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N.Y. Real Property Law Journal

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

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Message from the Section Chair

"Have no fear!" said the cat. "I will not let you fall. I will hold you up high as I stand on a ball. With a book on one hand! And a cup on my hat! But that is not ALL I can do!" said the cat... "Look at me! Look at me now!" said the cat. "With a cup and a cake on the top of my hat! I can hold up TWO books! I can hold up the fish! And a little toy ship! And some milk on a dish! And look! I can hop up and down on the ball! But that is not all! Oh, no. That is not all... "Look at me! Look at me! Look at me NOW! It is fun to have fun but you have to know how. I can hold up the cup and the milk and the cake! I can hold up these books! And the fish on a rake! I can hold the toy ship and a little toy man! And look! With my tail I can hold a red fan! I can fan with the fan as I hop on the ball! But that is not all. Oh, no. That is not all..." If you dig deep enough, I'm sure you can recall the famous story by Dr. Seuss, *The Cat in the Hat*. As I write this, I am feeling a lot like that Cat, juggling a zillion things in the air at once, and trying to keep it all from falling straight to the ground in a resounding "CRASH!" (I suppose it fitting that I went as said Cat for Halloween!) Thankfully, here at the RPLS, we have a lot of amazing, capable hands on deck to help juggle all the goings-on in our Section and our area of practice.

We have been busy. David Berkey and Stacy Wallach have been hard at work setting up and coordinating our new NYSBA RPLS Student Internship Program. This program matches law students with law firms to provide students interested in Real Property Law a semester of real life experience in a law firm. The law schools currently participating include Brooklyn Law School, Pace Law School, and St. John's Law School. We are extremely pleased with the response from law firms willing to participate and we look forward to a successful program. We expect that the internship program will commence in the Spring semester of 2012. There are lots of interested students and we are still accepting law firms to participate, so if you are willing and able, please email David Berkey (dlb@gdblaw.com) and Stacy Wallach (slw1234@hughes.net) for more information. Thanks David and Stacy!

As you may know, the NYS Banking and Insurance Departments have been merged to form the NYS Department of Financial Services, which will consist of five divisions, one of which is the Real Estate Finance Division. I am overjoyed to announce that our very own George J. Haggerty, former co-chair of our UPL Committee in the RPLS, is the new Executive Deputy Superintendent of the Real Estate Finance Division. I'm sure the number of balls he has to keep in the air just got significantly larger! Congratulations, George. We wish you the best of success and look forward to working with you on issues affecting real estate finance in N.Y.

We are continuing to work on the Diversity Initiative set forth by NYSBA President, Vince Doyle, and our team of Harry Meyer, Jimmy Lathrop, David Berkey, Mindy Stern and Marvin Bagwell have been diligently putting together the plan of action for the RPLS. Task Forces are also hard at work on issues from Electronic Recording to Escrow Fund Issues, to Title Agent Licensing and more.

I hope you will join us for the NYSBA Annual Meeting in New York at the end of January. Our program has been planned by Steve Alden and begins at 8:45 a.m. on Thursday, January 26th. After a short business meeting for the Section, the main program, "New York Real Estate, It ***IS*** Different," promises an amazing line up of speakers that will both educate and entertain you.

As many of you know, last year we set up the Lorraine Power Tharp Scholarship from the RPLS to be given to a student who exemplifies all the wonderful personal and professional qualities possessed by our dear Lorraine. I am overjoyed this year to announce the winner of this year's scholarship is Milana Khlebina, a 3L at St. John's Law School. Congratulations, Milana! We look forward to presenting the scholarship to you in January.

Finally, with all of this going on, and with what I hope and presume is a busy and fulfilling personal and professional life for each of you, I want to remind you not to take yourself too seriously. I want to thank my "Thing 1 and Thing 2," Laura Keller and Danika Pratt, for helping me juggle all my projects in the air while reminding me to take time and have fun too. The Cat in the Hat brought chaos, but it was fun, and in the end, he cleaned up the mess and no one was harmed!

Heather C.M. Rogers

Private Transfer Fee Obligations Banned in New York

By Michael J. Berey

On September 23, Governor Cuomo signed into law legislation adding new Article 15 ("Prohibition and Disclosure of Private Transfer Fee Obligations") to the Real Property Law, the Article to be known and cited as the "Private Transfer Fee Obligations Act" (the "Act").[1] A private transfer fee, also identified in the Act as a private transfer fee obligation, is typically a charge imposed by a real property developer of 1% of the sales price, payable to the developer or to its designee on each transfer of an interest in real property within the developer's project, such as a private home. The obligation to pay this charge affects each transfer of an interest in the same property for as long as ninety-nine years, and the charge is due even when the property owner has no equity in the property.[2]

A developer's designee may be a trustee. If so, the trustee, after retaining a portion of the charge for its expenses, distributes the balance of the fee to the developer, to a licensing company, and to any other persons who have purchased from the licensing company interests in an income stream arising from a securitized pool of private transfer fees on various projects.[3]

Instruments imposing a private transfer fee provide for a lien on the property to arise whenever the charge is due and unpaid.[4] Presumably, the provision for a lien will subject the instrument providing for the private transfer fee to the payment of the mortgage recording tax. How and when the mortgage recording tax would be computed is uncertain, and interest and penalties will accrue for the non-payment or the late payment of the tax.

