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N.Y. REAL PROPERTY LAW JOURNAL

Vol. 27, No. 3

NEW YORK STATE BAR ASSOCIATION
A PUBLICATION OF THE REAL PROPERTY LAW SECTION

Summer 1999

A Message from the Outgoing Section Chair

As one of my dear friends on the Section's Executive Committee (herself a former Chair) just told me, I am now a has-been! In reflecting on my past year as Chair, the highlight has been working with New York's real estate lawyers, dedicated and bright, on major issues confronting the profession—and our practice area in particular. Let me summarize the more significant activities of the Section since last June:

- The Section (guided by the efforts of Richard Fries) worked hard and realized the fruits of its labors in the passage last July of the revised Article 14 for non-judicial foreclosure.
- Concerns about the County Clerks and City Registers being able to deal adequately with Y2K led to my asking the district representatives to contact those officers within their respective jurisdictions and ask for a compliance update. Most of the

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A Message from the Incoming Section Chair

It is an honor as well as a somewhat daunting challenge to assume the leadership of the Real Property Law Section on the heels of our outgoing chair, Lorraine Power Tharp. For those of you who have the pleasure of knowing her, Lorraine is indeed an outgoing person in all the best ways. She brought energy, wisdom and charm to her stewardship of the Section and made a particular effort to broaden both the membership and the scope of activities we undertake. We look forward to another year of Lorraine's contributions to the Section as our distinguished immediate past Chair.

The Real Property Law Section, at roughly 4,200 members, is one of the largest in the State Bar Association, and this *Journal* is one of the primary means of sharing information among our members. The Section's standing committees are also critical to the exchange of legal knowledge, which is at the heart of the

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responses were positive, and things appear to be on track. If nothing else, it was worthwhile for them to know that we as a Section are not only concerned, but are watching.

- The Section reviewed and commented on the Revised Article 9 of the Uniform Commercial Code as proposed by the Business Law Section. While the Executive Committee of the State Bar authorized the Business Law Section to pursue this legislation, through our efforts that authorization is conditioned upon our Section's concerns (primarily with respect to co-op filings and fixture filings) being addressed.

- Of paramount concern to me through the past year has been increasing the activity level of the members and finding new ways to serve the members' needs. To that end, I communicated with you concerning the STAR tax exemption (which led many of you to call me with inquiries, resulting in an article in the *Journal*). A request for committee involvement has been mailed to each of you, and a survey on member needs and opinions has been sent to a portion of the membership. The results of that survey will be tabulated and used by the officers of the Section as a guide for this year. We continue to examine the difference in the residential practice throughout the state in order to get an understanding of how that practice area is changing and what we as a Section should do to preserve the role of the attorney.

- Diversity on the Executive Committee continues to be an issue near and dear to me, and I am proud to say that our representation of women is very good for a Section. There is always work to do in this area, and we do need to focus on representation of minorities in Section leadership.

- Another matter of importance to me was addressed positively when the Executive Committee passed a pro bono resolution at its May meeting. In January, I had invited Anthony Cassino, the State Bar Director of Pro Bono, to appear before our Executive Committee, and he was greeted with an enthusiastic response. A committee consisting of Harold Hanson, Karl Essler and Carol Dancy Stephens proposed certain pro bono initiatives, and you will receive a communication concerning the details of what we hope will be each member's commitment.

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Incoming Chair's Message

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Bar's mission. I hope that, over the coming year, more veteran members will make the time and effort to get a younger lawyer involved with the work of our committees. There is no better means of learning about the many benefits of active engagement in the Real Property Law Section.

One of the many challenges and opportunities which real estate attorneys will face in the coming years is the growth of lawyers practicing in Big-Five accounting firms and the rise of multi-disciplinary practice (MDP) in Europe and Canada. Many observers of the legal profession believe that MDPs offer a range of services which will be viewed as attractive by many clients. This in turn will create market pressures which are likely to conflict with traditional legal practice rules relating to client confidentiality, fee-sharing with non-lawyers, conflict of interest and the independence of lawyers' advocacy.

While MDP is obviously viewed by the Big-Five accounting firms and other service providers (including some law firms) as an opportunity for business expansion, its success will ultimately be driven by its competitive appeal in the marketplace. Consolidation is a theme of modern growth in so many business arenas; in the service sector, including professional services, some business clients may at times place greater emphasis on "one-stop shopping" than on the quality of the individual services provided.

Part of the task of the legal profession in confronting MDPs is to ensure that lawyers practicing in such firms uphold the same key ethical principles required of lawyers in traditional law firms. However, application of such principles to MDPs will require creativity because of the new business settings. For example, how should conflict of interest rules be applied in the context of MDPs which provide audit, management consulting and tax advisory consultation? How will disclosure and confidentiality obligations be applied as between auditors and attorneys? To what extent will attorneys' independent judgment be compromised if they are employed by a Big-Five accounting firm, forming just one part of the firm's consulting practice? Will the answer vary if the law firm itself becomes an MDP, employing accountants and other consultants but keeping the lawyers in charge?

Real estate attorneys have dealt with these kinds of issues in recent years. Real estate brokerage firms, residential closing services, title insurance companies, tax certiorari consultants and land use planning companies have each presented smaller versions of the issues cre-

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- This past year saw the formation of a new committee, Not-For-Profit Entities and Concerns, whose first Chair is Anne Reynolds Copps of Albany. One of that Committee's duties will be to monitor pro bono and find unique ways for our members to become involved.
- An issue of monumental importance to the profession as a whole is that of multi-disciplinary practice. We recently formed a committee, chaired by former Chair John Hall, to examine a report that has been prepared by a State Bar Special Committee to review this issue, and the Section has given its comments on the report to the State Bar. The report is to be discussed at the next House of Delegates meeting, and the Section officers will keep you apprised of developments in this area.

As I take my leave, I extend my sincere thanks to the State Bar staff, particularly Barbara Mahan, who works with the Section on its day-to-day activities, and Kathleen Heider, who so expertly coordinates our major conferences and meetings. The Executive Committee and, in particular, my fellow officers, Steve Horowitz, Jim Grossman and Mel Mitzner, were all extremely supportive and hard-working over the past year, for which I am very grateful. Finally, the efforts throughout the year of our *Journal* Co-editors Bill Colavito, Bob Zinman and Harry Meyer, deserve high praise and the thanks of the Section.

My wish for Steve is that he has as enjoyable a year as your Chair as I have.

All my best.

Lorraine Power Tharp

Incoming Chair's Message

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ated by MDPs. Our challenge as practicing lawyers is to consider these issues in a responsible and flexible way. We cannot blindly resist changes in the marketplace; nor should we allow business pressures to erode the time-tested principles of integrity, of which the legal profession is justly proud. As Section Chair, I hope to encourage lively debate and thoughtful study of these complex issues.

Steven G. Horowitz

Peconic Bay Transfer Tax Legislation

By Melvyn Mitzner*

By virtue of amendments to the N.Y. Town Law and N.Y. Tax Law,[1] the state legislature passed and the governor signed important legislation which, the governor stated, would authorize the towns of East Hampton, Riverhead, Shelter Island, Southampton and Southold to each pass a local law that would enable each town to implement a strategy for preserving the community character, the open spaces, historic treasures and environmental ecosystems in the towns that comprise the Peconic Bay Region in Suffolk County. The bill was designed to enable the towns to decide by referendum to adopt the legislation. Thus, to receive the funds, the towns were authorized to pass, by referendum, legislation and adopt a Peconic Bay Transfer Tax.

The towns all subsequently passed by referendum legislation adopting their respective statutes.[2]

The basics of the transfer tax are as follows:

Rate

Two percent of the gross amount of any transfer of $500 or more.[3]

Payment

Paid to the treasurer or the recording officer if the county treasurer designates the recording officer as the agent of the treasurer. The tax will be paid with the regular transfer tax which is paid at the time of delivery of the transfer instrument. The recording officer must endorse on each deed or instrument effectuating a transfer a receipt in form designated by the county treasurer. The county clerk, however, "shall not record" an instrument effectuating a conveyance unless the tax is paid.[4]

Note—All the local laws designate the recording officer to collect the taxes. Apparently, no fee is authorized for the recorder by statute and, as of the date of this writing, none has been agreed to.

Liability for the Tax

The tax shall be paid by the grantee.[5] If the grantee is exempt from the tax or fails to pay the tax then the grantor shall pay the tax. Where the liability for the tax falls on the grantor, both the grantor and grantee shall be jointly and severably liable for the tax.

Taxable Transfers[6]

1. Deeds.
2. Controlling interest—50 percent of, in the case of a corporation, the total combined voting power of stock or 50 percent of the beneficial interest in such stock; or in the case of a partnership association, trust or other entity, 50 percent or more of the capital, profits or beneficial interest in such an entity.
3. Leasehold and subleasehold consideration—shall include the price actually paid or the value of the rental or other payments attributable to the occupancy of the real property, or other payments attributable to the exercise of any option to renew. In an assignment or surrender of a leasehold interest, or subleasehold interest, the amount paid shall be taxable, but the consideration in determining the fair market value of the leasehold or subleasehold transferred shall not include the value of the remaining rental payments. A taxable lease or sublease is one where (a) the sum of the lease exceeds 49 years, (b) substantial capital improvements are made for the benefit of the lessee or sublessee and (c) the lease is for all or substantially all of the premises (not defined).
4. Options to purchase—the granting of an option to purchase with use and occupancy of the real property is taxable for the amount actually paid or the value of the grant of the option to purchase. In the case of an assignment of an option to purchase, if it is in a lease, consideration will not include the remaining rental payments.

Assignment of Contracts

Taxable as to the gain in the difference in the price paid and the price received for the Assignment of Contract.

Air Rights

Taxable for the amount paid.

Cooperative Housing Corporation Transfers[7]

The tax applies to the original conveyance of shares of stock in a co-op apartment or the original conveyance by the co-op, corporation or sponsor and the subsequent transfer of stock. A credit is given for the initial transfer to the co-op or corporation by a formula specified in the statute.

Returns

The treasurer of the county of Suffolk is to prepare a return modeled after the TP-584 form, and the form must contain at least the same materials as the TP-584 form.[8]

Exemptions[9]

1. In the towns of East Hampton, Shelter Island and Southampton, an exemption of $250,000 shall be allowed on improved real property or an interest therein and an exemption of $100,000 on unimproved real property.

   In the towns of Riverhead and Southold, an exemption of $150,000 shall be allowed on improved real property or an interest therein and an exemption of $75,000 shall be allowed on the consideration of the conveyance of unimproved real property.

   There is no apparent definition of improved or unimproved real property.

2. Real property, which is subject to the development restriction of an agricultural district or individual commitment to agricultural commitment.

3. Conveyance of real property, where the entire parcel of real property to be conveyed is subject to development restrictions either for agricultural, conservation, scenic or an open space easement; prohibition of development; and a purchase of development rights agreement.

4. Real property, where there is a transfer of development rights agreement, where the property being conveyed has had its development rights removed. *Note*—Many of these will require administrative and, possibly court, interpretation.

5. Conveyance of agricultural land, as defined under the Agriculture and Markets Law or pursuant to a developmental restriction, which restriction is for at least three years' duration.

6. Conveyance of open space, parks or property conveyed for historic preservation purposes or to any not-for-profit tax-exempt corporation operated for conservation, environmental, or historic preservation purposes.

7. The remainder of the exemptions are the same as the Article 31 transfer taxes such as the state of New York, United Nations, et al., where they are the grantor and the conveyances are exempt to such entities. *Note*—This provision is copied from the transfer tax statute (Article 31) and does not make much sense where the grantee is principally responsible. The exemptions are afforded to conveyances that secure a debt or other obligation, conveyances that correct or confirm a prior conveyance, conveyances that are made without consideration, bona fide gifts, tax sale conveyances, conveyances where there is no change of identity, deeds of partition, deeds pursuant to the federal Bankruptcy Act (Code), a contract of sale without the use or occupancy of property, or the grantee of an option to purchase real property without the use or occupancy of such property.

Credit

A credit[10] is allowed to the grantee on a piece of real property to the extent a tax was paid by the same grantee on a prior creation of a lease, an option to purchase or a contract of sale of all or a portion of the same real property. The formula is the tax paid on the creation of the leasehold, option or taxable contract by a fraction, the numerator of which is the value of the consideration used to compute the tax paid, which is not yet due to the grantor on the date of the subsequent conveyance, and the denominator of which is the total value of the consideration used to compute such tax paid.

Rules and Regulations

The county treasurer is authorized to pass rules and regulations for the administration of the tax,[11] including refunds. A two-year statute of limitations is established from the time the payment was made to seek a refund.

Judicial Review[12]

While no clear-cut administrative procedure is set forth, a four-month judicial review procedure is set forth from the time of the final determination. It is assumed that means final determinations of the county treasurer.

Conclusion

The 2 percent of gross purchase price above $500 Peconic Bay Transfer Tax will start for all of the towns, except Southold, on April 1, 1999 and for Southold, on March 1, 1999. The tax will be paid by the grantee.

In the towns of Riverhead and Southold, an exemption of $150,000 is allowed on improved property and $75,000 on unimproved property. In the towns of East Hampton, Shelter Island and Southampton, an exemption of $250,000 on improved property and $100,000 on unimproved property will be allowed. Certain types of property are exempt, such as eligible agricultural property.

As of this writing, there are no forms prepared, as is stated in the statute, but the county treasurer is currently working on the form.

Endnotes

1. 1998 N.Y. Laws ch. 114. Added § 64-e of the N.Y. Town Law as well as a new article of the N.Y. Tax Law § 1449, art. 31D. The latter article is called "Tax on Real Estate Transfers in Towns in the Peconic Bay Region."
2. (a) Towns of East Hampton—By resolution of #803 dated August 4, 1998, passing a resolution on July 31, 1998—Local Law No. 28 of 1998. The tax law will apply on any transfer on or after April 1, 1998, but does not apply to contracts entered into prior to April 1, 1999. Independent proof of the execution of the contract must be effectuated—e.g., recording of the contract, payment of a deposit, etc.

   (b) Town of Southampton—Local Law No. 39 of 1998. The tax also applies to any transfer occurring on or after April 1, 1999 and does not apply to conveyances made on or after April 1, 1999 pursuant to binding written contracts made prior to April 1, 1999. Independent evidence will be necessary to establish the execution of the contract, e.g. recording of the contract, payment of a deposit, etc.

