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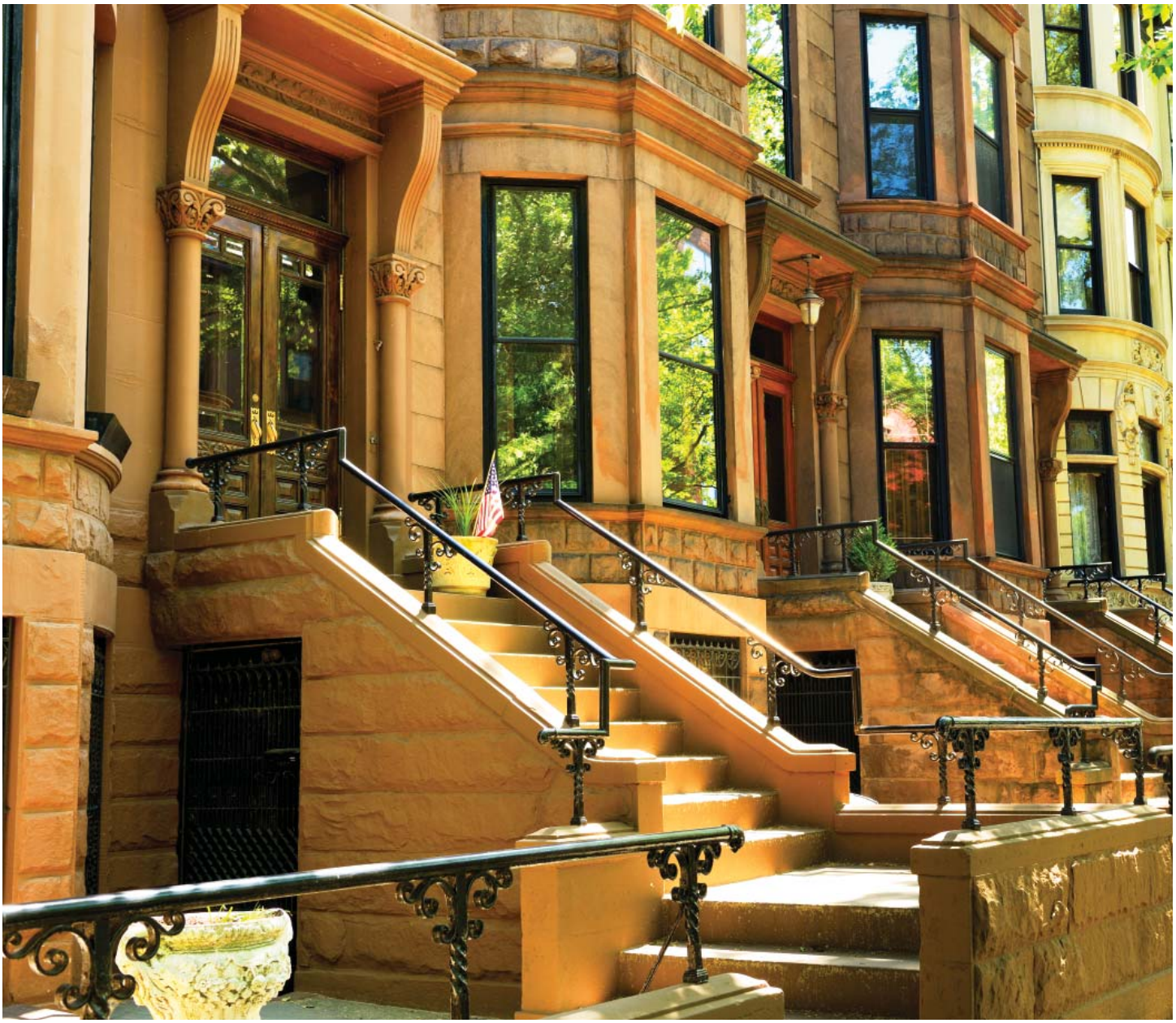

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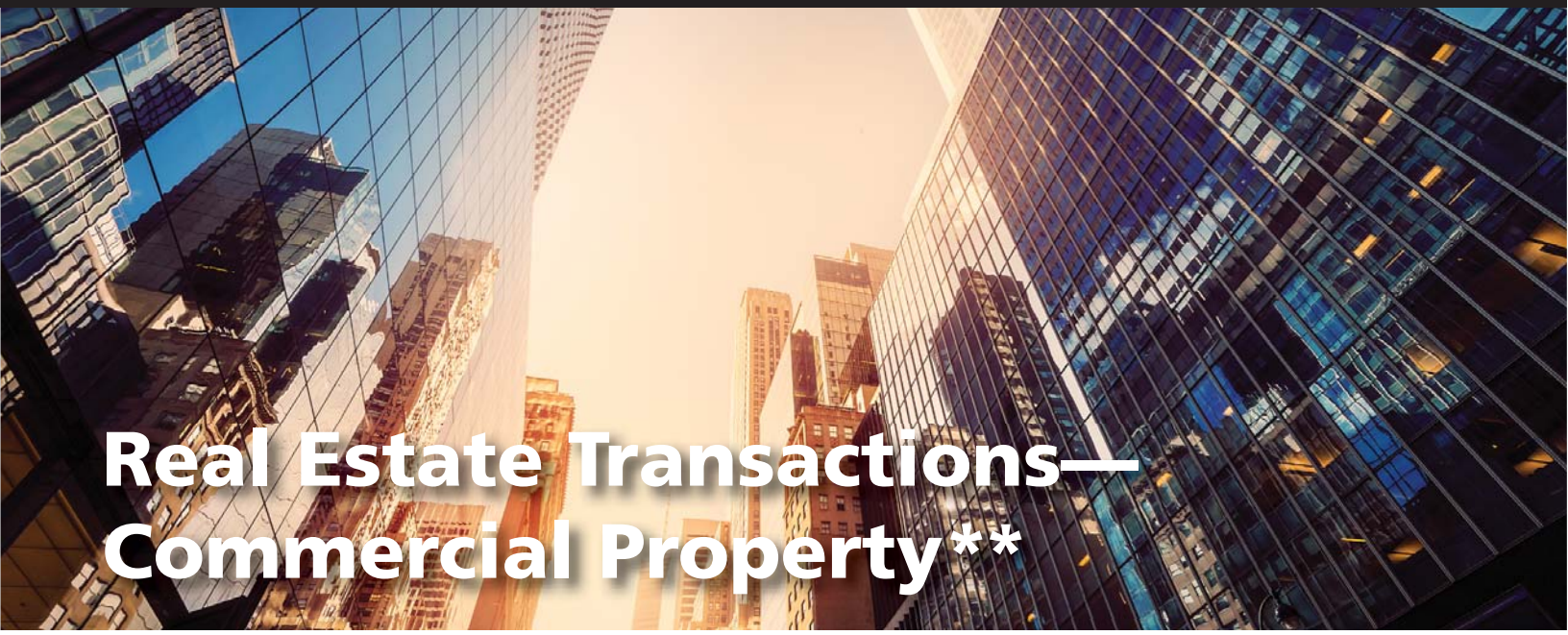

Real Estate Transactions—Commercial Property**

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Author

Christina Kallas, Esq.
Attorney at Law, New York, NY

A must-have for real estate practitioners, this practice guide provides an overview of the major issues an attorney needs to address in representing a commercial real estate client and suggests some practical approaches to solving problems that may arise in the context of commercial real estate transactions.

The 2016-2017 release is current through the 2016 New York State legislative session.

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Message from the Outgoing Chair

My predecessors warned me that my year as Chair would be over in a New York minute. Now I know why. As I contemplate the end of my tenure, I want to both express my gratitude to my colleagues and issue a call to action to all current and future Section members.

First, heartfelt thanks to my fellow officers, my colleagues on the Executive Committee and the Association staff. Your commitment to the continued success and vitality of our Section is awesome and inspiring. You have extended every courtesy to me personally, and made this a most excellent adventure. Thank you for making it so much fun.

As for my call to action, I offer the following:

Professionalism is and should remain a hallmark of our Section. We promote it through our CLE offerings, discourse in our Community, the forms we produce for statewide use, encouraging practitioners in other Sections to learn from ours, and by reminding you—our members—that one of the key values of membership is being able to stay current on the law through Section resources. To enjoy the satisfaction from our work we seek, we must continue to aim for excellence in all of our professional endeavors. If you are not an active member, you are missing the opportunity to step up your game. What are you waiting for?

Diversity remains an elusive goal for our Section, but one that we are fully committed to, and should continue to strive for. We are a collegial, inclusive group, and want both the Section leadership and our membership at large to address the real estate related concerns of every spectrum of our society. Please help us do so by getting involved and bringing to the Section leadership's attention the issues of concern to you and your clients and constituents.

We have one of NYSBA's most active and well-respected Communities. We should explore better ways to use it to keep our members informed and promote active membership. Your suggestions are welcome. We want to hear from you!

We have engaged in joint projects with other associations in the past, and should continue to do so. The more participants we have embracing both the mission and the method for accomplishing it, the greater the impact. I extend an invitation to my colleagues in the real estate related committees of other associations to reach out to the RPLS leadership to discuss additional ways to collaborate for every dirt lawyer's mutual benefit.

Last but not least, I call upon all millennials to please help us connect with you more effectively, through social media, our Community, and other means, such as easily accessible online libraries for forms and checklists. You are our next generation of leaders. We are counting on you!

Mindy H. Stern

Message from the Incoming Chair

I am honored to assume the role as chair of the Real Property Law Section on June 1st. My thanks to Mindy Stern for her terrific leadership over the past year, which allows me to step into this position with the Section running smoothly and committees busy with myriad projects.

The District Representatives, with the support of Harry Meyer and Jaime Lathrop, our Membership Committee co-chairs, have played a vital role in getting the message out about what Section membership has to offer. The fact that our Section continues to grow attests to the variety and quality of projects that the various committees undertake. I encourage all of you, old and new members alike, to take your membership to the next level and take part in at least one additional Section activity during the next year.

The committees and task forces and their chairs are listed in the back of the *Journal* and on the Section's website. Check out the Guide to the Real Property Law Section to learn the mission of the Section's substantive committees and get a taste for some of their activities. You can also find the Guide on our website. Please join a committee of interest and become an active participant in one of their many projects. All of the committees welcome new input. I guarantee you will benefit both professionally and personally from your involvement.

At any given time the committees and task forces are planning continuing legal education programs, reviewing and commenting on proposed legislation and regulations, and preparing and updating forms to assist us in our practice. If you have thoughts about projects we might pursue to assist real property practitioners in New York, please contact me, your District Representative to our Section, or another member of the Executive Committee so that we can continue to address issues that are helpful to your practice and your professional development.

After our 2016 Summer Meeting in Boston, we are returning to New York for the 2017 Summer Meeting, which will be held in Lake Placid July 27-30. As always, you can expect continuing legal education to be interesting and informative. Afternoons and evenings will be free to enjoy the many activities Lake Placid has to offer. The Summer Meeting is a great opportunity to get to know your colleagues. If you are attending our Section's Summer Meeting for the first time, ask about discounts we are offering to first-time attendees who are members of the Real Property Law Section.

I look forward to working with my fellow officers—Tom Hall, First Vice-Chair; Jerry Antetomaso, Second Vice-Chair; Ira Goldenberg, Secretary; Spencer Compton, Budget Officer—and all of the members of the Executive Committee who are so generous with their time and talents.

Trish Watkins

My Updated Wish List for New York Real Estate Law

By Joshua Stein

About 12 years ago, I wrote an article for this *Journal*, consisting of a "wish list" of 12 changes I wanted to see in New York real estate law. The 12 changes I wished for would have simplified and streamlined the law and practice of real estate in New York, without substantively benefiting or hurting any particular group.

Today, 12 years later, not one of my wishes has been granted. In some ways, New York law has changed in ways that were the opposite of what I wanted.

Given my impressive batting average and impressively consistent results to date, I thought it would be a good idea to update and expand my wish list.

Each item in my original (and now expanded) wish list would remove complexity and unnecessary issues, excitement, or risks from New York real estate law. Some items are minor, such as eliminating documents in real estate closings. Few should be controversial. Of course, almost any proposal for change, however minor, may offend someone somehow or have unintended consequences that I have not considered. In that case, or if I have missed some compelling reason that existing law is terrific and requires no change, I apologize. When I next republish my wish list, I will fix my misguided comments.

New York real estate practitioners take for granted many of the existing headaches and gratuitous complexities of New York real estate law, as described in this article. New York real estate law does not have to be this way. But it probably will continue to be this way.

My wish list reflects only my own opinions, or perhaps fantasies, and only at the moment of writing—and, in the case of everything on my original wish list, without interruption for the 12 years since publication. My wish list is in no way tempered by considerations of practicality or how much interest and excitement my great suggestions may elicit in the Legislature.

If I were appointed tomorrow as grand commissioner to improve New York real estate law, here are the first changes I would make, ranked by importance:

1. Foreclosures

New York's nonjudicial foreclosure statute for commercial properties lapsed in 2009.[1] Legislative efforts to revive it have failed. It was an excellent statute while it lasted, with ample borrower protections and no application at all to residential foreclosures. The Legislature should have extended it. But it fell victim to bad timing. During the financial crisis, the Legislature did not want to touch anything that might speed up any foreclosure, commercial or residential. Nothing in the Legislature's views seems to have changed in the many years since the statute lapsed and the financial crisis ended. That leaves judicial foreclosure as the sole remedy in New York for a defaulted loan, even if the foreclosure is uncontested or consensual. Even in these latter cases, judicial foreclosure in New York often takes years to accomplish for no good reason.

If the Legislature reinstates nonjudicial foreclosure, as it should, then it should nevertheless adjust the previous statute in two ways.

First, the lapsed nonjudicial foreclosure statute did not apply to any commercial building where residential renters occupy more than about two-thirds of the units.[2] But what if the mortgagee has no interest in terminating residential leases, or does not have the option thanks to rent regulation? There, it is hard to see why a defaulting owner of an apartment building should be any more immune from nonjudicial foreclosure than a defaulting owner of an office building or a shopping center. Any reinstated nonjudicial foreclosure law should eliminate any exclusion for apartment buildings with more than four units, as long as the mortgagee does not try to terminate any residential leases by foreclosure. This change would, among other things, almost always help residential tenants by replacing a financially stressed landlord with one who probably paid less and borrowed less, and hence is under less stress and likely to better maintain and operate the building.

Second, the lapsed nonjudicial foreclosure statute allowed a court to set aside a sale of the property within a year, even after resale to a bona fide purchaser.[3] Although such a purchaser might be entitled to restitution, this provision caused legitimate concern for purchasers and their title insurance companies, which often refused to insure title on foreclosed properties until the full year had lapsed. In the face of that risk, purchasers hesitated to acquire those properties and invest in necessary improvements. So lenders had to take title to foreclosed properties and maintain and carry them for a year before selling them. But the former nonjudicial foreclosure statute gave borrowers and all other interested parties generous protections, including the right to require any foreclosing lender to proceed judicially. An extra one-year right to set aside a sale was just counterproductive and unnecessary. If the Legislature revives nonjudicial foreclosure, it should eliminate any possibility of setting aside a sale, to encourage lenders to place foreclosed commercial real estate back into the marketplace as soon as possible.

On the residential side, the Legislature has made the judicial foreclosure process even slower and more complicated by enacting multiple layers of borrower protections and procedural requirements. Those requirements, combined with an already overburdened court system, have produced extraordinarily slow timelines for foreclosures, even if uncontested. During that excruciatingly slow process, no one really knows who owns the property in foreclosure. Hence no one has much incen-

tive to maintain it. This helps produce so-called "zombie houses" and hurts neighborhoods. The Legislature should look hard at what it can do to speed up residential foreclosures while giving residential borrowers reasonable, but not excessive, protections.

2. Yellowstone Injunctions

New York commercial lease disputes often quickly become high-intensity full-blown litigations as a result of glitches in the Real Property Actions and Proceedings Law that artificially increase the stakes in the early stages of any landlord-tenant litigation. These glitches have existed for about five decades, long enough to have been fixed.

A commercial tenant will often seek a so-called Yellowstone injunction to try to prevent the landlord from terminating the lease for a nonmonetary default or sometimes even monetary disputes, because the landlord might be wrong.[4] This process often takes place on an emergency basis, late some Friday afternoon. In seeking a Yellowstone injunction, a tenant need not demonstrate a likelihood of success on the merits, a typical hurdle to injunctive relief.[5]

Courts grant these injunctions readily but then take their time—often lots of time—to decide the merits of the case. So tenants in default often use the process to delay for years the landlord's legitimate lease enforcement. A procedural protection becomes a substantive protection just because it takes so long.

The Legislature could readily eliminate all the Yellowstone excitement and some of the opportunities for delay by saying that if a court ultimately decides a tenant was in fact in default under its lease, then the tenant will have a last clear chance to cure the default to prevent termination, regardless of what the lease says. Any such rule would need to be accompanied by an absolute requirement for the tenant to continue paying fixed rent, perform any undisputed obligations, and perhaps deliver security for disputed obligations, while the court decides the dispute. Faster courts would help, too.

