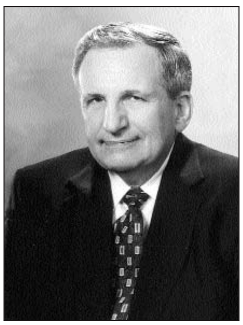
NYSBA

SPRING 2002 | VOLUME 30 | NO. 2

N.Y. Real Property Law Journal

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

A Message from the Section Chair



It is more than six months since the "day of destruction" and the effects of September 11 are still upon us. September 11 has had a huge effect on real estate, especially in the lower part of New York State. The real estate market both in the commercial and residential area south of 14th Street in Manhattan has been paralyzed. Commercial buildings have had prospective tenants leave and refuse to even look downtown. Lessees who have signed leases near Ground Zero have defaulted and elected to relocate to midtown Manhattan. Residential tenants have entered into agreements to end their leases and have relocated. The relocation of these residential people have created in the suburbs—Westchester, Rockland, Nassau and Suffolk Counties, as well as nearby New Jersey—a tight market for homes and apartments in these areas, thus already placing on a tight seller's market a lot of competition among home buyers. Statistics have shown that foreign and domestic tourists have stayed out of New York for two reasons. The first is the "embarrassment of the victims," the populace not wanting to know or be part of the attack on New York and indifference of people not wanting to deal with this problem. The second is the fear of being a "victim" by coming to New York City. Even in Manhattan there are people that regard the problems of lower Manhattan as remote and not part of "our Manhattan." While many people have opened their hearts and pocketbooks to the victims of 9/11, there are millions of people who do not want to know about the attack on the World Trade Center but only deal with it as if New York were a foreign country and the 9/11 attacks were not on them. Many real estate lawyers are now involved in "work-outs" on hotels here in the city. The hotels have suffered and are badly in need of relief and help in coping with the loss of tourism that post 9/11 has created. Many of the commercial office buildings downtown are suffering also. The tenants have left; many buildings were hurt by the dust, flying concrete, steel, and glass near Ground Zero and have not yet reopened. Many tenants, including law firms both large and small, have

Inside

relocated to midtown or other places. Many of the businesses have gone to nearby New Jersey, Westchester County and even downtown Brooklyn. This was especially true of law firms. Some, but only a few, have returned to lower Manhattan. Many will never return. One large New York law firm that took a sub-lease in midtown immediately after is again looking downtown for a large block of space, even if the space is not ready for occupancy for some time. The New York State Bar Association Real Property Law Section has tried to do its part in the post 9/11 circumstances. Many of the firms in midtown took in law firms from lower Manhattan and gave them free space. Some firms took in others having nothing to do with the law. Some of this available space was "matched" by the NYSBA. Qs and As for both residential and commercial tenants and owners were worked on by a subcommittee chaired by Second Vice-Chair Matthew Leeds. Participants in that endeavor were Ed Baer, Joshua Stein, Harold Lubell, Karl Holtzschue, John Hall, Jeffrey Chancas, Beatrice Lesser and David Berkey.

Some of the topics worked on by the committee were real estate taxation in regard to diminishing value of real property and the inability to pay real estate taxes. Mortgage payment relief in areas where there has been a death of one of the parties at "ground zero" or on the airplanes that went down or into the World Trade Center. Questions about people's rights as to title and possession of real property because of a death at the World Trade Center, etc., were discussed. What commercial tenants' rights and obligations are because of damage caused because of proximity to the World Trade Center were discussed and advice supplied. Questions as to liability on a commercial lease were written about for instances where one of the parties to the lease (i.e., tenant(s)) died at the World Trade Center site. Many people had questions about cooperative apartments. How do they obtain title? How do they get breaks in payment of loans or maintenance charges because the "breadwinner(s)" was killed? Problems in regard to the need for death certificates and how individuals can obtain death certificates were dealt with. Contract rights—where people were buyers or sellers and the real estate was damaged by dust, etc., and even where there was no physical damage—were also discussed. Problems of landlords where their tenants wish to relocate were dealt with, including the inability to pay rent.

All of our work has not been in the 9/11 area. We have continued to oppose legislation where there were no purposes for it and to promote legislation that was badly needed. We have Section members working in such areas as mortgage recording tax and consumer-oriented legislation.

The January program held at the Marriott Marquis Hotel was a huge success. First Vice-Chair John Privatera put together an excellent program, which was well received and applauded. Those who spoke and their topics were: Matthew Leeds, with a World Trade Center Report; David Berkey, on Rights of Condominiums and Cooperative Unit Owners when access is denied; Steven Baum, discussing the Sailors and Soldiers Relief Act; Leonard Sienko, on Law Firm Record Retention in the 21st Century; Joseph Philip Forte, discussing the Risk of Lost Collateral in the Securitized Market. Also speaking were James Branigan, who discussed the effect of 9/11 on the Real Property Insurance Market; Edward Baer, on September 11th's ramifications on Residential Land Commercial Leases; Karl Holtzschue, discussing the Property Condition Disclosure Act, which went into effect on March 1; and Sean Michael Griffin, who spoke to us on Industrial Development Agency Matters.

At the Real Property Law Section luncheon, Dick Morris introduced his father, Eugene Morris, who received the Real Property Law Section Professionalism Award. Gene richly deserves this award.

The Condominiums and Cooperative Committee also had a CLE session; some of their speakers were Joel Miller, Professor Paul Shupack, Terry Lewis and Com. John Lariviere, speaking on the Uniform Commercial Code and Cooperatives. Ronald Kahn and Leatha Sturges spoke on the new cooperative contract now in use. The co-chairs, who did a terrific job, were David Berkey and Joseph Walsh.

The Professionalism Subcommittee had a CLE program chaired by Co-chair Peter Coffey. The program was on "Can Attorney Professionalism Survive?", a discussion of the pressures on today's attorney. Co-chair Janet Stern was a participant in setting up the program. Some of the speakers were John Blyth, John Hall, Hon. Justice Anthony V. Cardona, Melvyn Mitzner, Lorraine Power Tharp, Mark Solomon, Joseph Dulin, Isabel Franco, Mark Ochs and Mimi Netter. It was a very successful program.

Another program that did well was the one on Attorney Opinion Letters, successfully co-chaired by David Zinberg and Jill Myers. Among the speakers were Stephen MacDonald and David Portal.

Recently the need for "terrorism" insurance on large buildings has just about killed the sale and refinancing of large trophy buildings in New York City. However we are optimistic that a solution may be near. Hopefully from the Congress; if not, maybe from the insurance industry.

The Real Property Law Section has been continuing its business even after 9/11 and our help to the Bar and all people has been well-received. We will continue to do whatever is necessary to assist the Bar and public to recover.

Melvyn Mitzner

Habitability Issues at Ground Zero: Reconsidering Real Property Law § 235-b in the Wake of September 11th

By Jay Berg

I. Introduction

Much has been written lately about whether residential tenants in lower Manhattan whose apartments and lives were turned upside-down as a result of the attacks on the World Trade Center can seek redress from their landlords.[1] The prevailing thought seems to be that they can.[2] In particular, many tenants residing in lower Manhattan who were forced to evacuate when the Twin Towers collapsed, and who returned weeks later to find their homes in disarray, are arguing that they are entitled to either a total or partial rent abatement from their landlords. This argument is based on the theory that the landlords are strictly liable for the conditions in the apartments under what is called "the implied warranty of habitability."[3] The implied warranty of habitability is codified in New York as Real Property Law § 235-b (RPL).[4] Surprisingly, some law firms that primarily represent landlords have agreed.[5]

The purpose of this article is to examine the implied warranty of habitability to determine if indeed it is applicable in the wake of September 11th. This article will demonstrate that RPL § 235-b was not enacted in order to hold landlords strictly liable for the acts of third parties. The attacks of September 11th were acts of war. At a minimum, they were the acts of criminals. If considered the former, then a private property owner should have full, or at least qualified immunity for any losses suffered by a tenant as a result of the collateral damage caused by the destruction of the World Trade Center. If deemed the latter, then an owner should only be liable if the attacks were foreseeable to the property owner and there was some action that the owner could have taken that would have prevented or mitigated the ensuing damage. In no event should property owners be held strictly liable under the umbrella of the implied warranty of habitability, as some tenant advocates have suggested.

". . . RPL § 235-b was not enacted in order to hold landlords strictly liable for the acts of third parties."

II. The Implied Warranty of Habitability

A. The Common Law

At common law, a lease was considered a sale of property.[6] Once the landlord delivered "the goods" (i.e., possession of the property), he fulfilled his legal obligations to the tenant.[7] The tenant, like any other buyer, took the property "as is," with no recourse if it turned out that the premises were uninhabitable.[8] The rule was *caveat emptor* or *caveat lessee*.[9] Further, since the covenants in the lease were considered independent, the tenant was obligated to pay rent, even if conditions were deplorable.[10]

These rules, which developed in medieval England, remained relatively unchanged for centuries.[11] It was not until the late 1960s and early 1970s, as the generation of Americans that came of age after the Second World War began to challenge the old notions of society, that landlord-tenant law, like other areas of law such as civil rights, finally began to catch up with the times.[12] Indeed, in a topical folk song from that era entitled "The Faucets are Dripping," the songwriter lambastes landlords who would winter in Miami while their tenants are forced to make do in substandard apartments in New York City.[13]

The first reported case in New York State in which a court held that there is an implied warranty of habitability in every residential lease was *Amanuensis Ltd. v. Brown.*[14] *Amanuensis Ltd. v. Brown* involved a group of non-payment proceedings brought by the owner against three tenants at 310 West 18th Street. At the time the owner had acquired the building, there existed numerous housing code violations which had been recorded against the property. The owners did nothing, or virtually nothing, to correct those violations.[15]

At the trial, the tenants acknowledged that they had not paid rent for some time, arguing, *inter alia*, that the owner had breached a warranty of fitness for use and a warrant for quiet enjoyment. The trial court agreed, finding, *inter alia*, that "modern scholarship is unanimous in its outspoken condemnation of the unfairness and harmful social consequences of a doctrine that permits a landlord to recover rent and evict tenants while defying the statutory requirement that he maintain the premises in accordance with the law."[16] In reaching that conclusion, the court relied on an article published in the *Fordham Law Review* in 1969 entitled "Law of Landlord-Tenant: A Critical Evaluation of the Past and Guidelines for the Future."[17] In that article, the authors had argued that:

> More often than not unjust in its preference for the cause of the landlord [landlord-tenant law] can only be described as outrageous when applied to the poor tenant in the multi-family dwelling. There it views with complacency the most wretched living conditions, littered and unlit hallways, stairways with steps and banisters missing, walls and ceilings with holes, exposed wiring, broken windows, lead pipes, stoves and refrigerators that do not work or work only now and then, and almost always the cockroaches and the dread of winter cold and uncertain heat.[18]

The *Amanuensis* court then went on to hold that residential tenants should be permitted to raise defenses to non-payment eviction proceedings in the following three situations:

> First, where the landlord has not made a good faith effort to comply with the law and there have been substantial violations seriously affecting the habitability of the premises.
>
> Second, where there are substantial violations and code enforcement remedies have been pursued and have been ineffective.
>
> Third, where substantial violations exist and their continuance is part of a purposeful and illegal effort to force tenants to abandon their apartments.[19]

Another early New York case in which the court found that there was an implied warranty of habitability in every residential lease was *Morbeth Realty Corp. v. Velez.*[20] In that case, the tenant, in accordance with Real Property Actions and Proceedings Law § 755, had deposited her rent with the court, claiming that the apartment was uninhabitable. Eventually, the tenant vacated the apartment, and the landlord sought release of the funds. The civil court found that as a result of the egregious conditions of the apartment, the landlord was entitled to only one-half of the sum on deposit, with the remaining half to be returned to the tenant. In particular, the court noted the seriousness of the conditions in the apartment. As the court stated:

> There persisted a severe roach and insect infestation, with an almost total lack of extermination service; virtually non-existent janitorial services; a nailed up back door, which prevented egress; a front door that could not be locked with knob that continuously fell off; a recurrent backing up of a malodorous waters in the kitchen sink when the other tenants in the same line use plumbing facilities; severe leaks from the ceiling in the kitchen and foyer; and a variety of other defects and violations that need not be detailed.[21]

The court found that these violations violated the tenant's implied warranty of habitability. While acknowledging that the doctrine of implied warranty of habitability had not been "squarely passed upon by the appellate courts of this state," the court nonetheless held that the doctrine was applicable. As the court stated:

> The doctrine rests upon the indisputable social reality that the apartment dweller, in exchange for the rent he pays expects not merely to occupy a certain amount of space, but also a body of goods and services which together make up the habitable apartment [citations omitted]. Accordingly, it implies in every residential tenancy a warranty by the landlord to maintain the apartment in a condition suitable for decent living. Where there has been a substantial failure by the landlord to maintain the apartment in a habitable condition, the right to receive rent is made subject to a defense comparable to that available in virtually every part of our society to one who does not receive that for which he agreed to pay.[22]

It wasn't long before the Appellate Division did take up the issue, in *Tonetti v. Penati.*[23] In *Tonetti v. Penati*, the Appellate Division, for the first time, determined that a warranty of habitability should be implied in the rental of premises for use as a residence, and, for that reason, the common-rule of *caveat lessee* should no longer be applied to residential leases. Interestingly, *Tonetti v. Penati* did not involve an apartment in New York City. Rather, it involved the lease of a five-bedroom private house in Palisades, New York.

In *Tonetti v. Penati*, the conditions in the house were so unbearable that the tenant moved out five days after he had moved in. The problems consisted of a terrible odor caused by the former tenant keeping four or five dogs inside the house; another unbearable odor being emitted by the furnace; and infestation by rats.

In the ensuing litigation, the trial court held for the tenant. The trial court's decision was affirmed by the Appellate Division, Second Department. The Appellate Division "relegate[d] to the limbo of history the orthodox view of *caveat lessee* and [held] that, unless expressly excepted, there is an implied warranty of habitability when a landlord leases premises for residential use."[24] As the court stated:

> It is evident that the rationale behind the common-law rule, which likened a lease to the sale of a chattel and therefore applied the ancient doctrine of *caveat emptor*, has no rational basis in a modern, urban society. Realistically viewed, and fiction discarded, a lease of residential premises establishes a contractual relationship with mutual obligations and is not intended to be treated as a conveyance of an interest in realty. The main concern of today's tenant is that he acquire premises which he can enjoy for living purposes; he is more mobile and generally less skilled at maintenance than the landlord. Repairs are more costly in dwellings, with modern plumbing and electrical facilities, and are more complex. Thus, writers on the subject have supported the adoption of a rule of an implied warranty of habitability (*see, e.g.*, 38 Fordham L. Rev, 225; 35 N.Y.U.L. Rev. 1279).[25]

As these cases indicate, the courts were attempting to level the playing field by allowing tenants to withhold rent in cases where the conditions in the apartment were abominable. Notably, in all of the cases cited, the conditions were caused by the acts or omissions of the landlord, which invariably were egregious.

B. RPL § 235-b

Three months after *Tonetti v. Penati* was decided, the Legislature enacted RPL § 235-b. As originally written, the statute provided as follows:

> **§ 235-b—Warranty of Habitability**
>
> 1. In every written or oral lease or rental agreement for residential premises the landlord or lessor shall be deemed to covenant and warrant that the premises so leased or rented and all areas used in connection therewith in common with other tenants or residents are fit for human habitation and for the uses reasonably intended by the parties and that the occupants of such premises shall not be subjected to any conditions which would be dangerous, hazardous or detrimental to their life, health or safety. When any such condition has been caused by the misconduct of the tenant or lessee or persons on his direction or control, it shall not constitute a breach of such covenants and warranties.
>
> 2. Any agreement by a lessee or tenant of a dwelling waiving or modifying his rights as set forth in this section shall be void as contrary to public policy.[26]

The legislative history of RPL § 235-b demonstrates that it was simply the intention of the Legislature to bring landlord-tenant law into the 20th century by shifting the responsibility for maintaining leased premises from the tenant to the landlord. As stated by Governor Hugh L. Carey in his Memorandum on § 235-b:

> The bill represents a significant beneficial change in the law of landlord and tenant. With few exceptions, the legal principles regulating the rights of tenants to the safe, sound and habitable housing accommodations are founded upon legal principles that evolved during the Middle Ages. In the absence of an express provision in the lease, the landlord is not obligated to make necessary repairs. To a very large extent, the doctrine of caveat lessee still prevails and requires the tenant to take the premises as they are and assume all risks as to their condition.[27]

The fact that the purpose of the law was to provide tenants with basic amenities can be seen by examining the Memorandum of Senator H. Douglas Barclay. According to the Senator, the bill was designed to meet minimal standards of habitability. As the Senator stated:

> In this era of consumer-oriented legislation no provision has yet been made for those individuals who rent residential property to assure that the property they rent will be habitable. While the tenant has the covenant to pay the rent, there is no corresponding covenant on the part of the landlord that the lease premises will meet the standard of livability. The bill would encourage landlords to maintain their property in a safe and sanitary condition and aid in the maintenance of housing stock.[28]

The first major case construing section 235-b of the RPL was *Park West Management Corp. v. Mitchell*.[29] In that case, the landlord was the owner of Park West Village, an apartment complex located on the upper west side of Manhattan. In May 1976, the employees of Union Local 32B went on strike. For the next 17 days, no maintenance or janitorial staff member reported to work at Park West Village. As a result, the tenants suffered extensive service interruptions, which prompted some of them to withhold rent.

Park West Village commenced summary proceedings in the Civil Court of the City of New York. As an affirmative defense, the tenants argued that Park West Village had breached its implied warranty of habitability by not providing essential services. The Civil Court agreed and found that the tenants were entitled to a 10 percent rent abatement for the disruption in services. The Civil Court's Order and Judgment was affirmed by the Appellate Term, the Appellate Division and, ultimately, the New York State Court of Appeals.

In pertinent part, the Court of Appeals held that "as the statute places an unqualified obligation on the landlord to keep the premises habitable, conditions occasioned by ordinary deterioration, work stoppages by employees, *acts of third parties* or natural disaster are within the scope of the warranty as well."[30]

Notably, while holding the landlord accountable for the deterioration of services as a result of the sanitation strike, the Court of Appeals was unwilling to impose "across-the-board" liability on landlords. The loss had to be substantial and directly affect the habitability of the apartment. As the Court stated:

> Petitioner maintains, and rightfully so, that a landlord is not a guarantor of every amenity customarily rendered in the landlord-tenant relationship. The warranty of habitability was not legislatively engrafted into residential leases for the purpose of rendering landlord's absolute insurers of service, which do not affect habitability. Rather, Section 235-b of the Real Property Law was designed to give rise to an implied promise on the part of the landlord that both the demised premises and the areas within the landlord's control are fit for human habitation at the inception of the tenancy and that they will remain so throughout the lease term.[31]

The Court of Appeals reaffirmed this principle in *Solow v. Wellner*.[32] In *Solow*, the Court of Appeals rejected a broad reading of RPL § 235-b. The Civil Court had held that the statute encompassed the level of services and amenities tenants reasonably expect to be provided under the terms of the lease. The Court of Appeals categorically rejected that interpretation, finding that the statute simply warrants that an apartment will be safe and habitable and that it does not cover expectations arising from the terms of the tenant's lease.

"Nevertheless, the underlying principle of Park West Village v. Mitchell, *to the effect that landlords could be held liable for breaches of the implied warranty of habitability, even if those breaches were caused by the acts of third parties, remained (and still remains) vibrant."*

Further, the courts have consistently been unwilling to extend liability under RPL § 235-b where the tenant has a remedy under tort law. For example, in *Curry v. New York City Housing Authority*,[33] a tenant brought suit against her landlord for damages allegedly sustained when her two-year-old child fell out of the window. Three causes of action were asserted, including a cause of action for breach of implied warranty of habitability embodied in RPL § 235-b.[34] Thereafter, the landlord moved to dismiss the complaint. The Supreme Court granted the motion in part, but declined to dismiss the cause of action for breach of the implied warranty of habitability. On appeal, the Appellate Division, First Department reversed and granted the motion. In particular, the Appellate Division found that RPL § 235-b does not impose strict liability on a landlord for all injuries or damages suffered as a result of the violation of the warranty of habitability. As the court stated:

> We agree that the language of warranty in § 235-b was adapted from the law of sales, with its implied warranty of fitness (UCC § 2-314), where it was the subject of a well known legal development in which strict liability was imposed on those who manufacture or sell defective goods and products to the public.
>
> However, the section's legislative history makes it quite improbable that the office contemplated extension of the principle of strict liability to landlords for injuries and damages traditionally the subject of tort liability.[35]

Nevertheless, the underlying principle of *Park West Village v. Mitchell*, to the effect that landlords could be held liable for breaches of the implied warranty of habitability, even if those breaches were caused by the acts of third parties, remained (and still remains) vibrant.

For example, in *Sutton Fifty-Six Co. v. Fridecky*,[36] the Appellate Division, First Department held that a landlord was responsible for breaches of the warranty of habitability not directly caused by its own actions. In *Sutton Fifty-Six Co. v. Fridecky*, the owner had constructed its building flush with the lot line, without any set back. This did not pose a problem until another building was constructed on the adjacent lot, which was also flush with the lot line. As a result, a brick wall was erected immediately opposite the windows in the first building, blocking out light, air and ventilation from the premises.

The affected tenants in those apartments stopped paying their rent and the landlord commenced a series of non-payment proceedings.[37] Citing *Park West Management Corp. v.*

Mitchell, the Appellate Division, First Department held that the fact that the breach was caused by the adjacent land owner erecting its own building on the lot line did not relieve the landlord of its obligations under the statutory implied warranty of habitability. As the court stated:

> Nor is it controlling that the "culprit" is the adjacent landlord, since the statutory warranty of habitability can apply to conditions resulting from events beyond the landlord's control. *Park West Management Corp. v. Mitchell*, 47 N.Y.2d 316, 418 N.Y.S.2d 310, 391 N.E.2d 1288, *aff'g* 62 A.D.2d 291, 404 N.Y.S.2d 115. Since the affirmative defense alleging the breach of warranty of habitability is a viable defense that should have not been dismissed, the counterclaim asserting the breach should have been severed.[38]

C. The Amendment to RPL § 235-b

Two months after *Sutton Fifty-Six Co. v. Fridecky* was decided, and in direct response to *Park West Management Corp. v. Mitchell,*[39] the Legislature, in the summer of 1983, amended section 235-b of the RPL, to create an exception in cases of labor disputes. Specifically, the following passage was added to the act:

> In determining the damages sustained by a tenant as a result of a breach of the warranty set forth in the section, the court shall, to the extent the warranty is breached or cannot be cured by reason of a strike or other labor dispute, which is not caused primarily by the individual landlord or lessor and such damages are attributable to such strike, exclude recovery to such extent, except to the extent of the net savings, if any, to the landlord or lessor by reason of such strike or labor dispute allocable to the tenants' premises, provided, however, that the landlord or lessor has made a good faith attempt where practicable to cure the breach.[40]

This amendment seems to suggest that the Legislature, contrary to the views expressed by The Court of Appeals in *Park West Village Corp. v. Mitchell,* did not intend to hold landlords liable for a decrease in services as a result of the acts of third parties over whom the landlord had no control. Whether the courts will follow the lead of the Legislature, and carve out their own exceptions to RPL § 235-b to cover the cases that are now being brought as a result of the events of September 11, 2001, remains to be seen.[41] However, if past performance is any indicator, it appears that the courts will continue to rely on *Park West Management Corp. v. Mitchell* for the proposition that the scope of the warranty of habitability does indeed encompass acts by third parties.

For example, in 1996, the Appellate Division, First Department, in *Elkman v. Southgate Owners Corp.*,[42] held that a landlord could be held liable for a breach of the warranty of habitability for conditions caused by an adjacent landowner. In *Elkman v. Southgate Owners Corp.*, a tenant sued his landlord claiming that noxious odors emanating from a retail fish store located in an adjacent building had breached his warranty of habitability. The landlord moved for summary judgment dismissing that cause of action. The Supreme Court denied the motion and the Appellate Division, First Department affirmed. In particular, the Appellate Division found that the landlord could be liable for the noxious odors emanating from the adjacent building, even though the landlord neither owned nor controlled that building.[43] Similarly, in *Palis Partners v. Vollenweider*,[44] the court, in a footnote, also found that under certain circumstances, the acts of persons not under a landlord's control can be the predicate for a breach of the warranty of habitability or a constructive eviction. Likewise, in *Nostrand Gardens Co-op. v. Howard,* the Appellate Division upheld a 50 percent rent abatement given to a tenant for breach of the tenant's implied warranty of habitability.[45] In *Nostrand Gardens Co-op v. Howard,* the tenant was subjected to constant yelling and other loud noises coming from the apartment above. Although the co-op had argued that there was nothing it could have done short of evicting the offending tenants (a daunting task considering that the tenants in question were an elderly woman and her mentally-impaired daughter), the Appellate Division still held that the co-op had breached the respondent's implied warranty of habitability.

Liability seems to depend on whether the landlord could have taken any measures to prevent the occurrence, or least done something to ameliorate the consequences. For example, in *Park West Village Corp. v. Mitchell*, the landlord could have hired non-union help to haul away the garbage. Similarly, in *Elkman v. Southgate Owners Corp.* and *Nostrand Gardens Co-op. v. Howard,* the landlord could have commenced actions in nuisance against the offenders and sought injunctions. Although these alternatives were not explicitly addressed by the courts in *Park West Village Corp. v. Mitchell*, *Elkman v. Southgate Owners Corp.* and *Nostrand Gardens v. Howard,* clearly the landlord's failure to take *any action* had some bearing on the courts' decision to hold the landlords responsible for the acts of the third parties.

