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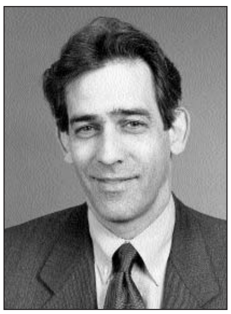
A Message from the Section Chair



There has been considerable discussion during the past year regarding the practice of law by multidisciplinary practice (MDP) groups. In June 1999, the State Bar's House of Delegates adopted a resolution urging further study of MDP but also opposing changes in existing regulations which prohibit attorneys from practicing law in MDP settings absent adequate safeguards for service to clients and the integrity of the legal profession. MDP refers to an organization which groups more than one profession together in order to provide a broader range of professional services to clients. The most common form of MDP these days is the large accounting firm which hires lawyers or acquires law firms. In such arrangements, ownership and control of the organization and thus of the legal services is lodged with professionals other than lawyers. MDP structures are common in Europe and are being considered in Canada and Australia.

Many lawyers are concerned that this practice format will take hold in the United States and undermine the historic independence of attorneys in their client relationships, raising a host of legal and ethical issues. These include the capacity of a lawyer to maintain independent judgment in an organization controlled by non-lawyers; unlawful practice of law, if the MDP permits non-lawyers to render legal advice and prepare legal documents; conflicts of interest, the rules for which differ considerably between the accounting and legal professions; and preservation of client confidences, another area in which accountants and attorneys have varying responsibilities. Proponents argue that MDP promotes efficiency by developing a "one stop shopping" professional organization which can address a broader range of client needs than the traditional law firm. The State Bar appointed in July 1999 a Special Committee on the Law Governing Firm Structure and Operation to undertake further study of MDP, which is anticipated to report in the spring of this year.

Real estate lawyers face somewhat analogous issues in the context of real estate brokers becoming involved in the preparation of contracts for the purchase and sale of homes. This practice is quite common in upstate New York, where most contract forms provide for review by an attorney (and possible rejection of the contract on legal grounds) within a short period after signing. However, the practice has not until recently spread downstate. Starting last fall, the Long Island Board of Realtors has made standard purchase and sale agreements available to its members in Nassau, Suffolk and Queens counties, the theory being that brokers will only fill in factual information such as price and mortgage amount and therefore not be engaged in rendering legal advice. Notwithstanding the opportunity for attorney review before the contract becomes final, many Long Island attorneys are strongly opposed to this development, viewing it as the unauthorized practice of law and a trend that will undermine client interests. In Westchester, by

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contrast, local attorneys and brokers have jointly developed a standard contract form (which requires attorney review and approval) and have made progress in working out conflicts related to broker-prepared contracts. Because of the varying practices throughout New York State, the State Bar Association has not taken a position on the wisdom or propriety of broker-prepared contracts. The Real Property Section continues to monitor developments in this area.

The Section recently established a task force to assess legislation proposed by the New York State Association of Realtors (NYSAR) which would require certain disclosure to be made by sellers of residential real property. Brokers have advocated this legislation on the basis that the residential real property transfer process suffers from the lack of a uniform instrument by which sellers can provide information to buyers about the condition of property for sale. The bill, known as the Property Condition Disclosure Act (S.5039-A, A.1173-C), passed the State Assembly in 1999 but not the Senate. It has raised serious concerns among real estate attorneys, especially since New York law relating to sellers still follows the doctrine of *caveat emptor* and does not generally require sellers to make any disclosure about the condition of property to be sold, with exceptions for fraud and certain other matters. New York law does, however, require brokers to disclose all facts known to them which materially affect the value or desirability of a property, thereby giving brokers a mandate which does not apply to their seller-clients. Many states have already adopted some form of seller disclosure legislation, though these statutes vary considerably in terms of the scope of required disclosure and the consequences of non-compliance by sellers. As to remedies, a number of states make sellers liable for damages arising from statutory non-disclosure, which of course represents a lower threshold for sellers' liability than fraud, while other states impose fines.

Many New York lawyers oppose statutory disclosure in any form because they feel it is likely to stimulate litigation, while others favor a limited statute in which disclosure would only be required with respect to facts which the purchaser cannot discover by a conventional inspection, such as the presence of filled land or sewage disposal problems. Some attorneys have expressed the policy concern that purchasers ought not be lulled into thinking that a professional home and pest inspection is unnecessary because the seller is required by law to make certain disclosures. Still others feel that New York should follow a more "pro-information" approach and adopt broader disclosure rules, along the lines of California's statute, believing that more information sharing over time will mean less litigation. Members of the Section's Executive Committee have been meeting with NYSAR representatives to further discuss the proposed legislation, and will follow its progress in the Legislature.

For those of you who missed the Annual Meeting of the Real Property Section at the end of January, we had a very large turnout (more than 350 members) for our continuing legal education program. The speakers covered a broad range of topics, from a description of revisions to the Code of Professional Responsibility to conservation easements to tips on commercial lease negotiations. Anyone wishing to obtain a copy of the excellent written materials should contact the State Bar staff in Albany.

Steven G. Horowitz

REQUEST FOR ARTICLES

If you have written an article, please send to:

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or to any of the co-editors listed on the back page.

Articles should be submitted on a 3 1/2" floppy disk, preferably in WordPerfect or Microsoft Word, along with a printed original and biographical information.

Section Members "Bullish" About Chicago Trip

Some of those who attended the program visited the Trading Floor at the Chicago Board of Trade. According to trip organizer Joel Sachs, the level of activity made the New York Stock Exchange seem mild by comparison.

Pictured above is a moment captured during the Real Property Law Section-sponsored trip over the weekend of October 21 for "An Architectural and Historic Heritage Tour of Chicago." Highlights of the trip included a program entitled "Current Legal Issues Involving Historic Preservation," presented by Section Members Michael Sillerman, Esq., and Stuart Beckerman, Esq. Also included on the agenda were an architectural tour of Chicago and a visit to the Frank Lloyd Wright home and studio.

The weekend received positive reviews and expressions of interest in future Section-sponsored trips. If Section members are interested joining future excursions, they are advised to contact their Section officers or Joel Sachs.

Solving the Mortgage Tax Barrier to Defeasance in New York

By Joseph Philip Forte

On February 25, 2000, the New York State Department of Taxation and Finance (the "Department") issued an Advisory Opinion of the State Tax Commissioner confirming that in a defeasance from a Commercial Mortgage Backed Securities (CMBS) transaction, the New York State mortgage tax would not be imposed on the assignment of a mortgage from a REMIC Trust nor on the subsequent modification and extension of the assigned mortgage. This ruling will have a significant impact on all borrowers and lenders who are involved in the financing of real estate in New York State as well as on their respective perspectives on securitized lending in the Capital Markets. It assures that such borrowers and lenders will continue to have equal access to such markets in New York. But how difficult an issue was this for New York financings.

Background

Historically, real estate finance business has been conducted within local markets. The traditional sources of real estate financing, whether for acquisition, development, or construction, have been the institutional lenders that do business in that local "Main Street" market—the commercial banks, thrifts, and insurance companies. Until recently, primary market lenders generally did not approach the capital, or "Wall Street," market for funding before or after loan origination. Likewise, with a few notable exceptions, Wall Street rarely made forays into the local real estate finance markets, and normally, it did so only to service an existing investment banking client with corporate real estate needs. Thus, while Main Street lenders focused primarily on the individual real estate project, Wall Street's focus in real estate finance, for the most part, was limited to corporate client relationships. However, in recent years, Wall Street has expanded its real estate focus to become another source of real estate financing accessing the capital markets.

The securitization of commercial mortgages had a slower and more deliberate growth than the securitization of residential mortgages. Although several mortgage backed securities transactions involving pools of commercial mortgages or a single large commercial mortgage (CMBS) were closed from 1984 to 1985, the strong resurgence of interest by traditional Main Street lenders in commercial mortgages in the mid-1980s stalled any further development of a CMBS market beyond some occasional isolated transactions. The oversupply of traditional Main Street capital, unfettered by market restraints, crowded out the capital markets investors, but the cycle quickly ran its course. A series of events, including the savings and loan crisis and the stiffening commercial bank regulatory environment in the late 1980s, led to a national real estate depression in 1990 that effectively strangled the flow of Main Street capital to commercial real estate. The credit crunch that followed severely impacted real estate investors, affecting lenders as well as owners with serious and significant negative impact on commercial real estate values. The converging interests of Main Street and Wall Street lenders in the development of the CMBS market provided a unique opportunity for the real estate industry to respond to the effects of the credit crunch.

Securitized Lending

In the early 1990s Wall Street again provided a countercyclical funding source for commercial real estate finance transactions—securitized lending. However, the task of developing a market to pool and securitize the commercial mortgage loans originated in the capital markets was eased into existence by the Resolution Trust Corporation's mandated sell-off of mortgages acquired in the liquidations of the failed savings and loan associations.

Since its initial inception in 1991 through today, the CMBS market has grown to nearly $250 billion of issuance with $78.3 billion of CMBS issued in 1998 alone. In 1998, securitized lending constituted of all commercial mortgage loans made—insurance companies made only $22.3 billion in portfolio loans in 1998. Most money center banks (albeit not regional banks or community banks) only make mortgage loans to sell them into the capital markets while some insurance companies now offer securitized as well as portfolio loans. The base of CMBS investors must expand beyond traditional real estate investors for the CMBS market to continue to grow and as a result CMBS transactions have been structured to attract the widest range of non-real estate investors.

Securitization

Securitized lending is based upon the securitization of mortgage loans. Securitization is a process whereby mortgage loans are acquired (by origination or purchase), and accumulated by a financial institution which then transfers the pool of mortgage loans to a legally separate entity, usually a trust, which in turn issues new financial instruments that represent an ownership interest in, or an obligation secured by, the pool of mortgage loans. Acquisition of these instruments can be structured as a sale, with the issuer selling certificates that represent an undivided fractional ownership interest in the issuer's mortgage pool, or as financing, with the issuer issuing debt instruments secured by the issuer's mortgage pool as collateral.

For buyers of the securities, the class or tranche structure of most securitizations allows investors to pick an investment that suits their risk and reward criteria, as well as the investment time frame which facilitates matching their assets and liabilities.[1]

Prepayment

One of the key elements necessary to the continued development of the CMBS market is to assure investors that their investments will remain outstanding for the term initially promised at the marketing of the CMBS issuance. Mortgage prepayments or refinancings wreak havoc with the financial engineering accomplished in a CMBS transaction which typically divides up cash flows from the pooled mortgages into numerous different payment and risk classes to attract as wide an array of different types of investors as possible. Therefore, CMBS structures must disallow (or compensate for) repayment of any mortgage principal before its scheduled repayment, whether in installments or at maturity.

Although prepayment consideration based on a yield maintenance was initially developed by Wall Street (in lieu of declining balance prepayment fees), to compensate investors for prepayments, any payment before maturity will still cause CMBS to be retired early, disrupting an investor's intended strategy in purchasing the CMBS for its portfolio. In addition, yield maintenance, as well as declining percentage prepayment fees, do not act as a sufficient disincentive to borrowers prepaying mortgages. Likewise, while such arrangements may compensate some CMBS investors, other classes of investors such as the class of "interest-only" investors may forfeit some or all of their investment upon prepayment. Consequently, to provide an alternative to the disruption to bond investors continuing cash flow expectations caused by prepayment, CMBS issuers have developed an alternative mechanism entitled "defeasance" to allow the bonds to remain outstanding.

Defeasance

The new defeasance arrangement was borrowed from corporate finance practice where bonds issued by a corporation are removed from a corporation's balance sheet by "in substance defeasance." The corporation has no legal power to retire the bonds contractually, but it can remove the bonds from its balance sheet for the remainder of their term. To accomplish this, the corporation acquires U.S. Treasury securities which mimic the payments to be made under the bonds and escrows the US Treasury securities to secure repayment of the bonds. The bonds are not satisfied but are repaid by the cash flow generated by the escrowed U.S. Treasury securities and not by the corporation. Thus, for investors the bonds remain outstanding for their term.

Because the outstanding bonds are not satisfied but remain outstanding, this arrangement is very attractive to CMBS issuers attempting to look more like the corporate bond market in an effort to attract new investors. Thus, in a CMBS defeasance the original borrower will substitute an income producing portfolio of U.S. Treasury securities in place of the mortgage in the CMBS Trust pool. The payments generated by the U.S. Treasury securities must in the aggregate match the monthly payments of principal and interest of the mortgage being defeased. The U.S. Treasury securities, *and not the cash flow from the mortgaged property or the original borrower*, will constitute the source of funds that will continue to make the payments under the Defeasance Note (defined below) in the CMBS Trust pool. The original borrower will be released from any obligation to make any payments under the Defeasance Note.

REMIC Qualification

For defeasance to work effectively in CMBS transactions, there are certain federal tax issues that must be considered and resolved. To avoid taxation on the pool level in certain circumstances, CMBS issuers will usually elect that the trust holding the pooled mortgages (the "REMIC Trust") be a "Real Estate Mortgage Investment Conduit" (REMIC) under applicable federal tax regulations (the "REMIC Rules"). This is the most commonly used tax structure for CMBS transactions. The substitution of the U.S. Treasuries for the mortgage must be accomplished in strict conformity with the REMIC Rules to avoid any unintended modification of the mortgage loan in the REMIC Trust, because any modification or exchange would jeopardize the tax status of the REMIC Trust and subject the entire CMBS issuance to taxation at the pool level. That unintended result would be catastrophic leading to dual taxation at the pool and investor levels. Defeasance, however, is specifically recognized by the REMIC Rules as a permissible transaction provided:

1. the substitute collateral is solely U.S. Treasury securities;
2. the mortgage documents expressly allow the substitution;
3. the mortgage lien is released from the REMIC Trust to allow sale of the mortgaged

property or other customary commercial transactions; and

4. the Defeasance does not occur within the first 2 years of the REMIC Trust.

