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N.Y. Real Property Law Journal

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NYSBA

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Message from the Outgoing Section Chair

I can hardly believe that it has been over a year since I wrote my first Chair's Message for this *Journal*—it has been a whirlwind of a year and I enjoyed every minute of it. I am so honored to have led such an amazing group of attorneys dedicated to their profession and area of practice. I am a better person for having worked with you all. This experience has been truly a gift.

First, I have to thank every member of the Executive Committee for working so hard, for enduring the changes I have made, and for doing it all with a smile. Specifically, I would like to thank the officers:

Steve Alden, 1st Vice Chair—you were not afraid to ask the tough questions and you blessed me with your unending support. You will be an amazing leader of the RPLS and we are lucky to have you.

Ben Weinstock, 2nd Vice Chair—you always had practical advice and resolutions to any issue. Thank you for grounding me.

David Berkey, Secretary—your no-nonsense, tactful approach to every issue along with your unbelievable work on the Internship Program was greatly appreciated.

Spencer Compton, Budget Officer—you never failed me or the RPLS in an often unenviable job. Thank you for your full support and assistance.

Along with new officer, Leon Sawyko, I leave the RPLS in very capable, dedicated hands.

I also want to thank the NYSBA staff; you who work tirelessly behind the scenes, often without recognition, to make the entire machine hum. Tiffany Bardwell is our Section Liaison from NYSBA and she has been utterly amazing: supportive, involved, responsive, proactive and effective. I cannot say enough about her, as without her help, my tenure may well have been disastrous. Thank you!

In other news…On May 1, 2012, we had another very successful trip to Albany for "Lobby Day." Karl Holtzschue, Tom Hall, Ira Goldenberg, Steve Alden, Ben Weinstock, and I, accompanied by Kevin Kerwin, Associate Director for the Department of Governmental Relations for NYSBA, had meetings with Assemblywoman Weinstein, Assemblymen Morelle and Bronson, and representatives from the Governor's Office, and Senators Seward and DeFrancisco. We were even treated to a meeting with Senate Majority Leader Dean Skelos. Look for photos in this issue of the RPLS *Journal*.

Results are in from the first participants in the RPLS Internship Program, and by all accounts it was a remarkable success! We look forward to continuing this program next semester and beyond. If you are interested in participating as a host firm, contact David Berkey at dlb@gdblaw.com.

Through our representative, Mike Berey, Chairman of the RPLS Task Force on e-Recording Legislation, the Section has been a very active member of the State's Office for Technology Focus Group on electronic recording regulations. The law giving local recording officers the option to electronically accept digitized paper documents or electronic records of real property instruments was signed into law by Governor Cuomo on September 23, 2011. Look for implementation of the process soon. Thanks to Mike and the rest of the Task Force. Great work!

Finally, I hope you can join us for the RPLS Summer Meeting at the Crystal Springs Resort in Hardyston, New Jersey on July 12-15, 2012. The facilities are unbelievable, and the program will be equally so. Bring the family—I promise you it will be worth it!

Heather C.M. Rogers

Message from the Incoming Section Chair

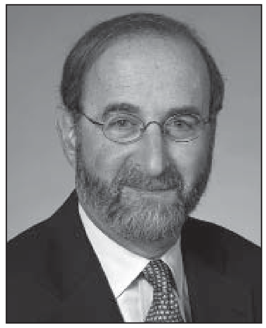
I am delighted to serve as the new Chair of the Section. In taking on this role, I am very fortunate to follow a long line of terrific chairs who have left the Section in fantastic shape. I particularly thank Matt Leeds, Josh Stein, Harry Meyer, Karl Holtzschue, Peter Coffey, Joel Sachs, Anne Copps and especially Heather Rogers for their superb leadership of the Section.

The Real Property Law Section was established in 1968 and, throughout its forty-four year history, it has provided New York real estate lawyers with first-rate continuing legal education programs, books and materials, opportunities to learn, understand and appreciate customs and practices of real estate lawyers in our communities, regions and other areas of New York State, and through our Annual and Summer meetings to get to meet, know and enjoy the company of other members of the New York real estate Bar.

During the Section's existence, and particularly in the last few years, the markets in which we practice have changed dramatically. Notwithstanding these changes, our mission has remained steady and our services to the profession have continued to grow. We continue to promote the successful and smooth consummation of real estate transactions, the creation of a cooperative and collegial real estate Bar and the sound development of real property law in New York State.

In carrying on our mission, I plan to focus on three areas—increasing our membership, promoting our CLE programs and strengthening our committees. Each of these three goals is compatible and consistent with the others.

With the guiding hand of Harry Meyer and Jaime Lathrop, our Membership Committee is actively exploring ways to increase our membership and is working with our thirteen District Representatives to advance this goal.



With the wonderful close attention of Larry Wolk and Joe Walsh, Chairs of our Continuing Legal Education Committee, we offer a superb series of CLE programs and will continue to promote their enormous value to New York real estate lawyers.

Through our numerous Committees, the Section provides many benefits to our members. Under the leadership of Karl Holtzschue and Sam Tilton, our Legislation Committee works with our members and our State Legislators to draft, review and adopt legislation of interest to New York real estate lawyers. Under the leadership of Ira Goldenberg and Dennis Greenstein, our Condominiums and Cooperatives Committee educates our members regarding condo and coop issues. Under the leadership of Joe DeSalvo, Gerry Antetomaso and Tom Hall, our Title and Transfer Committee keeps us abreast of issues which are key to any real estate practice. Under the leadership of Bill Colavito, Vince Di Lorenzo, Marvin Bagwell and Bill Johnson, our Publications Committee brings us topical and important articles of interest to New York real estate lawyers by publishing our *N.Y. Real Property Law Journal*. Under the leadership of Gino Tonetti, Gary Graber and Bob Zinman, our Real Estate Workouts and Bankruptcy Committee educates our members in these areas of the law. Our Land Use and Environmental Law Committee (Matt Fuller and Linda Margolin, Chairs) our Green Real Estate Committee (Nick Ward-Willis, Chair) and our Public Interest Committee (Lew Creekmore and Lauren Breen, Chairs) report on current issues in their respective areas. Under the leadership of Richard Fries and Frank Sarratori, our Real Estate Financing Committee monitors developments in this critical area of real estate law. Under the leadership of Brian Lustbader and Ken Block, our relatively new Real Estate Construction Committee reports on cases and issues and prepares forms in this area of real estate law. These are just a few of our active Committees and I urge you to turn to the last few pages of this *Journal* to see a complete list of our Committees and their Chairs. I'm sure you will find more than one which will interest you and assist you in your practice.

I assure you that attending Committee meetings and CLE presentations, receiving Committee Reports and participating in Committee activities will make you a better and better informed real estate lawyer.

In addition to our Committees, the Section has a listserv on which members raise questions and receive responses and a blog which is updated regularly. We also hold our Annual Meeting in New York City in January and this year our Summer Meeting will be at the Crystal Springs Resort in Hardyston, New Jersey from July 12 to July 15. Please try to join us at these meetings. You'll be glad you did.

I look forward to working with our wonderful team of officers—Ben Weinstock, our First Vice-Chair; David Berkey, our Second Vice-Chair; Leon Sawyko, our Secretary, and Spencer Compton, our Budget Officer—as we begin a new and exciting year together.

Steven M. Alden

Report on RPLS May 1, 2012 Trip to the New York State Legislature

Steve Alden, Tom Hall, Heather Rogers, Assemblywoman Weinstein, Karl Holtzschue, Ira Goldenberg and Ben Weinstock

Tom Hall, Steve Alden, Assemblyman Bronson, Heather Rogers, Karl Holtzschue, Ben Weinstock and Ira Goldenberg

For several years, the Real Property Law Section (RPLS) has had an active program of monitoring and reviewing proposed bills in the legislature and drafting bills of its own. On May 1, 2012, a group from the RPLS made our seventh annual trip to visit the legislature. Participants were: Heather Rogers (RPLS Chair), Steve Alden (1st Vice Chair, Past Co-Chair Financing Committee), Ben Weinstock (2nd Vice Chair), Karl Holtzschue (Co-Chair Legislation Committee), Tom Hall (Co-Chair Title & Transfer Committee), and Ira Goldenberg (Co-Chair Cooperatives & Condominiums Committee). Materials were prepared and appointments were arranged by Kevin Kerwin (Assoc. Director, NYSBA Governmental Relations), who led us on our visit.

We had meetings with: (1) Assemblywoman Helene Weinstein (Chair, Assembly Judiciary Committee) and her staff; (2) Assemblyman Harry Bronson, (3) Gail Steiner, Assistant Counsel to the Governor; (4) Assemblyman Morrelle (Chair, Assembly Insurance Committee) and staff; (5) Allison Cooper for Senator Seward (Chair, Senate Insurance Committee); and (6) Dottie Ponlid for Senator DeFrancisco (Chair, Senate Finance Committee). We also had a photo-op with Senator Dean Skelos, Senate President Pro Tempore, and Ben Weinstock briefed him on our issues. We took photos of several of the meetings with legislators.

We gave out a packet of materials at each meeting, including our contact information, a list of issues of interest to our Section (licensing of title agents, our bill on disclosure of title insurance service charges, our bill to repeal Highway Law 120, unauthorized practice of law, treatment of referees with respect to deeds, private transfer fees, standing to foreclose mortgages and assignment of mortgage in lieu of discharge), and copies of several of our legislative memoranda (available on the RPLS website). In response to questions, Ira Goldenberg provided language to expand coverage of the common interest exception to the transfer fee prohibition bill and Tom Hall provided clarifications of the bill on referees.

All in all, this was our most successful and enjoyable visit to date.

Karl B. Holtzschue
Co-Chair, RPLS Legislation Committee

Ben Weinstock, Steve Alden, Karl Holtzschue, Heather Rogers, Asemblyman Morelle, Tom Hall and Ira Goldenberg

Ira Goldenberg, Ben Weinstock, Senator Skelos, Heather Rogers, Tom Hall and Karl Holtzschue

Underwriting Mechanics' Lien Coverage in the New Economy

By S.H. Spencer Compton and Steven G. Rogers

In 2008, came the subprime mortgage loan crisis, the Lehman Brothers Chapter 11 bankruptcy filing and the financial meltdown. Numerous borrowers defaulted on commercial real estate financings, leaving many failed construction projects in their wake. As a result, title insurers have reevaluated the manner in which they underwrite mechanics' lien risk.

This article will discuss current approaches to underwriting inchoate mechanics' liens. An inchoate mechanic's lien is one that has not yet been filed, but once it is filed, its priority date relates back in time to the date upon which the work performed or materials furnished first commenced.

An existing mechanics' lien claim is illustrative of the kinds of tactics being employed today by certain indemnitors to evade their contractual liability.

A mixed use project consisting of three towers closed in April of 2007. The cost of construction was to be $124 million dollars, comprised of a $97 million dollar loan secured by an insured mortgage and $27 million dollars of borrower's equity. Since construction had already started, the "broken priority" of the mortgage to be insured was a concern. "Broken Priority" means that any inchoate liens could prime (i.e. gain priority over) the lien of the mortgage securing the construction loan.

A title insurance company's underwriters reviewed the borrower's financial information and took an indemnity from the local developer (now in bankruptcy) and its principal, Mr. X, individually. Mr. X is a businessman who owns a large company. At closing, he had a purported net worth of $750 million dollars. Mr. X also gave the mortgage lender a personal guaranty on the loan for $44 million dollars. (As of this writing, the lender has already obtained a judgment against Mr. X for $40 million)—Guess where this is going….

In July, 2008, due to cost overruns and a market decline (no condo sales), construction stops. The first tower is complete. The second tower is framed with 2/3 of its outside skin in place and the third tower is excavated only. $25 million dollars in mechanics' liens are promptly filed.

To date, the title insurer has spent $2 million in defense costs and will end up paying millions of dollars more to settle all of the claims.

The insurer is now suing Mr. X to honor his indemnity. He contends that 1) all of his assets are community property under state law and, since his wife did not sign the indemnity, the assets can't be executed on, and 2) the indemnity may be invalid or void because the title insurer owed him a duty to disclose that there were liens or potential liens against the project at the time of closing (there were notices of commencement but no actual liens recorded) and that the insurer should have obtained subordination agreements from these potential lien claimants prior to closing.

The title insurance company has since discovered that the cost to construct may have been artificially low due to side profit sharing agreements with some of the subcontractors where the subs agreed to discount the amount they would charge for their work in exchange for which they would be repaid the discount plus an additional payment upon completion of the project.

The title insurer has a hearing scheduled to amend its complaint against Mr. X to include fraud/misrepresentation. Adding insult to injury, one of the largest liens against the project belongs to a company owned and/or controlled by Mr. X.

In light of such unsatisfactory indemnity experiences, how are title insurance companies modifying their underwriting practices to address today's increased inchoate mechanic's lien risk?

Nationwide, there are essentially three different types of statutory schemes governing the attachment and establishment of the priority of mechanics' and construction liens:

1. priority established by the date on which materials or labor are first provided (or the commencement date), so long as an inchoate lien is filed or recorded ("Type 1");[1]
2. priority established by the date of filing of a notice of commencement or the lien itself ("Type 2");[2] or
3. priority established by the initiation of judicial action ("Type 3").[3]

The majority of jurisdictions, including New York, fall within scheme Type 1. In these States, upon the commencement of the furnishing of materials or performance of labor, as set forth in the particular statute, the mechanics' or construction lien is inchoate until the filing or recording of the notice of lien in the manner prescribed by statute.

Once perfected, the lien in these states attaches as of the date of the commencement, though not so in New York due to the lien clause required by Section 13 of New York's lien law. In New York, a lienor has a period of eight months following the completion of the improvements or furnishing of materials (four months if a single family residential property) in which to file their notice of lien.[4] Any conveyance instrument filed subsequent to the commencement of the improvement would be subject to the validly filed notice of lien unless it contains a covenant similar to the following:[5]

> AND the party of the first part, in compliance with Section 13 of the Lien Law, covenants that the party of the first part will receive the consideration for this 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 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.[6]

Alternatively, a statement as simple as, "subject to the trust fund provisions of section thirteen of the lien law"[7] may be used.

The party taking delivery of the instrument containing this covenant can rely upon the record in determining the status of title and those matters that affect it. They are not vulnerable to an inchoate lien being filed following the conveyance which springs into priority ahead of the interest conveyed to them. It adds an element of predictability for the purchaser not found in the other States that make use of scheme Type 1.

As a result of the Lien Law § 13(5) trust fund, the underwriting practices of title insurers of New York property in connection with inchoate mechanics' liens are somewhat different from those of title underwriters of property located in other States. So long as the instruments of conveyance contain the lien clause, inchoate mechanics' liens need not be addressed since the purchaser and/or lender will be conveyed their interests free of the same for the reasons set forth above.

Generally, the only mechanics' liens of concern are those duly filed in the county clerk's office that should be disclosed during a search of the clerk's records. Nor are inchoate liens a concern in those States that follow scheme Types 2 or 3. This is not the case, however, in the majority of jurisdictions.

When real property located in any States with scheme Type 1 (other than New York) is to be conveyed, the issue of inchoate liens is always of concern, especially in the case of commercial properties such as shopping centers or office buildings that are constantly undergoing repairs and renovation. It is often difficult to accurately pinpoint just what labor or materials may have been provided to the premises prior to closing.

When closing a transaction involving a property in one of these jurisdictions, the issue is addressed by furnishing the title insurer with affidavits and/or indemnities. The owner of the premises will generally provide an affidavit which states that the improvements on the real estate were completed, and that no new construction or major repair work has been performed thereon for at least the period within which the inchoate lien could be filed in the particular jurisdiction.

Further, the affidavit will state that the owner of the premises has not contracted for any labor or materials to be furnished that might become the subject of a lien or that such labor or materials, if furnished, has been paid for in full. If the owner cannot make those representations, then an indemnity in favor of the title insurer will be necessary in order for a title insurance policy to be issued without raising an exception to coverage with regard to inchoate liens which may take priority over the interest insured.

What other approaches are title insurance underwriters taking to get comfortable with inchoate mechanics' lien risks today? To the extent such a risk is a quantifiable dollar amount, an escrow account funded with some multiple of that amount may be required. Alternatively a bond or a letter of credit could be posted. Given the prohibitive cost of any of these solutions, a borrower's initial approach to the underwriter's concerns should be proactive cooperation with the underwriter's diligence efforts to accurately quantify the risk in question. Often what first may appear to be open-ended risk can be reduced to a tolerable contingency by a thorough and transparent presentation of the facts. Additionally, title insurers routinely are declining to insure mechanics' lien risks arising after the date of the title insurance policy by only issuing the FA 61 endorsement, which provides affirmative coverage against mechanics liens only up to the date of the policy.

Just as lenders reeling from their losses today have adopted more conservative lending standards, so title insurers are more cautious in light of recent history.

Endnotes

1. "Type 1" States: Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Montana, Nevada, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, Wyoming.
2. "Type 2" States: Florida, Kentucky, Louisiana, Maine, Massachusetts, Mississippi, Nebraska, New Jersey, Rhode Island, South Carolina.
3. "Type 3" States: District of Columbia, Maryland, New Hampshire.
4. N.Y. Lien Law § 10 (McKinney 2012).
5. *Id*. § 13(5).
6. Standard N.Y.B.T.U. Form 8002, *Bargain and Sale Deed, with Covenant against Grantor's Acts*, *available at* www.firstamny.com/doc/302.pdf.
7. N.Y. Lien Law § 13(5).

S.H. Spencer Compton is a vice-president and special counsel with the New York office of First American Title Insurance Company's national commercial services division. Steven G. Rogers is senior vice president and managing director, Northeast region, for that division.

Editor's Note: Due to both the complexity of New York's mechanics' lien law (Article 2 of the Lien Law) and the structuring of construction financing in this State, the determination of lien priority among competing mortgages and mechanics' liens is an art as well as a science. The real property practitioner is strongly advised to conduct her or his own due diligence when faced with lien priority issues. The foregoing article offers an excellent start, but it is wise to remember that the last word belongs to the Court.

The Property Condition Disclosure Act Celebrates Its Tenth Birthday

By Andrew D. Brodnick

Article 14 of the Real Property Law requires that the seller of a residential home either provide a Property Condition Disclosure Statement or provide a $500 credit at closing ("PCDA").[1] The PCDA, which became effective March 1, 2002, now celebrates its tenth birthday.

The PCDA was enacted to provide a better basis for the negotiation of the sale of a home.[2] In addition, its practical effect was to poke at least a dent in the mighty armor of caveat emptor, which provides that a seller with no fiduciary or confidential relationship to the buyer has no duty to disclose the existence of defects unless the defects are actively concealed or where the seller makes a misrepresentation or partially discloses the existence of a defect.[3] The PCDA, at least for those sellers who provide a disclosure statement rather than a credit at closing, changed caveat emptor. The seller was now required to come forward and provide information regarding the property which could assist the buyer in ascertaining defects. But the PCDA's intent was only to put a small dent in caveat emptor; the buyer was warned that the seller's statements were not "a warranty" and were not a substitute "for any inspections or tests."[4] The PCDA also "encouraged" buyers to obtain an independent professional inspection and to check public records.[5]

Surveys indicated that most downstate sellers opt out of the PCDA by providing a $500 credit at closing, while upstate attorneys reported that the disclosure statement was generally being provided.[6] A few of the sellers who chose to provide a disclosure statement were sued under section 465(2), which provides that the seller will be liable for the buyer's actual damages if the seller willfully fails to perform the requirements of the PCDA.

Not surprisingly, the effort to establish just how much of a dent the PCDA put into caveat emptor has befuddled the courts. The PCDA is not, as noted by at least one court, a model of clarity with respect to exactly how the PCDA was meant to change caveat emptor.[7] Karl Holtzschue suggested that the remedy provisions of the PCDA could be modified to address the confusion.[8]

This article will examine how the PCDA has fared towards changing judicial attitudes towards caveat emptor for the first ten years of its existence. It concludes with a suggestion as to how the PCDA should be applied so that it fulfills its function of modestly limiting caveat emptor.