   (c) Town of Riverhead—Local Law No. 14 of 1998 made statute effective as of April 1, 1999, but does not apply to conveyances made on or after April 1, 1999 pursuant to written contracts made and on or before that date for deeds recorded after April 1, 1999. The contract's execution date must be confirmed by independent facts such as recording of the contract payment of deposits, etc.

   d) Town of Shelter Island—Chapter 50 of the Town Code, called the "Community Preservation Fund," effective as of April 1, 1999, but shall not affect conveyances made on or after April 1, 1999 for which contracts were executed and binding prior to April 1, 1999. The contract's execution date must be confirmed by independent evidence such as recording of the contract, payment of a deposit, etc.

   (e) Town of Shelter Island—Local Law No. 20 of 1998 effectuates a new Article IV in the Southold Town Code, effective as of March 1, 1999, but the transfer tax shall not apply to conveyances which are recorded after March 1, 1999 for contracts of sale entered into prior to March 1, 1999. Independent proof is necessary to establish that the contract was executed prior to March 1, 1999 such as recording of the contract, payment of a deposit, etc.
3. N.Y. Tax Law § 1449-bb, art. 31D.
4. N.Y. Tax Law § 1449-cc, art. 31D.
5. N.Y. Tax Law § 1449-dd, art. 31D.
6. N.Y. Tax Law § 1449-aa, art. 31D.
7. N.Y. Tax Law §§ 1449-gg, 1449-aa, art. 31D.
8. N.Y. Tax Law § 1449-cc, art. 31D.
9. N.Y. Tax Law § 1449-ee, art. 31D.
10. N.Y. Tax Law § 1449-ff, art. 31D.
11. N.Y. Tax Law § 1449-jj, art. 31D.
12. N.Y. Tax Law § 1449-ll, art. 31D.

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LaSalle and the Future of Real Estate Investments

By Robert M. Zinman*

Six months after oral argument, the U.S. Supreme Court issued its decision in *Bank of America v. 203 N. LaSalle Street Partnership,*[1] a case that had the potential to resolve very perplexing issues affecting the future of real estate investments. Unfortunately, the narrow holding in favor of the mortgagee left open most of the issues raised by the case and, by implication, may have made the position of the real estate mortgagee somewhat more dangerous than it may have been otherwise.

1. The Decision

Justice Souter delivered the opinion of the Court, joined by Chief Justice Rehnquist and Justices O'Connor, Kennedy, Ginsburg, and Breyer. Justice Thomas, joined by Justice Scalia, filed a concurring opinion, and Justice Stevens filed a dissent. The majority held that a new value plan could not be confirmed over the objection of a senior class of creditors when the opportunity to contribute new value and receive ownership interests in the reorganized entity is reserved exclusively to old equity holders. It did *not* decide (1) whether a plan that gave the opportunity to contribute new value to others in addition to old equity holders would constitute what the Court determined to be the necessary "market exposure" for confirmation, (2) whether there was a new value corollary or exception to the absolute priority rule in the Bankruptcy Code, and (3) what the prerequisites to new value (first articulated by Justice Douglas in *Case v. Los Angeles Lumber Products Co.*[2]) mean in the context of such a plan.[3]

Justice Thomas' opinion, while concurring in the judgment, found that the Bankruptcy Code unambiguously would prevent the old equity interests from retaining *any* property under the plan on account of its junior interest and that the equity holders received at least one form of property—the exclusive opportunity to obtain equity—on account of their pre-petition equity interest. Thus, he concluded, the plan could not be confirmed, and there was no need for the majority's reliance on legislative history and its dicta concerning the desirability of a market test.

Justice Stevens pointed out that the petitioner failed to challenge the decision below on any of its findings but limited its appeal to whether the debtor's plan gave old equity an interest in the property "on account of"[4] its pre-petition interest in the debtor. On that issue, Justice Stevens found that the interest was *not* "on account of" the prior interest because the junior claimants did not receive the interest for a bargain price.

2. Why the Issue of New Value Is Critical to the Protection of Real Estate Investments

The new value issue has been considered crucial to real estate investments. An example of how a plan such as that approved by the Seventh Circuit in *LaSalle* could adversely affect the real estate mortgagee may be illustrated by the following hypothetical situation:

> Ace Insurance Company makes a $15 million loan to a real estate limited partnership, Law Drive Associates (LDA), whose only asset is an office building. LDA gives Ace a mortgage on the building to secure the payment of the note. A few years later, when the property value has decreased to $10 million, LDA files in Chapter 11 of the Bankruptcy Code. Under section 506(a) of the Bankruptcy Code, Ace is considered a secured creditor for $10 million (the value of the collateral) and an unsecured creditor for $5 million (this unsecured claim would be available whether or not the note was recourse).[5]
>
> LDA, which has an exclusive right to submit a plan of reorganization for 120 days, subject to extension by the court (90 days subject to extension if the single asset loan had been no greater than $4 million), proposes a plan under which (1) the mortgage will be reduced to the value of the collateral ($10 million) with a "market rate" interest (since there is no market for 100 percent loan-to-value loans, the "market" rates approved by courts generally reflect the rate for normal mortgage loans on buildings of that type with perhaps some add-on); (2) the unsecured class, of which Ace's deficiency claim is a part, will be paid, say, 10 cents on the dollar ($500,000 for Ace); and (3) LDA will make an equity contribution of, say, $300,000 and will retain the property free of the claims of creditors, thus wiping out $4.5 million of the mortgagee's deficiency claim.

Such a plan could be confirmed under the so-called new value exception as applied by the Seventh Circuit in *LaSalle*. The potential consequences for the real estate industry were articulated in the amicus brief of the American College of Real Estate Lawyers on behalf of the petitioner in *LaSalle*, as follows:

> Literally billions of dollars have been loaned to real estate developers by institutions, including insurance companies and pension plans that insure and protect millions of ordinary citizens, on the strength of real property collateral and the protection for realization on that collateral built into the Bankruptcy Code. Mortgage loans are securitized, rated and sold to investors seeking the security of mortgage collateral. These purchasers include individual investors and pension funds, as well as institutions investing policyholders' funds and deposits from individuals and corporations, all of whom make these investments based on the ability to realize the benefit of the bargain if there is a default in the income flow.
>
> The decision below can only result in the severe reduction of the availability of funds for real estate development from institutions and from the public, and higher credit standards and higher interest rates for those funds that are available or those securities that are sold. *LaSalle* not only threatens existing mortgage debt held by lenders, but also threatens the future of the real estate and real estate securities industry.[6]

Thus, the decision of the Supreme Court may be crucial to all parties involved in real estate financing.

3. Where Does the Holding in *LaSalle* Leave Real Estate Mortgagees?

Initially, it would appear that by striking down the plan in *LaSalle* (on the ground that only the debtor had the right to propose to give new value) the decision is helpful to the mortgagee. The unanswered question, however, is: What is the effect of a new value plan that allows others to make an offer for the property? The Supreme Court specifically saved for another day the issue of whether such a plan would satisfy its "market exposure" requirement. The Court also did not get to the issue of whether new value survived the adoption of the Code or, if it did, what prerequisites must be met before it can be applied. Yet, one cannot ignore the subtle implication in the decision—that the Court might be disposed to look favorably upon a new value plan as long as it did not afford the *exclusive* right to bid to the debtor.

Thus, it would appear almost certain that the debtor in the next new value case, or in *LaSalle* on remand, will propose a plan where the ability to offer new value is available to more than just the debtor. If we assume that such a plan giving the debtor *and others* the opportunity to contribute new capital and receive ownership interests in the reorganized entity can be confirmed, how will this affect the real estate mortgage? The answer will depend on the answers to several questions not yet considered by the courts.

a. *Who must be offered the right to participate?* One debtors' aficionado has orally communicated the suggestion that since the Supreme Court struck down the *LaSalle* plan because the debtor had the exclusive right to bid, a plan might be proposed that permits interests junior to the mortgagee to bid, but not the mortgagee. Such a plan, of course, would be based on "smoke and mirrors," because junior interests would not be expected to offer anything. By definition, the mortgage equals the value of the property (see hypothetical, p. 88). The debtor's old equity interests are bidding in excess of this value, they claim, only to avoid adverse tax consequences. Why would an interest junior to the mortgagee's secured claim want to bid at all? It is doubtful that such a plan would meet the approval of the Supreme Court, but it may be a significant period of time before that issue reaches the Court.

b. *If the plan provides for mortgagee bidding, would the mortgagee be permitted to credit bid (i.e., offset the amount owed by the debtor—including the mortgagee's deficiency claim—against any successful bid)?* One would think the answer would be yes, but the National Bankruptcy Review Commission (at least a significant group of commissioners) rejected credit bidding.[7] If credit bidding were permitted, the mortgagee would seem to be protected. However, since this would frustrate the debtor's efforts to keep the mortgaged property without paying the debt, it is likely that credit bidding will be a major issue of contention.

c. *If credit bidding is not permitted, where would the mortgagee's bid for the property go?* A predicate to new value articulated by Justice Douglas in *Los Angeles Lumber* was that the new value had to be essential to the success of the enterprise.[8] Thus, it would seem that the funds provided by the mortgagee's bid should be applied to the operation of the real estate. If the mortgagee becomes the owner as a result of its bid, it would probably not be upset about this result because the mortgagee would have to provide the funds after foreclosure, in any case. If the funds are allocated to pay unsecured creditors, the mortgagee would still appear protected since it would get back at least a lion's share of its contribution, given that its deficiency claim is normally the largest unsecured claim in single asset cases. If, however, there are junior *secured* interests, then the mortgagee's bid in excess of the mortgage balance would undoubtedly go to the junior secured creditors. Consider the effect of this in *LaSalle*, where old equity held an $11 million second mortgage. The mortgagee, having already lost most of its $38 million deficiency claim, will be asked to add to its loss by paying money to the debtor's principals! Under such circumstances, the mortgagee will probably not accept the invitation to offer a competing new value plan. Further, consider the effect of this uncertainty on real estate financing, where due-on-encumbrance clauses will be a necessity, and junior financing will become virtually impossible.[9]

d. *If competing plans may be offered, will the court be required to pick the plan offering the highest bid?* This is unclear. If courts find that a debtor's new value plan is "fair and equitable" (meets the requirements of absolute priority and can be confirmed), there is no requirement that the court select a competing plan, even if it offers more, although the Code states that the court should "consider" the "preferences" of creditors and equity security holders in making its determination.[10] For example, if the mortgagee's plan is sweeter, can the court nevertheless accept the debtor's plan on the ground that any benefit received by the estate from the higher bid is offset by the need to provide the debtor with a "fresh start"?

Thus, while elimination of exclusivity may seem an enticing solution to the new value problem, the decision could, if interpreted as a debtor would like, have significant and adverse effects on the mortgagee's position and thus on the future of real estate financing.

4. Why New Value Subverts the Intention of the Drafters of the Bankruptcy Code

One of the objectives of the drafters of the Bankruptcy Code was to protect real estate financing in a single asset real estate borrower's Chapter 11 proceeding by requiring "absolute priority" for dissenting creditor classes impaired by the debtor's proposed plan of reorganization. These provisions were the result of the so-called *Pine Gate*[11] line of cases, decided under Chapter XII of the former Bankruptcy Act, under which the bankruptcy courts allowed debtors to retain the mortgaged property upon paying the non-recourse mortgagee the depressed value of the collateral. At the time of those cases, there was no requirement for absolute priority under Chapter XII. As a result, Congress was asked to restore absolute priority to real estate arrangements under the new Chapter 11 of the Bankruptcy Code. Absolute priority requires that a plan be "fair and equitable" as to dissenting impaired creditors. Painting the picture with a rather broad brush, the protection provided by Congress is accomplished under the provisions of section 1129(b) of the Bankruptcy Code. Essentially, section 1129(b) prohibits the confirmation of a debtor's plan under which the borrower retains property "on account of" its prior ownership interest while creditors remain unpaid. The object was to prevent the borrower from keeping the asset without paying debts.

In *Los Angeles Lumber*,[12] discussed earlier, a 1939 pre-Code Supreme Court decision, Justice Douglas rejected a plan that would have awarded an interest to stockholders ("old equity") of the debtor based on a promised contribution of expertise to the enterprise. In *dicta*, Justice Douglas indicated that where funds were essential to the enterprise, it might be possible for the plan to award an interest to old equity in return for its contribution of the needed money or money's worth, provided that the interest retained by old equity was reasonably equivalent to the contribution, and the creditors' "full right of priority" was preserved.[13] This became known as the "new value exception" to the absolute priority rule.

No reported case applied the new value exception between the 1939 dicta and the adoption of the Bankruptcy Code in 1978.[14] Thereafter, particularly in single-asset real estate cases, a form of new value exception has often been applied.[15] As illustrated by the hypothetical above, in those post-Code decisions that have applied the new value exception, the debtor has been able to reduce the mortgage to the value of the collateral and retain the property in return for the new value contribution, while creditors' claims (including the mortgagee's deficiency claim—the amount of debt exceeding the value of the collateral) remain uncompensated. This result subverts the objective of the Code drafters and creates a situation that is somewhat worse for the mortgagee than under the *Pine Gate* rule the drafters were attempting to overcome. While under Chapter XII the mortgagee received the value of the collateral in cash, under the new value exception, as interpreted in single asset cases, the mortgagee would receive only a mortgage with a balance equal to 100 percent of the court-determined value of the collateral.

Opponents of this application of new value, have argued the following:

a. There is no new value exception in the Bankruptcy Code since Congress adverted to and rejected the exception by dealing with the problem the exception was designed to meet in a different way (by requiring absolute priority only for dissenting impaired classes of creditors, thus permitting classes to agree to allow old equity to participate); and

b. The new value exception as applied in post-Code cases does not meet the requirements articulated by Justice Douglas—namely, that the full priority rights of creditors be maintained (including the creditor's right to the control of the enterprise), that the new value be necessary to the preservation of the enterprise and that the interest retained by old equity (including the value of control) not be greater than the contribution made.