If a defeasance was effected in accordance with the requirements of these Treasury Regulations, it would not adversely affect or impair Treasury Regulations the tax qualification and status of the REMIC Trust as a real estate mortgage investment conduit.

Defeasance Procedure

To accomplish a defeasance in non-mortgage tax states, the existing mortgage lien is simply released from the REMIC Trust upon the simultaneous pledge of the requisite U.S. Treasury securities as substitute collateral for the securitized debt. While this procedure generally works to accomplish a defeasance for a borrower's purposes, the defeasance of a mortgage on New York property (as well as some other mortgage tax states where assignment may avoid a recording tax) from a CMBS REMIC Trust has some serious structural problems for the borrower.

Alternative Defeasance Procedure

To resolve this mortgage tax impasse, the following alternative procedure for defeasing an existing mortgage note (the "Mortgage Note") and taking it, together with the existing mortgage (the "Mortgage") by assignment from the REMIC Trust has been used for some time by certain securitized lenders:

1. The borrower ("Original Borrower") would execute a new note (the "Defeasance Note"), dated as of the date of the defeasance, payable to the lender providing the new financing (the "New Lender"), in an amount equal to the outstanding principal balance of the Mortgage Note. The new financing will be used to purchase U.S. Treasury securities. The Defeasance Note is otherwise identical to the Mortgage Note (e.g., interest rate, maturity, etc.) except that it would state that it is secured by the U.S. Treasury securities as the defeasance collateral and the security agreement required under the existing loan documents (the "Security Agreement"). The Security Agreement would name the New Lender as secured party and create a perfected first priority security interest in the defeasance collateral.

2. A new entity would be created which must be a newly formed special purpose entity that is not susceptible to substantive consolidation with the Original Borrower in the event of bankruptcy of the Original Borrower (the "Successor Borrower"). Upon transfer of the U.S. Treasury securities to the Successor Borrower, it will agree to assume the Defeasance Note and the Security Agreement.

3. The Defeasance Note, endorsed to the trustee of the REMIC Trust, the Security Agreement (and any related UCC filings), an assignment of each to the trustee of the REMIC Trust, an assumption of the Defeasance Note and the Security Agreement (the "Assumption") by the Successor Borrower as permitted in the existing loan documents and the defeasance collateral (together with the appropriate transfer documentation for the defeasance collateral to the Successor Borrower) would be delivered to a title insurance company acceptable to the trustee and to the New Lender (the "Title Company"), in escrow. The Mortgage Note, endorsed to the New Lender, together with the Mortgage and an assignment thereof to the New Lender would be delivered by the trustee of the REMIC Trust to the Title Company, to be held in escrow.

4. Upon compliance with the conditions to (a) the release of escrow, (b) the closing of the new Loan, and (c) the defeasance pursuant to the existing loan documents, the Title Company would deliver (i) the Defeasance Note, the Security Agreement, the Assumption and the related transfer and assignment documents to the trustee of the REMIC Trust, (ii) the defeasance collateral to the Successor Borrower, subject to the REMIC Trust's security interest, and (iii) the Mortgage Note, Mortgage and assignments to the New Lender, and the assignment (and other loan documents in connection with the new Loan) would be recorded.

5. After the release of escrow, (a) the Original Borrower will continue to be liable to the New Lender under the Mortgage Note and Mortgage; (b) the Successor Borrower will have assumed liability under the Defeasance Note and the Security Agreement and (c) the Original Borrower would be released from liability under the Defeasance Note and the Security Agreement. Thus, the Original Borrower under the Mortgage Note would continue to be liable for only one loan that is evidenced by the Mortgage Note and secured by the Mortgage, while the Successor Borrower would only be liable under the Defeasance Note and the Security Agreement.

New York Problem

The problem will arise when the New York borrower attempts to obtain an assignment of an existing securitized mortgage from a CMBS REMIC Trust. Although the trustee of the REMIC Trust will ordinarily be willing to deliver an assignment of the Mortgage to the New Lender at the request of the borrower, the New Lender would be unwilling to accept the assignment of the Mortgage unless the Title Company could affirmatively insure that not new mortgage tax would be due on the Mortgage as a result of the defeasance in accordance with the procedure outlined above.[2]

A. Further Obstacle

Yet the title industry in New York State has been unwilling to issue a mortgage tax endorsement to a lender's title insurance policy for the Mortgage without assurances from the Department that no new mortgage tax would be due on the Mortgage when assigned to the New Lender. The title industry recognized that this alternative defeasance procedure is not unlike the assignment of existing mortgages by portfolio lenders and others upon a refinancing by a new lender which is expressly recognized by the New York law and the Department.[3] However, it was the title industry's uncertainty as to whether the Department would agree that no new mortgage tax would be due and no significant potential liability would be incurred with the mortgage tax endorsement that has caused the title industry's reluctance to act without written confirmation from the Department.[4] Likewise, borrowers would not refinance securitized mortgages without assurance that no additional mortgage tax would be payable.[5] Of course, if any "new money" were advanced in addition to the outstanding principal balance (*not* the face amount) of the Mortgage an additional tax would be due and payable on that additional (or so-called "stub") amount.[6]

The Advisory Opinion

To overcome the title industry's reluctance to issue a mortgage tax endorsement in connection with an alternative defeasance, it was determined that obtaining a ruling from the Department would effectively resolve the mortgage tax issue for borrowers as well as title insurers. For this purpose, a formal Petition for Advisory Opinion was submitted to the Department (the "Petition").[7] The Petition outlined various legal as well as economic arguments in favor of the alternative defeasance procedure not being a taxable event. Recognizing the importance of this issue and its significant impact on securitized lending in New York, the Department responded quickly to the industry's request and issued an Advisory Opinion of the State Tax Commissioner (the "Advisory Opinion").

After carefully outlining the applicable New York State statutes and regulations and citing the appropriate case law, the Department rendered two opinions: first, the recording of an assignment of mortgage from the REMIC Trust in consideration of the Defeasance Note and Security Agreement "is not subject to the mortgage recording taxes,"[8] and second, the recording of a modification and/or extension agreement with respect to the assigned mortgage[9] by the New Lender would not be subject to any state mortgage taxes.[10] Based on this Advisory Opinion the title industry is willing to issue mortgage tax endorsements and with the endorsements borrowers should be comfortable in defeasing a loan from a REMIC Trust using the alternative defeasance procedure.

The Remaining Obstacle

While lenders and borrowers will no longer be reluctant to defease a loan because of the New York Mortgage tax, loans in other mortgage tax states may face similar issues as affected New York loans prior to the Advisory Opinion. The risks are real and economic if defeasance is impracticable in one state while available in others.

If New York borrowers were unable to use Defeasance, they would have been at a distinct disadvantage as compared to borrowers from other states. Because of the size of the New York mortgage tax, the economic consequence of serial taxation of the same mortgage would have had a chilling effect upon real estate transactions in New York. To avoid this result, New York borrowers would have been relegated to borrowing solely from an ever shrinking pool of portfolio lenders and been unable to obtain the benefits of borrowing in the capital markets. If portfolio lenders were, however, unable to fulfill the mortgage loan demand of New York borrowers, securitized lenders would probably then re-enter the market offering yield maintenance in lieu of defeasance, but at a significant additional cost to New York borrowers for the perceived negative value cost of selling that non-standard "story" loan into the capital markets.

While securitized lenders may never entirely replace traditional portfolio lenders as the principal source of real estate capital, nonetheless, with the actual decrease in the number of traditional real estate lenders in the Main Street market through liquidation and consolidation and the periodic reduction in appetite of Main Street lenders for commercial mortgages in good times and even less appetite in real estate downcycles, Wall Street and the CMBS market will continue to have a legitimate place in the commercial real estate market as a countercyclical source of real estate finance and as an exit strategy for primary market lenders, as well as for commercial mortgage portfolio investors.

The impact of less available, or in the alternative more expensive, mortgage capital for commercial real estate would be catastrophic for the

New York real estate industry and New York State in general. As the nationwide real estate industry consortium that was formed by several national real estate trade associations to foster the development of a CMBS market in the midst of the national real estate depression in the early 1990s observed in its report: "Th[e] dearth of capital resulted in a drop in property values, dampened investment returns, increased delinquencies and foreclosures, as well as industry layoffs. In turn, *this resulted in an erosion in state and local tax bases*, which adversely impacted community services."[11]

Today the commercial mortgage market has become a national market, and the increased availability of reasonably-priced commercial mortgage money is fueled by the real estate finance industry's access to the capital markets.[12] The investors in the capital markets, however, as well as the credit rating agencies whose imprimatur is critical to the securitization process, demand mortgages that are susceptible of being readily and predictably underwritten, originated, rated and pooled in securitizations.[13] Without the availability of defeasance to New York borrowers, the scheduled maturity of New York commercial mortgages (beyond any applicable prepayment lock-out period) could no longer be relied upon by investors because prepayments would occur adversely affecting some CMBS classes. Without certainty, the value of New York mortgages in CMBS pools would decrease in the marketplace. The result eventually would be less mortgage capital available for New York businesses and, to the extent available, higher interest rates for such financing. A decrease in capital would reduce property values, and eventually reduce the real property tax base thereby adversely affecting the State's revenues from transfer as well as mortgage taxes which result from property sales.

The real estate industry in each mortgage tax state must assess the risks to defeasance and the opportunity to remove any obstacle impeding their effective use of the capital markets.

Endnotes

1. Argante Cappelli & Michael Worth, *The Securitization of Real Estate Assets*, Real Estate Strategies at 2 (Summer, 1996).
2. N.Y. Tax Law § 253 (imposes a tax on the recording of a mortgage measured by the principal amount secured).
3. N.Y. Real Prop. Law § 275.
4. The assistance of Melvyn Mitzner, Esq. of Commonwealth Land Title Insurance Company in New York City was invaluable in dealing with the Department as well as the NYC Department of Finance.
5. N.Y. Tax Law § 258 (provides that, among other things, the failure to pay a mortgage tax on a mortgage prevents recordation of an assignment).
6. N.Y. Tax Law § 255.
7. On December 30, 1999, Joseph Philip Forte, on behalf of the New York State Bar Association Real Property Section, filed a Petition for Advisory Opinion and after consultation with the Department filed a Revised Petition on January 13, 2000. Petition No. M991230A.
8. *Id.* at 6.
9. Referred to as a "supplemental mortgage" in the Advisory Opinion in conformity with the New York statutory definition.
10. *Id.* at 6. It does, however, reiterate that a mortgage tax would be payable to the extent that the New Lender advances "new money" in addition to the unpaid principal amount of the mortgage assigned.
11. The Capital Consortium, Capital Markets Initiatives at 1 (June 25, 1996) (emphasis added).
12. *See generally* Joseph Philip Forte, *A Capital Markets Mortgage: A Ratable Model for Main Street and Wall Street*, 31 Real Prop. Prob. & Tr. J. 489 (1996).
13. *See,* The Capital Consortium, Capital Markets Initiatives at 5 (June 25, 1996).

Joseph Philip Forte is Chair of the Real Estate Practice Group at Thacher, Proffitt & Wood. He is a former Governor of the American College of Real Estate Lawyers; Immediate Past President of the Commercial Mortgage Securities Association; member of the Anglo-American Real Property Institute; and the current Publisher of *CMBS World*.

Chinese Walls of Dubious Value in New York State

By John E. Blyth

On July 1, 1999, the Court of Appeals in *Kassis v. Teacher's Ins. and Annuity Ass'n.*[1] struck down a so-called "Chinese Wall"[2] which a law firm had built around a "tainted attorney" so that the tainted attorney could not share with the rest of his new firm any confidential information of which he had knowledge gained while the tainted attorney was employed by his old firm. By its holding, the Court of Appeals reversed the First Department, which in this instance had previously approved the Chinese Wall.[3]

This holding of the Court of Appeals is consistent with DR 5-105(D) which provides that while lawyers are associated in a law firm, none of them shall knowingly accept or continue employment when any one of them practicing along would be prohibited from doing so under . . . DR 5-105(A) . . . except as otherwise provided therein. This provision in the Code governing "vicarious" or "imputed" disqualification is a kind of "Three Musketeers" rule in conflicts: it's one for all and all for one.[4]

Some firms have attempted to fight this disqualification by erecting a screen around the attorney so that his or her confidential information cannot be shared with others in the firm. DR 5-105(D), however, says nothing about "Chinese Walls" (also called "screens," "firewalls," "ethical walls," and "zones of silence").[5] Significantly, and although they could have done so had they wished, New York's four Appellate Divisions did not change DR 5-105(D) to permit a Chinese Wall when they made other changes to the Code of Professional Responsibility. The changes to the Code of Professional Responsibility became effective on June 30, 1999,[6] the day before the *Kassis* decision by the Court of Appeals.

In *Kassis*, an individual lawyer, newly hired by the firm representing the defendant, had been an associate in the firm that was representing the plaintiff in the same action. While representing the plaintiff, the lawyer had conducted depositions in the case, often conferred with the plaintiff, and participated in strategy sessions. In disqualifying the defendant's firm as a matter of law from continuing to represent the defendant, the Court of Appeals' holding consistent with earlier New York case law on the subject.[7]

Defendant's firm cautioned the attorney that he would not be permitted to participate in the *Kassis* litigation and that he was not to discuss that matter with anyone in the firm. When plaintiff's firm learned of the associate's employment with the defendant's firm, it requested details concerning the precautionary measures that defendant's firm planned to take in order to prevent the associate's inadvertent disclosure of confidential information he had obtained while at plaintiff's firm. Defendant's partner described the Chinese Wall which had been erected around the associate as follows:

1. The entire file, which presently consists of 15 redwells, will be kept in the partner's office in lieu of our general filing area.