I. Caveat Emptor

Caveat emptor provides that in an arm's length transaction involving real property, a seller (who does not make a misrepresentation and does not make partial disclosure) is not obligated to disclose defects unless: i) the seller actively concealed critical information at the time the contract was entered into,[9] or ii) there is a confidential or fiduciary relationship between the buyer and seller.[10] Some courts have recognized an exception where the seller has "superior knowledge" that the purchaser could not uncover through a reasonable inspection.[11]

II. The Property Condition Disclosure Act

The PCDA provides that every seller shall complete and deliver a property condition disclosure statement prior to the buyer signing a contract.[12] The Act applies to the sale of one-to-four family homes and excludes condominiums and cooperatives.[13] In all cases, the disclosure statement should be annexed to the contract of sale.[14]

The disclosure statement asks the seller a wide range of questions regarding the title and ownership of the home, and a series of questions regarding any environmental, structural or mechanical problems with the home. The seller responds to most questions by responding "yes, no, unkn [unknown], or n/a [not applicable]."[15] The seller concludes the disclosure by certifying that it is "true and complete to the seller's actual knowledge."[16]

The seller is put on notice that "a knowingly false statement or incomplete statement by the seller on this form may subject the seller to claims by the buyer prior to or after the transfer of title."[17]

In the event that the seller "fails to perform the duty prescribed in this article" the buyer receives a credit at closing of $500 against the purchase price.[18] The credit is not negotiated *into* the sales price; it is taken *out* of the sales price. If a seller provides a disclosure statement, the seller may be liable "only for a willful failure to perform the requirements of this article" which in turn entitles the buyer to "actual damages suffered…in addition to any other existing equitable or statutory remedy."[19]

The buyer is still required to perform due diligence, and cannot blindly follow the seller's representations. The seller's statements are not "a warranty" nor "a substitute for any home, pest, radon or other inspections or testing of the property or inspection of the public records"[20] The PCDA "encourages" buyers to have the home professionally inspected.[21]

III. Judicial Application of the PCDA

A. No Remedy

Malach v. Chuang was the first case to apply the PCDA and, in dicta, attempted to blunt its impact.[22] The seller stated in the disclosure statement that it was "unknown" whether there was any rot or water damage. Although the buyer knew that repairs to the deck around the swimming pool were required, the buyer discovered after closing that the base of the pool was so rotted that it needed to be replaced.[23]

The court found that the seller did not make misrepresentations in the disclosure statement because the seller told the truth when representing that it was "unknown" whether there was rotting.[24] As a result, even though the buyer did not state a claim under the PCDA, the court opined that the PCDA does not provide a cause of action because "it is not clear…what… 'a willful failure to perform the requirements of'" the PCDA means.[25] The court therefore concluded that the PCDA did not provide a remedy and actually "obfuscate[d] the issue of a purchaser's available remedies."[26]

Similarly, in *Middleton v. Calhoun*, the court (reviewing a small claims action) found no evidence that the seller actually knew that the septic system was defective.[27] The buyer did not test the septic system even though the buyer's contract was contingent on such a test. As with *Malach*, the court correctly found there was no claim under the PCDA, but "threw out the baby with the bathwater" by holding that the PCDA "did not create a cause of action for an alleged willful misrepresentation…."[28]

Renkas v. Sweers went even further than *Malach*.[29] The court denied a claim by the buyer even though it found that the seller *made* misrepresentations. The court found no remedy because the condition complained of was a latent defect and asserted that the PCDA "supports and reinforces…caveat emptor."[30]

As has been noted by Karl Holtzschue,[31] while *Malach* correctly declined to award relief under the PCDA due to the facts of that case, it erred in declaring that there was no remedy under the PCDA.[32] *Renkas* and *Middleton* followed in *Malach*'s footsteps by finding that the PCDA reinforced—not mitigated—caveat emptor.

B. Remedy—But Not Under the Facts

In *Fleischer v. Morreale*, the seller provided a disclosure statement which represented that there were no material defects to the roof and no flooding or drainage problems.[33] The buyer discovered within days that the roof was defective, which in turn led to basement flooding. The court recognized that the PCDA created a new statutory remedy which entitled a buyer to actual damages suffered if the seller willfully fails to disclose a known defect.[34] Similarly, the court in *Gabberty v. Pisarz* held that while the PCDA provided a remedy, the buyer was not entitled to invoke the remedy because the seller's failure to answer questions in the disclosure statement put the buyer on notice that certain defects needed further investigation.[35]

C. Remedy Awarded

Other cases have forthrightly applied a remedy. In *Calventi v. Levy*, the court found that it would "nullify" the statutory remedy if a buyer were not awarded damages after a seller failed to disclose knowledge of previous water basement leakage.[36] Furthermore, in *Ayers v. Pressman*, the court upheld a buyer's small claims action for title search expenses and mortgage application fees after the seller knew but did not disclose that the septic system encroached on the neighbor's property.[37]

In *McMullen v. Properter*, the court upheld a claim under the PCDA, where the seller failed to disclose known defects involving the septic system and covered up the "tell-tale" smell of a failing system.[38] The court reasoned that the misrepresentation in the disclosure statement might constitute active concealment which permits a claim to proceed notwithstanding caveat emptor.[39] In addition, the court in *Pettis v. Haag* found that concealment by the seller of electrical problems and flooding problems warranted a remedy.[40]

The Second Department held that a misrepresentation in the disclosure statement may constitute proof of active concealment which removes the defense of caveat emptor.[41] Similarly, the Third Department held that a misrepresentation "constitute[s] active concealment."[42] Finally, in *Meyers v. Rosen*, the Third Department found that a cause of action under the PCDA was stated when a seller was charged with failing to disclose knowledge of rodent infestation.[43]

IV. Conclusion

The legislature intended to create a remedy when it enacted the PCDA. (Section 465 of Article 14 is entitled "Remedy.")[44] A seller's failure to disclose a known defect constitutes a misrepresentation (which is an exception to caveat emptor because the seller did not remain silent) or—as the Second Department held in *Simone*—constitutes "active concealment."[45]

However, even if the seller loses the benefit of a caveat emptor defense, a buyer must still establish that he or she reasonably relied on the alleged misrepresentation.[46] The PCDA expressly maintained the requirement that a buyer conduct due diligence and it strongly recommended that a buyer obtain a professional home inspection. A seller may fail to disclose a known defect, but if the buyer could have discovered the defect with a modicum of due diligence, then the buyer did not reasonably rely on the seller's failure to disclose a known defect. The adequacy of the buyer's due diligence reflects the adequacy of the buyer's reliance.

A willful failure to disclose under the PCDA constitutes an exception to caveat emptor, but the buyer must still prove reliance. Highlighting that distinction would go a long way towards recognizing the small dent which the PCDA put into caveat emptor while respecting that reliance must always be established under both a fraud claim *and* under a PCDA claim.

Endnotes

1. *See* N.Y. Real Prop. Law §§ 460-467 (McKinney 2012).
2. *See* Karl B. Holtzschue, *Property Condition Disclosure Act Enacted*, N.Y. Real Prop. L.J., Winter 2002, at 15.

3. *See generally* Holtzschue, *infra* note 6, at 7-8 (providing an overview of caveat emptor case law, and then detailing how the PCDA "changed the ground rules").
4. N.Y. Real Prop. Law § 462(2).
5. *See id*.
6. *See* Karl B. Holtzschue, *The Purchaser Hasn't a Ghost of a Chance: Update on PCDA Cases and PCDA Revision*, N.Y. Real Prop. L.J., Winter 2007, at 8.
7. *See generally* Malach v. Chuang, 194 Misc. 2d 651, 665, 754 N.Y.S.2d 835, 846 (N.Y. Civ. Ct. Richmond Cnty. 2002) (stating in conclusion that certain remedies "contained in RPL § 462 are void for vagueness and unenforceable in a legal or equitable proceeding. The legislature needs to redraft those sections to either create a new right of action, or eliminate them so as to avoid confusion.").
8. *See* Holtzschue, *supra* note 6, at 15 (discussing the hard questions that have arisen since the PCDA's passage, as well as some proposed revisions and clarifications).
9. *See* Devine v. Meili, 89 A.D.3d 1255, 932 N.Y.S.2d 581 (3d Dep't 2011).
10. *See* Moser v. Spizzirro, 31 A.D.2d 537, 295 N.Y.S.2d 188 (2d Dep't 1968), *aff'd*, 25 N.Y.2d 941, 305 N.Y.S.2d 153 (1969).
11. *See* Karl B. Holtzschue, Holtzschue on Real Est. Cont. and Closing § 2:2.11[A] (2006) (citing Young v. Keith, 112 A.D.2d 625, 492 N.Y.S.2d 489 (3d Dep't 1985); 344 E. 72 Ltd. P'ship v. Dragatt, 188 A.D.2d 324, 591 N.Y.S.2d 28 (1st Dep't 1992) and McMillen v. Marzacano, 277 A.D. 977, 100 N.Y.S.2d 240 (1st Dep't 1950)); *see also* Stambovsky v. Ackley, 169 A.D.2d 254, 259, 572 N.Y.S.2d 672, 676 (1st Dep't 1991) (holding that caveat emptor will not apply where the seller had publicized the fact that the property was haunted and the buyer's reasonable inspection of the property could not have revealed "the property's ghoulish reputation").
12. *See* N.Y. Real Prop. Law § 462(1).
13. *See id*. § 461(5).
14. *See id*. § 462(1).
15. *Id*. § 462(2).
16. *Id.*
17. *Id.*
18. *See* N.Y. Real Prop. Law § 465(1).
19. *Id*. § 465(2).
20. *Id*. § 462(2).
21. *See id*.
22. *See generally* Malach v. Chuang, 194 Misc. 2d 651, 754 N.Y.S.2d 835 (N.Y. Civ. Ct. Richmond Cnty. 2002).
23. *See id*. at 652-53, 754 N.Y.S.2d at 837.
24. *See id*. at 653, 662-63, 754 N.Y.S.2d at 837, 844.
25. *See id*. at 656, 754 N.Y.S.2d at 839-40.
26. *Id*. at 657, 754 N.Y.S.2d at 840.
27. *See* 13 Misc. 3d 949, 956-58, 821 N.Y.S.2d 444, 450-51 (Rensselaer Cnty. Ct. 2006).
28. *Id.* at 956, 821 N.Y.S.2d at 450.
29. 10 Misc. 3d 1076(A), 814 N.Y.S.2d 892 (Sup. Ct. Monroe Cnty. 2005).
30. *Id.* at 5.
31. Karl B. Holtzschue, *First Court Case to Interpret Property Disclosure Act Holds Sellers Not Liable*, N.Y. St. B. J. March/April 2003, at 31.
32. The court also erred by misattributing the "sound and fury" soliloquy from Shakespeare's Macbeth to Lady Macbeth, rather than her husband. Malach v. Chuang, 194 Misc. 2d 651, 666, 754 N.Y.S.2d 835, 846 (N.Y. Civ. Ct. Richmond Cnty. 2002).
33. *See* 11 Misc. 3d 1004, 1005, 810 N.Y.S.2d 624, 625 (Dist. Ct. Suffolk Cnty. 2006).
34. *See id.* at 1008, 810 N.Y.S.2d at 627.
35. *See* 10 Misc. 3d 1010, 1016-17, 810 N.Y.S.2d 799, 804 (Sup. Ct. Nassau Cnty. 2005).
36. *See* 12 Misc. 3d 38, 40-41, 816 N.Y.S.2d 828, 829-30 (Sup. Ct. App. T. 2d Dep't 2006).
37. *See* 14 Misc. 3d 145(A), 836 N.Y.S.2d 496 (Sup. Ct. App. T. 9th & 10th Districts 2007).
38. *See* 13 Misc. 3d 1232(A), 831 N.Y.S.2d 354 (Sup. Ct. Yates County 2006).
39. *See id.*
40. *See* 84 A.D.3d 1553, 1554-55, 923 N.Y.S.2d 745, 747 (3d Dep't 2011).
41. *See* Simone v. Homecheck Real Estate Servs., Inc., 42 A.D.3d 518, 520-21, 840 N.Y.S.2d 398, 400 (2d Dep't 2007).
42. Anderson v. Meador, 56 A.D.3d 1030, 1035, 869 N.Y.S.2d 233, 238 (3d Dep't 2008) (citing *Simone*, 42 A.D.3d at 520-21, 840 N.Y.S.2d at 400).
43. *See* 69 A.D.3d 1095, 1099, 893 N.Y.S.2d 354, 358 (3d Dep't 2010).
44. *See* N.Y. Real Prop. § 465.
45. *See Simone*, 42 A.D.3d at 521, 840 N.Y.S.2d at 400.
46. *See* Eurycleia Partners LP v. Seward & Kissel, LLP, 12 N.Y.3d 553, 559, 883 N.Y.S.2d 147, 150 (2009) (explaining "The elements of a cause of action for fraud are a material misrepresentation of a fact, knowledge of its falsity, an intent to induce reliance, justifiable reliance by the plaintiff and damages.").

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Bad Boy or Bad Drafter: Are Bad Boy Guarantees Bad for Business?

By Gino G. Tonetti

In an increasingly complex and sophisticated business environment, lenders have turned to sophisticated and sometimes untested means to secure their interests. Originally used by lenders to ensure that borrowers in non-recourse real estate transactions acted in the best interest of the lender and the lender's collateral, "bad boy" guarantees were intended to modify unsavory borrower behavior and not to enhance the borrower's creditworthiness.[1] Yet, more recently, bad boy guarantees have been used as a credit enhancement by lenders and loan-servicers alike.[2] Notwithstanding such benefits, bad boy guarantees may be causing more harm than good as sloppy drafting and poor attention to detail may spell disaster for lenders and the business community nationwide.

Bad Boy Guarantee Defined

A "bad boy" guarantee, unlike a traditional guarantee, is a recourse carve-out guarantee used in non-recourse loans which provides for personal liability against the borrower and principals of the borrower upon the occurrence of certain enumerated "bad" acts. Traditionally, the enumerated bad acts triggering the borrower's and its principals' full liability included: misappropriation, misusing rental income, misrepresentations and fraud. However, more recently, the acts triggering bad boy guarantees have included voluntary bankruptcy filings (or soliciting an involuntary bankruptcy filing), incurring other or subordinated debt without the lender's consent, resisting foreclosure, modification of articles of organization, allowing tax liens on the subject property, or violation of SPE covenants.

There are two basic types of bad boy guarantees: springing guarantees and exploding guarantees. Springing guarantees provide for no liability beyond the secured collateral until the happening of a triggering event. By contrast, exploding guarantees provide for full liability to the borrower and its principals from inception of the loan and are extinguished upon the non-occurrence of an event.

Enforceability

There is limited case law discussing the enforceability of bad boy guarantees. In most jurisdictions, cases discussing bad boy guarantees are cases of first impression.[3] Still, almost every reported decision enforces them.[4] While a majority of courts hold that bad boy guarantees are unobjectionable, provisions providing for waivers of the judicial process are troubling (e.g., waivers of borrower's right to file for bankruptcy or oppose foreclosure). No court has fully analyzed the troubling nature of judicial waivers in the context of bad boy guarantees.[5] In fact, the court in *In re Extended Stay Inc.* balked at the opportunity to address whether a bad boy guaranty provided by David Lichtenstein, the debtors' President, Chief Executive Officer and Chairman, was void as a matter of public policy if it resulted in the encumbrance of the debtors' ability to file for bankruptcy.[6] Rather, the court stated that "[b]ecause the Debtors are now in chapter 11 and Lichtenstein, as president, chief executive and chairman did, in fact, authorize such filings, public policy arguments relating to the guaranty claims are of minimal relevance."[7] "The fact that [the guarantee liability] may be tied to bankruptcy filings does not lead to the conclusion that federal bankruptcy law is implicated in any way."[8] Moreover, "so called non-recourse carve-out guarantees are within the domain of bankruptcy remote structuring. Guarantees of the sort executed by [the CEO]…are intended to make bankruptcy cases less likely, to the point that they are remote risk factors for lenders."[9] While the court in *Extended Stay* did not address some of the public policy arguments, one could argue that a bad boy guarantee triggered by a bankruptcy filing or objection to foreclosure proceeding and provided by a company's officer or director is a contract to commit a tort and therefore a breach of fiduciary duty.

At least one court has held that bad boy guarantees are unenforceable penalty provisions because "[i]mmediate liability for the entire debt is not a reasonable measure of any probable loss associated with the [triggering event]."[10] However, courts are not in agreement. The court in *Heller Financial v. Lee*, addressing the same issue, rejected the notion that full liability is a penalty not related to actual damages.[11] In that case, the court reasoned that there was no penalty because the loan balance was the lender's actual damage.[12] The court, however, failed to correctly analyze the relationship between the guarantee trigger and the liability. That is, the trigger was a tax and mechanic's lien for approximately $821,000.[13] While the court found that the liens were enough to trigger recourse for the entire $9.9 million loan, the actual damages should have been capped at the damage caused by the priming liens.[14]

Effect on Business

While there are a number of uncertainties regarding the enforceability of bad boy guarantees, recent decisions at the state and federal level in Michigan regarding the interpretation and effect of bad boy guarantees in the commercial mortgage-backed securities (CMBS) context may wreak havoc on the business community nationwide. These concerns are highlighted by the decision in *Wells Fargo Bank, N.A. v. Cherryland Mall Ltd. Partnership.*[15]

In 2002, Cherryland obtained an $8.7 million non-recourse CMBS loan from Archon Financial, LP, an affiliate of The Goldman Sachs Group, Inc., posting property it owned as collateral.[16] The loan was also guaranteed by David Schostak. Following origination, the loan was subsequently transferred to Wells Fargo Bank N.A., as part of a real estate mortgage investment conduit (REMIC) trust. In 2009, Cherryland defaulted on its loan obligations by failing to make required loan payments. In 2010, Wells Fargo foreclosed on Cherryland's collateral. Following the foreclosure, Wells Fargo instituted an action to recover a $2.1 million deficiency claim from Cherryland and Schostak because, it alleged, that Cherryland's insolvency was a breach of its single purpose entity (SPE) status. The Circuit Court ultimately agreed with Wells Fargo and granted judgment in favor of Wells Fargo, as trustee of the REMIC, awarding Wells Fargo, among other things, a mortgage deficiency claim against Schostak and other fees and costs. Cherryland and Schostak appealed the Circuit Court's ruling. On appeal, Cherryland and Schostak challenged the enforceability of the guarantee, including the Circuit Court's interpretation of the related Mortgage, Note and Guarantee with respect to the guarantee trigger for failure to maintain "SPE status."[17]

While the Mortgage was generally non-recourse, the Mortgage (and Note by incorporation), provided that if Cherryland failed to maintain SPE status, the debt would become fully recourse as to the borrower (Cherryland) and guarantor (Schostak).[18] Upon review of the Mortgage and Note, the court found that neither the Mortgage nor Note contained a definition of SPE status. In fact, the Mortgage provided only a single reference to SPE status, which was contained in a section heading entitled "Single Purpose Entity/Separateness." Included under that heading was the covenant relied upon by the lower court in affixing guarantee liability to Cherryland and Schostak for failure to maintain SPE status. The covenant read: "Mortgagor is and will remain solvent and mortgagor will pay its debts and liabilities (including, as applicable, shared personnel and overhead expenses) from its assets as the same shall become due."[19] The lower court, however, failed to define the term SPE. Accordingly, the Court of Appeals reviewed de-novo, the trial court's decision.[20]

In its review of the subject provision, the Court of Appeals determined that while SPE was not defined in the Mortgage or Note, the reference to SPE in the heading entitled "Single Purpose Entity/Separateness" was enough to interpret the provisions following the heading as requirements for maintaining SPE status.[21] In response, Cherryland and Schostak, together with the lender, argued that the court should allow extrinsic evidence to interpret the term "SPE status" because it was never intended that the loan be a recourse obligation to Cherryland or Schostak and that the separateness provision (provided above) was not intended to be included in the definition of SPE status. The court, however, rejected Cherryland and Schostak's plea to allow extrinsic evidence because "the *only* reference [to SPE status] [was] the heading. Therefore, it is natural and logical to conclude that *all* of [that section], are terms necessary to maintain SPE Status."[22] Accordingly, the Court of Appeals upheld the Circuit Court's decision.[23]

The implications and fallout resulting from the court's decision in *Cherryland* may wreak havoc on the business community nationwide. Indeed, the *Cherryland* court acknowledges the potential effect of its decision, stating:

> We recognize that our interpretation seems incongruent with the perceived nature of a nonrecourse debt and are cognizant of the acmici's arguments and calculations that, if accurate, indicate economic disaster for the business community in Michigan if this Court upholds the trial court's interpretation. Nevertheless, the documents at issue appear to be fairly standardized nationwide, and defendants elected to take that risk—as did many other businesses in Michigan and nationwide.[24]

The impact on the business community as a result of the "form" bad boy provisions contained in CMBS loan agreements is not limited to those produced by Goldman Sachs or its affiliated entities. Just one month following the decision in *Cherryland*, the Court in *51382 Gratiot Avenue Holdings, LLC v. Chesterfield Development Co.*, rejected a similar argument in a CMBS loan originated by Morgan Stanley.[25] In *Chesterfield*, Morgan Stanley and the Mortgagee provided evidence that neither the Mortgagee nor the Mortgagor intended the loan to be a recourse obligation.[26] The court, however, reached the same conclusion as the court in *Cherryland*, ultimately enforcing a bad boy guarantee triggered by the Mortgagee's insolvency based upon the plain language contained in the agreement.[27]

The uncertainty and unintended consequences of drafting errors and sloppy construction of bad boy guarantees has yet to play out.[28] Given a loan servicer's fiduciary duty to maximize value for creditors, and therefore, an obligation to enforce bad boy guarantees, the potential fallout could be devastating for the business community. However, to imply that the legacy fallout of poorly constructed bad boy guarantees is limited to borrowers is erroneous. Poorly drafted bad boy guarantees can also harm lenders.[29] For example, in *ING Real Estate Finance (USA) LLC v. Park Avenue Hotel Acquisition LLC*, the court held that where a bad boy guaranty was drafted as a springing guarantee, as opposed to an exploding guarantee, such liability was an unenforceable penalty where the immediate liability for borrower's non-monetary default was not a reasonable measure of any probable loss associated with the delinquent payment triggering the liability.[30]

Conclusion

It is beyond contestation that lenders will continue to require bad boy guarantees to both modify borrower behavior and enhance borrower creditworthiness. However, because the drafting errors and sloppy construction of bad boy guarantees, as interpreted by courts, can harm both borrowers and lenders, it can be surmised that lenders are likely to amend their practices. Accordingly, attorneys representing both borrowers and lenders must carefully review loan documents to ensure bad boy guarantees are both reasonable and constructed as intended.