Here, on the other hand, given the unprecedented nature of the attacks on the World Trade Center, a court would be hard-pressed to hold a landlord liable for the collateral damage, unless it could be shown that the landlord did not take adequate steps to ameliorate the problem. Further, if the courts are made aware of the law with respect to property damage caused by acts of war and crime, it may also lessen the likelihood that landlords will be held accountable under RPL § 235-b.

III. Property Damaged as a Result of War

It is well settled that property owners may not sue the government for damages caused by acts of war.[46] As stated by the United States Supreme Court in *United States v. Caltex*,[47] a case stemming from the Second World War in which an oil company demanded compensation for losses it sustained when General MacArthur, in his retreat from Manila in 1941, ordered the company's refining facilities in that city demolished,

> The terse language of the Fifth Amendment is no comprehensive promise that the United States will make whole all who suffer from every ravage and burden of war. This Court has long recognized that in war time, many losses may be attributed solely to the fortunes of war, and not to the sovereign.[48]

Quoting from a case spawned by the Civil War,[49] in which the Pacific Railroad Company had sought compensation for 13 bridges that were destroyed by the Union Army in order to impede a Confederate advance on St. Louis, the Supreme Court stated that: "The destruction or injury of private property in battle, or in the bombardment of cities and towns, and in many other ways in the war, had to be borne by the sufferers alone, as one of its consequences."[50]

While this precedent came out of the Civil War, and involved governmental immunity for war-related property damage, there is no reason why the principle should not be applied to private property owners in the aftermath of September 11th. Indeed, it is interesting to note that there is actually a law on the books in New York State that exempts landowners from any liability for injuries to persons or property suffered as a result of an enemy attack, where the person was using the owner's property for sheltering purposes.[51] Although the statute was enacted at the height of the Cold War to provide immunity to landowners in the event of a nuclear attack,[52] it nevertheless evinces an understanding that injury to person or property, as the result of an act of war should not be compensable.

> *"[G]iven the unprecedented nature of the attacks on the World Trade Center, a court would be hard-pressed to hold a landlord liable for the collateral damage, unless it could be shown that the landlord did not take adequate steps to ameliorate the problem."*

For example, in *Field v. Manufacturer's Trust Co.*,[53] a case that came out of World War II, a tenant sued his landlord for an injury sustained during a citywide blackout in 1942. Specifically, the tenant, who had been acting as an air-raid warden, was seriously injured when he stepped over a parapet on the roof of his building and fell to the yard below. Following a bench trial, the court awarded the tenant judgment in the sum of $40,000. The Appellate Division, First Department reversed, and the Court of Appeals affirmed the reversal. In particular, the Appellate Division found that the landlord was immune from any liability under the War Emergency Act, which provided, *inter alia*, that "neither . . . any individual . . . corporation . . . or any of the agents thereof, in good faith carrying out, complying with or attempting to comply with any . . . Order . . . relating to Civil protection, shall be liable for any injury . . . to persons . . . as the result of such activity."[54] As the Court stated:

> By the enactment, the legislature obviously intended to give immunity to owners of buildings complying or attempting to comply in good faith with orders relating to civil protection. In view of the emergency conditions existing during World War II, the act was a valid exercise of the Police power.

Just as in World War II, an emergency condition exists in New York City as a result of the attacks on the World Trade Center. The emergency is no less real now than it was then. Indeed, it is more threatening today, what with the army guarding Grand Central and Pennsylvania Stations. The Legislature granted absolute immunity to property owners in 1942 in recognition of the exigencies of war. Should not the courts grant the same absolute immunity to property owners in 2002?

At the very least, an owner should be entitled to qualified immunity. That is, an owner should not be held liable for any breaches of the implied warranty of habitability as a result of the attacks on September 11th unless it can be shown that the owner unduly procrastinated in making the necessary repairs to the tenant's apartment. Such a rule would shield owners from liability under RPL § 235-b for conditions it did not create, while protecting tenants from landlords who drag their feet in making repairs. Certainly, it is more equitable than holding an owner absolutely liable under the umbrella of the implied warranty of habitability.

IV. Injury to Property Caused by Criminal Acts

The attacks of September 11th can also be seen as criminal acts. Indeed, the recent indictment of Zacarias Moussaoui for his role in the attacks reaffirms that fact. If such an analysis is applied to the events of September 11th, then the property owner should not be liable unless it can be shown that the attack was foreseeable to the property owner and that the property owner nonetheless took no precautions to avert it. As stated by Professor Neisser in her 1990 *St. John's Law Review* article on this subject:

> Traditionally, the implied warranty of habitability did not apply to criminal acts of third parties. The criminal act was consistently held to be a superceding cause, against which one had no duty to protect another unless there was a special relationship between the parties. The relationship of landlord and tenant was not considered to fit into this category. . . .[55]

New York does not fully subscribe to this theory. Specifically, the New York courts have held that a landlord's failure to take adequate measures to protect its tenants from criminal acts of third parties will, under certain circumstances, constitute a breach of the implied warranty of habitability.[56] However, in order to prove that there has been a breach of the implied warranty of habitability, the tenant must show that the criminal activity was foreseeable and that the landlord took no steps to protect the tenant's property.

For instance, in *Roberts v. Jam Realty Co.*,[57] a fire severely damaged a residential apartment building on East 25th Street. As a result, the tenants of the building, like the tenants of lower Manhattan who lived at or near Ground Zero, were temporarily forced to vacate their homes. While the building was unoccupied, a burglar broke into some of the tenants' apartments and stole property valued at $1 million. The tenants brought suit against the landlord, alleging that the landlord had been negligent in providing adequate security measures. The landlord moved for summary judgment, claiming that it had taken reasonable precautions to safeguard the apartments during the renovation of the building. The Supreme Court denied the motion and the landlord appealed. The Appellate Division, First Department, unanimously reversed, granted the motion for summary judgment, and dismissed the case. In particular, the Appellate Division found that while a landlord has a duty to take minimal precautions to safeguard the premises, that does not mean that the landlord can be held strictly liable for every criminal act of a third party As the court stated: "It is . . . well established that a landlord is not an insurer and, accordingly, that landlord's duty to offer protection against criminality on his or her premises arises only when the risk of such criminality is foreseeable. . . ."[58]

"It thus appears that a colorable (if not persuasive) argument can be made that the implied warranty of habitability of RPL § 235-b should not be applied to tenant grievances caused by the events of September 11th."

Martinez v. New York City Housing Authority is also instructive in this connection.[59] In *Martinez*, a 14-year-old boy was shot in the head by a bullet that had entered through an open bedroom window. Subsequently, the boy's mother brought suit against the landlord, the New York City Housing Authority. The landlord moved for summary judgment, but the motion was denied by the Supreme Court. On appeal, the Appellate Division, First Department, reversed and dismissed the complaint. In particular, the Appellate Division found that the Housing Authority had no duty to protect the boy from criminal acts of third parties committed on *neighboring properties*, notwithstanding the fact that the criminal act resulted in injury on defendant's property. The court further found that there was no evidence that the ongoing activities in the neighboring lot posed a risk of danger to the building's tenant sufficient to create a duty on the landlord, as the building owner, to take precaution to protect its tenants from the results of those criminal acts. Moreover, the fact that the court found that the defendant could not have taken any precautionary measures on its own property to prevent the injuries, reinforced the conclusion that the shooting was an act of violence by another not under the landlord's control.

The holdings in *Martinez v. New York City Housing Authority* and *Roberts v. Jam Realty Co.*, while not directly on point, should nevertheless be given serious consideration by housing courts deciding habitability issues at Ground Zero. These cases provide valuable guidance as to a landlord's liability with respect to the criminal acts of third parties, and that, after all, is what the events of September 11th are all about.

V. Conclusion

It thus appears that a colorable (if not persuasive) argument can be made that the implied warranty of habitability of RPL § 235-b should not be applied to tenant grievances caused by the events of September 11th. The implied warranty of habitability is a concept that was developed to deal with recalcitrant landlords who refused to provide basic amenities to their tenants. It was not intended to apply to conditions over which the landlord had no control, such as those resulting from the attacks on the World Trade Center.

While the implied warranty of habitability is no doubt a handy and familiar friend to housing courts, it is not a proper tool in this instance. Rather than rely on the implied warranty of habitability we suggest that courts, confronted with habitability issues caused by the ramifications of the attacks on the World Trade Center, look to the laws relevant to national defense or criminal activity to find their answers to the problems posed by September 11th.

Endnotes

1. Susan Saulany, *Since Attack, More Landlord-Tenant Clashes Downtown*, N.Y. Times, Nov. 23, 2001, Sec. D, p. 6, col. 1. Tom Perrotta, *Landlords Sue Rent-Striking Tenants,* N.Y.L.J., Nov. 23, 2001, p. 1, col. 3.
2. Jack L. Lester, *Testing the Warranty of Habitability at Ground Zero*, N.Y.L.J., Nov. 28, 2001, p. 1, 4, col. 1.
3. *Id*.
4. N.Y. Real Property Law § 235-b (McKinney's 1989 & 2001 Supp.).
5. Warren A. Estis, Jeffrey Turkel & William J. Robbins, *Landlord-Tenant Principles: Litigation Issues Will Likely be Guided by Well Established Laws*, N.Y.L.J., Nov. 27, 2001, p. 6, col. 3
6. Joan L. Neisser, *The Tenant as Consumer: Applying Strict Liability Principles to Landlords*, 64 St. John's L. Rev. 527 (1990) (hereinafter "Neisser").
7. Steven W. Smollens, *Landlord-Tenant Litigation: Non-Payment Proceedings, including the Warranty of Habitability*, p. 20, 1989–1993 (unpublished manuscript on file with the author) (hereinafter "Smollens").
8. Jesse Dukeminier & James E. Krier, Property 508, 521 (4th ed., Aspen Law & Business 1988).
9. *Id*.
10. Smollens at 20.
11. Thomas M. Quinn & Earl Phillips, *The Law of Landlord-Tenant: A Critical Evaluation of the Past with Guidelines for the Future,* 38 Fordham L. Rev. 225 (1969).
12. *See* Neisser at p. 531. That does not mean to say that the tenant was totally at the mercy of the landlord. The tenant could always sue for breach of the covenant of quiet enjoyment of the lease. That remedy however, was neither practical nor satisfactory. Under most standard leases, in order to assert a claim for breach of the covenant of enjoyment, the tenant must be current in his or her rental obligations. Moreover, the tenant had to have abandoned the premises, or at least that portion of the premises that was uninhabitable. *Dave Herstein Co. v. Columbia Pictures Corp.,* 4 N.Y.2d 117, 172 N.Y.S.2d 808 (1958).
13. Malvina Reynolds, "The Faucets are Dripping" (Schroeder Music Co, 1959), reprinted with permission in *Rise Up Singing: The Group Singing Songbook* at 18 (Peter Blood and Annie Patterson eds., 1988, 1992).
14. 65 Misc. 2d 15, 318 N.Y.S.2d 11 (Civ. Ct., N.Y. Co. 1971).
15. *Id.* at 14.
16. *Id.* at 17.
17. Thomas M. Quinn & Earl Philips, *The Law of Landlord-Tenant: A Critical Evaluation of the Past with Guidelines for the Future*, 38 Fordham L. Rev. 225 (1969).
18. Quinn & Phillips, *id.,* at 225, *quoted in Amanuensis Ltd. v. Brown*, 65 Misc. 2d 15, 318 N.Y.S.2d 11, 18 (N.Y. Civ. Ct., N.Y. Co. 1971).
19. *Amanuesis*, 65 Misc. 2d at 19.
20. 73 Misc. 2d 996, 343 N.Y.S.2d 406 (Civ. Ct., N.Y. Co. 1973).
21. *Id.* at 998.
22. *Id.* at 999.
23. *Tonetti v. Penati*, 48 A.D.2d 25, 367 N.Y.S.2d 804 (2d Dep't 1975).
24. *Id.* at 30.
25. *Id. a*t 29.
26. 1975 N.Y. Laws ch. 597, § 235-b.
27. Governor's Memorandum, *reprinted in* [1975] N.Y. Laws 1760–1761 (McKinney's).
28. Memorandum of Senator H. Douglas Barclay, reprinted in [1975] N.Y. Legis. Ann. 315.
29. 47 N.Y.2d 316, 418 N.Y.S.2d 310, 391 N.E.2d 1288 (1979).
30. *Id.* at 327 (emphasis supplied).
31. *Id*.
32. 86 N.Y.2d 582, 535 N.Y.S.2d 132, 658 N.E.2d 1005 (1995).
33. 77 A.D.2d 534, 430 N.Y.S.2d 305 (1st Dep't 1980).
34. *Id.* at 534.
35. *Id.* at 535.
36. 93 A.D.2d 720, 461 N.Y.S.2d 14 (1st Dep't 1983).
37. *Id.* at 15.
38. *Id.* at 16.
39 Smollens at 22.
40. RPL § 235-b, ch. 403, § 38, 1983 N.Y. Laws 729.
41. Estis, Turkel & Robbins, p. 6, col. 6.
42. 233 A.D.2d 104, 105, 649 N.Y.S.2d 138, 139 (1st Dep't 1996).
43. *Id.* at 139. *But see 56 Mac D., Inc. v. Gravine,* N.Y.L.J. Sept. 27, 2000, p. 26, col. 2 (tenant failed to substantiate allegation that recurring noxious odor from pizzeria located directly below her apartment violated RPL § 235-b).
44. 173 Misc. 2d 8, 13, 660 N.Y.S.2d 272, 276 (Civ. Ct., N.Y. Co. 1997).
45. 221 A.D.2d 637, 634 N.Y.S.2d 505 (2d Dep't 1995).
46. Corpus Juris Secundum, *War and National Defense*, § 15 (2001).
47. 344 U.S. 149, 73 S. Ct. 200 (1952).
48. *Id*. at 155.
49. *United States v. Pacific Railroad*, 120 U.S. 227, 7 S. Ct. 490, 30 L. Ed. 634 (1887).
50. 344 U.S. 149 at 153 (quoting *Pacific Railroad*, 120 U.S. at 234, 7 S. Ct. at 493).
51. N.Y. Unconsol. Law § 9193 (McKinney's 1974).
52. Report by the New York State Civil Defense Commission to the New York State's Defense Council Recommending a Shelter Policy for Adoption by the Defense Council, *reprinted in* 1952 N.Y. Laws XXXXX (McKinney) p. 1249 at 1253.
53. *Field v. Manufacturer's Trust Co.*, 271 A.D. 226, 62 N.Y.S.2d 716 (1st Dep't 1946), *aff'd*, 296 N.Y. 972 (1947).
54. 62 N.Y.S.2d at 719.
55. Neisser at p. 531.
56. *Carp v. Marcus,* 112 A.D.2d 546, 491 N.Y.S.2d 484, 485 (3d Dep't 1985). *See Mason v. U.E.S.S. Leasing Corp.*, 96 N.Y.2d 875, 730 N.Y.S.2d 770, 756 N.E.2d 58 (2001).
57. 260 A.D.2d 230, 688 N.Y.S.2d 69 (1st Dep't 1999).
58. 688 N.Y.S.2d at 71.
59. 238 A.D.2d 167, 655 N.Y.S.2d 523 (1st Dep't 1997).

The author is an associate in the law firm of Belkin Burden Wenig and Goldman, LLP, which is located in New York City. **The author wishes to express his gratitude to Sherwin Belkin, Edward Baer and Martin Meltzer, partners in the firm, for their valuable assistance in the preparation of this article. In addition, the author would like to thank Joseph Burden, also a partner in the firm, who suggested this article, guided the author through the writing, and encouraged its publication.**

Insurance Issues Resulting from the Attack on America—September 11, 2001

By James E. Branigan

This paper was prepared for presentation at the New York State Bar Association Real Property Law Section, Annual Meeting in New York, January 24, 2002, and updated on February 5, 2002, for publication in the New York Law Journal.

Introduction

On September 11, 2001, the United States was the target of an attack that in less than two hours resulted in the largest single insurable loss in recent times. This horrific event has changed our world and that of the insurance industry. Currently the debate rages over such issues as the adequacy of insurable values, the number of terrorist acts on 9/11, the reserving practices of insurance and reinsurance companies, and whether insurers and reinsurers will be able to meet their financial obligations to policyholders and each other. The impact will be felt for years to come as underwriters and legal experts define the rules and regulations required for terrorist coverage.

When more than 50 percent of reinsurance treaties expired on January 1, 2002, Congress had not yet agreed on legislative measures to cap insurer and reinsurer liability through some type of risk-sharing vehicle. The insurance industry has said its ability to continue to provide coverage for the terrorist peril as provided in policies in effect on 9/11 is limited, and is lobbying to have the government provide a backstop to its liability should another unthinkable disaster reoccur.

This article focuses on property and business income insurance coverage issues solely as a result of the terrorist attack on the World Trade Center (WTC). All losses from the terrorist attack are estimated to be $50 billion. While many of the issues reviewed in this article may be applicable to any property loss, the emphasis is on loss caused by terrorist acts.

Terrorist Insurance Coverage Issues

Definition

Most property insurance policies exclude losses from declared war or losses caused by a uniformed invasion force or sovereign power. The event that befell the WTC was neither; that is, it was not caused by a sovereign power, a uniformed invasion force or an act of declared war. Thus, in the absence of a policy term, condition or exclusion that limits or prevents coverage response, the Special Form (aka: so-called "All-Risk") policy pays the loss.

Determination of Cause

Was the *occurrence* two hijacked aircraft each crashing into one WTC tower or was the *occurrence* one terrorist plot that destroyed the WTC towers? The answer, pending a decision by the U.S. District Court for the Southern District of New York, will have a significant outcome. If the decision is one occurrence, insurers will be liable for the occurrence limit in their policy, which is reported to be approximately $3.6 billion. If the decision is two occurrences, the insurers liability would double to approximately $7.2 billion.

Collateral Damage

The damage around the towers caused by falling debris was substantial. Those buildings directly damaged likely will be covered for physical restoration expense (replacement cost) and loss of business income/rental income until the premises are "with due diligence and dispatch" restored to a condition that existed prior to the loss. Those properties not physically damaged, but barred from use during the period following the attack will likely have their loss of business income limited to a sub-limit. Most property insurance policies limit coverage to two weeks for prevention of ingress and egress. While longer periods and sub-limits for overall loss on a portfolio of buildings has been observed, the most common coverage extension is two weeks.

Firms with business income coverage may have funds available to continue their operations at a new location. Coverage for the additional expense of doing business over and above normal operating expenses can be insured by the inclusion of an extra expense endorsement. The contingent business interruption endorsement may also cover business interruption loss if an existing supplier or customer is unable to conduct business with the insured firm.

Types of Insurance Coverage Affected by 9/11/01

Some types of insurance coverage affected by the 9/11 attacks include the following:

- Property and Business Income coverage for direct damage to the towers caused by the impact of the aircraft and the resultant rain of debris on buildings in the surrounding area.
- Workers' Compensation coverage for employees injured in the attack.

- Life Insurance payments to beneficiaries.
- Disability insurance coverage for those unable to work following the events of 9/11.
- Public Liability coverage for such things as failure to provide adequate security or evacuation instructions.
- Aviation Insurance to cover both the loss of life and loss of the aircraft.
- Director's and Officer's Liability coverage for ensuing lawsuits due to inadequate insurance or failure to provide adequate measures to assure continued business operations.

Property Insurance Issues

Property insurance policies provide coverage for loss of property and are extended by endorsement to cover loss of business income. Most business policies contain a menu of coverage and include some or all of the following.

Direct Damage—Physical Loss

Property insurance policies pay a limit of insurance on a *per occurrence* basis. Other conditions that will determine how a loss is paid, and on what terms, include replacement cost or actual cash value, application of co-insurance penalties and imposition of sub-limits and other terms and conditions that would potentially limit a policy response.

Loss of Use

Business and Rental Interruption Insurance are endorsements to the property insurance policy and provide the insured with indemnification for lost net profit and continuing fixed expenses from the time of the occurrences, until using "due diligence and dispatch" the premises can be restored to a condition that existed prior to loss. Given that the time necessary to reconstruct the WTC has been estimated to be as much as five years, the necessary limits of insurance should be adequate to cover this time period.

Extended Period of Indemnity

Extended Period of Indemnity allows the landlord additional time to find tenants. By the time reconstruction is complete it is likely that most, if not all, tenants in the damaged and destroyed buildings will have found other space. When the premises are ready to be re-leased, indemnity under the Business Interruption or Rental Income coverage ends unless an Extended Period of Indemnity Endorsement has been added to the business interruption and rental income coverage. The Extended Period of Indemnity Endorsement is purchased in 30-day increments. Most purchasers select a 180- or 360-day indemnity period. Coverage may be purchased for longer periods; however, more than two years is rare.

Extra Expense Endorsement

Extra Expense Endorsement is an extension that pays for additional costs to the insured to continue operations as near normal as possible to those existing prior to loss. Extra Expense coverage is available under the Business Interruption & Rent Loss coverage forms (dollar for dollar) to the extent that the payment reduces the business or rental income loss under the coverage part. A separate Extra Expense Endorsement can provide coverage for sums in excess of those saved under the Business Interruption & Rent Loss form. Thus, if it costs a policyholder $1.25 to save $1.00 in lost business income, the additional 25¢ is paid by the Extra Expense Endorsement.

Property Insurance Coverage Extensions

While the loss of the towers and their replacement is the basis of direct property damage and business income, other losses covered in less obvious policy extensions and special endorsements may be of greater significance. Some examples include the following.

Prevention of Ingress & Egress and Act of Civil Authority

The inaccessibility of lower Manhattan (below 14th Street) made it impossible to gain access to buildings and business establishments for nearly two weeks, and in many cases longer. Prevention of Ingress & Egress and Act of Civil Authority is an extension of coverage found in nearly all property insurance policies; however, coverage is usually limited to two weeks. Some savvy corporate risk managers have been able to negotiate longer periods and/or sub-limits for groups of buildings.

Contingent Business Interruption

Contingent Business Interruption endorsement pays the insured's business interruption loss if the damage is of the type insured in the policy and prevents the insured from doing business due to loss at a customer or a supplier location. Service providers, such as restaurants and hotels, rarely purchase this type of coverage.

Law and Ordinance

A significant extension of coverage for rebuilding the destroyed towers is "Law and Ordinance," aka: "Demolition and Increased Cost of Construction" (D&ICC). This endorsement covers increased construction costs due to the enforcement of laws requiring that buildings be reconstructed to standards higher than those that existed at the time of loss. This coverage usually is subject to a sub-limit.

Debris Removal

A debris removal clause is a sublimit that could affect the availability of funds to reconstruct the WTC.

This clause, contained in most policies, has a sub-limit equal to 10 percent of the policy limit. This is an additional amount of insurance and should the cleanup exceed this limit the cost to remove the debris would come from the reconstruction fund, thereby leaving a potential shortfall.

Off Premises Service Interruption

Loss of business income caused by lack of utility service is another cause of ongoing business interruption. "Off Premises Service Interruption" is an endorsement that can cover this; however, it has many variations, including the number and type of utilities covered, whether the utilities are public or private, insurable perils, and the distance of the damaged utilities from the premises to which the coverage responds.

Leasehold Interest

A tenant can insure the financial loss associated with termination of a favorable lease through the purchase of leasehold interest insurance. This endorsement pays the tenant if a loss destroys its premises and the lease is canceled. The amount insured is the difference between the remaining lease payments and the market rental today to replace the space destroyed, through the remaining term and renewal option periods, discounted to present value.

Exclusions

Exclusions that are the focus of attention with regard to insurance coverage for future terrorist acts involve the following:

- Declared war is excluded from coverage in most policies.
- Terrorist acts are covered by an exception to the exclusion; to be excluded, the terrorist act must typically be caused by a sovereign power or uniformed invasion force.

The following is an example of a Pre 9/11 Terrorist Exclusion. Note the condition in which the exclusion applies and the exception to the exclusion.

A.) *Hostile or warlike action in time of peace or war, including action in hindering, combating or defending against an actual, impending or expected attack by any:*

(i) *Government or sovereign power (de jure or de facto);*

(ii) *Military, naval or air force; or*

(iii) *Agent or authority of any party specified in (i) or (ii) above.*

*Item (iii) of this exclusion does not apply to physical loss or damage insured by this Policy done by terrorists or done secretly by a foreign enemy or agent of any government or sovereign power (*de jure *or* de facto*), when not in connection with the operations of armed forces in or against the country where the Insured Location is situated.*

B.) *Discharge, explosion or use of any nuclear device, weapon or material employing or involving nuclear fission, fusion or radioactive force, whether in time of peace or war and regardless of who commits the act.*

C.) *Insurrection, rebellion, revolution, civil war, usurped power, or action taken by governmental authority in hindering, combating or defending against such an event.*

D.) *Seizure or destruction under quarantine or custom regulation, or confiscation by order of any governmental or public authority.*

E.) *Risks of contraband, or illegal transportation or trade.*

The New Terrorist Coverage Endorsement

The Insurance Services Office (ISO), a service arm of insurance companies, has filed a new terrorist coverage endorsement in more than 40 states. The new Terrorist Coverage is complex and limits the insurance industry's exposure to catastrophic loss by redefining occurrence and limiting loss for all insured losses, regardless of the number of policies involved.

Some states have accepted the new endorsement with reservation and others, including New York and California, have rejected the filing. The new ISO endorsement is a departure from traditional insurance and requires review to gain an understanding of the coverage.

When the total of all insured losses reaches a threshold of $25 million per incident, *all* coverage is canceled and void. This includes direct damage, resulting business income, prevention of access and other extensions as well. An incident (not the customary occurrence) is redefined as all insured losses, within the United States and Canada, that occur within a 72-hour period and *appear* to emanate from a common source; these are considered one occurrence. In addition, coverage is not provided for loss due to nuclear, chemical or biological loss or damage. Liability forms reportedly contain similar clauses and add the coverage canceling condition where the incident causes the death of 50 or more people.