In *LaSalle*, the Seventh Circuit rejected the above arguments and concluded, in essence:

a. Since Congress does not write on a clean slate, it is apparent that without explicit language rejecting Justice Douglas' *dicta*, new value applies under the Code;

b. The language of Bankruptcy Code section 1129(b) permits new value plans because it prohibits the retention of an interest by old equity only "on account of" its former interest, not when old equity retains an interest by offering new value; and

c. The post-Code new value plan meets pre-Code requisites set forth by Justice Douglas if the contribution is "substantial" in the judgment of the court, necessary to the confirmation of the debtor's *plan*, and reasonably equivalent to the value of the enterprise obtained by old equity (excluding the value of control).

In *LaSalle*, the Supreme Court failed to deal with any of these arguments except to hold that a plan giving the debtor the exclusive right to contribute new value and retain an interest could not be confirmed.

5. What Does the Future Hold?

As a result of its very limited holding, the immediate effect of the Supreme Court decision all were waiting for may well prove to provide full employment for Chapter 11 attorneys and congressional lobbyists as the attention shifts back—for the time being—from the Supreme Court to the bankruptcy courts and Congress for a resolution of these complex issues.

Endnotes

1. 119 S. Ct. 1411 (1999).
2. 308 U.S. 106 (1939).
3. The great interest in this case can be seen from the number of amicus briefs submitted. The American Bankers Association and the California Bankers Association (for Petitioner); American College of Real Estate Lawyers (for Petitioner); American Council of Life Insurance (for Petitioner); Prof. Ronald Mann and eight other law professors (for Petitioner); Prof. Bruce Markell (for Respondent); National Association of Credit Management (for Respondent); National Small Business United and other credit organizations (for Respondent); and the United States (for Petitioner).
4. Section 1129(b)(2)(B)(ii) of the Bankruptcy Code prohibits confirmation of a plan under which the debtor retains an interest "on account of its junior claim or interest" while creditors remain unpaid.
5. The alternative afforded the real estate mortgagee by Bankruptcy Code § 1111(b)(2)—electing a claim equal to the full amount of the existing debt with a current value equal to the value of the collateral—is not at issue in most new value situations and is not discussed here.
6. Brief of the American College of Real Estate Lawyers as Amicus Curiae in Support of Petitioner, *Bank of America v. 203 N. LaSalle Street Partnership*, 119 S. Ct. 1411 (1999).
7. *See* National Bankr. Rev. Comm'n, "Bankruptcy: The Next Twenty Years, Final Report" at 563-65 (1997) (discussing perceived problems with use of credit bidding).
8. 308 U.S. 106, 121 (1939).
9. Due-on-encumbrance clauses would not solve the problem completely since there could be nonconsensual liens, such as judgment liens, junior to the mortgage.
10. Section 1129(b) of the Bankruptcy Code provides, in part: "If the requirements of subsections (a) and (b) of this section are met with respect to more than one plan, the court shall consider the preferences of creditors and equity security holders in determining which plan to confirm."
11. *In re Pine Gate Assoc., Ltd.,* 2 Bankr. Ct. Dec. (CRR) 1478 (Bankr. N.D. Ga. 1976).
12. 308 U.S. 106 (1939).
13. Professors Ayer and Markell believe these requirements could never be met. John D. Ayer, *Rethinking Absolute Priority after* Ahlers, 87 Mich. L. Rev. 693, 1015 (1989); Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 Stan. L. Rev. 69, 93 (1991). *Compare* Robert M. Zinman, *New Value and the Commission: How Bizarre!*, 5 Am. Bankr. Inst. L. Rev. 477, 487-90 (1997).
14. In his concurring opinion in *LaSalle,* Justice Thomas stated:

    > [P]rior to the Code's enactment, no court ever relied on the *Case* dictum to approve a plan. Given its questionable pedigree prior to the Code's enactment, a concept developed in dictum and employed by lower federal courts only *after* the Code's enactment is simply not relevant to interpreting this provision of the Code.

    119 S. Ct. 1411, 1425 (1999) (emphasis added).
15. *See* Zinman, *supra* note 13 at 487-90.

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Another Blow to a Municipality's Tax Base—New Owners of Generating Facilities May Be Denominated Article 9-A Corporations and Thereby "Exempt" from Real Property Taxation

By Damian Hovancik and Mark D. Lansing*

I. Facts and Introduction

Beginning in 1996, the utility corporations in the state of New York embarked on the unbundling and deregulation of their generation assets. As part of that function, all utility corporations (except Central Hudson Gas & Electric Corporation—which retained the right to purchase its generation assets through a wholly owned subsidiary at its proposed auction) submitted plans to divest themselves of their generation assets (other than nuclear generation assets). In fact, all generation assets of New York State's public utility corporations (except nuclear, Central Hudson Gas & Electric Corporation's generating facilities, and two non-nuclear generating facilities of Niagara Mohawk Power Corporation) have been sold or are under contract to be sold (pending the Public Service Commission's approval).

For example, Niagara Mohawk Power Corporation recently announced the sale of seventy-six hydroelectric generation facilities to Orion Power Holding, Inc., as well as the sale of two of its fossil fuel generating stations to NRG Energy. In addition, Orange and Rockland Utilities, Inc. and New York State Electric & Gas Corporation made similar divestitures of their generation assets to Southern Company, AES Corporation, and Edison Mission.

If these new owners are considered Article 9-A corporations by the Department of Taxation and Finance (or they are legislated to be so) that status might result in certain machinery and equipment located at generation facilities being found to be non-taxable property immediately upon the transfer of title.[1]

II. Real Property Legal Analysis

Under New York real property tax case law, it is fundamental that real property is valued as it exists on the valuation date in question.[2] The Fourth Department held in *Addis Co. v. Srogi*[3] that "[p]roperty is assessed for tax purposes according to *its condition on the taxable status date, without regard to future potentialities or possibilities* and may not be assessed on the basis of some use contemplated in the future [citations omitted] [emphasis added]."[4]

In valuing real property, the Suffolk County Supreme Court in *Long Island Lighting Co. v. Assessor for Town of Brookhaven* stated: "In determining the market value on each [valuation date], the court must consider not only the condition of the property on that date, *but the existing state of the business world* and the political world insofar as it affects the market value of the [Station] [emphasis added]."[5]

To determine what property constitutes taxable real property, a few fundamental principles must be applied. First, "[t]he taxation of real property is authorized solely by statute. It is competent for the legislature to determine that any property, . . . , is real property for tax purposes."[6] In *Herkimer County Light & Power Co. v. Johnson*, the Appellate Division, Fourth Department established the long-held rule that, for real property tax purposes, the only applicable or relevant definition of real property was the one contained in the statute.[7] Therefore, and "[d]espite the common-law classifications of property as realty or personalty, '[t]he Legislature has the power to classify property as real property or not for purposes of taxation provided there is a reasonable basis for the classification.'"[8] Conversely, if the statute does not define certain property as real property, such property is not taxable real property.[9]

A second fundamental principle is that tax statutes are "to be construed *most strongly against* the government and in favor of the taxpayer [case citation omitted] and that they must be given a practical construction and be interpreted as an ordinary person reading them would understand them [emphasis added]."[10] However, this favorable interpretation for taxpayers is modified with respect to tax statutes providing an exemption or which take certain property out of the definition of real property. In those situations, "[t]ax exemptions . . . are limitations of sovereignty and are strictly construed. [Cases cited.] If ambiguity or uncertainty occurs, all doubt must be resolved against the exemption."[11]

A third principle is that the purpose of the Real Property Tax Law is "aimed principally at expanding the definition of real property with respect to utility companies."[12] As stated in *Crystal v. City of Syracuse Department of Assessment*, "[t]he concept of treating similar property differently for tax purposes, depending on the status of the owner or his use of the property is not new [citations omitted] and the discrete classification of electric utility equipment, . . . , has been recognized for years [case citations omitted]."[13]

However, "it is a well-settled rule that in the absence of statute, installations of public utilities retain their character as personal property."[14] As a result of the expansive treatment given to utility real property under the Real Property Tax Law, the courts have initially engaged in analyses determining whether the corporate owner of the subject real property is, in fact, a utility. If not, then the purported expansive nature of the Real Property Tax Law, with respect to utility real property, has been held inapplicable.[15]

III. Article 9-A Corporation

At one time, all property, both real and personal, was taxable. In 1933, the legislature determined that personal property should no longer be taxed. It also determined that, since a N.Y. Tax Law Article 9-A corporation was subject to a franchise tax, certain otherwise defined real property would not be subject to real property taxes if owned by an Article 9-A corporation.[16]

Based on the above-stated fundamental principles and legislative history, the meaning and effect of Tax Law Article 9-A on N.Y. Real Property Tax Law section 102(12)(f) (RPTL) in this new, deregulated market for electricity generation assets must be analyzed. First, this article analyzes RPTL section 102(12)(f), assuming the new owner is an "Article 9-A corporation." Then, the analysis shifts to the question of what constitutes an "Article 9-A corporation" under the Tax Law.

A. RPTL Section 102(12)(f) States Machinery and Equipment of Article 9-A Corporations Are Not Real Property

The pertinent language of RPTL section 102(12)(f) provides that the following property shall not be taxable real property:

> . . . movable machinery or equipment consisting of structures or erections to the operation of which machinery is essential, owned by a corporation taxable under *article nine-a of the tax law*, used for trade or manufacture and not essential for the support of the building, structure or superstructure, and removable without material injury thereto [emphasis added].[17]

By this language, generation property is non-taxable real property if each of the following six factors are satisfied:[18]

1. "movable machinery or equipment";
2. "consist[s] of structures or erections to the operation of which machinery is essential";
3. "owned by a corporation taxable under article nine-a of the tax law";
4. "not essential for the support of the building, structure or superstructure";
5. "removable without material injury thereto"; and
6. "used for trade or manufacture."

In determining whether elements 1, 2, 4 and 6 are met, both the intent of the owner and the actual permanency of the attachment to the real property are dispositive.[19]

To determine an owner's intent as to whether an improvement is permanently or semi-permanently affixed to realty, common law principles are not controlling, but they are instructive.[20] The Court of Appeals stated in *Consolidated Edison v. City of New York*: "While, as we have noted, common law principles are not determinative, they are instructive. Here the question must be resolved by reference *to the degree of physical and functional connection to the land-based station, as well as by reference to the intention of the parties* [emphasis added]."[21]

In *City of Lackawanna v. State Board of Equalization*, the Court of Appeals explained the interrelation between the application of common law principles with the actual statutory definition of real property, as follows:

> There is no doubt that, by common-law standards, these structures would be deemed real property. Their magnitude, their mode of physical annexation to the land and the obvious intention of the owner that such annexation be permanent would, indeed, compel that conclusion. *However, this is not decisive of the question presented. There must also be considered the definition of taxable real property contained in subdivision 12 (par. [f]) of section 102 of the Real Property Tax Law* [emphasis added].[22]

To determine whether certain machinery and equipment constituted real property in *Honeoye Corp. v. Board of Assessors of the Town of Bristol*, the Fourth Department stated:

> Inclusion in the definition of real property should depend on whether the equipment is *so inextricably attached* to

real property as to become a part thereof, not on the title of the business it is used in.

The equipment here is not of such tremendous size, and its installation of such a permanent nature, as to make its movement both physically and economically unfeasible. [Case citations omitted]. The equipment is fastened to the concrete floor by bolts and *is readily removed from the property*, although not necessarily without the use of a crane for the larger items, *without material damage to the structure*. Furthermore, the equipment is *not essential* to the *support of the building.* Therefore, it is not included in the category of real property. [Case citation]. [23]

A comparison of *Consolidated Edison v. City of New York* and *Honeoye Corp. v. Board of Assessors of the Town of Bristol* reveals that the key factors in determining whether property is affixed, as opposed to movable machinery, are the following:

1. the intent of the owner to permanently affix the improvement to the realty, building or structure;
2. the actual permanency of the attachment of the improvement to the realty, building or structure;
3. the size and magnitude of the improvement;
4. the essentialness of the equipment to the support of the building;
5. the injury (if any) to the building or structure by the removal of the improvement;
6. the size, nature and time of a project required to remove the improvement from the realty, building or structure;
7. whether the machinery is used in trade or manufacturing; and
8. the market, if any, for the movable machinery or equipment.[24]

With regard to manufacturing, it is defined as follows:

> "manufacturing" has been generally defined, for tax purposes, as the production, whether by hand or machinery, of a new and different article or product from raw or prepared materials, resulting in a product having a distinctive name, character and use. Some further treatment in order to fit for its ultimate use does not necessarily preclude the production process from being classified as manufacturing.[25]

For generation assets, the issue of "manufacturing" is of interest only because a limited number of cases have addressed the issue of whether electricity is a product or service. Those cases held that electricity was a service. If electricity is not a product, then the new generating facility owner is not a manufacturer and may not be able to take advantage of RPTL section 102(12)(f).

Assuming the owner demonstrates it is in manufacturing, the following properties of an Article 9-A corporation have been held to be non-taxable movable machinery:

1. a hopper, crushers, two-deck and triple-deck screens, conveyors, a classifying device, and electric motors, all of which were generally bolted to concrete foundations;[26]
2. ski lift machinery and equipment, bolted to concrete foundations;[27]
3. compressor station equipment, purification equipment and measuring regulating equipment, odorizer, filter separator, fuel heater and meter, four control panels, a calorimeter and generator (all could be unbolted, moved and without injury to building; not essential to structure of building and not of tremendous size);[28] and
4. 60-ton scale and bridge crane.[29]

Conversely, the following machinery were held not to be movable machinery, and thereby, constituted taxable real property:

1. blast furnaces, open hearth furnaces, soaking pit furnaces, and coke ovens were too large and too affixed to property to be movable machinery.[30]
2. four film coating machines (300 feet in height, not removable without removing brick wall);[31]
3. emergency power electric generating equipment (comprised of seven generators capable of generating 6 mw; required removal of exterior walls);[32]

For new owners of generating facilities that are Article 9-A corporations, the following property at a generating station may be found to be non-taxable real property:

1. generating turbines,
2. gas turbines and control panels,
3. emergency generators,
4. air pollution control facilities (Low NO_x burners), [33]
5. transformers,
6. certain components of switchyard, and

7. coal conveyors.

This list is not all-inclusive. To obtain a more detailed list of potentially non-taxable improvements located at a generating facility, the new owner must consult an engineer familiar with the components of the generating facility.

