. Serv. Law §§ 41–44 (2007).
32. N.Y. Real Prop. Tax Law § 581-a (2007).
33. *Id.*
34. *See* 9 N.Y.C.R.R. § 2656.2.
35. *See* 9 N.Y.C.R.R. § 2656.3.
36. New York Governor's Bill Jacket, *supra* note 26, at 5.
37. 936 So.2d 694 (Fla. Dist. Ct. App. 5th Dist. 2006).
38. *Id.*
39. *Id.* at 698.
40. *Id.*
41. *Id.* at 698 (emphasis added) (citations omitted).

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New Title Policy Forms Now Required in New York

By Marvin N. Bagwell

Currently, the title insurance policy forms disseminated in 1992 by the America Land Title Association ("ALTA") are used to insure almost all real property conveyances in New York State. Attorneys representing sellers, purchasers and lenders have developed an intimate acquaintance with the existing 1992 ALTA policy forms. However, fourteen years is a long time in the conveyancing business. Since 1992, the packaging, slicing and dicing of mortgages secured by real estate has led, for better or for worse (with now being for worse), to the development of secondary markets for all types of securitized loan "products." Securitization demands uniformity, so the variations among title policy forms which proliferated in different jurisdictions over the past fourteen years have been a hindrance to the wheels of commerce. The last decade and almost a half have also seen a marked increase in the cost of real estate and a consequent increase in the financial complexity of the transactions. Property owners no longer hold title for decades and lenders no longer hold mortgages throughout their terms. All parties to a transaction now look towards how best to profit from the disposal of today's asset tomorrow, and they expect title to be good when they convey. Good conveyancing attorneys no longer regard title insurance as an afterthought to be obtained at the last minute before closing. More often than not, especially in commercial transactions, the title person if not on the conference call when the deal is struck will certainly be on the e-mail list later that same day.

Courts have not been sitting in the wings idling either. Judges and justices have been busy issuing rulings and opinions which have re-interpreted provisions of the 1992 policy forms. Time has moved on and ALTA has not stood still. Over the last two years, ALTA, with the involvement of representatives from the realtor, lender and brokerage industries as well as from Fannie Mae and Freddie Mac, have re-written the 1992 policy forms. The Title Insurance Rate Service Association ("TIRSA"), the state-endorsed ratings bureau comprised of most of the title underwriters licensed by the State of New York, filed for approval to issue the new policy form in early 2007. The New York State Insurance Department approved the issuance of the new forms effective on May 1, 2007. As a result, we now have new 2006 ALTA owner (or fee) and mortgage (or loan) title policy forms which will become effective on May 1, 2007. On that date, the 2006 forms will replace the 1992 policy forms currently in use in New York. Our cheese has been moved.

In this article, the author will attempt to outline the most significant new provisions contained within the new policy forms. There, of course, have been changes, but many provisions which ALTA adopted for the national stage are already familiar to real estate practitioners in New York. For the most part, the changes take account of and will not adversely influence the way we are used to doing business in New York. They will, however, have a significant impact upon how claims made under title policies are resolved. For space reasons, this article cannot possibly be exhaustive. However, for those of you with a keen interest, you can read a side-by-side, line-by-line comparison of the 1992 ALTA policies with the 2006 policies at www.alta.org.

It is well advised first to examine the new definitions, which appear in the 2006 policy. Among the most significant is "Amount of Insurance." Under the 1992 policy, the amount of insurance was simply the coverage amount shown on Schedule A. However, the representatives of the various trade associations which advised ALTA, as well as the members of ALTA itself, recognized that this amount was quite often insufficient to reimburse a policyholder for its loss. Under both the 1992 policies and under the new 2006 policies, instead of paying a claim title immediately, the title underwriter has the right to establish title through litigation. Litigation is a timely and expensive process during which an insured owner may not have full access to the insured property and the lender may have a non-producing loan in its portfolio. In recognition of the fact that time is money, the 2006 policy provides that the "Amount of Insurance" may be increased by 10% if the title underwriter decides to litigate a claim and subsequently loses that litigation. That is, if the title underwriter is unable to establish title (fee policy) or lien priority (mortgage policy) through litigation, then the insured is entitled to recover 10% more than the coverage amount set forth on Schedule A. In addition, the policies provide that the insured decides on which date the amount of loss is to be determined. The date can be either the date on which the policyholder made the claim to the title underwriter or the date on which the claim is settled and paid. As property values go up and down, this flexibility gives the policy holder the ability to choose the point in time which would result in the greater recovery. If, however, the title underwriter litigates a claim and wins, the insured does not receive the 10% premium. The possibility that the title underwriter may be on the hook for 10% more than the amount insured is to serve as incentive for a claims department to settle claims earlier, thereby getting money into the hands of the policyholder sooner rather than later (Section 8(b)). All is not weighted on the side of the insured. The definition of "Amount of Insurance" also provides that the coverage payable as a claim may be reduced by the title underwriter's payment of prior losses (Section 12) or because liability will remain noncumulative. This means that payments made to a lender will reduce, by an equal amount, the coverage provided to the fee insured (Section 11).

Speaking of "Insured," the 2006 policy contains a new term, "Entity." An "Entity" is a corporation, partnership, trust, Limited Liability Company or other legal entity." This becomes significant because the definition of "Insured" now includes "Entity." The issue that ALTA is addressing is that of continuation of coverage. Under the 1992 policy, coverage continued to a successor to an insured only if that successor gained its interest by operation of law. For example, the coverage provided by a title policy would continue to the heirs or spouse of a deceased insured because the heirs or spouse succeeded to the insured's interest by operation of law. (The coverage, of course, was in the amount and as of the date of the original policy.) The test as to whether coverage continued was simple. If a new deed had to be recorded to vest title, then coverage ended. Hence, coverage was lost in many corporate and natural inter-family transfers as when a subsidiary corporation transferred title to its parent (or vice-versa) or when a parent conveyed to a child. New York title underwriters cured most of these continuation of coverage issues by amending (with Insurance Department approval) the TIRSA Rate Manual to provide that coverage continued for certain inter-family, no-consideration transfers even when a new deed had to be recorded. By including "Entity" within the definition of "Insured," ALTA has adopted the New York practice. However, the practitioner should keep in mind that the title underwriter still retains all rights and defenses that it had against any predecessor Insured.

Gap coverage is another New York practice that has been carried over to the 2006 ALTA policy. The coverage provided by a title insurance policy speaks as of the closing date. Under the New York Endorsement, which is attached to every fee and mortgage policy issued in this state, title coverage includes the period from the date of closing to the date of recording. In other words, the title policy provides coverage to the insured against loss caused by liens or encumbrances (with certain exceptions, such as for taxes and assessments) which arise during the time period from the closing to the actual recording of the instruments. This coverage is significant because for certain counties in New York, that time period or "gap" may be months long. ALTA has adopted the New York practice by defining "Date of Policy" to mean the date on which the instruments are recorded (Schedule A, 1(b)).

Now that we have discussed the new definitions, let's move on to the new coverages offered by the 2006 policy.

The first thing the sharp-eyed real estate practitioner would notice is that the term "Insuring Clauses" has disappeared. It has been replaced by the more descriptive term, "Covered Risks." The next thing to notice is that the number of "Covered Risks" seems to far exceed the number of the old Insuring Clauses. The eye is not deceiving you here. The 2006 policy lists all of the events which the courts, real estate practitioners and even the various title companies' claims departments have agreed over the past century that the title policy cover. Rather than being left unsaid, such matters as forgery, fraud, lack of proper corporate authorization, invalid powers of attorney are now specifically spelled out as being covered. "Covered Risks" paragraph 2(a) really is yesterday's news and does not provide anything new.

"Covered Risks" paragraph 2(c) is much more interesting. It seems to provide coverage against losses caused by "[a]ny encroachment, encumbrance, violation, variation, or adverse circumstance affecting the Title that would be disclosed by an accurate and complete land survey of the Land." Could it be true that the policy provides survey coverage without the necessity of purchasing a survey? Not in New York. What the ALTA Forms Committee gaveth to the other states, TIRSA taketh away in New York, but only partially. To see what happened, it is necessary to read the policy in conjunction with both the New York endorsement and the TIRSA Rate Manual.

In the case of the owner's policy, the New York Endorsement removes survey coverage completely by deleting paragraph 2(c). The TIRSA Rate Manual requires that in the absence of a survey, the following language must appear in the policy: "subject to any state of facts an accurate survey would show." The result for fee insureds in New York is if they do not purchase a survey and provide the survey to the title company, the title company will take a full survey exception. In effect, without a survey, the fee purchaser of a title policy would have no coverage for losses resulting from encroachment, gores, or "other adverse circumstances" affecting the land. If the fee insured purchases a survey and provides it to the title company, the title company will read the survey into the policy and take exceptions in the reading only for those defects that are shown on the survey. This is no different from the current situation faced by all fee insureds in New York.

The situation is a little different for lenders. The New York Endorsement to the Loan policy removes survey coverage but only if the property is not a 1 to 4 family residence. In other words, if the land to be insured is a 1 to 4 family residential property, then the lender will have survey coverage automatically. Because this coverage is provided automatically, TIRSA has withdrawn the Survey Endorsement. Since the lender will now have survey coverage on 1 to 4 family residential properties automatically, and since there is no longer a Survey Endorsement, which the lenders will require the borrowers to purchase, the result is a 10% savings in the cost of title insurance for homeowners in New York. However, if the land is not 1 to 4 family residential and is mixed use, commercial or vacant and the owner does not provide the title company with a survey of the property, then the TIRSA Rate Manual requires the title company to insert the following language in the policy: "subject to any state of facts an accurate survey would show." The result is that unless the property owner provides a survey to the title company, the lender will not have survey coverage for commercial property or for vacant land. This too is in conformity with current New York practice. The major change, and it is good news for homeowners, is a 10% savings in the cost of their title policy.

One quick note: the title policy now specifically covers losses resulting from the enforcement of any laws, permits or governmental regulation affecting the insured land when notice of the violation and/or enforcement action is recorded in the Public Records. This should not come as a surprising coverage (except to claims counsels) because in New York, case law from *Smirlock v. Title Guarantee*, 437 N.Y.S. 2d 57 (1981) to *Peretz Strahl, Inc. v. Fidelity*, 806 N.Y.S.2d 448 (2005) has been leading in the direction of providing insureds with the coverage. However, title industry observers should expect to see cases working their ways through the courts on exactly what constitutes "notice" or "public record" (even though "public record" is defined in the policy). With every advancement in technology and with more and more property information appearing on line, courts may be inclined to expand the concept of "public record." Title litigators should start their research now.

There is one other instance where TIRSA, in deference to New York law and practice, had to make a change to the 2006 ALTA loan policy. While the form of the policy remains unchanged, thereby maintaining the policy's national unified nature, the New York Endorsement and TIRSA Rate Manual have been amended so to not give away the ranch. Covered Risk 11 insures a lender against loss "due to the lack of priority of the lien of the Insured Mortgage upon the Title (a) as security for each and every advance of proceeds . . . over any statutory lien for services, labor or material. . . ." Even though the policy goes on to limit the coverage to "proceeds of the loan secured by the Insured Mortgage that the Insured has advanced *or is obligated to on Date of Policy to advance* (Covered Risk 11(a)(ii), emphasis added), TIRSA thought it best not to give lenders and the courts the opportunity to create new law. This is a vast simplification, but New York law, through the trust provision of Section 13 of the Lien Law, the Building Loan Affidavits required by Lien Law Section 22 and the new-found Lien Law Section 73 Notice of Lending provision, provides that construction mortgage advances do not have lien priority over a mechanic's lien which is filed prior to the date of the payment of the construction advance. Therefore, to nullify any thinking that the 2006 ALTA policy provided such coverage in New York, TIRSA deleted Covered Risk 11 and substituted the following coverage against loss or damage arising from "the lack of priority of the lien of the Insured Mortgage upon the Title (a) as security for each and every advance of proceeds of the loan secured by the Insured Mortgage over any statutory lien for services, labor or material furnished prior to the Date of Policy." Hence the New York version of the 2006 ALTA policy provides coverage against mechanic's liens only during the gap period. After the recording date of the construction or building loan mortgage, the lender must contact the title company and obtain a title "run-down" or continuation search ("contin") to make sure that title is "clean," i.e., no third party has filed a mechanic's lien or other encumbrance, before the lender can obtain coverage, that its advance has superior lien priority. This is a continuation of current New York practice and should not be disconcerting to the real practice bar.

The 2006 ALTA form policies contain many other changes that are less significant than the ones discussed above. Among the changes: various "Exclusions from Coverage" have been restated; the amount that must be in play to invoke the Waiver of Arbitration provision has been raised to $2 million; and the Proof of Loss requirements have been eased. To the regret of lenders, the creditors' rights exclusion, which was a contentious part of the 1992 policy, has not been removed in the 2006 loan policy form. The policy continues to exclude "[a]ny claim, by reason of the operation of federal bankruptcy, state insolvency or similar creditors' rights laws" from coverage with the exception of the instant transaction. Also, the Creditors' Right Endorsement continues not to be available in New York, which means that the title underwriters do not cover the impact of the borrower's entering bankruptcy or running afoul of creditors' right statutes post-policy or in the future. Time and your ability to persevere through this article (commendable if you have made it to this point) do not allow me to discuss all of the new policy provisions. Only time will tell whether the minor changes to the policy forms which were not included in this discussion ultimately will have more impact in the title industry than the significant innovations on which we have focused. One thing is certain: The law of unintended consequences has not been repealed. You, as a title industry consumer and real estate practitioner in conjunction with the courts, to borrow a new word just added to the American vocabulary, will be the ultimate "decider."

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Earnest Money Deposits as True Option Premiums? An Examination of Real Estate Down Payments and Forfeiture—From *Lawrence v. Miller* to *Uzan v. 845 UN Limited Partnership*

By Arthur G. Eliav and Daniel Ginzburg

Introduction

In April 1999, two Turkish billionaires, brothers Cem and Hakan Uzan,[1] entered into a contract to purchase two penthouse condominiums on top of the World Trump Tower, a skyscraper scheduled to be built at 845 United Nations Plaza[2] in New York City.[3] The brothers paid the sellers, Donald Trump and his partnership (hereinafter "Trump"), approximately $8 million as down payment, which amounted to twenty-five percent of the overall purchase price.[4] The closing was scheduled for October 2001.[5]

In September 2001, terrorists struck the World Trade Center in New York City. Six weeks later the Uzan brothers failed to appear at the closing.[6] In the subsequent lawsuit, initiated by the Uzans to reclaim their earnest money deposit,[7] the trial court held the buyers in breach of contract and denied complete recovery.[8] Instead, it allowed the brothers to recover any part of the down payment above ten percent of the overall price that did not reasonably reflect Trump's actual or potential losses.[9] On Trump's appeal, however, the First Department held that under a century-old New York precedent,[10] vendees defaulting on a real estate contract without lawful excuse could not recover *any* part of their down payment. Consequently, the Appellate Division refused to scrutinize the deposit amount for reasonableness in relation to the seller's damages, even where a quarter of the overall price would be forfeited.[11] Trump was allowed to retain the entire earnest money deposit of nearly $8 million.[12]

The court's decision sent shockwaves through real estate circles, both because of the high profile of the litigants involved as well as the exorbitant sum and percentage of money forfeited.[13] The *Uzan* decision prompted some commentators to call for a reevaluation of the real estate deposit law in New York.[14] Others,[15] however, attempted to defend the existing regime, by rationalizing the New York approach as being analogous to the option contracts scheme.[16]

This article will analyze the New York regime relating to recovery of earnest money deposits and demonstrate that the New York scheme of dealing with earnest money deposits is most similar to the option contract approach because of the protection that it offers vendors, the strictness with which it treats defaulting vendees and the limitations that it places on vendors' ability to recover damages over and above the amount of the down payment. Finally, this article will argue that because the New York approach is so similar to the option contract scheme, the courts of this State should make this parallel well pronounced for the sake of clarity and stability required in contractual relationships.

