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N.Y. Real Property Law Journal

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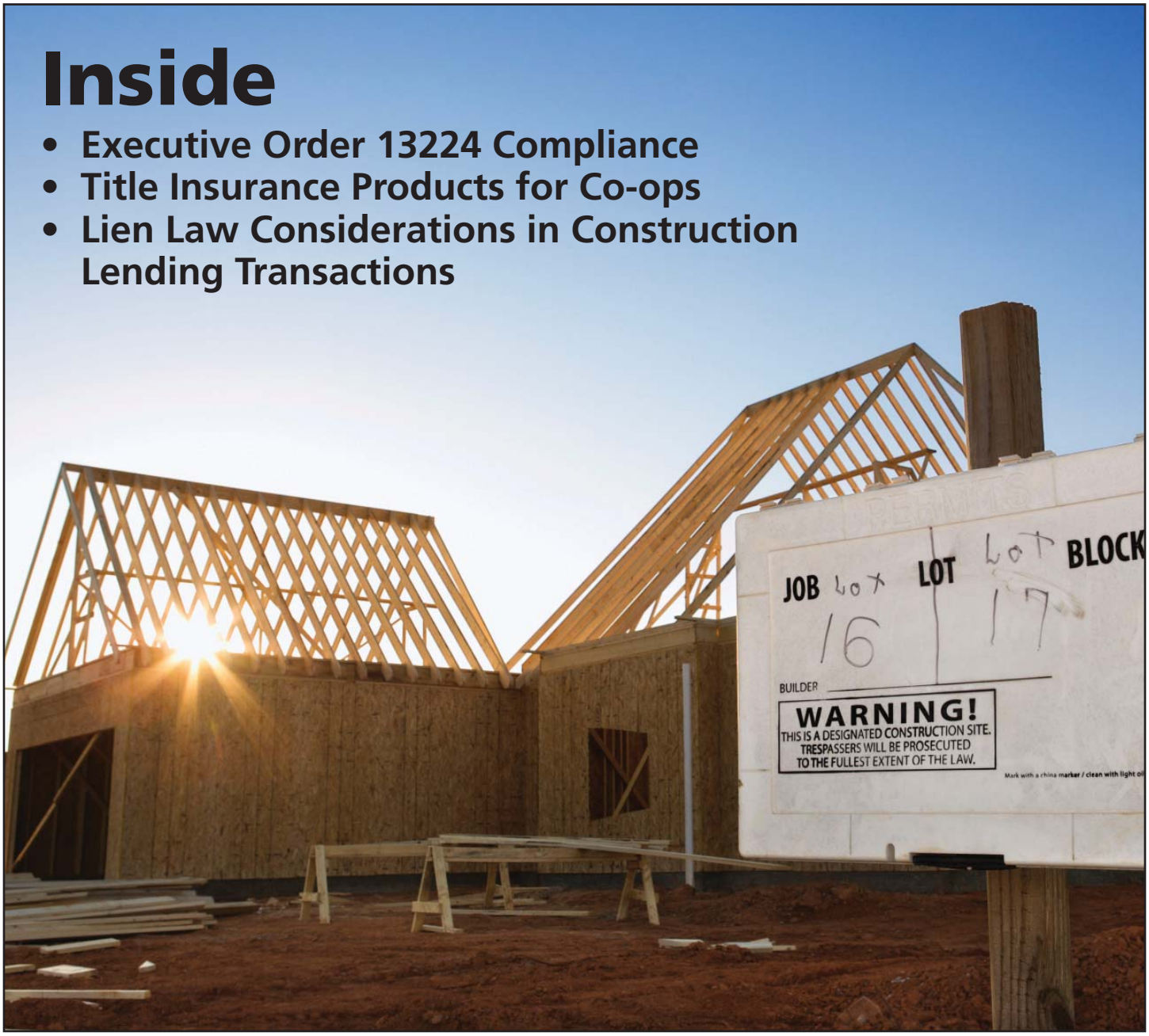

NYSBA

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A Message from the Outgoing Section Chair

Harry G. Meyer

There is a tremendous diversity of practice concentrations within members of our Section: finance, development, residential, commercial, industrial, landlord and tenant, low income, workforce, and affordable housing are but a few. Joining a Section committee or actively participating in our On-line Forum are two convenient ways to sharpen your skills and develop worthwhile contacts with colleagues to share ideas and obtain specific information for novel questions.

Similarly, within practice concentrations there are significant variations which reflect substantial differences within the marketplace. Ask a lawyer doing residential work in my area of western New York about proprietary leases for co-ops, and they will point out there are just a handful of co-op projects in the entire eight counties of our Judicial District. Conversely, many attorneys in the New York City metropolitan area may be unaware that lawyers in other parts of the state have for many years routinely been directly involved in the examination of title and the writing of title insurance as agents or examining counsel. This latter practice frequently avoids an unnecessary duplication of (and charging for) services in basic consumer transactions and enables a lawyer representing a purchaser/owner to more completely advise the client about nuances of title to the property.

Unfortunately, this well-organized practice is under attack by a coordinated effort mounted by the New York State Land Title Association to pass legislation. While providing long overdue and much needed regulation of title insurance agents (which our Section supports in concept), this legislation has buried in its middle Section 2161, which would expressly prohibit banks, developers and most attorneys in law firms from continuing to be involved in writing title insurance.

The efforts of our Title Insurance and Title and Transfer committees to hold a realistic dialogue with NYSLTA about this process and to suggest that proposed Section 2161 is tantamount to price fixing and territorial allocation was first met with the outright denial that Section 2161 applied to lawyers representing their clients. Then, the statement was made that "of course" Section 2161 is intended to apply to lawyers because "it is already unethical/illegal" for lawyers to be so involved under our own Code of Professional Responsibility. Bill Johnson, Co-chair of our Publications Committee, wrote an excel-

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A Message from the Incoming Section Chair

Karl B. Holtzschue

Be the Best We Can Be

I very much look forward to serving the Real Property Law Section as its Chair for the coming year. I have been inspired by the excellent work done during the past three years I have been an officer of the Section—under the leadership of my predecessors Dorothy Ferguson, Joshua Stein and Harry Meyer—and I have enjoyed working with my fellow officers Peter Coffey, Joel Sachs and Anne Reynolds Copps (incoming Secretary). The members of the Executive Committee are an impressive and knowledgeable group who work hard on your behalf.

When he was Chair and I was first elected, John Privitera asked me what would be my goals as Chair. At the time, I said that I didn't have any specific ones. However, in my first year as an officer, I attended the NYSBA's annual Section Leadership Conference, and was very impressed by the work done by other Sections and the NYSBA. Many ideas from that and subsequent conferences have since been implemented in our Section. For example, we have discussed and adopted guidelines for all members of the Executive Committee to make sure everyone knows what is expected of them: officers, committee chairs, House of Delegates, district representatives, members-at-large and administrative officers. Our legislation committee has been reorganized and become very active in reviewing bills and interacting with the legislature. We have expanded and diversified our membership.

So my goal for the coming year, John and other Section members, is to do all I can to enable us to **Be the Best We Can Be**—as real estate lawyers, as members of the bar, as members of the Section and as members of the Section's Executive Committee.

You as Section members can help by joining our committees and actively participating in their activities. I promise that you will learn a lot of interesting useful things and may find ways you can make a difference. A listing of the committees appears at the end of this *Journal*, including the names of the Co-Chairs and their contact information.

Information on the Section appears on the Section's portion of the NYSBA website (http://www.nysba.org/realprop). Among other things, as a member of the Section you can access, read and print out articles from our outstanding *New York Real Property Law Journal*. The

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lent article in the Winter 2007 edition of our *Journal* which refutes this unsupported analysis. We also feel that in the proposed legislation there should be an audit mechanism and some of us, perhaps more significantly, advocate the inclusion of a Client Protection Fund similar to the one to which all licensed New York lawyers contribute.

This legislation, to put it mildly, is in a state of flux, and I commend the incoming Chair Karl Holtzschue, Vice-Chair Peter Coffey, and Executive Committee members Spencer Compton, George Haggerty and Tom Hall for taking their time to visit with six members of the state legislature and staff to explain our concerns on the bill and various other matters. Commendations also to NYSBA Director of Government Relations, Ron Kennedy, who set up meetings with the following people for our Section:

Senator John DeFrancisco, Chair, Senate Judiciary Committee

Assemblymember Helene Weinstein, Chair, Assembly Judiciary Committee

Assemblymember Adam Bradley, sponsor of Title Agents Licensing Bill

Senator George Winner, sponsor of Title Agents Licensing Bill

Michael Avella, Counsel to Senate Majority Leader Bruno

Stephanie Sorrentino, Office of Assembly Majority Leader Canestrari

Our Section has gone on record with them and in written materials as being unequivocally opposed to Section 2161. (Note, Senator Winner spoke at the NYSLTA August 2007 Meeting at the KingsMill Resort in Virginia.)

Furthermore, as a result of this visit to Albany and other comments received, we have had a lively dialogue between Member-at-Large Steve Baum and the Public Interest Committee Co-chairs, Mike Hanley and Raun Rasmussen about another bill, S.4210/A.7376 sponsored by Judiciary Chairs DeFrancisco and Weinstein, which proposes an additional notice to mortgagors whose property is the subject of a foreclosure.

I commend all three of these Section members for the time and effort they have put into numerous e-mails and telephone calls in an attempt to fashion a position to and revision of the proposed legislation which is acceptable to the Section.

I also want to use their efforts as an example of the positive changes for a better, more defined and articulate expression of differing viewpoints. Our Section's enhanced procedures for information sharing and exchange of viewpoint is working: All New York state real property lawyers are encouraged to take a more active "political" role by involving themselves in Section activities as well as expressing their views through their elected representatives.

In the past people used to refer to being "volunteered" for all sorts of activities by their failure to take two steps to the rear quickly: The modern reality is that those who fail to actively and constructively involve themselves with the modern political arena will find that the laws and regulations governing their day-to-day activities are written by others, many of whom may have neither appropriate information, nor, in some instances any compassion to try to understand beyond a very narrow focus. We lawyers need to do good for the Community as well as the Profession. Lawyers have the intellectual depth, and the experience to understand and adjust the legal complexities affecting our Society far better than many others.

Harry G. Meyer

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articles cover current developments and in-depth analysis of real property issues, and go back to 2000. Also on the Section website: (1) Committees; (2) Minutes of meetings of the RPLS Executive Committee; (3) Upcoming Events; (4) Status of Pending Legislation; (5) RPLS Legislation Memos; (6) Forms for residential and commercial transactions, mortgages, mortgage foreclosures, and mechanics' liens; and (7) Loislaw LawWatch case summaries. We hope to make the website your primary source of information about the Real Property Law Section.

Among other things, we will be expanding the Upcoming Events portion of the website to let you know of forthcoming CLE and other committee events. Those events will also be posted on the bi-monthly NYSBA eNews that is distributed as email. Please look for them and **join us**.

Karl B. Holtzschue
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The Home Equity Theft Prevention Act

By James M. Pedowitz

The Home Equity Theft Prevention Act ("the Act"), enacted as Chapter 308 of the Laws of 2006, went into effect in New York State on February 1, 2007.[1] The Act has important and significant legal ramifications for practicing attorneys, legal aid groups, homeowners who may default on the mortgage on their primary residence located within a one- to four-family dwelling structure, title examiners, title insurance companies, real estate brokers, mortgage brokers, and investors in distressed real estate.

The law is comprehensive and its purpose, as stated in its legislative memo, is "to help protect homeowners from deed theft and 'foreclosure rescue' scams which result in the loss of their homes and the equity they have built over the years in their homes."

Section 2 of the Act amends section 595-a of the New York Banking Law,[2] and essentially prohibits mortgage lenders and mortgage brokers from making or arranging a loan to an "equity purchaser," as defined in the newly enacted section 265-a of the New York Real Property Law ("section 265-a"), if they had knowledge that the "equity purchaser" was not complying with the provisions of section 265-a with respect to such transaction.[3]

At the heart of the Act is the newly enacted section 265-a. It includes a number of statutory definitions of terms utilized in the new section, including: "bona fide purchaser or encumbrancer for value," "business day," "covered contract," "default," "equity purchaser," "equity seller," "foreclosure," "property owner" or "homeowner," "reconveyance arrangement," "representative," and "residence" and "residential real property." It is extremely important to familiarize oneself with these statutory definitions, as they are utilized throughout the Act and may contain language that alters, limits, or expands the normal meaning of a term.

Although the primary thrust of the Act is to regulate and limit the activities of individuals who approach homeowners facing a mortgage foreclosure or the loss of their home due to the enforcement of a real estate tax lien, the Act also affects the activities of mortgage bankers, mortgage brokers, and exempt organizations by amending section 595-a of the New York Banking Law. These amendments include a prohibition on making a mortgage loan, directly or indirectly, to an "equity purchaser" if the lender has knowledge that the "equity purchaser" was not complying with the provisions of section 265-a of the Real Property Law.[4]

The definitions of "covered contract," "equity seller," "equity purchaser," "residence" and "residential real property," and "bona fide purchaser or encumbrancer for value" are of particular importance and are essential to one's ability to understand and comply with the Act. These definitions give an indication of the circumstances under which the Act applies. The Act defines the above mentioned terms as follows:

> "COVERED CONTRACT" means any contract, agreement, or arrangement or any term thereof, between an equity purchaser and equity seller which:
>
> (I) is incident to the sale of a residence in foreclosure; or
>
> (II) is incident to the sale of a residence in foreclosure or default where such contract, agreement or arrangement includes a reconveyance arrangement.
>
> For purposes of this section, any reference to the "sale" of a residence by an equity seller to an equity purchaser shall include a transaction where an equity seller receives consideration from the equity purchaser, and a transaction involving a transfer of title to the equity purchaser where no consideration is provided to the equity seller.[5]
>
> "EQUITY PURCHASER" means any person who acquires title to any residence in foreclosure or, where applicable, default, or his or her representative as defined in this subdivision, except a person who acquires such title as follows:
>
> (I) to use, and who uses, such property as his or her primary residence;
>
> (II) by a deed from a referee in a foreclosure sale conducted pursuant to Article Thirteen of the Real Property Actions and Proceedings Law;
>
> (III) at any sale of property authorized by statute;
>
> (IV) by order or judgment of any court;
>
> (V) from a spouse, or from a parent, grandparent, child, grandchild or sibling of such person or such person's spouse;
>
> (VI) as a not-for-profit housing organization or as a public housing agency; or
>
> (VII) a bona fide purchaser or encumbrancer for value.[6]
>
> "EQUITY SELLER" means a natural person who is a property owner or homeowner at the time of the equity sale.[7]
>
> "BONA FIDE PURCHASER OR ENCUMBRANCER FOR VALUE" means anyone acting in good faith who purchases the residen-

tial real property from the equity purchaser for valuable consideration or provides the equity purchaser with a mortgage or provides a subsequent bona fide purchaser with a mortgage, provided that he or she had no notice of the equity seller's continuing right to, or equity in, the property prior to the acquisition of title or encumbrance, or of any violation of this section by the equity purchaser as related to the subject property.[8]

"BUSINESS DAY" means any calendar day except for Sunday or the public holidays as set forth in Section Twenty-four of the General Construction Law.[9]

"RESIDENCE" and "RESIDENTIAL REAL PROPERTY" means residential real property consisting of one- to four-family dwelling units, one of which the equity seller occupies or occupied at a time immediately prior to the equity sale as his or her primary residence.[10]

Red warning flags should pop up in any transaction involving a "residence or residential real property" that is either subject to a *lis pendens* in a mortgage foreclosure action pursuant to Article 13 of the New York Real Property Actions and Proceedings Law, or is listed on an active tax lien sale list.[11] In any transfer of property that involves a foreclosure sale, unless the transaction involves the foreclosing lender or tax lien holder, section 265-a is likely to apply, and failure to comply with its various provisions could have dire consequences, both civil and criminal.[12]

The best advice with respect to purchasing a property that is subject to either a tax or mortgage foreclosure, or facing such a foreclosure because of a tax or mortgage default, is to avoid the transaction. However, if the parties are certain they want to proceed with the sale, it is necessary to ensure that the transactions are executed by a written contract and the seller is given a five "business day"[13] period in which to cancel the transaction.[14] These provisions also apply to the sale of a home in foreclosure or default, in those instances where the transaction includes a "reconveyance arrangement"[15] that purports to allow the homeowner to regain possession of the home.[16] The Act specifies the terms that must be included in any such contracts, and requires that the contract be accompanied by a completed notice of cancellation form that advises the equity seller of his or her right to cancel the contract within five business days.[17] However, the requirements of the Act do not apply to certain sales, including sales to persons who are buying the home to use as their primary residence.[18]

The Act prohibits equity purchasers from taking certain actions prior to the expiration of the five "business day" cancellation period, such as transferring title to the property or encumbering the property.[19] Equity purchasers are also prohibited from making false or misleading statements regarding the details of a transaction, such as the value of the residence, the amount of proceeds the seller will receive after a foreclosure sale, the timing of the judicial foreclosure process, any contract term, etc.[20] Additionally, equity purchasers are prohibited from making certain types of representations which mislead or manipulate a seller, such as representing to the seller that the equity purchaser is assisting the homeowner in saving the home or preventing a completed foreclosure, unless there is a good faith basis for such representation.[21] There are criminal penalties associated with certain violations of the statute regarding taking certain actions or knowingly making false or misleading statements or representations to the seller.[22] Also, the seller may take civil action against the equity purchaser to rescind the transaction within two years if the equity purchaser violated the Act.[23] However, a rescission is not effective against any subsequent "bona fide purchaser."[24]

Several requirements and restrictions are placed on "reconveyance arrangements," such as providing that an equity purchaser shall not enter into a reconveyance arrangement where the seller has no reasonable ability to pay for the subsequent conveyance of title back to the seller.[25]

The Act also creates the new requirement of a separate notice, on paper of a different color, accompanying the summons and complaint in all mortgage foreclosure actions prior to instituting a mortgage foreclosure action.[26] This notice requirement is not limited to residential foreclosures.[27] As part of the Act, section 1303 was added to the Real Property Actions and Proceedings Law. Section 1303 of the Real Property Actions and Proceedings Law reads as follows:

Foreclosures; required notices.

1. The foreclosing party in a mortgage foreclosure action shall provide notice to the mortgagor in accordance with the provisions of this section with regard to information and assistance about the foreclosure process.

2. The notice required by this section shall be delivered with the summons and complaint to commence a foreclosure action. The notice required by this section shall be in bold, fourteen-point type and shall be printed on colored paper that is other than the color of the summons and complaint, and the title of the notice shall be in bold, twenty-point type. The notice shall be on its own page.

3. The notice required by this section shall appear as follows:

HELP FOR HOMEOWNERS IN FORECLOSURE

New York State Law requires that we send you this notice about the foreclosure process. Please read it carefully.

Mortgage foreclosure is a complex process. Some people may approach you about "saving" your home. You should be extremely careful about any such promises.

The State encourages you to become informed about your options in foreclosure. There are government agencies, legal aid entities, and other non-profit organizations that you may contact for information about foreclosure while you are working with your lender during this process.

To locate an entity near you, you may call the toll-free helpline maintained by the New York State Banking Department at _____ (enter number) or visit the Department's website at _____ (enter Web address). The State does not guarantee the advice of these agencies.

4. The Banking Department shall prescribe the telephone number and Web address to be included in the notice.

5. The Banking Department shall post on its Web site or otherwise make readily available the name and contact information of government agencies or non-profit organizations that may be contacted for information about the foreclosure process, including maintaining a toll-free helpline to disseminate the information required by this section.[28]

Section 265-a contains detailed requirements with respect to the agreement (the "covered contract") between the homeowner facing the loss of his or her home (the "equity seller") and the "equity purchaser." The covered contract must be written in at least twelve-point bold type and in English (or in both English and Spanish if Spanish is the primary language of the equity seller).[29] In addition to a long list of information,[30] the covered contract must also contain a notice in immediate proximity to the space reserved for the seller's signature, in capital letters or fourteen-point bold type, and it must include the date and time by which the contract can be cancelled by the seller.[31] The minimum amount of time for which the seller must be allowed to rescind the contract is five business days.[32]

During the five "business day" cancellation period, the "equity purchaser" is prohibited from taking certain actions.[33] The prohibitions include, but are not limited to, accepting a conveyance of any interest in the property, recording any document signed by the "equity seller," transfering the property, suggesting a waiver of the "equity seller's" rights, or paying any consideration to the "equity seller."[34] Any violation of these prohibitions is a criminal offense that can be either a Class A misdemeanor with a fine of up to $25,000 and a second offense within five years can be a Class E felony, with a fine of up to $25,000.[35]

All in all, the legislature is trying to send a clear message that it wants the complained-of practices stopped. If your clients want to engage in the business of acquiring properties that are in, or subject to, mortgage or tax lien foreclosure, it is imperative that they avoid coming within the purview of the new Act. Certainly they must avoid any "reconveyance arrangement," which is one of the elements that will bring the arrangement within the definition of "covered contract." There is no prohibition on buying a distressed property, so long as the price is fair and the seller is not made any promise or agreement of retention or re-acquisition of possession, or any interest in the title.

Endnotes

1. 2006 N.Y. Laws 308.
2. *See* N.Y. BANKING LAW § 595-a.
3. N.Y. BANKING LAW § 595-a(1)(h).
4. *Id.*
5. N.Y. REAL PROP. LAW § 265 a(2)(c).
6. N.Y. REAL PROP. LAW § 265-a(2)(e).
7. N.Y. REAL PROP. LAW § 265-a(2)(f).
8. N.Y. REAL PROP. LAW § 265-a(2)(a).
9. N.Y. REAL PROP. LAW § 265-a(2)(b).
10. N.Y. REAL PROP. LAW § 265-a(2)(k).
11. *See* N.Y. REAL PROP. LAW § 265-a(2)(g) (defining a "foreclosure").
12. *See* N.Y. REAL PROP. LAW § 265-a(9), (10).
13. *See* N.Y. REAL PROP. LAW § 265-a(2)(b) (defining a "business day").
14. N.Y. REAL PROP. LAW § 265-a(5).
15. *See* N.Y. REAL PROP. LAW § 265-a(2)(i) (defining "reconveyance arrangement").
16. *See* N.Y. REAL PROP. LAW § 265-a(5).
17. N.Y. REAL PROP. LAW § 265-a § 265-a(6).
18. *See* N.Y. REAL PROP. LAW § 265-a(e)(i)-(vii).
19. N.Y. REAL PROP. LAW § 265-a(7).
20. N.Y. REAL PROP. LAW § 265-a(7)(b).
21. N.Y. REAL PROP. LAW § 265-a(7)(c).
22. N.Y. REAL PROP. LAW § 265-a(10).
23. N.Y. REAL PROP. LAW § 265-a(9).
24. N.Y. REAL PROP. LAW § 265-a(8)(c).
25. N.Y. REAL PROP. LAW § 265-a(11)(b).
26. N.Y. REAL PROP. ACTS. LAW § 1303(2).
27. *See generally* N.Y. REAL PROP. ACTS. LAW § 1303.
28. N.Y. REAL PROP. ACTS. LAW § 1303.
29. N.Y. REAL PROP. LAW § 265-a(3).
30. N.Y. REAL PROP. LAW § 265-a(4).
31. N.Y. REAL PROP. LAW § 265-a(4)(i).
32. *See* N.Y. REAL PROP. LAW § 265-a(5).
33. N.Y. REAL PROP. LAW § 265-a(7).
34. *See id*.
35. N.Y. REAL PROP. LAW § 365-a(10).

James M. Pedowitz is counsel to Berkman, Henoch, Peterson & Peddy, P.C., in Garden City, New York. He is a past chair of the Section, and has written and lectured extensively on real estate, title insurance, mortgage foreclosure and various other real property subjects.