B. What Is an Article 9-A Corporation?

The final question regarding the exception to the definition of real property under RPTL section 102(12)(f) is, What constitutes an Article 9-A corporation? Recently, a number of public utility corporations sought guidance on this issue.[34]

By an advisory opinion for the El Paso Energy Marketing Company, the Department of Taxation and Finance (T&F) reviewed the interplay between Article 9 and Article 9-A of the Tax Law.[35] El Paso sought to set up a limited partnership in New York that would purchase and sell natural gas in the state of New York, but whose operation would not be subject to PSC supervision. El Paso sought a determination of whether Article 9 or Article 9-A was controlling. The Department of Taxation and Finance stated:

> To determine the classification and proper taxability of a corporation under either Article 9 or Article 9-A, an examination of the nature of the corporation's activities is necessary, regardless of the purpose for which the corporation was organized. See *Matter of McAllister Bros., Inc. v. Bates*, 272 App. Div. 511, 517 (3d Dep't 1947). Ordinarily, a corporation is deemed to be principally engaged in the activity from which more than 50 percent of its receipts are derived. See, e.g., *Joseph Bucciero Contracting, Inc.*, TSB-A-81(5)C, dated July 23, 1981.[36]

In another scenario, and before consummating their merger and acquisition, Long Island Lighting Company requested an opinion concerning the application of Tax Law sections 186 and 186-a (Article 9 of the Tax Law) to the new holding company, BL Holding, Inc. Without addressing the facts of that requested opinion, the Department of Taxation and Finance reiterated the criteria for determining whether an entity would be subject to tax under Article 9 or Article 9-A.

The sections and the criteria under which an entity may be subject to tax under Article 9 are as follows:

1. Article 9, section 186 requires that more than 50 percent of the corporation's receipts be from supplying gas or electricity in order to be "principally engaged" in the utility business;
2. Article 9, section 186-a requires that:
   (a) the entity be under PSC supervision; and/or
   (b) the entity sell gas or electricity by means of mains, pipes, or wires, etc., whether or not such activities are the main business of the entity.

In addition, section 209.4 of Article 9-A provides that corporations subject to the taxes of section 186 (not section 186-a) of the Tax Law (Article 9) are not liable for the taxes under Article 9-A (i.e., are not Article 9-A corporations). Although not specifically addressed in these rulings, T&F has ruled that a company can be subject to both the utility tax of section 186-a and the franchise tax of Article 9-A.[37] If this is accurate, the application of section 186-a would not necessarily affect an entity's ability to exempt property from the real property tax under RPTL section 102(12)(f).

In describing Tax Law sections 186 and 186-a, the Department of Taxation and Finance has repeatedly stated:

> Section 186 of the Tax Law imposes a franchise tax upon every corporation, joint-stock company or association formed for or principally engaged in the business of supplying gas, when delivered through mains or pipes, or electricity, "for the privilege of exercising its corporate franchise or carrying on its business in such corporate or organized capacity in this state."
>
> Section 186-a of the Tax Law imposes an excise tax on the furnishing of utility services . . . of a utility that is subject to the supervision of the PSC . . . or every other utility doing business in New York. Utility includes a person (whether or not such person is subject to such supervision) who sells or furnishes gas or electricity, by means of mains pipes or wires.[38]

As in *El Paso Energy Marketing Co.* (where T&F was confronted with the issue but did not decide whether El Paso was an Article 9-A corporation because of insufficient or indeterminable facts), neither of the other two advisory opinions directly addressed the factual question of whether, for example, BL Holding (or any of the limited liability companies under its umbrella) constituted an Article 9-A corporation. The failure of T&F to apply the law to the facts, or any proposed set of facts, is based on the requesting party's inability to provide a specified set of facts. As stated in *El Paso Energy Marketing Co.*,[39] "[a]n advisory opinion merely sets for the applicability of pertinent statutory and regulatory provisions to a specified set of facts."[40]

In *El Paso Energy Marketing Co.*, T&F addressed both the partnership's status and that of the partners under Article 9 or Article 9-A by stating that a partnership engaged in the purchase and sale of natural gas is subject to the tax imposed under section 186-a of Article 9. A corporation engaged in the same business would be found to have the same status. Regarding the status of the partners (there were two corporate partners, of which one was the wholly owned subsidiary of the other), T&F refused to make a determination as to the applicability of section 186 of Article 9, as it found the inquiry to be to fact intensive. However, it stated the following two general concepts:

> If Newco is a mere passive investor and does not participate in the day-to-day management or operations of Partnership, then, pursuant to *GTE Spacenet Corp. v. NYS Dept of Tax and Finance*, 224 A.D.2d 283 (1st Dep't 1996), Newco will not be subject to tax under section 186 of Article 9 of the Tax Law. However, if Newco is not a mere passive investor and it participates in the day-to-day management or operations of Partnership, Newco will not come within the scope of *GTE Spacenet*, and following *The Partners of Buffalo Telephone Company*, TSB-A-89(3)C, dated February 22, 1989,[41] Newco will be considered to be engaged in the business of Partnership and will be subject to tax under section 186 of the Tax Law.[42]

T&F then stated that "[t]he determination of whether Newco is a mere passive investor and whether it participates in the day-to-day management or operations of Partnership is a question of fact that is not susceptible of determination within the context of an advisory opinion."[43]

Presently, whether a new purchaser of generating assets is subject to Article 9 or Article 9-A of the Tax Law is a fact-intensive inquiry and not the subject of a blanket determination. However, and unless otherwise legislated, if the purchaser corporation (or a spun-off subsidiary), or LLC (or partnership) combined with a parent corporation under the principles of *GTE Spacenet*, is subject to the PSC's supervision or has total corporate receipts exceeding 50 percent from gas or electric sales, then T&F's opinion in the past has been that such corporations are Article 9, and not 9-A, corporations. As concisely summarized by T&F:

> GenSub would be in the business of generating and selling electricity. *If more than 50 percent* of GenSub's gross receipts are from such business, GenSub would be principally engaged in such business, and GenSub would be subject to tax under section 186 of the Tax Law. The tax would be imposed on GenSub's gross earnings, that is, all receipts from the employment of capital without any deduction, from all sources within New York State. *If 50 percent or less* of its receipts are from generating and selling electricity, then GenSub would be subject to tax under Article 9-A of the Tax Law pursuant to section 209.1 of the Tax Law [emphasis added].[44]

To summarize, in determining whether the new owner of a generating facility is an Article 9-A corporation, the following factors must be considered, (not necessarily all-inclusive):

1. amount of total corporate receipts from gas or electric sales, and how computed;
2. movability of assets;
3. activity of holding or parent company in managing or operating subsidiary's business; and
4. whether electricity is recognized as a manufactured good or product.

The final outcome to the new owner of generation assets—reduced taxes from deregulation, and, thereby, lower costs to the customer.

Endnotes

1. With the sales consummated, it would appear that only those utility subsidiaries purchasing generation assets in New York State are beneficially impacted by the Department of Taxation and Finance's determination that these out-of-state purchasing corporations are Article 9-A corporations. These subsidiaries, if not already so denominated, should seemingly likewise be considered Article 9-A corporations. Legislation may slow the treatment of such property to being non-taxable property.
2. *See Addis Co. v. Srogi*, 79 A.D.2d 856, 434 N.Y.S.2d 489 (4th Dep't 1980); *Long Island Lighting Co. v. Assessor for Town of Brookhaven*, Index Nos. 76/15628 *et al.* (Sup. Ct., Suffolk Co. 1992), *aff'd*, 202 A.D.2d 32, 616 N.Y.S.2d 375 (2d Dep't 1994).
3. 79 A.D.2d at 857, 434 N.Y.S.2d at 490.
4. *See also Spiegel v. Board of Assessors*, 161 A.D.2d 627, 555 N.Y.S.2d 811 (2d Dep't 1990), *app. dismissed without op.,* 76 N.Y.2d 889, 561 N.Y.S.2d 550, 562 N.E.2d 875 (1990) (real property must be assessed according to its condition and ownership as of the tax status date).
5. *Long Island Lighting Co.,* Index Nos. 76/15628 at 35.
6. *See Crystal v. City of Syracuse Dep't of Assessment*, 47 A.D.2d 29, 30, 364 N.Y.S.2d 618, 620 (4th Dep't 1975).
7. 37 A.D.2d 257, 55 N.Y.S.2d 924 (4th Dep't 1899).
8. *See Metromedia, Inc. v. Tax Commission of City of New York*, 60 N.Y.2d 85, 90, 468 N.Y.S.2d 457, 459 (1983); *see also Niagara Mohawk Power Corp. v. Cutler*, 109 A.D.2d 403, 405, 492 N.Y.S.2d 137 (3d Dep't 1985), *aff'd*, 67 N.Y.2d 812, 501 N.Y.S.2d 325 (1986); *D.P.C. Reconstruction Finance Corp. by N.L. Industries, Inc. v. Assessor of Town of*

Johnsburg, 135 A.D.2d 224, 525 N.Y.S.2d 404 (3d Dep't 1988).

9. *See Herkimer Light and Power v. Johnson,* 37 A.D.2d at ___, 55 N.Y.S.2d at 927 (4th Dep't 1899).

10. *See Crystal*, 47 A.D.2d at 31, 364 N.Y.S.2d at 620; *Manhattan Cable TV Serv. v. Freyberg*, 49 N.Y.2d 868, 427 N.Y.S.2d 933 (1980); *Grumman Corp. v. Board of Assessors of Town of Riverhead*, 2 N.Y.2d 500, 510, 161 N.Y.S.2d 393, 400 (1957); *Quotron Systems v. Irizarry*, 48 N.Y.2d 795, 423 N.Y.S.2d 918 (1979).

11. *See City of Lackawanna v. State Board of Equalization*, 16 N.Y.2d 222, 226-27, 264 N.Y.S.2d 528, 534 (1965); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. The Tax Commission of the City of New York*, (Sup. Ct., N.Y. Co. 1992) (J. Parness), *aff'd*, 191 A.D.2d 403, 595 N.Y.S.2d 688 (1st Dep't 1993).

12. *See Manhattan Cable TV Serv.*, 49 N.Y.2d 868; *Quotron Systems,* 48 N.Y.2d 795.

13. *See Crystal*, 47 A.D.2d at 32, 364 N.Y.S.2d at 622 (*see* cases cited therein at n.2).

14. *Id.* at 31.

15. *Id.*

16. *See Martin v. Gwynn,* 18 A.D.2d 851, 236 N.Y.S.2d 755 (3d Dep't 1963); *West Mountain Corp. v. Miner,* 85 Misc. 2d 416, 381 N.Y.S.2d 606 (Sup. Ct., Warren Co. 1976)

17. RPTL § 102(12)(f).

18. *See West Mountain Corp.*, 85 Misc. 2d at 422, 381 N.Y.S.2d at 610.

19. *See People ex rel. New York Edison Co. v. Feitner*, 45 Misc. 12, 90 N.Y.S. 826 (Sup. Ct., Oneida Co. 1904), *aff'd,* 99 A.D. 274, 90 N.Y.S. 904 (1st Dep't), *aff'd*, 181 N.Y. 549 (1905); *In re New York Telephone Co. Canoughl*, 290 N.Y. 537 (1943); *Consolidated Edison v. City of New York*, 44 N.Y.2d 536, 406 N.Y.S.2d 727 (1978); *Honeoye Corp. v. Board of Assessors of the Town of Bristol*, 77 A.D.2d 468, 433 N.Y.S.2d 943 (4th Dep't 1980).

20. *See Consolidated Edison*, 44 N.Y. 2d at 541 ("[t]he concepts and refinements which have been developed in the classifications of types of property at common law, while not determinative, are relevant for present purposes").

21. *Id.* at 542, 406 N.Y.S.2d at 731.

22. *City of Lackawanna v. State Bd. of Equalization*, 16 N.Y.2d 222, 226-27, 264 N.Y.S.2d 528, 531 (1965).

23. 77 A.D.2d at 471, 433 N.Y.S.2d at 946 (4th Dep't 1980).

24. *See Consolidated Edison,* 44 N.Y.2d at 541-42, 406 N.Y.S.2d at 730-31; *Honeoye Corp. v. Board of Assessors of the Town of Bristol,* 77 A.D.2d 468, 471, 433 N.Y.S.2d 943, 946 (4th Dep't 1980); *see also City of Lackawanna,* 16 N.Y.2d at 226-31, 264 N.Y.S.2d at 531-35; *Martin v. Gwynn,* 18 A.D.2d 851, 852, 236 N.Y.S.2d 755, 757 (3d Dep't 1963); *West Mountain Corp. v. Miner*, 85 Misc. 2d 416, 418, 381 N.Y.S.2d 606 (Sup. Ct., Warren Co. 1976).

25. *See Application of Will of Sirotta*, 117 Misc. 2d 1088, 460 N.Y.S.2d 242 (Sur. Ct., Westchester Co. 1983), *aff'd as mod. on other grounds*, 106 A.D.2d 507, 483 N.Y.S.2d 40 (2d Dep't 1984); *People ex rel. Post & McCord, Inc. v. Cantor*, 108 Misc. 632, 178 N.Y.S. 579 (Sup. Ct., N.Y. Co. 1919), *aff'd*, 194 A.D. 961, 185 N.Y.S. 949 (1st Dep't 1920), *aff'd*, 231 N.Y. 552 (1921).

26. *Martin v. Gwynn*, 18 A.D.2d 851, 236 N.Y.S.2d 755.

27. *West Mountain Corp.*, 85 Misc. 2d at 422, 381 N.Y.S.2d at 610.

28. *Honeoye Corp. v. Board of Assessors of the Town of Bristol*, 77 A.D.2d 468, 471, 433 N.Y.S.2d 943, 946 (4th Dep't 1980).

29. *Wallace v. Tompkins County Bd. of Assessment Review*, 92 A.D.2d 708, 460 N.Y.S.2d 384 (3d Dep't 1983).

30. *City of Lackawanna v. State Bd. of Equalization*, 16 N.Y.2d 222, 226-27, 264 N.Y.S.2d 528, 531 (1965).

31. *Anitec Imacre Corp. v. Assessor of City of Binghamton*, 109 A.D.2d 962, 486 N.Y.S.2d 454 (3d Dep't 1985).

32. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. The Tax Comm'n of the City of New York*, 191 A.D.2d 403, 595 N.Y.S.2d 688 (1st Dep't 1993) (by reason of their size, complexity, manner of annexation, intended to be permanent when installed).

33. We recognize such improvement is specifically non-taxable property under the RPTL. We list this property merely as an example of the nature of the property that might be considered non-taxable property from the provisions of RPTL § 102(12) if the improvement were owned by an Article 9-A corporation.

