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Message from the Section Chair

The Real Property Law Section has selected our esteemed colleague, Michael Berey, to receive the prestigious Professionalism Award. The Award is reserved for attorneys who exhibit outstanding competence, ability and achievement, and who have made strong contributions to the development and improvement of real property law. Michael fits this description perfectly. He served the Section and the bar with distinction for many, many years in a wide range of capacities. He shepherded the Section's nascent internet presence as the Webmaster of our Listserve and Blog. These very popular practice tools exist principally due to Mike's hard work and perseverance. Michael has been a speaker at many CLE programs on behalf of the State Bar and other providers, and he is a prolific author of articles, bulletins and newsletters. He has been active on a broad range of committees and task forces and has brought his encyclopedic knowledge and keen insight to bear on every issue and problem. Mike's opinion and help are sought by many real estate attorneys and he has been a lifelong mentor to attorneys, both young and old. Our Section is privileged to present this Award to Michael. The Award will be presented at our Section's luncheon on January 30, 2014 at the 21 Club at 12:15 pm. Please join us to honor our distinguished colleague.

We have extended our efforts working with other sections of the State Bar. We recently co-sponsored the Woman in the Law Program and partnered with the Young Lawyers Section in support of several other programs. We have also increased our continuing legal education and internship programs at Brooklyn Law School, Hofstra Law School, New York Law School, St. John's Law School, Albany Law School and Touro Law School. If you or your firm would like to participate in the internships program or would like more information, please contact David Berkey at dlb@gdblaw.com or Stacy Wallach at swallach@law.pace.edu.

Please make sure to mark your calendars to attend our Annual Meeting and program at the New York Hilton Midtown on Thursday, January 30, 2014 from 8:30 to 12:00. David Berkey has arranged a fascinating program of timely topics with compelling speakers. We look forward to a very meaningful meeting. There are also many informative substantive committee meetings that take place during the Annual Meeting and I encourage you to check the meeting calendar and participate.

Our Summer Meeting will be held at Queens Landing, Ontario, Canada from July 17 through July 20, 2014. Leon Sawyko has prepared an exciting agenda for this meeting. I encourage you to attend.

Benjamin Weinstock

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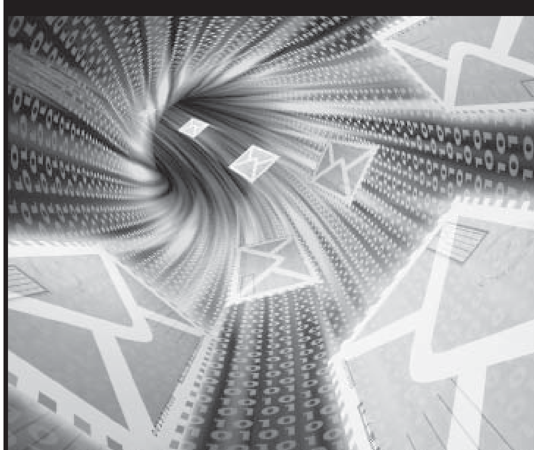

If you have written an article and would like to have it considered for publication in the *N.Y. Real Property Law Journal*, please send it to one of the Co-Editors listed on page 30 of this *Journal*.

Articles should be submitted in electronic document format (pdfs are NOT acceptable) and include biographical information.

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Qualified Mortgages: New Regulatory Standards and Safe Harbor from Liability

By Vincent Di Lorenzo

Introduction

On July 10, 2013 the Consumer Financial Protection Bureau (CFPB) issued a final rule[1] amending its earlier regulations defining and implementing the ability-to-repay requirements of the Dodd-Frank Act. The July 10th release clarified and amended final regulations that had been issued on January 10, 2013.[2] The effective date of the regulations is January 10, 2014.

In 2011 I authored an article describing the new mortgage underwriting requirements imposed by the Dodd-Frank Act.[3] That article identified four areas of unfinished business—issues that the Act allowed or required to be addressed in regulations to be formulated by the CFPB. These issues were: (a) imposition of regulatory requirements further limiting creditors' discretion in making underwriting decisions regarding borrowers' ability-to-repay; (b) possible exemptions to required underwriting criteria imposed by the Act aimed at promoting affordable housing; (3) the type of protection from liability provided by the Act's presumption of compliance granted to "qualified mortgages"; and (4) the additional underwriting requirements to be satisfied to avoid the risk retention requirements for securitized loans. This article discusses the CFPB's resolution of the first three of these issues in its final regulations. The last of these issues has yet to be settled by the federal regulators.

For real estate practitioners, resolution of these issues finalizes the underwriting standards that will become prevalent among creditors. These standards are discussed in Part One of this article. In addition, the CFPB's clarification of the presumption of compliance afforded qualified mortgages raises the issue of the nature of liability creditors may face for failure to satisfy the Act's underwriting requirements. This issue is explored in Part Two of this article, and includes a discussion of the new defense granted to borrowers in foreclosure actions.

Part One—Final Underwriting Requirements

The Dodd-Frank Act imposed on all creditors originating residential mortgage loans a duty to make "a reasonable and good faith determination…the consumer has a reasonable ability to repay the loan…."[4] It provides that a determination "shall include consideration of the consumer's":

- credit history,
- current income,
- expected income the consumer is reasonably assured of receiving,
- current obligations,
- debt-to-income ratio or the residual income after payment of non-mortgage debt and mortgage related obligations,
- employment status, and
- financial resources other than the consumer's equity in the dwelling that secures repayment of the loan.[5]

In addition, the creditor must verify the income or assets it relies upon to determine repayment ability.[6] No particular factor is required to be the basis for the creditor's underwriting decision, and there is no quantitative limit on underwriting such as a maximum debt-to-income ratio.

The Act provides that a creditor or assignee "may presume" the loan has met the ability-to-repay requirement if it is a "qualified mortgage."[7] The CFPB was authorized to determine the nature of that presumption. The statute imposes certain requirements and prohibitions for qualified mortgages, but also provides that a qualified mortgage must comply with "any guidelines or regulations established by the [Consumer Financial Protection] Bureau relating to ratios of total monthly debt to monthly income or alternative measures of ability to pay regular expenses after payment of total monthly debt…."[8] The 2013 CFPB regulations impose a maximum 43 percent debt-to-income (DTI) ratio for a loan to be a qualified mortgage.[9]

For a loan to be a qualified mortgage it must satisfy certain product limitations and requirements contained in the Act itself.[10] These include: (a) a term that does not exceed 30 years; (b) points and fees that do not exceed 3 percent; (c) a prohibition on interest-only, negative amortization, or balloon-payment loans, except for a limited authorization for balloon loans held in portfolio and extended predominantly in rural or underserved areas.[11]

In addition, the 2013 CFPB regulations limit, somewhat, the bases for underwriting decisions in order for a loan to be a qualified mortgage. Unlike the possible seven factors, discussed above, which may generally be considered by a creditor to determine a borrower's ability to repay, the CFPB regulations require that underwriting be based on a consideration of the consumer's (a) current or reasonably expected income or assets other than the value of the dwelling that secures the loan, and (b) current debt obligations, alimony and child support.[12] Finally, qualified mortgages are subject to the 43 percent maximum debt-to-income ratio.

The regulations do not impose a maximum loan-to-value ratio, and they do not require a minimum credit score or require creditors to obtain or consider a credit score.[13] However, a maximum loan-to-value ratio may later be imposed by federal regulators, but only if originators seek to avoid the risk retention requirements of the Dodd-Frank Act.[14]

In addition, the Dodd-Frank Act allows the CFPB to prescribe regulations that "revise, add to, or subtract from the criteria that define a qualified mortgage upon a finding that such regulations are necessary or proper to ensure that responsible, affordable mortgage credit remains available to consumers…."[15] The 2013 CFPB regulations create a temporary category of qualified mortgages (maximum of seven years) for loans that satisfy the underwriting requirements of a loan eligible to be purchased, guaranteed, or insured by Fannie Mae or Freddie Mac, the Department of Housing and Urban Development, the Department of Veterans Affairs, the Department of Agriculture, or the Rural Housing Service.[16] The exemption extended to loans purchased or guaranteed by Fannie Mae or Freddie Mac exists as long as they are operating under the conservatorship or receivership of the Federal Housing Finance Agency. The exemption extended to loans insured or guaranteed by the enumerated federal agencies exists until each agency promulgates its own qualified mortgage standards and such rules take effect. In any event, the temporary exemption expires seven years after the effective date of the CFPB regulations, namely on January 10, 2021. The loans need only be eligible for purchase, guarantee or insurance. They need not be actually sold, guaranteed, or insured, and they are not subject to the maximum 43 percent DTI ratio.

Finally, the 2013 CFPB regulations grant creditors making qualified mortgages a safe harbor[17]—i.e., they receive the benefit of a conclusive presumption of compliance with the Dodd-Frank Act's ability-to-repay requirements. This is true as long as the loan is not a "higher priced" loan, defined as a loan with an annual percentage rate that exceeds the average prime offer rate for a comparable first mortgage transaction by 1.5 percentage points or more.[18] Higher priced qualified mortgages receive a rebuttable presumption of compliance. The CFPB opined that the higher pricing was not only indicative of a higher level of risk, but also that a borrower would be more vulnerable.[19] It therefore was not willing to provide higher-priced qualified mortgage loans a conclusive presumption of compliance with the ability-to-repay requirements.

If a loan does not have the protection of a conclusive presumption of compliance with the ability-to-repay requirements, the borrower can submit evidence that, based on information available to the creditor, the borrower would have insufficient residual income or assets other than the value of the dwelling to meet living expenses at the time of consummation.[20] This is an interesting basis for imposition of possible liability since creditors are *not required* to consider residual income when satisfying underwriting standards imposed for qualified mortgages or the standards imposed generally for determinations of ability to repay. However, the determination of insufficient residual income is based on "information available to the creditor,"[21] including any recurring and material non-debt obligations of which "the creditor was aware at the time of consummation."[22] These are terms that will require clarification.

If creditors fail to comply with the Dodd-Frank Act's ability-to-repay requirements they, and assignees of the loan, are at risk of liability. For creditors and assignees, an important issue is the nature of the potential liability they might face.

Part Two—Creditors' Exposure to Liability

Recoverable Damages

The CFPB summarized the potential liability that an originator or assignee may face for violation of the ability-to-repay requirements. It consists of:

> …special statutory damages equal to the sum of all finance charges and fees paid by the consumer, unless the creditor demonstrates that the failure to comply is not material; actual damages; statutory damages in an individual action or class action, up to a prescribed threshold; and court costs and attorney fees that would be available for violations of other TILA provisions.[23]

The prescribed threshold for statutory damages in an individual action is "not less than $400 or greater than $4,000."[24] There is a three-year statute of limitations that applies to individual or class actions for damages for violation of the ability-to-repay requirements.[25] The three-year period begins to run on "the date of occurrence of the violation." Thereafter, the potential liability faced by the creditor or assignees changes significantly, as discussed below.

Recoupment or Setoff as a Defense

The Dodd-Frank Act created a second vehicle for potential liability on the part of creditors or assignees. It provided consumers with a "defense" in a judicial or nonjudicial foreclosure action subject to no time limit. The defense created by the statute is "by recoupment or set-off…."[26] The amount of recoupment or set-off after expiration of the otherwise applicable three-year statute of limitations is limited to the finance charges and fees paid by the consumer during the first three years of the loan.[27] This is a significant limitation of liability. However, within the three-year statute of limitations, the defense by way of recoupment or set-off would allow a consumer to recoup or set-off the actual damages, special statutory damages, statutory damages up to a prescribed threshold, and court costs and attorney's fees.[28]

Civil Penalties

In addition to liability in an action brought by a consumer, or defense raised by a consumer in a foreclosure action, there is the potential for civil liability in an administrative action. The Dodd-Frank Act extended the potential civil money penalty provisions of the federal banking laws to violations of "any provision of Federal consumer financial law[s]…."[29] Such potential penalties are in an amount: (a) not to exceed $5,000 per day for any violation (first tier penalty); (b) not to exceed $25,000 per day for recklessly engaging in a violation of a Federal consumer financial law (second tier penalty); or (c) $1 million per day for any violation that occurs "knowingly" (third tier penalty).[30]

Repurchase or Indemnification

A loan that is eligible to be purchased, guaranteed, or insured by government-sponsored enterprises or agencies is a qualified mortgage during a temporary period not to exceed seven years. In recent years, government-sponsored enterprises and agencies have forced creditors to repurchase loans they have purchased or indemnify the agency for an insurance claim. The repurchase or indemnification obligation may be triggered, among other reasons, by loan characteristics that make them ineligible for purchase, guarantee, or insurance.