An Overview of Executive Order 13224 Compliance

By Patricia Sandison

I. Introduction

In the wake of the terrorist attacks that occurred on September 11, 2001, President Bush issued Executive Order 13224 (hereinafter, the Order)—an order designed to incapacitate financial support to terrorists by blocking transactions undertaken by certain designated persons. The Order is part of a government anti-terrorism initiative to utilize the existing legal framework "as the basis to apply a wide range of customer due-diligence and organizational requirements to financial institutions and other entities," including a hardened focus on the real estate sector.[1]

II. Executive Order 13224

Executive Order 13224 on Terrorist Financing came into effect September 24, 2001 and relates to "Blocking Property and Prohibiting Transactions with Persons who Commit, Threaten to Commit, or Support Terrorism."[2] The Order is pursuant to the International Emergency Economic Powers Act, 50 U.S.C. §§ 1701, *et seq.*, and blocks "all property and interests in property" of:

> (a) foreign persons listed in the Annex to this order [on the Restricted Parties List];
>
> (b) foreign persons determined by the Secretary of State, in consultation with the Secretary of the Treasury and the Attorney General, to have committed, or to pose a significant risk of committing, acts of terrorism that threaten the security of U.S. nationals or the national security, foreign policy, or economy of the United States;
>
> (c) persons determined by the Secretary of the Treasury, in consultation with the Secretary of State and the Attorney General, to be owned or controlled by, or to act for or on behalf of those persons listed in the Annex to this order or those persons determined to be subject to subsection 1(b), 1(c), or 1(d)(i) of this order.[3]

III. OFAC and Restricted Parties and SDN Lists

An integral part of the Executive Order 13224 compliance process is to become familiar with the mission of the Office of Foreign Assets Control (OFAC) of the U.S. Department of the Treasury, which oversees enforcement of the Order. The mission of OFAC is stated as follows:

> [OFAC] administers and enforces economic and trade sanctions based on US foreign policy and national security goals against targeted foreign countries, terrorists, international narcotics traffickers, and those engaged in activities related to the proliferation of weapons of mass destruction. OFAC acts under Presidential wartime and national emergency powers, as well as authority granted by specific legislation, to impose controls on transactions and freeze foreign assets under US jurisdiction.[4]

The Restricted Parties List attached to the Order, and continuously updated, is administered by the Treasury's OFAC, which was already maintaining a list of "specially designated" persons whose assets can be blocked. The current blocking profiles of OFAC include three categories: individuals, commercial enterprises, and governmental entities.[5] Individuals, commercial entities and government officials are among those appearing on OFAC's SDN (Specifically Designated National) list, which is more than 220 pages long and is amended frequently. The most updated version of the SDN list is available at the U.S. Treasury Department's website: http://www.treas.gov/offices/enforcement/ofac/sdn/index.shtml. One problem of compliance with the Order is that the OFAC list contains several names that are quite common, creating difficulties for companies in determining if the person they are doing business with is in fact the person featured on the OFAC list.[6]

IV. Compliance Procedures

A. Who must comply?

Although "Tier One Entities," such as banks, trust companies, investment companies, brokers, insurance companies and similar "traditional" financial institutions, have "long been placed in the uncomfortable situation of policing their own customers to at least some degree, these requirements come as an unwelcome burden to many Tier Two Entities."[7] The term, "Tier Two Entities," refers to "any person engaging in the transfer of funds" and "any persons involved in the real estate closings and settlements," as referred to in Title III of the USA Patriot Act.[8] These persons may include brokers, lawyers, mortgage lenders, mortgage brokers, and title companies.[9] Roughly termed the "non-traditional financial institutions" (or Tier Two Entities), OFAC compliance obligations have broadened to include domestic real estate companies and domestic insurance companies, as well as other traditionally less federally regulated areas of commerce.[10]

The real estate industry is the subject of particularly high scrutiny because it has been determined to be particularly susceptible to terrorist financing schemes. Real estate transactions are regarded as more vulnerable because "high-value products are involved" and these transactions "offer excellent money-laundering opportunities."[11] A random sampling of Suspicious Activity Reports (SARs) describing real estate transactions

revealed that property management, real estate investment, realty and real estate development companies were the most commonly reported entities associated with money laundering and related illicit activity.[12] The incredibly broad construction of the phrase, "persons involved in real estate closings and settlements," offers little guidance and does even less to clear up who must actually comply. The Treasury Department, through its Financial Crimes Enforcement Network (FinCEN), identifies the "'potentially broad' universe of participants in real estate transactions" to include brokers, escrow agents, lenders, title insurers, appraisers, and even lawyers.[13] The Order, however, is so vague that it potentially applies to purchasers and sellers of their own real estate, as individuals, even though FinCEN does not intend to regulate or to regard them as Tier One financial institutions. An important factor with regard to the real estate sector is marking the actual flow of funds, where FinCEN notes that "involvement with the actual flow of funds used to purchase the property is a significant factor," thus placing the focus with particular emphasis on those persons who "actually touch the money."[14] This is supported by the SARs, which "showed an increase in the reporting of transactions using real estate-related accounts to launder money for politically exposed persons and for facilitating informal value transfer systems."[15] The Order, however, seems much more broadly focused on creating obstacles to terrorists out of every individual, and not necessarily just those who "actually touch the money."

According to the plain language of the Order, *all* U.S. businesses and non-profit agencies must address internal operations to ensure compliance with the Order. The Order makes U.S. businesses responsible for monitoring their current interactions with investors, joint venturers, trading partners and customers. The first step of any compliance program is to ensure that you are not doing business with any person, entity or group (including officers, directors, partners, or members with 25 percent or more ownership interest) listed as a terrorist or terrorist entity on the SDN list.[16]

B. How does one comply?

Ascertaining the compliance level that is right for one's business and risk level is tricky and, "because it is not an industry regulator, OFAC does not mandate the adoption of corporate due diligence policies and procedures."[17] Instead, "specific compliance programs must be developed internally and should be tailored to reflect a company's exposure to potential SDN transactions."[18] While some smaller organizations and individuals can settle for a more casual monitoring of the SDN list, other

> organizations routinely involved in the international transfer of funds, goods, or services, such as international banks and exporters, develop very comprehensive programs and even dedicate full-time staff to OFAC compliance issues.[19]

Because the SDN list is updated so frequently, compliance is made even more difficult, but OFAC now has an e-mail alert service advising recipients of changes as they are approved. To subscribe (no charge), go to: http://www.treas.gov/offices/enforcement/ofac/subscribe.html and enter your e-mail address to be added to the "OFAC Financial Operations Bulletin E-mail List." This is a good resource because there is no set interval for changes to the SDN list; instead, it is revised as needed.[20]

Even with update bulletins from OFAC it is a practical impossibility to comply with the OFAC's SDN list via manual searches. There are, however, multiple websites and software programs and companies whose sole purpose is to track names on the SDN list.[21] Examples of such electronic screening programs include: Bridger Insight,[22] Guidestar.org,[23] Attus OFAC WatchDOG,[24] and CSC OFAC Evaluator,[25] among many others (*Google* search "OFAC compliance"). Ultimately, whichever technology tool one selects to aid in compliance, it should be capable of data matching, database management, flexibility, precision, and of course, it should be updated concurrently with the OFAC-issued SDN list.[26] Most of the high-level software is in use today by only Tier One Entities.[27]

For both Tiers, companies like CSC, for example, also offer comprehensive solutions through additional consulting services to help a company (1) assess the risk level and determine where OFAC compliance is needed, (2) set up a compliance program with a compliance officer, and (3) evaluate and hone a company's security and monitoring capabilities, among other services.[28] A host of companies also offer total outsourcing of the function.[29] Compliance literature, such as Sheshunoff's *Compliance Guide to OFAC Standards*, may also prove to be a helpful starting point, as it covers all aspects of an effective OFAC compliance program.[30] OFAC has specifically targeted real estate for enforcement and special guidance because national and international law enforcement agencies have identified real estate as a primary mark for terrorists and other criminals.[31] As a result, specific to real estate concerns, a few credit reporting agencies have already added terrorist screening to their list of screening services:[32]

> The current pricing is dependent upon which company you use. Some companies are not offering this screening tool—yet, some include it as part of a package service, and some are charging a premium.[33]

Truth be told, beyond a blanket mandate that no business be transacted with an SDN, the regulations do not suggest what sort of compliance is required.[34] Compliance procedures will obviously "vary depending on the risk profile for each business, the resources of the business and the nature of its relationships."[35] The

point is that "sufficient controls for a small video production facility, for example, will not be adequate for a large diversified media conglomerate company with worldwide operations, relationships and customers."[36] The reality may be that small companies and individuals may be stuck trying to model their own, smaller-scope compliance strategies off the relevant "Tier One" example.

C. What to do when one has a "hit"

What should one do when the software program or your manual search flags a match? Once you've established that the hit is against OFAC's SDN list or targeted countries, you must evaluate the quality of the hit, ascertaining with due diligence the similarity of the client's name and information with that on the SDN list. Once one is confident that they have a match, one should call OFAC's compliance "hotline" at 1-800-540-6322. For more detailed instructions, go to the Treasury website, available at http://www.treas.gov/offices/enforcement/ofac/faq/answer.shtml#hotline.

V. Additional Precaution: Anti-Terrorism Compliance Clause to Contracts

Even if one doesn't find the parties one does business with on the SDN list, a second precaution should include adding an anti-terrorism compliance clause to every document one enters into, including: leases, amendments, purchase and sale agreements, consents to subleases, brokerage agreements, loan documents, construction contracts and vendor contracts.[37] Attorneys should also advise their clients of the new requirements, help them to initiate new procedures, and update models of contracts and agreements to include representations and covenants from contracting parties.[38] Members of the real estate community, in particular, should take steps to ensure that funds invested or deposited with them did not come from restricted parties. Potential risks of noncompliance and non-precaution are abundant. For example:

> A company selling property to a foreign investor may accept a contract deposit. If the purchaser is a Restricted Party, the deposit is blocked. The seller's remedies are unclear. If the contract is silent on the issue, may the seller terminate the contract? Even if the contract is terminated, the escrow agent may not pay the deposit to the seller to cover its liquidated damages. What happens to the vendee's lien held by the Restricted Party? Is the lien a property interest within the U.S. that is also blocked?[39]

To protect against these complications, an effective anti-terrorism clause is advisable. A representation that the party is in compliance with the USA Patriot Act is not reliable in and of itself, because "even though it is similar in intention, the Order was not issued pursuant to the PATRIOT Act."[40]

A. What constitutes an effective anti-terrorism clause?

An effective anti-terrorism clause should require the party to represent and warrant that:

> (i) it is not listed on the SDN List, (ii) it is not an entity that you are prohibited to do business with under anti-terrorism laws, (iii) it will not violate anti-terrorism laws, and (iv) it will not do business with any entity that will violate anti-terrorism laws. In addition, the anti-terrorism clause should state that the party shall provide you with a certification or other evidence confirming its compliance with the anti-terrorism clause and anti-terrorism laws and that the party will indemnify you in the event that it violates the anti-terrorism clause or anti-terrorism laws.[41]

Here is an example:

> **Anti-Terrorism and Money Laundering Representation and Indemnification.**
>
> Tenant certifies that: (i) neither it nor its officers, directors, or controlling owners is acting, directly or indirectly, for or on behalf of any person, group, entity, or nation named by any Executive Order, the United States Department of Justice, or the United States Treasury Department as a terrorist, "Specifically Designated National or Blocked Person," or other banned or blocked person, entity, nation, or transaction pursuant to any law, order, rule or regulation that is enforced or administered by the Office of Foreign Assets Control ("SDN"); (ii) neither it nor its officers, directors or controlling owners is engaged in this transaction, directly or indirectly on behalf of, or instigating or facilitating this transaction, directly or indirectly on behalf of, any such person, group, entity, or nation; and (iii) neither it nor its officers, directors or controlling owners is in violation of Presidential Executive Order 13224, the USA Patriot Act, the Bank Secrecy Act, the Money Laundering Control Act or any regulations promulgated pursuant thereto.
>
> Tenant hereby agrees to defend, indemnify, and hold harmless Landlord from and against any and all claims, damages, losses, risks, liabilities and expenses (including attorneys fees and costs) arising from or related to any breach

> of the foregoing certification. Should Tenant, during the term of this Lease, be designated an SDN, Landlord may, at its sole option, terminate this lease.

The party making such a representation as appears above must be careful in its breadth so as not to define a scope so broadly that it renders due diligence impossible.[42] For instance, "the representation should not extend to employees, nor to shareholders if the company is publicly traded or is of a nature such that confirming whether each shareholder or employee is not on the SDN list would be an impossible task."[43]

B. The anti-terrorism clause is NOT a panacea

It is worthy to note, however, that "while a breach of this representation may give rise to a default under the contract, it is not a panacea, as it will likely not absolve the party receiving the representation from liability under the [Executive] Order if that party did not independently verify the accuracy of the representation by checking the SDN list."[44] The representation and warranty are necessary because one cannot rely on a "best of knowledge" standard anymore;[45] one is not only required to ask, but to independently verify that the parties one does business with do not appear on the SDN list. It is also advisable, in order to establish that any violation of the Order by a U.S. company was unintentional, that the client keep a record that it conducted this verification, including in the record the results obtained.[46]

VI. Who is *actually* complying?

Duty to comply potentially applies to any business transaction anywhere involving any U.S. parties. While the steps outlined above are dutifully followed by banks and other high-level financial institutions that are accustomed to having to police their customers, it is hard to say what lower-level, smaller businesses are actually doing to comply with the Order. This is rarely reported and not easy to ascertain. With regard to franchisors, however, while most of these laws "potentially apply to *any* franchise transaction, most franchisors are not applying these procedures to their domestic transactions despite the fact that several law firms have urged them to do so."[47] The same publication also offers this ever-insightful rumination:

> We wonder whether the same law firms that are advising their clients to follow these procedures with respect to purely domestic transactions, are themselves following these procedures in their engagement letters with their clients.[48]

The excerpt sums it up quite aptly.[49] The Order is extremely broad and offers little guidance for compliance. It is increasingly apparent that "a literal interpretation of the OFAC rules could require retailers to check the names of every customer and landlords to check every person or firm seeking to lease space," but to date, OFAC has refused to establish even minimal guidelines for enforcement.[50] Aside from the "Tier One" financial institutions, the most actively compliant sectors are domestic real estate and insurance, which explains the ever-increasing appearance of anti-terrorist representation and warranty provisions in leases. Although all others are certainly included in the scope and under the jurisdiction of OFAC, and surely it is advisable that they comply, the extent of their *actual* compliance is speculative and unclear.

VII. Penalties for Non-Compliance

All U.S. citizens and permanent resident aliens, companies located in the United States, overseas branches of U.S. companies, and in some cases, overseas subsidiaries of U.S. companies, come under OFAC jurisdiction.[51] The full range of OFAC enforcement authority is far-reaching and the penalties are stiff. A person "willfully transacting business with a suspected terrorist" may be fined up to $50,000 and/or imprisoned for up to ten years, and perhaps even more alarming, these penalties apply not only to entities, but also to officers, directors, managers, and agents of entities.[52] Further, even unintentional violations of the Order are subject to civil penalties of up to $10,000.[53] Therefore, both American individuals and businesses must assure they are not doing business with "terrorists or with entities and individuals that support terrorism or persons deemed to be associated with such persons, or other SDNs."[54] Here are some examples of violations settled with OFAC:[55]

Company	Penalty	Offense
L.A. Dodgers	$75,000	Signing two Cuban nationals
CNA Insurance	$2,300,000	Selling reinsurance to Cuban companies
Ikea	$8,000	Importing rugs from Taliban-controlled Afghanistan
Tyson Foods	$150,000	Chicken to pre-war Iraq
Goodyear Tire	$195,000	Shipping tires to Cuba through Venezuela and Columbia
Johnson & Johnson	$110,000	Medical supplies to pre-war Iraq
GRE Insurance Group	$250,000	Insurance coverage for shipments to pre-war Iraq and Libya

VIII. Disclosure of Past OFAC Violations

According to OFAC's website, institutions are encouraged to "voluntarily disclose" past violations.[56] Self-disclosure is considered a mitigating factor by OFAC in civil penalty proceedings. A self-disclosure should be in the form of a detailed letter that includes any supporting documentation. This letter should be mailed to:

Office of Foreign Assets Control
U.S. Department of the Treasury, Treasury Annex
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

OFAC does not have any type of "amnesty" program for those that inadvertently violate the law; and OFAC explicitly states that "the ramifications of non-compliance, inadvertent or otherwise, can jeopardize critical foreign policy and national security goals."[57] It is here that the compliance program plays a vital role, because "OFAC does, however, review the totality of the circumstances surrounding any violation, including the quality of a company's OFAC compliance program," in its assessment in civil penalty proceedings.[58] It is advisable, therefore, that one records all efforts and due diligence.

IX. Conclusion

The problem undeniably lies in the unspecified breadth of the Executive Order. The Order applies to all U.S. individuals and businesses, and it is an absolute prohibition. As such, few are exempt. Yet the Order gives no guidance on compliance, especially compliance by smaller businesses and individuals. In reality, it is likely that few small businesses actually comply. However, the advisable action for small business or individuals is to execute minimum compliance via manual searches or low-end software, and to record their due diligence should an OFAC investigation occur. One exception, however, pertains to the real estate industry, since OFAC has specifically targeted real estate for enforcement and special guidance. Real estate, as a result, bears a heavier burden and is subject to heightened scrutiny. Therefore, those at all levels of the real estate sector should seriously consider implementing heightened internal compliance protocols.

In sum, compliance is a two-stage process. First, one must ensure that the client's customers, suppliers, tenants, and the like are not dealing with a specially designated national who appears on the SDN/Restricted Party list. Compliance with this prong can be achieved through a variety of methods, whether via a manual search of the list (although largely ineffective), by computer software, or by total outsourcing. Second, it is advisable to include in all contracts an anti-terrorism compliance clause, to further ensure that funds invested or deposited through one's business did not come from restricted parties. Conformity with both prongs of compliance is best, because one is not only required to ask, but also to independently verify an individual's absence from the SDN list. Compliance is especially important because there exists no "amnesty" program for those who inadvertently violate the law. OFAC will, however, view any violations in light of the quality of one's efforts to comply and other surrounding circumstances. Therefore, keeping records of due diligence is highly advisable.

Endnotes

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list checking to advanced identity verification and due diligence.

23. *Available at* http://www.guidestar.org. Guidestar checks U.S. organizations free of cost; however, it requires manual entries and provides only organizations, not individuals.
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Drug Holdover Proceedings: An Overview From "Knew," to "Should Have Known," to "Strict Liability"

By Gerald Lebovits and Douglass J. Seidman

I. Introduction

New York State law gives District Attorneys' offices, the Attorney General, neighboring tenants, and landlords two statutes to evict tenants and occupants of real property for illegal use: Real Property Actions and Proceedings Law (RPAPL) 711(5) (the "bawdy house" statute, which offers grounds to terminate a tenancy where a landlord-tenant relationship exists) and 715(1) (which provides grounds and procedure where use or occupancy is illegal). These statutes combine with Real Property Law (RPL) § 231, which does not create a separate right of action but which renders a lease void if the lessee allows the property to be used for any illegal trade, manufacture, or business,[1] and with RPAPL 721(8), which specifies who may maintain a proceeding. RPAPL 711(5) and 715 deprive tenants conducting illegal activity of their possessory interest, although not any ownership interest. They apply to residential and commercial real property. They allow the eviction of tenants and occupants who deal drugs, engage in illegal business activities, or otherwise use premises illegally.

To secure an eviction under New York law, a petitioner-landlord must prove that the tenant of record either actually knew that illegal-drug business was conducted from the premises or that a reasonable tenant would or should have known about it. That standard of proof is often called the "knew or should have known" standard.

Federal law lowers the standard for eviction for federally subsidized housing and for public housing. Under federal regulations, and so long as a lease clause allows it, a petitioner need prove only that an occupant or guest engaged in illegal drug activity at or near the premises. That standard is one of strict liability: A petitioner need prove sale or possession, not that the record tenant knew or should have known about it.

This article covers general issues associated with drug-holdover proceedings and examines the trend over time from "knew," to "should have known," to the latest standard: strict liability.

II. The Narcotics Eviction Program

In response to the drug problem sweeping the country, Robert Morgenthau, the District Attorney of New York County, began the Narcotics Eviction Program (NEP) in June 1988.[2] The NEP is a special, fast-track summary program that lets landlords and the New York City District Attorneys' Offices evict people who operate a business selling illegal drugs. The program's public-policy rationale is that neighborhoods where real property is used to sell drugs soon degenerate and are overrun by criminal elements.[3] The NEP allows landlords or the District Attorney (DA) to begin summary proceedings to evict those who sell drugs from residential or commercial spaces.

The DA in each county asks landlords to begin drug-eviction proceedings against tenants and occupants who allegedly use their premises to conduct illegal businesses. Cases brought by the DA's office or by landlords at its behest are called "red back" cases because they have red-colored backings attached to the pleadings to distinguish them from other holdover proceedings.[4] Under the NEP, law-enforcement officials work with landlords and tenants to remove drug dealers from their communities.[5]

The NEP created separate Narcotics Eviction Parts in the New York City Civil Court's Housing Parts, one for each borough except Richmond County, to hear drug-holdover proceedings.[6] The narcotics parts, formally called Illegal-Use Resolution and Trial Parts, hear cases in which allegations of illegal drug activity are the basis for the eviction proceeding.[7]

The Illegal-Use Parts offer several advantages. Motions in drug holdovers are heard and resolved quickly because the judges assigned to the Part are familiar with the applicable law and are sensitive to the Part's policy imperatives. NEP cases, moreover, are given priority over other landlord-tenant cases awaiting trial. This priority allows police officers and other witnesses to come to court to testify on trial dates, and not sit around waiting to be heard. The relatively speedy resolutions of these proceedings also allow premises to be rented quickly to other residential and commercial tenants before new traffickers can move in.[8]

Another advantage to the NEP is the help that ADAs offer to landlords, judges, and, from time to time, even tenants. Although the DA's Office has no standing if it does not bring the case itself, the DA's Office aids the landlord's proceeding by the daily presence of a paralegal or occasionally an ADA in the Illegal-Use Parts. The DA's personnel assure the presence of police offers and the production of evidence, and they discuss and negotiate settlements.

Depending on the county and the case, an ADA, or a law student working with an ADA, might even try the landlord's case. When they do not try the landlord's case, an ADA will offer strategy and hand over scripts to assist a landlord's lawyer to question witnesses. Practice and case law even allow ADAs to argue orally before the court and submit motions as a friend of the court.[9]

But the DA is not a party in a drug-holdover proceeding brought

by a landlord and cannot stop a landlord from settling a drug holdover.[10] Landlords and tenants often agree to settle. One settlement that averts a trial is a probation agreement in which the tenant agrees permanently to exclude from the home the offending household member who was involved in the illegal drug activity. Another possible disposition is the tenants' consent to a final judgment of possession in which the petitioner agrees to stay execution of the warrant for a lengthy period of time; that can be a significant benefit because after trial courts usually grant no stay at all, unless all consent. ADAs often tell landlords not to accept these settlements. The reality is that landlords usually accede to the ADA's demands even though they do not have to. They worry that an ADA will accuse them of not proceeding diligently and in good faith, and neither tenants nor the courts can force a landlord to settle. Additionally, judges, who approve settlements through so-ordered stipulations, often rely on an ADA's recommendation not to so-order the stipulation.

Similarly, an ADA will sometimes tell a landlord to move to discontinue a drug case it had earlier told a landlord to bring. A landlord has the discretion not to comply with the ADA's suggestion. The landlord might want to continue the case if it wants to evict the tenant for other reasons—for example, to raise the rent if the tenant's apartment is rent-regulated. But a landlord will rarely exercise that discretion to go forward absent an ADA's continuing approval. Once an ADA tells a judge that a case is so weak that the tenant should not be evicted, the judge will pay close attention to the ADA's argument that the petition should be dismissed, and the landlord's case is doomed. In this regard, the presence of an ADA, who cares about the drug case and not about a landlord's ability to raise the rent, protects the integrity of the proceeding and offers some comfort to tenants.

III. Events Leading to a Drug-Holdover Proceeding

The NEP dictates that an assigned ADA review all drug-related search warrants and felony arrests to determine whether to bring a drug-eviction proceeding.[11] The process begins when the landlord learns that a sale of a controlled substance occurred at or is being conducted from the premises. The ADA can gather further evidence through a search warrant or through confidential informants who might document the existence of illegal activity on the premises.

Once the ADA believes there is sufficient evidence to prove that an illegal business is being conducted on or from the premises, the DA's office begins a drug-eviction proceeding by serving a notice on the landlord. The notice asks the landlord to begin an eviction proceeding within five days against tenants using or allowing others to use the premises to sell drugs.[12] If the landlord refuses or neglects to act within a reasonable time, the DA's office has the authority to commence a proceeding against the tenants under RPAPL 715. That allows the DA's office to initiate the drug-holdover proceeding acting as the premises' owner or the landlord.[13] The DA can recoup its reasonable legal fees from a landlord that did not begin the drug-holdover proceeding or which did not diligently prosecute it despite the DA's notice.[14]

The DA's notice to the landlord need not comply with the Civil Practice Law and Rules (CPLR) statutory requirements pertaining to serving pleadings.[15]

IV. Commencing a Drug-Holdover Proceeding

A. Pretrial Notices

The general rule is that landlords need not serve a termination notice.[16] The reason is that RPL § 231(1) voids the lease if the premises are used for illegal trade or activity. Exceptions arise to the general rule. The first is that a termination notice is required as a condition precedent when the premises to be recovered are rent controlled[17] or rent stabilized[18] and the petitioner is a private landlord.[19] The second is when federal law requires a predicate notice, such as for public housing in New York City,[20] which is run by the New York City Housing Authority, and for Section 8 housing.[21] The third is for tenants of buildings owned or operated by New York City. Under RPL § 232(a), a month-to-month tenant of city-owned housing is entitled to a 30-day termination notice before an eviction proceeding may begin.[22]

Because RPL § 231(1) terminates a lease automatically, a drug-holdover proceeding is technically not a holdover at all, at least not a typical one. A typical holdover arises from an expired or terminated lease. A drug holdover arises from a landlord-tenant relationship that terminates as a matter of law upon the illegal use in the subject premises. Thus, the waiver doctrine, which affects typical holdovers, is inapplicable to so-called drug holdovers. Laches is no defense, and it is irrelevant whether a landlord, after commencing a drug holdover, accepts rent, begins and even obtains a final judgment in a nonpayment proceeding, or renews a lease.[23]

The termination notice must set forth the facts on which the proceeding is based. That requirement exists so that the respondent-tenant has ample notice about the proceeding and to ensure that the respondent has a fair chance to prepare a defense.[24] A termination notice is insufficient if it sets out only conclusory allegations.[25] Courts determine the adequacy of a termination notice on a case-to-case basis. A court that finds a termination notice insufficient will dismiss it under RPAPL 741(4).[26]

A landlord need never serve a notice to cure before starting a drug-eviction proceeding. Public policy forbids a court to grant a cure to a tenant who had actual or constructive knowledge of the illegal acts or who passively acquiesced in them.[27] A petitioner must prevail with an eviction,

therefore, even if the illegal activity ended long before trial.[28]

B. Petition and Notice of Petition

After serving a termination notice or if no termination notice is required, a landlord then serves the tenant with a petition and notice of petition. The petition in a drug-holdover proceeding that follows an arrest usually contains law-enforcement paperwork like the search warrant (although not the affidavit underlying the warrant[29]), police department property-clerk vouchers showing what the police allegedly seized, and laboratory reports stating whether the substance tested is an illegal drug and, if so, what kind and its weight. The failure to include documentation detailing the quantity of illegal narcotics recovered and a description of the illegal drug paraphernalia seized renders a petition facially defective and warrants dismissal of the petition.[30]

The statute of limitations for a landlord to bring a drug holdover is one year from the date of the search and seizure of the drugs and drug paraphernalia.[31] As opposed to a private landlord, the DA has a three-year period within which to serve and file the petition and notice of petition.[32]

C. Burden of Proof

The petitioner has the burden of proof, by a preponderance of the evidence, to show that leased premises were used for illegal purposes.[33]

A petitioner will not satisfy the burden of proof in a drug-eviction proceeding if the evidence shows that the tenant possessed the illegal drug for personal use. Nor will it be sufficient if the petitioner shows only that the illegal drug sale was a one-time or isolated occurrence. The petitioner must establish by a fair preponderance of the evidence that a continuing illegal business, not merely illegal activity, was conducted on or from the premises with the participation, knowledge, or at least passive acquiescence of one or more of the record tenants.[34]

The court decides whether the tenant was involved in the illegal business, knew that the illegal business was taking place in the premises, or should have known that the illegal business existed and did not take reasonable steps to prevent it.[35] The standard arising from the circumstance when a tenant should have known that the illegal business existed and did not take reasonable steps to prevent it is called the "knew or should have known" standard. The courts have found that "it is sufficient if the acts and conduct complained of warrant the inference of acquiescence in an occupancy contemplating the prohibited purpose."[36] A tenant who knew that the premises were being used to sell illegal drugs and did nothing about it will be evicted. If the tenant did not know about the illegal business but a reasonable person should have known about or recognized it, the ignorant tenant will be evicted.