3. Mortgage Consolidations

Every New York commercial refinancing forces the parties to perpetrate a complex series of assignment, consolidation, and amendment documents, to say nothing of occasional splitters, spreaders, and lost note documentation, all to mitigate mortgage recording tax. This massive accumulation of complex paperwork (and potential spurious legal issues) could and should be replaced by a simple affidavit that discloses the tax already paid on the existing mortgage debt that encumbers the property. The borrower would then pay any incremental tax on new debt resulting from the current transaction. Lenders would have the same incentives they already do to assure payment of the right tax. With this change, though, we could eliminate mortgage chains, most lost note documentation, and the tedious task of drafting documents whose sole purpose is the continuation and manipulation of old mortgages.

4. Revolving Loans

New York theoretically imposes its mortgage recording tax on every re-advance of a substantial commercial revolving loan.[6] That position simply prevents New York real property from securing such loans. The Legislature should solve this problem, as well as some other similar problems that the mortgage recording tax creates for substantial modern multistate transactions. By making it possible for New York real property to secure a broader range of modern finance transactions, the Legislature would increase tax revenue.

5. Lien Law

New York law on mechanics' liens and construction loans is absolutely incomprehensible and unnecessarily complex. It creates a regime about which a famous lawyer for mechanic's lien claimants once bragged that for any construction loan he could always find some way the construction lender had violated the Lien Law. The Legislature should clarify and simplify this statute—translate it into English without changing its essential substantive concepts and requirements. Along the way, I would also make at least one substantive change: the Lien Law should make it possible for landlords to know with certainty that they can avoid exposure to liens resulting from a tenant's construction work. This might require a mechanism like the "notices of non-responsibility" seen in other states.

6. Single-Member Entities

The rating agencies and securitization industry have decided that New York law makes New York single-member limited liability companies less reliable and less issue-free than Delaware entities of the same type. This concern has moved much entity formation business to Delaware and created the need to involve Delaware counsel in major transactions. Whatever problems the rating agencies and the securitization industry have identified could presumably be fixed by thoughtful New York legislation that reproduces the benefits of Delaware statutory and case law on limited liability companies. The Legislature should also repair anything else that makes New York less hospitable than Delaware for forming routine entities for real property transactions.

7. Scaffold Law

The Scaffold Law is unique to New York State. Labor Law Sections 240 and 241 impose liability on contractors and property owners for gravity-related injuries that workers sustain regardless of their conduct on the job.[7] Many insurance policies exclude coverage for this liability. The law applies to both private actors and the City of New York. In a bizarre twist, the law shifts liability away from the people who can best manage it, the contractors who actually oversee work on the site, as opposed to owners. The law has produced huge amounts of litigation, much of it against the City. The typical lawsuit can be charac-

terized as spear fishing by the plaintiffs' bar. The law to some degree discourages public and private investment. It increases construction costs and clogs courts. At least one reform group estimates that the law's statewide cost exceeds that of major infrastructure projects. New York's Scaffold Law should be abolished or revised to: (a) establish minimum standards for safety equipment and training, with immunity for an owner that meets those standards; (b) adopt a comparative negligence standard to take into account a worker's negligence; and (c) make it easier for owners to shift these risks to the contractors that actually oversee the work being done.

8. Conditional Limitations

If a lease ends ten days after a landlord gives notice of termination for default, the landlord qualifies to bring a summary proceeding to recover possession. New York's common law calls this a "conditional limitation."[8] On the other hand, if the lease ends automatically when the landlord gives notice of termination for default, the landlord does not qualify to bring a summary proceeding and must bring a plenary action in Supreme Court. That is because the termination is considered to have arisen from a "condition subsequent," which does not qualify for a summary proceeding.[9] The distinction makes no sense. Legislation should eliminate it, to allow summary proceedings in both circumstances and to prevent a possible glitch in lease drafting.

9. LLC Publication

A New York limited liability company must publish notice of its formation in two newspapers for six weeks.[10] Failure to publish precludes access to the court system or at least constitutes grounds for dismissal of an action brought by the LLC that failed to publish—and embarrassment for counsel. The law ostensibly protects the public by letting people know information that might help them decide whether to do business with an LLC. In 2017, though, we now have this cool new thing called the internet. And the New York Secretary of State has a reasonably good website with information on LLCs. So New York's publication law serves no purpose beyond subsidizing some newspapers. New York is one of only a handful of states that still require publication. The Legislature should get rid of it.

10. Insured Closing Letters

Abstract companies and title agents often hold escrows for transactions where they will write title insurance. The parties to those escrows sometimes worry about possible malfeasance or loss of funds. So they ask a national title insurance company to backstop performance by the abstract company or title agent. In most states, national title insurance companies often issue "insured closing service letters" or "closing protection letters," to protect parties to the transaction from these risks. In New York, however, the Department of Financial Services (formerly the Insurance Department) says any such letters can relate only to issuance of a title insurance policy. For mix-ups in, e.g., handling of funds or documents, New York buyers and sellers just have a claim against an abstract company or title agent—neither of which typically has a substantial balance sheet. New York should eliminate this minor headache for closings by allowing national title insurance companies to backstop abstract companies and title agents in a meaningful way. (New York did recently enact a title agent licensing law designed in part to raise standards in that business,[11] but the concern remains.).

11. Online Information

New York City, primarily under the Bloomberg Administration, has done a great job of making real property information available online. Most real estate lawyers especially appreciate ACRIS, the Automated City Register Information System. Vast amounts and categories of other real property information are also available online, both through the City's website (www.nyc.gov) and elsewhere. Resources include www.oasisnyc.net and other websites that consolidate data. A few categories of information, such as building loan agreements, still cannot be viewed online but should be made available. And, ideally, the City would organize all the various City-operated online data sources so a single search would give the user access to all municipal information on a particular property.

12. Opaque Disclosure Law

Whatever may be the merits or wisdom of the State's Property Condition Disclosure Act, the text of the act is hardly a model of transparency and clear disclosure. The Act would probably flunk New York's Plain English Law, which imposes a fine of $50 for using incomprehensible language in a consumer contract.[12] The PCDA and similar statutes should be rewritten in Plain English to help serve the Legislature's goal of achieving broad and effective communication of useful information.

13. Simpler Mortgage Documents

The New York Real Property Law on its face seems to create two great tools to simplify New York mortgage documents. First, anyone can incorporate by reference a statutory form of mortgage defined in the Real Property Law, thus creating a one-page mortgage.[13] Second, anyone has the statutory right to record a master mortgage.[14] Future mortgages can incorporate that master mortgage by reference, again creating one-page mortgages. No one uses either tool.

The statutory mortgage deserves not to be used, because it is woefully deficient and does not meet elementary requirements of New York law. It is an embarrassment but no one cares. The master mortgage makes much more sense. A similar tool is widely used in, for example, California.

The Legislature should update New York's statutory form of mortgage to reflect current law, and should consider taking steps to encourage use of master mortgages. On the other hand, because longer mortgages create more recording fees, neither of these changes seems likely

to happen anytime soon. One may need to placate the county clerks by establishing a special high fee to record a master mortgage.

14. Assignments of Rents for Mortgage Loans

Why must a mortgage lender obtain a separate assignment of rents, beyond the assignment already in the mortgage? The answer: New York law does not really require a separate assignment. The law gives lenders a secondary security interest in the rents if the mortgage—which often includes an assignment of rents—is somehow invalidated. Lenders' lawyers use a separate assignment to preserve their remedies during a foreclosure and as a backup measure in case something goes wrong in the mortgage. How often does something go wrong in a mortgage? Not very often or at all, in my experience. And how often does a foreclosing lender actually exercise its rights under an assignment of rents, rather than have a receiver appointed? Again, not very often or at all.

The Legislature should adopt the Uniform Assignments of Rents Act proposed by the Uniform Law Commission many years ago, or similar legislation, to make it clear that a mortgagee does not need a separate assignment of rents, and can, if it wants, enforce an assignment of rents built into a mortgage as soon as a foreclosure begins. The model act also eliminates the legal fiction that a lender licenses back to the borrower the right to receive rents. This minor change would eliminate an entire spurious body of law.

15. Assignment of Leases on Conveyance

When a seller conveys income-producing real property to a buyer, the seller ordinarily delivers both a deed and a separate assignment of the seller's interest in leases. Though routine, the assignment of leases does not accomplish much. It is difficult to imagine any set of facts where the landlord's interest in a lease would not travel with the property to its new owners. Buyers demand a separate assignment in part because they know goal-oriented landlord-tenant courts may require an owner to allege and prove how it obtained an interest in the property and leases (if the lease was signed by the previous landlord), but somehow a deed is not enough. The Legislature should amend New York law to say: (a) a deed automatically conveys the grantor's interest in leases, including rent arrearages, except to the extent the deed expressly says it does not in a particular case; (b) ownership of record establishes prima facie standing and chain of title in lease enforcement actions; and (c) the tenant has the burden to raise a genuine issue about whether the landlord holds record title or is, perhaps, just some stranger trying to have some fun enforcing a lease in which the plaintiff does not actually have any interest.

16. Wicks Law

The Wicks Law generally requires New York municipalities to hire separate contractors for HVAC, plumbing, and electrical work. Each contract must be awarded to the lowest "responsible bidder," whatever that means.[15] The Wicks Law supposedly promotes competition and prevents corruption in awarding public work contracts. If that were true, then why does it not apply to other trades? Modern projects certainly need superstructures, ironwork, paving, asphalt, and carpentry. Most private owners find it efficient to hire a general contractor or single construction manager for substantial building projects. New York government entities, on the other hand, must solicit and evaluate separate bids and hire internal staff to manage construction. All of this drives up the cost of administration, management, and coordination efforts; causes cost overruns and delays in governmental construction projects, and makes it hard to implement best practices in construction. The Wicks Law should be repealed.

17. Leasehold Condominiums

New York law says a condominium cannot be created on a leasehold—unless the project is located in a handful of favored areas and involves a quasi-public agency.[16] Although this law presumably tries to protect consumers, it in fact hurts consumers by relegating sponsors to the use of cooperatives, a truly wretched form of ownership, rather than condominiums for the rare leasehold project that includes for-sale apartments. New York should figure out a way to allow leasehold condominiums in a way that adequately protects consumers. Other states seem to do it.

18. Landlord Liability for Negligence

The New York General Obligations Law says a tenant cannot release a landlord from liability for negligence.[17] Some New York leasing practitioners argue that if a tenant promises to pay any "deductible" amount under a liability insurance policy that otherwise benefits the landlord, that agreement violates the General Obligations Law and is invalid. This argument then implies that the tenant should maintain the lowest possible deductible amounts, regardless of the tenant's risk management program company-wide. A low deductible requirement seems inappropriate, at least in a commercial transaction where the choice of a deductible amount simply represents a business decision in the parties' risk management program. The Legislature should remove this possible issue, at least for substantial commercial leases.

19. Memorandum of Contract

A recorded memorandum of contract is enforceable against third parties for 30 days after the stated closing date.[18] After that, it is presumably a nullity. But the statute does not expressly say that. And New York courts sometimes are quite open to creative theories and claims, such as an argument that: (a) the statute is not clear enough; (b) even if the contract memo expired, a later buyer still knows about the earlier contract so remains subject to it; or (c) in the interests of equity, a contract memo should remain effective longer than the statute says. Therefore, a careful seller may hesitate to record a contract memo. A careful buyer may hesitate to proceed in the face of a contract memo, even if it expired. A careful title insurance company may raise an exception for an expired contract memo when it really should not. The Legislature should make contract memos a practical

and reliable mechanism by revising the law to unequivocally say an expired contract memo does not put anyone on notice of anything. That proposition works well for expired UCC-1 financing statements. It should work just as well for expired contract memos.

20. Attorney Escrow Accounts

Attorneys sometimes steal escrowed money. It does not happen much, but it does happen. It usually happens because an attorney is struggling with addiction or some other problem. An escrow account gives a troubled attorney unrestricted access to a tempting pot of someone else's money to use to fund or hide those problems. Attorney escrow accounts should be subject to reasonable controls to protect clients, such as requiring: (a) banks to send monthly statements to everyone with an interest in the account; (b) online access to account information for lawyers and their clients; or, (c) signatures from more than one person to release an escrow. Any of this could be accomplished just by changing New York's rules on attorney escrows. The change would not need to affect New York's rules about interest on Lawyers' Accounts, by which interest on small escrows is used as a funding mechanism for legal services for the poor.

21. Premature Brokerage Claims

New York law allows a licensed broker to assert a claim without a written brokerage agreement if the broker procures a ready, willing, and able buyer or tenant, whether or not a transaction actually closes.[19] Careful sellers and landlords protect themselves from unexpected brokerage claims by appropriate documentation and dealing with reputable brokers who want repeat business. But the law still allows claims when a seller or landlord would not intuitively "expect" to face them. The Legislature should fix that.

That concludes my list of changes I would like to see in New York statutes and common law.

I have stayed away from suggesting reductions in taxes on real estate transactions, as these are obvious suggestions and not particularly creative. Although it goes against my personal views on these issues, I also note that New York's high taxes do not seem to have prevented New York real estate from doing quite well for investors for quite a long time.

The continued success of New York real estate investment has produced some of the highest rents and property values in the country or the world, making it difficult or impossible for nonwealthy people to find a place to live at reasonable cost. State and city governments are trying to solve this problem by promoting affordable housing construction, often at great hidden cost.

As a supplement to my wish list, I would suggest that if the state and city governments want to promote affordable housing, they should look critically at government programs that constrict and complicate production of new rental housing. Of course, all that constriction and complication helps preserve the high values of existing properties. Thus, it has its own constituency that will oppose any change.

Each of those constrictive and complex programs originally arose for a good, or at least politically appealing, reason. Each grew over time. Today one can reasonably argue they make it harder than necessary to build new housing and hence they merit a critical look. Those programs are: zoning; building and other codes; rent regulation; unusually high real estate taxes on multifamily rental property; environmental review; and finally, landmark preservation. I would gladly sacrifice all my earlier wish list items in exchange for cutting back (not eliminating) these six programs with an eye toward making it easier to build in New York City.

That gives me a total of 27 wishes that will not be granted.

 The author chaired the Real Property Law Section for the year ending in May 2006. The author appreciates the assistance with this article provided by Deborah Goldman and James Patalano of the author's legal staff; Richard S. Fries; Robert G. Harvey; Alfredo R. Lagamon, Jr.; and Donald H. Oppenheim. Blame only the author for any errors. Blame only the Legislature or the courts for any omissions.

Endnotes

1. N.Y. Real Prop. Acts. Law Art. 14 (Repealed July 1, 2009).
2. N.Y. Real Prop. Acts. Law § 1401 (Repealed July 1, 2009).
3. N.Y. Real Prop. Acts. Law § 1410 (Repealed July 1, 2009).
4. *See Graubard Mollen Horowitz Pomeranz & Shapiro v. 600 Third Ave. Assocs.*, 93 N.Y.2d 508, 693 N.Y.S.2d 91, 715 N.E.2d 117 (1999).
5. *See generally*, *Garland v. Titan W. Assocs.*, 147 A.D.2d 304, 308, 543 N.Y.S.2d 56, 59 (1989); *Continental Towers Garage Corp. v. Contowers Assocs. Ltd. Partnership*, 141 A.D.2d 390, 394, 529 N.Y.S.2d 322, 324-35 (1988); *Herzfeld & Stern v. Ironwood Realty Corp.*, 102 A.D.2d 737, 738, 477 N.Y.S.2d 7, 8 (1984).
6. N.Y. Tax Law § 250(2)(b).
7. N.Y. Lab. Law § 240, §241.
8. N.Y. Real Prop. Acts. Law § 711.
9. *Id.*
10. N.Y. Ltd. Liab. Co. Law § 206(a) (McKinney 2017).
11. N.Y. Ins. Law § 2139 (McKinney 2017) (adopted 2014).
12. N.Y. Gen. Oblig. Law § 5-702 (McKinney 2017).
13. N.Y. Real Prop. Law § 291-d(3) (McKinney 2017).
14. N.Y. Real Prop. Law § 291-d(1) (McKinney 2017).
15. N.Y. Gen. Mun. Law § 101 (McKinney 2017).
16. N.Y. Real Prop. Law § 339-e (McKinney 2017).
17. N.Y. Gen. Oblig. Law § 5-321(McKinney 2017).
18. N.Y. Real Prop. Law § 294(5) (McKinney 2017).
19. *See Realty Investors of USA Inc. v. Bhaidaswala*, 254 A.D.2d 603, 604, 679 N.Y.S.2d 179, 181 (3rd Dep't 1998); *see also Prime City Real Estate Co. v. Hardy*, 256 A.D.2d 80, 81, 681 N.Y.S.2d 245, 245-46 (1st Dep't 1998).

Commercial Tenant Harassment in New York City—Questionable Medicine

By Adam Leitman Bailey and Dov Treiman

Effective September 26, 2016, New York City adopted an ordinance giving commercial tenants a cause of action against their landlords for "harassment."[1] Clearly modeled on a similar law adopted in favor of residential tenants some few years ago, the authors of this bill may not fully have considered just how well the ideas of residential law port over to commercial settings. The operation of this law will call into question matters of policy, disparities in economic power, difficulties in enforcement, and potential chilling effects on legitimate commercial development. Beyond doubt, the authors of the law, as in its residential counterpart, have not given adequate consideration to the possibility that the tenants in this City may or may not harass landlords with the same frequency that landlords harass tenants, but giving a remedy to only one side may have unfortunate economic consequences.