On May 6, 2013 the Federal Housing Finance Agency directed Fannie Mae and Freddie Mac to limit mortgage acquisitions beginning January 10, 2014 to loans that meet the requirements for a qualified mortgage, including the temporary qualified mortgage provision for loans eligible to be purchased by Fannie Mae or Freddie Mac.[31] In addition, Fannie Mae and Freddie Mac will no longer purchase a loan that is subject to the ability-to-repay requirements if the loan is not fully amortizing, has a term longer than 30 years, or includes points and fees in excess of three percent of the loan.

The repurchase or indemnification risk is not a new risk introduced by the Dodd-Frank Act and the CFPB's ability-to-repay regulations. What is interesting, however, is the relevance of a demand or agreement to repurchase to a determination that the loan still enjoys qualified mortgage status. This issue was addressed by the CFPB in its July 10, 2013 regulations. The Bureau noted that "the mere fact that a demand has been made, or even resolved, between a creditor and government-sponsored enterprise or agency is not dispositive with regard to qualification of the loan as a 'qualified mortgage.'"[32] Rather, any evidence that may be brought to light in the course of a particular demand is relevant in assessing whether the loan was a qualified mortgage at consummation.[33]

An Evaluation

The most significant, potential risk of liability faced by creditors or assignees for failure to comply with the ability-to-repay requirements is the defense by way of recoupment or set-off in a foreclosure action. While individual actions to recover actual and statutory damages are possible, they are unlikely to be commenced by borrowers that are not in default.[34] Civil penalties are always a potential risk in an action commenced by the CFPB. In the past, the federal banking agencies were not likely to impose such penalties in cases of imprudent mortgage lending practices, in part because compliance was sought through informal and formal agreements with lenders to modify lending practices and not through imposition of civil penalties. It is not clear yet if the CFPB will continue this practice. In any event, the potential penalty would be $5,000 per day unless the creditor knowingly or recklessly failed to comply with the ability-to-repay requirements.

The potential liability of creditors through the newly created defense by way of recoupment could be significant. Recoupment would be not only for statutory damages and special statutory damages, as well as attorney's fees, but also for all actual damages sustained by the borrower for the creditor's failure to make a reasonable and good faith determination that the borrower had the reasonable ability to repay the loan. In a mortgage transaction that results in foreclosure, such actual damages would include loss of borrower's equity in the home and impairment of the borrower's credit due to the default and foreclosure, as well as other actual losses sustained.

This conclusion is subject, however, to three significant caveats. First, actual damages are not recoverable if the foreclosure occurs, and the defense is sought to be raised more than three years after the "occurrence of the violation."[35] Second, in non-judicial foreclosure states the borrower would be required to initiate a judicial action. Whether an action is initiated depends, in part, on the borrower's ability to obtain legal representation. Available evidence of claims under laws potentially analogous to the CFPB's ability-to-repay regulations, such as the Home Ownership and Equity Protection Act and state anti-predatory lending laws (which also provide for assignee liability), indicates claims have been very infrequent.[36] Third, while claims are potentially more frequent by way of the defense of recoupment in a judicial foreclosure action, the CFPB has itself recognized that only a small percentage of borrowers contest foreclosures and an even smaller percentage do so with the benefit of legal representation.[37] Finally, to succeed the borrower would be required to prove the creditor violated the general ability-to-repay requirements.[38]

Conclusion

Consumer groups, industry members, and government officials have struggled with the question of whether creditors are likely to offer only "qualified mortgages" in the future. The fear is that this would restrict availability of credit. The safe harbor created by the CFPB's regulation makes this more likely. However, this conclusion depends on creditors' assessment of the risk of liability for failure to meet the Act's ability-to-repay requirements. Past experience indicates that risk is likely small. Of course, only future experience will confirm or disprove that conclusion based on the frequency with which the new defense in foreclosure is asserted and on the CFPB's enforcement policy with respect to the ability-to-repay requirements.

Endnotes

1. *See* Amendments to the 2013 Mortgage Rules Under the Real Estate Settlement Procedures Act (Regulation X) and the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 44686-01 (July 24, 2013) (to be codified at 12 C.F.R. pts. 1024, 1026) (amending 12 C.F.R. § 1026.43).
2. *See id.*; *see also* Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 6408-1 (January 30, 2013) (to be codified at 12 C.F.R. pt. 1026).
3. Vincent Di Lorenzo, *Mortgage Underwriting After Dodd-Frank: New Standards and Unfinished Business*, 39 N.Y. Real. Prop. L. J. 2, Spring/Summer 2011, at 26.
4. 15 U.S.C. § 1639c (a)(1).
5. *Id.* § 1639c (a)(3).
6. *Id.* § 1639c (a)(4).
7. *Id.* § 1639c (b)(1).
8. *Id.* § 1639c (b)(2)(A)(vi).
9. 12 C.F.R. § 1026.43(e)(2)(vi) (2013) (Effective Jan. 10, 2014).
10. 15 U.S.C. § 1639c (b)(2)(A).
11. The complete terms of the exception for balloon loans are found at 15 U.S.C. § 1639c (b)(2)(E).
12. 12 C.F.R. § 1026.43(e)(2)(v).
13. *See* Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 6408-1, 6470.
14. *See* Department of Treasury et al., Proposed Rules, Credit Risk Retention, 76 Fed. Reg. 24090-01 (April 29, 2011) (to be codified at 12 C.F.R. pts. 43, 244, 373, and 1234; 17 C.F.R. pt. 246; 24 C.F.R. pt. 267) (the 2011 proposed qualified residential mortgage regulations imposed a maximum loan-to-value ratio of 80 percent for purchase transactions); *see also* Department of Treasury et al., Credit Risk Retention, at 270-271, 274-277 (August 28, 2013) (to be codified at 12 C.F.R. pts. 43, 244, 373, and 1234; 17 C.F.R. pt. 246; 24 C.F.R. pt. 267) (the 2013 revised, proposed regulations eliminate the maximum loan-to-value ratio, but also request additional comments on a proposal for a maximum 70 percent loan-to-value ratio), *available at* http://federalreserve.gov/newsevents/press/bcreg/bcreg20130828a1.pdf.
15. 15 U.S.C. § 1639c (b)(3)(B)(i).
16. 12 C.F.R. § 1026.43(e)(4).
17. *Id.* § 1026.43(e)(1).
18. *Id.* § 1026.43(b)(4) (for subordinate liens the loan must exceed the average prime offer rate by 3.5 percent or more).
19. Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 6408-1, 6506; *see also* 78 Fed. Reg. 6408-1, 6511 (the subprime market is comprised of borrowers who tend to be less sophisticated and have fewer options available, and thus more susceptible to being victimized by predatory lending practices).
20. 12 C.F.R. § 1026.43(e)(ii)(B); s*ee generally* Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 6408-1, 6511, 6513.
21. Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 6408-1, 6513.
22. 12 C.F.R. § 1026.43(e)(1)(ii)(B) (discussing the rebuttable presumption of compliance for higher-priced mortgage loans).
23. Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 6408-1, 6557.
24. 15 U.S.C. § 1640(a)(2)(A).
25. *Id.* § 1640(e).
26. *Id.* § 1640(k)(1).
27. *See Id.* § 1640(k)(2)(B); *see also* Ability to Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 6480, 6557.
28. *See* 15 U.S.C. § 1640(k)(2)(A).
29. 12 U.S.C. § 5565(c)(1).
30. *Id.* § 5565(c)(2).
31. *See* Federal Housing Finance Agency (May 6, 2013). *FHFA Limiting Fannie Mae and Freddie Mac Loan Purchases to "Qualified Mortgages*," available at www.fhfa.gov/webfiles/25163/QMFINALrelease050613.pdf.
32. Amendments to the 2013 Mortgage Rules Under the Real Estate Settlement Procedures Act (Regulation X) and the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 44686-01, 44702.
33. *See id.* at 44718 (noting that the July 10, 2013 regulations define qualified mortgages for purposes of the temporary exemption as loans eligible for purchase, insurance or guarantee "except with regard to matters wholly unrelated to ability to repay").
34. *See* Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 6408-1, 6512 (Jan. 30, 2013) (explaining that the CFPB drew the same conclusion based on the small size of many claims, the difficulty of securing an attorney to provide representation, and the low likelihood that claims could be successfully prosecuted. The consumer would be required to prove the creditor lacked a reasonable and good faith belief in the consumer's ability to repay at consummation or that it failed to consider the statutory factors in arriving at that belief.); *see also* 78 Fed. Reg. 6408-1, 6568 (the Bureau believes consumers who have fallen behind on their mortgage obligations are unlikely to initiate an ability to repay claim prior to foreclosure).
35. *See* 15 U.S.C. § 1640(e); *see also* 15 U.S.C. § 1640(k).
36. *See* Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 6408-1, 6568 (Jan. 30, 2013).
37. *See id.* at 6566.
38. *See id.* at 6462 (discussing evidence that may be used to prove a violation).

Vincent Di Lorenzo is professor of law at St. John's University and author of *New York Condominium and Cooperative Law* (West). A portion of this article is reprinted with permission from the September 9, 2013 edition of the *New York Law Journal*, copyright ALM Media Properties, LLC. Further duplication without permission is prohibited.

Gaining Access to Neighboring Properties for Protection During Construction

By Brian G. Lustbader

As they develop their properties, builders are required to avoid damaging adjoining properties from their construction work, something that has always been a problem, but especially so in New York City, where construction activities have damaged neighboring properties, most notably the seemingly epidemic spate of recent crane accidents. The method for dealing with these problems is the statutorily mandated requirement that the owner/developer enter into a license agreement with adjoining property owners permitting access to protect those properties. Despite the extensive, advanced planning that goes into real estate development projects, this requirement is often overlooked. Yet doing so will create real problems, as negotiating and/or litigating the myriad issues associated with these license agreements can create many delays to the development process, especially because neighboring property owners often leverage their required approval by making exorbitant demands.

Builders and the owners of properties adjoining construction sites each have enforceable rights that often conflict, so they must be balanced, usually a difficult and arduous task. The adjoining neighbor's rights include the ability to use its property without interference, that is, free from trespass, and also free from damage caused by others. The builder's rights are equally meritorious, as it is entitled to develop and build on that property as permitted by the local building authorities, subject only to non-interference with neighbors. In addition to some thorny legal issues, there are many practical issues the parties must address, including (a) monitoring for vibrations, cracking, and the like; (b) excavation, underpinning, sheeting, and shoring; (c) erecting sidewalk sheds, which often obstruct neighbors' entrances; and (d) erection of nettings and other protection of adjacent roofs, once the new building exceeds the height of its neighbors.

