NYSBA WINTER 2004 | VOLUME 32 | NO. 1

# N.Y. Real Property Law Journal

A publication of the Real Property Law Section
of the New York State Bar Association

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THE *PULLMAN* DECISION

## A Message from the Section Chair

Regarding my column in the last issue, one of my colleagues told me that he had seen the photo printed with the column, but that he had only read the first few sentences of the text. PLEASE READ THIS:

Write to me or any Committee Chair (listed on pgs. 26-27 of this publication) regarding any specific or general issue you would like the Section to address. My e-mail is mjleeds@bryancave.com.

Quick notes on certain recent developments:

**1. Withholding by non-residents in real estate transactions—**New Section 663 of the Tax Law and the revised New York State transfer tax return (TP-584) were described on page 46 of the last issue. These laws and the regulations have been substantially changed from their original unworkable provisions which would have required pre-closing certifications from the taxing authorities as to tax due and payment of tax before a closing. (That is, the original provisions might have created problems of payment before funds would be available from the closing and before the parties would even have known for certain that a transaction would close and that tax, if any, would be payable.) Good news! These issues, and others, were handled by amendments to the original law with the understanding and cooperation of the taxing authorities (and the Legislature and the Governor), prompted in large part by excellent persuasive comments and efforts of members of the Bar, including Title and Transfer Committee Co-Chair Samuel O. Tilton, Computerization and Technology Chair Michael J. Berey and Publications Co-Chair Joseph D. DeSalvo.

**2. Property Condition Disclosure Act; Issues Relating to Same-Sex Couples; Representation of the Section in the full State Bar—**The Executive Committee regularly addresses recent and ongoing developments, including topics being considered by the Association's House of Delegates. Former Section Chairs Mel Mitzner (equity in marriage issues) and John J. Privitera (association governance) and Title and Transfer Co-Chair Karl Holtzschue (on PCDA) have taken the respective

## Inside



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leads on focusing the Section's thinking on these important matters and communicating with the full Bar Association.

**3. Membership and Communication—**The Section is forging ahead on this year's (and, it is hoped, future years') themes of Membership (numbers and diversity) and Communication (Section members should be getting as much information as possible).

- **Membership—**Membership Committee Co-Chairs Richard S. Fries and Karen DiNardo are pressing a program to make sure that practitioners are aware of benefits and potential benefits of the Section. Equally important, they are trying to determine what members want most from the Section. The effort is to get all kinds of lawyers from all kinds of backgrounds and perspectives to add to the resources of the Section by joining and, to the extent they want, working.
- **Communication—**The current plan is to post minutes of Committee meetings (including those of the Executive Committee), as well as the work product of Committee projects, on the State Bar Web site. In addition, the *N.Y. Real Property Law Journal* continues to receive a great deal of praise. Special appreciation to Publication Chairs William A. Colavito, Robert M. Zinman, Harry G. Meyer and Joseph D. DeSalvo. Particular thanks also to the less-visible assistance of the St. John's University Student Editorial Board, particularly Editor-in-Chief Jay Bryan Mower and Managing Editor Ross L. Schiller.

**4. Continuing Legal Education and Annual Meeting in January, 2004 and Summer Meeting in July, 2004. Dates to note:**

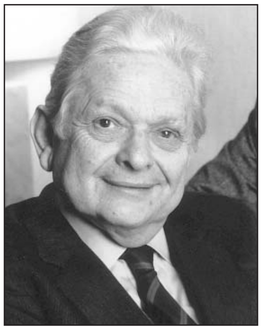
- Thursday, January 29, 2004: the full Real Property Section Meeting and CLE program in New York City from about 9:00 a.m.-12:00 noon in conjunction with the full State Bar Association Convention. The separate Section lunch program with speakers and awards will follow at about 12:00 noon.
- Thursday, July 15, 2004–Sunday, July 18, 2004: The Real Property Section Summer Meeting at The Equinox in Manchester, Vermont. More information to be circulated in early 2004.

Again, please contact a Committee Chair or an Executive Committee officer (including me, if you want) if you are interested in participating or would like to share any ideas or thoughts. The Section should be flexible and creative to do its membership, the Bar and the public some good.

Sandy, did you read down to here this time?

**Matthew J. Leeds**
**Bryan Cave LLP**
**New York City**

# *In Memoriam*
# *Bernard M. Rifkin*



Bernard M. Rifkin, Esq. passed away on September 9, 2003. He was 79 years of age, and will be sorely missed by many friends and colleagues in addition to his family.

"Bernie," as he was affectionately called by most of his friends, although he actually preferred "Bernard," was short in physical stature, but a giant in reputation as a real estate lawyer.

Born in Brooklyn on September 18, 1924, he was educated in its then-excellent public schools. He attended Brooklyn College, where he received his B.A. in 1945; Columbia University Law School, where he received his L.L.B. degree in 1948; and then New York University Law School, where he earned his L.L.M. degree in 1972.

He was best known for his work as a title lawyer, having served as Chief Counsel, first at Inter-County Title and Guaranty Company, later U.S. Life Title Insurance Company, and then at the Title Guarantee Company-New York, later Ticor Title Guarantee Company. After his nominal retirement, he continued working as Chief Counsel–Emeritus at Chicago Title Insurance Company/Ticor Title Guarantee Company until his untimely demise.

A listing of his activities with bar associations and other law-related organizations would make a very long list. Most notable was his work with the New York State Bar Association, Real Property Law Section, of which he was a past Chair, continuing to serve on its Executive Committee until his death. In 2002, he was awarded the Section's Real Property Professionalism award. In 1981, he was elected to membership in the American College of Real Estate Lawyers, a national organization of the most prominent real estate lawyers in the entire country.

Bernie was always ready and willing to share his knowledge and the benefit of his broad experience with others, and he chaired and lectured at countless educational programs over the years, mainly for Practising Law Institute, and the New York State Bar Association. He was also extremely active on behalf of the New York State Land Title Association, and participated in many of their educational activities. He was for many years an Adjunct Professor at New York University Law School, where he taught practical real estate law subjects to both undergraduate and graduate students.

He was an indefatigable worker and rarely, if ever, turned away from an opportunity to work on a project, whether it was the writing of law bulletins at Title Guarantee, the preparation of an article on a subject of interest, the writing of a chapter on real estate titles, or the daily review of the *New York Law Journal* for significant decisions that could be circulated among colleagues.

Bernie was also a religious man, who practiced his religion and was active in supporting religious activities and religious organizations. Related to that was his ardent support of Israel and Zionism—the creation of Jewish homeland. He was active in the Zionist Organization of America and was a past President of the Young Zionists of America.

Most important of all was that Bernie was a good person—honest, loyal and trustworthy. He had what could collegially be called "a good heart" and was loved by so many people, not only for his high degree of professional competence, but because of who he was. It is unfortunate that he never married, so he leaves no descendants; but he was an integral part of a sizable family with descendants of their own—who, we are confident, will continue to carry on with his good works.

Although Bernard M. Rifkin is no longer with us, the memory of the person and of his work will remain with those of us who were privileged to know him for as long as we are blessed with memory.

**James M. Pedowitz**

# Court of Appeals Holds Courts Powerless to Review Cooperative's Factual Findings

By Joel E. Miller

This article critically discusses the "*Pullman* rule" adopted earlier this year by a unanimous Court of Appeals in a case involving a housing cooperative's attempt to evict a tenant-shareholder who was considered an objectionable tenant by his fellow tenant-shareholders.[1]

In order to understand fully the importance of the *Pullman* rule, it must be viewed in context. The general subject is the power of a landlord to terminate a tenancy based on a lease provision authorizing such action if the tenant becomes or is considered by the landlord to have become objectionable. More specifically, the issue is what role the courts are to play in determining whether or not the tenant did or did not do the things that he is accused of doing, which things, we will assume, all would agree would render him objectionable. The discussion will proceed on the basis of three hypothetical cases.

## The "A" Case

Let us begin with a rather simple example. After Tenant Arthur moved into an apartment, someone began urinating in the halls. Although Arthur was not in fact the culprit, a person who had developed an intense dislike for him told several tenants that he was. The rumor, false as it was, nevertheless spread, and a number of tenants asked Landlord Alice to evict Arthur from the building. Alice reviewed Arthur's lease and found a clause saying that she could terminate his tenancy if he became "objectionable." She then sent him a notice referring to that provision and saying that his tenancy was over because he had been urinating in the halls. He refused to leave, and she brought a holdover proceeding against him.

Tenant Arthur defended—not on the ground that the alleged conduct would not render the perpetrator objectionable—but on the ground that he had not done it. Landlord Alice's position was that, although she could not prove that Arthur was the urinator, he had been so accused and she believed the charge. In view of the difficulty and cost of proving the fact, she said, her good-faith belief ought to be enough. Otherwise, she argued, the lease provision would be a dead letter.

Tenant Arthur, on the other hand, argued that he had agreed only that he could lose his home if he in fact became objectionable, which word implied an objective standard. To interpret the lease as leaving it entirely up to the landlord to decide would, he said, be unreasonable.

It seems clear that, in such a case, the court would require proof of the fact of objectionability, not merely proof that the landlord truly believed that the tenant was objectionable.

## The "B" Case

Let us next consider a case in which the facts are exactly the same, with one vital exception, namely that the lease from Landlord Betty to Tenant Benjamin provided that she could terminate his tenancy if she "in her sole discretion" determined that he had become "objectionable."

Leaving aside for the moment the effect of any applicable statute, it appears that Landlord Betty would win. It was long ago decided that such a provision would be given effect in accordance with its terms.[2] In other words, Landlord Betty would not have to prove that Tenant Benjamin was in fact the urinator. Indeed, inasmuch as he was not challenging her good faith, he would not even be allowed to show that he was not.[3]

## The Statute

"B"-case-type results did not sit well with the Legislature, and, as long ago as 1920, it enacted a statute seemingly precluding them in future cases.[4] The present version of the rule, which is found in N.Y. Real Property Actions and Proceedings Law section 711(1) (hereinafter "the must-prove-objectionability-in-court rule"), reads as follows:

> A proceeding seeking to recover possession of real property by reason of the termination of the term fixed in the lease pursuant to a provision contained therein giving the landlord the right to terminate the time fixed for occupancy under such agreement if he deem the tenant objectionable, shall not be maintainable unless the landlord shall by competent evidence establish to the satisfaction of the court that the tenant is objectionable.[5]

Clearer language can hardly be imagined. Under the statute, it would seem that a landlord such as Betty could succeed only if she could "establish to the satisfaction of the court that the tenant is objectionable." Moreover, decreed the Legislature, that had to be done by "competent evidence." In other words, in the case of a requested eviction based on such a provision, the court was instructed to require more than rumors and accusations (even if believed by the court to be true). What was needed was real proof of the kind that is admissible in a court of law, with the burden of proof being on the landlord, and the tenant having the right to cross-examine as well as to produce countervailing evidence of his own. Even more important, the issue was not to be the landlord's good-faith belief but whether the tenant was or was not in fact objectively objectionable.