2. The associate will be at a substantial distance from the partner's office.

3. The associate, upon commencement of his employment with the firm will be instructed not to touch the *Kassis* file nor to discuss the *Kassis* matter with any partner, associate or staff member of the firm.

4. There will be no meetings, conferences or discussions in the present of the associate concerning the *Kassis* litigation.

5. All future associates who may work on the *Kassis* matter with the partner in preparation for trial will be instructed not to discuss this file with the associate.

The three major arguments against screens[8] have not persuaded New York State courts to alter DR 5-105(D) to permit screening as a substitute for client consent. Of course, nothing in DR 5-105(D) prohibits a law firm from establishing a screen as a way of encouraging a client to consent to a law firm's representation adverse to that client. While courts do not recognize screens as a substitute for client consent, clients may recognize them as a basis for giving consent when conflicts arise.[9]

While acknowledging that each case is fact specific, the general rule enunciated by the Court of Appeals is that where an attorney working in a law firm is disqualified from undertaking a subsequent representation opposing a former client, all the attorneys in that firm are likewise precluded from such representation. In order for a Chinese Wall to be effective, the Court of Appeals stated that the one around whom it is built must have only insignificant knowledge of the other side's case.[10]

By switching sides, the lawyer created a presumption of "imputed disqualification" against the firm he joined. That imposed on the firm the burden of proving the data known by the disqualified newcomer "is unlikely to be significant or material in the litigation." If that could be shown, then precautions within the firm to bar any of the lawyers working of the defendant's case from learning anything from their new colleague who had worked on the plaintiff's case, i.e., the building of a Chinese Wall around the new lawyer, would rebut the presumption. Defendant's law firm could not rebut the presumption in the *Kassis* case.

As Professor Simon has pointed out, disqualification is not automatic. In *Solow v. W. R. Grace & Co.*,[11] the Court of Appeals cautioned that a per se disqualification rule would (a) impinge upon a client's right to be represented by counsel of his choice; (b) restrict an attorney's ability to practice his or her profession, (c) present significant hardships when the chosen attorney is disqualified, and (d) inflict hardship on the current client and delay upon the courts by forcing disqualification even though the client's attorney is ignorant of any confidences of the prior client. The case should not, however, be read as an approval of the erection of a Chinese Wall. As Professor Simon points out, the Court opts for full implementation of the irrebuttable presumption-attribution rule while the tainted attorney remains with the law firm seeking to avoid disqualification and focuses only on the attributes of the law firm after the tainted attorney has left, only then permitting rebuttal of the permanency of the taint.[12]

As noted above, the First Department in *Cummin v. Cummin*[13] in September 1999 provided a concrete limitation to the *Kassis* broad holding. In *Cummin*, the First Department unanimously reversed, on the law, the holding of the New York County Supreme Court. The facts are instructive:

Diane Cummin and Arch Cummin, after 14 years of marriage, separated in 1992. Following prolonged negotiations in contemplation of divorce, the parties reached a tentative settlement in 1998 but when the deal fell through, plaintiff decided to litigate. Before doing so, plaintiff discharged her attorney and contacted the chair of a matrimonial firm with 70 attorneys. After a routine search of the firm's conflict checking system, it was determined that the firm's managing partner and former head of the matrimonial department had briefly consulted with plaintiff's adversary (defendant) six years earlier. The managing partner did not remember defendant but it was conceded that the consultation had lasted 1 to 2 hours, during which they had discussed defendant's real estate and security holdings, his separate property claims, and issues of custody and support. Defendant paid $400 for the one-hour consultation but chose not to hire the firm to represent him. The firm has no file or any notes or memoranda regarding the consultation, other than the billing.

Even though the firm concluded that there was no conflict of interest, it nevertheless notified defendant's counsel that certain precautions were being taken to isolate the former managing partner from the litigation and decided to erect a "Chinese Wall" around the lawyer. The firm also solicited a favorable opinion from a law professor who was director of Hofstra University's Institute for the Study of Legal Ethics, presumably Professor Simon.

Noting that the presumption is rebuttable, the First Department distinguished the Court of Appeals holding in *Kassis*. In *Kassis*, the attorney's lead and active role in the case at the prior firm, his regular contact with the client, and his familiarity with all the details of the former client's confidences were factors which were not present in *Cummin*. The First Department relied upon the Court of Appeals implication that the presumption could be rebutted where confidential information previously acquired by a large firm, but never shared among its associations, could be physically isolated, such as with the erection of a "Chinese Wall." Accordingly, the presumption of shared confidences was rebutted on this record.

Several difficult questions remain unanswered:

1. What are the differences between "material" and "insignificant" knowledge? Will law firms be willing to take the chance that they know the differences?
2. What kind of due diligence is required when a law firm makes a lateral hire or hires a law school graduate who clerked for a different firm one or more summers before graduation?
3. Whose rules apply to a multistate practice when the rules concerning Chinese Walls are different from state to state?
4. What is truth?

Endnotes

1. *Kassis v. Teacher's Ins. and Annuity Ass'n.*, 93 N.Y.2d 611, 695 N.Y.S.2d 515 (1999).
2. *Id.* at 515.
3. With two justices dissenting, the Appellate Division held that the safeguards employed by defendant's firm eliminated the danger of the associate's inadvertently transmitting information he might have gained from his previous employment at the plaintiff's firm. *Kassis v. Teacher's Ins. and Annuity Ass'n*, 243 A.D.2d 191, 678 N.Y.S.2d 32 (1st Dep't 1998), *rev'd*, 93 N.Y.2d 611 (1999). As will be pointed out, however, the First Department in September, 1999 had another bite at the apple and effectively limited the broad sweep of the Court of Appeals' holding: "the presumption is rebuttable." *See Cummin v. Cummin*, 695 N.Y.S.2d 346 (1st Dep't 1999).
4. Simon, *New York Code of Professional Responsibility Annotated*, at 290 (West, 1999) [hereinafter Simon's].
5. See The Task Force on Conflicts of Interest, *Intra-Firm Instructions Concerning Screens and Related Forms*, 50 Bus. Law. 1381, 1404 (1995).
6. *The Lawyer's Code of Professional Responsibility*, adopted by the New York State Bar Association effective January 1, 1970,

as amended effective June 30, 1999 (New York State Bar Association, 1999).

7. *See Solow v. W.R. Grace & Co.*, 83 N.Y.2d 303, 610 N.Y.S.2d 128 (1994) (Irrebuttable presumption may be rebutted after tainted attorney has left the firm; however, for firms whose attorneys are so intimately acquainted with all the work in the office that they can be expected to share client confidences and ideas about how to handle client problems as a matter of course, disqualification will be imposed as a matter of law without a hearing); *Cardinale v. Golinello*, 43 N.Y.2d 288, 401 N.Y.S.2d 191 (1977) (the hallmark of the firm was its informality with constant cross-pollination and cross-current of discussion and ideas among all attorneys regarding all matters which the firm handled); *Hernandez v. Paoli*, 255 A.D.2d 130, 679 N.Y.S.2d 389 (1st Dep't 1998) (the law firm's informal setting, which included discussions among the attorneys and the full accessible file room warrants disqualification); *Trustco Bank of New York v. Melino*, 164 Misc. 2d 999, 625 N.Y.S.2d 803 (1995) (even though the "tainted" attorney may be insulated by being located in a different city from the city where the action takes place, the appearance of impropriety is so heightened by the presence of plaintiff's former counsel in the camp of the "enemy" that it can never be dispelled by any other means but disqualification).

8. (1) Lawyers cannot be trusted to act against their own financial and social interests by keeping useful information from their partners and associates; (2) even if attorneys can be trusted, inadvertent disclosures cannot be prevented; and therefore (3) clients will be less candid with their lawyers if they know that one day their lawyer may move to the enemy camp (the opposing firm). Simon's at 291.

9. *Id.*

10. *See Trustco Bank New York v. Melino*, 164 Misc. 2d 999, 625 N.Y.S.2d 803 (1995) where the court remarked that the maintenance of a Chinese Wall around the "tainted" attorney would require periodic hearings to assure the wall was not being breached. In effect, what this means is that the parapet of the Chinese Wall would have to be manned by the judiciary, and the judiciary does not have sufficient resources to take on this added duty. Nor is the impermeability of a Chinese Wall an attainable concept. Even the original "impermeable" Chinese Wall was overrun by the barbarians.

11. *Solow*, 83 N.Y.2d at 303.

12. Simon's at 292, 293.

13. *Cummin*, 695 N.Y.S.2d at 346.

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Did the Appellate Term in *Paikoff* Come to the Right Conclusion as to Who Is a "Non-Purchasing Tenant"?

By Joel E. Miller

The situation in *Paikoff v. Harris*[1] was this. Barry Paikoff and Stuart Ross had, pursuant to a non-eviction cooperative conversion plan, changed the form of ownership of a building that they owned in Brooklyn to the cooperative form of ownership. Because not all of the cooperative corporation's allocated shares had been purchased by others, Messrs. Paikoff and Ross had themselves acquired some of those shares and entered into proprietary leases with the cooperative corporation for the associated apartments. When one of those apartments became vacant some five years later, they (in their capacity as proprietary lessee) subleased it to Emil and Elizabeth Harris, who had had no prior connection with either them or the building. The agreed rent was $625 a month, which was presumably the market rent at the time. There then developed disputes between the parties, which were resolved by, inter alia, the sublessors entering into a new sublease with Mr. Harris at a far-below-market rent of $500 a month. When that sublease expired, the sublessors offered Mr. Harris a new sublease at $850 a month, which, albeit 70% above the then-operative $500-a-month settlement rent, was still below market. Mr. Harris rejected the proffered sublease, and he and his wife resisted the holdover proceeding that the sublessors then brought.

The Harrises urged two propositions. The first was that they were within one of the two classes of "non-purchasing tenants" protected by General Business Law § 352-eeee(2)(c)(iv), from which it would follow that they were shielded from "unconscionable increases beyond ordinary rentals for comparable apartments." The Harrises' second proposition was that the quoted "unconscionable" phrase encompassed any large percentage increase, regardless of what other tenants were ordinarily paying for comparable apartments.

The Housing Court did not rule on the second issue. It dismissed the sublessors' proceeding solely on the ground that they had incorrectly (according to the court) alleged that the Harrises were not within the protection of GBL § 352-eeee(2)(c)(iv).

On appeal, the Appellate Term held that, even if the Harrises were right as to the scope of the protected class that they claimed to be in, the lower court should not have ruled against the sublessors unless the Harrises' percentage-increase contention was also correct. The appellate court then considered that point and held that the Harrises' contention was in fact not correct, saying in part:

> We do not read [GBL § 352-eeee(2)(c)(iv)] as focusing on the size of the increase. Rather, its clear meaning is that the rent may not be increased beyond the rents being charged for comparable apartments.[2]

The appellate court then went on to say that, because the sublessors "showed that comparable apartments in the building were renting for higher amounts, and they submitted an affidavit from an experienced real-estate broker attesting to the reasonableness of the rent," whereas "tenants offered no proof from which the value of the apartment could be ascertained," "tenants were not within their rights in rejecting the proposed lease." It then ordered entry of a judgment awarding possession to the sublessors.

In view of that disposition, it was unnecessary for the Appellate Term to rule on the scope-of-the-protected-class point. However, it chose to do so, and it agreed "entirely" with the Housing Court's conclusion that the Harrises were within the protection of GBL § 352-eeee(2)(c)(iv). Notwithstanding that that ruling was, as an *obiter dictum*, technically not binding even on the lower courts within the appellate court's jurisdiction, it was clearly made for the guidance of those courts and undoubtedly will be followed by them unless overturned on appeal or otherwise abrogated.

All would agree that, inasmuch as the scope-of-the-protected-class point had been fully briefed and had received much publicity—and two other Housing Courts had already passed on it and reached the opposite conclusion[3]—it made sense for the Appellate Term to rule on the point. The purpose of this article is to show that that ruling, whatever one may think of it as a legislative matter, cannot be squared with the words of the statute, especially when viewed in the light of the history of the statute's development.

That is not to say that GBL § 352-eeee is well written. It is not. Nor is it to say that the Legislature necessarily drew the protection line at the most appropriate place. It is to say, though, that, once one has struggled through what the Appellate Term correctly referred to as the "ambiguities and inconsistencies in the statute," all of its relevant provisions can be given coherent and reasonable effect, and, unless one wishes to use the excuse of its less-than-pellucid drafting to overrule the Legislature, one must conclude that the Harrises were not within either of the classes protected by GBL § 352-eeee(2)(c)(iv).

The following portions of the article will discuss (i) the usual cooperative conversion process, (ii) the conflicting legislative objectives underlying the compromise reflected in GBL § 352-eeee, (iii) the evolution of the language of that section, (iv) what it is believed is the correct resolution of the issue, and (v) how the Appellate Term arrived at its contrary conclusion.

The Cooperative Conversion Process

Although a number of variations are possible, we shall for simplicity discuss the process only where a single person owns an apartment house with many rental tenants and then does the following, which is the usual procedure by which individual ownership is changed to the cooperative form of ownership. He first writes out a plan describing what he intends to do. That plan is commonly referred to as a "conversion" plan, and he is commonly referred to as "the sponsor" of that plan. Then, he establishes a cooperative corporation and causes it to allocate a number of its shares to each of the apartments in the building. No shares are issued at that time, however.