The idea of punishing indifferent tenants was well-stated in the seminal case of *City of New York v. Goldman*, in which the court found that "[t]here comes a time when one must look and when he looks, he must see. Convenient indifference should not be confused with pardonable ignorance."[37] A tenant cannot ignore that an illegal business is taking place in the subject premises. Instead, the tenant must take steps, like calling the police or having the person removed from the premises, to prevent the illegal business. Tenants who do not do so might be evicted.

D. Pretrial Issues

An array of pretrial collateral issues affect drug holdovers. First, an eviction does not constitute a multiple punishment in violation of the Double Jeopardy Clause. Thus, one can be both punished criminally after a conviction and evicted for the same conduct.[38] Second, neither the Fourth nor the Fifth Amendments require a stay of a Housing Part holdover proceeding to await the outcome of a related criminal trial. As to the Fourth Amendment, most courts have held that a motion to suppress evidence under *Mapp v. Ohio*[39] does not apply to drug-eviction holdovers.[40] As to suppressing statements under *Miranda*, a *Huntley* hearing is unavailable in a drug holdover.[41] As to the Fifth Amendment, a defendant in a criminal case who is a respondent in a Housing Part holdover must choose between preserving a Fifth Amendment privilege and not testify or risk an adverse inference. That dilemma does not, however, justify staying the drug holdover to await the resolution of the criminal action.[42]

Disclosure requests are possible but rarely granted to respondents in drug-holdover proceedings. The rule in drug holdovers is that disclosure should be denied unless the need for the information is compelling and particularized, and even then it should be granted only when the information sought will not jeopardize the safety of informants or the police or the confidentiality of current or impending law-enforcement investigations.[43] As to disclosing *Rosario* and *Brady* material—respectively, written or otherwise-memorialized statements by witnesses in law enforcement's possession and exculpatory material in law enforcement's possession—one court has held that they are neither relevant nor appropriate because a drug holdover "is not a criminal proceeding, [and thus that] 'there is no evidence or information which would tend to negate the guilt of the accused or mitigate the offense charge or which would tend to reduce the punishment of the accused.'"[44]

V. New York's Illegal-Use Statutes

New York's illegal-use statutes were enacted in the Victorian Era. Their original purpose was to give law enforcement a weapon against prostitution.[45] The language of each statute is broad and can be interpreted in different ways. Over the years, the purpose of these statutes has changed in response to social realities.[46] That purpose has extended to landlord-tenant relationships, allowing both landlords and tenants to bring eviction proceedings against illegal-use tenants.

RPL § 231 sets forth the legal consequences tenants face when they use their dwellings for illegal purposes. Section 231(1) provides that when tenants maintain apartments for an illegal use, the lease or tenancy ends. The statute provides that

> Whenever the lessee or occupant other than the owner of any building or premises, shall use or occupy the same, or any part thereof, for any illegal trade, manufacture or other business, the lease or agreement for the letting or occupancy of such building or premises . . . shall thereupon become void, and the landlord of such lessee or occupant may enter upon the premises so let or occupied.[47]

If a landlord knows that a tenant is using the premises to conduct an illegal business, RPL § 231 provides the right to commence an eviction proceeding. By its terms, it also states at subdivisions five and seven that the Attorney General or any owner or tenant, including any tenant living "within two hundred feet of the demised real property, may commence an action or proceeding in supreme court to enjoin the continued unlawful trade, manufacture or other business in such premises."[48]

RPAPL 711(5) allows landlords to bring eviction proceedings against an illegal-use tenant when "[t]he premises, or any part thereof, are occupied as a bawdy-house, or house or place of assignation for lewd persons, or for purposes of prostitution, or any illegal trade or manufacture, or other illegal business."[49] RPAPL 715 allows the DA's office and tenants residing within 200 feet of illegally used premises to begin eviction proceedings against illegal-use tenants if the landlord fails to do so.[50]

VI. Defining Illegal Use

Neither the RPAPL nor the RPL defines "illegal," "use," or "illegal use."[51] Courts have created a five-factor test to determine whether a tenant is engaged in "illegal use." "Illegal use" exists if there is (1) illegal conduct; (2) engaged in as a business; (3) more than once; (4) involving the premises to be recovered; and (5) with the participation, knowledge, or passive acquiescence of one or more of the record tenants.

A. Illegal Conduct

Legislators at first enacted the "illegal use" statutes to deal with public health, morals, and welfare. The statutes' longstanding moral dimension has generated terms like "bawdy house," "lewd persons," and "vice."[52] These terms have lead to complications in today's jurisprudence, but they apply to illegal trade, manufacture, or business.[53] New York's "illegal use" statutes are "unambiguous in proscribing 'any illegal trade, manufacture or business' without reference to the moral turpitude of any given conduct or the impact of such conduct on other tenants or in a neighborhood."[54]

Regardless of a business's morality, eviction proceedings are warranted if the conduct complained of violates the Penal Law.[55] Eviction is allowed for crimes like drug trafficking, prostitution, gambling, and storing fireworks.

B. Business Use

For conduct to fall under the illegal-use statutes, the illegal use must constitute a business. RPL § 231 allows a landlord to terminate a lease only when the premises are "used . . . for any illegal trade, manufacture or other business."[56] This narrow language forbids eviction proceedings based solely on an individual's personal use of illegal drugs, regardless of the duration or quantity of that personal use.[57] The landlord must instead prove that the respondents knew or should have known that they or an occupant engaged in illegal "trade" or "manufacture."[58]

To distinguish a person's personal use from business use, possession, or sale, New York courts look to several factors to determine whether the use relates to a sale, manufacture, or business. These factors include (a) quantity and packaging of the drugs;[59] b) paraphernalia;[60] (c) loose cash; (d) customer lists; (e) weapons and ammunition;[61] and (f) digital scales. This list is not exhaustive or conclusive. Courts make the determination on a case-by-case basis.

C. Continuity

The term "use" in the RPAPL and the RPL does not refer to a one-time occurrence: The "use" must occur continually on the premises.[62] A single act does not satisfy the "use" requirement.[63] Yet "[c]essation of illegal activity prior to trial will not prevent the petitioner from obtaining a judgment."[64]

If a tenant conducts a casual transaction selling a negligible quantity of drugs inside an apartment, the business requirement might be met, but the continuity requirement will not be satisfied, and an eviction will not be warranted.[65] One way for the courts to ascertain whether continuity exists is to examine the quantity of the drugs and the quality of other evidence seized during the tenant's arrest.

D. Nexus to the Premises

The RPAPL does not define "premises." "Premises" is an elastic, inclusive term that depends on the circumstances in the individual case. One court has held that the common areas of a building, including the street in front of an apartment building, constitute the premises for the purposes of a drug-holdover eviction.[66] Most courts have required that the petitioner prove the apartment is the location of the illegal drug sale or production. The landlord must demonstrate, therefore, that the premises were used to further an illegal business.[67] A sufficient nexus must exist between the operation of the illegal business and the complained-of premises.[68]

One way to prove this nexus is through an eyewitness who observes the tenant continually selling drugs from the premises. Another way is to offer testimony or video of foot traffic, which might circumstantially

suggest a drug business connected to the premises if the volume of traffic is large, at odd hours, and indicates stays of short duration. Often the drugs are seized on the premises during an arrest or pursuant to a search warrant. This shows a relationship to the premises. It allows courts to infer the connection to the premises by the drugs' location.[69]

People who conduct illegal activity on the street far from their apartments and who never store illegal substances inside their apartments cannot be evicted through a drug-eviction proceeding. In that event a sufficient nexus between the illegal business and the premises cannot be established.

E. Presence of Illegal Drugs

The petitioner must prove that illegal drugs were on the premises. This is usually done by introducing at trial a police laboratory report to prove that the substances found at the premises were illegal and by offering police testimony to show a chain of custody of those substances through property-clerk voucher forms from the time of the search warrant until the time of the police laboratory test. Most laboratory reports contain the chemist's certification and thus are automatically admissible. Without that certification, a petitioner must lay a sufficient foundation under the business record rule, CPLR 4518(a), to show that the report was made in the ordinary course of business, that it was the ordinary course of business to make such a report, and that the report was made within a reasonable time after the testing.

F. Acquiescence

Another factor that establishes illegal use is that the tenant participated in or had actual knowledge of the illegal business. It is unnecessary for the tenant to be involved in the actual drug sales for the court to find illegal use. It is enough that the tenant turned a blind eye to the illegal business.[70] For example, it is no defense that the tenant left the apartment to an acquaintance because of a medical emergency or vacation and that the illegal activities occurred while the tenant was elsewhere, if the tenant acquiesced in the drug activity.[71]

Proving that the tenant had actual knowledge of the illegal business is difficult. This difficulty has led to years of case law interpreting the "knew or should have known" standard.

VII. The "Knew or Should Have Known" Standard

New York case law applies six factors to ascertain whether a tenant knew or should have known about a drug business connected to the subject premises. The factors are (1) whether the contraband and paraphernalia were in plain view; (2) the size of the premises; (3) the drug-arrest history of the named tenant or the occupant who is alleged to have committed the illegal activity; (4) whether intensive foot traffic occurred in and out of the premises; (5) the presence of contraband; and (6) the connection between the person alleged to possess the contraband and the apartment in which the alleged drug business occurs.

The "knew or should have known" standard is vague. Although the courts must take into account the NEP's purpose, they cannot lose sight of the effect that evictions will have on indigent tenants, often with minor children, who were not involved in illegal activity. In a three-bedroom apartment where closets and locks are on each bedroom door, are parents supposed to do daily sweeps of the bedrooms to ensure that no illegal activity occurs? What about someone who rents a room to a boarder for extra money, either as a roommate or as a sublease? Should a tenant lose the home because of the roommate's or subtenant's activities? Yes, but only if the facts of the case show an inference of knowledge or willful blindness.[72]

An explanation of the factors that determine whether a tenant knew about or acquiesced in the illegal activity will help navigate this fact-intensive terrain.

A. Plain View

When the police execute a search warrant and find substantial contraband around the premises in the open, evicting the tenant from the subject apartment might be reasonable.[73] But it is improper to hold an innocent tenant liable for the illegal-use tenant's activities if the evidence shows that the illegal-use occupant concealed the illegal business activity by hiding the narcotics in a closet, in a locked box, under a bed, or in an obscure location. A tenant reasonably unaware of the illegal business activities of another tenant or occupant who took measures to hide the illegal business cannot be evicted.[74]

The size of the contraband found in the premises will affect a court's determination whether the contraband is in plain view.[75] An eviction is warranted when the contraband is so physically large that the tenant must have seen it and known what it was.[76] Tenants have a responsibility to be aware of the activities taking place in their premises in plain view, but they will not be evicted if the illegal activities were hidden from a person who reasonably had no reason to know about the activities.

B. The Premises' Size and Configuration

New York courts will consider the size and layout of the premises when determining whether the "knew or should have known" standard is satisfied. It is unreasonable to expect that a tenant would know what a third party is doing in a large apartment with several bedrooms, each with its own door with a lock.[77] In a small studio apartment, where everything is in the open, it will be easier for a landlord to prove that the other tenants knew about the illegal business conducted by the alleged illegal-use tenant or occupant.[78]

In some instances a court will find that even in a large apartment, the tenant should have known that an illegal business was taking place. That might occur when the configuration of the premises requires the tenant to pass through the rooms

where the contraband is located and the contraband is in plain view.[79] If the landlord or the DA can prove that a reasonable person would have seen the contraband and realized that another tenant or occupant was conducting an illegal business, an eviction will be justified.

C. History of Drug Arrests

New York courts will also consider the history of drug arrests of the alleged illegal user, roommate, subtenant, guest, or tenant when deciding whether the landlord has satisfied the "knew or should have known" standard. If the occupant has a history of drug use, drug possession, or drug arrests of which the record tenant was or should have been aware, it is more likely that an eviction will ensue.[80]

The courts are more likely to evict the other tenants as well,[81] because indifference is different from ignorance.[82] If a tenant knows that the co-tenant, guest, roommate, or subtenant has a history of selling drugs, with convictions for narcotics-related crimes, the tenant has a heightened duty to ensure that the co-tenant, guest, roommate, or subtenant is not conducting illegal business from the premises.

With regard to a drug-arrest history, the issue arises whether a landlord is precluded from using information from a tenant's sealed criminal records in a holdover proceeding. One Housing Part judge ruled that only a superior court has the power to entertain that application.[83] In a recent Supreme Court decision, a judge granted a motion to vacate a prior order unsealing the record of a criminal case.[84] The court held that the DA was not authorized under Criminal Procedure Law 160.50 to unseal a criminal-case record. According to the court, seeking to provide evidence for a civil eviction proceeding does not serve a criminal investigation purpose—the only purpose the statute authorizes—and, further, that the DA did not show that justice required the unsealing action.[85]

One consideration is whether the tenant of record was arrested during or right after the search warrant was executed. An arrest is proof of nothing, but a tenant not arrested will argue that the police officers' decision not to arrest means the absence of proof that the tenant was complicit in the drug crime.

More important than an arrest or the decision not to arrest is whether the tenant of record was arrested and then convicted after a trial or a plea of guilty to selling drugs or to possessing them with the intent to sell them. A person found guilty in a criminal case is collaterally estopped from arguing non-guilt in a civil case.[86] But a person arrested who was found not guilty or whose charges were dismissed or withdrawn does not benefit from that happenstance. The burden of proof in a criminal case is proof beyond a reasonable doubt. One can be found not guilty and still be evicted under the lesser preponderance standard applicable in civil cases. One can also benefit from constitutional protections afforded in criminal prosecutions but unavailable in civil cases. Moreover, the civil "knew or should have known" standard differs markedly from the individual culpability considered in criminal prosecutions. It is not a crime to know about drug activity and do nothing to stop it. One can be evicted, however, for knowing about it and not stopping it.

D. Foot Traffic Through the Premises

Another factor New York courts consider is foot traffic in and out of the premises. An eviction might be warranted if the landlord can prove extensive foot traffic. Foot traffic—especially traffic that moves quickly, as if the premises were a drug supermarket—might suggest that an illegal business is being conducted in or from the premises and that the supposedly unaware tenant is not innocent after all.[87] The court must decide on a case-by-case basis what constitutes an abnormally high level of foot traffic. It is easier for a court to make its determination in residential premises than in commercial premises. Businesses naturally have a high level of traffic.

E. Contraband in the Tenant's Room

New York courts have ruled that an eviction is warranted when the record tenants have contraband in their bedrooms or on their person.[88] The presence of contraband in the tenant's bedroom or on the tenant's person indicates that the tenant had actual knowledge of the illegal business. With actual knowledge, there is no need to resort to the "should have known" standard.

F. The Connection between Tenant and Drug Dealer

The relationship between the tenant and the person who sells or possesses the contraband for sale is significant, as is the duration of stay in the apartment. Where the person with the contraband was in the apartment only for two weeks as a boarder before the police raid, no eviction was warranted. Similarly, the illegal activity of a former boyfriend or girlfriend of the adult child of the tenant of record who is present in the apartment only for an occasional overnight would normally carry less weight for eviction of the otherwise innocent tenant than if the same illegal activity was done by the tenant's child. In short, where the illegal activity was caused by a family member, close friend, or paramour of the tenant of record, it is more likely that the "knew or should have known" test will be met than if the cause was a person less connected to the tenant.[89]

VIII. Strict Liability: The Recent Approach to Drug-related Activity

A. Public Housing Authorities

Congress enacted the United States Housing Act in 1937, effectively creating the first public housing.[90] Determining that creating sufficient and appropriate housing for poor people by private organizations and private landlords alone was impossible, Congress concluded that the federal government must intervene. The federal government decided to give local governments financial aid

to encourage constructing acceptable housing for citizens of low income.[91]

The Housing Act was created to "alleviate present and recurring unemployment and to remedy the unsafe and unsanitary housing conditions and the acute shortage of decent, safe, and sanitary dwellings for families of low income in rural or urban communities that are injurious to the health, safety, and morals of the citizens of the Nation."[92] Because public housing apartments are limited, the Act gives each public housing authority the option to give preference to specific groups, like elderly or disabled persons or low-income families.[93] Given the limited amount of public-housing apartments relative to the huge demand and the growing problem of drug dealing in housing-authority projects across the country, the federal government has taken steps in recent years to punish drug dealers and drug dealing in public housing.

One step the federal government took was to discourage drug dealing by evicting tenants who, the theory goes, could have prevented drug crimes by being vigilant about criminality. The requirement to be vigilant has led to the lesser strict-liability approach in which proof of knowledge of criminality is not required to cause a forfeiture of the home.

Congress passed the Anti-Drug Abuse Act of 1988 to fight drug dealers, who were increasingly becoming a blight on public-housing tenants.[94] The Act gives public-housing officials the authority to include a new lease provision addressing evictions for drug related and other criminal offenses. The Act, as later amended, provides that each "public housing agency shall utilize leases which . . . provide that any criminal activity that threatens the health, safety, or right to peaceful enjoyment of the premises by other tenants or any drug-related criminal activity on or off such premises, engaged in by a public housing tenant, any member of the tenants household, or any guest or other person under the tenant's control, shall be cause for termination of the tenancy."[95]

Continuing the nation's fight against drugs in public housing, a tougher stance was enacted against tenants who allow drug-related criminal activity to take place in or near their apartments. In his 1996 State of the Union Address, President Clinton announced his "One Strike" policy, asking local housing authorities and tenant associations to fight criminal gang members and drug dealers.[96] The "One Strike" policy urged public-housing authorities to adopt a tougher stance on evictions: "for residents who commit crime and peddle drugs . . . one strike and you're out."[97] After this announcement, Congress enacted the Housing Extension Act, and President Clinton issued a directive ordering the Department of Housing and Urban Development (HUD) to provide national guidelines for public-housing authorities to adopt the "One Strike Policy."[98] The intent was that the new, stricter policy would lead to "certain and swift eviction" for those who engage in drug-related criminal activity.[99]

The United States Supreme Court case of *HUD v. Rucker* clarified the ambiguity about the federal strict-liability standard that had persisted since the inception of the Drug-Abuse Act of 1988, in which the circuits were split about whether to apply a strict-liability standard. The Court found that 42 U.S.C. § 1437d(l)(6), which the Act created, "unambiguously requires lease terms that vest local public housing authorities with the discretion to evict tenants for the drug-related activity of household members and guests whether or not the tenant knew, or should have known, about the activity."[100] The statute clarifies that a lease termination is warranted for any drug-related activity, not just the drug-related activity about which the tenants knew or should have known.[101] The Court reasoned that Congress had a reasonable purpose in allowing no-fault evictions: to provide tenants of public-housing projects with "housing that is decent, safe, and free from illegal drugs."[102] The statute, however, does not require eviction. The decision to evict is left to the public housing authorities' discretion. The authorities' discretion is based on the "degree to which the public housing project suffers from 'rampant drug-related or violent crime, the seriousness of the offending action, and the extent to which the leaseholder has . . . taken all reasonable steps to prevent or mitigate the offending action.'"[103]

Scholars and housing advocates have written about the harm that this strict-liability statute has caused.[104] As one writer explained, "Although the laws and regulations are intended to reduce fear of gangs, criminals, drugs and violence in public housing, they provide another source of fear: being evicted for something the tenant did not do."[105] Indeed, "holding the tenant responsible for the illegal acts of 'other persons under her control' when that person is an adult is a severe penalty, especially when the leaseholder could not foresee or was not aware of the person's actions."[106] Thus, although "keeping public housing free of illegal drugs is an important objective, keeping innocent tenants in their homes is at least as important."[107] The strict-liability standard might maximize deterrence by putting the onus on the tenant to prevent drug activity by household members or guests. But strict liability is not always proper when a tenant has taken reasonable precautions against criminal activity. Thus, many believe that public-housing authorities should seek to evict only if the circumstances warrant this drastic measure.[108] Judges have also expressed the sentiment, even in non-strict-liability cases, that innocent tenants faced with the lack of affordable housing should not be evicted for a third person's acts.[109]

B. Section 8

The Section 8 program, called the Housing Choice Voucher Program, since 1996 grants federal subsidies for low-income tenants not in a federally subsidized public-housing authority like a New York City Housing

Authority (NYCHA) development. The voucher can be tenant-based or project-based. Tenant-based programs are administered in New York by public housing agencies (PHAs) like NYCHA, the Department of Housing and Community Renewal, and the Department of Housing Preservation and Development. Tenant-based programs stress tenant portability in the marketplace wherever landlords accept vouchers. Project-based programs, administered in New York by Quadel Consulting, a private company, apply to privately owned apartments, and typically to entire privately owned developments.

The issue in drug-holdover proceedings involving Housing Choice Voucher Program units, whether tenant- or project-based, is whether strict liability applies, assuming that the lease between the parties or the HUD-required lease has a clause that allows for strict liability, because strict liability may not be imposed absent a lease clause that allows for strict liability. Some commentators argue that strict liability does not apply to Housing Choice Voucher Program units.[110] These commentators contend that it is especially unfair to allow private owners of Section 8 housing to impose strict liability; unlike NYCHA, for example, which has the discretion whether to seek to evict on strict liability, private owners do not exercise that discretion in the public interest. But New York case law from the lower courts imposes strict liability.[111] The consensus among the lower courts that the "knew or should have known" standard does not apply to Section 8 housing in New York will likely continue until an appellate court holds otherwise.

C. The Federal Standard Versus the New York Standard

New York law requires that an eviction for illegal use be founded on commercial drug-related activity, as explained above. Under New York law, the tenant need not be directly involved in the illegal activity, but the landlord must establish that the tenant knew or acquiesced in the illegal activity.[112] Strict liability does not apply. In New York City today, the NYCHA, which runs all public housing in the five boroughs, has chosen to proceed under either New York's "knew or should have known" standard or the federal strict-liability standard depending on the circumstances of the case.

Until 1996, NYCHA dealt with tenants allegedly involved in illegal activity by holding an administrative termination hearing rather than by bringing a drug-holdover proceeding.[113] During this period, when a DA's Office asked NYCHA to commence a NEP proceeding under RPAPL 715(1), NYCHA would instead hold an administrative hearing.[114] The DA would then have to litigate the drug-holdover proceeding in Civil Court if it chose to do so.[115] The DA was not required to wait for an administrative hearing to be held before bringing a NEP case against a public-housing tenant.[116] Some believe that an administrative hearing provides procedural and substantive protections to tenants facing eviction.[117] At these hearings, NYCHA would sometimes seek to settle the matter by a stipulation that allowed for the conditional continuation of the tenants' tenancies. In extreme circumstances, NYCHA would pursue termination of the tenancy. If either the tenant or NYCHA refused to settle the matter, the hearing would be conducted before an administrative law judge, called a hearing officer, who would make a determination subject to approval or rejection by the NYCHA board. If the NYCHA board makes a determination unfavorable to the tenant, the tenant has three options: "to voluntarily vacate the apartment; to challenge the determination through an Article 78 proceeding in Supreme Court; or to appear in Housing Court upon the commencement of a summary holdover proceeding against her."[118]

In 1996, in *Escalera*, NYCHA obtained a modification of the consent decree to allow proceedings based on allegations of illegal drug activity to be brought directly in the Civil Court's Housing Part without first holding an administrative hearing.[119] In modifying the consent decree, the *Escalera* court found a dramatic increase in illegal drug trafficking and use and drug-related crime in New York's public housing.[120] This modification gave NYCHA the discretion to bring a drug-holdover proceeding in an NEP/Illegal-Use Part or, before bringing that proceeding, to hold an administrative hearing.

The *Rucker* decision gave NYCHA the discretion to pursue the federal standard of strict liability in those cases that suggest stringent enforcement. The circumstances of each case dictate the course NYCHA will pursue. Under many circumstances, applying the "knew or should have known" standard will lead to the same result that *Rucker*'s strict-liability standard allows. If the circumstances do not clearly indicate that the tenant either participated in or knew about illegal conduct in their apartment, NYCHA will have discretion to hold an administrative hearing and pursue the application of the "knew or should have known" standard.

IX. Conclusion

The courts' various approaches to the problems of narcotics sales show the common law's evolution in New York. The NEP is an innovative court program intended to remedy a widely recognized social scourge. The NEP allows drug-related activity in residential units in New York City to be addressed swiftly. The mechanism of having the DA push private landlords and NYCHA to commence holdover proceedings insures that the ignorance and sometimes connivance of landlords about alleged drug activities does not bar prompt action. The DA's ability to give landlords the details of the drug arrests and paraphernalia recovered by the police in drug raids also insures that landlords will have enough evidence to present their case fairly. The use of the DA's contacts and resources to insure that police officers appear to testify is essential to having all relevant evidence at trial, something private landlord's

attorneys are hard-pressed to arrange themselves.

The mere fact of a lawsuit does not mean that a claim has merit. The landlord must sustain its burden to prove the elements of its claim. Innocent tenants who neither knew nor should have known about the drug activity of others who have occupied their apartments temporarily should not be rendered homeless. The factors to which the courts have looked to determine whether the "should have known" standard has been met in New York balances society's need to limit drug businesses and the rights of innocent tenants to maintain their homes and commercial space when they are unaware of hidden and surreptitious activity. Given the shortage of affordable housing in New York, strict liability for federally subsidized and public housing is a severe but effective remedy.