Statutory and Regulatory Framework

There are a number of statutes and regulations that govern the relationship between builders and adjoining property owners. The statutory framework begins with Real Property Action and Proceedings Law (RPAPL) § 881, which requires the owner of the property under development to obtain a license from the adjoining property owner and also requires that the latter grant such a license.[1] The statute provides as follows:

> When an owner or lessee seeks to make improvements or repairs to real property so situated that such improvements or repairs cannot be made by the owner or lessee without entering the premises of an adjoining owner or his lessee, and permission so to enter has been refused, the owner or lessee seeking to make such improvements or repairs may commence a special proceeding for a license so to enter pursuant to article four of the civil practice law and rules. The petition and affidavits, if any, shall state the facts making such entry necessary and the date or dates on which entry is sought. Such license shall be granted by the court in an appropriate case upon such terms as justice requires. The licensee shall be liable to the adjoining owner or his lessee for actual damages occurring as a result of the entry.[2]

There are a number of important aspects of this statute. First, the statute—at least theoretically—grants the owner/builder the right to actually compel the adjoining property owner to grant a license for the owner/builder to enter the adjoining property, provided the "repairs cannot be made by the owner or lessee without entering the premises of [the] adjoining owner."[3] If the adjoining property owner refuses to grant the requested license, the builder/owner is entitled to proceed to court to obtain an order compelling the recalcitrant adjoining property owner to grant the license. The court hearing the matter is directed to grant that license "upon such terms as justice requires," while the owner/builder will remain liable to its neighbor for damages caused by its entry onto the adjoining property and, presumably, any damage resulting from its construction activities.[4]

In addition to the New York State RPAPL provision quoted above, New York City has its own, additional rules governing protection of adjoining properties during construction, as is true for many other jurisdictions. Section 3309 of the New York City Building Code provides, among other things, that the adjoining property owner "shall" grant a license to the builder, and if the adjoining owner fails to grant that license, then the liability for any damage devolves upon the party refusing to grant the license, i.e., the adjoining property owner.[5] This appears to be a sure-fire method to force the adjoining property owner to grant the requested license. In practice, however, this is not so because the New York City Department of Buildings (DOB) will usually refuse to grant the builder the requisite permit to build without receiving a copy of the signed licensed agreement, thereby negating the force of the Building Code section by eliminating the ability of the builder to force the issue short of moving in court as permitted under RPAPL § 881 noted above.[6]

Also of note is a problem with the New York statutory system, not limited to New York City. RPAPL § 881 has no provision for permanent easement(s) for anything that the builder might install on the adjoining property, for example, anchors to sheeting or shoring protection, structural elements added to party walls, or waterproofing/flashing.[7] Presumably, both parties will want these items to remain, but the statute does not require the adjoining property owner to allow this if he or she so chooses to demand removal.

Underlying Legal Principles—Competing Property Rights

There are no ironclad rules governing the relief to which each side is entitled, as RPAPL § 881 merely requires the court to grant the license "upon such terms as justice requires."[8] Finding the license that "justice requires" necessarily involves a balancing test, as the courts must balance those competing rights—for example, requiring the neighbor to grant access, but limiting the time period and the physical intrusion and requiring the builder to pay for or remedy all damages caused by its work. In some cases, the court will require the builder to pay for the neighbor's engineers and other professionals, obtain insurance coverage, and, in addition, post a bond to cover potential damages to the adjoining property, and/or pay a license fee to the neighbor for the period during which the protection is in place. The latter payment would be to compensate the neighbor for the extent of its loss of use of its property, whether complete or partial, over the time period required for protection.

All of these terms should be negotiated in a license agreement between the parties, discussed in more detail below. Where the parties are unable to come to agreement on the terms of that license agreement, however, one party or the other will need to apply to court for redress. Procedurally, it works in either of two ways. The most common scenario is where the builder/developer seeks a court order pursuant to RPAPL § 881.[9] If, however, the builder proceeds without a license (if the DOB grants a permit), the adjoining property owner is entitled to bring an injunction action seeking to stop construction unless, and until, the builder/owner enters into a satisfactory license agreement.[10] The adjoining property owner can also attempt to avoid the legal expense of applying to court by applying for a stop work order from the local department of buildings, e.g., the NYC DOB, but if that department refuses to get involved, as is often the case, then that adjoining property owner must proceed to court for an injunction.[11]

Even when one party does apply to the court for an order, more often than not the judge will attempt to resolve the issues informally without rendering an actual decision, because most judges do not like to get involved in the nitty-gritty of the specifics of each situation, in essence converting the case to a mediation with the judge acting as the neutral mediator. As a result, there are few reported decisions with any detailed analysis of the issues.

One of the few such decisions containing such an analysis is *Rosma Development, LLC v. South*.[12] In that decision, the adjoining owner raised an entire host of arguments as to why it need not be compelled to provide a license to the builder/owner, including the following: (1) the builder's work was not an "improvement" within the meaning of the statute, (2) the protection plans should have been part of the builder's DOB application, (3) the builder was "at fault" in seeking to construct an eight-story building between two four-story buildings and therefore should not be "rewarded" with a license for such improper behavior, (4) the builder's construction work will impair the adjoining owner's own efforts to improve its own property, and (5) DOB violations had been issued against the builder for its excavation work to date. In essence, rejecting all of these arguments, the Court ruled that the builder's rights to develop its property was a bona fide public purpose and therefore outweighed the adjoining owner's inconvenience, and required the latter to grant the requested license. However, in order to protect that adjoining property owner's interests, the Court required that that license be carefully circumscribed, as follows: (1) limited duration (12 months), (2) a license fee to be paid to the adjoining owner ($2,500/month), (3) prohibiting the builder from "unreasonably interfering" with the adjoining owner's use of its property, (4) requiring the builder to restore the adjoining owner's property to its prior condition, and (5) requiring the builder to be responsible for all damages, provide the requisite insurance, and hold the adjoining property owner harmless for all third-party claims, among other things.[13]

Terms to Include in License Agreements

Using the *Rosma* decision and the principles outlined above as a template, one can determine the items to include in license agreements between builders and adjoining property owners.[14] Below are some of those provisions:

1. Builder to provide to the neighbor with a schedule of the work to be performed, and sometimes the actual plans themselves, both for the protection work and the construction work generally (plans filed with the DOB should be sufficient as to the overall construction work). Alternatively, the builder can spell out in detail the specifics of the protection work, e.g., underpinning, sheeting and shoring, and/or roof protection work;
2. Builder to conduct pre-construction inspections, including photographs and videos of the

neighbor's property, and thereafter install gauges to monitor vibrations, cracks and the like during construction;

3. Builder to pay the fees incurred by the neighbor in connection with negotiation of the license agreement and thereafter, including fees for engineers, attorneys, etc.;
4. Builder to pay the neighbor a license fee, either as a lump sum, or on a per-month, or per-week basis, depending on the overall length of the project;
5. If no license fee is to be paid (or even conceivably if it is), builder to be assessed a penalty or liquidated damages if the protection work runs later than set forth in the schedule provided by the builder;
6. Builder to provide site security for all sidewalk sheds and scaffolding used for its work so as to assure that there are no intrusions into the neighbor's property;
7. Builder to provide full indemnification of neighbor and insurance at coverage amounts appropriate to the scope of the work being performed, naming the neighbor and its agents as Additional Insureds;
8. To address potential claims and/or damage to the neighbor's property, builder to agree to repair all damages caused on neighbor's property, and/or post a bond (as was required in *Rosma*), or put money in escrow;
9. Terms of license agreement to be kept confidential, as the builder usually will not want other neighbors to know the terms agreed upon;
10. Both parties to provide contact information for contact personnel who can be reached on a 24-hour basis, for emergencies, for access to the neighboring property, and otherwise;
11. Where party walls exist between the two parties' properties, builder to conduct probes to see whether to address structural issues in that wall; and
12. Establishing responsibility for closing up lot line windows in the neighbor's property, i.e., who is to perform the work and who pays for it.

This list is hardly exhaustive, however, as there are many other, site-specific issues that the parties will undoubtedly need to address.

Practical Considerations; When to Litigate

Negotiating a license agreement is not an easy proposition, even in the best of circumstances. Builders are anxious to get moving on their construction, as time is money and the sooner the work is complete, the sooner revenues will begin to flow, construction loans can be paid off, etc. Adjoining property owners, realizing that their approval is a prerequisite to the builder's ability to get started, will typically make high monetary demands in the hopes of reaping a windfall for granting consent. Under these circumstances, each side will have to measure how long to negotiate before actually going to court, each running its own cost/benefit analysis of the likely risks and rewards of litigation. For the builder, while litigation is never inexpensive, and one can never be assured of the result, waiting too long to litigate can mean a significant loss of time and money. Conversely, if the adjoining property owner's demands are excessive, it may find itself in court and ultimately receive a license agreement from a judge on terms not as favorable as those offered by the builder in the pre-litigation negotiating phase.

There are a few practical pointers to keep in mind. First, unlike typical litigation that can last for years, an action under RPAPL § 881 is necessarily a discrete, one-shot application and decision (or court-mediated settlement), so it is unlikely to last more than a month or so. As a result, litigation will not usually delay the builder unduly. In a similar vein, the builder need not establish a large litigation "war chest" for this type of action. In addition, as noted above, judges typically shy away from rendering decisions on these issues, and so will usually force the parties to settle, in essence acting as a mediator to bring the sides together. However, unlike the typical mediation where the mediator has no enforcement power, the judge as mediator has leverage with which to coerce a recalcitrant party—the very real threat that he or she will rule against that party acting unreasonably if the matter is not resolved. Given this state of affairs, parties should not be as leery of applying to court as they might be under ordinary circumstances.

Additional Issues, re: Insurance

There are many other issues that may arise regarding license agreements, including several related to insurance. As noted above, the adjoining property owner will want to be covered under the builder's insurance policy, but a question arises as to which side will cover the deductible in the event of a claim under the policy. Presumably it should be the builder, but in the absence of a specific provision in the license agreement's indemnification provision to that effect, that cost may devolve on the neighbor.

In addition, there are often many exclusions in the comprehensive general liability (CGL) insurance policies that may bear on ultimate payouts, e.g., subsidence, water damage. Other exclusions include consequential damages, e.g., lost rents, living expenses, and engineering and legal fees. Note that RPAPL § 881 only requires the builder to pay "actual damages," which necessarily precludes such consequential damages, so if the adjoining property owner wishes the benefit of such damages, it must seek to include them in the license agreement.[15]

Questions may also arise over whether coverage will extend to strict liability situations or only negligent acts of the builder and its contractor/construction manager. Note also that one attorney will typically represent both the owner/builder and its contractor/construction manager in the dealings with the adjoining property owner, but when insurance liability issues arise, those two parties' interests may no longer be aligned, so each may need separate counsel to avoid conflicts between them.

CGL policies usually exclude attorneys' fees in an injunction action, so a question may arise regarding responsibility to pay attorneys' fees there. And with respect to injunction actions, query whether a court decision there can act as "law of the case" in any subsequent proceeding between the same parties.

These questions are not answered in the present state of the case law, so it will pay to address as many of them as possible in any license agreement and thereby avoid open issues down the road.

Conclusion

Given that time is such a crucial aspect of any real estate development project, and the myriad issues, time and expense involved in negotiating license agreements with neighbors, when addressing their projects, owners/developers should be sure to allocate the necessary time and advanced planning required to address the issues outlined here, in addition to all the other matters they need to address in getting their projects built.

Endnotes

1. N.Y. Real Prop. Acts. Law § 881 (McKinney's 2013).
2. *Id*.
3. *Id*.
4. *Id*.
5. N.Y.C. Bldg. Code § 3309.2 (Int'l Code Council 2008); N.Y.C. Bldg. Code § 3309.4 (Int'l Code Council 2008).
6. N.Y. Real Prop. Acts. Law § 881 (McKinney's 2013).
7. *Id*.
8. *Id*.
9. *Id*.
10. *Id.; see e.g.*, McMullan v. HRH Constr. LLC, 38 A.D.3d 206, 207, 831 N.Y.S.2d 147, 149 (1st Dep't 2007).
11. N.Y. Real Prop. Acts. Law § 881 (McKinney's 2013) (when permission is denied to enter an adjoining property to make repairs to an owner's building, owner may "commence a special proceeding for a license so to enter").
12. Rosma Dev., LLC v. South, 5 Misc. 3d 1014(A), 798 N.Y.S.2d 713 (Sup. Ct. Kings Cnty. 2004).
13. *Id.* (holding that adjoining property owners must be reasonable in denying the neighboring property's developer from entering the premises in order to make improvements or repairs).
14. *See id.* (providing a general template for a RPAPL 881 license).
15. N.Y. Real Prop. Acts. Law § 881 (McKinney's 2013).