Under the Act, all private transfer fee obligations set forth in instruments entered into or recorded after the Act's effective date are void and unenforceable.[5] Private transfer fee obligations entered into prior to the effective date of the Act are limited, as discussed below.

The concept of private transfer fees has not had a favorable reception. For example, the Federal Housing Finance Agency, the regulator and conservator of Fannie Mae and Freddie Mac, and the regulator of the Federal Home Loan Banks issued a proposed rule that would prevent Fannie Mae, Freddie Mac and the Federal Home Loan Banks from investing in mortgages on any property burdened with a private transfer fee covenant.[6] The Director of the Office of Single Family Program Development of the U.S. Department of Housing and Urban Development ("HUD"), in a letter to the President of ALTA (American Land Title Association), has stated the following: "HUD agrees that this [private transfer] fee unnecessarily increases the cost of homeownership, and in most cases the homebuyer is unaware of its existence. Our General Counsel has confirmed that private transfer fees would clearly violate HUD's regulations at 24 C.F.R. § 203.41, which prohibit 'legal restrictions on conveyance', defined to include limits on the amount of sales proceeds retainable by the seller."[7]

The Real Property Law Section of the New York State Bar Association, in its Memorandum of Support of the legislation objected "to private transfer fee obligations as being adverse to the interests of consumers. A private transfer fee obligation causes additional, unnecessary closing expense without any benefit to property sellers and purchasers while depressing prices and complicating and delaying closings."[8] Other commentators have also asserted that these charges provide no benefit to homeowners or their property.[9]

New York is the 37th state to ban private transfer fees.[10] The Legislature, in Section 471 of the Act, noting the public policy of New York supporting "the marketability of real property and the transferability of interests in real property free of title defects or unreasonable restraints on alienation," declared "that private transfer fee obligations violate this public policy by impairing the marketability and transferability of real property and by constituting an unreasonable restraint on alienation.…"[11] Governor Cuomo, in his Approval Memorandum, concurred, stating that "private transfer fees are objectionable and contravene the public interest because they needlessly drive up the cost of real property, making it more difficult for a prospective purchaser to acquire such property."[12]

Definitions

A private transfer fee is defined in Section 472 ("Definitions") of the Act as "a fee, charge or any portion thereof, required by a private transfer fee obligation and payable, directly or indirectly, upon the transfer of an interest in real property, or payable for the right to make or accept such transfer, regardless of whether the fee or charge is a fixed amount or is determined as a percentage of the value of the property, the purchase price, or other consideration given for the transfer."[13]

A "private transfer fee obligation" is defined as "an obligation arising under a declaration or covenant recorded against the title to real property or under any other contractual agreement or promise, whether or not recorded, that requires or purports to require the payment of a private transfer fee to the declarant or other person specified in the declaration, covenant or agreement, or to their

successors or assigns, upon a subsequent transfer of an interest in the real property."[14]

A "transfer" is "the sale, gift, conveyance, assignment, inheritance, or other transfer of an ownership interest in real property located in this state."[15]

Prohibition

Under Section 473 ("Prohibition") of the Act, a private transfer fee obligation "recorded or entered into" in New York after the effective date of the Act is not binding or enforceable and does not run with the land.[16] Under Section 474 ("Liability for violations"), "any person who records or enters into an agreement imposing a private transfer fee obligation...after the effective date of this section shall be liable for (1) any and all damages resulting from the imposition of the transfer fee obligation on the transfer of an interest in real property...and (2) all attorneys' fees and costs incurred by a party to the transfer or mortgagee of the real property to recover any transfer fee paid or in connection with an action to quiet title."[17] An agent acting on behalf of a principal, such as a person engaged by a developer to record an instrument purporting to impose a private transfer fee obligation, has no liability.[18]

Excluded Transactions

Certain types of charges are expressly excluded in Section 472 from the definition of a private transfer fee. These include, for example: additional consideration payable by the transferee to his or her transferor after closing, such as consideration paid on a one-time basis based upon any subsequent appreciation in the value of the property, a commission payable to a real estate broker, shared appreciation or profit participation payable to a lender, payments made for the release of a right of first refusal to purchase or of an option to purchase, amounts payable to or imposed by a governmental entity, amounts payable to a not-for-profit or charitable organization for activities benefiting the community that is subject to the payment, and amounts paid to purchase or transfer a club membership relating to the property.[19]

Private transfer fees also do not include cooperative and condominium flip taxes or similar charges. Excluded from the definition of a private transfer fee is "[a]ny fee, charge, assessment, fine, or other amount payable to a homeowners' association, condominium, cooperative, mobile home, or property owners' association pursuant to a declaration or covenant or law applicable to such association.…" To prevent private transfer fees from being paid indirectly to a developer when a property being transferred is a part of any such community, the Act also provides that "[n]o amount shall be paid to a homeowners,' condominium, mobile home, or property owners' association for the payment to the declarant of the condominium or the creator of the homeowners,' cooperative, mobile home or property owners' association, or their designee."[20]