34. Moreover, in 1998, the New York State Business Council recognized that utilities were restructuring their subsidiaries to be Article 9-A corporations, and the potential benefits associated therewith, as it recommended legislation that would eradicate a "subsidiary tax" on the holding company. *See* S.7320.

35. *See El Paso Energy Marketing Co.*, TSB-A-98(8)C, dated June 15, 1998.

36. *Id.* at 3.

37. *See RCN of New York, Inc.*, TSB-A-94(7)C, dated May 12, 1994.

38. *Central Hudson Gas & Electric Corp.*, TSB-A-98(2)R, dated July 29, 1998, at pp. 10, 11 (impliedly determined the proposed restructuring transaction did not result in Article 9-A application); *Long Island Lighting Co. v. Assessor for Town of Brookhaven*, Index Nos. 76/15628 *et al.* (Sup. Ct., Suffolk Co. 1992), *aff'd*, 202 A.D.2d 32, 616 N.Y.S.2d 375 (2d Dep't 1994)., *El Paso Energy Marketing Co.*, TSB-A-98(8)C.

39. Another unresolved issue concerning RPTL § 102(12)(f), is whether all machinery and equipment of an entity which is subject to § 186-a, and that is also an Article 9-A corporation, can be non-taxable real property. The alternative is that any assets of an Article 9-A corporation used in a utility business (taxed under § 186-a) would not be exempt under the RPTL.

40. N.Y. Tax Law § 171, twenty-fourth; 20 NYCRR 2376.1(a).

41. *See The Partners of Buffalo Telephone Co.*, Adv. Op. Comm. T&F, Feb. 22, 1989, TSB-A-89(3)C. T&F determined that if a partnership is exercising any of the privileges of § 209.1, then all of its corporate general partners are subject to the tax imposed by Article 9-A. Based on this reasoning, T&F opined that the logical extension of this analysis applied equally to partnership exercising the activities set forth under § 186 or 186-a of Article 9 (i.e., that all corporate general partners would be subject to the same taxation).

42. *El Paso Energy Marketing Co.*, TSB-A-98(8)C at p. 3.

43. *Id.* at p. 3.

44. *New York State Electric and Gas Corp.*, TSB-A-98(11)C, dated July 29, 1998, at p. 9.

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Utility Valuation Following Deregulation Revisited as Court of Appeals Speaks on Utility and Commercial Property Valuation in Tax Certioraris

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In a prior article,[1] the issue of valuing utility and complex commercial property in tax certiorari proceedings in the state of New York was explored. That article particularly emphasized the developing "market" relative to electric generation assets resulting from the deregulation and unbundling of the generation assets of the utility industry. Essentially, the Court of Appeals recently decided four tax certiorari proceedings, which directly commented upon the concept of a "market." The Court of Appeals confirmed that article's conclusion that the market approach (or income approach) is preferable to the cost approach to value generation assets in the new deregulated frontier (thereby, further eroding the cost approach), provided such market exists.[2]

Those recent Court of Appeal cases predominantly addressed two issues: (1) the standard of proof in a tax certiorari proceeding and (2) the impact and presence of a market on valuation methods. The remainder of this article explores the impact of those decisions on the valuation of complex industrial, commercial and utility property in the state of New York. Initially the standard of proof implications are analyzed, followed by review of the re-affirmance that the sales and income approaches to value are preferable to the cost approach.

A. The Standard of Proof

It has been long held in New York that the taxpayer in a real property tax proceeding must, at a minimum, evince substantial evidence to prove a prima facie case.[3] Left for many years undecided (or at least not specifically addressed in various appellate court decisions) was what evidentiary standard governed the tax proceeding once the prima facie case was established.[4] That indecision and confusion were silenced by the recent Court of Appeals decisions.[5]

Historically, a real property tax assessment has been treated as presumptively valid. As such, a taxpayer must rebut that presumption by establishing a prima facie case that the assessment(s) is(are) erroneous.[6] The Fourth Department succinctly explained the presumption as follows:

> Such *a presumption is not evidence* but serves in place of evidence until the opposing party comes forward with his proof, whereat it disappears. *It has no weight as evidence and is never to be considered in weighing evidence.* In other words, it merely obviates any necessity, on the part of the assessors, of going forward with proof of the correctness of their valuation. So understood, "the presumption of correctness" is merely another way of saying that the burden of proof in a proceeding to review an assessment is on the relator-taxpayer. On him that burden has always rested. [Case citations omitted; emphasis added.][7]

Once the prima facie case is made, the assessment loses its presumptive validity and can no longer be used to determine the value of the property.[8]

The evidentiary standard to establish a prima facie case was, and is, substantial evidence.[9] While some courts once held that the standard was "clear and convincing evidence,"[10] that standard was put to rest in the 1980s.[11] Unfortunately, recognition of the lower standard and actual application of that standard became diametrically at odds in the appellate courts, necessitating that the Court of Appeals revisit the issue.[12]

Substantial evidence is not a demanding standard.[13] It is only "such relevant proof as a reasonable mind may accept as adequate to support a conclusion."[14] The standard is "[m]ore than seeming or imaginary, it is less than a preponderance of the evidence, overwhelming evidence, or evidence beyond a reasonable doubt."[15] In its recent decisions, the Court of Appeals held that a taxpayer's challenge of its real property tax assessments cannot be dismissed when it provides reasonable and competent expert evidence that is based on objective data and sound appraisal theory (even when such evidence is anecdotal).[16] However, objectivity does not mean a total lack of appraisal judgment. In *Broadway-Saranac v. Board*,[17] the Third Department placed the substantial evidence standard and appraisal judgment in proper focus, as follows:

> Although his appraisal was not free from error, the *de minimis* errors which we do find do not detract from the

over-all reliability of his report. Most of the criticisms . . . *deal with matters of judgment*, and it is clear to us that the *exercise of judgment* by petitioner's expert was *generally supported by substantial facts*. [Emphasis added.][18]

Once the taxpayer jumped this low hurdle of substantial evidence, the issue became what evidentiary standard governed the remainder of the proceeding to determine whether the taxpayer's real property was overassessed. The Court of Appeals held that once a taxpayer establishes a prima facie case, the evidentiary standard applied in most other civil cases is likewise to be applied in tax certiorari proceedings (i.e., preponderance of evidence).[19] As recognized by the Court of Appeals, the more reasoned view for many issues that were formerly denominated by the appellate courts as matters of law (to achieve a dismissal) must once again be considered matters attributable to the more normal weight and credibility considerations (i.e., matters of fact).

Pragmatically, the Court of Appeals' decisions have another meaning. By re-emphasizing the low threshold for demonstrating a prima facie case, the Court of Appeals reaffirmed that the lower courts were

1. To ensure that municipalities perform their statutory duties under N.Y. Real Property Tax Law section 500 (RPTL) (i.e., ensure that they assess a large commercial or utility property at fair market value);

2. To treat tax certiorari proceedings as being remedial, and thereby, the focus and purpose is to determine the value of the property (as opposed to simply dismissing the proceeding on technical theories);

3. To treat 22 NYCRR (Uniform Rules of Trial Court) section 202.59 as subject to the applicable evidentiary standards (i.e., substantial or preponderance of evidence), dependent upon the stage of the court's review, and to reject arguments that this rule established a separate or higher standard for taxpayers to overcome.

It is a generally accepted observation that tax certiorari proceedings, particularly those involving complex industrial and utility real property, are laborious, extensive and costly, and consume much of a court's limited time. Yet, it has become equally well accepted that a failure to reach fair market value (and thereby, an equitable tax assessment), has and will continue to result in commerce leaving the state of New York. The Court of Appeals' decisions reflect this truism.

B. The Marketplace of Value for Complex Commercial and Industrial Property and Utility Generation Assets

Under New York law, whether a "market" exists relative to the property being valued is a question of fact (not law). The "market" can be defined in two manners: (1) a market for the sale (both new and used) of the property (e.g., the sale of turbines, racetracks or golf courses) or (2) a "market" with respect to the direct or intrinsic income generation from the real property (e.g., leases), otherwise known as the income capitalization method.[20] If no market exists, the property is labeled "specialty property."[21]

As all practitioners that have litigated utility property tax challenges are aware, a concept known as "specialty property" has existed under New York law for over a century. For this type of property, the only approved valuation approach to determine "fair market value" is the cost approach of reproduction cost new less depreciation (RCNLD). Dogmatically and properly, since the late 1800s, the courts repeatedly have found that all forms of utility property are specialty property.[22] Yet, and even though it mandated the use of the cost approach, the Court of Appeals has consistently cautioned the lower courts that use of the cost approach is disfavored as it produces the maximum, not real market, value.[23] Recently, and again warning of the rigid application of the cost approach, the Court of Appeals, in *Saratoga Harness Racing v. Williams*,[24] reiterated that if a market exists, the valuation of the property should be by the market or income approach.

Beginning in 1996, the utility corporations in the state of New York embarked on the unbundling and deregulation of their generation assets. As part of that process, all New York utility corporations submitted plans to divest themselves of some or all of their generation assets (other than nuclear generation assets). In fact, most generation assets of New York State's public utility corporations (except nuclear) have been sold or are under contract to be sold (pending the Public Service Commission's approval).

This divestiture phenomenon is not restricted to the state of New York. It includes the New England states, as well as the sale of generation assets in California, Pennsylvania and North Carolina (not to mention international transactions). Based on these sales, many contend that a market is in the process of developing, or has developed, for electric generation assets.

In addition, the New York Mercantile Exchange (NYMEX™) monitors market sales of electricity (as well as other energy commodities). The question arises: Has New

York's "specialty property" designation for utility generation assets become antiquated?[25] The Court of Appeals' recent decisions provide some insight.

In its recent real property tax decisions, the Court of Appeals reemphasized that the market approach was preferred and that "the best evidence of value, of course, is a recent sale of the subject property between a seller under no compulsion to sell and a buyer under no compulsion to buy."[26] The Court of Appeals stated the need for trial courts and practitioners to investigate the presence of a market for the property being valued in a tax certiorari proceeding. Such investigation appeared all the more necessary when the same property had been previously held to be "specialty property." In *Saratoga*,[27] the Appellate Division, Third Department resorted to a prior holding that harness racetracks were specialty property.[28] In reversing the Third Department's holding, the Court of Appeals found that a market existed (both for the sale of harness racetracks and based on lease agreements at other racetracks, even though the racetrack being valued was owner-occupied). Based on the Court's finding of a "market" on these facts, the application of this reasoning to the sale of generating assets is compelling.

However, and before making that leap, the practitioner must decide whether an auction process (controlled and regulated by the PSC) constitutes an arm's-length transaction between two parties (neither of which is being coerced to buy *or sell* the property). For example, auctions in bankruptcy proceedings (even when subject to "blind bidding") do not constitute a market.[29] In addressing this initial concern, both the taxpayer and the taxing entity must totally familiarize themselves with the process and the PSC and utility's "agreement" to divestiture as part of the global move to a competitive market.

Assuming a court finds that the auction process factually meets the definition of a market, the following chart shows the impact of recent sales based on net book value and price per kilowatt (based on public report and without any analysis of the underlying agreements or generating assets sold).

Sale of Generating Facilities

Seller	Purchaser	Price/NBV*	Price/kW**
NEES	PG&E	1.45	$318.00
NYSEG	AES	1.6	$678.57
	Edison Mission	3.2	$955.41
Orange&Rockland	Southern	1.16	$270.27
NMPC	Orion	1.70	$642.97
PG&E Company	Southern/FPL Energy	1.71	$236.42
	Duke		
Boston Edison	Sithe Energies	1.19	$269.75
Central Maine Power		3.53	$713.92
Eastern Utilities Assocs.	NRG Energy, Inc.	1.80	$343.75
Bangor Hydroelectric Co.	PP&L (Pa. Power & Light)	1.80	$997.76
Maine Public Service	Wisconsin Public Service	1.80	$407.41
	Average	**1.90**	
	* - **NBV** is Net Book Value	**Average**	**$501.97**
	** - kW is Kilowatt		

The column denominated "Price/NBV" merely divides the reported total sale price of the assets by the total net book value of the assets sold. With respect to "Price/kW," the total sales price is divided by the total kilowatts sold.

In addition to the market approach, the Court of Appeals also found the income approach more desirable than the cost approach. In addressing this approach, the Court of Appeals stated:[30]

> This appeal turns on whether the comparable lease income method of valuation is proper in these particular circumstances. As this Court recognized in *Matter of Allied Corp v. Town of Camillus* (80 N.Y.2d 351, 590 N.Y.S.2d 417, 604 N.E.2d 1348), "while property must be assessed at market value, there is no fixed method for determining that value" (*id.* at 356). "The ultimate purpose of valuation, whether in eminent domain or tax certiorari proceedings, is to arrive at a fair and realistic value of the property involved so that all property owners contribute equitably to the public fisc" (*id.*). The Court explained that "any fair and nondiscriminatory method that will achieve that result is acceptable" (*id.*).

As a measurement of value, the Court of Appeals recognized that the comparable lease method was appropriate, as follows:[31]

> The comparable lease income method proffered at trial by *Saratoga Harness*, on the other hand, is generally used as a component of the income capitalization approach to real property valuation (i.e., "the value of a property's earning power based on the capitalization of its income") (Appraisal Inst., *The Appraisal of Real Estate*, *supra*, at 81). The technique generally involves two steps: (1) the appraiser determines the "market rent" of the property in question, and (2) capitalizes (or converts to present value) that rent to determine the proper value of the subject property (see, e.g., Appraisal Inst., *The Appraisal of Real Estate*, *supra*, at 449).
>
> This methodology is accepted as valid within the field of real property appraisal (see, Appraisal Inst., The Appraisal of Real Estate, *supra*, at 471-489; see also, 1 Bonbright, The Valuation of Property, at 169, 216-232). In addition, this Court implicitly recognized and countenanced this formula in *W.T. Grant Co. v Srogi* (52 N.Y.2d 496, 508, 512, 438 N.Y.S.2d 761, 420 N.E.2d 953 [upholding an appraisal of leased premises based on "the rent which a national chain store would agree to pay on a percentage lease"]).