I. Earnest Money Deposits in Residential Real Estate

A. *Uzan v. 845 UN Limited Partnership*

In April 1999, the Uzan brothers and their associate, Antonio Bentacourt, executed seven purchase agreements for apartments in the Trump Tower.[17] Bentacourt purchased two units on the fifty-ninth floor, Cem Uzan agreed on a unit on the 80th floor, and the four remaining units, combined into single apartments for each of the brothers, became the subject of the aforementioned litigation.[18] The offering plan[19] included a clause requiring the initial down payment of ten percent as well as a second payment of fifteen percent within 180 days of receipt of the executed purchase agreement.[20] Furthermore, the purchase agreements prominently disclosed the vendor's right to retain the entire down payment should there be an uncured breach.[21]

The purchase agreement was subject to an intense, two-month-long period of negotiations,[22] during which a prominent local firm[23] represented the Uzan brothers.[24] Ultimately, the purchasers were scheduled to pay ten percent at the signing, seven-and-a-half percent twelve months later, and a final seven-and-a-half percent eighteen months after the execution of the contract.[25] The brothers met all deadlines and paid the last amount in October 2000, one year before the closing date.[26]

On September 11, 2001, terrorists flew two passenger planes into the World Trade Center, striking down New York City's tallest buildings. Citing their concerns regarding future terrorist attacks, the Uzan brothers failed to appear at the closing on October 19, 2001.[27] Upon the expiration of the thirty-day cure period,[28] Trump's partnership terminated the four purchase agreements.[29]

The brothers brought an action to recover their down payments, alleging fraud and deceptive sales practices on the part of the partnership for failing to specifically advise prospective purchasers of the risks of terrorist attacks on Trump World Tower.[30] In the alternative, the Uzans sought to have the down payment declared an unenforceable penalty.[31] Supreme

Court dismissed the claims of fraud and granted partial summary judgment to the vendors on the question of the down payment.[32] The Court allowed the Partnership to retain the initial ten percent down payment in its entirety, whereas the other fifteen percent would be subject to a reasonableness analysis.[33] The Appellate Division reversed the Supreme Court's judgment with regard to the latter and held that the entire twenty-five percent should be non-refundable as stipulated in the original contract.[34]

B. The New York Regime: History

The Appellate Division's decision in *Uzan,* upholding the seller's right to retain earnest money in the case of a buyer's willful breach, draws on a rule established by the Court of Appeals more than a century ago in *Lawrence v. Miller*.[35] In that case, plaintiff's assignor made a $2,000 down payment on a real estate purchase and subsequently defaulted.[36] After a short cure period, seller retained the down payment and ultimately sold the property to another buyer. The buyer's assignee then brought an action to obtain a refund of the down payment.[37] The court held that "[t]o allow a recovery of this money would be to sustain an action by a party on his own breach of his own contract, which the law does not allow."[38] Refusing to adopt such "ill doctrine," the *Lawrence* court denied recovery of the down payment.[39]

The other Court of Appeals decision relied on by the *Uzan* court is *Maxton v. Lo Galbo*.[40] There, a vendor contracted to construct and sell a house, accepting a ten percent down payment.[41] When the vendees terminated the contract by placing a stop on the check, the vendor sued to recover the down payment.[42] The vendees argued that the vendor's recovery should be limited to actual damages[43] but the court ruled for the vendor,[44] upholding *Lawrence*.[45]

According to the Appellate Division deciding *Uzan*, the Court of Appeals in *Maxton* drew two legal principles from *Lawrence*.[46] The first is the "parent rule": "one who breaches a contract may not recover the value of his part performance."[47] From the parent rule, the *Maxton* court derived the second principle: "the vendor is entitled to retain the down payment in a real estate contract, without reference to his actual damages."[48]

In its analysis of *Lawrence,* the *Maxton* court also paid attention to criticism directed at the ruling's harsh result.[49] The court noted that much of the criticism was directed at the general "parent rule," which prevents *any* defaulting party from recovering its part performance.[50] The court emphasized, however, that it was the instances of the application of this harsh rule *outside of the real estate domain* that prompted most of the criticism.[51] The court concluded that in cases dealing with recovery of down payments on real estate contracts, "a majority of jurisdictions" still followed the *Lawrence* approach.[52] It further defended the *Lawrence* rule by referring to the New York legislature's rejection of a proposed law to modify it.[53]

Nevertheless, despite its steadfast adherence to the *Lawrence* rule throughout the opinion, the *Maxton* court emphasized that the case before it involved only a ten percent down payment and reserved its opinion on a defaulting vendee's rights to recover on a percentage paid beyond that threshold.[54] It noted that the ten percent figure represents "long-established 'usage'"[55] in New York real estate down payments and that it would usually constitute a percentage sufficient to satisfy the reasonableness analysis, had there been such an analysis for real estate down payments in New York.[56]

The *Maxton* court's disclaimer provided the basis for the trial court's decision in *Uzan*, which required a reasonableness analysis for the down payment exceeding ten percent of the purchase price.[57] The trial court in *Uzan*, apparently understanding the *Maxton* disclaimer to create a limitation on the *Lawrence* rule and capping the forfeiture at ten percent of the overall price, subjected the remaining fifteen percent to a "reasonableness" analysis.

The Appellate Division in *Uzan* did not ignore the *Maxton* disclaimer, but chose to read it differently than the lower court. Rather than concentrating on the ten percent figure, seemingly presented in *Maxton* as an initial cap on the amount of vendees' forfeiture, the Appellate Division focused on the underlying considerations of the *Maxton* court, especially the conventionality of the forfeited amounts within the particular business setting.[58] It further noted the particularity of the pre-construction luxury condominium market in New York City as being exceptionally volatile[59] and risk-prone.[60] It then cited the Third[61] and Fourth[62] Departments' application of the *Lawrence* rule in cases where, as in *Uzan,* the amount of forfeited down payments exceeded ten percent.[63] Thus, relying on the unique nature of the pre-constructed luxury condominium market and decisions upholding forfeiture of deposits larger than ten percent from other departments, the First Department was able to avoid the apparent cap that the Court of Appeals fixed in *Maxton*, and allowed Trump to retain the entire twenty-five percent down payment.

Though the results of the application of the *Lawrence* rule "may seem severe,"[64] according to the *Uzan* court the down payments may be returned to defaulting vendees if there is evidence of a disparity of bargaining power, duress, fraud, illegality or mutual mistake.[65] This notion is rooted in the New York courts' concern for freedom of contract formation, since the rule strictly looks to the provisions upon which the parties agreed.[66] This argument is further sustained by the fact that real estate dealings are usually arm's-length transactions, with attorney representation of the various parties.[67] The New York courts operate under the premise that since such parties are less likely to be the victims of unfair dealing and can make educated decisions, the courts should allow them some breathing room and hold the parties strictly accountable for the choices they make.[68]

Another factor in support of the *Lawrence* rule that flows from the courts' strict adherence to the amount of non-refundable down payment agreed to by the parties is judicial economy.[69] The courts applying the *Lawrence* rule need not delve into a complex analysis of reasonableness of the liquidated damages provisions.[70]

II. The Reasonableness Approach to Liquidated Damages

Several American jurisdictions[71] have taken an alternative approach to that of New York.[72] These jurisdictions subject the liquidated damages provisions in real estate contracts to the standard reasonableness analysis.[73] Under this examination, according to the Restatement of Contracts, the liquidated damage provision is deemed enforceable "only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss."[74] New York has so far resisted this approach.

III. The Option Contract Approach to Liquidated Damages

Regardless of whether one finds the New York approach of dealing with liquidated damages in the real estate setting more favorable than either one of the two alternative *reasonableness* standards, it is imperative to see the difference in basic considerations and the application of the respective methods, as well as to recognize the importance of the New York approach within the context of our system of federalism. By differing in its approach, New York exemplifies the laboratory for social and economic experiments of which Justice Brandeis wrote in his famous dissent in *New State Ice Co. v. Liebman*.[75] In order to better understand the nature of New York's experiment, the following section analogizes it with a phenomenon well known to the law of contracts: the option contract. Specifically, it demonstrates the similarity of the New York treatment of liquidated damages in real estate purchase contracts to its approach to the law of option contracts.

A. Option Contracts

When compared to other jurisdictions, New York's approach to liquidated damages in the event of purchasers' default is most favorable to the sellers. They are entitled to retain the stipulated amount regardless of whether it represents a reasonable estimate of either potential or actual damages. Such favorable treatment of the non-breaching vendors is paralleled only by the treatment of optionors. This subsection will further compare the two positions.

First, strictly speaking, option contracts are those agreements where one party pays or receives an option premium[76] for an exclusive right of acceptance, which can be exercised within a certain time period.[77] In such arrangements, the vendee gives consideration in exchange for the vendor's offer becoming irrevocable for the duration of the option.[78] Though an option contract can be bilateral,[79] its inherent character is that of a unilateral contract.[80] Unilateral option contracts are created when vendees give consideration at the time of contract formation, creating in vendors the duty to keep the offer standing for a specified time period. The contract is unilateral because the optionee has no outstanding duty to do anything once the option contract is executed.[81] Generally, however, a real estate option contract consists of two parts: (1) the agreement to hold open to the optionee the opportunity to accept, and (2) the underlying potential contract, which is not binding until accepted.[82] If the optionee elects to accept the offer made irrevocable by the first part of the option contract, then the underlying second contract materializes into a full-blown bilateral contract for purchase, where the optionee has the duty to pay the exercise price[83] and the optionor to transfer title.[84]

It is a settled rule that in order to validly exercise an option to purchase real property, the optionor must strictly adhere to the conditions of the option agreement.[85] If an optionee fails to timely exercise his right of acceptance he cannot expect to recover any part of his premium, for as the time of the option came to an end, he had received the full benefit of his bargain.[86] Furthermore, in general, courts do not inquire into the sufficiency of the consideration for an option contract any more than for any other type of contract.[87] The consideration for the option to purchase, i.e., the option premium, often constitutes a part-payment for the ultimate purchase price.[88] Thus, a perspective vendee may pay the premium, which, in the event of vendee's acceptance, will be applied toward the purchase price. This scheme is highly similar to the down payment arrangement, where a buyer deposits a stipulated amount of money that is applied toward the overall purchase price if the deal eventually goes through.

B. Earnest Money Deposits as Option Premiums

In fact, the treatment of earnest money deposits in the New York real estate market seems to parallel exactly the law of option contracts. To test the hypothesis that down payments in New York function as option premiums, this subsection will analyze the facts and the decision of the *Uzan* case in light of option contracts doctrines. If one were to assume that the $8 million down payment paid by the Uzan brothers to Donald Trump[89] constituted an option premium in the eyes of the Appellate Division, then its decision becomes far more palatable.

If the Uzans' down payment is viewed as consideration for an option, then their failure to show up at the closing (for whatever reason)[90] constitutes an election not to exercise their power of acceptance. Under the option model, the optionee's failure to timely exercise his rights results in a complete loss of the premium, since the lifetime of the option for which he bargained and provided consideration has expired.[91] Thus, the Uzan brothers, failing to tender the exercise price in a timely fashion, i.e., by the closing (or in this case, curing) date, would have no claim for restitution against Trump. By failing to timely create a bilateral contract between themselves and Trump, the Uzans absolved him from any duty once the option expired. Owing no other duty to the Uzans, nothing bars Trump from holding on to the condominiums and the $8 million as payment for keeping the units off the market. Incidentally, this is exactly what Trump argued in his defense,[92] and the court accepted as a justification for its reasoning in the actual case.[93]

Furthermore, would the result have been the same under New York law had it not been the Uzan brothers who sought the remedy but Donald Trump? Assuming that Trump suffered a great loss from the Uzans' breach and sued for expectancy[94] or reliance,[95] would the result be identical under New York's approach to liquidated damages and under the standard law of option contracts?[96] First, under the law of option contracts the result is clear: Since the right to accept is completely discretionary with the optionees,[97] the Uzans would be under no obligation to pay the exercise price. Having breached no duty by electing not to proceed with the purchase, the Uzans would not give Trump a cause of action and his compensation would be restricted to the option premium he received. Conveniently, the same result occurs under the New York liquidated damages analysis: where the parties agreed to liquidate damages, the *vendors* are limited in their recovery to the stipulated amount.[98] Thus, if Trump's actual damages from the Uzans' breach would exceed $8 million, both under the option contract approach and under the current New York liquidated damages analysis, he would not succeed in a suit to recover beyond the liquidated amount. Such an outcome stands in line with the New York courts' concern for freedom of contract,[99] efficiency and judicial economy.[100]

Thus, whether it is a defaulting vendee seeking restitution of its earnest money deposit or a non-breaching vendor seeking to sue the defaulting party for damages in excess of the amount liquidated, the outcome and the policy considerations are identical under the option contract analysis and under the New York real estate down payment scheme. This conclusion invites a call for clarity.

C. A Call for Clarity

If the New York courts indeed treat earnest money deposits as option premiums and view the entire real estate down payment scheme through the prism of an option contract, they should declare so clearly. Such a pronouncement would lessen the need to inquire into whether the parties were sophisticated enough themselves,[101] or were represented by prominent local counsel,[102] to understand the intricacies of New York real estate law. The conditions and intricacies of an option contract as an "either/or" proposition are far more accessible to those not well versed in the law.[103] For the sake of clarity, which the New York courts have noted as being especially important in issues relating to contractual rights,[104] the courts of this State must make it unambiguous that they will treat real estate down payments as option premiums.

Conclusion

New York has its own approach to the question of earnest money payments. Occasionally this approach creates a windfall for some and brings severe forfeiture to others. Whether the reasonableness analyses functioning in other jurisdictions are more equitable to both parties is open to debate. Under federalism, however, a state has great freedom to organize its policy priorities in the sphere of contracts and real estate, among others. Nevertheless, its freedom to do so should be conditioned on the obligation to make the law as clear and accessible to as many people as possible. Therefore, because the New York approach to earnest money payments in real estate is so dissimilar from other jurisdiction and so analogous to the law of option contracts, the New York courts should make this parallel apparent.

Endnotes

1. Together with their father, Kemal, the Uzan family ranked number 312 on the list of the World's Richest People in 2001, with a total net worth of $1.3 billion. FORBES.COM, FORBES WORLD'S RICHEST PEOPLE 2001 (2001) *at* http://www.forbes.com.
2. http://www.trumpworldtower.com/index.shtml.
3. *Uzan v. 845 UN Limited Partnership*, 10 A.D.3d 230, 233 (1st Dep't 2004).
4. *See* Helen Peterson, *Trump Wins a Suite Deal*, N.Y. DAILY NEWS, June 16, 2004, at 20.
5. *Uzan*, 10 A.D.3d at 233.
6. Jeffrey Meltzer, *Be Careful What You Write*, N.Y.L.J., November 29, 2004, at s1.
7. Earnest money is "[a] deposit paid (often in escrow) by a prospective buyer (esp[ecially] of real estate) to show a good-faith intention to complete the transaction, and ordinarily forfeited if the buyer defaults." BLACK'S LAW DICTIONARY 547 (Bryan A. Garner ed., 8th ed. 1999). "The amount of earnest money deposited rarely exceeds 10 percent of the purchase price, and its primary purpose is to serve as a source of payment of damages should the buyer default." JOHN W. REILLY, THE LANGUAGE OF REAL ESTATE 131 (4th ed. 1993).
8. "[T]he [trial] court granted defendant partial summary judgment, finding that plaintiffs forfeited the portion of their down payment amounting to 10% of the purchase price." *Uzan*, 10 A.D.3d at 236.
9. "The court held that the remainder of the down payment was subject to a liquidated damages analysis to determine whether it bore a reasonable relation to [Trump's] actual or probable loss." *Id.* Liquidated damages are "[a]n amount contractually stipulated as a reasonable estimation of actual damages to be recovered by one party if the other party breaches." BLACK'S LAW DICTIONARY, *supra* note 7, at 418. The earnest money deposits are not necessarily intended as liquidated damages. Often, they are advanced to allow the promisee to make an initial investment, to start construction, for example. However, in *Uzan* the court treated earnest money as liquidated damages and, for the purposes

of this Comment, the authors do so as well, unless specified otherwise.

10. *See infra* Part I.B. (discussing the history of real estate deposit law in New York).

11. "If plaintiffs were dissatisfied with the 25% non-refundable down payment provision in the purchase agreements, the time to have voiced objection was at the bargaining table." *Id.* at 240 (citing *Maxton v. Lo Galbo*, 68 N.Y.2d 373, 382 (1986)).

12. "[I]t is clear that plaintiffs are not entitled to a return of any portion of their down payment." *Uzan*, 10 A.D.3d at 239.

13. *See, e.g.*, Meltzer, *supra* note 6 (noting that that *Uzan* decision was one of the three most important real estate decisions of 2004).

14. "I . . . disagree with the court (if it really means this) that any conceivable forfeiture of an earnest money deposit should automatically be upheld, without inquiry into whether it was prospectively reasonable. And I think that very few courts in other states would agree with NY on this point." Posting of Dale Whitman, Professor of Law, University of Missouri-Columbia, to BrokerDIRT@listserv.umkc.edu (July 15, 2004) (copy on file with author).