Endnotes

1. Heller Fin., Inc. v. Lee, No. 01-C-6798, 2002 WL 1888591, at *4 (N.D. Ill. Aug. 16, 2002) ("nonrecourse loans create issues in terms of the motivation of borrowers to act in the best interest of the lender and the lender's collateral…. As a result, lenders identified defaults that posed special risks and carved them out of the general nonrecourse provision. These carve-outs provide the protection that lenders require, personal liability, to insure the incentive to repay the loan and maintain the viability of collateral").
2. CSFB 2001-CP-4 Princeton Park Corporate Ctr., LLC v. SB Rental I, LLC, 980 A.2d 1, 5, 410 N.J. Super. 114, 121 (N.J. App. Div. 2009) (holding that "[t]hese carve-outs, which are perceived to affect the value of the collateral that secures the loan, afford the lender the protection required by causing the debtor and any guarantors to be personally liable, thus enabling the creditor to look beyond simply the mortgaged property for repayment of the loan.").
3. *See, e.g.*, *id*. at 2 (referring to the nonrecourse carve-out clause as a matter of first impression in New Jersey).
4. *See, e.g.*, Blue Hills Office Park LLC v. JP Morgan Chase Bank, 477 F. Supp.2d 366, 382-83 (D. Mass. 2007) (indicating that full liability is triggered by the failure to maintain single purpose entity status); First Nationwide Bank v. Brookhaven Realty Assocs., 223 A.D.2d 618, 621, 637 N.Y.S.2d 418, 421 (2d Dep't 1996) (holding that a bankruptcy contingent guaranty is enforceable under New York law). *But see* ING Real Estate Fin. (USA) LLC v. Park Ave. Hotel Acquisition LLC, 26 Misc. 3d 1226(A), 907 N.Y.S.2d 437, 2010 NY Slip Op. 50276(U) (Sup. Ct. N.Y. Cnty. Feb. 24, 2010) (concluding that a bad boy guarantee was an unenforceable penalty).
5. Courts have, however, had the opportunity to review specific waivers of the Bankruptcy Code's automatic stay. *See e.g.*, In re Deb-Lyn, Inc., No. 03-00655 (GVL1), 2004 WL 452560, at *4 (N.D. Fla. Feb. 20, 2004) (holding that waivers of the automatic stay are per se unenforceable); In re Powers, 170 B.R. 480, 484 (Bankr. D. Mass 1994) (deciding that the existence of a pre-petition agreement waiving the automatic stay is a "primary element" to consider in determining whether there is "cause" to lift the stay under section 362(d)(1)); In re Cheeks, 167 B.R. 817, 818 (Bankr. D. S.C. 1994) (rendering a pre-petition agreement waiving the automatic stay valid and enforceable).
6. 418 B.R. 49, 57 (Bankr. S.D.N.Y. 2009), *aff'd in part*, 435 B.R. 139 (S.D.N.Y. 2010).
7. *Id*. at 59.
8. *Id*. at 60.
9. *Id*.
10. ING Real Estate Fin. (USA) LLC v. Park Ave. Hotel Acquisition LLC, 26 Misc. 3d 1226(A), 907 N.Y.S.2d 437, 2010 NY Slip Op. 50276(U), 5 (Sup. Ct. N.Y. Cnty. Feb. 24, 2010).
11. No. 01-C-6798, 2002 WL 1888591, at *4 (N.D. Ill., Aug. 16, 2002).
12. *Id.* at *5.
13. *See id.* at *2.
14. *See id.* at *1.
15. No. 304682, 2011 WL 6785393 (Mich. Ct. App., Dec. 27, 2011).
16. *See id.* at *2.
17. *See id.* at *3.
18. *See id.* at *4.
19. *Id*. at *5.
20. *Id*. at *3.
21. Wells Fargo Bank, N.A. v. Cherryland Mall Ltd. P'ship, No. 304682, 2011 WL 6785393, at *8 (Mich. Ct. App., Dec. 27, 2011).
22. *Id*.
23. *Id*. at *12.
24. *Id*. at *11.
25. No. 2:11–CV–12047, 2012 WL 205843, at *10 (E.D. Mich. Jan. 24, 2012).
26. *Id*. at *4.
27. *Id*. at *4.
28. On March 29, 2012, recognizing the impact of the court's decision in *Cherryland*, the Michigan State legislature enacted the Nonrecourse Mortgage Loan Act (the "Act") to "regulate the use and enforceability of certain loan covenants in nonrecourse commercial loan transactions" within Michigan. *See* Michigan Comp. Laws §§ 445.1591-1595 (2012). The Act makes invalid and unenforceable any post-loan closing solvency covenant contained in a commercial nonrecourse loan within Michigan. *See id*. § 445.1593. However, the Act "does not prohibit a loan secured by a mortgage on real property located in this state from being fully recourse to the borrower or the guarantor, including, but not limited to, as a result of a post closing solvency covenant, if the loan documents for that loan do not contain nonrecourse loan provisions." *Id*. § 445.1594. Moreover, while it appears that the Michigan legislature intended to render ineffective bad boy guarantees resulting from post-closing insolvency covenants, the act seems to approve the use of exploding guarantees which provide for full liability to the borrower and its principals from inception of the loan, and are extinguished upon the non-occurrence of an event. Accordingly, lenders seeking to end-run the Act may use exploding guarantees to accomplish what the Act intends to prohibit.
29. The uncertainty caused by the unintended consequences of poorly drafted bad boy guarantees may also have a negative effect on the CMBS market.
30. 26 Misc. 3d 1226(A), 907 N.Y.S.2d 437, 2010 NY Slip Op. 50276(U), 5 (Sup. Ct. N.Y. Cnty. Feb. 24, 2010). Poorly drafted bad boy guarantees may also harm lenders when the party controlling the borrower's actions is not responsible for the guarantee. For example, where a mezzanine lender purchases a controlling equity stake in a borrower whose principal is subject to a bad boy guarantee, the mezzanine lender can force defaults triggering bad boy guarantees, including threatening to put the borrower in bankruptcy in order to gain leverage over the first lien lender in negotiations.

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NYSBA Ethics Opinions 752, 753 and 755—Written by Traditionalists Who Wish to Live in a World That No Longer Exists

By Peter V. Coffey

The practice of law has, in the last 50 years, experienced an upheaval, if not a discombobulation. One area of upheaval is the providing of legal and non-legal services to a client in the same transaction—by lawyers from the largest law firms in the largest metropolitan areas, to the sole practitioner on Erie Boulevard in Schenectady, New York. This reality presents an ethical question—are consumers of legal services sufficiently intelligent to understand the dual nature of the representation with appropriate disclosure? In the Spring 2010 issue of the NYSBA *N.Y. Real Property Law Journal*, Karl Holtzschue, the former Chair of the New York State Real Property Law Section, published an article in which he concluded "yes."[1] In the Fall of 2010 the same *Journal* published a second article on the subject which concluded the answer is "no."[2] Karl got it right.

On July 23, 2001, the Appellate Divisions approved new "Multiple Disciplinary Practice, or MDP" rules for New York lawyers by putting in place DR 1-106 and DR 1-107.[3] This debate focuses on whether or not Disciplinary Rule 1-106, now Rule 5.7, permits lawyers to provide such dual services in the same transaction. In the opinion of this writer there is no question but that DR 1-106 now Rule 5.7, intended to permit such representation and was adequate to its purpose. Many, however, were opposed to such representation and still are. The issue is one of conflicts. DR 1-106 did not specifically mention Canon 5, which was the old conflicts Canon, and so those opposed to the practice argued that even if DR 1-106 intended to permit such representation it was not sufficiently clear that it overrode the conflict provisions of Canon 5 [assuming, of course, in the first place that Canon 5 actually did proscribe such dual representation]. Accordingly, the reasoning goes, DR 1-106 was simply ineffective to achieve its intended purpose—the conflict rules of Canon 5 prohibits the practice, regardless of DR 1-106/Rule 5.7. Not only that, those holding this opinion hold it to such an extent that they will not even consider allowing the client to consent after full disclosure—the practice constitutes a non-consentable conflict, they say—there will be no consumer sovereignty in the State of New York. An historical perspective is called for.

A. General Historical Perspective

The gist of the debate centers on the effect of Disciplinary Rule 1-106, Rule 5.7. This Rule is the result of the New York State Bar Association's attempt to deal with the changing world lawyers practice in. These changes have been discussed in numerous publications, articles, books, etc. and probably no where as well and as pointedly as in Richard A. Posner's book *Overcoming Law*.[4] This book is largely an economic analysis of the profession, but in the first chapter, Posner speaks of the philosophy of a pragmatic approach to law. He compares the modern day legal profession to a medieval guild and states:

> We can begin to sense the ideological parallels, and to understand their common material basis, between the medieval craft guild and the modern legal profession as it stood on the eve of the transformation of the market for legal services that began in about 1960. In both forms of market organization, cartelization is facilitated by the creation of an ideological community that genteelly resists the 'commodification' of its output—resists, that is, the commercial values of competition, innovation, *consumer sovereignty*, and the deliberate pursuit of profit. …Professions advance "claims to esoteric knowledge and unselfish service."[5]

But change always comes with a price. In her book, *A Nation Under Lawyers*, Mary Ann Glendon also notes in her introduction that it was the 1960's which fostered much of the change stating, "[t]hese developments are instances of a far-reaching transformation of lawyers' beliefs and attitudes that has been quietly underway since the mid-1960s."[6] Glendon problematically states: "[i]n two successive revisions of its rules of ethics, the American Bar Association has removed almost all language of moral suasion, abandoning the effort to hold up an image of what a good lawyer ought to be in favor of a minimalist catalogue of things a lawyer must not do. Conduct once strictly forbidden is now not only permitted but widely practiced."[7]

Glendon mentions advertising and then succinctly sets forth the issues:

> The upheaval in the profession has been substantial enough to raise troubling questions:
>
> To what extent will future Americans be able to count on practitioners to subordinate self-interest to client representation and public service?...

> What influence do the new ways of lawyers have on the ideas, habits and manners of their fellow citizens?...
>
> Are lawyers, in the aggregate, currently promoting or undermining the orderly pursuit of dignified living in these latter-day law-saturated United States? With so many of them clambering toward the helm, or cavorting on deck, what happened to the steady hand on the rudder of the democratic vessel?[8]

Glendon concludes:

> But one should not underestimate the resilience of the dynamic legal traditions of craft professionalism, constitutionalism, and practical reasoning. If we are hopeful, why should we not believe that the energies of those fertile traditions can be harnessed to the needs of a modern, diverse democratic republic? *That task will not be accomplished by the sort of traditionalist who wishes to live in a world that no longer exists*, or by the sort of innovator who begins with a clear slate and an empty head. What will count are sufficient numbers of lawyers who are knowledgeable enough to be at home in the law's normal science, imaginative enough to grasp the possibilities in the current situation, bold enough to explore them, and painstaking enough to work out the transitions a step at a time.[9]

There were cries, almost despairing, regarding the changes which were afoot. In his book *The Lost Lawyer—Failing Ideals of the Legal Profession*, Anthony T. Kronman had the following to say:

> The inward change of which I am speaking has been brought about by the collapse of the lawyer-statesman ideal. For more than a century and a half that ideal has helped to shape the collective aspirations of lawyers, to define the things they cared about and thought important to achieve. Even thirty years ago,[10] it was still a potent force in the profession. But in the years since, as my generation has risen to power, the ideal of the lawyer-statesman has all but passed from view. Law teachers no longer respect it. The most prestigious law firms have ceased to cultivate it. And judges can no longer find the time, amid the press of cases, to give its claims their due.
>
> That ideal of the lawyer-statesman offered an answer to the question of what a life in the law should be. It provided a foundation on which a sense of professional identity might be built. And because the foundation it provided was rich in human values, this ideal was appealing at a personal level too. The decline of the lawyer-statesman ideal has undermined that foundation, throwing the professional identity of lawyers into doubt. It has ceased to be clear what that identity is and why its attainment should be a reason for personal pride. This is the great inward change that has overtaken the legal profession in my generation, and its outward manifestations, which are visible in every branch of professional life, all point to a collective identity crisis of immense—if largely unacknowledged—proportions.[11]

For an interesting discussion of professionalism, see the Decision of Chief Judge Breitel in the case of *In Re Freeman's Estate*.[12]

Finally, how about chucking the whole idea of professionalism. Well, if not chucking it entirely, establishing a middle ground between the professionalism paradigm and the business paradigm which was the conclusion of Professor Russell Pearce, Edward & Marilyn Bellet Chair in Legal Ethics, Morality and Religion at Fordham University, all as set forth in his article: *The Professionalism Paradigm Shift: Why Discarding Professional Ideology Will Improve the Conduct and Reputation of the Bar*.[13] As Professor Pearce writes, "[t]he crisis presents the legal community with an opportunity to move to a new paradigm **offering better service to clients** and greater benefit to the public."[14] In discussing the famous (or infamous) case of *Bates v. State Bar of Arizona*[15] case, Professor Pearce states:

> The Court's analysis squarely rejected the Business–Profession Dichotomy. It declared that "the belief that lawyers are somehow above trade has become an **anachronism** and described the organized bar's continued reliance on the dichotomy as hypocritical. The Court treated the market for legal services like the market for other business products and services, not as a special professional market subject to the invisible hand of reputation. Contrary to the Professionalism Paradigm, **consumers in a more open market would be able to make informed decisions regard-**

> **ing the purchase of legal services…**" [dare we say consumer sovereignty].[16]

Pearce sees today as does Glendon, as opposed to Kronman, as "a time for hope." He states particularly:

> The legal profession is on the verge of a radical transformation. In the past few years, the best and the brightest of the legal world have chronicled the decline of professionalism and offered prescriptions for its revival…[and] this attention is but one result of the loss of faith in the distinction between a business and a profession (Business-Profession dichotomy) at the heart of the existing paradigm that organizes our beliefs and values about the delivery of legal services—what I call the "Professionalism Paradigm." But while many commentators describe the current crisis as cause of despair, this Article identifies it as a time for hope. The crisis presents the legal community with **opportunity** to move to a new paradigm offering **better service to clients** and greater benefit to the public.[17]

The world of the legal profession has changed, and that is an understatement. It is a cliché but there is no going back—back to the outmoded ideas and practices of a long-ago time. Those who would be traditionalists "wishing to live in a world that no longer exists" are directors of the guild tenaciously clinging to outmoded ideas and rules—lacking the imagination and boldness **and most particularly hope** to face the new world and undertake and accept the changes that are necessary in this new world. **These traditionalists will render the legal profession a footnote in the history of the provision of legal services every bit as much as the guilds became a footnote in the history of industrial production.**

The soul of the legal profession in the State of New York has not been without boldness, imagination and hope so as to address the crisis. And so in the late 1990s the New York State Bar Association, recognizing the crisis, turned to a collective group headed by two of its finest: Robert MacCrate[18] and Steven Krane. This group addressed, in addition to many other issues, particularly as it is relevant here, the issue of attorneys providing multiple services to a client in the same transaction.

B. Specific Historical Perspective—the MacCrate Report Addresses the Issue of Ancillary Services

The New York State Bar Association, peopled as it is with such outstanding and nationally recognized authorities in ethics and not wishing to be categorized as a "medieval guild," undertook a massive examination of the practice of law, specifically from the perspective of multi-disciplinary practice. A committee appointed by the New York State Bar Association issued a report ***PRESERVING THE CORE VALUES OF THE AMERICAN LEGAL PROFESSION—The Place of Multidisciplinary Practice in the Law Governing Lawyers—Report of the New York State Bar Association Special Committee on the Law Governing Firm Structure and Operation.***[19] It is dated April 2000 and is generally known as the MacCrate Report named after the Chair of the Special Committee, Robert MacCrate. In preparation for a New York State Ethics Seminar, I spoke on the phone at some length with Robert MacCrate regarding the profession. To Mr. MacCrate, the Bar was peopled by lawyers of intelligence, integrity, and commitment to public service and to their clients. It was clear to me that if change needed to be made, this was the man with the intelligence and boldness to make the changes so to preserve the "professional identity" of a dynamic legal profession of today.

The MacCrate Report sought to determine the advisability of providing multi-disciplinary services—and how those services could be provided in light of what was actually happening today in the legal marketplace—while still maintaining a standard of ethical integrity for the profession. The Report flatly recognized the current situation when it stated as follows:

> **3. Ancillary business conducted as law firm subsidiaries—in addition to instances to which non-lawyer professionals are employed by law firms (or in which individual lawyers are dual professionals) there are those instances in which law firms have created separate, wholly-owned entities through which to conduct ancillary businesses. A 1992 study by the *National Law Journal* reported that the nation's 250 largest law firms at the time conducted over 50 ancillary businesses in such diverse areas as real estate development, management consulting, institution consulting, federal and state governmental affairs consulting, TITLE INSURANCE, management information services, public issues and management, international trade consulting….**[20]

From the beginning, the MacCrate Committee recognized that the 250 largest law firms in the United States are providing these ancillary services to their clients in transactions in which they are representing their clients. Note that this is a report of what the 250 largest law firms in the country do. It is interesting to note that the literature of ethical lawyer regulation is replete with comment that these ethical rules fall most harshly upon small and solo practitioners while permitting large law firms to do pretty much as they choose. Indeed, many commentators indicate that the impetus for ethical regulation for lawyers was kindled by the disdain for the small or solo Jewish and Catholic practitioners.[21]

And so we go to the specifics of the discussion of the MacCrate Commission. For our purposes, there are two subchapters in the MacCrate Report which addressed our issue and they are subchapter 3 of Chapter 4, **"Ancillary Businesses Conducted as Law Firm Subsidiaries"** and subchapter 1 of Chapter 12, **"With Respect to Ancillary Services Offered by Lawyers and Law Firms**." An examination of those discussions results in the unequivocal conclusion that the MacCrate Report proposed the providing by a lawyer or a law firm, either in its own name or through entities totally controlled by the lawyer or law firm, of legal representation and non-legal services in the same transaction. There simply can be no question.[22] The MacCrate Report then goes on to state: "[t]oday there is anecdotal evidence that law firms throughout the country continue to own and operate ancillary subsidiaries within the existing legal and ethical framework governing lawyers…." and gives a few examples showing the extensive provision of additional non-legal services.[23] The Report extensively discusses the history and the current practice regarding the provision of ancillary services in Chapter 12, Subchapter 1, and states that ultimately, in 1992, the ABA adopted a permissive approach to the provision of ancillary services by lawyers or law firms:

> This permissive approach to the conduct of ancillary business enterprises is echoed by the American Law Institute's Forth Coming "Restatement of the Law Governing Lawyers": So long as each enterprise bills separately and so long as the ancillary [enterprise] does not engage in the practice of law, involvement of both the lawyer's law practice and lawyer's ancillary business enterprise **in the same matter** does not constitute impermissible fee splitting with a nonlawyer, even if nonlawyers have ownership interests or exercise management powers in the ancillary [entity].[24]

Wow! In analyzing the consequences of this rule, the Report states specifically: "[l]ikewise, the lawyer must be mindful of conflicts of interest arising out of the activities of the ancillary business, **obtaining conflict waivers if necessary**."[25] It does not get any clearer than that. The provision of ancillary services to a client in the same transaction is permitted assuming there is the proper disclosure of conflicting interests and consents obtained.