Before he goes any further, the sponsor must submit the plan to the Attorney General, who reviews it and, typically after requiring some rewriting, "accepts it for filing." Once the plan is filed, it must be presented to all the tenants of the building—who are commonly referred to as "insiders"—and must include an offer by the cooperative corporation to sell to each insider the shares allocated to his apartment. In order to get the ball rolling (and for other reasons that will be explained below), the subscription price for insiders is usually set very low. The sponsor may also cause the cooperative corporation to offer to other persons—who are commonly referred to as "outsiders"—the shares allocated to any vacant apartments and the shares that insiders have elected not to purchase. In the plan, the sponsor also commits to purchase himself, if the plan is consummated, any shares not purchased by either insiders or outsiders.

When enough shares have been subscribed for, the plan is declared effective. The subscribers then pay into the cooperative corporation the subscription price for their shares, and a closing is held (usually, but not necessarily, within a few months). At the closing, all of the following take place: the subscribed-for shares are issued to those subscribers who have paid in full; all the other shares (which, unfortunately, are commonly referred to as "unsold" shares[4]) are issued to the sponsor, who pays for them at that time in cash;[5] the sponsor deeds the building to the cooperative corporation in exchange for the bulk of the money it received for its shares;[6] and the cooperative corporation enters into a proprietary lease of each apartment with the owner of the shares allocated thereto. At that point, the conversion process is complete; the building is now owned in the cooperative form of ownership.

The sale process—as distinguished from the conversion process—is not necessarily complete, however. The sponsor may wish to sell any "unsold" shares that he now owns. Normally, he does that by reference to the same plan, now amended, however, to include information about the closing.

During the formative period of the statutes that we are considering, the market for cooperative apartments was hot, and, wherever the purchaser could be given occupancy, sponsors could hardly wait to sell their "unsold" shares. Sales even of shares allocated to apartments occupied by non-dislodgeable tenants were common, the only question being whether or not the sponsor could afford to wait until a vacancy occurred. In recent years, however, a strange phenomenon developed: rental rates went way up, while cooperative apartment prices went down. That caused many sponsors to hold onto their "unsold" shares and rent out the associated apartments after they were vacated, which caused consternation among those who believe that sponsors are devils to be exorcised from the building at the earliest possible moment. That in turn led many to assert that sponsors who were for the time being retaining ownership of "unsold" shares were acting wickedly and illegally by failing to "complete the conversion." This is not the place to consider whether or not that position has any merit as a substantive matter; the point here is purely a linguistic one, and it is that, prior to the confusion caused by that recently coined rallying cry, everyone who spoke about a cooperative conversion was speaking about a process that ended *qua* conversion when the closing occurred. When considering the understanding of the drafters of the rules applicable to people in the position of the Harrises, it must be understood that those drafters would undoubtedly have described the Harrises as having first signed their lease after the conversion was over and not while the conversion process was still going on.[7]

The Legislative Objectives

Some difficulty is involved in understanding the policy decisions underlying GBL § 352-eeee, due to the fact that the Legislature was motivated by two conflicting desires. Like the hungry dieter who feels a powerful urge to put food in his belly and at the same time wants passionately not to put food in his belly, the Legislature was being pulled in diametrically opposite directions and was forced to arrive at some more-or-less satisfactory compromises. Understanding what was intended by the statute requires that both objectives be kept in mind.

On the one hand, the Legislature has always been concerned with improving the position of tenants in dealing with landlords, especially in scarce-housing situations. Perhaps the clearest manifestation of this concern is the system of rent regulation that has been with us, in one form or another, since the 1940s. It is important to bear in mind that the principal objective of rent regulation is to prevent rent gouging—i.e., to keep a landlord from charging rents that are too high—so that the focus is on the apartment. In theory, then, the identity of the particular tenant should not matter. However, it is clear enough that, were landlords allowed to evict their existing tenants and replace them with new ones—even though ostensibly at the same rent,—there would be no practicable way of preventing under-the-table payments. Accordingly, no-reason-need-be-given evictions from rent-regulated apartments have always been prohibited. That fact—coupled with the fact that in operation rent regulation has often fixed rents enormously below market—has led to the existence of a sizable group of tenants (hereinafter referred to, admittedly with only approximate accuracy, as "regulated tenants") who essentially have the benefits of home ownership without any capital outlay.

Before we look at the principal legislative objective that competes with rent regulation, it is important to note that not every tenant of an apartment is a regulated tenant. For one thing, there are many areas in the state where no form of rent regulation is now in effect. Also, even where rent regulation does exist, there are a number of rules—as, for example, those meant to encourage new construction—under which some apartment tenants are excluded from coverage. Whatever the reason for such exclusion, it cannot be doubted that such persons (hereinafter referred to as "free-market tenants") are, unless protected by some other rule, subject to unlimited rent increases and/or eviction when their leases expire. It follows that home ownership obviously is an alternative that has considerably more appeal for a free-market tenant than it does for a regulated tenant.

Nevertheless, many free-market tenants are content to remain as renters. They have shelter of their choosing without the financial strain or risk entailed in ownership. True, they do not have an absolute *right* to stay on, but they have every *expectation* that, so long as they pay a market rent and are otherwise good tenants, they will be permitted to do so. As we shall see, the Legislature has deemed that expectation worthy of some degree of protection, notwithstanding that it collides, to some extent, with the legislative objective about to be discussed.

Starting from the basic proposition that owner occupancy of residences is a good thing, the Legislature has long been actuated by a desire to induce the owners of rental apartment houses to convert them to cooperatives or condominiums. Indeed, that purpose has often been stated in the most unmistakable terms. A 1978 statute, for example, began with the following:

> Section 1. Legislative finding. The legislature hereby finds and declares that the conversion of residential real estate from rental status to cooperative or condominium ownership is an effective method of preserving, stabilizing and improving neighborhoods and the supply of sound housing accommodations in the state [and] that it is sound public policy to encourage such conversions. . . .[8]

Virtually identical language was repeated in later statutes.[9]

In theory, such conversions could take place without any legislative assistance, and occasionally that did happen.[10] In most cases, though, the presence of large numbers of regulated tenants effectively prevented cooperative and condominium conversions. Because such tenants were "usually and understandably quite content to maintain the status quo,"[11] few would be willing to purchase at a price that would result in the building owner receiving enough proceeds so that a conversion would be attractive to him, even taking into account the amount by which rent regulation had depressed the value of his building. It soon became apparent that, if such conversions were to take place on an appreciable scale, those tenants who elected not to buy could no longer be given essentially unlimited protection against eviction.

The Legislature was not, however, willing simply to remove from rent regulation any apartment in a building whose owner wished to convert it to cooperative or condominium ownership. On the contrary, it repeatedly stated that one of its aims was "protecting tenants in possession who do not desire or who are unable to purchase the units in which they reside from being coerced into vacating such units . . . or into purchasing such units under the threat of imminent eviction."[12] Eventually, it adopted a compromise that had its roots in a regulation that the Temporary State Housing Rent Commission had promulgated in 1951.[13] The compromise was this: if the tenants were given a realistic opportunity to buy[14] and enough of them chose to do so, the non-buyers would be subject to eviction by a purchaser of the unit (i.e., the allocated shares or the condominium unit, as the case may be) who wished to move into the apartment. The percentage that was enough varied from time to time, but, for a long time it was fixed at 35%.

The 35% solution worked rather well for a while. It also had an effect that was perhaps unintended, namely that the building owner ordinarily could induce purchases by regulated tenants only by offering them steep discounts. "Insider" sales in the range of half of the price that could be obtained on a resale were the norm, and "flips" at multiples of the purchase price were not uncommon.[15] On the other hand, even with that—as well as other sweeteners that the sponsor usually had to throw into the pot[16]—owners of buildings subject to rent regulation were by and large eager to convert their buildings.

Evolution of GBL § 352-eeee

For a long time, a converting owner had no need to concern himself with meeting legal requirements—including a minimum percentage threshold—unless he wanted to sell units to persons who would be able to evict non-buyers. Although regulated tenants remained protected, free-market non-buyers—whether or not in occupancy before the plan was consummated—thus had little or no protection.[17]

That changed in 1974, when the Legislature enacted the first of a series of statutes that, inter alia, provided protections for certain free-market non-buyers. Unfortunately, tracing the developments embodied in those enactments is mind-boggling, due to a number of reasons, one of which is that there were four different sets of rules, the applicability of which depended on where the building was located. Also, the subject of our present concern—namely, the extent of protection for free-market non-buyers—was not the prime focus of the legislative attention. Much bigger fish were being fried. Let us take a look at the most pertinent provisions of those statutes.

Laws of 1974, Chapter 1021. This statute temporarily added to the GBL a § 352-e(2-a), which applied statewide and whether or not the apartments were rent-regulated. The new subsection provided that a conversion plan could be declared effective only if at least 35% of the tenants in occupancy "consented to purchase under the plan."[18] The new subsection also contained a provision that effectively ruled out achieving that goal by "warehousing" vacant apartments.[19] It also required the plan to provide that, except for default,

> no eviction proceedings will in any case be brought against occupants resident in the . . . building . . . at the date of the first offering of cooperative or condominium interests, before [a certain date] . . . for failure to purchase or any other reason applicable to termination of tenancy.[20]

Additionally, the Attorney General was authorized to

> condition such letter [i.e., the letter allowing the plan to go forward] on the following factors: if such tenants dwell in apartments subject to government controlled rentals, their status shall continue during such period if they do not purchase under the particular plan; if tenants do not reside in apartments under such government controls, their rentals shall, according to the plan of conversion, not be subject to unconscionable increases beyond ordinary rentals for comparable apartments during the period of moratorium on evictions.[21]

The no-eviction-absent-default period was until the later of July 1, 1976 or the second anniversary of the first offering, and the permitted proscription of what we shall refer to as "unconscionable-beyond-comparable" increases was obviously meant by the Legislature, not to allow the Attorney General to put free-market apartments under rent regulation for that period, but merely to allow him to preclude a form of indirect eviction during that period.[22] This provision was the remote ancestor of GBL § 352-eeee(2)(c)(iv). It cannot be doubted that, in its original form, it would not have covered the Harrises (because they moved in long after the moratorium period). The provision's form changed, though, and a question to be answered is whether the Legislature intended to broaden it enough to cover persons in the position of the Harrises.

The GBL subsection added by the 1974 statute was originally to remain in effect for two years, but was extended for another year[23] before it was allowed to expire.

Laws of 1978, Chapter 544. This statute added a new GBL § 352-ee (the number of which was changed to § 352-eee the following year when it was realized that a different § 352-ee had been added by Chapter 509 of the Laws of 1978). The new section added by Chapter 544 applied only to electing cities, towns and villages in the Counties of Nassau, Westchester and Rockland.[24] For the first time, it provided rules for both "eviction" and "non-eviction" plans, and provided, as to every consummated plan, certain protections for "purchasers under the plan" and for "non-purchasing tenants." All of those terms were defined.

No plan could be declared effective unless sales of at least 15% were achieved. If that level was reached, the plan could be declared effective as a "non-eviction" plan.[25] An "eviction" plan required sales of at least 35%.[26]

A measure of protection was mandated for every "purchaser under the plan." The plan had to provide that the rights granted to him thereunder could not be "abrogated or reduced regardless of any expiration of or amendment to [the new GBL section]."[27]

A cooperative conversion sponsor—who, as a matter of language, would be a purchaser under the plan as to "unsold" shares—obviously did not need such protection, and the definition of "purchaser under the plan" (which is further discussed below) was artificial in that it excluded any person who owned shares allocated to more than one dwelling unit.[28] If confirmation were needed, the Legislature's action in setting forth that specific exclusion would support the view that sponsors would otherwise have been within the ordinary meaning of "purchaser under the plan."

Before we examine the definitions of "purchasers under the plan" and "non-purchasing tenants," let us look at the protections that the latter group received.

First, the above-mentioned rights-continue-despite-change-of-the-law requirement was applicable to "non-purchasing tenants" as well as to "purchasers under the plan." In addition, all plans were required to provide (i) that "non-purchasing tenants who reside in dwelling units subject to government regulation as to rentals and continued occupancy shall continue to be subject thereto"[29] and (ii) that "all dwelling units owned [sic][30] by non-purchasing tenants [were to] be managed by the same managing agent who manages all other dwelling units in the building [and] such managing agent [was] to provide to non-purchasing tenants all services and facilities required by law on a non-discriminatory basis."[31]

Other protections for "non-purchasing tenants" varied, naturally enough, according to whether the plan was an "eviction" plan or a "non-eviction" plan.

An "eviction" plan had to provide that, other than for default, "no eviction proceedings will be commenced against non-purchasing tenants for a period of two years after the plan is declared effective [or] at any time against non-purchasing tenants who are sixty-two years of age or older on the date the plan is declared effective."[32] There was an unconscionable-beyond-comparable provision for "such non-purchasing tenants," i.e., those at least 62 years old on the effective date. Two distinct classes were covered, the first being "such non-purchasing tenants who reside in [already unregulated] dwelling units," and the second being "such non-purchasing tenants who reside in dwelling units [that become unregulated] after the plan has become effective."[33] The status of "non-purchasing tenant" *vel non* was thus plainly meant to be determined no later than the effective date of the plan, and the Harrises would not have been covered.

In a "non-eviction" plan, seniors needed no *special* protection. Rather, *all* "non-purchasing tenants" were given precisely the same protections that seniors were given in "eviction" plans. In particular, the provision referred to exactly (except as to age) the same two classes of "non-purchasing tenants" who were to be protected from unconscionable-beyond-comparable increases.[34]

It is interesting that, in approving a similar law for New York City a year later, Governor Carey described the 1979 law as being "almost identical to Chapter 544 of the Laws of 1978 which I approved last year to protect senior citizens in similar circumstances in Nassau, Rockland and Westchester counties." The protections given to younger non-purchasers were not mentioned.