Web sites with general information regarding the National Association of Insurance Commissioners (NAIC) and the details regarding the policy forms and state filing are as follows:

- National Association of Insurance Commissioners (see 12/21/01 Press Release)
- Independent Insurance Agents of America—policy form
- Insurance Services Office—state filings

State of the Insurance Market

This section covers the state of the insurance market Pre- and Post-September 11, 2001.

Prior to 9/11, the world insurance markets were in the process of rebounding from one of the longest soft insurance markets in history. The competitive pricing of various insurance products in recent years lowered rates to levels never seen before. Premium increases in the year preceding 9/11 marked the beginning of insurers' efforts to once again become profitable, and 9/11 was a major disruption to that attempted recovery.

Post 9/11, many property insurance renewals are experiencing significant rate increases ranging from 20 percent and in some cases more than 400 percent. In addition, insurance coverage is being reduced and features such as Blanket Limits of Liability and Terrorist Coverage are difficult, if not impossible, to obtain.

In the months following 9/11, the chief executive officers of A I G and Travelers Insurance companies have discussed the need for a federal backstop or a reinsurance arrangement. They propose that the government provide coverage for 90 percent of the loss in excess of the first $10 billion in losses caused by terrorist acts. They noted that the insurance industry has a capacity to absorb at most $130 billion and that exposure to yet a second loss of the magnitude of the WTC would have serious effects on the industry. Warren Buffet, chairman of Berkshire Hathaway, proposed an FDIC-type system to provide a vehicle to fund and share risk among all commercial insureds.

Reinsurers have refused to provide unlimited terrorist coverage to retail insurance companies. What action is left for retail insurers who will not take on more risk than their in-house capacity (the amount they keep without the benefit of reinsurance)? The answer is to reduce the overall policy limit to the amount of terrorist coverage they are willing to underwrite. This creates an overall capacity shortage, which drives rates up dramatically, and limits the coverage extensions afforded to policyholders. One example is the reduction or elimination of Blanket Limits; a coverage enhancement often afforded the insureds. Capacity is the available amount of coverage. Lower supply and higher demand result in dramatic premium increases for the insurance-buying public.

Lender Reaction

Generally, lenders can be expected to be very cautious. They will demand copies of the actual insurance policies and will likely insist on terrorist insurance coverage on larger, well-known buildings.

Some lenders are already taking a position that the lack of terrorist insurance is an increased hazard and may be an acceptable risk if borrowers pay additional fees for their loans. Other lenders will require remotely located additional collateral or personal guarantees from the borrower's principals.

According to agencies like Standard & Poor's (S&P) that rate commercial mortgage-backed securities (CMBS), many are evaluating the exposure and need for coverage on a case-by-case basis. Large target properties in major cities will likely be required to provide terrorist coverage while a strip shopping center in a rural area will likely not be required to have terrorist coverage. S&P may in some cases accept a terrorist exclusion and will likely add a notation or subscript to the security listing that coverage is not provided.

Conclusion

While the insurance industry and legislators continue to search for a workable solution to cover terrorist attacks, failure to find an acceptable risk-sharing partner, even if only temporary, will continue to raise premium levels and restrict coverage. Presently, insurance for terrorist risk is available at substantial cost on a restricted basis. One broker noted that in a recent placement on a $200 million insurable value building in Europe, the additional cost to add terrorist coverage was $1 million.

James Branigan is president & CEO of Omega Risk Management LLC. His firm provides insurance consulting services to corporations and conducts due diligence reviews for financial institutions originating large commercial loans throughout the United States and Canada. Mr. Branigan has written several papers on insurance in real estate finance for the Practising Law Institute (PLI) and co-authored a chapter on insurance in *Commercial Leasing*, which will be published by the New York State Bar Association later this year. He has served on the PLI faculty for three years, been a speaker for the NYSBA Committee on Leasing and was a panelist on insurance in commercial leasing for the NYC Dirt Lawyers. His most recent presentation was before the NYSBA Real Property Law Section Annual Meeting. Mr. Branigan has delivered numerous insurance training sessions for commercial lenders and law firms throughout the U.S. Mr. Branigan attended the City and State University of New York where he studied Fire Science and Business. He is licensed as an Insurance Broker and Insurance Consultant by the State of New York and served in the United States Navy. James Branigan can be contacted at (631) 692-9866 or omegarm@optonline.net.

City and State Tax Rulings Open the Door for Synthetic Leases in New York

By Joshua Stein

Until recently, commercial real estate lawyers in New York were unsure of how the city and state would tax a real estate "synthetic lease" transaction. There was a general sense of dread, a sense that synthetic leases might attract so many state and city taxes that they were probably not feasible in New York.

The New York State Department of Taxation & Finance (the "State") recently eliminated much of that fear by issuing a favorable Advisory Opinion[1] relating to a proposed synthetic lease in Manhattan (the "Synthetic Lease Advisory Opinion").[2]

At about the same time, the New York City Department of Finance (the "City") issued a letter ruling[3] (the "City Letter Ruling") that took a similarly favorable approach to synthetic leases for the City's various taxes.[4] Together, the Synthetic Lease Advisory Opinion and the City Letter Ruling make synthetic leases feasible transactions in New York (at least as a matter of City and State taxation). These pronouncements represent a very welcome clarification of how the taxing authorities will look at these transactions.

A typical "synthetic lease" begins when an operating company, often publicly traded (the "User"), wants to acquire or build a new facility, but also wants to keep that real estate off its balance sheet while retaining all the benefits and burdens of ownership. This would include the benefit of possible appreciation, as well as depreciation deductions for tax purposes, but not for financial statement purposes.

Users very often want to achieve all those goals, and all simultaneously. They have in recent years been able to do it by structuring the transaction as a "synthetic lease."

In a synthetic lease transaction, the User does not directly acquire the desired asset. Instead, the User arranges to have a single-purpose entity (the "SPE") acquire the asset directly from a third-party seller.[5] The SPE then leases the asset to the User.

The lease from the SPE to the User—the "synthetic lease"—gives the User the functional and economic equivalent of ownership, in virtually all respects, for all purposes except the User's financial statements. If the lease satisfies a list of accounting criteria, the User need not burden its financial statements with ownership of the real estate, and those statements will show rent payments under the lease rather than interest (and indebtedness) and depreciation expenses. This makes the public markets and, hence, the User happier.

To finance the acquisition and synthetic lease of the real estate asset, the User enlists some or all of its regular bank lenders (the "Participants") to make a loan to the SPE so the SPE can acquire the asset and lease it to the User. The SPE grants a mortgage to the Participants (the "Participants' Mortgage").[6] The "rent" payments under the lease will exactly equal the debt service payments under the Participants' loan plus some minor compensation for the equityholders of the SPE.[7]

At the end of the lease term, based on the terms and conditions of the lease, the User will almost certainly exercise one of its options to acquire the real estate from the SPE, at which point the magic of the synthetic lease (the financial statement vanishing act) ends. The User must then show the real estate on its financial statements, or figure out some other way to carry the investment.

Synthetic leases and some other financing structures are collectively called "off-balance-sheet financing" because the User in effect (and in substance but not in form) borrows money but the User's financial statements don't show it. Similar but more aggressive techniques were widely used by Enron Corporation and its various partnerships ("Enron").[8] Enron did not appear to be involved in any way in the Synthetic Lease Advisory Opinion. Still, Enron's collapse and the resulting accounting issues will probably lead the public markets, securities regulators, and the accounting profession to change their view of all off-balance-sheet financing, including synthetic leases. If that is so, then the Synthetic Lease Advisory Opinion and the City Letter Ruling may have been issued just in time to be prospectively irrelevant.

Beyond the accounting, taxation, and other issues that this article suggests, synthetic leases raise a number of other issues in almost every area of law and practice that real estate lawyers need to consider in any substantial transaction, including bankruptcy, conveyancing, corporate governance, enforceability, income taxation, qualification to do business, recharacterization, and title insurance.[9]

At least for the synthetic lease under consideration,[10] the Synthetic Lease Advisory Opinion establishes a very practical and reasonable structure to define the transfer tax and mortgage recording tax payable on one of these transactions. The State adopted a "substance over form" approach that will facilitate synthetic leases in New York.

Instead of imposing multiple transfer taxes on what is in substance a financing transaction, the State treats much of the transaction as just one taxable mortgage. The State deems any subsequent duplicative mortgages to be merely "supplemental" to the first, hence taxable only on the incremental indebtedness that they secure. This approach is far more practical and conducive to modern business transactions than the State's approach in, for example, dealing with substantial commercial revolving loans.[11]

Based on the Synthetic Lease Advisory Opinion, the State's taxation of a synthetic lease transaction can be summarized as follows:

1. *Acquisition*. For transfer tax purposes, the State will treat the SPE's acquisition of the real estate in the first instance as if the User were acquiring it.[12]
2. *Recorded Mortgage.* When the SPE records the Participants' Mortgage, the State will collect a single mortgage recording tax on the amount secured.
3. *Deemed Mortgage*. The State will deem the User to have conveyed the real property to the SPE, but will treat this conveyance as a mortgage (the "Deemed Mortgage"), and not as a conveyance subject to transfer tax.[13]
4. *Mortgage Tax on Deemed Mortgage*. The State will treat the Deemed Mortgage as being "supplemental" to the Participants' Mortgage.[14] The State will therefore impose a mortgage recording tax on the Deemed Mortgage only to the extent that the principal amount of financing implied by the synthetic lease exceeds the principal (tax-paid) amount of the Participants' Mortgage. The Deemed Mortgage will otherwise be exempt under New York Tax Law section 255.[15]
5. *Mortgage Recording Tax on Synthetic Lease*. The synthetic lease will be treated as part of the same mortgage financing described in "4" above. The implied debt in that financing would have been taxed when the State taxed the Participants' Mortgage and the Deemed Mortgage, as described above.[16] The State will collect that tax only once (on the Participants' Mortgage and the Deemed Mortgage) and will not collect it a second time on the synthetic lease itself. Of course, if the implied financing under the synthetic lease were to exceed the amount of the Deemed Mortgage (very unlikely or impossible), then the State would collect a mortgage recording tax, but only on that excess.
6. *Net Effect.* As a result of the last five steps, the mortgage recording tax on all documents recorded to close a synthetic lease transaction will reflect the maximum total debt that those documents secure. It will, however, need to be paid only once.
7. *Repurchase*. Eventually, the User may (will?) exercise its option to purchase or otherwise acquire the real property. At that point, when the SPE transfers title to the real property to the User, that conveyance will not be subject to transfer tax but will instead be deemed a nontaxable "satisfaction" of the Deemed Mortgage.[17] The Participants' Mortgage would remain in place, and could be satisfied or refinanced.

The Synthetic Lease Advisory Opinion means that the State transfer and mortgage recording consequences of a synthetic lease financing match those of a traditional fee acquisition accompanied by a simultaneous fee mortgage. That is the right result. It should facilitate the use of synthetic leases in the State.

In the City Letter Ruling, the City took a similar approach and treated the synthetic lease as a financing. The City said it would not try to collect New York City Real Property Transfer Tax on the various conveyances after the SPE's initial acquisition of the asset. And, even though the synthetic lease requires the User to pay "rent," the City said it would treat those payments as nontaxable debt service for the City's Commercial Rent and Occupancy Tax.

In reaching these very favorable and practical conclusions, both the City and the State scrutinized the synthetic lease transaction structure, and focused on a series of its characteristics. Although those characteristics mirrored those of many other synthetic lease transactions, they gave the taxing authorities a road map to reach the right result. Anyone who structures a synthetic lease in New York should try to create a similar road map.

The following briefly summarizes the elements of the synthetic lease that supported the favorable treatment in the Synthetic Lease Advisory Opinion and the City Letter Ruling:

- *Parties' Intentions*. In all the synthetic lease documents, the parties consistently said they intended the synthetic lease be treated as a financing for tax and other purposes[18]—everything except the User's financial statements.[19]
- *Control*. The synthetic lease gives the User complete control over

the real property. The User pays all costs of ownership, giving the SPE an absolutely "triple net" rental income. The User has nearly total flexibility in its use, alteration, and (sub)leasing of the real property.[20]

- *Debt-like Obligations*. The User's obligations under the synthetic lease are much like those of a corporate borrower under a financing agreement. The "rent" payments precisely equal the debt service on the implied loan. The transaction relies in large part on the User's credit rather than the real estate.[21]

- *Development Controls*. A "Construction Agency Agreement" gave the User full control over the construction and development process and decisions, along with responsibility for all related liabilities.[22]

- *Risk of Loss; Control of Appreciation*. Under the synthetic lease, the User bears the full risk of casualty and condemnation and receives the full benefit of future appreciation.[23]

- *Future Purchase*. The User has a variety of purchase options and obligations. The User ultimately bears most or all of any shortfall in value (below the implied loan balance) if the real property is sold to a third party or if an Event of Default occurs. As a result of all these provisions considered together, the User is quite likely to acquire the real property at the end of the lease term or possibly earlier.[24]

- *Corporate Headquarters*. In the particular transaction, the real property in question was to become the User's world headquarters. Therefore, external facts further indicated that the User was likely to acquire the real property at the end of the synthetic lease.[25]

Except for the last point, virtually any synthetic lease transaction would have all the same characteristics as this one, and hence would probably qualify for the same favorable treatment. The parties to any such future transaction may, however, not want to rely on the Synthetic Lease Advisory Opinion and City Letter Ruling.[26] They might instead want to obtain their own determinations.

The Synthetic Lease Advisory Opinion did not consider the tax implications if the User were to grant a leasehold mortgage, as additional security, either to the Participants or to the SPE. Based on the practicality displayed in the Synthetic Lease Advisory Opinion and the City Letter Ruling, however, it may be reasonable to expect the taxing authorities to treat such a leasehold mortgage as being another "supplemental" instrument, tax-exempt on the same basis as the other components of the transaction. Another advisory opinion and another letter ruling may be necessary to reach that result, though.

In the meantime, the Synthetic Lease Advisory Opinion and the City Letter Ruling certainly represent good news for synthetic lease transactions in New York. If the synthetic lease transaction survives as an accounting matter, it should now be feasible in New York. Even if the synthetic lease does not survive, though, these two pronouncements demonstrate a practical approach that, if followed in other contexts, may help facilitate other new and creative transaction structures in New York.

Endnotes

1. The Synthetic Lease Advisory Opinion was obtained by Carolyn Joy Lee of Roberts & Holland. Ms. Lee reviewed this manuscript in draft, and her helpful comments and suggestions are very much appreciated. The author also acknowledges with thanks the very helpful comments of Kim N.A. Boras, a partner in the Los Angeles office of Latham & Watkins.
2. N.Y. Dep't Tax & Fin. Comm'r Adv. Op., N.Y. Tax Rep. (CCH) ¶ 404-004 (2001) (hereinafter "Synthetic Lease Advisory Opinion"). The following discussion of the Synthetic Lease Advisory Opinion ignores some preliminary steps that occurred in the transaction before the SPE took title to the real property, in this case a condominium unit.
3. New York City Dep't of Finance Letter Ruling, April 19, 2001 (FLR-004773-721). A copy of the City Letter Ruling can be found at: <http://www.ci.nyc.ny.us/html/dof/pdf/00pdf/lr4773.pdf>. The City Letter Ruling was also obtained by Carolyn Joy Lee of Roberts & Holland.
4. The City Letter Ruling considered the City's Real Property Transfer Tax and Commercial Rent and Occupancy Tax. It did not address mortgage recording tax, which the State generally administers, although the City sometimes publicly disagrees with the State's interpretations. No such disagreement was apparent regarding the issues this article describes.
5. To comply with accounting standards for synthetic leases, the User cannot already own the asset. The synthetic lease is not a substitute for the traditional "sale and leaseback."
6. The User may also mortgage its leasehold under the synthetic lease, but the transaction described in the Synthetic Lease Advisory Opinion did not include that element. Although the Participants might want the User to guaranty the loan, any such guaranty would typically violate the accounting rules that synthetic leases must satisfy. The User's rental stream under the synthetic lease does, however, give the Participants much the same level of credit support for the loan.
7. The synthetic lease must comply with certain accounting criteria to be honored for accounting purposes, including minimum outside equity capitalization of the SPE.
8. Those partnerships were in many cases subject to the same minimum outside equity requirements that apply to any synthetic lease SPE.
9. For more on all these issues, the reader should refer to the Web site operated by John Murray, Vice President and Special Counsel, First American Title Insurance Co. Chicago National Commercial Division (Chicago). Mr. Murray, a nationally recognized authority on synthetic leases, has posted on that site over a dozen of his articles on many issues that synthetic leases create. *See* http:<//www.first.am

.com/faf/html/cust/jm-articles.html>. Mr. Murray's articles do not fully explore any accounting issues—issues that collectively exceed in magnitude and scope all the issues that Mr. Murray does cover in his articles. *See also* articles by Evelyn D. Giaccio, Kim N.A. Boras and Robert S. Bozarth in 456 Practising L. Inst.: Com. Real Est. Fin. 947–1079 (May 2000).

10. An Advisory Opinion may not be relied upon except by its addressees. *See* note 26.

11. *See, e.g.,* Joshua Stein, *A Simple Proposal to Simplify New York's Mortgage Recording Tax*, N.Y. Real Prop. L.J., vol. 25, no. 1, at 26 (Winter, 1997); *New York Mortgage Recording Tax on Revolving Loans: The Problem and a New Solution for Multistate Transactions*, NYSBA Real Prop. L. Section Newsl., vol. 22, no. 1, at 13 (Winter 1994).

12. The Synthetic Lease Advisory Opinion does not directly state this result because of certain unusual elements of the transaction. Anyone structuring a synthetic lease transaction should, however, expect that a transfer tax will be due on the SPE's acquisition of the real property from a third-party seller, unless that conveyance independently qualifies for some transfer tax exemption.

13. Synthetic Lease Advisory Opinion at 21–22, 25.

14. The word "supplemental" triggers partial or complete exemption from the mortgage recording tax under N.Y. Tax Law § 255 (McKinney 1999).

15. Synthetic Lease Advisory Opinion at 26–28. In other words, the Participants' Mortgage and the Deemed Mortgage merely overlap and secure the same obligation. In Florida, which suffers from similar tax burdens (and has the benefit of a statute to much the same effect as the Synthetic Lease Advisory Opinion), attorneys who close synthetic lease transactions commonly ask the User to join in the Participants' Mortgage, simply to bolster the argument that it secures the same indebtedness as the Deemed Mortgage. (The preceding was reported to the author by John Murray, author of the Web site cited in note 9.) The User cannot, however, guaranty the loan that the Participants' Mortgage secures.

16. Synthetic Lease Advisory Opinion at 22.

17. *Id.* When the User exercises the purchase option and takes title to the real estate, can the Participants' Mortgage be assigned to a new lender to be "consolidated" and "restated" to save future mortgage recording tax? The Synthetic Lease Advisory Opinion does not answer that question. Presumably, instead of simply exercising the option, and perpetrating a deemed "satisfaction" of the deemed mortgage, the User will be able to figure out some way to preserve and re-use the tax-paid Participants' Mortgage.

18. Synthetic Lease Advisory Opinion at 3–4.

19. In the post-Enron financial world, such statements may be much less likely to be made.

20. Synthetic Lease Advisory Opinion at 6.

21. *Id.* at 7–8.

22. *Id.* at 5–6.

23. *Id.* at 8–9.

24. *Id.* at 3, 9–12.

25. It is unclear how much weight the Department placed on this last fact. Would a non-headquarters project create a distinguishable set of facts entitled to less favorable treatment? What if some future User were less image-conscious than this one?

26. State advisory opinions and City letter rulings benefit only the taxpayer that requested them. Moreover, a future transaction may be structured differently, use words differently, and be distinguishable in other ways from the transaction described in the Synthetic Lease Advisory Opinion and the City Letter Ruling. Those two documents therefore amount to helpful guidance but not definitive law. *See In re U-Need-a-Roll Off Corp.*, TSB-H-84(16)S, N.Y. State Tax Rep. (CCH) ¶ 251-000 (Jan. 20, 1984); *see also* N.Y. Tax Law § 171, pt. "Twenty-fourth" (McKinney 2001–2002 Interim Pocket Part).

Joshua Stein, a real estate partner in the New York office of Latham & Watkins and a member of the American College of Real Estate Lawyers, will be Secretary of the Real Property Law Section for the year starting June 1, 2002. This article is an extract from his upcoming book entitled *New York Commercial Mortgage Transactions*, which Aspen Law & Business will publish in July 2002. Other articles by the author are available at www.real-estate-law.com.

Federal Preemption of Real Estate Lending Activities of OTS Regulated Lenders

By John G. Hall

For a large part, the law of real estate lending is the statutory and case law of the state in which the real property is situated or where the loan is originated. Nevertheless, when the lender is a federally chartered institution such as a national bank, federal savings bank or federal savings association, state law is frequently overridden and preempted by federal statutes or regulations. The area is a complex area of the law with many pitfalls. The purpose of this article will be to familiarize the real estate attorney with areas that have been the subject of some concern.

I. Basic Constitutional and Statutory Provisions

Article VI, Section 2 of the United States Constitution (the Supremacy Clause) provides:

> Clause 2. Supreme Law of Land
>
> This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any thing in the Constitution or Laws of any State to the Contrary notwithstanding.

In the area of real estate lending, the statutory scheme is embraced in two acts.

(a) Federal Thrifts (Federal Savings Associations and Federal Savings Banks) are regulated by the Homeowners Loan Act, 12 U.S.C. section 1462 *et seq.*

(b) National Banks are regulated by the National Bank Act, 12 U.S.C. section 21 *et seq.*

II. The Federal Regulatory Structure

Pursuant to the federal statutory scheme, the Office of Thrift Supervision (OTS—formerly the Federal Home Loan Bank Board), has enacted regulations impacting real estate lending.

The Office of Thrift Supervision regulates federal savings banks and federal savings associations. Its regulations are set forth in 12 CFR Part 500 *et seq*. It has a number of specific regulations that deal with preemption, such as:

1. 12 CFR Part 560—Dealing with Lending and Investment
2. 12 CFR Part 590—Dealing with Preemption of State Usury Laws
3. 12 CFR Part 591—Dealing with Preemption of State Laws prohibiting Due on Sale Laws

III. The Doctrine of Preemption

When Congress enacts legislation or a federal agency issues regulations pursuant to congressional enabling legislation, conflicting state legislation may be challenged via the Preemption Doctrine. The doctrine establishes the rule that federal law overrides any inconsistent state law or regulation where there is an actual conflict between the two sets of legislation such that both cannot stand—e.g., where federal law prohibits an act which state law requires. Preemption can be either *express* or *implied*. Express preemption occurs when a federal statute specifically prohibits parallel state legislation in that field. Implied preemption occurs when a body of federal law in a particular field or area is so pervasive that it leaves no doubt that Congress intended to preempt state law (even though Congress has not specifically stated such in the statute).

Unfortunately, in actual practice, implied preemption seldom occurs in totally clear-cut circumstances. In addition, Congress seldom articulates a specific intent to totally preempt an entire field. In other cases Congress sometimes enacts in legislation a savings clause permitting concomitant state regulations.

The United States Supreme Court in *Pennsylvania v. Nelson*,[1] enunciated a three-prong test to ascertain implied preemption parameters:

1. Pervasiveness of the federal regulatory scheme.
2. Federal occupation of the field as necessitated by the need for national uniformity.
3. Danger of conflict between state laws and the administration of the federal program.

In areas where state law has not been preempted, federal courts will apply state law.

The Director of the Office of Thrift Supervision is authorized by federal statute to provide for the organization, incorporation, examination, operation and regulation of associations (including federal savings banks and federal savings associations) "under such regulations as the Director may provide. . . . "[2] Pursuant to such statutory authority regulations were enacted by the Director of the Office of Thrift Supervision, which provide in 12 CFR section 560.2(a) and (c) as follows:

Section 560.2 Applicability of Law.

> (a) Occupation of field. Pursuant to sections 4(a) and 5(a) of the HOLA, 12 U.S.C. § 1463(a), 1464(a), OTS is authorized to promulgate regulations that preempt state laws affecting the operations of federal savings associations when deemed appropriate to facilitate the safe and sound operation of federal savings associations, to enable federal savings associations to conduct their operations in accordance with the best practices of thrift institutions in the United States, or to further other purposes of the HOLA. To enhance safety and soundness and to enable federal savings associations to conduct their operations in accordance with best practices (by efficiently delivering low-cost credit to the public free from undue regulatory duplication and burden), OTS *hereby occupies the entire field of lending regulation for federal savings associations.* [emphasis added] OTS intends to give federal savings associations maximum flexibility to exercise their lending powers in accordance with a uniform federal scheme of regulation. Accordingly, federal savings associations may extend credit as authorized under federal law, including this part, without regard to state laws purporting to regulate or otherwise affect their credit activities, except to the extent provided in paragraph (c) of this section or § 560.110 of this part [dealing with usury (explanation added)] For purposes of this section, "state law" includes any state statute, regulation, ruling, order or judicial decision.
>
> * * *
>
> (c) State laws that are not preempted. State laws of the following types are not preempted to the extent that they only incidentally affect the lending operations of Federal savings associations or are otherwise consistent with the purposes of paragraph (a) of this section:
>
> (1) Contract and commercial law;
>
> (2) Real property law;
>
> (3) Homestead laws specified in 12 U.S.C. § 1462a(f);
>
> (4) Tort law;
>
> (5) Criminal law; and
>
> (6) Any other law that OTS, upon review, finds:
>
> (i) Furthers a vital state interest; and (ii) either has only an incidental effect on lending operations or is not otherwise contrary to the purposes expressed in paragraph (a) of this section.

It thus appears that the Director of the Office of Thrift Supervision clearly intended to exempt federal savings associations from the applicability of state law for many real estate lending issues, such as prepayment or late charges.