15. "[T]he buyer's agreement to commit to the earnest money arrangement [in New York] is, in a very real sense, consideration for an option to purchase." Posting of Patrick A. Randolph, Professor of Law, University of Missouri-Kansas City, to BrokerDIRT@listserv.umkc.edu (July 6, 2004) (copy on file with author). "Most contractual arrangements are either structured as options or include options as important elements." Avery Weiner Katz, *The Option Element in Contracting*, 90 Va. L. Rev. 2187, 2188 (2004).

16. "An option contract is a promise which meets the requirements for the formation of a contract and limits the promisor's power to revoke an offer." Restatement (Second) of Contracts, § 25 (1981). For a fuller discussion of the law of option contracts, see *infra* Part III.A.

17. *Uzan*, 10 A.D.3d at 231.

18. *Id.* In November 2004, these apartments were sold at a sheriff's auction to liquidate some holdings of the Uzan brothers, their associates and family members, in order to satisfy the $4.2 billion judgment against the brothers won in court by Motorola. William Neuman, *For Lovers of the Dark: Anne Rice's Manhattan Haunt*, N.Y. Times, Oct. 31, 2004, §11 at 2.

19. An Offering Plan is reviewed by the New York Attorney General's office before a developer can offer condominiums for sale. N.Y. Gen. Bus. Law § 352-e (2005).

20. "The condominium offering plan included a section titled 'Special Risks to be Considered by Purchasers,' which stated:

> Purchasers will be required to make a down payment upon execution of a Purchase Agreement in an amount equal to 10% of the purchase price, and within 180 days after receipt of the executed Purchase Agreement from Sponsor [i.e., Trump] or 15 days after Purchaser receives a written notice or amendment to the Plan declaring the Plan effective, whichever is earlier, an additional down payment equal to 15% of the purchase price. . . .

Uzan, 10 A.D.3d at 232.

21. Paragraph 12(b) of the Purchase Agreement provided that

> upon the occurrence of an Event of Default . . . if Sponsor elects to cancel . . . and if the default is not cured within . . . thirty (30) days, then this Agreement shall be deemed cancelled, and Sponsor shall have the right to retain, as and for liquidated damages, the Down payment and any interest earned on the Down payment.

Id at 233.

22. This factor was emphasized in order to portray the sophistication of the parties at the bargaining table. This justification was then seized upon to build a foundation for a finding of a lack of mutual mistake or equality of bargaining power, which would have somewhat justified the severity of the forfeiture that eventually resulted.

23. The court also took notice of the firms that represented the litigants in order to further bring out the competence of parties to conduct sophisticated negotiations, and consequently to follow their results, as harsh as they turned out to be to the buyers. The Uzans were represented by Marcus Rosenberg & Diamond LLP, and Trump by Kramer Levin Naftalis & Frankel LLP.

24. *Uzan*, 10 A.D.3d at 232.

25. *Id.* at 232.

26. *Id.* at 233.

27. *Uzan*, 10 A.D.3d at 233. In a footnote, the court hinted at the fact that aside from international terrorists, the Uzans might have been concerned about their ongoing multi-billion dollar legal battles with Motorola wireless phone company. *See* Barnaby J. Feder, *2 Phone Giants in Court to Fight Turkish Family,* N.Y. Times, February 17, 2003, at C2.

28. Trump had given the Uzan brothers thirty days to cure in accordance with paragraph 12(b) of the Purchase Agreement. *See supra* note 21.

29. *Uzan*, 10 A.D.3d at 235.

30. *Id.* at 234. "They alleged that Donald Trump had prior special knowledge that certain tall buildings, such as Trump World, were potential targets for terrorists." *Id.*

31. *Id.* "[This] cause of action sought a declaratory judgment that the down payment was an 'unconscionable, illegal and unenforceable penalty.'" *Id.*

32. *Id.*

33. *Id.* at 236. The trial court relied in its reasoning on the Court of Appeals decision in *Maxton v. Lo Galbo*, 68 N.Y.2d 373 (1986).

34. "[U]pon plaintiffs' default and failure to cure, defendant was entitled to retain the full 25% down payment." *Uzan*, 10 A.D.3d at 240.

35. 86 N.Y 131 (1881) (defaulting vendee cannot recover any part of his down payment).

36. *Id.* At closing, the vendee was not ready to pay the amount agreed upon and the vendor "refused to give another day," thus putting the vendee in default. *Id.* at 132.

37. *Id.*

38. *Id.* at 140; *Uzan*, 10 A.D.3d at 236-37.

39. *Lawrence*, 86 N.Y. at 140 (*citing Ketchum v. Evertson*, 13 Johns. 358 (N.Y. Sup. Ct. 1816) (where defaulting vendees were seeking to recover their real estate down payment, it would be an "alarming doctrine" to hold that they may violate a contract and thus create their cause of action)).

40. 68 N.Y.2d 373 (1986) (where a vendee defaulted on a real estate purchase, its ten percent down payment is forfeited in favor of the vendor without considering actual or potential damages sustained by the latter).

41. *Id.* at 376.

42. *Id.* at 375.

43. "[Vendees] urge that plaintiff's recovery should be limited to actual damages, and that we should, therefore, reexamine the rule of *Lawrence v. Miller*, which permits a vendor on a real estate contract to retain the down payment when the purchaser willfully defaults." *Id.* at 375–76.

44. *Id.* at 382.

45. The Court of Appeals noted that, in general, courts should depart from their prior holdings only if compelled by "the most cogent reasons," especially in issues relating to contractual rights, "where it can reasonably be assumed that settled rules are necessary and necessarily relied upon, (I do not think that the "and" is appropriate here) stability and adherence to precedent are generally more

important than a better or even a 'correct' rule of law." *Id.* at 381 (internal citations omitted).

46. *Uzan,* 10 A.D.3d at 237.

47. *Id.*

48. *Id.*

49. "Much of the criticism of *Lawrence v. Miller* is directed at the rule on which it is based, which broadly holds that a party who defaults on a contract cannot recover the amount or value of part performance." *Maxton,* 68 N.Y.2d at 379. In his criticism of the rule, Professor Corbin noted that it is particularly inequitable because "the amount of forfeiture increases as performance proceeds, so that the penalty grows larger as the breach grows smaller." Arthur L. Corbin, *Right of a Defaulting Vendee to the Restitution of Installments Paid*, 40 YALE L.J. 1013, 1029 (1931). For example, had the Uzans failed to pay the second or third installment of the down payment, they would have capped their losses at ten percent or seventeen-and-a-half percent, respectively. Their adherence to the payment schedule, however, increased the amount they forfeited.

50. "This parent rule is applicable to contracts generally, and has been applied to a wide variety of circumstances including the sale of goods, employment contracts for a fixed term, construction contracts, and installment land sales. In all of these cases the common law would deny any relief to the defaulting party even when there had been substantial, or nearly complete performance." *Maxton*, 68 N.Y.2d at 379 (internal citations omitted).

51. *Id.*

52. *Id.* at 380 (citing James O. Pearson, Jr., Annotation, *Modern Status of Defaulting Vendee's Right to Recover Contractual Payments Withheld by Vendor as Forfeited*, 4 A.L.R. 4th 993 (1981)).

53. "Several years ago the Law Revision Commission proposed that that the Legislature of this State abrogate *Lawrence v. Miller,* and adopt a 'more equitable' rule. The proposed law was not adopted. . . . A similar proposal was later made, and adopted, by the Legislature, with respect to the right of a buyer to recover for part performance after defaulting on a contract for the sale of goods." *Id.* at 380–81 (internal citations omitted). The *Maxton* court interpreted this distinction made by the legislators between real estate and goods as indicative of their support of the *Lawrence* rule as it pertained to the former.

54. "It should be emphasized that we do not have before us any question concerning installment payments beyond a 10% down payment and thus we express no view concerning the parties' rights with respect to such payments following the vendee's default." *Id.* at 382 n.3.

55. *Id.* at 381. The court further emphasized its concern for, and deference to, customary practice of the industry by referring to the "traditional 10%" in its subsequent referrals to the figure. *Id.* at 382 (the court mentions "traditional 10%" twice).

56. "[T]he [ten percent forfeiture] provision would probably be upheld as a valid liquidated damages clause in view of the recognized difficulty of estimating actual damages and the general acceptance of the traditional 10% down payment as a reasonable amount." *Id.*

57. *See supra* notes 8–9 and accompanying text.

58. Like the court in *Maxton*, *see supra* note 55 and accompanying text, the *Uzan* court noted that "it is customary in the pre-construction luxury condominium industry for parties to price the risk of default at 25% of the purchase price." *Uzan*, 10 A.D.3d at 240. The court relied on affidavits of Donald Trump and representatives of various real estate consulting firms based in New York, who confirmed that the twenty to twenty-five percent down payment figures are standard practice in the new construction luxury condominium market in New York City. *Id.* at 235. Furthermore, Trump provided proof of other purchases, which included twenty-five percent down payments, made by one of the Uzan brothers in New York. *Id.* at 236. This evidence was intended to show that not only is this practice standard, but that the Uzans were fully aware of it.

59. Testifying before the court, Marilyn Weitzman, president of a nationwide real estate consulting firm headquartered in New York, affirmed that "the demographic profile for potential purchasers in the luxury condominium submarket includes many foreign nationals, who are inherently high-risk purchasers because their incomes and assets are often difficult to measure, and to reach." *Id.* at 235–36. Weitzman, as well as Michael Martin, a consultant to the Trump Corporation, also testified based upon research that "the volatility of individual real estate transactions increases with the size of the unit involved, and that the price swings for three- and four-bedroom units, such as the penthouse units [the Uzans] sought to purchase here, were greater than for smaller apartments." *Id.* at 236.

60. In his affidavit, Trump stated that there are obvious risks in pre-construction real estate deals associated with "the substantial length of time between contract signing and closing," during which time vendors have to keep the units off the market. *Id.* at 235. Further, Marilyn Weitzman agreed that further risks in the submarket stem from the fact that "future competition is largely unknown." *Id.*

61. *Collar City Partnership v. Redemption Church*, 235 A.D.2d *665* (3d Dep't 1997), *lv. denied*, 90 N.Y.2d 803 (finding that where plaintiff made numerous payments that were applied to the final purchase price and constituted, in total, fifty percent thereof, in consideration of defendant's agreement not to cancel the contract and of plaintiff's time for performance, whether the funds advanced by plaintiff were deemed consideration to extend the closing date or additional deposits on the contract, in no event was plaintiff entitled to the return of same); *Vitolo v. O'Connor*, 223 A.D.2d 762 (3d Dep't 1996) (holding that where vendees were required to show that they made a diligent application to secure required mortgage and failed to do so, forfeiture of the twenty-three percent down payment was tolerable). Both *Collar City* and *Vitolo* cited *Maxton* to support their respective forfeitures.

62. *Badame v. Bock Enters., Inc.*, 190 A.D.2d 1066 (4th Dep't 1993) (holding that the Supreme Court erred in limiting the sellers' damages to ten percent of the contract price). *Badame* also cited *Maxton.*

63. *Uzan*, 10 A.D.3d at 238–39.

64. "[T]he results of the application of this doctrine to the facts of this case may seem severe. . . ." *Vitolo*, 223 A.D.2d at 764. "[A]pplication of the *Maxton/Lawrence* rule might seem severe. . . ." *Uzan*, 10 A.D.3d at 239.

65. *Uzan*, 10 A.D.3d at 237 (*citing Cipriano v. Glen Cove Lodge # 1458*, 1 N.Y.3d 53 (2003) (finding that where a real estate seller draws a prospective buyer into a transaction when it cannot possibly convey marketable title and then itself stymies the efforts of the buyer to remove the encumbrance, the seller may not rely on the language of a rider relieving it of any obligation to bring any action to render title marketable to keep the buyer's down payment).

66. "Except in cases where there is a real risk of overreaching, there should be no need for the courts to relieve the parties of the consequences of their contract." *Maxton*, 68 N.Y.2d at 382. Overreaching is "[t]he act or an instance of taking unfair commercial advantage of another, esp[ecially] by fraudulent means." BLACK'S LAW DICTIONARY, *supra* note 7, at 1136.

67. This is the reason for the court's emphasis on the prominence of the Uzans' lawyers. *See supra* note 23 and accompanying text.

68. "If the parties are dissatisfied with the rule of *Lawrence v. Miller*, the time to say so is at the bargaining table." *Maxton*, 68 N.Y.2d at 382. *See also Uzan*, 10 A.D.3d at 240 ("If plaintiffs were dissatisfied with the 25% non-refundable down payment provision in the purchase agreements, the time to have voiced objection was at the bargaining table.").

69. "[B]ased upon notions of efficiency and avoiding unnecessary litigation, the [*Lawrence*] rule should remain in effect." *Id*. at 238 (citing *Maxton*, 68 N.Y.2d at 381).

70. "[The New York] courts have consistently . . . recognized a distinction between real estate deposits and general liquidated damages clauses. Liquidated damages clauses have traditionally been subject to judicial oversight to confirm that the stipulated damages bear a reasonable proportion to the probable loss caused by the breach. By contrast, real estate down payments have been subject to limited supervision." *Uzan*, 10 A.D.3d at 237.

71. The *Maxton* court insisted that these jurisdictions represent a minority. 68 N.Y.2d at 380. However, Professor Randolph notes that "[a]lthough, in 1986, the New York court may have been correct in stating that the majority approach in America favored earnest money forfeiture without reasonableness analysis, this may no longer be the case in residential contracts. Many jurisdictions have adopted buyer friendly statutes requiring liquidated damages analysis." Posting of Patrick A. Randolph, *supra* note 15.

72. *See e.g., Vines v. Orchard Hill*, 181 Conn. 501, 510 (1980) (discussing the shift in law towards allowing restitution to defaulting real estate purchasers and ruling that such recovery is available in Connecticut).

73. "If excessive, the liquidated damage provision may be deemed unenforceable as a 'penalty', in which event, presumably, the injured party's damages will be determined under customary standards." MARVIN A. CHIRELSTEIN, CONCEPTS AND CASE ANALYSIS IN THE LAW OF CONTRACTS 198 (4th ed. 2001)

74. RESTATEMENT (SECOND) OF CONTRACTS § 356 (1981). The Uniform Commercial Code provision, which applies only to sales of goods, echoes the language of the Restatement, adding as an additional consideration for reasonableness of liquidated damages "the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy." U.C.C. § 2-718 (1998). Both texts authorize parties to liquidate damages only to the extent that the stipulated amount is reasonable in light of *anticipated* or *actual* damages. This approach, which considers not only the reasonableness of the stipulated amount at the time of contract formation, but also at the time of the actual breach, is known as the retrospective approach, since the evaluation of *actual* damages can only be done in retrospect. Its alternative, the prospective approach, considers the reasonableness of liquidated damages provisions only in light of damages *anticipated* at the time of contract formation.

75. 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) (arguing for the State of Oklahoma's right to monopolize ice production in that state).

76. "[T]he option premium . . . is the unconditional amount that the optionee must pay upfront in order to acquire the right to exercise the option. . . ." Katz, *supra* note 15, at 2205.

77. "An option is an obligation by which one binds himself to sell, or buy, and leaves it discretionary with the other party to buy, or sell, which is simply a contract by which the owner of the property agrees with another person that he shall have the right to buy the property at a fixed price within a certain time." *Spitzli v. Guth*, 183 N.Y.S. 743, 746 (Sup. Ct. N.Y. Oneida 1920), *appeal dismissed*, 188 N.Y.S. 951 (App. Div. 1921). Option contracts, for the purpose of this article, should be distinguished from rights of first refusal, sometimes referred to as an "option of first refusal." Generally, those provisions allow one party to have a priority in the purchase of some property if the other party decides to sell it. Since the transaction is conditioned on the "optionor's" willingness to sell, it does not create a binding duty or a "real" option contract.

78. "An option is a promise which meets the requirements for the formation of a contract and limits the promisor's power to revoke an offer." RESTATEMENT (SECOND) OF CONTRACTS § 25 (1981). A New York court has characterized an option contract as "nothing more than an irrevocable offer." *Eckstein v. Chapkewitz Fur Co. Inc*., 225 N.Y.S. 400, 401 (Sup. Ct. N.Y. New York 1927).

79. *See* CORBIN ON CONTRACTS § 11.2 (1993). A bilateral option contract can be created, for example, when B promises to keep an offer open to A for 30 days, in exchange for a $1,000 promissory note. Thus, since both parties have duties toward each under the option (A to pay on the note and B to keep the option open), a bilateral contract is created.

80. *See* 10-3 Warren's Weed, New York Real Property § 1.01 (2004). "The traditional view regards an option as a unilateral contract. . . ." 1 SAMUEL WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 5-16 at 717 (R. Lord ed. 1990).