## The "C" Case

Let us now consider a case exactly like the "B" case, except that the landlord is a housing cooperative. Inasmuch as the statute makes no exception based on the nature of the landlord—governmental agency, church, hospital, or whatever—one would have thought that fact to be irrelevant. Indeed, if pressed to find relevance, one would have had to conclude that that fact militated in favor of applicability of the must-prove-objectionability-in-court rule. After all, the termination of a proprietary tenancy can involve a forced sale of the ousted tenant-shareholder's apartment, which could of course subject him to an enormous financial loss. Also, petty jealousies and bitter intramural factional warfare are not unknown in cooperatives. As the Court of Appeals observed in a 1990 case, "[Cooperative] board decisions concerning what residents may or may not do with their living space may be highly charged and emotional."[6]

## The *Pullman* Rule

Nevertheless, the rule adopted by the Court of Appeals in *Pullman* has in effect exempted a cooperative landlord acting under a proprietary lease from the strictures of the must-prove-objectionability-in-court rule.[7] The words "in effect" are included in the preceding sentence because the Court did not say that the rule does not apply to cooperatives. On the contrary, the Court specifically held that the rule does apply even where the landlord is a cooperative acting under a proprietary lease,[8] but proceeded to render that holding meaningless by also holding that, unlike any other landlord, all that a cooperative landlord seeking to enforce such a lease provision need show is that it itself determined, in accordance with its own procedures, that the tenant-shareholder was objectionable. What about "establish to the satisfaction of the court" and "competent evidence"? The Court's answer was as follows:

> In the realm of cooperative governance and in the lease provision before us, the cooperative's determination as to the tenant's objectionable behavior stands as competent evidence necessary to sustain the cooperative's determination. If that were not so, the contract provision for termination of the lease—to which the [tenant-shareholder] agreed—would be meaningless.[9] ***
>
> [T]he relationships among shareholders in cooperatives are sufficiently distinct from traditional landlord-tenant relationships that the statute's 'competent evidence' standard is satisfied by the application of the business judgment rule.[10]

This writer must admit that he finds the Court's purported reconciliation wholly unconvincing. It is impossible to believe that the Legislature had such a meaning in mind when it used the words "competent evidence," let alone the statute's specific requirement that the objective fact of objectionability—not the view of one of the litigants—must be "establish[ed] to the satisfaction of the court."

Moreover, the second quoted sentence—in which the Court attempts to justify its holding on the ground that the tenant-shareholder agreed to the cooperative's power—clearly demonstrates the illogic of its position. The very purpose of the Legislature's must-prove-objectionability-in-court rule was to rescue tenants who had agreed to a landlord-can-decide-on-its-own lease provision. Also, superimposing the must-prove-objectionability-in-court rule on a landlord-can-decide-on-its-own lease provision does not entirely eliminate the effect of such a provision. All that it does is require a proper court showing by the landlord seeking to enforce it. On the other hand, if (unlike either the "A" case or the "B" case) the lease contained no objectionability provision at all, it is at best doubtful that a landlord would be able to terminate a lease based on a tenant's objectionability. Indeed, as the Court of Appeals itself noted in *Pullman*, "The cooperative does not contend that it has the power to terminate the lease absent the termination provision."[11]

Prior to a consideration of the scope and impact of the Pullman rule, it will be helpful to take at least a quick look at how the issue arose in the case that produced it.

## *Pullman* in the Trial Court

*Pullman* was an ejectment action in which the plaintiff cooperative was attempting to evict the defendant tenant-shareholder (Mr. Pullman), asserting that it had terminated his proprietary lease under a provision therein that allowed it to do so if, upon the affirmative vote of the holders of at least two-thirds of its outstanding stock, it "determine[d] . . . that because of objectionable conduct . . . , the tenancy of the Lessee is undesirable."[12] There was no doubt that a meeting had been held at which the cooperative's shareholders had adopted a resolution declaring Mr. Pullman's conduct "objectionable" and directing the board of directors to terminate his proprietary lease. As the Court of Appeals noted, "[t]he resolution contained the findings upon which the shareholders concluded that [Mr. Pullman's] behavior was inimical to cooperative living."[13]

The board did send a notice declaring Mr. Pullman's proprietary lease terminated, and, when he refused to vacate the premises, commenced the ejectment action. The cooperative's complaint included two distinct causes of action, each of which was based on the proprietary lease provision. In its first cause of action (hereinafter referred to as "the vote-based cause of action"), the cooperative contended that it had to show no more than that its shareholders had by a sufficient vote determined that Mr. Pullman had engaged in "objectionable conduct" that made his tenancy "undesirable," so that the court had no need to inquire into the truth or falsity of the charges against him. The cooperative's second cause of action (hereinafter referred to as "the actual-facts cause of action") was that Mr. Pullman had in fact engaged in "objectionable conduct" that made his tenancy "undesirable."

When Mr. Pullman moved to dismiss the complaint, the cooperative cross-moved for summary judgment on both causes of action. The Supreme Court dismissed the cooperative's vote-based cause of action as being inconsistent with RPAPL section 711(1), but it let stand the cooperative's actual-facts cause of action. However, after studying the affidavits that the parties had submitted in support of their respective versions of what had occurred, it refused to grant the cooperative summary judgment thereon, saying in part:

> Plaintiff's reiteration of its case against Pullman does not alter the fact that numerous disputes exist concerning the events upon which the Co-op based its finding of Pullman's alleged objectionability. These factual issues . . . must be tried.

## *Pullman* in the Appellate Division

The cooperative appealed those rulings, and, by a three-to-two vote, the Appellate Division held that the Court of Appeals' decision in the *Levandusky* case[14] made the cooperative's own determination conclusive. Accordingly, it not only reinstated the vote-based cause of action, but it also granted the cooperative summary judgment thereon.[15] According to the Appellate Division majority, the cooperative was not required to demonstrate in court that Mr. Pullman was objectionable, the stated ground being that "*Levandusky* . . . insulates the determination of this co-op board from judicial review."[16] Also, later in its opinion, the majority (somewhat confusingly, inasmuch as its previous discussion had been cast in terms of its asserted lack of power to second-guess a decision by a cooperative's *board of directors*) announced that it was "defer[ring] to the unanimous vote of assembled shareholders to terminate [Mr. Pullman's] tenancy, without passing on the merits of that decision."[17]

Justice Saxe wrote a vigorous dissent (concurred in by Justice Wallach) that included the following:

> In my view, the motion court properly held that the *Levandusky* rule is inapplicable in these circumstances, and that the co-op corporation has the obligation to demonstrate its entitlement to possession of the apartment by proving to the satisfaction of the court that the lessee had engaged in objectionable conduct. Moreover, based on an examination of this record, I would hold that material issues of fact exist, precluding the grant of summary judgment.
>
> I respectfully disagree with the position taken by the majority, namely, that application of the rule enunciated in *Levandusky* precludes the court from considering the evidence and determining independently whether the plaintiff co-op corporation has established the right to eject the proprietary lessee from his home on grounds of objectionable conduct. I suggest that the proprietary lessee, like any other tenant, is entitled to judicial scrutiny of the basis of the ejectment.[18]

## The *Levandusky* Case

At this point, it may be helpful to review what the Court of Appeals had decided in *Levandusky*, the case relied on by the Appellate Division majority. There, the core issue was whether or not a tenant-shareholder was obliged to obey a governance rule that had been adopted by the cooperative's board of directors in the exercise of their honest business judgment—namely that no tenant-shareholder was ever to relocate any steam riser within the corporation's building. As the court said:

> This appeal . . . fundamentally presents the legal question of what standard of review should apply when a board of directors of a cooperative corporation seeks to enforce a matter of building policy against a tenant-shareholder.[19]

Mr. Levandusky's position was that the courts should nullify any cooperative board policy not shown to be reasonable, and his contention was that the riser rule adopted by his cooperative's board was unreasonable in that it did not allow for any exceptions. He wanted to show that his particular pipe relocation would do no harm. The Court ruled against him, holding that the mere reasonableness or unreasonableness of his board's decision had no relevance. Rather than being examined for reasonableness, the Court decided, cooperative board decisions, such as the one under challenge, were to be tested under a standard similar to that embodied in the rule that the courts had developed to shield corporate directors from personal liability if a decision arrived at by them in the exercise of honest business judgment turned out badly for the corporation—the so-called business judgment rule. The following excerpts indicate the Court's approach:

> The proprietary lessees . . . consent to be governed, in certain respects, by the decisions of a board. Like a municipal government, such governing boards are responsible for running the day-to-day affairs of the cooperative and to that end, often have broad powers in areas that range from financial decisionmaking to promulgating regulations regarding pets and parking spaces. ***
>
> For present purposes, we need not, nor should we determine the entire range of the fiduciary obligations of a cooperative board, other than to note that the board owes its duty of loyalty to the cooperative—that is, it must act for the benefit of the residents collectively. So long as the board acts for the purposes of the cooperative, within the scope of its authority and in good faith, courts will not substitute their judgment for the board's. Stated somewhat differently, unless a resident challenging the board's action is able to demonstrate a breach of this duty, judicial review is not available.[20] ***
>
> The difference between the reasonableness test and the rule we adopt is twofold. First—unlike the business judgment rule, which places on an owner seeking review the burden to demonstrate a breach of the board's fiduciary duty—reasonableness review requires the board to demonstrate that its decision was reasonable. Second, . . . reasonableness review permits—indeed, in theory requires—the court itself to evaluate the merits or wisdom of the board's decision. ***
>
> Allowing an owner who is simply dissatisfied with particular board action a second opportunity to reopen the matter completely before a court, which—generally without knowing the property—may or may not agree with the reasonableness of the board's determination, threatens the stability of the common living arrangement.
>
> Moreover, the prospect that each board decision may be subjected to full judicial review hampers the effectiveness of the board's managing authority. The business judgment rule[21] protects the board's business decisions and managerial authority from indiscriminate attack. ***
>
> Under the rule we articulate today, we decline to review the merits of the board's determination that it was preferable to adhere to a uniform policy regarding the building's piping system.[22]

Notwithstanding that the *Levandusky* opinion contains certain broad statements that can be misunderstood if read out of context, it is clear that the Court's focus was on the traditional functions of a cooperative board—namely, "the board's business decisions and managerial authority" in "areas that range from financial decisionmaking to promulgating regulations." Inasmuch as a corporate board does not traditionally make binding factual findings—as, for example, that a particular tenant did nor did not have a television set on a given date—*Levandusky* cannot be fairly read as placing such determinations beyond judicial review.

## *Pullman* in the Court of Appeals

But that is exactly what *Pullman* seems to have done. The cooperative's own factual findings on which it based its conclusion that Mr. Pullman was objectionable—which the *Pullman* Court referred to as "a list of specific findings as to [Mr. Pullman's] objectionable behavior"[23]—were held to be beyond judicial review. The Court was quite clear on the point, stating that it "agree[d] with the Appellate Division majority that the business judgment rule applies"[24] and that "the business judgment standard governs a cooperative's decision to terminate a tenancy in accordance with the terms of the parties' agreement."[25] In the form of proprietary lease adopted by the cooperative and agreed to by all of its tenant-shareholders, the court pointed out, "the cooperative reserved to itself the authority to determine whether a member's conduct was objectionable and to terminate the tenancy on that basis."[26]

## Discussion

As a preliminary matter, it should be noted that in *Pullman* the Court of Appeals recognized that the rule that it was then adopting was not a necessary application of *Levandusky*:

> Although we applied the business judgment rule in *Levandusky*, we did not attempt to fix its boundaries, recognizing that this corporate concept may not necessarily comport with every situation encountered by a cooperative and its shareholders.[27]

It follows that the *Pullman* rule may be critically examined without challenging *Levandusky*.

As indicated above, this writer is troubled as a jurisprudential matter by the Court of Appeals' interpretation in *Pullman*—perhaps "modification" would be a better word—of the must-prove-objectionability-in-court rule enacted by the Legislature.

Leaving that aspect aside and focusing solely on the advisability of the rule that the Court chose to adopt, that too is open to question.

Whether arrived at by the board or by the shareholders,[28] it cannot be denied that a cooperative's factual findings are not tested by the safeguards that our law usually requires before someone can be deprived of valuable personal and property rights. As can be attested to by anyone who has attended sessions at which such matters are voted upon, reckless unsubstantiated (and often untrue) statements abound, even unspoken rumors become operative facts, and there is little or no genuine opportunity for questioning or effective rebuttal. Yet, under the *Pullman* rule, such determinations are as a practical matter conclusive and binding, beyond the power of any court to review. Unless the targeted tenant-shareholder can demonstrate bad faith—which he will only exceptionally be able to do—the truth is simply irrelevant once the cooperative has spoken.[29]

That is the most disturbing feature of the Court of Appeals' decision. Prior to its advent, a tenant-shareholder would have been justified in believing that he could lose his home only if he became objectively objectionable. Now, however, it appears that an unpopular tenant-shareholder can be ousted by the mere whim of his fellows, provided, of course, that (i) his proprietary lease contains a usual objectionability provision, (ii) the necessary recitals are included in the documents that the cooperative prepares and it does not otherwise falter procedurally, and (iii) the tenant-shareholder's enemies either do not have or are clever enough not to disclose some improper motivation. While one can wholeheartedly agree with the Court of Appeals that "the *Levandusky* standard should not serve as a rubber stamp for cooperative board actions, particularly those involving tenancy terminations,"[30] the overwhelming likelihood is that that is exactly what will happen. And the possibility that an entrenched board will use the *Pullman* rule to squelch incipient dissenting views should not be overlooked.