Endnotes

1. *N.Y.C. Hous. Auth. v. Pretto*, 8 Misc. 3d 708, 711, 795 N.Y.S.2d 871, 873 (Hous. Part Civ. Ct., Bronx Co. 2005) ("RPL § 231 does not create a cause of action to evict a tenant. To evict a tenant, a landlord must rely upon the provisions of RPAPL §§ 711(5) and 715(1)."); Andrew Scherer, *Residential Landlord and Tenant in New York* § 8:101, at 555 (2007).
2. Irving B. Hirsch, *Understanding Forfeiture and Related Civil Actions in Criminal Law: Padlock Proceedings; Nuisance Abatement Actions Evictions,* Practising Law Institute Litigation and Administrative Practice Course Handbook Series Criminal Law and Urban Problems, 164 PLI/Crim. 117, at 120 (1992).
3. *Kellner v. Cappellini*, 135 Misc. 2d 759, 765, 516 N.Y.S.2d 827, 831 (Hous. Part. Civ. Ct., N.Y. Co. 1986).
4. George M. Heymann, Outside Counsel, *Eviction Proceedings for Alleged Illegal Drug Activities: An Overview*, N.Y.L.J., May 28, 1999, p. 1, col. 1.
5. Steven I. Kessler, *New York Criminal and Civil Forfeitures Including Narcotics Eviction Proceedings* 265 (1999).
6. *Id*. at 268 & n. 18 (citing *Martinez v. N.Y.C. Hous. Auth.*, N.Y.L.J., July 2, 1996, p. 26, col. 3 (Sup. Ct., N.Y. Co.) and *City of N.Y. v. 924 Columbus Ave. Assocs.*, N.Y.L.J., Oct. 19, 1994, p. 22, col. 3 (Sup. Ct., N.Y. Co.)).
7. Scherer, *supra* note 1, at § 8:133, at 569.
8. *See* Kessler, *supra* note 5, at 268.
9. *See., e.g., Rochdale Village Inc. v. Harris*, 172 Misc. 2d 758, 763, 659 N.Y.S.2d 416, 419 (Hous. Part Civ. Ct., Queens Co. 1997).
10. *See* Heymann, *supra* note 4 (citing cases) ("Does the court have the authority to accept and 'so order' a stipulation of settlement entered into between petitioner(s) and respondent(s) after a settlement conference, immediately prior to trial, without the consent of the District Attorney's office? The answer is yes.").
11. *See* Hirsch, *supra* note 2, at 123.
12. National Institute of Justice, The Manhattan District Attorney's Narcotics Eviction Program 5 (1995).
13. *Id*.
14. RPAPL 715(4).
15. *See* Hirsch, *supra* note 2, at 125.
16. *E.g., Hudsonview Co. v. Jenkins*, 169 Misc. 2d 389, 645 N.Y.S.2d 741 (Hous. Part Civ. Ct., N.Y. Co. 1996).
17. State Rent and Eviction Regulations, 9 N.Y.C.R.R. § 2204.2(a)(4), authorizes the eviction of rent-controlled tenants based on use of the premises for illegal activity, but only if a notice terminating the tenancy under 9 N.Y.C.R.R. § 2204.3(a) is served. *See Park 83rd St. Corp. v. Thomas*, N.Y.L.J., June 3, 1992, p. 23, col. 3 (Hous. Part Civ. Ct., N.Y. Co.).
18. 9 N.Y.C.R.R. § 2524.2(c)(2) (requiring service of seven-day notice to vacate on rent-stabilized tenant to proceed on ground of using premises for immoral or illegal purpose); *see* 9 N.Y.C.R.R. 2524.3(d) (allowing eviction of rent-stabilized tenants using or permitting use of dwelling for immoral or illegal purpose).
19. *2312-2316 Realty Corp v. Font*, 140 Misc. 2d 901, *passim*, 531 N.Y.S.2d 727, *passim* (Hous. Part Civ. Ct., Bronx Co. 1988).
20. *See* 24 C.F.R. Part 866; *Jackson Terrace Ass'n v. Patterson*, 155 Misc. 2d 556, 557, 589 N.Y.S.2d 141, 141 (Dis't Ct., Nassau Co. 1992), *appeal dismissed*, 159 Misc. 2d 637, 611 N.Y.S.2d 430 (App. Term, 2d Dep't 9th & 10th Jud. Dists. 1994) (mem.) (but noting in dictum, in decision rendered before federal regulations required termination notice, that termination notices are not ordinarily required for proceedings brought under RPAPL 711(5).
21. 24 C.F.R. §§ 966.4(I)(2)(iii)(A), 966.4(I)(3)(i)(B)(2), 966.4(I)(3)(ii); *N.Y.C. Hous. Auth. v. Harvell*, 189 Misc. 2d 295, 296, 731 N.Y.S.2d 919, 920 (App. Term, 1st Dep't 2001) (per curiam).
22. Kessler, *supra* note 5, at 277–78.
23. *See, e.g., Hudsonview*, 169 Misc. 2d at *passim*, 645 N.Y.S.2d at *passim*.
24. *N.Y. Co. Dist. Attorney's Office v. McDaniels*, N.Y.L.J., May 24, 1991, p. 22, col. 4 (Hous. Part Civ. Ct., N.Y. Co.).
25. *Dowarp Realty v. Acevedo*, N.Y.L.J., Apr. 3, 1990, p. 26, col. 2 (App. Term, 1st Dep't) (per curiam).
26. *Cleo Realty Assocs. v. Stevens*, N.Y.L.J., Mar. 19, 1992, p. 26, col. 6 (Hous. Part Civ. Ct., N.Y. Co.) ("RPAPL 741(4) requires a petition 'to state the facts upon which the special proceeding is based.'").
27. *E.g., N.Y. Co. Dist. Attorney's Office v. Merced*, N.Y.L.J., Sept. 22, 1994, p. 29, col. 6 (Hous. Part Civ. Ct., N.Y. Co).
28. *Broadway Central Securities Corp. v. Buchanan Restaurant Co., Inc.*, 218 App. Div. 594, 599–600, 218 N.Y.S. 539, 544 (1st Dep't 1926).
29. Depending on confidentiality issues, affidavits underlying search warrants might be obtainable in Criminal Court (if the case is a misdemeanor or unindicted felony) or Supreme Court (if the Grand Jury has voted to indict) so that a defendant can move to controvert the search warrant during a *Franks/Alfinito* hearing and thus seek suppression on Fourth Amendment grounds. *See People v. Castillo,* 80 N.Y.2d 578, 592 N.Y.S.2d 945, 607 N.E.2d 1050 (1992), *cert. denied*, 507 U.S. 1033 (1993).
30. *Cleo Realty*, N.Y.L.J., Mar. 19, 1992, p. 26, col. 6.
31. *Pretto*, 8 Misc. 3d at 713, 795 N.Y.S.2d at 875.
32. *Id*., 795 N.Y.S.2d at 874–75.
33. *Normandy Realty v. Boyer*, 2 Misc. 3d 407, 410, 773 N.Y.S.2d 186, 189 (Hous. Part Civ. Ct., Bronx Co. 2003).
34. *See* Hirsch, *supra* note 2, at 125–26.
35. *Id.* at 132.
36. *City of N.Y. v. Goldman,* 78 Misc. 2d 693, 696–97, 356 N.Y.S.2d 754, 758 (Civ. Ct., N.Y. Co. 1974).
37. *Id.* at 696, 356 N.Y.S.2d at 758.
38. *City of N.Y. v. Wright*, 162 Misc. 2d 572, 573–74, 618 N.Y.S.2d 938, 938 (App. Term, 1st Dep't 1994) (per curiam) (noting in case of tenant who pleaded guilty to felony attempted possession of a controlled substance, following seizure of 35 jumbo vials of crack, drug paraphernalia, cash, and a gun, that eviction was not punishment but "was intended to protect the health, welfare and safety of the public residing in the same community as well as the tenants who reside in the same building"), *aff'd*, 222 A.D.2d 374, 636 N.Y.S.2d 33 (1st Dep't 1995) (mem.), *appeal dismissed*, 87 N.Y.2d, 644 N.Y.S.2d 146, 666 N.E.2d 1060 (1996).
39. 367 U.S. 643 (1961).
40. *E.g., Pleasant E. Assocs. v. Soto*, N.Y.L.J., Oct. 27, 1993, p. 26, col. 3 (Hous. Part Civ. Ct., N.Y. Co.) (noting that paramount justification for exclusionary rule—to deter unlawful police behavior—does not arise in drug holdovers). For a discussion of the issue, see *Ackert v. Figueroa*, N.Y.L.J., Apr. 8, 1997, p. 27, col. 1 (Hous. Part Civ. Ct., Queens Co.).
41. *N.Y.C. Hous. Auth. v. Grillasca*, 12 Misc. 3d 223, 224, 810 N.Y.S.2d 893, 895 (Hous. Part Civ. Ct., N.Y. Co. 2006) (Gerald Lebovits, J.) (citing *Miranda v. Arizona*, 384 U.S. 436 (1966), and *People*

v. Huntley, 15 N.Y. 72, 255 N.Y.S. 838, 204 N.E. 179 (1965)); *contra City of N.Y. v. Prophete*, 144 Misc. 2d 391, 393, 544 N.Y.S.2d 411, 413 (Hous. Part. Civ. Ct., N.Y. Co. 1989) (noting in dictum that to introduce statements, petitioner must lay foundation that statements were elicited voluntarily).

42. *54 W. 16th St. Apt. Corp. v. Dawson*, 179 Misc. 2d 264, 268, 684 N.Y.S.2d 400, 404 (Hous. Part Civ. Ct., N.Y. Co. 1998).

43. *Compare Grillasca*, 12 Misc. 3d at 226, 810 N.Y.S.2d at 896 (denying disclosure because of law-enforcement considerations), *with Wingate Hall Co. v. Betances*, N.Y.L.J., Sept. 29, 1993, p. 22, col. 6 (Hous. Part Civ. Ct., N.Y. Co.) (granting partial disclosure because respondent made compelling and particular demonstration of need for limited discovery and because petitioner did not demonstrate any risk to confidential informants).

44. *Merced*, N.Y.L.J., Sept. 22, 1994, p. 29, col. 6 (citation to Criminal Justice Standards omitted).

45. Kessler, *supra* note 5, at 265.

46. *Id*.

47. RPL § 231(1).

48. *Id.* § 231(6) & RPAPL 715(1). Rare are the cases brought by homeowners and tenants who live within 200 feet of an apartment, instead of by the landlord at the DA's prodding. *See, e.g.*, *Kellner*, 135 Misc. 2d at 760, 516 N.Y.S.2d at 828.

49. RPAPL 711(5).

50. *Id.* 715(1); Kessler, *supra* note 5, at 264–65.

51. *Spira v. Spiratone,* 148 Misc. 2d 787, 789, 561 N.Y.S.2d 881, 883 (Hous. Part Civ. Ct., N.Y. Co. 1990).

52. *See* RPAPL 711(5), 715(1).

53. *Spira*, 148 Misc. 2d at 788, 561 N.Y.S.2d at 882 (finding, however, that attending church is not an illegal use).

54. *1165 Broadway Corp. v. Alawie*, N.Y.L.J., Nov. 8, 1995, p. 26, col. 3 (Hous. Part Civ. Ct., N.Y. Co.).

55. Kessler, *supra* note 5, at 263.

56. RPL § 231.

57. *Normandy Realty*, 2 Misc. 3d at 41–2, 773 N.Y.S.2d at 189–190.

58. RPAPL 711(5) & 715(1).

59. *Clifton Court, Inc. v. Williams*, N.Y.L.J., May 27, 1998, p. 28, col. 6 (App. Term, 2d Dep't 2d & 11th Jud. Dists.) (mem.) (finding that nearly 60 crack vials, a razor, and empty ziplock bags transportable in a couple of pockets does not prove that apartment was locus of drug operation); *Howard Ave. Assocs. v. Rojas*, N.Y.L.J., Apr. 5, 2002, p. 20, col. 6 (Hous. Part Civ. Ct., Kings Co.) (Gerald Lebovits, J.) (denying eviction of parents who had no knowledge that adult son had hidden marijuana for personal use sufficient to fill eight cigarettes—a violation, not a crime—and had no paraphernalia); *Kings Co. Dis't Attorney's Office v. Underwood*, 143 Misc. 2d 965, 968, 543 N.Y.S.2d 247, 250 (Hous. Part Civ. Ct., Kings Co. 1989) (holding that presence of 193 vials of crack reflected that drugs were being sold).

60. *N.Y. Co. Dis't Attorney's Office v. Geigel*, N.Y.L.J., Dec. 27, 1991, p. 24, col. 6 (Hous. Part Civ. Ct., N.Y. Co.) (noting that recovery heroin, cocaine, crack, crack vials, jars containing substances used to dilute cocaine, glassine envelopes, cocaine grinders, cash, and scale was sufficient to evict).

61. *N.Y.C. Hous. Auth. v. Otero*, 2004 N.Y. Slip Op. 51454(U), 5 Misc. 3d 134(A), 799 N.Y.S.2d 162, 2004 WL 2683688, at *1, 2004 N.Y. Misc. LEXIS 2941, at *1 (App. Term, 1st Dep't 2004) (per curiam) (noting recovery of stun gun and "multiple rounds of ammunition").

62. *Randazzo v. Santangelo*, N.Y.L.J., Mar. 26, 1997, p. 31, col. 6 (Hous. Part Civ. Ct., Queens Co. 1997).

63. *N.Y.C. Hous. Auth. v. Boney*, N.Y.L.J., Feb. 3, 1998, p. 29, col. 5 (Hous. Part Civ. Ct., Kings Co.) (finding that single sale without other evidence of ongoing drug business is insufficient to support drug holdover).

64. Scherer, *supra* note 1, § 8:129, at 566.

65. *See 1165 Broadway Corp. v. Dayana of N.Y. Sportswear, Inc.*, 116 Misc. 2d 939, 944, 633 N.Y.S.2d 724, 727 (Civ. Ct., N.Y. Co. 1995).

66. *City of N.Y. v. Rodriguez*, 140 Misc. 2d at 467, 469–70, 531 N.Y.S.2d 192, 193-94 (Hous. Part Civ. Ct., Bronx Co.).

67. *City of N.Y. v. Omolukum*, 177 Misc. 2d 796, 801–02, 676 N.Y.S.2d 918, 922 (Hous. Part Civ. Ct., Bronx Co. 1998) (denying eviction of tenant for drug-related activities of former boyfriend, who was arrested for selling drugs once in front of building and twice in the building lobby where, although he gave his address as tenant's, she had kicked him out of apartment because of his violent behavior before arrests).

68. *See generally RRW Realty Corp. v. Flores*, N.Y.L.J., Feb. 10, 1999, p. 28, col. 3 (Hous. Part Civ. Ct., N.Y. Co) (discussing issue of nexus between alleged drug activity and three apartments in two buildings).

69. *N.Y.C. Hous. Auth. v. Manley*, N.Y.L.J., Jan. 8, 1997, p. 26, col. 2 (Hous. Part Civ. Ct., N.Y. Co.).

70. *Omolukum*, 177 Misc. 2d at 800–01, 676 N.Y.S.2d at 921.

71. *E.g.*, *In re Syracuse Hous. Auth. v. Boule*, 265 A.D.2d 832, 832–33, 701 N.Y.S.2d 541, 541–42 (4th Dep't 1999) (men.) (allowing eviction under strict-liability standard because tenant's babysitter and another engaged in drug-related activity in or near federally subsidized premises while tenant was at work).

72. *See 88-09 Realty, LLC v. Hill*, 305 A.D.2d 409, 757 N.Y.S.2d 904 (2d Dep't 2003) (mem.); Drug Holdovers: *It's Getting Harder for Tenants to Claim Innocence*, 3 Finkelstein & Ferrara's Landlord-Tenant Practice Reporter 1 (Jan. 2002).

73. *N.Y.C. Hous. Auth. v. Eaddy*, 2005 N.Y. Slip Op. 50617(U), 7 Misc. 3d 131(A), 801 N.Y.S.2d 237, 2005 WL 954877, at *1, 2005 N.Y. Misc. LEXIS 811, at *1-2 (App. Term 1st Dep't 2005) (per curiam) (applying "knew or should have known" standard even though premises was public housing).

74. *Village Mgmt. Corp. v. Grant*, N.Y.L.J., Jan. 19, 1996, p. 25, col. 2 (App. Term, 1st Dep't 1996) (per curiam).

75. *N.Y.C. Hous. Auth. v. Barnes*, N.Y.L.J., July 25, 2005, p. 19, col. 3 (Hous. Part Civ. Ct., Kings Co.) (finding presence of 183 ziploc bags, one larger plastic bag of "green, leafy" marijuana, and two loaded handguns sufficient to evict).

76. *Farhadian v. Diaz*, N.Y.L.J., Feb. 26, 1990, p. 23, col. 4 (App. Term, 1st Dep't 1990) (per curiam) (finding that large quantities of drug paraphernalia, cash, and numerous firearms, as well as a safe that contained additional drugs and drug paraphernalia, show tenant's knowledge of illegal conduct); *Otero,* 2004 N.Y. Slip Op. 51454(U), 5 Misc. 134(A), 799 N.Y.S.2d 162, 2004 WL 2683688, *1, 2004 N.Y. Misc. LEXIS 2941, *1 (applying "knew or should have known" standard rather than *Rucker* strict-liability standard and allowing eviction where "police officers recovered a package containing 288 bags of cocaine, which was observed by the officers being thrown from a window of the subject premises . . . [and] digital scales, a speed loader, a stun gun, multiple rounds of ammunition, a metal safe, over $6,000 in cash, and marijuana from two bedrooms"); *Dist. Attorney, Kings Co. v. Garcia,* N.Y.L.J., May 6, 1994, p. 33. col. 1 (Hous. Part Civ. Ct., Kings Co. 1994) (allowing eviction where sealing device was found, not in tenant's brother's locked bedroom, but in kitchen).

77. *Kingsley Court Assocs. v. Moreno*, L&T Index 92465/03 (Civ. Ct., N.Y. Co. 2004) (Gerald Lebovits, J.) (unpublished opinion) (denying eviction where apartment was 2,500 to 2,800 square feet with three or four bedrooms and where drugs and paraphernalia were found in bedroom of temporary guest hidden from view from elderly tenant of record).

78. *ARJS Realty Corp. v. Perez,* 2003 N.Y. Slip Op. 51220(U), 10, 2003 WL 22015784 at *3, 2003 N.Y. Misc. LEXIS 1093, at *12 (Hous. Part Civ. Ct., N.Y. Co.) (after arguing despite the case law to the contrary that the "knew or should have known" standard no longer exists under New York law, court found that if it does, tenant should have known about illegal activities committed in apartment smaller than 400 square feet).

79. *Village Mgmt*., N.Y.L.J., Jan. 19, 1996, p. 25, col. 2; *855-79 LLC v. Salas*, 10 Misc. 3d 132(A), 814 N.Y.S.2d 560, 205 N.Y. Slip Op. 52039, at *1, 205 WL 3440804, at *1 (App. Term, 1st Dep't 2005) (per curiam) (eviction warranted for "31 decks of heroin, one bag of cocaine, three bags of marijuana, 26 marijuana cigarettes, and assorted drug paraphernalia, mainly in the single bedroom of a 'railroad' style apartment").

80. *Pizarro*, N.Y.L.J., June 24, 1993, p. 24, col. 6 (eviction warranted where apartment's co-occupant was tenant's 18-year-old grandson whom tenant knew had "many times" had glassine envelopes in his bedroom); *Garcia*, N.Y.L.J., May 6, 1994, p. 33, col. 1 (noting that tenant's "plea of guilty [to attempted possession of drugs] coupled with his prior conviction for drug possession shows he is no stranger to the drug scene. This background becomes relevant in evaluating the bona fides of Respondent's claim of no knowledge").

81. *Pizarro*, N.Y.L.J., June 24, 1993, p. 24, col. 6.

82. *Goldman*, 78 Misc. 2d at 696, 356 N.Y.S.2d at 758.

83. *M.S. Hous. Assocs. v. Williams*, 13 Misc. 2d 1233(A), 2006 WL 3228403, at *2 (Hous. Part Civ. Ct., N.Y. Co. 2006) (ruling that if court had power, it would not exercise it here because petitioner did not demonstrate that desired information could not be obtained through other means: "For example, petitioner could use other evidence such as witness[es] to the alleged drug activity and or the police involved in the criminal investigation who would be able to testify based on their recollection.").

84. *People v. Diaz*, Indictment No. 40097/05 (Sup. Ct., N.Y. Co.) (Jan. 31, 2007) (unpublished opinion). For an excellent discussion of *Diaz*, see George M. Heymann, Outside Counsel, "*Diaz" and Eviction Proceedings for Illegal Drug Activities*, N.Y.L.J., Mar. 7, 2007, at 4 col. 4.

85. *Accord People v. Canales*, 174 Misc. 2d 387, 64 N.Y.S.2d 228 (Sup. Ct., Bronx. Co. 1997).

86. *190 Stanton Inc. v. Santiago*, 60 Misc. 2d 224, 225, 302 N.Y.S.2d 693, 694–695 (Civ. Ct., N.Y. Co. 1969) (assuming collateral-estoppel effect of convictions but declining to evict tenant).

87. *N.Y.C. Hous. Auth. v. Andino*, LT 10468/96 (Civ. Ct., Richmond Co. 1996) (unpublished opinion).

88. *Pizarro*, N.Y.L.J., June 24, 1993, p. 24, col. 6.

89. *Eaddy*, 2005 N.Y. Slip Op. 50617(U), 7 Misc. 3d 131(A), 801 N.Y.S.2d 237, 2005 WL 954877, at *1, 2005 N.Y. Misc. LEXIS 811, at *1-2 (finding that person arrested inside apartment whom tenant described as her "significant other" was enough to evict).

90. United States Housing Act of 1937, ch. 896 § 3, 50 Stat. 888, 888–89 (codified as amended at 42 U.S.C. § 1437-1437z-7 (2000)).

91. Caroline Castle, Note, *You Call That a Strike? A Post-Rucker Examination of Eviction from Public Housing Due to Drug-Related Criminal Activity of a Third Party*, 37 Ga. L. Rev. 1435, 1447 (2003) (citing Housing Act of 1937 § 1).

92. Housing Act of 1937 § 1.

93. 42 U.S.C. § 1437d(c)(4)(A) (1994 & Supp. 2002).

94. *HUD v. Rucker*, 535 U.S. 125, 127 (2002).

95. 42 U.S.C. § 1437(d)(1)(6) (1994 ed. Supp. V). This was implemented in the code of federal regulations pursuant to 54 Fed Reg 15, 1998 (April 28, 1989).

96. President Clinton, 1996 State of the Union Address.

97. *Id.*

98. HUD Directive No. 96-16, at 1.

99. Attachment to HUD Directive No. 96-16, at 1.

100. *Rucker*, 535 U.S. at 130.

101. *Id.* at 131.

102. *Id*.

103. *Id.* at 134 (citing 42 U.S.C. § 11901(2)).

104. *See, e.g.*, Peter J. Saghir, *Home Is Where the No-Fault Eviction Is: The Impact of the Drug War on Families in Public Housing*, 12 J.L. & Pol'y 369 (2003). Saghir argues that the *Rucker* decision upheld an unconscionable leasehold provision and put an unfair burden on public housing tenants. He argued for more holistic approaches such as instituting second-chance policies and community-based crime reduction and prevention strategies. Although Saghir concedes that the government has taken steps to protect tenants living in public housing, he found that the strict-liability policy negatively affects law-abiding innocent tenants.

105. Castle, *supra* note 91, at 1436.

106. Renai S. Rodney, *Am I My Mother's Keeper? The Case Against the Use of Juvenile Arrest Records in One-Strike Public Housing Evictions*, 98 Nw. U.L. Rev. 739, 765 (2004).

107. Castle, *supra* note 91, at 1468.

108. *Id*. at 1464.

109. *See, e.g.*, *Lloyd Realty Corp. v. Albino*, 146 Misc. 2d 841, 846, 552 N.Y.S.2d 1008, 1011 (Hous. Part Civ. Ct., N.Y. Co. 1990).

110. Anne C. Fleming, Note, *Protecting the Innocent: The Future of Mentally Disabled Tenants in Federally Subsidized Housing after HUD v. Rucker*, 40 Harv. C.R.-C.L. L. Rev. 197, 202 (2005) ("Section 8 tenancies operate quite differently from those of public housing residents. Through portable vouchers, the Section 8 program creates subsidized housing maintained by private landlords and does not concentrate low-income subsidized tenants in one development. The program therefore should not suffer from the same problems as those that plague public housing developments. Although the regulations for Section 8 are similar to those for public housing, this key difference between the two programs should exclude Section 8 tenants from the strict liability interpretation of the federal regulations affirmed in Rucker.") (footnote omitted).

111. *B&L Assocs. v. Wakefield*, 6 Misc. 3d 388, 390–391, 785 N.Y.S.2d 681, 683 (Hous. Part Civ. Ct., Kings Co. 2004); *Hampton Houses, Inc. v. Smith*, N.Y.L.J., Mar. 13, p. 23, col. 2 (Hous. Part Civ. Ct., N.Y. Co.).

112. *Howard Ave.*, N.Y.L.J., Apr. 5, 2002, p. 20, col. 6.

113. *Escalera v. N.Y.C. Hous. Auth.*, 425 F.2d 853 (2d Cir. 1970). NYCHA agreed in a consent decree to provide an administrative hearing before bringing public housing tenants to court.

114. Hirsh, *supra* note 2, at 129.

115. *Id*.

116. *N.Y. Co. Dist. Attorney's Office v. Oquendo*, 147 Misc. 2d 125, 129–30, 553 N.Y.S.2d 973, 976 (Hous. Part Civ. Ct., N.Y. Co. 1990).