81. "The chief and distinguishing characteristic of an option contract to purchase is that it binds the optionor to sell property but does not, without election, obligate the optionee to buy." FRANK JAMES, THE LAW OF OPTION CONTRACTS 4–5 (1916).

82. In an option contract, "two elements exist: *first*, an offer to sell or buy, which does not become a contract until accepted; *second*, the completed contract to leave the offer open for a specified time." *Spitzli*, 183 N.Y.S. at 746.

83. "[T]the exercise or strike price . . . is the amount that optionee must pay conditionally in the event that she chooses to exercise her rights. . . ." Katz, *supra* note 15, at 2205.

84. "When a valid option to purchase real property is accepted the obligations and remedies of the parties become mutual . . ." *Trustees of Hamilton College v. Roberts*, 119 N.E. 97, 99 (N.Y. 1918). Also: "The contract of purchase does not arise until there has been an acceptance. However, once an option has been accepted by the person to whom it was made, it becomes a binding contract of purchase on both parties." 10-3 Warren's Weed, New York Real Property § 2.04 (2004).

85. *Boal v. Smith*, 35 A.D.2d 730 (2d Dep't 1970), *aff'd*, 29 N.Y.2d 518 (1971) (holding that where a notice required to exercise an option was sent in an untimely fashion, the option could no longer be exercised); *T.I.P. Holding No. 2 Co. v. Wicks*, 63 A.D.2d 263 (2d Dep't 1978) (installment payment seven days late); *see also Weissman v. Adler*, 187 A.D.2d 647 (2d Dep't 1992); *Piazza v. Sutherland*, 53 Misc. 2d 726 (Sup Ct. N.Y. Suffolk, 1967).

86. "Despite equity's dislike of forfeitures, requirements governing the time and manner of exercise of power of acceptance under an option contract are applied strictly." RESTATEMENT (SECOND) OF CONTRACTS § 25 (2004), note to comment d. *See also T.I.P. Holding No. 2 Co.*, 63 A.D.2d 263.

87. "As a general rule the courts will not enter into an inquiry as to the adequacy of the consideration." *Sanford v. Smith*, 4 Misc. 2d 820, 824 (Sup. Ct. N.Y. Delaware, 1946) (one dollar nominal consideration was held valid), *aff'd*, 273 A.D. 928 (3d Dep't 1948). "Consideration sufficient to support the garden variety contract will likewise support an option." 3-11 CORBIN ON CONTRACTS § 11.7 (1993).

88. "Frequently, an option to buy land is given in consideration of a sum of money that is to be regarded as a part of the total purchase price in case the option holder later elects to buy." *Id. See, e.g., T.I.P. Holding No. 2 Co.*, 63 A.D.2d at 264–66.

89. *See supra* note 4 and accompanying text.

90. *See supra* note 27 and accompanying text.

91. *See supra* notes 85–86 and accompanying text.

92. "In his affidavit in support of the cross motion, Donald Trump stated that he sought 25% down payments from pre-construction purchasers at the Trump World Tower because of the substantial length of time between contract signing and closing, during which period the sponsor had to keep the units off the

market, and because of the obvious associated risks." *Uzan*, 10 A.D.3d at 235.

93. "For [Trump], the 25% deposit served to cover [his] risk for keeping the apartments off the market should the purchaser default." *Id.* at 240.

94. "Assuming a failure or unwillingness to perform on the part of the promisor, the law customarily provides a remedy to the promisee in the form of money damages based upon the promisee's expectation interest." CHIRELSTEIN, *supra* note 73, at 159.

95. In a suit for reliance damages the party seeks compensation for expenditures made in reliance on the duty breached. *Id.* at 185.

96. Though Trump was not the plaintiff in *Uzan,* for the sake of consistency the article will continue to use the other facts of the case in this hypothetical.

97. *See supra* note 77 and accompanying text.

98. *Lerner v. Perry*, 61 A.D.2d 754 (1st Dep't 1978); *Elias v. Wal-Mart Stores*, 224 A.D.2d 479 (2d Dep't 1996); *Kaplan v. Walsh*, 188 Misc. 1036 (N.Y. App. Term., 2d Dep't 1947). *Cf. Alexsey v. Kelly*, 205 A.D.2d 649 (2d Dep't 1994) (contract provision allowed for choice between liquidated or actual damages); *Mohen v. Mooney*, 205 A.D.2d 670 (2d Dep't, 1994) (argued and decided on the same respective dates as *Alexsey,* involving similar facts and identical holding); *see also Smith v. Putnam*, 145 A.D.2d 383 (1st Dep't 1988) (where a contract provided for a choice between liquidated damages or suing for actual damages and plaintiff chose the former, he was limited to it); *accord Zahralban v. Vicbar Constr. Corp.*, 16 Misc. 2d 550 (N.Y. Sup. Ct. Kings, 1958); *cf. Leading Bldg. Corp. v. Segrete*, 60 A.D.2d 907 (2d Dep't 1978) (where a down payment was not classified as liquidated damages, vendor could sue for actual damages).

99. By limiting the parties to the benefit of their own bargain, the New York courts encourage the contracting parties to customize their contracts to best fit their needs. *See supra* notes 64–66 and accompanying text.

100. Stricter enforcement of liquidated damages provisions creates more incentive for parties to stipulate to damages in advance and discourages lawsuits challenging such provisions. *See supra* notes 69–70 and accompanying text.

101. *See supra* note 22 and accompanying text.

102. *See supra* note 23 and accompanying text.

103. "Casting a penalty clause in option closing . . . probably makes it clearer to the less sophisticated party that the payment is a basic contractual obligation, especially if the penalty takes the form of a prepaid deposit." Katz, *supra* note 15, at 2228.

104. *See supra* note 45 and accompanying text.

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Water and Sewer Charges in New York City

By Francisco Augspach

In New York City, water supply and sewer use is a public service provided by the City through the Department of Environmental Protection ("DEP"). Water and sewer charges often disrupt real estate sales because they become a lien on the premises when billed, and because of the risk that past periods will be re-billed, leaving the purchaser with a debt that it had no part in incurring. This article explains the rules concerning water and sewer charges in New York City, warns of circumstances that pose unexpected risks, and offers solutions for the real estate practitioner.

I. Billing Systems and Re-bills

Water charges are what the City charges for supplying water: at the time of this writing at $1.81 per one hundred cubic feet ("HCF"). Sewer rent charges are what the City charges for the discharge of serviced waters into its sewers. Sewer rent charges are measured indirectly by the amount of water supplied to the property. At the time of this writing, sewer charges are generally 159% of the basic water charge. For example, if a tax lot is supplied 100 HCF, then the water charges would run at $181, and the sewer charges at $287.79, for a total of $469.79. The cost of water itself is measured either by actual consumption, using a meter, or by imposing a yearly flat fee, or both. While billing is done by DEP, collection is relegated to the Department of Finance, which can use the same means it has available to collect real estate taxes, including tax liens.[1]

A. Metering

Under metering, water and sewer charges are paid at the end of each quarter based on consumption. DEP claims to have the required personnel to read every meter in the City every three months. However, meter-readers are sometimes unable to complete their routes on time,[2] and meters sometimes break or fail. Even if the meter is read, DEP prevents mistakes in readings by ignoring unusually high and unusually low ones. The result is that many bills that appear on the records are "ESTIMATE"—i.e., based on past periods—as opposed to "ACTUAL" readings.[3]

If you are closing at the end of the term but before billing, there is no open amount to request from the seller. The first reaction to this common occurrence is to find the last billed amount and base an adjustment on it, on the assumption that the next charges will be somewhat similar. If the last bill reads ESTIMATE, then that means that the DEP has done the same thing as you to calculate it. That means that the meter has gone unread for over three months.

1. Re-bills on Metering

DEP reserves the right to adjust ESTIMATE charges once an ACTUAL reading is entered. Relying on the last estimated bill means that the meter has not been read in over three months. If the seller has been living in the property and there has been no substantial change in the occupancy, it might be safe to rely on the estimate. But what if you are closing in July and there is a swimming pool? The pool might have been cleaned and refilled in the interim. What if a basement apartment was created or the occupancy has been otherwise increased? The single most recurrent case is that of the undetected leak: Say you are closing in April and the last actual reading is from November. In cold winters water pipes have a tendency to freeze and burst and to create leaks, which can be difficult to detect. If the meter is not read, such leaks accrue charges over months until DEP visits the premises and the current owner receives a hefty bill for past periods.

While most re-billing occurs on estimated readings, actual readings are also subject to re-billing. The paramount example is meter tampering. If the meter does not measure consumption properly, DEP will recoup unbilled charges once a more thorough inspection is carried out. Other examples of re-billing on actual readings are meter malfunction and connection issues, such as having a leak between the point of entry and the meter, or having a second, unaccounted-for point of entry.[4]

Under the current rules (effective as of July 1, 2006), DEP may adjust charges up to four years after service was provided.[5] As to residential properties, this is questionable because Public Services Law § 118(2) prohibits back billings over twenty-four months after service was provided to residential properties. Culpable conduct, such as violation of the certificate of occupancy, meter tampering or preventing readings, voids both back billing limits.[6]

2. Metering: Is It Worth It?

Given the difficulty metering causes at real estate purchases, because of the likelihood of re-billing, there is a widespread desire in the real estate industry for the City to move back to billing by frontage; i.e., yearly flat rate billing. In light of the fact, it is meaningful to acknowledge that the universal metering program has borne fruit. For the twelve-month period ending on June 30, 2006 water consumption in New York City was at its lowest since 1951, when the City had 300,000 fewer inhabitants. With its daily consumption per capita at 136 gallons, New York consumes less water than Boston (177 gallons) or Denver (170 gallons), but not as little as Seattle (124 gallons) or San Francisco (97 gallons).[7] Linking cost with supply has produced the desired result of rationing consumption.

B. Frontage

"Frontage" billing means billing according to square footage, use and occupancy, and fixture count. While commercial properties have been billed by meter since 1873, it took forty years of legislative debate and a severe drought to introduce metering on residential properties in 1986. Despite the City's best attempts at switching every account to metering, including the threat of surcharges (see below) and reimbursement of meter installation expenses,[8] many properties continue to be billed on frontage. Charges on frontage are straightforward: they are assessed yearly on July 1 based on the current rate schedule, and become due on July 31. The rate schedule is regularly revised and updated by the Water Board.[9] Frontage is also important because it is DEP's default billing system in the event meters are defective or absent.

1. Surcharges

In 1999 DEP sent letters to all its unmetered customers threatening to impose surcharges on any property that lacked a meter by July 1, 2000, unless the customer made a request to DEP to install one before that date.[10] Surcharges equal all amounts paid on frontage since July 1, 2000. For example, if an account was assessed and paid $500 dollars per year, DEP may impose surcharges of $500 per year since July 1, 2000. At the time of this writing, that is seven years' surcharges for a total of $3,500.[11] If a meter is installed before surcharges are posted, the risk disappears.[12] Once the owner complies, DEP will not look for past incompliance, but imposed surcharges will not be forgiven. Customers that made a timely request to have meters installed have been imposed surcharges, but the Appellate Division, Second Department, held that the imposition is capricious and arbitrary if the customer complied with the requirement of request by June 30, 2000.[13] However, preventing DEP from installing a meter by missing the appointment may expose the customer to surcharges.[14] The constitutionality of surcharges, as a possibly excessive fine, has been upheld by the Appellate Division.[15]

2. Re-bills on Frontage

There is a widespread misconception that frontage charges are not subject to re-bills. While re-bills on frontage are not as frequent as those on metering, they do happen. Frontage charges are based on use and fixture count. If the number of faucets, sinks, or showers changes, or if a pool is added, or the use of the property is altered, then frontage charges can be re-assessed retroactively. To illustrate, every illegal apartment, pool, fountain, commercial use, or bathroom carries the risk that frontage charges may be re-billed as of the date of the alteration. Moreover, the back billing limit of four years would not apply to any of those instances because violation of the certificate of occupancy constitutes culpable conduct, and culpable conduct voids back billing limits.[16]

C. Flat-Rate Plans

DEP currently runs three flat-rate plans. All three plans offer fixed annual charges to qualifying multi-family buildings. For this purpose, "multi-family" means six or more dwelling units.[17] All three plans require: (1) that customers be in compliance with their certificates of occupancy and (2) that all commercial units, if any, be metered separately.

1. The Pre-Transition Plan

Once metering on residential properties was introduced in 1986, the City faced substantial reluctance from landlords to switch to metered billing. In order to ease the passage, the City introduced the Pre-Transition Plan for those properties that had meters installed before July 1, 1992. Under this plan, combined water and sewer rent charges are paid at a fixed rate per dwelling unit. At the time of this writing, the combined charge per unit is $569.65. As its name implies, it is only temporary: it is due to expire on June 30, 2009.[18]

2. The Transition Plan

For properties installing meters on or after July 1, 1992, DEP introduced the Transition Plan. Under this plan, charges are calculated the same way as under frontage. This plan is due to expire on June 30, 2009.[19] New constructions and properties that were once on metering are ineligible.

3. The Multi-Family Conservation Plan

When DEP insisted that all buildings be metered by 2000 with the threat of surcharges, there was a general concern that residential landlords would face higher expenses, but that rent control and rent stabilization laws would prevent them from shifting the cost over to their tenants. There was a general fear that metering would mean higher charges and that landlords would be forced into bankruptcy or financial hardship. As a response, DEP introduced the Multi-Family Conservation Plan.[20]

Similar to the Pre-Transition Plan, charges are calculated per dwelling unit. The combined water and sewer rent charges currently are $583.35 per unit. In order to join, the customer must prove abatement of leaks and installation of high-efficiency washers and low consumption water-fixtures, among other conditions.[21] While this plan has no expiration date set, it might not be here to stay. Applications received after December 31, 2008 will not be considered.

4. Re-bills on Flat-Rate Plans

Properties under flat-rate plans are also subject to re-billing. As stated above, there are conditions that must be satisfied in order to qualify for the plans. In order to remain in good standing, those conditions must be complied with at all times. If a property is found to be in violation of its certificate of occupancy, or if commercial units are not metered separately,[22] or, in the case of the Multi-Family Conservation Plan, non-qualifying water-fixtures are installed, then the customer will no longer be in good standing, and charges will be adjusted retroactively.

The fact that a building may be under a flat-rate plan does not mean that it does not have a meter for its residential units. In fact, having a working meter is a requirement under all three plans. As long as the customer is in good standing, the meter will not be read, and the customer will pay the flat rate. The meter becomes what is called a "monitor meter." If the customer ceases to be in good standing, the monitor meter will be read and actual consumption will be billed retroactively, as of the date of the violation. Henceforth, the customer will continue on metering until its status under the plan is restored. Once again, violation of the certificate of occupancy constitutes culpable conduct, which voids the four-year back billing limit. To illustrate, a purchaser of a six family building that has had a seventh illegal unit for the last five years is taking two risks: (1) that she may have to pay water and sewer charges for the unaccounted unit for the last five years and (2) that she will receive a property with a meter that has not been read in at least five years. (2) means that she would have to pay for the difference between the actual consumption and what was paid to DEP in the last five years. The slightest undetected leak could result in a costly bill after five years (see I.A.1., Re-bills on Metering, above).

II. Remedies

A. Title Meter Reading and Flat-Rate Account Reconciliation

The importance of ordering a title meter reading or a flat-rate account reconciliation prior to closing cannot be stressed enough. In fact, practitioners who regularly do so do not need to fear the many risks in water and sewer charges. DEP offers protection to "innocent purchasers" if a title meter reading (also called "property transfer reading") or flat-rate account reconciliation is ordered 30 days prior to closing. If duly ordered, the purchaser will not be liable for re-bills.[23] As the name implies, title meter readings apply to metered accounts, and flat-rate account reconciliations to accounts on frontage and flat-rate plans.[24]

It is important to note that a "title reading" or "property transfer reading" is different from "actual," "final" and "special" readings. Title readings put DEP on notice that the property will be transferred, and that it will have one last chance to post charges for past periods. It is different from a regular "actual" reading because DEP carries out a thorough inspection, rather than simply reading the meter. For example, if after the purchase DEP discovers that the meter had been tampered with by the seller, the purchaser would be liable for past periods even if there was a actual reading at the time of closing, but not if a title reading was duly ordered. A "special" reading is an actual reading done at the customer's request. It does not put DEP on notice that the property will be transferred and, therefore, it does not afford the protection of a title reading. Lastly, a special meter reading is more expensive than a title reading. The former costs $75 for the first meter plus $25 per additional one, while the latter is only $25 regardless of the number of meters. The generous price on the more thorough title reading is explained as a subsidy to encourage sellers to order readings prior to closing.[25] Flat-rate account reconciliations cost $25 and put DEP on notice of transfer as well. A "final" reading occurs only when a meter has been removed, which does not necessarily mean that the property will be transferred.