The MacCrate Report proposed that proposed Rule 1-106 be based upon the Pennsylvania model. Just in case there is any question at all whether or not the MacCrate Report intended that 1-106 permit the providing of ancillary services to clients who are receiving legal services, the Report goes on to propose that the advertising rules in DR 2-101, "Publicity and Advertising," be amended to provide for the advertising of "**legal and non-legal**" services; the range of fees for legal and non-legal services.[26] The proposal by the MacCrate Committee regarding advertising clearly illuminates its intention in proposing Rule 1-106. The lawyer or law firm and a lawyer-controlled entity are permitted to provide legal services and ancillary services [non-legal] to clients in the same transaction and advertise the same.[27] And if there remains any question at all it is noted that Steven Krane, who was a Vice-Chairperson of the MacCrate Committee (and whose recent death has caused such a loss to the Bar) was unequivocal in his statement as to what the MacCrate Committee meant when it proposed 1-106. He would tell this story often. His parents retained a lawyer and received great estate and elder law planning. But they did not have long-term care insurance and as a consequence the legal services were ultimately fruitless. Without the concomitant purchase long-term care insurance, so much was lost. Steven felt that the lawyer should be able to provide the legal advice and sell long-term care insurance so that the client received a complete representation and was completely protected. (Furthermore, the idea that the MacCrate Committee had not heard about Canon 5 is dispelled by its specific reference to DR 5-107(B).)[28]

C. The Specific Provisions of DR 1-106/Rule 5.7

Pursuant to the proposal of the MacCrate Committee, the four Chief Judges of the Appellate Division, effective November 1, 2001, put into place **DR 1-106 Responsibilities Regarding Non-Legal Services.** A detailed examination of **DR 1-106** shows conclusively that the Rule intended to allow the practice of lawyers providing, either through themselves or through a controlled entity, legal services and non-legal services in the same transaction. And as will be seen subsequently, those who challenge the effectiveness of **DR 1-106**, particularly the New York State Bar Association Committee on Professional Ethics, do not take serious issue with that statement. Their point is that in proposing **DR 1-106** and in enacting it, the MacCrate Committee and the four Chief Judges of Appellate Division failed to take into consideration Canon 5.[29] These traditionalists maintain that Canon 5, left intact, trumps **DR 1-106** and the only real solution is simply to ignore **DR 1-106**.

In any event, we proceed with an examination of **DR 1-106**:

> **DR 1-106 [1200.5-b]. Responsibilities Regarding Nonlegal Services**
>
> **A. With respect to lawyers or law firms providing**

nonlegal services to clients or other persons:

1. A lawyer or law firm that provides nonlegal services to a person that are not distinct from legal services being provided to that person by the lawyer or law firm is subject to these Disciplinary Rules with respect to the provision of both legal and nonlegal services.

2. A lawyer or law firm that provides nonlegal services to a person that are distinct from legal services being provided to that person by the lawyer or law firm is subject to these Disciplinary Rules with respect to the nonlegal services if the person receiving the services could reasonably believe that the nonlegal services are the subject of an attorney-client relationship.

3. A lawyer or law firm that is an owner, controlling party or agent of, or that is otherwise affiliated with, an entity that the lawyer or law firm knows to be providing nonlegal services if the person receiving the services could reasonably believe that the nonlegal services are the subject of an attorney-client relationship.

4. For purposes of DR 1-106(A)(2) and (A)(3), it will be presumed that the person receiving nonlegal services believes the services to be the subject of an attorney-client relationship unless the lawyer or law firm has advised the person receiving the services in writing that the services are not legal services and that the protection of an attorney-client relationship does not exist with respect to the nonlegal services, or if the interest of the lawyer or law firm in the entity providing nonlegal services is de minimis.

B. Notwithstanding the provisions of DR 1-106(A), a lawyer or law firm that is an owner, controlling party, agent, or is otherwise affiliated with an entity that the lawyer or law firm knows is providing nonlegal services to a person shall not permit any non-lawyer providing such services or affiliated with that entity to direct or regulate the professional judgment of the lawyer or law firm in rendering legal services to any person, or to cause the lawyer or law firm to compromise its duty under DR 4-101(B) and (D) with respect to the confidences and secrets of a client receiving legal services.

C. For purposes of this section, "nonlegal services" shall mean those services that lawyers may lawfully provide and that are not prohibited as an unauthorized practice of law when provided by a non-lawyer.[30]

Paragraph (A) begins with notice that we are talking about lawyers or law firms providing non-legal services to clients. Subparagraph (1) presents the scenario of a lawyer or law firm providing non-legal services that are not distinct from legal services being provided to the person and calls for the lawyer or law firm to be subject to the Rules [Rules of Professional Conduct] in the provision of both legal and non-legal services. It is assumed, as you can see, that the law firm is going to provide legal and non-legal services to the client in the same transaction. The question is whether or not the Rules of Professional Conduct apply to the provision of non-legal services. Where those services are not distinct from legal services, the Rules of Professional Conduct apply to both.

Subparagraph (2) presents the next scenario. Here the non-legal services are distinct from legal services, but if the person receiving the services—the client—could reasonably believe that in receiving the legal and non-legal services, the Rules of Professional Conduct and the lawyer-client relationship still governs, then these Disciplinary Rules apply to the lawyer or law firm in providing both legal and non-legal services.

Subparagraph (3) addresses the situation where the non-legal services are being provided by an entity that is owned or controlled or otherwise affiliated with the lawyer or law firm which the lawyer or law firm knows to be providing non-legal services. The New York State Bar Ethics Committee has maintained there is a major distinction between the lawyer personally providing these non-legal services on the one hand, or through another entity which the lawyer or law firm owns or controls on the other. That distinction was abolished by DR 1-106(A)(3). This subparagraph allows the lawyer to provide non-legal services through an entity in which the lawyer or law firm is an "owner, controlling party or agent of, or that is otherwise affiliated, with an entity that the lawyer or law firm knows to be providing non-legal services." As they say, it does not get any clearer than that. However, again, as was true in subparagraph (2), if the client could reasonably believe that the entity owned or controlled by the lawyer is part of the lawyer or law firm so that the lawyer-client relationship applies, then the Disciplinary Rules apply to the entity controlled by the lawyer or law firm. **It is not the providing of these services, both legal and non-legal services, to a client, either through the lawyer or law firm itself or the entity controlled or owned by the lawyer that is a problem. That is basically assumed and**

provided for by DR 1-106. The question addressed by the Disciplinary Rule—having assumed that legal and non-legal services are going to be provided to the client—is solely under what circumstances the Rules of Professional Conduct apply to the entity owned and controlled by the lawyer or law firm which is providing non-legal services.

Subparagraph (4) goes on and sets forth further rules regarding situations described in (A)(2) and (A)(3). This subsection says it is **presumed** that the client understands that the Rules apply and that the client is protected by those Rules "unless the lawyer or law firm has advised the person receiving the services in writing that the services are not legal services and that the protection of the lawyer-client relationship with respect to the non-legal services…" is inapplicable. So the Rule is that the lawyer or law firm can provide notice to the client by saying "as to these non-legal services being provided by our title company, the lawyer-client relationship will not apply." Of course, at that point the client is able to say, "I am sorry I do not buy that type of situation—I expect you will be accountable as a lawyer in any event", in which case it must be addressed and worked out between the lawyer and the client. But, the client is put on notice by subparagraph (4), which of course gives the client the opportunity to address the situation and resolve it with the lawyer. Again, though, Rule 1-106 assumes throughout its scenarios that legal and non-legal services are going to be provided by the lawyer or law firm to the client in the same transaction. As we have read the provisions of the statute this is clear.

Rule 5.7(a)(4) has a very interesting provision at the end. It provides: **"or if the interest of the lawyer or law firm in the entity providing non-legal services is *de minimis*."** If we have a *de minimis* situation the Rules simply do not apply at all—in this case it is the interest in the non-legal entity which is *de minimis* but the point is DR 1-106 is not interested in *de minimis* situations. It is governing scenarios that involve services that are beyond those that are simply *de minimis*. This is a very important provision because the State Bar Ethics Committee would go in exactly the opposite direction by declaring that where the attorney is providing legal services he, she or it may provide non-legal services only where those non-legal services *are* ministerial tasks [*de minimis*].[31]

Rule 5.7(b) addresses the issue raised by the MacCrate Committee that the lawyer or law firm cannot give up control to the non-legal entity. The lawyer or law firm shall not permit any non-lawyer providing the services to "direct or regulate the professional judgment of the lawyer or law firm in rendering legal services to any person or cause the lawyer or law firm to compromise its duty under Rule 1.6(a) and (c) with respect to the confidential information of a client receiving legal services."

Finally, Rule 5.7(c) states: "[f]or the purposes of this Rule, 'nonlegal services' shall mean those services that lawyers may lawfully provide and that are not prohibited as an unauthorized practice of law when provided by a non-lawyer." The first example that comes to mind is a title agency. Reported cases show that title insurance companies and title agencies have had non-lawyers read title, prepare title reports, attend closings, collect documents, etc. While a lot of lawyers would like to claim that is the unlawful practice of law, that assertion simply is not accepted, and for well over 100 years it has been the common practice of non-lawyers to participate in those activities. This activity of non-lawyers is the classic example of what subparagraph (c) is talking about.[32]

At this point, is it possible to argue that Rule 1-106 did not intend to authorize lawyers to provide legal and non-legal services in the same transactions by setting forth rules governing the practice? It is not.

The analysis set forth above is consistent with the analysis of Roy Simon, the Reporter for COSAC. Mr. Simon annually issues what is the "Bible" regarding the Rules of Professional Conduct in the State of New York.[33] Mr. Simon initially explained the purpose of **DR 1-106** and stated that its purpose was: "to govern situations in which a law firm is directly or indirectly providing nonlegal services to its clients or to members of the general public."[34] Mr. Simon goes on to state that subparagraph (A) not only allows the practice but "also allows a law firm to escape the reach of most (but not all) Disciplinary Rules when providing nonlegal services if the law firm gives a client written notice that the nonlegal services are not legal services and lack the protection of the attorney-client relationship."[35] This is all as has been set forth above herein in discussing the specifics of the Rule.

In discussing **DR 1-106** in his analysis, Mr. Simon states DR 1-106 (and DR 1-107) specifically provide that:

> 1. a law firm may directly provide nonlegal services that **are bound up with ("not distinct from") the legal services it is providing to its clients;**
>
> 2. a law firm may directly provide nonlegal services that are distinct from legal services it is providing to its clients;
>
> 3. a law firm may provide non-legal services through a separate entity that it owns or controls….[36]

There it is.

Without quoting the entire text of Mr. Simon, there are several examples or discussions given by him which give his opinion as to the intent and **"spirit"** of **DR 1-106.** First of all, Mr. Simon talks about a law firm that is going "to take advantage of the **spirit** of DR 1-106 by hiring an accountant."[37] The accountant provides services to a client by giving accounting advice in a real estate closing.

Mr. Simon concludes that in this case the provision of legal and nonlegal services cannot be distinguished and that the Disciplinary Rules apply to both the accounting advice and the legal advice.[38] But the point is the very example given by Mr. Simon indicates what the "spirit" of DR 1-106 is and that is clearly to allow the providing of legal and non-legal services to the client the same transaction.

Furthermore, Mr. Simon goes on to give another example and in that case he states: "[t]he risk of confusion is magnified if the separate entity is located near the law firm's offices, sublets space within the law firm, or uses the law firm's name or the lawyer's name as part of the name (e.g., if the law firm of Smith & Jones owns a subsidiary called 'Smith & Jones Environmental Services' or if a sole practitioner named Ralph Ettlinger is a partner in a real estate firm called '**Ralph Ettlinger & Sons Realty'**), or if the nonlegal services are provided to a client of the law firm in connection with the same matter in which the law firm is providing legal services to the client."[39] It is clear Mr. Simon does not see any problem with providing legal and real estate services (real estate brokerage services?) to the client in the same transaction.

Finally, in his analysis Mr. Simon goes on to discuss a rather complex situation in which a building collapses and the law firm had provided engineering services. The question is whether or not the presumption of DR 1-106(A)(4) is rebuttable. Mr. Simon argues that it should be, but most particularly for our discussion is the basis for Mr. Simon's analysis. He states that to make the presumption non-rebuttable "will defeat the purpose of DR 1-106, **which is to encourage law firms to meet more of their clients' needs, including the needs for nonlegal services.**"[40] Steve Krane would not have said it differently. How explicit can one get? It is the very purpose of DR 1-106 to encourage attorneys to provide legal and non-legal services in the same or related transactions. **It is the purpose of DR 1-106, it is the spirit of DR 1-106, it is what DR 1-106 is all about.**

In his initial analysis of DR 1-106, back in December 2001, Mr. Simon gives another example particularly as it refers to DR 1-106(A)(3):

> [Where] the law firm becomes the agent for (thus "affiliated with") Chicago Title & Trust, as a well known title search company, and the firm's lawyers and paralegals become authorized to conduct title searches in the title company's name. The title company provides the services, but it does so through the law firm's personnel.[41]

It is noted the New York State Bar Association Committee on Professional Ethics consistently condemns the providing by lawyers of title services, title insurance and title companies, etc. to their clients. Mr. Simon sees no problem as long as proper disclaimer is given as set forth in his analysis above. Specifically, Mr. Simon states:

> When the nonlegal services are being provided by a separate entity outside the law firm, and the law firm has made the routine disclaimer set out in DR 1-106(A)(4) (making it crystal clear that the nonlegal services are not legal services and are not subject to an attorney-client relationship), conflicts are never imputed between legal and nonlegal services. There are two sides of a river and conflicts cannot cross because there is no bridge between them.[42]

We have then DR 1-106. We know its background, its history, and its development. We know what it was intended to do—permit lawyers to provide legal and non-legal services to their client in the same transaction and to provide a framework for such provision. We know that it accomplished exactly that. So what could be the problem? Mr. Simon sounded the warning bell when he stated: "[w]hether the courts and bar association ethics committees will **tolerate** the literal meaning of the new rule, however, is open to question. Only time will tell."[43]

D. The Traditionalists Who Wish to Live in a World That No Longer Exists

The members of the New York State Bar Association Committee on Professional Ethics wasted no time in telling of their intolerance.

As we have seen 1-106 became effective November 1, 2001, and boy, oh boy, did this upset the gods of the guild, particularly the members of the New York State Bar Association Committee on Professional Ethics—**they were not alone—**Mark Ochs, former Chief Counsel of the Committee on Professional Standards of the Third Department, was particularly vociferous in his dislike of DR 1-106. The members of the Ethics Committee wasted no time and in four months, specifically on February 22, 2002—and it must be presumed that the preparation of this opinion started well before that date—issued its Opinion 752.[44] **It is fascinating when it is understood that the Ethics Committee was answering a question no one asked**. It seems clear that the Committee was rushing to get its own opinion out there because it simply did not like DR 1-106. In essence, the Opinion does what it can—in a most convoluted way—to gut the impact of DR 1-106. Then quickly followed Opinion 753 which came four days later on February 26, 2002.[45] To complete the trilogy, we have Ethics Opinion 755 which was issued within two months, specifically April 10, 2002.[46] Wow! These Opinions have one common theme and that is we said it before [and the Committee cites numerous opinions given prior to the enactment of DR 1-106] and we will say it again—we will not tolerate the providing of legal and non-legal services in the same transaction to a client and we do not care what DR 1-106 says. We all know as lawyers that if you frame the question in a given way the answer is preordained. For a fascinating discussion of the phrasing of the question as presaging the Opinions' conclusion, *see* Posner's *Cardozo, A Study of Reputation*,[47] specifically Chapter 3, Cardozo's Judicial Technique, and particularly Posner's analysis of two cases—*Palsgraf v. Long Island R. Co.*[48] and *Hynes v. New York Central R. Co.*[49] In the *Palsgraf* case, Cardozo describes Mrs. Palsgraf as standing on a platform—almost a bystander—rather than as a ticketed passenger on a train platform entitled to all of the protection accruing in a carrier-passenger relationship. In the *Hynes* case, Cardozo describes the situation as: "On July 8, 1916, Harvey Hynes, a lad of sixteen, swam with two companions from the Manhattan to the Bronx side of the Harlem River or United States Ship Canal,"[50] So we have Mrs. Palsgraf described basically as a bystander and Harvey Hynes described as a lad of sixteen taking a summer swim. And of course, guess what? Bystanders lose and lads of sixteen win, which is exactly what the outcome of the Cardozo opinions was. It should be noted of course that again Palsgraf was a ticketed passenger of a common carrier and Hynes was a trespasser. And so a review of the question as framed in the Opinions of the New York State Bar Association Committee on Professional Ethics tells us what the opinion of the committee is going to be.

Opinion 752

(A) In Opinion 752, it is stated, "New York recently adopted a new disciplinary rule, DR 1-106, addressing the responsibilities of lawyers or law firms providing nonlegal services to clients or other persons."[51] That is a misstatement, of course. The rule addressed the issue of providing legal **and** non-legal services to clients in the same transaction. In attempting to limit the application of DR 1-106 to the providing of non-legal services the Committee conveniently supports its opinion that you cannot combine the both of them in the same transaction and attempts to strip DR 1-106 of its applicability to such situations.

(B) In any event, the Committee gets straight to the point, stating as follows:

> This committee has **previously** [we told you before and we are about to tell you again] **held** [so what] that in some transactions—notably real estate transactions—a lawyer who also operates certain ancillary businesses may not provide both legal and non-legal services in the same transaction **even with the informed consent of the client**. The question considered in this opinion is the extent to which those earlier opinions, and the disciplinary rules on which they were based, apply after the promulgation of the new rule.[52]

Does anyone have any question what the conclusion is going to be? We said it before and we will say it again—can't do it. Particularly note the citing and exclusion of real estate transactions and recall that Simon in his analysis at several points brought up real estate transactions as exemplifying the applicability of DR 1-106. Recall that the MacCrate Committee specifically mentioned abstracting as an area of service being provided by major law firms to their clients.[53]

(C) The Opinion then rephrases in different words while making the same point that was made in the initial discussion regarding the question as follows: "[i]n a number of opinions that this committee has issued over the years, we have opined that in certain circumstances a lawyer also engaged in a nonlegal business cannot provide both legal and nonlegal services in the same transaction **even with the consent of the client**."[54] WOW!

(D) Having already made the point twice in Opinion 752 the Committee concludes by making the statement for a third time: "[t]he prohibitions on acting as a broker and a lawyer in the same transaction or other similar bars on dual roles for the lawyer owning or operating ancillary businesses continues to apply **after** the promulgation of 1-106."[55] We said it before and we are going to say it again—you cannot act in providing a client with legal and non-legal services in the same transaction. This conclusion is based not upon a comprehensive discussion of DR 1-106, but is simply a dismissal of DR 1-106 and a reapplication of the Committee's previous opinions based upon Canon 5.

Opinion 753

(A) Essentially Opinion 753 is merely a reiteration of what the Ethics Committee concluded in Opinion 752, for the Opinion states: "[i]n N.Y. 752 (2002), we concluded that these decisions and similar opinions limiting or barring lawyers from performing dual roles, survive the promulgation of DR 1-106. **This is because the decisions were based upon the application of DR 5-101(A) to the legal services, not to the nonlegal services.**"[56] As shown previously, the Committee simply strips the application of DR 1-106 to the providing of legal services and limits its applicability to **non-legal** services.

(B) Opinion 753 further states:

> As noted, this committee has held in a number of opinions that a lawyer cannot act as a real estate broker and as counsel to a party in the same transaction. N.Y. State 208, 291, 340, 493. The rationale for these opinions is that a lawyer should not have a personal stake in the advice rendered and a broker who is paid only if the transaction closes cannot be fully independent in advising the client as a lawyer.[57]

Once again, the Committee is standing pat. It made its decisions previously; it does not like the practice, and that is it. The Courts can pass all the rules they want but we ain't gonna budge. Note **that in these pronouncements by the Committee, there is no serious discussion of what DR 1-106 actually provides for**. Opinion 753 continues:

> As noted, in NY State 595, 621 and 738, we found that a lawyer could not refer real estate clients to a title abstract company in which the lawyer had an ownership interest and that would be hired to provide insurance or to perform other than ministerial [*de minimis*] tasks. That conclusion was based upon DR 5-101(A). *See, e.g.*, NY State 738 (2001). As set forth above, these Rules continue to apply after the promulgation of DR 1-106. Our opinion in NY State 595 expressly extended this prohibition to counsel for the lender.[58]

It just does not get any clearer. Whatever 1-106 says—whatever 1-106 means—whatever 1-106 was intended to do is simply not pertinent to the Committee's discussion. Just read our previous Opinions and you will understand why you cannot do it—ignore that man [DR 1-106] behind the curtain.