On the brighter side, it is possible that the law will change so as to leave an individual tenant-shareholder less at the mercy of the cooperative. Perhaps the Court of Appeals will in some future pronouncement tell us that it did not really mean what it seemed to say in *Pullman*.[31] Even more likely, the Legislature may react to the decision by enacting a "bill of rights" for tenant-shareholders. Meantime, though, every tenant-shareholder must be careful not to voice a minority (in the building) political opinion or to offend anyone friendly with those in power. To some, that may be the epitome of harmonious living, but this writer does not share that view.

## Endnotes

1. *40 West 67th St. Corp. v. Pullman*, 100 N.Y.2d 147, 760 N.Y.S.2d 745 (2003). *See also* Menachem J. Kastner and Jarred I. Kassenoff, *Cooperatives Authorized To Use Business Judgment Rule In Terminating Shareholder Leases*, N.Y. St. B.J., vol. 75, no. 6, at 32 (July/August 2003).
2. *Waitt Constr. Co. v. Loraine*, 109 Misc. 527, 179 N.Y.S. 167 (1st Dep't 1919); *Manhattan Life Ins. Co. v. Gosford*, 3 Misc. 509, 23 N.Y.S. 7 (Ct. Comm. Pleas of N.Y. City and County 1893).
3. Presumably, the lease would be read as requiring the landlord to have an honest belief in the tenant's objectionability. It would not be reasonable to construe the provision as giving the landlord an absolute right to terminate the tenancy any time that she wished.
4. Laws 1920, ch. 133.
5. RPAPL § 711(1).
6. *Levandusky v. One Fifth Ave. Apt. Corp.*, 75 N.Y.2d 530, 539, 554 N.Y.S.2d 807, 812 (1990).
7. *40 West 67th St. Corp. v. Pullman*, 100 N.Y.2d 147, 760 N.Y.S.2d 745 (2003).
8. Although that point has sometimes been misunderstood, there can be no legitimate doubt. Among other things, the Court stated in so many words that "RPAPL 711 (1) applies to the termination before us." *Id.*
9. 100 N.Y.2d at 154.
10. 100 N.Y.2d at 155. The business judgment rule is discussed at n. 21, below.
11. 100 N.Y.2d at 156.
12. Contrary to some published reports, the proprietary lease did not define "objectionable conduct" in great detail. All that the lease said on the subject was that "[r]epeatedly to violate or disregard the rules and regulations . . . , or to permit or tolerate a person of dissolute, loose or immoral character to enter or remain in the building or apartment, shall be deemed to be objectionable conduct." Virtually none of what Mr. Pullman was found by the shareholders to have done—e.g., "circulation to shareholders of written statements that are derogatory and defamatory of members of the board of directors of the Corporation"—was claimed by the cooperative to be in violation of its house rules, and the cooperative did not contend that Mr. Pullman had brought in a "person of dissolute, loose or immoral character."
13. 100 N.Y.2d at 153. It is interesting to note that those findings were not the same as the matters stated as facts in the Court of Appeals' opinion.
14. *Levandusky v. One Fifth Ave. Apt. Corp.*, 75 N.Y.2d 530, 554 N.Y.S.2d 807 (1990).
15. *40 West 67th St. v. Pullman*, 296 A.D.2d 120, 742 N.Y.S.2d 264 (1st Dep't 2002) (3–2), *aff'd* 100 N.Y.2d 147, 760 N.Y.S.2d 745 (2003). The cooperative's actual-facts cause of action was dismissed by the Appellate Division, evidently as being duplicative in view of its disposition of the cooperative's vote-based cause of action.
16. 296 A.D.2d at 124, 742 N.Y.S.2d at 267. At another point, the Appellate Division stated that "*Levandusky* explicitly precludes judicial inquiry into the lawful actions taken by a co-op Board of Directors." 296 A.D.2d at 124, 742 N.Y.S.2d at 267.
17. 296 A.D.2d at 128, 742 N.Y.S.2d at 270.
18. 296 A.D.2d at 131, 742 N.Y.S.2d at 272 (*Levandusky* citation omitted).
19. 75 N.Y.2d at 530, 554 N.Y.S.2d at 808.
20. Obviously, a cooperative board seeking to eject an objectionable tenant-shareholder is "act[ing] for the purposes of the cooperative" and "within the scope of its authority." Thus, if the stated rule applies in such a case, the cooperative's "bad faith" will be the only issue available to the defense.
21. Strictly speaking, the Court did not apply the business judgment rule itself. Although the distinction has unfortunately been blurred, the Court was, when it focused on the point, quite clear,

including the following in its opinion (emphasis added): "[A] standard for judicial review of the actions of a cooperative or condominium governing board must be sensitive to a variety of concerns—sometimes competing concerns. . . . We conclude that these goals are best served by a standard of review *that is analogous to the business judgment rule* . . . Application of *a similar doctrine* is appropriate. . . . We emphasize that reference to the business judgment rule *is for the purpose of analogy only*." 75 N.Y.2d at 536-40, 554 N.Y.S.2d at 810-13 (emphasis added). See also *40 West 67th St. Corp. v. Pullman*, 100 N.Y.2d at 153 (stating "*Levandusky* established a standard of review *analogous to* the business judgment rule.") (emphasis added).

22. 75 N.Y.2d at 536-40, 554 N.Y.S.2d at 810-13.

23. 100 N.Y.2d at 156.

24. *Id.* at 152.

25. *Id.* at 150.

26. *Id.* at 153. In view of the Court of Appeals' great emphasis—in both *Levandusky* and *Pullman*—on the notion that a cooperative is a special arrangement creating a sort of mini-government in which "a shareholder-tenant voluntarily agrees to submit to the authority of a cooperative board, and consequently the board 'may significantly restrict the bundle of rights a property owner normally enjoys'" (100 N.Y.2d at 157, quoting from 75 N.Y.2d at 536), the question naturally arises whether the Pullman rule is applicable where the lease that a cooperative is claiming that it terminated is a lease that is not a proprietary lease. Are a cooperative's tenants who are not voting members of the community also to be deprived of the benefits of the must-prove-objectionability-in-court rule? If so, will the outcome be the same even if the landlord became a cooperative only after the non-shareholder's lease was entered into?

27. 100 N.Y.2d at 154.

28. Some commentators have interpreted the *Pullman* rule as requiring action by the shareholders as a body (as opposed to the board of directors). However, even though the Court of Appeals did make various references to the shareholder vote that occurred in that case as well as to the fact that Mr. Pullman chose not to attend the meeting, a careful reading of the Court's opinion demonstrates that the Court does not regard a shareholder vote as an essential element in every case. Moreover, as poor a forum as a directors' meeting may be for making a factual determination based upon objective consideration of probative evidence, a meeting of shareholders—typically attended principally by personally interested shareholders holding proxies solicited from and unthinkingly given by the many shareholders who are too disinterested and/or intimidated to attend—is undoubtedly one of the world's least appropriate fora for such a purpose. Among other things, there is neither time for reflection nor opportunity for investigation, and the reluctance of a shareholder to rise in opposition to the strongly held view of a neighbor with whom he must co-exist on a daily basis cannot be overstated. Whether or not the *Pullman* shareholders' meeting was an exception, the Court of Appeals has created a rule that presumably will apply to all shareholder meetings, good and bad.

29. It must be emphasized that, under the *Pullman* rule, in an ouster case no court is ever allowed even to consider whether or not the target actually did what he was accused of, unless he is first able to prove that the decision was arrived at for an improper reason—as, for example, that the cooperative wished to remove a person that it had learned was a member of a certain ethnic group or to obtain his apartment for the personal use of one of the members of the board—a showing that will in most cases be utterly beyond the target's power to make. It also bears emphasis that, in the rare case in which the targeted tenant-shareholder is able to show bad faith, the remedy will be, not to examine the tainted decision for soundness, but to throw it out altogether and require the cooperative to start over. Thus, under the *Pullman* rule no court will ever review a cooperative's factual decision on the merits.

30. N.Y.2d at 157.

31. One indication that that might happen is the fact that the Court of Appeals took the trouble to state as proven facts all the terrible things that Mr. Pullman had been accused of doing, which suggests that the outcome might have been different if the Court of Appeals had harbored doubts about the soundness of the cooperative's factual findings. Another indication is the presence in the *Pullman* opinion of some statements that seem inconsistent with the Court's holding (i.e., that the cooperative's factual findings are beyond the power of any court to review). One such instance is the Court's statement that "in [the RPAPL § 711(1)] context, the competent evidence *that is the basis for the shareholder vote* will be reviewed under the business judgment rule." 100 N.Y.2d at 154 (emphasis added). Perhaps the Court will in a later case manage to take into consideration whether or not the alleged conduct did in fact occur and/or whether or not the average person would find it objectionable if it could not be shown not to have occurred.

**Joel E. Miller is a sole practitioner in Flushing, New York, concentrating in real estate, corporate and income tax matters. He is the chair of the Liens Subcommittee of the Condominiums and Cooperatives Committee of the Real Property Law Section. He is a former member of the faculty at St. John's University School of Law. A brief version of this article first appeared in the *New York Real Estate Law Reporter*.**

# The Business Judgment Rule and Fiduciary Obligations Are Applied to Shareholder Decisions in Cooperative Housing Corporations

By Vincent Di Lorenzo

## Introduction

In May 2003, the New York Court of Appeals handed down its decision in *40 West 67th Street Corporation v. Pullman*.[1] In *Pullman* the Court applied the business judgment rule[2] to the decisions of cooperative housing corporation shareholders. In doing so it also reaffirmed that judicial intervention is justified if a decision is not made in furtherance of corporate purposes or not made in good faith. This aspect of the decision recognizes a fiduciary duty owed by cooperative corporation shareholders to other shareholders. Shareholders are not free to vote their shares in disregard of these obligations without fear of judicial intervention. Commentary on the *Pullman* decision has focused on the first aspect of the Court's decision—the business judgment rule.[3] However, the second aspect of the Court's decision—recognition of fiduciary obligations—is equally important. Both parts of the decision are examined in this article.

## The *Pullman* Litigation

*Pullman* involved a housing cooperative containing 38 units. David Pullman purchased a unit in October 1998. Soon after Pullman moved in, he began making numerous requests to change the building's facilities or services. Each request was considered by the board and deemed inadvisable. Pullman also repeatedly complained and threatened to sue the managing agent and president of the cooperative for failure to abate an alleged noise problem in the unit above Pullman's unit. In October 1999 alone, Pullman sent at least 16 written complaints about the alleged noise problem to the managing agent. The board investigated Pullman's complaints but found them to be unsubstantiated. In 2000, Pullman instituted four lawsuits against his upstairs neighbors, who had been unit owners for more than 20 years, the co-op and its managing agent. Tension between Pullman and his upstairs neighbors continued to build and Pullman was apparently assaulted by one of the neighbors in an elevator. This resulted in criminal charges, which were ultimately adjourned in contemplation of dismissal, and the circulation of leaflets by Pullman to other unit owners. The leaflets stated that Pullman's neighbor was a psychopath and should be evicted, and also called for ouster of the president of the cooperative. Pullman also made alterations to his unit without board approval, had construction work performed on the weekend in violation of house rules, and would not respond to board requests to correct these conditions.