The Residential Ordinance

Like the earlier residential ordinance,[2] the commercial ordinance forbids a landlord from taking actions "intended to cause a…tenant to vacate covered property, or to surrender or waive any rights"[3] while engaging in certain forbidden activities. While the residential and commercial lists of forbidden activities include matters not covered in the other list, both lists have in common: (1) using force or threats; (2) interrupting or discontinuing essential services; (3) using frivolous lawsuits; (4) removing property from the premises; (5) interfering with the entrance locks; and (6) unspecified miscellaneous acts intended to interfere with the legitimate use of the premises. To this core list of common forbidden activities, the commercial list adds: (1) preventing people from entering the premises; and (2) interfering with business by commencing unnecessary construction or repairs on or nearby the tenant's business.[4]

"The remedy called for in this ordinance is principally an expensive Supreme Court proceeding as the Civil Court has no jurisdiction to handle either the injunctive aspect of the case or the damages aspect of the case if they exceed $25,000, as they are likely to do."

While the residential ordinance has been around since 2008, it has not developed a significant body of case law that would answer any questions one might have about what does and does not come under the ambit of the activities forbidden under both sets of laws. Four of these core activities are not particularly needing of further definition: (1) force; (2) frivolous lawsuits; (3) removing property; and (4) entrance locks. But, both "essential services" and "miscellaneous" would not only benefit from such a body of case law, but are obviously different in the residential and commercial contexts, regardless of the similarity of the language. While a front desk receptionist would not normally be an "essential service" in a residence, such a person could be vital to certain businesses. Similarly, the scope of "miscellaneous" is going to be vastly different in the residential and commercial settings.

"In some circumstances, this may be a very easy showing as the landlord actually does want the tenant to vacate the premises so as to be able to do more elaborate development of the two properties."

Who Has the Power?

Before examining the specific commercially forbidden activities, it is useful to step away from the ordinance itself and examine the economic reality in which it lives. By and large, it is a reasonable assumption that a residential landlord has more economic heft than its residential tenant. While there are undoubted exceptions to this rule, in the overwhelming majority of cases in New York City, this principle holds true. However, the same cannot be said of commercial tenancies. There are many landlords in such situations who are "Mom and Pop" operations with tenants who are well-heeled multi-location operations, some even international operations. In such tenancies, the power the tenant currently holds can be and often is extremely significant. Let us therefore read the remainder of this statute considering both the possibility that the landlord is holding the trump cards and the possibility that the real power resides with the tenant.

Interfering With Entry

Indeed, specifically against that background let us consider the two forbidden activities we have not yet discussed under the commercial statute. These are "preventing a commercial tenant or such tenant's invitee from entering a covered property occupied by such tenant" and "substantially interfering with a commercial tenant's busi-

ness by commencing unnecessary construction or repairs on or near covered property."[5]

"Unlike the residential ordinance, which finds enforcement as either an inexpensive proceeding in the Housing Part of the Civil Court or as a counterclaim to a landlord's proceeding in the same court, from a practical point of view, the only known use of the commercial ordinance is in State Supreme Court."

Consider the things that can prevent a tenant or invitee from entering the commercial premises. These can be real and substantial barriers like boarding up a store or they could be more metaphoric barriers like failing to remove snow from the sidewalk or tolerating disreputable people congregating immediately in front of the store, or allowing a disreputable or disgusting business to operate immediately next door to the complaining tenant. Which of these is sufficient to rise to the level of "harassment" under this ordinance? With a law that is less than a year old, we are in no position to know.

Motivation to Sue

Now, no doubt, you will want to quibble that the ordinance in forbidding these activities requires not only that the activity take place, but also that it be done with the specific intent of chasing the tenant away from its tenancy. That is where the question of economic disparity comes in. The remedy called for in this ordinance is principally an expensive Supreme Court proceeding as the Civil Court has no jurisdiction to handle either the injunctive aspect of the case or the damages aspect of the case if they exceed $25,000, as they are likely to do. If the tenant is a small operation, the tenant will lack the wherewithal to bring the suit unless counsel is willing to take the case on a contingency. If the landlord is a small operation, the landlord will lack the wherewithal to defend the suit and no one is going to take such a suit on a contingency because there is no allowance in the statute of attorneys' fees for the landlord who successfully rebuffs the suit or indeed for a landlord who is being harassed by the suit.

Of course, that leads one to ask what a commercial tenant would be doing harassing a landlord in such manner and the answer is simple. Let us say that the tenant is in the 17th year of a 20-year lease and the landlord has indicated it does not plan to allow a renewal. This new ordinance could, in the hands of a sufficiently wealthy tenant, be used to terrorize a landlord into giving the lease extension it did not want to give, even if only to avoid a completely invalid, but very expensive, lawsuit. For this reason, the City Council might want to consider the possibility of awarding attorneys' fees not merely to the prevailing party, but allowing for interim awards during the course of the action.

Unnecessary Construction

However, that is the comparatively innocuous of the two special forbidden activities of the commercial ordinance. The other is "interfering with business by commencing unnecessary construction or repairs on or nearby the tenant's business."[6] Now, consider this scenario in the context of a commercial tenancy: The owner of the property has two immediately adjacent properties, one where the subject commercial tenancy is located and the other an open lot recently acquired in which the owner intends to erect a new building. The first thing one notes about this new building is that one is hard pressed to come up with an argument that it is "necessary." Yet, the commercial ordinance allows the tenant to enjoin the construction of this building upon a finding that it is "unnecessary" if the tenant can demonstrate to the court that the construction is interfering with its business (a relatively easy showing) and that the landlord intends for the tenant to vacate the subject premises. In some circumstances, this may be a very easy showing as the landlord actually does want the tenant to vacate the premises so as to be able to do more elaborate development of the two properties. Yet, what is perfectly legitimate business becomes, under this ordinance, something that is made to look evil and, if the tenant plays it correctly, something that provides the tenant with a completely unearned cudgel.

"Will a court therefore determine that the Civil Court does have sufficient equitable power to entertain the kinds of general injunctions this ordinance calls for?"

Standing

Many commercial occupancies are formulated not in the classic form of a lease, but rather as a license. It is unclear whether this ordinance will receive broad enough application to confer its benefits on licensees, but since the law spreads the benefits of so-called "remedial statutes" as broadly as possible, licensees may be included as well. A remedial statute "should be accorded its broadest protective meaning consistent with legislative intent.[7]

Enforcement

Unlike the residential ordinance, which finds enforcement as either an inexpensive proceeding in the Housing Part of the Civil Court or as a counterclaim to a landlord's proceeding in the same court, from a practical point of view, the only known use of the commercial ordinance is in State Supreme Court. While the commercial ordinance

Adam Leitman Bailey is the founding partner of Adam Leitman Bailey, P.C. Dov Treiman is a partner at the firm.

says that the tenant "may bring an action in any court of competent jurisdiction for a claim of commercial tenant harassment,"[8] that does not on its face allow or disallow "commercial tenant harassment" as a counterclaim instead, indeed a counterclaim in a summary proceeding. While RPAPL § 743 allows an answer in a summary proceeding to "contain any legal or equitable defense, or counterclaim,"[9] that does not confer plenary equitable jurisdiction on the New York City Civil Court. Such equitable jurisdiction as the Civil Court does possess is to be found in Civil Court Act § 201, which confers various kinds of equitable powers, none of them applicable to this ordinance.[10] However, § 212 does state, "In the exercise of its jurisdiction the court shall have all the power that the Supreme Court would have in like actions and proceedings."[11] Will a court therefore determine that the Civil Court does have sufficient equitable power to entertain the kinds of general injunctions this ordinance calls for?

We note that when the tenant brings its own suit under this ordinance, it is as an "action" under the general provisions of the CPLR rather than a special proceeding governed by CPLR Article 4 and there is no provision for the kind of summary proceeding under RPAPL Article 7.[12] Thus, when brought as an action, the tenant and the landlord are both entitled to plenary discovery with all the papers, delays, and expenses that such proceedings entail. If it is a direct action, there really is no curtailing all of these procedural aspects of the case. But, if it is brought as a counterclaim in a summary proceeding in Civil Court, it is an unresolved question as to what the scope of discovery proceedings would entail, especially since it is unresolved that the case is properly brought as a counterclaim at all.

"The City Council appeared to believe that with a light rewriting of the residential tenant harassment ordinance, a similar law could be enacted to protect commercial tenants."

The remedies the ordinance calls for include, but are not limited to, "injunctive relief, equitable relief, compensatory damages, punitive damages, and reasonable attorneys' fees and court costs."[13] The ordinance also mandates that there is a mandatory "civil penalty in an amount not less than one thousand dollars and not more than ten thousand dollars."[14] One wonders why the court does not have jurisdiction to award a penalty of less than one thousand dollars. A ceiling on the penalty makes sense, but one struggles to justify the floor.

One place where the City Council did clearly seek to balance the parties' rights is in the provision in the ordinance in which the tenant is not relieved of the obligation to pay rent and the penalties and awards set forth in the ordinance can be set-off against the rent.

Since the ordinance does call for such a set-off, there is a clear interaction in the rights of the landlord and the tenant. While there is an extremely long line of authority that discourages tenants from bringing State Supreme Court actions and using them to remove and consolidate summary proceedings from the Civil Court,[15] this provision of the ordinance may be sufficient to overturn that line of thought. This too is one of the unanswered questions.

Conclusion

The City Council appeared to believe that with a light rewriting of the residential tenant harassment ordinance, a similar law could be enacted to protect commercial tenants. However, it appears that the provision was insufficiently thought through, giving, in some cases, the upper hand to one who already had greater economic power. If indeed this law is necessary at all, time under it will point the way to the amendments which may be necessary to refine the law to something that is both more just and more practical.

Endnotes

1. *See*, N.Y.C. Admin. Code tit. 22, ch. 9, § 22-903 (2016).
2. *See generally*, N.Y.C. Admin. Code tit. 27, ch. 1, § 27-2004(a)(48) (2008).
3. N.Y.C. Admin. Code tit. 22, ch. 9, § 22-902(a)(i) (2016).
4. N.Y.C. Admin. Code tit. 22, ch. 9, § 22-902(a)(8,9).
5. *Id*.
6. N.Y.C. Admin. Code tit. 22, ch. 9, § 22-902(a)(9).
7. *See* 245 *Realty Assocs. v. Sussis*, 243 A.D.2d 29, 35, 673 N.Y.S.2d 635, 639 (1st Dep't 1998).
8. N.Y. CITY ADMIN. CODE tit. 22, ch. 9, § 903.
9. N.Y. REAL PROP. ACTS. LAW § 743 (McKinney 2017).
10. N.Y. CITY CIV. CT. ACT § 201 (McKinney 2017)..
11. N.Y. CITY CIV. CT. ACT § 212 (McKinney 2017).
12. N.Y. CITY ADMIN. CODE tit. 22, ch. 9, § 903.
13. *Id*.
14. *Id*.
15. *See, e.g., Cox v. J.D. Realty Assoc.*, 217 A.D.2d 179, 637 N.Y.S.2d 27 (1st Dept. 1995).

Blockchain Technology and Its Applicability to the Practice of Real Estate Law

By S.H. Spencer Compton and Diane Schottenstein

Real estate transactions are steeped in traditions that have hardly changed over hundreds of years. Today, as computer-based property recording systems are prevalent in our cities but roll out at a snail's pace in rural areas (often hindered by strained municipal budgets), and e-signatures are little used (due to legitimate fears of fraud), arguably the real estate closing process has lagged in its use of computer-aided technology. Yet other aspects of real estate ownership have been transformed by the internet: smart home technology to remotely control heating and lighting and monitor security; Airbnb which increases the value of real estate ownership and disrupts the hotel industry; and the real estate brokerage community's design/photographic/communication technology to list and virtually show properties. Now add to our brave new world blockchain, a cloud-based decentralized ledger system that could offer speed, economy and improved security for real estate transactions. Will the real estate transaction industry avoid or embrace it?

What Is Blockchain?

Blockchain is best known as the technology behind bitcoin; however, bitcoin is not blockchain. Bitcoin is an implementation of blockchain technology.[1] Blockchain is a data structure that allows for a digital ledger of transactions to be shared among a distributed network of computers. It uses cryptography to allow each participant on the network to manipulate the ledger in a secure way without the need for a central authority such as a bank or trade association.[2] Using algorithms, the system can verify if a transaction will be approved and added to the blockchain, and once it is on the blockchain it is extremely difficult to change or remove that transaction. A blockchain can be an open system or a system restricted to permissive users. There can be private blockchains (for ownership records or business transactions, for instance) and public blockchains (for public municipal data, real estate records etc.). Funds can be transferred by wires automatically authorized by the blockchain or via bitcoin or other virtual currency.[3] Transparent, secure, and frictionless payment is touted as one of blockchain's many benefits.

How Does a Blockchain Differ from a Record Kept by a Financing Institution or a Government Agency?

In a blockchain, there is no third-party intermediary verifying the veracity of the transaction; rather it is verified by "nodes."[4] A "node" is a transaction between computers. Each node contains the history of a transaction down to the "genesis block" or beginning block. Once a command is made to execute a transaction, the node will trace through the history of the blockchain all the way to the genesis block to confirm that the new transacting party is "cleared" to join the block.[5] The new block can then be added to the chain, which creates an indelible and transparent record of transactions.

How Is a Blockchain Transaction More Secure Than Any Other Transaction?

In theory, blockchain is tamper-proof because it is decentralized and not controlled by one party. All the nodes maintaining the same database will be involved in verifying the transaction, which is a check on the veracity of the system. The system is analogous to creating a unique digital fingerprint (or "hash") for each transaction that is stored in the database by each member of the blockchain. The hash is validated by algorithms and can only be changed if the utilized consensus mechanism verifies that the transaction is legitimate. This assures secure and authenticated transactions. Is blockchain inviolable? Time will tell.

How Widely Is Blockchain Used?

During the past three years, over $1.4 billion in venture capital has been invested in blockchain research and development and more than 2,500 patents have been filed. A consortium of over 90 corporations is working to design and apply distributed ledger technologies ("DLT") to global financial markets.[6] Other firms across a variety of industries are experimenting with DLT as a transparent and secure manner to digitally track the ownership of assets.[7] Generally, blockchain is viewed as a way to speed up transactions, cut costs, and reduce fraud.[8] For example, today a banking transaction must go through a clearinghouse, which delays the settlement of the transaction and generates a fee (anecdotally, ranging from 12-20 percent of the transaction amount). DLT can address these frictions through improved end-to-end settlement speed, data auditability, resilience, and cost efficiency. Fees per transaction could be reduced to a decimal percentage of a penny. These are significant benefits to commerce.

One issue proponents of blockchain technology face is that members of the blockchain must agree on a common network protocol and technology stack. To date, there is an uncertain and unharmonized regulatory environment as well as no formal legal framework in which to conduct transactions. There are also many lingering questions about privacy and security. Nonetheless, blockchain

seems to be the nascent next generation of transformative financial services infrastructure.[9]

But how might Blockchain affect the real estate industry and the practice of real estate law?

The Use of Blockchain to Record Real Property Instruments

Blockchain could change the way real property transfers and encumbrances are recorded in the United States. Currently, the local recorder's office (typically on a county-by-county basis) records and maintains property records such as deeds, mortgages, easement and covenants and restrictions. According to the U.S. Census Bureau, as of 2013, there were a total of 3,143 counties (and county equivalents) in the nation.[10] Consequently, the U.S. real property recording system is disconnected and decentralized because each state and local government has a role in local real estate ownership and has latitude to create its own laws, recording requirements and fee structures. This fragmented and local nature of real estate is why local state counsels are necessary to close multi-state real estate transactions.

Notably, in 2016, the Cook County Recorder's office in Illinois announced that it would experiment with the use of blockchain technology for transferring and tracking real property titles and other public records. The Cook County Recorder's Office, which handles real property transactions in Chicago, is the second largest recording office in the U.S., and is the first in the country to implement blockchain technology. Specifically, the office will test blockchain applications of property title transfers and a system for filing liens, compatibility between a blockchain and a traditional, server-based setup, fraudulent use prevention and conveyances of vacant property in Chicago.[11] Earlier in 2016, the government of Vermont released a report regarding the potential use of blockchain technology for public record keeping.[12] Although local municipalities are recorders only and do not warrant the accuracy or correctness of what is recorded, the Illinois and Vermont projects seem to indicate a desire to further secure and streamline those states' existing systems of land ownership records. Further, it is reported that Sweden, Honduras, the Republic of Georgia, and Ghana have all implemented blockchain-based systems for recording real estate ownership.[13]

Prevention of Fraud

The recording systems in use today are susceptible to abuse by fraud. Although the variety of fraudulent schemes is as broad as the imagination, some involve identity theft while others involve fraudulent manipulation and filing of false documents. An all-too-familiar example of this is the fraudster who knows that a home is owned by an absent or elderly individual. The fraudster files a forged deed based on documents openly available on the county website and then sells the property, pockets the purchase price, and leaves behind a tale of woe.

Because blockchain relies on encryption to validate transactions by verifying the identities and obtaining the consent of all parties involved, "false" transactions cannot be added to the blockchain. Accordingly, proponents argue that blockchain could resolve many of the fraud issues arising from identity theft and fraudulent payment schemes. However, many types of real estate fraud do not involve filing false documents and those schemes may not be prevented by the use of blockchain.