Presently, and due to the regulated nature of the generating asset market prior to 1996, very few, if any, leases of generating assets exist that can be used for the comparable lease method. Some practitioners have conjectured or speculated on such leases in the deregulated market and thereby (in one manner or another), developed a theory that such projected leases (or a measurable income stream) would be based on a ¢/kW basis (i.e., a method of measuring the income revenue stream at a generating station). In this regard, NYMEX™ reports "market" sales of electricity. In addition, electric-generating corporations ("gencos") have entered into arm's-length "power purchase" contracts (with both transmission and distribution companies and endusers).

However, before one gets to the actual application of the income approach, the inquiry remains whether the ingredients of an income approach are sufficiently (as opposed to speculatively) in place. One concern is whether the income approach merely values a business enterprise, as opposed to the real property. That is, whether a generating facility (as a manufacturer of electricity) should be treated differently from any other manufacturing facility (where the income approach generally is not available, on the basis that such approach values the business enterprise, as opposed to the real property).[32]

To overcome this hurdle, an argument has arisen specific to hydroelectric stations. The proponents contend that the generation process for hydroelectric stations is so integral to the underlying land that the land is an inherently intertwined and intrinsic factor of that manufacturing process. By this contention, the combination of the dam, turbines and water flow are claimed to be so entwined with the manufacture of electricity at the hydroelectric plant, as to make the income generated by that plant susceptible to the income approach. Based on this argument, the income stream derived from the manufacture of electricity is contended to be appropriate for income capitalization.

In making this contention, the practitioner should be aware that the cost approach to value a cheese manufacturing plant (declared to be specialty property even though, nationally, a market existed) was required in *Kraft v. Canton.*[33] That decision was based on the factual finding that the manufacturing plant was so integral and entwined with the land *and surrounding community* that other valuation approaches were not applicable. The application of this concept to hydroelectric stations has not been made, simply because up to this point all hydroelectric stations have been valued by the cost approach alone.

Moreover, and unfortunately, this same integration of natural resources and electric generation does not so neatly apply to fossil fuel or nuclear generation plants. Should the law then permit the owner of a hydroelectric station to apply a valuation approach that the owner of the fossil fuel generation plant does not have available? Although the query can be equally characterized in terms of the Court of Appeals' mandated equity in contributing to the public fisc, these are the "economic realities"[34] that must be addressed in future tax certiorari proceedings.

Finally, if these issues are not resolved in such a manner as to permit the in-state generating assets to compete against the out-of-state generating assets, it may result in litigation based on interstate commerce clause implications.

The new frontier of deregulation poses many issues and traps for the unwary, as the courts must grapple with new valuation approaches.

Endnotes

1. *Utility Valuation Following De-Regulation*, N.Y. Real Prop. L.J., vol. 25, no. 4 (Fall 1997), p. 127.
2. *Niagara Mohawk Power Corp. v. Town of Geddes*, 239 A.D.2d 911, 659 N.Y.S.2d 632 (4th Dep't 1997), *lv. granted*, 91 N.Y.2d 806, *rev'd and remanded*, 92 N.Y.2d 192, 677 N.Y.S.2d 275 (1998); *FMC Corp. v. Unmack*, 242 A.D.2d 904, 662 N.Y.S.2d 907 (4th Dep't 1997), *lv. granted*, 91 N.Y.2d 947, *rev'd and remanded*, 92 N.Y.2d 179, 677 N.Y.S.2d 269 (1998); *Saratoga Harness Racing, Inc. v. Williams,* 241 A.D.2d 655, 659 N.Y.S.2d 938 (3d Dep't), *lv. granted*, 91 N.Y.2d 802 (1997), *rev'd and remanded*, 91 N.Y.2d 639, 659 N.Y.S.2d 938 (1998). In so finding, the Court of Appeals declared a very low threshold of evidence to find a market. In *Saratoga*, both parties rejected the evidence of market for the sale of the property involved in that proceeding.
3. *Welch Foods, Inc. v. Town of Portland*, 187 A.D.2d 948, 591 N.Y.S.2d 646 (4th Dep't 1992); *Bradley v. Board of Assessment Review*, 198 A.D.2d 766, 605 N.Y.S.2d 725 (4th Dep't 1993); *Frank Zappala v. Hann*, 198 A.D.2d 879, 604 N.Y.S.2d 443 (4th Dep't 1993); *General Motors Corp. Central Foundry Div. v. Assessor of Massena*, 146 A.D.2d 851, 536 N.Y.S.2d 256 (3d Dep't), *appeal denied,* 74 N.Y.2d 604, 543 N.Y.S.2d 397 (1989); *Adirondack Mountain Reserve v. Board of Assessors*, 99 A.D.2d 600, 471 N.Y.S.2d 703 (3d Dep't), *aff'd in part and appeal dismissed in part*, 64 N.Y.2d 727, 485 N.Y.S.2d 744 (1984).
4. In fact, a conflict had developed between the Appellate Division Departments as to the actual standard they effectively applied. The Fourth and Third Departments effectively returned the standard to the previously rejected "clear and convincing standard," while the Second Department correctly applied the much lower substantial evidence standard. *Compare Niagara Mohawk Power Corp. v. City of Dunkirk*, 221 A.D.2d 912, 635 N.Y.S.2d 380 (4th Dep't 1995), *appeal dismissed*, 87 N.Y.2d 1054, *lv. denied*, 88 N.Y.2d 803 (1996); *Niagara Mohawk Power Corp. v. Town of Tonawanda*, 236 A.D.2d 784, 653 N.Y.S.2d 907 (4th Dep't 1997); *Niagara Mohawk Power Corp. v. Town of Bethlehem,* 225 A.D.2d 841, 639 N.Y.S.2d 492 (3d Dep't 1996); *FMC Corp.*, 242 A.D.2d at 904. *Long Island Lighting Co. v. Assessor of the Town of Brookhaven*, Index Nos. 76/15628, *et seq.* (Sup. Ct., Nassau Co.), *aff'd*, 202 A.D.2d 32, 616 N.Y.S.2d 375 (2d Dep't 1994).
5. The Appellate Division, Fourth Department preceded the Court of Appeals by finding the preponderance of evidence standard controlled in *Carriage House Motor Inn, Inc. v. Watertown*, 136 A.D.2d 895, 524 N.Y.S.2d 930 (4th Dep't 1988).
6. *Welch Foods*, 187 A.D.2d 948; *Bradley*, 198 A.D.2d 766; *Frank Zappala*, 198 A.D.2d 879; *General Motors Corp. Central Foundry Div.*, 146 A.D.2d 851; *Adirondack Mountain Reserve*, 99 A.D.2d 600.
7. *Bradley*, 198 A.D.2d at 767, 605 N.Y.S.2d at 726.
8. *Broadway-Saranac Lake Corp. v. Board of Assessors*, 43 A.D.2d 649, 349 N.Y.S.2d 830 (3d Dep't 1973); *Bradley*, 198 A.D.2d at 767, *Frank Zappala*, 198 A.D.2d 879.
9. *Welch Foods*, 187 A.D.2d at 948; *Fusco v. Assessor of the City of Utica*, 78 A.D.2d 995, 578 N.Y.S.2d 333 (4th Dep't 1991), *General Motors Central Foundry Corp.*, 146 A.D.2d at 851; *Adirondack Mountain Reserve,* 99 A.D.2d at 600; *Kraft, Inc. v. Assessor*, Real Prop. Tax Rptr., Vol. 4, No. 1, p. 69 (Sup. Ct., St. Lawrence Co.) (1996) (Demarest, J.); *Buckeye Pipeline Co. v. State Bd. of Real Prop. Serv.*, Index No. 8155/92 (Sup. Ct., Albany Co. (1997) (Teresi, J.).
10. *Nezelek Dev. Corp. v. City of Binghamton*, 61 A.D.2d 1108 (3d Dep't 1978); *Barker's Stores v. Board of Review*, 74 A.D.2d 994, 427 N.Y.S.2d 103 (4th Dep't 1980).
11. *Carriage House Motor Inn, Inc. v. Watertown*, 136 A.D.2d 895, 524 N.Y.S.2d 930 (4th Dep't 1988).
12. *Niagara Mohawk Corp. v. Town of Marcy*, __ A.D.2d __, __ N.Y.S.2d __ (4th Dep't 1999). *Compare with* Court of Appeals' decision and reversal in *Niagara Mohawk Power Corp. v. Town of Geddes*, 239 A.D.2d 911 (4th Dep't 1997).
13. *Welch Foods*, 187 A.D.2d at 948; *Gristmacher v. Felicetta*, 57 A.D.2d 444, 394 N.Y.S.2d 956 (4th Dep't 1977).
14. *300 Gramatan Ave. Assoc. v. State Div. of Human Rights*, 45 N.Y.2d 176, 180, 408 N.Y.S.2d 54, 56 (1978); *Gristmacher*, 57 A.D.2d 444. "Substantial Evidence consists of proof within the whole record of such quality and quantity as to generate conviction in and persuade a fair and detached fact finder that, from that proof as a premise, a conclusion or ultimate fact may be extracted reasonably, probatively, and logically." 5 N.Y. Jur. 2d *Article 78 and Related Proceedings*, § 37.
15. *300 Gramatan Ave. Assoc.*, 45 N.Y.2d at 180-81, 408 N.Y.S.2d at 56-57.
16. *Niagara Mohawk Power Corp. v. Town of Geddes*, 239 A.D.2d 911 (4th Dep't 1997); *FMC Corp. v. Unmack*, 242 A.D.2d 904 (4th Dep't 1997).
17. 43 A.D.2d 649, 649, 349 N.Y.S.2d 830, 831 (3d Dep't 1973).
18. *Niagara Mohawk Power Corp.*, 239 A.D.2d 911; *FMC Corp.*, 242 A.D.2d 904.
19. *Niagara Mohawk Power Corp.,* 239 A.D.2d at 912; *FMC Corp.,* 242 A.D.2d 904.
20. *Saratoga Harness Racing, Inc. v. Williams,* 241 A.D.2d 655, 659 N.Y.S.2d 938 (3d Dep't), *lv. granted*, 91 N.Y.2d 802 (1997), *rev'd and remanded*, 91 N.Y.2d 639, 659 N.Y.S.2d 938 (1998).
21. *Allied Corp. v. Town of Camillus,* 80 N.Y.2d 351, 590 N.Y.S.2d 417 (1992);

Brooklyn Union Gas Co. v. State Bd. of Equalization and Assessment, 65 N.Y.2d 472, 492 N.Y.S.2d 598 (1985); *Great Atlantic & Pacific Tea Co. v. Kiernan*, 42 N.Y.2d 236, 397 N.Y.S.2d 718 (1977); *Onondaga County Water Dist. v. Board of Assessors,* 39 N.Y.2d 601, 385 N.Y.S.2d 13 (1976); *Semple Sch. for Girls v. Boyland*, 308 N.Y. 382, 126 N.E.2d 294 (1955); *Long Island Lighting Co. v. Assessor for Town of Brookhaven*, Index Nos. 76/15628 *et al.* (Sup. Ct., Suffolk Co. 1992), *aff'd*, 202 A.D.2d 32, 616 N.Y.S.2d 375 (2d Dep't 1994); *Rose v. State of New York*, 29 A.D.2d 1003, 289 N.Y.S.2d 553 (3d Dep't 1968); *Niagara Mohawk Power Corp. v. Town of Bethlehem*, 225 A.D.2d 841, 639 N.Y.S.2d 492 (3d Dep't 1996).

22. *Niagara Mohawk Power Corp.*, 221 A.D.2d at 912; *FMC Corp.*, 242 A.D.2d at 904.

23. The Court of Appeals specifically observed that courts are required to be cautious about "applying reproduction cost new less depreciation method because *it is most likely to result in overvaluation*, given its tendency to ascribe too little weight to such factors as rising construction costs and *diminishing value by functional obsolescence* (emphasis added)." *Allied Corp.*, 80 N.Y.2d at 356-57, 590 N.Y.S.2d at 420. New York courts recognize that RCNLD has no relationship to market value, but rather establishes the maximum value for the real property. *Rochester Urban Renewal v. Patchen Post, Inc.*, 45 N.Y.2d 1, 407 N.Y.S.2d 641 (1978); *Great Atlantic & Pacific Tea Co.*, 42 N.Y.2d 236 (RCNLD establishes upper limit of value); *860 Fifth Ave. Corp. v. Tax Comm'n of N.Y. City*, 8 N.Y.2d 29, 200 N.Y.S.2d 817 (1960); *Suburbia Apartments, Inc. v. Board of Assessors of County of Nassau*, 66 Misc. 2d 918, 923, 323 N.Y.S.2d 258, 262 (Sup. Ct., Nassau Co. 1971) (summation approach sets upper limits of value beyond which property may ordinarily not be assessed).

24. 241 A.D.2d 655.

25. Such designation of "specialty property" should remain for transmission and distribution property, as such property does not specifically have a market (either in sales or for access charges or fees, the latter to remain under strict regulatory control). Some municipality representatives have posited the theory of a market, based on recent mergers and acquisitions of utility companies. They theorize that the purchasing utility company must have performed an income valuation approach in reaching the "purchase price" and allocated that value to transmission and distribution property. This theory is lacking for two reasons. First, even if such a valuation and allocation were completed, that analysis could and would have been applied to existing transmission and distribution property. However, that approach has not been applied because such income valuation would be based on rate-making factors and considerations, which, among other factors, involves net book value (an admittedly non-market-value concept). Secondly, any allocation, if made at all, would be speculative and would necessarily have to distinguish other purposes for making the allocation (e.g., income tax considerations).

26. *FMC Corp.*, 92 N.Y.2d at 189. *Hellerstein v. Assessor of Town of Islip*, 37 N.Y.2d 1, 371 N.Y.S.2d 388 (1975); *Grandview Heights Ass'n, Inc. v. Board of Assessors of Town of Greece*, 176 Misc. 2d 901, 904-5, 674 N.Y.S.2d 571 (Sup. Ct., Monroe Co. 1998) ("and assuming the price is not affected by undue stimulus").

27. 241 A.D.2d 655.

28. *Saratoga Harness Racing*, 241 A.D.2d 655.

29. *Waldenmaier v. State*, 33 A.D.2d 75, 305 N.Y.S.2d 381 (3d Dep't 1969).

30. *Saratoga Harness Racing,* 91 N.Y.2d at 643.