The proprietary lease to each unit in the cooperative provided that a unit owner's lease may be terminated on 30-days' notice if the lessee was found to be undesirable due to "objectionable" conduct. Vote of at least two-thirds of the shareholders was required. On June 27, 2000, the shareholders held a special meeting to determine if Pullman's tenancy was "objectionable" and should be terminated. Pullman was notified of the meeting but did not attend. After discussion, the shareholders voted to terminate Pullman's proprietary lease. The vote was 2,048 shares in favor of termination, 0 shares opposed, and 542 shares not present and voting. Thereafter a notice of termination was delivered to Pullman, who ignored it. The cooperative corporation then brought an action seeking, among other things, possession of Pullman's unit. The trial court dismissed the first claim of the complaint seeking ejectment and possession based solely on the shareholders' vote. The trial court ruled that RPAPL section 711(1) required the plaintiff to prove objectionable conduct by competent evidence to the satisfaction of the court. The Appellate Division modified the lower court's order, on the law, to grant plaintiff summary judgment on its first claim.[4] On appeal, the Court of Appeals affirmed.

## Judicial Deference and *Pullman*

The controversy surrounding the *Pullman* decision is not a product of the Court's decision to invoke the business judgment rule as a general approach to shareholder decisions. Deference to shareholder determinations is not a controversial position *per se*. The controversy is the result of the context in which that approach was taken, namely a decision to terminate a unit owner's lease, cancel his shares, and evict him from his unit. The terms of RPAPL section 711(1) made the decision even more controversial since the statute suggests that the court should independently determine if the tenant is engaged in objectionable conduct. The Court of Appeals reconciled its embrace of the business judgment rule with the terms of the statute by ruling that "courts will normally defer to [the shareholder] vote and the shareholders' stated findings as competent evidence that the tenant is indeed objectionable under the statute."[5] The Court was convinced that relationships among shareholders in cooperatives are sufficiently distinct from traditional landlord-tenant relationships that the deference provided by the business judgment rule satisfied the statute's requirements.

This brings us back to the *Levandusky* decision which examined the special relationship among shareholders in a cooperative. The Court in

*Levandusky* noted that inherent in cooperative unit ownership is a voluntary choice to cede certain privileges of single ownership to a governing body. Possible abuses on the part of the governing body are addressed through judicial intervention when acts are not in furtherance of a corporate purpose or are not made in good faith.[6] In *Levandusky* the Court also noted that courts are ill-equipped to evaluate decisions that are essentially judgments based on experience.[7]

Even in the context presented by the *Pullman* litigation, i.e., possible eviction from one's unit, these justifications seem persuasive. Cooperative unit ownership involves shared rights and obligations. It is a voluntary undertaking in a common venture. It is not a venture in which each participant has veto power. Moreover, it would be difficult for any court to determine how objectionable David Pullman's conduct was to other unit owners in the cooperative. In a cooperative setting this is not purely an objective decision—i.e., whether most landlords would find the conduct objectionable. The nature of a cooperative makes this, in part, a subjective standard—i.e., whether the other unit owners in this development find the conduct so objectionable as to warrant the extreme sanction of eviction. A court is indeed ill-equipped to second guess this type of shareholder determination.

## Fiduciary Duty and *Pullman*

While embracing the business judgment rule, the *Pullman* decision has another aspect to it that is significant. The Court noted that judicial intervention would be justified when the decision maker "acted (1) outside the scope of its authority, (2) in a way that did not legitimately further the corporate purpose or (3) in bad faith."[8] The latter two bases for intervention confirm a fiduciary duty on the part of shareholders to other shareholders. Shareholders are not free to make decisions for personal reasons unrelated to a corporate purpose or in an arbitrary manner.

This ruling appears to be at odds with a prevailing view that shareholders do not have fiduciary obligations to other shareholders unless they are majority or controlling shareholders.[9] It is true that the Court of Appeals has recognized fiduciary obligations on the part of majority or controlling shareholders to minority shareholders.[10] This duty has occasionally been applied to shareholder decisions in a cooperative.[11] The rationale for the recognition of duty is not, however, merely the power that results from majority ownership. Rather, fiduciary obligations are deemed to arise when the power to manage the affairs of the corporation is in the hands of a particular decision maker, whether the board or a majority shareholder.[12] Management power creates fiduciary obligations.

Fiduciary duties have also been recognized in shareholders of closely held corporations.[13] Once again, this duty arises when the shareholders are managing the affairs of the corporation. The earlier reported cases in the corporate area involve corporations with a handful of shareholders.[14] *Pullman* involved a corporation with 38 units and at least as many shareholders. Yet the size of the corporation is not determinative, just as the power to control decisions due to majority ownership is not determinative. The existence of management decision-making power is key.

## Conclusion

The *Pullman* case is the latest example of a line of decisions in which the New York courts have deferred to the actions of unit owners in a cooperative. Despite some protest that the decision does not adequately protect a unit owner faced with eviction, it can be viewed as a reasonable accommodation of the interests of all parties involved. The Court recognized that cooperative unit owners as a group have rights just as individual unit owners have rights. The Court also reaffirmed that there are limits to judicial expertise especially when the required determinations are, in part, necessarily subjective because they are based on the existence of an environment acceptable to members of an individual community.

## Endnotes

1. 100 N.Y.2d 147 (2003).
2. The Court had earlier applied the rule to decisions of Cooperative Housing Corporation boards. *Levandusky v. One Fifth Avenue Corp.*, 75 N.Y.2d 530 (1990).
3. John Caher, *Co-op Boards Given Broad Power To Evict*, N.Y.L.J., May 14, 2003, at 1; Peter S. Herman, *No Judicial Review for Co-op's Eviction of 'Objectionable' Tenant*, N.Y.L.J., June 7, 2002 at 4 (discussing the appellate division case); Jay Romano, *Court Ruling Broadens Co-op Power*, N.Y. Times, May 25, 2003, sect. 11 at 7.
4. 296 A.D.2d 120, 742 N.Y.S.2d 264 (1st Dep't 2002).
5. *Pullman*, 100 N.Y.2d at 155.
6. *Levandusky*, 75 N.Y.2d at 536-37.
7. *Id.* at 539. The Court also noted that greater scrutiny would threaten the stability of the common living arrangement and hamper the effectiveness of the decision maker's managing authority. *Id.* at 540-41.
8. *Pullman*, 100 N.Y.2d at 155.
9. 14A N.Y. Jur. 2d *Business Relationships* §§ 828, 840-41 (2003).
10. *Alpert v. 28 Williams St. Corp.*, 63 N.Y.2d 557, 483 N.Y.S.2d 667 (1984) (involving two couples that owned two-thirds of the shares of the corporation).
11. *Barbour v. Knecht*, 296 A.D.2d 218, 743 N.Y.S.2d 483 (1st Dep't 2002). *See also Sherry Assocs v. The Sherry-Netherland*, 273 A.D.2d 14, 708 N.Y.S.2d 105 (1st Dep't 2000) (resident shareholders as a group owe fiduciary duty to owners of transient units for investment purposes, who are a minority overall).
12. *Alpert*, 63 N.Y.2d at 568.
13. *Kavanaugh v. Kavanaugh Knitting Co.*, 226 N.Y. 185, 195 (1919).
14. *E.g., Kavanaugh, id.* (three shareholders); *Benson* v. *RMJ Securities Corp.*, 683 F. Supp. 359, 374-75 (S.D.N.Y. 1988) (five shareholders).

**Vincent Di Lorenzo is Professor of Law at St. John's University and author of *New York Condominium and Cooperative Law* (West).** **The research assistance of Mr. Daniel Leventhal of St John's University School of Law is gratefully acknowledged.**

# Representing a Purchaser in an REO (“Real Estate Owned”) Transaction

By Steven J. Baum

“REO” stands for Real Estate Owned, a term frequently used in the trade to describe real property taken back by a plaintiff at a foreclosure sale, and then resold in the open market. It is also called an “ORE,” for Owned Real Estate. Do not confuse either of these with an OREO. This is the chocolate cookie that you eat the frosting out of first. The latter has nothing to do with this article, although it would be nice to have a few while reading this *Journal*.

The REO transaction is more commonplace these days. With foreclosures at a record high, and many of the properties bid in by the foreclosing plaintiff, REO properties in all areas of the state are available. This article will explore some nuances when representing a buyer of this type of property, with an emphasis on title and closing requirements.

## I. Background

After a home is sold at foreclosure, and the successful bidder is the plaintiff, a referee’s deed is executed and submitted for recording. The entity taking title might be the plaintiff or an assignee. An eviction is commenced if the property is occupied. Once vacant, the property is “trashed out” or cleaned and made ready for sale.

HUD, FannieMae and FreddieMac sell thousands of REO properties each year. Also, many other banks, mortgage servicers and institutional investors sell these types of property. Real estate brokers are assigned to market the homes through conventional channels such as the multiple listing system, Internet and newspaper advertising. Realtors often perform additional functions such as regular property inspections, overseeing needed repairs, and general maintenance (grass cutting, snow plowing).

In some instances the contract of sale for the REO transaction deviates from the “normal” arm’s length deal most real estate attorneys are accustomed to in their community.

*“With foreclosures at a record high, and many of the properties bid in by the foreclosing plaintiff, REO properties in all areas of the state are available.”*

## II. The Contract

An REO contract of sale falls into two categories: (i) a local contract with seller-designated riders or (ii) a seller-drafted and mandated contract.

### A. Local Contract with Riders

Counsel for the purchaser should not be lulled into believing that any portion of the local contract they are used to seeing will have any teeth left after reviewing the riders. Thus, the first piece of advice is obvious, but often overlooked: READ THE RIDERS CAREFULLY.

Almost every rider contains a clause stating its terms supersede any conflicting clause in the “main” contract. The riders place additional burdens and requirements on the purchaser that are usually not mentioned in a conventional contract. What to watch out for will be discussed below. Careful attention to the wording of the riders will allow counsel to adequately advise their client.

### B. Seller-Drafted REO Contract

Many REO sellers prefer to have one or more form contracts for each state. They don’t like to get involved with local custom, or be responsible for reading the small print in local contracts that may carry large seller liability if not caught. Also, there is some concern that a local judge will find a way to disregard a rider’s language in favor of the regular main text. Buyer’s counsel may be completely unfamiliar with the contract. It is usually drafted in favor of the seller (and for good reason) and contains none of the usual seller covenants and promises a standard local contract supplies.

## III. Review of Critical Provisions of the REO Contract

The concept is simple: what is being sold was never lived in by the seller. Nor was it an investment property the seller maintained and was familiar with. Faced with the unknown, the REO seller wants to promise nothing, be responsible for very little, and not be held accountable for the acts of prior owners.

Some common clauses a buyer’s counsel should note carefully:

A. **“As is” provision.** The REO contract sells the premises to the buyer without any representations. There will be no warranties concerning property zoning, additions, alterations, toxic or hazardous substances, mold, or other material deficiencies. However, almost all contracts will allow the purchaser to inspect the property to determine to what extent they will accept the property in its present condition. It is critical that you advise your purchaser client to have a careful inspection of all aspects of the property. There is rarely a post-sale cause of action a purchaser in an REO transaction can bring against the seller. Once title transfers, all representations merge with the deed. The key is to advise your client to do their homework ahead of time. The timing of the inspection and the opportunity to accept or reject is strictly adhered to. Missing a date may waive your client's rights and force them to proceed with the purchase, or forfeit any deposit, or more.

B. **Title documents.** Unlike the seller in a conventional sale, the REO seller usually will not provide a survey or an abstract of title. Counsel for a purchaser must determine if it is in their client's best interests to have one prepared. If the buyer is obtaining institutional financing, the lender may require an updated survey. Both the cost and timing of the survey should be addressed with the purchaser. Obtaining prior title documents such as a copy of an existing survey may be difficult. Often, the attorney representing the seller is not the same counsel who conducted the mortgage foreclosure. Files may be closed, stored, archived or simply misplaced, making it time consuming or impossible for seller's counsel to retrieve old title policies and searches.