Blockchain technology relies on a public key and a private key—passwords effectively—held by the party inputting information. Currently, if a private key to the blockchain is lost or stolen, there is no recourse available under existing blockchain technology. In a worst case scenario, the loss or compromise of a private key is tantamount to loss of control over all of one's transactions within the blockchain. A malevolent party could pose as the user until the private key is deactivated in the same manner a thief could continue spending on a stolen credit card until it is canceled.[14] A blockchain network cannot distinguish between transactions performed by a legitimate user or a malevolent actor with unauthorized access to the legitimate user's private key. So long as protocols are properly followed, bad data can be input, accepted and added to the blockchain.[15] Like other databases, blockchain is susceptible to the principle "garbage in, garbage out."[16] Nonetheless, except where there is illicit system/key infiltration, blockchain should significantly reduce low level, less sophisticated fraud. Like so much of blockchain's architecture, the cybersecurity elements continue to evolve.

How Might Blockchain Affect the Role of Title Insurance Companies?

Today, it is standard practice in most transactions for a purchaser to order a title search, which at closing, after payment of a premium, becomes a title insurance policy. Many advocates of blockchain technology believe that some day it will eliminate the need for title insurance, thereby reducing transaction costs and accelerating the speed of real estate transactions. A Goldman Sachs report entitled, "Blockchain: Putting Theory into Practice," estimates that about 70% of title search requests are found to be without defect and approximately 30 percent of title policy requests are found to have title defects of some type.[17] In these instances, title companies rely on an in-house network of labor to manually review (abstractors) and clear (underwriters) title issues.

Title insurers also deal with claims that do not involve a total failure of title such as nuances of covenants and restrictions, easements, and other issues. In addition to paying an insured's loss in the event of a sustained claim, title insurance also (and more frequently) absorbs the

insured's legal defense costs. Presumably the implementation of a blockchain recording system would have no effect on this critical aspect of title insurance.

Implementing Blockchain in the U.S. Land Transfer Recording System

Certain concerns about blockchain could hinder a wholesale reinvention of the U.S. land transfer recording system. Currently, local governments control land transfers. Political resistance to giving up this control would seem likely, unless, for instance, it were part of a broader program to privatize government functions. The existing public land records provide transparent notice to all. The parties that rely on this recording system to protect the priority of their liens, deeds and other encumbrances might push back out of an aversion to change. Most significantly, getting all real property transaction constituents (municipalities, property owners, banks, taxing authorities, attorneys and courts) to agree to uniform protocols and standards as well as payment processes will be a lengthy negotiation. Retraining current land record employees to work in the blockchain system also could be challenging. Nonetheless, in recent years, a number of land recorder offices all over the nation have upgraded to electronic recording to the point that it is routine in certain jurisdictions to have all land records and tax payment systems available online.

Although this article focuses on the potential use of blockchain to record land transfers, even prior to such a sea change blockchain has already become part of a real estate transaction. On July 22, 2016, BlockChain.HK reported that Ubitquity, a company which devised a blockchain real property transfer platform, actually used its technology in the settlement of a home transfer. The home was purchased by Atlantic Sotheby's International Realty chief real estate officer.[18] So it seems that even if the U.S real property recording system is never changed, blockchain technology may be coming to the real estate industry in other ways.

Weighing the potential benefits against the legitimate concerns about blockchain technology suggests that a transformation of the U.S. land transfer recording system will not happen overnight, if ever, nor will the title insurance industry become redundant. It does seem likely, however, that some aspects of blockchain may be incorporated by both land recorder offices and the title insurance industry. Streamlining land transfers and reducing fraud are goals worth achieving.

Smart Contracts

Smart contracts are another aspect of blockchain technology that may affect future real estate transactions. According to Misadium, a London-based company that launched in this space, "the smart contract…is a digital representation of the mutual agreements contained in a traditional real estate contract as lines of software code that self-executes and self-enforces. It has the power to move funds between bank accounts, transfer property titles and reconcile payments. At any time, a smart contract can be converted to a traditional contract form for legal purposes."[19] Real estate contracts can get complicated quickly. However, a smart contract could be used, for instance, in a very simple storage locker or residential property lease. Areas of the country where adhesion forms are common would more likely accept the use of smart contracts. In the Netherlands, it was recently announced that the city of Rotterdam will use a blockchain to record lease agreements for the Cambridge Innovation Center ("CIC"), enabling the city and companies housed in CIC office space to conclude contracts faster and easier than before.[20]

Diane Schottenstein has been practicing law in New York for over twenty years. She has extensive experience in leasing, financing, and the acquisition and sale of commercial and residential real estate.

S.H. Spencer Compton is a vice president and special counsel at First American Title Insurance Company in New York City. He has lectured and published articles about commercial real estate law and practice as well as title insurance, UCC insurance and 1031 exchanges.

Conclusion

Change is inevitable even to the practice of real estate law. That said, the wholesale transformation of our varied state by state real property recording systems into a single uniform blockchain system seems far in the future, if ever. Nonetheless, it is possible, even likely, that aspects of blockchain technology may be integrated into our current system. Using blockchain technology, party-to-party money transfers could be made faster, cheaper and more securely. Smart contracts could drive transactions where consumers typically sign adhesion contracts, but in large dollar transactions with sophisticated parties represented by attorneys, document negotiations will likely persist. Notwithstanding the reservations about blockchain, the smart money is betting on its implementation. It is definitely something to watch and be able to adapt to. Ignore blockchain at your peril.

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Endnotes

1. *See generally What Is Blockchain Technology? A Step-by-Step Guide for Beginners*, https://blockgeeks.com/guides/what-is-blockchain-technology (last visited April 10, 2017).
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Individual Liability of Shareholders, Officers, and Directors Under the Interstate Land Sales Act

By Vincent Di Lorenzo

Introduction

Real estate developments are typically conducted through the medium of business entities intended to shield its owners of individual liability. Corporations, limited liability companies and limited partnerships have traditionally been viewed as effective mechanisms to accomplish this outcome. Does current law continue to allow such mechanisms to create a shield from individual liability? This article explores this issue by examining the liability provisions of the Interstate Land Sales and Full Disclosure Act (ILSA).[1] The conclusion drawn is that the terms of the Act, as interpreted and applied by the courts, allow owners of these business entities to be held individually liable for fraudulent conduct in violation of the Act.

The Terms of the Statute

ILSA prohibits the sale or lease of any lot based on untrue statements or omissions of material facts.[2] This is the anti-fraud provision contained in section 1703(a)(1) of the Act. ILSA's additional anti-fraud provisions, contained in section 1703(a)(2), prohibit: (a) employing any device, scheme or artifice to defraud;[3] (b) obtaining money or property by means of an untrue statement or omission of material fact;[4] and (c) engaging in any transaction, practice or course of business which operates as a fraud or deceit upon a purchaser.[5] Courts have confirmed that the first of these prohibitions, found in section 1703(a)(1), applies to developers or agents who sell or lease lots. However, the other prohibitions apply to developers or agents who engage or participate in the prohibited activities in question regardless of whether the defendants sold or leased the lots.[6]

"In addition, the Fourth Circuit has embraced the view that the statute should be interpreted broadly to reach the individuals who actually conduct the fraudulent activity."

These prohibitions apply to "any developer or agent" who engages in such activities "directly or indirectly."[7] The term "developer" is defined as "any person who, directly or indirectly, sells or leases, or offers to sell or lease, or advertises for sale or lease any lots…."[8] Moreover, the term "agent" is defined as "any person who represents, or acts for or on behalf of, a developer…."[9] These statutory terms suggest a broad reach to its prohibitions. If the developer is a corporate or partnership entity, do these statutory terms allow an interpretation that permits imposition of individual liability on principals of the developer or its officers and directors?

Legislative Purpose

The Tenth Circuit noted, in *McCown v. Heidle*r, that the purpose of the Interstate Land Sales Act is "to prohibit and punish fraud in…land development enterprises."[10] Moreover, the Act "should be construed not technically and restrictively, but flexibly to effectuate its remedial purposes."[11]

"The court initially noted that each defendant's liability depended on whether the defendant participated in the fraudulent sales or could be considered as a controlling person in an organization that participated in the sales."

In addition, the Fourth Circuit has embraced the view that the statute should be interpreted broadly to reach the individuals who actually conduct the fraudulent activity. In *Kemp v. Peterson*[12] the named defendants included not only the corporation engaged in selling the lots in question but also its officers and owners. The court noted:

> Applicants' contention that they are not individually responsible for violations of the Act…is also without merit…. [O]fficers, directors and participating planners may be held individually liable for violations of the Act, notwithstanding the absence of a clause in the Act establishing liability for "controlling stockholders, officers and directors…." To hold otherwise would defeat the purpose of the Act, since it is the alleged officers of the corporation who are behind the alleged fraud.[13]

The specific legal bases used by the courts for imposition of individual liability are examined below.

Direct Participation as Basis for Liability

The Second Circuit's decision is *United States v. Amrep Corporation*[14] is the starting point for direct participation as the basis for individual liability on the part of corporate officers and directors. The case was a criminal action

alleging mail fraud and interstate land sale fraud. The court noted:

> [P]articipation by a corporation in a scheme to defraud does not ipso facto make participants of its officers. Prerequisite to such a finding is proof that the officers were "conscious promoters" of the illicit scheme….
>
> Where, however, the prosecution introduces evidence of active and knowing participation by corporate officers, they are equally liable with the corporation….[15]

The court then concluded that liability could be imposed in the situation presented because proof at trial showed that corporate officers participated in setting up a fraudulent sales program, trained and instructed the salesman, prepared sales pitches that were widely and consistently used, and monitored the results. The evidence offered by the government showed that the individual defendants were fully aware of the corporate activities subsequently found to be fraudulent and actively participated therein. Substantial evidence was introduced that they were cognizant of the type of representations being made and both permitted and encouraged them.[16]

"However, the key to the decision is the classification of an individual defendant as an indirect seller if the person is involved in some manner in the selling efforts."

A subsequent decision recognizing the potential liability of corporate insiders is *Gibbes v. Rose Hill Plantation Development Company.*[17] In that case the claim was made against the agent of the developer and its corporate insiders. The court initially noted that each defendant's liability depended on whether the defendant participated in the fraudulent sales or could be considered as a controlling person in an organization that participated in the sales.[18] In the end, however, it dismissed the claim of one plaintiff because he did not purchase the lot from the named defendant or its agent, and dismissed the claim of the second plaintiff because she purchased the lot four years before the association of the particular defendants with the allegedly fraudulent sales effort.[19]

Indirect Seller Status as Basis for Liability

Liability has been imposed on individuals involved in fraudulent sales of lots on the basis of indirect seller status. The leading case exploring liability of an individual as an indirect seller is *Bartholomew v. Northampton National Bank of Easton.*[20] The *Bartholomew* case involved sales of lots in a development known as Sherwood Forest. The development consisted of two parcels. One parcel was owned by Castle Kress, a limited partnership which promoted and sold lots in the development. The second parcel was owned by another limited partnership, Raven Hill Forest, which hired Castle Kress to promote and sell lots in the development. Castle Kress was composed of one general partner, National Realty Investors Corp., and one limited partner, Poconos Skyland Development Company Inc. In turn, Poconos Skyland was solely owned by William Brock, who also owned the first tract of land in the development prior to the limited partnership agreement. Purchasers of lots in the Sherwood Forest development received deeds from Castle Kress. However, in the *Bartholomew* case the defendants were William Brock and the banks that financed the development. The court agreed that William Brock and the banks were not direct sellers because they did not personally appear as parties on the purchasers' deeds.[21] The court then considered defendants status as indirect sellers. It concluded that an indirect seller is one who is "involved in some manner in the selling efforts related to a land development project."[22] However, in the *Bartholomew* case the court found that William Brock and the banks did not sell, offer to sell or advertise the lots personally or through agents or "other means."[23]

While liability was not imposed by the Third Circuit based on the facts in the *Bartholomew* case, later cases have employed the approach taken by the court in recognizing potential liability as an indirect seller. Thus, in *Barker v. Hostetter,*[24] the direct seller of the homes constructed as part of a homeowner's association was Willow Creek LLC. Wilmer and Joyce Hostetter had owned the land in question. They later sold the lots to the Keystone Corporation and together with Keystone conveyed the lots to Willow Creek LLC. However, the Hostetters had earlier recorded, as declarant, a declaration of covenants and restrictions for the development. They had also issued a public offering statement in which they were identified as the sole declarants.

"The court reversed the lower court ruling that the absence of a common control provision in ILSA foreclosed imposition of such liability. It embraced the view that the Act should be construed not technically and restrictively, but flexibly to effectuate its remedial purpose."

The court distinguished *Bartholomew* and denied the Hostetters' motion to dismiss the action. Relying on the language in *Bartholomew,* the court concluded that

the Hostetters were "involved in some manner in the selling efforts" for the development through "other means."[25] Specifically, the public offering statement provided that "the Declarant intends to offer units for sale."

"The court listed the following as some evidence of personal involvement: furnishing a substantial amount of capital for the development, establishing asking prices, obtaining permits and financing, paying the brokers, and being responsible for actually developing the site."

The *Barker* decision may be an unusual fact pattern in that individual defendants would often not serve as declarants. However, the key to the decision is the classification of an individual defendant as an indirect seller if the person is involved in some manner in the selling efforts. The indirect seller basis of liability was also utilized in *Hester v. Hidden Valley Lakes, Inc.*[26] in a factual context that has broader significance. In the *Hester* case Hidden Valley Lakes Inc. purchased the land in question, subdivided the land, and offered lots for sale. The individual defendants, Jack Lacy and Harry Lepping, were the only shareholders of the corporation, and served as its president and secretary. In finding the individual defendants liable as indirect sellers, the court first noted that defendant Lacy signed each of the property reports involved in the action and defendant Lepping signed the statement of record. In addition, Lacy's deposition indicated that both had sufficient control over their employees to be able to give instructions for the distribution of property reports. The court concluded: "[e]ven if they did not directly sell any of the lots in the subdivision, they had sufficient control over the salesmen and sales policy of the corporation to be considered indirect sellers."[27]

Control Person as Basis for Liability

The Interstate Land Sales Act does not expressly impose liability based on control person status. However, the Fourth and Tenth Circuits have recognized this basis of liability under ILSA. The first decision recognizing the claim was *McCown v. Heidler.*[28] In that case the defendants were officers and members of the board of directors of the developer, Timberlake Inc., or the parent corporation, Heidler Corporation. The court reversed the lower court ruling that the absence of a common control provision in ILSA foreclosed imposition of such liability. It embraced the view that the Act should be construed not technically and restrictively, but flexibly to effectuate its remedial purpose. Liability should not be imposed only on the corporate entity which "in a fraudulent scheme as here alleged, ends up defunct and offers no reserve for recovering to those persons defrauded."[29] Rather, to be meaningful the basic protection of the Act "must be leveled against the fraudulent planners and profit makers for otherwise the Act would be pragmatically barren."[30]

The court rejected the claim that Congress' rejection of a proposed amendment that would have added a controlling persons clause was dispositive. Rather, it noted that directors and officers are routinely held liable under the Securities Act apart from a controlling persons clause.[31]

In *Kemp v. Peterson*,[32] the Fourth Circuit also explicitly explored control person liability under ILSA. The defendants included the officers and owners of the corporate developers. The *Kemp* case involved an order of the district court enjoining defendants from future violations of ILSA and freezing their individual assets as security for putative claims of lot owners. The court rejected the contention that officers and owners are not individually liable for violations of the Act. Rather, citing the *McCown* decision, the court concluded:

> [O]fficers, directors and participating planners may be held individually liable for violations of the Act, notwithstanding the absence of a clause in the Act establishing liability for "controlling stockholders, officers and directors."…. To hold otherwise would defeat the purpose of the Act, since it is the officers of the corporation who are behind the alleged fraud.[33]

"The case law recognizing liability of an individual officer, director or shareholder under ILSA as a control person rely on the purpose behind the Act and draw an analogy to control person liability under federal securities laws."

Subsequent decisions in the federal district courts in other circuits have cited the decisions in *McCown* and/or *Kemp* to permit claims to be brought individually against officers and directors of corporate developers without explaining the basis for liability.[34] In addition, two decisions in the Florida federal district courts have attempted to explain the *Kemp* decision by noting that individual liability of officers and directors requires some "personal involvement in the sale or offer to sell."[35] The import of this statement is not clear. The factual allegations in the *Santidrian* case, for example, did not permit a finding of liability, but the allegations were very limited in their scope. Plaintiffs alleged that the individual defendant in question was liable solely

"because he is 'President and a Director and shareholder of Defendant Landmark.' No other allegations of Bell's personal involvement in the sale of their property appear in the Complaint…."[36]

This requirement of "personal involvement" does not necessarily exclude control person liability based on the power or ability to control the specific transaction or activity upon which the primary violation was predicated. Indeed, a later decision of a federal district court, *Plant v. Merrifield Town Center Limited Partnership*,[37] opined that both *Kemp* and *Santidrian* require "personal involvement," and then explained, "[s]igning property reports and having the ability to control employees are actions sufficient to warrant a finding that an officer or director was personally involved in sales efforts."[38]

Another, subsequent federal district court decision, *Root v. Generations Land Companies, LLC*,[39] also concluded that *Santidrian* was in harmony with *Kemp* since liability could be based on proof that the officers of the corporation were behind the fraud or were otherwise personally involved in the sale or effort to sell. The court listed the following as some evidence of personal involvement: furnishing a substantial amount of capital for the development, establishing asking prices, obtaining permits and financing, paying the brokers, and being responsible for actually developing the site.

"Liability has resulted in cases of direct participation in the fraudulent activity. It has also been imposed based on control person status."