(C) In Opinion 753 the Committee launches into a convoluted dissertation on "the particular dual employments suggested by the inquirer." It appears that even the Committee understands that its dissertation is convoluted, for at the end of the Opinion it attaches a chart in which they indicate which relationships are acceptable and which are not. [Of course, according to DR 1-106 they are all with proper disclosure and consent acceptable.] When great progress was made in optics resulting in the perfection of the telescope, various objects were discovered in the sky which caused increasing problems to those "traditionalists" who clung to the idea that the earth was center of the universe. In order to support their position in the face of the new developments, these "traditionalists" created convoluted rings which crossed over each other, all in a last-ditch attempt to support their position that these new discoveries really did not contradict their traditionalist opinion. It is difficult not to have the chart of the Ethics Committee bring to mind the convoluted rings of those traditionalists who clung to the position that the earth was the center of the universe.

Opinion 755

This Opinion deals primarily with the provision of non-legal services—in the words of the Opinion: "[a]ncillary business organizations; transactions between lawyer and client; solicitation."[59] And to that extent the Opinion is somewhat irrelevant to our discussion. But make no mistake about it—this Opinion is talking about the providing of non-legal services to a client and solely the provision of non-legal services. No mixing of legal and non-legal services—no sir! Any question about that is resolved early on in the Opinion with a reference to NY State 252 (2002) in which the Opinion states: "we concluded that the lawyer's financial interest in certain non-legal businesses—such as brokerages—could make it **impossible** under the rule governing personal conflicts of interest, DR 5-101(A) (sic), for the lawyer to render unconflicted professional services in matters where the non-legal business is involved."[60] Just because the Committee is engaging in a discussion of mechanics of providing non-legal services, let us not get the idea it is talking about mixing legal and non-legal services. "We said it before and we said it again—ain't gonna happen." To the extent the Opinion reiterates the Opinion given in NY State 752 and actually states the Opinion in more absolute terms it is relevant to our discussion. To the extent it goes on and discusses the providing of non-legal services solely is somewhat irrelevant to our discussion.

One aspect of the Opinion that is quite interesting is footnote 3, which refers to the MacCrate Report and comments that the MacCrate Report noted that law firms are involved in "a wide range of non-legal businesses that are conducted by law firms or by entities owned by law firms. Among them were: lobbying, economic or scientific expertise, appraisal services, accounting, financial planning, **real estate and insurance brokerage, title insurance,** various consulting businesses (management, human resources, environment, etc.) and private investigation."[61] The reference is to Chapter 4, pp. 96-106. But there is no reference at all to Chapter 12 of the MacCrate Report as discussed previously in this article.

Additionally, the following comment is contained in the MacCrate Report: "Likewise, the lawyer must be mindful of conflicts of interest arising out of the activities of the ancillary business, obtaining conflict waivers, if necessary."[62] You can do it—just disclose. The overriding implication of the Ethics Committee's trilogy is that in adopting DR 1-106/5.7 nobody paid any attention to Canon 5 and conflicts of interest. That implication is unfounded as can be seen by the MacCrate Committee comment.

In essence then, the Committee did not, in its trilogy, seriously analyze DR 1-106/Rule 5.7. It merely discussed what it had discussed before—essentially Canon 5—and clung to its previous Opinions. It is as if DR 1-106/Rule 5.7 never existed. For this reason, its conclusions are wrong and without probative value.

E. The Interaction Between COSAC and the NYSBA Committee on Professional Ethics

In January of 2003, the New York State Bar Association established the Committee on Standards of Attorney Conduct (COSAC) [at this point it should be noted that COSAC submitted to the New York State Bar Association a complete compilation of all the Rules which COSAC was proposing together with COSAC's commentary on the Rules being proposed followed by the notation of any changes from the existing New York Code; Reporter's Notes; and corresponding New York Disciplinary Rules].[63] Its organizational meeting was held in New York City on January 21, 2003. "COSAC was divided into three subcommittees each chaired by an outstanding individual and each section having the services of three of the most outstanding ethics professors in the country as associate reporters, one of whom was assigned to each subcommittee."[64] Additionally, the Chief Reporter and Vice Chair of the Committee was Roy D. Simon, probably the most outstanding professor on New York State Ethics. The Chair, of course, was the renowned Steven C. Krane. The Committee undertook 32 months of work, held approximately 50 conference calls each, from one to two hours in length, and held 11 days of in-person plenary sessions with full day meetings conducted in New York City, Albany and Rochester. Additionally, there were other members of the Committee who were nationally recognized experts in the field. The efforts of COSAC resulted in a monumental revision of the Rules of Ethical Conduct governing attorneys in the State of New York beginning with the entirely re-formatting of those rules in accordance with the Model Rules as proposed by the American Bar Association.[65]

For our purposes, focusing on old DR 1-106, which became Rule 5.7, COSAC proposed the addition of a new subparagraph (d) which is as follows:

> (d) A lawyer or law firm shall not, whether directly or through an affiliated entity, provide both legal and non-legal services to a client in the same matter or in substantially related matters unless (i) the lawyer or law firm complies with Rule 1.8(a) regarding the provision of the non-legal services and (ii) the lawyer or law firm reasonably believes it can provide competent and diligent representation to each affected client and (iii) the client gives informed consent, confirmed in writing.[66]

The purpose in proposing subparagraph (d) was explicit. At this point it should be noted that COSAC submitted to the Bar Association a complete compilation of all the rules as previously proposed together with COSAC's commentary on the Rule followed by the notation of any changes from the existing New York Code; Reporter's Notes; and corresponding New York Disciplinary Rules.[67]

COSAC had no tolerance for the New York State Bar Association Committee on Professional Ethics Opinions as discussed above and was explicit in its commentary as to why it adopted new subparagraph (d) [subsequent version of proposed Rule 5.7 set this subparagraph as (c) but for consistency, I will refer only to (d)]. Again it should be noted that Steve Krane was Chairman of COSAC and there is no doubt as has been set forth above where he stood on the issue.

In the COSAC Commentary, particularly to subdivision (d), it is stated:

> ¶ (d) is new and has no counterpart in either the current New York Code or the Model Rules. This ¶ and the **accompanying comments** are meant to overrule NYSBA Ethics Opinion 752, 753 and 755 **and to make clear that the provision of legal and non-legal services in the same or substantially related matters [is permitted] [as long as compliance is had with the disclosure rules as set forth in this commentary]…**[T]hat is, there may be cases where a conflict in this situation is non-consentable but there **are not entire categories of transactions** (such as lawyer acting also as broker) in **which the conflict is non-consentable**.[68]

It is my opinion as someone who was a member of COSAC involved in all of the discussions, as far as I can recall the true determination of COSAC was not that these Opinions needed to be "overruled." I believe the term "overrule" is wrong (it is the wrong word to be used and the wrong approach in order to understand COSAC's opinion). What really should have been stated was that the COSAC meant to "instruct." It was not intended that subdivision (d) would add substance to DR 1-106/Rule 5.7—it was the opinion of COSAC, as clearly indicated by the above, that DR 1-106 was totally effective. It was not DR 1-106 that needed bolstering. It was the New York State Bar Association Committee on Professional Ethics that needed instruction and its Opinions which needed correction. It was the intent of COSAC to make clear that these opinions were wrong. Members of COSAC were most upset by these Opinions and in proposing (d) it used the sledgehammer. In inserting subparagraph (d) and the accompanying Comments—particularly see Comments 5, 6 and 7 as originally proposed [now [5], [5A], [5B] and [5C] in the revised Comments, COSAC was instructing the Committee on Professional Ethics as to the errors of its ways. The marginal commentary goes on when it gets to Comments 5, 6 and 7 and states: "Comments [5], [6] and [7] are new and relate **to new ¶ 5.7(d).**" (Emphasis supplied.) In the Reporter's Notes in the section entitled "Changes from Existing New York Code" it is stated as follows: "This paragraph and **the accompanying Comments**, are meant to overrule NYSBA Ethics Opinions 752, 753 and 755"[69] (emphasis supplied), and again recites there are no categories of representation or transactions which are entirely non-consentable. **Pay particular attention to the Editor's Notes pointing that the "accompanying comments" are meant to overrule the NYSBA Ethics Opinions. Those Comments play a significant part in the history of this saga.** Note that when 5.7(d) disappeared, the Comments remained. They were indeed originally meant to accompany 5.7(d), but again even when 5.7(d) was removed the Comments stayed.

There may have been debate in COSAC—there was debate on almost everything but for anyone to in any way assert that the position of COSAC pertaining to 1-106/5.7 **with or without subparagraph (d) is** anything other than that legal and non-legal services can be provided for in the same transaction is contradicted by everything COSAC has ever written on the subject. COSAC's position is so overwhelmingly documented and consistent as to be beyond cavil.

F. The Interaction Between the Courts and COSAC

I am not telling tales out of school when I state there was a great deal of tension between COSAC on the one hand and the Courts on the other hand regarding COSAC's proposed Rules. COSAC issued the report referred to above. It was submitted to the House of Delegates of the New York State Bar piecemeal so that each section could be thoroughly vetted, if you will, before approval. Ultimately, the New York State Bar Association, with some modifications, approved the work of COSAC which was then submitted to the Courts. Roy Simon, probably the cheerleader for COSAC, was quite pointed in his comments stating in the *New York Professional Responsibility Report*—May 2009, in discussing Rule 1.7:

> Instead of using one of those models, the Courts wrote their own rule on the fly, under tight schedule, relying on a small (6 person) special committee, without the benefit of public comment or public hearings. In its hasty, secret and elite process, the Court significantly weakened the regulation of client-to-client conflicts.[70]

Mr. Simon stated previously: "Problems like this could be avoided if the Courts would circulate draft rules for public comment, or hold public hearings on them, or at least write comments or explanatory memos to illuminate language that they added on their own initiative."[71] [How different is the procedure of the Courts from the procedure previously outlined as undertaken by COSAC and the New York State Bar Association House of Delegates.] Stephen Wechsler, one of the three associate Reporters of COSAC, stated that the COSAC's endeavor resulted in what is:

> Without doubt...the biggest, most fundamental change in the entire history of the regulation of lawyers in New York State.... The difficulty in adapting to the new rules is compounded by the way in which the Appellate Division adopted them. The new rules first appeared just two weeks before the end of 2008.... The Appellate Division did not provide for any discussion or comment.... In addition, the Appellate Division rejected large parts of the work that had been done by the New York State Bar Association [COSAC] in its effort to change the rules. That project, which ran over five years, had produced a large body of commentary and explanation. The Appellate Division ignored much of this, but did not provide any comparable tools for the Bar to use in adapting to the new rules.[72]

And you should understand that these comments are some of the milder commentary heard within COSAC when the Court came out with its own rules.

In any event, the Courts eliminated the subparagraph (d) (or if you prefer subparagraph (c)) which had been inserted by COSAC. Why they did it is a mystery because as Steve Wechsler points out, they gave no indication, no commentary, no explanation, no nothing. The explanation which I have heard most often and is generally circulated—and is in the article—is that DR 1-106 was new (it had been around since only 2001) and the Courts felt it was better to just leave it alone.[73] Who knows, but that seems to be the generally circulated explanation.

In any event, the Courts did remove subdivision (d). In understanding the following discussion, it is important to remember the Reporter's Notes. They stated in p. 9 under the paragraph entitled "**Changes from Existing New York Code"** (emphasis in original) of the Reporter's Notes that "this paragraph **and the accompanying comments**, are meant to overrule NYSBA Ethics Opinions 752, 753 and 755."[74]

The Comments were prepared by COSAC and were based upon the Rules as proposed by COSAC. When the presiding Justices of the four Appellate Divisions changed the Rules, the Comments had to be appropriately changed. And so, in a good faith effort COSAC sought the guidance of the New York State Bar Association as to how to proceed. As Roy Simon stated:

> At that point, pursuant to authority granted to it in a 2007 Resolution by the House of Delegates, COSAC reviewed and revised the proposed Comments to conform to the Comments to the official Rules **by eliminating language** in the proposed Comments that was inconsistent with the Rules as

> adopted. This project took several months (COSAC did not, of course, amend the black letter Rules of Professional Conduct **in any way)**.[75]

These Comments are quite important, as stated by Mr. Wechsler:

> The Appellate Division ignored much of this (the explanation and Comments of COSAC), but did not provide any tools for the Bar to use in adapting the new Rules, obviously no one wants to make a disciplinary blunder. On the other hand, the new Rules (and their Comments) give lawyers guidance on handling practical situations and problems that routinely arise in practice. In many cases, the guidance is clearer and more helpful than that which was provided by the Disciplinary Rules.[76]

Mr. Wechsler goes on: "The Comments are written in a clear, explanatory style, often giving best practices, and are much more detailed, precise and practice oriented than the ECs."[77] (It should be noted that the author was a member of the Subcommittee of COSAC which undertook revision of the Comments after the Courts' "changing" of COSAC's proposed Rules and in fact was Chairman of the Subcommittee to revise Rules 2.0 to 8.5, which of course includes Rule 5.7.)

Specifically, Comments [5], [6] and [7] outlined the recommended procedures lawyers should adopt in providing legal and non-legal services in the same transaction. How do we know this—we know it because the heading in the Comments preceding Comments [5], [6] and [7] state as follows:

"Provision of Legal and Non-Legal Services in the Same Transaction" (Highlighting in original)

Because this is so crucial to the entire discussion, I repeat—Comments [5], [6] and [7] were preceded by the heading:

"Provision of Legal and Non-Legal Services in the Same Transaction" (Highlighting in original)

And so what did COSAC do in reconsidering Comments [5], [6] and [7] in light of the fact that subparagraph (d) had been eliminated? (COSAC did not flinch. It reasserted in almost exact terms the Comments it originally proposed.) COSAC intended the Comments to state in unequivocal language that the providing of legal and non-legal services in the same transaction was permitted pursuant to DR 1-106 and remains permitted with or without Subparagraph (d) given the proper disclosure. There is no such thing as non-consentable situation. Most importantly, the heading preceding Comments [5], [5A], [6] and [7] remained the same: "**Provision of Legal and Non-Legal Services in the Same Transaction."** COSAC did change the numbering from [5], [6] and [7] to [5], [5A], [5B], [6] and [7]. In Comment [6], it took out the reference to "Rule 5.7(d)" and went on with talking about "in the context of providing legal and nonlegal services in the same transaction." In Comment [7], again, COSAC took out the reference to Rule 5.7(d) and began Comment [7] with the following: "In addition, in the context of providing legal and nonlegal services in the same transaction." How many times does COSAC have to say it? Rule 5.7 with or without (d) is speaking of providing legal and non-legal services in the same transaction. It is beyond my comprehension how anyone can argue that it is not the position of COSAC—that a lawyer can represent a real estate client and provide abstract services either in his or her own capacity or through an entity owned by him/her or it. The importance of this discussion is that COSAC considered the removal of subparagraph (d) explicitly and continued the Comments as originally proposed. COSAC then submitted the revised Comments to the House of Delegates which adopted them and Comments 5[A], 5[B] and 6 and 7 **making these Comments and their contents the official position of the New York State Bar Association on the matter.**

G. The Courts—Round 2

As Mr. Simon pointed out, COSAC undertook in good faith to revise the Comments it had initially proposed and modify them to the extent they were inconsistent with the Rules as adopted by the Chief Judges of the Appellate Division. The Courts were not happy with COSAC's efforts. It was the feeling of the Courts that COSAC had merely gone through the Comments and revised them in a cursory fashion but left intact the Comments as they reflected the Rules as originally proposed by COSAC. The feelings became quite acerbic. One official of the Courts took the position of attacking the new Comments at every opportunity, warning lawyers not to have any reliance upon these Comments as they did not reflect the changes to the Rules that the Courts had instituted. Ultimately, the Courts did reach out to the Bar Association. The Courts undertook a pervasive review of the revised Comments proposed by COSAC, specifying every item of disagreement, i.e., every word, or punctuation for that matter, in the revised Comments which the Courts felt were not consistent with the Rules they adopted. And so John W. McConnell, Chief Counsel to the Office of Court Administration, communicated to the Bar Association, expressing the position of the Court and setting forth 45 concerns regarding COSAC's proposed revised Comments.

So what did the Courts have to say about the Comments to Rule 5.7, particularly Comments [5], [5(A)], [5(B)], [6] and [7]? The Courts left these Comments almost untouched. They did suggest under Comment [5(A)] that the words "materially limited" should be removed in essence because "the reference to 'materially limited' is incorrect, as that language was deleted from the final version of

Rule 1.7(a)(2)." In short, the Courts had no problem with Comment [5A]. They just asked that some minor language be brought in conformity with Rule 1.7 as adopted by the Courts. The Courts expressed no disagreement with the heading "Provision of Legal and Nonlegal Services in the Same Transaction" and **made no objection whatsoever to the constant repetition of that statement in Comment [6] or [7].** The Courts were fully aware of the fact that they had removed (d)—fully aware of what they had done. And yet they had no problem with Comment [5], [5A], [5B], [6] and [7]—**in short, the Courts felt that the elimination of paragraph (d) was insignificant as to the effectiveness of 5.7 in providing for the provision of legal and non-legal services in the same transaction.** As was stated by Thomas More in *A Man for All Seasons*: "Not so, Master Secretary, the maxim is 'que tacet consentire.' The maxim of the law is silence gives consent. If, therefore, you wish to construe what my silence 'betoken,' you must construe that I consented. Not that I denied."[78]

Accordingly, the only proper interpretation that can be given to the matter is that the Courts are perfectly happy with Comments [5], [5A], [5B], [6] and [7] and the practice of providing legal and non-legal services in the same transaction, as long as disclosure as called for in the Comments is made.

H. The Courts' Decisions

In case after case the Courts have consistently in case after case declined to object to the practice of an attorney in representing a real estate client also providing abstract and title services if there is proper consent. The disciplinary cases are consistent in that attorneys have been disciplined not for engaging in the practice itself, but for failure to obtain the consent of the client, **which is exactly what the Comments talk about—the consent of the client must be obtained—that was the conclusion of COSAC—that is the position of the New York State Bar Association—and that is in accord with the decisions of the State of New York.** In re *McKinnon*, the Court dismissed a charge asserted against an attorney for referring matters to his abstract company.[79] It dismissed the charge on its face stating: "We dismiss Specification 4 which simply alleges that respondent referred real estate clients to an abstract firm he controlled. **An attorney may perform abstract work for a real estate client without necessarily becoming involved in impermissible conflicts of interest**."[80] In the case of *In Re Ford*, the Court is more specific.[81] In that case, the attorney was charged with representing seller and buyer, which from a reading of the case, it may be presumed the Court found impermissible. However, the Court stated, "[o] n this record, however, we decline to find that respondent engaged in a conflict of interest by referring real estate clients to his title abstract company."[82] The Court states further, "[i]n mitigation, respondent states that he no longer simultaneously represents sellers and buyers of real property and no longer refers clients to his title abstract company without obtaining the written consent after providing them with written disclosure."[83] It does not get much clearer than that. A lawyer can provide legal and nonlegal services as defined in 5.7 as long as you give proper disclosure.

In *In re Drysdale*, the attorney was charged with representing over 200 clients in real estate transactions and referring most if not all of them to an abstract company owned by her to provide "title abstract services and title insurance for those approximately 200 real estate clients…."[84] [a tad more than diminimus]. Was there a problem? Yes!—Engaging in an impermissible conflict?—No way. The Court explains: "Respondent failed to disclose her interest, or the implications of her interest, in Vision Abstract, Inc., to any of those approximately 200 clients."[85] The Court made no statement whatsoever that the practice of referring clients to Vision Abstract was impermissible. It was the failure to give proper disclosure. *See also, Beverwyck Abstract, LLC ex rel. Engels v. Gateway Title Agency, LLC*,[86] in which the Court discussed the ethical implications of the arrangement of an attorney providing abstract services to his/her client stating: "A failure to appropriately disclosure (sic) these various relationships to all interested parties would raise serious issues of professional responsibility (*citing Drysdale*)." Again, it is the failure to disclose, not the activity itself.