31. *Id.* at 644. The Court of Appeals also found that

    [m]ost relevantly here, when this method is utilized for owner-occupied space, it "is usually estimated at market rent levels." Appraisal Inst., The Appraisal of Real Estate, at 489. The rubric is that "market rent is the rental income that a property would most probably command in the open market." Appraisal Inst., The Appraisal of Real Estate, at 478-479 [emphasis omitted]. The estimated annual rent, or market rent, should be determined by analysis of the rent paid for other comparable properties and then imputed to the subject property:

    "The rents of comparable properties can provide a basis for estimating market rent for a subject property once they have been reduced to the same unit basis applied to the subject property. Comparable rents may be adjusted just as the transaction prices of comparable properties are adjusted in the sales comparison approach." Appraisal Inst., The Appraisal of Real Estate, at 481.

32. The new owners of the generating assets also have another issue, which is whether they are Article 9-A corporations under N.Y. Tax Law. If yes, and limiting the analysis solely to real property tax concerns, then the new owner will seek to claim that certain machinery and equipment used in the manufacturing process are not real property under the N.Y. Real Property Tax Law. RPTL § 102(12)(f).

33. N.Y. Real Prop. Tax Rptr., Vol 4, No. 1, p. 69 (Sup. Ct., St. Lawrence Co. 1996).

34. *Great Atlantic & Pacific Tea Co. v. Kiernan*, 42 N.Y.2d 236, 240, 397 N.Y.S.2d 718, 722 (1977).

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Lenders Awarded Post-Foreclosure Rights*

By Howard W. Kingsley**

Lenders can now minimize their potential losses by including specific provisions in their mortgages, thanks to a recent decision by the Appellate Division, Second Department. *GMS Capital and SRC Holdings Corp. v. Siegmund Spiegel/ Baldur Peter, P.C.*[1] dramatically expanded the post-foreclosure rights of lenders by permitting them to seek any deficiency due under the mortgage loan from any third party, provided the borrower agrees to give the lender such rights in the mortgage. This was the first time an appellate court has held that a lender's "right to recover any deficiency under the specific terms of the Mortgage Agreement survives foreclosure" if the "mortgage clearly contemplate[s] a post-foreclosure action on the mortgage debt" against a third party, who is likely to have greater resources than the delinquent borrower.

Until recently, the law in this area was well settled and provided lenders with only one avenue to obtain any deficiency. Pursuant to N.Y. Real Property Actions and Proceedings Law section 1371 (RPAPL), a lender can only seek a deficiency judgment against the borrower and/or the guarantor, not any third party, if that right was granted in the judgment of foreclosure and sale. The amount of the deficiency judgment is measured by all amounts due under the foreclosure judgment with interest, costs and disbursements, less the higher of the market value of the property as determined by the court or the bid amount.

Moreover, a lender has only 90 days to apply for the deficiency judgment after the transfer of the referee's deed to the successful bidder. If a lender does not move for a deficiency judgment within that time, "the proceeds of the sale regardless of amount shall be deemed to be in full satisfaction of the mortgage debt and no right to recover any deficiency in any action or proceeding shall exist." In addition, once the auction occurred, the mortgage was deemed extinguished as a matter of law.[2] As a result, if a deficiency judgment was not sought against a party liable under the mortgage documents, a lender had no rights whatsoever.

". . . a lender has only 90 days to apply for the deficiency judgment after the transfer of the referee's deed to the successful bidder."

In 1995 and 1996, two appellate courts deviated from these restrictive principles. In *Melino v. National Grange Mutual Insurance Co.*,[3] the borrower assigned to the lender her rights under a fire insurance policy required by the mortgage. After the defendant insurance company settled the fire claim, it sought a declaratory judgment because it did not know whether to pay the proceeds to Melino (the plaintiff and former owner of the house) or the mortgagee, the successful bidder at the foreclosure sale. Relying on *Whitestone Savings & Loan Ass'n v. Allstate Insurance Co.*, Melino argued that she, not the mortgagee, was entitled to the insurance proceeds because the mortgage was extinguished when it was foreclosed and the mortgagee's failure to seek a deficiency judgment barred recovery. The mortgagee argued that it was entitled to the insurance proceeds under the provision of the mortgage by which the mortgagor simply assigned the rights under the insurance policy and the right to receive any proceeds thereunder. The Third Department held that such assigned rights were not extinguished by the foreclosure sale:

> The mortgage, in essence, is a contract between plaintiff and the Bank, setting forth each party's rights and remedies with respect to the mortgaged premises. Thus, absent a showing of fraud, duress, undue influence or illegality, none of which appears to have occurred here, the mortgage remains enforceable [citation omitted] and, in accordance with basic principles of contract law, should be interpreted to give each of its subject provisions full force and effect [citation omitted].

Shortly thereafter, the Second Department followed suit. In *L.G.H. Enterprises, Inc. v. Kadilac Mortgage Bankers, Ltd.*,[4] the plaintiff-mortgagor executed a $70,000 mortgage in favor of the defendant-mortgagee, by which the mortgagor assigned to the mortgagee the proceeds under a certain fire insurance policy. As a result of the mortgagor's default under such mortgage, the defendant-mortgagee commenced an action to foreclose the mortgage, obtained a Judgment of Foreclosure and Sale, and purchased the mortgaged premises at the foreclosure sale, leaving a substantial deficiency. The mortgagee did not seek a deficiency judgment under RPAPL section 1371.

Prior to the issuance of the foreclosure judgment, however, the premises was destroyed by fire and the insurer issued a $100,000 check made payable to both the mortgagor and mortgagee (presumably as the loss payee). Because the mortgagee and mortgagor could not agree as to who was entitled to the check, the plaintiff-mortgagor sought a judgment declaring that it was entitled to the insurance proceeds. Citing *Whitestone Savings*, the lower court granted the mortgagor's motion for summary judgment, holding that the mortgagee was barred from any recovery because it did not seek a deficiency judgment.

In reversing the lower court, the Second Department stated that "the Supreme Court correctly acknowledged, when a mortgagee fails to obtain a deficiency judgment, it may not recover under a mortgagee loss payable clause contained in an insurance policy." However, relying solely upon *Melino*, the court went one step further, holding that pursuant to the terms of the mortgage, the mortgagee was "contractually entitled to the insurance proceeds" by virtue of the assignment clause in the mortgage, despite the mortgagee's failure to seek a deficiency judgment.

Based upon these two cases, the terms of the mortgage as they related solely to the assignment of insurance policies and proceeds were not extinguished. Relief was therefore available for the first time against a party other than the borrower and/or the guarantor. However, because those two cases involved only the narrow issue of two lenders' claims to insurance proceeds under loss payable clauses, the holdings were extremely limited.

Using those two new precedents, the Second Department in *GMS Capital* greatly expanded the post-foreclosure rights of lenders by permitting them to assert their post-foreclosure rights to seek a deficiency against any third party for any claims the borrower may have had, not just those claims relating to its loss payable clause, provided the borrower agreed to give the lender those post-foreclosure rights in the mortgage.

The facts of *GMS Capital* are as follows. In 1987, the borrower, Marilyn Ethel Sheer, retained an architect, Siegmund Spiegel/Baldur Peter, P.C., to prepare plans and supervise construction for an addition to her home in Roslyn, New York. In 1989, and after construction on the house was substantially complete, Sheer obtained a $475,000 mortgage from the lender. By virtue of the mortgage, Sheer assigned to the lender all of her claims and any damages received for any injuries to the house, and she agreed that the lender was entitled to apply such proceeds against, among other things, any post-foreclosure deficiency. As a result of Sheer's default under the terms of the mortgage, the lender foreclosed the mortgage and obtained a Judgment of Foreclosure and Sale in 1992. After the automatic stays stemming from Sheer's bankruptcy proceedings were lifted, the house was sold at the foreclosure auction in 1994 to the mortgagees, GMS Capital and SRC Holdings Corp., for $20,000, leaving a deficiency due under the mortgage of $565,000.

After the foreclosure sale, GMS Capital and SRC Holdings contemplated seeking a deficiency judgment pursuant to RPAPL section 1371 but did not do so because the mortgage indebtedness was discharged in bankruptcy; and, in any event, Sheer was "judgment proof," as is typically the case. Since seeking a formal deficiency judgment would have been futile, GMS and SRC looked to the mortgage to attempt to recover the deficiency. While inspecting the property, GMS and SRC discovered that the house was sinking and believed that the architect had been negligent. Based upon the provisions of the mortgage that assigned to the lender all of Sheer's claims and any damages received for any injuries to the house, GMS and SRC sued the architect, seeking damages for the diminution in value of the house due to the architect's negligence and breach of contract. After the lawsuit was commenced, GMS and SRC sold the house to a third party, leaving a shortfall between the net proceeds received from such sale and the amount due under the Judgment of Foreclosure and Sale of almost $200,000.

After discovery, the architect moved to dismiss the complaint based upon *Whitestone Savings* and its well-settled progeny, as well as RPAPL section 1371. GMS and SRC opposed the motion, relying on the recent *Melino* and *L.G.H. Enterprises* cases. The trial court denied the motion and the architect appealed.

Departure from Long-standing Principles

By holding that "the plaintiffs' right to recover any deficiency under the specific terms of the Mortgage Agreement survives foreclosure," the Second Department departed from the long-standing principles set forth in *Whitestone Savings*, under these circumstances, and RPAPL section 1371 is no longer the bar to recovery that it once was. By holding that "specific terms of the Mortgage Agreement survive foreclosure," the court opened the door to myriad opportunities for lenders to assert once-prohibited claims against any third party for any claim that a borrower may assign to a lender as additional security for the loan. This new rule is equitable, because a lender should be able to enforce all of its rights and remedies, pursuant to the agreed-on terms of the mortgage, to attempt to recover the full mortgage indebtedness. Perhaps these rights are now being granted as a remedial measure after many lenders sustained substantial losses in connection with the depressed real estate market in the late 80s and early 90s.

The lesson to be learned from the *GMS* case is clear: lenders should include clear and specific provisions in their mortgages by which the borrower (1) assigns to the lender, as additional security, all of its rights in and to the mortgaged property and any proceeds received in connection with asserting those rights and (2) agrees that the proceeds received shall be applied to any post-foreclosure sale deficiency, so that it will be in a substantially better position to recoup any deficiency if the mortgage loan is foreclosed.

Endnotes

1. 674 N.Y.S.2d 733 (2d Dep't 1998).
2. *See Whitestone Savings & Loan Ass'n v. Allstate Ins. Co.*, 28 N.Y.2d 332, 321 N.Y.S.2d 862 (1971).
3. 213 A.D.2d 86, 630 N.Y.S.2d 123 (3d Dep't 1995).
4. 225 A.D.2d 735, 640 N.Y.S.2d 155 (2d Dep't 1996).

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Residential Building and Zoning Checklist

By James S. Grossman*

I. Many attorneys believe that title issues are the sole concerns of their clients in residential real estate transactions. However, for the client who merely seeks counsel to advise them regarding the purchase of a home, compliance with building and zoning laws and regulations at the time of purchase, and in the future, are important considerations. This checklist contains an overview of common zoning and building code issues. The practitioner should supplement the list with any issues which are important in the municipality in which the sale is to occur.

A. Ask buyer about intentions or plans for expansion and use of the residential property *prior to* signing the contract. At a minimum, the contract should provide that the existing structures/uses are in compliance with all applicable zoning and building codes and that purchasers' intended expansions/uses are in compliance.

B. Check local zoning codes and other local codes and ordinances to determine if the existing structures and/or your client's intended expansion or use may be impacted. A legal use or structure at the time of construction may not remain in compliance if structural modifications have been made or are made.

C. To assure that the existing structures/uses or proposed additions/uses comply with zoning requirements, review of local zoning ordinances for any purchase should include review of the following:

1. Setback requirements (i.e., distance from structure to lot line)

   a. Rear;

   b. Front;

   c. Side; and

   d. Be sure to analyze applicable setback for corner lots, where both frontages may require compliance with front setback requirements.

2. Area or height requirements—i.e., acreage or lot size limitations or height of structures (especially sheds).

3. Frontage requirements—i.e., required amount of frontage at the street line to allow maintenance of a single-family dwelling.

4. Limitations on the kind, size and number of structures on the property:

   a. Sheds;

   b. Garages, attached and unattached;

   c. Saunas;

   d. Fencing;

   e. Decks or patios;

   f. Satellite dishes;

   g. Dog runs; and

   h. Pools, tennis courts, etc.

5. Miscellaneous restrictions:

   a. Storage of recreational vehicles on the property.

   b. Restrictions relating to the number of dogs or other animals or kind of animal allowed on the property.

6. Restrictions on non-single-family uses:

   a. In-law apartments—are they allowed? Do they require a permit?

   b. Tenants or boarders permitted?

   c. What are the customary home occupations? Some uses often not permitted are the following:

   (1) Hair cutting/beauty salon;

   (2) Occupations which are commercial enterprises, such as landscaping ser-

vices, especially any use requiring parking of commercial vehicles on site;

(3) Professional offices not limited to residents of the dwelling or with more than a limited number of employees;

(4) Uses which exceed a statutory percentage of the structure's floor space;

(5) Retail operations—i.e., storage of merchandise on site;

(6) Uses which include exterior displays or goods visible from the outside;

(7) Uses requiring external structural alterations not normally associated with residential use;

(8) Uses which produce noises, such as lawnmower repair, or which cause dust, smoke or vibrations;

(9) Dance lessons or group music lessons; and

(10) Review limitations on signs if a home occupation is proposed.

D. Review conditions regarding pre-existing non-conforming use or structure:

1. Any intended extension of the use or expansion of the structure may negate the non-conforming status.

2. Change of use may not be allowed or may require variances to maintain the structure in its current location if it violates setback or other area requirements.

E. Review carefully any double lot where the placement of a new or existing home may eliminate the ability to develop the second lot.

F. Be aware of local and state building codes for standards for construction and construction materials, especially for additions to an existing structure or for new construction:

1. With additions, focus on compliance with plumbing codes and electrical systems.

2. Review location of existing septic fields and requirements for possible expansions or additions to the system.

3. Are certificates of occupancy or required permits available for the existing structures and any additions? Note that the contract should provide that every structure on the property complies with local and state building codes, rather than a catch-all provision stating the property is suitable for single-family use.

G. If property is not in a residential zone or is near a non-residential zone, the potential uses of nearby properties should also be discussed with client.