The GBL section added by Chapter 544 also contained an interesting provision that had to do with those apartments that were occupied by tenants who did not purchase under a "non-eviction" plan. The plan was required to provide (with an exception for "a transaction involving the sale of all the shares or dwelling units not theretofore sold") that

> the shares allocated to any dwelling unit occupied by a non-purchasing tenant or such unit itself will not be sold to any other person [i.e., a person other than the tenant] until such time as such non-purchasing tenant terminates occupancy voluntarily or by reason of death or is evicted for [default].[35]

Obviously, the Legislature at that time thought it advisable to protect such a "non-purchasing tenant"—who, it must be remembered, could not in any event be evicted absent a default on his part—from even having to feel the pressure of a purchaser waiting to move in. For no stated reason, the provision was deleted less than a year later, never to reappear.

The definition of "non-purchasing tenant" had two parts, the second of which was the following exclusionary sentence: "A person who sublets a dwelling unit from a purchaser under the plan shall not be deemed a non-purchasing tenant."[36]

Let us stay with that part of the definition for a moment. The drafter clearly was mindful of the following important question that might occur to a non-sponsor person considering a purchase under the plan: "If I purchase and later rent the apartment out, will the tenant that I install be entitled to 'non-purchasing tenant' protections?" Although it is unlikely that the answer to that question would have been in the affirmative in any event, the Legislature evidently intended to make its intention crystal clear, presumably to encourage non-sponsor purchases.

But doing so raised other questions. Not every owner of allocated shares or a condominium unit would be a "purchaser under the plan" as those words were ordinarily used. It was clear that there would be people who would acquire ownership—gratuitously or otherwise—from prior owners and, unless the acquisition was a purchase from the sponsor, it would be without any reference to the plan. It was plain that such persons should be within the exclusionary sentence. One way of doing that would have been to substitute other words for the inappropriate term "purchaser under the plan," but, for whatever reason, that was not done. Instead, the hole was plugged by adding a wholly artificial definition of the term. "Purchaser under the plan" was defined as "A person who owns the shares allocated to only one dwelling unit or who owns such dwelling unit itself."[37]

That patch seemed to work well enough, although, as we shall see, considerable trouble resulted on those occasions when the definition was overlooked or ignored and "purchaser under the plan" was construed (or misconstrued) in isolation.

Another point about the exclusionary sentence may be mentioned at this time. Although it is likely that the reference was meant to be to a person who first became a subtenant by virtue of an agreement made with a "purchaser under the plan," it might have been possible as a matter of language to interpret the provision as applying to anyone who at the time in question had in any way become a subtenant of such an owner. That construction became wholly untenable, however, as soon as the short-lived prohibition against the selling of single-occupied apartments was removed.

The inclusionary part of the statute's definition of "non-purchasing tenant" read as follows:

> A person who has not purchased under the plan and who is a tenant entitled to possession at the time the plan is declared effective or a person to whom a dwelling unit is rented subsequent to the effective date and the spouse of any such person.[38]

It cannot be doubted that three classes of person were referred to, and the only sensible construction is that those classes were the following:

1. "A person who has not purchased under the plan and who is a tenant entitled to possession at the time the plan is declared effective."
2. "A person who has not purchased under the plan and who is . . . a person to whom a dwelling unit is rented subsequent to the effective date."
3. The spouse of any person in either of the two foregoing classes.

Any other construction would include the spouse of a Class 2 person but not the spouse of a Class 1 person, and there would seem to be no reason for doing that.

It follows that one could not read the second class as including everyone in the world to whom a unit was rented after the effective date; inclusion in the second class required that the person also had to be "a person who has not purchased under the plan." And the overwhelming likelihood is that the Legislature saw fit to include those words—as to both classes—because it wished to protect, not just any person who happened to be a tenant at the time in question, but only a tenant who had had an opportunity to buy and had elected not to do so.[39]

That view is supported by the legislative finding stated in at the beginning of Chapter 544, which included the following (emphasis added):

> that it is sound public policy to encourage [cooperative and condominium] conversions while, at the same time, protecting *tenants in possession who do not desire or who are unable to purchase the units in which they reside* from being coerced into vacating such units by reason of deterioration of services or otherwise or into purchasing such units under the threat of imminent eviction; that in certain parts of the state the position of *non-purchasing tenants* is worsened by a serious public emergency characterized by an acute shortage of housing accommodations; that preventive action by the legislature in restricting rental rates and evictions *during the process of conversion from rental to cooperative or condominium status* is imperative to assure that such conversions will not result in unjust, unreasonable and oppressive rents and rental agreements and to forestall profiteering, speculation and other disruptive practices which threaten the public health, safety and general welfare; and that in order to prevent uncertainty, hardship and dislocation *in connection with the conversion process*, the provisions of this act are necessary and desirable to protect the public health, safety and general welfare.

None of that language bespeaks a concern with persons who first took occupancy after the conversion process was over.

It remains to attempt to arrive at some explanation of why the statute provided for two classes (besides spouses) rather than only for one. One can speculate that the drafter (i) first focused on those who would constitute the great bulk of the group that the Legislature desired to protect—i.e., those who would be in occupancy on the effective date[40]—and (ii) then thought about the fact that he or she might be leaving a logical gap, inasmuch as the exclusionary sentence would not apply to persons who rented from the sponsor after the effective date but prior to the closing (because there would be no "purchasers under the plan" until the closing actually took place). Although persons first becoming tenants after the effective date might well know about the plan, in which case they would not be as entitled to protection as those who had taken occupancy at a time when a cooperative conversion was only a possibility rather than a near certainty, they would not necessarily know and they had to be slotted in somewhere, and it probably seemed that little harm would be done by including them as "non-purchasing tenants" (which they literally were, of course[41]). Besides, it would have seemed clear enough that the sponsor could protect himself, if he wanted to, simply by not renting to them until after the closing.

Laws of 1979, Chapter 135. This statute amended in a few respects the new section that had been added to the GBL the preceding year (in addition to changing its number from § 352-ee to § 352-eee). One of the modifications was the deletion of the above-described prohibition against the selling of the shares allocated to an occupied apartment. Unfortunately, there was neither a legislative finding nor an approval memorandum that might have told us the reason for the change. Perhaps the Legislature had simply realized that "non-purchasing tenants" had ample protection without the no-sale provision.

Laws of 1979, Chapter 432. This statute added a new GBL § 352-eeee, which applied only in New York City. As the Governor noted in his approval memorandum, it roughly paralleled § 352-eee as it then existed. There were, however, important differences.

Chapter 432 began with a legislative finding, which was essentially the same as the 1978 finding, except that it even more clearly reflected a concern with pre-conversion tenants as opposed to later arrivals. In addition to a repetition of statements of the kind previously made, the following recitation was included (emphasis added):

> [I]n the city of New York the position of non-purchasing tenants who are sixty-two years of age or older is particularly precarious by reason of the limited financial resources of many such persons, the physical limitations of many such persons *and the long-term attachments that many such persons have to the neighborhoods in which they presently reside*.

Unlike § 352-eee, the new section did not define "non-eviction plan," and "eviction plan" was defined somewhat differently. The latter definition was "A plan which . . . can result in the eviction of a non-purchasing tenant by reason of the tenant failing to purchase pursuant thereto."[42] The term "non-purchasing tenant" was defined just as it was in § 352-eee, except that the words "and the spouse of any such person" were removed.[43] That change made it possible to read the second class covered by the first part of the definition as being simply "a person to whom a dwelling unit is rented subsequent to the effective date" rather than the more restrictive "A person who has not purchased under the plan and who is . . . a person to whom a dwelling unit is rented subsequent to the effective date." There was, however, no indication that any substantive change in that regard was intended. Thus, one is impelled to the conclusion that the coverage of the second class was meant to remain as it was.

Although the exclusionary sentence of the "non-purchasing tenant" definition was retained—the scope of which sentence, it will be remembered, depended on the meaning of "purchaser under the plan"—no definition of that term was included. Because, as explained above,[44] it is impossible to believe that the Legislature intended the words "purchaser under the plan" to be taken literally, the omission must be regarded as an oversight. In any event, the successor version of § 352-eeee did contain a definition of "purchaser under the plan."

The version of § 352-eeee added by Chapter 432 included a new term—"eligible senior citizens"—which was defined as follows:

> Non-purchasing tenants who are sixty-two years of age or older on the date the attorney general has accepted the plan for filing and spouses of any such tenants, on such date, who have resided in the building . . . as their primary residence for at least two years prior to [that] date . . ., who have an annual income of less than thirty thousand dollars and who have elected . . . to become non-purchasing tenants under the provisions of this section [sic].[45]

The protections afforded to "eligible senior citizens" under § 352-eeee were essentially the same as those that had been afforded to all seniors under § 352-eee a few weeks before. For other "non-purchasing tenants," only two protections were provided. One was a same-managing-agent provision that was the same as in § 352-eee.[46] The second was a new subsection reading in its entirety as follows:

> Any tenant who has vacated his dwelling unit or is about to vacate his dwelling unit because any person is engaged in any course of conduct (including, but not limited to, interruption or discontinuance of essential services) which substantially interferes with or disturbs the comfort, repose, peace or quiet of such tenant in his use or occupancy of his dwelling unit or the facilities related thereto may apply to the attorney general for a determination that such conduct does exist or has taken place and in such case the attorney general may apply to a court of competent jurisdiction for an order restraining such conduct and, if he deems it appropriate, an order restraining the owner from selling the shares allocated to the dwelling unit or the dwelling unit itself.[47]

The Governor's approval memorandum stressed the plight of non-purchasing seniors, including a reference to "the long-term attachments that many such persons have to the neighborhoods in which they presently reside," and noted that "The Attorney General is given broad enforcement powers to prevent the harassment of non-purchasing tenants." The Governor also expressed concern that the law should not be "interpreted so as to result in unintended hardship to either tenants or sponsors."

Laws of 1980, Chapters 754, 755 and 756. The Governor's approval memorandum described these statutes as follows (emphasis added):

> These bills amend the General Business Law, relating to conversions of apartment buildings to cooperative or condominium ownership in the Counties of Nassau, Westchester and Rockland and in the City of New York, to provide protections to handicapped persons who reside in such buildings. Under the provisions of the legislation, a handicapped resident *who refuses to participate in the conversion plan* may not be evicted from the building nor may such person be the subject of unconscionable increases in rent. Presently, similar protections are afforded to elderly residents.
>
> In addition, the legislation increases the income level for senior citizens in New York City who are eligible for such protection from $30,000 to $50,000; and it requires that the offeror of the conversion plan provide regular notice to the Attorney General and the tenants of the percentage of tenants in occupancy who have agreed in writing to purchase under the plan.
>
> These bills afford necessary and reasonable protection for handicapped and elderly persons *who choose not to join in a cooperative or condominium conversion plan*, but who would undergo extreme hardship if they were forced to leave their present dwelling.

Laws of 1982, Chapter 555. This statute replaced the then-existing GBL § 352-eeee with a new GBL § 352-eeee which, like its predecessor, applied only in the City of New York. The revised § 352-eeee is the statute that was construed by the courts in *Paikoff v. Harris* and the other two cases referred to above.[48]

Chapter 555 began with a legislative finding that was quite similar to those quoted above. Although there are some differences in wording, there is no indication of any sea change as to the basic legislative objectives.

Similarly, although the replacement § 352-eeee differed materially from its predecessor—including an increase of the 35% threshold for "eviction" plans to 51%[49]—we need not for present purposes concern ourselves with most of those differences. It is, however, important to note that, unlike the earlier version, the new one contained a definition of "purchaser under the plan," which definition was the same as was included in § 352-eee except that, significantly, the words that excluded sponsors were not there.[50] It would seem, then, that there could thenceforth be no legitimate doubt that a sponsor owning "unsold" shares was a "purchaser under the plan."

The definition of "non-purchasing tenant" was identical to that contained in § 352-eee.[51] The unconscionable-beyond-comparable provisions were also the same as in that section.[52]

Governor Carey's approval memorandum included the following (emphasis added):

> The bill . . . provides that non-purchasing tenants in eviction plans will be permitted to remain as rental tenants for three years after the effective date of the plan. The income and residence requirements for eligible senior citizens protected against eviction will be eliminated and disabled tenants will be protected against eviction. Non-eviction plans shall be declared effective upon the sale [sic] of 15 percent of units by the tenants or by purchasers intending to reside in the unit.
>
> The number of cooperative and condominium conversions continues to increase steadily in the City of New York. An emergency continues to exist in the City due to the extremely tight rental housing market. Vacancy rates are very low in most neighborhoods. It is, therefore, necessary to increase protections *for tenants living in buildings undergoing conversion* and to provide both tenants and sponsors with a *workable conversion process*.

Again the expressed concern was exclusively with existing, not future, tenants.

Laws of 1983, Chapter 402. A little less than a year later, the existing GBL § 352-eee was replaced by a new § 352-eee, likewise applicable only to buildings in electing communities in the three counties. It was essentially similar to the new § 352-eeee, with certain differences not here pertinent.

The new § 352-eee contained definitions of "purchaser under the plan"[53] and "non-purchasing tenant"[54] that were the same as those in the new § 352-eeee, and they were obviously intended to have the same meaning.

Governor Cuomo's approval memorandum, which was not unlike Governor Carey's the year before, contained the following (emphasis added):

> The bill would conform, in large measure, the provisions governing cooperative and condominium conversions in Nassau, Westchester and Rockland Counties to

> those applicable in New York City since 1982. Such provisions include substantial tenant protections such as a 51% purchase requirement in eviction plans, a minimum three years occupancy for non-purchasing tenants after an eviction plan is declared effective[55] and a private right of action for tenants harassed by landlords.
>
> Conversions of rental buildings in Nassau, Westchester and Rockland Counties continue to occur at an accelerating rate. Although such conversions may ensure the preservation of buildings and enhance the stability of some communities, they may also cause dislocation and encourage harassment of tenants. This bill provides protection to tenants in rental buildings that are *to be converted* to cooperative or condominium status.