C. **Status of Title**. To say title coming out of a foreclosure is anywhere near marketable is like saying politicians routinely fulfill campaign promises. It just doesn't happen. Most well-drafted REO contracts or riders contain a provision for selling property whose title is insurable. Insurable title is essentially what a seller's title insurance company is willing to approve. Most sellers have recognized that allowing a purchaser's attorney or their designee to examine title is a death knell to closing. Where a seller offers to pay for, and issue an owner's policy for the sales price, buyer's counsel should leap at the opportunity. Here's why:

   i. The preliminary commitment may already be prepared by seller's counsel in anticipation of closing.

   ii. Seller's counsel is used to dealing with the numerous title issues that arise in a foreclosure context. They transact business with those title companies who understand the processes and risks. These title companies often allow special risks to be undertaken and omitted from policies where they are familiar with and have a "comfort level" with the lawyer who handled the foreclosure. Not every title company is comfortable with title arising out of a foreclosure. I have seen many preliminary policies raising objections that simply should not be broached, e.g., discharging the mortgage that was foreclosed, and in my opinion, it is in the best interests of the purchaser to accept the seller's offer to issue a title policy at their expense.

   iii. If the seller's counsel is also the foreclosure counsel, title curatives may already be in the file and do not have to be produced or explained to an outside title company.

In my experience, the major cause of delays occurs when title is examined by inexperienced or ultraconservative title companies, who raise a myriad of issues. Most of these issues force seller's counsel to jump through a series of proverbial hoops to cure what would otherwise be insurable title to those who are aware of the risk of foreclosed title. Forcing seller's counsel to attempt to discharge 30-year-old mortgages; requiring prior grantors to reconvey to correct minor legal description errors; and obtaining releases from judgment creditors for judgments that clearly are not against the former owner are some the problems which arise when seller's counsel is not allowed to furnish a fee policy. All of these issues are insurable without delay by sophisticated seller's counsel who maintain strong relationships with proactive title companies.

Should the buyer's attorney still want to examine title, careful attention must be paid to the cutoff date for notifying the seller of any objections. Faxing the title report the day before closing with 15 objections probably waives the buyer's rights to contest title, if the contract required seven business days' notice of the same.

D. **Deed**. A bargain and sale deed is regularly used to convey title. A warranty deed is rarely given as no seller wishes to warrant title based on the short period of time their interest was of record.

E. **Closing.** Purchaser's counsel should pay careful attention to the date of closing. It is often made time of the essence as to the purchaser. Furthermore, there may be per day penalties, sometimes as much as $100/day, or more, for the buyer not closing on time. Extensions may be granted, but often at the sole discretion of the seller.

F. **Deed Transfer and Recording Taxes.** These fees, substantial in all areas of the state, may be the responsibility of the purchaser to pay. Recognizing the effects of this provision will prevent embarrassment at the closing table.

G. **Seller's Default.** REO contracts commonly provide that the only remedy a purchaser has for a seller's breach, willful or not, is a return of the deposit. And for good reason: the seller can never be certain that an order to show cause may be brought post-foreclosure and pre-REO closing. The seller must protect itself in case a court overturns the foreclosure sale.

H. **Closing Funds.** Any REO contract requires certified closing funds, including those coming from an institutional lender and money from the buyer. Attorney's trust account checks still must clear through the banking system, and thus are of no use to a seller who wants immediate use of the funds. A buyer's attorney must ensure that all funds are in the proper form so the transaction can close in accordance with the terms of the contract.

## IV. Conclusion

Representing a buyer of an REO property requires a clear understanding of the contract, and any applicable riders. Buyers must be advised of contract provisions regarding condition of the property, the right to inspect, title documentation and closing costs to name just a few. Dates in the contract for completion of inspections, as well as closing dates are strictly adhered to, and may expose the purchaser to monetary penalties if not timely met. Counsel should look to the seller to provide insurable title, preferably in the form of an owner's title policy paid for by the seller. The closing will run smoothly if funds are in the required form (certified, cashier's check) as specified in the REO contract.

**Steven J. Baum represents FreddieMac, FannieMae and many other lenders and mortgage servicers for REO closings. He is the Eighth Judicial District Representative to the Real Property Law Section's Executive Committee. Mr. Baum is based in Buffalo, New York and has a statewide REO practice.**

# Local Law 47 and its Applicability to Absentee Landlords

By Michael Miglino

Pursuant to the enactment of Local Law 47 (of the Laws of 2003), the City of New York will impose a 25 percent surcharge on real property taxes assessed against absentee landlords who own Class 1 properties within the city's five counties.

The surcharge affects only Class 1 property in the City of New York, which includes one-, two-, or three-family houses (including condominium units) and some mixed-use properties, that are not owner-occupied and that generate rental income for the owner.

There are several exclusions from the imposition of the surcharge, but a property owner must apply to the New York City Department of Finance (DOF) in order to be excluded from this additional tax charge. A property owner can be excluded from the surcharge for any of the following reasons:

a. the property is the primary residence of the owner, or

b. the property is occupied by the parents of the owner, or

c. the property is occupied by the children of the owner, or

d. the property is vacant or unoccupied, or

e. the property is occupied by someone other than the child or parent of the owner, but no rental income is derived from the property.

The application for exclusion from the surcharge can be found on the DOF's Web site at www.nyc.gov/finance. The completion of the application is not a precondition to the recording of a deed in the City of New York, and there is no requirement that it be completed by any parties at a real estate closing. As mentioned earlier, however, a party who can claim an exclusion must make application to the DOF in order to avoid the surcharge.

The statute is effective for the tax year commencing July 1, 2003. Entry of the surcharge may begin to appear on tax bills of affected properties prior to the end of this year. Notwithstanding its enactment into law, Local Law 47 has become a controversial issue. New York City Mayor Michael Bloomberg, although including the revenue to be derived from the new statute in his budget, has been reported as saying that the tax may be too costly to administer and may be impossible to collect fairly. Consequently, he may propose legislation to abolish the surcharge.

**Michael Miglino is Regional Counsel for Chicago Title Insurance Company.**

# New York's Navigation Law Gets CERCLA'd: Trend or Misstep?

By Angela M. Demerle

## Introduction

Article 12 of New York's Navigation Law (the "Oil Spill Law")[1] was enacted in 1977 to address liability and cleanup for oil spills on land and water in New York State. The Oil Spill Law bears similarity to subsequently enacted federal and state "Superfund" statutes by imposing strict liability on certain categories of responsible parties, providing for cleanup financed by a government fund, and authorizing private parties to sue for cost recovery.

The federal Superfund statute, the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)[2] explicitly imposes strict liability on the current owners of property on which a release has occurred. The owner's control over disposal activities is irrelevant.

Liability of the current landowner under the Oil Spill Law, the New York Court of Appeals recently decided in *State v. Green*,[3] should not be based on mere ownership alone. Rather, the determining factor is whether the landowner had knowledge of and control over activities related to petroleum on its property. In the same breath, however, *Green* set such a narrow definition of a current landowner who may *not* have control over such activities as to obviate its original premise. In other words, while mere "status" as current landowner is not enough to declare an owner of contaminated land liable under New York's Oil Spill Law, it is hard to envision very many circumstances where mere ownership wouldn't suffice.

The question explored in this article is whether the Court of Appeals has, for all practical purposes, decided that a current landowner is by definition a "discharger" under the Oil Spill Law and thus subject to strict liability for cleanup costs on the property no matter by whom it was contaminated. This discussion can only guess at the answer. The only true indication of the Court's direction lies in future litigation involving a genuinely innocent landowner who has the backbone (and litigation fund) to insist he is not a discharger by virtue of mere title ownership alone. But beware—even the most innocent of landowners may not escape the oft-used premise raised time and again in environmental litigation that the Oil Spill Law is remedial in nature, with a statutory purpose to clean up the environment, and if the landowner doesn't clean up the mess, who will? Most courts, in the end, seem to agree.

## The Landowner's Liability Under CERCLA

CERCLA was enacted in 1980 to provide for the cleanup of inactive hazardous waste disposal sites. CERCLA includes in its definition of those who may be held liable for cleanup costs, commonly referred to as potentially responsible parties (PRPs), current owners and operators of the facility.[4] While CERCLA does not specify that it is a "strict liability" statute, a PRP will be held liable, without fault, if its waste is found on site.[5]

Escape from CERCLA's strict liability scheme is extremely limited; only acts of God, war, and releases caused by the acts and omissions of third parties will suffice.[6]

The third defense, commonly referred to as the "third party" or "innocent landowner" defense, excludes from liability under CERCLA landowners who acquire the contaminated property without having reason to know that hazardous substances had been disposed there. These defendants must prove in conjunction with this defense that they undertook all appropriate inquiry into the previous ownership consistent with good commercial practice,[7] a task easier said than done.[8]

To summarize, CERCLA imposes liability on the current owner of a contaminated facility regardless of fault. The landowner is exempted from such liability only by acts of God, war, or by qualifying as an "innocent owner." Accordingly, "status" is the significant determining factor when examining the current landowner's liability under CERCLA. Control over the activities that caused the contamination in the first instance is irrelevant.

## The Landowner's Liability Under New York's Oil Spill Law

The Oil Spill Law was enacted to prevent the unregulated discharge of petroleum which may result in damage to the environment and to effect the prompt cleanup and removal of discharges by providing for liability for damage sustained within the state as a result of such discharges.[9]

The Act provides for strict liability, without regard to fault, for any person who discharges petroleum into the waters of the state or onto lands "from which it might flow into said waters."[10] These responsible parties (RPs) are liable for all cleanup and removal costs and all direct and indirect damage.[11] A discharge is any "intentional or unintentional leaking, pumping, pouring, emitting, emptying or dumping of petroleum into the waters of the state or onto the lands from which it might flow into said waters."[12] Section 181(5) of the Act allows for private causes of action to be brought directly against the discharger by any "injured person" for the costs of cleanup and removal and direct and indirect damages.[13]

Defenses under the Oil Spill Law are even more limited than CERCLA and include only acts or omissions "caused by war, sabotage, or government negligence."[14] Cleanup should be consistent with the National Contingency Plan (NCP).[15]

CERCLA explicitly provides that a current owner of property on which a release has occurred is liable; the Oil Spill Law does not. Thus, New York courts have, over the years, issued a number of opinions on the matter, culminating in 2001 with the case of *State v. Green*.[16]

## Unity of Ownership: Property and Tanks

A landowner generally owns both the property and the tanks and/or equipment from which a discharge has occurred. In such a case, liability is clear. But is the landowner a "discharger" under the Oil Spill Law, if, for example, the landowner does not own the tanks or has leased the premises to a tenant whose operations resulted in a discharge?

The first significant case to explore the issue of fragmented ownership/operations was *State v. Wisser Co.*[17] *Wisser* held that a property owner whose only association with the discharge on the property was that its tenant operated leaking underground storage tanks on the property was strictly liable under the Oil Spill Law. The court's opinion was premised on the property owner's mere ownership of the system from which a discharge occurred. "[Navigation Law §181(1)] has been construed to impose liability on, among others, the owner of a system from which a discharge occurred. . . ."[18] The *Wisser* court relied on *State v. New York Cent. Mut. Fire Ins. Co.*,[19] where the Third Department held that a homeowner whose residential heating oil tank discharged into the environment was strictly liable under the Oil Spill Law by virtue of ownership and control of the heating system from which the fuel oil leaked.

Subsequent Third Department opinions grappled with the same issue in different contexts.[20] For example, in *310 South Broadway Corp. v. McCall*,[21] the landlord of a gas station applied to the New York State Department of Environmental Conservation's Oil Spill Compensation Fund for damage to property and loss of income caused by its tenant's operation of gas stations. The Fund denied the application concluding the owners of the real property were also the owners of the tanks and thus were strictly liable under the Oil Spill Law and ineligible for compensation from the Fund.

In *State v. Speonk Fuel*,[22] the purchaser of petroleum-contaminated property was presumed liable under the Oil Spill Law as the owner of a system from which a discharge had occurred. The court held that even though the offending tanks, pipes and fixtures were removed prior to purchase, there was no evidence the system was not included in the purchase. The *Speonk* court noted that in most cases the property owner and system owner are one and the same.[23] But, according to *Speonk*, when there is no such unity of ownership, liability without regard to fault is properly imposed on the system owner and not on the faultless property owner. *Speonk* referenced for support of its holding an opinion the Third Department decided the same day, *State v. Green*.[24]

In *Green*, the property owner, Lakeside, leased a mobile home site to Vanessa Green, who used an above-ground oil tank that she owned and maintained to heat her home. The tank collapsed, a spill occurred, the state cleaned it up and sued Green, Lakeside, and the company that had supplied the oil and serviced the tank. Lakeside, the owner of the mobile home park, but *not* the system from which the discharge occurred, convinced the Third Department that it was not a discharger because it did not own, maintain or install the tank. In other words, its mere status as owner was not enough to deem it a discharger.