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Post-Closing Improvements to Real Property May Diminish Owner's Title Policy Coverage*

By Joseph S. Petrillo**

It is fairly common for individuals, partnerships, corporations or other legal entities to acquire real property wherein significant improvements are intended to be made post-closing. Typically, an American Land Title Association (ALTA) Owner's Policy (10/17/92) ("Owner's Policy") is requested and issued in the amount of the land acquisition, and rarely is there significant consideration regarding the impact of the post-closing improvements on the title insurance coverage. Most often, the transaction is one wherein vacant land is acquired with simultaneous construction financing in which ALTA Loan Policy ("Loan Policy") is also required.

For the purposes of this discussion, assume that vacant land is acquired for $200,000 with a corresponding $200,000 Owner's Policy. Assume further that $400,000 of improvements are made to the property, thereby increasing the total value of the property to $600,000. Lastly, assume a title defect (i.e., undiscovered recorded easement) resulting in a partial loss, which diminishes the value of the property in the amount of $60,000. What is the measure of damages a title company may be liable for under the Owner's Policy?

The Owner's Policy contains specific provisions which address those situations wherein substantial post-closing improvements are made. Paragraph 7(b) of the Conditions and Stipulations of the 1992 ALTA Owner's Policy provides:

> [I]f subsequent to the Date of Policy an improvement is erected on the land which increases the value of the insured estate or interest by at least 20% over the Amount of Insurance stated in schedule A, then this policy is subject to the following:
>
> (ii) where a subsequent improvement has been made, as to any partial loss, the Company shall only pay the loss pro rata in the proportion that 120% of the Amount of Insurance stated in Schedule A bears to the sum of the Amount of Insurance stated in Schedule A and the amount expended for the improvement.
>
> The provisions of this paragraph shall not apply to costs, attorneys' fees and expenses for which the Company is liable under this policy, and shall only apply to that portion of any loss which exceeds, in the aggregate, 10 percent of the Amount of Insurance stated in Schedule A.

In sum, this paragraph determines the extent of a title insurer's liability under the Owner's Policy where post-closing improvements have been made to the property. Initially, the title insurer is liable for 10 percent of the Amount of Insurance stated in the policy. If that amount is insufficient to cover the full amount of damages, the Owner's Policy provides the following formula to compute the title insurer's liability for the remaining damages:

(120% of the Amount of Insurance + Amount Expended on Improvements) x (Remaining Loss) = Covered Loss

To better illustrate how this formula works, we explain as follows:

1. The insurer is liable for 10 percent of the Amount of Insurance or $20,000 of the $200,000 policy.
2. To determine the insurer's liability on the remaining $40,000 of loss, we must apply the formula contained in the policy:
   - (a) Amount of Insurance = $200,000
   - (b) 120 percent of Amount of Insurance ($200,000) = $240,000.
   - (c) Amount expended for improvements = $400,000
   - (d) Amount of Insurance ($200,000) plus Amount Expended for improvements ($400,000) = $600,000.
   - (e) Proportion that 120 percent of Amount of Insurance ($240,000) bears to the Amount of Insurance plus the amount of improvements ($600,000) = 2/5 (two-fifths) or 40 percent.
   - (f) The insurer is liable for 40 percent of the $40,000 remaining loss or $16,000.
3. Based on this calculation, the insurer in our example would have a total liability of $36,000 on the $60,000 loss, leaving the insured with a non-covered loss of $24,000.

This example illustrates the potential under the Owner's Policy for non-covered loss to an insured who erects post-closing improvements to the insured property. Although partially protected, this insured runs a risk of loss in significant proportion to the amount expended on the improvement.

While some erroneously believe that this risk presented by post-closing improvements can be eliminated by purchasing a Market Value Policy Rider ("Rider"), the terms of such Rider severely limit its applicability. To begin, the Rider clearly limits itself to "homeowners" as defined in the Rider, which excludes one who purchases vacant land for construction purposes. Furthermore, the Rider defines "homeowner" as referring to the owner of residential property of up to four dwelling units, rendering it unavailable for commercial property. Lastly, even where the Rider is available, its terms expressly exclude "the market value of any improvements made to the premises subsequent to the date of the Policy." Thus, the Market Value Policy Rider is ineffective for the purpose of protecting the insured from non-covered loss due to post-closing improvements.

In an effort to protect an insured who anticipates post-closing improvements, it is recommended that the Owner's Policy at acquisition be in an amount equal to the acquisition cost, together with the value of the contemplated improvements. When issued, this Owner's Policy would contain a "Pending Improvements" clause in Schedule B. Although reflected as an exception, the language would provide that the liability of the company will increase as and when the improvements shall be commenced, up to the face amount of the policy.

Often, developers do not purchase the Owner's Policy in the amount of the contemplated improvements, based on the erroneous thinking that this will significantly increase the cost of the Policy. However, being that in most transactions involving improvements the construction financing is placed simultaneously with the land acquisition, this is not so.

"In an effort to protect an insured who anticipates post-closing improvements, it is recommended that the Owner's Policy at acquisition be in an amount equal to the acquisition cost, together with the value of the contemplated improvements."

The standard Owner's Policy for the land acquisition covers only the $200,000 of the present value of the property. Therefore, the construction loan for $400,000 carries a higher premium than the land acquisition, due to the amount exceeding the Owner's Policy. This differential is not subject to a simultaneous policy discount. However, using an Owner's Policy with the recommended "Pending Improvements" clause, the entire amount of the land acquisition and improvement is reflected in the policy premium. Therefore, the simultaneous Loan Policy for the construction loan carries a significantly discounted premium that allows for a substantial amount of insurance to be purchased at a reduced rate. Although the Owner's Policy with the recommended "Pending Improvements" provision carries a higher premium due only to the increased amount of Owner's insurance, this is minimized by a discounted Loan Policy premium.

In conclusion, additional provisions can be incorporated into the Owner's Policy to offset the potential loss to an insured who intends to erect post-closing improvements to the insured property. One recommendation is that the Owner's Policy include a "Pending Improvements" clause wherein the amount of insurance increases up to the face value of the policy as the improvements proceed until completion. Although a policy with this clause would carry a higher premium (due only to the increased amount of insurance), our example has shown us that this additional cost would not be as significant as some think, and it would provide the insured with a very significant difference in title insurance coverage. By utilizing this recommended provision, an Owner's Policy can more fully protect the insured from the possibility of non-covered loss even after post-closing improvements are erected.

***This article previously appeared in the *New York Real Estate Journal* and is reprinted with permission.**

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BERGMAN ON MORTGAGE FORECLOSURES . . .

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Assault on Foreclosure Judgment Interest*

We had occasion in these pages some years ago to observe that an early 1950s musical refrain once treacled "little things mean a lot,"[1] which obviously can be true. The context was the then-new and welcome confirmation that interest on the judgment of foreclosure and sale *could* exceed 9 percent—and could reflect some default rate of interest—*if* the mortgage provided as such with appropriate clarity.[2] Because, for any number of reasons, the time from issuance of judgment of foreclosure and sale until conduct of the sale can enormously exceed the roughly four weeks' advertising time, the perhaps seemingly inconsequential rate of interest on the judgment can be a matter of consequence. (Even if the sale is optimally conducted, the interest rate is meaningful for institutional lenders who own a large portfolio of defaulted loans.)

That the foreclosure judgment will bear *some* rate of interest (be it the 9 percent judgment rate or something greater as directed by the mortgage documents) is something mortgage lenders and servicers have understandably taken for granted.

Although the assumption that interest automatically accrues on the foreclosure judgment is well-founded, recent case law offers the warning that undue delay following entry of the judgment could be a basis to deny an award of post-judgment interest.[3] To be sure, the CPLR provides that every money judgment bears interest from the date of entry,[4] and that is why all assume that interest on the foreclosure judgment will accrue. According to well-settled law, the underlying basis for post-judgment interest is as a penalty for the delayed payment of a judgment. *But*, where delay after judgment is caused solely by the plaintiff, defendants, it is said, should not suffer the penalty of paying interest.[5]

In equity, the court has this discretion, and wrongful conduct by either party is a factor to consider.[6] So, for example, if a plaintiff wrongfully refuses to allow redemption, interest on the foreclosure judgment can be denied.[7] Such a consequence for an affirmative error hardly seems objectionable. More insidious, though, would be a denial of interest to the plaintiff who, perhaps inadvertently, neglects to schedule a foreclosure sale. So there is a portentous lesson of care here for foreclosing plaintiffs.

Endnotes

1. Bruce Bergman, *Interest on the Foreclosure Judgment B An Unfolding Drama*, 20 Real Prop. L Section Newsl., 4 (Oct. 1992).
2. *Marine Mgmt. v. Seco Mgmt.,* 176 A.D.2d 252, 574 N.Y.S.2d 207 (2d Dep't 1991).
3. *Erhal Holding Corp. v. Rusin*, __ A.D.2d __, 675 N.Y.S.2d 138 (2d Dep't 1998).
4. CPLR 5003.
5. *Erhal Holding Corp.*, __ A.D.2d __, 675 N.Y.S.2d 138 (citing *Juracka v. Ferrara*, 120 A.D.2d 822, 824, 501 N.Y.S.2d 936); *Ariola v. Petro Trucking Corp.*, 50 Misc. 2d 216, 217-18, 270 N.Y.S.2d 309.
6. *Sloane v. Gape*, 216 A.D.2d 285, 627 N.Y.S.2d 785 (2d Dep't 1995) (citing *South Shore Fed. Sav. & Loan Ass'n v. Shore Club Holding Corp.*, 54 A.D.2d 978, 389 N.Y.S.2d 29); *Bosco v. Alicino*, 37 A.D.2d 552, 322 N.Y.S.2d 414.
7. *Sloane*, 216 A.D.2d 285, 627 N.Y.S.2d 785 (2d Dep't 1995).

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NYSBA**CLE** **Publications**

Real Estate Transactions—Residential Property*

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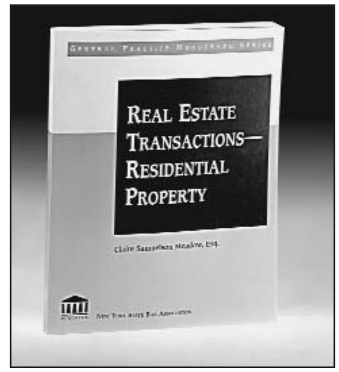
Blank Worksheet for Estimating Closing Costs • Attorney's Checklist—Action Prior to, at Time of, and Subsequent to Closing • Disclosure Regarding Real Estate Agency Relationships • Residential Contract of Sale (Blumberg Form A125) • Standard Form Contract of Sale (NYBTU Form 8041) • EPA/HUD Lead Paint Fact Sheet • Lead Paint Disclosure Form for Housing Sales • Lead Paint Disclosure Form for Housing Rentals and Leases • *Protect Your Family from Lead in Your Home* pamphlet • Rider Clauses to Contract of Sale—Purchaser • Holdover Agreement (Short Form) • Holdover Agreement (Long Form) • Occupancy Agreement • Acceleration Affidavit—To Postpone Condition Requiring Borrower to Sell Current Residence • Attorney's Affidavit of Compliance • Warranty Deed with Full Covenants (Blumberg Form A285) • Bargain and Sale Deed, with Covenant Against Grantor's Acts (Blumberg Form A291) • Bargain and Sale Deed, Without Covenant Against Grantor's Acts (Blumberg Form A289) • Quitclaim Deed (Blumberg Form A293) • Executor's Deed (Blumberg Form A296) • Administrator's Deed (Blumberg Form A298) • Referee's Deed in Foreclosure (Blumberg Form M297) • Tax Guides for Westchester County and New York City • F.I.R.P.T.A. Non-Foreign Certification by Individual Transferor • F.I.R.P.T.A. Affidavit of Facts Relating to the Withholding of Tax upon the Disposition of United States Real Property Interests Pursuant to 26 U.S.C. § 1445(B)(2) • Real Property Transfer Report (Form RP-5217) and Instructions • NYC Real Property Transfer Tax Return • NYC Cooperative Transfer Summary Return (January-June) • NYC Cooperative Transfer Summary Return (July-December) • Combined New York State Real Estate Transfer Tax Return/Credit Line Mortgage Certificate (Form TP-584) and Instructions (Form TP-584-I) • New York State Real Estate Transfer Tax Return Supplemental Schedules (Form TP-584.1) • City of Mount Vernon Real Property Transfer Tax Return • City of Yonkers Real Property Transfer Tax Return • Claim for Refund of Real Property Transfer Gains Tax (Form TP-165.8) • Undertaking/Indemnity for Transfer Tax by Transferee and Its Designated Title Agency • Rider Clauses to Contract of Sale—New Construction • Condominium Contract of Sale (Blumberg Form M146) • Rider Clauses to Contract of Sale—Condominium Unit • Contract of Sale—Cooperative Apartment (Blumberg Form M123) • Rider Clauses to Contract of Sale—Cooperative Apartment • Brokerage Agreement—Seller • Guide to Addresses and Numbers where Deeds are Recorded • Blank Worksheet Form for Calculating Seller's Closing Costs • Rider Clauses to Contract of Sale—Seller • Seller's Attorney's Transmittal Letter • Phraseology of Typical Title Report Exceptions • General Offices, Addresses and Telephone Numbers for Assistance in Disposing of Matters Raised in the Title Report • Sample Schedule A—Real Property Description • Reporting of Gross Proceeds from Real Estate Transactions (IRS Form 1099-S) • Annual Summary and Transmittal of U.S. Information Returns (IRS Form 1096) • Sample of "No Other Name" and "No Judgments" Affidavit Submitted for Clearance of Title—Exceptions Raised • Statement of Closing Title • Natural Person Mortgagee—Affidavit of Exemption § 253(1-a) • Durable General Power of Attorney—New York Statutory Short Form with Attorney's Affidavit of Full Force and Effect (Blumberg Forms P644 and M51) • Durable General Power of Attorney—New York Statutory Short Form (Blumberg Form P44) • Durable General Power of Attorney Effective at a Future Time—New York Statutory Short Form (Blumberg Form M49) • Nondurable General Power of Attorney—New York Statutory Short Form with Attorney's Affidavit of Full Force and Effect (Blumberg Form P43)



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Cite as: *N.Y. Real Prop. L.J.*

Real Property Law Section
New York State Bar Association
One Elk Street
Albany, New York 12207-1096

N.Y. REAL PROPERTY LAW JOURNAL

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