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N.Y. Real Property Law Journal

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

Real Property Law Section Lobbying Trip to Albany. See Report, p. 7.

L to R: George Haggerty, Karl Holtzschue, Gov. Andrew M. Cuomo, Dennis Greenstein, Anne Copps, Steve Alden and Jerry Antetomaso

NYSBA

Table of Contents

Message from the Outgoing Section Chair

Spring Edition

My initial contact with RPLS was a call from John Blyth as chair of the Nominating Committee asking if I would serve as a District Representative. Lester Bliwise was the incoming chair. As a District Representative, we were expected to keep the local bar associations apprised of what was new and exciting in the world of real property. In addition, we were expected to arrange a CLE and/or social program with local members. The chair or another officer would attend so that there was a connection to the section. The duties are much the same today. It is good to see that our current district reps have been having fun while carrying out this critical liaison function. Nancy Connery of the 1st has had several events, Margie Vella (3rd) and Michelle Wildgrube (4th) have a day at the Saratoga Race Track and holiday party, Laura Monte (8th) has had an event. Lisa Stenson Desamours (9th) had a joint party with the Westchester Bar. Lawrence DiGiovanna (2nd) held an event in Brooklyn on April 13. John Jones (6th) had an event in Binghamton on April 27.

The membership committee under David Berkey and Harry Meyer is working on a mentoring program. This will allow younger members to be assigned a more senior member as a mentor. This should be a great way to encourage younger lawyers to join RPLS and to make a more personal connection among our members. Please volunteer for this program by contacting Harry Meyer at HMeyer@hodgsonruss.com.

A new subcommittee of Membership is developing an internship program for law students. Stay tuned for developments.

Finally, I would like to thank everyone who made the Annual Meeting a huge success. Heather Rogers helped me plan the program and secure speakers. The speakers, John Jones, Michael Manzi, Dale Degenshein, Benjamin Weinstock, Nancy Connery, Richard Fries, Michael Berey, Matthew Leeds, Karl Holtzschue, Vincent Di Lorenzo, Christopher Burdick and Peter Coffey prepared great materials and scholarly presentations. Our liaison, Lori Nicoll, made the whole event look seamless and effortless, though we all know how much effort she put in to make it happen.

The entire section thanks our past chair, Joel Sachs, for the planning and execution of the Memorial Service of our dear friends, Ed Baer and Mel Mitzner. It was a beautiful service that remembered them personally as well as their contributions to the practice of law. There were several lighthearted as well as touching anecdotes. Both of our friends were mentioned and remembered many times during the meeting.

Our luncheon speaker, Brian Lawlor, Commissioner of Homes and Community Renewal (formerly DHCR), gave us an overview of what to expect in affordable housing in the upcoming years.

We also celebrated the RPLS Attorney Professionalism Award presented to Joshua Stein. He was joined by his mother, sister, daughter and many well wishes.

I hope to see all of you at the Summer Meeting in Ellicottville. It's just a quick, inexpensive flight from New York City and a short drive from Upstate. It is a great venue for families and very reasonably priced. Join us for good food, good friends and great CLE.

All the best! Anne

Summer Edition

You are being treated to three chair's messages in this edition as the spring and summer editions were combined this year. This is my last message to you as chair. You are in excellent hands with Heather Rogers, who took over as chair at the beginning of June. Heather has been a really great vice-chair. I value her advice and thoughtful counsel. The other officers, Steven Alden, Ben Weinstock and Spencer Compton, have been a very good team. We have had a number of thorny issues this year. Their assistance has been invaluable. David Berkey will be a fine addition to that team as incoming secretary.

The entire Executive Committee has been tremendously helpful in more ways than can be said. I want to particularly thank Karl Holtzschue for continuing to act as Parliamentarian and for his tireless efforts on Legislation with Sam Tilton.

The ethics committee of NYSBA is revisiting Opinion 817 (regarding seller's concessions). Tom Hall and Ben Weinstock provided invaluable time and assistance on preparing presenting material to the NYSBA ethics committee.

The remaining co-chairs of Title and Transfer, Joe DeSalvo and Jerry Antetomaso, took on the task of working with the Elder Law and Trusts and Estates Law Sections in an attempt to resolve the issues created by the Legislature in trying to recapture Medicaid dollars from estates.

(Continued on page 5)

Message from the Incoming Section Chair

I step into this role as Chair of the RPL Section a year early due to the untimely passing of our good friend, Ed Baer, but I do so with great honor and a hope that I will do Ed proud by walking in his feisty footsteps and taking us all where he should have led us. I want to thank Anne Reynolds Copps for her leadership this past year—I can only hope to handle it with half the grace and confidence as she did. I look forward to continue working with the fabulous team I have in Steve Alden as First Vice-Chair; Benjamin Weinstock as Second Vice-Chair; David Berkey as Secretary; and Spencer Compton as the Budget Officer, along with a superb list of who's who in the Real Estate Industry of dedicated members of the RPLS Executive Committee.

I have been a member of the Executive Committee for a number of years, and when I first started, not only was I one of a few women at the table, but arguably the youngest. The experience has been invaluable, making me both a better person and attorney. I consider myself extremely lucky to have gotten the chance to learn from some amazing attorneys, to work on meaningful projects and to improve my knowledge base. As the experience has been so rewarding, one of my goals for this coming year is to reach out to younger attorneys and their firms to encourage involvement in the Section. It is truly the gift that keeps on giving. To that end, our Summer Meeting this year in Ellicottville, New York at the Holiday Valley Resort was selected as it has something for everyone, including younger families. Please consider attending—the CLE schedule is top rate and the accompanying activities will not disappoint, I promise!

I want to encourage you to get involved in a committee or a task force on something that you are passionate about. We have lots to choose from and we could use your help! I look forward to working hard, listening well, and providing real value to those of you that are members of the RPL Section of the NYSBA, so I would like to invite you to contact me at anytime with questions, concerns or suggestions. My email is hrogers@davidsonfink.com.

This past year with the unfortunate passing of so many of our members we are reminded that no one can guarantee our quantity of life, so every decision should be based on quality—I hope you can continue to count on the RPLS as adding to that quality.

Heather C. M. Rogers

Message from the Outgoing Section Chair

(Continued from page 4)

We have a gifted group who have been very generous with their time and expertise. I am very grateful for this and for the wonderful friends with whom I have learned, laughed, cried, gardened, quilted, shopped, shared favorite books and wines. I thank you all for those opportunities. They were unforgettable and undoubtedly will continue.

I particularly want to thank past chairs for their leadership, guidance and willingness to provide continued service to the Executive Committee. They will undoubtedly give Heather the same valuable assistance.

As this went to press, we learned of yet another terrible loss to our section. Harold Lubell, one of our past chairs, died in early April 2011. Harold was a mentor and role model to many of our chairs. He was a gentleman in every way. In late January he called me to say that he would be missing the Annual Meeting for the first time. He had decided to stay in Florida a bit longer this year. We spoke for half an hour and he said he would see me in April. God laughs while mortals plan. Our condolences go to his wife and best friend, Ruth, and their lovely family.

All the best, Anne

In Memoriam

Harold Lubell

The Real Property Law Section mourns the loss of one of its outstanding leaders with the passing of Harold Lubell in April, 2011.

To this organization, Harold is most identified as one-time Chair of the Section, former Chair of the Condominiums and Cooperatives Committee and long-time member of the Executive Committee. Frequently, Harold also contributed significantly to other efforts and special projects, certainly not limited to the Committee on Continuing Legal Education, the Committee on Professionalism and a Special Committee on Mortgage Fraud.

That is only a list of offices. Colleagues who worked with Harold would offer that what he really provided was friendship, with the natural correlation of being a mentor, by example as much as by any advice that might be offered on a specific topic. This was not just handling administration and leadership of the Section and its Committees, but also involved instruction and approaches on how to conduct oneself, how to be collegial, how to share humor, and how to maintain perspective. In an organization of such varied constituencies that must serve practitioners in small and large population centers, upstate and downstate, small and large firms, in public service and in the private sector, Harold drew the real estate Bar together in a thread that served the entire State's legal community as a whole.

It was not as a result of mere tenure, but it was natural and even necessary, that Harold was one of the first recipients of the Section's highest honor, its Professionalism Award. In a career filled with recognition, Harold said repeatedly that that Award meant the most to him.

Looking at Harold's presence and contributions to the industry goes far beyond the State Bar, as he was active in numerous other organizations. Harold taught at Fordham Law School. He wrote and lectured widely for organizations ranging from *The Real Estate Review* to the American Land Title Association to the Practising Law Institute. He was a true dirt lawyer, who in his career also became a nationally known expert on real estate financing and an expert in the world of cooperatives and condominiums. These skills developed as a lawyer in small firm private practice, as Associate General Counsel with New York Life Company, as Assistant Attorney General in Charge of the Real Estate Financing Bureau of the Attorney General's Office and as a partner in Robinson Silverman Pearce Aronsohn & Berman, LLP (later merged into Bryan Cave, LLP) in New York City.

Harold was recognized as a Fellow of the American College of Real Estate Lawyers and worked in many groups, ranging from the Associated Builders Organization to the Rent Stabilization Association. In fact, Harold was for many years a representative on the New York Annual Rent Guidelines that annually set the maximum increases permitted in rent stabilized lease renewals.

We are glad to have known Harold. We will miss working with him and being with him.

The Executive Committee
Real Property Law Section

Report on RPLS 2011 Trip to the N.Y. State Legislature

For several years, the Real Property Law Section (RPLS) has had an active program of monitoring and reviewing proposed bills in the legislature and drafting bills of its own. On May 17, 2011, a group from the RPLS made our sixth annual trip to visit the legislators. Participants were: Anne Copps (RPLS Chair), Karl Holtzschue (Co-Chair Legislation Com.), Steve Alden (2nd V. Chair, Past Co-Chair Financing Com.), Jerry Antetomaso (Co-Chair Title and Transfer Com.), George Haggerty (Co-Chair UPL Com.), and Dennis Greenstein (Co-Chair Cooperatives & Condominiums Com.). Materials were prepared and appointments were arranged by Kevin Kerwin (Assoc. Dir., NYSBA Governmental Relations), who led us on our visit.

Meetings

(1) 10:30 am Office of Assemblywoman Helene Weinstein (Chair, Assembly Judiciary Com.)

(2) 11:15 am Office of Counsel to the Governor

(3) 12:30 pm Office of Senator DeFrancisco (Chair, Senate Finance Committee)

(4) **1:10 pm Governor Cuomo [!]**

(5) 1:30 pm Office of Assemblyman Morrelle (Chair, Assembly Insurance Com.)

(6) 2:30 pm Office of Senator Seward (Chair, Senate Insurance Com.)

We gave out a packet of materials at each meeting, including our contact information, a list of issues of interest to our section (listed below), and copies of several of our legislative memoranda.

Visit with Governor Cuomo

Our own George Haggerty, a friend of the Governor since boyhood, arranged for him to see us for about 20 minutes, an unexpected highlight of our visit! We are grateful for the opportunity to present our interests, on behalf of the Real Property Law Section, to the Governor. (See photo on front cover).

Licensing of Title Agents

As we did last year, we said that we support licensing of title agents and worked with the NYS Insurance Department on compromise legislation. That bill has not been introduced. We oppose, unless amended, the NYSID's original bill, which has been reintroduced as A4707, and we oppose the NYSLTA bill, both of which would make it impossible for lawyers to continue being title agents for clients.

Public Option Title Insurance

As we did last year, we said that we strongly oppose the bills to create government-run title insurance, saying that the present private system works very well. We said that we thought that the profits projected by the bills are illusory.

Disclosure of Title Insurance Service Charges

As we did last year, we explained the purpose of our consumer protection bill to require separate disclosure of title insurance charges. We thanked Senator De Francisco for sponsoring our bill this year (S4920) (NYSBA Memo # 10).

Repeal of Highway Law 120

As we did last year, we explained the purpose of our bill to correct an oversight in the Eminent Domain Procedure Law. We thanked Senator DeFrancisco for sponsoring our bill this year (S4919). We told the Senator that we would review objections he had received that the bill might prevent negotiations outside the EDPL.

Electronic Recording

We explained that we support electronic recording, but had recommended some clarifying changes (RPLS Memo # 10).

Coop/Condo Ombudsman

We explained that we oppose the bill to establish an ombudsman for cooperative and condominiums (RPLS Memo #13).

Unauthorized Practice of Law

We explained that we support A5700/S1998, which would make unauthorized practice of law a felony, recommending that it be expanded to cover a couple of other sections. We explained that a committee of NYSBA is drafting a similar bill that would felonize UPL only where there is material damage.

Private Transfer Fees

We said that we support the bill to prohibit private transfer fees (RPLS Memo #14).

Standing to Foreclose Mortgages

We said that we had not taken a formal position yet on A629/S697, but that we had concerns that it might be read to not permit a lost note affidavit, that holding an original mortgages was not necessary as they are recorded, and that there are no notes in some foreclosure cases, such as condominium liens and tax liens.

Assignment of Mortgage in Lieu of Discharge

Senator DeFrancisco shared with us his bill to allow a mortgagor to receive an assignment of mortgage in lieu of a discharge when the mortgagor is refinancing an existing loan (S2906). [We had previously decided to support the bill, but not issue a memo]. He asked us to review potential amendments, which appear to be unnecessarily complex.

RPLS Memoranda are available on the RPLS website.

Karl B. Holtzschue
Co-Chair, RPLS Legislation Committee

Select Issues in Representing HPD Supervised Mitchell-Lama Cooperatives

By Adam Leitman Bailey and Leni Morrison Cummins

New York City Mitchell-Lama cooperatives provide heavily publicly subsidized maintenance payments to those lucky enough to call them home.[1] The New York City Mitchell-Lama program provides 54,000 homes to persons whose financial circumstances would otherwise negate such a possibility.[2] As a result, Mitchell-Lama cooperatives are extremely popular and have decade-long waiting lists. As with many desirable things in life, corruption pervades the Mitchell-Lama process.[3] In some buildings, illegal black markets sell apartments for 500 percent higher than maximum legal sales prices. For example, in one building we represent, a one-bedroom apartment is legally sold for $20,000, but goes for upwards of $100,000 on the black market. Other unit owners attempt to make money on their units by subletting them or by charging key money upon an illegal sale.[4]

The Board of Directors of a New York City Mitchell-Lama cooperative is responsible for ensuring that all its shareholders are legitimate and comply with title 28, chapter 3 of the Rules of the City of New York (the "Mitchell-Lama Rules").[5] This can be a daunting task in that these buildings consist of hundreds to thousands of units. Therefore, many Boards of Directors hire attorneys to investigate and prosecute illegality in their cooperatives, including non-payment of maintenance, false claims to succession rights, non-primary residence, illegal sublets, and falsification of documents.

Fraud claims, which include, but are not limited to, forged birth certificates, cooked-up tax returns, false forms of identification, fake nationality papers, and sham bank accounts, are complex to battle. To prove the fraud, the law firms that the Board of Directors hire need to have the sophistication and expertise to hunt down the truth and to ensure the sanctity of maintaining affordable housing in New York City.

Non-Payment of Maintenance

The Board of Directors assesses and calculates maintenance based on household composition and income, as reported on Household Income Affidavits.[6] The Board must verify the accuracy of Household Income Affidavits by comparing income stated on each affidavit with the income stated on each occupant's certified tax return.[7] If shareholders do not submit their Household Income Affidavits or certified tax returns in a timely manner, the regulations require the Board to apply a rent surcharge. The Board's attorneys verify that the Board is assessing the proper maintenance, and will commence proceedings against shareholders who do not pay their maintenance. In most proceedings involving a New York City Mitchell-Lama cooperative, the Board attorneys must first commence proceedings before the Department of Housing Preservation and Development ("HPD") to obtain a so-called "certificate of eviction" prior to going to court;[8] however, for non-payment of maintenance cases, attorneys may go directly to civil court by bringing a summary non-payment proceeding.[9]

Succession Rights

To avoid the decade-long Mitchell-Lama waiting lists, many prospective shareholders attempt to establish their right to succeed to the tenancy of a shareholder who is deceased or has permanently vacated the premises.[10] Prospective shareholders will go to great lengths to prove their right to succeed to a tenancy. The Board's attorneys must know every detail of the Mitchell-Lama rules and must scrutinize each and every document the purported successors submit to make sure they appear truthful and accurate. When such documents reveal a facial anomaly, the Board's attorneys will often contact the applicants to resolve the issue before going to formal administrative proceedings.

