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# CLIENT ADVISORY

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NOVEMBER 2010

## NEW LAW AND RULES AFFECT FORECLOSURE ACTIONS

In recent months, widespread publicity has been given to instances of foreclosure actions being brought by financial institutions that cannot establish that they are the holders of the mortgages being foreclosed. In response to this situation, the New York State court system has issued an administrative order dated October 20, 2010, which requires lawyers representing plaintiffs in residential foreclosure actions to file an affirmation confirming that they have taken reasonable steps to verify the accuracy of the papers they file. The plaintiff's attorney must now certify, under penalty of perjury, that he or she has communicated with a representative of the plaintiff financial institution and has conducted a diligent inquiry regarding the mortgage, and that "to the best of my knowledge, information and belief, the Summons and Complaint and all other documents filed in support of this action for foreclosure are complete and accurate in all relevant respects." A copy of the form is available at <http://www.courts.state.ny.us/attorneys/foreclosures/Affirmation-Foreclosure.pdf>

Many mortgage documents contain clauses providing that in the event of a default by the borrower, the lender is entitled to collect its legal fees incurred in any foreclosure or other collection proceeding. On October 20, 2010, Governor Paterson signed into law a bill known as the "Access to Justice in Lending Act," which enacts new **Real Property Law § 282**. This statute provides that if a mortgage agreement covering residential property contains a clause granting attorneys' fees to a prevailing lender, it will also be interpreted and enforced so as to provide that same right to a prevailing borrower. Thus, if the lender violates the mortgage agreement, or brings an unsuccessful foreclosure action, the borrower will be entitled to recover reasonable legal fees. The law provides that any provision in loan documentation purporting to waive its protections is void. The new law applies to foreclosure actions commenced on or after December 19, 2010.

For purposes of the new statute, "residential real property" is defined as including one-family to four-family residences, as well as condominium and cooperative units that are occupied by the borrower. Although the law was primarily intended to apply to lending institutions, it is anticipated that unit owners may seek to apply it against condominiums and cooperatives that seek to enforce liens against units.

## COURT, ENFORCING RESTRICTIONS ON BORROWING BY CONDOMINIUMS, VOIDS NOTE PAYABLE TO SPONSOR'S AFFILIATE

Historically, New York law imposed rigid limits on borrowing by condominiums. In 1997, the law was changed to give condominium boards more extensive borrowing authority, but subject to specific statutory conditions. A recent court decision affirms that a financial obligation imposed unilaterally to benefit a sponsor without authorization in the condominium documents or under the statutory scheme is invalid. **Board of Managers of Marbury Club Condominium v. Marbury Corners, LLC**, 26 Misc. 3d 1240(A), 2010 WL 3730082, 2010 N.Y. Slip Op. 51650(U) (Sup. Ct. Westchester Co. Sept. 22, 2010).

This case involved a 55-unit new-construction residential condominium. The Offering Plan was filed in 2004 and declared effective in January 2005. On April 14, 2005, the Sponsor caused the Board of Managers, still under Sponsor control, to execute a substantial promissory note in favor of an affiliate of the Sponsor. The note, which was to be paid over a period of 35 years, was secured by an assignment of common charges, a security agreement, and a UCC-1 financing statement. Its existence was disclosed in the Offering Plan, although there was no specific consideration stated for the note nor any indication of a debt it was repaying. In 2009, the Board of Managers, now under unit owner control, brought suit seeking a determination that the note was invalid and could not be enforced, as well as repayment to the Condominium of the amount already paid on the note.

Real Property Law § 339-jj authorizes a condominium board of managers to borrow money and incur debt, and to assign future common charges to secure the borrowing, in two situations. The first is where the Condominium Declaration or By-Laws expressly authorize borrowing power. The second is where the condominium documents do not prohibit borrowing, and the transaction takes place at least five years after the conveyance of the first condominium unit; is for specific purposes listed in the law such as maintenance, repairs, improvements, working capital, bad debts and unpaid common expenses, and the like; and is approved by a majority in interest of the unit owners.

Here, the Board of Managers argued that the promissory note that the Sponsor had caused to be issued at the inception of the Condominium satisfied neither source of borrowing authority. The Board contended that because the Condominium Declaration and By-Laws contained no provision expressly authorizing the Board to borrow money, the first category of borrowing authority did not apply. Also, because the Condominium had not existed for five years and the use of proceeds did not correspond to any statutory category, the second category of borrowing authority did not apply.

The Sponsor's position was that the note had been fully disclosed in the Offering Plan and that the unit owners were aware that it was an obligation of the Condominium when they purchased their units. The Sponsor asserted that the promissory note was part of the overall consideration that it received for sale of condominium units to their purchasers, in lieu of increasing the purchase prices of the units, and that structuring the offering in this way benefited the unit owners by decreasing the assessed valuation of their units for real property tax purposes. The Sponsor urged that the Condominium and its unit owners would receive an unfair "windfall" if they prevailed.

The court granted summary judgment in favor of the Board of Managers. The court agreed with the Board that the Condominium's governing documents, the Condominium Declaration and the By-Laws, did not create any document-based borrowing authority. The reference to the promissory note in the Offering Plan, the court held, could not substitute for expressly including borrowing authority in the Declaration or the By-Laws as required under the statute. Nor was there a statute-based basis of authority for this borrowing. The court held that "[n]ot only is a borrowing by the Condominium for the purpose of financing the acquisition of units, or for the purpose of creating an artificially low sales price for real estate tax purpose[s], not a borrowing within the scope permitted by the statute, but the borrowing occurred within the first five years of the Condominium." In particular, "[b]orrowing by the Condominium in order to line the Sponsor's pockets is simply not within the scope of the limited purposes allowed by" the law. The court also rejected the Sponsor's contention that the review and clearance of the Offering Plan by the Attorney General's office represented a determination that all aspects of it complied with the law.