117. For an excellent article covering *Escalera* and *Rucker* issues in New York, see Barbara Mulé & Michael Yavinsky, *Saving One's Home: Collateral Consequences for Innocent Family Members*, 30 N.Y.U. Rev. L & Soc. Change 689 (2006).

118. *Id*. at 695.

119. *Escalera v. N.Y.C. Hous. Auth.*, 924 F. Supp. 1323 (S.D.N.Y. 1996)

120. *Id*. at 1340.

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Housing Judge Rules that Attorney General's Acceptance of Conversion Plan Nullifies Holdover Proceedings Against Persons Otherwise Unentitled to Remain in Possession

By Joel E. Miller

In our society, one of the fundamental rights of an owner of real property is the right to rent all or part of it to someone else *for an agreed-upon period of time*. By entering into a lease agreement for a described term, an owner does not—at least, not ordinarily—give up his right to recover possession at the end of that term. As stated in a leading treatise often cited by the courts:

> Upon expiration of a lease, it is the obligation of a tenant to vacate from the leased premises. His rights to continue in possession thereof have expired. If, nevertheless, he continues in possession, he then becomes a trespasser on his landlord's property.[1]

As suggested above, there are exceptions to a lessor's recovery right. Emergency rent control laws are an obvious example. This article will report on a decision as to one aspect of another exception—namely, the recovery-right limitation that the Legislature has decided that an owner must accept as one of the conditions of his being allowed to attempt to convert his property to a condominium or cooperative.

The consideration that motivated the Legislature is not hard to fathom. As ably stated by the Appellate Term for the Second and Eleventh Judicial Districts:

> It is apparent that the protections afforded non-purchasing tenants[2] were necessitated by the change in the owner's economic incentives as a result of the conversion. In the case of a rental building, it is to the owner's economic benefit to retain a nonobjectionable tenant who is paying a market rent. In that situation, the owner's interest coincides with the tenant's interest in not being dislocated and with the public interest in stable and uninterrupted tenancies. However, after a conversion, the apartment may be more valuable to the owner empty than occupied by a tenant, even one paying a market rent. In that case, it is in the owner's economic interest to evict the tenant, and the interest of the owner diverges from those of the tenant and the public. It is . . . against this financial incentive to displace the nonpurchasing tenant that the Legislature sought to protect.[3]

The decision that is the subject of this article dealt with only one narrow aspect of the rights afforded to certain persons under General Business Law Article 23-A—commonly referred to as "the Martin Act," which, among other things, prohibits the public offering of cooperative or condominium apartments other than by an offering plan that the Attorney General has accepted for filing—and more particularly on portions of General Business Law § 352-eeee ("Quad-E"), the Martin Act provision that governs cooperative and condominium conversions in New York City.

Quad-E provides different rules for conversions under "eviction" plans and "non-eviction" plans. There are of course enormous differences between the two types of plan, but those differences are not our present focus. Rather, we will direct our attention to one of the things that they have in common, which is that in a plan of either type a statutorily defined "non-purchasing tenant" must be granted a stay-on right—i.e., a right to remain in possession notwithstanding that his lease has expired, so long as he does not breach his obligations and is willing to pay a market rent. The duration of that right differs, however, according to the type of plan. In an "eviction" plan (which, it may be noted in passing, requires a much higher degree of tenant participation before the conversion is allowed to go forward) it generally lasts only "three years after the date on which the plan is declared effective";[4] in a "non-eviction" plan it goes on forever.[5]

As noted, regardless of the duration of the stay-on right, it may be invoked only by a "non-purchasing tenant." The definition of that term is therefore key. Insofar as here relevant, Quad-E defines "non-purchasing tenant" as:

> A person who has not purchased under the plan and who is a tenant entitled to possession at the time the plan is declared effective or a person to whom a dwelling unit is rented subsequent to the effective date.[6]

By reason of the word "or," there are obviously two varieties of "non-purchasing tenant." Although questions concerning the inclusiveness of

the second variety (i.e., the "subsequent to the effective date" variety) has given rise to much intense—and, thus far at least, continuing—controversy,[7] we are now concerned principally with the inclusiveness of the "tenant entitled to possession at the time the plan is declared effective" variety.

In considering the proper interpretation of that phrase, one must be cognizant of the fact that every consummated conversion plan involves the following four critical dates:

1. The date on which a draft plan is submitted to the Department of Law for review ("the Submission-for-Review Date"). A copy of the draft plan must be "sent to each tenant in occupancy" on the Submission-for-Review Date.[8]
2. The date, at least several months after the Submission Date, on which the Department of Law accepts a plan for filing (virtually always somewhat revised from the originally submitted draft) ("the Acceptance-for-Filing Date"), after which the presenter is first allowed to commence selling efforts.
3. The date, typically a year or more after the Acceptance-for-Filing Date, on which the plan is declared effective ("the Declaration-of-Effectiveness Date").
4. The date, typically a few months after the Declaration-of-Effectiveness Date, that the first transfer occurs under the plan ("the Closing Date").

As can be seen, appreciable periods can elapse between those dates, so that the Legislature's choice of writing the "non-purchasing tenant" definition in terms of the Declaration-of-Effectiveness Date rather than some other date is a matter of some importance. As this writer previously pointed out, there is room for disagreement as to whether "the Legislature necessarily drew the protection line at the most appropriate place,"[9] but, however that may be, as to the first variety of "non-purchasing tenant" the words of the statute—"at the time the plan is declared effective"—would seem to be a clear reference to the Declaration-of-Effectiveness Date and not subject to any other construction.

That is not, however, how a Manhattan housing court judge saw it. In a recent decision, he interpreted the words "at the time the plan is declared effective" to refer not to the Declaration-of-Effectiveness Date, but to the much earlier Acceptance-for-Filing Date.[10] In the cases before him, holdover proceedings were brought against free-market tenants whose leases had expired. At the time that the proceedings were commenced, not only had the plan not yet been declared effective (and, for all that appears, it may never have been declared effective), but the Attorney General had not yet accepted the plan for filing. Nevertheless, the respondents refused to surrender possession, claiming to be "non-purchasing tenants," and, while the cases were pending, the Attorney General did accept the plan for filing. That, according to the court, mandated the dismissal of the proceedings:

> Respondents fall squarely within the class of persons protected from eviction as "tenants in occupancy"[11] by both the plain language and the articulated legislative intent of the Martin Act [citations]. *** The rights afforded by the Martin Act accrued to respondents at the time the plan was accepted for filing. *** The Martin Act gives respondents the right to be free from eviction in the event they choose not to purchase their dwellings or for any other reason applicable to "expiration of tenancy" [citation]. *** [T]he eviction or removal of a tenant in a building undergoing conversion, *after* acceptance of the plan, is prohibited by the terms of the Martin Act [citation], absent some good cause shown, such as nonpayment of rent or similar breach [citation]. Respondents are the subjects of "no cause" evictions as their leases were not renewed through no fault or breach on their part; petitioner simply declined to renew their leases. Consequently, the Martin Act [citations] is a valid defense to eviction proceedings in buildings undergoing conversion once the plan is accepted for filing [citation]. *** In light of the Attorney General's acceptance of the non-eviction plan for the subject residential building, respondents are protected from "no cause" holdover eviction proceedings by the Martin Act [citations]. Accordingly, the petitioner's holdover proceedings against respondents are dismissed.[12]

It is important to note that none of the court's citations were to decisions that had gone the same way. It would thus seem that there are none, so that this court's interpretation of Quad-E is unique.

Because it is the purpose of this article merely to call attention to the decision, no attempt will be made to analyze how the court arrived at its conclusion. Nevertheless, it may not be amiss to observe how it appears to this writer that "its ruling on the status of the [respondents] as 'non-purchasing tenants' would seem to be more legislative than judicial and . . . one must be cognizant of the possibility that other courts may not reach the same result."[13]

Endnotes

1. 1 Hon. Robert F. Dolan, Rasch's Landlord and Tenant including Summary Proceedings § 10.1 (4th ed. 1998).

2. Purchasing tenants obviously do not need protection against forced relocation.

3. *Paikoff v. Harris*, 185 Misc. 2d 372, 377, 713 N.Y.S.2d 109, ____ (App. T., 2d Dep't 1999).

4. GBL § 352-eeee(2)(d)(ii).

5. GBL § 352-eeee(2)(c)(ii).

6. GBL § 352-eeee(1)(e).

7. *See* Miller, *Did the Appellate Term in* Paikoff *Come to the Right Conclusion as to Who is a "Non-Purchasing Tenant"?*, 28 N.Y. Real Prop. L.J. 44 (2000); Miller, *New York City's Other Appellate Term Disagrees with* Paikoff *as to Who is a "Non-Purchasing Tenant,"* 29 N.Y. Real Prop. L.J. 3 (2001).

8. GBL § 352-eeee(1)(f).

9. *See* Miller, *Did the Appellate Term in* Paikoff *Come to the Right Conclusion as to Who is a "Non-Purchasing Tenant"?*, 28 N.Y. Real Prop. L.J. 44 (2000).

10. *322 West 57th Owners LLC v. Penhurst Productions, Inc.* (Civ. Ct., N.Y. Co. March 19, 2007), N.Y.L.J.

11. It may be pointed out that the court substituted "tenant in occupancy" for the definition's "tenant entitled to possession" and did not focus on whether or not the Legislature might have intended a distinction between a "tenant *in* possession" and a "tenant *entitled to* possession."

12. Slip opinion at pp. 20–23.

13. The quoted words are from Miller, *Did the Appellate Term in* Paikoff *Come to the Right Conclusion as to Who is a "Non-Purchasing Tenant"?*, 28 N.Y. Real Prop. L.J. 44, 54 (2000). Although written with reference to a decision interpreting a different aspect of the "non-purchasing tenant" definition, they seem equally applicable here.

Joel E. Miller is a partner in Miller & Miller LLP, which has offices in Manhattan and Queens. He has authored numerous articles and has lectured for a wide variety of organizations. He was formerly a professor of law at St. John's University School of Law.

Title Insurance Products for Co-ops: Increasingly Higher-Cost Apartments Are Compelling Practitioners to Rethink Their Strategies

By S.H. Spencer Compton

Over the past several years, the prices for New York area cooperative apartments have soared. With such higher values comes a commensurately greater impact in the event of a title loss, and yet, until recently, title insurance products offering protection comparable to that which is available for real estate have been limited. Historically, cooperative apartment buyers and their lenders instead have relied on the assurances of competent due diligence backed up by the malpractice insurance of their attorneys. But in the new pricing stratosphere, where ordinary two bedroom co-ops are trading in the several-million-dollar range, attorneys are faced with greater potential risk for even the smallest error.

Traditionally, lenders and buyers have required title insurance protection for loans on and acquisitions of real estate and condominiums. Because a cooperative apartment is not a real estate purchase but instead a purchase of an interest in personal property in the form of stock in a corporation (that either owns a fee or leasehold interest in an apartment house) together with a long-term lease of a particular apartment, many lawyers have not obtained title insurance protection for their clients on the purchase or financing of a cooperative apartment unless there was a particular known risk. Liens for security interests against cooperative units are perfected by Uniform Commercial Code filings against the owner's name, indexed in certain counties, such as in the City of New York, in the land records in the county in which the cooperative building is located.

In a typical transaction, the purchaser's attorney asks the search company to perform a Cooperative Apartment Lien Search, which searches for UCC filings, judgments and liens against the cooperative corporation or sponsor in an initial sale or the seller in the case of a subsequent sale. Where the purchaser intends to use lender financing to acquire the unit, the lender generally requires searches to be run against the purchaser as well. The search reveals whether there are any security interests perfected and attached to the shares of stock and whether there are any judgments or other liens filed against the seller and, if applicable, the purchaser. The search will also furnish information as to any open mortgages of record on the building. A diligent practitioner will also review the minutes of the last year's board of directors meetings of the cooperative corporation to check for any pending costly capital improvement projects or potential litigation.

"[I]n the new pricing stratosphere, where ordinary two bedroom co-ops are trading in the several-million-dollar range, attorneys are faced with greater potential risk for even the smallest error."

Usually, this is the extent of due diligence in a cooperative unit acquisition. No title insurance is purchased. Note that, in the case of a condominium unit or other real estate sale, a title insurance policy will likely be part of the transaction. Counsel can explain to the client just what protection the client has, when it arises and what to do if the policy protection must be relied upon. None of this is the case with respect to a Cooperative Apartment Lien Search. The issuer's liability is presumably based only on a cause of action in negligence of the company in conducting its search, which is often difficult to establish. Most companies impose a limitation on liability in their Cooperative Apartment Lien Search. Furthermore, the protections of a title insurance policy that the real estate practitioner is accustomed to are not available in the Cooperative Apartment Lien Search. There is no duty to defend the title, or to bear the cost of any defense. Sometimes, where there are concerns about the source of title (e.g., a sale out of bankruptcy, foreclosure or a divorce), a Title Insurance Rate Service Association, Inc. ("TIRSA") leasehold title insurance policy may be purchased for the benefit of the purchaser of the unit and/or its lender. The policy insures the purchaser against any adverse matter that would attach to or encumber the shares of stock it is purchasing in the cooperative corporation.

A TIRSA lender's policy insures the lender, who has taken possession of the stock certificate and filed a UCC-1 financing statement putting the world on notice of its security interest in the shares, that it has a valid, perfected, lien. Additionally, the title insurance company can issue a TIRSA cooperative endorsement to either policy, insuring that the cooperative corporation has been duly formed and has good title to the cooperative's land and building. This endorsement also insures that maintenance charges on the unit have been paid through the transfer date. The premium for the TIRSA leasehold title insurance policy with the cooperative endorsement is 70 percent of the standard rate charged for policies on real property.

Cooperative leasehold title insurance has long been available in New York. However, because the ownership interest being purchased is personal property not real property and, accordingly, co-op purchase loans are not secured by leasehold mortgages but rather by pledge agreements secured by UCC 1 filings, such insurance has never become customary.

"The new Eagle 9® UCC Cooperative Interest Insurance Policy for Buyers affords coverage against loss or damage if any person other than the insured has rights in the Cooperative Interest, a security interest, or if there is a creditor lien or a federal or state tax lien in any portion of the cooperative interest."

Recently, however, a moderately priced insurance product which specifically insures a buyer's title to its cooperative interest has become available. The new Eagle 9® UCC Cooperative Interest Insurance Policy for Buyers[1] affords coverage against loss or damage if any person other than the insured has rights in the Cooperative Interest (defined in New York's version of Article 9 of the UCC Code to mean "an ownership interest in a cooperative organization, which interest, when created, is coupled with possessory rights of a proprietary nature in identified physical space belonging to the cooperative organization"), a security interest, or if there is a creditor lien or a federal or state tax lien in any portion of the cooperative interest. The Buyer's Policy also insures against loss if there is a claim under the policy's other insuring clauses arising out of an adversary proceeding filed by or against a secured party under the Federal Rules of Bankruptcy Procedure 7001 (2) to determine the Unencumbered Status of the cooperative interest or that the insured did not have rights in the cooperative interest.

The following are some of the not inconceivable situations the Buyer's Policy insures against:

- A person other than the insured claims rights of ownership.
- A lender attempts to enforce a wrongfully terminated financing statement. July 1, 2001 was the effective date of the revision to Article 9 dealing with secured transactions under New York's Uniform Commercial Code. Lenders and their counsel should note that when a security interest in a cooperative interest was perfected by filing before July 1, 2001, either a UCC Financing Statement Amendment (Form UCC3) filed as a "Continuation"—which provides perfection of the security interest for only 5 years—or a Cooperative Addendum—which provides perfection of the security interest for 50 years—should have been filed prior to July 1, 2006. Failure to correctly comply with the foregoing has resulted in the lapsing of numerous UCC-1 filings perfecting liens against cooperative interests. Additionally, there has been some confusion at certain recording offices regarding the provisions of revised Article 9. Certain UCC3 Continuations filed in April 2006 have an incorrect expiration date of 50 years, whereas certain UCC3 Continuations filed in June 2006 have correct expiration dates of 5 years. Future litigation on the validity of these filings is inevitable.
- A cooperative unit is transferred without knowledge that the seller of the unit is in bankruptcy. An undisclosed bankruptcy of the seller is a significant risk, for there may be nothing in the local bankruptcy records to disclose the facts. Whereas an innocent purchaser for value of real property from an undisclosed bankruptcy is protected by Section 549-c of the Bankruptcy Code so long as there is no notice of the bankruptcy in the bankruptcy court in the district where the property is or in the county's land records, no such protection exists for a co-op purchaser, because a co-op is not real property.
- A federal tax lien filed against the seller in a jurisdiction in which he or she also has a residence is being enforced against the unit. Unless the search company is instructed to search for liens and filings in that other jurisdiction, the federal tax lien may not be revealed by the search in the initial jurisdiction.
- A claim is asserted that the person transferring the unit on behalf of the seller-entity did not have the authority to do so.
- Claims to ownership of the unit are asserted, or a proceeding is commenced to enforce a lien in a bankruptcy.
- A lender attempts to enforce an unknown, filed but misindexed financing statement.
- A unit is transferred to the insured after notice is served that a judgment is being enforced against the unit.
- The federal or state government attempts to enforce a federal or New York state tax lien filed against the seller.[2] Note that where a federal tax lien is misfiled by a recording office (as against a "corporation" instead of against an "individual," for example), a Cooperative Apartment Lien Search would not disclose the lien. However, if the buyer or lender had purchased either a TIRSA leasehold title insurance policy or an Eagle 9® UCC Cooperative Interest Insurance Policy, the insurer would

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be contractually obligated to defend and, if necessary, pay the claim.

- A claim is asserted that the seller did not have the authority to transfer the unit due to a claim of fraud or undue influence.
- A claim of ownership is asserted by an heir or legatee of a deceased seller.
- A claim of ownership is asserted by a person to whom the stock and proprietary lease relating to the unit was transferred when it was claimed at closing that the stock and lease were lost.

As with other title insurance products, the insurer will also pay costs, legal fees and expenses incurred in defense of the insured title.

"[M]any buyers, lenders, cooperative corporations, and their attorneys are reconsidering the protections offered by both the TIRSA Coop Leasehold Title Insurance Policy and the more moderately priced Eagle 9® UCC Cooperative Interest Insurance Policy."

The premium to purchase an Eagle 9® UCC Cooperative Interest Insurance Policy for Buyers is more moderately priced than that of a TIRSA Coop Leasehold Owner's Policy. Significant simultaneous issuance and refinance discounts are available for a lender's UCC Cooperative Interest Insurance Policy.

The cooperative corporation's records and other records maintained by the managing agent depend for accuracy and completeness upon the competency, accuracy and integrity of the persons who have maintained them over the years. Total reliance on those records can result in misinformation and financial loss that may be difficult or impractical to recover. Over the course of time, managing agents change and officers of the corporation retire or sell their units, all of which can lead to missing or incomplete records and potential liability for the corporation and, indirectly, its shareholders. A Cooperative Organization Endorsement to the Eagle 9® UCC Cooperative Interest Insurance Policy for Buyers can, if purchased, protect the cooperative corporation against loss if any person other than the insured unit purchaser, or his or her seller, asserts or has rights in the cooperative interest.

Conclusion

As New York City cooperative apartment prices continue to rise dramatically, generating commensurately greater impact in the event of a title loss, and as frequent misindexings on the part of recording offices and misfilings on the part of lenders in the wake of the July 1, 2006 revised Article 9 filing deadline occur, many buyers, lenders, cooperative corporations, and their attorneys are reconsidering the protections offered by both the TIRSA Coop Leasehold Title Insurance Policy and the more moderately priced Eagle 9® UCC Cooperative Interest Insurance Policy.

Endnotes

1. The new Eagle 9® UCC Cooperative Interest Insurance Policy for Buyers is available only from First American Title Insurance Company of New York.
2. A filed financing statement complying with Sections 502(A) and (B) is effective even if the Filing Office is required to refuse to accept it. Section 9-520(C). In addition, a misindexed record remains effective. Section 9-517.

S.H. Spencer Compton is a Senior Vice President and Special Counsel at First American Title Insurance Company of New York.

Subject to the Approval of My Attorney Clauses

By Dorothy H. Ferguson

I. Scope of Review:

A. Form of Approval Clause

1. Broome County Board of Realtors Form (see Exhibit "A"):

Attorney Disapproval:

- Offer subject to approval by Buyer's attorney and Seller's attorney.
- If a party fails to:
  - select an attorney within 3 business days from the date of acceptance of offer; or
  - have an attorney respond, in writing, within 3 business days of the attorney's receipt of contract

  the "attorney disapproval" contingency is deemed waived.
- An attorney's written response will be deemed effective if given by:
  - the Seller's attorney, to the Buyer or Buyer's attorney, or Buyer's Agent, or
  - the Buyer's attorney, to the Seller's attorney, listing agent or subagent.
- Written response deemed effective if posted within the 3 days time period
- "Business day" is Monday through Friday, except legal holidays as defined in Section 24 of the General Construction Law.

2. Greater Rochester Association of Realtors and Monroe County Bar Association Form (see Exhibit "B"):

Attorney Approval

- Broker fills in the number of calendar days of the approval period, *excluding Sundays and public holidays* from date of acceptance (Approval Period).
- If either attorney (i) does not provide written approval within the Approval Period; or (ii) makes written objection to or conditionally approves (collectively, the Objections) the contract within the approval period and the Objection is not cured by written approval by both attorneys and all of the parties within the Approval Period, then

  (A) either Buyer or Seller may cancel the contract by written notice to the other and any deposit shall be returned to the Buyer; or

  (B) the approving attorney may notify the other party (with a copy to the other attorney listed, if any) in writing that no approval has been received and that the noticed party has five (5) calendar days, *inclusive of Sundays and public holidays,* from receipt of the notice (Grace Period) to provide written attorney approval or disapproval of the contract.

  (C) The approving attorney shall provide to the noticed party (with a copy to the other attorney listed, if any) a copy of the approving attorney's approval letter, whether conditional or not, along with the written notice of the Grace Period.

  (D) If written attorney approval or disapproval is not provided to the approving attorney within the Grace Period, then this Attorney Approval contingency shall be deemed waived by the noticed party and any conditions in the approving attorney's approval letter shall be deemed accepted by the noticed party.

B. Scope of Review Given Broad Interpretation by Courts

1. *Youla v. Rappaport*, 115 N.Y.S.2d 408 (Sup. Ct., Kings Co. 1949) (The court stated that the words in the contract "subject to rejection by attorney for the seller in 3 days" were broad enough to include rejection of the agreement not only as to matters of form but also on price to be paid. If the parties had intended to restrict the approval to matters of form, they could have done so. (The court did not explain the meaning of "approved as to form.")).
2. *Ulrich v. Daly*, 225 A.D.2d 229, 650 N.Y.S.2d 496 (3d Dep't 1996) ("There is nothing in the attorney approval clause which prohibits the attorney from considering matters extrinsic to the contract in deciding whether to approve or disapprove the matters contained in the contract." The court held that an attorney may disapprove a contract on the basis of the price and a better offer since the attorney approval clause did not expressly exclude such approval. (The attorney approval clause provided, "(T)his agreement is contingent upon Purchaser and Seller obtaining approval of this Agreement by their attorney as to all matters contained therein.")).
3. *Schreck v. Spinard*, 13 A.D.3d 1027, 788 N.Y.S.2d 214 (3d Dep't 2004) ((S)ince the agreement does not limit the matters that the attorney may consider in deciding whether to approve it. . . , it is irrelevant that the agreement was disapproved for no reason other than . . . defendant had the opportunity to sell the property to a third party at a higher price.)

4. *Pelusio v. Chen*, unreported decision of Thomas A. Stander, J. (Sup. Ct., Monroe Co. 2003) ("Necessarily the attorney must have the freedom and right to review the substantive terms of the contract, the impact of the proposed agreement upon his client, and make a legal determination of whether to approve or disapprove the agreement. The evidence shows that the attorney for Sellers performed his obligations to review the contract substantively, rather than just as to form, and exercised his sole legal judgment to disapprove the contract.")

5. *Niederhofer v. Lindner*, 6 A.D.3d 1218, 775 N.Y.S.2d 705 (4th Dep't 2004) ("The contract does not limit the matters that may be considered by the parties/attorneys in deciding whether to approve it.")

II. Good Faith Requirement:

A. Examples of Relevant New York Decisions:

1. *McKenna v. Case*, 123 A.D.2d 517, 507 N.Y.S.2d 777 (4th Dep't 1986) (The court ruled that attorney disapproval of a contract will be considered in bad faith and invalid if it is based upon instructions from the client to disapprove, rather than based upon the attorney's review of the contract with the client. "(D)efendant acted in bad faith by instructing his attorney to disapprove the contract. Defendant, by interfering and preventing his attorney from considering the contract, acted in bad faith and, therefore, the condition that the contract be approved by the seller's attorney must be deemed waived and the contract formed.")

2. *Ulrich v. Daly*, 225 A.D.2d 229, 650 N.Y.S.2d 496 (3d Dep't 1996) ("In contrast to the *McKenna* case, . . .there is no evidence that defendants interfered and prevented their attorney from considering the contract. It is clear that in comparing the various terms of the other offer with the corresponding terms of the parties' contract, defendant's attorney considered the contract. That the attorney's review of the matter included consideration of the other offer does not establish bad faith, for the attorney approval clause does not prohibit consideration of extrinsic matters.")

3. *Austin v. Trybus*, 136 A.D.2d 940, 524 N.Y.S.2d 895 (4th Dep't 1988) ("Parties to a real estate contract have an implied obligation to deal fairly and to act in good faith.")

4. *Faber Construction Company, Inc. d/b/a Faber Homes v. Cukalevska*, unreported decision of Thomas A. Stander, J. (Sup. Ct., Monroe Co. 2001) ("An attorney's disapproval of a real estate contract is effective unless the disapproval is occasioned by bad faith " (citing *McKenna*). "Parties to a real estate transaction are under an implied obligation to deal fairly and in good faith." (citing *Austin v. Trybus*))

5. *Pelusio v. Chen*, unreported decision of Thomas A. Stander, J. (Sup. Ct., Monroe Co. 2003) ("In a real estate transaction bad faith has been determined to exist when the uncontradicted proof . . . conclusively shows that a defendant instructed his attorney to disapprove the contract, and the defendant interfered and prevented his attorney from considering the contract.")