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Court of Appeals Takes the Bull by Its Horns: Liability for Roaming Cattle and Other Domestic Animals

By Karen M. Richards

Introduction

In the last decade, the Court of Appeals consistently rejected a negligence cause of action to recover damages for personal injuries caused by a domestic animal.[1] Rather, the sole viable claim was for strict liability, which was established by evidence that the animal's owner knew or should have known of its vicious propensities.[2] This changed in May 2013 when the Court held that a landowner or the animal's owner may be liable under ordinary tort-law principles when a domestic animal is negligently allowed to stray from the property on which it was kept.[3]

The Rule Articulated in *Collier*

In 2002, the Court of Appeals in *Collier v. Zambito* discussed the traditional rule, which provides that if a domestic animal's owner knew or should have known of the animal's vicious propensities, the owner faces strict liability for the harm the animal causes as a result of those propensities.[4] The Court explained vicious propensities as including:

> the propensity to do any act that might endanger the safety of the persons and property of others in a given situation. Knowledge of vicious propensities may of course be established by proof of prior acts of a similar kind of which the owner had notice.
>
> In addition, an animal that behaves in a manner that would not necessarily be considered dangerous or ferocious, but nevertheless reflects a proclivity to act in a way that puts others at risk of harm, can be found to have vicious propensities—albeit only when such proclivity results in the injury giving rise to the lawsuit.[5]

Although the traditional rule had existed in New York for almost 200 years, after *Collier* later courts would refer to it as "the rule articulated in *Collier*."[6]

The only issued addressed in *Collier,* where a 12-year-old boy was bitten by the owners' dog while a guest at their home, was whether the owners should have known of the dog's dangerous propensities. In a 4-2 decision, the majority found that although the dog was excitable and confined to the kitchen when visitors were at the house, there was no evidence that its behavior was threatening or menacing.[7] Accordingly, the Court affirmed the decision of the Appellate Division to grant the owners' motion for summary judgment and dismiss the complaint.[8]

Although the question of whether general negligence principles were applicable in cases involving animal-inflicted injuries was not addressed in *Collier,* four years later the Court addressed this question in *Bard v. Jahnke*.[9] Mr. Bard was injured by a freely roaming breeding bull, but he was unable to recover under the strict liability rule because he could not show the bull's owner knew or should have known of its vicious propensities.[10] He argued, in the alternative, that he could recover under a common-law cause of action for negligence without establishing the owner was aware of the bull's vicious propensities and pointed to Restatement (Second) of Torts as supporting his argument. Section 518 of the Restatement specifically referenced bulls and "provided generally that the owner of a domestic animal, which the owner does not know or have reason to know to be abnormally dangerous, is nonetheless liable if he intentionally causes the animal to do harm, or is negligent in failing to prevent harm" and also provided in part that the keeper of a domestic animal is required to know the animal's characteristics.[11]

The Court rejected Mr. Bard's argument that the Restatement supported a negligence cause of action, noting that it had never held that particular breeds or kinds of domestic animals are dangerous or that male domestic animals kept for breeding are dangerous as a class. In a 4-3 decision, it thus declined to "dilute [its] traditional rule" by allowing "a companion common-law cause of action for negligence."[12] Instead, it stated that "when harm is caused by a domestic animal, its owner's liability is determined solely by application of the rule articulated in *Collier*."[13]

The majority's rejection of the Restatement was, according to Judge R.S. Smith in dissent, "a mistake" that left "New York with an archaic, rigid rule, contrary to fairness and common sense that will probably be eroded by ad hoc exceptions."[14] He noted that before the majority's rejection of the Restatement, the "Court's opinions were consistent with the Restatement rule"[15] and that it had never opined that the strict liability involved in *Collier* "is the only kind of liability the owner of a domestic animal may face—that, in other words, there is no such thing as negligence liability where harm done by domestic animals is concerned."[16]

Despite the rulings in *Collier* and *Bard*, courts continued to debate whether a negligence cause of action survived. One such court was *Bernstein v. Penny Whistle Toys, Inc.*, where the plaintiffs brought an action against the owner of a toy store, whose dog unexpectedly bit the plaintiffs' eight-year old child while she was petting the dog.[17] At the Appellate Division, the dissent opined that the defendants owed an additional duty to the child beyond that of a pet owner who knows the pet has vicious propensities.[18] In supporting its position, the dissent stated "it is important to recognize that [*Collier* and *Bard*] only discuss the animal *owner's* liability."[19] An additional duty was owed because the defendants owned and operated a business, the primary purpose of which was to sell wares to and for children, and necessarily, their goal was to attract children into the store as customers. Consequently, "as proprietors of the business, in addition to the legal obligations of a dog owner, [the defendants] must also be held to the standard of care imposed by the law of premises liability, to maintain their premises in a reasonably safe condition in view of the circumstances."[20] Further, the dissent did not view *Bard* "as eradicating the continued viability of prior cases which impose an enhanced duty toward children upon property owners who keep animals, where the presence and actions of children on the premises are reasonably foreseeable."[21]

In response to the dissent's position, the Appellate Division majority stated:

> The dissent would circumvent the clear meaning of the Court of Appeals' rulings by constructing a theory grounded in premises liability, the practical impact of which is to profoundly increase the exposure faced by individuals who own a domestic animal where that animal has shown no propensity for being vicious. The reality is that a significant number of these types of cases, including *Collier* and *Bard*, involve situations where domestic animals injured individuals on premises either owned or operated by the person who also owns the animal. In our view, such an expansion is impermissible in light of the clear and unequivocal language contained within *Collier* and *Bard*.[22]

Finding that "the Court of Appeals has squarely spoke on this issue"—that an owner's liability is determined solely by the rule articulated in *Collier*[23]—the majority thus affirmed the Supreme Court's dismissal of the complaint against the dog's owner, as there was no evidence the dog had exhibited a vicious propensity prior to the incident in question. The Court of Appeals unanimously affirmed the majority's decision, thus rejecting the argument that in certain limited circumstances, such as those present in *Bernstein*, a negligence cause of action was viable.[24]

Conversely, the Appellate Division in *Petrone v. Fernandez* was not divided in its opinion.[25] It unanimously recognized that a dog owner faced potential liability where a statutory leash law violation, "coupled with affirmative canine behavior such as a dog bite or an attack upon the plaintiff or where there is a history of prior violations," could serve as a predicate for the owner's potential liability.[26] In reaching this finding, the Appellate Division noted that neither *Collier* nor *Bard* addressed the question of whether negligence involving the violation of a leash law could result in liability when an unleashed dog causes harm. Further, it considered "dicta" the *Bard* Court's statement, "when harm is caused by a domestic animal, its owner's liability is determined *solely* by application of the rule articulated in *Collier*"[27] because it

> does not appear to have been written by the Court of Appeals with ordinance-violation circumstances in mind.... Indeed, were we to interpret it in such a manner, protections provided by municipal leash laws could be severely weakened, if not eliminated altogether.[28]

The Court of Appeals unanimously disagreed, noting that only a year before, in *Bernstein*, it had rejected "the notion that a negligence cause of action survives *Collier* and *Bard*."[29] Therefore, the owner's "violation of the leash law was irrelevant because such a violation constituted only some evidence of negligence, and negligence is not a basis for imposing liability after *Collier* and *Bard*."[30] Citing to *Bard*, the Court reiterated that "when harm is caused by a domestic animal, its owner's liability is determined solely by application of the rule articulated in *Collier*—i.e., the rule of strict liability for harm caused by a domestic animal whose owner knew or should have known of the animal's vicious propensities."[31]

While the Court's decision in *Petrone* was unanimous, Judge Pigott wrote "separately to make clear that, while [he] concur[red] with the majority," he did so on "constraint" of *Bard*.[32] In Judge Pigott's view:

> and for the reasons stated in Judge R.S. Smith's dissent in *Bard*, it was wrong to reject negligence altogether as a basis for the liability of an animal owner. Negligence by the owner, even without knowledge concerning a domestic animal's vicious propensity, may create liability.
>
> Nevertheless, because I believe that the majority of this Court in *Bard* intended to restrict liability for animal-induced injuries to circumstances where there is strict liability, I cannot accept the Appellate Division's position that the present case is distinguishable from *Bard* as a leash law negligence case. Consequently, I vote to reverse and, although I would not have joined the majority's opinion in *Bard*, I must, on constraint of that decision, concur in the majority's opinion in the present case.[33]

The Court's decisions in *Collier*, *Bard*, *Bernstein*, and *Petrone* made it clear that there was no common-law negligence cause of action to recover damages for injuries caused by a domestic animal. The inability to assert a negligence claim precluded a plaintiff from prevailing against the owner of a domestic animal solely on the basis that the owner allowed the animal to roam or escape confinement. If an animal roamed from the property on which it was kept, even if it roamed because the owner failed to secure the animal properly, unless the plaintiff could prove the owner knew or should have known that the animal had vicious propensities, the owner was not liable for any harm the animal caused. This would change in 2013 with the Court's decision in *Hastings v. Sauve*.

Hastings v. Sauve

Even though years had gone by since the Court decided *Collier, Bard, Bernstein, and Petrone*, courts continued to express dissatisfaction that a negligence cause of action could not lie in cases where a domestic animal caused harm. One such court was the Third Department in *Hastings v. Sauve*, where the plaintiff, who was injured when her vehicle collided with a cow that had wandered onto a highway, alleged that the defendants were negligent in not properly confining the cow to pasture and by allowing it to wander onto the highway.[34] The Third Department advocated that traditional rules of negligence should apply in limited circumstances, such as those present in *Hastings*:

> There can be no doubt that the owner of a large animal such as a cow or horse assumes a very different set of responsibilities in terms of the animal's care and maintenance than are normally undertaken by someone who owns a household pet. The need to maintain control over such a large animal is obvious, and the risk that exists if it is allowed to roam unattended onto a public street is self-evident and not created because the animal has a vicious or abnormal propensity. Here, plaintiff was injured not because the cow was vicious or abnormal, but because defendants allegedly failed to keep it confined on farm property and, instead, allowed it to wander unattended onto the adjacent highway in the middle of the night, causing this accident. The existence of any abnormal or vicious propensity played no role in this accident, yet, under the law as it now exists, defendants' legal responsibility for what happened is totally dependent upon it. For this reason, we believe in this limited circumstance, traditional rules of negligence should apply to determine the legal responsibility of the animal's owner for damages it may have caused.[35]

Nevertheless, although the Appellate Division noted its "discomfort" with the strict liability rule "as it applies to these facts—and with this result," it stated it was "not for this Court to alter this rule and, while it is in place, we are obligated to enforce it."[36] It thus found summary judgment was properly granted to the defendants because the plaintiffs only pled a negligence cause of action.[37]

The Court of Appeals unanimously disagreed, reversing the order of the Appellate Division, and denying the defendants' motions for summary judgment. The panel of judges included Judge R.S. Smith and Judge Pigott, both of whom in earlier cases had criticized the Court's rejection of a negligence cause of action. The Court wrote:

> This case, unlike *Collier, Bard, Bernstein*, and *Petrone*, did not involve aggressive or threatening behavior by any animal. The claim here is fundamentally distinct from the claim made in *Bard* and similar cases: It is that a farm animal was permitted to wander off the property where it was kept through the negligence of the owner of the property and the owner of the animal. To apply the rule of *Bard*—that when harm is caused by a domestic animal, its owner's liability is determined solely by the vicious propensity rule—in a case like this would be to immunize defendants who take little or no care to keep their livestock out of the roadway or off of other people's property.[38]

Thus, as critics of the rule articulated in *Collier* had previously recognized, the *Hastings* Court also recognized that situations exist where an owner or keeper of a domestic animal may be liable for harm caused by the animal, even in the absence of knowledge concerning the animal's vicious propensity. It therefore held "that a landowner or the owner of an animal may be liable under ordinary tort-law principles when a farm animal—i.e., a domestic animal as that term is defined in Agriculture and Markets Law §108(7)—is negligently allowed to stray from the property on which the animal is kept."[39]

Conclusion

The Court of Appeals distinguished *Hastings* from previous cases by pointing out that the cow, unlike the animals in previous cases decided by the Court, did not display aggressive or threatening behavior.[40] Thus, arguably, ordinary tort-law principles may apply to only a very narrow set of facts—where a domestic animal, as defined in Agriculture and Markets Law §108(7), is negligently allowed to stray from the property on which it is kept and causes injury not associated with aggressive or threatening behavior.