According to title 28 of the Rules of the City of New York ("R.C.N.Y."), section 3-02(p), a purported successor must establish the following to prove his or her right to succeed to a tenancy: (1) he or she is a family member of a deceased or vacated shareholder or a person with a financial and emotional interdependence with a shareholder of record;[11] (2) he or she resided with a shareholder of record in the premises as their primary residence for at least two years prior to the death of a shareholder of record (or permanent vacating of the apartment), or at least one year if the remaining occupant is a senior or disabled; and (3) he or she appeared on at least the last two Household Income Affidavits the shareholder of record submitted prior to the shareholder's death (or permanent vacating of the apartment).[12] If the years in question are prior to 2003, HPD will view the Household Income Affidavits only as an indicating factor of residence and will not view them as dispositive of residence or lack thereof.[13]

The first requirement of R.C.N.Y. section 3-02(p), requires a minimum familial relationship.[14] Section 3-02(p)(2)(ii) defines "family" as "husband, wife, son, daughter, stepson, stepdaughter, including any adopted children, father, mother, stepfather, stepmother, brother, sister, nephew, niece, uncle, aunt, grandfather, grandmother, grandson, granddaughter, father-in-law, mother-in-law, son-in-law, or daughter-in-law."[15]

The rules also include a codification of the expanded definition of family from *Braschi v. Stahl Associates Company*.[16] "Family" also includes those people who can prove an "emotional and financial commitment and interdependence" between themselves and a shareholder of record.[17] No single factor is determinative, but HPD will review the following factors: longevity of the relationship, shared payment of expenses or bills, joint ownership of bank accounts or joint credit cards, engaging in family activities together, executed wills in each other's names, holding themselves out as family members, regularly performing family functions, and engaging in patterns of behavior showing emotional commitment.[18] These criteria require that the parties acted like family, but not necessarily that their relationship was spouse-like or that the parties had any particular sexual orientation.[19]

When a Board alerts its attorneys that an occupant's claim to succession rights may be illegal, attorneys must investigate to confirm or refute the illegality.[20] In this regard, it is important to realize that the goal is only the supervising agency's satisfaction that the Mitchell Lama's management is making appropriate efforts to limit the governmental benefits it administers to those who are genuinely entitled to them, which keeps those benefits flowing to the entire complex, including those for whom there is no question that they are duly qualified.[21] HPD will therefore make frequent inquiries to ascertain that the Board and its attorneys are employing appropriate levels of diligence. Therefore, the Board's attorneys' single most important job in preserving the Mitchell-Lama development's subsidies is to keep HPD satisfied that the Board is acting vigilantly to limit the development's occupants to those who are legally entitled to be such.

Therefore, in succession cases, attorneys first send a demand letter to the purported successor at the address of the premises requesting that he or she submit documents to prove within a reasonable period from the date of the letter (a two-week period is advisable) his or her right to succeed to the tenancy.[22] HPD views the following documents as proof of requisite relationship and residence: certified birth certificates, certified tax returns, and W-2s.[23] HPD views the following documents as merely indicative (but not dispositive) proof of requisite relationship and residence: church or temple records, expired or current driver's licenses, expired or current passports and passport applications, documents relating to voter registration, past or current library cards, documents relating to health club membership, documents relating to any purchase or lease of a motor vehicle, credit card and bank account statements.[24]

Attorneys should engage in further due diligence to ensure the legitimacy of documents they receive from purported successors. With regard to foreign birth certificates, attorneys should take special care to ensure that translated birth certificates are legitimate (not forgeries) and that they correspond to certified birth certificates from the corresponding foreign country. Where the attorney doubts the genuineness of the birth certificate, he or she is well advised to consult an independent translator.[25] Attorneys should also do a database search for both the shareholders of record and the purported successors to determine a history of residences,[26] and verify the death of those allegedly deceased record shareholders. Attorneys will also consider hiring a private investigator to perform a detailed analysis and report on the purported successor and record shareholders to determine familial relationship and cohabitation.[27]

Once the attorneys have established that succession does not appear proper under the rules, they must send a Denial of Succession Rights letter to the purported successor and send a copy to HPD.[28] Upon receipt, HPD will send a letter to both the purported successor and the attorney requesting that both parties submit the documentary proof of each party's position. The HPD Hearing Officer will then independently review the documents submitted by both sides and make a decision.[29] The Hearing Officer's decision will either be a denial of succession rights, which will include a Certificate of Eviction, or a decision not to deny succession rights.[30] If the Hearing Officer decides to deny succession rights and issues a Certificate of Eviction, the attorneys must then bring an eviction proceeding in Housing Court based on the Certificate of Eviction.[31] If the Hearing Officer decides not to deny succession rights, the attorney may appeal the decision through a CPLR Article 78 proceeding[32] or request that succession rights be granted through HPD's division of Administrative Services. If HPD's division of Administrative Services determines that the purported successor has succession rights, the Board may reissue the stock in the successor's name.[33] If it does not, the attorney is essentially forced to commence an Article 78 proceeding because HPD has simultaneously not denied succession, but has refused to grant it. Fortunately, such events are indeed rare. In actual practice, HPD generally gives the attorneys substantial cooperation in advising what must be done to get all the right pegs into the right holes.

Non-Primary Residence and Illegal Sublet Cases

A shareholder of a Mitchell-Lama cooperative must maintain the cooperative apartment as a primary residence.[34] R.C.N.Y. section 3-02(n)(4) states: "It is required that the apartment of the tenant/cooperator be at initial occupancy and continue to be his or her primary place of residence."[35] In addition, R.C.N.Y. section 3-02(n)(3) states: "No tenant/cooperator may accept any consider-ation or thing of value from a guest, invitee or other occupant in exchange for occupancy, whether temporary or permanent, unless such person is listed on the application, income affidavit or re-certification of the tenant/cooperator and the tenant/cooperator continues to maintain the apartment as his or her primary residence."[36]

To build a case against a shareholder for non-primary residence or illegal sublet, the attorneys must once again begin with fact-finding. The attorneys should begin by searching investigative databases to confirm identified alternative addresses for the record shareholders and to ascertain or confirm the names of the possible illegal subtenants.[37] In addition, to gather further evidence and information to establish their case, attorneys should hire private investigators to engage in undercover investigation.[38] Attorneys should also send a letter to the shareholder requesting proof that he or she maintains the cooperative apartment as a primary residence, sending the letter both to any identified alternate addresses and the address of the premises.[39] Attorneys should also send a letter to any identified illegal subtenants or to any unidentified occupants because an illegal occupant may respond to the letter with proof of the illegal occupancy without realizing the purpose of the letter, thereby proving the case against the shareholder.

If the shareholder submits documentation in an effort to prove that the premises are a primary residence, attorneys should carefully scrutinize the documents to look for possible fraud on the part of the shareholder.[40] Indicators of possible fraud include: (1) the shareholder submits ancillary documents (e.g., magazines or advertisements mailed to the residence in the shareholder's name), but nothing dispositive of residency (i.e., such as certified tax returns or W-2s); or (2) the shareholder submits bank account or credit card statements that have very little activity or low balances.

Once the attorneys have acquired ample proof of non-primary residence or illegal sublet and have given the shareholder at least two weeks to submit documentation, they may bring an action against the shareholder. According to R.C.N.Y. sections 3-18(a)(2) through (3)(i), the attorneys must send the shareholder a Notice of Intention to Terminate Lease and Preliminary Notice of Grounds for Eviction ("Notice of Intention to Terminate") by hand-delivery to the shareholder or to a person of suitable age and discretion at the premises.[41] Pursuant to R.C.N.Y. section 3-18(a)(1), the attorneys must also serve the Notice of Intention to Terminate by either first-class and certified or registered mail, with return receipt requested.[42]

Once the attorneys have served the Notice of Intention to Terminate, and ten days have passed, the attorneys must provide HPD with proof that justifies eviction, together with an affidavit stating that the attorneys effectuated service of the Notice of Intention to Terminate upon the shareholder, as mandated by R.C.N.Y. section 3-18(a).[43] The attorneys may then schedule a Hearing with HPD and, having done so, must serve the Notice of Hearing upon the shareholder at the address of the premises using the same methods of service used for the Notice of Intention to Terminate.[44] The attorneys should give the shareholder sufficient notice in advance of the Hearing to allow the shareholder to arrange scheduling without an excuse for an adjournment or worse, a default. While the statute does not prescribe a set amount of time to provide, it is advisable to allow ample time to close out tenant-generated delays.

HPD conducts the initial Hearing in the form of a conference. Officially, the role of the Board's attorney attending the Hearing is to explain the Housing Company's position. However, the Board's attorney should use the Hearing as an opportunity to: (i) establish admissions from the shareholder by asking appropriate questions about the location of the actual residence, and who, if anyone, is residing in the Mitchell-Lama premises; and (ii) settle the case by giving the shareholder a few months to vacate the premises. To encourage settlement, the attorney should inform the shareholder of R.C.N.Y. section 3-06(A)(2), which allows a Board to deduct from a shareholder's equity investment in the cooperative any legal fees incurred on its behalf in bringing a proceeding against a shareholder.[45] Otherwise, long HPD hearings, followed by Housing Court proceedings, will likely exhaust the equity. Understanding this, a logical shareholder will seriously consider settlement.

If the Board's attorney does not settle the case at the initial Hearing, the Hearing Officer will schedule a formal hearing.[46] At the hearing, the Board's attorney must establish a *prima facie* case against the shareholder, but the Hearing Officer is not bound by the rules of evidence.[47] According to R.C.N.Y. section 3-18(b), the Hearing Officer may accept any evidence deemed relevant and material.[48] This routinely includes hearsay, but rarely third-hand hearsay. If the Hearing Officer decides against the shareholder, the Hearing Officer will include the issuance of a Certificate of Eviction in the decision.[49] The Board's attorneys may use the Certificate of Eviction as incontrovertible evidence of the illegal occupancy in a summary holdover proceeding in Housing Court. The Housing Court is fairly limited in its determination to whether service of process was correctly done in its proceeding because the only allowable challenge to or contradiction of a certificate of eviction is an Article 78 proceeding.[50]

Falsification of Documents

Most Mitchell-Lama leases contain a clause that calls for a default if a shareholder submits false documents to the Board or the managing agent. If a shareholder falsifies either Household Income Affidavits (incorrect statements as to household composition or amount of income) or lease applications, the attorneys should immediately send the shareholder a Notice of Intention to Terminate for reason of breach of the lease clause that prohibits falsification of documents.[51] The attorneys should then follow the same procedures for marshalling evidence and scheduling hearings that they use in primary residence and illegal sublet cases.

Conclusion

Representation of a New York City supervised Mitchell-Lama cooperative is a subspecialty all its own. It is governed entirely by a set of rules that are generally clear, except when it comes to figuring out just how those rules interact with the summary proceedings statutes. The great challenge for an attorney undertaking this kind of representation is to get the big picture: the client has relatively little reason to care in its own right whether individual cooperators are abiding by the rules, with the notable exception of nuisance or other things that can harm the complex. However, the client cares a great deal that HPD sees that the Board is diligently enforcing the rules. That, therefore, is the standard: satisfying HPD. While for other landlord clients, attorneys should be keeping an eye on the bottom line, since Mitchell-Lama complexes are designed to operate at a tax subsidized loss, maintaining entitlement to the subsidy is vastly more important than minimizing losses.

Endnotes

1. There are both New York City supervised and New York State supervised Mitchell-Lama projects. This article focuses on those supervised by New York City's Department of Housing Preservation and Development ("HPD"). *See generally State Supervised Middle Income Housing Developments For Families and Senior Citizens*, N.Y. State Homes & Community Renewal, http://www.dhcr.state.ny.us/apps/hsgdevls/hsgdevls.asp (last visited Apr. 18, 2011); *Mitchell-Lama Housing*, N.Y. City Dep't of Housing Pres. and Dev., http://www.nyc.gov/html/hpd/html/apartment/mitchell-lama.shtml (last visited Apr. 18, 2011).
2. *Mitchell-Lama Housing*, N.Y. City Rent Guidelines Bd., http://www.housingnyc.com/html/resources/mitchell/ mitchell.html (last visited Apr. 18, 2011).
3. *See* Charles V. Bagli, *Subsidized Housing Plagued by Neglect and Corruption*, N.Y. Times, Sept. 20, 2007, at B3, *available at* http://query.nytimes.com/gst/fullpage.html?res=940CE6DD163AF933A1575AC0A9619C8B63.
4. *See An In Depth Review of the Division of Housing and Community Renewal's Oversight of the Mitchell-Lama Program*, N.Y. State Office of the Inspector Gen. (Sept. 2007), http://www.ig.state.ny.us/reports/reports-2007.html; *see also* Office of the N.Y. State Attorney Gen., Tenants' Rights Guide, *available at* http://www.ag.ny.gov/publications/2011/Publications/Tenant_Rights_2011.pdf.
5. *See generally* 4 Warren's Weed New York Real Property § 33.42 ("All aspects concerning a cooperative corporation's board of directors are governed by the corporate law pursuant to which the cooperative corporation is organized.… Additionally in government-assisted cooperatives, various statutes, rules and regulations may affect the workings of a particular board.").
6. *See generally* N.Y.C.R.R tit. 9, ch. 4, § 1727-2.3 (LEXIS 2011) ("[T]he housing company shall take such steps as it deems necessary to ascertain and verify that gross income of applicants, tenants or cooperators is within applicable income limits.… As a minimum, verification of aggregate annual income will be based upon information furnished as outlined below. Note that more than one method may be needed to obtain acceptable verification.… (8) Notarized affidavit from person or persons making contributions, in case of contributions by relatives or other persons. Dates and amounts of contributions should be specified."), *available at* http://www.metcouncil.net/factsheets/9NYCRR1727.html.
7. *See generally* New York, N.Y., R.C.N.Y. tit. 28, ch. 3, § 3-03 (c)(4) (N.Y. Leg. Publishing Co. 2010) ("The income affidavits will be subject to verification at any time, pursuant to such method as may be determined by HPD, including, but not limited to, spot check audits of certified income tax forms and verification by the New York State Department of Taxation and Finance as set forth in § 60(9) of the Private Housing Finance Law.").
8. *See id.* § 3-18(a) ("Except as otherwise provided in this subdivision, no eviction proceeding based upon a holdover or a breach of the terms of the lease or occupancy agreement shall be initiated by a housing company against a residential tenant/cooperator without the issuance of a certificate of eviction by HPD following an administrative hearing by an HPD designated hearing officer."). New York State Mitchell-Lama cooperatives differ from New York City Mitchell-Lama cooperatives in that the governing regulations do not require State Mitchell-Lama cooperatives to follow the additional agency procedure required for City Mitchell-Lama cooperatives. Instead, under title 9 of the N.Y.C.R.R., section 1727-5.3, attorneys for New York State Mitchell-Lama cooperatives must send a verified petition to the commissioner, who then must certify that he has no objection to the eviction procedure.
9. *See* R.C.N.Y. tit. 28, ch. 3, § 3-18(a) ("Notwithstanding the foregoing, such hearing and certificate of eviction shall not be required for any eviction proceeding based upon non-payment of rent/carrying charges or any sum which constitutes rent or additional rent pursuant to the applicable lease or occupancy agreement.").
10. *See* Villafane v. N.Y. State Div. of Hous. & Cmty. Renewal, 2009 WL 2208403, at *5 (Sup. Ct. N.Y. County 2009) ("The right to request succession in housing accommodations subject to [Mitchell-Lama] arises when the tenant of record of the subject apartment dies or otherwise permanently vacates the apartment." (citing 9 N.Y.C.R.R. § 1727-8.3(a))).
11. *See* R.C.N.Y. tit. 28, ch. 3, § 3-02(p)(2)(ii)(B). The criteria for determining such interdependence are identical to those currently prevalent in both rent control and rent stabilization.
12. *See Villafane*, 2009 WL 2208403 at *5 (citing 9 N.Y.C.R.R. §§ 1727-3.6, 1727-8.2(a)(2)(b)).
13. The Mitchell-Lama Rules were amended in 2003, and HPD recognizes claims relating to years prior as grandfathered under the Mitchell-Lama Rules prior to the 2003 revision. *See* Kahn v. N.Y. City Dep't of Hous. Pres. & Dev., 2010 N.Y. Slip Op 51197U, *3 (Sup. Ct. N.Y. County 2010) ("The regulations implementing the Mitchell-Lama Law which relate to succession rights were amended as of

February 1, 2003 (discussing title 28 of the R.C.N.Y., section 3-02(p)).

14. *See* R.C.N.Y. tit. 28, ch. 3, § 3-02 (p)(1).

15. *Id.* § 3-02 (p)(2)(ii)(A).

16. 74 N.Y.2d 201, 211, 543 N.E.2d 49, 53–54, 544 N.Y.S.2d 784, 788–89 (1989).

17. *See id.*; *see also* R.C.N.Y. tit. 28, ch. 3, § 3-02(p)(2)(ii)(B).

18. *See* R.C.N.Y. tit. 28, ch. 3, § 3-02(p)(2)(ii)(B).

19. *See Braschi* at 211, 543 N.E.2d at 53–54, 544 N.Y.S.2d at 788–89 (1989) (holding that the term "family" was applicable to a homosexual couple); R.C.N.Y. tit. 28, ch. 3, § 3-02 (p)(2)(ii)(B).

20. *See e.g.*, Matter of Oehling v. Donovan, 7 Misc. 3d 1005A, 801 N.Y.S.2d 238, 2005 N.Y. Slip Op. 50464U (Sup. Ct. King's County 2005) (unreported) (using investigation conducted by the private housing company as proof of an illegal succession claim).

21. *See Note 2: Statement of Basis and Purpose in City Record* (Nov. 12, 2003), R.C.N.Y. tit. 28, ch. 3, § 3-02.

22. *See* R.C.N.Y. tit. 28, ch. 3, § 3-02(p)(3).

23. *See id.* § 3-02 (n) ("The facts and circumstances to be considered in determining whether a tenant/cooperator occupies a dwelling unit as his or her primary residence include, but are not limited to, whether such tenant/cooperator: (i) specifies an address other than such dwelling unit as his or her place of residence or domicile in any tax return, motor vehicle registration, driver's license or other document filed with a public agency.…").