Granfathered Private Transfer Fees

Under Section 473 of the Act, private transfer fee obligations "recorded or entered into" prior to the effective date of the Act are not prohibited. It is not clear from the text of the Act how a private transfer fee obligation entered into but not recorded before the effective date of the Act can be valid while instruments imposing such charges "recorded" after the effective date are unenforceable.[21]

In grandfathering any prior instrument imposing a private transfer fee obligation, the legislature at the suggestion of the Real Property Section took care to ensure that it did not validate an agreement that would otherwise be unlawful under New York's common law.[22] The courts may, for example, hold that an agreement imposing a private transfer fee is an invalid restraint on alienation or that it is unenforceable against future owners of a property since it does not "touch or concern" the land. Under Section 473, "this Article shall not validate any private transfer fee agreement that is contrary to the laws of this state." Further, "[t]his section shall not be deemed to require that a private transfer fee obligation recorded, filed or entered into in this state before the effective date of this section is presumed valid and enforceable."[23]

If there is an grandfathered agreement requiring the payment of a private transfer fee, the seller of an interest in real property which is subject to such an agreement (including presumably the seller of a cooperative unit) is required by Section 475 ("Disclosure"), prior to the buyer's signing the contract of sale, to furnish the purchaser a written statement of the existence of the private transfer fee obligation, with a description of the obligation and a statement that it is subject to the prohibitions of the Act.[24]

For a private transfer fee obligation "imposed prior to the effective date of the Act, under Section 476 ("Notice requirements for existing private transfer fee obligations") the so-called "receiver of the fee," the person or entity to which the private transfer fee is to be paid, is required within six months of the Act's effective date to file (that is, record) against the subject property in the county records an acknowledged document meeting certain requirements as to form, stating, among other things, the legal description of the burdened property and the name and contact information for the receiver of the fee.[25]

If the receiver of the fee does not file the statement, the affected property may be transferred free and clear of the private transfer fee obligation.[26] If a notice of transfer fee is filed, but the receiver of the fee fails to provide within thirty days of the date of a written request sent to the address in the recorded notice of transfer fee a written statement of the

amount payable, the transferor may convey the property free and clear of the private transfer fee obligation. To transfer the real property interest free and clear of the obligation, the transferor must record "prior to or simultaneously with" the conveyance an affidavit stating that a request for a written statement of the transfer fee payable was sent to the address set forth in the notice of transfer fee filed by the receiver of the fee, and the receiver of the fee failed to provide the statement requested within thirty days of the date on which the transferor sent its request. When recorded, the affidavit is deemed to be conclusive evidence of the facts stated therein.[27]

It is believed that there will be few, if any, grandfathered private transfer fee obligations in New York due to the possible mortgage tax consequences of having recorded such an agreement.[28] If, however, there are any grandfathered instruments, counsel for the parties to a transaction affected by such an instrument will need to follow the guidelines set forth in the Act. Their title insurers will need to determine what affirmative insurance, if any, they can afford in title insurance policies to issue. Private transfer fee obligations recorded or entered into on or after the effective date of the Act are not enforceable.[29]

Nothing contained in this Article is to be considered as the rendering of legal advice for specific cases, and readers are responsible for obtaining such advice from their own legal counsel. This Article is intended for educational and informational purposes only. The views and opinions expressed in this Article are solely those of the Author, and do not necessarily reflect the views, opinions, or policies of the Author's' employer, First American Title Insurance Company.