That title meter readings and account reconciliations must be ordered 30 days prior to closing presents a timing issue for closing attorneys. Most closings are scheduled with at most two weeks' notice. It is difficult to foresee scheduling beyond that. The fact is that DEP asks for 30 days, but does not generally need all 30 days. In the case of properties with only one meter, or fewer than six residential units, three business days is a reasonable time for a title reading or flat-rate account reconciliation to be done and posted. A purchaser will qualify as an "innocent purchaser," if the closing takes place between the posting of the charges and the expiration of the 30 days since the order. The problem arises when the premises has multiple meters or when it is used in violation of its certificate of occupancy. Those readings will take longer and could leave a short window of opportunity to close with the protection. On the other hand, those are also the cases that carry a higher risk of re-billing and that would be better addressed prior to closing.

B. Title Insurance and Re-bills

Title insurance protects the purchaser from "Any defect in or lien or encumbrance on the title" as of the date of policy.[26] Water and sewers charges constitute a "lien or encumbrance." Hence, anything attaching as of the date of policy is insured against. However, charges attach only when they are posted. Liens posted subsequently to the date of policy are not insured. Water charges that may result from DEP's re-bill of prior periods only attach as of the date of the re-bill. If said date is subsequent to the policy, the policy does not insure against them.[27]

The reader might argue this result by drawing an analogy with other typical issues, such as forgeries. Forgeries in the chain of title are insured against. Forgeries happen prior to the date of policy and cause the insured and insurer's good faith reliance. The claim asserted by the injured party would appear of record only after the date of policy. Likewise, water consumption happens prior to closing, does not appear of record, and DEP asserts its claim after the closing. Why would the policy protect from forgeries but not from taxes based on the prior owner's periods?

The difference lies in the effective date of encumbrance. Both are based on happenings prior to the date of policy. The property rights of a prior owner whose signature was forged vested prior to the date of policy, presumably when she purchased or inherited the premises. Water charges, on the other hand, only become liens as of the day they are posted. Hence, as of the date of policy the injured prior owner would have vested rights while the DEP would have no claim.[28]

Title policies insuring properties in New York City commonly include an exception in schedule B ("Matters excepted from coverage") excepting all charges from the date of the last actual reading or that may be rebilled on an actual reading. Attorneys representing purchasers oftentimes believe that this exception is what causes the re-bills to be excepted from coverage and thus sometimes fiercely insist that it be removed from schedule B. The truth is that the exception is merely a re-statement of what is the result of the application of the terms of the policy. It is only expressly stated as a warning to the insured. Suppressing it changes nothing.

Asking for affirmative insurance against re-bills fails to resolve the issue for the insured, too. First, underwriting guidelines prohibit it, because it is against the nature of title insurance to insure against future contingencies. Asking for and providing such coverage betrays a misunderstanding of title insurance and may not be relied upon by attorneys experienced in transactions involving title insurance. Second, even if the agent issuing the policy is willing to provide affirmative insurance, it is unclear whether it could be done effectively. As seen in the previous paragraph, removing the exception from schedule B does not help. Adding affirmative language would most likely fail as well, because it would be inconsistent with the terms of the policy and the nature of title insurance. While an agent may add language increasing or reducing specific coverage to tailor it for a transaction, it might not be binding upon the underwriter for an agent to insure against risks clearly outside the scope of title insurance. In other words, a title insurer cannot insure against re-bills any more than it can insure against termite damage, future condemnation, flood or fire.

C. Adjustments, Escrow Holdbacks and Credits on Metered Accounts

If no title reading was ordered, adjustments on metered accounts should be made with the last actual reading in mind, not only the amount shown, but also how long ago the meter was read. An actual reading within the last three months is the best possible scenario. It is considered prudent for an attorney to rely on that last actual reading when no intervening circumstances are known. If the last actual reading is over three months old it becomes a question of risk management: one should look into the occupancy and use, and the specific circumstances known about the premises. For example, a survey may disclose the existence of a fountain or a pool, an appraisal may indicate leaks and mold, and the client may have personal knowledge of the condition of the property or of common problems in the neighborhood. The longer the period between actual readings, the greater the exposure to a re-bill. While most meters are read regularly, situations occur where a meter has gone unread for years. These situations call for special attention.

Practitioners usually feel safe depositing funds in escrow and waiting for the next actual reading. This conservative approach has two problems: (1) an actual reading may take too long to appear (unless it is ordered), and (2) since the actual reading will post-date the closing, the seller may disagree on which charges are her responsibility, leading to a renewed discussion. Finally, since these issues arise on closed files they are usually not treated as diligently as open files. All this results in an open water account accruing new charges, penalties and interest at 9%, and eventually 15%, annual yield[29] and in an increasingly frustrated client involved in an issue that may know no end.

A much healthier but not generally explored approach is to collect a straight credit from the seller. Instead of requesting a certain amount to be held in escrow, the seller might agree on giving a smaller amount as an unconditional credit. Of course one suffers the risk of having taken too small a credit, but holding escrow is no more certain if the seller will argue the charges, and the advantages of a clean credit may overcome this. First, neither attorney is expected to work unpaid hours to negotiate an escrow release. Second, no late charges accrue while negotiating the issue. Third, if the client is reasonable and agrees on the credit at closing, the relationship with the client is spared.

One last remedy to be considered is eminently practical: if there is no time to wait for a meter reading, why not have the parties read the meter? Reading a meter is no mystery; it can be read much like an odometer. One need only know the consumption at the last actual reading and the current charge per HCF. For example, if the last actual reading on March 3 shows 00045100 cubic feet and the meter on September 3 shows 00100000, then we can easily conclude that 54900 cubic feet, or 549 HCF units, were consumed in the last 180 days. If the current charge per HCF is $1.81, then the water charges amount to $993.69. As for the sewer rent charges, they are 159% of the water charge, or $1,579.97, amounting to a total combined charge of $2,573.66. If the purchasers can take a picture of the meter on the final walkthrough, their attorney would be able to calculate the charges. Information regarding the previous actual reading and current charge per HCF can be easily obtained from the tax records. For more information on how to read a meter visit http://www.ci.nyc.ny.us/html/dep/pdf/readmeter.pdf.

D. Adjustments, Escrow Holdbacks and Credits on Frontage and Flat-Rate Plans

Because they pay yearly fixed charges, adjustments on frontage and flat-rate plans are straightforward. On the other hand, if the property is being used or occupied in violation of its certificate of occupancy, then it is ripe for a re-bill. A purchaser's attorney who knows that the property is illegally used and occupied should bear in mind the fact that hefty re-bills may follow. Moreover, if the property is on frontage, surcharges may be imposed as well. As for surcharges, as we have seen, the liability would be an amount equal to the sum of all monies billed on the account since July 1, 2000, even if the account is up to date (see I.B.1., Surcharges, above). As for the re-bill itself, it varies. If the property is on frontage, it would be calculated according to the actual use as of the date of the illegal alteration. If the property is on a flat-rate plan, then the meter would be read, so it would depend on actual consumption. In the case of frontage, one could read the rate schedule or look for another property to use as a proxy to determine the potential liability. In the case of flat-rate plans, it would be best to resort to solutions as if on metering, as above, such as having the parties read the meter if there is not enough time to obtain a reading.

III. Special Circumstances

A. Meter Cannot Be Placed

Occasionally, the physical circumstances of a building make it impossible for a meter to be installed. This is especially true in areas of high population density where yard space is lacking. A meter must be protected from the elements, so an indoor location is preferable. If there is no physical space, meters can be placed outdoors, but then some sort of protection (a meter pit) must be built around it. This requires extra space, which might also make it impossible to place it outdoors. In short, it might be impossible to place the meter without extensive re-plumbing. DEP recognizes this impossibility will maintain the account on frontage without imposing surcharges in that case. Staff at DEP has informally advised the author that technical advancements make it possible to install meters where they couldn't go before, and that property owners are to install meters when it becomes feasible, or they may suffer surcharges. If a flat-rate account reconciliation is duly ordered, upon examining the premises DEP will be able to determine whether a meter can be placed under current technology.

B. Allowances

As we have seen, the sewer rent charge is 159% of the water charge. Yet, the nature of some businesses makes it very likely that not every drop of water provided to the property will be discharged into the sewers. For example, if the property is an ice factory, then most of the water supplied will be sold in ice cubes and not discharged by the factory. Hence, ice factories receive an 85% allowance on sewer charges. As a practical example, if 100 HCF of water are supplied, the water charge would be $1,810, and the regular sewer rent $2,877.90. With the 85% allowance, the sewer rent comes down to $431.69. Other examples of businesses with high allowances are florists (50%), bakeries (40%), cemeteries (50%), dry cleaning (50%), and water used for building construction or sanitary purposes (90%).

Allowances are troubling for the closing attorney because they can only be claimed as long as the property is used for the designated purpose. As soon as DEP learns that the business is no longer operational, it can revoke the allowance retroactively, as of the date operations ceased. For example, suppose you are buying a store that used to be a dry cleaning business, but that has been out of business for a year. Any sewer charges incurred in that year would have been reduced by the allowance. If after the purchase DEP becomes aware that dry cleaning stopped for a year, charges would be re-adjusted for the entire year. This risk, like all others, disappears if a title meter reading or flat-rate account reconciliation is obtained prior to closing.

C. Meter Shown on Record, but No Charges

There are a number of reasons why records may show that a building has a meter but to find no charges of record. First and foremost, it could be a new meter. If so, charges would appear only at the end of the first quarter. Another reason is that it could be a monitor meter, such as would have a property on a flat-rate plan, as explained above, in which case the account itself would show charges. Lastly, it could be a fire meter or a cooling tower meter, as explained below.

D. Fire Meters

Fire meters are used to measure water used by sprinklers and other fire protection systems.[30] This water is not subject to sewer rent charges. Ideally, water used for this purpose has a different point of entry from the rest of the water, thereby circumventing the master meter and keeping a clear account of what consumption is subject to sewer rent charges. In that case, the fire meter would be placed in the second point of entry and would be read normally for charges.

Unfortunately, physical circumstances sometimes prevent having two points of entry. In those cases, DEP places a "tee" after the master meter to divide water meant for fire purposes from the rest. The fire meter would then be placed on the branch meant for fire protection. All the water passing through the fire meter would have already passed through the master meter. In this case, the purpose of the fire meter is to calculate the amount of water that should be deducted from the master meter reading in order to calculate sewer rent charges. In other words, in this case the fire meter is used to calculate sewer rent deductions, not water charges.

The use of fire meter water for any other purpose is prohibited[31] because it would be an attempt to avoid sewer rent charges. An illegal connection tapping into the secondary point of entry is an instance where re-billing can occur despite the fact that the last reading was an actual reading.

One might think that fire meters accrue charges only in case of a fire, but in practice charges accrue over time as a result of testing. Fire meters do not post readings regularly. They only appear when they are actually read, and readings can be ordered as well. Tax searches sometimes neglect to specify that a meter is a fire meter. This causes confusion because the tax search reveals a meter that has been in place for years, but that was never read.

E. Cooling Tower Meters

Cooling tower meters follow the principle behind allowances: not all water provided will be discharged into the sewers. They measure the amount of water that flows into cooling towers because that water will vaporize as a result of the cooling process. Since it will not be discharged into the City sewers, the meter measures the amount of water that will be entitled to an 85% allowance. Cooling tower meters are only read on demand and they only result in a credit on previously billed sewer charges.

F. Exemptions

Certain entities are exempt from water and sewer charges.[32] In order to benefit from the exemption, the entity must apply for it with DEP. Failure to apply results in forfeiture. Mixed-use properties may be entitled to exemption if the principal use is exempt.[33] For a list of all entities entitled to exemption visit http://www.ci.nyc.ny.us/html/dep/pdf/exemption.pdf. Since water and sewer charges are levied by the City and collected by the Department of Finance, it is common for practitioners to assume they are a tax, and hence that entities exempt from taxes are also exempt. This is not the case. Water and sewer charges are a public service by the City and not a tax. In fact, the federal government, the state government and their respective agencies do pay water and sewer charges.

G. New Buildings

New buildings to be over 75 ft. in height or to have six or more stories must have meters prior to commencement of construction.[34] While under construction, the site must have one meter per point of entry. Once the construction is finished, these meters are to be replaced by an entire premises meter.[35] Multiple accounts and meters are expected in major projects, and amounts due on the construction accounts are rolled into the entire premises account once the project is over. This can be dangerous because purchasers do not expect newly opened accounts to show any charges. Buildings under six stories are not required to have accounts during construction, but may apply for a permit to use fire hydrant water.[36] All new buildings and major renovations are required to install meters upon completion.[37]

H. New Developments

A new development is one of the areas of greatest concern. The unwary look at the water search, confirm that the meter was recently installed as the building was finished, and assume there cannot possibly be rebills. The problem with this approach is that it ignores charges against the base lot.

Suppose a developer buys a tract of land, tax lot 1, which dimensions are 100 feet by 200 feet. The developer subdivides lot 1 into ten lots of 20 ft. by 100 ft., numbered lots 1 through 10. All charges accrued prior to the subdivision attach to all new ten lots. Any unpaid amounts become a foreclosable lien. In theory, the City does not apportion tax lots until all taxes are paid. In practice, water charges that have not appeared of record, or that may subsequently appear on an actual reading, are not accounted for and continue to be a lien against the base lot after the subdivision. This should be a concern for every purchaser of lots 1 through 10, following the example. The owner of lot 1 should be particularly concerned because the Department of Finance records do not distinguish between "old lot 1" and "new lot 1." This means that the owner of lot 1 will receive all outstanding tax bills on the base lot, including the foreclosure notice. Needless to say, charges on a base lot of 100 ft. by 200 ft. can be daunting to the residential owner of a lot 20 ft. by 100 ft. The purchasers of lots 2 through 10 are not free of risk, because if the owner of new lot 1 pays outstanding taxes on the base lot, the other purchasers will probably be liable for contribution.[38] Purchasers of newly created tax lots should always request tax searches on the base lot.

I. Condominiums

Condominium units pay their own real estate taxes, but not always their own water charges. Condominiums have one account for residential owners per building. If there is only one apartment building, then there is only one account. If, on the other hand, the condominium consists of a row of houses, then each house with its own heater and no more than three stories should have its own meter.[39] If each of these houses has only one dwelling unit, then each owner has her own water account and will be billed directly. In that case, water and sewer would not be paid through the common charges and should be taken care of at closing, as if purchasing a regular house. If the buildings are multiple residences, then there will be a common account shown against each common elements lot.

Water charges billed against the common elements lot (or lots) are divided among the unit owners through the common charges. As with all other charges affecting the common elements, water charges do not become a lien against the individual units until the managing board assesses the common charges.[40]

The same does not apply to charges on the base lot. As is the case with new developments, any outstanding charges on the base lot become a lien against anything standing on it. It is important to differentiate between the base lot and the common elements lot. The base lot is the lot that existed prior to the creation of the condominium; i.e., prior to the filing of the condominium declaration. The builder's mortgage loan, for example, would be filed against the base lot, and just like the taxes, it covers the entire building, regardless of individual title to units. The common elements lot comes into existence with the creation of the condominium. Any charges filed against it do not attach to the individual units until they are assessed in the common charges.[41] Concern over charges against the base lot generally belong only to transactions involving new condominiums, because outstanding charges quickly become tax lien certificates, which are more conspicuously filed. Lastly, on any condominium unit purchase it is always prudent to check whether the condominium is up to date with its water payments or whether past periods are outstanding. If not, the purchaser should expect an assessment or an increase in the common charges in the near future.

J. Homeowners' Associations for Apportionment of Water Charges

As discussed above, DEP encourages homeowners without meters to obtain them. However, the City used to be reluctant to create separate accounts for each homeowner in new developments, particularly in Staten Island. Abstract searches in Richmond County regularly reveal Homeowners' Associations for the sole purpose of apportioning water charges from a base frontage account. Some of these associations continue to appear of record but have outlived their purpose because the individual owners now have individual accounts. This becomes troublesome because the title company finds it of record and expects to receive a letter at closing evidencing that the seller is up to date with the association's dues, but the seller has no knowledge of its existence. However, affidavits from the adjoining owners swearing to the fact that the association no longer exists or tax records showing that each owner now has her own account will serve as proof that the association has been voided and that therefore no letter from it will be required.