24. *See id.* § 3-02 (p)(2)(ii)(B) (explaining the factors to be considered in determining whether a person residing with the tenant/cooperator can prove an "emotional and financial commitment and interdependence" between that person and the tenant/cooperator to come within the definition of "family member" under the rule).

25. It has been the experience of the authors' offices that any one complex will have a surprisingly low number of different foreign countries involved as the homelands of the residents. This means that at most small numbers of independent interpreters will suffice and often the language in question may be known to one or more of the attorneys' own employees.

26. *See, e.g.*, Matter of Oehling v. Donovan, 7 Misc. 3d 1005A, 801 N.Y.S.2d 238, 2005 N.Y. Slip Op 50464U (Sup. Ct. King's County 2005) (using an investigation report provided by the housing company as proof of petitioner's lack of habitation of the subject premises).

27. *See* Santiago v. E. Midtown Plaza Hous. Co., Inc. & N.Y. City Dep't of Hous. Pres. & Dev., 2007 N.Y. Slip Op. 32101(U), 2007 WL 2176927, at *1, (Sup. Ct. N.Y. County 2007) (explaining that the landlord hired a private investigator to prove the apartment was not petitioner's primary residence).

28. *See* Matter of Hampton v. N.Y. City Div. of Hous. & Cmty. Renewal**,** 9 Misc. 3d 1106(A), 2005 N.Y. Slip Op. 51433(U) (Sup. Ct. N.Y. County 2005) *available at* http://www.nycourts.gov/reporter/3dseries/2005/2005_51433.htm (stating that the documentary evidence included a "three page letter which annexes the landlord's attorney's affirmation in opposition to the succession rights request").

29. *See* R.C.N.Y. tit. 28, ch. 3, § 3-02(p)(8)(ii) ("The Commissioner or his or her designee…shall issue the final agency decision with regard to the applicant's application.").

30. *See id.*

31. *See id.* § 3-18(b) ("In the event the hearing officer finds grounds for the eviction, he or she shall issue a certificate authorizing the housing company to commence summary proceedings for such eviction of the tenant/co-operator.").

32. *See e.g.,* Trump Vill. Section 3, Inc. v. Dashevsky, 8 Misc. 3d 777, 783, 799 N.Y.S.2d 854, 857 (N.Y. Civ. Ct. N.Y. County 2005) (explaining that the only method of review of the commissioner's certificate of "Eviction" or "No Objection" is by a CPLR article 78 proceeding in Supreme Court); R.C.N.Y. tit. 28, ch. 3, § 3-02(p)(8)(ii).

33. *See* R.C.N.Y. tit. 28, ch. 3, § 3-06(d) ("In no event may the right of occupancy in a Mitchell-Lama mutual housing company development be bequeathed to another. Upon the death of the tenant/co-operator, the shares must be returned to the mutual housing company, which will arrange for a sale pursuant to subdivision (a) of this section. Notwithstanding the foregoing, eligible members of the tenant/cooperator's immediate family in occupancy may acquire such shares if they meet the requirements of § 3-02(p) of these rules.").

34. *See* R.C.N.Y. tit. 28, ch. 3, § 3-02(m)(1)(vi).

35. *Id.* § 3-02(n)(4).

36. *Id.* § 3-02(n)(3).

37. *See* Matter of Hochhauser v. N.Y. City Dep't of Hous. Pres. & Dev., 48 A.D.3d 288, 289, 853 N.Y.S.2d 22, 23 (1st Dep't 2008) (finding that petitioner did not sustain his burden of establishing his entitlement to succession rights after evidence showed that he provided an address other than the subject apartment as his place or residence on a tax return filed during the relevant time period).

38. *See* Christine Haughney, *Using Private Eyes to Keep Track of Tenants,* N.Y. Times, Aug. 30, 2010, at A18, *available at* http://www.nytimes.com/2010/08/31/nyregion/31appraisal.html?scp=1&sq=8/31/2010,%20TENANT&st=cse.

39. *See* R.C.N.Y. tit. 28, ch. 3, § 3-02(n)(4)(iv).

40. *See id.* § 3-02(n)(4)(i)-(iv); *see generally* Waterside Redevelopment Co. v. N.Y. City Dep't of Hous. Pres. & Dev., 270 A.D.2d 87, 88, 704 N.Y.S.2d 63, 65 (1st Dep't 2000) (holding that tenant's subletting a portion of the apartment without the express written approval of petitioner and HPD and her intentional failure to include the other occupants, or their income, on her annual income affidavits constituted acts of fraud and/or illegality that were not curable).

41. *See* R.C.N.Y. tit. 28, ch. 3, § 3-18(a)(2).

42. *See id.*

43. *See id.* §§ 3-18 (a), (b).

44. *See id.* § 3-18 (b).

45. *See generally* Greystone Mgmt. v. Conciliation & Appeals Bd. of N.Y., 94 A.D.2d 614, 462 N.Y.S.2d (1st Dep't 1983).

46. *See* R.C.N.Y. tit. 28, ch. 3, § 3-18 (b).

47. *See id.* ("The hearing officer may accept any evidence which he or she deems to be relevant and material.").

48. *See id.*

49. *See id.* § 3-18(a) ("[N]o eviction proceeding based upon a holdover or a breach of the terms of the lease or occupancy agreement shall be initiated by a housing company against a residential tenant/cooperator without the issuance of a certificate of eviction by HPD following an administrative hearing by an HPD designated hearing officer.").

50. *See* R.C.N.Y. tit. 28, ch. 3, § 3-18 (c).

51. *See* N.Y. Admin. Code tit. 9, ch. 4, §§ 1727-5.3 (a)(7), (8)(b)(2) (2010) (LEXIS); *see generally* Hochhauser v. N.Y. City Dep't of Hous. Pres. & Dev., 48 A.D.3d 288, 288, 853 N.Y.S.2d 22, 23, 2008 N.Y. Slip Op. 1414 (1st Dep't 2008).

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Sales and Compensating Use Tax—Title Abstracts and Searches

By Christopher W. Burdick

This article summarizes the applicability of sales and compensating use tax to abstracts of title, tax searches, municipal violation searches and certain other information services effective September 1, 2010.[1]

A. Announcement of the New Policy

The new policy first was announced by the New York State Department of Taxation and Finance on July 19, 2010, through a bulletin (the "July 19 Bulletin")[2] intended to "clarify the tax treatment of certain information services under sections 1105(c)(1) and 1005(c)(9) of the Tax Law."[3] The policy was discussed further in the Department's September 23, 2010, Tax Bulletin (the "September 23, 2010 Bulletin"),[4] and through a series of exchanges with the New York State Land Title Association ("NYSLTA").[5]

The relevant portions of the New York State Tax Law are as follows:

> § 1105. Imposition of sales tax
>
> On and after June first, nineteen hundred seventy-one, there is hereby imposed and there shall be paid a tax of four percent upon:
>
> ****
>
> (c) The receipts from every sale, except for resale, of the following services:
>
> (1) The furnishing of information by printed, mimeographed or multigraphed matter or by duplicating written or printed matter in any other manner, including the services of collecting, compiling or analyzing information of any kind or nature and furnishing reports thereof to other persons, but excluding the furnishing of information which is personal or individual in nature and which is not or may not be substantially incorporated in reports furnished to other persons, and excluding the services of advertising or other agents, or other persons acting in a representative capacity, and information services used by newspapers, radio broadcasters and television broadcasters in the collection and dissemination of news, and excluding meteorological services.
>
> ****
>
> (9) (i) The furnishing or provision of an entertainment service or of an information service (but not an information service subject to tax under paragraph one of this subdivision), which is furnished, provided, or delivered by means of telephony or telegraphy or telephone or telegraph service (whether intrastate or interstate) of whatever nature, such as entertainment or information services provided through 800 or 900 numbers or mass announcement services or interactive information network services. Provided, however, that in no event (i) shall the furnishing or provision of an information service be taxed under this paragraph unless it would otherwise be subject to taxation under paragraph one of this subdivision if it were furnished by printed, mimeographed or multigraphed matter or by duplicating written or printed matter in any other manner nor (ii) shall the provision of cable television service to customers be taxed under this paragraph.
>
> (ii) Notwithstanding the rate and date set forth in the opening undesignated paragraph of this section and notwithstanding the opening undesignated paragraph of this subdivision, on and after September first, nineteen hundred ninety-three, in addition to any other tax imposed under this section, and in addition to any other tax or fee imposed under any other provision of law, there is hereby imposed and there shall be paid an additional tax at the rate of five percent upon the receipts which are subject to tax under subparagraph (i) of this paragraph on the furnishing or provision of an entertainment or information service which is received by the customer exclusively in an aural manner. Such additional tax shall not be imposed by section eleven hundred seven, eleven hundred eight or eleven hundred nine of this article and shall not be

included among the taxes authorized to be imposed pursuant to the authority of article twenty-nine of this chapter.[6]

The Department's July 19 Bulletin explained that although its policy on the taxability of the sale of certain public documents had previously been set out in an Advisory Opinion, some may have continued to "reasonably rely" upon correspondence to the contrary from the Department predating the Opinion.[7] The bulletin cited the Department's advisory opinion in *State Farm Mutual Automobile Insurance Co*.[8] The Opinion replied to petitioner's December 14, 2001 query regarding whether reports furnished to State Farm by two separate companies for retrieving accident reports from local police authorities were subject to sales or compensating use tax.[9] The companies, which State Farm engaged, did not obtain such reports from a database or computer terminal but in person or by mail from the police department. The Department held that "the furnishing of copies of records obtained by a company from a police agency's files is the furnishing of an information service and is not a delivery service even though the information is collected from a single source… [t]his service is not exempt merely because the information may have been generated from a governmental source."[10]

The changes, the Department stated in its July 19 Bulletin, "better reflect controlling judicial case law and administrative decisions, as well as achieve a more consistent interpretation of the statutory language regarding taxation of information services."[11] The Department determined that it would prospectively apply its changed interpretation of section 1105(c)(1) of the Tax Law to "sales of information delivered on or after September 1, 2010."[12] The Department included among such sales, the sale of an abstract of title to either a prospective purchaser of real property or to an attorney representing a purchaser, but excluded an attorney's title opinion. The Department recognized that treating the sale of an abstract of title as the sale of a taxable information service constituted a change to its policy on such sales, revoked any previous statements by the Department to the contrary and cautioned that such previous statements no longer could be relied upon.[13]

Many of us in the title industry recognize the assistance the Department provided in its willingness to informally weigh and reply to questions which arose following the issuance of the July 19 Bulletin. The exchanges were quite helpful and resulted in the Tax Department gaining a better understanding of the workings of the title industry and the title industry better understanding the applicability of the sales and compensating use taxes throughout its purchase, use and resale of information services.

B. Clarifying the Scope and Applicability of the New Policy—NYSLTA August 2010 Questions and Answers

Ahead of the September 1, 2010 effective date of the Department's new policy, a committee of the NYSLTA led by Mr. Michael Miglino and Mr. Michael Berey served as a clearinghouse for generic questions from NYSLTA members regarding the new policy. These questions were posed to the Department, and NYSLTA distributed the exchange as its first set of questions and answers, which appears in these materials titled, "Sales and Compensating Use Tax Questions regarding Abstracts of Title."[14] Some of the key points which came out of this exchange and which led, at least in part, to the Department's September 23, 2010 Bulletin are:

1) **Insurance products are not taxable:** The Department recognizes that the sale of an insurance product is not taxable. As such, the premium charged for a title insurance policy or a guaranteed search is not subject to sales or use tax. Note, however, that a dollar limitation of liability on a report or certificate does not in and of itself qualify it as an insurance product.[15] A title company's additional work charges for especially difficult titles, if used as part of its charges to issue a title insurance policy are not taxable.[16]

2) **Abstracts of title not defined:** Since much of the discussion involves the term "abstracts of title" or "examination of title," NYSLTA asked the Department whether it would provide a definition, to which the reply: "We are not planning on defining the term because the issue is whether an information service is being conducted, not whether a title search, per se, is being done."[17]

3) **Title reports, certificates of title, lien searches, foreclosure certificates, cooperative unit searches, zoning lot parties-in-interest certificates are taxable**: The litmus test on whether the item is subject to sales or use tax is whether it is an insurance product: where the reports or certifications are simply a certification of some set of facts ascertained through searches of public databases and not insurance products, "then they would all be taxable information services."[18]

4) **Title company purchase of abstracts are taxable:** Except in certain instances where a title company purchases an abstract for resale, a title company's purchase of an abstract from a search company is subject to sales tax. This is the tax treatment regardless of whether the title company uses the

abstract for use in preparing its title insurance policy. The title company is obligated to pay the tax to the search company which in turn would have to register for sales tax purposes, collect the tax and file sales tax returns remitting the tax with the return.[19] Similarly, where the title company is purchasing a tax search in connection with preparing its policy, the purchase is taxable. If it is re-selling the search, then the title company may purchase it without paying tax and provide its resale certificate to the search company.[20]

5) **Resale of abstracts and other information services:** A title company will not be required to pay sales tax on the purchase for resale of abstracts, tax searches, municipal searches or other information searches provided that they are purchased only for resale and not for the title company's use (such as in preparing a title insurance policy). In such an instance the title company, as noted above, would need to furnish its resale certificate to the search company.[21] Note, however, that the title company will need to charge its customer sales tax upon the resale.

6) **Service charges are taxable; cancellation charges are not:** Service charges a title company levies for ordering and forwarding searches to its customer also are taxable, if the services are not insured under the company's title policy.[22] The same is true for providing certified copies of instruments from the public records[23] and good standing certificates and franchise tax reports.[24] If title does not close or is cancelled, if the title company does not charge the customer for municipal searches, abstracts, tax searches and the like, it does not have to charge a sales tax (sales tax is only due if there is a sale). Also, as to a canceled title, if the title company levies a cancellation charge, then assuming that the title company does not use any of the items mentioned and does not provide them to the customer, the cancellation fee is not taxable (no information service has been provided).[25]

7) **Actual charges for recording instruments are not taxable:** Regardless of whether the transaction is to be insured, any clerk fees for recording an instrument are not subject to sales tax.[26]

8) **Lawyer's issuance of a title report is taxable:** Discussed in the context of the different zones (see below), the Department advised that since a non-lawyer is authorized to prepare a title report, a lawyer's preparation of a title report is not a legal service, and as such is subject to sales tax as payment for an information service.[27] There is a different result, however, in Zone 1 where it is customary for the seller to purchase an abstract at the request of examining counsel (usually buyer's attorney) with the latter then issuing a title report and clearing and closing title. The services of the examining counsel are not taxable.[28]

9) **Land surveys are not subject to tax:** The charges of a licensed land surveyor are not subject to sales or use tax nor is the title company's charge for ordering and delivering it.[29]

10) **Abstracts produced out of state:** An abstract produced by a company in another state or country may be subject to tax. There are several possibilities:

    a. The out-of-state person produces the abstract outside New York, delivers it out of state and it is used out of state, then it is not subject to sales or use tax. "What matters is where it is delivered and used."[30]

    b. An abstract delivered in New York or used in New York is subject to sales and/or use tax.[31] An example of an abstract used in New York is the New York office of a title company using an abstract either acquired from out of state or provided to it from one of its out of state offices for use in processing a title insurance policy or closing title in New York.[32]

    c. A search company with a "nexus" to New York would need to collect sales tax and remit it.[33]

    d. An abstract for a New York property which is produced out-of-state (assume no nexus), is not reviewed in New York and the transaction closes out of state is not subject to sales or use tax.[34]

11) **Differing sales tax rates may apply:** The title company may need to pay an additional tax due to later use of an abstract in a New York municipality with a higher rate than where the abstract originally was delivered. The applicable local sales tax rate is that of the New York municipality to which the search company delivered the abstract.[35] Delivery of an abstract to a title company's office in White Plains, but then transferred to and used by the company's office in Manhattan, is subject to an additional tax upon the transfer. In this example, a sales tax is paid by the White Plains office and then a use tax is payable due to New York County's rate being higher than White Plains'—the use tax is on the difference. If the facts are changed, and the White Plains office delivers the abstract at no charge to a customer in Manhattan, no additional tax

is charged because the title company did not use the abstract in Manhattan.

12) **Differences between "Zones":** For title insurance rate purposes the New York map is divided into two Zones: Zone 1, generally comprised of the counties north and west of Albany, and Zone 2 comprised of all other counties.[36] Several title industry questions revolved around the fact that in Zone 1, the cost of the abstract is not included in the title insurance premium and in Zone 2, it is included. This difference does not affect the title company's obligation to pay a sales tax to the search company for an abstract used in producing the title insurance policy.[37] Though the title insurance company may not charge its customer a sales tax on the premium for the title insurance policy produced from the abstract, the question arose whether it may charge for the abstract. The Department replied that if the Insurance Department permitted the title company to assert a charge labeled "sales tax recovery fee," such a charge would not be considered to be a sales tax.[38] As of this writing, TIRSA has not requested permission to levy such a charge.