Endnotes

1. Ch. 522, § 470-76, 2011 N.Y. Laws, State of N.Y., 234th Sess., *available at* http://open.nysenate.gov/legislation/bill/A7358-2011.
2. *See* Memorandum of Sen. Libous on Bill S5203 (234th Sess.), *available at* http://open.nysenate.gov/legislation/bill/S5203-2011.
3. *See id*.
4. *See id.*
5. *See* Ch. 522, § 473 *supra* note 1.
6. Private Transfer Fees, 76 Fed. Reg. 6702-02, 6703 (Feb. 8, 2011) (to be codified at 12 C.F.R. pt. 1228).
7. *See* Letter from Margaret E. Burns, Director of Office of Single Family Program Development, U.S. Department of Housing and Urban Development, (undated), http://www.alta.org/press/FHA_101510.pdf, pg. 47.
8. Michael J. Berey, *The Real Property Law Sections Support This Legislation*, N.Y.S.B.A. (May 16, 2011), http://www.nysba.org/Content/ContentFolders/Legislation/LegislativeMemoranda20112012/RPLS14.pdf; *see also* Berey *infra* note 10.
9. *See Private Transfer Fee Covenants and Their Consequences for Real Property*, Am. Land Title Ass'n (Feb. 2010), http://www.alta.org/advocacy/docs/ALTATransferFeeCovenant_Backgrounder.pdf; *see also* R. Wilson Freyermuth, *Putting the Brakes on Private Transfer Fee Covenants*, Prob. & Prop., July/Aug. 2010, *available at* http://www.americanbar.org/publications/probate_property_magazine_home/probate_2010_index/probate_july_aug_2010_index.html (stating that private transfer fees impede the sale of real estate and the transfer of land by imposing additional unwarranted transaction costs); Marjorie Ramseyer Bardwell & James Geoffrey Durham, *Transfer Fee Rights—Is the Lure of Sharing in Future Appreciation a Flawed Concept?*, Prob. & Prop., May/June 2007, at 28, *available at* http://www.americanbar.org/publications/probate_property_magazine_home/probate_2007_index/probate_may_june_2007_index.html (raising questions about the validity of private transfer fee covenants, and laying out several grounds for attacking a transfer fee device).
10. *See* Press Release, Am. Land Title Ass'n (Sept. 26, 2011) (on file with author); *see also* Michael J. Berey, *Current Developments: Special Edition*, First Am. Title Ins. Co. (Sept. 27, 2011), http://www.firstamny.com/doc/Current_092711.pdf.
11. Ch. 522, § 471, *supra* note 1.
12. Governor's Approval Memorandum, ch. 522, no. 8 of 2011, (Sept. 23, 2011), *available at* http://public.leginfo.state.ny.us/menugetf.cgi. The memorandum may be accessed by inputting A7358 into the field for Bill No.
13. Ch. 522, § 472(1), *supra* note 1.
14. *Id*. § 472(3).
15. *Id.* § 472(1).
16. *Id*. § 473.
17. *Id*. § 474.
18. *Id.*
19. Ch. 522, § 472, *supra* note 1.
20. *Id.*
21. The Act merely states that "[t]his section shall not apply to a private transfer fee obligation recorded or entered into prior to the effective date of this section" without any explanation as to the mechanisms of recording of the private transfer fee obligations that were entered into prior to the enactment of the Act. *See id*. § 470-73.
22. The Real Property Law Section of the New York State Bar Association in its Memorandum in Support suggests that "[p]rivate transfer fee obligations may not be enforceable under New York's common law." Memorandum from Michael J. Berey, *supra* note 8.
23. Ch. 522, § 473, *supra* note 1.
24. *See id*. § 475.
25. *See id*. § 476.
26. *See id.*
27. *See id.*
28. Readers are requested to email mberey@firstam.com information as to any private transfer fee obligation in New York predating the Act.
29. *See* Ch. 522, § 473, *supra* note 1.

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Introduction to the New York Lien Law for Counsel to Owners of Troubled Construction Projects

By Joshua Stein and Colin Bumby

A substantial commercial construction project (a "Project") can go wrong in many ways. One common way occurs when the general contractor (the "GC") becomes insolvent or otherwise trips and falls and cannot finish the project. When that happens, the owner of the Project (the "Owner") will find itself in an awkward corner, potentially facing claims from parties that Owner didn't even know existed.

When an Owner engages a GC under a traditional general contract, that GC agrees to build the Project for a fixed fee[1] and pay all subcontractors and material suppliers (collectively, "Vendors"[2]). At any point during the Project, however, GC may drop the ball as suggested above, or may default in other ways. In a perfect world, i.e., in an Owner's fantasyland, GC will at that point have paid all its Vendors everything due them. GC will have funded these payments from money that Owner gave GC to pay for the Project.

More likely, however, GC will not be current in paying Vendors. To the contrary, GC's problems will usually also lead to delayed Vendor payments. GC will have used funds from this Project to pay other debts or clean up similar messes on previous Projects. Or those payments may have funded home theater systems, birthday parties, and cruises in the Caribbean and elsewhere.[3]

Owner will derive cold comfort from the fact that GC remains liable to unpaid Vendors. As a practical matter, unless someone pays Vendors, they won't keep working. Although Owner could conceivably finish the Project with replacement Vendors, that process will cause huge disruptions and delays. Moreover, Owner will find some Vendors so vital that Owner cannot replace them.

In New York, Owner may also face direct claims against the Project and the real property on which it sits (together, the "Site") from unpaid Vendors, as a result of New York's "floridly complicated and impenetrably opaque"[4] Lien Law (the "Lien Law"). The Lien Law gives Vendors two possible ways to make claims against Owner or the Site, in addition to any direct contractual rights that any particular Vendor can assert.[5]

First, Lien Law Article 2 ("Article 2") allows an unpaid Vendor to file a mechanic's lien against the Site (a "Lien") and enforce that Lien.

Second, Lien Law Article 3-A ("Article 3-A") creates a separate trust fund regime to protect GCs and Vendors. Article 3-A makes Owner a statutory trustee over certain funds available for a Project. If Owner diverts assets from that trust, then Owner may incur liability to any Vendors that hold Liens or contracted directly with Owner.[6]

Owner will want to minimize its Article 2 and Article 3-A exposures if a Project goes bad, whether because of GC default or bankruptcy or otherwise. Owner will also want to: (1) complete the Project; (2) do so on time; and (3) do so on budget. As a practical matter, Owner will count itself lucky to achieve even the first goal if GC gets into trouble. But the strategies suggested here may help Owner achieve the best possible outcome under the circumstances.