Also, while cats and dogs have been treated as domestic animals under common-law, importantly, section 108(7) of the Agriculture and Markets Law does not include them in its definition, and therefore, the ruling in *Hastings* does not apply to them.[41] As the *Hastings* Court stated, it did "not consider whether the same rule applies to dogs, cats, or other household pets; that question must await a different case."[42]

Endnotes

1. Agriculture and Markets Law § 108(7) defines a "domestic animal" as "any domesticated sheep, horse, cattle, fallow deer, red deer, sika deer, whitetail deer which is raised under license from the department of environmental conservation, llama, goat, swine, fowl, duck, goose, swan, turkey, confined domestic hare or rabbit, pheasant or other bird which is raised in confinement under license from the state department of environmental conservation before release from captivity, except that varieties of fowl commonly used for cock fights shall not be considered domestic animals for the purposes of this article." N.Y. Agric. & Mkts. Law § 108(7) (Consol. 2013). *See* Collier v. Zambito, 1 N.Y.3d 444, 446, 807 N.E.2d 254, 256, 775 N.Y.S.2d 205, 207 (2004); *see also* Bard v. Jahnke, 6 N.Y.3d 592, 597, 848 N.E.2d 463, 467, 815 N.Y.S.2d 16, 20 (2006). *See also* Petrone v. Fernandez, 12 N.Y.3d 546, 550, 910 N.E.2d 993, 996, 883 N.Y.S.2d 164, 167 (2009). *See also* Bernstein v. Penny Whistle Toys, Inc., 10 N.Y.3d 787, 788; 886 N.E.2d 154, 856 N.Y.S.2d 532 (2008).
2. Although many cases specifically reference the animal owner's liability, often the animal owner was also the owner of the property on which it injured the plaintiff. *See* Dufour v. Brown, 66 A.D.3d 1217, 1218, 888 N.Y.S.2d 219, 221 (3d Dep't 2009) (stating "[a] person who harbors or keeps a [domestic animal] with knowledge of [its] vicious propensities is liable for the injuries caused by the [animal]").
3. Hastings v. Sauve, 21 N.Y.3d 122, 126, 989 N.E.2d 940, 942, 967 N.Y.S.2d 658, 660 (2013).
4. Collier v. Zambito, 299 A.D.2d 866, 750 N.Y.S.2d 249 (4th Dep't 2002), *aff'd*, 1 N.Y.3d 444, 446, 807 N.E.2d 254, 256, 775 N.Y.S.2d 205, 207 (2004).
5. *Id.* at 446-447, 807 N.E.2d at 256, 775 N.Y.S.2d at 207.
6. Bard v. Jahnke, 6 N.Y.3d 592, 599, 848 N.E.2d 463, 815 N.Y.S.2d 16; *Bernstein*, 10 N.Y.3d 787, 788, 886 N.E.2d 154, 155, 856 N.Y.S.2d 532, 533; *Petrone*, 12 N.Y.3d 546, 550, 910 N.E.2d 993, 996, 883 N.Y.S.2d 164, 167.
7. Collier v. Zambito, 1 N.Y.3d at 447, 807 N.E.2d 254, 775 N.Y.S.2d 205. The dissent found the dog's behavior and its confinement to the kitchen created a question of fact as to whether the owners were aware the dog was a potential danger. The majority also noted that the owners were unaware of any prior incidents in which the dog had attempted to bite or attack anyone, but the dissent stated this "should not be dispositive" as the dog "had never been given the opportunity to do so."
8. *Id.* at 448, 807 N.E.2d 254, 775 N.Y.S.2d 205. The Supreme Court in *Bard* found the bull's owners "were subject to 'some duty of enhanced care' to restrain or confine the animal or to warn a human being who might come into contact with it," and thus granted the owners' motion for summary judgment because they were unaware Mr. Bard would be in the barn. The Appellate Division found that summary judgment was properly awarded to the owners but on the basis of the Court's decision in *Collier*—there was no evidence the bull had prior vicious propensities.
9. *Bard*, 6 N.Y.3d at 592, 599.
10. *Id.* at 596. The bull had regular contact with other farm animals, farm workers, and the defendants' family, and concededly had never displayed any hint of hostility and had never attacked any farm animal or human being prior to attacking Mr. Bard.
11. *Id.* at 598.
12. *Id.* at 599.
13. *See id.* at 599 (noting the "common shorthand rule for our traditional rule—*the 'one-bite rule'—is a misnomer" since an animal's propensity to cause injury can be proven by something other than prior comparably vicious acts); *see also* Perrotta v. Picciano, 186 A.D. 781, 782 (1st Dep't 1919) (stating the popular theory that "every dog is entitled to one bite finds no support in the decisions of the courts of this state"); *accord* Conroy v. Sperl, 209 A.D. 804 (1st Dep't 1924); *accord* Palmer v. Hampton, 129 Misc. 417, 418 (N.Y.C. City Ct. N.Y. Cnty. 1927); *see also* Tessiero v. Conrad, 186 A.D.3d 330 (3d Dep't 1992) (stating "[t]he fact that an animal may have previously responded by biting does not automatically establish, as a matter of law, either vicious propensities or knowledge thereof").
14. *Bard*, 6 N.Y.3d at 599 (Smith, J., dissenting) (Judge Smith noted the majority's rejection of the Restatement made the Court of Appeals "the first state court of last resort to reject the Restatement rule").
15. *Id.* at 600.
16. *Id.* at 601.
17. Bernstein v. Penny Whistle Toys, Inc., 40 A.D.3d 224, 225 (1st Dep't 2007), *aff'd*, 10 N.Y.3d 787 (2008).
18. *Id.* at 226.
19. *Id.*
20. *Id.*
21. *Id.* at 227.
22. *Bernstein*, 40 A.D.3d at 224.
23. *Id.*
24. Bernstein v. Penny Whistle Toys, Inc., 10 N.Y.3d 787, 788, 886 N.E.2d 154, 155 (2008).
25. Petrone v. Fernandez, 53 A.D.3d 221 (2d Dep't 2008), *rev'd*, 12 N.Y.3d 546 (2009).
26. *Id.* at 221, 229.
27. *Id.* at 228.
28. *Id.*
29. Petrone v. Fernandez, 12 N.Y.3d 546, 550, 910 N.E.2d 993, 996 (2009).
30. *Id.*
31. *Id.* (citing Bard v. Jahnke, 6 N.Y.3d 592, 599, 848 N.E.2d 463, 468 (2006)).
32. *Id.* at 551. (J. Pigott, concurring).
33. *Id*. at 552.
34. Hastings v. Sauve, 94 A.D.3d 1171, 941 N.Y.S.2d 774 (3d Dep't 2012) *rev'd*, 21 N.Y.3d 122, 989 N.E.2d 940 (2013). Defendant, William Delarm, assisted by defendant, Albert Williams, operated a cattle-shipping business and used a corral on property owned by defendant, Laurier Sauve, to temporarily store the cattle, including the cow in question, before they were shipped for slaughter. There was evidence that the fence separating Sauve's property from the road was overgrown and in bad repair.
35. *Id.* at 1173.
36. *Id.*
37. *Id.* at 1172.
38. *Id.*
39. *Id.*
40. *See, e.g.,* Collier v Zambito, 1 N.Y.3d 444, 447 (2004) (stating that an animal that behaves in a manner that would not necessarily be considered dangerous or ferocious, but nevertheless reflects a proclivity to act in a way that puts others at risk of harm, can be found to have vicious propensities).
41. Filer v. Adams, 106 A.D.3d 1417, 1419, 966 N.Y.S.2d 553, 556 (3d Dep't 2013) (stating that while dogs are not listed as domestic animals, they have been treated as such under common-law).
42. *Hastings*, 21 N.Y.3d at 126.

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The Most Important Issue in Every Ground Lease

By Joshua Stein

When a property owner and a developer negotiate a long-term ground lease of a development site, one issue overshadows almost all others: how should ground rent adjust over time to protect the property owner, as lessor, from inflation? And how can the lessor participate in future increases in value of this particular site, which may or may not correlate with inflation? At the same time, though, how can the developer assure that its leasehold position will also maintain its value without becoming overwhelmed by rent payments that no longer make any business sense?

TYPICAL APPROACH • Lessors and lessees typically resolve these concerns by agreeing that every two or three decades, they will reappraise the development site that the lessor originally delivered to the transaction. In my experience, the ground rent will then adjust to equal six or seven percent of the then-current fair market value of the site, i.e., whatever someone would pay to purchase the development site. Until that happens, rent may go up a bit every year or few years[1]—or not, especially in older ground leases. In most cases, the rent never drops.

The reference to six or seven percent in rent adjustment formulas has remained remarkably stable for quite a while, even through the very low interest rates of the last few years.

Although ground leases typically use the approach just described, prospective ground lessees sometimes worry that if a ground rent adjustment occurs in a low-interest rate period like today's, the typical approach may overcompensate the lessor, leaving the lessee paying ground rent that may feel excessive. Once the adjustment occurs, this approach might diminish or even destroy the value of the leasehold estate.

LENDER'S CONCERNS • Leasehold lenders, generally even more conservative than developers and investors, will likewise fear that a massive increase in ground rent at some distant date will diminish or destroy the security for their loans. Though "cowboy" developers may sometimes take risks, lenders rarely have the same mindset, and they never forget that the obligation to pay ground rent is always structurally senior to any leasehold lender's collateral.[2]

In response to these concerns, a lender or prospective lessee will sometimes suggest a "cap" on ground rent adjustments. Typically, though, a lessor will regard any such proposal as a non-starter, because it necessarily undercuts the protection that the lessor wanted to achieve through the future ground rent adjustments.

Applying a fixed percentage to future land values will create problems for both a lessee and its lender—and wonderful results for the lessor—if, at the moment of the rent reset, valuations in the larger real estate market use capitalization rates significantly below six percent. At any such time, real estate values will reflect a capitalization of future income at, say, four percent, but the ground lease will require payment of ground rent at, say, six percent of that capitalized amount, which may put the lessee in an untenable position and undercut or destroy the value of the lender's collateral.

LINKAGE TO INTEREST RATES? • Some ground leases try to mitigate these risks by replacing a fixed adjustment percentage with a percentage tied to interest rates at the time of the rent reset. The parties might choose a long-term rate like 20-year Treasury securities, or, more unusually, they might use a shorter-term one like the prime rate. In either case, they would look at the average level of that rate over some period and then add on some spread.

Although some commentators may have seen a trend toward this type of formula, I have not seen it. Like many of the comments in this article about "typical" practice, my failure to note the trend might only reflect the particular universe of ground lease transactions that I have personally been involved with or seen recently. Or it could reflect a view in the market that in the long run—i.e., multiple business cycles—six or seven percent has worked reasonably well, and that there's no reason to believe it will stop working anytime soon.

Of course, if a "typical" rent reset occurs in a real estate depression—or at any time when valuations use very high capitalization rates—the lessee may get lucky.

As an alternative, a ground lease could theoretically refer to some objective third-party index for long-term capitalization rates for real estate investments at the time of the rent reset. And, very occasionally, the revaluation might direct the appraisers to determine the new rent based generally on market conditions for newly negotiated ground leases at the time of the rent reset. In other words, the rent would adjust to equal "fair market rental value" at the time of adjustment, without using any formula to derive the rent adjustment from land value or anything else. The drafters of the ground lease must still define with absolute clarity how fair market rental value is to be determined. They also must define any assumptions the appraisers should consider in that process.

VALUATION ON A RANGE OF DATES • Ground lease negotiators sometimes suggest that instead of valuing the site on a specific date, the valuation should look to a range of dates, using the average value over, say, a three- or five-year period whose midpoint is the intended rent reset date.

That approach may make some sense. Suppose a rent reset used a single fixed valuation date of October 1, 2008, two weeks after the Lehman Brothers bankruptcy filing. Given the state of the financial and commercial real estate worlds on that date, the lessor would probably feel victimized by a very low valuation. Going forward, that particular lessor might favor using an average of the values on multiple dates over multiple years.

Valuation on a range of dates would not need to require a complete reappraisal each time; perhaps the only full appraisal would precisely tie to the midpoint date. The other dates could require only adjusted appraisals, taking into account only certain elements of the appraisal analysis, such as then-current capitalization and vacancy rates.

Lessors and lessees generally prefer, however, to avoid the time, expense, and logistical difficulties of dealing with multiple appraisal dates. They tend to feel that way even though an average of multiple appraisals might make the calculation less arbitrary. The use of a single bright-line date introduces a greater element of luck for both parties, but both seem generally willing to take their chances.