13) **Title continuations not subject to sales tax:** A charge to its customer for a policy date down (e.g., title continuation letter) for a building loan is not subject to sales tax because it is a charge for an insurance product.[39] Note, however, that the title company would need to pay the search company sales tax on its purchase of the information used in preparing the continuation.[40]

C. Addressing a Few Other Issues—NYSLTA's September 3, 2010 Questions and Answers

In early September NYSLTA posed to the Department a handful of follow-up questions to the August 2010 exchanges. The September exchange was set out in NYSLTA's September 3rd Questions and Answers distributed to its members. There are a few responses, though little new ground was broken:

1. The person that purchases the taxable information service (e.g., an abstract) is the person responsible to pay any subsequent use tax if the rate is higher than the rate of the New York municipality where the person took delivery of the information service.[41]

2. Where a title company buys an abstract, initially not intended for use in preparing a policy, and resells it to the customer, but then later uses it for preparing a policy, the title company is subject to use tax.[42]

3. Assuming that a title is canceled and the title company has no further need of searches it purchased for resale and discards them, no use tax is due.[43]

4. Where the title company buys searches for resale to its customer, bills the customer and the customer fails to pay, the title company must report and remit the tax. If the sale is later written off as a bad debt, the title company may seek a refund for the sales tax paid.[44]

5. Where the title company buys searches for resale to its tax exempt customer (e.g., a not for profit or governmental entity), the title company may still give its vendor a resale certificate to avoid paying the sales tax.[45]

6. If information services (e.g., Delaware lien and judgment searches) are delivered to New York, the services are taxable; the origin (e.g., Delaware) of the services is irrelevant. Also it does not matter whether the property in question is in New York or some other jurisdiction. "What matters is where delivery (and possible subsequent use) occurs."[46]

D. The Department's September 23rd Tax Bulletin—Codifying the Informal Exchanges into Official Department Guidance

The Department's September 23rd Tax Bulletin made official the bulk of the informal exchanges described above. It should be noted that unlike its July 19th Bulletin, the Department's September 23rd bulletin deals only with the tax treatment of title industry related information services and insurance products. As most of the matters covered in the Tax Bulletin are discussed above, I only will summarize the most significant items.

The bulletin identifies categories subject to sales tax:

> Sales of the following items are subject to sales tax unless the resale exclusion applies, as discussed below:
>
> - Abstracts of title,
> - Tax searches,
> - Searches of municipal records for violations,
> - Certified or noncertified copies obtained from the public record,
> - Certificates of title and lien searches,
> - Certificates of good standing and franchise tax searches,
> - Cooperative unit searches, and
> - Zoning lot parties-in-interest certifications."[47]
>
> Nontaxable sales
>
> - Title insurance or a guaranteed title search;
> - Surveyor charges, whether or not done by

a licensed surveyor, and property inspections;

- Charges for recording instruments and related service charges; and
- Charges of an examining counsel for examining an abstract, issuing a title report and closing title, when the title underwriter issues the title policy. (An attorney's issuance of a title report in other contexts may be subject to sales tax. [Reference omitted])[48]

As in the informal exchanges, the bulletin also addresses the tax treatment of abstracts of title, municipal searches, land surveys, additional charges by title companies, additional charges, charges in Zones 1 and 2, failure to close, transactions involving out-of-state companies, timing questions, down-dating and charges for closing services.[49] The bulletin uses some fact patterns discussed in the informal exchanges. There are no substantive differences between the advice set out in the bulletin and that set out in the informal exchanges. The bulletin is provided with these materials, as it embodies the formal guidance of the Department.

E. A Handful of Remaining Questions Are Addressed: NYSLTA November 2, 2010 Questions and Answers and NYSLTA December 1, 2010 Questions and Answers

While the Department's September 23, 2010 Bulletin settled the great bulk of questions, NYSLTA posed a few other questions to the Department with the following results:

1. A title company's mortgage foreclosure guarantee is not an insurance product. It is an information service subject to sales tax unless the purchaser is tax exempt, such as a governmental entity or its qualified agent.[50]
2. An Industrial Development Agency which is exempt from tax may outline in an appointment letter to an appointed agent what the agent should do to claim the exemption.[51] The Department also explained that claiming an exemption for a federal entity can be substantiated with a governmental purchase order and an invoice made out to the entity.[52]
3. Where a title company orders search work for its out-of-state customer on property outside of New York and the results are delivered to its nonresident customer, the title company's sale is not taxable because it is search work purchased for resale. Neither the delivery in New York would be taxable nor would the subsequent delivery to the customer outside New York.[53]
4. In Zone 1, where the search is not included in the title premium, the title company is not reselling the search when a policy is issued regardless of any separate statement of charges. The sale of the search to the title company is taxable.[54] Further, the title company's sale of the search and examination to the customer is not taxable when an insurance policy is issued.[55]

The process which the Department has taken by working closely with NYSLTA has resulted in few hiccups in the implementation of the new policy.

Endnotes

1. I will not address the taxability of risk management analysis reports or sales tax registration requirements which are mentioned in New York State Department of Taxation and Finance's "Taxpayer Guidance Division's Bulletin."
2. *See Sales and Compensating Use Tax Treatment of Certain Information Services*, TSB-M-10(7)(S), Sales Tax, Office of Tax Policy Analysis.

   Taxpayer Guidance Division, N.Y. Dep't of Tax. & Fin. (Jul. 19, 2010), *available at* http://www.tax.ny.gov/pdf/memos/sales/m10_7s.pdf [hereinafter *July 19th Bulletin*].
3. *See id*.
4. *See Abstracts of Title and Other Public Records Searches,* Tax Bulletin, TB-ST-5, N.Y. Dep't of Tax. and Fin. (Sept. 23, 2010), *available at* http://www.tax.ny.gov/pdf/tg_bulletins/sales/b10_5s.pdf [hereinafter *Sept. 23rd Bulletin*].
5. The informal exchanges between the Tax Department and the NYSLTA, except one, can be found on the NYSLTA website. *See* N.Y.S. Land Title Ass'n, Inc., http://www.nyslta.org/resources.htm (last visited Apr. 2, 2011) (listing "Sales Tax Q&A 9-03-10," "Sales Tax Q&A 11-2-10," "Sales Tax Q&A 12-01-10"). There is another informal exchange of questions and answers, which were distributed to NYSLTA members in late August prior to the September 1, 2010 effective date ("August 2010 Sales Tax Q&A"). Note that the terms "title company" and "agent" are used throughout the informal exchanges. As both title companies and their agent's purchase, use and resell "information services" the taxability does not differ between them. In this discussion, I will use the term "title company" to apply both to companies and agents, with no slight intended to my friends and colleagues among title agents. To avoid cumbersome language, I will use the term "abstract" to include an abstract of title, title examination and similar information services.
6. N.Y. Tax Law § 1105 (McKinney 2010).
7. *See July 19th Bulletin*, *supra* note 2.
8. *See id.* at 3.
9. *See State of New York Commissioner of Taxation and Finance: Advisory Opinion*, TSB-A-04(29)(S), Sales Tax, Office of Tax Policy Analysis Technical Services Division, N.Y. Dep't of Tax. & Fin. (Dec. 28, 2004), *available at* http://www.tax.ny.gov/pubs_and_bulls/advisory_opinions/sales_ao_2004.htm.
10. *Id*. *See also* Matter of Hooper Holmes, Inc. v. Wetzler, 152 A.D.2d 87, 544 N.Y.S.2d 233 (3d Dep't 1989), *appeal denied*, 75 N.Y.2d 706 (1990).
11. *See July 19th Bulletin, supra* note 2.
12. *See id.*
13. *See id.*
14. *See Sales and Compensating Use Tax Questions regarding Abstracts of Title*, N.Y.S. Land Title Ass'n, Inc. (Aug. 2010) (on file with author) [hereinafter *Aug. 2010 Sales Tax Q&A*]. The propositions cited in endnotes 14-35 can also be found in the *September 23rd Bulletin*, *supra* note 4.

15. *See Aug. 2010 Sales Tax Q&A*, *supra* note 14 (answering question 4—"[i]f the certified abstract is an insurance product, it would not be a taxable information service, but, in the absence of authority to that effect, the mere listing of a liability amount would not make a certified abstract into something other than an information service").
16. *See id.* (answering question 3).
17. *See id.* (answering question 20).
18. *See id.* (answering question 4).
19. *See id.* (answering question 1). Note the reply to a follow-up question that if the search company failed to bill for the sales tax, the title company is liable for the uncollected tax and is required to pay it directly to the Department.
20. *See Aug. 2010 Sales Tax Q&A, supra* note 14 (answering question 2).
21. *See id.* (discussing "resales" in the answers to questions 2, 5, 10 and 18).
22. *See id.* (answer to question 5).
23. *See id.* (answering question 8).
24. *See id.* (answering question 9).
25. *See id.* (answering question 14).
26. *See Aug. 2010 Sales Tax Q&A, supra* note 12 (answering question 16).
27. *See id.* (answering question 13).
28. *See id.* (answering question 13).
29. *See id.* (answering question 7).
30. *See id.* (answering question 18).
31. *See id.*
32. *See Aug. 2010 Sales Tax Q&A, supra* note 12 (answering question 19).
33. *See id.* (answering question 18).
34. *See id.* (answering question 19).
35. *See id.* (answering question 18).
36. Title Ins. Rate Serv. Ass'n., Title Ins. Rate Manual, §2A (4th Rev. Mar. 3, 2010) *available at* http://www.tirsa.org/TIRSA_Rate_Manual_041310.pdf (stating Zone 1 is comprised of the following counties: Allegany, Broome, Cattaraugus, Cayuga, Chautauqua, Chemung, Chenango, Clinton, Cortland, Delaware, Erie, Essex, Franklin, Fulton, Genesee, Hamilton, Herkimer, Jefferson, Lewis, Livingston, Madison, Monroe, Montgomery, Niagara, Oneida, Onondaga, Ontario, Orleans, Oswego, Otsego, St. Lawrence, Saratoga, Schenectady, Schoharie, Schuyler, Seneca, Steuben, Tioga, Tompkins, Warren, Washington, Wayne, Wyoming, and Yates; Zone 2 is comprised of the following counties: Albany, Bronx, Columbia, Dutchess, Greene, Kings, Nassau, New York, Orange, Putnam, Queens, Rensselaer, Richmond, Rockland, Suffolk, Sullivan, Ulster and Westchester).
37. *See Aug. 2010 Sales Tax Q&A*, *supra* note 14 (answering question 11).
38. *See id*.
39. *See id.* (answering question 23).
40. *See id*.
41. *See Sales Tax Questions Informal Responses of the N.Y. State Dep't of Taxation and Finance*, N.Y.S. Land Title Ass'n, Inc. (Sept. 3, 2010), *available at* http://www.nyslta.org/pdf/SalesTax_QA_090310.pdf (answering the first question on page 1).
42. *See id*. (answering the third question on page 1).
43. *See id*. (answering the second question on page 2).
44. *See id*. (answering the third question on page 2).
45. *See id*. (answering the fourth question on page 2).
46. *See id*. (answering the ninth question on page 3).
47. *See Sept. 23rd Bulletin*, *supra* note 4.
48. *See id*. at 2.
49. *See id*. at 1-5.
50. *See Sales Tax Questions Informal Responses of the N.Y. State Dep't of Taxation and Finance*, N.Y.S. Land Title Ass'n, Inc. (Nov. 2, 2010), *available at* http://www.nyslta.org/pdf/SalesTax_QA_110210.pdf [hereinafter *Nov. 2, 2010 Q&A*].
51. *See Sales Tax Questions Informal Responses of the N.Y. State Dep't of Taxation and Finance*, N.Y.S. Land Title Ass'n, Inc. (Dec. 1, 2010), a*vailable at* http://www.nyslta.org/pdf/SalesTax_QA_120110.pdf. [hereinafter *Dec. 1, 2010 Q&A*].
52. *See id*.
53. *See Nov. 2, 2010 Q&A*, *supra* note 50 (answering the second question).
54. *See Dec. 1, 2010 Q&A*, *supra* note 51 (answering the fourth question).
55. *See id.* (answering the fifth question).

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Does the Law on Property Tax Exemptions After *Erie Station* Favor Properties That Turn a Profit, and How Does This Affect Currently Exempt, but Underused Properties?

By James Skloda

The recent economic downturn, and the accompanying decline in income and sales tax collections, has forced New York's cities, towns and villages to examine all aspects of their budgets in search of additional savings or revenue.[1] With budgets already stretched to the breaking point and tax increases politically unpalatable, one area where this effort appears to be manifesting itself is local governments' treatment of property seeking or receiving real property tax exemptions. Increasingly, local governments are scrutinizing tax-exempt applications more carefully than ever, as well as re-examining properties previously granted an exemption.[2] Fortunately, recent court decisions provide some additional guidance as to which properties must receive an exemption, and what a municipality must show before revoking an exemption. Ironically, decisions since the Court of Appeals ruling in *Adult Home at Erie Station, Inc. v. Assessor*[3] sometimes result in profit-making properties being exempt, while previously exempt but underused properties that don't generate a profit are subject to real property taxes. Owners of non-income generating property will need to exercise caution to avoid this perverse result.

Background

Property tax collections comprise a large share of tax revenue for many of New York's municipalities, particularly upstate. Outside of New York City, the property tax is by far the largest tax burden imposed by local governments, representing 79 percent of all local taxes outside of New York City.[4] Since property taxes are relatively stable and locally controlled, they tend to increase when sales taxes and state aid decrease or stagnate.[5] However, as New York taxpayers already have one of the highest combined state and local tax burden in the nation, further increasing property taxes is politically difficult.[6]

Part of the reason that the property tax burden is so high is that a significant percentage of the real property value is exempt from real property taxation. As of 2009, at least 30% of real property value was exempt from taxation in 13 upstate counties.[7] In various upstate cities, the exemption rate is even higher, led by Ogdensburg with an exempt rate of 64.1%, but also including major upstate cities of Albany (55.50%), Syracuse (49.60), and Buffalo (37.62%).[8] One effect of high exemption rates is to increase the burden on the remaining non-exempt properties, which contributes to the high local tax burden.

Given the difficulty of raising tax rates, and the general declines in government revenue, it should come as no surprise that local governments are looking for ways to increase the number of properties on the tax rolls. One way to do this is to vigorously examine, contest and defend against new exemption applications. However, with recent case law favoring owners seeking exemptions, it also appears that recently there has been a trend to reexamine properties already receiving a property tax exemption, and to revoke the exemptions for such properties to the extent allowable.[9] This trend is particularly apparent in upstate cities that have seen a loss of population leading to the closing or nonuse of properties once serving such populations, especially churches and other religious properties.[10] Recent court decisions make it clear that the local government will bear a high burden in showing that a property is no longer entitled to an exemption, but exempt property owners still must be vigilant in their use of the property or risk losing the exemption.[11]

Exemption Requirement—Ownership

Real Property Tax Law Section 420-a sets forth two requirements for a property to be exempt from real property taxes: a property must be owned by a corporation organized or conducted exclusively for religious, charitable, hospital or educational purposes; and must be used exclusively for carrying out one or more of such purposes either by the owner or by another such corporation or association.[12] The provisions of the statute are mandatory.[13] If a property meets the above requirements, it *shall* be exempt from taxation. Importantly, nothing in the statute limits exemptions to properties that do not generate a profit.

The requirement that a property be owned by a corporation organized exclusively for religious, charitable, hospital or educational purposes is relatively straightforward. However, even this seemingly simple language is open to interpretation. For example, there is some authority for the proposition that the owner of the property does not need to be a "corporation" despite the plain language of the statute.[14]

Additionally, New York courts have broadly defined the words "conducted exclusively" so that most organizations are included, provided the organization provides some public benefit. In fact, it is now well settled that the word "exclusively" is not to be read literally but means "principal" or "primary."[15]

A recent example of the broad interpretation of the requirement that a property be owned by a corporation or association organized or conducted exclusively for exempt purposes is *Tap, Inc. v. Dimitriadis.*[16] In *Tap,* the Petitioner sought a property tax exemption for property that it owned and allegedly rented to low-income individuals at below market rates. The Respondent, in addition to challenging the use of the property as charitable, also alleged that the Petitioner was not "organized or conducted exclusively" for a charitable purpose, as required by RPTL Section 420-a. It was undisputed that the certificate of incorporation of Petitioner did not include any reference to providing low-income housing, and that the principal purpose of the Petitioner, prior to taking ownership of the property in question, had been primarily architectural in nature: fixing up houses, helping families find housing, and assisting people and businesses in recovering from fires and floods.[17] The court, citing settled law that an organization's purpose may depend on its actual activities and not the language of the organizational documents, held that the Petitioner's history of providing housing "information, housing assistance, and grant administration services," directed primarily at depressed areas, qualified the Petitioner as being conducted exclusively for charitable purposes, thus satisfying the first prong of RPTL Section 420-a.[18] The trial court's decision was made after the Third Department remanded based on a determination that the property was not entitled to a charitable purpose.[19]

Exemption Requirement—Use and the *Erie Station* Decision

Based on existing court decisions, it appears unlikely that any not-for-profit corporation that owns a property being used for exempt purposes will be found to not be "conducted" primarily for an exempt purpose. Open to debate, however, is whether a particular use of a property is an exempt use, and also whether a property is "exclusively" used for an exempt purpose. As set forth above, "exclusively" has been interpreted to connote "primarily."[20] RPTL Section 420-a also provides that the property for which an exemption is sought does not need to be used for an exempt purpose by the owner; use by another corporation or association organized for an exempt purpose is sufficient.[21] Prior to the Court of Appeals decision in *Adult Home at Erie Station, Inc.,* there was also a general understanding, by assessors at least, that a property was not entitled to an exemption if its "use" did not represent a financial disadvantage versus using the property for a non-exempt purpose. Thus, properties that generated revenue comparable to a similar property that was not put to an exempt use were generally denied an exemption. The decision in *Adult Home at Erie Station, Inc.* altered this understanding and fundamentally changed the analysis required when reviewing exemption applications.[22]

Adult Home at Erie Station, Inc. involved two Petitioners—Adult Home at Erie Station Inc. or "AHESI," and Regional Economic Community Action Program, Inc. or "RECAP."[23] AHESI owned and operated an adult home, with a substantial percentage (90%) of its tenants paying below market rates based on income, with some 50% being SSI recipients. No residents were turned away for inability to pay. Despite the fact that providing housing to the elderly is not an exempt purpose, the Court affirmed the decision of the Appellate Division, granting an exemption to AHESI, holding that using property for *low-income* housing was an exempt purpose. Importantly, it was acknowledged by both sides that AHESI actually received less than market rents in furtherance of its exempt purpose.[24]

RECAP owned homes in which homeless people, alcoholics, drug addicts and other afflicted members of society lived while they received treatment.[25] Treatment did not occur at the houses, but providing housing furthered the treatment programs. RECAP, unlike AHESI, received market rents while the properties were occupied. The Appellate Division denied RECAP an exemption, holding that a property owner that receives the same rent as a commercial landlord cannot be using its property for a charitable purpose. The Court of Appeals reversed, holding that the amount of rent received was not determinative, but rather the use of the property determined whether it was entitled to the exemption, stating: "[t]hat these people (or the government agencies that support them) pay market rents, and that RECAP may even benefit economically from its rental income, does not change the result. The issue is not whether RECAP benefits, but whether the property is 'used exclusively' for RECAP's charitable purposes."[26] Thus, whether a property turns a profit is not a factor in the determination of whether an exemption is warranted.[27] After *Erie Station*, it is not surprising that recent cases have almost uniformly held that properties seeking an exemption from real property taxes are entitled to such an exemption.