As to the issue of whether or not OTS regulations could preempt state statutes, the United States Supreme Court has held that they can.[3]

IV. Applicability of the Doctrine of Preemption to Wholly Owned Subsidiaries of Federal Lenders

Although some states have attempted to take a different posture (e.g., New Jersey Licensed Lender Act which provides that the doctrine of preemption applies to federal institutions but would not apply to their operating subsidiaries) the Office of Thrift Supervision has taken the position that state laws that purport to regulate the activities of federal savings associations operating subsidiaries are preempted by federal law to the same extent that federal law preempts the state law application to a federal savings association itself.[4] The preemption apparently would not apply to service corporations as opposed to operation corporations.[5]

V. Specific Applications of the Doctrine of Preemption

A. Prepayment Charges

Under New York law,[6] prepayment must be permitted if the premises consist of a one- to six-family residence and the interest rate is over 6%. If prepayment is made after one year it must be permitted without penalty. If prepaid within one year such a prepayment penalty as is set forth in the loan contract may be collected.

Federal regulations applying to federal thrifts state:

> Any prepayment on a real estate loan must be applied directly to reduce the principal balance on the loan unless the loan contract or the borrower specifies otherwise. Subject to the terms of the loan contract, a Federal savings association may impose a fee for any prepayment of a loan.[7]

Turning to the Preemption Doctrine, the issue is whether in imposing a prepayment charge in its loan documents a federal association must comply with state law or may go beyond state law. If the association in its written contract complies with the state law, state law would not be in conflict with its federal regulation. It would, however, limit the amount of prepayment which could be charged by a federal association. In the one federal case which addressed the issue,[8] the Ninth Circuit Court of Appeals affirmed the lower court's decision and held that "federal law preempts the field of prepayment of real estate loans to federally chartered savings and loan associations." There, plaintiffs brought suit against federally chartered banks in California and sought a declaratory judgment that the bank's prepayment penalty was void as it was inconsistent with the California state statute. The court held the prepayment penalty valid and stated that any state law in the area is inapplicable to federal savings and loan associations operating within the state. This premise has been confirmed by the Office of Thrift Supervision, which monitors federally chartered banks, in its opinion dated July 13, 1993. The opinion states "that the exercise of the office's authority is preemptive of any state law purporting to address the subject of the operations of a Federal savings association." Thus, a federally chartered savings association, is exempt from General Obligations Law § 5-501 by 12 CFR § 560.34, which allows the bank to impose a prepayment penalty charge.

It thus appears that both the court and the Office of Thrift Supervision as stated in its letter of July 13, 1993, clearly feel that the *area* of prepayment penalties has been completely preempted by the federal regulation.

B. Late Charges

Section 254-b(1) of the Real Property Law of the State of New York limits the amount of late charges. That statute provides:

> If a bond or note, or the mortgage on real property, heretofore or hereafter made, improved by a one to six family residence occupied by the owner, securing the payment of same, or a note representing a loan for the purpose of financing the purchase of an ownership interest in, a proprietary lease from, a corporation or partnership formed for the purpose of the cooperative ownership of residential real estate, contains a provision whereby the mortgagee or lender retains the right to collect a late charge on any installment which has become due and remains unpaid, such charge on any such delinquent installment, regardless of the period it remains in default, shall not exceed and shall only be enforced to the extent of two percent of such delinquent installment; provided, however, that no charge shall be imposed on any installment paid within fifteen days after the due date. No such late charge shall be deducted from any regular installment payment by the mortgagor or borrower, but shall be separately charged and collected by the mortgagee or lender. In the absence of a specific provision in a bond, note or mortgage no late charge on any delinquent installment shall be assessed or collected. The term "installment" shall include amounts representing interest, amortization of principal and payments in respect of insurance premiums, taxes and utility charges if the bond, note or mortgage provides for collection thereof by the mortgagee.

Late charges may be imposed by a federally chartered thrift in accordance with 12 CFR section 560.33, which provides:

> A Federal savings association may include in a home loan contract a provision authorizing the imposition of a late charge with respect to the payment of any delinquent periodic payment. With respect to any loan made after July 31, 1976, on the security of a home occupied or to be occupied by the borrower, no late charge, regardless of form, shall be assessed or collected by a Federal savings association, unless any billing, coupon or notice the Federal savings association may provide regarding installment payments due on the loan discloses the date after which the charge may be assessed. A Federal savings association may not impose a late charge more than one time for late payment of the same installment, and any installment payment made by the borrower shall be applied to the longest outstanding installment due. A Federal savings association shall not assess a late charge as to any payment received by it within fifteen days after the due date of such payment. No form of such late charge permitted by this paragraph shall be considered as interest to the Federal savings association and the Federal savings association shall not deduct late charges from the regular periodic installment payments on the loan, but must collect them as such from the borrower.

Although the section provides no specific limit on late charges, the Office of Thrift Supervision has taken the position that a late charge cannot exceed 5% of the amount of an overdue payment.

Again, considering the Preemption Doctrine[9] is not necessarily in conflict with section 254(b) of the

New York Real Property Law but could be harmonized with it—i.e., a late charge could be charged but only insofar as it complied with New York law, i.e. at 2% and not 5%. However, if the federal government intended to completely occupy the field section, section 254(b)(1) of the New York Real Property Law would be preempted.

No cases have been found dealing with the preemption issue insofar as it relates to late charges. Nevertheless the Director of the Office of Thrift Supervision as stated earlier appears to have totally preempted the area.

C. Lender's Obligation to Pay 1/4% of Mortgage Tax

Section 253(1)(a) of the Tax Law imposes an additional 1/4% mortgage tax to be paid by the mortgagee where the property consists of a one- to six-family structure with separate cooking facilities for each unit and the mortgagee is not a natural person. The statute also provides that this tax may not be passed through to the borrower.

In *Dime Savings Bank F.S.B. v. State of New York*,[10] the Appellate Division, Second Department in a 3–2 decision held that the anti-pass-through provision was preempted by federal regulations. A federally chartered lender could therefore pass-through the 1/4% to the borrower.

Dime's victory, however, was somewhat a pyrrhic victory. Although Dime won the right to pass the tax along to the borrower, competitively it could not do so because its borrowers would end up paying a 1/4% more in closing costs than they would at another lender which could not avail itself of preemption.

D. Prohibition of Due on Sale Clauses

The United States Supreme Court upheld the validity of the exercise of a due on sale clause by a federal thrift, despite a California statute prohibiting it.[11] The courts of New York have upheld the validity of a due on sale clause where there was not a resulting prepayment charge.[12] The decision held that there was not a conflict with Real Property Law section 254(a), which recognizes the validity of a due on transfer but prohibits the levying of a prepayment charge when the due on sale transfer provision is implemented.

Indeed, the decision parallels the present OTS regulation, which provides in 12 CFR section 591.5(b)(2) that "a lender shall not impose a prepayment penalty or equivalent fee when the lender or party acting on behalf of the lender (i) declares by written notice that the loan is due pursuant to a due on sale clause. . . ."

E. Escrow Accounts for Real Estate Taxes, Etc.

The New York State Legislature in 1989 enacted title 3-A of the Real Property Tax Law (sections 953 to 959), regulating tax escrow accounts. The law is applicable to "mortgage investing institutions" which by definition include federal savings banks and federal savings and loan associations (these are now known as "federal savings associations," although the New York statute has not been amended). Although this area is a fairly clear cut area of preemption, it is clear that the New York Legislature is trying to thwart preemption in this area.

In its opinion letter of January 3, 1991, the OTS held that New York Real Property Tax Law sections 953 *et seq.* were clearly preempted insofar as they

1. Required the payment of interest on mortgage escrow accounts.
2. Prohibited the charging of fees on escrow accounts.
3. Required that the lender provide to the borrower periodic written statements disclosing specified information about the status of the escrow account.

A similar determination had been previously made in *First Federal Savings and Loan Association v. Greenwald*[13] in regards to a Massachusetts statute.

F. New York Real Property Law Section 274(a) and Payoff Statement Fax Charges

Section 274(a) of the New York Real Property Law requires that under designated circumstances, the mortgagee of certain residential real property deliver within 30 days "mortgage-related" documents defined to include a loan payoff statement. Section 274(a)(2) also prohibits the mortgagee from charging borrowers for the mortgage-related documents pursuant to an initial request, but a mortgagee "may charge not more than twenty dollars or such amount as may be fixed by the banking board, for each *subsequent* payoff statement provided."

Although on its face, the statute is not entirely clear that it would bar charging for the service of faxing a payoff statement to the borrower, the Appellate Division, Second Department held in *Negrin v. Norwest Mortgage, Inc.*[14] that a claim for charging for a payoff statement did state a cause of action.

When an inquiry was made as to whether this statute would be applicable to a federally chartered institution, The Office of Thrift Supervision in a letter of its Chief Counsel, Carolyn J. Buck, dated April 21, 2000 stated in part:

> OTS regulations are clear that federal law preempts state laws that restrict loan related fees. Section 560.2(b)(5) expressly provides that state laws purporting to impose requirements regarding loan related fees are preempted . . . [a]

> charge for faxing loan payoff statements at the borrower's request, is a loan related fee . . . therefore under Section 560.2(b)(5) [of 12 CFR], to the extent Section 274(a)(2) would prohibit [the lender] from charging a borrower for faxing a loan payoff statement requested by the borrower, Section 274(a)(2) does not apply. . . .

Parenthetically it should be noted that the statute by its terms in defining "Banking Organization" states that it shall include any institution chartered or licensed by the United States. This obviously would be of no effect if the statute is preempted.

G. Preemption of State Usury Statutes

Although General Obligations Law section 5-501 and Banking Law section 14-a set the maximum rate of interest in New York at 16%, federal law exempts certain lenders from this limit. Pursuant to 12 U.S.C. section 1735(f)(1)–(5) and (7), qualified creditors are exempt from the New York usury law. Qualified creditors include:

1. a party which is insured by a federal agency.
2. a party which is regulated by a federal agency.
3. a party which makes or invests in residential real estate loans aggregating more than $1 million a year and is a regular extender of consumer credit which is payable by agreement in more than four installments or for which the payment of a finance charge is or may be required.[15]

OTS has enacted regulations dealing with the preemption of state usury laws in 12 CFR Part 590.

VI. How Far Can the Preemption Envelope Be Pushed?

Recent litigation in other states has begun to push the preemption doctrine to new limits. In 1982 the Alternative Mortgage Transactions Parity Act, 12 U.S.C. section 380, *et seq.*, was enacted to extend the rights of non-federally chartered housing creditors (such as mortgage companies) to make alternative mortgage loans provided they were in accord with federal regulations.

The Office of Thrift Supervision in response to the statute then enacted regulation 12 CFR section 560.220, which provides as follows:

> Section 560.220 Alternative Mortgage Parity Act.
>
> Pursuant to 12 U.S.C. 3803, housing creditors that are not commercial banks, credit unions, or Federal savings associations may make alternative mortgage transactions as defined by that section and further defined and described by applicable regulations identified in this section, notwithstanding any state constitution, law, or regulation. In accordance with section 807(b) of Public Law 97-320, 12 U.S.C. § 3801 note, §§ 560.33, 560.34, 560.35 and 560.210 of this part are identified as appropriate and applicable to the exercise of this authority and all regulations not so identified are deemed inappropriate and inapplicable. Housing creditors engaged in credit sales should read the term "loan" as "credit sale" wherever applicable.

It identified section 560.33 (late charges); section 560.34 (prepayment charges) and sections 560.35 and 560.210 (both dealing with adjustable rate loan terms) as portions of the regulations applicable to non-federally chartered lenders.

As a result both in Virginia and New Jersey attacks on state prepayment statutes were upheld and non-federally chartered lenders were permitted to impose prepayment charges on adjustable rate loans despite state statutes to the contrary.[16] In *Black v. Financial Freedom Senior Funding Corp.*,[17] an action was brought against a mortgage lender asserting that a reverse mortgage violated various California laws against elder abuse, unlawful business practices, fraudulent concealment and negligent misrepresentation. The non-federally chartered lender defended, claiming that the Parity Act preempted the plaintiff's claims. The appellate court held that preemption was inapplicable since it only applied to specifically preempted laws such as those mentioned in section 560.220 of the regulations (late charges, prepayment charges, adjustable rate loan terms). It further held that the California statutes involved were not in conflict with other federal laws.

None of these decisions would be applicable in New York because New York opted out of the Alternative Mortgage Transactions Parity Act.[18] Nevertheless, the New York attorney may deal with an out-of-state mortgage company (either licensed or unlicensed in New York) which wrongfully attempts to apply the doctrine of preemption in these areas.

VII. Additional Preemption Issues in Other States

A. Pass-Through of Lender's Legal Fees to Borrower

New Jersey, by statute,[19] sought to regulate the amount of legal fees that a lender could pass on to a borrower. The Supreme Court of New Jersey held that where a lender was a federally chartered institution the state statute was preempted and the fees could be passed along.[20]

B. Licensing of Title Agent Subsidiary of National Bank

Title agents must be licensed in New Jersey. N.J.S.A. 17:46B-30.1 specifically prohibits a bank, trust company or other lending institution from being licensed to sell title insurance or otherwise act as agent for the sale of title insurance.

The United States District Court for New Jersey held that in the case of a national bank which is regulated by the Office of the Comptroller of the Currency and not by the OTS, that the statute was preempted by section 92 of the National Bank Act.[21]

Endnotes

1. 350 U.S. 497 (1956).
2. 12 U.S.C. § 1464(a).
3. *Fidelity Federal S&L v. de la Cuesta, Z.*, 458 U.S. 141, 151 (1982).
4. *See* OTS Chief Counsel Opinion dated August 19, 1997.
5. See *Spitz v. Goldome Realty Credit Corp.*, 569 N.E.2d 43, *aff'd*, 600 N.E.2d 1185 (1992).
6. General Obligations Law § 5-501(3).
7. 12 CFR § 560.34.
8. *Meyers v. Beverly Hills Federal Savings & Loan Ass'n*, 499 F.2d 1145 (1974).
9. 12 CFR § 560.33.
10. 174 A.D.2d 173 (2d Dep't 1992).
11. *Fidelity Federal v. de la Cuesta*, *supra*, note 3.
12. *First Federal Savings & Loan Ass'n of Rochester v. Jenkins*, 109 Misc. 2d 715 (1981).
13. 591 F.2d 417 (1st Cir. 1979).
14. 263 A.D.2d 39 (2d Dep't), 700 N.Y.S.2d 184 (1999).
15. 15 U.S.C. § 1602(F)(1); 12 U.S.C. § 5(b)(2)(D).
16. *National Home Equity Mortgage Ass'n v. Face*, 64 F. Supp. 2d 584 (E.D. Va. 1999), *aff'd*, 239 F.3d 633 (4th Cir.); *Shinn v. Encore Mortgage Servs.*, 96 F. Supp. 2d 419.
17. 92 Cal. App. 4th 917, 112 Cal. Rptr. 2d 445 (2001).
18. *See* 12 U.S.C. § 3804(a); N.Y. Banking Law § 6-a.
19. N.J.S.A. 46:10A-6.
20. *Turner v. First Union Nat'l Bank*, 162 N.J. 75, 740 A.2d 1081 (1999).
21. *Valley National Bank v. La Vecchia*, 59 F. Supp. 2d 432 (Dist. N.J. 1999).

John G. Hall is a Partner in the Staten Island law firm of Hall and Hall. He is a Past Chair of the Real Property Law Section.

This article has been reprinted with permission from the *Real Estate Finance Journal*. It has been updated since its original publication.

Housing Cooperatives: Ownership by Trusts

A Retrospective and a Forecast

By Anita Rosenbloom and Richard Siegler

Seven years ago, we co-authored an article discussing trust ownership of cooperative and condominium apartments.[1] We noted then an increase in the number of requests that co-op housing corporations were receiving for permission to transfer co-op apartments to trusts. The increase was attributable in large part to the issuance in 1992 of final Treasury Regulations blessing qualified personal residence trusts (QPRTs). The trend has continued and we believe that it is likely to continue, despite passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). This article is intended to update the 1994 article to take account of new developments and our experiences since then in dealing with trust transfers of co-op apartments. Condominium transfers to trusts are beyond the scope of this article and should be dealt with separately.

There remain two types of trusts into which most transfers are proposed: the QPRT and the grantor trust (also commonly referred to as a "revocable trust" or a "living trust"). In the case of the grantor trust, EGTRRA should have absolutely no impact on the popularity of these trusts, because these trusts are not designed to achieve any estate or gift tax savings. Typically, they are includible in the grantor's gross estate for estate tax purposes.[2] In contrast, as discussed below, the QPRT is a creature of the Internal Revenue Code and generally the sole reason for establishing it is to attain gift and estate tax savings. Whether it makes sense for an individual client to transfer his co-op apartment to a QPRT in light of EGTRRA will depend upon an analysis of traditional factors such as the person's age, state of health, available gift tax exemption, anticipated estate tax exemption, projected taxable estate, cost basis in the apartment, the value of the apartment and a consideration of the client's comfort level in parting with ownership. It also may depend upon his estate planning counsel's ability to predict the future—whether or not there ultimately will be a permanent repeal of the federal estate tax and a substitution of a modified carryover basis regime with respect to assets inherited from a decedent.

> *"Although taken as a whole, the pending changes under EGTRRA are very substantial, the increase in the estate and generation-skipping tax exemptions and drop in the marginal estate, gift and generation-skipping tax rates are phased in very gradually."*

Assessing the Impact of the Economic Growth and Tax Relief Reconciliation Act of 2001

Although taken as a whole, the pending changes under EGTRRA are very substantial, the increase in the estate and generation-skipping tax exemptions and drop in the marginal estate, gift and generation-skipping tax rates are phased in very gradually. No changes occur until January 1, 2002, when the estate and gift tax exemptions increase to $1,000,000, and the top estate, gift and generation-skipping tax rates are reduced from 55 percent to 50 percent. Thereafter, the marginal estate, gift and generation-skipping tax rates decline only an additional 5 percent during the period from 2002 to 2009 before repeal of the estate and generation-skipping taxes in 2010. The gift tax continues to apply in 2010 and thereafter at a 35 percent rate. Furthermore, the estate tax exemption does not increase to $1,500,000 until 2004, $2,000,000 until 2006 and jump to $3,500,000 until 2009, before repeal of the tax in 2010. Repeal is not everlasting. Repeal under EGTRRA would apply only for decedents dying during 2010. After that, the "sunset" provisions of the 2001 Act resurrect the estate, gift and generation-skipping taxes as they existed before the 2001 Act was enacted. Commencing on January 1, 2002, the gift tax exemption increases to $1,000,000 but remains frozen at that level indefinitely.

The slow phase-in of the increase in the estate and generation-skipping tax exemptions, uncertainty regarding the ultimate repeal of the estate and generation-skipping taxes and continuation of the gift tax with the exemption fixed at $1,000,000 make it likely that older and very high net-worth individuals will continue to find the QPRT an attractive vehicle for leveraging the use of their $1,000,000 gift tax exemption through its discount features. Individuals with more modest estates may rethink the merits of putting their apartment into a QPRT. A single person who has a life expectancy beyond 2009 and projects a taxable estate below $3,500,000 may have little incentive to transfer his co-op to a QPRT. A married couple can leave $7,000,000 to their heirs, free of estate tax under EGTRRA through proper coordination of their wills and split ownership of their assets, assuming that they both survive to 2009. If the couple's combined assets are below the $7,000,000 threshold, they may pass on the QPRT. Yet another couple with comparable assets may be inclined to transfer their co-op to a QPRT out of concern that their assets could appreciate beyond $7,000,000, or that either might die prematurely or a feeling of uncertainty about the full phase-in of the estate tax exemption.

"There is much speculation as to whether these onerous and complex carryover basis rules will ever become effective."

In each case, the potential gift and estate tax savings that may be produced by the QPRT must be weighed against the loss of the step-up in basis that would occur for a testamentary transfer occurring in the next eight years. Of course, where an individual has a relatively high cost basis in the residence, this will not be a factor. But for those individuals with a low cost basis, the loss of the step-up should be carefully considered. Under current law, subject to certain limited exceptions, assets inherited from a decedent generally receive a "stepped-up" basis equal to the fair market value of the assets on the date of the decedent's death (or six month anniversary of death if an alternate valuation date is elected). This step-up in basis wipes out the taxable gain on any appreciation in the value of the residence that occurred prior to the decedent's death. In contrast, when an individual gifts a residence to a QPRT, the remainderman receives a carryover basis equal to the lesser of the donor's basis or the fair market value of the residence on the date of the gift (increased by any gift tax paid on any unrealized appreciation).[3] As a result, the built in gain is passed along to the remainderman.[4]

Under EGTRRA, in tandem with the estate tax repeal in 2010, the step-up in the basis of a decedent's assets will be limited to the first $1,300,000 of assets passing to anyone and an additional $3,000,000 of assets passing to the decedent's surviving spouse. The permitted basis increase would be allocated by the executor on an asset-by-asset basis. The basis of all assets acquired from a decedent exceeding the $1,300,000 and $3,000,000 figures will be equal to the lesser of the decedent's adjusted basis, or the fair market value of the assets at the decedent's death. Although not technically part of the new carryover basis regime, EGTRRA revises section 121 of the Internal Revenue Code to allow the $250,000 exclusion of gain on the sale of a principal residence to be claimed by the decedent's estate or beneficiaries.[5] There is much speculation as to whether these onerous and complex carryover basis rules will ever become effective.

For individuals considering transferring a residence with a low cost basis to a QPRT, these meandering and uncertain rules regarding basis should be considered. Regrettably, this somewhat distasteful exercise forces the person to contemplate their life expectancy, since the rules that will apply will be dependent upon the year of death. An older client who is considering a short-term QPRT and has a life expectancy of eight years or less, must weigh the trade-off between the income tax on the capital gain that will be incurred by the remainderman of the QPRT upon the sale of the residence with the potential gift and estate tax savings. (If the individual refrains from transferring the residence to the QPRT and dies before 2010 owning the residence, the step-up in basis would wipeout the gain.) Of course, the potential capital gain may not be of great concern if it is anticipated that the remainderman of the QPRT will continue to own the residence for a lengthy period of time so that recognition of the gain is delayed, or that the remainderman will convert the residence to his principal residence (with the consent of the co-op) and hold it for the requisite period to qualify for the $250,000 exclusion of gain ($500,000 in the case of a married couple) in his own right. For those individuals who reasonably can expect to live until 2010 and have some level of confidence that the estate tax will be repealed and replaced by a modified carryover basis regime (which basically converts the estate tax to an income tax when the residence is sold), they will need to compare the potential gift and estate tax savings produced by the QPRT with the capital gain which will be realized by the remainderman. The remainderman will not be able to take advantage of the $250,000 exclusion of gain which would be available if the residence is the grantor's personal residence and the grantor dies owning it after 2010. Similarly, there will be no opportunity for the grantor's executor to make the basis allocation (up to $1,300,000 if the residence passes to anyone, with an additional $3,000,000 if it passes to the surviving spouse) that would be available if the grantor dies after 2010 owning the residence, whether or not it is his principal residence.

Despite the complexity and uncertainty created by EGTRRA, it is likely that very high net-worth individuals still will perceive benefits in transferring personal residences to QPRTs. Individuals with more modest estates may be less inclined to do so. It therefore can be expected that cooperative corporations will continue to receive such requests from their wealthier shareholders. Furthermore, the number of requests for transfers to grantor trusts should be undiminished.

From time to time, cooperative corporations also may receive requests for transfers of apartments to a testamentary trust under the will of a deceased shareholder (typically to fund a credit by-pass trust) or a request for a transfer to (or a purchase by) an existing trust established by a third party other than the intended resident. It is likely that these types of requests also will continue. Indeed, it is possible that there will be an increase in the number of requests to transfer co-op apartments to credit shelter trusts under a deceased shareholder's will, as the federal estate tax exemption expands over the next eight years and a larger portion of the estate will pass into these trusts.

Since it is likely that cooperative corporations will continue to receive requests for transfers to trusts, we will now discuss the ramifications of these transfers from the perspective of the co-op, with a view towards facilitating shareholder requests.[6]

Role of Counsel

For those co-ops which have not already confronted the issue of trust ownership of an apartment, ideally they should seek the advice of counsel in advance to formulate a general policy to deal with such requests so that they are prepared to address them when they are received. When a co-op board receives a request for a transfer to a trust, it should seek the advice of counsel in reviewing the particular request. Counsel for the co-op should understand that the decision whether to permit a transfer to a trust is a policy matter invariably within the discretion of the co-op board. If a board is inclined to accommodate a request for a transfer to a trust, co-op counsel should attempt to ensure that the co-op is at no greater financial or other risk with a trust as a shareholder than with a natural person.

The first step in the process is to review the trust instrument itself.[7] It cannot be emphasized enough that each trust instrument—and this means the entire instrument, not just excerpts—must be reviewed by an attorney well-versed in trust issues. After review of the trust instrument, counsel should advise the board of the basic terms of the trust and any problematic provisions and should recommend documentation which may alleviate board concerns. Counsel should conclude whether there is any legal reason why the transfer to the trust should not be approved. Ultimately, the final decision is within the discretion of the board.

It should be made clear to the shareholder seeking the transfer that the fees of the co-op's counsel for review of the trust documents and advice to the co-op, as well as other fees in connection with the transfer, will be borne by the shareholder seeking the transfer, regardless of whether the transfer is approved. Legal fees can vary dramatically depending on the complexity of the trust instrument and the extent of modifications needed. Shareholders should be made aware of this before the fees are incurred.

QPRTs

The QPRT is a potentially highly effective estate planning device for an individual who owns a valuable residence. Final Treasury Regulations[8] setting out the requirements for this form of trust were issued in 1992. A QPRT is a form of trust which can be used to remove a residence from an individual's gross estate while making a taxable gift valued below that of the present market value of the residence. The residence may be a fee interest in a house, a condominium or a co-op apartment, but it must be a personal residence of the grantor as defined in the applicable Treasury Regulations.