Prior to *Speonk* and *Green*, other New York courts weighed in on the matter with similar results. For example, the Fourth Department decided in *Drouin v. Ridge Lumber*,[25] that plaintiff landowners could recover under the Oil Spill Law from their long-term tenant on the property. The tenant was found to be the exclusive owner of the tanks and the court refused to hold plaintiffs liable as "dischargers" under the Oil Spill Law merely by virtue of their status as landowners. Another example is *Popolizio v. City of Schenectady*[26] where the Third Department refused to impose liability on a defendant based solely on his status as a former owner of the property; the court wanted to see proof that the former owner actually caused or contributed to the discharge. Finally, in the same year the Third Department decided *State v. Green*, the Federal District Court, Southern District of New York, held in *Bologna v. Kerr-McGee Corporation*[27] that it could not rule without further fact finding that a former landowner who had no involvement in the delivery of petroleum to a property was liable under the Oil Spill Law.

Thus, until the appeal of *Green* to the Court of Appeals there was a comforting symmetry to the various opinions addressing a landowner's liability under the Oil Spill Law. Courts refused to be "CERCLA'd," understanding that the Oil Spill Law pre-dates and cannot be presumed to operate like CERCLA. The Oil Spill Law does *not* contain language stating that a current owner of contaminated property is by definition a "discharger," liable under the Oil Spill Law. This understanding is not hard to come by: the definition of "discharger" under the Oil Spill Law, that is, the "status" that makes one liable under the statute, requires more than mere title to the contaminated property; rather it takes an "act or omission" that causes a discharge to occur.[28]

Nor is it difficult to identify an "act or omission" of an *owner of a system* which could result in a discharge. Examples are lack of maintenance, failure to close the tanks or the abandonment of tanks knowing that they would surely deteriorate over time, *et cetera*. The "act or omission" of a mere property owner with no ownership interest in the tanks is much harder to envision.

But we must again return to the premise that the Superfund statutes and the Oil Spill Law are remedial statutes and are subject to liberal interpretation by the courts to fulfill the purpose for which they were intended.[29] Indeed, a close reading of *Green* reveals that this is the premise used to hold Lakeside, the landowner, to be a discharger under the Navigation Law. The Court held Lakeside liable because it could control the activities occurring on its property and had reason to believe petroleum would be stored there.[30] In this regard, the Court of Appeals' opinion makes clear two things: first, Lakeside could have done more to respond to the spill, and second, the State should not be responsible for cleaning up a mess on Lakeside's property. But recall that the contamination was from a system which Lakeside did not own and, in reality, did not control. The Court of Appeals, in its liberal interpretation of the remedial statute, held the property owner liable despite its "innocent" status precisely because it felt the landowner was not so innocent in its *response* to the spill.

The Court of Appeals did acknowledge the symmetry of the previous line of appellate cases where mere ownership was not considered sufficient indicia of "discharger" status so as to impose liability, stating that while

> . . . we refuse to impose liability based *solely* on ownership of contaminated land, we nonetheless conclude where, as here, a landowner can control activities occurring on its property and has reason to believe that petroleum products will be stored there, the landowner is liable as a discharger for the cleanup costs.[31]

If a landowner is not liable merely because of its "status," what might occasion an escape from the onerous confines of the statute? The Court was not that helpful, mentioning that a "midnight dumper" or "errant oil truck" might be situations where a landowner lacks control and knowledge.[32] These extremely rare occurrences mentioned by the Court of Appeals make it almost impossible for any current owner of land where petroleum activities are occurring or with knowledge of past activities to escape liability under the Oil Spill Law. Indeed, it seems for now, at least, that *Green* has "CERCLA'd" the Oil Spill Law.

But there still remains the sticky "technical" problem that the Oil Spill Law was drafted five years *before* CERCLA and requires something more than status, i.e., an "act or omission" resulting in a discharge, to impose liability for cleanup costs. This may come as small solace to the truly innocent landowner in the future who, for example, purchases property with absolutely no knowledge that there are leaking underground tanks there, and who, absent this knowledge, cannot "control" the contamination, until, of course, it is discovered at some subsequent point in time.

What does *Green* say about this owner? CERCLA at least provides a defense if the owner can show himself to be truly "innocent" under its stringent statutory requirements. The Oil Spill Law has no such defense written into its liability scheme, probably because the legislature, when the Act was drafted in 1977, did not foresee how broadly the courts would paint the definition of a discharger. No doubt, such a landowner may be tempted to question its liability under *Green*. After all, no knowledge and no control should give the truly innocent landowner shelter from "discharger" status if *Green* holds true to its premise.

This landowner may prevail if the litigation reaches the Court of Appeals with the plaintiff as a private party, for example, a neighbor seeking reimbursement from the innocent property owner for contamination the unknown tanks caused to the neighbor's property. In such a case, it's much easier for the Court to forget the remedial purpose of the statute and let each property owner deal with cleaning up its own investment.[33] But if such a case reaches the Court of Appeals with the state as plaintiff, the Oil Spill Law may finally find itself "CERCLA'd" in its most pure form: the landowner declared liable based on status alone. Is this where we are going? Only time will tell whether *Green* did indeed "CERCLA" the Oil Spill Law.

## Endnotes

1. Oil Spill Prevention, Control and Compensation Act, N.Y. Navigation Law 170-202 (Nav. Law) (McKinney's 2002).
2. 42 U.S.C. 9601-9675 (2002).
3. 96 N.Y.2d 403 (2001).
4. 42 U.S.C. 9607(a)(1).
5. *New York v. Shore Realty Corp.*, 759 F.2d 1032, 1042-44 (2d Cir. 1985).

6. 42 U.S.C. 9607(b)(1-3) (2002).
7. 42 U.S.C. 9601(35)(B) (2002).
8. *See, e.g., United States v. Shell Oil Co.*, 841 F. Supp. 962 (C.D. Cal. 1993); *Foster v. United States*, 922 F. Supp. 642 (D.D.C. 1996).
9. Nav. Law 181(1).
10. *Id.*
11. *Id.*
12. Nav. Law 172(8).
13. The Oil Spill Law did not originally specify whether a private party could sue others for damages caused by the discharge of petroleum. *Snyder v. Jessie*, 565 N.Y.S.2d 924 (4th Dep't 1990), *appeal dismissed*, 569 N.Y.S.2d 613 (1991) held that the Oil Spill Law did not create such a cause of action. That same year the legislature amended the law to allow for private causes of action. This amendment applies retroactively to spills that occurred before the amendment. *Snyder v. Newcomb Oil Co., Inc.*, 603 N.Y.S.2d 1010 (4th Dep't 1993).
14. Nav. Law 181(4) (2001).
15. *Id.* at 176(4).
16. *See supra* note 3.
17. 566 N.Y.S.2d 747 (3d Dep't 1991).
18. *Id.* at 748.
19. 542 N.Y.S.2d 402 (3d Dep't 1989).
20. The Third Department is called upon more often than other Appellate Courts to decide appeals under the Oil Spill Law because this is the Appellate Division where the State of New York generally brings suit for reimbursement for expenses it incurs in remediation of oil spills.
21. 712 N.Y.S.2d 206 (3d Dep't 2000).
22. 710 N.Y.S.2d 652 (3d Dep't 2000).
23. *See, e.g., State v. Arthur L. Moon*, 643 N.Y.S.2d 760 (3d Dep't 1996), *lv. denied*, 653 N.Y.S.2d 282 (1996); *State v. Tartan Oil Corp.*, 638 N.Y.S. 2d 989 (3d Dep't 1996).
24. 709 N.Y.S.2d 704 (3d Dep't 2000).
25. 619 N.Y.S.2d 433 (4th Dep't 1994).
26. 701 N.Y.S.2d 755 (3d Dep't 2000).
27. 95 F. Supp. 2d 197 (S.D.N.Y. 2000).
28. Nav. Law 172(8).
29. *See B.F. Goodrich v. Betkoski*, 99 F.3d 505, 514 (2d Cir. 1996).
30. 96 N.Y.S.2d at 407.
31. *Id.* (emphasis added).
32. *Id.*
33. *See, e.g., Roosa v. Campbell*, 737 N.Y.S.2d 461 (4th Dep't 2002), where the Fourth Department held a former owner and former operator liable under the Oil Spill Law. They both denied any knowledge of the leaking abandoned USTs on the property.

**Angela Demerle is an associate at Harter, Secrest & Emery, and has concentrated her practice in environmental law since 1989. She has worked extensively on a broad range of environmental issues including hazardous and solid waste, Superfund litigation, environmental criminal defense, state and federal permitting, underground storage tanks and spill liability, bankruptcy and environmental law, and land use development.**

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# Surviving the Bankruptcy Process: A Guide for the Shopping Mall Owner

By Daniel M. Pomerantz

With the recent economic downturn, as in most slow business cycles, we have seen a rash of bankruptcies, including many anchor tenants in shopping centers. The process of tenant bankruptcies can be confusing and stressful for even the most seasoned shopping mall owners, tenants, developers, and brokers. The following are answers to the 15 most common and significant questions brought forward by clients regarding how tenant bankruptcies affect their lives and livelihoods:

### 1) Why does a company declare bankruptcy?

A "bankrupt company" is one that has insufficient funds to pay its debts.[1] A voluntary bankruptcy begins when a company realizes it cannot pay its debts and files a petition to begin federal bankruptcy proceedings. If a company has generally been failing to pay its debts, and there is no bona fide dispute over the company's obligation to do so, its creditors may be able to force the company to begin involuntary bankruptcy proceedings.[2] Once the initial filing process is complete, the bankruptcy process proceeds in the same manner, regardless of whether it was begun voluntarily or involuntarily.

### 2) What are the steps involved?

1. A voluntary or involuntary petition is filed with the appropriate federal court.

2. Assuming the petition has not been dismissed or suspended by the bankruptcy court, an "automatic stay" becomes immediately effective.[3] This means that creditors are not allowed to exercise default remedies against the debtor, including eviction.

3. The bankruptcy judge will appoint a "United States trustee" to handle administrative functions. The trustee will call a meeting of the creditors within a "reasonable time," and all creditors will be given notice.[4] At such point lenders, landlords and other parties-in-interest become officially involved.

4. The bankruptcy court will confirm a bankruptcy plan that addresses issues such as the proposed use, sale or lease of the property, and compensation for parties involved, including attorneys and trustees. All creditors will be given notice of hearings on these matters, as well as an opportunity to raise objections.[5]

5. Under the bankruptcy plan, assets of the tenant may be sold or kept, and leases and executory contracts may be rejected, assigned or assumed. Finally, the creditors will be paid to the extent possible, and the company may either cease to exist, if it has filed under Chapter 7 (Liquidation), or emerge from the bankruptcy process as a solvent entity, if it has filed under Chapter 11 (Re-Organization).

### 3) What is "debtor in possession" financing?

A company that has filed for bankruptcy is called the "debtor." If the debtor continues to operate the business while in bankruptcy, then the debtor is called a "debtor in possession" or a "DIP," because the debtor still *possesses* the assets necessary to operate the business.[6] After proper notice to creditors and a hearing, the bankruptcy court may authorize the debtor to obtain: (1) senior secured, (2) junior secured, or (3) unsecured debt to continue operations.[7] This debt will be treated as an "administrative expense," and will be given priority over all "pre-petition debts," incurred prior to the filing of the petition for bankruptcy.[8] Courts give DIP financing a high priority because this encourages lenders to support an otherwise high-risk borrower. The debtor's pre-petition lenders can, and often do, choose to provide DIP financing.[9]

### 4) How do debtors pay their bills if they are bankrupt?

When the debtor is authorized by the bankruptcy court to continue its business operations, it is also automatically authorized to make payments incurred in the ordinary course of business.[10] Such payments include paying regular suppliers, employees, rental payments, etc. It does not include most capital expenditures or expansion, although in special circumstances a debtor might request approval from a court to engage in such activities.[11]

A debtor needs money to make payments. The debtor has three potential sources of cash at its disposal:

1. **Cash reserves**: Once the debtor files for bankruptcy and the automatic stay is in place, the debtor ceases to make payments to creditors, but it may still have some cash reserves.