The case law recognizing liability of an individual officer, director or shareholder under ILSA as a control person rely on the purpose behind the Act and draw an analogy to control person liability under federal securities laws.[40] The courts have explained that under the federal securities laws, to establish a prima facie case of controlling person liability, a plaintiff must show a primary violation by the controlled person and control of the primary violator by the defendant. Control over a primary violator may be established by showing the defendant had "the power to direct or cause the direction of the management and policies of the primary violator, whether through ownership of voting securities, by contract or otherwise."[41] In addition, at least in the Second Circuit it must be shown that the controlling person was a culpable participant in the fraud.[42] Once plaintiff makes out a prima facie, the burden shifts to the defendant to show how he or she acted in good faith and did not directly or indirectly induce the acts constituting the violation. Good faith is proven by the exercise of due care in supervision of the violator's activities.[43]

Vincent Di Lorenzo is a professor of law at St. John's University and author of *New York Condominium and Cooperative Law* (Thomson/West).

As noted, the Second Circuit requires culpable participation on the part of the control person. However, most other Circuit Courts have rejected a culpable participation requirement. For example, the Seventh Circuit adopted a standard that looks "to whether the alleged control person actually participated in, that is, exercised control over, the operations of the person in general and then to whether the alleged control person possessed the power or ability to control the specific transaction or activity upon which the primary violation was predicated, whether or not that power was exercised."[44] In this formulation, control person liability extends to a broader class of situations than the direct participation basis for liability.

The courts' decisions in *McCown* and *Kemp* had earlier been cited as imposing another form of secondary liability, namely for aiding and abetting a primary violation.[45] The United States Supreme Court rejected civil liability for aiding and abetting under the Securities Act in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*[46] Subsequent decisions considering liability under ILSA based on aiding and abetting a primary violation have similarly rejected this concept since Congress has not expressly provided for it in the Act.[47] These cases, however, have not rejected the concept of liability as a control person.[48]

Conclusion

Individual liability has been imposed on principals of business entities engaged in fraudulent activity in violation of ILSA, as well as officers and directors of development companies. Liability has resulted in cases of direct participation in the fraudulent activity. It has also been imposed based on control person status. In most Circuit Courts the latter does not require culpable participation in the fraud, but only the power or ability to control the activity upon which a primary violation is predicated. Liability has been imposed, despite the lack of a controlling person clause in the statute, in order to best serve its remedial purposes.

Endnotes

1. 15 U.S.C. §§ 1701-1720.
2. 15 U.S.C. § 1703 (a)(1)(C).
3. 15 U.S.C. § 1703 (a)(2)(A).
4. 15 U.S.C. §1703 (a)(2)(B).
5. 15 U.S.C. § 1703 (a)(2)(C).
6. *Dalzell v. RP Steamboat Springs LLC*, 781 F. 3d 1201, 1208 (10th Cir. 2015). *See also In re Total Realty Management, LLC*, 706 F3d 245,

252-3 (4th Cir. 2013). The court in *Dalzell* went on the define the statutory term "sell" as encompassing developers who directly or indirectly participate in the exchange of consideration for the purchase of a lot. *Dalzell* at 1210.

7. 15 U.S.C. § 1703 (a).
8. 15 U.S.C. § 1701 (5).
9. 15 U.S.C. § 1701 (6) (but does not include an attorney whose representation of another consists solely of rendering legal services).
10. 527 F.2d 204, 207 (10th Cir.1975).
11. *Id.*
12. 940 F.2d 110 (4th Cir. 1991).
13. *Id*. at 113. Cases in the Eighth and Ninth Circuit have also entertained actions brought not only against the corporate developer, but also against its officers, directors and controlling stockholders. *See Adolphus v. Zebelman,* 486 F. 2d 1323 (8th Cir. 1973); *Kamm v. California City Development Co.*, 509 F.2d 205 (9th Cir. 1975). These decisions did not, however, discuss the possible legal bases upon which liability may be imposed upon such defendants.
14. *U.S. v. Amrep Corp.*, 560 F. 2d 539 (2d Cir. 1977).
15. *Id*. at 545 (citations omitted).
16. *Id*.
17. *Gibbs v. Rose Hill Plantation Development*, 794 F. Supp. 1327 (D.S.C. 1992).
18. *Id*. at 1333.
19. *Id.* at 1341-42.
20. *Bartholomew v. Northampton Nat. Bank of Easton*, 584 F.2d 1288 (3d Cir. 1978).
21. *Id.* at 292.
22. *Id.*
23. *Id*. at 293.
24. *Barker v. Hostetter*, 2014 WL 1464319 (E.D. Pa. 2014).
25. *Id*. at *9, *citing Bartholomew,* 584 F. 2d at 1293.
26. *Hester v. Hidden Valley Lakes, Inc.*, 495 F. Supp. 48 (N.D. Miss. 1980).
27. *Id*. at 54.
28. *McCown v. Heidler*, 527 F.2d 204 (10th Cir.1975).
29. *Id*. at 207.
30. *Id.*
31. *Id*. (citing *Kerbs v. Fall River Industries*, 502 F. 2d 731 (10th Cir. 1974)). The court also noted that numerous courts have entertained actions under the Securities Act leveled at controlling stockholders, officers and directors, citing cases in the Eighth, Ninth, and Fifth Circuits, among others.
32. *Kemp v. Peterson*, 940 F.2d 110 (4th Cir. 1991).
33. *Id.* at 113. (citations omitted).
34. *See Husted v. Amrep Corporation*, 429 F. Supp. 298, 310-11 (S.D.N.Y.1977) (each individual defendant is an officer and/or director of one or more of the corporate defendants); *Sewell v. D'Alessandro & Woodyard Inc.*, 655 F. Sup. 2d 1228, (M.D. Fla. 2009) (actions brought against corporate developers and their principals, but court concluded elements of fraud were not pleaded with particularly as required by Rule 9(b)).
35. *Santidrian v. Landmark Custom Ranches, Inc.,* 2008 WL 4571820 (S.D. Fla. 2008); *see also Parra v. Minto Town Park, LLC,* 2008 WL 477 3272 (S.D. Fla. 2008).
36. *Santidrian*, 2008 WL 4571820 (S.D. Fla. 2008); *See also Parra Minto,* 2008 WL 477 3272 (S.D. Fla. 2008) *(*plaintiffs must set forth the individual's personal involvement in the allegations and no such allegation was made in the complaint).
37. *Plant v. Merrifield Town Center Limited Partnership*, 2009 WL 6059552 (E.D. Va. 2008).
38. *Id*. at 19. The court also cities the *Hester* decision, s*upra* notes 26 and 27, which involved liability as an indirect seller rather than a control person.
39. *Root v. Generations Land Co.*, 2011 WL 1527335 (W.D.N.C. 2011).
40. Controlling person liability is explicitly provided for section 20(a) of the Exchange Act, 15 U.S.C. §770.
41. *Id.* at 1472-1473 (citing 17 C.F.R §240. 126-2).
42. *S.E.C. v. First Jersey Securities*, 101 F. 3d 1450, 1472 (2nd Cir. 1996).
43. *Id.*
44. *Harrison v. Dean Witter Reynolds, Inc*., 974 F. 2d 873, 881 (7th Cir. 1992). *See generally* 9 Louis Loss, Joel Seligman and Troy Paredes, Securities Regulation 572-576 (4th ed. 2014) (noting that the Seventh, Eighth, Ninth, Tenth and Eleventh Circuits have rejected the culpable participation requirement, while the Second and Third Circuit continue to recognize it).
45. *E.g. Orsi v. Kirkwood*, 1992 WL 511406 (E.D. Va.1992); *Fuls v. Shastina Properties, Inc.*, 448 F. Supp. 983, 990 (N.D. Cal. 1978); *Timmreck v. Munn, 433 F. Supp.* 396, 406-07 (N.D. Ill. 1977).
46. *Cent. Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164, 191 (1994).
47. *RFT Management Company, LLC. v. Gilbert*, 2012 WL 252 984 (D.S.C. 2012); *Aaron v. Trump Organization,* 2011 WL 278 4151 (M.D. Fla. 2011).
48. *RFT Management Company,* 2012 WL 252 984 (D.S.C. 2012) (distinguishing possible liability as a direct participant or a control person from possible liability for merely aiding and abetting).

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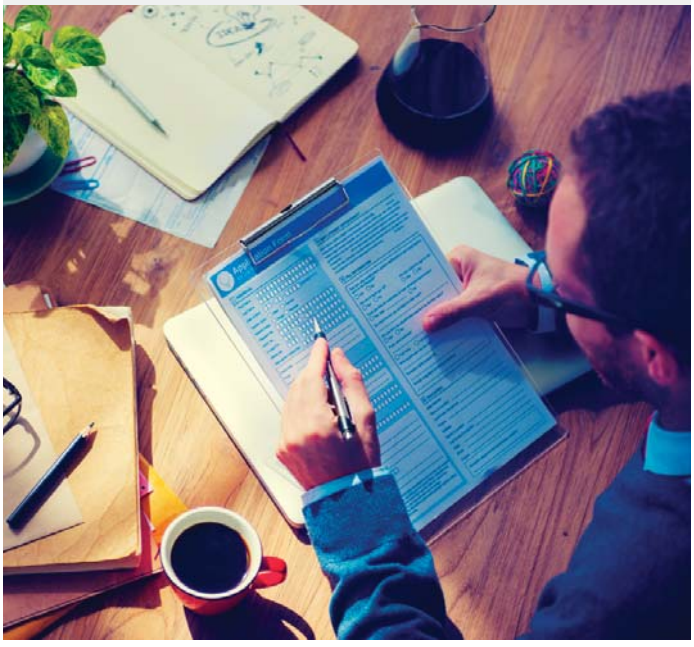

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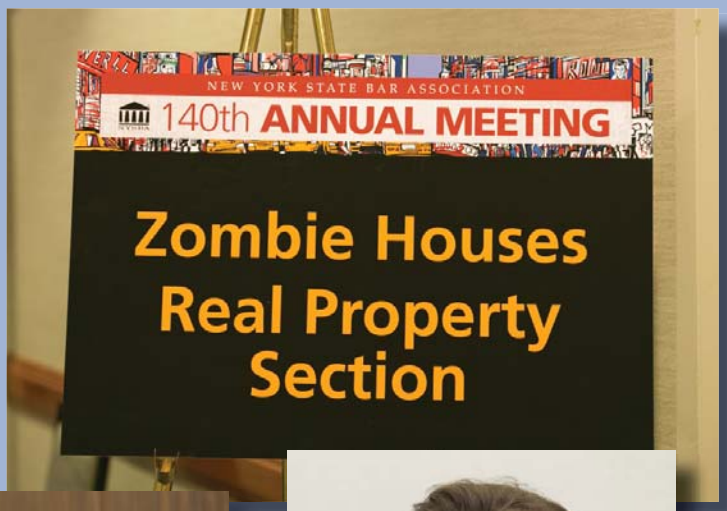

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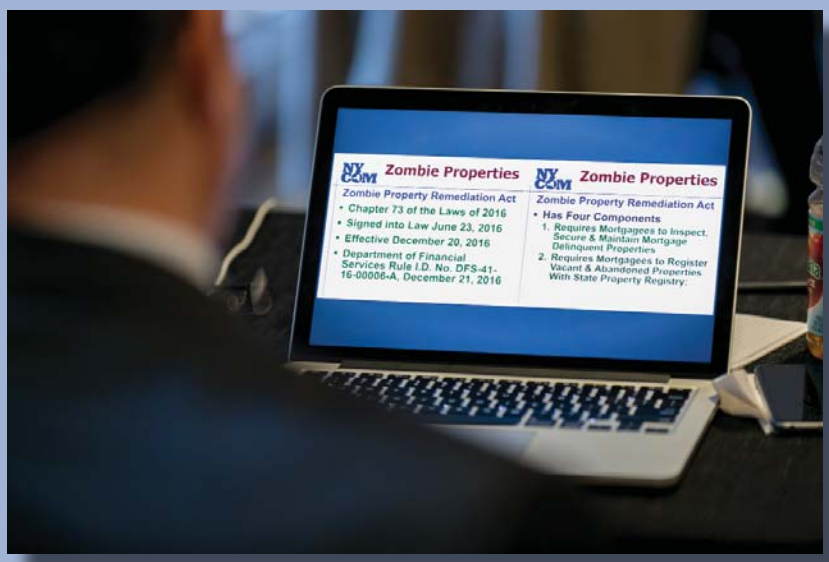

Heather C.M. Rogers

Termination for Convenience—Pre-Nup in the Construction Context

By Brian G. Lustbader

Construction contracts between project owners and contractors are a lot like marriages. Both parties enter hoping for a successful long-term relationship, but as issues arise, some end up dissolving. When they do, it is important that the parties have mechanisms in place to disengage in a straightforward manner so they can move on with their lives.

The Basic Termination Mechanisms

When a relationship with a contractor or construction manager has turned sour, a construction project owner has two termination options:

1. For cause, which is based on a contract breach or default, and often leads to litigation or arbitration; or
2. Without cause—"termination for convenience"—where there is no such claim of breach/default.

Reasons for Terminating for Convenience Rather Than for Cause

Similar to a pre-nuptial agreement, "termination for convenience" is when no court action (or arbitration) takes place—the parties simply agree to dissolve their relationship based on previously agreed-upon financial terms and then part ways. Owners typically go this route when the project has become unworkable, i.e., project abandonment, which can occur for a number of reasons, such as a loss of financing or failure to obtain necessary public authority approvals.

"If the agreement has been terminated for convenience, the owner may not thereafter try to claim damages arising out of the contractor's pre-termination work, including costs to remediate work improperly performed by the contractor, or to complete the contractor's incomplete work."

Despite having valid reasons to terminate for cause, an owner may want to terminate for convenience to avoid the time and effort—and expense—of a protracted dispute and possible litigation or arbitration. It is a more cost-effective way to deal with such a situation—a clean break, akin to a no-fault divorce. The way to make this possible is to include the termination for convenience option in the construction agreement at the start of the project.

Crafting the Termination for Convenience

A key component of this option is determining how much to pay the terminated-for-convenience contractor or construction manager. Under the standard AIA contract provision, the owner terminating for convenience is required to pay the contractor or construction manager for the work performed to the date of termination, plus reasonable overhead and profit on the work not performed.[1] This means the owner agrees to pay what the contractor lost as a result of not being able to finish the project. In establishing "reasonable overhead and profit on work not performed," contractors usually request that owners pay the contractors' entire overhead and profit for the project as if it had been fully completed. They may also add on home office overhead, lost opportunity costs, and related items. Construction managers typically request the analogous as-yet-unearned fee for the project.

"This argument, typically based on assurances of agreement continuation emanating from the terminating party, usually fails in the absence of an actual showing of outright fraud."

To avoid such a large payout, or the time and effort of negotiating which items to pay, it is best to have the agreement spell out precisely what damages will and will not be paid. For example, it may be useful to eliminate any reference to paying profit or fee, or even overhead to the contractor or construction manager. What would be appropriate to pay is the contractor's or construction manager's actual cost of the work performed up to the termination date, plus retainage attributable to that work. Demobilization costs should also be paid. Whether anything else should be included, such as a portion of lost profits or unearned fee, is subject to negotiation between the parties. It is critically important to set forth in the agreement which categories of items are not going to be paid, such as extended home office overhead, lost opportunity costs, etc. This is the way to establish clarity as to what is and what is not to be paid.

Litigating Termination for Convenience Issues

Because the New York courts have addressed many issues arising out of termination for convenience issues scenarios, those decisions should inform the ways the attorneys should craft the termination for convenience provisions in construction contracts.

No Owner Claims for Default Damages

As noted above, owners will often invoke the termination for convenience mechanism even when grounds for termination for cause exist. There is no turning back, however. If the agreement has been terminated for convenience, the owner may not thereafter try to claim damages arising out of the contractor's pre-termination work, including costs to remediate work improperly performed by the contractor, or to complete the contractor's incomplete work. This is true even if the contractor independently initiates an action against the owner seeking additional damages. Several Appellate Division decisions, have confirmed this rule, notably the Appellate Division decisions in *Paragon Restoration v. Cambridge Square Condominiums* and *Tishman Constr. Corp v. City of New York*.[2]

"Less than a year later, with several months left on the contract, IBM terminated the agreement with American Vending, after which the latter sued IBM for fraud in the inducement, breach of contract and unjust enrichment."

This rule is in contrast to the rule that permits the owner in a construction agreement to convert a termination for cause to a termination for convenience. In fact, many owners provide in their agreements that such a conversion will be automatic in the event a termination for cause is challenged, the purpose undoubtedly being to avoid a contractor's claim for damages for improper termination for cause.[3]

Owner's Motives Irrelevant

In the context of a termination for cause, the owner must have a valid basis for terminating the contractor/construction manager. Those bases are set forth in the standard form agreements, e.g., AIA A101/201, A107, or ConsensusDOCS, and many owners' attorneys add additional bases for termination for cause.

Where the termination is for convenience, however, the owner need not have any reason, or even a bad faith reason for terminating. That is, a court will not overturn this type of termination.[4]

Fraud in Inducement Claim Difficult to Maintain

In order to avoid the last-stated proposition regarding terminating party's motive, another, somewhat related argument terminated parties have attempted to use to avoid losing their ability to claim additional damages on a termination for convenience is the contention that the terminating party has engaged in fraudulent conduct, or that it fraudulently induced the terminated contractor to enter into the agreement in the first place. This argument, typically based on assurances of agreement continuation emanating from the terminating party, usually fails in the absence of an actual showing of outright fraud.