As always, the legal rights, obligations, analysis, and strategy for any Project will depend on the facts and circumstances of that Project. That holds particularly true for the Lien Law. Application of the Lien Law to any set of facts usually amounts to a difficult exercise, given: (a) the opacity of the Lien Law; (b) the limited scope of cases interpreting the Lien Law; (c) the fact-intensive nature of the scant case law that does exist; and (d) the history of surprises in this area, particularly in Article 3-A.[7]

Thus, although this article seeks to offer a general roadmap, any Owner or its counsel must fully understand the facts and think through the law that applies to them, and not rely on this summary. This article offers only a rudimentary introduction to the Lien Law, and only from an Owner's point of view.

I. Owner's Obligations Under the Lien Law

This article first summarizes an Owner's exposure under Article 2, then turns to Article 3-A. It does so for three reasons, all discussed at greater length below:

1. Article 2 Lien claims have priority over Article 3-A trust claims. Article 3-A expressly blesses the use of "trust assets" to pay Liens,[8] and imposes extra liability on an Owner that applies Article 3-A trust funds to make payments that violate Article 2 priority rules for Liens.[9]
2. The Article 2 priority rules restrict an Owner much more than comparable rules under Article 3-A.
3. Owner must therefore figure out how to contend with its Article 2 obligations before it figures out how to deal with Article 3-A.

This discussion focuses primarily on Owner's Lien law problems. For a typical Project, of course, most of the money will come from a construction lender. In some ways, a lender's issues will overlap Owner's. The Lien

Law's requirements for a "building loan contract" will, however, compound a lender's headaches. This article does not cover the special concerns of a construction lender.[10]

A. Owner and Article 2

If a Vendor files a valid Lien under Article 2, Owner will need to pay that Lien or figure out how to get rid of it. If Owner doesn't, then eventually the Lien holder can foreclose its Lien and force a sale of the Site. In the meantime, so long as a Lien remains in place, Owner may find the Site unsaleable and unfinanceable. Often, Owner cannot proceed with the Project either, because Owner's lender will refuse to fund further advances.

Article 2 contains two sets of rules that Owner must understand.

First, Article 2 defines how much a Vendor can expect to successfully claim on its Lien. As against the rest of the Lien Law, these provisions are relatively comprehensible.

Second, Article 2 defines the priorities an Owner must follow if it wants to pay multiple Lien holders. These rules limit Owner's freedom to play favorites in paying Lien holders.

1. Owner's Liability to Mechanic's Lienors

In general, Owner faces exposure for the amount a Vendor claims in a Lien only to the extent that: (a) the Lien is valid; (b) the Lien holder's claim represents a reasonable estimation of the amount owed, and, (c) Owner still owes money to GC. If the Owner does not owe money to GC when a subcontractor files a Lien, but an open balance later arises, the Lien will attach only to the after-arising "Lien Fund."[11]

First, Owner is only liable to a Lien holder if the Lien is valid. To obtain a valid Lien, the claimant must: (a) follow numerous technicalities to properly file the Lien,[12] and (b) meet three substantive conditions in Lien Law Section 3. Those three substantive conditions are:

a. Vendor must fall within a certain class of persons that provide materials or services that improve property, which includes contractors, subcontractors, laborers, and material suppliers;[13]

b. Vendor must have "permanently" improved Owner's real property;[14] and

c. Owner, or its agent (who can be GC or some other Vendor) must have requested, or at least consented to, the improvement.[15]

Second, even if the Lien is valid, Owner faces exposure only to the extent of the unpaid balance due the Lien holder when it filed its Lien.[16]

Third, Vendor must have "substantially performed" its contract before it can collect what it is owed under its contract.[17] Otherwise, the Vendor can recover only in "quantum meruit." Although the measure of damages based on "substantial performance" consists of the contract price less the cost of completion, the measure of damages in "quantum meruit" consists of the fair value of its work—measured not by the contract balance, but instead by the reasonable value to Owner of Vendor's labor and materials.[18]

A court will generally hold that Vendor has "substantially performed" if Vendor can demonstrate that it "has in good faith intended to comply with the contract," and has substantially done so.[19] Thus, if Vendor's work contains slight defects or deviations from the plans, it can still collect the unpaid balance of its contract minus any damage that resulted from defects or deviations.[20] If, however, Vendor's work is somewhat significantly incomplete or defective—even, e.g., to the extent of as little as five percent of the total value of the contract—a court may decide that Vendor has not "substantially performed."[21] As in so many areas of the law, and particularly the Lien Law, much depends on the particular facts and circumstances and how a specific court decides to view them.