Recent Decisions: Low-Income Housing and Religious Use Exemptions

Two specific issues which have been the subject of multiple recent court decisions after *Erie Station* are exemptions for properties providing low-income housing and exemptions for religious use. In most cases, in the aftermath of *Erie Station*, the property was ultimately awarded an exemption by the courts, further evidence of how difficult it is for local governments to deny property tax exemptions that fit under the broad definition of "charitable" or "religious."

In *United Church Residences of Fredonia, New York Inc. v. Newell*, the facts were very similar to *Erie Station,* in that the property at issue provided rental housing to "very low income elderly or disabled persons."[28] There was no dispute that the residents were very low-income individuals, or that the rent the residents paid was below market rent. However, the owner received rent subsidies from HUD which brought the rent amounts up to market rates for the area. Thus, the owner of the property was receiving the same income that it would have had it rented the units to anybody, regardless of income. In a short opinion, citing *Erie Station,* the Court of Appeals reversed the Appellate Division, agreeing with the trial court and finding that the receipt of rent subsidies did not remove the property from an entitlement to a tax exemption.[29]

In *Association for Neighborhood Rehabilitation v. Board of Assessors and The Board of Assessment Review of the City of Ogdensburg* ("*ANR*"), the property at issue was very similar to the RECAP properties in *Erie Station*; however, unlike RECAP, the Petitioner in *ANR* did not require its tenants to undergo treatment or avail themselves of social services, and did not actually provide services to the tenants, but merely referred them to appropriate sources of assistance.[30] The City argued that since the tenants of the properties at issue weren't required to receive treatment, the Petitioner didn't provide such services itself, and the Petitioner received market rents, the property was not being used for a charitable purpose. The court disagreed, granting an exemption to the residences owned by Petitioner, and further expanding the definition of charitable use.[31] Ironically, since the Petitioners in *Erie Station, United Church Residences of Fredonia, ANR,* and *TAP, Inc.* did not have to pay real property taxes, it is likely that their properties were more profitable than similarly situated properties that did not restrict themselves to the "charitable" purpose of housing low-income individuals.

Perhaps emboldened by the Court decisions granting exemptions for adult homes and properties for people with low incomes, the Petitioner in *Lake Forest Senior Living Community v. The Assessor of the City of Plattsburgh* attempted to push the tax exemption boundary line a little farther.[32] In *Lake Forest*, the property in question was a 44-unit congregate living facility used exclusively for the allegedly charitable mission of providing moderately priced housing and support services to the elderly. The city initially granted a tax exemption to the property, but revoked it several years later after reviewing the use of the property. All of the property's tenants were middle class and paid market rents, none received SSI benefits, and the property, while owned by a not-for-profit, generated significant income. Although Petitioner claimed they had a "policy" of not evicting tenants if they were unable to pay, the leases contained no such provision and there is nothing in the decision to indicate that any of the tenants were not paying rent. Petitioner claimed that, despite earning a profit, they were entitled to an exemption because of the services they provide to their elderly patients, including emergency monitoring, transportation and housekeeping. However, the trial court and the Appellate Division ruled against the Petitioner and upheld the revocation of the tax exemption, holding that providing services to the elderly at a market price is not a charitable activity, so long as the tenants weren't poor.[33]

Petitioners were generally successful in recent court decisions involving exemptions for religious use, including a case in which the entity using the property was a for-profit enterprise and the owning religious corporation actually profited from the use of the premises for which an exemption was sought. In *Congregation Rabbinical College of Tartikov, Inc. v. Town of Ramapo,* the property in question was solely used for the operation of a summer religious day camp.[34] In this case, the day camp was run by a for-profit corporation that did not own the property. In addition, the for-profit corporation actually paid the owner between $60,000 and $70,000 per year for the right to use the property. Since the owner of the property leased the property at a profit, and the entity leasing the property was a for-profit enterprise, and the property at issue was only used for this profit-making activity, the trial court concluded that the property was not entitled to a tax exemption.[35]

On appeal, however, the Second Department overturned the trial court's decision, citing a long list of cases for the proposition that an owner deriving "some profit" from the use of the property would not defeat a tax exemption claim so long as the primary use was for the tax-exempt purpose of its owner.[36] The Appellate decision failed to note that in each of the cited cases, the property was either operated by the owning corporation, or another not-for-profit, or the area being leased to a for-profit company and the revenue generated was incidental to the exempt use of the property (e.g., the contracting of a college cafeteria to a food service company).[37] In *Congregation Rabbinical College*, the sole use of the property in question was for a profit-making venture. Thus, under the holding in this case, a property that makes a profit, even though a lease to a for-profit company, can be exempt from real property taxes, providing the property is used for an exempt purpose of the owner. Such a holding runs contrary to the popular understanding among assessment officers that a lease of a property for an amount in excess of the carrying, maintenance, and depreciation charges of the property will render such property ineligible for a full exemption from real property taxes, which understanding was based on the plain language of RPTL Section 420-a(2), which states in part: "such real property shall be exempt from taxation only so long as it or a portion thereof, as the case may be, is devoted to such exempt purposes and so long as any moneys paid for such use do not exceed the amount of the carrying, maintenance and depreciation charges of the property or portion thereof, as the case may be."[38]

Contrast the decision in *Congregation Rabbinical College,* in which a property was being used for exempt purposes, albeit at a profit to the property owner, to the result in *Community Church of Syosset v. Assessor and the Assessment Review Com'n.*[39] In *Syosset*, in order to cover property costs, the church began leasing out meeting rooms to various community groups, including a not-for-profit dedicated to enhancing the lives of individuals with disabilities, a teacher education group, the local chamber of commerce, and a competitive obedience club, among others. While not entitled to an exemption themselves, most (if not all) of the entities renting space appear to have been not-for-profit community-based groups. In addition, the Petitioner alleged that all the revenue generated by the lease was "greatly needed" by the Petitioner and was used to fund church services and to provide a venue for organizations to improve the community.[40] After learning of the church's rental of space to non-exempt entities, the assessor determined that a portion of the property should be subject to an assessment. The church challenged the assessor's determination but the trial court sided with the assessor, as did the Appellate Division on appeal. Although the trial court's decision placed great emphasis on the fact that the rentals were generating income from the property, under *Congregation Rabbinical College,* such considerations should not affect the outcome. Notably, the Appellate Division decision made no mention of the revenue generated in its decision. Rather, what cost the church its full exemption is that the property was used for non-exempt purposes.[41] In other words, under New York law, an owner of real property can generate income by renting the entire property to a profit-making entity so long as its use of the property is arguably in furtherance of the owner's exempt purpose, but an exempt property owner cannot allow any portion of its exempt property for non-exempt purposes, even if the owner limits such use to not-for-profit groups and even if the owner doesn't charge for such non-exempt use.

Tax-Exempt Status of Partially Used Properties

Based on the above cases, it is clear that regardless of profit, a property that is used exclusively for exempt purposes will likely be entitled to an exemption while properties that are not exclusively used for such purposes will not be entitled to an exemption or limited to a partial exemption. Yet to be fully addressed by the Courts, but drawing increasing scrutiny from local assessors, is the exempt status of property that is either: exclusively, but rarely, used for exempt purposes, or which is used exclusively for exempt purposes but is larger than is necessary for the owning organization's current needs. Such properties represent the next likely subject of tax-exempt litigation.

For cash-strapped not-for-profit organizations, a long-vacant building (thus available at a significant discount), with room to grow, can be an attractive place to conduct exempt activities. However, as the buildings weren't custom built for their use, and such properties often require expensive renovations, it is not uncommon for there to be significant amounts of unused space. From some assessors' perspective, this unused space cannot, by definition, be considered used for exempt purposes and thus should not be entitled to an exemption. Property owners would counter that use of any part of the building for exclusively exempt purposes (without any corresponding non-exempt uses) means that the entire building is used for exempt purposes. Courts that have addressed the question have reached differing conclusions.

In *Southwinds Retirement Home, Inc. v. City of Middletown*, the property at issue was used by multiple entities for multiple exempt purposes.[42] However, there was also a significant amount of warehouse space that was not actively used which the City argued was not used for exempt purposes and thus was not entitled to an exemption.[43] The *Southwinds* court, citing a line of cases that involved the temporary non-use of portions of various types of properties (including an apartment building, cemetery, and a school) that did not lose their tax exemptions because they were not being fully utilized, held that the Petitioner's property would not lose its exemption because it was partially unused. In so holding, the Court stated: "If a portion of the property actually be used for one or more of the purposes of the incorporation, and the remainder be temporarily unoccupied, the building, as a whole is used exclusively for carrying out thereupon one or more such purposes."[44] The trial court's decision was upheld on appeal to the Second Department.[45]

A different result was reached in *Upstate Properties Development, Inc. v. The City of Syracuse*, where the property at issue had been vacant for several years and fallen into a state of disrepair prior to Petitioner's purchase of it.[46] Upon purchasing the property, the Petitioner spent significant sums to rehabilitate part of the building and put it to use for exempt purposes, and had good-faith (but non-specific) plans to rehabilitate more of the building in the future. The City rejected the Petitioner's tax-exempt application, in part because the entire building was not utilized by Petitioner. The Petitioner challenged the denial in an Article 7 proceeding, where it was conceded by both parties that at least 25% of the square footage of the building located on the property was actively used by the Petitioner. The City challenged the use of the 25% as an exempt purpose but did not allege that any of the remaining property was used for non-exempt uses, just that it wasn't used at all. The Court ruled that the Petitioner was entitled to an exemption for the 25% that was being actively used by Petitioner because it was being used in furtherance of its exempt purposes. The remaining 75%, however, would be subject to taxation because the Petitioner failed to show tangible progress for making further improvements, such as permits, applications, or plans.[47]

While it is easy to sympathize with the City of Syracuse's position that a building with only 25% of its square footage put to active use should not be entitled to a full tax exemption, the decision sets a dangerous precedent. In addition to ignoring the use of the non-building part of the property (parking lot, lawn, etc.), it stands for the proposition that every potentially tax-exempt property is only entitled to a partial exemption if an assessor or court determines that part of the property isn't being appropriately utilized, and opens an endless source of possible litigation as very few properties are ever fully utilized. Just a few possible sources of dispute would include a church with empty pews, an office with empty cubicles, an adult home with empty beds, or a school with empty classrooms. The plain language of the RPTL Section 420-a only requires that the property in question be used exclusively for tax-exempt purposes, which the Court in *Upstate Properties* found it was. There was no finding that the property was used for non-exempt purposes. Once it is established that a property is used solely for exempt purposes, a further inquiry into whether the space was underutilized is a recipe for uncertainty.

A related issue, and perhaps more pressing, is an examination into the percentage of time that exempt activities take place in an exempt property. Most areas of the state have seen closures of at least some places of worship over the last decade, as a broad spectrum of religious entities try to keep up with congregations that have migrated from city centers to the suburbs, and often again into newer, more modern suburbs even further from the city center. The result has been a necessary prioritizing of assets, including places of worship, often resulting in at least some closures of churches, mosques, synagogues and schools. From a property tax perspective, the question is whether these unused buildings continue to be entitled to their exemption from real property taxes. Importantly, such buildings are rarely completely unused. Typically, the property is maintained by the religious organization and is still available for special services, marriages, meetings of church-related groups, and used for storage of religious items.

Whether or not the revocation of a real property tax exemption is permissible is obviously a fact specific question. However, where a revocation of a previously granted exemption is at issue, the burden is on the government to prove the property is subject to taxation.[48] Given this burden, and the fact that the statute in question, RPTL Section 420-a, does not appear to require a minimum amount of time that such a property is used, provided it is used exclusively for exempt purposes, it would appear that the owners of such properties have a legitimate argument that the properties are entitled to an exemption from real property taxes, even if they are seldom used. However, with the ever shrinking number of properties available for taxation, it is likely that local governments will continue to press this issue until there is a definitive ruling.

Conclusion

Traditionally, local governments have refused to grant exemptions on properties where it was clear that the property was generating revenue that exceeded the carrying costs of the property. Recent case law makes clear that New York courts are less concerned with whether a property is making a profit for its owner and more concerned with the use of the property. Such a focus on the use of the property is likely to force local governments to further examine the "use" of properties that are partially vacant or are not put into use on a daily basis. Owners of such properties should take special care to not utilize their properties for non-exempt purposes. Meanwhile, assessors must look only at the use of a property, rather than the alleged profit derived from its use, in granting or denying tax-exempt status. With the ever-shrinking number of non-residential properties on the tax rolls, there is sure to be more litigation in this field, at least until the courts or legislature further clarify the meaning of "exclusive" and whether the statute requires a minimum percentage of space or time be dedicated to exempt uses.

Endnotes

1. Richard Deitz, Andrew L. Haughwout & Charles Steindel, *The Recession's Impact on State Budgets of New York and New Jersey*, 16 Current Issues in Econ. & Fin. 1, 1-2 (2010).
2. *See* Memorandum from City of N.Y. Dep't of Fin., Fin. Pol'y Relating to the Revocation of Real Prop. Tax Exemptions (July 12, 2005), http://www.nyc.gov/html/dof/html/pdf/04pdf/fm05_5.pdf.
3. Adult Home at Erie Station, Inc. v. Assessor, 10 N.Y.3d 205, 886 N.E.2d 137, 856 N.Y.S.2d 515 (2008).
4. Thomas P. DiNapoli, *Property Taxes in New York State*, 2 Local Gov't Issues in Focus 2, 2 (2006).

5. *Id*.

6. *See generally* Mark Robyn & Gerald Prante, *State-Local Tax Burdens Fall in 2009 as Tax Revenues Shrink Faster than Income*, 189 Tax Found. Special Report 1, 3 (2011), http://taxfoundation.org/research/show/22320.html (comparing state and local tax burdens across the United States).

7. *See* N.Y. St. Dep't of Tax'n & Fin., Office of Real Prop. Tax Serv., Exemptions from Real Property Taxation in New York State: 2009 County, City & Town Assessment Rolls (2009), http://www.orps.state.ny.us/ref/pubs/exempt/ex09/exrpt09.htm#section2.

8. *Id*.

9. *See* Lake Forest Senior Living Community, Inc. v. Assessor, 72 A.D.3d 1302, 898 N.Y.S.2d 369 (3d Dep't 2010); Southwinds Retirement Home Inc. v. Middletown, 23 Misc. 3d 1138A, 889 N.Y.S.2d 507, 2009 NY Slip Op 51180U, at *1 (Sup. Ct. Orange County June 9, 2009); *See also* Stephanie Strom, *States Move to Revoke Charities' Tax Exemptions*, N.Y. Times, February 27, 2010, at A21 (describing how declines in tax revenue have caused many states to eliminate tax exemptions for various nonprofits, including property tax, which has largely remained sacrosanct until now).

10. *See* Congregation Rabbinical College of Tartikov, Inc. v. Town of Ramapo, 72 A.D.3d 869, 900 N.Y.S.2d 103 (2d Dep't 2010); *see* Community Church of Syosset v. Assessor, 2009 NY Slip Op 33204, No.11096/09 2009 WL 5585590, at *1-2 (Sup. Ct. Nassau County Dec. 30, 2009).

11. *See* Southwinds, 23 Misc.3d 1138(A), 2009 NY Slip Op 51180U, at *3.

12. N.Y. Real Prop. Tax Law § 420-a (McKinney 2010).

13. *Id.* § 420-a(2).

14. *See* N.Y.C Dep't of Fin. Ltr. Rul., FLR 09-4890 (June 1, 2009), *available at* http://www.nyc.gov/html/dof/html/pdf/redacted%20letter%20rulings/redacted_property_09-4890.pdf; *see also* N.Y.C. Dep't of Fin. Ltr. Rul., FLR 08-4882 (April 17, 2009), *available at* http://www.nyc.gov/html/dof/html/pdf/redacted%20letter%20rulings/redacted_property_041709.pdf.