For example, in *American Food & Vending Corp. v. International Business Machines Corp*,[5] the plaintiff, American Food & Vending Corp.'s predecessor, ARA Services, Inc., had an agreement with IBM to supply food vending services over a two-year period, with an ability on IBM's part to terminate for convenience on 90 days' notice. Thereafter, ARA expended some $100,000 to comply with an expanded scope of work requested by IBM for food vending services. Shortly thereafter, American Food purchased ARA's assets, including the $100,000 in machinery. Before going through with the purchase, American Vending sought, and obtained, IBM's assurance that American Food "had nothing to worry about" with respect to perpetuation of ARA's existing vending agreement with IBM.[6] IBM then wrote to American Vending consenting to ARA's assignment of the contract to American Vending, with a 60-day termination for convenience proviso. Less than a year later, with several months left on the contract, IBM terminated the agreement with American Vending, after which the latter sued IBM for fraud in the inducement, breach of contract and unjust enrichment. Despite the alleged fraud on the part of terminating party inducing non-terminating party to remain in contract, fraud and breach of contract causes of action were dismissed where the terminating party showed it had terminated pursuant to termination for convenience provision.

"The court permitted the conversion and ruled that surety would be obligated if compensable damages were proved, but then found that no such damages had been shown, and so granted the surety's motion to dismiss."

A similar result obtained in *Abacus, v. Datagence, Inc.*,[7] where the appellate court affirmed a non-jury verdict dismissing a fraud in the inducement counterclaim on the ground that "no evidence that plaintiff entered into the contract with the intention not to perform," and "both parties had unfettered right to terminate the contract pursuant to a 'termination of convenience clause."[8]

Surety Considerations

Very often, contractors obtain performance and payment bonds assuring that they will fully perform their work and pay their subcontractors and suppliers. In that way, if the contractor fails to complete its work or pay its subcontractors, the owner will be entitled to terminate the agreement for cause, and seek from the surety that issued the bonds full completion of the project and/or payment of subcontractors who did not receive payment. Termination for convenience, however, would not permit any claim against the surety because, by definition, the owner is not claiming a contract breach, i.e., is not claiming that the termination was "for cause."

Nevertheless, sureties have been involved in cases where a termination for convenience occurred. In one such case, on a performance bond, the owner originally terminated for convenience, but then converted that termination to one for cause (which is the reverse of the usual direction of such conversions), and called upon the surety to meet the contractor's obligations on account of the "for cause" termination.[9] The court permitted the conversion and ruled that surety would be obligated if compensable damages were proved, but then found that no such damages had been shown, and so granted the surety's motion to dismiss. In another case, on a payment bond, the surety was able to dismiss a subcontractor's action on a payment bond because the two-year statute of limitations in the surety bond had run, even though the surety had agreed to negotiate with the subcontractor beyond that two-year period.[10]

Conclusion

If properly drafted, the termination for convenience provision in a construction contract can help the "divorcing" parties dissolve a relationship on carefully prescribed financial terms, just as a pre-nuptial agreement does in a marriage, allowing both parties to move forward on terms each one can live with.

Endnotes

1. The provision referenced in the text is to the American Institute of Architects (AIA) Document A201-2007 "General Conditions of the Contract for Construction," which general conditions are applicable to most AIA form agreements, The AIA has just issued (effective April 30, 2017) new form agreements, including a new A201-2017. That form changes the termination for convenience provisions in certain respects by, among other things, deleting the reference to the Owner paying "reasonable overhead and profit on the Work not executed" and inserting instead the following:"including costs attributable to termination of Subcontracts; and the termination fee, if any, set forth in the Agreement." While those changes are important to be aware of, they do not alter the necessity of including the provisions outlined in this article.
2. *Paragon Restoration Grp., Inc. v. Cambridge Sq. Condos.*, 42 A.D.3d 905, 839 N.Y.S.2d 658 (4th Dep't 2007); *Tishman Constr. Corp. v. City of N.Y.*, 228 A.D.2d 292, 293, 643 N.Y.S.2d 589 (1st Dep't 1996).
3. *Minelli Constr. Co., Inc. v. WDF Inc.*, 134 A.D.3d 508, 20 N.Y.S.3d 530 (1st Dep't 2015).
4. *Louis Food Serv. Corp. v. Dep't of Educ. of City of N.Y.*, 76 A.D.3d 956, 908 N.Y.S.2d 235, 260 (2d Dep't 2010) (termination for convenience may be exercised "without inquiry"); *Watermelons Plus, Inc. v. N.Y.C. Dep't Of Educ.*, 76 A.D.3d 973, 908 N.Y.S.2d 80 (2d Dep't 2010) (termination for convenience sustained even though not raised until eve of trial); *A.J. Temple Marble & Tile v. Long Island R.R.*, 256 A.D.2d 526, 682 N.Y.S.2d 422 (2d Dep't 1998) ("a party has an absolute, unqualified right to terminate a contract on notice pursuant to an unconditional termination clause without court inquiry into whether the termination was activated by an ulterior motive", quoting *Big Apple Car v. City of N.Y.*, 204 A.D.2d 109, 111, 611 N.Y.S.2d 533 (1st Dep't 1994)); *L & M Bus Corp. v. N.Y.C. Dep't of Educ.*, 2008 NY Slip Op. 33633(U) (Sup. Ct. N.Y. County 2008) (the termination for convenience clause is valid, without any provision requiring good faith), *but see affirmance in part*; *L & M Bus Corp. v. N.Y.C. Dep't of Educ.*, 71 A.D.3d 127, 892 N.Y.S.2d 60 (1st Dep't 2009) ("where an agency has the right to terminate an agreement without cause, the decision to terminate may not be made in bad faith and is subject to review under CPLR article 78"); *G & R Elec. Contractors, Inc. v. State*, 130 Misc. 2d 661, 496 N.Y.S.2d 898 (Ct. Cl. 1985) (upholding New York State's termination for convenience even though the State admitted it had committed errors in its preparation of specifications).
5. *Am. Food & Vending Corp. v. IBM*, 245 A.D.2d 1089, 667 N.Y.S.2d 545 (4th Dep't 1997).
6. *Id.* at 1090, 667 N.Y.S.2d at 545.
7. *Abacus v. Datagence, Inc.*, 66 A.D.3d 552, 553, 887 N.Y.S.2d 94, 95 (1st Dep't 2009).
8. *Id*.
9. *400 15th St., LLC v. Promo-Pro Ltd*., 28 Misc 3d 1233(A), 960 N.Y.S.2d 341 (Sup. Ct. Kings County 2010).
10. *A.J. McNulty & Co. v. P.J. Carlin Const. Co*., 247 A.D.2d 254, 669 N.Y.S.2d 29 (1st Dep't 1998).

Brian G. Lustbader, a partner at Schiff Hardin LLP, is co-chair of the Real Estate Construction Committee of the New York State Bar Association Real Estate Section. He can be reached at blustbader@SchiffHardin.com.

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Bergman on Mortgage Foreclosures
Peril and Ambiguities in the New Foreclosure Statutes

By Bruce J. Bergman

While the new omnibus foreclosure law (L.2010, ch.73), effective December 20, 2016, can be presented as needed protection for borrowers and citizens generally, it can also be seen as dangerous for any foreclosing lender, adding expense, delay and confusion. Although very lengthy and detailed—any thorough analysis vastly exceeds space available here—some questionable aspects of the categories will be addressed.

Judgment and Sale

Amendment regarding the foreclosure sale [RPAPL § 1351(1)] seeks to accelerate the process, requiring the sale be held within 90 days of the *date* of the judgment. Aside from presupposing that it is lenders who volitionally delay sales (a point strongly disputed) this fails to account for realities of foreclosure process. First, a judgment is not even available to a foreclosing plaintiff until *entered*. Depending upon the venue, this can be weeks or months after the *date* of the judgment.

"How many of these borrower attempts deemed a bar to mortgage enforcement could be invoked—and their duration—are imponderables."

Then, referees may not be readily available because they are on trial, on vacation, have become ill or died, or were appointed or elected a judge or to some public office that precludes service as a referee; some of these events require a motion to amend the judgment to appoint a different referee, increasing time.

Settlement discussions can postpone scheduling a sale, so a rapid sale date will tend to chill that effort. Finally, a borrower's order to show cause or bankruptcy filing can readily stay any ability to set a sale. Too often, 90 days just won't work.

Conveyance Restraint

Addition to the conveyance provision [RPAPL § 1353(1)] requires the plaintiff, if the successful bidder at the foreclosure sale, to list the property for resale within 180 days of execution of the deed or within 90 days of completion of construction or renovation. How it is constitutional for a law to tell property owners that they are bound to sell property, and within a certain period, is perplexing.

If the borrower or tenant is holding over, the property is typically not salable until an eviction has been completed, and such proceedings can be delayed interminably.

If sale prices are depressed, the plaintiff may wish to refrain from selling quickly to avoid suffering an even greater loss. Indeed, renting the property may be the better alternative for some period and denying that right is both inappropriate and potentially damaging.

90-Day Notice Requirements

The new language allows commencement of legal action only "if you have not taken any actions to resolve this matter within 90 days…" But "any action to resolve the matter" is not defined. A borrower could assert that action to resolve has been fulfilled, i.e., application for a new mortgage, seeking a mortgage modification, or sending a letter stating that a resolution is sought, or a correspondence seeking to make partial payments of the arrears. If any of these might be deemed as "seeking resolution," the ability to begin a foreclosure would not exist. How many of these borrower attempts deemed a bar to mortgage enforcement could be invoked—and their duration—are imponderables. It is easy to conclude, though, that a challenging impediment to foreclosure has just emerged.

"And if the mortgage were to be assigned (as is common, multiple times) the information would need to be preserved throughout the assignment process, something glaringly difficult as a practical matter."

Repeated notices will now be a problem. The new provision adds the distinction that the one notice need only be sent for the "same delinquency" and provides that:

> Should a borrower cure a delinquency but redefault in the same twelve month period, the lender shall provide a new notice pursuant to this section.…

An obvious ploy of wily borrowers is manifest. They could default, cure on the 89th day, be entitled to a new

notice and do this eternally. This would assure that the borrower could always remain at least three months in arrears on the mortgage obligation, all in contravention of the mortgage contract.

"That defendant is therefore permitted to serve and file an answer, without waiving any substantive defenses within thirty days of initial appearance at the settlement conference."

The obligation to provide the notice in some other language if the borrower had limited English proficiency is also deeply troubling. How is the mortgage holder to know whether any borrower has "limited English proficiency"? How limited would it have to be, how would that be determined and who would determine it are problematic. Presumably this assessment would have to be made by someone present at the time of the closing (even though some closings proceed by mail). Assuming one can articulate how limited is limited, and determine what the native language is, such information would have to be preserved eternally in the mortgage file, to be used at some future date if a default eventuated necessitating a 90-day notice. And if the mortgage were to be assigned (as is common, multiple times) the information would need to be preserved throughout the assignment process, something glaringly difficult as a practical matter. One can readily assess how borrowers could game the system here.

"Therefore, the existing requirement that a foreclosing party assumes maintenance of the premises at the judgment stage if vacant and abandoned, or populated by tenants, already is offensive and parlous."

Settlement Conferences

Although there is no good reason why a defendant in a foreclosure action should be treated any differently than any other defendant in serving a timely answer, the new standard permits a defendant who appears at a settlement conference, but who did not file an answer, to be presumed to have a reasonable excuse for the default. That defendant is therefore permitted to serve and file an answer, without waiving any substantive defenses within 30 days of initial appearance at the settlement conference. That answer, otherwise woefully late, vacates any default. This yet further delay imposed upon the process may be unfortunate.

During the settlement process, the statute now specifically requires that any motion made by plaintiff (or defendant) must be held in abeyance during the settlement process. The main problem here (aside from impeding plaintiffs in disposing of a borrower's answer) is the ill-advised prohibition against moving regarding *other* defendants. There are multitudinous examples of time-consuming procedures plaintiffs need to pursue when other defendants may answer or assail the action. Prohibiting efficient efforts against those others only further delays the foreclosure.

New Maintenance Obligation

Because a mortgage holder possesses only a *lien* on the mortgaged premises, and therefore is not an owner, requiring such party to maintain the premises creates an unpredictable and unexpected expenditure, beyond what any mortgage contract contemplates. Moreover, it imposes tort liability upon such a lender because it foists care, custody, and control into its hands. Therefore, the existing requirement that a foreclosing party assumes maintenance of the premises at the judgment stage if vacant and abandoned, or populated by tenants, already is offensive and parlous.

"Finally, it remains imprecise as to the relationship between this new statute and the existing section which imposes maintenance liability as of the foreclosure judgment stage."

The new requirement creates a maintenance obligation at the *inception* of an action, even earlier if the vacancy or abandonment is or could have been determined. This obligation to maintain continues until the property has been sold or transferred to a new owner. This later provision, however, is unclear because it is not apparent whether this means the obligation ends if the owner of the property conveys title (which would not necessarily change anything) or whether it means the moment when someone has bid at a foreclosure sale. Servicers will be confused and the provision is well worthy of clarification.

A possible savings provision appears, but it too is ambiguous. The provision is that a servicer who peacefully enters a vacant and abandoned property so as to maintain it pursuant to this section "shall be immune from liability when such servicer is making reasonable efforts to comply with the statute." Whether that means that a servicer cannot be sued for trespass (a likely interpretation) or whether this is a blanket way to avoid tort liability devolving to a foreclosing party is too vague to render an opinion.

While the new section appropriately requires that any local law inconsistent with these provisions cannot be imposed, precisely where there will be such inconsistencies

will not always be so obvious—and the fact is that local governments do have such statutes.

"And, a defendant—particularly one who has abandoned the premises—may be very difficult to find so that the time consumed in serving such a defendant can be surprisingly lengthy."

Finally, it remains imprecise as to the relationship between this new statute and the existing section which imposes maintenance liability as of the foreclosure judgment stage.

Expedited Procedure for Vacant and Abandoned Property

Because from a lender's viewpoint imposition of property maintenance shortly after a borrower becomes delinquent is so draconian, it is welcome that the omnibus bill adds a new RPAPL § 1309 and § 1310 offering an accelerated process to reach a judgment of foreclosure and sale where the property is vacant or abandoned. The essence of the accelerated procedure is good: an order to show cause is made after service is complete to demonstrate the vacancy (not as certain or effortless as the statute implies) asking the court to compute the sum due without the necessity of appointing a referee, and to issue the judgment of foreclosure and sale. But there are some perhaps unrecognized infirmities or undue burdens in the procedure:

- It can be an open question as to when a lender can have determined that a property was vacant. This is sometimes not so precise.

"In some counties, rendering of the judgment of foreclosure and sale will be far less swift than the procedure might have intended."

- The application cannot be made until the defendant's time to answer shall have expired. If "the Defendant's" means the borrower it is one thing, quite another if it means all the other defendants in the action. This is unclear and needs remediation. And, a defendant—particularly one who has abandoned the premises—may be very difficult to find so that the time consumed in serving such a defendant can be surprisingly lengthy.
- A property cannot be deemed vacant for, among other reasons, that an "action to quiet title" exists. While on its face this seems reasonable, an action to quiet title can take many forms; for example, a junior lender might be trying to direct recordation of a copy of a mortgage when an original was lost. This should have nothing to do with prohibiting a foreclosure on a vacant property and yet the blanket term "action to quiet title" will have such an effect regardless of the actual nature of that action.
- Although delineation of all the proof a plaintiff must present upon the order to show cause is extensive, the court may still require the plaintiff to appear and provide testimony in support of the application. While this is hardly irrational, it is apparent that such a procedure can cause delays with hearing dates far in the future, together with the possible difficulty of producing witnesses.
- While the court is directed to make a written finding as soon as practicable as to whether the plaintiff has proved its case, court delays in many venues within the state are well recognized. In some counties, rendering of the judgment of foreclosure and sale will be far less swift than the procedure might have intended.

"In sum as to an abandoned or vacant property, the foreclosing party will be compelled to spend money and assume liability for a period of time greater than the statute would have predicted."

- Even though the property may be clearly and actually abandoned, provision is made that no judgment of foreclosure and sale can be entered if the mortgagor—or any other defendant—has filed an answer, appearance, or other written objection that is not withdrawn. First, filing an appearance is not an objection. Next, this gives *carte blanche* to any defendant to torpedo the accelerated procedure merely by serving an answer.

In sum as to an abandoned or vacant property, the foreclosing party will be compelled to spend money and assume liability for a period of time greater than the statute would have predicted.

Mr. Bergman, author of the four-volume treatise, *Bergman on New York Mortgage Foreclosures*, LexisNexis Matthew Bender, is a member of Berkman, Henoch, Peterson, Peddy & Fenchel, P.C. 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*.

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2016 – David Ullman—Columbia Law School
2017 – Megan McGuiggan

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New Foreclosure Legislation: Boon or Burden?

By Nandini Chowdhury

On June 23, 2016, Governor Andrew Cuomo signed the New York State Abandoned Property Neighborhood Relief Act of 2016, which, among other things, amended the Real Property Actions and Proceedings Law (RPAPL) to include three provisions impacting vacant and abandoned properties. Effective as of December 20, 2016, the legislation was promulgated to combat the blight of vacant and abandoned properties that are in the process of being foreclosed, also known as "zombie properties."[1] In doing so, the newly enacted legislation imposes a pre-foreclosure duty on lenders and servicers to maintain vacant and abandoned properties, expedites the foreclosure process for such properties, and creates an electronic registry of the properties.[2] While the new legislation intends to protect neighborhoods from the negative impact of blight, it creates a financial and bureaucratic burden for lenders and servicers, which they must discern how to navigate.