The doctrine of "substantial performance" applies a little differently to an "installment contract," a contract structure often seen in construction. Here, Vendor accepts payments in installments based on Vendor's completion of specified tasks. An installment contract might say, for example, that Vendor will receive a percentage of the contract based upon completion of each floor in a multifloor building. Vendor will be entitled to payment under its contract to the extent it has "substantially performed" each installment even if it has not "substantially performed" the entire contract.[22] Thus, if Vendor has substantially completed two of five floors, it will be entitled to the contract price for only those two floors. For the other three floors, Vendor will be limited to "quantum meruit"—at least until Vendor substantially completes each of those three floors.

The doctrine of "substantial performance" should not be confused with the concept of "substantial completion" in many construction contracts.[23] The American Institute of Architects ("AIA") form construction contract defines "substantial completion" as the stage in the Project when "Owner can occupy or utilize the [w]ork for its intended use."[24] Put another way, the AIA's version of "substantial completion" occurs at the point when Owner can take beneficial occupancy of the work.

A construction contract will often require Vendor to demonstrate "substantial completion" as a condition to payment, or at least as a condition to the final payment.[25] The contract may also require Vendor to obtain a certificate from the architect stating that the work has been completed in accordance with the terms and conditions of the contract, as a condition precedent to payment.[26] Where a certificate is required, a Lien will not be enforced without such certificate, unless Vendor can demonstrate that it was unreasonably withheld.[27]

As a fourth limitation under Article 2, Owner's liability to Lien holders cannot exceed the total amount Owner owes GC.[28] Each Vendor essentially steps into the shoes of GC in asserting claims against Owner (in effect becoming "subrogated" to GC's claims against Owner), and those claims cannot exceed whatever claims GC could assert against Owner.[29] As a result of this principle of subrogation, Owner owes Vendor only the lesser of:

a. Whatever GC owes Vendor when Vendor files its valid Lien, and

b. Whatever Owner owes GC when Owner receives notice of filing of that Lien.

Similarly, if Vendor has contracted out part of its contract to some other Vendor (a "Sub-Vendor," typically a subcontractor), Sub-Vendor becomes subrogated to Vendor's rights. Thus, Sub-Vendor's Lien is valid and enforceable only up to the amount, if any, still due and unpaid to Sub-Vendor from GC.[30] If no funds are due, Sub-Vendors are relegated to their trust fund rights.[31]

Where GC owes Vendor funds, Owner would then owe Sub-Vendor the lesser of:

a. Whatever Vendor owes Sub-Vendor when Sub-Vendor files its valid Lien,

b. Whatever GC owes Vendor when GC receives notice of filing of that Lien.

These "subrogation"-based limits are also subject to the requirements for "substantial performance" discussed above. If, for example, GC has not "substantially performed" under its contract, then Vendor Lien holders will see their claims capped at GC's "quantum meruit" damages, if any, instead of as described in subparagraph "b" of the two preceding formulas.[32]

2. Priorities Under Article 2

If Owner must pay one Lien holder, Owner will probably find it must pay many. If so, it will need to navigate the complicated and perilous Article 2 priority rules. These priority rules should, however, not be relied upon as written. They are nuanced, have been heavily litigated, and the Lien Law gives courts plenty of authority and latitude to fashion remedies as they see fit.[33] For context, an action to enforce a Lien takes the form of an action to foreclose a mortgage.[34] This means that the action is one in equity.[35] Against that backdrop, Owner must proceed with great care.

Article 2 priority rules do not follow the "first-to-file" priority rules that typically apply in real property law. As among Lien holders claiming from the same Project, order of filing does not matter.[36] Instead, Lien holders will be treated the same regardless of when they filed, with two important exceptions. First, if a Vendor does not file until after an earlier filed Lien has been discharged, the late filing Vendor will lose any rights to whatever Owner paid the Lien holder who filed first.[37] Second, if a Vendor does not file until after Owner has conveyed the property under a recorded deed containing the statutory covenant provided by Lien Law § 13(5), that Vendor will not be treated the same as those Vendors who filed before the conveyance.[38]

The Lien Law sets four priorities as among valid Liens in a foreclosure action under Article 2:

1. Laborers for daily and weekly wages;[39]
2. Sub-Vendors;[40]
3. Vendors that directly supplied GC;[41] and finally
4. GC and other parties with whom Owner has contracted directly.[42]

Within each priority level, multiple Lien holders have "parity," meaning they each take a pro rata share in proportion to their claims.[43] Where a single contract covers more than one building, each Vendor should have a priority claim on the part of the real property or the particular building where such Vendor's labor was performed or such Vendor's materials were used.[44]

If Owner disregards these statutory priorities and chooses to pay certain favored Vendors first, Owner should not face significant penalties. Lien Law § 56 states: "Payments voluntarily made upon any claim filed as a lien shall not impair or diminish the lien of any person except the person to whom the payment was made."[45] Implicitly, Lien Law § 56 recognizes and permits voluntary payments of any Lien. Although payments made under Lien Law § 56 to certain Vendors do not diminish the Lien of other Vendors, practically speaking, the payments work to reduce the overall Lien fund. First, most construction contracts will reduce the contract price payable to GC when Owner pays Vendors and Sub-Vendors directly. Second, GC will not be able to include the amount of the Lien Law § 56 payment to Vendor or Sub-Vendor in its Lien claim.