K. Multiple Accounts and Meters

Every commercial unit may keep its account and meter. In the case of a mixed-use building, there would also be a meter for all the residential units (which could be a monitor meter). There is no limit to the number of meters and accounts a property may have. However, all charges on every account become a lien on the entire tax lot, and not only the portion supplied by the respective meter.

L. Unusual Sewer Charges

Very few properties are not reached by the City's water supply, but obtain their water from wells. However, if they discharge into the sewers, they will be liable for sewer rent charges. DEP will estimate the water consumed applying the same schedule as for properties on frontage, and then calculate sewer rent charges normally.[42] The water itself would not be charged.

Con Edison supplies some properties with steam. After it is used, it condensates and it is discharged into the sewers. Con Edison reports to DEP the amount of steam supplied, and DEP bills sewer rent in relation to it.[43] This is the single most recurrent explanation of sewer charges that are well above 159% of the water charged.

M. No Charges, Irregular Charges, or Unexpected Credits Found

In the event tax records show extremely irregular charges, such as unexpected credits, extremely low charges, or no charges at all, the Appellate Division has held that the customer (or purchaser) carries the burden "to take reasonable steps to investigate the public record."[44] In addition, charges posted but mailed to the wrong address are not subject to the backbilling limitation when the customer takes notice, but late payment charges and interest may be forgiven.[45] Finally, properties which borders lie beyond 100 feet of the City's sewers are not required to be connected.[46]

N. If All Else Fails . . .

Complaints regarding water bills must be filed within four years, and the Rules of the City of New York provide for three levels of administrative review.[47] DEP encourages customers to pay the charges rather than waiting for a final decision, as late charges and interest continue to accrue. It is worth noting that DEP has discretion to forgive charges based on extraordinary leaks or disasters[48] and to offer payment plans.[49] The judicial test of review is whether the charges are arbitrary, capricious or lacking in a rational basis.[50] DEP is usually given deference in the interpretation of its own rules.

IV. Conclusion

This article has been an attempt to summarize and explain the rules concerning water and sewer charges and to warn of potential risks and provide remedies. While I may have succeeded in explaining the rules, I have certainly failed in the latter. The complexity of the rules is such, the cases so unforeseeable, and the liability involved so difficult to estimate, that neither can every risk be foreseen, nor can an appropriate remedy be provided for those risks that are known. But that only emphasizes the case for ordering title meter readings and account reconciliations prior to closing. Attorneys who make a habit of doing so need not worry about the many risks pointed out in this article. Attorneys for purchasers would be wise to include a clause in their contracts calling for a title meter reading or a flat-rate account reconciliation, as the case may be. Attorneys for sellers may recognize the benefits of obtaining a reading over depositing their clients' fund in escrow with the post-closing work that may involve.

For instances where it is impossible to order a timely title reading, one should keep in mind: (1) that frontage and flat-rate plans can result in re-bills, (2) that violations of the certificate of occupancy have an incidence on water charges, (3) that the backbilling limit of four years is voided by culpable conduct, (4) that base lot charges follow newly created lots, and (5) that title insurance does not protect the purchaser, regardless of what the title agent may say.

Endnotes

1. N.Y.C. Admin. Code §§ 20-317.
2. To illustrate, DEP has known instances where meter-readers developed a relationship with their regular customers and entered into illegal agreements by which the readers would grossly underestimate readings. In order to avoid this risk of corruption, meter-readers are regularly assigned new routes, which means that readers may occasionally get lost and be unable to finish them. *See* David M. Halbfinger, *20 Arrested in Scheme to Cut Water Bills,* N.Y. Times, Oct. 22, 1998.
3. "ESTIMATE" and "ACTUAL" are the classifications as used in the records of the Department of Finance.
4. *See* III.D., Fire Meters, below.
5. 15 RCNY Ch. 42, App. A, Part V, Sec. 6.
6. *Id.*
7. Sam Roberts, *More Masses Huddling, but They Use Less Water,* N.Y. Times, Oct. 3, 2006.
8. DEP used to run a very generous reimbursement program for homeowners installing meters for the first time. Although the program still exists today, qualification is discretionary. New constructions are not qualified. 15 RCNY Ch. 42, App. B. More information *available at* http://www.nyc.gov/html/dep/pdf/reimbmet.pdf (last visited September 24, 2007).
9. N.Y.C. Admin. Code §§ 24-514 (b).
10. Extensive litigation has ensued from customers' timely requests to have meters installed and DEP's imposition of surcharges regardless. In the typical scenario, the customer made the request to DEP in June 2000, and when DEP imposed charges, the customer installed its own meter and sued to vacate the surcharges. It was the Water Board's position that (a) installing a meter by June 30, 2000 or (b) making a request to DEP by that date were "two mutually-exclusive options," and that the customer's initiative to install its own meter after surcharges had been imposed had voided the immunity afforded by the timely request. The courts decided against the Water Board, finding its interpretation of the rule arbitrary and capricious. *President Park Inc. v. City of New York*, 2005 NY Slip Op. 51571 (U) (Kings County Oct. 3, 2005); *2222 Mgt. Corp. v. Dept. of Envtl. Protection*, 2004 NY Slip Op. 51647 (U) (Kings County Dec. 15, 2004); *Botanical Realty v. City of New York*, 2005 NY Slip Op. 50500 (Mar. 31, 2005). One case decided by the Supreme Court in New York County upheld the Water Board's interpretation of mutually exclusive options. Application of *512-514 Realty, LLC v. The City of New York*, New York County Index No. 111243/04 (Conf. *President Park, Id.* at 3.)
11. 15 RCNY § 20-05(a)(1); 15 RCNY Ch. 42, App. A, Part II, Sec. 3.
12. N.Y.C. Admin. Code §§ 24-335.
13. *770 Owners Corp. v. City of New York*, 20 A.D.3d 572, 799 N.Y.S.2d 263, 2005 NY Slip Op. 06121(2d Dep't July 25, 2005). As opposed to the customers in the cases referred to in note 10, this plaintiff did not undertake to place a meter, but simply waited after making its timely request to DEP.
14. *2222 Mgt. Corp. v. Dep't of Envtl. Protection, id*.
15. *77 Realty, LLC v. New York City Water Board,* 16 A.D.3d 247 (1st Dep't 2005), 792 N.Y.S.2d 36 (1st Dep't March 22, 2005).
16. 15 RCNY Ch. 42, App. A, Part V, Sec. 6.
17. Residential properties with fewer than six dwelling units may qualify for an initial cap on meter charges. Said cap is equal to 150% of the last annual frontage charge and applies only for the first metering year. 15 RCNY Ch. 42, App. A, Part VI, Sec. 5. All residential properties, regardless of the number of units, may qualify for a cap on all meter charges of $1,083.83 per year for the first dwelling unit and $722.28 per year per additional dwelling unit. 15 RCNY Ch. 42, App. A, Part VI, Sec. 4.
18. 15 RCNY Ch. 42, App. A, Part VI, Sec. 7.
19. 15 RCNY Ch. 42, App. A, Part VI, Sec. 6.
20. Eric Lipton, *In Policy Switch, City Eases Stance on Water Meters,* N.Y. Times, Dec. 15, 2000.
21. 15 RCNY Ch. 42, App. A, Part VI, Sec. 9. More information is *available at* http://www.ci.nyc.ny.us/html/dep/pdf/mfappfrm.pdf (last visited September 24, 2007).
22. Consumption for commercial purposes must be separate from consumption for residential purposes under the plans. However, it is not required that every commercial unit have its own meter; it is enough if they share one.
23. 15 RCNY Ch. 42, App. A, Part V, Sec. 3.
24. Obtaining a flat-rate reconciliation on a frontage account prior to closing does not dispel the risk that surcharges may be subsequently imposed. But see III.A., Meter Cannot Be Placed, below.
25. In fact, the author was told by staff at DEP that the Water Board had even suggested no charge on title meter readings. It was only at the request of search companies that the $25 charge was imposed at all. This way they have a receipt to document the request.
26. *See* 2006 ALTA Owner's Policy, 1, Item 2. The same language appeared on the 1992 ALTA Owner's Policy.
27. To illustrate, consider the case of the seller who has fraudulently benefited from a real estate tax exemption, and thus paid too little in real estate taxes. When the Department of Finance discovers the fraud it will post and collect a special assessment from the current homeowner. This assessment, as it would be subsequent to the date of policy, would not be covered against, regardless of the fact that it is based on periods prior to the date of policy.
28. It is important to remember, nevertheless, that water and sewer charges, like taxes, always have priority over private liens, such as mortgages, regardless of filing dates. *See* N.Y.C. Admin. Code §§ 24-317 (b); N.Y.C. Admin. Code §§ 24-317 (e).
29. DEP imposes 9% interest, but should it become a tax lien, it becomes 15%. N.Y.C. Admin. Code § 11-332. Due dates on re-bills may be extended up to six months by application. 15 RCNY, Ch. 42, App. A, Part VI, Sec. 3 (b). The City reserves the right to shut off water service if charges are not paid within two years of the due date for commercial and multi-family properties. For residential properties with less than six dwelling units, the term is three years. N.Y.C. Admin. Code §§ 11-314; 15 RCNY Ch. 42, App. A, Part VIII, Sec. 2; App. C, Sec. 3; and Public Authorities Law § 1045-h(8); § 1045-j(5). Termination and restoration charges would be borne by the owner. 15 RCNY § 20-04 (d)(4).
30. 15 RCNY § 20-10.
31. 15 RCNY § 20-05(a)(5)(iii).
32. 15 RCNY Ch. 42, App. A, Part V, Sec. 7; Chapters 893 & 894 of the Laws of 1980.
33. The Appellate Division affirmed judgment and order of the Supreme Court to overturn DEP refusal to grant an exemption where the taxpayer was a church, but the property also served as residence for the church administrator and teacher. *Bethlite Community Church, Great Tomorrows Elementary School v. Department of Envtl. Protection of City of N.Y.*, 2006 NY Slip Op. 01709 (1st Dep't Mar. 9, 2006).
34. 15 RCNY § 20-05(a)(3)(i).
35. 15 RCNY § 20-05(a)(3)(ii).
36. 15 RCNY § 20-05(a)(4) ; § 20-08(b); 15 RCNY Ch. 42, App. A, Part IV, Sec. 4.1.
37. N.Y.C. Admin. Code §§ 24-334 and I.B.1., Surcharges, above.
38. The problem of the base lot also concerns real estate taxes. However, since these are easily quantifiable and

prospective—i.e., paid at the beginning of the period—the uncertainty is greatly reduced. Nevertheless, diligence requires that the base lot be searched as well for outstanding taxes.

39. NYC Admin. Code § 20-05(l).

40. RPL Art. 9-B (Condominium Law) Sec. 339-l.1.

41. By way of example of the non-liability of the unit owners as to common elements, consider *Pekelnaya v. Allyn*. The Supreme Court declared condominium unit owners to be jointly and severally liable for damages caused to pedestrians by a fence falling off the rooftop, which was part of the common elements, but the Appellate Division reversed on the law. *Pekelnaya v. Allyn*, 2005 NY Slip Op. 07860 (1st Dep't Oct. 25, 2005).

42. 15 RCNY Ch 42, App. A, Part III, Sec. 3.

43. 15 RCNY Ch. 42, App. A, Part III, Sec. 1 (B.1); 15 RCNY Ch. 42, App. A, Part III, Sec. 7.

44. *333 E. 89 Realty LLC v. New York City Water Board*, 272 A.D.2d 549, 708 N.Y.S.2d 155 (2d Dep't May 22, 2000).

45. 15 RCNY Ch. 42, App. A, Part V, Sec. 6; *Perry Thompson Third Co. v. City of New York*, 279 A.D. 108 (1st Dep't 2000), 718 N.Y.S.2d 306, decided December 19, 2000.

46. *Jansen Court Homeowners v. City of New York*, 17 A.D.3d 588, 795 N.Y.S.2d 594 (2d Dep't Apr. 18, 2005), and N.Y.C. Admin. Code §§ 27-901(e)(2)(b).

47. 15 RCNY Ch. 42, App. A, Part IX, Sec. 2; Public Authorities Law § 1045-g.

48. 15 RCNY Ch. 42, App. A, Part VI, Sec. 8.

49. 15 RCNY Ch. 42, App. A, Part VIII, Sec. 4.

50. *Mid-City v. New York City*, 290 A.D.2d 301 (1st Dep't 2002); *Westmoreland Apt. v. New York City Water Board*, 294 A.D.2d 108 (1st Dep't 2002); *Hermany Farms v. Chapin*, 287 A.D.2d 565 (2d Dep't 2001), 731 N.Y.S.2d 663.

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Assumption or Rejection of Commercial Leases Under BAPCPA

By David J. Kozlowski

Introduction

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") became effective for bankruptcy cases filed on or after October 17, 2005.[1] BAPCPA fixes the time in which Chapter 11 tenant/debtors may assume or reject leases.[2] Previously, tenant/debtors had 60 days to decide, with "for cause" extensions available through the court.[3] These extensions could delay the decision for months or years,[4] prejudicing the landlord. BAPCPA increased this initial period to 120 days[5] with an available "for cause" extension of 90 days.[6] Further extensions can be granted only with the landlord's consent.[7] Failure to decide results in the leases being deemed rejected.[8]

This change, essentially a hard time-limit on assumption of commercial leases in bankruptcy, can cause problems for retail debtors with numerous leases over a wide geographic area, who may need more than 210 days to decide whether to assume or reject the leases.

In removing judicial discretion and capping the debtor's time to assume, Congress may have caused problems for such retail debtors who now must assume all their unexpired nonresidential leases prematurely, or risk having them rejected 210 days from the order for relief. The legislation also may have had the side effect of curtailing use of designation rights as a device to maximize the estate. The change reduces the time to find end buyers, potentially decreasing the value of the designation rights, or possibly ending their usage altogether.

A Brief Explanation of Designation Rights

Section 363(b) of the Bankruptcy Code ("the Code") allows debtors, after notice and a hearing, to sell or lease property of the estate.[9] Unexpired leases are considered property of the estate and are subject to being leased or sold under section 363(b).[10] Over time, the process of selling unexpired leases developed where tenant-debtors had multiple below-market leases.[11]

Designation rights were defined by the court in *In re Ames Dep't Stores Inc.*[12] as "the right to direct the debtors to assume and assign . . . Unexpired Leases . . . to third parties qualifying under the Code, after such non-end users locate ultimate purchasers of the Unexpired Leases. . . ."[13] This practice became widely used in large corporate bankruptcies with multiple leases as a way to add value to the estate. However, the benefit of designation rights extends beyond adding value, as they also "bring immediate liquidity to the bankruptcy estate while allowing the debtor to focus on issues other than marketing unwanted leases."[14]

Rejecting Property After Assumption in Bankruptcy

Occasionally, a tenant/debtor assumed a lease, only to determine it was not needed for reorganization and subsequently rejected it. Upon assumption, the landlord was owed rent as an administrative expense (rather than having a general unsecured claim in bankruptcy if rejected). The question as to whether, upon subsequent rejection of the lease, the remaining rent due under the unexpired term of the lease was still owed to the landlord as administrative expenses or whether it became general unsecured claims was answered in *Nostas Associates v. Costich* (*In re Klein Sleep Products*),[15] where the court held that a landlord was entitled to unpaid rent as an administrative expense claim from the bankruptcy estate for remaining time on a lease which had been assumed but subsequently rejected. This meant that the landlord was paid off the top, before the other creditors.[16] This remaining time was not subject to the cap applying to leases rejected outright under 502(b)(6) of the Code.[17] With this precedent existing, rejecting an assumed lease became a dicey proposition as doing so would create a potentially large and theoretically limitless administrative expense.