RPAPL §1308

RPAPL § 1308 charges lenders and servicers of vacant and abandoned one-to-four family residential properties with a duty to maintain the properties.[3] The law applies solely to first-lien mortgage holders and excludes state or federally chartered banks, savings banks, savings and loan associations, and credit unions that originate, own, service and maintain their mortgages and originate less than 0.3 percent of total loans in the state of New York.[4] Within ninety days of the borrower's delinquency, the lender or servicer is obligated to conduct an exterior inspection of the property every twenty-five to thirty-five days, at different times of the day.[5]

Based on such inspections, if the lender or servicer has a reasonable basis to believe that the property is vacant and abandoned, the lender or servicer is required to secure and maintain the property.[6] Additionally, within seven business days of determining the property to be vacant and abandoned, the servicer must post a notice with its contact information on an easily accessible area of the property and must continue to monitor the property to ensure that the notice remains posted while also accounting for any potential change in occupancy.[7]

If the borrower, property owner or occupant does not provide any indication that the property is not vacant or abandoned for seven days after the notice has been posted, § 1308 provides an exhaustive list of actions a lender or servicer must undertake to further maintain and secure the property.[8] These actions include, *inter alia*, replacing door locks, securing windows and doors, securing any attractive nuisances, winterizing plumbing and heating systems, and providing basic utilities.[9] The obligation to maintain and secure the property continues until certain events occur, such as where the occupant has asserted his or her right to occupy the property, the borrower has filed for bankruptcy, a court has ordered the servicer to cease maintaining the property, the ownership of the property has been transferred, the servicer has released the lien, or where the mortgage note has been assigned, transferred or sold to another servicer.[10]

From a lender's viewpoint, the maintenance requirement can be quite onerous in that it potentially exposes lenders and servicers to a variety of tort liabilities, ranging from personal injury to nuisance as it forces the care, custody and control of the property onto the lender.[11] While the section provides some solace in a provision that states that a servicer who peacefully enters a vacant property with the intention of maintaining it "shall be immune from liability when such servicer is making reasonable efforts to comply with the statute," it is unclear as to whether this protects a servicer from being sued for trespass or provides blanket protection against tort liability.[12]

To further heighten the burden, a lender or servicer may be subject to a civil penalty of up to $500 for each day a violation persists, should the lender or servicer fail to maintain the property as set out in RPAPL § 1308.[13] Moreover, any municipality that undertakes the maintenance of a property the servicer is obligated to maintain, will have a cause of action against the servicer to recover costs incurred as a result of maintaining a property on behalf of the servicer.[14]

It also remains unclear as to how RPAPL § 1308 will coincide with the existing RPAPL § 1307, which is effective as of April 2010. Under RPAPL § 1307, a lender or servicer is responsible for maintaining a vacant property only after a judgment of foreclosure and sale has been granted, unlike RPAPL § 1308, which imposes the duty shortly after a borrower becomes delinquent.[15]

RPAPL § 1309

Despite the taxing requirements set forth in RPAPL § 1308, RPAPL § 1309 provides foreclosing lenders and servicers with some much-needed judicial relief.[16] As of May 2016, New York has 3,352 vacant residential properties in its foreclosure process, making it one of the markets with the most "zombie" foreclosures.[17] Amplifying the problem, New York also has one of the most protracted foreclosure processes in the United States, taking an average of 1,283 days, as opposed to the national average of 803 days.[18] Section 1309 attempts to abridge that timeline by permitting foreclosing lenders and servicers with the opportunity to expedite the foreclosure process once properties have been proven to be vacant and abandoned.[19]

The section defines "vacant and abandoned property" as a residential real property where there are no occupants present and where there is no evidence of occupancy on the property during the mandated inspections.[20] Vacancy can also be ascertained where the property is not maintained in a manner consistent with the standards set forth in the New York property maintenance code, and where there are visual cues such as overgrown or dead vegeta-

tion, accumulation of mail and trash, and where the property is unsecured and open to casual entry or trespass.[21] Nevertheless, the section provides that a property will not be deemed vacant and abandoned if it is undergoing construction, occupied on a seasonal basis, the subject of a probate or quiet title action, or if it is damaged by a natural disaster with the intention of being repaired and reoccupied by the owner.[22]

Once the borrowers' time to answer the foreclosure complaint has expired, the lender or servicer may make an application by notice of motion or order to show cause, directly seeking an expedited judgment of foreclosure and sale, without first moving for an order of reference.[23] As such, lenders and servicers can forgo the requirement of having a referee appointed to compute the amount due and owing to the lender by directly requesting that the court confirm the amount.[24] While the lender must provide documentation evidencing that the property is vacant in its motion, this section may shave months off the foreclosure process, "allowing the lender to recapture the residence and the community to have a new homeowner instead of a blighted property."[25] Unfortunately, the section also provides that where a defendant has demonstrated an intention to contest the foreclosure action by either filing an answer, appearance or other written objection that is not withdrawn, a judgment of foreclosure and sale cannot be entered, thereby giving defendants wide latitude to file an objection and impede what is otherwise intended to be an expedited process.[26]

RPAPL § 1310

RPAPL § 1310 directs the New York State Department of Financial Services ("DFS") to create and maintain a statewide online registry of vacant and abandoned properties.[27] Most importantly, the section requires lenders and servicers to submit information on properties that they know to be vacant and abandoned to DFS, within 21 days of becoming aware that the property is vacant or abandoned.[28] The specific language of the provision is quite vague, in that it states that the lender or servicer must notify DFS when the lender or servicers "learns, or should have learned," that the property is vacant and abandoned, thereby subjecting lenders and servicers to even more burdensome requirements.[29] Nonetheless, the section's requirement that DFS must establish and maintain a toll-free hotline for neighbors and community members to report any hazards, blight, or other such concerns caused by vacant properties should prove to have a positive impact on neighborhoods statewide, provided that DFS works diligently to address such concerns.[30]

While the overall intended benefits of the newly enacted legislation remain to be seen, the mandates imposed upon lenders and servicers may prove to be onerous. Going forward, it is essential that lenders and servicers remain diligent in their inspections, and work to maintain and secure properties that are deemed to be vacant and abandoned in an effort to remain in compliance with the legislation. Failing to do so may cause an already prolonged foreclosure process to become more delayed and financially burdensome than it need be.

Nandini Chowdhury is a second-year student at St. John's University School of Law and a Staff Member of the *N.Y. Real Property Law Journal*. The opinions expressed in this article are solely those of the author.

Endnotes

1. *See* Press Release, Governor Cuomo Signs Sweeping Legislation to Combat the Blight of Vacant and Abandoned Prop. (Jun. 23, 2016), https://www.governor.ny.gov/news/governor-cuomo-signs-sweeping-legislation-combat-blight-vacant-and-abandoned-properties.
2. *Id.*
3. N.Y. Real Prop. Acts. § 1308 (McKinney 2016).
4. *Id.*
5. N.Y. Real Prop. Acts. § 1308(1) (McKinney 2016).
6. N.Y. Real Prop. Acts. § 1308(2) (McKinney 2016).
7. N.Y. Real Prop. Acts. § 1308(3) (McKinney 2016).
8. N.Y. Real Prop. Acts. § 1308(4) (McKinney 2016).
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19. N.Y. Real Prop. Acts. § 1309(1) (McKinney 2016).
20. N.Y. Real Prop. Acts. § 1309(2)(a) (McKinney 2016).
21. *Id.*
22. N.Y. Real Prop. Acts. § 1309(2)(d) (McKinney 2016).
23. Adam Leitman Bailey, *Recent Efforts to Speed Up Foreclosure Proceedings in N.Y.* New York Law Journal (Aug. 30, 2016), http://www.newyorklawjournal.com/id=1202766331727/Recent-Efforts-to-Speed-Up-Foreclosure-Proceedings-in-NY?slreturn=20170227225815.
24. N.Y. Real Prop. Acts. § 1309(1)(d) (McKinney 2016).
25. Adam Leitman Bailey, *supra* note 23.
26. N.Y. Real Prop. Acts. § 1309(5)(a) (McKinney 2016).
27. N.Y. Real Prop. Acts. § 1310(1) (McKinney 2016).
28. N.Y. Real Prop. Acts. § 1310(2) (McKinney 2016).
29. *Id.*
30. N.Y. Real Prop. Acts. § 1310(5) (McKinney 2016).

Heywood Condominium v. Wozencraft: Appellate Division Holds Receiver Is Empowered to Evict Condominium Owner Before Completion of Foreclosure Action

By Anthony Ruzzi

Under the New York Condominium Act the board of managers of a condominium is "far less empowered to deal with difficult condominium owners."[1] The Condominium Act expressly permits the condominium to place a lien on a unit for unpaid common charges.[2] The Act also allows the board to foreclose on its lien and request that a receiver be appointed to collect the reasonable rental value of the unit.[3] However, on January 12, 2017, the Appellate Division in *Heywood Condominium v. Wozencraft* determined that a receiver is authorized to evict a unit owner even before the conclusion of a foreclosure action.[4]

In this case, the Defendant purchased a unit in the Heywood Condominium in 2006. Upon purchase of the unit, the Defendant agreed to abide by the condominium by-laws. In reaching its conclusion, the court relied heavily on certain provisions of these by-laws, which included:

1. Dissatisfaction with the quantity or quality of maintenance or service is not grounds for failure to pay common charges.[5]
2. Failure to pay common charges on time would result in late fees that would begin to accrue interest after thirty days.[6]
3. The board is permitted to add reasonable attorney's fees to the arrearage incurred to collect the unpaid common charges, late fees, and interest. These charges shall act as a lien upon the unit and are the personal obligation of the unit owner.
4. Lien foreclosure by the board based on unpaid common charges.[7]
5. Explicit permission to appoint a receiver and require the unit owner to pay the fair rental value of the unit in any action brought by the board to foreclose its lien.[8]

Interestingly, the last three by-law provisions include language taken directly from the Condominium Act in §§ 339-z and 339-aa.

Less than one year after purchasing the unit, Defendant stopped paying his monthly common charges. He complained that he was not being provided certain "non-essential services such as doorman services, service calls to his unit, and receipt of packages and deliveries."[9] After sixty days of non-payment, Plaintiff board exercised its right under the house rules to suspend the same nonessential services for failure to timely pay common charges.

Anthony Ruzzi is a second-year student at St. John's University School of Law and a Staff Member of the *N.Y. Real Property Law Journal*.

In 2013, while a plenary action seeking a money judgment was pending, the Plaintiff recorded a lien with the city registrar for approximately $211,000. The Plaintiff then filed a notice of pendency and commenced a foreclosure action. At the same time as the filing of the foreclosure action, the Plaintiff moved for the appointment of a temporary receiver.[10] The court granted the Plaintiff's motion and appointed a receiver.[11] The receiver was directed to rent the unit, even to the Defendant, for its $6,500 fair market rental value. The receiver was also granted the authority by the appointment order to remove any tenant, including the Defendant, for the protection of the unit.[12] After six months, the receiver moved for a writ of assistance to evict the Defendant from the unit for failure to pay any of the $6,500 monthly fair rent. The Supreme Court granted this motion in September 2015. In December 2015, the Appellate Division granted a stay of the order pending appeal.[13]

While the foreclosure action was still pending, the Appellate Division affirmed the decision of the Supreme Court and concluded the Defendant's ejectment was not unconstitutional because he failed to comply with court's order to pay the fair market rental. In reaching its decision, the Appellate Division looked to the language of both the condominium by-laws and the Condominium Act. It noted that the Defendant's challenges to the appointment of a receiver were unpersuasive because New York Real Property Law § 339-aa and the by-laws provide for the appointment of a receiver and the imposition of rent payments on the unit owner.[14] The court was also not persuaded by the Defendant's argument that he could not be forced to pay rent for a unit he owned, citing to the same Real Property Law section.[15]

The Appellate Division correctly resolved the conflict in this intricate dispute. The plain language of New York Real Property Law §§ 339-z and 339-aa permit a condominium to place a lien on any unit, foreclose that lien judicially, and appoint a receiver to rent the unit during the foreclosure action to the unit owner or any other paying party. Additionally, the by-laws contained identical language to the Condominium Act, which the Defendant agreed to when he purchased the unit. Of significant note is the fact that the Defendant also agreed in the by-laws

that he would not withhold payment of common charges as a way of expressing dissatisfaction with maintenance or services.[16] Thus, the Defendant could have avoided this outcome simply by upholding his contractual responsibilities while seeking an agreement with the board.

While the decision of the court is very significant in that condominiums have now been given a means of evicting an unruly owner before the completion of a foreclosure action, it still requires that the condominium has to complete a lengthy judicial process in order for the court to appoint a receiver. Although ejectment by a receiver may be a faster remedy than a foreclosure action, the condominium cannot evict an owner on its own without a court order. Thus, as noted by the court, "[e]jectment under these circumstances does not deprive Defendant of his 'real property ownership/occupancy rights without due process of law.'"[17] Furthermore, the instances of a condominium unit owner refusing to pay common charges as well as violating a court order to pay rent to a receiver are scarce. The court admitted this fact at the beginning of its opinion when it stated that these appeals are a "rare occurrence."[18] Given the language of both the by-laws and Condominium Act, coupled with the low chance of abuse by plaintiff condominiums, the Appellate Division reached a wise conclusion in this case.

Endnotes

1. *Heywood Condominium v. Wozencraft*, 2017 N.Y. Slip Op. 00257, *1 (1st Dep't Jan. 12, 2017).
2. N.Y. Real Prop. Law § 339-z (McKinney 2017).
3. N.Y. Real Prop. Law § 339-aa (McKinney 2017).
4. *See generally Heywood v. Wozencraft*, 2017 N.Y. Slip Op. 00257, *1 (1st Dep't Jan. 12, 2017).
5. *Wozencraft*, *supra* note 1, at *1.
6. *Id.*
7. *Id.*
8. *Id.*
9. *Id.*
10. *Id.*
11. *Id.*
12. *Id.*
13. *Id.*
14. *Id.* at *5.
15. *Id.*
16. *Id.* at *1.
17. *Id.* at *7.
18. *Id.*

The Real Property Law Section Welcomes New Members

Peter A. Ackerman
Diana Acosta
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Andrew Leider
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Daniel C. Ross
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Peter A. Strauss
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Robert F. Wied, Jr.
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Jieun Yoon
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Bruce Yukelson
David Zandi
Mark I. Zelko
Joseph Yan Jun Zhu

Section Committees and Chairs

The Real Property Law Section encourages members to participate in its programs and to volunteer to serve on the Committees listed below. Please contact the Section Officers or Committee Chairs for further information about the Committees.