Finally, and most recently, we have two decisions, the first of which is *In re Tambini*, a case in which the attorney was involved in a plethora of ethical problems resulting in his disbarment.[87] The Court states specifically:

> Charge 21 alleges that respondent is guilty of an impermissible conflict of interest, in violation of Code of Professional Responsibility, DR 5-101(a) […] Since 2003, the respondent, either directly or through Expedient Settlement, represented lenders in one or more real estate transactions in New York State for which Expedient Title, of which the respondent is a principal, received fees for title and/or abstract services in such transactions. **The respondent failed to obtain the consent of the represented lender after full disclosure of his multiple interest in such transaction.**[88]

In so finding that the problem was the failure to obtain consent, the Court rejected the charge that the attorney had engaged in an impermissible conflict. It is not impermissible, and note the specific reference to Canon 5—yes—the Court was aware of Canon 5.

The second most recent case is *In re Woitkowski*.[89] "Charge No. 9 alleges that the respondent engaged in an impermissible conflict of interest, in violation of the Code of Professional

Responsibility DRs 5-101(a) and DR1-102(a)(7)."[90] Again, the Court is aware of Canon 5. The Court outlines that Woitkowski operated Real Abstract, PC at the same address as his law office and represented buyers and sellers in real estate transactions. "During that time, respondent procured title abstract services and title insurance for buyers he represented **in those transactions** through Real Abstract...."[91] What did the Court have a problem with? The fact that this was his practice—no. The fact that "[t]he respondent failed to disclose the implications of his personal interest in Real Abstract to those buyers."[92] The Court specifically cited Canon 5 and reached an entirely different conclusion from that of the Ethics Committee.

Accordingly, the decisional law of the State of New York is clear—providing legal services for a client and also providing abstract and title insurance services is not an impermissible conflict. It does require the disclosure as is so clearly set forth in the Comments to 5.7 adopted by COSAC and the New York State Bar Association and with which the Courts found no problem.

I. "Because Rule 5.7 (c)/(d) Was Not Adopted, It is Not Consentable for a Lawyer to Refer a Client to the Lawyer's Title Abstract Company."

This was the title of the article above referred to which appeared in the Fall 2010 issue of the *New York Real Property Law Journal*.[93] As stated initially, the article takes issue with Mr. Holtzschue (unnamed in the article) who concluded that the practice is permissible and the elimination of subparagraph (c) meant very little.

Specifically, the article quotes, and it is presumed, adopts, the conclusions of Opinion 752, stating as follows: 1) "'[t]hat in some transactions—notably real estate transactions—a lawyer who also operates certain ancillary businesses may not provide both legal and non-legal services in the same transaction, **even with the informed consent of the client'** continued to apply following the then recent adoption of DR 1-106."[94] 2) "'[T]he fact that the title abstract agency to which a lawyer refers a real estate client is owned, in whole or in part, by the lawyer's spouse, does not insulate the lawyer from the reach of NY State 595 and NY State 621.'"[95] 3) "In determining that the adoption of DR 1-106 did not overturn its previous [o]pinions finding that the provision of certain legal and nonlegal services in the same transaction is non-consentable, the Ethics Committee concluded that even if the steps described in the aforesaid DR 1-106(A)(4) were followed, thereby overcoming the presumption that those **non-legal** services were subject to the Code, the attorney still remained subject to those DR's governing the provision of **legal** services."[96] In short, the article's review of the New York State Bar Ethics Opinions 752, 753 and 755 only serves to highlight the error of those Opinions. No recitation as to why DR 1-106 did not overrule these Opinions—DR 1-106 is just summarily dismissed as apparently an act of pure futility by the Appellate Division presiding justices. 4) "Thus, notwithstanding the adoption of DR 1-106 (now Rule 5.7), it remained the Ethics Committee's position, as stated in NY State 595, that, with respect to the activities which were subject of its prior opinions '**the type and kind of conflict posed is so significant that the provision of consent is inadequate to protect the client's interests which converge with the law firm's business as an abstract company.**'"[97]

Well, what about those Comments? As shown above, COSAC remained adamant in putting forth the Comments to 5.7, most particularly as has been discussed Comments [5], [5A], [5B], [6] and [7] all included under the heading of "**Provision of Legal and Non-Legal Services in the Same Transactions." (**Emphasis in original.) COSAC, essentially without change, stayed with those Comments **after** the Courts removed subparagraph (c)/(d). It continued to assert those Comments in its second review after the Courts came back and said to COSAC—your Comments do not reflect accurately the changes we made in the Rules. The New York State Bar Association House of Delegates adopted those Comments in the first go-around, in the second go-around and in the third go-around. But the article then asserts: "[w]ithout the inclusion of Proposed Paragraph (c) in the final version of Rule 5.7, that portion of the Commentary is not germane."[98] Germane to what? Are we to simply summarily dismiss the Commentary? To conclude the Comments are simply irrelevant? Not Germane? This argumentation is based in part on the fact that because subparagraph (c)/(d) is removed there is no difference between DR 1-106 and Rule 5.7. No question about that. But as has been seen DR 1-106 was made to effectuate the very changes the Ethics Committee and the article so vigorously oppose. One may oppose the change made by DR 1-106/5.7 from its inception—but COSAC does not, the Bar Association does not and the Courts do not.

Finally, the article makes some very interesting comments:

1) "Inquiries to representatives of the Bar Association, COSAC and the Appellate Division as to whether they believe such to have occurred [the dismissal of Opinions 752, 753 and 755] were all answered in the negative." We have no idea of whom the article speaks.[99]

2) "Moreover, [the opinion of Mr. Holtzschue] is not shared by the parties involved in the preparation of the Comments or the adoption of the Rules."[100] Again, we do not know of whom the article is speaking of regarding the "the parties involved in the preparation of the Comments" but as a party intimately involved in the preparation of those Comments, I can state that that is wrong and the empirical evidence contradicts that statement—every position taken by COSAC from the time it first discussed 5.7 and issued its initial Comments to its issuance of the current Comments rejects this statement.

3) As for the Bar Association, it has been seen that the House of Delegates repeatedly adopted the Comments headed by the statement: "**Provision of Legal and Non-Legal Services in the Same Transaction**." That is the official position of the New York State Bar Association, adopted according to the By-Laws of the New York State Bar Association. The New York State Bar Association Committee on Professional Ethics stated in its Digest preceding Opinion 752, "[in] certain circumstances, a lawyer owning or operating an ancillary business continues to be barred after the promulgation of DR 1-106 from **providing legal and non-legal services in the same transaction even with the consent of the client.**"[101] The official position of the New York State Bar Association as adopted by its House of Delegates is clear as outlined above. These statements are directly contradictory. We have the position of the Ethics Committee and the position of the New York State Bar Association. They contradict each other. Again, we do not know who in the Bar Association was talked to but whoever that person was, his or her opinion was contrary to the official position of the New York State Bar Association. Given the fact that the House of Delegates has officially adopted the position as set forth in the Comments, it is submitted that the New York State Ethics Committee is required to withdraw Opinions 752, 753 and 755.

4) Finally, we have the Courts. Again, we are told that someone in the Courts advised that "the decision was made that said paragraph [(c)/(d)] not be included in the final version of Rule 5.7 because the Appellate Division was unwilling to negate Opinions 752, 753 and 755."[102] First of all, that contradicts the article's previous statement that the Appellate Division did not adopt subparagraph (c)/(d) because it did not want to play around with the Rule that had been so recently adopted. Furthermore, because the Courts—after an extraordinarily intensive review of all the Comments—did not (except for a very minor correction) request any change to Comments [5], [5A], [6] and [7] to Rule 5.7, it is clear that the Courts are perfectly comfortable with attorneys providing legal and non-legal services in the same transaction. Furthermore, because the Courts did make that minor revision to the Comments of 5.7, it is beyond challenge that they did not look at Comments [5], [A], [5] and [7]. Once again, the empirical evidence contradicts this assertion.

Conclusion

We are lawyers attempting to honorably provide services. We cannot listen to those who are "the sort of traditionalists who wish to live in a world that no longer exists." Their voice is wrong—intellectually, legally, and practically. The legal world is changing and it is that wrong voice which will bring about a "collapse"[103] of our profession. For our clients—we must be dynamic, resilient. The practice of law is a profession—of which many of us are intensely proud, we will not be empty headed. We of the New York State Bar Association have been blessed in that we have lawyers "who are knowledgeable enough to be at home in the law's normal science, imaginative enough to grasp the possibilities in the current situation, bold enough to explore them and painstaking enough to work out the transition a step at a time."[104] Think of the people we have had—MacCrate, Halpern, Krane, Simon, Lieber and a host of others who have examined difficult problems within the profession and have led this Bar Association in maintaining its relevancy, its vibrancy, its integrity. That is exactly what the MacCrate Committee did in proposing 5.7 to the New York State Bar Association, which thereafter proposed it to the Courts, who adopted it. That is exactly what COSAC did in reviewing the Rules and proposing again and again the Rule and the Comments necessary to effectuate the change. It is time to move on.

Endnotes

1. Karl B. Holtzschue, *N.Y. Rules of Professional Conduct Make It Consentable for a Lawyer to Refer a Client to the Lawyer's Title Abstract Company*, N.Y Real Prop. L.J., Spring 2010, at 15.
2. Kenneth F. Jurist, *Because Rule 5.7(c) Was Not Adopted, It Is Not Consentable for a Lawyer to Refer a Client to the Lawyer's Title Abstract Company*, N.Y Real Prop. L.J., Fall 2010, at 23.
3. *See generally*, John Caher, *Multidisciplinary Practice Rules Adopted by State; New York Takes Lead on Lawyer-NonLawyer Partnerships*, N.Y. L.J., July 25, 2001, at 24, col. 1 (discussing the Appellate Divisions' adoption of the provisions).
4. Richard A. Posner, Overcoming Law (1995).
5. *Id*. at 56 (emphasis added).
6. Mary Ann Glendon, A Nation Under Lawyers (1996), at 6.
7. *Id.* at p. 5.
8. *Id.* at p. 13.
9. *Id.* at p. 291 (emphasis added).
10. This is 1995 and would bring the time frame back to that identified by Posner and Glendon.
11. Anthony T. Kronman, The Lost Lawyer—Failing Ideals of the Legal Profession (1993), at 354. *See* Robert MacCrate, *"The Lost Lawyer" Regained: The Abiding Values of the Legal Profession*, 100 Dick. L. Rev. 587 (1996) (for a retort to Kronman's book).
12. 34 N.Y.2d 1, 311 N.E.2d 480, 355 N.Y.S2d 336 (1974).
13. 70 N.Y.U. L. Rev. 1229 (1995) [hereinafter *Pearce*].
14. *Id.* at 1230 (emphasis added).
15. 433 U.S. 350 (1977).
16. *Pearce*, *supra* note 13, at 1249 (emphasis added).
17. *Id.* at 1230 (emphasis added).
18. The same Robert MacCrate who authored the retort to the Kronman book. Mr. MacCrate is one of the most respected and it may well be said beloved lawyers in the United States and certainly in the New York State Bar Association. *See*, July/August *State Bar News* at p. 10—under a picture of Mr. MacCrate it is stated: "Venerable advocate for legal profession still keeps watch—Robert MacCrate marks anniversaries of State Bar, ABA Presidencies and his 90th birthday." The article notes that the "State Bar Executive Committee passed a resolution at its June meeting in Cooperstown recognizing MacCrate's 'extraordinary accomplishments and legal legacy'."
19. New York State Bar Association Special Committee on the Law Governing Firm Structure and Operation, *Preserving the*

Core Values of the American Legal Profession, 2000 [hereinafter *MacCrate Report*].

20. *Id*. at 100 (underlining in original, emphasis of "Title Insurance" added).
21. *Id*. at 326-29, 385 n.141; *see also Pearce*, *supra* note 13, at 1247; *Glendon*, *supra* note 6 at 41-43; Jerold Auserbach, Unequal Justice: Lawyers and Social Change in Modern America 40-53 (Oxford University Press, Inc., 1976) (harshly criticizing the basis of the legal profession's Canons of Ethics).
22. *MacCrate Report*, *supra* note 19, at 100.
23. *Id*. at 101-102.
24. *Id*. at 331 (emphasis added).
25. *Id*. at 332 (emphasis added).
26. *Id*. at 340.
27. *Id*. at 336.
28. *MacCrate Report*, *supra* note 19, at 310-15.
29. *Id*.
30. Code of Professional Responsibility DR 1-106 (22 NYCRR 1200.5-b), *amended by* N.Y. Rules of Professional Conduct, Rule 5-7.
31. N.Y. St. Bar Ass'n Comm. on Prof. Ethics, Op. No. 753 (2002).
32. *See* People v. Title Guar. & Trust Co., 227 N.Y. 366 (1919), *rev'd,* 36 N.Y.Crim.R. 210, 180 A.D. 648, 168 N.Y.S. 278 (2d Dep't 1917); N.Y. Rules of Prof'l Conduct R. 5.7(c).
33. Roy Simon, Simon's New York Code of Professional Responsibility Annotated (2008 Ed.).
34. *Id*. at 128.
35. *Id*.
36. *Id* (emphasis added).
37. *Id*. at 130 (emphasis added).
38. *Id*. at 130.
39. Simon, *supra* note 33, at 132 (emphasis added).
40. *Id*. at 139 (emphasis added).
41. Roy Simon, *Imputed Conflicts Under New DR 1-106*, New York Professional Responsibility Report, December 2001, at 1.
42. *Id.* at 4.
43. *Id.* at 5 (emphasis added).
44. N.Y. St. Bar Ass'n Comm. on Prof. Ethics, Op. No. 752 (2002).
45. N.Y. St. Bar Ass'n Comm. on Prof. Ethics, Op. No. 753 (2002).
46. N.Y. St. Bar Ass'n Comm. on Prof. Ethics, Op. No. 755 (2002).
47. Richard A. Posner, Cardozo, A Study in Reputation (1990).
48. 248 N.Y. 339, 162 N.E. 99 (1928).
49. 231 N.Y. 229, 131 N.E. 898 (1921).
50. *Id.* at 231.
51. N.Y. St. Bar Ass'n Comm. on Prof. Ethics, Op. No. 752, at 1.
52. *Id.* at 1.
53. *Supra.* at fn. 19.
54. N.Y. St. Bar Ass'n Comm. on Prof. Ethics, Op. No. 752, at 2 (emphasis added).
55. *Id*. at 3 (emphasis added).
56. N.Y. St. Bar Ass'n Comm. on Prof. Ethics, Op. No. 752, at 3.
57. *Id.* at 5.
58. N.Y. St. Bar Ass'n Comm. on Prof. Ethics, Op. 753 at 6.
59. N.Y. St. Bar Ass'n Comm. on Prof. Ethics, Op. 755, at 1 (under the heading "Topics").
60. *Id*. at 3.
61. *Id*.
62. *MacCrate Report*, *supra* note 19, at 332.
63. Comm. on Standards of Attorney Conduct, *Proposed New York Rules of Professional Conduct*, http://www.nysba.org/AM/Template.cfm?Section=Committee_on_Standards_of_Attorney_Conduct_Home&Template=/CM/ContentDisplay.cfm&ContentID=4786.
64. Comm. on Standards of Attorney Conduct, *Proposed New York Rules of Professional Conduct: Introduction*.
65. *Id*.
66. Comm. on Standards of Attorney Conduct, *Proposed New York Rules of Professional Conduct: Rule 5.7 Responsibilities Regarding Non-legal Services*.
67. *Id*.
68. *Id.* (emphasis added).
69. *Id*.
70. Roy Simon, *Some Interesting Provisions in the New Rules—Part 2, Rule 1.6(b) Through Rule 1.7*, New York Professional Responsibility Report, May 2009, at 3.
71. *Id.* at p. 2.
72. In an article for apparently LexisNexis, the New York Rules of Professional Conduct, which appeared in a booklet of the New York State Bar Association for a program entitled "Ethics in the Wake of the New Rules of Professional Conduct."
73. *Jurist*, *supra* note 2 at 25.
74. *See* fn. 68, discussion of Rule 5.7 at p. 9 (emphasis added).
75. Roy Simon, Simon's New York Code of Professional Responsibility Annotated 4 (2009 ed.).
76. Professor Wechsler on the New York Rules of Professional Conduct as set forth in NYSBA CLE Publication, "Ethics in the Wake of the New Rules of Professional Conduct," 2009, at p. 9.
77. *Id*. at 11.
78. Thomas Paprocki, *Presumption as a Matter of Law and Eternal Salvation*, 45 J. Cath. Leg. Stud. 177, 178 (2006).
79. 223 A.D.2d 807, 637 N.Y.S.2d 321 (3d Dep't 1996).
80. *Id.* at 807-08, 637 N.Y.S.2d at 322 (emphasis added).
81. 287 A.D.2d 870, 732 N.Y.S.2d 115 (3d Dep't 2001).
82. *Id*. at 871, 732 N.Y.S.2d at 116.
83. *Id*.
84. 27 A.D.3d 196, 197, 811 N.Y.S.2d 97, 98 (2d Dep't 2006).
85. *Id*. at 198, 811 N.Y.S.2d at 98.
86. 24 Misc. 3d 1235(A), at 1 n.2 (Sup. Ct. Albany Cnty. 2007).
87. 77 A.D.3d 143, 904 N.Y.S.2d 177 (2d Dep't 2010).
88. *Id* at 148, 904 N.Y.S.2d at 181 (emphasis added).
89. 84 A.D.3d 15, 921 N.Y.S.2d 74 (2d Dep't 2011).
90. *Id.* at 18, 932 N.Y.S.2d at 77.
91. *Id*. at 19, 932 N.Y.S.2d at 78 (emphasis added).
92. *Id*.
93. *Jurist*, *supra* note 2, at 23.
94. *Id*. (emphasis in original).
95. *Id*. at 24 (quoting N.Y. St. Bar Ass'n Comm. on Prof. Ethics, Op. 738 (2001)) (emphasis omitted).
96. *Id*. (emphasis in original).
97. *Id*. (emphasis in original).
98. *Id*. at 25.
99. *Jurist*, *supra* note 2, at 25.
100. *Id*. at 24.
101. N.Y. St. Bar Ass'n Comm. on Prof. Ethics, Op. No. 752 (emphasis in original).
102. *Jurist*, *supra* note 2, at 38.
103. *Kronman*, *supra* note 11, at 354.
104. *Glendon*, *supra* note 6, at 291.

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Recent Cases Shed Light on Lien Law Issues

By Thomas A. Glatthaar

In my experience as a title lawyer for more than twenty years, I have found that there are certain eternal truths. One is that, in New York, Lien Law issues strike fear in the hearts of many. That is because the risks are so great in this area of practice. Shortcomings in documentation or in procedure oftentimes result in the mortgage loan being completely subordinated to mechanic's liens regardless of when filed, regardless of whether the lienors can show that they were injured (or, frankly, whether their actions were affected in any way) by these flaws. Because of the technical nature of Lien Law compliance, and because of the "winner-take-all" nature of these disputes, lien priority issues are perhaps the most litigated area of any lending practice.

Four recently decided cases help shed some light on certain technical New York Lien Law issues. Almost by definition, they all arise under circumstances where the project went bad and the loan at issue went south. Each of the cases underscore traps for the unwary that can result in a loss of priority. In at least some instances, I would expect that the decisions discussed will not be the last word on these subjects.