The need to periodically revalue the site for the purposes of ground rent adjustment practically invites litigation or arbitration. For obvious reasons, lessor and lessee will have dramatically different ideas of the value of the land, or of how the appraisers should proceed, particularly as markets and other circumstances change. The exact wording of the ground lease, and how it addresses those possible changes, becomes crucially important in determining what exactly the appraisers should appraise and how they should go about it.

For instance: should the appraisers appraise raw land, or should they include improvements? Should they include the improvements that existed on the site when the parties signed their lease, or whatever improvements exist at the time of revaluation? This is a common disagreement. The lease should entirely pre-empt it. In general, the appraiser should try to replicate whatever existed when the parties signed the lease, usually vacant land. To avoid confusion, the lease should say that as clearly as possible.

GROUND LEASES OF MORE THAN JUST GROUND • If improvements existed at lease inception, and the lessor initially demised those improvements to the lessee along with the underlying "ground," the market will often still regard the transaction as a "ground lease," even though it covers existing improvements and not just ground. The characterization as a "ground lease" would depend largely on whether the lessee's rights and obligations looked more like ownership (an investment transaction and typically regarded as a ground lease) or mere rights of occupancy not readily salable or financeable in the market (a "space lease").[3]

If a ground lease covers improvements that existed at the time of lease inception, the rent reset should usually consider only the improvements as they existed at that time. The rent reset clause might, however, require the appraisers to take into account any upgrading or expansion that the lessee accomplished. This effectively forces the lessee to pay rent in exchange for value that the lessee rather than the lessor created or provided. Forcing the lessee to pay twice for whatever (re)development the lessee accomplished—once when doing the work, a second time by paying adjusted rent based on the completed work—hardly seems "fair." Fair or not, the lease language should resolve that question and not leave it to courts, appraisers, and arbitrators.

FUTURE CHANGES IN THE SITE • Any ground lease negotiator also should consider possible future disconnects between the development potential of raw land (assumed to be unimproved) and the actual physical development that exists on the site at the time of any rent reset.

For example, changes in zoning or other law could change the value of the site, if it were priced as hypothetical raw land. For the rent reset, though, the parties need to think about one minor detail: if the transaction played out as the parties originally anticipated, then by the time of the rent reset the lessee will have already built improvements on the land. At the time of the rent reset, those improvements will probably not be obsolete—i.e., ready for demolition or major redevelopment.

If zoning at the time of the rent reset would allow much more development than the building already in place at that time, then that upzoning does not help the lessee very much. If the lessee must pay rent for newly created development potential that the lessee cannot really use, then the lessee's leasehold may no longer make economic sense. Conversely, if zoning changes have reduced the permitted development on the site, but the lessee's improvements are now overbuilt and can remain as a legal nonconforming use, then the lessor would argue that the revaluation process should ignore the down zoning.

Another question along those same lines: should newly discovered environmental issues affect the land value? The answer will depend in part on which party bears the risk of unexpected environmental conditions, taking into account the terms of the ground lease. And what if some government decides to issue a landmark designation for the existing improvements?

Lessors and lessees might also find themselves fighting over whether any appraisal of the land should, in appraising the land, "consider the terms of the lease," a concept that appears in many older ground rent adjustment clauses and a few newer ones. The whole concept seems circular. That's because the value of the lessor's land, if considered subject to the terms of the lease, will depend largely on the amount of the ground rent, assuming the lessee is reasonably likely to actually pay that ground rent. Thus, it may not make sense—it seems circular—to consider the ground rent in measuring the value of the land for purposes of determining the ground rent.

One can eliminate the circularity by deciding that the parties probably meant that any valuation should take into account any lease terms that limit permitted uses or other rights of the lessee.

For example, land will have a higher value if it can be used for "any permitted use." If, on the other hand, the lease says the lessee can use the site only to construct a "car wash with ancillary coffee shop," regardless of what the law might then allow, then that limited range of uses—if applied to the land value as part of the appraisal process—will drive down the value of the land. In this case, "considering the terms of the lease" means accounting for how much those terms decrease the value of the land. It makes sense: if the lease only allows the lessee to construct a car wash with an ancillary coffee shop, the lessee should not pay rent for the right to build a 50-story office building, even if zoning law might allow it.

But "considering the terms of the lease" could also mean something more. It could also mean the appraisers should consider anything else in the lease, except ground rent, that increases or decreases the value of the lessor's position. For example, if the lease gives the lessee a below-market purchase option, this will lower the value of the lessor's position. And what if the lease requires the lessor to deliver to the lessee some nonstandard but expensive service? Is that a term of the lease that the appraisers should consider in valuing the land "considering the terms of the lease"? Again, these are fascinating questions. Litigators and courts and expert witnesses could have a lot of fun and deep thought resolving them. We shouldn't give them the chance. Again, the words of the lease should leave no uncertainty.

If the lease has only a decade or two remaining in its term, then an appraisal "considering the terms of the lease" should perhaps consider the fact that, as an economic matter, the lessee doesn't have enough "useful life" left to justify a major construction or redevelopment project. Should the appraisers consider that as a negative in measuring the value of the land "subject to the lease"? Isn't the short remaining life of the lease a term that ought to be considered?

Over an extended period of time, differences of opinion on these and similar issues translate directly to dollars—lots of them. Any careful lease drafter should prevent the issue by avoiding any suggestion that the appraisers should "consider the terms of the lease." Instead, the appraisal clause in the lease should state exactly what circumstances warrant consideration, and what assumptions the appraiser should make. If the appraiser should consider the narrow scope of uses permitted under the lease, that's what the appraisal clause should say. If other particular provisions of the lease should increase or decrease value, identify those. And if the appraiser should disregard the terms of the lease entirely, that's what the appraisal clause should say.

Anyone writing a land value rent reset clause in a lease should consider asking appraisers whether they can understand and apply the language as written. After all, the hope is that appraisers rather than lawyers or courts will be the parties charged with interpreting and applying the words in the lease.

Even if the lease handles the panoply of appraisal issues correctly, the "standard formula" described above—six or seven percent of land value—will never precisely correlate with what the adjusted rent "should be" according to some "fair" view of the world. It is a crapshoot. But lessors and lessees often still take their chances, recognizing that there may be surprises while comforting themselves by knowing that this is the way everyone does it (or at least many people do it), and that lenders have underwritten and financed similar leaseholds for decades.

IS THERE A BETTER WAY? • Lessors and lessees do sometimes try to find a logically superior and perhaps less risky way to handle ground rent adjustments. They often start by suggesting that the ground rent should reflect the lessee's revenues, at least in part. The lessor could receive some percentage of "gross revenues," perhaps after modest deductions, and perhaps with a floor. That percentage might reflect the expected ratio between the value of the land and the value of the lessee's completed development project.

It sounds reasonable. But what if the lessee does not try very hard to rent space in the completed development project? Or occupies the space itself to conduct business? Or subleases the space to a chain store at below-market rents while simultaneously entering into an above-market lease with the same chain store in another state? What if the lessee does a lousy job with subleasing, or fails to invest the capital necessary to achieve the highest rents? And what should the lease allow the lessee to deduct? Leasing costs? Capital expenditures necessary to attract space lessees? If the lessee borrowed money to improve the property, should the lessee have the right to deduct debt service? Interest? At what rate? How does the lessor know the lessee is not lying or artificially reducing its revenues? Before long, the exercise reinvents the Internal Revenue Code.

If a lessor and a lessee do decide to go down that road, then they (particularly the lessor) should take a few measures to prevent disputes. Keep it dumb and simple, avoiding exclusions, complex characterizations, and fine lines whenever possible. They all provide fertile ground for misunderstandings, mischaracterizations, strategizing, gaming the system, and disputes. Try to give the lessor a low percentage of a broadly defined variable without too many deductions. Gross revenue with no deductions has a lot of appeal to it. Paint with a broad brush. Think about every possible circumstance that might occur and how it might play out given the lease language and definitions. Finally, ask an appraiser and a lender how they would interpret, and react to, whatever "brilliant" contingent rent clause the parties think they want to perpetrate.

Any contingent rent formula in a ground lease might also award the lessor a small percentage of capital transactions—lease assignments, refinancings, or other transactions tantamount to either. Here, too, the principles and issues above will arise, including the risk of recreating the Internal Revenue Code. And, again, any uncertainty about line drawing or inclusions or exclusions will breed disputes down the line.

For example, does a "refinancing" include the case where a lessee holds its leasehold free and clear, and places an entirely new mortgage on the leasehold? Can it be a "re"-financing if no financing existed before the transaction closed? Does "refinancing" refer to placing any form of financing on an asset that had previously been financed in some other way at any time, or does it merely refer to replacing one mortgage with another? Should the lessee's first construction loan be "exempt" from any payment to the lessor? First permanent loan? If multiple sales of the leasehold occur, should the lessor participate only in the "profit" since the last sale? What about multiple refinancings over time? If the lessor participates only in the "new loan proceeds," what if some of those loan proceeds arose only as a result of amortization of the previous loan?

These questions only scratch the surface of the issues that can arise once lessor and lessee start down the contingent rent road.

SMALL PERCENTAGES—NOT SO SMALL • Setting aside the many opportunities for dispute that arise in measuring any contingent rent, even a very low percentage of the lessee's gross revenues, can place a very significant burden on the lessee, and give the lessor a correspondingly significant stream of contingent rent. Suppose, for example, that the lessee agrees to pay the lessor three percent of a truly gross measure of revenue, with no meaningful deductions at all. Three percent sounds like a really small percentage.

Assume, however, that the lessee's operating expenses, real estate taxes, and insurance consume 50 percent of gross revenue. Assume ground rent consumes another 10 percent and debt service another 20 percent.

After those deductions, the lessee really gets to keep only 20 percent of the gross revenue. The lessor's three percent share of that gross revenue represents almost one-sixth of the lessee's bottom line. Moreover, a lessee might operate at a loss even though gross revenue seems substantial. In other words, instead of adding up to 80 percent of gross revenue the lessee's expenses could add up to 105 percent.

In all these cases, paying even a very small percentage of gross revenue to the lessor can put quite a dent in the lessee's bottom line. Assuming the lessee will consider the concept at all, the lessee might respond in part by trying to credit one ground rent stream against another—similar to the operation of a natural breakpoint with percentage rent in a retail lease or a right for a space lessee to offset real estate tax escalations against percentage rent. Similar considerations arise if the lessor will receive a percentage of refinancings, lease assignment proceeds, or other capital transactions.

As a variation, the parties could conceivably measure the lessor's participation in the lessee's operating revenue based not upon the lessee's actual earnings, with all the headaches that entails, but instead based on how much the lessee reasonably "should have earned" based on market conditions at the time of determination.

If the project consists of a an up-to-date office building, for example, the contingent rent determination could assume the lessee achieves the same occupancy rate and rental levels as other comparable buildings in the market, and expense levels consistent with similar buildings. In each case, the measurement would disregard the lessee's actual financial performance. The lessee would then pay contingent rent based on these benchmark market-based numbers.

Although this idea may sound practical or at least creative, the parties still must consider the possibility of future changes in circumstances, starting with a change of use of the building. And the lessee will worry that circumstances or issues peculiar to this property will prevent the lessee from achieving strong enough actual results to match the benchmark-based contingent rent the lease requires the lessee to pay.

Yet another possibility: the developer might agree to give the lessor a small "carried interest" in the lessee entity. Any carried interest will, however, raise another host of issues, some of them variations on the problems discussed earlier in this article. Many of the carried interest issues will arise from the fact that the developer will probably invest substantial additional capital to generate the anticipated value and return from the project. Another set of problems might arise from the lessor's concern that the developer could somehow redirect or dilute project income in a way that makes the carried interest worthless. Those two groups of issues only scratch the surface of what a carried interest might entail.[4]

If the parties do not want to agree to any form of contingent ground rent, the question then becomes: how else can the lease protect the lessor from inflation and equitably compensate the lessor, while protecting the lessee from destruction of its leasehold through an unaffordable rent increase?

OTHER INDEXES • One might tie periodic major rent adjustments to an index. For example, rent might rise with the consumer price index. People in real estate, particularly lenders, usually think the CPI goes up faster than real estate values and rents; hence, they may propose a cap on the adjustments.[5] But if the parties "cap" any periodic rent adjustment, then the lessor will not achieve its goal of protecting itself from inflation.