The QPRT plan generally works as follows: An individual transfers a personal residence into an irrevocable QPRT, retaining the right to use the residence for a fixed term, for example five years. The QPRT provides that upon the expiration of the term, the residence is to pass to designated beneficiaries or a follow-on trust for such beneficiaries. The creation of the QPRT is a completed gift to the beneficiaries, but only in the amount of the current actuarial value of the remainder interest, which passes to the designated beneficiaries upon the expiration of the term for which the grantor has reserved the use of the residence. For example, if an individual 60 years of age transfers a residence worth $1,000,000 to a QPRT in October of 2001, retaining the use of the property for 10 years, the amount of the taxable gift would be approximately $484,000.[9] If the term of the QPRT is extended, the taxable gift is reduced. On the other hand, if the term is shortened, the taxable gift would be increased.[10] Note that for the QPRT to achieve estate tax savings, the grantor must survive the fixed term for which he or she retains the right to use the residence. If the grantor dies within the term of the QPRT, the entire QPRT (including the residence) would be includible in his or her taxable estate.

A QPRT will be established under a trust agreement which will be irrevocable (to accomplish its gift and estate tax objectives), although some QPRTs may grant the trustees a limited power to amend the QPRT to comply with requirements of the tax law. The QPRT is a form of grantor retained income trust, commonly referred to in estate planning circles by the acronym "GRIT." Thus, some of the transmittal papers provided by the shareholder making the request may refer to the trust as a "GRIT." In almost all cases, however, the trust agreement is likely to make a reference to a "QPRT." Although most of the requests that co-ops are likely to receive will involve a QPRT, not all GRITs are QPRTs. In certain limited circumstances, it is possible that the request will be to a GRIT which is not in the QPRT format. It also should be noted that while a QPRT may be a "grantor trust" for *income tax purposes* for a certain period of time, depending upon how the trust instrument is drafted, its provisions will be substantially different from the revocable form of grantor trusts discussed below.

In order to achieve its estate planning objectives, each QPRT must be drafted to comply with the requirements imposed by Treasury Regulations. These require certain language to be incorporated in the trust agreement. Some issues to be considered by a co-op board in reviewing transfer requests are set forth below.

1. The grantor (i.e., the shareholder) will reserve the right to use the apartment for a fixed term of years. Although the QPRT trust agreement may restrict occupancy to the grantor during the term for which he or she has reserved the use of the apartment, co-op boards nevertheless should seek an occupancy agreement executed by the grantor individually and the trustees of the trust, confirming that the grantor and the grantor's family will be the sole occupants of the apartment throughout the term of the trust. Exhibit A is a sample form of occupancy agreement.

2. The trust agreement must preclude the trustees from holding assets other than the subject co-op apartment and cash to meet six months' expenses for the residence. While the trust agreement may permit the infusion of cash from time to time to cover six months of expenses, generally there will be no requirement that such moneys be added to the trust. Although not mandatory under the Treasury Regulations, many QPRTs may impose upon the grantor the obligation to meet all expenses relating to the apartment, such as maintenance and assessment charges due pursuant to the proprietary lease and insurance costs. The fact that the residence is subject to a mortgage does not jeopardize the trust's status as a QPRT under the Treasury Regulations, but may impact the size of the initial taxable gift and have further gift tax implications when mortgage payments are made, depending upon whether the debt is recourse or non-recourse.[11] Hence, in the case of all QPRTs, it is incumbent on a co-op board to seek a personal guaranty of the proprietary lease obligations by the grantor, as there will be nominal funding of the trust other than with the residence itself. Exhibit B is a suggested form of guaranty.

3. Upon the expiration of the fixed term for which the grantor has reserved the use of the apartment, the trust principal (including the apartment) will pass to designated beneficiaries such as children, other family members or even non-family members. In some cases, the trust agreement will provide that the apartment passes outright to the children or other beneficiaries; in other cases it will provide that it passes into a trust for the particular beneficiaries. For example, it may pass into a combined discretionary trust for the grantor's issue and name a non-family trustee (who is not one of the grantor's issue) as the trustee. Some grantors feel that this gives them more assurance that their children (or other beneficiaries) will not sell the apartment while they remain in residence and that the trustee will enter into a lease which will permit the grantor to continue to occupy the apartment after the expiration of the fixed term. If the grantor wishes to continue to occupy the apartment following the expiration of the fixed term, he or she will have to lease the apartment from the new owners at a fair market rent to avoid potentially adverse gift and estate tax consequences. If a co-op board is willing to consent to the transfer of an apartment into a QPRT, it also must decide whether it is willing at the time of the initial application to also consent to the subsequent transfer of the apartment to the grantor's children (or other beneficiaries) at the expiration of the fixed term.

If a board is reluctant to pre-approve the transfer to the children (or other beneficiaries) as owners, it could limit its approval to the initial transfer of the apartment into the QPRT. However, this may not fully accommodate the grantor's wishes. It is likely that the grantor will wish to continue to occupy the apartment at the expiration of the fixed term by entering into a lease or similar arrangement with his or her children (or other beneficiaries) who will then become the new owners. For these reasons, the grantor may desire that the co-op board pre-approve the transfer to his or her children (or other beneficiaries) at the expiration of the fixed term. Although this is rarely done, it is entirely a policy decision to be made by the board. A compromise is to allow occupancy by the grantor. It may be possible to permit other occupancies without a change in ownership, such as permitting occupancy by the immediate family of the grantor, who by virtue of the proprietary lease provisions would also be entitled to occupy an apartment.

Note that a board's refusal to pre-approve the transfer to the grantor's children (or other beneficiaries) may only delay the issue since, if the grantor survives the term of the QPRT and the apartment is not sold during the term, the board will most likely receive a request at the expiration of the term for approval of the transfer of the apartment to the beneficiaries. In addition, the board can expect a request for permission of the grantor to sublease the apartment from the new owner, which raises additional policy considerations.

If a co-op board is unwilling to pre-approve the transfer to the grantor's children (or other beneficiaries), it is important that the board obtain a written confirmation from the grantor and the trustees that the board is only approving the initial transfer of the apartment into the trust and that all further transfers by the trustees, including those to the beneficiaries upon the expiration of the fixed term or the grantor's prior death, must be approved by the board at such time. It is also recommended that this letter agreement contain a general confirmation from the grantor and the trustees that, in the event of a conflict between the terms of the trust agreement and the proprietary lease, the co-op's by-laws or certificate of incorporation or the occupancy agreement, the provisions of the proprietary lease, by-laws, certificate of incorporation and occupancy agreement shall prevail. A sample letter agreement can be found in Exhibit C.

4. As noted above, if the grantor does not survive the fixed term, the trust fails as an estate planning device and the trust agreement typically will provide that all of the trust assets (including the apartment) are to be distributed upon the grantor's death as the grantor may appoint pursuant to a testamentary power of appointment, to the executors of the grantor's estate or perhaps to designated beneficiaries. This should not present a problem to the co-op since it is no different than if the grantor owned the apartment individually at the time of death and disposed of it under the terms of a will. All such transfers following the death of the shareholder would require board approval pursuant to the proprietary lease.

5. There will be extensive provisions in the trust agreement which deal with the possibility that the trust could cease to be a QPRT, within the meaning of the Treasury Regulations. In general terms, this could happen if the apartment ceases to be used or held for use by the grantor as a personal residence, if the apartment is sold and a new residence is not purchased within a two-year period or the apartment is destroyed and the proceeds of insurance are received and not used to purchase or construct a new apartment within two years after the date of receipt of such proceeds. In such events, the trust agreement must provide that, within 30 days after the date on which the trust has ceased to be a QPRT, either (a) the trust be terminated and the assets (i.e., the apartment) be distributed to the grantor, (b) the trust be converted to a qualified annuity trust pursuant to which the grantor is entitled to receive a qualified annuity interest (as defined by the applicable Treasury Regulations) or (c) the trustees be given the option of complying with either (a) or (b). These provisions will appear in all QPRTs, as they are required by Treasury Regulations. However, these provisions ought not to be of any concern to a co-op board because the events which trigger them, such as the sale of the apartment or the rental of the apartment so that it ceases to be a personal residence of the grantor, would require board approval in the regular course.

6. It is advisable to obtain an opinion from the grantor's counsel, admitted to practice in the state the laws of which govern the trust, addressed to the co-op, to the effect that: (a) the copy of the trust agreement furnished to the co-op is a true and correct copy; (b) there have been no amendments to the trust agreement; (c) the trust is a valid and existing trust under the law of the particular state cited in the trust agreement; (d) the trustees named in the trust agreement are the current trustees of the trust; (e) these individuals, in their capacities as trustees, have full authority to execute the proprietary lease and assume all of the obligations thereunder, and to execute the occupancy agreement and letter agreement described above; and (f) the obligations under the proprietary lease which are being assumed by the trustees will be binding upon any successor trustees.

Grantor Trusts

A grantor trust is a revocable, amendable trust created primarily for the benefit of the shareholder/grantor during his or her lifetime. Often, assets other than a co-op apartment will be transferred to a grantor trust. Typically, the income and principal of the trust may be freely used by the trustee for the grantor's benefit during the grantor's lifetime. The grantor trust is often used as a will substitute, providing for the disposition of the trust assets upon the death of the grantor, but does not result in estate or gift tax benefits. There is a perception that the grantor trust permits the avoidance of probate proceedings, saves expenses and facilitates property transfers. However, these benefits may not actually materialize.[12] At the least, the grantor trust may be used to administer assets where the grantor becomes disabled or incapacitated.

The concerns raised by the grantor trust and the QPRT are somewhat different. For example, in the case of a QPRT, the grantor may likely be alive at the termination of the trust, giving rise to issues of occupancy and control of the co-op apartment. Further, virtually the only asset in a QPRT will be the co-op apartment, while a grantor trust is usually funded with other assets. Despite these differences, the documentation recommended to alleviate the concerns raised by both the QPRT and the grantor trust are similar. In a transfer to a grantor trust, as with any transfer of a co-op apartment to a non-individual, the occupancy of the apartment should be controlled by an occupancy agreement similar to that found in Exhibit A. A personal guaranty by the grantor, similar to that in Exhibit B, is advisable as a secondary source of funds for maintenance and other charges should the trustees fail to pay the same. It should be confirmed, by the execution of a letter agreement similar to Exhibit C by the grantor of the trust, the trustees thereof, and any known beneficiaries, that no further transfer of the apartment from the trust, either during the grantor's lifetime or after his or her death will be permitted without board approval, even if the transfer is to a named beneficiary of the trust. Finally, the attorney opinion referred to above should also be obtained.

Testamentary Trusts and Trusts Created by Third Parties

In addition to what have become routine requests for transfers to QPRTs and grantor trusts, from time to time a co-op may receive a request for a transfer to a trust created under the will of a deceased shareholder, usually to fund a credit by-pass trust, or a request for a transfer to, or a purchase by, an existing trust established by a party other than the intended resident. Generally, if the co-op policy permits non-individual shareholders such as trusts to own an apartment, a transferee in these situations should be reviewed like any other transferee, including a review for financial stability. The trust instrument should be reviewed for troublesome issues, such as spendthrift provisions, discussed below. Documentation similar to that recommend for QPRTs and grantor trusts should be obtained.

Spendthrift Provisions

While each trust instrument must be examined for problematic provisions, one particular trust provision co-op boards should be aware of is a "spendthrift" provision which purports to protect the assets of the trust from the creditors of the beneficiary and/or grantor. If a spendthrift provision is valid in the jurisdiction governing the trust, it might preclude a co-op from seeking satisfaction of any claims that it may have against the grantor of the trust (or any other beneficiary of the trust) out of the trust assets, such as claims arising out of a personal guaranty of the proprietary lease obligations. Spendthrift provisions are most common and most troublesome in the case of grantor trusts, because it is likely that the grantor will have transferred substantially all, or at least a significant portion, of his or her assets into the trust. However, in many jurisdictions, including New York, a spendthrift provision in a grantor trust would not be binding against the grantor's creditors.[13]

Regardless of whether as a matter of law a spendthrift provision is binding against the grantor's creditors, a co-op board ought to be wary of permitting the transfer of an apartment to a trust which recites on its face that the shares and proprietary lease (as well as all other assets of the shareholder placed in the trust) would be beyond its reach should it seek to execute a judgment against the grantor or other beneficiaries, as the co-op would be on notice of the existence of these provisions. To alleviate the concerns raised by the presence of a spendthrift provision, it is recommended that either (1) the trust agreement be amended in such a manner as to confirm that the spendthrift provisions shall be of no force or effect against the co-op, and that any claim that it may have against the grantor, individually, or in his or her capacity as trustee, or against any other trustee, including but not limited to claims arising out of a default under the proprietary lease, may be asserted against and satisfied out of the trust assets; or (2) the attorney's opinion letter referred to above includes a confirmation of the same. An amendment to the trust agreement would appear to be preferable as it would afford the co-op the greatest protection and should be obtainable in the case of an amendable grantor trust. Exhibit D is a suggested form of amendment. While amending a QPRT may be problematic, the spendthrift issue arises less frequently in QPRTs. This is so because the transfer of a co-op apartment will be the sole reason for the QPRT, and co-op approval will invariably be sought before the QPRT is created. Thus, any spendthrift provision can be deleted or revised in the drafting stage.

Conclusion

There appears to be no legal reason for a co-op board to reject proposed transfers to QPRTs, grantor trusts, testamentary trusts or third-party trusts, provided that the particular trust instrument does not contain problematic provisions, appropriate collateral documentation is obtained and the particular circumstances surrounding the proposed transfer do not otherwise raise independent concerns. Indeed, we would hope that most of these requests would be approved where the co-op can be adequately protected, as most shareholder requests are motivated by a desire to facilitate estate planning.

Unfortunately, we have seen instances where co-op boards have adhered to somewhat rigid policies—not without cost to the shareholder and his intended beneficiaries. For example, what could be a more compelling set of circumstances than to permit the transfer of an apartment to a credit by-pass trust under a will for the benefit of a surviving spouse, when there are otherwise inadequate assets to fund the trust. To deny the request would result in a waste of the decedent's estate tax exemption and higher estate taxes when the spouse dies and the apartment is taxed as part of the second estate.

"In the end, the decision to permit a trust (or other non-natural individual) to own co-op shares and proprietary leases is a policy decision for co-op boards."

Another appealing case is where a request is made for the purchase of an apartment by a trust for the primary benefit of the intended resident which was created by a third party, such as a parent or grandparent. The trust (which is the proposed purchaser) may enjoy a tax-favored status, such as being exempt from the generation-skipping tax and insulated from estate tax on the death of the beneficiary. Permitting the purchase by the trust may not only facilitate the purchase, but insulate any appreciation on the residence from estate and generation-skipping taxes.

Regrettably, we know of situations where such requests have been denied at a considerable cost to the deceased shareholder's heirs and the beneficiaries of the third-party trust. Sometimes the refusal of the request may be due to a lack of familiarity by the co-op board or its managing agent with the various forms of trusts and how readily the co-op can be insulated from any financial or other risk resulting from trust ownership. As the use of trusts become more commonplace in estate plans, both for tax and non-tax reasons, and co-op apartments increasingly represent a significant asset of shareholders' estates, we would urge co-op boards to consider these requests with an open mind. Although few in number, there are some buildings which have an absolute policy against permitting trust ownership of apartments.[14] We suggest that such boards review their general policy for the benefit of their shareholders.

In the end, the decision to permit a trust (or other non-natural individual) to own co-op shares and proprietary leases is a policy decision for co-op boards. Some co-op boards have determined that non-individual ownership of co-op apartments is inconsistent with the basic co-op housing principle of owner-occupancy.[15] Most proprietary leases are drafted presuming a natural person as the lessee. They include provisions which do not make sense in cases of non-individual ownership. For example, most proprietary leases restrict occupancy to the named lessee and his or her family; obviously, a trust lessee can have no family. Further, it can be argued that the co-op is at a greater risk of disputes when actual ownership and beneficial ownership are divided as between a trust, its trustees, its grantor and its beneficiaries. While the foregoing concerns may be alleviated for some boards by the documentation we have suggested, the question may arise whether this documentation, which essentially modifies certain terms of a proprietary lease relating to occupancy and transfers, is an amendment of the proprietary lease which is invalid without shareholder approval. Since there is virtually no case law offering guidance on this issue, it is not entirely free from doubt. However, a strong rebuttal to this position can be based on a co-op's absolute right to withhold consent to a trust transfer for any reason, which implies the right to impose any condition to such transfer. In rare cases, it may be appropriate for a co-op which permits transfers to trusts to consider amending certain provisions of its proprietary lease to reflect this form of non-individual ownership.

Co-op boards, with the advice of counsel, should carefully consider all aspects of trust ownership and formulate a policy which is acceptable and appropriate for the particular building, balancing the desire to accommodate shareholders and the duty to serve the co-op as a whole. Over the past decade, in our experience with approximately 100 co-ops which have confronted this issue with our advice, virtually all have permitted trust transfers. Moreover, those that have allowed trust transfers to date have virtually never encountered problems resulting from trust ownership. Once trust transfers are permitted, it will be difficult for a co-op board to deny this privilege to other shareholders in good standing who are willing to abide by the co-op's requirements for such transfers.

Endnotes

1. Richard Siegler & Anita Rosenbloom, *Co-operatives, Condominiums: Ownership by Trusts*, NYSBA Trusts and Estates Law Section Newsletter, Spring 1994, p. 5.
2. I.R.C. §§ 2036, 2038.
3. I.R.C. § 1015(d).
4. Until recently, it was possible through a clever maneuver to shield the remainderman from the gain by having the grantor reacquire the residence from the QPRT just prior to expiration of the grantor's retained term. Under this "bait and switch" technique, the remainderman would receive cash or other assets. Further, if the grantor retained the residence until death, its basis would be stepped-up. The Internal Revenue Service responded by issuing Treasury Regulations, effective for trusts created after May 16, 1996, requiring that, in order to qualify as a QPRT, the trust instrument must prohibit the trust from selling or

transferring the residence, directly or indirectly, to the grantor, the grantor's spouse or an entity controlled by the grantor or the grantor's spouse. Treas. Reg. §§ 25.2702-5(c)(9).

5. The estate or beneficiaries can only claim the exclusion for a post-death sale of the decedent's principal residence if the decedent used the property as such for at least two of the five years before the sale. The period of occupancy by the decedent also can be added to the period of occupancy by an heir to determine if the heir meets the requirements for his or her own $250,000 exclusion.

6. The Tax Reform Act of 1986 amended I.R.C. § 216 to include in the definition of "tenant-stockholder non-natural persons, including trusts, owning co-op shares." Richard Siegler, "Impact of Tax Reform on Co-op Housing," N.Y.L.J., March 4, 1987, p. 1, col. 1.

7. Note that for various reasons, trusts are established under the laws of different states; just because the co-op apartment is located in New York does not mean the trust will be governed by New York law.

8. Treas. Reg. § 25.2702-5(c).

9. If the transfer is made after November 1, 2001, the figures may vary slightly. This is because the interest rate upon which the Internal Revenue Service's valuation tables are based fluctuate from month to month. The interest rate is equal to 120 percent of the average yield on Treasury obligations with maturities between three and nine years. This example further assumes that the grantor has reserved a contingent reversionary interest in the QPRT instrument providing that, if the grantor fails to survive the trust term, the residence will pass to his estate or as he may appoint by a general testamentary power of appointment. The value of the grantor's contingent reversionary interest reduces the value of the gift.

10. The amount of the taxable gift turns on five factors: (1) the interest rate used by the Internal Revenue Service in its valuation tables, (2) the value of the residence on the date of the gift, (3) the grantor's age, (4) the length of the trust term and (5) whether the grantor has reserved a contingent reversionary interest.

11. Treas. Reg. § 25.2702–5(c)(2)(ii). Note that shareholders with loans must generally obtain their lender's consent to a transfer to a trust.

12. *See Should I Create a Revocable Inter Vivos Trust?*, 63 N.Y. St. B.J. 48 (Dec. 1991).

13. EPTL 7-3.1.

14. In the event that the cooperative corporation refuses to consent to the proposed transfer to a QPRT, the IRS has confirmed that it nevertheless may recognize the transfer for transfer tax purposes. Priv. Ltr. Rul. 94-47-036 (Aug. 29, 1994); Priv. Ltr. Rul. 94-33-016 (May 18, 1994); Priv. Ltr. Rul. 92-49-014 (Sept. 4, 1992). In those cases, after the co-op board disapproved the request for transfer to the QPRTs, the donor assigned beneficial title to the co-op shares and the proprietary lease to the QPRT and undertook as nominee to hold legal title for the QPRT. We would not suggest this course of action as it would be a default under the proprietary lease.

15. Many proprietary leases provide that board consent is not required for a transfer of an apartment to the spouse of the shareholder and/or that board consent to a transfer to a financially responsible member of the shareholder's family may not unreasonably be withheld. This raises the issue of whether a transfer to or by a trust for the benefit of a grantor's spouse or other family member should be subject to the same relaxed consent provisions.

In addition, most proprietary lease provisions imposing a flip tax are triggered by a sale and payment of consideration, and as originally drafted do not expressly cover a gift transfer to a trust. Therefore, each flip tax provision should be reviewed. If a board wishes to amend the co-op's proprietary lease to impose a fee upon trust transfers, this almost always requires shareholder approval.

Anita Rosenbloom is a partner of Stroock & Stroock & Lavan LLP, specializing in estate planning and a co-author of *Manning on Estate Planning*, published by Practising Law Institute.

Richard Siegler is a partner in the New York City law firm of Stroock & Stroock & Lavan LLP and a member of the Committee on Condominiums and Cooperatives of the Real Property Section of the New York State Bar Association. He is also Adjunct Professor at New York Law School where he teaches a course on cooperative housing and condominium law.

***Reprinted from the Winter 2001 NYSBA* Trusts and Estates Law Section Newsletter, *vol. 34, no. 4 An earlier version of this article appeared in a March 3, 1993 edition of the* New York Law Journal.**

Exhibit A

OCCUPANCY AGREEMENT

[name of trustee] and [name of trustee], as Trustees (collectively, the "Trustees") of the [name of settlor/grantor] Trust, dated ____________ between [name of settlor/grantor], as [Grantor][Settlor], and [name of trustee] and [name of trustee], as Trustees (the "Trust"), are the holders of the shares (the "Shares") of (the "Corporation") allocated to Apartment ___ (the "Apartment") located at [address] and the proprietary lease appurtenant thereto (the "Lease"). The Trustees hereby agree with the Corporation that, notwithstanding any provisions of the Lease or any other document, they will not sublet or permit the occupancy of the apartment by any parties other than [name of settlor/grantor] and [her][his] immediate family (i.e., spouse, children and parents) residing with [her][him]. Any violation of this Agreement shall be considered a default by the Trustees, as lessee, under the provisions of the Lease. The occupant of the Apartment and Trustees shall be subject at all times to the Lease (including house rules) and the by-laws of the Corporation (the "By-laws").

The Trustees acknowledge and understand that the By-laws and Lease provide that the Shares are transferable only as an entirety and only to an assignee of the Lease approved in writing in accordance with the provisions of the Lease. The Trustees hereby represent that any transfer of the Shares or subletting of the Apartment made by them shall be done only in accordance with the provisions of the Lease and the By-laws. In the event of a conflict between the terms of the Trust and the terms of this Agreement, the Lease, the By-laws or the certificate of incorporation of the Corporation, as the same may be amended from time to time, the terms of this Agreement, the Lease, the By-laws and the certificate of incorporation of the Corporation, as the same may be amended from time to time, shall prevail.

The Trustees recognize that the Corporation is relying upon the foregoing representation in permitting a transfer of the Shares of the Lease to the Trustees and that the Corporation would not otherwise consent to such transfer.

The Trustees agree that any and all costs and expenses, including without limitation, reasonable attorneys fees and disbursements, incurred by the Corporation in connection with the enforcement of this Occupancy Agreement shall be deemed additional rent under the Lease.

The Trustees consent to the jurisdiction of the New York courts and consent to the service of process on the Trust by certified mail addressed to the Apartment.

This Agreement may be modified only by a written instrument signed by the Trustees and the Corporation.

This Agreement shall be binding on the estates, heirs, executors, administrators, personal representatives, successors and assigns of each of the undersigned.

This Agreement shall be governed by the internal laws of the State of New York, without giving effect to principles of conflicts of law.

IN WITNESS WHEREOF, the undersigned have executed this Agreement as of the ___ day of ________, ____.

[name of co-op corporation]

By:_________________________
Name:
Title:

____
[name of trustee],
as Trustee of the Trust

____
[name of trustee],
as Trustee of the Trust

Accepted and Agreed to:

____
[name of settlor/grantor],
individually and as [Grantor]
[Settlor] [and as Trustee]
of the Trust

Exhibit B

GUARANTY OF LEASE

WHEREAS, by a certain Assignment of Proprietary Lease, dated _________, _________, [name of trustee] and [name of trustee], as Trustees under that certain Trust Agreement dated ______________ between [name of grantor/settlor], as [Grantor] [Settlor], and [name of trustee] and [name of trustee], as Trustees (such Trustees hereinafter collectively called "Assignee"), will acquire all of the lessee's right, title and interest in and to a certain lease (the "Lease") dated ___________, between ("Lessor Corporation"), as lessor, and [name of grantor/settlor], or [her][his] predecessor in interest, as lessee, for apartment ___ ("Apartment") in premises located at ___________ ________________, New York, New York; and

WHEREAS, by instrument dated ________________ ("Assumption of Lease") Assignee will assume all of the obligations of [name of grantor/settlor], as lessee under the Lease, and is about to become the lessee of the Apartment by virtue of said instrument or the execution of a new lease.

NOW, THEREFORE, in consideration of the premises and the consent of Lessor Corporation or its directors to the assignment of the Lease to Assignee and to the transfer to Assignee of the shares of Lessor Corporation which accompany the Lease, [name of grantor/settlor] ("Guarantor") hereby guarantees to Lessor Corporation the timely performance of all of Assignee's obligations under the Lease, including, without limitation, the prompt payment by Assignee of all rent (maintenance charges) and any and all other charges or assessments payable under the Lease, as the same may be amended from time to time, accruing from and after the effective date of the Assumption of Lease.