B. Secondary Sources:

1. Debra Pogrund Stark, *Navigating Residential Attorney Approvals: Finding a Better Judicial North Star*, 39 J. Marshall L. Rev. 216 (2006). ("The key guidepost that attorneys can turn to from these cases [citing New York cases *McKenna* and *Ulrich*, among others] on what constitutes good faith in the context of an attorney disapproval clause is that the disapproval cannot be based upon a direction from the client to disapprove, but must be based upon the attorney's actual review of the contract. If the client is not asking the attorney to review the contract and to provide counsel to the client on the contract and the deal, but is instead directing the attorney to disapprove the contract unrelated to any advice from the attorney on the deal, then it is not a proper exercise of the attorney approval right." *Also see* Stark's further comments on the holding in *Ulrich*, "Finally, the ruling that there was no evidence of bad faith, because there was no evidence that the sellers had interfered with or prevented their attorney from considering the contract, provides a very helpful test on the issue of what constitutes a bad faith disapproval.")

2. Alice M. Noble-Allgire, *Attorney Approval Clauses in Residential Real Estate Contracts—Is Half a Loaf Better Than None?*, 48 U. Kan. L. Rev. 339 (2000) ("The breadth of discretion that courts have recognized is illustrated by the rarity of cases finding that attorneys have acted in bad faith in disapproving a contract." The author noted that in the New York *McKenna* case, the defendant instructed his attorney to disapprove the contract and that in *Austin v. Trybus*, a prospective purchaser and his attorney had acted improperly when the purchaser "fail[ed] to contact an attorney for more than three months . . . and the attorney delay[ed] . . . disapproving the contract until the date of closing." The author further noted, "(C)ourts have not found bad faith beyond these two examples or even provided examples of conduct that might qualify.)

3. John E. Blyth, *Subject to the Approval of My Attorney: "A Second Bite at the Apple" Revisited*, 20 N.Y. St. B.A. Real Prop. L. Sec.

Newsl., Oct. 1992, at 13. ("(T)he requirement of good faith . . . in one way or another, permeates all of the cases. Sometimes it is expressed as a lack of fraud or as a lack of arbitrariness, but the requirement is there. It means not only the good faith of the attorney, but also the good faith of the client, *i.e.*, absence of bad faith." The author raises the possibility of a malpractice action against an attorney who rejects a contract because of price if the seller or buyer is sued for specific performance and impleads the attorney on the ground that the attorney advised the client that the rejection is acceptable. The author recommends that if the rejecting attorney suspects that the ground for rejection might be considered by a court to be in bad faith, the attorney should advise the client, in writing, of the risk of a lawsuit. *Also see* Stark, *Navigating Residential Attorney Approvals: Finding a Better Judicial North Star*, 39 J. Marshall L. Rev. 216 (2006), at page 226, "(I)f an attorney believes that a client's real reason for directing the attorney to disapprove after consultation with the attorney is improper, the attorney should cease representing the client or explain that this action is impermissible and propose and follow a proper course of action.")

III. Do Attorney Approval Clauses Operate as Counteroffers?

A. Characterization of Attorney Approval Clause as Condition Precedent

"(I)f attorney approval is viewed as a condition precedent, there is no valid contract absent such approval." Alice M. Noble-Allgire, *Attorney Approval Clauses in Residential Real Estate Contracts—Is Half a Loaf Better Than None?*, 48 U. Kan. L. Rev. 339 (2000). "The attorney approval clause may, under this view, also be called a "conditional acceptance." Debra Pogrund Stark, *Navigating Residential Attorney Approvals: Finding a Better Judicial North Star,* 39 J. Marshall L. Rev. 216 (2006). Stark notes that characterization of the attorney approval clause as a conditional acceptance produces the undesirable effect that "good faith" is not required in the exercise of the clause, since no contract has been created in the first place. "(I)f a court construes the presence of an attorney approval clause to create a conditional acceptance (as opposed to a conditional contract), then, if an attorney proposes any changes to the contract under the clause, this will be construed as a counteroffer, even when the proposal is clarified as mere suggestion. The other party can then claim that there is no binding contract and no obligation to approve or disapprove the contract in good faith." As an example of a case holding that attorney approval clauses in a contract signed by both parties are counteroffers or create a conditional acceptance of the purchase and sale agreement, Stark cites *Pelusio v. Chen* (Unreported decision of Thomas A. Stander, J. (Sup. Ct., Monroe Co. 2003)), which held that when the contract language makes the agreement subject to the approval of attorneys, then the contract is not binding and enforceable until approved. Note, however, that in *Pelusio,* Judge Stander considers at length the issue of bad faith and concludes that the attorney properly disapproved the contract, with no bad faith on the part of the seller.

B. Characterization of Attorney Approval Clause as Condition Subsequent

Under this characterization, a contract is formed at the time the agreement is signed. "The duty to perform does not arise until the attorney approves the contract, or, conversely, the duty is discharged if the attorney does not approve the contract. However, neither party can refuse to perform simply because he has changed his mind about the bargain or for reasons other than attorney disapproval." Alice M. Noble-Allgire, *Attorney Approval Clauses in Residential Real Estate Contracts—Is Half a Loaf Better Than None?*, 48 U. Kan. L. Rev. 339 (2000). *See also* Debra Pogrund Stark, *Navigating Residential Attorney Approvals: Finding a Better Judicial North Star*, 39 J. Marshall L. Rev. 216 (2006). Stark notes that the attorney approval clause under this view may also be known as a "conditional contract," requiring "good faith" in its exercise. As an example of a case holding that the attorney approval clause is a condition subsequent (conditional contract), Stark cites *Austin v. Trybus*, which held that the buyer's failure to contact an attorney for more than three months after acceptance of the purchase offer and the attorney's delay in disapproving the contract until the date of closing were unreasonable as a matter of law and that the condition of attorney approval ceased to exist because it was not timely exercised.

C. The Reviewing Attorney's Practical Dilemma: Take it or Leave it

1. If an attorney approval clause is characterized as a condition precedent (or conditional acceptance), "a modification to the contract raised by an attorney (even if it is just moving the closing date by one day), constitutes a rejection of the contract and a counteroffer to form a new contract. As a result, such modification could kill the deal." Stark, *Navigating Residential Attorney Approvals: Finding a Better Judicial North Star*, 39 J. Marshall L. Rev. 216 (2006), FN 69 and FN 75, quoting Helen W. Gunnarsson, *Attorney Approval Clauses and Residential Real Estate Contracts:*

Mere Modification or More? 93 Ill. B.J. 72, 74 (2005)

2. As a precaution, some attorneys have added to their proposed modifications a provision such as, "The foregoing is not to be construed as a counteroffer." Some prominent real estate attorneys, however, have found this to be ineffective and have suggested that the suggested change will still be construed as a counteroffer. Stark, *Navigating Residential Attorney Approvals: Finding a Better Judicial North Star*, 39 J. Marshall L. Rev. 216 (2006) FN 69.

3. In many cases, the attorney desires to approve the contract in part and propose modifications of the objectionable provisions, without terminating the deal. Partial approvals, however, are not an option. (*See* Noble-Allgire at page 376, citing John E. Blyth, *Subject to the Approval of My Lawyer—A Second Bite of the Apple*, 2 Prob. & Prop. 19, 20 (1988) "No case has been found construing partial approval.")

4. The question of whether a proposed modification may be deemed a counteroffer is an example of the numerous issues confronting the reviewing attorney. *(See* Noble-Allgire at FN 75, quoting Harold I. Levine, *Avoiding Malpractice-Attorney Approval* at 2 (1986) (available from publisher, Attorneys' Title Guaranty Fund, Inc., Champaign, Ill.) "Broker, seller and buyer can spend weeks or months negotiating a deal, but the lawyer has 72 hours to review the contract and be charged with the responsibility. Those of us who labor in the valleys of the law will tell you that the lawyer usually gets the contract in the last 24 to 36 hours.")

5. The issue is unresolved. It is recommended that the reviewing attorney caution his or her client that any proposed modification could kill the deal. The attorney should discuss with the client whether the proposed change is worth the risk.

IV. Good Faith Disapproval? Scenarios for Discussion.

(For an excellent discussion of these types of issues, see Debra Pogrund Stark, *Navigating Residential Attorney Approvals: Finding a Better Judicial North Star*, 39 J. Marshall L. Rev. 216 (2006), pp. 218–221.)

A. The prospective buyer has applied to medical schools in Rochester and in California. She was accepted at the University of Rochester and has an accepted purchase offer for a home in the City of Rochester. During the attorney approval period, she is advised that she has been accepted in medical school in California, and she decides to relocate there. Solely for this reason, she directs her attorney to disapprove the contract. May her attorney disapprove the contract?

B. The prospective buyer has submitted to her attorney an accepted purchase offer. During the attorney approval period, the client calls her attorney in a panic and advises that she will be "over her head" financially if the deal goes through. After reviewing her client's income and proposed mortgage payments, the attorney agrees. May her attorney disapprove the contract on these facts?

C. After discussion with her client, the attorney for the buyer provides seller's counsel an unconditional approval letter. Within the attorney approval period, the buyer's attorney receives a disapproval letter from seller's attorney. No reason for the disapproval is given. May seller's attorney disapprove the contract without providing buyer's counsel the reason for disapproval? (For discussion of this issue, see *Dennis F. McKenna v. Smith*, 704 N.E.2d 826 (Ill. App. Ct.), at 829, citing *Olympic Restaurant Corporation v. Bank of Wheaton* 622 N.E.2d (Ill. App. Ct. 1993) at 909.)

D. The attorney for the seller has reviewed the purchase contract and has discussed the pertinent terms with her client. During the discussion, seller reveals that he has received a better offer. The seller directs the attorney to disapprove the contact. The attorney knows that the primary (although not the sole) reason for disapproval is the higher offer. May the attorney disapprove the contract in good faith?

V. Summary

Attorney approval clauses are not to be taken lightly. Real estate practitioners have little guidance in this area. The sparse authority that is provided reveals the challenges to the reviewing attorney who has a duty to zealously represent his or her client, yet abide by the duty to exercise the clause in good faith. Conflicting case law may make competent representation even more difficult. What we do know is that in all cases the attorney should review with his or her client the pertinent terms of the contract to ensure that the contract reflects the agreement of the parties. The attorney should also raise any potential concerns that the client may not have considered. If the attorney or the client proposes a modification to the contract, the attorney should warn his or her client that the proposed modification may result in a termination of the contract, and the client should decide if the proposed change is worth the risk. The attorney must be aware that disapproval of the contract for an improper reason may result in attorney liability based upon a claim of bad faith.

The article is from the New York State Bar Association CLE Seminar on Hot Topics in Real Property Law and Practice held in Binghamton on November 17, 2006 and Rochester on December 13, 2006.

Exhibit "A"

Broome County Board of Realtors Form

18. Attorney Disapproval:

This offer is subject to approval by Buyer's attorney and Seller's attorney. Failure of a party to select an attorney within 3 business days from the date of acceptance of offer or to have an attorney respond, in writing, within 3 business days of the attorney's receipt of a copy of this contract shall be deemed to be a waiver by the party of the "attorney disapproval" contingency. An attorney's written response will be deemed effective if given by: 1) the Seller's attorney, to the Buyer or Buyer's attorney, or Buyer's Agent, or 2) the Buyer's attorney, to the Seller's Attorney, listing agent or subagent. A written response will be deemed effective if posted within the 3 days time period. As used in the Contract, a business day refers to Monday through Friday, except legal holidays as defined in Section 24 of the General Construction Law.

Exhibit "B"

Greater Rochester Association of Realtors/Monroe County Bar Association Form

4. **Contingencies.** Buyer makes this offer subject to the following contingencies. If any of these contingencies is not satisfied by the dates specified, then either Buyer or Seller may cancel this contract by written notice to the other. (Check and complete applicable provisions.)

   (c) **Attorney Approval.** This contract is subject to the written approval of attorneys for Buyer and Seller within _____ calendar days, *excluding Sundays and public holidays*, from date of acceptance (the Approval Period). If either attorney (i) does not provide written approval within the Approval Period or (ii) makes written objection to or conditionally approves (collectively, the Objections) the contract within the Approval Period and the Objection is not cured by written approval by both attorneys and all of the parties within the Approval Period, then (A) either Buyer or Seller may cancel this contract by written notice to the other and any deposit shall be returned to the Buyer or (B) the approving attorney may notify the other party (with a copy to any attorney listed below) in writing that no approval has been received and that the noticed party has five (5) calendar days, *inclusive of Sundays and public holidays*, from receipt of the notice (Grace Period) to provide written attorney approval or disapproval of the contract. The approving attorney shall provide to the noticed party (with a copy to any attorney listed below) a copy of the approving attorney's approval letter, whether conditional or not, along with the written notice of the Grace Period. If written attorney approval or disapproval is not provided to the approving attorney within the Grace Period, then this Attorney Approval contingency shall be deemed waived by the noticed party and any conditions in the approving attorney's approval letter shall be deemed accepted by the noticed party.

   (d) **Waiver of Attorney Approval.** This offer is not subject to the Buyer's attorney approval.

New York Lien Law Considerations in Construction Lending Transactions[1]

By John K. Bouman

I. Background

Mechanic's lien rights are purely a creature of statute in New York. There are no such rights at common law.[2]

A. **Lien Priority:** Article 2 of the Lien Law provides for the creation and Article 3 of the Lien Law provides for the enforcement of mechanic's liens against owners, contractors and lenders and orders the lien priority among these three groups.

A lender who fails to comply with Article 2 of the Lien Law runs the risk that the lien of its mortgage will be subordinated to a subsequently filed mechanic's lien. Lien Law § 22.

B. **Diversion of Trust Funds** Article 3-A of Lien Law provides protection for contractors, materialmen and laborers who perform work and/or provide materials in connection with an "improvement" to real property.

It impresses a trust on the monies received by an owner pursuant to a building loan agreement filed after the "commencement of the improvement." Payment of trust assets must first be used by the owner to pay for the "cost of improvement" before using any part of such assets for any other purpose.

A lender to whom trust assets are assigned becomes a statutory trustee and must comply with Article 3-A of the Lien Law or run the risk that the repayment of loan advances to it will be deemed to be a diversion of trust funds subject to being recaptured by Lien Law beneficiaries. Lien Law § 72(1).

II. Some important definitions

A. **"Improvement"** means "the demolition, erection, alteration or repair of any structure upon, connected with, or beneath the surface of, any real property and any work done upon such property or materials furnished for its permanent improvement." Also includes "the drawing by any architect or engineer or surveyor, of any plans or specifications or survey, which are prepared for or used in connection with such improvement . . . [and] the performance of real estate brokerage services in obtaining a lessee for a term of more than three years of all or any part of the real property to be used for other than residential purposes pursuant to a written contract of brokerage employment or compensation." Lien Law § 2(4).

B. **"Commencement of the Improvement":** This term is not defined, but the lender should assume that an improvement is "commenced" at the time the earliest architectural, engineering or surveying work begins even though, as is often the case, the borrower has not yet acquired title to the real property.

C. **"Cost of improvement":** Includes expenditures incurred by the owner of the real estate in paying

1. The claims of an architect, engineer, surveyor, contractor, subcontractor, laborer or materialman arising out of the improvement;
2. Sales taxes based on the purchase price or value of materials or equipment required to be installed or furnished in connection with the improvement;
3. Fair and reasonable sums paid for obtaining building loan and subsequent financing;
4. Payment and performance bond premiums;
5. Sums paid to take by assignment prior existing mortgages (i.e., mortgages which were recorded prior to the commencement of the improvement) which are consolidated with building loan mortgages;
6. Sums paid to discharge or reduce the indebtedness under prior existing mortgages and other encumbrances;
7. Sums used to discharge building loan mortgage obligations, whenever recorded.
8. Real estate taxes, assessments and water rents existing prior to the commencement of the improvement and accruing during the making of the improvement; and
9. Interest on building loan mortgages, ground rent and insurance premiums accruing during the making of the improvement. Lien Law § 2(5).

Note: The proceeds of a building loan may be used to reimburse the owner for any payments made for "cost of improvement" items before the first building loan advance; provided that (a) such payments were made after the commencement of the improvement and (b) such payments are itemized in the building loan agreement. Lien Law § 2(5). *See, e.g.*, ***In re Elm Ridge Associates***, 234 F.3d 114 (2d Cir. 2000); ***United States v. Eljos Associates***, 1986 U.S. Dist. LEXIS 20351, No. 84 Civ. 1952,

1986 WL 10467 (S.D.N.Y. Sept. 17, 1986); and ***Adirondack Trust Co. v. Thomas J. Bien & Associates***, 168 Misc. 2d 919 (Sup. Ct., Saratoga Co. 1996).

III. Private Improvements vs. Public Improvements

A. A "private" improvement means any improvement of real property not belonging to the State of New York or a public corporation. In the case of a private improvement, the mechanic's lien must be filed against the real property at any time during the progress of the work or within eight (8) months after the completion of the contract or the final performance of the work or the final furnishing of the materials, dating from the last item of work performed or materials furnished. Lien Law § 10(1).

B. A "public" improvement means any improvement of real property belonging to the State of New York or a public corporation. A public corporation includes a municipality, a school district and a public benefit corporation. Publicly owned real property cannot be liened, so in this case the mechanic's lien must be filed with the head of the department or bureau having charge of the construction or demolition of the public improvement and with the comptroller of the state or the financial officer of the public corporation or other officer or person charged with the custody and disbursement of the funds applicable to the contract at any time before the construction or demolition is completed and accepted by the State or public corporation and within thirty (30) days after such completion and acceptance. The comptroller or financial officer must record certain information regarding the mechanic's lien in a "lien book" provided for this purpose. Lien Law § 12.

Note: An industrial development agency is a public benefit corporation, so an IDA project should be a "public improvement" and the real property should not be subject to lien, but Section 2(7) of the Lien Law, which contains the definition of a "public improvement," was amended in 1992 to provide that if the beneficial interest of an improvement is in an entity other than the state or a public corporation (which is the case in most IDA transactions), such improvement shall be deemed to be a "private" improvement which is subject to mechanic's liens on real property.

IV. Priority of Liens (Article 2)

A. A mechanic's lien will have priority over any mortgage not recorded at the time the lien is filed. Lien Law § 13(1).

Note: Lenders making an unsecured line of credit available to subdivision developers would sometimes ask the developer to sign a mortgage "just in case." The loan officer would then put the mortgage in the desk drawer rather than record it. Any subsequently filed mechanic's lien would have priority over the unrecorded mortgage.

B. A mechanic's lien will have priority over any building loan advances on a prior recorded mortgage made after the filing of the mechanic's lien. Lien Law § 13(1). This is why lenders insist on getting a clean title continuation as a condition to making each advance.

V. Trust Fund Covenant

A. Every deed or other instrument of conveyance recorded after the commencement of an improvement must contain a covenant by the grantor that it will receive the consideration for such conveyance and will hold the right to receive such consideration as a trust fund to be applied first for the purpose of paying the cost of the improvement and that it will apply the same first to the payment of the cost of the improvement before using any part of the total of the same for any other purpose. Lien Law § 13(5). This is known as the "trust fund covenant" and may be shortened to: This conveyance is being made "subject to the trust fund provisions of Section 13 of the Lien Law." Lien Law § 13(5).

What happens if this covenant is not contained in the deed? The deed will not be "valid" as against any mechanic's lien filed within eight (8) months after the completion of the work. Lien Law § 13(5). In other words, if the deed does not contain the trust fund covenant, a mechanic's lien may be filed against the real property of the grantee even though the work in question was performed for and should have been paid by the grantor.

B. Every building loan mortgage and every other mortgage recorded after the commencement of an improvement must also contain a trust fund covenant by the mortgagor. Lien Law § 13(3). The covenant may be shortened to: This mortgage is being given "subject to the trust fund provisions of Section 13 of Lien Law." Lien Law § 13(5).

What happens if this covenant is not contained in the mortgage? A subsequently filed mechanic's lien would "prime" (i.e., have priority over) the mortgage. Lien Law § 13(2).

VI. Building Loans

A. **Priority:** A building loan mortgage will have priority over a mechanic's lien to the extent of all building loan advances made before the filing of a mechanic's lien; provided that the requirements of Article 2 of the Lien Law are followed. Lien Law § 22.

B. **Requirements:** What does a lender need to do in order to obtain this priority?

1. First, you need a "building loan contract"[3] which is defined as a contract whereby a lender, in consideration of the express promise of an owner to make an improvement upon real property, agrees to make advances to or for the account of such owner to be secured by a mortgage on such real property. Lien Law § 2(13).

2. Next, you need a "building loan mortgage," which is defined as a mortgage made pursuant to a building loan contract and includes an agreement wherein and whereby a building loan mortgage is consolidated with existing mortgages so as to constitute one lien upon the mortgaged property. Lien Law § 2(14).

3. Requirements of a building loan contract (Lien Law § 22):

(a) Must be in writing and duly acknowledged by the borrower and the lender.

(b) Must contain a "true statement under oath," verified by the borrower, showing the following:

(1) the consideration paid or to be paid for the loan;

(2) all other expenses, if any, incurred or to be incurred in connection therewith; and

(3) the net sum available to the borrower for the improvement.

This statement is usually referred to as a "Lien Law affidavit." A sample form of Lien Law affidavit is attached to this outline as **Exhibit A**.

4. The building loan contract must contain the trust fund covenant required by Section 13(3) of the Lien Law. Lien Law § 13(2).

5. The building loan mortgage must also contain the trust fund covenant. Lien Law § 13(3).

6. The building loan contract must be filed in the county clerk's office where the real property is located on the same date as or prior to the date of the recording of the building loan mortgage.[4] A sample of letter of instructions to the title company regarding the proper filing and recording sequence of the building loan contract and the building loan mortgage is attached to this outline as **Exhibit B**. If this letter is acknowledged by the title closer, the title company will be "on the hook" if the closer fails to follow the filing and recording sequence outlined therein and, as a result, the lien of the lender's mortgage is subordinated to a subsequently filed mechanic's lien.

7. **Practice point:** Lender's counsel should present a duplicate executed copy of the building loan agreement to the county clerk to be time-stamped, certified and returned to counsel for proof purposes.

8. Is a lender obligated to see to the proper application of advances by the owner? No. Once having obtained the trust fund covenant from the borrower, the lender is not obligated to police the advances. Lien Law § 13(3).

9. Customary practice in completing Lien Law affidavits:

(a) The consideration paid or to be paid for the loan is generally understood to be the commitment fee.

(b) All other expenses incurred or to be incurred in connection therewith. No one knows for sure what the word "therewith" modifies.

Some say it means in connection with the loan, in which case you would only list such things as:

(1) lender appraisal fees;

(2) fees of the inspecting architect;

(3) title insurance premiums for the lender's policy;

(4) legal fees of lender's counsel;

(5) recording fees;

(6) mortgage recording tax; and

(7) interest on the building loan during the construction period.

Others think it means any "cost of improvement" items to be funded from building loan advances. This is the approach used in the sample form of Lien Law affidavit.

Still others think it means "in connection with the improvement," in which case you could list every expense incurred or to be incurred by the borrower in that regard, such as:

(1) land acquisition costs;

(2) fees for obtaining zoning approvals and building permits;

(3) legal fees of borrower's counsel;

(4) title insurance premiums for the owner's policy;

(5) rent up expenses;

(6) management fees;

(7) borrower's overhead costs; and

(8) developer's fees.

But many lenders' counsel believe that these are "bad" costs, i.e., costs that should not be funded from building loan proceeds. This is the approach taken in the attached sample form of Lien Law affidavit.

(c) Net sum available to the borrower for the improvement. This is the bottom line, the most important part of the affidavit. It is generally thought that above the line you have permissible "soft" costs (i.e., those expenses that qualify as "cost of improvement") and that the net sum

available means the "hard" costs associated with the construction of the improvement. This is the number that contractors, mechanics and materialmen will zero in on, at least theoretically, in making their decision as to whether to provide labor for and/or supply materials to the project.

Note: A Lien Law claimant does not have to prove reliance, i.e., that he saw the Lien Law affidavit before starting the work and relied on it to his detriment. The statute presumes that the claimant saw it and that he relied on it.

C. Consequences of Non-Compliance. If the parties fail to comply with the above requirements, "the interest of each party to such [building loan] contract in the real property affected thereby, is subject to the lien and claim of a person who shall thereafter file a notice of lien under this chapter." Lien Law § 22.[5]

D. Leading Case. ***Nanuet Nat'l Bank v. Eckerson Terrace, Inc.***, 47 N.Y.2d 243 (1979).

1. ***Facts*:** A building loan agreement was filed and a building loan mortgage was recorded. The construction loan was disbursed. Several mechanic's liens were filed. The borrower defaulted on the loan. The lender commenced an action to foreclose the mortgage and named the mechanic's lienors as parties' defendant in the foreclosure action with the intent of extinguishing their liens. The mechanics' lienors contended that the Lien Law affidavit attached to the building loan agreement contained material misstatements and that such misstatements rendered the mortgage subordinate to their mechanic's liens. The Lien Law affidavit stated that:

   (a) Amount of construction loan was $108,000.

   (b) Consideration paid for loan was $108,000.

   (c) All other expenses were to be paid by the borrower.

   (d) The net sum available for the improvement was $108,000!

   The lender pointed out that the misstatements, if any, were not made by it but by the borrower, since the Lien Law affidavit is signed by the borrower, not the lender, and that Section 22 does not require that a lender guarantee the accuracy of the affidavit.

2. **Legislative Purpose of Section 22:** The Court of Appeals said that the legislative purpose of Section 22 was "to readily enable a contractor to learn exactly what sum the loan in fact made available to the owner of the real estate for the project." *Id*. at 247.

3. **Holding:** A lender will suffer the subordination of lien penalty if it knowingly files a materially false Lien Law affidavit.