Ganfer & Shore, LLP provided advice to the Board of Managers in this case, and the court cited a law review article co-authored by Matthew J. Leeds, a member of the firm, in the decision.

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### **The Bedbug Disclosure Act and Cooperatives and Condominiums**

Bedbug complaints and reports of bedbug infestations recently have risen dramatically. New York City's Department of Housing Preservation and Development (HPD) reported receiving over 11,000 such complaints and over 4,000 confirmed infestations in 2009, compared with approximately 500 complaints and 80 infestations just six years ago. The news media has provided extensive coverage of bedbug infestations in popular department stores and landmarked office buildings, as well as in theaters, libraries and schools throughout the City.

To address this perceived epidemic, New York State legislators recently passed the "Bedbug Disclosure Act" (A 10356B/S8130) which added new Section 27.2018.1 to the New York City Administrative Code. Existing Section 27.2018 of the Administrative Code requires all owners of residential accommodations (defined in the law to include residential cooperatives and condominiums) (i) to keep their premises free from rodents and insect infestations, and (ii) to apply continuous eradication measures. Under the Disclosure Act, owners of "housing accommodations" subject to the New York City Administrative Code are required to deliver each tenant signing a "vacancy lease" a notice setting forth the property's bedbug infestation history within the prior year. The term "property" includes both the individual apartment and the building in which such apartment is located. While there are no financial or legal penalties expressly stated in the law for failure to furnish the requisite notice, renters who do not receive the disclosure may file a complaint with the DHCR, and the DHCR can then mandate disclosure.

The DHCR notification form may be found at <http://www.dhcr.state.ny.us/Forms/Rent/dbbn.pdf>.

The Disclosure Act and the form that the DHCR has promulgated create a number of ambiguities with respect to whether cooperatives and condominiums are covered and, if so, the manner in which such buildings must comply.

Even though the Disclosure Act was initially intended to address apartment rentals, there is no definitive decision that it only applies to rentals. On the contrary, the Disclosure Act specifically refers to all housing accommodations subject to the New York City Administrative Code; this includes cooperatives and condominiums as well as rentals. The Disclosure Act and the DHCR form utilize the term "vacancy lease." This is a term commonly used only for rent-regulated apartments and not generally applicable to market-rate rentals and apartment sales in cooperatives and condominiums. Nevertheless, an article published on October 17, 2010 in *The New York Times*, quoted Nancy Peters, a spokeswoman for the DHCR, as stating that cooperatives must follow the Disclosure Law when sales occur, because a purchaser enters into a proprietary lease with the apartment corporation.

In addition, cooperative and condominium boards cannot ignore how the bedbug issue has affected the purchase and sale process within their buildings. Prospective purchasers are, in many instances, investigating the bedbug histories of both a particular apartment and the building as a whole as part of

their attorneys' due diligence process, and they are requiring unit owner-sellers to make representations about bedbug history in the contract of sale.

**During this period of uncertainty as to the reach of the Disclosure Act, cooperative and condominium boards should review their current policies on insect infestation and clearly enunciate policies relating to bedbugs. They may wish to evaluate their positions on disclosures to new purchasers and to existing owners, responsibility for eradication measures, including the financial responsibility for extermination, and notice policies required of unit owners to the board and its managing agents.**

**Position on Disclosures:** Boards should discuss with counsel the form that disclosures about bedbugs should take, and whether notification should be made to prospective purchasers only or to existing unit owners as well. If bedbug infestations and/or eradications have occurred within a building, boards should evaluate how to reflect those occurrences in their meeting minutes and whether a formal notice to prospective purchasers about bedbug infestations and eradication efforts should be added to the standard application package.

**Eradication:** Boards should evaluate how to allocate the cost of eradicating known bedbugs. If the cost is to be borne solely by unit owners, a board should examine its building's house rules and adopt possible amendments enunciating such policy. Boards should review with counsel whether a purchaser, at the time of purchase, should be expressly obligated to accept responsibility for future bedbug exterminating expenses as owner of an infested apartment.

**Obligations of Unit Owners with Respect to Bedbugs:** Boards may want to consider whether unit owners should be required to notify management of any incidence of bedbugs within a residential unit. The DHCR disclosure form requires building owners to state, without qualification, whether there has been bedbug infestation anywhere within the building during the prior year. Cooperative and condominium boards and their managing agents will need to have information available with respect to individual apartment units if they are to accurately complete the DHCR form.

Boards should consider enunciating policies with respect to bedbug incidence reporting and record keeping as well as with respect to the board's right to enter residential units in order to make routine bedbug inspections and to monitor, supervise and confirm the efficacy of eradication efforts. In formulating such policies, boards should evaluate if notice requirements and/or mandatory eradication measures may be imposed only upon new purchasers or whether such policies are to be applicable to all unit owners.

There are reports that legislators may be introducing a separate disclosure law expressly for cooperatives and condominiums. If that occurs, we will monitor and discuss such legislation in a future Client Advisory. Nevertheless, while the initial intent of the legislators behind the 2010 Bedbug Disclosure Act was to address New York City rentals, the Disclosure Act creates sufficient ambiguity as to cooperatives and condominiums that it simply cannot, and should not, be ignored.