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Altshuler Shaham Provident Funds, Ltd. v. GML Tower LLC involved a mortgage loan on property in the Syracuse area.[1] Pursuant to a loan agreement dated March 29, 2007, the plaintiff agreed to lend $10 million to defendant GML Tower LLC ("GML"). The loan agreement expressly stated that the proceeds of the $10 million loan were to be used as follows: $5.5 million was to be used to pay off and take the existing mortgage on the property by assignment,[2] and the remaining $4.5 million was specifically earmarked to be used to pay for improvements to be made by the borrower on the property. It is unclear, however, whether there was an express promise by the borrower in the loan agreement to make improvements. At the loan closing on May 2, 2007, plaintiff advanced $5.5 million for the purpose of paying off and taking by assignment the existing mortgage. The assignment of mortgage was recorded on May 3, 2007, as was a modification and extension agreement related to the existing mortgage.[3] This modification and extension agreement did not speak to the planned construction of improvements.[4]

Construction commenced on the project no later than July 2007, and plaintiff advanced the remaining funds in several advances over time.[5] On March 4, 2008, the parties entered into a modification of the loan agreement, and on March 6, 2008, the last of the $4.5 million loan proceeds were advanced. The following day, a Mortgage Increase, Modification and Spreader Agreement between the parties was recorded. This document did not address planned improvements, nor is there any indication that this document treated the loan in any way other than as a single, $10 million loan.[6]

Neither the original loan agreement nor the March 4, 2008 modification thereof was ever filed with the county clerk.[7] Mechanic's liens were filed against the property starting in September 2008. When plaintiff commenced the action to foreclose in December 2008, the lienholders answered and raised various affirmative defenses, including an assertion that the filed liens had priority over the lien of the mortgage because plaintiff had failed to file a building loan contract or the March 4, 2008 modification thereof in violation of New York Lien Law Section 22.[8] The plaintiff disputed the assertion that the March 29, 2007 loan agreement was a building loan contract,[9] or that the mortgage itself was a building loan mortgage,[10] pointing out, among other things, that the $4.5 million was not even secured at the time it was advanced. In addition, plaintiff argued that even assuming that the loan at issue was in violation of Section 22, the $5.5 million then-existing mortgage that was taken by assignment at closing had unquestioned priority over the later-filed mechanic's liens because the priority of that mortgage was established when its proceeds were advanced and the mortgage itself recorded.[11]

The court rejected both of these arguments.[12] It found that a building loan contract is an agreement to provide a loan to a borrower for the purpose of erecting an improvement on the premises where the loan is advanced in installments as construction progresses,[13] and that the loan agreement in this case is a building loan contract. The obligation to comply with the Section 22 filing requirements can exist even if the loan is not secured by a contemporaneous mortgage.[14]

Further, the court rejected the plaintiff's arguments with respect to the priority of the $5.5 million portion of the loan that was originally purchase money and which was taken by assignment by plaintiff.[15] The court pointedly followed the **holding** of the *Atlantic Bank of New York v. Forrest House Holding Co.*,[16] **holding** that a failure by a lender to meet the requirements of New York Lien Law Section 22 will result in the lender's "entire mortgage, including [the] part securing loan proceeds advanced for the purchase of the property…"[17] suffering Section 22's subordination penalty.[18]

In so concluding, the court rejected the holding in Federal Deposit Insurance Corporation, as receiver for *Yankee Bank for Finance & Savings, FSB v. Task Associates, Inc.*,[19] (coincidentally, also arising out of Syracuse).[20] *Yankee Bank* arose in the context of a material modification to a building loan contract[21] for which no modification was in fact filed.[22] The court followed a long line of cases in holding that the failure to file a material modification triggered the subordination penalty under Lien Law Section 22.[23] However, the court in *Yankee Bank* distinguished between the building loan funds actually expended towards the purchase of the building (which the court found were not subject to the statutory subordination penalty and which, together with interest thereon, had a first priority claim on the foreclosure sale proceeds) from the balance of the building loan funds (which was subordinated to the claims of mechanic's lienors).[24]

Comment: Of note is the fact that the court in *Altshuler* seems to put substantial emphasis on its finding that the mortgage recorded March 7, 2008 (labeled "Mortgage Increase, Modification and Spreader Agreement") did in fact consolidate multiple mortgages into a single lien, and seemed to imply this element (a single, consolidated lien) was necessary to its conclusion that the entire mortgage loan (including the $5.5 million portion which was, originally, purchase money) was subject to the Section 22 subordination penalty. To avoid this penalty affecting the entire loan, the existing mortgage debt needs to be kept outside the building loan agreement (say, covered by a separate loan agreement) and should also be kept as a separate mortgage lien.

One should be cautious about taking any existing mortgage by assignment through the use of building loan funds, the more careful approach being to keep these mortgages being acquired by assignment separate, and keep the funds needed to acquire these mortgages outside of the building loan and the building loan contract. By doing so, one could retain the priority of these mortgages as against any mechanic's lien subsequently filed.

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An interesting unpublished decision in *International Exterior Fabrications, LLC v. J. Petrocelli Contracting, Inc.* involves, at its heart, the filing requirement in New York Lien Law Section 22.[25] The owner of the property acquired title in 2006. In conjunction with the acquisition, the owner executed and delivered an acquisition loan note and mortgage, a building loan note and mortgage, and a project loan note and mortgage. A building loan agreement and a project loan agreement were also executed, and the building loan agreement was filed with the County Clerk prior to the recording of the mortgages. Work on the project commenced shortly after that closing with J. Petrocelli Contracting, Inc., as general contractor. In September Fidelity National Family 2007, the owner, seeking additional funds, refinanced its mortgages with Citicorp. The new lender took the existing mortgages by assignment, advanced additional funds, and consolidated the loans and mortgages into two distinct liens. First, a building loan, comprised of the old and new building loans only and secured by a consolidated, amended and restated building loan mortgage, and second, a project loan, comprised of additional project loan funds and the existing acquisition loan and project loan that were assigned at closing and secured by a consolidated, amended and restated project loan mortgage. Again, owner and lender entered into an amended and restated building loan agreement and an amended and restated project loan agreement. The amended and restated building loan agreement was filed more than ten days after it was executed[26] but before the recording of the consolidated, amended and restated building loan mortgage.[27]

The project ran into difficulties, and several mechanic's liens were filed, including one by plaintiff.[28] Plaintiff commenced an action to foreclose on its mechanic's lien. Plaintiff named the new lender and asserted priority over the lien of the building loan mortgage by virtue of a failure to file amended and restated building loan agreement in compliance with the requirements of Section 22. The court disagreed:

> There is no question that the Citigroup Building Loan Mortgage was "made pursuant to" the Citigroup Building Loan Agreement—this mortgage was newly created to secure the additional funding governed by that loan agreement—and it was created on the same day that loan agreement was executed. Thus, Lien Law section 22 only required the Citigroup Building Loan Agreement to be filed before the Citigroup Building Loan Mortgage was recorded, which was done here. The ten-day filing requirement would only have applied if there were *subsequent* modifications to the Citigroup Building Loan Agreement, and in this case there were none.[29]

Comment: Although there is ample case law on the question of whether a modification to a building loan contract is "material," this case appears to be one of first impression on a question that could arise any time in what is a fairly common fact pattern: when an existing building loan agreement (and the building loan mortgage securing advances) is assigned to a new lender who adds new money and amends and restates both the building loan agreement and the mortgage, is the resulting building loan a new building loan (requiring the filing of a building loan agreement prior to or simultaneously with the recording of the building loan mortgage) or is it a modification of an existing building loan (requiring filing of a modification of the original agreement within ten days of execution thereof)? The court does not seem to hesitate in concluding that the resulting building loan agreement is not a modification under Section 22, to the detriment of lien claimants.

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Another unpublished ruling presents (among a series of others) the interesting question of whether, under the facts set forth in the case, a project loan agreement should be subject to the filing requirements for building loan contracts in Lien Law Section 22.

Lehman Brothers Holdings, Inc. v. 25 Broad, LLC involves a mortgage foreclosure action covering three mortgages (a term loan mortgage, building loan mortgage and project loan mortgage) encumbering property in New York County.[30] The mortgages were made on March 9, 2007. The first mortgage was the term loan in the amount of $231,677,693.00, as a refinance of existing mortgage indebtedness, with existing mortgages being assigned to the new lender and a consolidated mortgage executed and recorded. The second mortgage was a building loan mortgage in the amount of about $19.6 million. Again, the existing mortgage loan was assigned to the new lender as part of a refinance of existing mortgage indebtedness, and an amended and restated mortgage was executed and recorded.[31] The third mortgage, also assigned to the new lender as part of a refinance of existing mortgage indebtedness, and also for which an amended and restated mortgage was executed and recorded, was a project loan mortgage. Over time, various contractors who performed work or furnished materials or services on the property in connection with the project were purportedly not paid and filed liens against the property. The borrower defaulted on its mortgage obligations, and the lender commenced an action to foreclose on all three mortgages. Some of the mechanic's lienors asserted priority over all three of the mortgages, the assertion being that each of the mortgages was, for varying reasons, subject to the filing requirements of Lien Law Section 22, which, these mechanic's lienors assert, were not met. With regard to the senior mortgage, three arguments are presented to support this view:

1. the senior mortgage "is a building loan contract" because it was executed contemporaneously with a completion guaranty, and a default under the guaranty is a default on the senior mortgage.

2. a promise to make improvements[32] is implied from the fact that a default under the building loan contract that was filed was also a default under the senior mortgage.

3. the senior mortgage is actually a consolidated mortgage, and one of the earlier mortgages is a 1996 building loan mortgage.[33]

The court dismissed these arguments in swift fashion.[34] The court pointed out that a building loan contract is an agreement to provide a loan for the purpose of erecting a building;[35] the senior mortgage, however, was advanced in one lump sum and was not made for the purpose of making improvements on real property; in fact, the loan agreement called for the proceeds of the senior loan to be used to refinance the existing debt (and for no other purpose). All of the monies secured by the senior mortgage (including the 1996 building loan mortgage) were advanced long ago, and there was no express promise in the senior mortgage to make an improvement. On the question of the completion guaranty, the court held that the existence of a cross-default between the completion guaranty and the senior mortgage was not enough to transform the senior mortgage.[36]

With regard to the building loan mortgage, the lienholder argues that it should achieve priority over the recorded building loan mortgage on two bases:[37]

1. certain letter agreements were entered into between the borrower and the lender after closing that the lienholder asserts are "material modifications," and applicable law required that such modifications be filed in accordance with Lien Law Section 22.[38]
2. the 2007 building loan mortgage amends and restates a 2005 building loan mortgage, and "it is impossible to determine if the original 2005 Building Mortgage was filed as required under Lien Law Section 22."[39]

The court found that the lienholder failed to establish the letter agreements that the parties signed were material.[40] The court also held that whether or not a building loan contract was ever filed in connection with the 2005 building loan mortgage is "irrelevant." What is relevant, according to the court, is that the plaintiff filed a building loan agreement with the County Clerk in conjunction with the 2007 building loan mortgage, and that this building loan agreement "was filed prior to the filing of the mechanic's liens."[41]

This is noteworthy in two respects. First, interestingly (to me at least), in establishing the priority of the building loan mortgage, the court strongly implies that it agrees with the holding in the *International Exterior Fabrications* case (infra) that where one takes an existing building loan mortgage and building loan agreement by assignment and files an amended and restated building loan agreement in connection therewith, that amended and restated agreement is *not* a building loan modification, but is a *new* building loan contract.[42] Second, the fact that a building loan agreement is filed prior to the filing of the mechanic's liens is not a statutory requirement to establishing priority.[43]

The court then turned to the project loan mortgage and project loan agreement.[44] Lienholder asserted once again that the project loan documents were actually building loan documents. They pointed to a provision in the project loan agreement (among others, the court says) that linked that loan to the construction of the "Project Improvements."[45]

The lender argued that this loan was earmarked for development-related costs and not for cost of improvement, and that there was no express promise to make improvements as required by Section 2(13) of the New York Lien Law. Nevertheless, the court held for the lienholder, pointing out that "even if not labeled a building loan contract, the Project Mortgage can still be denominated as a building loan contract (sic) if it meets the Lien Law requirements of a building loan."[46] The court points out that the Project Loan Agreement has a section regarding "Conditions for Final Construction Advance," and finds that "there can be no dispute that the Project Loan Agreement provides for loan payments in consideration of making improvements to the property," and that the lender provided no evidence of how the project loan proceeds were to be used (if, in fact, they were not being used to pay for cost of improvement). Because the Project Loan Agreement was not filed, the project loan mortgage suffers the subordination penalty in Lien Law Section 22.[47]

Comment: I am not quite sure what to make of this decision, and would caution, at this point, against overreaction or reading too much into it. The court seemed to put great emphasis, in deciding that the senior loan was not a building loan, on the fact that the loan agreement specified that the "[b]orrower shall use the proceeds of the Senior Loan to refinance the existing financing encumbering the Property (and for no other purpose)."[48] If the court is charging a lender with stating clearly in a loan agreement the uses for which a loan made in this context is intended, then that is a new and unusual requirement, but such a requirement could be accommodated. The project loan agreement is not available for review, so it is uncertain how the parties detailed the anticipated use of these loan proceeds or how closely the advance of funds under the project loan was tied in to progress of the construction job.[49] It is certain, however, that there is not enough information in the decision to determine whether "there can be no dispute" that the project loan agreement should have been filed as a building loan agreement under Section 22.[50]

One more noteworthy point that this case brings up is the importance of carefully considering, in this context, which mortgages the lender should foreclose. There may have been good reason for the lender here to initially seek to foreclose all three mortgages. Once the lienholders raised defenses, the lender shifted tactics, seeking to split off the priority of the senior and building loan mortgages (where, as the court holds, the lienholders had no valid basis for attack) from the project loan mortgage (where, at least in the eyes of this court, they did have grounds to challenge priority). Of the $277.97 million total loan package, almost all of it was in the senior and building loans, and the project loan had not been fully advanced. Hindsight being 20-20, if the lender was concerned about the priority of the project loan,[51] it could likely have foreclosed on the two other mortgages and, because of the amounts involved, would likely have ended up completing the foreclosure without incident (and would have been able to bid in at a high enough level to protect almost all of its loan package).

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In what appears to be a case of first impression in New York, the Supreme Court, Monroe County addressed the question of whether a mortgage loan, advanced in whole or in part into an escrow account to fund certain required repair work, is a building loan mortgage in *Lehman Brothers Holdings, Inc. v. Genwood Strathallan LLC.*[52] This court answered in the affirmative.[53]

The transaction involved the refinance of an existing mortgage on property in Rochester, N.Y.[54] At the time of closing (January 30, 2007), the lender made a first mortgage loan in the amount of $12.75 million (evidenced by a consolidated, amended and restated note of even date) and a second in the amount of $1.75 million. The bulk of the loan proceeds were used to take an existing mortgage by assignment. In addition, at least some portions of the first mortgage loan were advanced by lender at closing into two interest-bearing escrow accounts, which were to be disbursed pursuant to a First Repair Escrow Agreement ("First Repair Escrow Agreement") that was entered into at closing. The First Repair Escrow Agreement requires the borrower to perform certain repairs and deferred maintenance at the property, and provides that "…the escrows shall be used for the…work." It also affirmatively states that the escrow deposits secure the borrower's obligation to complete the work. The consolidated mortgage documents with respect to this loan were recorded promptly after closing.[55]

Further, the parties also entered into a Second Repair Escrow Agreement ("Second Repair Escrow Agreement") at the closing, and opened another interest-bearing escrow account for the same.[56] This Second Repair Escrow Agreement covered different required work than the first agreement but otherwise contained the same material terms. This Escrow Agreement was funded by an advance made by the lender several months after closing, which advance was secured by a second mortgage on the property. Funding for this loan took place subsequent to closing, and the second mortgage was recorded in August 2007.[57]

Defendant M&T Remodeling Services, Inc. ("M&T") performed work at the property.[58] M&T was not paid and filed a lien in the amount of $299,500.00 in April 2009. When the borrower defaulted on the mortgage loans, lender commenced a mortgage foreclosure action, naming and serving numerous defendants, including M&T. M&T answered the complaint, asserting its lien and requesting a determination of priority. The lienholder argued that, even though the notes, loan agreement and the first and second mortgages contained no promise on the part of the borrower to make improvements on the property, the loan agreement when read in tandem with the First Repair Escrow Agreement and the Second Repair Escrow Agreement is a building loan contract as defined in New York Lien Law Section 2(13). In doing so, the court underscores the following points:

> 1. the work set forth in the First and Second Repair Escrow Agreements was "required" by the Lender, and the existence of the escrow accounts was to secure the borrower's "obligation" to perform under the First and Second Repair Escrow Agreements.[59]
>
> 2. there was a timeline for the completion of the work. This, in the court's view, seems to reinforce the point that the work was not discretionary, though it is difficult to ascertain how important an element this is.[60]

Further, the court dismisses the argument that the loans are not building loans because the funds were advanced in a lump sum rather than installments.[61] The money, the court points out, was not made available to the borrower in one lump sum; the borrower was required to fund the escrows, and those escrowed funds could not be used for the purposes specified in the First and Second Repair Escrow Agreements. The court quoted approvingly a commentator who criticized the escrow mechanism as an effort to avoid Lien Law requirements that may not work, and pointed out that such an arrangement still required periodic disbursements from the escrow account. In view of the foregoing, the court imposed the "harsh…statutorily imposed penalty" in Lien Law Section 22, subordinating the entire first and second mortgages to the filed liens.[62]

Comment: Many people have expressed Lien Law concerns over the years regarding loan structures involving the funding of an escrow account at closing, the proceeds of which are controlled by the lender and are intended to be used to pay for improvement of real property. There are many variations on this structure, and this case leaves a number of questions unanswered. For example, the court seems to go out of its way to point out that the work at issue needs to be completed within a time frame. Is that a necessary element to finding that the loan agreement and the First and Second Repair Escrow Agreements, when read together, constitute a building loan contract?

One little-noticed but important conclusion that the court reached was that the loan wasn't fully funded at closing but was instead advanced in installments.[63] The court found that the funding of the First and Second Repair Escrow Agreements with loan proceeds was a disbursement "in a sense"; it was apparently not a disbursement for lien law purposes because the money "was not available to the Borrower in a lump sum."[64] Assuming that this rationale withstands scrutiny, its import lies in the fact that, even assuming that one could structure a transaction that circumvents the Lien Law Section 22 issue (that is, the loan would not be a building loan), the loan proceeds would, in this court's view, still not be "advanced," and any advance from the escrow account might be subject to matters arising after the date of the initial closing and prior to the escrow advance.[65]

On a separate point, again, one should be cautious about taking *any* existing mortgage by assignment through the use of building loan funds. The more careful approach would be to keep these mortgages being acquired by assignment as a separate mortgage loan, and keep the funds needed to acquire these mortgages outside of the building loan and the building loan contract. By doing so, one could retain the priority of these mortgages as against any mechanic's lien subsequently filed.

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To conclude, there is one thing you can certainly say about the New York Lien Law: there are certain well-worn principles that guide the construction lending practice, but there seems to be a limitless number of fact patterns to test those principles. The courts seem to be forever answering questions that reinforce, expand or contract these seemingly simple and unquestionably fundamental questions: What is a building loan contract? When do you need to file one? And what happens if you don't? Stay tuned, because if there is one thing you can be sure of, it is that more will follow.

Endnotes

1. 28 Misc. 3d 475, 900 N.Y.S.2d 846 (Sup. Ct. Onondaga Cnty. 2010), *aff'd*, 83 A.D.3d 1563, 921 N.Y.S.2d 601 (4th Dep't 2011), *appeal denied*, 86 A.D.3d 934, 926 N.Y.S.2d 838 (4th Dep't 2011), *appeal denied*, 18 N.Y.3d 892, 963 N.E.2d 778 (2012).
2. Remember, the money used to acquire by assignment a pre-existing mortgage on the real property is a "cost of improvement" as defined in N.Y. Lien Law § 2(5) (McKinney 2012).
3. The modification and extension agreement, among other things, reduced the principal balance of the existing mortgage from $7 million as appeared on the public records, to the $5.5 million reduced principal amount.
4. *Altshuler*, 28 Misc. 3d at 477, 900 N.Y.S.2d at 848.
5. *Id.*
6. *Id.* at 478, 900 N.Y.S.2d at 849.
7. *Id.* at 477, 900 N.Y.S.2d at 848.
8. N.Y. Lien Law § 22.
9. *See id.* § 2(13).
10. *See id.* § 2(14).
11. *Altshuler*, 28 Misc. 3d at 480, 900 N.Y.S.2d at 850.
12. *Id.*
13. *Id.* at 479, 900 N.Y.S.2d at 850 (citing Alden State Bank v. Sunrise Builders, Inc., 48 A.D.3d 1162, 1164, 853 N.Y.S.2d 230, 232 (4th Dep't 2008); Finest Inv. v. Security Trust Co., 96 A.D. 2d 227, 229, 468 N.Y.S.2d 256, 258 (4th Dep't 1983)).
14. *Id.* at 480, 900 N.Y.S.2d at 850.
15. *Id.* at 481, 900 N.Y.S.2d at 851.

16. 234 A.D.2d 491, 492, 651 N.Y.S.2d 607, 608 (2d Dep't 1996); *see also* Thomas A. Glatthaar, *Uncertainty in the Lien Law Raises Lenders' Concerns*, N.Y. L.J., June 8, 1998, at 1.

17. *Altshuler*, 28 Misc. 3d at 481, 900 N.Y.S.2d at 851.

18. *See Atlantic Bank*, 234 A.D.2d at 492, 651 N.Y.S.2d at 608 (concluding that § 22 subordination provision is a "statutorily imposed penalty").

19. 731 F. Supp. 64 (N.D.N.Y. 1990).