4. **Rationale.** A lender usually operates from a bargaining position strong enough to demand accurate information from the borrower. The effort required for compliance on the part of the lender is modest. The threat of a loss of lien priority will be an effective deterrent to a lender's indifference to the truthfulness of the borrower's Lien Law affidavit. In the preparation of a Lien Law affidavit, the bank's role must be a responsible one. It is neither perfunctory nor ministerial. *Id*. at 248.

E. Other Cases

1. In ***HNC Realty Co. v. Golan Heights Developers, Inc.***, 79 Misc. 2d 696 (Sup. Ct., Rockland Co. 1974), the court concluded that the lender had filed a building loan agreement containing a materially false Lien Law affidavit. The net sum available to the borrower for the improvement was overstated by some $3.9 million dollars, which had been used to purchase by assignment certain prior existing mortgages which were then consolidated with the building loan mortgage. That fact was not disclosed in the Lien Law affidavit even though the affidavit contained a space for insertion of sums paid to take by assignment prior existing mortgages and such an expenditure would have qualified as a "cost of improvement." But see the ***In re Elm Ridge Associates, United States v. Eljos Associates*** and ***Adirondack Trust Co. v. Thomas J. Bien & Associates*** cases cited above.

2. In ***F.L. Mitchell Corp. v. Marine Midland Bank***, 172 A.D.2d 1050 (4th Dep't 1991), the Lien Law affidavit expressly stated that the net sum available to the borrower for the improvement was $0. Consequently, the contractors and materialmen were apprised that no funds from the proceeds of the loan were available for the improvement, and the court rejected their argument that the lien of the bank's mortgage should be subordinated to their subsequently filed mechanic's liens. This is the perfect affidavit!

3. ***In re Admiral's Walk, Inc.***, 134 B.R. 105 (W.D.N.Y. 1991). The Lien Law affidavit stated that the commitment fee for the loan was $95,000 when in fact it was $75,000. The Bankruptcy Court found that such a discrepancy was not "material" and noted that the lower commitment fee actually resulted in more cash for payment to contractors and materialmen. In other words, a "good" mistake.

4. ***In re Elm Ridge Associates***, 234 F.3d 114 (2d Cir. 2000).

   Facts: Lien Law affidavit stated that the net sum available for the improvement was $5,800,000. At

the closing, $4,600,000 of the first building loan advance was used to reimburse a related party for certain previously completed site work, including basic earthwork, street widening, construction of sidewalks and curbs, connecting site to municipal water supply, etc. Note that all of these expenses qualified as "cost of improvement."

Issue: Did the lender knowingly file a materially false Lien Law affidavit because it failed to exclude from the net sum available the amount to be reimbursed for work already in place?

Argument: The contractor acknowledged that these expenses qualified as "cost of improvement," but pointed out that under Lien Law Section 2(5) they should have been itemized in the building loan agreement. Since they were not itemized, the lender should suffer the subordination penalty.

Holding: The Lien Law Affidavit was not materially false.[6]

Rationale: Section 22 uses the term "improvement," not "cost of improvement," and it is Section 22, not Section 2(5) or Article 3-A, which subjects lenders to the subordination penalty. Nothing in Section 22 indicates that the statute is concerned with when the borrower incurs the obligations that the loan will be used to pay. The statute is focused on what portion of the loan will be available for the improvement but not on the timing of the contract for each item of work in the improvement.

Query: What would the result have been if the borrower had been reimbursed for expenses that did not qualify as "cost of improvement"?

5. ***Howard Savings Bank v. Lefcon Partnership***, 209 A.D.2d 473 (2d Dep't 1994). Does the fact that the lender knew or should have known that the loan was significantly underfunded and failed to disclose that fact in the affidavit mean that the affidavit was false and misleading when made? No. "[T]he disclosure contemplated by [Section 22 of] of the Lien Law is not intended to function as a guaranty that a construction project is adequately financed or economically viable. Nor does the Lien Law impose upon a lender a continuing duty to apprise a contractor of the economic condition of its borrower." *Id*. at 476.

F. Structuring Considerations. What can the lender do when it knows that a portion of the loan is to be used for non-cost of improvement items (e.g., "bad" costs such as land acquisition costs, development fee, borrower's legal fees, etc.)?

1. **Most Conservative Approach:** Require that the borrower defer all non-cost of improvement items until all cost of improvement items (including "hard" costs) have been paid in full (i.e., where the lender has obtained certificates of payment and releases of lien from all Lien Law claimants). The borrower's covenant is to apply building loan proceeds first to the cost of improvement. When those costs have been paid or otherwise accounted for in full, the balance of building loan can be used for any other purpose. Obviously, from a timing standpoint, this will not work when the borrower needs to borrow funds at the beginning of the transaction for "bad" costs, such as land acquisition.

2. **Common Practice:** In larger loans (which will bear the cost of additional lawyering), bifurcate the loan, i.e., fund all non-cost improvement items (like land acquisition costs) up front prior to the building loan closing as a conventional loan and separate this loan from the building loan by using a separate note and mortgage and by recording the conventional mortgage at least one day before the building loan mortgage. Be sure to include a trust fund covenant in both the conventional mortgage and the building loan mortgage and do not consolidate the two mortgages.[7] In smaller loans, bifurcate the mortgage (i.e., splitting the mortgage into a conventional mortgage and a building loan mortgage). In either case, the building loan agreement should be written in the amount of the building loan only.

3. **Project Loan:** If you have non-cost improvement items which have to be advanced over time (e.g., borrower entitled to receive 10 percent of its developer's fee at the time of each building loan advance), use a project loan agreement and separate this loan from the conventional loan and the building loan by using a separate note and mortgage and by recording the project mortgage at least one day after the building loan mortgage. Do not consolidate the two mortgages. The project loan will not qualify as a building loan, so do not try to file it as a building loan agreement. Also, be aware that any subsequently filed mechanic's lien will prime all project loan advances whenever made. So keep the amount of the project loan as small as possible and insist on getting a clean title continuation as a condition to making each project loan advance.

4. **Last Resort:** Include the non-cost of improvement items in the Lien Law affidavit under "all other expenses" and hope for the best! The rationale is that a truthful disclosure has been made. The net sum available for the improvement will not be overstated. Trust fund beneficiaries should not be misled. See,

e.g., ***Amsterdam Savings Bank v. Terra Domus Corp.***, 97 A.D.2d 41 (3d Dep't 1983), where the Lien Law affidavit revealed that $50,000 of the building loan was to be used for land acquisition costs which are not a "cost of improvement." The court said the purpose of Section 22 was "to provide contractors with accurate information concerning the net amount of borrowed funds that is available for the improvement." The subordination penalty will be applied only when a lender knowingly files a materially false Lien Law affidavit. Here the affidavit was factually correct even though the expense in question was not a cost of improvement.

The court also noted, in dicta, that the borrower could have accomplished the same result in a different way by granting to the seller of the property a purchase money mortgage for $50,000 and then asking the lender to use building loan proceeds to purchase that mortgage by assignment. That would be a proper "cost of improvement" and a way to use building loan proceeds to purchase the property. The court said: "We refuse to penalize [the lender] for acts done directly which could have been accomplished indirectly, especially where the statute providing the penalty was designed for a purpose which was fulfilled herein."

In other words, providing accurate information may be more important than technical compliance with the requirements. A word of caution: Remember that a mortgage will qualify as "prior existing" and therefore eligible for purchase as a cost of improvement only if it was recorded prior to the commencement of the improvement.

VII. Building Loan Advances

A. The principal amount of the building loan increases as advances are made against construction work in place. The promise to pay in the building loan note usually reads as follows: "Borrower promises to pay to the order of Lender the principal sum of $_____ or so much thereof as may from time to time be advanced by Lender to Borrower pursuant to the Building Loan Agreement." This is sometimes referred to as a "grid" note since, prior to the advent of the computer, the advances were noted by the lender on a grid attached to the note. The borrower usually submits a requisition and signs a receipt for each advance for record keeping purposes.

B. The title report is marked up at the building loan closing. It will contain a pending disbursements clause reading as follows:

"Pending disbursement of the full proceeds of the loan secured by the Mortgage described therein, this policy insures only to the extent of the amount actually disbursed plus interest accrued thereon but increases as disbursements are made in good faith and without knowledge of any defects in, or objections to, the title up to the face amount of the policy."

So title insurance coverage will increase as each building loan advance is made; provided there are no intervening mechanic's liens.

C. The lender will order a title continuation the day before each advance is made. It receives an oral report from the title company, later confirmed in writing (usually in letter form). After completing the title update, the title company usually reports to the lender: "Nothing further found." If so, the lender should make the advance that same day. But if an intervening lien is found (whether a mechanic's lien, a lien for unpaid real estate taxes, a judgment lien, etc.), the lender should not make the advance because that advance would be subordinate to the lien. The lender should first make sure that the lien is discharged of record, then order another title continuation.

D. The lender will advise the title company when it is ready to make the final building loan advance. After the final advance is made, the title company will remove the pending disbursements clause and issue the final loan policy.

VIII. Modification of Building Loan Agreements

The requirements of Section 22 also apply to "any" modification of a building loan agreement.

A. **Requirements:** The modification:

1. Must be in writing and duly acknowledged.

2. Must contain a Lien Law affidavit. Should the affidavit be updated? Not clear from a reading of Section 22. I think that is the better practice.[8]

3. Must be filed in the county clerk's office within 10 days after the execution of the modification. Note that some decisions made by the lender orally could also have the effect of a modification, e.g., an oral waiver of a bonding or retainage requirement.

B. **Effect on Previous Work:** It is important to note that no modification of a building loan agreement will affect or impair the right or interest of any person who, previous to the filing of the modification, had furnished work or materials or contracted to furnish work or materials. His right or interest is to be determined by reference to the terms

of the original building loan agreement. Lien Law § 22.[9]

C. **Meaning of "any modification thereof":** Not every change in a building loan agreement will constitute a "modification" within the meaning of Section 22 despite a literal reading of that section. For example, in ***New York Savings Bank v. Wendell Apartments, Inc.***, 41 Misc. 2d 527 (Sup. Ct., Nassau Co. 1963), it was held that an agreement merely extending the date for completion of the project did not constitute a "modification" of the building loan agreement which had to be filed since:

1. it did not vary or modify any of the essential terms of the contract with respect to the amount or manner of payment of advances,
2. it left the parties with the same rights and liabilities as existed under the original building loan agreement, and
3. no right of any person was enlarged or restricted or impaired by the extension of the completion date.

The courts have stated that a modification of a building loan agreement is "material" if it:

1. alters the rights and liabilities otherwise existing between the parties to the agreement, or
2. enlarges, restricts or impairs the rights of any third-party beneficiary.

See, e.g., ***HNC Realty Co. v. Bay View Towers Apartments***, 64 A.D.2d 417 (2d Dep't 1978), and ***Security National Bank v. Village Mall at Hillcrest, Inc.***, 85 Misc. 2d 771 (Sup. Ct., Queens Co. 1976).

Additional gloss has been provided by the ***Security National Bank*** case cited above, where the court said:

> [W]here an essential term of the building loan agreement is changed, such as the amount or manner of payment, a modification must be filed. From the face of the statute itself, it can be seen that those terms which are required to be stated in the building loan agreement by virtue of the terms of section 22 of the Lien Law should also be deemed material when dealing with modifications. The terms listed in the statute are the consideration paid or to be paid for the loan, the expenses, if any, to be incurred in connection therewith, and the net sum available to the borrower for the improvement. Any modification dealing with these matters is, as a matter of law, to be considered essential. *Id*. at 783.

Subsequent agreements between the borrower and the lender which should have been filed as modifications to the building loan agreement include:

1. Conversion of a residential apartment project from rental to individual condominium units. ***Security National Bank*** cited above. Reason: contractors and materialmen should have been advised that a change had occurred which substantially diluted the security upon which they were entitled to rely in the making of their business decisions concerning extension of credit to the builder. In fact, the property to which their liens would attach that stood to safeguard their interest was depleted by approximately 62 percent, representing the approximate percentage of the value of the improvement that could not be reached by their liens because such amount had been conveyed to individual condominium unit owners.
2. Reduction of retainage from 10 to 5 percent. ***Security National Bank*** cited above. Reason: the modification of the retainage agreement reduced by $800,000 the amount of money which the mechanic's lienors could reasonably have expected to be available at the completion of the project, which could well have been detrimental to the contractors.

But a contrary result was reached in ***In re Lynch III Properties Corp.***, 125 B.R. 857 (Bkrtcy. E.D.N.Y. 1991). Here the lender under the building loan agreement was to retain 10 percent of the funds advanced to the borrower as retainage until certain conditions were met. In fact, the lender did not retain any of the funds (a unilateral decision made by a bank officer). The building was not completed, the loan went into default, the mortgage was foreclosed, and the contractors and materialmen claimed that the bank's failure to retain the retainage constituted a material modification of the building loan agreement. The lender responded by asserting that a modification is material only when it has caused a profound adverse effect upon the mechanic's lienors.[10] It contended that by making early advances to the borrower, the mechanic's lienors were in no way damaged and in fact actually benefited because once there was a default, the lender was no longer obligated to make any further advances and since the building was not completed, the mechanic's lienors could not reach the retainage in the lender's hands. The court agreed with the bank and explained the difference between the two cases as follows:

> [I]n the Security National Bank case, the mechanic's liens were adversely affected by the bank's failure

to keep retainage. In . . . [that case], the project was completed and certificates of occupancy had been issued. Had the bank retained a portion of the funds it advanced as retainage, it would then have been obligated to pay the borrower the funds it had retained, which would then be available to the mechanic's liens. *Id*. at 862.

To like effect is ***In re Admiral's Walk, Inc.*** cited above.

3. Waiver by a lender of performance bonds. In ***Yankee Bank for Finance & Savings FSB v. Task Associates, Inc.***, 731 F. Supp. 64 (N.D.N.Y. 1990), the building loan agreement required the borrower to provide a surety payment bond for the protection of the subcontractors and stated that no funds would be advanced by the lender beyond a certain amount without the bond. The lender advanced funds beyond that amount without obtaining the required bond, and this "modification" of the building loan agreement was never filed. In holding that the lender's mortgage was subordinate to the interests of the mechanic's lienors, the U.S. District Court said:

   [I]t is clear that the construction loan agreement created specific rights in third parties, namely the defendant mechanics lienors. Such a bond would have permitted the mechanics lienors to sue for payment directly on the bond, thereby greatly increasing the chances that they would get paid. The . . . [lender's] failure to require the bond was therefore a "material modification" to the loan agreement because it "restrict[ed] or impair[ed] the rights of [a]… third party beneficiary." *Id*. at 70.

   In ***HNC Realty Co. v. Bay View Towers Apartments*** cited above, the Appellate Division subordinated the lender's mortgage where it was shown that although the building loan contract required a payment bond covering all concrete, electrical and plumbing subcontractors, the lender in fact accepted a bond which merely assured that the borrower would "faithfully account" for the proceeds of the loan, and no provision was made in the bond for assertion of any rights by anyone other than the lender. The court said:

   There is no question that . . . [the lender's] failure to exact compliance with the [building loan] contract's requirement that . . . [the borrower] procure a surety payment bond covering . . . subcontractors worked to impair the rights of those subcontractors. Had the required bond been given, the subcontractors would have been paid directly by the surety and this lawsuit would have been avoided. *Id*. at 426.

4. What about a subsequent change in the amount of equity required of the borrower? In the ***Admiral's Walk*** case cited above, the Bankruptcy Court said:

   [U]nlike a BLC provision for a Payment Bond, this provision did not establish a source of direct payment for section 22 beneficiaries. In short, even if section 22 [of the BLC] had required $2.7 million in cash up front, it contains no manifest requirement that such funds would be applied to payment of mechanic's claims instead of, for example, to marketing or other "soft" costs.". . . "[A]lteration of rights as between the lender and borrower is not alone sufficient to warrant subordination—there must also be some element of impairment of rights of section 22 beneficiaries in order that a modification be so "material" or "essential" as to warrant its filing, on penalty of subordination. *Id*. at 120–121.

IX. Division of Trust Funds (Article 3-A)

A. **Background:** Any funds that an owner, contractor or subcontractor receives in connection with a contract for or in connection with an improvement of real property and any right of action for such funds due or earned thereon constitute assets of a trust fund of which the owner, contractor or subcontractor is the trustee. Lien Law § 70(1). A lender or mortgagee as such is not a statutory trustee. *See, e.g.*, ***ALB Contracting Co., Inc. v. York-Jersey Mortgage Company***, 60 A.D.2d 989 (4th Dep't 1978), and ***Givoh Associates v. American Druggists Insurance Company***, 562 F. Supp. 1346 (E.D.N.Y. 1983).

   The trust assets of which an owner is trustee must be held and applied for payment of the "cost of improvement." Lien Law § 71(1). The trust assets of which a contractor or subcontractor is trustee must be held and applied for payment of the items specified in Lien Law § 71(2), including payment of claims of subcontractors, architects, engineers, surveyors, laborers and materialmen, payroll taxes, sales taxes, unemployment insurance, benefits or wage supplements and insurance and surety bond premiums. Persons entitled to such payments are designated beneficiaries of the trust. Lien Law § 71(4).

   It is a diversion of trust assets to pay, transfer or apply any trust assets for any purpose other than a purpose of the trust

before payment or discharge of all trust claims, whether or not there are trust claims in existence at the time of the transaction or whether the diversion occurs by reason of the voluntary act of the trustee or by his consent. Lien Law § 72(1).[11]

The term "trust claims," with respect to a trust of which an owner is trustee, means (a) claims of contractors, subcontractors, architects, engineers, surveyors, laborers and materialmen arising out of the improvement for which the owner is responsible and (b) any obligation of the owner incurred in connection with the improvement for a payment or expenditure which constitutes a "cost of improvement." Lien Law § 71(3)(a). With respect to a trust of which a contractor or subcontractor is trustee, the term means claims arising for payment for which the trustee is authorized to use trust funds under Lien Law § 71(2).

Any beneficiary of the trust may bring an action against such transferee to recover assets diverted from the trust. Lien Law § 77(1). Since loan payments are generally not a purpose of the trust, a lender who receives loan payments from an owner, contractor or subcontractor may be the recipient of diverted trust funds. Such funds may be recovered from the lender by unpaid beneficiaries of the trust.

Lien Law § 73 provides that in any action against a person to whom trust assets have been transferred (in this case, the lender) to recover assets diverted from the trust, a transferee named in a Notice of Lending (i.e., the lender) shall be entitled to show, by way of a defense, that the transfer was made in repayment of advances made to or on behalf of the trustee (i.e., the owner, contractor or subcontractor) in accordance with such Notice of Lending and that, prior to the making of such advances, the transferee procured the trust fund covenant from the trustee.

B. Requirements of a Notice of Lending (Lien Law § 73(3)):

1. In the case of a private improvement, the Notice of Lending is filed in the county clerk's office where the improvement is located. Lien Law § 73(3)(a). The clerk will enter certain facts relating to the notice in the "lien docket" provided for this purpose and index the notice against the name of the trustee to whom or on whose behalf the advances will be made.

   In the case of a public improvement, the Notice of Lending should be filed with the head of each department or bureau having charge of construction of the improvement and with the financial officer of each public corporation or other officer or person charged with the custody and disbursement of the corporate funds applicable to the contract for the public improvement. Lien Law § 73(3)(a).

2. A Notice of Lending will be effective with respect to all advances made:

(a) on the day of filing,

(b) subsequent to the day of filing, and

(c) up to five days before the date of filing.

3. The Notice of Lending must contain, among other things:

(a) the name and address of the person making the advances;

(b) the name and address of the person to whom or on whose behalf the advances will be made;

(c) a description of the improvement and of the real property involved;

(d) the maximum principal amount of all advances which may be made pursuant to the notice; and

(e) the date of any advance made on or before the date of filing for which the notice is intended to be effective.

   The Notice of Lending may contain a termination date beyond which no further advances will be made by the lender.[12]

4. If the lender later wants to continue making advances after the termination date stated in the notice, it should file a subsequent notice called a "Second Notice of Lending" or a "Third Notice of Lending," as the case may be, within 60 days prior to the termination date of the existing notice. The subsequent notice should identify the prior notice(s) to which it relates. Lien Law § 73(3)(c).

5. If the lender later wants to increase the maximum amount of advances which might be made pursuant to the Notice of Lending, it should file an amendment to the Notice of Lending. Such amendment will be effective as to the increased amount only with respect to advances made not more than five days before the date of filing of the amendment and thereafter. Lien Law § 73(3)(c).

C. **Closing the Loop.** Developers often borrow against an open line of credit (i.e., unsecured) to pay architects, engineers, surveyors and contractors for preliminary plans, surveys, initial site work, etc., before obtaining a building loan. The lender wants to secure these advances at the time of the building loan closing by taking a portion of the building loan proceeds to repay the unsecured borrowings. But since the building loan proceeds are trust funds, the lender would be engaging in a diversion of trust funds under Article 3-A of the

Lien Law. See Lien Law § 72(1). What can be done to avoid this result?

The lender files a Notice of Lending at the time it starts making the unsecured advances. Then when the lender gets to the building loan closing, it "closes the loop" by disclosing the repayment of the unsecured borrowings in the Lien Law affidavit attached to the building loan agreement. See optional paragraph 4 of the sample form of Lien Law affidavit attached to this outline as **Exhibit A**.[13]

Practice Point: Lender's counsel should present a duplicate executed copy of the Notice of Lending to the county clerk to be time-stamped, certified and returned to counsel for proof purposes.

D. Consequences of Failing to File a Notice of Lending. ***National Surety Corp. v. Fishkill National Bank***, 61 Misc. 2d 579 (Sup. Ct., New York Co. 1969), involved a claim to recover trust funds allegedly diverted by a bank. The contractor assigned to the bank all moneys due or to become due to him from a municipality under a construction contract for a public works project. The bank filed the assignment with the municipality but did not file a Notice of Lending. Under the assignment, the municipality paid to the lender certain amounts payable under the contract which the lender applied in repayment of loans it had made to the contractor. The contractor defaulted, the unpaid subcontractors were paid by the surety which sued the bank to recover the payments on a diversion of trust funds claim.

Holding: Since the bank had failed to file a Notice of Lending in the manner required by the statute, the assignment was invalid as against the surety, and the surety was entitled to a judgment that the bank's application of the funds to its own use constituted a diversion. The court said:

> It was the clear intent of the [New York State] Legislature in 1959 to re-emphasize that lenders must recognize the subordination of their claims to persons who had acquired the status of trust beneficiaries. . . . When a bank receives funds pursuant to an assignment of the proceeds of a contract for a public improvement, it acquires immediate knowledge that it is receiving trust funds under the statute. The law has stated expressly the purposes for which the trust funds are to be first applied and the repayment to the bank of its loan is certainly not one of these purposes. *Id*. at 584.

To like effect are ***Eljan Mason Supply Inc. v. I.F. Associates Corp.***, 84 A.D.2d 720 (1st Dep't 1981), and ***LeChase Data/Telecom Services, LLC v. Daniel Goebert***, 2 Misc. 3d 195 (Sup. Ct., Monroe Co. 2003).

E. ***Leading Case: Aspro Mechanical Contracting, Inc. v. Fleet Bank N.A.***, 1 N.Y.3d 324 (2004).

1. **Facts:** The borrower entered into a "turnkey" contract of sale with the New York City Housing Authority pursuant to which the borrower agreed to acquire certain real property owned by the Housing Authority, construct residential buildings thereon and then convey title to the improved property back to the Housing Authority upon receipt of the purchase price for the improvements.

   The lender made a building loan to the borrower to provide construction financing for the project. The building loan was advanced pursuant to a building loan agreement which met the disclosure and filing requirements of Section 22 of the Lien Law, and the building loan mortgage contained the trust fund covenant required by Section 13 of the Lien Law. As additional security for the repayment of the building loan, the lender required the borrower to assign all of its right, title and interest in and to the turnkey contract to the lender so that, when the borrower conveyed title to the improved property back to the housing authority, the housing authority would pay the purchase price directly to the lender, which, in turn, would apply the proceeds thereof to the repayment of its building loan. The mortgage stated that the turnkey contract had been assigned to the lender, but the specific rights and responsibilities of the assignment were not disclosed, and the assignment itself was not recorded.

   The project was completed, title was conveyed back to the housing authority, the housing authority paid the purchase price to the lender, and the lender applied the proceeds to the repayment of its building loan and discharged the mortgage.

2. **Subcontractors' Contentions:** Certain individuals and entities who had subcontracted with the borrower to provide labor, services and materials for the project and had not been paid sued the lender pursuant to Section 77 of the Lien Law to recover trust funds allegedly diverted by it. They alleged that (a) the funds the housing authority owed to the borrower were trust funds, (b) they, as subcontractors on the project, were beneficiaries of that trust, (c) the lender became a statutory trustee under Article 3-A of the Lien Law when it took an assignment of the turnkey contract, (d) the lender had not filed a Notice of Lending disclosing the fact that it intended to apply trust assets to the repay-

ment of its building loan, and (e) it had diverted trust funds by paying itself prior to paying the plaintiffs' claims, thus violating its fiduciary obligations under the trust.

3. **Lender's Defense:** The lender's defense was that since it was not an owner, contractor or subcontractor, it was not a "trustee" within the meaning of the Lien Law and that the proceeds paid to the lender pursuant to the assignment were not trust assets. It also argued that its self-payment was permissible because it used the proceeds to pay its properly recorded secured loan, which was superior to the plaintiffs' claim by reason of the Lien Law's statutory priority provisions (i.e., Article 2).

4. **Holding:** The Court of Appeals determined that: (a) the funds the housing authority owed to the borrower under the turnkey contract were trust funds, (b) the borrower was a statutory owner-trustee, (c) the plaintiffs, as subcontractors, were trust beneficiaries, (d) by requiring that the borrower's right to receive the sale proceeds under the turnkey contract be assigned to it, the lender became a statutory owner-trustee, (e) as a trustee, the lender was obligated to act as a fiduciary manager of the trust funds, (f) as such, it owed the beneficiaries a duty of loyalty and was required to administer the trust solely in the interests of the beneficiaries, (g) the lender had a fiduciary duty to advise the beneficiaries of its intent to use trust assets to discharge its building loan, and (h) nothing filed or recorded by the lender provided the beneficiaries with this information. It therefore held that the lender's application of trust assets to repay its building loan without acknowledging its status as a trustee and providing notice to trust beneficiaries of the intended transfer constituted self-dealing and a breach of its fiduciary duty and ordered the lender was ordered to pay over $1,900,000 in stipulated damages to the plaintiffs.