Because Lien Law § 56 does not expressly limit an Owner's liability, a court could conceivably frown upon[46]—and impose liability on account of—payments that an Owner makes to favored Vendors without regard to Lien priority rules. No available case considers that specific question.

B. Owner as Statutory Trustee Under Article 3-A

Above and beyond Liens arising under Article 2, Lien Law Article 3-A establishes an entirely separate legal regime. Under this system, Owner can automatically become a statutory trustee to hold certain "trust assets"

for the benefit of certain Vendors known as "trust beneficiaries."[47] These "trust assets," as provided for in Article 3-A, include funds that Owner receives in connection with an improvement of real property.[48] Funds that do not originate from any of the seven sources described in Article 3-A are not "trust assets."[49] For example, Owner's own invested equity capital does not constitute a "trust asset."

Although any Owner may find Article 3 a greater nuisance than Article 2, Article 3-A is, as a substantive matter, not nearly as onerous as Article 2. Usually, Owner will not owe any Vendor more under Article 3-A than Owner owes the same Vendor under Article 2. Article 3-A also usually allows an Owner to pick and choose which Vendors to pay first, but subject to one crucial caveat. If Owner violates the very limited priority rules in Article 3-A, Owner can face severe consequences under New York Penal Law.[50] It's a crime!

1. Owner's Liability to Vendors

Owner's potential liability under Article 3-A is staggeringly broader than under Article 2. Owner will, however, rarely owe Vendors more under Article 3-A than under Article 2.

Owner *potentially* owes Vendors the entire amount of Owner's "trust assets," which consist of certain funds Owner has received or is due to receive to complete the Project. Owner's "trust assets" include its construction loan proceeds plus any availability—including future availability—under the construction loan. The "trust assets" in Owner's hands could also include other funds Owner received, or Owner's rights of action for payment of funds in connection with the Site.[51] Owner should note that if a single construction loan agreement governs the entire Project, this will create a single pool of "trust assets," even if multiple notes and mortgages exist. If multiple construction loan agreements govern different pieces of the Project, multiple pools of "trust assets" will exist.[52]

From this large pool of "trust assets" under Article 3-A, however, only a certain limited class of Vendors will actually have the right to make claims as "trust beneficiaries." Lien Law § 71(4) defines "trust beneficiaries" as Vendors that hold valid "trust claims."[53] Most Vendors will, however, rarely have valid "trust claims" against Owner. That is because, under Lien Law § 71(3)(a), for the trust where Owner acts as trustee, "trust claims" means only "claims of contractors, subcontractors, architects, engineers, surveyors, laborers and materialmen arising out of the improvement, *for which the owner is obligated*."[54] Under New York law, Owner is "obligated" only to those Vendors that are in privity of contract with Owner[55] or that have actually obtained valid Liens on the Site.[56] In the typical case, Vendors who are "trust beneficiaries" have obtained valid Liens, so their "trust claims" simply consist of whatever they can claim under Article 2. Sub-Vendors who are not in privity of contract with Owner—hence unable to claim against "trust assets" held by Owner—may still have valid "trust claims" against the GC or other Vendors who have received "trust assets."[57]

2. Article 3-A Priority Rules

Owner can pay favored Vendors first out of the "trust assets"—even if those Vendors are not themselves "trust beneficiaries"—if Owner follows a few simple rules.

Owner can pay any Vendor claim for a cost of improvement, and can apply any "trust asset" among Vendors as Owner chooses, so long as a court has not directed Owner to make particular payments of "trust assets."[58] A court will probably direct payments only if it finds that Owner has diverted "trust assets."[59] Owner can avoid diverting "trust assets" by following two precautions.[60]

First, Owner cannot use "trust assets" for any purpose except the purpose of the trust. Virtually every payment Owner would want to make for the Project will probably meet that test, given that Lien Law § 71 defines the "purpose of the trust" as "payment of the cost of improvement."[61] Courts have occasionally found that a few Project-related payments an Owner might want to make would flunk that test, such as refunds to Owner for emergency advances, corporate administrative costs, and attorneys' fees. [62] Despite occasional exceptions like these, the "purpose of the trust" remains quite broad.

Second, Owner must keep records on the inflow and outflow of "trust assets"—failing which, a court can decide that Owner has "diverted trust assets."[63] Any diligent Owner can usually satisfy these recordkeeping requirements, though, because Owner should typically maintain most or all of the same records for its own purposes anyway. [64] Owner's failure to maintain these records could be disastrous should a "trust beneficiary" demand to examine them, especially if Owner could not reconstruct them quickly under pressure.[65]

If Owner does not follow these two simple rules in disbursing trust assets, Owner may face dire consequences. Courts have wide latitude to fashion the "appropriate" relief to protect "trust beneficiaries."[66] Courts can recover "trust assets" disbursed to third parties, require Owner to replenish the trust, limit Owner's authority over the trust, direct Owner to distribute trust assets based on a set priority scheme, and hold Owner (or certain Owner agents) liable for damages. The Lien Law even contemplates criminal liability.[67]

II. Owner's Strategies to Contend with Lien Law

Owner can and should plan a strategy early in the life of any Project—and certainly as soon as a prob-

lem erupts, although at that point it can be too late—to minimize Owner's exposure to a financially troubled GC, so Owner can come as close as possible to achieving its three goals: completing the Project, doing so on schedule, and doing so on budget. This section of the article discusses some measures that Owner and its counsel might consider taking.