Klein Sleep Products' rule had negative implications for all parties. The classification of rents due under assumed nonresidential leases as administrative expenses shrank the estate to the detriment of other creditors. Likewise, the debtor's ability to reorganize was hampered by these rents (which were on premises the debtor no longer occupied). Landlords came out the best, collecting their money from the estate right off the top, as opposed to having general unsecured claims. But even landlords were hurt as debtor uncertainty prolonged the time that a store was unoccupied. In the case of shopping center owners, this result could be worse than having only an unsecured claim against the debtor's estate, but having a new tenant occupying the premises (and thus having certainty).[18] Ultimately, Congress added section 503(b)(7) to the Code, settling on the following language:

> 503(b) After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including—
>
> (7) with respect to a nonresidential real property lease previously assumed under section 365, and subsequently rejected, a sum equal to all monetary obligations due, excluding those arising from or relating to failure to operate or a penalty provision, for the period of 2 years following the later of the rejection date or the date of actual turnover of the premises, without reduction or setoff for any reason whatsoever except for sums actually received or to be received from an entity other than the debtor, and the claim for remaining sums due for the balance of the term of the lease shall be a claim under 502(b)(6)[.][19]

365(d)(4): The Change

The House Judiciary Committee Report in 2005 noted that the amendments to 365(d)(4) of the Code were "to establish a firm, bright line deadline by which an unexpired lease of nonresidential real property must be assumed or rejected."[20] The House Judiciary Committee went further, indicating that the provision was designed to remove discretion from bankruptcy judges in granting extensions beyond 210 days.[21] The argument that section 365(d)(4) of the Code was the product of extensive negotiation over the three previous sessions of Congress and was not hostile to lessees won out. As a result, the amendments to the Code for which the International Council of Shopping Centers ("ICSC") lobbied were eventually enacted by BAPCPA.[22]

Survey and Results

The author conducted a survey via mail and e-mail inquiries to bankruptcy and real estate professionals. Survey questions were sent to select members of the American Bankruptcy Institute and the American College of Real Estate Lawyers, who have a special interest in both real estate and bankruptcy. The 27 respondents are all among the leading professionals dealing with the assumption or rejection of commercial leases in corporate bankruptcies. A list of the questions follows this article as "Appendix A." Copies of the answers to this survey are on file with the author. Those providing content were assured of their privacy—all requests for further information will be considered with the privacy of the individuals in mind.

The survey found that in large business reorganizations, the decision whether to accept or reject leases was rarely made within 210 days. All responders to the survey indicated that leases were usually, if not always, assumed after 210 days in bankruptcies with multiple leases, and 61% noted that debtors could not have sped up the determination process.[23] This majority of the survey respondents indicated a variety of roadblocks preventing the debtor from assuming in a more timely fashion, including the debtor needing more time to operate, needing a financial model to be in place, and needing to evaluate locations. Respondents who believed debtors could speed things up fell generally into two camps—those who felt the debtor could simply decide sooner and those who thought the process could be sped up, but that speeding up the process would limit options and could devalue the property. These results indicate fundamental problems with the assumption period in BAPCPA. Major changes need to be made in the approach taken toward assumption of leases. Tenant-debtors may be forced to change their behavior or risk having the 210-day period expire, causing all unassumed leases to be deemed rejected.[24]

Of all the aspects of lease assumption or rejection affected by BAPCPA, designation rights suffer greatest. Courts were often willing to grant extra time to allow debtors to sell designation rights, as the marketing of these leases often takes a long time. Under the BAPCPA changes, there is not enough time for a debtor to determine which leases to sell, market and auction designation rights, get court approval, give the designation rights holder sufficient time to market the leases, choose designees, and have the assignments to designees approved and closed. More than one-third of survey respondents believed designation rights would become less valuable and harder or impossible to sell due to both the rush to sell before the expiration of the 210 days and the inability to market and sell them in many typical cases. Because debtors almost never know which leases they will be assuming and which they will be rejecting by 210 days, it is unreasonable to expect that they will know which leases they will be able to assume and assign within the same time-frame. Some responders to the survey offered answers focused on beginning preparations pre-petition, thus avoiding the problem.

But there is some hope—under Section 365(d)(4)(B)(ii), the court may grant extensions beyond 210 days with the lessor's prior written consent. The survey found several circumstances in which lessors would be likely to grant written consent to extend time. One-quarter of the survey respondents believed landlords would grant extensions if they were monetarily compensated for it. Forty percent assume the landlord would be willing to have time extended if the landlord had no new tenant ready to lease the property. This is probably because shopping centers can ill-afford stores "going dark" for extended periods, and because collecting rent from a debtor who is current is better than collecting no rent and simply having a general, unsecured claim in the bankruptcy proceeding. Similarly, a handful of responders felt extensions would be granted where the rent was over-market and where the debtor was conforming with the lease terms. Other answers provided included where the 210 days would occur at an inconvenient time (such as the holiday season), where assumption was being negotiated, and where the landlord feared immediate rejection. However, since many of the reasons a landlord would give consent to generally do not apply to below-market leases, sale of designation rights (which are valuable when leases are below-market and can be sold at a profit) will likely still suffer.

The survey found that the changes are expected to result in debtors waiting longer to file in an effort to extend their time. These tenant-debtors may prepare better pre-petition by hiring lease consultants and financial advisors to provide analysis "so that chapter 11 is used to implement planned restructurings and not as a haven for business trial and error."[25] This is especially so since only landlords in bad markets will be likely to grant extensions to entice tenants. As a solution, half of the responders who answered believed a tenant could bargain at the lease's inception that in the event of the tenant's bankruptcy, the landlord would consent to allowing extra time to assume the lease. Several pointed out that, while conceptually accurate, tenants are optimistic when entering into lease agreements, and would likely not be considering hypothetical bankruptcy scenarios.[26]

Just under 79% of survey respondents believed there would be any adverse affects on real estate closings. Also, responses were generally ambivalent as to whether the real estate industry would suffer any problems from these BAPCPA changes. On the other hand, an overwhelming majority (90.48%) of responders were of the opinion that this particular change to the Code was negative for bankruptcy law, citing the undue pressure placed on debtors to formulate a business plan and the unfair advantages given landlords as general reasons.[27]

Conclusion

There are several problems with the BAPCPA changes to section 365(d)(4), the most important of which is the 210-day maximum in which a debtor must assume or reject an unexpired nonresidential lease without written consent of the lessor. The proponents indicated that this time would be sufficient, negatively characterizing judicial discretion in granting exceptions. The empirical data show otherwise. Bankruptcies involving multiple unexpired nonresidential leases most often saw leases assumed after 210 days, and most practitioners surveyed did not believe the debtor could have come to the decision sooner. While this could be solved by debtors assuming all leases for which they are "on the fence," Congress's refusal to abandon *Klein Sleep Products* (rather, simply limiting the court's holding) all but assures huge administrative expense claims for each assumed and subsequently rejected lease. Debtors could try to plan before filing Chapter 11, but would still run the risk of assuming leases that will ultimately be rejected, as the debtor would not have the benefit of operating through several business cycles or holiday seasons, and may not have settled upon a final business model or a reorganization plan.

Potentially lost in the wake of BAPCPA is the sale of designation rights. Again it is the artificial time-frame which causes the problem. Two-hundred ten days may not be sufficient to find an end buyer. Survey responders noted designation rights are expected to become harder to sell, less valuable, and a less viable option.

These problems are not completely without solutions. It is likely that more pre-pack bankruptcies will be filed, or, at least, better preparation and examination of leases will occur in corporations on the verge of filing. When entering lease agreements, real property attorneys need to be aware of potential clauses ensuring receipt of the lessor's written consent to an extension in the event of the corporation's filing for bankruptcy relief. Finally, the option of assuming leases near the 210-day deadline, with the possibility of subsequent rejection, while not the most desirable solution, will provide a way past 210 days and allow time to market designation rights. Although, such an option may come at great expense.

Ideally, Congress would reexamine these changes. Unfettered bankruptcy judges are positives in a system that favors creativity, flexibility and elasticity. Handcuffing judges into a rigid time-frame that benefits one group of creditors is contrary to the ideal of debtor rehabilitation. Congress should review BAPCPA and realize that what has been seen as small abuses by several judges is outweighed by the rehabilitative and "fresh start" goals of the bankruptcy system.

Endnotes

1. Pub. L. No. 109-8, 119 Stat. 23 (2005).
2. 11 U.S.C. § 365(d)(4).
3. 11 U.S.C. § 365(d)(4) (1994) (prior to 2005 amendment).
4. *See Hatch: On Assuming or Rejecting Leases Under the New Law*, 24-3 AM. BANKR. INST. J. 6 (Apr. 2005); Richard Levin & Alesia Ranney-Marinelli, *The Creeping Repeal of Chapter 11: The Significant Business Provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L.J. 603, 623 (2005); William I. Kohn et al., *Reforms Benefiting Business Creditors Generally*, 24-5 AM.

BANKR. INST. J. 6 (June 2005); Robert N. Zinman, *New Bankruptcy Law Affects Real Estate Investments*, 33-4 N.Y. REAL PROP. L. J. 173 (2005).

5. 11 U.S.C. § 365(d)(4)(A)(i).

6. 11 U.S.C. § 365(d)(4)(B)(i).

7. 11 U.S.C. § 365(d)(4)(B)(ii).

8. 11 U.S.C. § 365(d)(4)(A).

9. 11 U.S.C. § 363(b).

10. Robert N. H. Christmas, *Designation Rights—A New, Post-BAPCPA World*, 25–1 AM. BANKR. INST. J. 10 (February 2006) (*citing 48th Street Steakhouse Inc. v. Rockefeller Group Inc*. (*In re 48th Street Steakhouse Inc*.), 835 F.2d 427, 430 (2d Cir. 1987) ("the courts are in agreement that unexpired leasehold interests . . . constitute property of the bankrupt estate"), *cert. denied*, 485 U.S. 1035 (1988)). Debtors have the option of assigning the lease. 11 U.S.C. § 365(f) (1994) (prior to 2005 amendment); Robert N. Zinman, *New Bankruptcy Law Affects Real Estate Investments*, 33-4 N.Y. REAL PROP. L. J. 173 (2005).

11. Pamela Smith Holleman, *Solvent Shopping Center Tenants: Reexamination in Light of In re Trak Auto Corp.: Part I*, 23–10 AM. BANKR. INST. J. 14, 64–65 (Dec. 2004/Jan. 2005) (noting that third parties find value in these leases both because they are below-market, but also because debtors had historically been able to assign leases notwithstanding restrictive provisions therein; the latter benefit was undercut by *In re Track Auto Corp.*, 367 F.3d 237 (4th Cir. 2004), but the former benefit still exists).

12. 287 B.R. 112 (Bankr. S.D.N.Y. 2002).

13. *In re Ames Dep't Stores Inc.*, 287 B.R. at 114, n.2. A tenant-debtor would find a third-party who, for a fee, markets the tenant-debtor's unwanted leases to other parties. These other parties then pay for the right to have the lease assigned to them, the third-party coordinates the other parties' intent to the tenant-debtor, who then assumes and appropriately assigns the leases in question. Note that designation rights are not the sale of the power to assume leases, as that power rests solely in the trustee or debtor-in-possession ("DIP"), and the trustee or DIP retains that power in a designation rights scenario; this logic is not beyond reproach. *See* Elizabeth Warren & Jay L. Westbrook, *Warren & Westbrook Professors of Law: Selling the Trustee's Powers*, 23–7 AM. BANKR. INST. J .32 (Sept. 2004). For more on the definition of designation rights, *see, e.g.*, *In re Ernst Home Center, Inc*., 209 B.R. 974 (Bankr. W.D. Wash. 1997). For a discussion of the designation rights issue in *In re Ames Department Stores Inc.*, see generally Daniel J. Carragher, *Smooth Sailing for Designation Rights Sales*, 22–1 AM. BANKR. INST. J. 26 (Feb. 2003).

14. Smith Holleman, *supra* note 11, at 64.

15. 78 F.3d 18 (2d Cir. 1996).

16. *Id.* at 30. *See also* Thomas McIntyre Devaney, Comment, *The Klein Sleep Decision: Section 502(b)(6) Lease Damages Cap as the Rule, Not the Exception*, 4 AM. BANKR. INST. L. REV. 557, 561–63 (1996).

17. McIntyre Devany, *supra* note 16, at 559. Section 502(b)(6) of the Code caps the claim of a lessor for damages resulting from termination of a lease at a maximum of three years. 11 U.S.C. § 502(b)(6).

18. Of course, once the debtor elected to reject a lease, the landlord could mitigate his own loss and find a new tenant. However, the idea that the debtor could reject at all after assuming had to be discouraging for landlords. Ideally, one imagines that landlords would prefer the certainty of knowing as soon as possible whether the debtor will assume or reject the lease, thus allowing them the most time to find a willing tenant, rather than be in limbo on every assumed lease and having to wait for the debtor to exercise the option of subsequent rejection. From this point of view, at least the *Klein Sleep Products* decision could discourage debtors from assuming then rejecting.

19. 11 U.S.C. § 503(b)(7).

20. H.R. Rep. No. 109–31 Part 1, at 86 (2005).

21. *Id*.

22. *Id*. at 428 (noting the National Retail Federation is a strong supporter on the same side of the ICSC). From the ICSC view, things worked out well:

> On balance, however, Congress weighed the potential advantages to the bankruptcy estate of permitting freer assignability of shopping center leases against the goals of landlords to maintain occupancy and the high caliber of tenant mix and the aligned interests of the other tenants of shopping centers, and came down emphatically in reinforcing Congress's prior policy judgment in favor of landlords.

Kevin P. Groarke, *The Bankruptcy Amendments and Shopping Center Leases: Enhancing Use Restrictions and Curing the Incurable*, 25 SHOPPING CTR. LEGAL UPDATE: THE LEGAL J. OF THE SHOPPING CENTER INDUSTRY 2 (2005).

23. It is noteworthy that every survey respondent who represents landlords believed debtors could speed up the process, while 64% of those representing tenants or debtors believed the process could not be sped up.

24. 11 U.S.C. § 365(d)(4)(A). "[A]n unexpired lease of nonresidential real property under which the debtor is the lessee shall be deemed rejected . . . if the trustee [DIP] does not assume or reject the unexpired lease by . . . 120 days after the date of the order for relief. . . ."

25. Quoting from one survey responder's answer; anonymous but on file with the author.

26. *See* Survey, Question 7.

27. *See* Survey, Question 6. Note that one responder feels the amendment "levels the playing field" for landlords, and another thinks the change is good because "it forces resolution or finality in a shorter time frame."

The author is a graduate of St. John's University School of Law and an attorney in western New York. **He thanks Prof. Robert Zinman, who provided the idea for, and guidance on, this study. He also thanks his wife and proofreader, Suzanne.**

Appendix A

General Information

Name

Address, Phone Number, E-mail

Primary Practice Area: Bankruptcy, Real Estate, Both (If you primarily practice real estate law, do you regularly represent landlords, tenants, both?)

Empirical Study Information

1. Given your experience in bankruptcy reorganizations where assumption or rejection of multiple leases of nonresidential real property was at issue prior to the adoption of the amendment, was the determination as to which leases would be assumed or rejected made before the expiration of 210 days from filing? Please indicate whether you are writing from the landlord's point of view or the tenant's.
    a. Is there anything the debtor could have done to speed up the process?
    b. Specifically, what roadblocks would have impeded or prevented (did impede or prevent) making the determination in 210 days?
2. Given that debtors sometimes sell designation rights, and that this process can often take a long time, how do you perceive that lease designation rights will be affected under the new law?
3. If coming to the 210-day mark and the determination to assume or reject certain leases still has not been made, a possible option will be to assume all leases in question, then later reject undesirable leases in the reorganization plan. What potential problems, if any, do you foresee in this proposal? Is new 11 U.S.C. § 503(b)(7) limiting administrative expense claims in this situation helpful? Can you propose solutions to any of these problems?
4. Generally, what problems does this amendment portend for the real estate industry?
    a. Under what circumstances would a landlord be willing to grant permission to extend the time limit in the lease?
    b. Is there anything that could be done by the lessee to insulate itself?
5. Did you perceive the court's ability to grant almost limitless extensions under the old law as a positive? Why or why not?
6. Overall, is this particular change (not BAPCPA as a whole) a positive or negative change to bankruptcy law? To real estate law?
7. Do you think this amendment will have an adverse affect on closings of new real estate transactions?
8. Are there any other implications from this amendment that you believe should be considered?

How the Residential Mortgage-Backed Securities Market Impacts Dirt Lawyers and Their Clients

By David J. Reiss

I want to demonstrate that the secondary mortgage market is relevant to the day-to-day practice of real estate lawyers. To do so, I will review the changes in the residential mortgage market for those of you who haven't spent much time thinking about this; describe how these changes are now affecting borrowers; and indicate how these changes have led to a potential financial crisis of extraordinary magnitude.

Let me start by distinguishing the primary mortgage market from the Secondary Mortgage Market. The primary mortgage market is the market for originating loans with individual borrowers. If you have seen *It's a Wonderful Life*, you pretty much know where it started in earnest, with Savings and Loans like the Bailey Building and Loan. Local depositors put money in the Savings and Loan to earn interest and local borrowers borrow money from it, paying interest. The problem with this financing model is that rich and low-growth communities will tend to have lots of deposits and not make many loans. Poor and growing communities will tend to have few deposits and a great demand for loans.