   The Court concluded that the filing of a Notice of Lending "would have satisfied . . . [the lender's] fiduciary duty to provide notice to the trust beneficiaries of its use of trust assets to discharge . . . [the borrower's] debt . . . and eliminate any taint of self-dealing by a trustee who is also a trust beneficiary."

5. **Notes:** The term "cost of improvement" includes "sums paid to discharge building loan mortgages whenever recorded" and "interest on building loan mortgages accruing during the making of the improvement." Therefore, the lender in this case was both a trustee of trust funds and a trust fund beneficiary.

6. **Related Issue:** Did the lender's repayment of itself in breach of its fiduciary obligation also invalidate its Article 2 lien priority and render it liable to unpaid Lien Law beneficiaries for the full amount of the transferred trust funds? That was apparently the conclusion reached by the lower courts but was not addressed by the Court of Appeals (because the parties had stipulated as to the damages prior to the appeal). In other words, one of the possible consequences of a successful diversion of trust funds claim is that the lender could also lose its lien priority. A double whammy!

7. **Lesson Learned:** A lender that becomes a statutory trustee by virtue of an assignment of trust funds must fulfill the fiduciary requirements of a trustee, which includes maintaining books and records of the trust (Lien Law § 75) and, more importantly, disbursing trust funds properly. Lien Law § 71. In order for the lender to protect the right to payment, it should file a Notice of Lending. This ensures that the other Lien Law beneficiaries will be aware of the lender's dual position as trustee and beneficiary, thereby satisfying the lender's fiduciary duty to provide notice. Failure to file a Notice of Lending under these circumstances may result in a severe penalty: disgorgement of all improperly diverted trust funds and the possible loss of its lien priority.

F. **Implications of *Aspro*:** Should a lender now start filing a Notice of Lending in connection with each building loan it closes? Not necessarily. There are only two instances where such action would appear to be required:

1. Where the borrower wants to borrow money on an unsecured basis to pay for cost of improvement items prior to the building loan closing, and the lender intends to secure these advances later by taking a portion of the building loan proceeds (which are trust funds) to repay the unsecured borrowings. A sample of this type of Notice of Lending is attached to this outline as **Exhibit C**.

2. Where the lender steps into the shoes of an owner-trustee by taking an assignment of sale proceeds that are trust assets as security for its loan. A suggested form of this type of Notice of Lending is attached to this outline as **Exhibit D**.

X. Some Final Thoughts

A. **Use of Lien Waivers:** Can't we eliminate all these problems by simply requiring the borrower to get the contractors, subcontractors, materialmen, suppliers, etc. to waive all of their Lien Law rights in advance? That does not work. Such a waiver would be "void as against public policy and wholly unenforceable." Lien Law § 34.

But beneficiaries can effectively waive their Lien Law rights after receiving payment (to the extent of such payment). Therefore, most lenders require certificates of payment and partial lien waivers from beneficiaries as progress payments are made.

B. **Use a payment bond:** A payment bond generally insures that the subcontractors, materialmen, suppliers, etc. of a contractor will be paid. If they are paid, they should not be able to file a mechanic's lien.

The problem is the availability and cost of the bond. Every contractor has a bonding limit. Since work on a public improvement almost always has to be bonded, contractors resist using up any of their bonding limit on private improvements. Also, the premium on a bond is very expensive, and the contractor will simply increase the construction cost by the amount of the premium for the bond. This additional cost may make the difference between whether a given construction project is feasible or not. So the owner and contractor often "gang up" on the lender and try to persuade it to waive the bonding requirement. Their usual argument is: "I can get this same building loan from your competitor with no bonding requirement."

Endnotes

1. Statutes and cases reviewed in November 2006.
2. "The statute which gives to a contractor, mechanic or materialman a lien upon the lands of another, created a remedy in such cases which was unknown to the common law. . . ." *Spruck v. McRoberts*, 139 N.Y. 193, 197 (1893).
3. Although the Lien Law refers to this instrument as a "building loan contract," most lenders refer to it as a "building loan agreement" or "BLA." The two terms are synonymous.
4. "As the [building loan] agreement . . . was not filed, the contractors did not have the statutory notice of the existence of an agreement which would impair the validity of their [mechanic's] liens by diverting the value which they put into the property by their labor and materials to the payment of other obligations . . . [H]aving failed to file the building loan agreement . . . , the . . . [lender] must suffer the consequences." *McDermott v. Lawyers Mortgage Co.*, 232 N.Y. 336, 347–48 (1922).
5. "A debt secured by mortgage is not an interest in real estate. The mortgage is a lien given as security for the debt. When the mortgage, prior in time of record, becomes subject to a mechanic's lien, prior in law, the mortgage is subordinated thereto as an encumbrance on the real estate, but the [mechanic's] lien does not attach to the mortgage debt nor to the mortgage itself, which is an incident to the debt . . . ''Subject to' as used in . . . [Section 22] is synonymous with 'subordinate to' or 'inferior to.' It does not import that the subsequent lienor shall have a lien on the first lien itself or that the prior mortgagee shall pay the debt." *McDermott v. Lawyers Mortgage Co.*, cited above, *id*. at 348–49.
6. A similar holding was made in *United States v. Eljos Associates* and *Adirondack Trust Co. v. Thomas J. Bien & Associates* cited above.
7. This technique may not work. See, e.g., *HNC Realty Co. v. Golan Heights Developers, Inc.*, cited above. Here the lender purchased certain prior existing mortgages by assignment and then consolidated them with its building loan mortgage. The Lien Law affidavit failed to disclose that $3.9 million of building loan proceeds were being used for this purpose. The court said this was a "material misstatement." The lender then asked that the subordination penalty be imposed on the building loan portion only, not on the assigned mortgages portion, which would therefore remain superior to the subsequently filed mechanic's liens. In refusing to limit the subordination penalty in this manner, the court pointed out that the term "building loan mortgage" is defined to include "an agreement wherein and whereby a building loan mortgage is consolidated with existing mortgages so as to constitute one lien upon the mortgaged property." Lien Law § 2(14). The subordination penalty will affect the lender's entire interest in the property, including an interest obtained through acquisition by assignment of prior mortgages, which are thereafter consolidated with the building loan mortgage itself.

   See also Atlantic Bank of New York v. Forrest House Holding Company, 234 A.D.2d 491 (2d Dep't 1996). In this case the lender asserted that its mortgage had priority over the mechanic's liens, at least to the extent of the portion of the loan used for land acquisition. The court noted that the subordination provision of Section 22 applied to building loan contracts "either with or without the sale of land" and held that if a lender fails to comply with the requirements of Section 22 "its entire mortgage, including that part securing loan proceeds advanced for the purchase of the property, would become subordinate to any subsequently filed mechanic's lien." *Id*. at 492.
8. The legislative purpose of Section 22 is "to readily enable a contractor to learn exactly what sum the loan in fact made available to the owner of the real estate for the project." *Nanuet Nat'l Bank v. Eckerson Terrace, Inc.*, cited above, at 247.
9. I am not aware of any case which has construed this provision.
10. I do not believe this to be a correct interpretation of the cases.
11. *See, e.g., RLI Insurance Company v. New York State Division of Labor*, 97 N.Y.2d 256, 263 (2002): "Lien Law article 3-A mandates that once a trust comes into existence, its funds may not be diverted for non-trust purposes. Use of trust assets for any purpose other than the expenditures authorized by Lien Law § 71 before all trust claims have been paid or discharged constitutes an improper diversion of trust fund assets, regardless of the propriety of the trustee's intentions. . . ." *Id*. at 263.
12. If the Notice of Lending relates to several or undetermined projects, it must contain a termination date, which cannot be more than two years after the notice is filed.
13. *See Adirondack Trust Company v. Thomas J. Bien & Associates, Inc.*, 168 Misc. 2d 919 (Sup. Ct., Saratoga Co. 1996), where the court held that the lender did not knowingly file a materially false Lien Law affidavit and therefore would not lose its priority to a subsequently filed mechanic's lien where it failed to disclose in the affidavit that it was deducting from the proceeds of the first building loan advance a substantial sum in repayment of earlier unsecured advances made to the general contractor with respect to the same improvement, as disclosed in previously filed Notices of Lending.

John K. Bouman is a partner in the law firm Nixon Peabody LLP.

Exhibit A

Sample Form of Lien Law Affidavit

SECTION 22
LIEN LAW AFFIDAVIT
attached to and forming a part of
BUILDING LOAN AGREEMENT,
dated as of _____, 200_,
between
[Name of Borrower]
and
[Name of Lender]

STATE OF NEW YORK)
SS:
COUNTY OF _____)

_____, being duly sworn, deposes and says that:

He resides at _____ and is the _____ of _____, a _____ (**"Borrower"**), which has entered into a certain Building Loan Agreement with _____, a _____ (**"Lender"**), dated as of _____, 200_ (the **"Building Loan Agreement"**), relating to the [construction] [rehabilitation] and equipping of a _____ (the **"Improvement"**) on certain real property located on _____, in the _____ of _____, _____ ____ County, New York (the **"Property"**). All capitalized terms used in this Affidavit and not otherwise defined shall have the same meanings assigned thereto in the Building Loan Agreement.

The amount of the Loan is $_____.

The consideration paid, or to be paid, for the Loan (i.e., the commitment fee) is $_____.

All other expenses, if any, incurred or to be incurred in connection therewith are as follows:

1. Architect's and engineer's fees $_____
2. Taxes based on the purchase price or value of materials or equipment required to be installed or furnished in connection with the performance of the Improvement $_____
3. Fair and reasonable sums paid for obtaining building loan and subsequent financing:
   - (a) Mortgage broker's commission for obtaining the Loan $_____
   - (b) Cost of lender's appraisal $_____
   - (c) Inspection fees of Lender and/or the Inspecting Architect $_____
   - (d) Legal fee and disbursements of Lender's counsel $_____
   - (e) Cost of title examination and UCC searches, title insurance premium for loan policy and title continuation charges $_____
   - (f) Cost of surveys $_____
   - (g) Recording and filing fees $_____
   - (h) Mortgage recording taxes $_____
   - (i) Other (specify) $_____
4. Payment and performance bond premiums $_____
5. Sums paid to take by assignment prior existing mortgages which are consolidated with building loan mortgages and also the interest charges on such mortgages $_____

6. Sums paid to discharge or reduce the indebtedness under prior existing mortgages and accrued interest thereon and other prior existing encumbrances $_____

7. Sums paid to discharge building loan mortgages whenever recorded $_____

8. Taxes, assessments and water rents existing prior to the commencement of the Improvement and accruing during the making of the Improvement $_____

9. Interest on building loan mortgages accruing during the making of the Improvement $_____

10. Ground rent accruing during the making of the Improvement $_____

11. Insurance premiums accruing during the making of the Improvement $_____

TOTAL AMOUNT OF ABOVE ITEMS $_____

[Optional paragraph #1 –

Certain of the foregoing amounts are based upon good faith estimates of costs or expenses not yet incurred and certain items listed above may cost more or less than such estimates. Borrower reserves the right to use unexpended amounts from any of said items to defray increases incurred in any other item or items listed above; provided that the total amount of Loan proceeds expended on said items does not exceed the total amount of said items shown above.]

After payment of the above items, the net sum available to Borrower for the Improvement will be $_____.

[Optional paragraph #2 –

Borrower paid for some of the above items prior to the date of the first Loan advance but subsequent to the commencement of the Improvement. Proceeds of the Loan will be used to reimburse Borrower for such payments, which are itemized in the Building Loan Agreement.]

[Optional paragraph #3 –

From the net sum available to Borrower for the Improvement, the sum of $_____ will be paid by Borrower to the General Contractor for work already completed with respect to the Improvement under the Construction Contract.]

[Optional paragraph #4 –

From the net sum available to Borrower for the Improvement, the sum of $_____ will be paid by Borrower to Lender, as a transferee named in the notice or notices of lending described below which were filed in the office of the County Clerk in which the Property is located, as provided in subdivision three of Section 73 of the New York Lien Law, in repayment of one or more unsecured advances made by Lender to or on behalf of Borrower, as a trustee named in Section 70 of the New York Lien Law, prior to the first Loan advance and applied for a purpose of the trust, as stated in subdivision one or subdivision two of Section 71 of the New York Lien Law:

Date(s) of Notice of Lending	**Date(s) Filed**	**Name of Trustee**	**Amount**
__/__/__	__/__/__	_____	$_____]

This Affidavit is made pursuant to and in compliance with Section 22 of the New York Lien Law.

[Alternative paragraphs –

The reason this affidavit is verified by deponent and not by Borrower is that Borrower is a limited liability company and deponent is a [managing member] [manager] thereof. The facts stated herein are true to the knowledge of deponent.]

The reason this affidavit is verified by deponent and not by Borrower is that Borrower is a [limited] partnership and deponent is a [general] partner thereof. The facts stated herein are true to the knowledge of deponent.]

The reason this affidavit is verified by deponent and not by Borrower is that Borrower is a corporation and deponent is an officer thereof. The facts stated herein are true to the knowledge of deponent.]

_____

Sworn to before me this _____ day of _____, 200_.

_____
Notary Public

Exhibit B

LETTER OF INSTRUCTIONS TO TITLE COMPANY

_____, 200__

[Name and Address of Title Company]

RE: Your Title Report No. _____

Name of Borrower: _____

Property Address: _____

_____

Gentlemen:

We are counsel for _____, a _____ (**"Lender"**), in connection with the above loan.

Enclosed are the following documents:

Two executed counterparts of a Building Loan Agreement between Borrower and Lender, dated as of _____ 1, 200__ (the **"Building Loan Agreement"**).

Building Loan Mortgage made by Borrower to Lender covering the above-described property, dated as of _____ 1, 200__ (the **"Building Loan Mortgage"**).

Please cause one copy of the Building Loan Agreement to be duly filed in the _____ County Clerk's Office and cause the other copy thereof to be time-stamped and certified by the _____ County Clerk. After the Building Loan Agreement has been filed, please cause the Building Loan Mortgage to be duly recorded in the [____ _____ County Clerk's Office] [City Register's Office, _____ County, New York]. The time-stamped, certified copy of the Building Loan Agreement and the recorded Building Loan Mortgage are to be returned to the undersigned.

Kindly acknowledge receipt of the documents transmitted to you herewith and the instructions contained herein by dating and signing the enclosed copy of this letter at the indicated place and returning it to the undersigned.

Very truly yours,

[Lender's Law Firm]

By:_____

Enclosures

BY HAND

RECEIPT OF THE AFORESAID DOCUMENTS AND INSTRUCTIONS IS HEREBY ACKNOWLEDGED.

[Name of Title Company]

By: _____

Date: _____, 200__

Time: _____

Exhibit C

SAMPLE NOTICE OF LENDING

TO THE CLERK OF THE COUNTY OF _____, NEW YORK, AND TO WHOM IT MAY CONCERN:

Please take notice that on _____, 200__, the undersigned, _____, a _____ _____ having an office at _____ (**"Lender"**), made an unsecured advance of $_____ and may (but is under no obligation to) make further unsecured advances from the date of and including this advance to an aggregate principal amount not exceeding $_____ to _____, a _____ having an office at _____ (**"Borrower"**), pursuant to a general line of credit with Lender in connection with the [construction] [renovation] of the following improvement:

[Describe the Improvement]_____
_____
_____
_____
_____
_____
_____
on certain real property located at _____ in the _____ of _____, _____ County, New York [Block _____, Lot _____] (the "Property").*

Borrower is the "owner" (as said term is defined in Section 2(3) of the New York Lien Law) of the Property to be improved.

The maximum principal amount of all advances which might be made pursuant to this Notice is $_____.

This Notice shall be deemed effective as of the date of the initial advance, _____, 200__.

[This Notice will terminate on _____, 200_.]**

This Notice is being given and filed pursuant to Section 73 of the New York Lien Law.

Borrower certifies that it has executed this Notice prior to the making of any advances by Lender relating to the above-described improvement and hereby covenants and agrees that it will receive all such advances and will hold the right to receive the same as trust funds to be first applied to the payment of "trust claims" (as said term is defined in Section 71 of the New York Lien Law) related to said improvement and that it will apply the same to such payments only, before using any part of such advances for any other purpose.

---

* The identification of the Property will be sufficient if it includes the name of the record owner and the location of the real estate by street and number and town or city or, if the real estate is in the City of New York, by county, except that if the real estate is in the City of New York or the counties of Nassau or Onondaga, where the block system of recording or registering and indexing conveyances is in use, the notice must also specify the block in which the real property is located. Lien Law § 73(3)(b).

** Only required where the Notice relates to several or undetermined projects. The termination date cannot be more than two years after the Notice is filed. Lien Law § 73(3)(b).

This Notice may be signed in one or more counterparts.

Dated: _____, 200__

BORROWER:

_____

By: _____

Its: _____

LENDER:

_____

By: _____

Its: _____

BORROWER'S ACKNOWLEDGEMENT

STATE OF NEW YORK)

SS:

COUNTY OF _____)

On _____, before me, the undersigned, a Notary Public in and for said State, personally appeared _____, personally known to me or proved to me on the basis of satisfactory evidence to be the individual(s) whose name(s) is (are) subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their capacity(ies), and that by his/her/their signature(s) on the instrument, the individual(s), or the person on behalf of which the individual(s) acted, executed the instrument.

_____

Notary Public

LENDER'S ACKNOWLEDGEMENT

STATE OF NEW YORK)

SS:

COUNTY OF _____)

On _____, before me, the undersigned, a Notary Public in and for said State, personally appeared _____, personally known to me or proved to me on the basis of satisfactory evidence to be the individual(s) whose name(s) is (are) subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their capacity(ies), and that by his/her/their signature(s) on the instrument, the individual(s), or the person on behalf of which the individual(s) acted, executed the instrument.

_____

Notary Public

Exhibit D

SAMPLE NOTICE OF LENDING

TO THE CLERK OF THE COUNTY OF _____, NEW YORK, AND TO WHOM IT MAY CONCERN:

Please take notice that on _____, 200__, the undersigned, _____, a _____ _____ having an office at _____ (**"Lender"**), made a building loan to _____ _____, a _____ having an office at _____ (**"Borrower"**), in a principal amount of up to $_____ (the **"Building Loan"**) in connection with the **[**construction**] [**renovation**]** of _____ _____ (the **"Improvement"**) on certain real property located at _____ in the _____ of _____, _____ County, New York **[**Tax Map Parcel No. _____**]** **[**Block _____, Lot _____**]** (the **"Property"**). The Building Loan will be advanced by Lender to Borrower pursuant to the terms of a certain Building Loan Agreement between Borrower and Lender, dated as of _____, 200_ (the **"Building Loan Agreement"**), which is intended to be filed in the _____ County Clerk's Office, evidenced by a certain Building Loan Note of Borrower to Lender in the face amount of $_____, dated _____, 200_, and secured by a certain Building Loan Mortgage made by Borrower to Lender covering the Property, dated as of _____, 200_ (the **"Building Loan Mortgage"**), which is intended to be recorded in the **[**_____ County Clerk's Office**] [**City Register's Office, _____ County**]** after the Building Loan Agreement has been filed.

The maximum principal amount of Building Loan advances which might be made by Lender to Borrower pursuant to the Building Loan Agreement is $_____.

Borrower, as seller, and the _____ Housing Authority, a public body created and organized pursuant to and in accordance with the laws of the State of New York (the **"Housing Authority"**), as purchaser, have entered into a certain Turnkey Contract of Sale, dated as of _____, 200_ (the **"Turnkey Contract"**), a memorandum of which is intended to be recorded in the **[**_____ County Clerk's Office**] [**City Register's Office, _____ County**]**, pursuant to which the Housing Authority has agreed to purchase the Property and the Improvement upon its completion for a purchase price of $_____. As additional and collateral security for the payment of the Building Loan, Borrower will assign to Lender all of Borrower's right, title and interest in and to the Turnkey Contract, including, without limitation, its right to receive the purchase price thereunder, pursuant to a certain Assignment of Turnkey Contract, dated as of _____, 200_ (the **"Assignment of Turnkey Contract"**), which is intended to be recorded in the **[**_____ County Clerk's Office**] [**City Register's Office, _____ County**]** immediately after the recording of the Building Loan Mortgage.

Borrower is the "owner" (as said term is defined in Section 2(3) the New York Lien Law) of the Property to be improved. Lender has become a statutory owner-trustee of trust assets under Section 70(5)(g) of the New York Lien Law by reason of the Assignment of Turnkey Contract. The Assignment of Turnkey Contract is being made as security for or in consideration of or in repayment of Building Loan advances being made to or on behalf of Borrower. Lender intends to apply the purchase price under the Turnkey Contract, when paid, to the reduction and payment of all principal sums secured by the Building Loan Mortgage, together with all accrued and unpaid interest thereon. Lender is therefore both a trustee of trust assets and a beneficiary thereof within the meaning of the New York Lien Law.

This Notice shall be deemed effective as of the date of the initial Building Loan advance, _____, 200__.

This Notice is being given and filed pursuant to Section 73 of the New York Lien Law.

Lender certifies that it has executed this Notice prior to making any Building Loan advances to Borrower relating to the Improvement and hereby covenants and agrees that it will receive the purchase price payable under the Turnkey Contract and will hold the right to receive the same as trust funds to be first applied to the payment of "trust claims" (as said term is defined in Section 71 of the New York Lien Law) related to the Improvement and that it will apply the same to such payments only, before using any part of such advances for any other purpose.

This Notice may be signed in one or more counterparts.

Dated: _____, 200__

LENDER:

_____

By: _____

Its: _____

LENDER'S ACKNOWLEDGEMENT

STATE OF NEW YORK)

SS:

COUNTY OF _____)

On _____, before me, the undersigned, a Notary Public in and for said State, personally appeared _____, personally known to me or proved to me on the basis of satisfactory evidence to be the individual(s) whose name(s) is (are) subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their capacity(ies), and that by his/her/their signature(s) on the instrument, the individual(s), or the person on behalf of which the individual(s) acted, executed the instrument.

_____

Notary Public

Bergman on Mortgage Foreclosures:

Yes, Absence of the Breach Letter Can Be Fatal to the Foreclosure

By Bruce J. Bergman

For some mortgage lenders and servicers, the problems inherent in the 30-day breach (or cure) letter may be academic. In our experience in New York, however, the peril is very real and we have railed at length in other publications in recent years against the imposition of the 30-day requirement. Just as a reminder, there is neither statute nor case law in New York which obliges a mortgage holder to afford a defaulting borrower notice and an opportunity to cure. The mortgage contract can, however, impose that mandate, which may be found in some commercial mortgages. As to residential mortgages, because most are, or expected to be sold on the secondary market, the Fannie Mae/Freddie Mac uniform instrument is widely used and that form *does* impose a notice requirement.

Much of the discussion has been directed to the many problems and delays that the 30-day breach letter imposes upon mortgage servicers and the foreclosure process, particularly exacerbated in judicial foreclosure states like New York. The main danger, of course, is that a foreclosure could fail for want of ability to prove mailing of the breach letter. Does it happen in real life? It certainly does and a recent case at the appellate division level highlights this with greater—and, from a lender's viewpoint, unfortunate—clarity [*Norwest Bank Minnesota v. Sabloff*, 297 A.D.2d 722, 747 N.Y.S.2d 559 (2d Dept. 2002)].

The ultimate holding in the case was that although the plaintiff mortgage holder argued vigorously, "it failed to demonstrate that the mortgage was properly accelerated as a matter of law. . .".

The court conceded that the filing of the summons and complaint constituted a proper acceleration of the mortgage. (That has always been the rule in New York). The court likewise acknowledged that the language in the breach letter satisfied the requirements of the mortgage. (That overcame one hurdle, but proof that the letter was sent was still critical.)

The only way the plaintiff could prove that the letter was sent, however, was through the affirmation of its attorney containing conclusory assertions that notice was given. This was held insufficient to establish that the plaintiff served the notice to cure on the borrower. On that basis, summary judgment was denied with the likelihood that the case would be stalled forever, thus necessitating a discontinuance and a beginning of the action all over again.

While it should, perhaps, be apparent that an attorney in New York would by his or her own statements be unable to prove that a breach letter was sent, the lender or servicer which actually mailed that letter should have been able to do so. But as a practical matter, with thousands of letters sent, it is not necessarily so easy to produce the required affidavits, particularly when some lender or servicer's staff can sometimes be transient.

The ultimate point here is underscoring the reality that concerns about the 30-day cure letter and its effect upon the mortgage foreclosure process are not merely academic. Rather, they are quite real.

Mr. Bergman, author of the three-volume treatise, *Bergman on New York Mortgage Foreclosures* (Matthew Bender & Co., Inc., rev. 2004), is a partner with Berkman, Henoch, Peterson & Peddy, P.C., Garden City, NY; 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.

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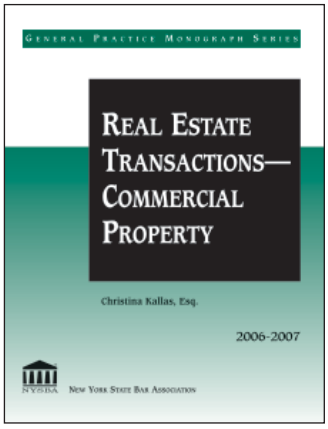

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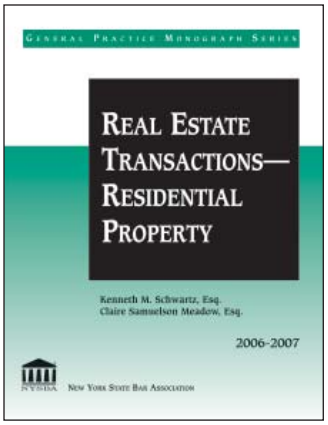

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