Perhaps the parties can find an index better than CPI; Class A office rents, average daily rate for hotel rooms in a certain market stratum, real estate tax assessments, or retail rents are all possibilities, in each case for some defined local geographical area. Real estate professionals may have varying degrees of confidence in any possible index. They would need to choose accordingly. Future changes in the chosen index would drive changes in the ground rent, regardless of what a particular lessee does or earns in the demised premises. Such an index could make sense, especially if it matched likely uses of the site. A combination of multiple indexes might also work, though it might not ultimately differ significantly from measuring contingent rent based on a marketplace benchmark of what the lessee "should have earned," as suggested above.

Ground leases once required lessees to pay rent equal to the dollar equivalent of a certain amount of gold. The federal government outlawed such clauses in the 1930s as part of the New Deal. Gold clauses became legal again for any "obligation issued after October 27, 1977."[6] A federal court validated such a clause as recently as 2008.[7] Gold clauses certainly would have protected lessors from inflation in the recent past. In the last few decades, gold clauses would have produced dramatic rent increases given the ever-increasing dollar value of gold, i.e., the plummeting value of the dollar as against gold.

Lessees, however, would fear a disconnect between the price of gold and the "right" rent, in dollars, for a given site over time. During the last few decades, any such fear would have been entirely justified. Looking ahead, however, a lessor may worry that gold has run its course, or that during the ground lease term gold might no longer function as a reliable repository of value. A lessor may also worry that a gold clause may not accurately reflect the future value of this particular site. The lessor might care more about that value than about the general value of the dollar.

RECALIBRATION OF RELATIVE VALUES • The parties could also try to devise a rent adjustment structure in which, over time, the lessor and the lessee will each maintain a position whose value always equals about the same percentage of the value of the project as a whole. In other words, whatever rent reset formula the ground lease used, it would contemplate a valuation of both the lessor's and the lessee's position, after taking into account the contemplated adjustment. Then the ground lease would also add a requirement—and, to assure it, perhaps another rent adjustment—that at the end of the day each party would maintain about the same percentage of the value of the project as a whole.

For example, if the initial ground rent were calibrated to give the lessor a position worth 34 percent of the project as a whole, then any future ground rent would need to be calibrated to maintain that percentage, taking into account market conditions at the time of any rent reset. This approach would still require appraisals and the headaches and uncertainties they create. It would, however, at least address each party's fear that, over time, the rent adjustment would shift too much value into the other party's pockets.

Although recalibrating relative values has a theoretical appeal to it, it is not at all market standard. In fact it is unheard of. And its appeal is complicated by the need to consider additional capital investment the lessee will make in the project, to upgrade it and increase its value, or even just to keep it functional and rentable on attractive terms. If the property's value as a whole increases as a result of the lessee's investment and brilliant development, leasing, and management strategies, how does one slice up the resulting profits? The issue becomes particularly troublesome if the lease demises a vacant site; it may be easier in an existing building. But the issues involved may not be all that different from those that arise whenever a ground lease requires appraisal of anything other than the actual building (and underlying land) on the site at the moment of appraisal.

Because of the ever-shortening duration of the remaining lease term, however, the lessee's leasehold estate is "supposed to" decline in value over time, requiring some further adjustment, particularly in the last few decades of the lease term. This could take various forms—each with its own unique bundle of trouble—all beyond the scope of this article, and most requiring substantial consumption of aspirin.

Instead of looking at relative shares of value, the parties might look at their relative shares of overall property income. The lease might start out by providing for a fixed rental stream with fixed bumps. But it could also say that if the lessor's share of overall gross revenue (or, less desirably, net operating income before ground rent) ever drops below a certain percentage, then the lessor can require an increase in ground rent to bring that percentage back to a certain level. This approach is not too different from the percentage rent discussed earlier. It is also a variation on the technique of "debt service coverage ratio" from real estate financing, except it refers instead to a "ground rent coverage ratio," with the goal of keeping it within a certain band.

Conversely, if as a result of those increases in ground rent the lessor's share ever rose beyond a certain percentage, then ground rent would drop, but never below the fixed rent schedule. Arrangements like these can give the lessor a form of participation in future upside without opening up the possibility of making the leasehold estate uneconomic. But, like so many other alternatives discussed in this article, these arrangements come with tremendous definitional issues and hence possible disputes. Moreover, they tempt the lessee to game the system in any number of ways.

RENT ADJUSTMENT TIMING • Anyone who negotiates future contingent rent adjustments in a ground lease should also consider how the timing of those rent adjustments interacts with the timing of a lessee's renewal options. In a lessee's perfect world, each rent adjustment period would correspond to an option term. The lessee would know the adjusted rent before needing to exercise a renewal option. As an equivalent alternative, the lessee could have the right to withdraw the exercise of an option if the lessee didn't like the rent as ultimately determined.

Both of those approaches, though perhaps typical, convert each option into a one-way negotiation in which the rent can only go down from whatever number the rent determination process produced. Of course, the leverage they give the lessee is roughly equivalent to the lessee's right to walk from the lease at any time. That walk-away right always gives any lessee the ability to try to negotiate the rent downward at any time. The ability to not exercise—or withdraw the exercise of—a renewal option creates much the same leverage.

The dynamic changes, of course, if the lessee has significant credit or a creditworthy guarantor, or if credit enhancement measures, such as a security deposit or a letter of credit, back the lessee's obligations. In those cases, the lessee can't so easily threaten to walk away from the lease, so the lessee truly realizes a benefit by knowing the adjusted rent before the deadline to exercise the renewal option.[8]

A more balanced approach might require the lessee to exercise each option before knowing the outcome of the rent determination process, with no right to withdraw the exercise of the option, only the right to walk away from the lease. The renewal options would be disconnected from the rent determination or renegotiation process, putting the parties in the same position—and giving each the same leverage—as if the rent adjustment occurred part of the way through the lease term, rather than as part of the renewal process.

Except for the possible need to conform to "tradition," it seems unnecessary and perhaps even inappropriate to tie the timing of rent adjustments to the timing of renewal options. In any case, it is not "obvious" that adjustment periods should conform to renewal terms.

REAL ESTATE DERIVATIVES? • Ground lessors and lessees might eventually hedge some risks of real estate inflation and ground rent adjustments through insurance or real estate futures markets, in much the same way farmers hedge commodity prices. But commercial real estate is not as fungible as pork bellies and corn. And, after some false starts with real estate derivatives during the boom that ended in 2008, it's safe to assume that brilliant new derivative products are not at the top of anyone's list. Great financial minds may bridge part of that gap, perhaps by insuring against inflation through puts and calls involving long-term TIPS bonds. That too has its risks and costs.

Lease negotiators typically worry that creative structures like those proposed in this article will not work right because of some problem or gap that no one notices until the litigation or arbitration begins and the parties and their counsel take out their magnifying glasses and apply them to the lease. It is a reasonable form of free-floating anxiety when trying to create something new and different that will work correctly for 99 years.

My own many recent experiences as an expert witness suggest that the commercial real estate industry and the lawyers who serve it categorically overestimate their own intelligence and ability to "get everything right" in the context of ever-more-complex deal structures and terms.[9] The more complex and creative the various gradations and nuances become, the more likely the parties will get them wrong, leaving land mines in the lease to produce unpleasant surprises when applied in the real world. The incredibly complex language and multi-page sentences that are so common in today's real estate documents often manage to include some imperfection. And, whenever writers of legal documents try to use words to define some future hypothetical that is intended to replicate a set of present known conditions—pretty much what one does in a land valuation rent reset—the fallibility of lawyers often becomes particularly apparent.

Legitimate fear of complexity, legitimate fear of change, and the constant need to satisfy future lenders will often drive ground lease negotiators back to the traditional rent adjustment formula described early in this article.

Endnotes

1. These annual increases, typically small, add up in a significant way over time. They sometimes take the form of a CPI increase, annually or every few years, subject to a low cap. That cap may apply to either: (a) each increase or (b) all increases, considered as a whole, since the start date. Which party will benefit more from which type of cap will not always be obvious. The measurement of that cap can create room for misunderstandings.
2. This assumes, of course, that the lessor does not agree to join in the leasehold mortgage, sometimes referred to colloquially and incorrectly (and, in the eyes of some courts, almost humorously) as "subordinating the fee." In today's market, that assumption is almost always

correct, so this article accepts it as part of the territory.

3. Can a ground lease demise part of a building? Must a ground lease demise at least some ground as part of the transaction? To define a transaction as a ground lease, the author would look to the character of the leasehold estate created—the terms of the ground lease—and not place great emphasis on whether the lease demises any ground. Others, including perhaps *Black's Law Dictionary*, disagree.

4. Many of these issues also arise in negotiating a joint venture. *See* Joshua Stein, *Agenda for a Joint Venture Agreement*, The Practical Lawyer, April 2010, at 36, (www.pdf2go.org/165.html).

5. Historically, over any extended period the CPI has actually risen only 2% to 3% a year, despite perceptions of wild inflation over many years. Some periods of very high inflation did occur, of course, but looking back over the long term the CPI has not grown all that dramatically. It has certainly not been "out of control" over the long term. Commercial real estate values considered as a whole over the entire United States have trailed the CPI (except in Manhattan, where they have barely matched it). These statements are all wild overgeneralizations—they should not be relied upon in any way or even taken very seriously—but they do summarize the author's non-authoritative but also nontrivial research in the area. Further insights on these issues will be welcomed.

6. 31 U.S.C. § 5118(d)(2)(1997).

7. 216 Jamaica Ave., LLC v. S & R Playhouse Realty Co., 540 F.3d 433, 441 (6th Cir. 2008).

8. In a typical ground lease, the creditworthy lessee's "walk-away exposure" may not be all that great. Most leases, including ground leases, allow a lessor only two major forms of recovery upon a lessee's default. First, the lessor can sue for the rent every month. Second, the lessor can sue the lessee for the excess, if any, of the fair market rental value over the reserved rental for the remaining lease term, discounted to present value. In a typical ground lease, almost by definition, no such excess exists: the lease has value to the lessee precisely because the ground rent is below fair market value rather than above fair market value. That fact precludes the lessor from suing for a large and attention-getting lump-sum award if a creditworthy lessee decides to walk away. To recover, the lessor must leave the lease in place and keep suing the lessee every month for unpaid rent, which the lessor might not find too appealing. The comments in this footnote may imply that lessors and their counsel should think more about the measure of damages if a creditworthy lessee does decide to walk away from a ground lease. Of course, the lessor may happily recover possession of a completed building and call it a day.

9. For more on this topic, *see* Joshua Stein, *It's Complicated, But is it Right?*, The Mortgage Observer, February 2013, at 12. The author's expert witness assignments mostly involve complex and nuanced documents for large transactions. Aside from ground leases, the line-up often includes joint venture agreements; development agreements; intercreditor agreements; and loan documents, particularly nonrecourse clauses and carveouts. With the help of great minds, these documents cover every possible eventuality perfectly except, it seems, the one eventuality that actually occurs; hence, the litigation.

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Bergman on Mortgage Foreclosures: Danger in Settlement Negotiations Redux

By Bruce J. Bergman

If there was ever a time that foreclosing lenders were under pressure to settle cases—at least those involving home loans—today is the time. Courts insist upon it; the government demands that it be done and there is the mortgage lender or servicer's own desire to achieve a performing loan. So there can hardly be anything wrong in pursuing some settlement path—except that in actuality, danger lurks if the lender or servicer does not assiduously make clear its position.

To immediately make the point, a foreclosure can be upset at any stage if the borrower comes forward and convinces a court that he thought settlement negotiations were proceeding and that he therefore was not obliged to defend the case. We called attention to this anomaly at some greater length in our *New York Law Journal* article of December 31, 2008 entitled "Entertainment of Settlement Could Backfire on Lender," at 5, col. 2. [Reference there for the noted lengthier review is invited.] And it has happened again in a recent case: *Wells Fargo Bank, N.A. v. Chateau*, 36 Misc.3d 280, 947 N.Y.S.2d 773 (2012).