Attorney Opinion Letters
Gregory P. Pressman
Schulte Roth & Zabel LLP
919 Third Avenue
New York, NYNY 10022-4728
gregory.pressman@srz.com

Charles W. Russell
Harris Beach PLLC
99 Garnsey Road
Pittsford, NY 14534
crussell@harrisbeach.com

Awards
Peter V. Coffey
Englert, Coffey, McHugh
& Fantauzzi, LLP
224 State Street
P.O. Box 1092
Schenectady, NY 12305
pcoffey@ecmlaw.com

Commercial Leasing
Deborah Leigh Goldman
Joshua Stein PLLC
501 Madison Avenue, Room 402
New York, NY 10022-5635
success1968@hotmail.com

Robert J. Shansky
Scarola, Malone & Zubatov, LLP
1700 Broadway
New York, NY10019
rjshansky@smzllp.com

Sujata Yalamanchili
Hodgson Russ LLP
The Guaranty Building
140 Pearl Street Suite 100
Buffalo, NY 14202-4040
syalaman@hodgsonruss.com

Condemnation, Certiorari and Real Estate Taxation
Karla M. Corpus
National Grid
300 Erie Boulevard West
Syracuse, NY 13202
kmcorpus@gmail.com

Steven Wimpfheimer
Steven Wimpfheimer, Esq.
166-25 Powells Cove Blvd.
Whitestone, NY 11357
wimpf1@gmail.com

Condominiums & Cooperatives
Dale J. Degenshein
Stroock & Stroock & Lavan LLP
180 Maiden Lane, Suite 3961
New York, NY10038
ddegenshein@stroock.com

Continuing Legal Education
Scott A. Sydelnik
Davidson Fink LLP
28 E. Main Street, Suite 1700
Rochester, NY 14614
ssydelnik@davidsonfink.com

David J. Zinberg
Ingram Yuzek Gainen Carroll &
Bertolotti, LLP
250 Park Avenue, 6th Floor
New York, NY10177
dzinberg@ingramllp.com

Diversity
Harry G. Meyer
Hodgson Russ LLP
The Guaranty Building
140 Pearl Street
Buffalo, NY 14202
hgmeyer96@gmail.com

Green Real Estate
Joel I. Binstok
York Consulting
570 Lexington Avenue, Suite 2900
New York, NY 10022
JBinstok@yorkleaseaudit.com

Nicholas M. Ward-Willis
Keane & Beane, PC
445 Hamilton Avenue, Suite 1500
White Plains, NY 10601
nward-willis@kblaw.com

Sujata Yalamanchili
Hodgson Russ LLP
The Guaranty Building
140 Pearl Street Suite 100
Buffalo, NY 14202-4040
syalaman@hodgsonruss.com

Land Use and Environmental Law
Alan J. Knauf
Knauf Shaw LLP
2 State Street, 1400 Crossroads Building
Rochester, NY 14614-1314
aknauf@nyenvlaw.com

Linda U. Margolin
Bracken Margolin Besunder, LLP
1050 Old Nichols Road, Suite 200
Islandia, NY 11749
lmargolin@bmblawllp.com

Landlord and Tenant Proceedings
Paul N. Gruber
Borah, Goldstein, Altschuler, Nahins &
Goidel, P.C.
377 Broadway
New York, NY10013
pgruber@borahgoldstein.com

Landlord and Tenant Proceedings *(continued)*
Peter A. Kolodny
Kolodny PC
15 Maiden Lane, Suite 2000
New York, NY10038
pk@kolodnylaw.com

Legislation
Richard A. Nardi
Loeb & Loeb LLP
345 Park Avenue, 21st Floor
New York, NY10154
rnardi@loeb.com

Samuel O. Tilton
Woods Oviatt Gilman LLP
700 Crossroads Building, 2 State Street
Rochester, NY 14614-1308
stilton@woodsoviatt.com

Low Income and Affordable Housing
Richard C. Singer
Hirschen Singer & Epstein LLP
902 Broadway, 13th Floor
New York, NY 10010
rsinger@hseny.com

Membership
Jaime Lathrop
Law Offices of Jaime Lathrop, PC
641 President Street, Suite 202
Brooklyn, NY 11215-1186
jlathrop@lathroplawpc.com

Harry G. Meyer
Hodgson Russ LLP
The Guaranty Building
140 Pearl Street
Buffalo, NY 14202
hgmeyer96@gmail.com

Not-for-Profit Entities and Concerns
Susan E. Golden
Venable LLP
1270 Avenue of the Americas
New York, NY 10020-1700
SGolden@Venable.com

Anne Reynolds Copps
Copps DiPaola, PLLC
126 State Street, 6th Floor
Albany, NY 12207
arcopps@coppsdipaola.com

Professionalism
Patricia E. Watkins
Bartlett, Pontiff, Stewart & Rhodes PC
One Washington Street
P.O. Box 2168
Glens Falls, NY 12801-2168
pew@bpsrlaw.com

Professionalism ***(continued)***
Nancy A. Connery
Schoeman, Updike & Kaufman
551 Fifth Avenue
New York, NY 10176
nconnery@schoeman.com

Public Interest
Maria Theresa DeGennaro
Empire Justice Center
Touro Law Center PAC
225 Eastview Drive
Central Islip, NY 11722
mdegennaro@empirejustice.org

Daniel Farwagi Webster
Legal Services for the Elderly, Disabled or Disadvantaged of WNY, Inc.
438 Main Street, Suite 1200
Buffalo, NY 14202
dwebster@lsed.org

Publications
Marvin N. Bagwell
Old Republic National Title Insurance Co.
400 Post Avenue, Suite 310
Westbury, NY 11590
MBagwell1@OldRepublicTitle.com

Vincent Di Lorenzo
St. John's University School of Law
8000 Utopia Parkway
Belson Hall, Room 4-46
Jamaica, NY 11439
dilorenv@stjohns.edu

William P. Johnson
Nesper, Ferber, DiGiacomo, Johnson & Grimm, LLP
501 John James Audubon Pkwy
Suite 300
Amherst, NY 14228
wjohnson@nfdlaw.com

Matthew J. Leeds
Ganfer & Shore LLP
360 Lexington Avenue
New York, NY 10017
mleeds@ganfershore.com

Real Estate Construction
Gavin M. Lankford
Harris Beach PLLC
99 Garnsey Rd
Pittsford, NY 14534-4532
glankford@harrisbeach.com

Brian G. Lustbader
Schiff Hardin LLP
666 5th Avenue, Suite 1700
New York, NY 10103
BLustbader@schiffhardin.com

Real Estate Financing
Richard S. Fries
Sidley Austin LLP
787 Seventh Avenue
New York, NY 10019
richard.fries@sidley.com

Heather C.M. Rogers
Davidson Fink LLP
28 East Main Street, Suite 1700
Rochester, NY 14614
hrogers@davidsonfink.com

Real Estate Workouts and Bankruptcy
Garry M. Graber
Hodgson Russ LLP
The Guaranty Building
140 Pearl Street, Suite 100
Buffalo, NY 14202-4040
ggraber@hodgsonruss.com

Gino Tonetti
620 West 42nd Street, Apt. S4H
New York, NY 10036-2017
gino_tonetti@yahoo.com

Daniel Neil Zinman
299 Ridgewood Ave
Glen Ridge, NJ 07028
danzinmanesq@gmail.com

Student Affairs Committee
Ariel Weinstock
Katsky Korins LLP
605 3rd Avenue, 16th Floor
New York, NY 10158-0180
aweinstock@katskykorins.com

Title and Transfer
Gilbert M. Hoffman
Bousquet Holstein PLLC
110 West Fayette Street
One Lincoln Center, Suite 900
Syracuse, NY 13202
ghoffman@bhlawpllc.com

Toni Ann Christine Barone
Law Firm of Barone & Barone,LLP
43 New Dorp Plaza
Staten Island, NY 10306
tabarone@verizon.net

Website and Electronic Communications
Michael P. Stevens
Associate of Edward Joseph Filemyr IV
11 Park Place, Suite 1212
New York, NY 10007
michaelpstevens@gmail.com

Task Force on Attorney Escrow
Gilbert M. Hoffman
Bousquet Holstein PLLC
110 West Fayette Street
One Lincoln Center, Suite 900
Syracuse, NY 13202
ghoffman@bhlawpllc.com

Benjamin Weinstock
Ruskin Moscou Faltischek, P.C.
1425 RXR Plaza
East Tower, 15th Floor
Uniondale, NY 11556-1425
bweinstock@rmfpc.com

Task Force on Bylaws
Karl B. Holtzschue
Law Office of Karl B. Holtzschue
122 East 82nd Street
New York, NY 10028
kbholt@gmail.com

Task Force on Draft Department of Financial Services Title Insurance Regulations
Gerard G. Antetomaso
Evans Fox LLP
100 Meridian Centre Blvd.
Suite 300
Rochester, NY 14618
jerry@evansfox.com

Thomas J. Hall
The Law Firm of Hall & Hall, LLP
57 Beach Street
Staten Island, NY 10304-0002
hallt@hallandhalllaw.com

Task Force on Zombie House
Joel H. Sachs
Keane & Beane PC
445 Hamilton Ave
White Plains, NY 10601
jsachs@kblaw.com

Leon T. Sawyko
Harris Beach PLLC
99 Garnsey Road
Pittsford, NY 14534
lsawyko@harrisbeach.com

Section District Representatives

First District
Vacant

Second District
Lawrence F. DiGiovanna
Abrams Fensterman
1 MetroTech Centre
Suite 1701
Brooklyn, NY 11201
LDiGiovanna@abramslaw.com

Third District
Alice M. Breding
Law Office of Alice M. Breding, Esq., PLLC
1407 Route 9, Suite 10
Halfmoon, NY 12065-6588
alice@bredinglaw.com

Fourth District
Michelle H. Wildgrube
Cioffi Slezak Wildgrube, P.C.
2310 Nott Street East
Niskayuna, NY 12309
mwildgrube@cswlawfirm.com

Fifth District
Ann Marie McGrath
Law Office of Ann McGrath
8196 Oswego Rd.
Liverpool, NY 13090
annmcgrathesq@msn.com

Sixth District
John E. Jones
Hinman Howard & Kattell, LLP
700 Security Mutual
80 Exchange Street
Binghamton, NY 13901-3400
jonesje@hhk.com

Seventh District
Vacant

Eighth District
David Christopher Mineo
Chicago Title
55 Superior Boulevard
Mississauga, ON L5T2X9
Canada
dmineo@ctic.com

Ninth District
Lisa M. Stenson Desamours
1400 Half Moon Bay Drive
Croton On Hudson, NY 10520
lmstenson1@gmail.com

Tenth District
Daniel J. Baker, Esq.
Certilman Balin Adler & Hyman, LLP
90 Merrick Avenue
9th Floor
East Meadow, NY 11554
dbaker@certilmanbalin.com

Sanford A. Pomerantz
Schroder & Strom LLP
7 Jodi Court
Glen Cove, NY 11542
sandyslaw@optonline.net

Eleventh District
Joseph J. Risi
Risi & Associates
35-11 36th Street
Ste. 404
Long Island City, NY 11106
risi.associates@rcn.com

Steven Wimpfheimer
166-25 Powells Cove Blvd.
Whitestone, NY 11357-1522
wimpf1@gmail.com

Twelfth District
Vacant

Thirteenth District
Toni Ann Christine Barone
Law Firm of Barone & Barone, LLP
43 New Dorp Plaza
Staten Island, NY 10306
tabarone@verizon.net

Section Officers

N.Y. Real Property Law Journal

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Junior Staff Biographies

Full name: Nora Boujida
Year in school: Second Year Law Student at St. John's University School of Law
Position in Journal: Junior Staff Member
Email: boujida.nora@gmail.com
Biography: Nora Boujida intends to practice corporate law upon graduation. Her practice area interests include tax and securities law. During the summer of 2016, Ms. Boujida completed an in-house internship at Hubbell Inc., where she gained corporate experience and worked on mergers and acquisitions, tax, intellectual property, litigation, and employment law matters. This past fall, she also participated at the St. John's Securities Arbitration Clinic, where she represented underserved investors before FINRA in securities arbitration claims. This coming summer, Ms. Boujida is looking forward to joining Andersen Tax as a summer intern.

Name: Yesenia Campiglia
Year: Second Year Law Student at St. John's University School of Law
Position on Journal: Junior Staff Member
Email: yescampiglia@gmail.com
Biography: I came to law school to gain the knowledge and skills I needed to better help individuals in need. This *Journal* has allowed me to further develop my legal research and writing skills. While at St. John's University School of Law, I interned with The Door's Legal Services Center and worked on Special Immigrant Juvenile Status cases, representing clients before the Family Court and Immigration Court. I also visited a detention center in Texas to help refugee women and children prepare for their interviews with immigration judges. Currently, I am part of the Refugee & Immigrant Rights Litigation Clinic. After I graduate, I would like to practice in immigration law or family law.

Name: Nandini Chowdhury
Year: Second Year Law Student at St. John's University School of Law
Position on Journal: Junior Staff Member
Email: nandini.chowdhury@outlook.com
Biography: Throughout my time in law school, I have become particularly interested in real estate law and hope to practice in the field in the future. Since May 2016, I have been working at a law firm that focuses on representing lenders and mortgage servicers in foreclosure actions. At the firm, I assist with drafting affidavits and motions for summary judgment as well as with preparing memoranda of law pertaining to various real estate issues.

Name: James Clarke
Year: Second Year Law Student at St. John's University School of Law, M.S. Accounting Student at St. John's University College of Business
Position on Journal: Junior Staff Member
Email: Jclarke32@gmail.com
Biography: I am interested in performing both legal and financial services for a range of clients in the business world. Previously I have had the opportunity to develop experience in reducing commercial real property taxes through Article 78 certiorari proceedings, working with local Industrial Development Agencies, and handling contractual disputes. I plan to further develop my ability to represent businesses and investors of all sizes by working in fields including, but not limited to: real estate transactions, landlord-tenant relationships, tax planning, intellectual property, corporate and securities, labor and employment, contracts, commercial litigation, compliance, and general business formation, operation, and disposition.

Name: Richard Cordero
Year: Second Year Law Student at St. John's University School of Law
Position on Journal: Junior Staff Member
Email: richard.cordero15@gmail.com
Biography: While at St John's School of Law, I have interned with Edrington Americas, the parent company of luxury Scotch Liquor companies such as Macallan and Highland Park. Currently, I work as a law student advocate with the New York Legal Assistance Group (NYLAG) through their Economic Justice Clinic. I also work as an intern with Natter & Natter, a firm focusing on intellectual and copyright law. After passing the bar, I plan to practice trust and estate as well as real property law.

Name: Brian Driscoll
Year: Second Year Law Student at St. John's University School of Law
Position on Journal: Junior Staff Member
Email: Driscoll718@gmail.com
Biography: While at St. John's University School of Law, I discovered my interest in property law, particularly commercial and real estate transactions. My legal exposure began with my judicial internship with the Honorable Joseph Zayas, the Administrative Judge of Queens Supreme Court, Criminal Term. Although this internship focused around criminal law, I was also exposed to the procedural intricacies central to the legal system. I plan to use what I have learned from school and from my legal experiences to pursue my interest in property law.

Name: Kyle Gens
Year: Second Year Law Student at St. John's University School of Law
Position on Journal: Junior Staff Member
Email: kyle.gens15@stjohns.edu
Biography: I started my legal career working as a paralegal and arraignment clerk for Brooklyn Defender Services. Also before law school, I worked in a small real estate firm that focused on commercial real estate. While at St. John's School of Law, I have interned with Brooklyn Family Defense Practice in Brooklyn Family Court and currently I am part of the Criminal Defense Clinic in Brooklyn Criminal Court. I am interested in both criminal and real estate law.

Name: Philip George
Year: Second Year Law Student at St. John's University School of Law
Position on Journal: Junior Staff Member
Email: philip.george15@stjohns.edu
Biography: My primary interest is in Intellectual Property Law. Before I started law school, I worked at a local real estate firm that focused on residential real estate. This past summer I interned for the Honorable Charles Apotheker and I am currently working for an IP boutique firm in Manhattan that I interned for last semester.

Name: Christopher William Hofmann
Year: Second Year Law Student at St. John's University School of Law
Position On Journal: Junior Staff Member
Email: Christopher.Hofmann15@stjohns.edu
Biography: After an internship at the Manhattan District Attorney's Office during his senior year at New York University, Christopher knew he wanted to be a litigator. He is currently a member of his law school's mock trial team and a "student lawyer" in the Consumer Justice for the Elderly Litigation Clinic. Additionally, Christopher is involved in the Student Bar Association as a member of the Budget Allocation Committee. He previously was elected class representative during his 1L year. Although Christopher has previously worked at both the United States Attorney's Office and the Manhattan District Attorney's Office, he has a growing interest in Trusts & Estates and Land Use law and hopes to further explore these fields this summer.

Name: Aaron Jacob
Year: Second Year Law Student at St. John's University School of Law
Position on Journal: Junior Staff Member
Email: Aaronjacob17@gmail.com
Biography: I am interested in practicing law in real estate and tax law. Before entering law school I have worked in a real estate management firm, where I focused on preparing the management for incoming co-op owners. Currently, I am assisting low-income elderly individuals in dealing with consumer debt issues, including foreclosures and deed theft, as part of my participation in the Consumer Justice for the Elderly Litigation Clinic.

Name: Dana Kurtti
Year: Second Year Law Student at St. John's University School of Law
Position on Journal: Junior Staff Member
Email: dkurtti92@aol.com
Biography: Over the past two summers, I have interned at the Rockland County District Attorney's Office, which solidified my desire to be a litigator and to pursue a career in public service. This coming summer, I will be interning in the Summer Honors Program at the New York City Law Department, helping its over 800 attorneys provide legal representation for the City of New York. After law school, I am particularly interested in pursuing a career in either criminal prosecution or in the prosecution of juveniles.

Name: Maria Ortega-Lobos
Year: Second Year Law Student at St. John's University School of Law
Position on Journal: Junior Staff Member
Email: maria.ortegalobos15@my.stjohns.edu
Biography: The reason I came to law school was to make a difference in society and help those in need. I am interested in immigration but I want to venture into labor and employment law. While at St. John's University School of Law I was chosen to participate in a public interest trip to Texas. There, I helped detained women in Karnes with their credible fear interviews. This past summer I interned in Catholic Charities Community Services, helping unaccompanied minors with their asylum cases. This year I am in the Refugee and Immigration Rights Litigation Clinic, where I also assist in immigration services. I truly enjoy client interactions and seeing the fruits of my labor.

Name: Gleny M. Peña
Year: Third Year Law Student at St. John's University School of Law
Position on Journal: Junior Staff Member
Email: gleny.pena13@stjohns.edu.
Biography: I began my legal career right out of college working in law firms that focused on immigration and criminal law. I then worked at Kaye Scholer LLP in the commercial real estate department presenting lenders in complex transactional work. I was also a paralegal at the law firm Grad & Weinraub, LLP for over six years, assisting attorneys on real estate matters, both residential and commercial, tenant litigation and other general practice areas of law. I currently work as a Law Intern in the Law Department of the Port Authority of New York and New Jersey. I am interested in working in commercial real estate and maintaining my involvement in public interest work.

Name: Anthony Ruzzi
Year: Second Year Law Student at St. John's University School of Law
Position on Journal: Junior Staff Member
Email: aruzzi@me.com
Biography: During the summer after my first year at St. John's University School of Law, I worked in the Rockland County District Attorney's Office assisting two Assistant District Attorneys with their cases. I researched and drafted motion responses and represented the People in Justice Court. While the work was interesting, I found a passion for property law, which was my favorite 1L course, and accepted a position on the *Journal*. Currently, I am working with Legal Services NYC helping low income New York City residents file for bankruptcy. This summer and upon graduating I hope to find employment in bankruptcy, corporate, or property law.

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One Elk Street, Albany, New York 12207-1002

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