15. Adult Home at Erie Station, Inc. v. Assessor, 10 N.Y.3d 205, 214, 886 N.E.2d 137, 140, 856 N.Y.S.2d 515 (2008).

16. No. 0218643/2008, (Sup. Ct. Rensselaer County Nov. 21, 2008); 17 Real Prop. Admin. Rep. 1, 83 (2009).

17. *See id*.

18. *See id*.

19. Tap, Inc. v. Dimitriadis, 49 A.D.3d 947, 853 N.Y.S.2d 214 (3d Dep't 2008).

20. *See* Adult Home at Erie Station, Inc., 10 N.Y.3d at 214, 886 N.E.2d at 140, 856 N.Y.S.2d at 515.

21. *See* N.Y. Real Prop. Tax Law § 420-a(2) (McKinney 2010).

22. Adult Home at Erie Station, Inc., 10 N.Y.3d at 214-216, 886 N.E.2d at 140-142, 856 N.Y.S.2d at 515.

23. *Id.*

24. *Id.*

25. Adult Home at Erie Station, Inc., 10 N.Y.3d at 215, 886 N.E.2d at 141, 856 N.Y.S.2d at 515.

26. Adult Home at Erie Station, Inc., 10 N.Y.3d at 216, 886 N.E.2d at 142, 856 N.Y.S.2d at 515.

27. *Id.*

28. United Church Residences of Fredonia New York, Inc. v. Newell, 12 Misc. 3d 1193A, 824 N.Y.S.2d 759, 2006 NY Slip Op 51558U, *3 (Sup. Ct. Chautauqua County Aug. 4, 2006).

29. United Church Residences of Fredonia, New York, Inc. v. Newell, 10 N.Y.3d 922, 923, 892 N.E.2d 392, 393, 862 N.Y.S.2d 327, 393 (2008).

30. Ass'n for Neighborhood Rehabilitation v. Bd. of Assessors, 24 Misc. 3d 1206A, 889 N.Y.S.2d 504, 2009 NY Slip Op 51289U, at *6-7 (Sup. Ct. St. Lawrence County June 23, 2009).

31. *Id.* at *6-8.

32. *See* Lake Forest Senior Living Community, Inc. v. Assessor of the City of Plattsburgh, 72 A.D.3d 1302, 898 N.Y.S.2d 369 (3d Dep't 2010).

33. *Id.* at 1302-05, 898 N.Y.2d 373-75.

34. Congregation Rabbinical College of Tartikov, Inc. v. Ramapo, 72 A.D.3d 869, 870, 900 N.Y.S.2d 103, 104 (2d Dep't 2010), *leave to appeal granted*, 15 N.Y.3d 704, 934 N.E.2d 321, 907 N.Y.S.2d 752, 2010 NY Slip Op 80939, 2010 N.Y. LEXIS 2228 (Aug. 31, 2010).

35. *See* Congregation Rabbinical College of Tartikov, Inc., 23 Misc. 3d 1117A, 886 N.Y.S.2d 70, 2009 NY Slip Op 50797U (Sup. Ct. Rockland County 2009).

36. Congregation Rabbinical College of Tartikov, Inc., 72 A.D.3d 869, 871, 900 N.Y.S.2d 103, 105, 2010 NY Slip Op 3267, at *2 (2d Dep't 2010).

37. *See* Pace College v. Boyland, 4 N.Y.2d 528, 532, 151 N.E.2d 900, 902, 176 N.Y.S.2d 356, 358-9 (1958).

38. N.Y. Real Prop. Tax Law § 420-a(2) (McKinney 2010).

39. *Compare* Congregation Rabbinical College of Tartikov, Inc., 72 A.D.3d 869, 900 N.Y.S.2d 103, 2010 NY Slip Op 3267 (holding a property used for tax exempt purposes, albeit at a profit to the owner is entitled to tax exemption), *with* Community Church of Syosset v. Assessor, 2009 NY Slip Op 33204U, No.11096/09, 2009 WL 5585590 (Sup. Ct. Nassau County 2009) (holding a nonprofit organization which leased space to community groups to cover property costs was not entitled to tax exemption because portions of the property were used for non-tax exempt purposes even though most of the entities renting were not-for-profit groups).

40. *Id.*

41. Community Church of Syosset v. Assessor, 76 A.D.3d 1064, 1064, 907 N.Y.S.2d 875, 876, 2010 NY Slip Op 06791 (2d Dep't 2010).

42. Southwinds Retirement Home Inc., v. Middletown, 23 Misc. 3d 1138A, 889 N.Y.S.2d 507, NY Slip Op 51180(U) (Sup. Ct. Orange County 2009).

43. *Id*. at *1.

44. *Id.* at *10 (citing People ex rel. Young Men's Ass'n. v. Sayles, 32 A.D. 197, 53 N.Y.S. 67 (3d Dep't 1898), *aff'd*, 157 N.Y. 677, 51 N.E. 1093 (1898)).

45. *See* Southwinds Retirement Home, Inc. v. Middletown, 74 A.D.3d 1085, 903 N.Y.S.2d 138, 2010 NY Slip Op 05412 (2d Dep't 2010).

46. Upstate Props. Dev. Inc. v. Syracuse, 27 Misc.3d 1205(A), 910 N.Y.S.2d 409, 2010 Slip Op 50566(U), *2 (Sup. Ct. Onondaga County Apr. 7, 2010).

47. *Id.*

48. *See* Southwinds, 74 A.D.3d 1085, 903 N.Y.S.2d 138, 2010 NY Slip Op 05412.

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Mortgage Underwriting After Dodd-Frank: New Standards and Unfinished Business

By Vincent Di Lorenzo

Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act[1] rejected the principles-based approach to mortgage market regulation that had characterized the residential U.S. market since 1982, and substituted a more rules-based regulatory regime. This article explores the new statutory requirements imposed on creditors, their likely impact on the types of "innovative" mortgage products that led to large numbers of foreclosures, and the open issues that Congress relegated to agency determination.

A number of "innovative" mortgage products were offered by creditors in the last decade which troubled Congress due to the resultant losses suffered as a consequence the inherent risks posed. These included no documentation and limited documentation loans, adjustable rate mortgages with low initial rates, payment option loans, and loans with very high loan to value ratios.[2] The Dodd-Frank Act prohibits only no documentation loans, but its requirements will influence the future availability of other "innovative" but, at times, risky mortgage products. The extent of future offerings of such loans and their exact terms depends, however, on additional regulatory action.

Scope of Coverage

The Dodd-Frank Act's requirements apply not only to federally chartered banking institutions[3] but also to state chartered banking institutions and state chartered mortgage companies. This is because Title 14 of the Act is an amendment to the Truth-in-Lending Act which defines a "creditor" as a person who regularly extends credit which is payable in more than four installments.[4] The requirements in Title 14 only apply to "residential mortgage loans." This is a new term found in the Dodd-Frank Act that is defined differently than the term "residential mortgage transaction" which is found in the Truth-in-Lending Act. "Residential mortgage loan" means a consumer credit transaction secured by a mortgage or deed of trust on a dwelling or residential real property that includes a dwelling.[5] Thus, it encompasses mortgages obtained to purchase a dwelling as well as refinancings and home equity loans.[6]

The Dodd-Frank Act's new mortgage underwriting requirements are contained in section 1411 of the Act. However, to ascertain the Act's influence on future underwriting practices we must also examine the standards imposed in section 1412 of the Act, which must be met in order for the mortgage to be characterized as a "qualified mortgage." In addition we must examine the restrictions on prepayment penalties found in section 1414 of the Act. Finally, we must examine the regulatory requirements that will be imposed (a) for "qualified residential mortgages" under section 941 of the Act, and (b) to clarify the "reasonable ability to repay" requirement contained in Title 14 of the Act.

Minimum Underwriting Requirements

Our starting point in the analysis of the Dodd-Frank's impact on future availability of "innovative" mortgage products is section 1411 of the Act. It provides:

> no creditor may make a residential mortgage loan unless the creditor makes a reasonable and good faith determination…that…the consumer has a reasonable ability to repay the loan…[7]

The term "reasonable ability to repay" is not further defined in the statute. However, the statute does constrain the creditor's basis for making determinations. It provides that a determination "shall include consideration of the consumer's":

- credit history,
- current income,
- expected income the consumer is reasonably assured of receiving,
- current obligations,
- debt-to-income ratio or the residual income after payment of non-mortgage debt and mortgage related obligations,
- employment status, and
- financial resources other than the consumer's equity in the dwelling that secures repayment of the loan.[8]

In addition, the creditor must verify the income or assets it relies upon to determine repayment ability.[9]

Section 1411 also clarifies how the "ability to repay" standard is to be applied to non-standard loans, i.e., loans that are not fixed rate, self-amortizing loans.[10] For variable rate mortgages that allow a consumer to defer any repayment of principal or interest, the creditor must use a fully amortizing repayment schedule to determine consumer's ability to repay. For interest only loans, the creditor must use the payment required to amortize the loan by its final maturity to determine consumer's ability to repay. For all calculations, the creditor must assume: (a) the loan proceeds are fully disbursed, (b) the loan is repaid in equal monthly amortizing payments for principal and interest over the entire term of the loan, and (c) the interest rate over the entire term is a fixed rate equal to the "fully indexed rate" at the time of the loan closing. The "fully indexed rate" is the index rate at the time the loan is made plus the margin that will apply after the expiration of any introductory rate. In addition, if the creditor knows or has reason to know that one or more residential mortgage loan secured by the same dwelling will be made to the same consumer, then the "ability to repay" determination must be based on the combined payments for all loans.[11]

What effect does section 1411 have on the availability of the "innovative" mortgage products that led to the current mortgage crisis? No documentation loans, in which creditors did not require or verify information regarding borrowers' income or assets, are explicitly prohibited for both federally chartered and state chartered creditors. The former process of underwriting limited documentation loans is prohibited as well. Some lenders characterized loans in which they documented borrowers' employment, but not their income or assets, as limited documentation loans. This process is prohibited, since the statute requires "consideration" of all the factors listed, as well as verification. However, the statute does not stipulate any required basis for a determination regarding "ability to repay." Instead it provides flexibility to creditors in making determinations, since the list of factors to be "considered" is long and, in fact, non-exclusive. It includes items such as credit history, employment status, and expected income. There is a risk that this non-exclusive list of factors can again lead to actual decisions that are based on limited criteria, i.e., not primarily based on the borrower's income. This might again lead to risky loans in the search for short-term profits. This is an ambiguity in the statute that must be addressed by the regulators.

It would be wise for regulators to clarify the "ability to repay" requirement imposed by the statute by differentiating between a mandatory basis for determinations and additional factors that can influence a decision. For example, it would be wise for regulators to require that ability to repay must be based on the income and/or assets of the borrower, with the other factors enumerated in the statute providing additional evidence for the creditors' evaluations. This is the first item of unfinished business in the revamping of mortgage underwriting requirements. The risk-retention rules proposed by the federal regulators in March of 2011, and the minimum underwriting requirements proposed by the Federal Reserve Board in April of 2011, begin to address this issue and are discussed below.

Turning to the other "innovative" mortgage products offered during the last decade, the statute certainly allows adjustable rate mortgages and payment option loans, even loans with low initial interest rates. The most risky underwriting practices with respect to such loans are avoided, however, because underwriting cannot be based on the low initial interest rate or on any payment option other than a fully amortizing repayment schedule. The statute is silent on loan-to-value ratios. The "ability to repay" requirement in section 1411 is the only requirement that may address the risks posed by loans in which the borrowers have little equity at risk.

This further highlights that the Act's "ability to repay" requirement is the key to its potential impact. What is missing from this requirement is a quantitative standard and ceiling with regard to "ability to repay," i.e., a debt-to-income ratio. This is the second item of unfinished business in the statute that is further discussed in the last section of this article.

Additional Standards for "Qualified Mortgages"

Creditors' decisions regarding availability of certain mortgage products and the terms of such mortgages will not be determined solely by section 1411 of the Dodd-Frank Act. They will also be heavily influenced by section 1412 of the Act which creates a new category of loan called "qualified mortgages." There are several reasons for this heavy influence. First, a qualified mortgage carries a presumption of compliance with the minimum underwriting requirements in section 1411 not only for the creditor but also for assignees of the loan.[12] Second, "qualified residential mortgages" are not subject to the five percent risk retention requirements in the event of securitization that are contained in 941 of the Dodd-Frank Act.[13] The federal regulators must define "qualified residential mortgages" that do not require risk retention,[14] but such definition cannot be broader than the term "qualified mortgage" contained in section 1412.[15] Finally, prepayment penalties can only be imposed on mortgages that are "qualified mortgages," as discussed below.

Section 1412 of the Dodd-Frank Act stipulates the terms required for a mortgage to be a "qualified mortgage." It also clarifies the manner in which ability to repay will be tested for adjustable rate mortgages. Section 1412 provides that "qualified mortgage" means every "residential mortgage loan" for which the income and financial resources of the borrower are verified and documented. However, section 1412 also stipulates that "qualified mortgages" are those:

a) for which periodic payments do not result in an increase in principal;

b) the terms of which do not result in a balloon payment;

c) with a term that does not exceed thirty years;

d) in which the underwriting process: (1) for a fixed rate loan is based on a payment schedule that fully amortizes the loan over the loan term, and (2) for adjustable rate loans is based on the maximum rate permitted during the first five years;

e) for which total points and fees (as defined in the Truth in Lending Act, 15 U.S.C. 1602 (aa) (4)) do not exceed three percent, excluding, in some circumstances, loan discount points that will result in a bona fide reduction in the interest rate; and

f) that comply with any guidelines or regulations established by the Board regarding debt-to-income ratio or alternative measures of consumer's ability to pay regular expenses after payment of total monthly debt.[16]

Returning to the question of the effect of the Dodd-Frank Act on future availability of "innovative" mortgage products, section 1412 clarifies that ability to repay for adjustable rate mortgages can be based on the maximum rate permitted during the first five years of the loan. Section 1411 did not contain such clarity, since it referred to only the "fully indexed rate" as the basis for such determination. Section 1412's requirements will dissuade creditors from offering adjustable rate mortgages with low initial interest rates that are in effect for short period, e.g., six months or one year. Underwriting determinations cannot be based on a low initial interest rate, unless the low rate is the rate in effect during the first five years. Section 1412's requirements also lead to the conclusion that payment option loans resulting in increases in principal or balloon payments may not reappear. This is not based, however, on any statutory prohibition. It is based on the possible influence exerted on creditors' decisions by the advantages provided by offerings of "qualified mortgages," e.g., avoiding the risk retention requirements of the statute.

Restrictions on Prepayment Penalties

Section 1414 of the Dodd-Frank Act is the final piece of the puzzle providing a picture of various influences on creditors' decisions with respect to future "innovative" mortgage products. Section 1414 prohibits prepayment penalties for any mortgage that is not a "qualified mortgage."[17] However, it further defines the term "qualified mortgages" solely for purpose of the prepayment prohibition. Specifically, it excludes (a) adjustable rate mortgages, and (b) mortgages with higher interest rates, namely with an APR exceeding the average prime offer rate by 1.5 or more percentage points for first lien mortgages with principal amounts within Fannie Mae conforming loan limits, 2.5 percent or more for jumbo loans, and 3.5 percent or more for subordinate lien loans.[18] What effect this will have on the widespread availability of adjustable rate mortgages is a great area of uncertainty.

In addition to such prohibition, section 1414 also limits the amount of any prepayment penalty that can be imposed for "qualified mortgages." It provides that prepayment penalties may not exceed 3 percent in year one, 2 percent in year two, and 1 percent in year three. No prepayment penalties are allowed after the first three years of the loan.[19] Finally, section 1414 requires that a creditor offering a consumer a mortgage loan with a prepayment penalty must also offer the consumer a mortgage loan without a prepayment penalty.[20]

These limits on prepayment penalties address the concern of the Congress that some borrowers found it difficult to refinance loans due to high prepayment penalties when they faced difficulty in meeting revised payment terms.

Unfinished Business—Proposed Regulations

This article has identified several items of unfinished regulatory business on which action is necessary to avoid repetition of offerings of unsafe mortgage products witnessed during the last decade. The most important is the need for regulatory limits on creditors' discretion in defining "ability to repay." Section 1411 of the Dodd-Frank Act does not clearly require underwriting decisions to be based on the borrower's income, and does not provide quantitative limits on creditors' discretion in making such determinations such as a maximum debt-to-income ratio. The only requirement is that the creditor "makes a reasonable and good faith determination..." of ability to repay.[21] Unfortunately this brings to mind the principles-based standards that existed prior to the Dodd-Frank Act that did not constrain creditors' decisions. For example, banking institutions were prohibited from making "unsafe and unsound" loans,[22] and were required to institute "prudent underwriting standards" for their real estate lending operations.[23] These principles-based standards did not stop Countrywide, for example, from underwriting a significant number of no documentation and limited documentation loans, payment option adjustable rate mortgages, and mortgages with very high loan to value ratios.[24] Nor did they stop Washington Mutual from underwriting a significant number of "stated income" mortgage loans.[25]

The Dodd-Frank Act authorizes regulatory clarification of its "ability to repay" requirements contained in section 1411.[26] This authority is repeated in the standards imposed for "qualified mortgages" in section 1412 of the Act, which specifically mention the option of formulating regulatory debt-to-income ratios.[27] It is also contained in the authority to impose requirements for "qualified residential mortgages" found in section 941 of the Act. This may be the most important piece of unfinished business under the Dodd -Frank Act with respect to mortgage underwriting practices.