We hasten to observe that this is rarely an issue in a commercial foreclosure, a notation which supplies an enlightening thought. As many readers will recognize, in the commercial foreclosure action, the typical magnitude of the case, and as a matter of custom, the foreclosing plaintiff has both the wherewithal and the desire to assure that settlement negotiations do not lead to borrowers' untoward claims that some concession had been made by the lender. This is accomplished by the lenders' insistence that borrowers sign a pre-negotiation letter before discussions can proceed. Among other things, such a letter provides that no change in the mortgage document obligations is arrived at unless there is a new writing signed by the plaintiff and that the foreclosure proceeds during any settlement negotiations, all without waiver of any of the plaintiff's rights. [There is more to it than this, and for those who wish to explore it, attention is invited to 2 *Bergman on New York Mortgage Foreclosures* §24.07, LexisNexis Matthew Bender (rev. 2012)].

This formality, however, is rarely pursued in the residential foreclosure case, which then leaves lenders and servicers open to a possible charge that a borrower believed settlement was in the offing. The case which was the subject of the earlier-mentioned article is worthy of revisiting, but we will move on to the new case since the article can be consulted.

In the recent case, a borrower had defaulted in the foreclosure action and later moved to vacate that default claiming that his lawyer had failed to interpose an answer. For reasons not particularly relevant here, the court was unimpressed with that excuse. In addition, though, the borrower stated that its (inattentive) attorney had assured him that the foreclosure action would not proceed while negotiations took place and that his counsel had made five attempts to obtain a loan modification.

Although all this lacked any documentary support (upon which basis we opine the court could have rejected them) the court also found that the assertion was combined with the borrower's claim that his failure to timely respond to the complaint was also due to his good faith belief in settlement negotiations. The court then ruled that such a good faith belief will supply a reasonable excuse for failure to timely answer.

While it sounds like the borrower's belief was based upon what his own attorney told him, rather than any representations by the servicer, there was nevertheless some indication that the servicer was entertaining the possibility of a settlement, i.e., perhaps by way of mortgage modification.

The failure here—what led to the court allowing the borrower to vacate the achieved stages of the action—was the absence of a lender written declaration that the foreclosure action was proceeding apace, notwithstanding any possible negotiations or any consideration of a mortgage modification. Without that, the door was open for the court to do what it really wanted to do—give the borrower a chance to submit an answer.

The ultimate damage was that an answer would require a motion for summary judgment and all the expense and delay that portends. It likely could have been avoided by a more dedicated approach to the settlement process—and such is the lesson of the cited case.

Mr. Bergman, author of the three-volume treatise, *Bergman on New York Mortgage Foreclosures*, LexisNexis Matthew Bender, is a member of Berkman, Henoch, Peterson, Peddy & Fenchel in Garden City. He is a fellow of the American College of Mortgage Attorneys and a member of the American College of Real Estate Lawyers and the USFN. His biography appears in *Who's Who in American Law* and he is listed in Best Lawyers in America and New York Super Lawyers.

Student Case Comments

Wells Fargo Bank, N.A. v. Meyers: Second Department Provides Guidance on Remedies for a Breach of CPLR 3408(f)

New York CPLR 3408, a statute requiring mandatory settlement conferences in certain residential foreclosure actions, was amended in 2009 to help more homeowners avoid foreclosure during the subprime mortgage crisis.[1] The amendments included CPLR 3408(f), a provision requiring that "both the plaintiff and defendant shall negotiate in good faith to reach a mutually agreeable resolution, including a loan modification, if possible."[2] However, CPLR 3408(f) does not provide any specific remedy for failure to negotiate in good faith.[3] The lack of such a remedy was the issue considered by the Appellate Division, Second Department, in *Wells Fargo Bank, N.A. v. Meyers*.

In 2009, Wells Fargo commenced an action to foreclose on mortgaged premises held by defendants Paul and Michela Meyers.[4] Defendants sought a loan modification from Wells Fargo in 2008 but were told that they needed to default for a period of three months in order to qualify for a modification.[5] The Meyers had not previously defaulted on any of their payments.[6] After defaulting, defendants were accepted into a loan modification program and received a trial modification offer in August 2009 from Wells Fargo under the federal Home Affordable Modification Program (HAMP).[7] This first trial modification offer required the defendants to make three trial payments and indicated that Wells Fargo would not foreclose on the mortgage during the trial period.[8]

Despite defendants' compliance with the terms of the first trial modification offer, Wells Fargo commenced a foreclosure action on September 2, 2009. Soon thereafter, Wells Fargo informed defendants that due to a "miscalculation" a second three-month trial modification period was required.[9] Defendants accepted the second trial modification offer and complied with it but were ultimately informed that their request for a final loan modification was denied because they did not qualify for a HAMP modification.[10] However, thereafter Wells Fargo offered defendants a third trial modification offer that defendants could not afford.[11] Defendants were forced to reject the third offer. After the parties could not reach a settlement the Supreme Court scheduled a hearing to determine if Wells Fargo had negotiated in good faith pursuant to CPLR 3408(f).[12]

Following a hearing, the Supreme Court found that Wells Fargo failed to negotiate in good faith and, invoking its powers in equity, ordered Wells Fargo to execute a final loan modification based on the terms of the original loan modification and directed a dismissal of the foreclosure complaint.[13] Wells Fargo appealed from this order and the Second Department granted leave to appeal.[14] On appeal, the Second Department saw no reason to disturb the Supreme Court's finding that Wells Fargo had not negotiated in good faith. However, the court held that the Supreme Court's remedy was not authorized by the statute. Indeed, the court's attempt, in effect, to rewrite the mortgage and loan agreement would violate Wells Fargo's rights under the Contract Clause of the U.S. Constitution.[15] Finally, the Supreme Court's determination violated Wells Fargo's due process rights, since it was not on notice the court was considering the remedy it imposed.

The Second Department held that "it is obvious that the parties cannot be forced to reach an agreement, CPLR 3408 does not purport to require them to, and the courts may not endeavor to force an agreement upon the parties."[16] In support of this holding, the Second Department characterized the original trial modification as a trial arrangement and not as an agreement imposing binding obligations on both parties.[17] Alternatively, the Second Department noted that "even if the HAMP trial period was an agreement, it is not subscribed by the party against which it is intended to be enforced."[18] The Appellate Division reversed and remitted the order of the Supreme Court.

Hoping to provide some guidance, the Appellate Division noted several alternative remedies that have been imposed by the lower courts for failure to negotiate in good faith pursuant to CPLR 3408(f). These include the imposition of exemplary damages, stay of the foreclosure proceedings, monetary sanctions, and dismissal of the action.[19]

Endnotes

1. Wells Fargo Bank v. Meyers, 966 N.Y.S.2d 110 (N.Y. App. Div. 2013).
2. *See* CPLR 3408(f) (McKinney 2013) (establishing a good faith negotiation requirement in foreclosure settlement conferences).
3. *See Meyers*, 966 N.Y.S.2d at 110; *see also* CPLR 3408(f) (McKinney 2013).
4. *Id.*
5. *Id.* at 110-11.
6. *Id.* at 111.
7. *Id.* (explaining the trial modification offer requirement of the Home Affordable Modification Program).
8. *Id.* (noting that defendants did not expect plaintiff to foreclose based on plaintiff's representation).
9. *Meyers*, 966 N.Y.S.2d at 111.
10. *Id.*
11. *Id.* at 111-112.
12. *Id.* at 112.
13. *Id.* (citing Notey v. Darien Constr. Corp., 41 N.Y.2d. 1055 (1977)).
14. *Meyers*, 966 N.Y.S.2d at 114.
15. *See id.* at 115, 117; *see also* U.S. Const. art. I, § 10, cl. 1 (West).
16. *See id.* at 116; *see also* CPLR 3408(f) (McKinney 2013).
17. *Meyers*, 966 N.Y.S.2d at 116 (characterizing the original trial modification agreement as a trial arrangement).

18. *Id.* at 116-117 (quoting HSBC Mortg. Corp. (USA) v. Gigante, 2011 N.Y. Slip Op. 33327(U) (N.Y. Sup. Ct. 2011)).
19. *See id.* at 116; *see also* Bank of Am., N.A. v. Lucido, 2012 N.Y. Slip Op. 50655(U) (N.Y. Sup. Ct. 2012) (establishing imposition of exemplary damages as a remedy for a 3408(f) breach); Deutsche Bank Trust Co. of Am. v. Davis, 2011 N.Y. Slip Op. 51238(U) (N.Y. Sup. Ct. 2011) (establishing imposition of monetary sanctions or staying the foreclosure proceedings as remedies); Wells Fargo Bank, N.A. v. Hughes, 2010 N.Y. Slip Op. 20081 (N.Y. Sup. Ct. 2010) (establishing dismissal of the action as a remedy).

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* * *

White v. Farrell: The Measure of a Seller's Damages for a Buyer's Breach of Contract to Sell Real Property Is the Difference Between the Contract Price and Fair Market Value of the Property at the Time of the Breach

On March 21, 2013, the Court of Appeals of New York held in *White v. Farrell* that the measure of a seller's damages for a buyer's breach of contract to sell real property is the difference, if any, between the contract price and the fair market value of the property at the time of the breach.[1]

In May 2004, Dennis and Nancy Farrell, defendants, listed their house for sale. The house was located in Skaneateles, New York.[2] On June 12, 2005, the Farrells' real estate agent showed the property to plaintiff Paula White and her now-deceased husband, Leonard.[3] That day, "the Whites signed a contract to buy the property for $1.725 million."[4] On July 7, 2005, the Whites' attorney notified the Farrells' attorney that the Whites were terminating the contract because of a drainage problem that might "never be rectified."[5] In fact, the Whites signed a contract to purchase another piece of property on July 23, 2005 for $1.7 million.[6] Almost a year later, on June 6, 2006, the Whites filed suit against the Farrells to recover their down payment, and the Farrells counterclaimed for damages for breach of contract.[7]

The Court of Appeals noted it had never considered the measure of damages for a buyer's breach of contract. The court opted to measure damages recoverable by the seller for a buyer's breach of contract as the difference between the contract price and fair market value of the property at the time of the breach.[8] The court noted that this is a longstanding rule in New York adopted by many appellate decisions dating back to 1916.[9] Further, the court found this measure of damages is followed in other states, and is consistent with the "general contract principle[]" that damages are tied to the date of the breach.[10] The court then chose to remit the case to the Supreme Court to determine the amount of damages recoverable in this case.[11]

To guide the Supreme Court, the Court of Appeals clarified that the resale price is relevant in determining damages.[12] In fact, the resale price can be "very strong evidence of fair market value at the time of the breach," when the amount of time between default and resale is short, "market conditions remain substantially similar," and the contracts have comparable terms.[13] The court further explained the facts that the Supreme Court will need to consider when deciding the damages issue.[14] These facts include that the Farrells' real estate agent, Ms. Roche, opined that the value of the property on the date of the breach was $1.725 million, the same as the amount in the Farrells' contract with the Whites.[15] Roche's opinion is subject to dispute, however, because the Farrells sold the property for $1.377 million on January 11, 2007.[16] Further, the court advised the Supreme Court to consider any differences in market conditions and contract terms, whether the Farrells sufficiently mitigated their damages, and "the cost to remedy the property's drainage deficiencies.…"[17] Judge Pigott dissented.[18] Judge Pigott argued that the better rule is to allow the seller to resell the property and recover the difference between the unpaid contract price and the resale price, "less expenses avoided because of the buyer's breach."[19] This rule, captured in the Uniform Land Transactions Act, provides certainty to parties and affords more protection to the seller than the majority's rule.[20]

Endnotes

1. 20 N.Y.3d 487 (2013).
2. *White v. Farrell*, 20 N.Y.3d 487, 489 (2013).
3. *Id.* at 490.
4. *Id.*
5. *Id.* at 491.
6. *Id.*
7. *White v. Farrell*, 20 N.Y.3d at 492.
8. *Id.* at 499-500.
9. *Id.* at 499.
10. *Id.*
11. *Id.* at 501-02.
12. *White v. Farrell*, 20 N.Y.3d at 499.
13. *Id.*
14. *See id.* at 501.
15. *Id.*
16. *Id.*
17. *White v. Farrell*, 20 N.Y.3d at 501-02.
18. *See id.* at 502.
19. *Id.* at 502-03.
20. *Id.* at 503.

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