2. **DIP financing**: As discussed above, the debtor also has an opportunity to obtain DIP financing.

3. **Inventory**: The debtor may sell inventory in the ordinary course of its business operations, even

if that inventory is subject to security agreements.[12]

Because the debtor has access to cash and is not making debt payments, it is able to make its day-to-day payments and continue operating.

### 5) How long can a company stay in bankruptcy?

There is no time limit on how long a bankruptcy can last. A simple bankruptcy could be resolved in a matter of months, while a complex bankruptcy could last years.

### 6) How does bankruptcy affect the debtor's leases?

As soon as the debtor files a bankruptcy petition, the "automatic stay" goes into effect.[13] The automatic stay prevents creditors from exercising any default remedies against the debtor and precludes a landlord from evicting the debtor or bringing a suit for any rent that may be in arrears or other defaults under the lease.[14] After the bankruptcy petition is filed, the debtor must pay current rent, also referred to as "post-petition rent." Though a landlord cannot sue on pre-petition defaults, such as back rent, the debtor (or the trustee who is administering the debtor's estate) is required to "timely perform all the obligations of the debtor,"[15] including current rent payments.[16]

As discussed before,[17] the debtor has three options with regard to its lease:

1. **Assumption**: The debtor will keep the lease. It is anticipated that the debtor will emerge from bankruptcy as solvent and continue its business operations at the leased premises.

2. **Rejection**: The debtor will terminate the lease. The property will revert to the landlord who may then lease to a new tenant.

3. **Assignment**: The debtor will "sell" the lease or, more accurately, will assume the lease and then immediately assign it to a new tenant for value. A lease has value when the rent is below market or the space is particularly advantageous to certain potential purchasers. The court can allow the assignment of a lease notwithstanding an anti-assignment clause.[18]

If the debtor assumes or assigns the lease, then it will be obligated to cure pre-petition defaults,[19] which (in the case of back rent) means making appropriate payments to the landlord.[20] If the lease is assigned, the assignment will usually require the purchaser to pay cure amounts in addition to the consideration due to the debtor's estate. The landlord is also entitled to "adequate assurance of future performance."[21] In the shopping center context, "adequate assurance" means an assurance that the source of the rental payments (i.e., the tenant's business operations) will produce sufficient revenue to pay the base rent and that the percentage rent will not decline significantly.[22] "Adequate assurance" also means that the assumption of the lease will not disrupt the tenant mix if the tenant has changed its business or assigned the lease.[23] If the debtor rejects the lease,[24] then the landlord will have to make a claim against the estate for pre-petition damages (i.e., back rent and any other payments due under the lease). The landlord is a "secured creditor" to the extent that there is a security deposit held pursuant to the lease, but the landlord will have to compete with other unsecured creditors for any excess claim beyond the security deposit, and may never recover the full amount of the claim.

### 7) Does the debtor still have to pay rent each month?

Yes, the debtor will have to continue to pay current rent. However, the debtor will not have to cure defaults (i.e., pay back rent) until the lease is either assumed or assigned. If the lease is rejected, then the landlord will have to make a claim for damages.[25]

### 8) How long does a debtor have to decide whether it will stay or go?

A debtor must reject, assume or assign leases within 60 days of filing for bankruptcy, although the court has the power to (and frequently will) extend this time limit if circumstances warrant.[26]

### 9) Does a landlord get control of the debtor's space if the debtor enters bankruptcy?

As a general rule, a landlord can take control of the space *only* when the debtor rejects the lease. The landlord would then take control of the space just as if the lease had expired.[27] However, a landlord can petition the bankruptcy court to make an exception to the general rule in special circumstances. The court makes these special exceptions on a case-by-case basis, so there can be no guarantee of success for such a petition. Nonetheless, some examples of relevant circumstances can include casualty to the property, if the debtor is holding over in the space beyond the natural expiration of the lease, the impairment of the landlord's interests pursuant to a mortgage, the inability of the debtor to cure, ***and*** a bleak possibility for a reversal of fortune, etc.[28]

### 10) What about a debtor's fixtures?

Presumably by "fixtures" we're talking about the trade fixtures—signs, counters, cabinets, etc., and not items such as permanent HVAC systems or additional support beams, which are really a part of the premises. Fixtures are subject to the same rules as the lease itself—they can be assumed or assigned along with the lease or, if they can be removed without damage to the premises, they can be taken as personal property of the estate and sold for value. If the lease is rejected, trade fixtures can also be abandoned. If the landlord incurs costs in removing abandoned trade fixtures, those costs can be asserted as a damages claim upon rejection.

### 11) Is the debtor still obligated to pay percentage rent?

Percentage rent is not treated differently than base rent under the bankruptcy code.[29] The debtor is obligated to make post-petition rent payments and cure payments in the manner that has been outlined in questions 6 and 7 above.[30]

### 12) What should a landlord put in the lease to protect against a tenant bankruptcy?

This is an interesting question with no single answer. Whenever a landlord enters into a lease agreement with a tenant, there will always be some amount of business risk involved, as no lease can ever be one hundred percent secure. However, a knowledgeable attorney can incorporate a variety of legal protections into a lease agreement that will serve to mitigate the business risks to the landlord to the extent possible. Some examples of the legal protections that can be provided for include:

**Third-party guarantee**: The obligations of an outside guarantor are not affected by the bankruptcy of the debtor. A letter of credit or a sufficiently large security deposit can also be useful.

**Default clause**: Leases often contain a clause that defines filing for bankruptcy, or related acts as "events of default." Due to the automatic stay, the landlord will typically be prohibited from exercising any default remedies. However, it is useful to have this clause in the lease because a state of default will allow the landlord to draw on the various types of security mentioned above. Also, as discussed earlier,[31] in certain special circumstances the landlord might be able to petition for court authority to exercise certain limited default remedies.

**Assignment clause**: This clause should provide that the tenant remains liable even after assignment. Alternatively, the clause can provide that the original tenant will be liable unless the new tenant meets certain financial criteria such as adequate credit rating and revenues. This mechanism can reduce the risk of an unstable tenant moving in.

**Lender-style mechanisms**: These tools are most commonly used in a lending situation but, with a little creativity, they can be adapted for a leasing situation. One such mechanism is basically a set of financial covenants and tests informally called the "early trigger." For example, it might be a breach under the lease if the tenant's revenues or credit rating fall below a certain level. Such a clause can trigger an event of default allowing the landlord to evict before the tenant files for bankruptcy or just allow a landlord to obtain additional security. Lenders also use "fixture filing," a UCC-1 security interest in the tenant's fixtures, furnishings and equipment (FF&E). If the tenant rejects the lease, the landlord can take possession of the tenant's FF&E and sell it for value.

### 13) How does a landlord or broker protect his or her brokerage commission? Does a landlord or broker have to return the commission within a certain period of time?

**Broker's perspective**: If the broker's fee is to be paid by the landlord, the brokerage contract will not be affected by the tenant's bankruptcy unless the contract provides otherwise. If the fee is to be paid by the tenant, the bankruptcy process may affect the ability to collect. If the broker has not yet found space for the debtor, then the debtor may be able to reject the contract. If the broker has fully performed under the brokerage contract, and the only performance that remains is payment of the brokerage fee, then the debtor will generally not be able to reject.[32] The broker will then have to make a claim against the estate to recover the fee.

**Landlord's perspective**: A landlord should negotiate certain protections into the brokerage contract. For example: the broker could be paid in installments over time unless the tenant has superb credit ratings and revenues. Even if the broker is paid in full, the contract can provide that the commission will be refunded if the tenant files for bankruptcy within a certain time frame.

### 14) How do I find out the current status of a bankruptcy and how it affects my shopping center?

The clerk at the relevant bankruptcy court has access to all public documents and anyone can request copies for a small copying fee. Though it never hurts to become educated on the bankruptcy process, an experienced lawyer can assist in understanding the relevance of pertinent documents and the effect that they might have on your shopping center.

### 15) Does a landlord need to disclose to prospective tenants that an anchor tenant is in bankruptcy?

While there is no specific legal requirement to disclose the bankruptcy of an anchor tenant, the bankruptcy should be reflected in any projections of revenues, customer flow or other figures that are used to induce prospective tenants to lease space. If such figures do not take the bankruptcy into account, there is a possibility that a landlord could be sued for fraud. Bankruptcies are public knowledge and a landlord should assume that prospective tenants might independently discover the bankruptcy. If the discovery comes as a surprise to the prospective tenant, this could affect the quality of your business relationship.

## Conclusion

Bankruptcy and real estate are each complex, specialized areas of law and business. When a tenant declares bankruptcy, there is no substitute for expert legal assistance based on a thorough understanding of both of these legal practice areas.

Ideally, a team of bankruptcy and real estate experts will work in close coordination with the in-house business experts of the client. With constant communication, an open mind and a creative spirit, it is truly possible for such a team to help their client survive, succeed and even thrive throughout and beyond the ordeal of a tenant's bankruptcy.

## Endnotes

1. Black's Law Dictionary, at 147 (6th ed. 1990).
2. 11 U.S.C. § 303.
3. 11 U.S.C. § 362.
4. 11 U.S.C. § 341; *see also* Fed. R. Bankr. P. 2002(a)-(c).
5. Fed. R. Bankr. P. 2002 (a)-(c).
6. David G. Epstein, Bankruptcy in a Nutshell, 411 (West Group 2002)(emphasis in original).
7. 11 U.S.C. § 364.
8. 11 U.S.C. § 503(b)(1).
9. Epstein, *supra* n. 6 at 423.
10. 11 U.S.C. § 363(c)(1).
11. The debtor would typically have to show that such activities would benefit the estate and, therefore, the creditors, as well.
12. 11 U.S.C. § 363(c)(1).
13. 11 U.S.C. § 362.
14. *Id*.
15. 11 U.S.C. § 365(d)(3). With certain exceptions that relate to obligations arising from pre-petition insolvency, i.e., penalties, etc.
16. Laurence Cherkis, Steven Abramowitz & Lawrence P. King, Collier Real Estate Transactions and the Bankruptcy Code ¶ 3.01[2] (MB 2001).
17. *See* Question #2, *supra.*
18. 11 U.S.C. § 365.
19. 11 U.S.C. § 365(b)(1). Tenant will either cure immediately or will provide "adequate assurance of a prompt cure."
20. Non-monetary defaults, such as breach of an obligation to keep the premises in good repair, would also have to be cured.
21. *See* 11 U.S.C. § 365(b)(3) (adequate assurances required for shopping mall leases).
22. *Id.*
23. 11 U.S.C. § 365(b)(3)(D).
24. 11 U.S.C. § 365(a).
25. For greater detail, see the answer to the previous question.
26. 11 U.S.C. § 365(d).
27. *Id. See also* Cherkis *supra* note 16 at ¶ 3.01[2].
28. 11 U.S.C. § 365(d)(3).
29. 11 U.S.C. § 365(d)(3) and Cherkis *supra* note 16 at ¶ 3.01[2].
30. *See* Questions #6 and #7 *supra*.
31. *See* Question #9 *supra.*
32. *See* 11 U.S.C. § 365 (detailing the debtor's ability to reject executory contracts). *But see* Vern Countryman, *Executory Contracts in Bankruptcy,* 57 Minn. L. Rev. 439 (1973); 58 Minn. L. Rev. 479 (1974) (defining an "executory contract" as one that is so far unperformed on both sides that the failure of either party to complete performance would be a material breach, excusing further performance from the other party"). *See also* EPSTEIN *supra* note 6 at 339 (discussing the wide applicability of the Countryman definition).