Once more, the focus is on persons in occupancy before the conversion has already occurred.

Laws of 1983, Chapter 771. This statute inserted a new § 352-e(2-a) into the GBL. The new subsection was designed to protect only "non-purchasing tenants" who were "eligible senior citizens" or "eligible disabled persons" in electing communities where neither GBL § 352-eee nor GBL § 352-eeee was applicable. No protections were provided for other "non-purchasing tenants."

The protections that were given to eligible seniors and disabled persons were against non-default evictions and unconscionable-beyond-comparable increases.[56] Because those prohibitions applied to all plans, there was no need to distinguish between "eviction" and "non-eviction" plans, and those terms did not appear.

Like the pre-1982 version of § 352-eeee, the new § 352-e(2-a) contained a definition of "non-purchasing tenant"[57]—which was identical to the definition of the term in the new §§ 352-eee and 352-eeee—but, strangely, no definition of "purchaser under the plan." As noted above,[58] that may lead to some problems in applying the exclusionary sentence of the "non-purchasing tenant" definition. The most plausible explanation for the omission is that the Legislature was not thinking at all about persons who were not pre-conversion tenants who had elected not to buy.

That is confirmed by a legislative finding at the beginning of Chapter 771 that was quite similar to the legislative findings referred to above. There were again references to the necessity of: "restricting rents and evictions during the process of conversion from rental to cooperative or condominium status"; preventing "disruptive practices . . . during the conversion process"; and "prevent[ing] uncertainty, hardship and dislocation in connection with the conversion process." Even clearer confirmation was provided by the concluding paragraph of the legislative finding, which read as follows (emphasis added):

> It is the intent of the legislature that senior citizens and the disabled, residing in [the covered] areas of the state . . . be afforded certain protections *if their rental units should be considered for conversion to either a cooperative or a condominium*.

The Governor's approval memorandum was of the same tenor, and included the following (emphasis added):

> This bill would authorize cities, towns and villages to protect senior citizen and handicapped tenants *in condominium or cooperative conversions*. Under the bill, non-purchasing senior citizens who are 62 years of age or older and eligible handicapped persons may not be evicted (except for failure to pay rent, illegal occupancy, etc.) and may not receive unconscionable rental increases *upon the conversion of a rental building to cooperative or condominium status*. The bill would apply outside of New York City and certain municipalities in Nassau, Westchester and Rockland Counties *where the conversion process is subject to comprehensive legislation*. ***
>
> Because of housing shortages and their limited financial resources, elderly and handicapped tenants, who cannot afford the price of cooperative apartments or condominium units, often suffer hardship as a result of eviction or exorbitant rental increases *upon conversion*. The trauma of moving from apartments *that have been occupied for long periods of time* increases the likelihood that many of these tenants will become prematurely institutionalized or need government housing assistance upon eviction.
>
> In combination with a bill I approved earlier this year . . ., this bill will help ease the anxiety of the elderly, many of whom fear the loss of their homes and are denied access to new housing. The elderly and handicapped have suffered disproportionately from the recent economic recession and federal cutbacks; these bills will insure that they do not continue to suffer *as the country's economic recovery makes condominium and cooperative conversions more profitable*.

Again, the concern was with long-time residents who had legitimate expectations that they would be permitted to continue to rent. None of the language applies comfortably to persons who took occupancy after a conversion was complete.

Application to the Harrises

The GBL § 352-eeee provision invoked by the Harrises was the following:

> 2. The attorney general shall refuse to issue a letter stating that the offering statement or prospectus . . . has been filed whenever it appears that the offering statement or prospectus offers for sale residential apartments or condominium units pursuant to a plan unless: ***
>
> (c) The plan provides, if it is a non-eviction plan, as follows: ***
>
> (iv) The rentals of non-purchasing tenants who reside in dwelling units not subject to [rent regulation] and non-purchasing tenants who reside in dwelling units with respect to which [rent regulation] is eliminated or becomes inapplicable after the plan has been accepted for filing by the attorney general shall not be subject to [unconscionable-beyond-comparable] increases.

A mere reading of that provision alone would seem to make it clear that only persons present during the conversion process were meant to be protected. Were it otherwise, the Legislature would have used the word "person" rather than the phrase "non-purchasing tenant." A limitation was obviously intended.

In any event, two groups of "non-purchasing tenant" are referred to, and the second includes, not such persons whose apartments became unregulated *after they took occupancy*, but such persons whose apartments became unregulated *after the filing date of the plan*. The first group must be those whose apartments were already unregulated on the same date, i.e., the filing date of the plan. That indicates the Legislature's focus.

Leaving that aside, the Harrises in any event needed to show that Mr. Harris was a "non-purchasing tenant." GBL § 352-eeee(1)(d) defines that term in two parts, the first of which reads as follows:

> A person who has not purchased under the plan and who is a tenant entitled to possession at the time the plan is declared effective or a person to whom a dwelling unit is rented subsequent to the effective date.

Here again, there are two distinct classes. All agree that the first is "A person who has not purchased under the plan and who is a tenant entitled to possession at the time the plan is declared effective." The Harrises did not claim to be within that class.

At first blush there may seem to be a question as to what persons the Legislature intended to include within the second class. While it might be possible to read the second class as including every "person to whom a dwelling unit is rented subsequent to the effective date," whether or not he is "a person who has not purchased under the plan," such a reading would make little sense. The more reasonable reading would be that a person does not fall within the second class unless he is "a person who has not purchased under the plan and who is . . . a person to whom a dwelling unit is rented subsequent to the effective date." As shown above,[59] that reading is the one that undoubtedly comports with the Legislature's intention.

The question then becomes whether Mr. Harris was "a person who has not purchased under the plan" as the Legislature used those words. While the thought may have been unartfully expressed, there can be little doubt that he was not. No protection was needed for a person who had actually purchased. As the above-discussed legislative history makes clear, the Legislature was concerned only with those who were present during the conversion process, and those words were doubtless included to restrict the coverage to those who, for whatever reason, did not become purchasers at that time. Later non-purchasers were simply not within the legislative contemplation.

But, aside from any question of Mr. Harris's includability in the first part of the definition of "non-purchasing tenant," the definition has a second part, which reads as follows: "A person who sublets a dwelling unit from a purchaser under the plan shall not be deemed a non-purchasing tenant."

Accordingly, the question presents itself whether Mr. Harris's sublessors were "purchasers under the plan." As explained above,[60] there would seem to be little doubt that they would be so described as a matter of ordinary speech. But that does not matter if the term is defined, and "purchaser under the plan" is in fact a defined term, the definition reading as follows: "A person who owns the shares allocated to a dwelling unit or who owns such dwelling unit itself."[61] No one could or did contend that Mr. Harris's sublessors did not own the shares allocated to the subject apartment. It would seem to follow that, no matter how one were to resolve all previous issues, the Harrises were not "non-purchasing tenants."

The Appellate Term's Decision

The Appellate Term did not see it that way. It is submitted, though, that its reasoning left a great deal to be desired.

Let us start with the Appellate Term's treatment of the definition of "purchaser under the plan." All that the opinion did was to assert, without any explanation whatever, that the definition was only "arguably" broad enough to include a sponsor. Then, again without the slightest explanation, it simply ignored that definition.[62]

The Appellate Term's treatment of the exclusionary sentence was similar to its treatment of the "purchaser under the plan" definition. Without any explanation whatever, the opinion simply recited the exclusionary sentence and then ignored it.[63]

Without the exclusionary sentence, all that was left to construe was the first part of the definition of "non-purchasing tenant." Here again, one may have difficulty in being satisfied with what the Appellate Term did. First, the court, again without explanation, read the second part of the primary definition without taking into account the words referring to non-purchase, declaring that the statute "defines 'nonpurchasing tenant' to include 'a person to whom a dwelling unit is rented subsequent to the effective date.'" The court then concluded that, so read, the definition "would seem to require the inclusion of persons who rent from sponsors."

It would follow, of course, that the definition would then include, not only persons who rent from sponsors, but also persons who rent from anyone else in the world, including persons who were undoubtedly "purchasers under the plan." The Appellate Term recognized the problem, but, rather than reconsidering its unexplained discarding of the exclusionary sentence, it proceeded by creating its own exclusion out of whole cloth. Without the citation of any authority, it simply adopted a rule that "non-purchasing tenant" does not include "persons who rent from bona fide purchasers for occupancy."

One more portion of the Appellate Term's opinion on this point is open to criticism. When one tries to express better what a poorly drafted statute was intended to say, one necessarily supplies words that are not there. Yet, the Appellate Term dismissed as follows the sublessors' attempt to reconcile the various parts of the statute: "We are not persuaded by [sublessors'] claim that the statute should be read to mean 'a person to whom a dwelling unit is rented subsequent to the effective date *but prior to the closing date*' because the underscored words do not appear in the statute."

Conclusion

The correctness of the Appellate Term's holding on the percentage-increase issue—i.e., that GBL § 352-eeee(2)(c)(iv) requires that rents for comparable apartments must be taken into account—would seem to be beyond reasonable debate.

As to the portion of the opinion dealing with the scope-of-the-protected-class point, much of what the court had to say was admirable—especially its discussion of the economic dynamics of a cooperative conversion—but its ruling on the status of the Harrises as "non-purchasing tenants" would seem to be more legislative than judicial, and, despite the fact that judges when they have a choice generally like to be seen on the side of tenants rather than landlords, one must be cognizant of the possibility that other courts may not reach the same result.

Endnotes

1. 178 Misc. 2d 366, 679 N.Y.S.2d 251 (Civ. Ct., Kings County 1998), *modified*, N.Y.L.J. Oct. 19, 1999, p.32, col.3 (App. T. 2d Dep't). To the extent not stated in the courts' opinions, the facts set forth below were gleaned from an examination of the briefs of the parties.
2. Actually, even that interpretation may overly favor protected tenants. The statute as written does not bar *all* increases above market; it says only that *unconscionable* increases above market are prohibited.
3. *Pembroke Square Assoc. v. Coppola*, N.Y.L.J. May 5, 1999, p. 32, col. 6 (Civ. Ct., Queens County); *Park West Village Assoc. v. Nishioka*, N.Y.L.J. May 26, 1999, p. 27, col. 3 (Civ. Ct., N.Y. County).
4. The elliptical expression "unsold shares"—which in actuality is short for "shares not sold to persons other than the sponsor"—has the potential to be misleading. It has sometimes been mistakenly understood to mean that the cooperative corporation received no consideration for such shares, as is illustrated by the affirmation referred to in note 63 infra. Whether the sponsor paid cash for such shares or paid for them with a portion of his building, he has given value and is clearly a purchaser. And, inasmuch as that purchase was required under the plan and was necessary for the plan to be consummated, he is clearly a purchaser under the plan in everyday speech. Whether or not he is a "purchaser under the plan" as a term of art defined in a particular statute is one of the issues to be discussed in this article.
5. Sometimes the sponsor pays with a part interest in the building rather than in cash.
6. If the sponsor paid for the "unsold" shares with a part interest in the building, only the remaining part interest in the building is conveyed for the cash.
7. In *Paikoff*, both the Housing Court and the Appellate Term stated clearly that the Harrises had appeared on the scene long after the conversion was over.
8. Laws of 1978, Ch. 544.
9. Laws of 1979, Ch. 432; Laws of 1982, Ch. 555; Laws of 1983, Ch. 771.
10. *See, e.g., De Minicis v. 148 East 83rd Street, Inc.*, 15 N.Y.2d 432, 261 N.Y.S.2d 1 (1965).
11. *Gilligan v. Tishman Realty & Construction Co.*, 283 App. Div. 157, 160, 126 N.Y.S.2d 813, 815 (1st Dep't 1953), *aff'd*, 306 N.Y. 974 (1954).
12. Laws of 1978, Ch. 544, § 1; Laws of 1979, Ch. 432, § 1; Laws of 1982, Ch. 555, § 1; Laws of 1983, Ch. 771, § 1.
13. *See Gilligan v. Tishman Realty & Construction Co.*, 283 App. Div. 157, 159, 126 N.Y.S.2d 813, 815 (1st Dep't 1953), *aff'd*, 306 N.Y. 974 (1954).
14. It was early held that "an owner of real property—a multiple dwelling—may [not] cut off the possessory rights of statutory tenants . . . by transferring the property to a corporation under a so-called 'co-operative plan' and selling to strangers, without offering to the tenants, the shares allocated to their apartments." Rather, the court ruled, a regulated tenant could not be evicted unless he had been given a "reasonable alternative." *People ex rel. McGoldrick v. Sterling*, 283 App. Div. 88, 90, 96, 126 N.Y.S.2d 803, 805, 811 (1st Dep't 1953).
15. One result was that the courts were many times called upon to resolve hard-fought disputes as to which of several competitors was the insider entitled to purchase at the bargain price. *See, e.g.*,

Rubinstein v. 160 West End Owners Corp., 74 N.Y.2d 443, 548 N.Y.S.2d 155 (1989); *Manolovici v. 136 East 64th St. Assoc.*, 70 N.Y.2d 785, 521 N.Y.S.2d 414 (1987); *Spitalnik v. Springer*, 59 N.Y.2d 112, 463 N.Y.S.2d 750 (1983).

16. *See, e.g.*, *Richards v. Kaskel*, 69 Misc. 2d 435, 330 N.Y.S.2d 582 (Sup. Ct., N.Y. County), *modified*, 40 A.D.2d 804, 338 N.Y.S.2d 279 (1st Dep't 1972), *rev'd*, 32 N.Y.2d 524, 347 N.Y.S.2d 1 (1973).