Guarantor agrees to reimburse the Lessor Corporation for all costs and expenses, including without limitation, reasonable attorneys fees and disbursements, incurred by the Lessor Corporation in connection with the enforcement of this Guaranty. In the event Assignee defaults or fails to pay any sum when due, Lessor Corporation may require Guarantor's performance without first requiring that the Assignee perform.

The obligations of Guarantor hereunder are direct and absolute. A separate cause of action or separate causes of action may be brought and prosecuted against any Guarantor without the necessity of joining Assignee or previously proceeding or exhausting any remedy against Assignee or any other person who might have become liable for the indebtedness of the Trust by assumption thereof.

Notice of default or any extension of time to cure a default is hereby waived. This Guaranty shall remain in effect notwithstanding the modification of the Lease or the execution of a new lease by Assignee or any modification thereof.

This Guaranty is an absolute and unconditional guaranty and may not be changed or terminated orally but only by an agreement in writing signed by the party against whom enforcement of such change or termination is sought. All rights and remedies under the Lease and this Guaranty are cumulative.

This Guaranty and all of its provisions shall be binding on Guarantor and Guarantor's estate, heirs, executors, administrators, personal representatives, successors and assigns.

In any action on this Guaranty, guarantor waives trial by jury and the right to assert any counterclaim.

This Guaranty shall be governed by the internal laws of the State of New York, without giving effect to principles of conflicts of law.

New York, N.Y.
Date: _________________

____
[name of grantor/settlor]

State of New York)
: ss.
County of New York)

On the _____ day of ___________________ in the year ____, before me, the undersigned, personally appeared [NAME OF GRANTOR/SETTLOR], personally known to me or proved to me on the basis of satisfactory evidence to be the individual whose name is subscribed to the within instrument and acknowledged to me that (s)he executed the same in his/her signature on the instrument, the individual, or the person upon behalf of which the individual acted, executed the instrument.

____
Notary Public

Exhibit C

LETTER AGREEMENT

[name of trustee] and
[name of trustee]
Trustees of The [name of settlor/grantor] Trust
____
New York, New York _________

Date:_________________

[name of co-op]

Re: Transfer of Apartment

Dear Sir/Madame:

As a condition to your approval of the transfer of the shares of [name of co-op] (the "Shares") and the proprietary lease (the "Lease") allocated to Apartment ____ at, [address] New York, New York (the Shares and the Lease may be collectively referred to herein as the "Apartment"), to us, [name of trustee and [name of trustee], as Trustees of the [name of settlor/grantor] Trust, dated _________, _________, between [name of settlor/grantor], as [Grantor][Settlor], and us, as Trustees (the "Trust"), we, as Trustees of the Trust, [name of known beneficiary, if any, individually,] and [name of settlor/grantor], individually, hereby acknowledge and agree that, notwithstanding any purported disposition in the Trust Agreement, you shall retain and reserve the rights granted to you under the Lease, under your by-laws (the "By-laws") and under your certificate of incorporation (the "Certificate") to review and approve or reject in your sole discretion any further transfer of the Apartment by us, as Trustees, including, without limitation, any transfer which may take effect upon the death of [name of settlor/grantor] or the termination of the Trust, whether to a beneficiary of the Trust, to another trust or otherwise.

We, [name of trustee] and [name of trustee], in our capacities as Trustees of the Trust, and [name of settler/grantor], individually and as [Grantor][Trustee] of the Trust, agree that we shall be jointly and severally liable for any and all costs and expenses, including without limitation, reasonable attorneys fees and disbursements, incurred by you in the enforcement of this Letter Agreement, and that such costs and expenses shall be deemed additional rent under the Lease.

We, [name of beneficiary, if any] and [name of settlor/grantor] hereby further acknowledge and agree that, in the event of a conflict between the terms of the Trust and this letter agreement, the Lease, the By-laws, the Certificate or the Occupancy Agreement of even date herewith, the terms of this letter agreement, the Lease, the By-laws, the Certificate and the Occupancy Agreement shall prevail.

This letter agreement shall be binding on the estates, heirs, executors, administrators, personal representatives, successors and assigns of each of the undersigned.

This letter agreement shall be governed by the internal laws of the State of New York, without giving effect to principles of conflicts of law.

Very truly yours,

____
[name of trustee], as Trustee of the Trust

____
[name of trustee], as Trustee of the Trust

ACKNOWLEDGED AND AGREED TO:

____
[name of settlor/grantor], individually [and as Trustee] of the Trust

____
[name of beneficiary, if any, individually]

Exhibit D

PROPOSED AMENDMENT OF SPENDTHRIFT PROVISIONS

"The Grantor hereby directs that the spendthrift provisions set forth in Paragraph _____ of said Trust Agreement shall be of no force or effect against [NAME OF CORPORATION], and hereby confirms that any claims [NAME OF CORPORATION], may have against the Grantor in her[his] individual capacity or against any other beneficiaries or Trustees of any trust established under this Trust, including but not limited to any claims arising out of the guarantee which the Grantor is making or arising out of a default under the lease, may be asserted against and satisfied out of the assets of any trust established under this Trust Agreement and subject to judgment, levy, execution, sequestration, attachment, bankruptcy proceedings or other legal or equitable process in connection therewith, whether such claims arise during the life of the Grantor or after her[his] death. The Grantor hereby directs that the provisions of this Amendment shall not be modified, amended or revoked without the prior consent of [NAME OF CORPORATION] and any such purported modification, amendment or revocation shall be ineffective against [NAME OF CORPORATION]."

Have Reports of the Death of the Duty to Mitigate in New York Been Greatly Exaggerated?[1] A New Interpretation of *Holy Properties Ltd., L.P. v. Kenneth Cole Productions, Inc.*

By Jason Kee Low

I. Introduction

In *Holy Properties Ltd., L.P. v. Kenneth Cole Productions, Inc.*,[2] the Court of Appeals is widely regarded as having affirmatively held that the landlord-respondent had no duty to mitigate damages after an unjustifiable abandonment of the premises by the tenant.[3] However, the language in the opinion dealing with the termination of the conveyance and lease agreement may reasonably be interpreted to suggest otherwise. There potentially exists a duty to mitigate damages by a landlord, but subject to certain qualifications.

At issue in *Holy Properties* was a lease provision that presumably relieved the landlord of liability for failure to re-let the demised premises. The court interpreted the lease provision as having

1) expressly relieved the landlord of any duty to mitigate damages after abandonment by the tenant; and

2) permitted the landlord to hold the tenant liable for rent due under the lease.[4]

The tenant-appellant's ("Cole") first principal argument urged the court to depart from the well-settled New York approach[5] and adopt the contract rule of mitigation in the lease damages context as other courts have done.[6] Nevertheless, the court predicated its decision partly on the ground that in real property law "established precedents are not lightly to be set aside."[7] That is, venerable New York cases recognize leases as present transfers of estates in real property.[8]

Cole's second principal argument centered on the landlord's termination of the landlord-tenant relationship prior to commencing eviction proceedings.[9] Pursuant to the lease agreement, the landlord exercised a conditional limitation to terminate the lease upon the tenant's default. This effectively ended the conveyance, leaving only the contractual aspect of the lease. The tenant argued that, therefore, its liability was for contract damages only and that the landlord had a duty to mitigate in accordance with contract law.[10] Although the court acknowledged the conveyance had ended because of the eviction proceedings, it dispensed with this argument, citing that the lease contract expressly provided that the landlord was under no duty to mitigate damages.[11]

It is the court's approach in rejecting Cole's second principal argument that might necessitate a lease provision specifying no duty to mitigate before a landlord, who has terminated the lease, may assert such a claim. Accordingly, the primary focus herein will be on the issue of whether lease survival clauses are the decisive factor in a court's determination of whether to impose a duty to mitigate upon a landlord after the tenant defaults on the lease. If a lease survival clause is decisive, then there is a duty to mitigate absent such a clause where the landlord terminates the lease.

II. The Modern Landlord-Tenant Arrangement and Policy Reasons for Adopting a Mitigation Duty

The traditional rule of no mitigation, which regards leases as conveyances, conformed to the way the ancient farm lease operated.[12] The land itself was the subject of the lease, and any structures on it were incidental.[13] The tenant did not expect, nor was he provided with, any services from the landlord.[14] Since the landlord was absent from the land, the tenant was better equipped to make any repairs necessary and maintain the land.[15]

While it may have been better suited for agrarian societies, the traditional rule is dated and inconsistent with the contemporary landlord and tenant framework, which involves mostly urban property.[16] The modern urban lease is not for land, but is typically for space or part of the space in a building.[17] Such a lease necessarily includes a continuous flow of essential services from the landlord to the tenant, items that are not under the tenant's control.[18] For instance, the landlord controls a building's access, heating, lighting, air conditioning, elevator service, cleaning, and waste removal. Although landlord or tenant may be responsible for maintenance within the leased premises, neither expects the tenant to maintain the building's support structure, climate control, or electrical or plumbing systems.[19] The modern urban lease then, "contemplates no single unilateral act by landlord, but a continuous mutual exchange of consideration."[20] A lease can therefore be recognized as both a conveyance and a contract, which many courts and commentators have done.[21]

Notwithstanding the contractual nature of a lease, several policy reasons in favor of adopting a mitigation rule arguably outweigh the rationale underlying the traditional rule.[22] First, a duty to mitigate requirement would prevent landlords from needlessly accumulating damages[23] after a tenant's breach of a lease agreement, and thereby encourage the productive use of land. Favoring a mitigation duty for landlords upon a tenant's breach, the Colorado Supreme Court stated,

> Under traditional property law principles a landlord could allow the property to remain unoccupied while still holding the abandoning tenant liable for rent. This encourages both economic and physical waste. In no other context of which we are aware is an injured party permitted to sit idly by and suffer avoidable economic loss and thereafter to visit the full adverse economic consequences upon the party whose breach initiated the chain of events causing the loss.[24]

Second, physical damage to leased property from vandalism or by accident is less likely if the property is in use.[25] Third, the mitigation rule is consistent with the trend disfavoring contract penalties.[26]

> [A]llowing a landlord to leave property idle when it could be profitably leased and forcing an absent tenant to pay rent for that idled property permits the landlord to recover more damages than it may reasonably require to be compensated for the tenant's breach. This is analogous to imposing a disfavored penalty upon the tenant.[27]

It follows from the above that the modern contractual view of a lease has been accepted as common wisdom. However, it is notable that proponents of the modern view have overlooked the protection a lease as a conveyance affords a tenant if the landlord becomes insolvent. If a lease is regarded as a contract, the landlord's insolvency could compromise the tenant's possessory interest in the leased premises—that is, the trustee of an insolvent landlord's estate may reject any unexpired leases of real property. Nonetheless, section 365(h)[28] of the Bankruptcy Code provides for such a contingency in two ways:

1) by permitting the tenant to treat the lease as terminated by the rejection;[29] and
2) if the term of the lease has commenced, by permitting the tenant to retain its rights under the lease and remain in possession of the leased property.[30]

Additionally, the tenant is entitled to enforce any renewal terms included in the balance of the lease term.[31] Accordingly, the tenant would not be deprived of the estate for the term which the tenant bargained for. The tenant may also offset the rent reserved under the lease against damages caused by the rejection, but has no other remedy if it elects to retain its rights.[32]

In theory, therefore, section 365(h) of the Bankruptcy Code regards an unexpired lease of an insolvent landlord as a conveyance in order to preserve the tenant's proprietary interest in the leased premises, which would otherwise be trumped by the landlord's insolvency.

III. The Court's Holding and Its Potential Fallacy

In its analysis, the court stated that the landlord had three options when the tenant abandoned the premises prior to expiration of the lease.[33] The traditional no duty-to-mitigate rule is evinced in the first option—that the landlord could do nothing and collect the full rent due under the lease.[34] Second, the landlord could accept the tenant's surrender, re-enter the premises and re-let them for its own account.[35] Third, the landlord could notify the tenant that it was entering and re-letting the premises for the tenant's benefit.[36] Should the landlord undertake the third option, the rent collected would be apportioned first to repay the landlord's expenses in re-entering and re-letting and then to pay the tenant's rent obligation.[37] However, the court noted, New York law permitted the landlord to invoke the first option to take no action and hold the tenant liable for the rent for the entire lease period.[38]

Although the court is perceived to have affirmatively held that no duty to mitigate exists on the landlord's part because of the established rule mentioned above, a closer reading of the opinion with respect to the lease provision may invoke a very different conclusion. The court clearly noted that "[a]lthough an eviction terminates the landlord-tenant relationship, the parties to a lease are not foreclosed from contracting as they please. If the lease provides that the tenant shall be liable for rent after eviction, the provision is enforceable."[39] Given the court's mindful consideration of this lease provision in its analysis, it is reasonable to question whether the court would have found for the landlord-respondent if not for this lease provision. Perhaps the parties to a commercial lease in New York may not be subject to an absolute rule of no mitigation, but they may be subject to what is essentially a *default* rule that a landlord has no duty to mitigate damages. That is, after the landlord-tenant relationship terminates because the lessee defaults and the landlord thereafter terminates the conveyance, the landlord will have a duty to minimize damages, unless there is a lease provision relieving the landlord of such a duty.

A case directly on point with the proposition that a landlord's duty to mitigate is conditioned upon the parties' intentions in the lease agreement is the Texas case of *Metroplex Glass Center, Inc. v. Vantage Properties, Inc.*[40] There, the lessee sought to appeal a grant of summary judgment to the lessor for unpaid rentals due under a lease for commercial premises. The lessee appealed on the ground that the question of mitigation of damages was not established as a matter of law.[41] In response, the court specifically stated, "With respect to the contention that mitigation of damages was not established as a matter of law, no duty exists to mitigate damages unless that duty is imposed by the lease."[42] Therefore, the court held, since the lease between the parties imposed no affirmative duty to re-let the premises upon the lessee's abandonment, the lessor was under no obligation to mitigate damages by re-letting the abandoned premises.[43] Clearly, the court based its decision on the absence of a lease provision imposing the duty to mitigate, even though Texas adhered to the traditional no-mitigation rule at the time of *Metroplex*.[44]

A similar inference may be drawn from a 1996 Pennsylvania Superior Court opinion concluding that a landlord has no duty to mitigate damages. *Stonehedge Square Ltd. Partnership v. Movie Merchants, Inc.* involved an action brought by a landlord to recover unpaid rents following the tenant's breach of the lease.[45] The tenant vacated the leased premises in a shopping center prior to the expiration of the lease term. The trial court initially found that the landlord had no duty to mitigate damages, but reversed itself after granting the tenant's post-trial motion.[46] On appeal, the landlord raised the question of whether Pennsylvania law imposes a duty to mitigate on commercial lessors when the lessee breaches the lease.[47] The tenant argued that contract law governs landlord-tenant leases and imposes a duty to mitigate on the non-breaching party.[48] However, the court reasoned that contract law provided no relief to the tenant under the facts of that case, because the 37-page lease agreement did not contain a provision compelling the landlord to mitigate its damages upon the tenant's violation of the lease term. That said, the court went on to assert,

> It is well established that, "the law will not imply a contract different than that which the parties have expressly adopted." . . . This rule is particularly apt when reviewing a contract involving two parties of relatively equal bargaining power, as is generally the case in a commercial lease setting. The only exception to this rule is when the inclusion or absence of a contract term would be violative of public policy. . . . We find no such violation in this context, for the established law in Pennsylvania does not require that a landlord mitigate a tenant's damages.[49] (citations omitted).

While the court acknowledged that several lower courts had imposed a mitigation duty upon landlords in both residential and commercial lease contexts, the court still found for the landlord because Pennsylvania followed the traditional rule. Nevertheless, by having placed considerable emphasis on the lack of a lease provision for mitigation of damages and the contractual nature of a commercial lease, the court appears to have subjected the traditional rule to a qualification regarding lease clauses that dictate whether a landlord is required to mitigate damages. The Pennsylvania Supreme Court subsequently affirmed, on appeal, the Superior Court's holding in *Stonehedge*.[50]

In cases where the lease expressly provided that the landlord would have a mitigation duty if the premises were abandoned or vacated, courts have held that the landlord is obligated to do so. In *Harmon v. Callahan,* the Illinois Court of Appeals recognized that a landlord generally has no duty to mitigate damages by re-letting the premises upon a tenant's abandonment.[51] In taking the position that a lease is an executed contract, the court opined,

> It would seem to be the law that where a lease is made, and subsequently the premises are abandoned by the tenant, and following that there is merely a re-entry by the landlord, the original contract still stands and the tenant is liable on his promise to pay rent; that mere abandonment and re-entry do not cancel the lease; and, further, that, under such circumstances, the mere abandonment of the premises by the tenant and re-entry by the landlord does not give rise to an obligation on the landlord to endeavor to re-rent. . . . The tenant and the landlord fixed their obligations when the lease was made, and no subsequent *ex parte* conduct on the part of the tenant and mere re-entry by the landlord, which may be for the necessary preservation of the premises, should increase the obligations of the landlord.[52]

However, the court duly noted that *clause 7* of the lease expressly obligated the landlord to re-let the premises following the tenant's abandonment. Therefore, the clause distinguished *Harmon* from cases involving simple abandonment and re-entry. Under that provision, the court held that the landlord had a duty to re-let the premises with reasonable diligence. The court also stated,

> [A]fter re-entry, the landlord may by writing make himself

> liable to exercise diligence in re-renting, or he may re-enter and relet and be chargeable with the rents he actually obtains. But, in the absence of any such voluntary conduct, mere abandonment and re-entry do not oblige the landlord to endeavor, by affirmative action, to decrease the tenant's liability.[53]

On that account, *Harmon* further underscores the influence of lease survival clauses in a court's determination of any duty to mitigate on a landlord's part—even in 1919, when the anti-mitigation rule was staunchly followed by a majority of states.[54]

IV. Conclusion

Rather than fully resolving the confusion concerning a landlord's duty to mitigate damages, the court's opinion in *Holy Properties* tends to raise several key issues.

First, *Holy Properties* involved parties to a commercial lease, and the court did not characterize the duty with respect to residential leases. Remarkably, the court chose to not do so even though the landlord-respondent raised the issue in its brief and conceded that a mitigation duty was appropriate in the residential lease context.[55] Accordingly, it is possible the holding in *Holy Properties* may only be applicable to commercial leases;[56] the court emphasized the certainty of settled rules, particularly in business transactions.[57]

Second, the court acknowledged that the landlord-tenant relationship terminated when Holy Properties instituted summary eviction proceedings, but still held the tenant was liable for rent due under the lease. To reiterate, many courts and commentators view leases as both conveyances and contracts, and in contract law, the non-breaching party has a duty to mitigate its damages. The duty dissolves upon mutual agreement between the parties to discharge and terminate their duties under an existing contract, which constitutes a rescission. "If any contractual right to further performance under the contract or if any right to damages for a breach of the contract continues to exist, there has been no complete rescission. If all such rights have been discharged, there has been both 'rescission' and 'accord and satisfaction.'"[58] By not imposing a duty to mitigate upon the landlord, however, the court appears to have implicitly stated that the contract was terminated along with the conveyance, instead of being breached. If that were the case, there would have been no basis for holding Cole liable for rent payments, since contracts are based upon mutual obligations on the part of both parties.[59]

Third, the court's reliance upon Paragraph 18 of the lease in support of its holding is questionable. Paragraph 18 did not expressly abrogate the landlord's duty to mitigate, but only stated "Owner shall in no event be liable in any way whatsoever for failure to re-let the demised premises. . . ."[60] Arguably, if the law in New York were indeed well-settled with respect to the issue of mitigation, the court could have simply held that there was no duty to mitigate without even discussing Paragraph 18.

Provisions in lease agreements relieving a landlord of any duty to mitigate may therefore be a necessary antecedent to a landlord's position of having no mitigation duty. As evidenced by the aforementioned cases, lease survival clauses are apparently accorded greater consideration by courts over the well-settled law in determining whether a landlord was under a duty to mitigate. Accordingly, parties to a lease in New York, commercial or residential, should insist on a lease provision that expressly states in unequivocal terms whether there exists a duty to mitigate damages upon breach of the lease. At a minimum, such a provision would create certainty for parties to a lease and may serve to reduce litigation until the issue in New York is definitively resolved by the Court of Appeals, the Appellate Division, or through legislative action.

Endnotes

1. *Cf.* Samuel L. Clemens (a.k.a. Mark Twain, 1835–1910), is often quoted as having stated, "The reports of my death have been greatly exaggerated." BrainyMedia, *BrainyQuote*, Feb. 19 2002, at <http://www.brainyquote.com/quotes/quotes/m/q141773.html>.
2. 87 N.Y.2d 130, 661 N.E.2d 694, 637 N.Y.S.2d 964 (1995).
3. *See Whitehouse Estates v. Post*, 173 Misc. 2d 558, 662 N.Y.S.2d 982 (Sup. Ct. App. T., 1st Dep't 1997); *342 Madison Ave. Assocs. v. Suzuki Assocs.*, 187 Misc. 2d 488, 722 N.Y.S.2d 729 (Sup. Ct., N.Y. Co. 2001); *Duda v. Thompson*, 169 Misc. 2d 649, 647 N.Y.S.2d 401 (Sup. Ct., Westchester Co. 1996); *see also* Robert E. Parella, *Real Property, 1995-96 Survey of New York Law*, 47 Syracuse L Rev. 681 (1997).
4. *See Holy Properties*, 87 N.Y.2d at 135, 661 N.E.2d at 696, 637 N.Y.S.2d at 966.
5. Under New York law, if a tenant abandons the premises prior to the expiration of the lease, the landlord may do nothing and collect the full rent due under the lease. *See Becar v. Flues*, 64 N.Y. 518 (1876); *Underhill v. Collins*, 132 N.Y. 269, 30 N.E. 576 (1892); *In re Hevenor*, 144 N.Y. 271, 39 N.E. 393 (1894).
6. *See, e.g., Parkwood Realty Co. v. Marcano*, 77 Misc. 2d 690, 352 N.Y.S.2d 623 (N.Y.C. Civ. Ct., Queens Co. 1974); *Lefrak v. Lambert*, 89 Misc. 2d 197, 390 N.Y.S.2d 959 (N.Y.C. Civ. Ct., Queens Co. 1976), *modified*, 93 Misc. 2d 632, 403 N.Y.S.2d 397 (Sup. Ct. App. T., 2d & 11th Dep't 1978); *Forty Exchange Co. v. Cohen*, 125 Misc. 2d 475; *Paragon Indus. v. Williams*, 122 Misc. 2d 628; *Grays v. Brooks*, 148 Misc. 2d 646; *Syndicate Bldg. Corp. v. Lorber*, 128 A.D.2d 381, 512 N.Y.S.2d 674 (1st Dep't 1987); *Rubin v. Dondysh*, 146 Misc. 2d 37, 549 N.Y.S.2d 579 (N.Y.C. Civ. Ct., Queens Co. 1989), *reargument denied*, 147 Misc. 2d 221, 555 N.Y.S.2d 1004 (N.Y.C. Civ. Ct., Queens Co. 1990), *rev'd*, 153 Misc. 2d 657, 588 N.Y.S.2d 504 (Sup. Ct. App. T., 2d & 11th Dep't 1991); *Douglas Manor House v. Wohlfeld*, 66 Misc. 2d 265 (Sup. Ct. App. T., 1st Dep't 1970).
7. *Holy Properties*, 87 N.Y.2d at 134, 661 N.E.2d at 696, 637 N.Y.S.2d at 966.
8. *See Becar v. Flues*, 64 N.Y. 518 (1876); *Reichart v. Spiess*, 203 A.D. 134, 196 N.Y.S. 466 (2d Dep't 1922); *Centurian Dev. v. Kenford Co.*, 60 A.D.2d 96, 400 N.Y.S.2d 263 (4th Dep't 1977).

9. *See Holy Properties*, 87 N.Y.2d at 135, 661 N.E.2d at 696, 637 N.Y.S.2d at 966.

10. *See id*.

11. *See id.* at 134, 661 N.E.2d at 696, 637 N.Y.S.2d at 966.

12. *See generally,* Milton R. Friedman, Friedman on Leases § 1.1 (4th ed. 1997).

13. *See id.*

14. *See id.*

15. *See id.*

16. *See* Edwin Smith, Jr., Comment, *Extending the Contractual Duty to Mitigate Damages to Landlords When a Tenant Abandons the Lease,* 42 Baylor L. Rev. 553, 554 (1990).

17. *See* Friedman, *supra* note 12.

18. *See id.*

19. *See id.*

20. *Id.* at 7.

21. *See Bernstein v. Seglin*, 184 Neb. 673, 171 N.W.2d 247 (1969). Emphasizing the contractual aspects of the modern lease, the court stated, "A modern lease of a business building ordinarily involves multiple and mutual running covenants between lessor and lessee." Similarly, in *Jackson v. Pepper Gasoline Co.*, 280 Ky. 226, 133 S.W.2d 91 (1939), the court stated, "The lease from appellant to appellee is a bilateral contract, since there are mutual promises between the parties to the lease." *See also* Robert Schoshinski, American Law of Landlord and Tenant § 1.1 (1980).

22. *Schneiker v. Gordon*, 732 P.2d 603 (Colo. 1987).

23. The landlord's damages in *Holy Properties* amounted to $718,841.51.

24. *Schneiker*, 732 P.2d at 610.

25. *See id*.

26. *Austin Hill Country Realty v. Palisades Plaza,* 948 S.W.2d at 293, 298, 40 Tex. Sup. J. 924, 75 A.L.R.5th 647 (1997) (citing text).