**Daniel M. Pomerantz, Esq. has practiced as an Associate at the New York headquarters of Weil, Gotshal & Manges, LLP in both the Real Estate Department and in the Business Finance and Restructuring Department. Mr. Pomerantz now works as General Counsel for Expresión Media Group in Chicago and consults for a variety of private clients.**

# Bergman on Mortgage Foreclosures: When the Borrower Hides from a Deficiency

By Bruce J. Bergman

There is an exigent maxim in the database of every attorney who will ever prosecute a foreclosure and then pursue a deficiency judgment: service by publication is not personal service and therefore does not supply a necessary predicate for deficiency judgment liability. Mix that aphorism with the observation that separating the good guys from the bad guys is almost exclusively a philosophical debate—perhaps unavoidably in any event a function of perspective. Sometimes, though, the flagrant defalcators are more readily exposed. This true story should be one of those rare instances.[1]

Plaintiffs sold a property to defendants and took back a purchase money mortgage. Default ensued, a foreclosure action was begun, and several weeks before the foreclosure sale, defendants fled the premises (under cover of darkness, no less) leaving it, as the court described it, in a filthy, damaged and deplorable condition. Defendants escaped leaving no forwarding address.

After plaintiffs bid in the property at the sale for a sum considerably less than the debt, they sought a deficiency and, because the defendants were nowhere to be found, obtained an order permitting service of the deficiency motion by publication. A deficiency judgment for some $88,000 was awarded.

Suddenly chagrined years later by this turn of events, defendants surfaced, moving to vacate the deficiency judgment. The attack was a two-pronged claim: first, that the defendants were not personally served, so that pursuant to CPLR 317 they had up to five years to defend; second, that pursuant to CPLR 5015, there was an excusable default and a meritorious defense. Both the Supreme Court and the Third Department were unimpressed.

As to the supposed excuse and meritorious defense, the court found that defendants knew exactly what had occurred—the sale at a deficient price—and that their response was to go into hiding. An assertion that they did so to avoid plaintiff's harassment was unsupported by any evidence. Defendants' conduct—stealthy departure and damaging the premises—was found to be consistent with a campaign to avoid liability. And defendants' appraisal prepared *before* they trashed the premises could not support "merit" to their position because that appraisal did not reflect the reduced value engendered by defendants' own later actions.

On the vital issue of service of process, the ruling was that the ability to assault a judgment after its entry applies to those defaulters served with a *summons* by other than personal service. Here defendants were personally served in the foreclosure action itself (and appeared). While the deficiency judgment motion was served by publication, that motion did not commence a new action, but rather sought additional relief in the pending foreclosure.

In sum, yes, service in the foreclosure action by publication bars seeking a deficiency against those so served. But, service by publication of the deficiency motion itself is no impediment to award of a judgment.

## Endnote

1. *Koval v. Loebach*, 212 A.D.2d 902, 622 N.Y.S.2d 987 (3d Dep't 1995).



**Mr. Bergman, author of the three-volume treatise, *Bergman on New York Mortgage Foreclosures*, Matthew Bender & Co., Inc. (rev. 2000), is a partner with Certilman Balin Adler & Hyman, LLP in East Meadow, New York, outside counsel to a number of major lenders and servicers, and an Adjunct Associate Professor of Real Estate with New York University's Real Estate Institute where he teaches the mortgage foreclosure course. He is also a member of the USFN, the American College of Real Estate Lawyers and is on the faculty of the Mortgage Bankers Association of America School of Mortgage Banking.**

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206 Park Avenue
Rochester, NY 14607
(585) 697-0040
Fax: (585) 697-0043
E-Mail: jmyers@jmyerslaw.com

David J. Zinberg (Co-Chair)
250 Park Avenue
New York, NY 10177
(212) 907-9601
Fax: (212) 907-9681
E-Mail: dzinberg@ingramllp.com


**Committee on Awards**


John G. Hall (Chair)
57 Beach Street
Staten Island, NY 10304
(718) 447-1962
Fax: (718) 273-3090
E-Mail: hallj@hallandhalllaw.com


**Committee on Commercial Leasing**


Austin J. Hoffman, II (Co-Chair)
4 Clinton Square
Syracuse, NY 13202
(315) 422-7000
Fax: (315) 422-7019
E-Mail: austinhoffman@pyramidmg.com

Bradley A. Kaufman (Co-Chair)
101 Park Avenue
New York, NY 10178
(212) 309-6022
Fax: (212) 309-6273
E-Mail: bkaufman@morganlewis.com


**Committee on Computerization & Technology**


Michael J. Berey (Chair)
633 Third Avenue, 16th Floor
New York, NY 10017
(212) 850-0624
Fax: (212) 331-1511
E-Mail: mberey@firstam.com


**Committee on Condemnation, Certiorari & Real Estate Taxation**


Robert L. Beebe (Co-Chair)
514 Vischers Ferry Road
Clifton Park, NY 12065
(518) 373-1500
Fax: (518) 373-0030
E-Mail: rbeebe@beebelaw.com

Jon N. Santemma (Co-Chair)
300 Garden City Plaza, 5th Floor
Garden City, NY 11530
(516) 393-8277
Fax: (516) 393-8282
E-Mail: jsantemma@jshllp.com


**Committee on Condominiums & Cooperatives**


David L. Berkey (Co-Chair)
845 Third Avenue, 8th Floor
New York, NY 10022
(212) 935-3131
Fax: (212) 935-4514
E-Mail: dlb@gdblaw.com

Joseph M. Walsh (Co-Chair)
42 Long Alley
Saratoga Springs, NY 12866
(518) 583-0171
Fax: (518) 583-1025
E-Mail: joewalsh@spalaw.net


**Committee on Continuing Legal Education**


Terrence M. Gilbride (Co-Chair)
One M&T Plaza, Suite 2000
Buffalo, NY 14203
(716) 848-1236
Fax: (716) 849-0349
E-Mail: tgilbrid@hodgsonruss.com

Harold A. Lubell (Co-Chair)
1290 Avenue of the Americas
New York, NY 10104
(212) 541-2130
Fax: (212) 541-4630
E-Mail: halubell@bryancave.com


**Committee on Environmental Law**


Joel H. Sachs (Co-Chair)
1 North Broadway, Suite 700
White Plains, NY 10601
(914) 946-4777 x318
Fax: (914) 946-6868
E-Mail: jsachs@kblaw.com

John M. Wilson, II (Co-Chair)
2400 Chase Square
Rochester, NY 14604
(585) 232-5300
Fax: (585) 232-3528
E-Mail: jwilson@boylanbrown.com


**Committee on Land Use & Planning**


Karl S. Essler (Co-Chair)
Two State Street, 14th Floor
Rochester, NY 14614
(585) 232-1660
Fax: (585) 232-4791
E-Mail: kessler@fixspin.com

Carole S. Slater (Co-Chair)
36 West 44th Street, Suite 712
New York, NY 10036
(212) 391-8045
Fax: (212) 391-8047
E-mail: cslater@slaterbeckerman.com


**Committee on Landlord & Tenant Proceedings**


Edward G. Baer (Co-Chair)
270 Madison Avenue
New York, NY 10016
(212) 867-4466
Fax: (212) 867-0709
E-Mail: ebaer@bbwg.com

Gerald Goldstein (Co-Chair)
200 Garden City Plaza, Suite 315
Garden City, NY 11530
(516) 248-6400
Fax: (516) 248-6422
E-Mail: gg@dmlegal.com

**Committee on Legislation**
Robert W. Hoffman (Co-Chair)
1802 Eastern Parkway
Schenectady, NY 12309
(518) 370-4743
Fax: (518) 370-4870
E-Mail: rwhooplaw@juno.com

Gary S. Litke (Co-Chair)
237 Park Avenue, 20th Floor
New York, NY 10017
(212) 880-6190
Fax: (212) 682-0200
E-Mail: glitke@torys.com

**Committee on Low Income & Affordable Housing**
Brian E. Lawlor (Chair)
38-40 State Street
Albany, NY 12207
(518) 486-6337
Fax: (518) 473-8206
E-Mail: blawlor@dhcr.state.ny.us

**Committee on Membership**
Karen A. DiNardo (Co-Chair)
28 Main Street, Suite 1400
Rochester, NY 14614
(585) 238-2038
Fax: (585) 232-3141
E-Mail: kdinardo@phillipslytle.com

Richard S. Fries (Co-Chair)
405 Lexington Avenue
New York, NY 10174
(212) 973-0111
Fax: (212) 891-9598
E-Mail: rsfries@swidlaw.com

**Committee on Not-for-Profit Entities & Concerns**
Anne Reynolds Copps (Co-Chair)
126 State Street, 6th Floor
Albany, NY 12207
(518) 436-4170
Fax: (518) 436-1456
E-Mail: arcopps@nycap.rr.com

Mindy H. Stern (Co-Chair)
60 East 42nd Street
New York, NY 10165
(212) 661-5030
Fax: (212) 687-2123
E-Mail: mstern@schoeman.com

**Committee on Professionalism**
Peter V. Coffey (Co-Chair)
224 State Street
P.O. Box 1092
Schenectady, NY 12301
(518) 370-4645
Fax: (518) 370-4979
E-Mail: pcoffey@ecmlaw.com

Janet Sandra Stern (Co-Chair)
1025 Old Country Road, Suite 205
Westbury, NY 11590
(516) 876-1106
Fax: (516) 997-7876
E-Mail: janet@sawlaw.com

**Committee on Publications**
William A. Colavito (Co-Chair)
One Robin Hood Road
Bedford Hills, NY 10507
(914) 666-4606
Fax: (914) 241-1881
E-Mail: wcolavito@yahoo.com

Joseph D. DeSalvo (Co-Chair)
188 East Post Road, 4th Floor
White Plains, NY 10601
(914) 286-6415
Fax: (212) 331-1455
E-Mail: jdesalvo@firstamny.com

Harry G. Meyer (Co-Chair)
One M&T Plaza, Suite 2000
Buffalo, NY 14203
(716) 848-1417
Fax: (716) 819-4632
E-Mail: hmeyer@hodgsonruss.com

Robert M. Zinman (Co-Chair)
St. John's University School of Law
8000 Utopia Parkway
Jamaica, NY 11439
(718) 990-6646
Fax: (718) 990-6649
E-Mail: zinmanr@stjohns.edu

**Ad Hoc Committee on Public Relations**
Maureen Pilato Lamb (Co-Chair)
510 Wilder Building
One East Main Street
Rochester, NY 14614
(585) 325-6700 x220
Fax: (585) 325-1372
E-Mail: mplamb@frontiernet.net

Harold A. Lubell (Co-Chair)
1290 Avenue of the Americas
New York, NY 10104
(212) 541-2130
Fax: (212) 541-4630
E-Mail: halubell@bryancave.com

**Committee on Real Estate Financing**
Steven M. Alden (Co-Chair)
919 Third Avenue
New York, NY 10022
(212) 909-6481
Fax: (212) 909-6836
E-Mail: smalden@debevoise.com

Leon T. Sawyko (Co-Chair)
99 Garnsey Road
Pittsford, NY 14534
(585) 419-8632
Fax: (585) 419-8815
E-Mail: lsawyko@harrisbeach.com

**Committee on Title & Transfer**
Karl B. Holtzschue (Co-Chair)
122 East 82nd Street, Apt. 3C
New York, NY 10028
(212) 472-1421
Fax: (212) 472-6712
E-Mail: kholtzschue@nyc.rr.com

Samuel O. Tilton (Co-Chair)
2 State Street
700 Crossroads Building
Rochester, NY 14614
(585) 987-2841
Fax: (585) 454-3968
E-Mail: stilton@woodsoviatt.com

**Committee on Unlawful Practice of Law**
John G. Hall (Chair)
57 Beach Street
Staten Island, NY 10304
(718) 447-1962
Fax: (718) 273-3090
E-Mail: hallj@hallandhalllaw.com

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Real Property Law Section
New York State Bar Association
One Elk Street
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