Quantitative measures of borrowers' ability to repay, as well as additional standards aimed at avoiding future risky underwriting practices, were proposed in March of 2011 by the federal regulators pursuant to section 941 of the Dodd-Frank Act.[28] These proposed regulations prohibit "qualified residential mortgages" from containing certain features, namely terms permitting negative amortization, interest-only payments, balloon payments, and significant interest rate increases.[29] The proposed regulations also contain underwriting requirements designed to ensure that "qualified residential mortgages" are of very high credit quality. These underwriting standards include: (a) a requirement of a first-lien position[30]; (b) a term not exceeding 30 years[31]; (c) a maximum loan-to-value ratio of 80 percent for purchase mortgage transactions, 75 percent on rate and term refinance loans, and 70 percent for "cash out" refinancings[32]; (d) a debt-to-income ratio of no more than 28 percent for mortgage-related debt payments and 36 percent for total debt payments[33]; and (e) a requirement that total points and fees not exceed three percent of the total loan.[34] These are proposed requirements which may be modified before being embraced as regulatory requirements. Exempt from these regulatory requirements for "qualified residential mortgages" are mortgage loans, or securitizations based on such loans, that are insured or guaranteed by the United States or an agency of the United States.[35] This exemption extends to FHA insured mortgage loans. In addition, securities issued by Fannie Mae and Freddie Mac are exempt from the risk retention requirements while these entities are operating under conservatorship or receivership of the Federal Housing Finance Agency.[36]

These proposed regulations do not prohibit mortgage loans that do not comply with these regulatory requirements. They only require risk retention if the loans are securitized. This risk retention requirement, found in section 941 of Dodd-Frank, may serve as a significant disincentive to origination of loans that do not comply with the enumerated regulatory requirements in the long term. In the short term, the exemption currently available for securities issued by Fannie Mae or Freddie Mac limits the impact of the proposed requirements.

In addition, The Federal Reserve Board proposed regulations in April of 2011 that serve to clarify the minimum underwriting requirements contained in section 1411 of the Dodd-Frank Act, as well as the standards to be met for "qualified mortgages" as that term is used in section 1412 of the Act.[37] The most important of the proposed rules are the rules clarifying the minimum underwriting standards contained in section 1411 of the Dodd-Frank Act, since these are required standards for residential mortgage loans. The proposed rules state "a creditor *must* consider…[t]he consumer's current or reasonably expected income or assets, other than the value of the dwelling that secures the loan..."[38] in making a determination of the consumer's ability to repay the loan. This addresses the first item of unfinished business identified in this article. However, the proposed regulations regarding minimum underwriting requirements, in contrast to the proposed regulations regarding risk retention, do not contain a maximum debt-to-income ratio of any sort. This was the second item of unfinished business identified in this article. Rather they merely state that "the creditor must consider the ratio of the consumer's total monthly debt obligations to total income…[and] the consumer's remaining income after subtracting the consumer's total monthly debt obligations from the total monthly income."[39]

The April 2011 proposed regulations also address the standards to be met for "qualified mortgages." Curiously these standards do not include the mandate that underwriting decisions must be based on the consumer's current or reasonably expected income or assets.[40] As discussed earlier in this article, mortgage loans that are deemed to be "qualified mortgages" carry a presumption of compliance with the minimum underwriting requirements of section 1411 of the Dodd-Frank Act. The proposed regulations establish a safe harbor for compliance with the minimum underwriting requirements without a mandate that the creditor's decisions must be based on the consumer's income or assets.[41]

Conclusion

The Dodd-Frank Act sought to avoid repetition of the risky mortgage underwriting practices witnessed during much of the last decade. Its statutory mandates regarding underwriting practices fall short of accomplishing this purpose. However, regulatory clarification of the requirements imposed by the Act may accomplish the statutory purpose. The effective date of Title 14 of the Act is the day after its enactment.[42] The Federal Reserve Board is granted regulatory authority under Title 14 until the transfer of authority over consumer financial protection functions to the Consumer Financial Protection Bureau. This "designated transfer date" has been established as July 21, 2011.[43] Proposed regulatory clarifications were issued in March and April of 2011. We must await final action on these regulations, in part by the Consumer Financial Protection Bureau after the designated transfer date, to determine if the statute will accomplish its purpose.

Endnotes

1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat.1376 (2010) (hereinafter Dodd-Frank Act).
2. S. Rep. No. 111-176, at 11-14 and 41 (2010) (Senate report accompanying S. 3217, discussing loans made without verification of income and in the form of risky option-adjustable-rate mortgages).
3. The term banking institutions as used in this article encompasses both commercial banks and thrifts.
4. 15 U.S.C.A. § 1602 (f) (2010).
5. Dodd-Frank Act, *supra* note 1, § 1401 (amending 15 U.S.C. § 1602).

   The term "consumer" credit transaction is defined in the Truth-in-Lending Act as credit extended to a natural person and the money, property or services which are the subject of the transaction are primarily for personal, family, or household purposes. 15 U.S.C.A. § 1602 (h) (2010).
6. The requirements imposed in section 1411 of the Dodd-Frank Act do not, however, apply to reverse mortgages or temporary or bridge loans of twelve months or less.
7. Dodd-Frank Act, *supra* note 1, § 1411 (a) (2).
8. *Id.*
9. *Id.*
10. *See id.*
11. *See id.*
12. *See id.* at § 1412.
13. *Id.* at § 941 (b), (c) and (e).
14. *See id.* at § 941 (b) (2) and (e) (4). The federal banking agencies, Securities and Exchange Commission, Secretary of Housing and Urban Development, and Director of the Federal Housing Finance Agency will jointly define the term "qualified residential mortgage."

    The risk retention regulations must be issued within 270 days of the date of enactment of the Dodd-Frank Act, and become effective one year after the regulations are issued. *Id.* § 941 (2).
15. *Id.* at § 941 (c) (4) (C).
16. *Id.* at § 1412.
17. *Id.* at § 1414.
18. *Id.*
19. *Id.*
20. *See id.*
21. *Id.* at § 1411 (a) (2).
22. 12 U.S.C. §§ 371 (a) (real estate lending by national banks), 1463 (a) (safe and sound operations of savings associations), and 1828 (o) (safety and soundness in real estate lending by all insured depository institutions).
23. Regulations reiterated the safety and soundness requirement and added a requirement that lending policies must establish "prudent underwriting standards, including loan-to-value limits that are clear and measurable." 12 C.F.R. § 365.2 (b) (FDIC). *See also* 12 C.F.R. §§ 560.101 (b) (Office of Thrift Supervision) and 34.61 (b) (Office of the Comptroller of the Currency). In 2003-2004 the Comptroller of the Currency, however, moved to a more rules-based regulation that prohibited loans based predominately on the bank's realization of the foreclosure value of the borrower's collateral, without regard to the borrower's ability to repay the loan according to its terms. *See* 12 C.F.R. § 34.3 (b).
24. *See, e.g.*, Ruth Simon & James R. Haggerty, *Countrywide's New Scare—'Option ARM' Delinquencies Bleed into Profitable Prime Mortgages,* Wall St. J., Oct. 24, 2007 at C1.
25. Federal Deposit Insurance Corporation, Office of Inspector General, *Evaluation of Federal Oversight of Washington Mutual*, Report No. EVAL-10-002, at 9-10, http://www.fdicorg.gov/reports10/10-002EV.pdf.
26. Dodd-Frank Act, *supra* note 1, § 1411 (a) (2) (in accordance with regulations prescribed by the Board, no creditor may make a residential loan unless the creditor makes a reasonable and good faith determination the consumer has a reasonable ability to repay the loan).
27. *Id.* at § 1412 (The term "qualified mortgage" means any residential mortgage loan that complies with any guidelines or regulations established by the Board relating to ratios of total monthly debt to monthly income or alternative measures of ability to pay).
28. *See* Dodd-Frank Act, *supra* note 1, § 941 which requires regulations to be prescribed not later than 270 days after enactment.
29. Department of Treasury et. al, Credit Risk Retention, at 75-76, www.federalreserve.gov/newsevents/press/bcreg/bcreg 20110329al.pdf. The annual rate of interest after the closing of the mortgage transaction may not exceed: (a) two percent in any twelve month period, and (b) six percent over the life of the mortgage transaction.
30. *Id.* at 70-71.
31. *Id.*
32. *Id.* at 78-79.
33. *Id.* at 83 (calculations are based on the maximum interest rate chargeable during the first five years and a payment schedule that fully amortizes the mortgage loan over its full term, which cannot exceed 30 years).
34. *Id.* at 85.
35. *See id.* at 108.
36. *See id.* at 51-53.
37. FEDERAL RESERVE SYSTEM, REGULATION Z; TRUTH IN LENDING (April 2011), http://www.federalreserve.gov/newsevents/press/bcreg/20110419a.htm.
38. *Id. a*t 373 (emphasis added—proposed regulation 12 C.F.R. 226.43 (c) (2)).
39. *Id. a*t 377 (proposed regulation 12 C.F.R. 226.43 (c) (7)).
40. *See id.* at 381 (proposed regulation 12 C.F.R. 226.43 (e)).
41. *See id.* The requirements imposed that recognize a safe harbor for "qualified mortgages" refer only to the repayment ability requirement in proposed regulation 12 C.F.R. 226.43 (c) (1) (general requirement of an ability to repay) and not the specific basis for making that determination found in proposed regulation 12 C.F.R. 226.43 (c) (2) .
42. Title 14 of the Act contains no separate provision establishing an effective date. Section 4 of the Dodd-Frank Act contains a general effective date for the Act's requirements of one day after the statute is enacted, unless otherwise provided in one of the Act's provisions. *See* Dodd-Frank Act, *supra* note 1, § 4.
43. Bureau of Consumer Financial Protection, Designated Transfer Date, 75 Fed. Reg. 57252 (Sept. 20, 2010).

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Real Property Law Section

The Need for Clarification of Opinion 817

I. Introduction

The Real Property Law Section (the "RPLS") of the New York State Bar Association ("NYSBA") appreciates the invitation by the Committee on Professional Ethics (the "Ethics Committee") to provide input on Opinion 817. The RPLS is one of the largest sections of NYSBA with approximately 4900 members. The vast majority of those members practice in small or solo firms, many of which are engaged in residential real estate transactions. Consequently, the issues discussed in Opinion 817 are of enormous importance to the RPLS as well as thousands of other practicing attorneys across New York State.

The RPLS strongly believes in the importance of having attorneys representing all parties in residential real estate transactions. Competent and capable representation of Sellers, Buyers and Mortgage Lenders are important safeguards in the transaction that is often described as "the largest financial transaction" that most people ever encounter in their lives. Unfortunately, many non-lawyers have continually attempted to erode and eviscerate the role of attorneys in residential real estate transactions. From real estate brokers who draft contracts, to mortgage brokers who "advise" buyers on financing, to non-lawyer "settlement companies" who tout that a lawyer is not necessary to conduct a closing, to non-lawyer title agencies who have attempted to legislate attorneys out of their proper role as the party that should opine on the state of the title, the residential real estate practice of law is under siege on many different fronts. For this reason, it is important that the Ethics Committee, when issuing Opinions such as Opinion 817, be mindful of overly broad or vague statements that further hamper the ability of the honest, decent and ethical practitioner to effectively represent his or her clients in the largest financial transaction of their lives.

II. Defining the Issue

Perhaps it is helpful to first address that which is clearly prohibited. There is no doubt that any manipulation of a sales price where the true sales price is knowingly hidden from a Lender, with the knowledge or participation of an attorney to the transaction, is clearly unethical (and undoubtedly illegal). Similarly, the manipulation of a sales price where the true sales price is knowingly hidden from the public record, with the knowledge or participation of an attorney to the transaction, is likewise unethical. However, these are typically not the scenarios that the residential real estate practitioner is faced with in the current real estate market. The typical scenario is that which is recited in the Ethics Committee's informal response dated December 15, 2009 to Inquiry No. 43-09. That factual scenario was stated to be as follows:

> Seller's attorney is presented with a binder[1] calling for a contract for the sale of a single-family home for $300,000, with a mortgage contingency clause for $285,000, representing 95% financing. Before the contract is prepared, the buyer's loan officer (i.e., lender) contacts the seller's attorney asking that the contract be prepared containing the following language: (1) the selling price should be increased by $18,000, to $318,000, to reflect a seller's concession of 6%; (2) a sum certain seller's concession of $18,000 will be applied to buyer's closing costs or otherwise; and (3) the mortgage contingency clause should be increased to mortgage of $302,100 (representing 95% financing).

The seller's attorney and the buyer's attorney defer to the loan officer, an individual licensed by the New York State Banking Department who has been engaged by the buyer to procure the mortgage loan. The loan officer asks the seller's attorney to put in writing that the above formula fully meets underwriting guidelines and was initiated by the loan officer. The sales contract also expressly states that the sales price has been increased by a sum equivalent to the seller's concession, clearly indicating that the price the seller agreed to receive was $300,000. A similar disclosure is set forth in the HUD-1 Settlement Statement, on the Real Property Transfer Tax Return and on the Real Property Transfer Report in connection with the sale of the real property.

III. The Impetus Behind Seller's Concessions

First, it should be noted that as of June 2008 approximately 84% of all residential mortgages were either owned or guaranteed by one of the major Government Sponsored Entities (GSEs), such as Fannie Mae and Freddie Mac.[2] Moreover, in the recent years since the onset of the "mortgage crisis" not much has changed. The New York Times reported on February 9, 2011, "Roughly 90 percent of the money invested in mortgages currently flows through Fannie, Freddie and the Federal Housing Administration.…"[3] The GSEs as well as the FHA and VA all have underwriting manuals that specifically define and allow (and therefore encourage) the use of Seller's Concessions.[4] Thus, it is the secondary market that has created the incentive to use the Seller's Concession as a means to increase the amount that a Purchaser can finance when obtaining a mortgage on his or her home. If the secondary market did not allow and encourage the use of Seller's Concessions, there would simply be no need or utility for them in any residential real estate transaction.

Secondly, it is probably fair to say that the notion of using a Seller's Concession almost never comes about as a result of the suggestion or advice of the Buyer's or Seller's Attorney. Likewise, it is almost never the result of the suggestion of the Seller or Buyer. Indeed, the Sellers, in particular, frequently do not understand the device or the reason for its use.[5] Almost universally, it is the Real Estate Broker, a Mortgage Broker, or a Loan Officer that has suggested that the price be "grossed up" with a Seller's Concession in a corresponding amount. Finally, it would probably also be fair to say that residential real estate attorneys would be thrilled if Seller's Concessions did not exist. They simply unduly complicate the transaction. However, the reality is that residential real estate attorneys do have to deal with Seller's Concessions every day. A clarification of Opinion 817, which clearly delineates a safe harbor in which residential real estate attorneys can operate, would be a great service to the bar and the public.

IV. Specific Problems with Opinion 817

A. Opinion 817 Incorrectly Suggests That Fully Disclosed Seller's Concessions Are Inherently Fraudulent or Misleading to the Secondary Mortgage Market and the General Public

First, the inquirer in Opinion 817 colors the inquiry by stating that the inquirer has been advised by the lender that this type of Seller's Concession is "apparently authorized" but that the "Seller's counsel is unaware" whether the lender's guidelines or those of FNMA or FHLMC discuss a price gross-up. The inquirer goes on to state that he or she is "concerned" that reporting the gross-up on the mortgage application and the HUD-1 "may violate federal law" including sections of the U.S. Code which criminalize loan fraud.[6] Thus, the inquiry is replete with innuendo that even a fully disclosed gross-up and seller's concession is fraudulent both upon the Lender and the secondary mortgage market. However, given the fact that the vast majority of residential mortgage loans are owned or guaranteed by the secondary mortgage market and the further fact that the secondary mortgage market participants explicitly recognize and encourage seller's concessions, the suggestion that the practice is inherently fraudulent is simply not realistic.

In this regard, we should keep in mind that the elements of fraud not only require a misstatement of a material fact, they also require that there must be ***reliance on the misstatement*** and that the ***reliance must be reasonable***.[7]

In view of the foregoing, how can a Seller's Concession which is fully disclosed in the contract and set forth in the HUD-1 (which is prepared by the Lender's Attorney)[8] be a fraud on the original lender or any loan purchaser? First, there has been no misstatement to the original Lender. The Seller's Concession was set forth in the Contract and the Lender's closing statement (the HUD-1). If the original Lender sells the loan on the Secondary Market and fails to disclose the seller's concession, then it is the **LENDER** that is making a misrepresentation and not the attorneys to the transaction. Moreover, to the extent that the purchaser or "ultimate investor" of the loan fails to review the HUD-1 closing statement for the loan and somehow "relied" upon the stated sales price and loan amount from some other source or document, that loan purchaser would be hard pressed to demonstrate that its reliance was reasonable. In short, the theory that a fully disclosed Seller's Concession is somehow a "fraud on the secondary market" fails on a number of levels and is therefore entirely fallacious. The secondary market authorizes sellers' concessions, is the most sophisticated player in the residential mortgage business and can adequately protect itself with a minimum of effort by reviewing the HUD-1s on the loans it is purchasing. If a loan purchaser wishes to rely on representations and warranties of a loan seller, that is its own business decision. A loan purchaser's choice to engage in little or no due diligence, coupled with a failure of a loan seller to disclose the existence of a seller's concession, cannot in any way be the fault of the attorneys involved in the real estate transaction when the seller's concession was properly disclosed in the contract and the HUD-1.