20. *Altshuler*, 28 Misc. 3d at 481, 900 N.Y.S.2d at 851.

21. *See Yankee Bank*, 731 F. Supp at 70. The "material modification" at issue was a waiver by the lender of a requirement that a surety bond be provided for lender's benefit prior to any advance of funds beyond the funds advanced at the closing where the property was acquired.

22. *See Yankee Bank*, 731 F. Supp. at 70.

23. *See, e.g.*, HNC Realty Co. v. Bay View Towers Apartments, Inc., 64 A.D.2d 473 (2d Dep't 1978). *See also* Thomas A. Glatthaar, *Pitfalls of Modifying Building Loan Contracts*, N.Y. Real Prop. L.J., Spring 2009, at 64 (discussing the unique problems involved in modifying building loan contracts and mortgages).

24. *Yankee Bank*, 731 F. Supp. 64, 71-72 (N.D.N.Y. 1990).

25. No. 101679/10, 2011 NY Slip Op. 31545(U), 3 (Sup. Ct. N.Y. Cnty. April 11, 2011).

26. *See* N.Y. Lien Law § 22 (requiring modifications of building loan contracts to be filed within ten days of their execution).

27. *See id.* (requiring a building loan contract "with or without the sale of land" to be filed in the office of the county clerk in which the property is located prior to or simultaneously with the recording of the building loan mortgage).

28. *See Int'l Exterior*, 2011 NY Slip Op. 31545(U), 5.

29. *Id*. at 7.

30. *See* Lehman Brothers Holdings, Inc. v. 25 Broad LLC., No. 100886/2009, 2011 NY Slip Op. 31931(U), 4 (Sup. Ct. N.Y. Cnty. June 16, 2011).

31. *Id*. at 6-7 (noting that an amended and restated Building Loan Agreement was filed prior to the recording of the amended and restated mortgage).

32. N.Y. Lien Law § 2(13) (defining a "building loan contract" as an agreement that exists when one party expressly promises to make an improvement on real property and the other, in consideration for that promise, promises to make a loan advances secured by a mortgage).

33. *Lehman Brothers*, 2011 NY Slip Op. 31931(U), 13.

34. *Id*. at 15-16.

35. *Id*. at 16; *see also* Alden State Bank v. Sunrise Builders, Inc., 48 A.D.3d 1162, 853 N.Y.S.2d 230 (4th Dep't 2008).

36. *Lehman Brothers*, 2011 NY Slip Op. 31931(U), 19.

37. *Id*. at 20-21.

38. *Id*. *See also* Glatthaar, *supra* note 23 (discussing modifying building loan contracts, including "material modifications").

39. *Lehman Brothers*, 2011 NY Slip Op. 31931(U), 21 (citing one of many instances in this case where the court and/or the parties appear to a building loan contract (which is required to be filed under Lien Law § 22) and a building loan mortgage, which is not).

40. *Id*. at 22.

41. *Id*. *See also id*. at 22 n.5 (noting that, as a technical matter, whether the building loan contract is filed before the filing of a mechanic's lien is not relevant to the question of priority).

42. Int'l Exterior Fabrications, LLC. v. J. Petrocelli Contracting, Inc., No. 101679/10, 2011 NY Slip Op. 31545(U), 7 (Sup. Ct. N.Y. Cnty. April 11, 2011) (indicating that if the 2007 building loan agreement was a modification and the 2005 agreement had never been filed, this defect would result in a loss of priority regardless of whether the 2007 modification was done in accordance with statute); *see also* Packard v. Sugarman, 31 Misc. 623 (Sup. Ct. Onondaga Cnty. 1900); P.T. McDermott v. Lawyers Mortgage Co., 232 N.Y. 336 (1922).

43. A detailed discussion of this subject is beyond the scope of this article. Suffice to say, to achieve priority in a building loan context to the extent of funds advanced prior to the filing of a mechanic's lien, a mortgagee must file a building loan contract, including a Lien Law affidavit that is materially correct, prior to or simultaneously with the recording of the building loan mortgage.

44. *Lehman Brothers*, 2011 NY Slip Op. 31931(U), 22.

45. *Id*. at 23 (defining "Project Improvements" in the project loan agreement as "the renovation and construction work show on the plans and specifications").

46. *See id.* at 23-24 (citing Lincoln First Bank, N.A. v. Spaulding Bakeries Inc., 117 Misc. 2d 892 (Sup. Ct. Broome Cnty. 1983). Interestingly, the *Lehman* court seems to use the phrase "building loan contract" for the phrase "building loan mortgage" interchangeably throughout the decision, which is cause for some concern.

47. *Id*. at 24.

48. *See id.* at 16.

49. There is an obvious link between these two points, but it seems to me that once the project loan funds are earmarked for their anticipated uses, disbursement has to be tied to incurring those expenses and not to the overall progress of the construction project.

50. *Lehman Brothers*, 2011 NY Slip Op. 31931(U), 24.

51. *See* Thomas A. Glatthaar, *Soft Cost Mortgages May Run Afoul of State Lien Law*, N.Y. L.J., Nov. 14, 1994, at S3, for a discussion on project loan mortgages, their uses and potential issues, including priority issues.

52. *See* Lehman Brothers Holdings, Inc. v. Genwood Strathallan LLC, No. 2010/10157 (Sup. Ct. Monroe Cnty. Oct. 29, 2011).

53. *See id.* at 14-15.

54. *Id*. at 3.

55. *Id*.

56. *Id*.

57. *Id*.

58. *Genwood Strathallan*, No. 2010/10157, 3.

59. It is unclear whether the failure to complete the "required" work, or to do so within the time frames set forth in the First and Second Repair Escrow Agreements, would constitute a default under the mortgage, or simply preclude the borrower from gaining access to the escrowed funds.

60. *See Genwood Strathallan*, No. 2010/10157, 13.

61. *Id*.

62. *Id*. at 8 (citing Atlantic Bank of New York v. Forrest House Holding Co., 234 A.D. 2d 491 (2d Dep't 1996)). It is interesting, to me at least, to note that, had the existing mortgage not been consolidated with the new first in this case, it is likely that the existing mortgage would not have been subordinated to the mechanic's lien so long as the First and Second Repair Escrow Agreements made no reference to this existing mortgage and the funds needed to acquire it.

63. *See id.* at 13-14.

64. *Id*. at 13.

65. *See id.* at 14.

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Bergman on Mortgage Foreclosures: No Need to Substitute Plaintiff Upon Mortgage Assignment

By Bruce J. Bergman

This question arises all the time. During the course of a mortgage foreclosure action, the note and mortgage (or whatever the more extensive mortgage documents may be) are assigned by the foreclosing plaintiff. Is there a mandate to make a motion to change the caption of the action to reflect the name of the new mortgage holder as the plaintiff?

The answer is no, as a matter of statute (CPLR § 1018) and case law, confirmed as recently as October, 2011 [*Citimortgage, Inc. v. Rosenthal*, __ A.D.3d __, __ N.Y.S.2d __ (2d Dept. 2011).] For those who may want to delve more deeply into case law and nuances on this subject, see 2 *Bergman on New York Mortgage Foreclosures* § 23.46, LexisNexis Matthew Bender (rev. 2011).

Why this is particularly relevant as a practical matter is highlighted by the mentioned new case. The borrower delivered a mortgage in 1988 to A, immediately assigned to B. In 1994, B assigned to C. In early 2008, C assigned to Citibank which, upon encountering a default, began a foreclosure in July, 2008.

On July 1, 2009 the judgment of foreclosure and sale was signed. Thereafter, and as is not uncommon, in May, 2010, Citibank assigned the mortgage to PennyMac. A sale was scheduled for July, 2010, intercepted by the borrower's order to show cause alleging lack of standing (to be addressed in a separate alert) and, relevant to this review, the charge that the foreclosure could not proceed because PennyMac (plaintiff Citibank's assignee) had not been formally substituted as plaintiff.

Not so, ruled the court (based upon established case law and the noted practice statute)—although the ultimate real life mischief was that while the foreclosing plaintiff won on this point in the trial court, the borrower appealed. The mortgage holder won there too, but victory came fifteen months after the originally scheduled sale date.

So, it helps to be right on the law—and servicers and practitioners should be familiar with this principle—but being correct didn't stave off time and expense.

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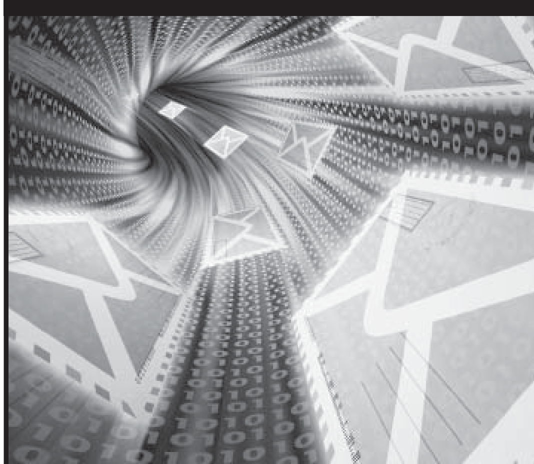

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Student Case Comment: *Eastside Exhibition Corporation v. 210 East 86th Street Corporation*: A De Minimis Departure from the "One Inch Rule" in Partial Actual Evictions

On February 21, 2012, in *Eastside Exhibition*, the New York Court of Appeals held that "under the circumstances…where such interference by a landlord is small and has no demonstrable effect on the tenant's use and enjoyment of the [leased] space, total rent abatement is not warranted."[1] Plaintiff Eastside Exhibition operated a multiplex theater on two floors leased in defendant's seven-story retail and office building.[2] In December 2002, the third year of the lease, defendant-landlord, without notice or consent from plaintiff, installed cross-bracing between steel support columns on both of plaintiff's leased floors in preparation for two new floors to be added to the building.[3] The "concededly unaesthetic" cross-bracing necessitated a change in the flow of moviegoers' foot traffic on the first floor of the leased premises and a "slight diminution" of the waiting area on the second floor.[4] As a remedy for this alleged partial actual eviction, plaintiff ceased paying rent and commenced an action seeking a permanent injunction to have defendant remove the cross-bracing and discontinue any further work.[5] Additionally, plaintiff sought abatement of its rent obligation.[6]

The Supreme Court, New York County, granted plaintiff a temporary restraining order on any further construction by the defendant.[7] At a nonjury trial, the parties stipulated that the cross-bracing occupied approximately 12 square feet of the total leased space, which constituted between 15,000 and 19,000 square feet.[8] The Supreme Court dismissed the plaintiff's claim for complete rent abatement and awarded defendant-landlord unpaid rent.[9] It concluded that the taking of 12 square feet on non-essential space constituted a de minimis taking not justifying full rent abatement.[10]

On appeal, the First Department modified the decision and held that "there is no de minimis exception to the rule that any unauthorized taking of the demised premises by the landlord constitutes an actual eviction."[11] In spite of this modification on the law, the Appellate Division declined to award plaintiff full rent abatement and concluded that the correct remedy was to compensate plaintiff for actual damages.[12] On remand, the Supreme Court found that the plaintiff failed to establish actual damages and accordingly made no award to the plaintiff.[13] The Appellate Division again affirmed, "declining to revisit legal issues as it felt bound by the law of the case as earlier expressed in the first Appellate Division order."[14]

In its February 2012 decision, the Court of Appeals addressed the question of whether a landlord can make an intrusion "that is of such a trifling amount that imposition of the draconian remedy of total rent abatement is unjustified."[15] The majority (6-1) answered that question in the affirmative. The Court initially recognized the long-standing nature of the remedy of total rent abatement for actual partial evictions, and did not "jettison or overrule it."[16] The Court maintained that total rent abatement is available "even if a tenant remains in possession of the premises,"[17] but also made clear that "not every intrusion amounts to an eviction."[18] Given the circumstances here, Judge Ciparick, writing for the majority, held that "[f]or an intrusion to be considered an actual partial eviction it must interfere in some, more than trivial, manner with the tenant's use and enjoyment of the premises."[19] The Court reasoned that full rent abatement under these circumstances (taking of less than one-tenth of one percent of the leased space) would be inherently inequitable, especially considering "modern realities that a commercial lessee is free to negotiate appropriate lease terms."[20]

In an impassioned dissent, Judge Read distinguished constructive eviction (requiring substantial and material deprivation of tenant's use and enjoyment of the premises *and* tenant's relinquishment of the premises) from actual eviction. According to Judge Read, "the majority conflates actual and constructive eviction."[21] Judge Read sees actual eviction (no matter how small) as "a deprivation of beneficial use and enjoyment *by virtue of the physical expulsion*."[22] She also raised an important underlying policy concern that an abolition of the "one inch rule" in favor of the new de minimis rule "affords no predictability of outcome."[23] She further stated that prior to this decision, "it was very risky for a landlord to intrude on leased space in disregard of the tenant's right to the whole of the property because the tenant might withhold rent."[24] Now, tenants are left with "no effective way to combat unauthorized takings by landlords."[25]

This monumental shift away from the "one inch rule" will inevitably result in litigation for years to come, as it is now "left up to the courts to determine whether the ouster is merely trifling in amount and trivial in effect."[26]

Endnotes

1. Eastside Exhibition Corp. v. 210 E. 86th St. Corp., __ N.E.2d __, 18 N.Y.3d 617, 619, 2012 NY Slip Op. 01321 (2012).
2. *Id*. at 620.
3. *Id*.
4. *Id*.
5. *Id*.
6. *Id*.
7. *Eastside Exhibition*, 18 N.Y.3d at 620.
8. *Id*.
9. *Id*. at 621.
10. *Id*.
11. *Id*. *See also* Eastside Exhibition Corp. v. 210 E. 86th St. Corp., 23 A.D.3d 100, 104-05 (1st Dep't 2005).
12. *Eastside Exhibition*, 18 N.Y.3d at 621.
13. *Id*.
14. *Id*. at 621-22.
15. *Id*. at 622.
16. *Id*. *See also* Dyett v. Pendleton, 8 Cow 727 (NY Sup. Ct. 1826); Edgerston v. Page, 20 N.Y. 281 (1859); Fifth Ave. Bldg. Co. v. Kernochan, 221 N.Y. 370 (1917).
17. *Eastside Exhibition*,18 N.Y.3d at 622 *See also* Barash v. Pennsylvania Term. Real Estate Corp. 26 N.Y.2d 77 (1970).
18. *Eastside Exhibition*, 18 N.Y.3d at 622, (referencing Lounsbery v. Snyder, 31 N.Y. 514 (1865)).
19. *Eastside Exhibition*, 18 N.Y.3d at 623.
20. *Id*.
21. *Id.* at 628 (J. Read, dissenting).
22. *Id*. (emphasis added).
23. *Id*. at 631.
24. *Id*.
25. *Id*. at 632.
26. *Id*. at 631.

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Student Case Comment:
Real Property Law § 291-i: Intended to Streamline and Modernize Real Property Recording for Counties, Real Estate Professionals and Taxpayers[1]

On September 22, 2012, N.Y. Real Property Law § 291-i will become effective, and with it "the way we record real estate transactions will undergo a fundamental change by entering the digital age."[2] Simply speaking, the law will now permit the electronic recording of instruments affecting real property. As the Sponsor of the bill stated, "[u]ltimately, electronic recording will improve the records process from the point of origin (e.g. title companies, banks, attorneys' offices) to country clerks' offices. It will improve work flow, increase productivity, speed up the recording process and improve data accuracy."[3]

Under the old recording system, instruments under Real Property Law Article 9 were signed and notarized, with the originals sent with recording fees, cover sheets, transfer tax returns, and equalization forms to the County Clerk. Once received, the Clerk examined the documents to determine if they are acceptable, and then recorded the instruments with a distinctive record number in the order they were received.

Under the Real Property Law § 291-i, the mechanics are as follows. A scanned image of the original signed and notarized instrument is sent via e-mail to the County Clerk, along with any accompanying documents required to be filed as a condition of recording an instrument affecting real property. For recording purposes, the instruments are "delivered" to the County Clerk once they are successfully transmitted. In addition to scanning the originals, parties to the instrument and notaries may sign and notarize the instrument electronically. This is in contrast to Article 9 of the Real Property Law, which required a "wet signature," or a "signature affixed in ink or pencil or other material to a paper document."[4]

The new system also provides additional protection to the recording process. The digitized documents are digital images of paper documents that are accurate depictions of the original paper documents that cannot be altered without detection.[5] The electronic recording system itself is a specific technology that does not permit changes without leaving an evidence trail.[6] Thus, the instruments are protected from fraud and clerical errors. In addition to being a "green" project that benefits the environment by reducing paper flow,[7] N.Y. Real Property Law § 291-i will increase clerk's offices' accuracy and productivity, thereby enhancing their services and saving taxpayer dollars.[8]

Electronic recording is not a new concept. In 2002, New York State passed the Electronic Signatures and Records Act (hereafter "ESRA"). ESRA was intended to supplement federal laws passed to allow the use of electronic signatures and records in lieu of handwritten hard-copies,[9] However, real property instruments recordable under Article 9 were explicitly excluded.[10] By permitting the use of digitized documents and electronic signatures, RPL § 291-i ensures that ESRA reaches its full potential in supplementing federal laws by supporting and encouraging electronic commerce and electronic government.[11] To this end, it was clear that the legislature believed that it is in everyone's best interest to promote the use of electronic technology in everyday life.

Some may be concerned that "e-laws" exclude older generations who are less technologically savvy. Attorneys in the field who have been working for years without computers may be less inclined to utilize this system, and may be wary of an e-filing system taking over real property recordings. The benefit of § 291-i is that it is not mandated, but is an option for clerk's offices to implement.[12] Once a county clerk's office makes the decision to utilize the electronic system, they are required to accept electronic signatures and records, while also continuing to accept handwritten and paper documents.[13]

There are a few concerns with the new system. The law does not indicate whether the County Clerk's office has the opportunity to reject documents sent for recording. Also, the law does not create a mechanism for the payment of recording fees.[14] Once the legislature solves these issues, utilizing the electronic system will be beneficial to local government, practitioners, and citizens alike. By accepting real property recordings online, it will make filing faster and easier for practitioners and citizens, in addition to making the process "green." Most importantly, one can hope that the streamlined system will assist county clerks in ensuring that real property records are as accurate and up-to-date as possible.

Endnotes

1. N.Y. Office for Tech., *New Law Streamlines and Modernizes Real Property Recording for Counties, Real Estate Professionals and Taxpayers*, September 27, 2011, *available at* http://cio.ny.gov/assets/documents/real_property_memo.pdf.
2. N.Y. Real Prop. Law § 291-i (McKinney 2012); Benjamin Weinstock, *E-Recording is Coming to New York*, Suffolk Lawyer, January 2012.
3. *New York State Senate Introducer's Memorandum in Support*, N.Y. Office for Tech. (September 23, 2011), *available at* http://cio.ny.gov/assets/documents/E-Recording%20Law%20Support%20Memo-1%20copy.pdf.

4. Records and Recordation—Property—Electronic Filing, Ch. 549 (11) (McKinneys Session Laws 2011).

5. *See* Michael J. Berey, *Current Developments: Special Edition: Electronic Recording*, First Am. Title Ins. Co., Sept. 27, 2011, *available at* http://www.firstamny.com/doc/Current_092711.pdf.

6. N.Y. Real Prop Law § 291-i(2).

7. Brian Heaton, *Richland County, S.C., Designs Award-Winning E-Recording Software*, August 30, 2011, *available at* http://www.govtech.com/e-government/Richlan-County-SC-E-Recording-Software.html.

8. *New York State Senate Introducer's Memorandum in Support*, *supra* note 3.

9. N.Y. Office for Tech., *supra* note 1.

10. Berey, *supra* note 5; *New York State Senate Introducer's Memorandum in Support*, *supra* note 3.

11. N.Y. Office for Tech., *supra* note 1.

12. *Id.*

13. *New York State Senate Introducer's Memorandum in Support*, *supra* note 3.

14. Weinstock, *supra* note 2.

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2012 President's Section Diversity Challenge

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Submission Guidelines

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

For ease of publication, articles should be submitted via e-mail to any one of the Co-Editors, or if e-mail is not available, on a disk or CD, preferably in Microsoft Word or WordPerfect (pdfs are NOT acceptable). Accepted articles fall generally in the range of 7-18 typewritten, double-spaced pages. Please use endnotes in lieu of footnotes. The Co-Editors request that all submissions for consideration to be published in this *Journal* use gender-neutral terms where appropriate or, alternatively, the masculine and feminine forms may both be used. Please contact the Co-Editors regarding further requirements for the submission of articles.

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

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