27. *Reid v. Mutual of Omaha Ins. Co.*, 776 P.2d 896, at 905–906. Note, however, that it may be unlikely that a landlord would deliberately act in this manner in the context of modern property realities; this is especially applicable to residential property situations where rent control is a factor.

28. 11 U.S.C. § 365(h) (2000) provides, in pertinent part:

> (h)(1)(A) If the trustee rejects an unexpired lease of real property under which the debtor is the lessor and—(i) if the rejection by the trustee amounts to such a breach as would entitle the lessee to treat such lease as terminated by virtue of its terms, applicable nonbankruptcy law, or any agreement made by the lessee, then the lessee under such lease may treat such lease as terminated by the rejection; or
>
> (ii) if the term of such lease has commenced, the lessee may retain its rights under such lease (including rights such as those relating to the amount and timing of payment of rent and other amounts payable by the lessee and any right of use, possession, quiet enjoyment, subletting, assignment, or hypothecation) that are in or appurtenant to the real property for the balance of the term of such lease and for any renewal or extension of such rights to the extent that such rights are enforceable under applicable nonbankruptcy law.
>
> (B) If the lessee retains its rights under subparagraph (A)(ii), the lessee may offset against the rent reserved under such lease for the balance of the term after the date of the rejection of such lease and for the term of any renewal or extension of such lease, the value of any damage caused by the nonperformance after the date of such rejection, of any obligation of the debtor under such lease, but the lessee shall not have any other right against the estate or the debtor on account of any damage occurring after such date caused by such nonperformance.

29. *See id.* § 365(h)(1)(A)(i).

30. *See id.* § 365(h)(1)(A)(ii).

31. *See id*.

32. *See id.* § 365(h)(1)(B).

33. *See Holy Properties*, 87 N.Y.2d at 135, 661 N.E.2d at 696, 637 N.Y.S.2d at 966.

34. *See id*.

35. *See id.*

36. *See id.*

37. *See id.*

38. *See supra* note 5.

39. *Holy Properties*, 87 N.Y.2d at 134, 661 N.E.2d at 696, 637 N.Y.S.2d at 966.

40. 646 S.W.2d 263 (Tex. App. 5th Dist., 1983).

41. *See id*.

42. *Id*. at 265.

43. *See id*.

44. The Texas Supreme Court explicitly adopted a mitigation rule 14 years later in *Austin Hill*, but consistent with its view that a lease is both a conveyance and a contract, indicated that the landlord and tenant may contract otherwise. *See Austin Hill, supra* note 26, at 299.

45. 454 Pa. Super. 468, 685 A.2d 1019 (1996).

46. *See id.* at 479–80, 685 A.2d at 1015.

47. *See id.* at 479, 685 A.2d at 1014.

48. *See id.*

49. *Id.* at 479–80.

50. 552 Pa. 412, 715 A.2d 1082 (1998).

51. 214 Ill. App. 104 (1919).

52. *Id.* at 108, 109.

53. *Id.*

54. *See id.*

55. The landlord-respondent asserted that, "[t]he dual concerns—shortage of housing and unequal bargaining power—which *fuel the engine of tenant protection in the residential sphere* simply do not exist in the commercial context." Respondent's Brief at 50 (emphasis added).

56. In *Whitehouse Estates v. Post*, 173 Misc. 2d 558, 662 N.Y.S.2d 982 (Sup. Ct. App. T., 1st Dep't 1997), the court applied the anti-mitigation holding from *Holy Properties* to a residential lease. However, other lower New York courts not bound by the Appellate Term, First Department, could, theoretically, recognize the landlord's duty to mitigate by distinguishing *Holy Properties* from cases involving residential leases. *See Parkwood Realty Co. v. Marcano*; *Lefrak v. Lambert, supra* note 6.

57. *Holy Properties*, 87 N.Y.2d at 135, 661 N.E.2d at 696, 637 N.Y.S.2d at 966.

58. Arthur Corbin, Corbin on Contracts § 1236, at 533 (1964).

59. Cole argued that Paragraph 18 of the lease provided that tenant was liable for damages and not rent in the event the lease was canceled as a result of re-entry or summary eviction proceedings by the landlord. Paragraph 18 stated the tenant was liable for rent up until the landlord brought such actions. *See* Appellant's Brief at 26, 27.

60. *Id*. at 26.

Jason Kee Low is a third-year law student at St. John's University School of Law. **The author wishes to sincerely thank Professor Robert M. Zinman for his guidance and uncommon wisdom.**

Real Estate Developers: Don't Buy the Farm!

By John D. Kern

Farmland and open space in rural America is disappearing at an estimated rate of 35,000 acres per week and roughly five million acres yearly.[1] As a result, many communities have felt it necessary to pursue legislative and legal venues to protect their farmland and open spaces from the marketplace of real estate speculators and developers, and the desire of property owners to sell their land to the highest bidder. Real estate developers should be aware of a growing number of legislative incentives to protect agricultural land that may adversely affect entrepreneurs. This has created palpable tension between many local communities and real estate developers and caused many headaches for attorneys.

One of the most prevalent examples of this tension in New York State is in the area of Suffolk County, Long Island. In Suffolk County, it is estimated that between 11,000 and 15,000 acres of farmland a year are lost to development.[2] Some feel this is reaching crisis proportions, especially considering that agriculture in New York State produces in excess of $3 billion gross income for the state.[3]

The Constitution of the State of New York provides as a policy the preservation of natural resources and scenic beauty. Article XIV states: "The policy of the state shall be to conserve and protect its natural resources and scenic beauty and encourage the development and improvement of its agricultural land for the production of food and other agricultural products."[4] To carry out this policy, the Legislature has enacted laws and statutes to address taxation issues, establish a farmland protection trust fund, bar nuisance actions against farmers, sever and sell development rights, transfer development rights, allow municipalities to acquire open spaces to preserve the "character of the community" and quality of life, and create conservation easements.[5] This article will analyze the extent of intrusion that legislative initiatives place on the ability of real estate developers to pursue their projects. Attorneys who have a better understanding of these zoning laws and statutes will better serve their clients. This will allow the developer to work well with the community, establishing his goodwill, and paving the way for future projects. It is a pre-requisite to have an understanding as to why and how these lands can be preserved, the importance of doing so, and how attorneys and their clients can work within the regulations.

"The agricultural industry provides both economic and environmental benefits to the local economy."

The Importance of Preserving Agricultural Land

> *While the farmer holds title to the land, actually, it belongs to all the people because civilization itself rests on the soil.*[6]
>
> —Thomas Jefferson

It is, first, important to understand why communities want to preserve their farmlands and open spaces, from an economic perspective. Farm, forest and, open lands cost the local community an average of $.37 per acre in community services, as opposed to $1.15 per acre for residential development.[7] Protecting farmland in critical areas such as flood plains can reduce the costs associated with drainage projects.[8] Along the same line, nearly one-third of all the irrigated farmland in New York State is located in Suffolk County. This permits the state farming industry to sustain itself in times of drought.[9] Other industries are also dependent upon the farming industry. These include suppliers, marketers, and, particularly in Suffolk County, the tourist industry. Every summer thousands of people flock to the area due to its particular rural and farming character. The Suffolk County Planning Commission estimates that the tourist industry has grown into a $2 billion industry. This would hardly be the case if the entire area were turned into some sort of east coast Malibu Beach. It is therefore essential that people recognize that preserving farmland and rural character is necessary to preserve the $2 billion tourist industry. There are also other inter-related agricultural industries that depend on farming such as equipment sales and rentals, farm centers such as Agway stores, veterinary services and products, and seed fertilizers.[10] Bearing these factors in mind, it is easy to see why development in Suffolk County has become a touchy subject.

The agricultural industry provides both economic and environmental benefits to the local economy. Farmland works as a protection of wildlife habitat in that its use is compatible with wetland protection and stormwater filtering, thus saving the state time and money in wildlife preservation projects and public works. This gives the legislature a strong incentive to restrict development.

However, suburban land values average 1,800 percent more when utilized for building purposes as opposed to cultivation or grazing.[11]

In addition, New York farmers pay the highest per-acre tax of any agricultural state.[12] The fact of the matter is that farmland is readymade for development. It is flat, contiguous, has proper drainage, and has already been cleared of vegetation and tree stumps. One of the purposes of many of the zoning techniques is to continue to make farming an attractive economic pursuit by protecting the farmer's equity in his land, providing tax incentives and a certain degree of judicial immunity, particularly from nuisance suits.

Techniques of Farmland Preservation

Having a working knowledge of the various preservation techniques will allow an attorney to better understand how to work within the zoning laws, saving both time and clients' money. It will also permit the attorney and the client to arrive at a meeting of the minds and a closing of the development deal in a more expeditious fashion or, as we shall see later, a transferring of the deal to an area where it is more needed.

Conservation Easements

A conservation easement is a voluntary restriction placed on a landowner's property for the purpose of providing for the conservation, protection, and preservation of open space, natural, historic and cultural resources.[13] An agricultural conservation easement is defined as a voluntary legally recorded agreement between the landowner and a qualified conservation organization that restricts land to agriculture and open spaces. Landowners sell agricultural conservation easements to a private conservation or government agency. This is also called a purchase of an agricultural conservation easement or "PACE" and is designed specifically to protect farmland. Its purpose is to limit the practice of subdividing and development. This is a very flexible tool and is usually combined with another administrative program such as a transfer of development rights (TDR) or a purchase of development rights (PDR), explained later in this article. A conservation easement can also be donated to a charitable organization for significant tax benefits to the landowner.[14]

Further tax benefits are that the easement decreases the value of the property, thereby decreasing the amount of property and estate taxes that must be paid.[15] The easement decreases the value of the land, thereby decreasing the amount of estate taxes that the family must pay. This helps to keep the family farm in the family, and not force the beneficiaries to sell off some of the land to pay the taxes.[16]

"The fact of the matter is that farmland is ready-made for development. It is flat, contiguous, has proper drainage, and has already been cleared of vegetation and tree stumps."

A similar type of conservation easement is the transfer development rights or TDR program. The concept behind the TDR program is that a landowner who is in a regulated area, the regulations of which restrict development, may sell the development rights to a developer. The developer in turn will then use these rights to build in an area where such development is more appropriate and needed. When development rights are transferred from one piece of property, the land is then restricted with a permanent agricultural conservation easement.[17] The price of the development rights is equal to the reduction in the market value of the land resulting from the removal of the development rights. This would be the difference between the value of the land for agricultural or open space, and its current market value.[18]

In New York, a TDR program is governed by statute. A municipality has the authority to designate the various sending and receiving zones for the development rights as long as it follows a "comprehensive plan." The zoning board must assure the fact that the area designated as a receiving zone to where the rights will be transferred (1) has adequate facilities, (2) that there will not be an adverse environmental impact, and (3) that development is permissible within the district.[19] There are various manners in which the development rights are defined, based upon the methods in which development is controlled. There may be floor-to-area ratios (FAR), height allowances, or lot size allowances. It is also important to look at the regulations within the particular district. The purchasing developer may not be able to use all of his rights in one district.[20] The advantage of TDR programs is that they permit the landowner to benefit financially, allow the developer to develop, and at the same time preserve open space and/or agricultural use of the land. The farmer receives compensation, and an easement protecting the land is in place without having to implement a regulatory scheme which might otherwise amount to a taking. Zoning regulations do not necessarily address the fairness issue for the landowner. Since TDR programs require the voluntary participation of the landowner, the fairness problem is significantly resolved.

A purchase of development rights program or PDR is similar to a TDR program, except that a government body, as opposed to a private individual or business entity, purchases the landowner's development rights creating a conservation easement.[21] This is also a voluntary program. It is much less of an economic burden to the government entity because it is only purchasing a part of the land as opposed to purchasing the entire land for its full market value. Unfortunately for the developer, once the government entity purchases the development rights they will not be sold to the developer. In New York State, preservation of open space is a statutorily permitted purpose, unless it can be shown that a statute was enacted for an improper purpose.[22] Therefore, if a developer's attorney receives knowledge of a PDR about to occur, he should recognize it as an opportunity and start negotiating for a TDR in his client's favor. Municipalities are open to this, as it shifts the economic burden of land preservation to the private sector.

Suffolk County was the first local municipality to enact a PDR program to protect its farmland.[23] It is based upon New York General Municipal Law § 247(2) which states:

> The acquisition of interests or rights in real property for the preservation of open spaces and areas shall constitute a public purpose for which public funds may be expended or advanced, and any county, city, town or village after due notice and public hearing may acquire by purchase . . . development right, easement, covenant, or other contractual right necessary to achieve the purposes of this chapter, to land within such municipality.

The statute gives local governments explicit authority to purchase interests in private land condemning it for the purpose of preserving farmland for agriculture, or open spaces, and restricting its nonagricultural use. The restriction is a negative instrument in gross. It is then recorded with the property deed as a covenant that runs with the land. The buyer (in this case a local government) then has the rights and responsibility to prevent development on the land. The landowner still retains all other rights with the exception that he cannot build on the land. Some exceptions are allowed to permit farm-related structures on the land.[24] The PDR is also a more permanent mechanism than zoning. Zoning is often subject to the whims of political pressure, and can change at almost any time and for almost any reason.

"[I]f a developer's attorney receives knowledge of a PDR about to occur, he should recognize it as an opportunity and start negotiating for a TDR in his client's favor. Municipalities are open to this, as it shifts the economic burden of land preservation to the private sector."

PDR programs are not without their problems. Although cheaper than buying all of the farmer's land, funding is always a problem. The results of the PDR programs (and TDR programs as well) often produce fragmented conservation easements. This is to say the easements are spread out sporadically and do not follow a cohesive contiguous plan.[25] There has been some discussion in county legislatures of allowing the sale of a PDR, but this is little more than just talk.

A relatively new solution is a lease of development rights program or "LDR." In an LDR, the farmer gives up his right to develop on the land for a period of time in exchange for a yearly lease. This helps spread the costs of the easement for the municipality. The farmer still has the value of his equity in his land because the development rights are not completely lost. They are merely suspended for the time period of the lease; likewise, however, the land is only preserved for the time period of the lease. In addition, if the municipality cannot maintain its lease payments, the land returns to the farmer along with the right to develop it.[26] Knowing when these leases expire will allow an attorney to seize a valuable business opportunity for a client.

Agricultural Districts

Agricultural districting is a plan that is authorized at the state level and enacted at the local level. It permits a landowner or group of landowners to take advantage of various land preservation techniques (such as PDRs and TDRs) by voluntarily designating their land as an agricultural district, participating in the TDR or PDR program, and retiring the land from development possibilities. This is more advantageous than having regulations forced upon them through zoning ordinances.[27] Agricultural districts provide many benefits to landowners. One such benefit is eligibility for differential tax assessments. This will allow for lower tax assessments and may also exempt the farmer from further special tax assessments. Some districts require the landowners to sign an agreement that prohibits development for the term of the enrollment.[28] If the landowners break the agreement, many districts impose severe financial penalties.[29] New York, for example, imposes a penalty of five times the tax saved in the last year in which the land benefited from the special agricultural assessment.[30]

A landowner wishing to participate must first apply to the local government. The local government then reviews and approves the application. The application is then sent to the state government for final approval. State governments often require that the local municipality already have a plan in place to protect the agricultural land, such as a

PDR or TDR, before the landowner may file the application.[31] If a developer feels he has found an opportunity the viability must be cross-checked to see if the area is under an agricultural districting plan. If the developer unwittingly violates the district plan and the agreement there will be severe monetary penalties incurred. Unless the developer is willing to pick up the monetary penalties from violating the district plan and the agreement (in New York, five times the amount of tax saved in the last year) pursuing the opportunity would be an exercise in futility. The economic penalties are simply too strong.

Agricultural Protection Zoning

In most states, agricultural protection zoning or (APZ) is implemented at the county level. However, towns and townships may also have APZ programs. Early agricultural zoning programs were based on the traditional or Euclidean zoning method. The Euclidean principle is governed by the concept that zoning extremes should be separated from one another, if not by natural features or surface infrastructures, then perhaps by intervening medium-intensity zones.[32] It is driven by both the aesthetic and the compatible. This became known as cumulative zoning. This meant that all higher or more preferred uses are permitted in lower categories in order to create the separation.[33] Agricultural use was ranked at or near the bottom. Therefore, as was often the case, residential or commercial dwellings were erected in agriculturally zoned areas adjacent to farms despite their incompatibility. The result was often nuisance suits. This would in turn lead farmers, who after finding that farming was no longer profitable or enjoyable, to sell their farms to developers for the higher uses.

Today, zoning ordinances are more non-cumulative. The higher or more preferred use (i.e., residential) is not permitted in the lower category (i.e., agricultural). All of the specified use of the zone is dedicated exclusively to the designated use. Therefore, if the area is zoned for agricultural use, the land can only be dedicated to agriculture and other closely related uses.[34] In New York State, to overcome the zoning use, or to get a variance, a landowner must establish practical difficulties of unnecessary hardship or significant economic injury.[35] The records must show that: (1) the land in question cannot yield a reasonable return if used only for the purpose allowed in that zone, (2) the plight of the owner is due to unique circumstances and not to the general conditions in the neighborhood which may reflect the unreasonableness of the zoning ordinance itself, and (3) the use to be authorized by the variance will not alter the essential character of the locality.[36] Some jurisdictions have held that the challenger must overcome the presumption of the validity by showing that there is no relation to the public health, safety, or welfare.[37] Agricultural zoning has also withstood Fifth Amendment challenges as it has been considered a valid exercise of police power for a governmental entity.[38]

Despite the appearance of durability, agricultural zoning has been challenged and overcome through petitions and political pressure. The controversy generally settles around the issue of "downzoning." When an APZ ordinance is enacted, it results in a reduction of permitted residential densities in the new zone. This reduction is called downzoning, and invariably results in the reduction of the market value of land.[39] "Upzoning" is the opposite. This is when more residential dwellings are permitted in the area. Petitions for upzoning or rezoning of farmland have been successful. APZs do, however, remain as the method most commonly used in the United States for preventing the conversion of agricultural land to nonagricultural uses.[40]

The concern for communities in maintaining large blocks of farmland is to preserve what is called the critical mass of agricultural land. This is the threshold of land that must not be developed in order to ensure that there will be enough farmland to support the local industries that service it.[41] A properly executed APZ is a substantial hurdle for development in that it places a substantial restriction on the development potential of large tracts of land.

Buffer Zones

Buffer zones are also a common zoning technique used in America today. They are similar to the Euclidean method in that their purpose is to separate designated zoning areas from one another by supplying a natural progression from one type of zoning to another. Certain types of industrial commercial uses, or possibly even high-rise residential buildings, are simply not appropriate for residential communities, and therefore need to be separated.[42]

In cluster zoning, the purpose is to meet the maximum amount of density allowed on a particular tract of land. Improvements are also placed on the tract so as to allow the preservation of open space or buffer areas on certain borders. This way the new development does not abut the agricultural land. However, often this land is owned by the developers or homeowners' association.[43] Property owners may object to renting their open space to farming operations because of the various nuisances with which farming is associated. Oftentimes the land itself is simply not large enough for a farmer to support large commercial agricultural operations.[44] The end result is often one which serves well to preserve open spaces for the enjoyment of the residents, but is not necessarily an effective tool to preserve farmland.

A technique similar to cluster zoning is the planned unit development (PUD). The PUD allows for residences in which people can live combined with open spaces, recreational areas, and convenience, commercial, business and professional buildings.[45] This protects the adjacent farmland from being developed to support the various services necessary for a community's survival. Like cluster zoning, the buffered areas that are not built upon can be placed between the community of residences and the nearby farmland. This provides greater protection for the farms and prevents any possible nuisance issues. The main opposition to the PUD is that it conflicts with the traditional zoning of separation of uses.[46] It is still, however, embraced by many states and communities as a technique to permit proper and compatible use of land. It allows for preservation, while still providing people with places to live and the services necessary to sustain a community.

For the PUD to work effectively, it must be combined with a floating zone program. This is to say that the zoning ordinance is held back to "float" until an appropriate use and location for the development can be figured out. Once the proper use is defined, however, the ordinance is then mapped. This could create problems in a community, particularly if certain neighbors end up with a commercial or industrial use abutting their property. If the abutting use becomes significantly inconsistent, an issue of spot zoning may arise.[47]

A result that often accompanies cluster zoning and PUDs is open space zoning. The concept is that the adjoining farmland or open space is simply zoned as unavailable for development.[48] This, however, is a very extreme measure, and invariably affects the market value of the land. The end result may often be considered a taking if the landowner suddenly finds his land zoned out of any possible higher use. This would in turn require compensation from the local municipality, which many small communities can ill afford.

Discouraging the development of the land by affecting the market value is often done through a technique of large lot zoning. This is done by establishing high minimum lot acreage for development. In some cases, the lot size may be as high as 160 acres.[49] Needless to say, this may also result in an adverse effect on the market value of the land and bring about a takings issue.

Accessory Uses

If a farmer is able to realize significant economic benefits from his land, he will be much less likely to sell it to developers. Agriculture & Markets Law § 305-a(1)(a) states that "local governments, when exercising their powers to enact and administer comprehensive plans and local laws . . . shall not unreasonably restrict or regulate farm operations within agricultural districts in contravention of the purposes of this article unless it can be shown that the public health or safety is threatened." Allowing a farmer to use the land for something other than the specific use of farming to realize economic gain may accomplish this benefit. This can be done through a policy of accessory uses. Such accessory uses may include limited commercial uses such as opening shops or stands or farmers' markets. Permitting the farmer to use a dwelling for a bed and breakfast to take advantage of the tourist industry is another possibility. Some municipalities have even permitted farmers to have low-level apartment houses on their property which they may rent out to tenants.[50] The advantage of this technique is that it permits the farmer to realize significantly more economic gain in a more subtle way. It serves a dual purpose of preserving the farmland while at the same time addressing the public's concern for the character of the community. In a recent Court of Appeals decision, *Town of Lysander v. Paul Hafner*,[51] a farmer in Onondaga County was allowed to keep singlewide mobile home structures on his property to house farm workers. The Supreme Court and the Appellate Division had granted summary judgment to the town enjoining Farmer Paul from using mobile homes without building permits and certificates of occupancy. The lower courts had held that section 305-a(1)(a) did not create an exemption from local zoning authorities or ordinances for all "farm operations," and that the statute did not provide any protection to "farm residential buildings," including mobile homes.[52] The Court of Appeals, however, reversed and granted Mr. Hafner summary judgment. The higher court looked to the legislative intent of section 303, which gave county legislative bodies the power to create agricultural districts. The Court held that lands falling within those "agricultural districts" may be entitled to various statutory protections and benefits. According to section 301(11), buildings located on farms may be considered part of farm operation. The legislative history supports the view that the statute was amended in 1997 to strengthen, not limit, the protections against unreasonably restrictive local laws and ordinances. The Town failed to make any evidentiary showing that an absolute ban on singlewide mobile homes was needed because the public health or safety was threatened. The Court went on to hold that "farmers rely on mobile home housing for their farm laborers to accommodate the long work day, seasonal housing needs and to address the real shortage of rental housing in rural areas. Local government prohibitions or restrictions on the use of mobile homes can significantly impair the viability of farm operations."[53] This is a big victory for farmers, allowing them an accessory use that will facilitate their industry.

Whichever technique is used, the municipality, landowner, and the developer must bear in mind that zoning is a valid excise of authority. The concept of property ownership is one of a bundle of rights. Some rights belong to the property owner and some to the municipality representing the community interests as a whole. Property owners are not permitted simply to do as they see fit with their land. Simply because an individual purchased farmland at a low price 30 years ago, does not mean that he or she has the right to sell it to the highest bidder to build the East Quogue Trump Taj Mahal.

> *"Simply because an individual purchased farmland at a low price 30 years ago, does not mean that he or she has the right to sell it to the highest bidder to build the East Quogue Trump Taj Mahal."*

Conclusion

Should one buy the farm for development? One needs to be fully aware of what one is getting into. Zoning is a very strange animal. The attorney may even better serve his client's interest by enlisting local counsel when attempting to deal with zoning issues and trying to recognize opportunities at a local level. Many a competent real estate or transactional attorney who handles many diverse real estate matters for a client has run into trouble when it comes to dealing with zoning boards and municipalities. Being familiar with how to navigate through the sea of complex rules, political issues, and sometimes egos, will help an attorney to better serve his client and facilitate matters for the client in future deals.