17. *De Minicis v. 148 East 83rd Street, Inc.*, 15 N.Y.2d 432, 435, 261 N.Y.S.2d 1, 6 (1965) ("Subdivision 3 of section 55 of the [State Rent and Eviction] regulations lays down a procedure for converting controlled apartments into cooperatives, but the result of noncompliance is only that certificates of eviction will not be issued to the shareholders to dispossess the statutory tenants."). The effect of purported but improper compliance was the same. *Richards v. Kaskel*, 32 N.Y.2d 524, 347 N.Y.S.2d 1 (1973).

18. Former § 352-e(2-a)(1)(i).

19. Former § 352-e(2-a)(1)(iv).

20. Former § 352-e(2-a)(1)(iii).

21. *Id*.

22. It is interesting that here the amount-of-rent rule was a backup for the no-eviction rule, just the reverse of the relationship between the corresponding two rules in the rent regulation area. See page 47 *supra*.

23. Laws of 1976, Ch. 504, § 1.

24. Former § 352-ee(7).

25. Former § 352-ee(1)(b).

26. Former § 352-ee(1)(c).

27. Former § 352-ee(2)(f).

28. Former § 352-ee(1)(d).

29. Former § 352-ee(2)(e).

30. In later versions, the word was corrected to "occupied."

31. Former § 352-ee(3).

32. Former § 352-ee(2)(d).

33. *Id*.

34. Former § 352-ee(2)(c).

35. Former § 352-ee(2)(c)(iv).

36. Former § 352-ee(1)(e). The use of the single word "sublets"—rather than the longer "sublets (in the case of a cooperative) or lets (in the case of a condominium)"—was an obvious slip. There is no reason that the exclusion should not be equally applicable to condominium situations. Moreover, the slip is one that is made more often than not by practitioners in the field, who tend to think in terms of cooperatives (with a tack-on of condominium terminology when they are reminded).

37. Former § 352-ee(1)(d).

38. Former § 352-ee(1)(e).

39. Presumably, no sponsor would, after presenting a conversion plan, rent a vacant apartment to someone who would not be given an opportunity to buy.

40. There are minor mysteries here. For instance, is it possible that the phrase "tenant entitled to possession" was used in order to exclude tenants *not* entitled to possession, as, perhaps, tenants who had sublet their apartments? If, as seems more likely, possession as against the landlord was meant, is not every tenant so entitled? Maybe the drafter was concerned about tenants who, although entitled to possession, were not actually in possession. But isn't a tenant still a tenant even if he is not in actual possession?

41. Note the use of the word "rent" rather than "sublet."

42. Former § 352-eeee(1)(b).

43. Former § 352-eeee(1)(c). A reference to spouses did surface in the definition of "eligible senior citizens," which is discussed below.

44. See page 51 *supra*.

45. Former § 352-eeee(1)(e). This provision obviously cannot be taken literally. A requirement that a person already be a "non-purchasing tenant" cannot rationally be made a pre-condition for electing to be a "non-purchasing tenant."

46. Former § 352-eeee(4).

47. Former § 352-eeee(5).

48. See note 3 *supra*.

49. GBL § 352-eeee(1)(c).

50. GBL § 352-eeee(1)(d).

51. GBL § 352-eeee(1)(a).

52. GBL § 352-eeee(2)(c)(iv) and (2)(d)(iii).

53. GBL § 352-eee(1)(d).

54. GBL § 352-eee(1)(e).

55. Because GBL § 352-eee(2)(d)(ii) allowed the period to end on "the date which is three years after the date on which the plan is declared effective," no one would contend that the writer believed that a purchaser after the effective date would be a "non-purchasing tenant."

56. GBL § 352-e(2-a)(b)(i).

57. GBL § 352-e(2-a)(a)(ii).

58. See page 50 *supra*.

59. See pages 50, 51 *supra.*

60. See page 51 *supra*.

61. GBL § 532-eeee(1)(d).

62. The Housing Court had arrived at the same place by a more direct route; it never mentioned the definition, which, as examination of the sublessors' brief shows, had in fact been forcefully called to its attention. That being the case, it is more than a little surprising that the court saw fit to include in its opinion a statement that "if the Legislature intended that a holder of unsold shares should be considered a purchaser 'under the plan,' the legislation should have contained a provision to that effect." 178 Misc. 2d at 376, 679 N.Y.S.2d at 258 (some quotation marks omitted).

63. The Housing Court did address the point, but, because it did not take into account the statutory definition of the term, it relied on what it believed to be the "commonly understood definition" of "purchaser under the plan" and held that it did not include a "holder of unsold shares." 178 Misc. 2d at 375, 679 N.Y.S.2d at 257. The lower court also relied on the following statements made by an Assistant Attorney General in an affirmation submitted in another proceeding:

> The position of the Office of the Attorney General is that a sponsor or holder of unsold shares is not a 'purchaser under the plan.' . . . [T]he plain import of 'purchaser under the plan' is someone who purchases shares allocated to an apartment under the conversion plan. This would not include a sponsor . . . Since shares still held by a sponsor are, by definition, 'unsold' shares, a sponsor would not be a 'purchaser under the plan.'

178 Misc. 2d at 374, 679 N.Y.S.2d at 256-57. Examination of the entire affirmation reveals that the Assistant Attorney General, like the Housing Court, seemed to be completely unaware of the statute's definition of "purchaser under the plan."

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In the Fight to Streamline Single Asset Real Estate Bankruptcies—Dangerous and Disturbing Arguments

By Robert M. Zinman

I hope this article does not sound like the cries of Chicken Little. That is certainly not intended. The sky is not falling, nor is it about to fall. However, arguments made to thwart a provision in both the House and Senate versions of the bankruptcy reform legislation designed to shorten the time it takes to complete single asset real estate reorganizations, discloses an antipathy to things we all take for granted—the foreclosure process and the priority system. While it appears that the arguments were rejected, at least for now (we will not know until we see what comes out of the House/Senate Conference),[1] the willingness of some of our elected representatives to accept and act upon these arguments and some academicians to support other proposals to restrict secured credit, causes concern. This article will first discuss the proposed amendment and then the arguments that were and are being raised against the amendment and the consequences these arguments may have for mortgage foreclosures and the priority system.

The Proposed Amendment

Both the House and Senate versions would eliminate the current $4 million cap on the applicability of a provision added in 1994 to reduce the debtor's exclusive period for the filing of a reorganization plan in single asset real estate bankruptcies. The cap limited the applicability of that provision to situations where the debt was under $4 million.

The 1994 provision to reduce the time for submission of a single asset real estate debtor's plan had been based on recommendations originally made by Scott Carlisle of UNUM Life Insurance Company.[2] Lenders had, for some time, been concerned that borrowers had a 120-day exclusive period, subject to modification by the court, to propose a plan of reorganization.[3] Most single asset real estate reorganizations did not require so much time. During this exclusive period, the undersecured lender would be receiving no return on its investment and would be stayed from taking any action against the debtor or the debtor's property while the debtor would continue to recover fees and commissions from the property. As the result of Carlisle's suggestions, Congress enacted Bankruptcy Code § 362(d)(3), which provides that in single asset cases, unless the debtor submits a plan that has a reasonable possibility of being confirmed within 90 days after the commencement of the case (subject to extension by the court), either relief from the stay must be granted or the debtor must pay lost opportunity costs (market rate interest on the value of the collateral) monthly to the mortgagee.

Single asset real estate was defined in Bankruptcy Code § 101(51B) to mean a single real property asset or project (if residential, with four or more units) in which no substantial business is being conducted other than operation of the real estate. At the last minute before enactment, at the suggestion of Congressman Brooks, the definition was limited to situations where the secured debt was $4 million or under. This "cap" effectively excluded most single asset real estate projects.

The purported reason for the cap was that transactions with greater debt required more time to prepare a plan of reorganization. Proponents of the original legislation retorted that the size of the debt really has little to do with the time necessary for preparing a plan of reorganization where no business other than operation of real estate was involved. Further they pointed out that the court would have the discretion to extend the time for filing a plan if the circumstances justified such an extension. Finally they wondered why Congressman Brooks, whose amendments generally tended to favor the little guy, would insist on restrictions that only affected small developers. The Donald Trumps and Trammel Crows of this world would be exempt.

Immediately after the passage of the provision, real estate people, seeking to encourage investment in real estate, urged that the cap be repealed. When the National Bankruptcy Review Commission issued its report in 1997, it recommended, inter alia, that the cap be eliminated. The reasons given by the Commission were as follows:[4]

> The time needed to formulate a plan is similar in large and small SARE [single asset real estate] cases, because the basic task in each instance is usually financial restructuring rather than business restructuring. The focus of the plan in SARE cases of all sizes is typically on a single secured creditor. The harm caused by delay is also similar in large and small SARE cases. The debtor's failure promptly to file a plan or commence interest payments imposes the cost and risk of reorganization on the secured creditor to the same extent in SARE cases of all sizes. Finally, reorganization provides limited social benefit

> in SARE cases of all sizes. Unsecured trade creditors are typically a very small percentage of total debt in large SARE cases as well as small ones. Although preservation of jobs and going-concern value may be an issue in some SARE cases, it is not *typically* an issue in either large or small SARE cases. In those unusual cases in which enforcement of the ninety-day deadline would cause injustice, the Bankruptcy Code affords sufficient flexibility to courts to extend the deadline as appropriate.

The opposition to removal of the cap was extraordinary. So extraordinary that it seemed the opposition was not simply based on a conclusion that more than 90 days were needed in some cases. It appeared that the real attempt was to undermine the entire provision. For example, in public arguments, attacks were often made on the scope of the definition of single asset real estate. Those opposed to elimination of the cap argued that the definition is so broad that it would encompass hotels, gambling casinos and convalescent homes, among others. Such an argument is, of course, equally applicable to small nursing homes and hotels as to large ones and would not seem to be related to the cap. In any case, it would seem obvious from the language of the definition, which requires that no business be conducted other than the operation of real estate, that the argument was preposterous.

Social Reform Arguments Against Elimination of the Cap

As time went on, the arguments against elimination of the cap began to take on the tone of social reform having nothing to do with bankruptcy. They seemed an attempt to deflect the argument to issues involving politically sympathetic parties, and had little or nothing to do with the cap or the Bankruptcy Code. The two major arguments are discussed below.

Elimination of the Cap would hurt tenants. The operative word is, of course, "tenants." This argument maintains that if the mortgagee is permitted to foreclose, it could cut off leases to tenants and this should not be permitted. The predicate for the argument, based on state priority law outside of bankruptcy, is only partially correct. When a tenant with notice of an existing interest in the property, such as a recorded mortgage, executes the lease, the tenant takes subject to that existing interest, but if the mortgage is placed on the property after the lease has been executed, the lease will be superior to the rights of the mortgagee. Similarly, when a bank makes a loan secured by a mortgage on real estate, the mortgage will be subject to prior mortgages and interests in the real estate, and prior to subsequent interests. This means that when the mortgagee forecloses, the purchaser at the foreclosure sale is entitled to receive the same state of title that existed when the mortgage was recorded. Thus only if the lease is junior to the mortgagee can the foreclosure cut off the rights of the tenant. It is doubtful, however, that the foreclosing mortgagee would be anxious to cut off rent-paying tenants in most instances.

Of this argument, two things can be said. First, a tenant, having notice of the prior mortgage interest, may protect itself by demanding a non-disturbance agreement or a subordination agreement from the prior mortgagee as a condition to signing the lease. This is often done. Even this author's first year property students have no difficulty understanding this. Second, this argument has nothing to do with the bankruptcy, the Bankruptcy Code, or the debtor. It affects two parties not in bankruptcy under priority rules of state law, and the same result would occur whether there were a bankruptcy or not. It does have everything to do with the validity of security interests, the foreclosure process, and the priority system.

Foreclosure of the mortgage will hurt workers and unions. The operative words are "workers" and "unions." The argument is that if the mortgagee is able to foreclose, it might have the power to dismiss employees or cancel union contracts. Somehow, foreclosure of a mortgage is viewed as anti-labor, enabling the mortgagee to injure innocent employees and the unions representing them. Like the last argument, it is unrelated to bankruptcy or single asset real estate, but very much related to security interests, the foreclosure process, and the priority system.

The argument itself makes no sense. Single asset real estate owners generally have few, if any, employees. Certainly workers do cleaning and maintenance but they are often employed by the independent contractor hired to do the work. While a foreclosing mortgagee or other purchaser at a foreclosure sale, dissatisfied with the work of an existing contractor, may be able to engage a new contractor to do such work (whether bankruptcy is present or not), this does not necessarily adversely affect any worker or any union. A new contractor often will employ the existing workers who are familiar with the project and, if building employees are normally unionized in the area, the new contractor will normally have unionized workers. Indeed, since foreclosing mortgagees are normally institutions, it is far more likely that the institution would insist on a union shop than the developer. This is because the institution is usually in a business serving the general public and is adverse to adverse criticism, while the developer is less concerned about publicity and more concerned about reducing costs.

Here again, we see a virtual non-issue used in an attempt to deflect Congressional consideration from the substance of the amendment to a politically charged situation involving parties NOT in the bankruptcy and having nothing whatsoever to do with the single asset bankruptcy provision or the $4 million cap.

Both arguments do not even purport to deal with single asset real estate in the context of the issue of whether the cap should be removed from the definition of single asset real estate. The evils they see would apply equally to projects with $4 million or less in debt and to projects with more debt than that. It is indeed strange that those making the arguments against removal of the cap seem content to permit the supposed injustice to continue to apply where the debtor is a small real estate developer but not to apply when the debtor is a major real estate player.