B. Opinion 817's Significant Discussion of the North Carolina and New Jersey Opinions Further Reinforces the Incorrect Conclusion That Fully Disclosed Seller's Concessions Are Inherently Fraudulent

Opinion 817 engages in significant analysis and discussion of North Carolina Formal Ethics Opinion 12 (2001) and New Jersey Ethics Opinion 710 and its clarification. The North Carolina Opinion is completely inapposite because it addressed a situation in which a builder who was selling a number of lots wanted his lawyer to obtain and affix deed stamps on the sale of the first lot based upon a price higher than what was actually paid. The Seller's motivation in doing so was to enhance sales of future lots by making the public record appear as though the sales price for the first lot was higher than the actual price. Clearly the North Carolina Opinion is dealing with an **undisclosed** seller's concession and is therefore of little or no value in analyzing the ethics of a fully disclosed concession.

With respect to New Jersey Ethics Opinion 710, the facts presented were similar to the facts presented in Opinion 817. Critically, however, in Opinion 710, it is explicitly stated that "the inquirer states that the amendments are calculated to increase the size of the purchaser's mortgage loan and '**is a fraudulent practice perpetrated on the ultimate investor**.'" (emphasis added). Given the underlying (incorrect) assumption that this is per se a fraudulent practice, it is hardly a surprise that the New Jersey Ethics Committee concluded that the practice violated the ethical rules prohibiting an attorney from engaging in conduct involving dishonesty, fraud, deceit or misrepresentation. The New Jersey Opinion was a foregone conclusion based upon the recitation of the inquirer. Therefore, it is of little value in analyzing the ethical propriety of a fully disclosed Seller's Concession that is not fraudulent.

C. The Holding of Opinion 817 Fails to Give Clear Guidance to the Practitioner

Opinion 817 states the following:

> Thus we hold that a lawyer may not ethically participate in such a "gross-up" of the actual purchase price and concomitant seller's concession unless there is neither deception nor misrepresentation at work in the transaction and its predictable consequences. At a minimum this means the gross-up (and not merely the grossed-up purchase price) must be disclosed in the transaction documents. We are persuaded that merely reporting "a seller's concession" may imply either that the seller has agreed to reduce the purchase price he or she would otherwise have obtained or that the reported sales price is the actual price of the property less certain costs the seller has agreed to pay. If neither of these is the case, then reporting concession, without more, is misleading under DR 1-102.

The above holding is problematic for a number of reasons. First, it implies that simply reporting the gross-up and the concession is not enough. Why? If you give me $100 and I give you $10 back, we all know that you gave me $90. If an attorney reports the sales price as $318,000 with an $18,000 seller's concession, we all know the price is $300,000. To require the Seller's and Buyer's attorney to try to ascertain the motives behind the concession is simply unrealistic and puts the attorneys in an impossible situation. Indeed, it is entirely possible that the Seller's motive and the Buyer's motive for the concession might be entirely different. Reporting the true facts and all of the true facts should be sufficient.

Second, the use of the phrase "transaction documents" throughout the Opinion is ambiguous. What are the transaction documents? Do attorneys now need to recite the price and the concession in the Deed,[9] the Note, the Mortgage or the multitude of other documents signed at a residential real estate closing? Many of the "transaction documents" customarily make no mention of the purchase price. The use of this phrase fails to give appropriate guidance as to the proper actions that an attorney should take.

D. The Ethics Committee's December 15, 2009 Informal Response to Inquiry No. 43-09, While Helpful, Still Does Not Provide Clear Guidance and Is Not a Formal Opinion

The Ethics Committee's informal response to Inquiry No. 43-09 is helpful to the extent that it seems to clarify that disclosure of the Seller's Concession in the "transaction documents" applies only to those documents where the sales price is stated. While this clarification is welcome, it is of little value to the real estate practitioner because it is contained in an informal response limited solely to the facts set forth in the inquiry and has "no effect as precedent insofar as any other state of facts is concerned."

However, RPLS disagrees with the Ethics Committee's conclusion that there must be disclosure of the fact that the **reason** for the seller's concession is the gross-up of the sales price. Again, if the grossed up price and the concession are clearly set forth, there is no fraud. The fact that the parties (with or without the knowledge of their attorneys) may have been motivated by the very underwriting guides that the secondary market promulgates should not make a difference. Indeed, it should come as no surprise to the secondary market that the consumers will adapt their behavior to comply with the underwriting guidelines. If the consumers are operating within the parameters of the guidelines, then the secondary market is not being misled.

V. Recommendations

The RPLS recommends that an amended and restated version of Opinion 817 be promulgated. The amended and restated version should provide a clear roadmap for the practitioner to be in compliance with his or her ethical obligations. The practicing attorney should be able to use the Opinion as a guide to a safe harbor for ethical practice. In so doing, the Opinion should, at a minimum, cover the following:

1. Any suggestion that a fully disclosed gross-up and seller's concession is inherently fraudulent and misleading to the Lender or Loan purchasers on the secondary market should be rejected.

2. Disclosure of the grossed up sales price and the Seller's concession on the Contract of Sale, the HUD-1, the RP-5217 (or RP-5217NYC as applicable) should be sufficient to provide the attorney with a safe harbor. If there is disclosure on the contract and the HUD-1, there is no misleading or fraud to the Lender or the secondary market. If there is disclosure on the RP-5217, the public record will be likewise be free of any misleading information.

3. The reason for the gross-up and the concession should make no difference in the attorney's obligation. So long as it is properly disclosed, there should be no further obligation as to the motivations of the parties.

4. Even if there is a post-contract request to amend the contract (or to create a new contract) containing a gross-up and a concession, the attorney has acted properly as long as the transaction is properly disclosed in the amended contract, the HUD-1 and the RP-5217.

Endnotes

1. It should be noted that this factual scenario is typical of the "downstate" practice where the Seller's attorney prepares the contract after receiving a "binder" from the real estate Broker. In the "upstate" practice, the real estate broker typically prepares the contract, which is then provided to the attorneys for approval.

2. *See*, Federal Housing Finance Agency, *About FHFA 2008*, http://www.fhfa.gov/Default.aspx?Page=4.

3. *See*, Plans Near for Freddie And Fannie, *New York Times*, 2/9/11.

4. See the attached excerpt from the Fannie Mae Selling Guide discussing Interested Party Contributions (IPC's). As is clear from that excerpt, the types of "Seller's Concession" addressed in Opinion 817 is just one example of an IPC. The other GSEs have similar published underwriting requirements for Seller's Concessions or IPCs. *See, e.g.*, FHLMC Single Family Seller/Servicer Guide, Section 25.3; VA Lender's Handbook Chapter 8, Section 5.6.

5. The conversation between the Seller and the Attorney frequently goes something like this: CLIENT: "I thought I was selling my house for $300,000.00, why does the contract say the price is $318,000.00?" ATTORNEY: "Well, you are giving the Buyer an $18,000.00 credit at closing, so the net amount to you is $300,000.00." CLIENT: "Why would we do it this way?" ATTORNEY: "This is the way the financing has been structured by the Buyer, it will enable him to borrower more money to finance some of his closing costs." CLIENT: "I really don't get it but if you are sure that I am getting $300,000 for selling my house, it's OK with me because that is what I agreed to with the Buyer. Where do I sign?"

6. *See*, Opinion 817, ¶¶ 2 and 3.

7. *See, e.g.*, *East End Cement & Stone, Inc. v. Carnevale,* 73 AD3d 974 (2nd Dept 2010) ("with respect to alleged misrepresentations, 'if the facts represented are not peculiarly within the party's knowledge, ***and the other party has the means available to him of knowing***, by the exercise of ordinary intelligence, the truth or the real quality of the subject of the representation, he must make use of those means, or he will not be heard to complain that he was induced to enter into the transaction by misrepresentations.'" *East End* at 975 (citations omitted) (emphasis added); *see also*, *Danaan Realty Corp. v. Harris,* 5 NY2d 317, 322 (1959)).

8. Significantly, many residential lenders now require the HUD-1 to be faxed to them from the closing table for their review before authorizing their own attorney to disburse the mortgage proceeds.

9. It should be noted that the consideration is usually **NOT** recited in the Deed (other than certain specific types of Deeds, such as Executor's or Referee's Deeds).

Respectfully Submitted,
New York State Bar Association
Real Property Law Section
Anne Reynolds Copps, Chair

Bergman on Mortgage Foreclosures: New Foreclosure Notice Statutes Mean Business

By Bruce J. Bergman

Foreclosing lenders really do have to dot every "i" or possibly face dismissal of their actions.

Because the New York legislature believes that borrowers neither recognize nor understand the consequences of defaulting on a mortgage, a number of statutes have been passed over the last few years imposing special and extensive notice requirements upon foreclosing lenders. One is the extraordinary 90-day notice requirement for subprime mortgages but this is an obligation of the lender or servicer. Sundry others are solely the province of lender's counsel.

In analyzing the various statutes, the concern of lender's counsel was always that a court might dismiss a foreclosure if there was any degree of non-compliance. That fear has been realized in a recent case [WMC Mortgage Corp. v. Thompson, __Misc.3d__, 877 N.Y.S. 2d 855 (Sup. Ct., Kings Co. 2009)]. This was at the trial court level and we suggest that an appeal is unlikely; it is faster and less expensive to just begin the action anew. So this is likely to set an unwelcome standard.

What the case said, and why it is an unsettling precedent for holders of defaulted mortgages, follows.

Among these many new mandates is one to provide notice to the mortgagor in a residential case advising of help available for homeowners. The text is somewhat extensive, must be presented in certain size typefaces, must accompany the summons and must be on a different colored paper [RPAPL § 1303 (1)]. Counsel needs to assure that this is done.

In the new case, the notice was not appended. When this non-compliance was revealed upon application for the order of reference, lender's counsel asked that the summons be amended from the inception. In order words, "we will send the notice now, consider it sent at the beginning of the case." No, ruled the court, this is a defect which can only be corrected by proper service of the notice with the summons and complaint—case dismissed.

What was ignored by the court, if argued by lenders counsel, was extensive case law holding that without demonstrated prejudice, neglect to comply with statute or procedure can be considered ministerial and not fatal. Was prejudice demonstrated here, that is, was the borrower actually denied anything? Then too, there are specific statutes allowing courts to permit correction of errors. Was this mentioned by counsel? Did the court consider it? [For a full discussion of case law and statute on these points see 1 Bergman On New York Mortgage Foreclosures § 2.06A, LexisNexis Matthew Bender (rev. 2009).]

Our point is that there was authority for the court to refrain from dismissing the foreclosure for failure to include the notice at the beginning. But it chose not to.

Yet there is more: This particular notice is solely for the borrower. Assuming failure to append the notice to the summons meant the action was invalid against the borrower, it does not affect the validity of service upon all the other defendants. Thus, the action itself could have survived via unassaulted valid service on the other defendants with need to serve only the borrower anew.

The final upshot of all of this which will likely be with us for some time: The "new" statutes are probably viewed strictly. This may not be surprising, although we would disagree with the conclusion. It does, however, underscore the obvious. Lenders' counsel must meticulously comply with all the mandates (and defaulting borrowers will benefit when counsel stumbles). Rescue from the courts in this arena is unlikely.

Mr. Bergman is the author of the three-volume treatise, *Bergman on New York Mortgage Foreclosures*, LexisNexis Matthew Bender (rev. 2009) and is a member of Berkman, Henoch, Peterson & Peddy, P.C., Garden City, New York. He is also a member of the USFN and the American College of Real Estate lawyers and a Fellow of the American College of Mortgage Attorneys.

Student Case Comment:

Mortgage Foreclosure: “Commencement” and “Standing” in *Wells Fargo Bank, N.A. v. Marchione*

By Allison Hoyt

Wells Fargo Bank, N.A. (“Wells Fargo”), acting as trustee for Option One Mortgage Corporation, originator of Vincent and Debbie Marchione’s (“the defendants”) mortgage and holder of a note signed by Vincent Marchione, filed a summons and complaint on November 30, 2007 to foreclose on the defendants’ mortgage. The defendants were served on December 7, 2007. Defendants moved to dismiss Wells Fargo’s complaint for lack of standing. The Supreme Court, Westchester County, granted the defendants’ motion and the Appellate Division, Second Department, affirmed on October 20, 2009.

Absent from Wells Fargo’s complaint was any documentation of an assignment of the defendants’ mortgage from Option One Mortgage Corporation to Wells Fargo. Documentation of the purported assignment was first submitted to the Supreme Court in Wells Fargo’s papers on January 18, 2008, in opposition to the defendants’ pre-answer motion to dismiss the complaint for lack of verification. The assignment was dated December 4, 2007 and contained a provision stating that it had become effective on October 28, 2007.

Defendants, in reply, again moved to dismiss Wells Fargo’s complaint, this time for lack of standing. The Supreme Court granted the defendants’ motion and the Second Department affirmed stating that “Wells Fargo lacked standing to bring this foreclosure action because it was not the assignee of the mortgage on November 30, 2007, the day the action was commenced.”[1] In so holding, the Court clarified an issue of procedure—whether the filing or the service of the summons and complaint commenced the action—and rejected Wells Fargo’s argument that it had an interest in the defendants’ mortgage as of October 28, 2007.

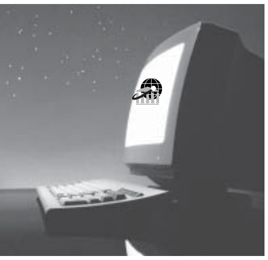
First, in holding that the filing of the summons and complaint signified commencement of the action, the Court relied on a holding from the Third Department, *LaSalle Bank, N.A. v. Ahearn*,[2] and stated that the assignment of a mortgage “must have occurred prior to the commencement of the action, which is the date of filing (*see* CPLR 304), to confer standing to sue upon the assignee.”[3] Second, again relying on *LaSalle Bank, N.A. v. Ahearn*, the Court explained that the execution date of the assignment is “generally controlling and a written assignment claiming an earlier effective date is deficient unless it is accompanied by proof that the physical delivery of the note and mortgage was, in fact, previously effectuated.”[4]

Because there was no evidence that physical delivery of the note and mortgage was previously effectuated, the execution date of the assignment controlled, not the retroactive effective date cited therein. Therefore, since Wells Fargo commenced the action, i.e., filed the summons and complaint before the assignment was executed, Wells Fargo did not have standing to sue.

Endnotes

1. Wells Fargo Bank, N.A. v. Marchione, 69 A.D.3d 204, 207, 887 N.Y.S.2d 615, 617 (App. Div. 2d Dep’t 2009).
2. 59 A.D.3d 911, 912, 875 N.Y.S.2d 595, 597 (App. Div. 3rd Dep’t 2009).
3. Wells Fargo Bank, N.A. v. Marchione, 69 A.D.3d at 207, 887 N.Y.S.2d at 617.
4. *Id.* (quoting *LaSalle Bank, N.A. v. Ahearn*, 59 A.D. at 912).

Allison Hoyt is a third-year student at St. John’s University School of Law. She is also the outgoing Associate Managing Editor of the *New York Real Property Law Journal*.



Student Case Comment:

Imposition of Severe Sanctions Without Authorization from a Statute or Rule Is Improper: *IndyMac Bank, F.S.B. v. Diana L. Yano-Horoski, et al.*

By Milana Khlebina

This case involves the issue of whether the Supreme Court erred in imposing sanctions on plaintiff, IndyMac Bank. On January 12, 2009 in the Supreme Court of Suffolk County IndyMac Bank issued a judgment of foreclosure and sale against defendant Yano-Horoski for defaulting on her mortgage. Following the judgment, the court scheduled settlement conferences in which both parties participated. The court, sua sponte, ordered a hearing to determine whether IndyMac Bank acted in bad faith during settlement negotiations. At the conclusion of the hearing, the court held that the plaintiff acted in bad faith, vacated the judgment of foreclosure and sale, and cancelled the note and mortgage in its entirety. *IndyMac Bank F.S.B. v. Yano-Horoski*, No. 2005-17926, (N.Y. Sup. Ct. Suffolk County Nov. 19, 2009). The plaintiff appealed. On appeal, the Appellate Division, Second Department reversed the decision of the Supreme Court and reinstated the note, mortgage, and the judgment of foreclosure and sale. This court held that the Supreme Court erred in imposing sanctions on the plaintiff. *IndyMac Bank F.S.B. v. Yano-Horoski*, No. 2009-11392, (App. Div. 2d Dep't 2010).

The court ruled that in order to warrant severe sanctions, such as cancelling the mortgage and note, authorization for such sanctions must stem from a statute or a rule. A plaintiff must be given a fair warning that such sanctions are under consideration. Imposing severe sanctions on the plaintiff for acting in bad faith during settlement negotiations in the instant case was erroneous because no statute or rule warrants such sanctions. The plaintiff was not given a fair warning of the possibility of being sanctioned. Finally, there was no acceptable basis for relieving the homeowner of her contractual obligations to the plaintiff. A court's equitable powers will not be sufficient to relieve a homeowner of her contractual obligations.

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