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PROTECTIONS FOR NEW YORK RESIDENTIAL TENANTS MAY CREATE HEADACHES FOR LENDERS

Edward L. Harris, Jr. • 212.453.3789 • *eharris@cozen.com*

On December 15, 2009, New York Governor David Paterson signed a bill that significantly revised existing law with respect to mortgage foreclosures. The legislation was preceded by the enactment, in 2008, of protections for borrowers under "subprime" and other similar loans. The 2009 legislation, presumably a response to economic conditions and the resulting "spike" in foreclosure actions (which were noted in its legislative history), expands those protections and extends their scope beyond "subprime" and other similar loans. For example, Section 1305 of the New York Real Property Actions and Procedures Law affords new, and perhaps unclear, rights to tenants of residential properties under foreclosure, having implications for multi-family lenders in general.

New York law has long favored tenants. New York City is, of course, predominantly populated by renters rather than owners. Most of those renters probably have never given much thought to the possibility that, because residential leases are almost universally expressly subordinate to any and all mortgages, a landlord's mortgage default could result in the termination of the property's leases. For many years, this was not a real risk, as most tenants enjoyed either rent-controlled or rent-stabilized status, which gave them certain rights to continued occupancy regardless of sale or foreclosure. Many tenants, however, no longer enjoy such protection. Always alert for the possibility of injustice, the legislature has acted to protect not only unregulated tenants but also occupants under unwritten agreements.

Section 1305 is innocently titled "Notice to tenants." The section does not apply to rent-controlled or stabilized tenants, but rather to anyone else who either "appears as a lessee on a lease...that is subordinate to the mortgage" or who is "a party to an oral or implied rental agreement with the mortgagor." A person meeting either of those tests is a "tenant" under the section. Regardless of the nature and extent of the rights explicitly given to a tenant under his or her lease (or whether or not there was a lease), Section 1305 gives the tenant the right to remain in occupancy following a foreclosure sale for the greater of ninety days after the new owner gives notice to the tenants of such sale or "the remainder of the lease term." The tenancy continues under the same terms and conditions as were in effect at the time of the sale. The lender, or its successor following a foreclosure sale, is required to give all tenants notice of their rights under Section 1305, and the name and address of the new owner. The ninety-day period does not start until the new owner gives proper notice, providing an extended occupancy period even to tenants whose leases may have expired.

There are some mitigating factors. The tenant cannot be the owner of the property being foreclosed, and the rent cannot be "substantially less than the fair market rent" for the unit unless the rent is governmentally subsidized. Fair market rent is defined, in essence, as the rent for a residential unit of similar size, location and condition. Although the definition appears to be reasonable, Section 1305 does not specifically address whether a court should consider the lease term, escalations, or other provisions in determining "fair market rent". The section also permits the new owner to evict the tenant if the tenant defaults in payment of rent or upon the expiration of the ninety days or the "lease" term. It does not expressly deal with past due rent or other defaults under the lease.

Apart from tinkering with long-established rules regarding priority, has the legislature created a monster or have they simply added an additional set of notice and procedural burdens? Normally, most lenders, or foreclosure bidders, would not want to terminate a market-rate lease, unless they had plans for condominium conversion or some other kind of complete change of use. Even if the lease rent is slightly below market, since the majority of residential leases are for a term that is two years or less, a new owner might be content to keep the tenant, rather than try to rent space in a down market. At the same time, if the lender underwrote the loan properly, and the property had enough market-rate leases, there likely would be no mortgage default leading toward foreclosure. One could also argue that, in the current economic climate, unregulated tenants paying fair market rent do not need this protection; they should most readily be able to find alternate housing if their tenancy were terminated by foreclosure.

Simply giving the proper notice to all tenants may pose a problem. Most lenders do not require copies of all leases as a condition of closing their loans, nor do they require the due diligence files to be kept updated as time passes. There is usually a rent roll, which may or may not identify everyone who qualifies as a "tenant" and which is likely to be very stale at foreclosure. Of perhaps greater concern is the mischief that an owner facing foreclosure might cause. Why not give a tenant a five or ten year lease, particularly if it lets the owner pocket some cash? The tenant would be taking a risk that the rent might be considered "substantially less than the fair market rent," which would limit the cash that he or she might be willing to invest. Yet assuming that the new owner would have the burden of proving that the rent was below market, and given the relative scarcity of ten year residential leases for comparison purposes, it might be a risk worth taking. And how, exactly, does the new owner establish the length or financial terms of an oral rental agreement?

Historically, a lender could rely to a certain extent on a title company to identify all of the parties to be named as defendants in a foreclosure action. No such agency will likely have the willingness or ability to identify confidently all of the persons required to be given a notice of foreclosure under Section 1305. Mortgagees should consider increasing their level of due diligence with respect to rent rolls, tenant rosters and leases, although ultimately they will be relying upon their mortgagors for most of this information. Honest and responsible mortgagors will face an additional burden, and yet probably will never default. Third-parties may reduce the amount that they are willing to bid at foreclosure sales. The expense of completing a foreclosure will almost certainly increase. Some tenants may receive a windfall of sorts, and others will receive protection that they do not need, while tenants' lawyers will be able to raise issues concerning adequacy of notice and oral agreements.

Given the impact of Section 1305, as well as of the amendments to Sections 1303 and 1304 and the addition of a new Section 1306 (none of which are discussed above and all of which affect the foreclosure process), will interest rates increase or underwriting terms become less favorable for borrowers? Probably not, at least not unless it becomes clear that the new provisions create substantial delays or increased costs. Foreclosure is already perceived, correctly, as costly and complicated in New York. Stuyvesant Town aside, multi-family loans are generally viewed as a relatively safe and conservative component of a loan portfolio, with a relatively low default rate. The market is also extremely competitive. Although lenders should be aware of the new legislation, it is difficult to gauge its effect on loan terms without more experience.

If you are a lender seeking to make new loans on multifamily real property, or are considering the foreclosure of such a loan, please contact us. Cozen O'Connor attorneys are well versed in the hindrances posed by the new legislation on the foreclosure process, as well as in the possible amelioration of such an impact on the lender's ability to assert its rights at the default of the borrower or a loan guarantor.

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