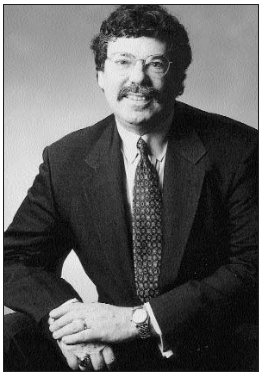
Endnotes

1. Julian Conrad. Juergensmeyer & Thomas E. Roberts, Land Use Planning and Control Law (1998) (hereinafter "Juergensmeyer").
2. Telephone interview with Kevin MacDonald, Vice-President, The Group For The South Fork, (Aug. 2, 2001) (hereinafter "MacDonald interview").
3. *American Farmland Trust*, *Agricultural and Farmland Protection for New York*, at http://www.farmland.org (hereinafter "American Farmland Trust").
4. N.Y. Const. art. XIV, § 4.
5. Sean F. Nolon & Cozata Solloway, *Preserving Our Heritage: Tools to Cultivate Agricultural Preservation in New York State*, 17 Pace L. Rev. 591 (1997).
6. Sam Sheronick, *The Accretion of Cement and Steel onto Prime Iowa Farmland: A Proposal for a Comprehensive State Agricultural Zoning Plan*, 76 Iowa L. Rev. 583 (1991).
7. American Farmland Trust, *supra* note 3.
8. David L. Szlanfucht, *How to Save America's Depleting Supply of Farmland*, 4 Drake J. Agric. L.333 (1999).
9. Agricultural & Farmland Protection Plan, Suffolk County, Executive Summary (1998).
10. Nolon, *supra* note 5.
11. Juergensmeyer, *supra* note 1 at 597.
12. 17 Pace L. Rev. 591.
13. N.Y. Envtl. Conserv. Law § 49-0203(1)(3) (McKinney 2001).
14. American Farmland Trust, *supra* note 3.
15. Nolon, *supra* note 5.
16. *Id.*
17. American Farmland Trust, *supra* note 3.
18. Patricia Salkin, Zoning and Land Use Control, Land Acquisition Programs § 56.04 (2001).
19. New York Town Law § 261-a(2)(a).
20. Salkin § 56.04, *supra* note 18.
21. *Id.*
22. *North Shore Unitarian Universalist Society v. Incorporated Village of Upper Brookville*, 110 A.D.2d 123, 493 N.Y.S.2d 564, 565 (2d Dep't 1985).
23. Mark R. Riely, *Evaluating Farmland Preservation Through Suffolk County, New York's Purchase of Development Rights Program*, 18 Pace Envtl. L. Rev. 197 (2000) (citing Local Law 19-1974. Now codified as Local Law 16 in Chapter 8 of The Suffolk County Code).
24. American Farmland Trust, *supra* note 3.
25. Riely, *supra* note 23.
26. *Id.*
27. *Id.*
28. American Farmland Trust, *supra* note 3.
29. *Id.*
30. Juergensmeyer, *supra* note 1 (citing N.Y. Agric. & Mkts. Law § 306).
31. American Farmland Trust, *supra* note 3.
32. David Callies, Robert H. Freilich & Thomas E. Roberts, Cases and Materials on Land Use, 3d Edition (1999) (hereinafter "Land Use").
33. Juergensmeyer, *supra* note 1 at 618.
34. *Id*.
35. *In re Doyle*, 79 N.Y.2d 592, 597, 584 N.Y.S.2d 417 (1992).
36. *Mignon M. Otto v. Albert Steinhilber*, 282 N.Y. 71, 73 (1939).
37. William Weinstein, Zoning and Land Use Control, Discrimination and Exclusion in Zoning § 3.01 (2001).
38. *Id.*
39. American Farmland Trust, *supra* note 3.
40. Nolon, *supra* note 5.
41. American Farmland Trust, *supra* note 3.
42. *Village of Euclid et al. v. Amber Realty Co.*, 272 U.S. 365, 384 (1926).
43. Juergensmeyer, *supra* note 1 at 623.
44. American Farmland Trust, *supra* note 3.
45. Juergensmeyer, *supra* note 1.
46. *Id.*
47. Land Use, *supra* note 32 at 136.
48. American Farmland Trust, *supra* note 3.
49. Juergensmeyer, *supra* note 1 (citing *Wilson v. County of McHenry*, 92 Ill. App. 3d 997, 416 N.E.2d 426 (1981)).
50. American Farmland Trust, *supra* note 3.
51. *Town of Lysander v. Hafner*, 96 N.Y.2d 558, 733 N.Y.S.2d 358 (2001).
52. *See id.* at 562–563.
53. *Id.* at 564 (quoting the conclusions of the Commissioner of Agriculture and Markets).

John D. Kern will receive his J.D degree from St. John's University School of Law in June of 2002. He is a student co-editor in chief of the *New York Real Property Law Journal*. This article is based on a term paper written for Professor Patrick J. Rohan, Dean Emeritus at St. John's University School of Law, for his course in Land Use and Planning.

Non-Judicial Foreclosure Renewed in New York

By Bruce J. Bergman



Who was waiting with bated breath for this one? Servicers of commercial loans, perhaps; servicers of residential loans, perhaps not. (May we opine that it should be all mortgage lenders and attorneys who represent them?) But there is a value in knowing that the procedure exists in New York—even to recognize that it *may* have limited application.

To immediately address the first point, non-judicial foreclosure came to New York (hallelujah) on July 7, 1998. It was to be effective, however, only until July 1, 2001. Not surprisingly, on June 29, 2001, the New York State Legislature extended the statute (RPAPL Article 14) to July 1, 2005.

So, non-judicial foreclosure goes on in New York. How much does it matter?

Lenders who originate and service mortgage loans throughout the country are gleefully aware that in almost half the states, speedy non-judicial or power of sale foreclosure is the preferred method. These lenders are likewise, but painfully, aware that in a majority of states, time-consuming and expensive *judicial* foreclosure is the path to enforce a defaulted mortgage. And New York has always been among the most difficult states in the judicial category.

So, New York made an attempt in 1998 to ease the process. The details of why that effort did not achieve expectations are too lengthy to address here, so reference will be made to a more expansive source.[1]

In short, though, a main problem with non-judicial foreclosure in New York is that it is available only for non-residential properties. Even as to commercial properties which *are* covered by the statute, there is much room for a borrower to thwart the procedures.[2] In the end, probably the best use of non-judicial foreclosure is in *consensual* commercial cases.

The genesis of what became the new Article 14 was the labor of a New York State Bar Association task force intending to shortcut the time-consuming judicial foreclosure process generally in New York State. Although large commercial foreclosures in particular tended perhaps to suffer unduly from protracted delays, there was no intention by the state bar to confine the prospective streamlined statute to commercial cases and exclude residential foreclosures. When the state bar draft went through the legislative process, however, residential properties were excluded as subjects for non-judicial foreclosure. Although the statute is not labeled as applying essentially to non-residential properties, such is its actuality. In the New York State Senate Memorandum in Support of Bill Number S.4784A (the 2001 extension of the statute until 2005), the purpose of the bill was recited as being "to extend the provisions of Article 14 of the Real Property Actions and Procedures (sic) law, which provides for the foreclosure of certain commercial mortgages by power of sale."

Given the statute's somewhat limited breadth, maybe all this is small comfort. But at least for what it is worth, non-judicial foreclosure continues to exist (although not thrive) in the Empire State.

Endnotes

1. See 1 Bergman on New York Mortgage Foreclosures, § 8.03, "Exceptions and Impediments to Power of Sale Foreclosure" (Matthew Bender & Co., Inc., rev. 2002).
2. *Id.*

Mr. Bergman, author of the three-volume treatise, *Bergman on New York Mortgage Foreclosures*, Matthew Bender & Co., Inc. (rev. 2002), is a partner with Certilman Balin in East Meadow, New York, an Adjunct Associate Professor of Real Estate with New York University's Real Estate Institute where he teaches the mortgage foreclosure course and a special lecturer on law at Hofstra Law School. He is also a member of the USFN and the American College of Real Estate Lawyers.

New York State Bar Association Committee on Professional Ethics

By Peter Coffey

On February 1, 2001, the New York State Bar Association Committee on Professional Ethics issued Opinion 737, establishing a bright line approach regarding the issuing of escrow checks against "undeposited or uncleared client funds." The Committee's decision was as follows: "A lawyer may not issue a check from an attorney escrow account drawn against a bank or certified check that has not been deposited *or* has not cleared." (Emphasis supplied). In my opinion the "*or*" should either read "*and*" or be omitted entirely as the mention of a deposit is not crucial (checks cannot clear unless they are deposited!). In simple terms, the Committee requires that the check clear—i.e., that funds be in the account as a result of the negotiation of the instrument. Surely the Committee is not saying that simply depositing is sufficient. I do not believe the language really indicates nor did the Committee in any way intend to have that sentence read "either/or." However the use of the word "or" does give a potential reading to the sentence of that nature.

RULE 1: There is nothing which will excite the passions of Disciplinary Committee attorneys more than a perceived problem with an escrow account. In this discussion always remember Rule 1 and remember Corollary 1 to Rule 1. In their excitement disciplinary attorneys cannot restrain themselves to limiting examination or investigation to the problem at hand. Examination of every conceivable aspect of your escrow account activity for the entire length of your practice is the desire of this excited disciplinary attorney. (I understand the seven (7) year rule—not all the desires of even disciplinary attorneys are fulfilled.)

That being said, we can discuss some escrow account issues both inside and outside the scope of the opinion. Again, particularly noted is that the Opinion speaks of writing escrow checks against checks received *"in the form of a bank or certified check."* We are not talking about putting a client's personal check into an escrow account and writing an escrow check against that check. That is simply impermissible and will bring swift and certain discipline when the Lawyers' Fund reports to the Ethics Committee that the attorney has had a check returned for insufficient funds. Furthermore, we are not speaking of issuing checks against wired funds which have not been verified to be in the account. I am sure no one needs to be reminded that whether Ethics are or are not involved liability is, and a returned check will have to be made good. In this regard, failure to replace the checks with valid funds will result in discipline.

"There is nothing which will excite the passions of Disciplinary Committee attorneys more than a perceived problem with an escrow account."

The Opinion singles out residential closings as the setting in which the issue arises most often. In addition to the situation set forth in the Opinion, I would add another: The purchase price is $500,000 and the balance due on the seller's mortgage is $375,000. The seller's attorney receives an escrow check drawn on the escrow account of the bank's attorney in the sum of $300,000 and the purchaser delivers a bank check in the sum of $200,000. The title company requires a check in the sum of $375,000—the payoff of seller's mortgage. In order for the closing to take place, either seller's attorney or bank's attorney will have to process these checks through his or her escrow account and issue an escrow check of $375,000 to satisfy the mortgage.

Many would think this is a simple case and the answer is clear—checks can only be written on collected funds. However, the Opinion itself indicates the complexity involved. The Opinion cites five reasons supporting the practice, and while I believe the Committee articulately dismisses these reasons, the fact that five well-reasoned opinions can be given for sustaining the practice indicates the complexity of the situation. Furthermore, the Opinion acknowledges that other states have come to a different opinion.

The Opinion cites three cases in support of its opinion. All cases contain in the parenthetical description of the case the words "*inter alia*." Those two words are particularly appropriate to the three citations as indeed there were a substantial number of other reasons why discipline was imposed. I suggest that those cases do not support a finding of discipline—certainly not discipline at the Appellate Division level—for the sole reason that checks were issued against uncollected funds. The factual descriptions point to different situations; in the *Abbatine* case, the $10,000 deposit against which the $4,147.18 check was issued was not made for 16 days; the *Ferguson* case involved the issuance of a check against "wired" funds not yet received; in the *Joyce* case, the Appellate Division did indeed sustain a charge that “[o]n at least four occasions, the respondent issued checks from his escrow account for a particular transaction in advance of depositing the subject funds into this escrow account, causing checks to clear against the funds of other clients or third parties.” However, there were a host of other charges, and the conduct cited first by the court is abhorred by real estate practitioners. Joyce represented a bank at closing and held escrow monies for items to be completed on a new home. He released the funds to the building without obtaining the permission of the purchaser’s attorney.

Anytime a check is returned for insufficient funds and proper explanation cannot be given to the bank within five days, the bank is required to report the matter to the Lawyers’ Fund which in turn is required to report the matter to the appropriate Disciplinary Committee. Let us assume the worst. The matter is reported to the Committee. In the situation posed by the Opinion and the situation described in this article, what will happen to the attorney? The first complexity is whether or not there were “available funds.” (Remember again the discussion above—it is clearly the intent of this Opinion that “deposit” is not the operative event.) Oftentimes banks will make funds available to the attorney or law firm if the funds have been on deposit for one day. It is not inconceivable that in certain cases funds will be made available immediately upon the deposit. I know of at least one Committee which will not discipline an attorney who writes an escrow check against available funds. If the checks were written at closing and clearly not against the available funds but the deposit was made immediately after the closing and something happened with the clearing of the checks or God forbid the checks actually blew away, the lawyer would probably receive a letter not constituting discipline. (The second time is probably a different matter.)

> *“If you exercise good conservative judgment and the worst happens, you can . . . avoid discipline.”*

If you exercise good conservative judgment and the worst happens, you can, in my opinion, avoid discipline.

Finally, I want to state that I am not nor is the Real Property Law Section of the New York State Bar Association advocating this practice. I am simply discussing what I believe are the ethical consequences of an attorney participating in such conduct—which conduct is not simply common but is, in reality, all but mandatory for any attorney wishing to practice in this area.

Bar Association Announces Web Site Redesign

By Michael J. Berey

At the Annual Meeting of the New York State Bar Association held in Manhattan in January of this year, the Association's Electronic Communications Task Force announced that a redesigned, more dynamic Association Web site is expected to be rolled out this May.

The Web site, at <http://www.nysba.org>, reports the activities of 68 Committees and 23 Sections, including the Real Property Law Section, in over 12,000 pages. Still, the Electronic Communications Task Force responded to a perceived need to make the Web site easier to navigate and to have it always be current in its content. Many of the changes will be obvious only to Association members, who have complete access to what the site has to offer, but the redesign will also suggest to visitors that there is value in being a member of the Association.

What are some of the services the new Web site has to offer? Each member will be able to create a personal profile enabling ready access to content of particular interest. Registration to the Association's Continuing Legal Education programs and individualized CLE credit tracking will be available online. An electronic bulletin board will be part of the site, enabling discussion amongst members on issues of common interest. Members will be notified of updates to the site by e-mail.

Easier location of substantive material on the Association's Web site will be possible through an enhanced search function and the provision of an extensive table of contents.

Legal research by use of the Web site will be enhanced for members through a new partnership with Loislaw, a Division of Aspen Publishers. Loislaw will enable access, without charge, to cases reported in New York State courts and the Second Circuit Court of Appeals within the immediately prior three years.

In addition, under the Association's arrangement with Loislaw, representatives of the Real Property Law Section can track for the Section's members newly reported cases which will be highlighted in the Section's part of the Web site. This will be accomplished by directing the Loislaw database to match certain key words, such as "condemnation" or "mortgage tax," and to report cases with such terms in their text to the Section. Articles published in the *N.Y. Real Property Law Section Journal* will also be available through Loislaw, allowing the cases and statutes referenced in an article to be accessed through the use of hyperlinks inserted in the text.

The March/April issue of the *State Bar News* details the scope of the Association's redesigned Web site and provides instructions on how to access the new features. The New York State Bar Association is taking steps to provide further value to its members.

Michael J. Berey is Chair, Committee on Computerization and Technology, Real Property Law Section, New York State Bar Association.

Section Committees & Chairs

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

Committee on Attorney Opinion Letters
David J. Zinberg (Co-Chair)
250 Park Avenue
New York, NY 10177
(212) 907-9601
Fax: (212) 907-9681
E-Mail: dzinberg@aol.com

Jill M. Myers (Co-Chair)
46 Prince Street
Rochester, NY 14607
(716) 697-0041
Fax: (716) 697-0043
E-Mail:
jmeyers@fergusonandmyers.com

Committee on Awards
John G. Hall (Chair)
57 Beach Street
Staten Island, NY 10304
(718) 447-1962
Fax: (718) 273-3090
E-Mail:hallj@hallandhalllaw.com

Committee on Commercial Leasing
Austin J. Hoffman, II (Co-Chair)
4 Clinton Square
Syracuse, NY 13202
(315) 422-7000
Fax: (315) 422-7019
E-Mail:austinhoffman@pyramidmg.com

Joshua Stein (Co-Chair)
885 Third Avenue, 10th Floor
New York, NY 10022
(212) 906-1342
Fax: (212) 751-4864
E-Mail: joshua.stein@lw.com

Task Force on Computerization & Technology
Michael J. Berey (Co-Chair)
633 Third Avenue, 16th Floor
New York, NY 10017
(212) 850-0624
Fax: (212) 331-1511
E-Mail: mberey@firstamny.com

Leonard E. Sienko, Jr. (Co-Chair)
12 East Main Street
Hancock, NY 13783
(607) 637-5400
Fax: (815) 361-2750
E-Mail: lennyesq@hancock.net

Committee on Condemnation, Certiorari & Real Estate Taxation
Robert L. Beebe (Co-Chair)
514 Vischers Ferry Road
Clifton Park, NY 12065
(518) 373-1500
Fax: (518) 373-0030
E-Mail: rbeebe@beebelaw.com

Jon N. Santemma (Co-Chair)
120 Mineola Boulevard, Suite 240
Mineola, NY 11501
(516) 294-8081
Fax: (516) 294-8302
E-Mail: sandattys@aol.com

Committee on Condominiums & Cooperatives
David L. Berkey (Co-Chair)
845 Third Avenue, 8th Floor
New York, NY 10022
(212) 935-3131
Fax: (212) 935-4514
E-Mail: dlb@gdblaw.com

Joseph M. Walsh (Co-Chair)
42 Long Alley
Saratoga Springs, NY 12866
(518) 583-0171
Fax: (518) 583-1025
E-Mail: joewalsh@spalaw.net

Committee on Continuing Legal Education
Terrence M. Gilbride (Co-Chair)
One M&T Plaza, Suite 2000
Buffalo, NY 14203
(716) 848-1236
Fax: (716) 849-0349
E-Mail: tgilbrid@hodgsonruss.com

Harold A. Lubell (Co-Chair)
1290 Avenue of the Americas
New York, NY 10104
(212) 541-2130
Fax: (212) 541-4630
E-Mail: lubell@rspab.com

Committee on Environmental Law
Joel H. Sachs (Co-Chair)
1 North Broadway, Suite 700
White Plains, NY 10601
(914) 946-4777
Fax: (914) 946-6868
E-Mail: jsachs@kblaw.com

John M. Wilson, II (Co-Chair)
2400 Chase Square
Rochester, NY 14604
(585) 232-5300
Fax: (585) 232-3528
E-Mail: jwilson@boylanbrown.com

Committee on Land Use & Planning
Karl S. Essler (Co-Chair)
Two State Street, 14th Floor
Rochester, NY 14614
(716) 232-1660
Fax: (716) 232-4791
E-Mail: kessler@fixspin.com

Carole S. Slater (Co-Chair)
36 West 44th Street, Suite 712
New York, NY 10036
(212) 391-8045
Fax: (212) 391-8047
E-mail: csslater@msn.com

Committee on Landlord & Tenant Proceedings
Edward G. Baer (Co-Chair)
342 Madison Avenue
New York, NY 10173
(212) 867-4466
Fax: (212) 867-0709
E-Mail: ebaer@bbwg.com

Gerald Goldstein (Co-Chair)
500 Old Country Road, Suite 107
Garden City, NY 11530
(516) 248-6400
Fax: (516) 248-6422
E-Mail: ssgdmgc@aol.com

Committee on Legislation
Robert W. Hoffman (Co-Chair)
1802 Eastern Parkway
Schenectady, NY 12309
(518) 370-4743
Fax: (518) 370-4870
E-Mail: rwhooplaw@juno.com

Gary S. Litke (Co-Chair)
237 Park Avenue. 20th Floor
New York, NY 10017
(212) 880-6190
Fax: (212) 682-0200
E-Mail: glitke@torys.com

Committee on Low Income & Affordable Housing
Jerrold I. Hirschen (Co-Chair)
36 West 44th Street, Room 712
New York, NY 10036
(212) 819-1130
Fax: (212) 302-8536
E-Mail: iihhs@aol.com

Brian E. Lawlor (Co-Chair)
38-40 State Street
Albany, NY 12207
(518) 486-6337
Fax: (518) 473-8206
E-Mail: blawlor@dhcr.state.ny.us

Committee on Membership
Richard S. Fries (Chair)
405 Lexington Avenue
New York, NY 10174
(212) 973-0111
Fax: (212) 891-9598
E-Mail: rfries@swidlaw.com

Committee on Not-for-Profit Entities and Concerns
Anne Reynolds Copps (Co-Chair)
126 State Street, 6th Floor
Albany, NY 12207
(518) 436-4170
Fax: (518) 436-1456
E-Mail: arcopps@albany.net

Mindy H. Stern (Co-Chair)
60 East 42nd Street
New York, NY 10165
(212) 661-5030
Fax: (212) 687-2123
E-Mail: mstern@schoeman.com

Committee on Professionalism
Peter V. Coffey (Co-Chair)
224 State Street
P.O. Box 1092
Schenectady, NY 12301
(518) 370-4645
Fax: (518) 370-4979
E-Mail: pcoffey@ecmlaw.com

Janet Sandra Stern (Co-Chair)
1025 Old Country Road, Suite 205
Westbury, NY 11590
(516) 876-1106
Fax: (516) 997-7876
E-Mail: janet@sawlaw.com

Committee on Publications
William A. Colavito (Co-Chair)
One Robin Hood Road
Bedford Hills, NY 10507
(914) 666-4606
Fax: (914) 241-1881
E-Mail: wcolavito@yahoo.com

Joseph D. DeSalvo (Co-Chair)
188 East Post Road, 4th Floor
White Plains, NY 10601
(914) 286-6415
Fax: (212) 331-1455
E-Mail: jdesalvo@firstamny.com

Harry G. Meyer (Co-Chair)
2000 M&T Plaza
Buffalo, NY 14203
E-Mail: hmeyer@hodgsonruss.com

Robert M. Zinman (Co-Chair)
St. John’s University School of Law
8000 Utopia Parkway
Jamaica, NY 11439
(718) 990-6646
Fax: (718) 990-6649
E-Mail: zinmanr@stjohns.edu

Ad Hoc Committee on Public Relations
Maureen Pilato Lamb (Co-Chair)
510 Wilder Building
One East Main Street
Rochester, NY 14614
(585) 325-6700 x220
Fax: (585) 325-1372
E-Mail: mplamb@frontiernet.net

Harold A. Lubell (Co-Chair)
1290 Avenue of the Americas
New York, NY 10104
(212) 541-2130
Fax: (212) 541-4630
E-Mail: lubell@rspab.com

Committee on Real Estate Financing
Leon T. Sawyko (Chair)
99 Garnsey Road
Pittsford, NY 14534
(585) 419-8632
Fax: (585) 419-8815
E-Mail: lsawyko@harrisbeach.com

Committee on Title & Transfer
Karl B. Holtzschue (Co-Chair)
122 East 82nd Street, Apt. 3C
New York, NY 10028
(212) 472-1421
Fax: (212) 472-6712
E-Mail: kholtzschue@nyc.rr.com

Samuel O. Tilton (Co-Chair)
2 State Street
700 Crossroads Building
Rochester, NY 14614
(585) 987-2841
Fax: (585) 454-3968
E-Mail: stilton@woodsoviatt.com

Committee on Unlawful Practice of Law
George R. Grasser (Co-Chair)
3400 HSBC Center
Buffalo, NY 14203
(716) 847-5490
Fax; (716) 852-6100
E-Mail: ggrasser@phillipslytle.com

John G. Hall (Co-Chair)
57 Beach Street
Staten Island, NY 10304
(718) 447-1962
Fax: (718) 273-3090
E-Mail: hallj@hallandhalllaw.com

Publication of Articles

The *Journal* welcomes the submission of articles of timely interest to members of the Section in addition to comments and suggestions for future issues. Articles should be submitted to any one of the Co-editors whose names and addresses appear on this page.

For ease of publication, articles should be submitted on a 3½" floppy disk, preferably in Microsoft Word or WordPerfect 5.1 and no longer than 8–10 pages. Please also include one laser-printed copy. The Editors request that all submissions for consideration to be published in this *Journal* use gender neutral terms where appropriate or, alternatively, the masculine and feminine forms may both be used. Please contact the Co-editors regarding further requirements for the submission of articles.

Unless stated to the contrary, all published articles represent the viewpoint of the author and should not be regarded as representing the views of the Editors, Board of Editors or the Section or substantive approval of the contents therein.

Student Editorial Assistance
St. John's University, School of Law

Co-Editors in Chief
David Dunn
John D. Kern

Contributing Students

Catherine Biondo
Joseph Bozutti
Melissa Carvalho
Cindy Chen
Suzanne Delio
Jake Derenthal
Matthew Didora
Ariel Gordon
Brian Graffeo
Thomas Horan
Alexandra Khasidova
Diana Lin
Harris Liolis
Stanley Liu
Jason Kee Low
Nancy Mahmoud
Jennifer Marinaccio
Michael McCarthy
Jay Mower
Michael Rosenberger
Ross Schiller
George Schneider
Patricia Wolfe

Correction

In our last issue we failed to list the name of John Kern as Co-Editor in Chief under the heading of Student Editorial Assistance, St. John's University School of Law. John has worked as a student editor on both our Winter and Spring 2002 issues.

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

Real Property Law Section
New York State Bar Association
One Elk Street
Albany, NY 12207-1002

ADDRESS SERVICE REQUESTED

N.Y. REAL PROPERTY LAW JOURNAL

Section Officers

Chair
Melvyn Mitzner
655 Third Avenue
New York, NY 10017
(212) 973-6205
Fax: (212) 883-6825
E-Mail: mmitzner@landam.com

1st Vice-Chair
John J. Privitera
P.O. Box 459
Albany, NY 12201
(518) 447-3337
Fax: (518) 447-3368
E-Mail: privitera@mltw.com

2nd Vice-Chair
Matthew J. Leeds
1290 Avenue of the Americas
New York, NY 10104
(212) 541-2290
Fax: (212) 541-1390
E-Mail: leedsm@rspab.com

Secretary
Dorothy H. Ferguson
46 Prince Street
Rochester, NY 14607
(716) 697-0042
Fax: (716) 697-0043
E-Mail:dferguson@fergusonandmyers.com

Co-Editors

William A. Colavito
One Robin Hood Road
Bedford Hills, NY 10507
(914) 666-4606
Fax: (914) 241-1881
E-Mail: wcolavito@yahoo.com

Joseph DeSalvo
188 East Post Road, 4th Fl.
White Plains, NY 10601
(914) 286-6415
Fax: (212) 331-1455
E-Mail:jdesalvo@firstamny.com

Harry G. Meyer
2000 M&T Plaza
Buffalo, NY 14203
E-Mail: hmeyer@hodgsonruss.com

Robert M. Zinman
St. John's University
School of Law
8000 Utopia Parkway
Jamaica, NY 11439
(718) 990-6646
Fax: (718) 990-6649
E-Mail: zinmanr@stjohns.edu

This *Journal* is published for members of the Real Property Law Section of the New York State Bar Association.

ISSN 1530-3918

NON-PROFIT
U.S. POSTAGE
PAID
ALBANY, N.Y.
PERMIT NO. 155