In reality, the arguments do not deal with any part of the single asset bankruptcy provisions. Rather they seem to be an attempt to use the bankruptcy laws to attack collaterally state mortgage foreclosure laws and the national system of priorities by maintaining that foreclosure and its consequences has such tawdry consequences for tenants, workers and unions. This is not the first time that the rights of secured creditors have been attacked. A few years ago Professor Elizabeth Warren and others proposed to the National Bankruptcy Review Commission and the American Law Institute,[5] to carve out 20% of all collateral value for the benefit of unsecured creditors both in the Bankruptcy Code and Article 9 of the Uniform Commercial Code. The *bad news* is that the arguments are listened to. This author recalls vividly trying to explain to an influential Congressman why mortgagees should be able to cut off subordinate interests on foreclosure! The *good news* is that it does not appear that enough people support the underlying anti-secured creditor theory to result in damaging legislation at this time. The Warren proposal was rejected. The problem is that some very influential people supported that proposal.[6] It will come up again.

As to the future of the proposal to eliminate the $4 million cap, while a Conference[7] is designed to resolve *differences* between the House and Senate, it is likely that the elimination of the cap will be attacked very strongly as various provisions are traded off to achieve a consensus. In attacking the elimination of the cap, it is likely that the previous social arguments will be made again. If those arguments are successful with respect to the elimination of the cap, the next step will certainly be a more direct attack on foreclosure, priority and secured credit. Thus, when these arguments are made again, real estate people must be ready to defend. This is important not only to facilitate removal of the cap, but also to preserve the property rights and priority rules that are so important to promoting real estate investment and the success of our economy. These rights also tend to protect the freedoms we enjoy. Diligence should be the watchword.

Endnotes

1. Since the writing of this article it appears that no Conference will be held. If banking reform legislation is enacted this session it will most likely be the result of an unofficial negotiated compromise.
2. *See* Scott Carlisle, *Single Asset Real Estate in Chapter 11: Secured Creditors' Perspective and the Need for Reform*, 1 Am. Bankr. Inst. L. Rev. 133 (1993).
3. 11 U.S.C. § 1121 (b), (d) (1994).
4. Nat'l Bankr. Rev. Comm'n, Bankruptcy: The Next Twenty Years, Final Report 667 (1997).
5. *See e.g.*, Memorandum from Professor Elizabeth Warren to the Council of the American Law Institute, April 25, 1996, proposing "a set aside of assets for unsecured creditors." (copy available from the St. John's University School of Law Bankruptcy Library).
6. Elizabeth Warren is Leo Gottlieb Professor of Law at Harvard and was the Reporter for the National Bankruptcy Review Commission. See, inter alia, Kenneth N. Klee, *Barbarians at the Trough: Riposte in Defense of the Warren Carve-Out Proposal*, 82 Cornell L. Rev. 1466 (1997); Lucian A. Bebchuk & Jesse M. Fried, The Uneasy Case for the Priority of Secured Claims in Bankruptcy, 105 Yale L.J. 857 (1996); David Gray Carlson, *On the Efficiency of Secured Lending*, 80 Va. L. Rev 2179 (1994).
7. See note 1 *supra*.

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Recent Cases of Interest

The following case summaries were prepared by the student editors from St. John's University, School of Law.

Town Board's Rezoning of Golf Course Not Considered Regulatory Taking

Bonnie Briar Syndicate, Inc., v. Town of Mamaroneck, et al., 94 N.Y.2d 96 (1999)

A town's change in zoning of land primarily used for a golf course from residential to solely recreational use was held to be a legitimate use of Town Board power and did not constitute a regulatory taking.

Facts

The Bonnie Briar Syndicate, Inc. (hereinafter "plaintiff") owns a 150-acre tract of land, originally zoned residential in 1922, and used since for the Bonnie Briar Country Club and private residential lots. Several months prior to the Town of Mamaroneck's (hereinafter "defendants") rezoning actions, plaintiff had submitted a preliminary subdivision plan, for additional residential development of the Briar property, to the defendants. Subsequently, the defendants requested revisions that the plaintiff complied with. The final subdivision plan comported with a development study conducted by a planning firm hired by the defendants; but rezoning was implemented anyway. After rezoning, the Briar property was limited to solely recreational use, thereby precluding any further residential development. The defendant's stated goals and interests were to preserve open space, provide recreational opportunities for Town and other area residents, and mitigate flooding of both coastal and flood plain areas.

In defending its actions, the defendants cited a 1994 findings statement it issued in conjunction with the rezoning review required under the State Environmental Quality Review Act (SEQRA). The statement explained that, "less than 5% of the Westchester County watershed of the Long Island Sound remained[] open space."[1] Additionally, defendants found that, "residential development within the Town could increase flooding already experienced by many area homeowners," and the type of development proposed by plaintiff would, "frustrate the Town's goal of preserving recreational opportunities for Town and area residents."[2] The latter point was made in observation of the fact that the majority of Bonnie Briar members lived within a five-mile radius of the property.

Plaintiff brought this action alleging, primarily, that the defendant's actions amounted to an unconstitutional taking of its property and, as such, deserved compensation. After dismissal, by the Supreme Court (affirmed by Appellate Division), of a cause of action alleging an insufficient relationship between its goals and zoning ordinance,[3] the defendants moved for summary judgment on plaintiff's remaining claims. The Supreme Court denied defendants' motion but it was subsequently reversed in their favor by the Appellate Division and remitted for the entry of judgment declaring the law constitutional as applied to this case.[4] An appeal was then submitted by the plaintiff to the Court of Appeals.

Analysis

In affirming the order of the Appellate Division, the Court of Appeals held that defendants' decision, "easily qualifies as a valid regulatory denial of development pursuant to a generally applicable zoning law." Additionally, the Court held that defendants' actions were in "reasonable relation to the legitimate objectives stated within that law (to further open space, recreational opportunities, and flood control)."[5]

The Court based its ruling on plaintiff's claim that there was an insufficiently "close causal nexus" between the public interest the defendants sought to assist and the rezoning measure that changed plaintiff's zoning from residential to solely recreational. The Court of Appeals followed the United States Supreme Court in rejecting the application of the "essential nexus" test[6] in all regulatory takings cases, thereby limiting the inquiry requirement to exactions and not general zoning regulations like those in the principal case.

The court declined to assess whether the rezoning measures instituted by the defendants were more stringent than necessary to advance further public objectives.

Endnotes

1. *Bonnie Briar Syndicate, Inc., v. Town of Mamaroneck, et al.,* 94 N.Y.2d 96, 103 (1999).
2. *Id.* at 103.
3. *Id.* at 104.
4. *Id.* at 104.
5. *Id.* at 108.
6. *City of Monterey v. Del Monte Dunes*, 526 U.S. 687 (1999).

David Dunn '02

Lenders May Be Unable to Prosecute False Statements on Loan Applications if a Form Question Is Fundamentally Ambiguous

United States v. Watts, N.Y.L.J. Sept. 13, 1999 at 34 (E.D.N.Y. 1999)

In *United States v. Watts*, the U.S. District Court for the Eastern District of New York held that a borrower's representation on a bank's form questionnaire of an intent to make future improvements costing an unspecified amount of money provided no useful basis for determining whether that statement was knowingly false. The court's two-part analysis consisted of 1) whether the question was so excessively vague as to render the statement fundamentally ambiguous, and 2) whether the government met its burden of proving the statement's falsity.

Two of the defendants, mother and daughter, applied to the Greenpoint Savings Bank for $210,000 in 1994 to refinance their Staten Island home. The house, which defendants had owned since 1986, had undergone extensive renovations costing approximately $200,000 prior to the making of the loan application. In the "describe improvements" section of the Uniform Residential Loan Application, defendants placed a checkmark in the box entitled "made" and also placed a checkmark in the box "to be made."

The third defendant was the women's attorney who submitted the application to the bank. When the loan closed in February 1995, the bank issued a check in the name of the attorney, who deposited the check in his "special account." Six weeks later, the attorney drew two checks from the special account for $95,000 each, made payable to defendant's then-husband's employers, a telephone debit card business. The attorney was subsequently issued shares of stock, as nominee in that company. Although substantial improvements in excess of $200,000 had been made prior to the loan's February 1995 closing, there was no evidence of additional exterior work, nor the issuance of building permits, to indicate improvements made after the loan closed.

Defendants were convicted of making a false statement to a bank, 18 U.S.C. § 1014, at a June 1999 jury trial. In granting the motion for acquittal under Rule 29(a), Fed. R. Crim. Pro., the court stated that a "fundamentally ambiguous statement . . . should not have been presented to the jury."

Additionally, defendant attorney's convictions for money laundering and money laundering conspiracy under 18 U.S.C. § 1956 and § 1957 were also vacated. Since these crimes lacked the necessary predicate of the § 1014 conviction for false statement to a bank, the court did not address the parties' arguments pertaining to these issues.

In vacating the conviction, Judge Allyne R. Ross noted that the government had failed to sustain its burden of proving, as an essential element of § 1014, that the statement was false and that defendant knew the statement was false at the time it was made. First, however, as a threshold question in determining applicability of § 1014, the court considered the statement's fundamental ambiguity. The statement in question was defendant's checkmark in the "to be made" box under the "describe improvements" section of the form questionnaire, which was a representation of an intention to make unspecified improvements at an unspecified cost. In characterizing this representation as "amorphous," the court held that it should not have been presented to the jury.

Notwithstanding the issue of fundamental ambiguity, the court also found that the government failed to meet its burden of proving beyond a reasonable doubt that the statement was knowingly false. In looking at the issue of defendants' actual intent to perform in the future, the court noted, "the mere fact of subsequent non-performance is not alone sufficient for conviction."[1] The court also pointed out that "money is fungible" and a promise on a loan application to make improvements to property was not a promise to use the very same dollars to pay for the intended improvements.

Furthermore, it was not defendants' burden to prove that improvements had been made, but rather the government's burden to prove "the falsity of any reasonable interpretation that . . . would make the defendant's statement factually correct."[2] The government's evidence addressed the apparent absence of exterior improvements as could be inferred from viewing photographs of the house exterior, as well as those improvements that might have necessitated a building permit. Thus, the government was unable to prove that defendants failed to perform any improvements on the house after the closing, nor that defendants knowingly had any intention of performing future improvements at the time of making the loan application.

Lastly, the court discounted the government's attempt to create a new argument that a literally true but intentionally misleading statement should not be a permitted defense. Notwithstanding the finding that the disputed statement was fundamentally ambiguous, the court concluded that the one reasonable construction of the statement was that "the borrowers intended, at the time they signed the loan application, to make some nominal improvement to their home," and that the government had failed to disprove that one "literal truth."[3]

Endnotes

1. The court quoted *States v. Shah*, 44 F.3d 285, 293-94 (5th Cir. 1995).
2. The court quoted *United States v. Diogo*, 320 F.2d 898, 907 (2d Cir. 1963).
3. The court quoted *United States v. Attick*, 649 F.2d 61, 63 (1st Cir.), *cert. denied*, 454 U.S. 861 (1981).

Nancy J. Volin '02

Bergman on Mortgage Foreclosures:

The Irksome Case of the Hyperactive Referee

By Bruce J. Bergman

Sure, that $50 fee for the referee to compute is archaic and inadequate. But then, foreclosing plaintiffs and veteran referees recognize both that the tasks are most often not extensive and that there is some element of public service involved. None of this is, however, to belittle the referee's role. Although plaintiff's counsel prepares the figures, the referee should verify them with care and assure that plaintiff derives all the sums to which it is entitled, but nothing more.

It all seems quite elemental. In the mortgage foreclosure case, a referee is appointed to compute and determine whether the property is to be sold in parcels. Sometimes, though, a referee may decide to explore other issues—such as service of process—and then apply for a greater fee deemed commensurate with the additional effort. Plaintiff's counsel will explain to the referee (politely above the astonishment) that the job is clearly constrained and the fee really is confined to that $50. There is no doubt about this, but where is it written so that even the committedly overzealous will be persuaded?

If such pointed clarity didn't exist before, it does now.[1] This is a classic situation and could hardly be more focused in its meaning. Here was a foreclosure which elicited a summary judgment motion inclusive of a demonstration that the mortgage barred oral modification. The order granting summary judgment appointed a referee to compute. When the defeated borrower decided nevertheless to press the issue of a claimed oral modification of the note and mortgage, the referee took testimony on the point! Having launched into this exploratory excursion, the referee sought recompense—28.5 hours at $250 per hour.

Incredible as it seems (and hence this column), Supreme Court confirmed the referee's report and awarded the requested fees. The Second Department disagreed. Because a referee's duties are defined by the order of reference,[2] ruled the Appellate Division, the referee had no authority to take testimony concerning oral modification of the mortgage. Regarding payment for more than 28 hours of time, absent stipulation by the parties or a specific rate set by the court in the order of reference, ". . . a referee's fee must be limited to the statutory per diem fee of $50."[3]

As an exclamation point to the holding, Supreme Court was directed to issue a new order of reference for a new computation before a new referee and a recalculation of the referee's fee—no doubt here about the court's view. Although applicable statutes were never ambiguous, some might have argued that unusual instances could require interpretation; pleasingly, not anymore.

Endnotes

1. *Al Moynee Holdings Ltd. v. Deutsch*, 254 A.D.2d 443, 679 N.Y.S.2d 400 (2d Dep't 1998).
2. *Id.*, citing CPLR 4311; *Lloyds Bank v. Kahn Lbr. & Millwork Co.*, 220 A.D.2d 645, 632 N.Y.S.2d 966.
3. *Id.*, citing CPLR 8003[a]; *In re Charles F.*, 242 A.D.2d 297, 660 N.Y.S.2d 594; *Scher v. Apt*, 100 A.D.2d 582, 473 N.Y.S.2d 521.

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