The Secondary Mortgage Market is the market where lenders and investors buy and sell mortgages that were made in the primary mortgage market. The secondary market acts to spread deposits from savers wherever they are (the Northeast, for instance) to borrowers wherever they are (the Southwest, for instance). Originating lenders often sell mortgages in order to get new capital to make new loans. Investors buy mortgages for the same reasons that they might buy any other investment product—to meet their "rate of return" and risk expectations.

The secondary market for prime loans that we know today was created in large part by government-chartered but publicly traded Fannie Mae and Freddie Mac. Fannie and Freddie were specially created by the federal government to encourage homeownership. By offering to purchase loans made by lenders on certain standardized terms, Fannie and Freddie offered liquidity and stability to what had been an informal secondary market.

In the last two decades, Fannie and Freddie became the darlings of Wall Street as they reported growth and profits year after year by borrowing money at low rates and using it to purchase residential mortgages that pay interest at higher rates. Indeed, as of September 30th of last year, Fannie and Freddie had $4.35 trillion in mortgage-related obligations.[1] That's a lot of trillions. The magnitude of this number can be understood only in comparison to the amount of U.S. government debt owned by the public—$4.84 trillion at that time.[2] So the difference between the two is pretty much a rounding error.

Fannie and Freddie have been wildly successful in parlaying their government charters into humongous for-profit enterprises. The success of the secondary market dramatically changed the role of the originating lender in a mortgage transaction—no longer was it acting like Bailey Bros.—it is now often no more than a thinly funded entity with a credit line at a bank and an agreement to sell its loans to a mortgage-backed securities issuer.

Historically, the secondary market had focused on prime borrowers: those with steady incomes, good credit histories and significant down payments. It has also offered a limited array of mortgage products—for instance, a fixed interest rate loan with a 30-year term. In the last ten years, residential lenders and secondary market investors have become comfortable extending credit to homeowners who do not have all of those prime characteristics, the so-called "subprime" borrowers.

That is the subprime market, a market not nearly as standardized as the prime market. Simultaneously, it has begun to offer a dizzyingly wide array of mortgage products. What is of note is that the prime market is starting to mimic some of the behaviors of the subprime market. Historically, Fannie Mae and Freddie Mac, knowing the value of their unique privileges, were protective of homebuyers, refusing to purchase loans that had predatory terms. This impacted the practice of many loan originators who wanted the option of selling their loans to Fannie and Freddie. But the new loan market, with its exotic mortgages and with its pressures to increase growth and profits, has greatly eroded this institutional consumer protection. Indeed, Fannie and Freddie, in order to increase market share and profits, are now purchasing more and more of these exotic products, giving them an unofficial seal of approval.

Now, lenders try to advertise the lowest possible introductory rate, planning to make their profit after the introductory period expires and through poorly disclosed points and fees. Let me give you two examples. The *Wall Street Journal* recently had an article about a lawsuit over an Option ARM with a 1.95% introductory interest rate.[3] The plaintiffs—the borrowers—understood the fixed period of the interest rate to be for 5 years because the disclosure statement said that the loan was a "5-year fixed" loan. The lender—a legitimate bank, I might add—said that the phrase "5-

year fixed" referred to the payment schedule, not the interest rate that was to be charged. The district court sided with the borrowers, holding that the Truth in Lending Act disclosures were unclear and confusing.[4]

A reporter at the *Wall Street Journal*, who is doing a story on predatory practices in the Secondary mortgage market, gave me my second example. It's my personal favorite from the brave new world of mortgage finance. He described a product being marketed by a national lender: It had a two-year teaser cap on payments combined with a three-year prepayment penalty period. This, of course, can create a perfect storm for a borrower. Once the artificially low payments of the 2-year teaser period end, the borrower might find it difficult to make her payments on the loan. But if she tries to refinance to a more appropriate product at that point, she will be forced to pay a prepayment penalty to avoid default, thereby ensuring that the lender wins one way or another. So it's clear that today's Secondary mortgage market has changed radically from the days when relatively benign lenders like Savings and Loans and the old-school Fannie and Freddie lent to homeowners on relatively simple terms. In the Wild West of today, even conservative Fannie and Freddie are starting to feel the pressure to participate heavily in the subprime and exotic mortgage markets.

There are three things about the modern residential Secondary mortgage market that I think are worth noting. First, there has been a dramatic move from local standards to national, and now international standards regarding real estate law and practice. Second, there has been another dramatic move from a safe environment for borrowers to a predatory environment for some borrowers. And finally, there has been a dramatic move from localized risk in the real estate market to the globalization of risk in the real estate market.

I'd like to spend some time on this last point. There are two relatively new and material risks that the securitization of residential mortgages has produced. First, a tidal wave of easy money, as seen with the explosion of subprime lending, is now turning into a tidal wave of bad loans in the hands of homeowners and investors. We have not yet seen how this will play out. Second, there has been a concentration of residential mortgage risk in a small number of hands, in particular, in Fannie Mae and Freddie Mac, the mortgage finance behemoths.

As to the first risk, we have all been reading articles about how that tidal wave of 3/1, 5/1 and 7/1 ARMS are about to reset at significantly higher interest rates over the next couple years. This is happening at just the same time that home prices are falling in many markets throughout the country. This is, of course, bad news for many homeowners who might be forced into short sales of their homes. But it will also be bad for investors who have purchased these mortgages as well as the loan originators who may be contractually required to buy back some of these loans from investors.

Let's move on to the second risk. The concentration of risk in Fannie Mae and Freddie Mac is more systemic and dangerous. Fannie's and Freddie's overall success in exploiting the benefits of their government charters has concentrated an extraordinary amount of risk in those two companies. This has been compounded by their successful fights to expand their market share by winning additional privileges from Congress and by moving into subprime and exotic mortgage markets. Despite—or, perhaps, because of this concentration of risk in the two companies—it is received wisdom on Wall Street that the federal government would bail out Fannie Mae and Freddie Mac if they could not pay their debts—even though they are for-profit, privately owned mortgage finance companies. This is because of their government charters and because of their public mission of encouraging homeownership. Fannie's slogan is, after all, "Our business is the American dream."

The seemingly remote possibility of a bailout of what had been seen to be two highly profitable companies has become more likely as wave after wave of accounting scandals involving the misstatement of earnings sweep over them. The risk that these scandals pose has been compounded by the fact that Fannie and Freddie's hedging strategies expose them to serious risks: if the interest payments that the two companies owe to their lenders become mismatched with the interest payments they receive from homeowners whose mortgages they own, the companies can become insolvent. While only a handful of policy wonks focus on this arcane issue, the cost to taxpayers of a bailout could be hundreds of billions of dollars, easily dwarfing the cost of the Savings and Loan crisis of the 1980s. Hundreds of billions of dollars: That figure should make you all sit up and take notice.

As the Fannie and Freddie scandals have lapped onto the shores of Capitol Hill, Congress has considered a variety of regulatory reforms that are all decidedly incremental and none of which would eliminate the implicit guarantee. Indeed, the current House bill (one that Treasury Secretary Paulson is supporting) would just minimally increase the regulatory oversight of the two companies. It would also make a small portion of their profits go into an affordable housing trust fund. And that's it in terms of actual reform.

At the same time that it imposes these modest burdens on Fannie and Freddie, the bill would actually increase the conforming loan limit in certain high-cost markets like New York and California—thereby allowing Fannie and Freddie to increase their market share. And most importantly, the House proposal does nothing to protect the taxpayer from picking up the bill if one of these entities were to become insolvent. It does not appear that Congress is willing to confront the serious risks posed by Fannie and Freddie.

Thus, I propose that the Federal Reserve should act independently to limit that exposure as much as possible until Congress is able to come up with a proportionate response to this brewing crisis. Alan Greenspan and Benjamin Bernanke, the past and current chair of the Federal Reserve Board, have both recognized this precise risk. So the good news is that the Federal Reserve, an independent agency, can start taking actions that would reduce the magnitude of the threat that these companies pose to the international financial system and the American taxpayer. (Yes, these companies are so large that the failure of either one would present a serious risk to the entire international financial system.)

The Federal Reserve Board grants Fannie and Freddie significant privileges that treat them as instrumentalities of the federal government. These special privileges reinforce the implied guarantee that has allowed Fannie and Freddie to issue such extraordinarily large amounts of securities and thus become such risky ventures for the entire financial system. The Federal Reserve should unilaterally stop granting such privileges to Fannie and Freddie.

This will work to reduce the amount of Fannie and Freddie securities that are outstanding by making them less attractive investments. It will also send a strong signal to investors that the federal government will not necessarily guarantee those securities. Such a course will have the short-term benefit of reducing the risk that such debt poses as well as the long-term benefit of putting pressure on Congress and Fannie and Freddie themselves to hammer out a solution that meaningfully protects the American taxpayer.

So let me now tie this back to my original point: the residential Secondary mortgage market is relevant to dirt lawyers. Well, I would make three claims: it is relevant to our clients; it is relevant in our practice; and it is relevant to us as citizens, in particular, as citizens with expertise in this area of the law.

The impact of the brave new world of residential mortgage finance and refinance on your clients is not news to real estate lawyers. But we should be prepared for greater and greater complexity in finance options for your clients, not just in the subprime but also in the prime market. Your counsel will be of greater and greater value as you help your clients navigate their options. As a New York judge in a recent mortgage fraud case recently noted, "Had claimants been represented by counsel, this litigation would probably not be before the court."[5] Here was a case involving what appeared to be a straightforward refinance with mainstream lenders and the court still found gouging on their part. That is the new world we operate in. We need to advise borrowers about the risks that they face not only when they finance their home purchases but also when they refinance. To do this, we need to educate them about the risks posed in this new world.

It is relevant to your practice in New York as we see that the state government has less and less of a say in how real estate transactions are handled here and finance corporations with a global reach set the agenda even more and more. Federal preemption of state laws is always on the horizon. Rating agencies set the agenda for mortgage finance companies, which in turn set the agenda for states. Luckily, we now have a governor who is very jealous of the prerogatives of the states—and should be open to thoughtful proposals that allow New Yorkers to both access the global financial system and protect themselves from rapacious lenders.

Academics have some role to play in this. We are slowly confronting the *idée fixe* that people are rational actors and finding that no, in fact, people are only somewhat rational actors—think of, perhaps, your father, your sister, yourself. Thus, we should draft statutes that protect New Yorkers in the rare but important real estate transactions that they engage in over the course of their lives. Protect them from the mortgage finance companies that have modeled human behavior so well in their automated underwriting systems that they know us better than we know ourselves—at least when it comes to mortgage payment behaviors. And these companies know that we don't always act rationally in this sphere.

Working from the insights of Nobel Prize winner Daniel Kahneman and others regarding the cognitive basis for common human errors—a field known as behavioral economics—academics now have a theoretical framework and vocabulary to discuss how and why people make bad decisions.[6] This research should, of course, inform efforts to implement appropriate consumer protection legislation that does not shut off cheap credit for New Yorkers.

Finally, the Secondary Mortgage Market is relevant to you as citizens in that we should have some say in how this all plays out. Do we, as citizens of New York state, want global finance corporations setting the important real estate finance standards for New York in an area of the law where New York has often thought it important to set its own consumer protection standards? Do we, as taxpayers, accept the irresponsible concentration of risk in Fannie Mae and Freddie Mac? We, as members of the real estate bar, have a responsibility to take leadership roles in these debates.

Endnotes

1. Fannie Mae, Monthly Summary, January 2007, at 1, *available at* http://www.fanniemae.com/ir/monthly/index.jhtml?s=Monthly+Summary (as of Dec. 31, 2006); Freddie Mac, Monthly Volume Summary, January 2007 at 1, *available at* http://www.freddiemac.com/investors/ (as of Dec. 31, 2006).
2. Federal Reserve Board, Federal Debt Subject to Statutory Limitation, *in* Statistical Supplement to the Federal Reserve Bulletin, February 2007 (as of Sept. 30, 2006).
3. Ruth Simon, *Ruling Faults Lender in Option ARM Suit*, WALL STREET J., Jan. 18, 2007, at D6.
4. *Andrews v. Chevy Chase Bank, FSB*, 240 F.R.D. 612, 2007 U.S. Dist. LEXIS 3162 (E.D. Wis. Jan. 16, 2007). The District Court subsequently stayed part of its order relating to the certification of a class pending the resolution of an interlocutory appeal. *Andrews v. Chevy Chase Bank, FSB*, 474 F. Supp. 2d 1006 (E.D. Wis. 2007).
5. *Bonior v. Citibank, N.A.*, 14 Misc. 3d 771, 828 N.Y.S.2d 765 (2006) (N.Y. City Civ. Ct. 2006).
6. *See, e.g.*, Daniel Kahneman, *Maps of Bounded Rationality: Psychology for Behavioral Economics*, 93 AMER. ECON. REV. 1449 (2003).

Bergman on Mortgage Foreclosures: When Property Is Lost for Taxes—No Salvation Here

By Bruce J. Bergman

Mortgage lenders and servicers know that they must follow with care the payment of real estate taxes on all mortgaged properties. If those taxes are in arrears long enough, the ultimate result (whether by tax lien sale and issuance of a deed or a tax lien foreclosure action) is that the borrower loses his title *and* the mortgage is extinguished. That is a draconian result and must be avoided.

While there can still be a suit on the note, it isn't so often that borrowers who have lost their property for taxes (and defaulted on the mortgage) have money or other exposed property upon which to execute.

What happens, though, when a wily borrower who lost the property for failure to pay taxes then goes out and buys the once-mortgaged property, either at the tax lien foreclosure sale or from the taxing authority that took the property back? Does that give the mortgage lender or servicer another shot at going after the property? The answer used to be yes; then it was no; then an exception said yes again, and while one more recent case agrees with the helpful exception, another one disagrees. A brief explanation follows.

There was from time immemorial in New York a venerable "doctrine of the delinquent purchaser" which held that a landowner who defaults in payment of real estate taxes, and later repurchases the land at a tax sale, does not get a title better than he previously had, because no man may take advantage of his own wrong. Equity would view as fraudulent the act of a party who acquired title through defaulting upon his obligations. Under this doctrine, a lender in this situation would be saved. The mortgage apparently cut off by the tax sale survives anew.

But in 1983, the tax law in New York changed in such a way that the courts altered their interpretation and concluded that property purchased at a tax sale must produce a final, completely unassailable title. That meant that a borrower who defaulted on taxes *could* buy his own property back at a tax sale free of the lender's mortgage which had been extinguished by that tax sale. [*Melahn v. Hearn*, 60 N.Y.2d 944, 471 N.Y.S.2d 47, 459 N.E. 156 (1983)]

Troubled by this, a 1994 case said that because a borrower warrants title to the property and the mortgage and also gives the lender a lien upon *after acquired* property, when that borrower buys its own property back at a tax sale, the mortgage reattaches to the property the moment it is back in the ownership of the borrower. So, although the mortgage had been extinguished by the tax lien sale, the borrower's repurchase resurrects the mortgage as a lien on the property. [*Salamanca Fed. Sav. & Loan Assn v. Darrow*, 162 Misc. 2d 729, 619 N.Y.S.2d 508 (1994)]

That was a lower court decision and although another lower court agreed [*Federal Home Loan Mort. Corporation v. Smallwood*, N.Y.L.J., Apr. 12, 2000, at 35 col. 4 (Sup. Ct., Orange Co., Owen, J.)], yet another disagreed with this otherwise heartening exception [*First Nat'l Bank of Downsville v. Atkin*, 183 Misc. 2d 425, 704 N.Y.S.2d 440 (Sup. Ct. 2000)]. The naysayer opines that a lender should not receive another "bite of the apple," especially when that lender (or servicer) has chosen to sit on its rights by failing to redeem the property when it had a right to do so. Equity should not require that a court strain to interpret terms of the mortgage in a manner contrary to reason merely to salvage for the lender rights that it has lost as a result of its own neglect or tactical decision.

In sum, there is no clear rescue if the property is lost for failure to pay taxes—and a clever borrower then buys that property. At best the law in New York is unsettled, so that there is certainly no assurance that a mortgage lender or servicer can find solace on this subject. The lesson which no mortgage lender or servicer should need, then, is: be vigilant about real estate taxes.

Mr. Bergman, author of the three-volume treatise *Bergman on New York Mortgage Foreclosures* (Matthew Bender & Co., Inc., rev. 2004), is a partner with Berkman, Henoch, Peterson & Peddy, P.C., Garden City, New York; an Adjunct Associate Professor of Real Estate with New York University's Real Estate Institute, where he teaches the mortgage foreclosure course; and a special lecturer on law at Hofstra Law School. He is also a member of the USFN and the American College of Real Estate Lawyers.

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