A. Prepare the Battlefield

Contracts between Owner and GC must address the handling of Liens. In general, Owner should require GC to secure the discharge of Liens in fairly short order. Until Liens are discharged, Owner must be exceedingly careful before disbursing funds to GC, because payments made to a GC after Owner receives notice of a Vendor's Lien will not reduce that Lien, and Owner may end up paying twice for the same work.

B. Gather Information

Owner may not know its GC has been delinquent in paying Vendors until the moment Owner receives a Vendor's Notice of Lien.[68] With its bubble of blissful ignorance burst, Owner should promptly take all reasonable steps to collect information about its Project to (a) understand the whole picture, (b) plan Owner's strategy and (c) prepare to defend itself in court.

This information gathering should be given the highest priority. It may amount to a time-consuming ordeal. Even while Owner collects information, Owner will need to make some strategic decisions. Additional Notices of Lien will probably arrive during this process, further complicating matters.

1. Information Owner Needs

Owner will want answers to a variety of questions, including:

a. How much does Owner owe GC under the contract?

b. How much does GC owe to Vendors under their contracts?

c. What do these Vendors owe their Sub-Vendors?

d. To what extent have GC and Vendors substantially performed under their contracts?

e. Which Vendors have filed Liens?

f. Of the various GC and Vendor claims, how much covers labor?

g. How much retainage does Owner still hold, and what claims does Owner anticipate against the retainage?

2. Sources of Information

With any luck, Owner will already have maintained the records that Article 3-A requires. But those records, even when combined with information in Notices of Lien, will probably not give Owner a full picture of the Project. Owner should turn to other sources, including:

a. GC's records;

b. Vendor records;

c. A full title search of the Site, to include an examination of any unrecorded but filed documents under the Lien Law;

d. A litigation search on GC and perhaps major Vendors; and

e. Physical inspection of the Site.

GC's records probably constitute Owner's best source of information, though Owner may have difficulty obtaining them, depending on the terms of Owner's contract with GC, Owner's leverage against GC at the time, and GC's willingness to cooperate. Owners should consider retaining a forensic accounting firm to assist in unraveling the mess.

Even if the construction contract does give Owner the right to review GC's payment records, GC might just tell Owner to take a flying leap—especially given that GC knows Owner will probably soon terminate GC's contract anyway. Owner might have better luck by seeking the assistance of a cooperative Vendor. In doing so, Owner would indirectly take advantage of Article 3-A, which makes GC a statutory trustee of its own Article 3-A trust. As a result of that trust, Article 3-A allows Vendors to demand copies of GC's records. Still, even if a cooperative Vendor exists, that Vendor may need a month to obtain GC's records. Finally, if GC becomes subject to bankruptcy or similar protection, GC's records may become publicly available.

C. Complete the Project: Dealing with the Lender

For Owner to achieve its primary goal, completing the Project, Owner will typically need a source for more funds. If a Lien has been filed against the Project, this will usually constitute a default under Owner's construction loan and excuse the lender from further funding. The documents will, however, usually let Owner solve that problem by bonding the Lien.[69]

Once Owner knows a Lien has been filed, Owner will usually want to notify its construction lender—so the lender hears about the problem first from Owner rather than from a regular title continuation—and be ready to answer the lender's questions about the Lien. These questions will usually not vary much from the questions Owner will ask about the same Lien, as described above. More generally, the construction lender's agenda will largely overlap Owner's agenda, except that the lender will have some unique burdens, concerns, and risks driven by the "building loan" provisions of the Lien Law[70] and a major recent surprise from the New York Court of Appeals in interpreting a lender's risks under Article 3-A.[71] That lender-specific rat's nest lies beyond the scope of this article.

D. Bond the Project

The filing of a single Lien can function much like a drop of blood in a tank of sharks. Other Vendors will race to file their own Liens, further

complicating Owner's Project and relations with its construction lender.

Owner can, in theory, prevent other Vendors from filing additional Liens against the Site by filing a bond under Lien Law § 37.[72] After Owner files such a bond, any future Liens will attach to the bond, not the Site.[73] A § 37 bond is, however, quite expensive, typically costing 1% to 2% of the bond amount. It also requires Owner to deliver substantial credit support, perhaps at least the remaining cost of the Project plus some cushion, typically very unpalatable or even impossible. Finally, such a bond gives Lien claimants tremendous leverage going forward, as it gives them security far superior to a claim against real property. Thus, Owner may not choose to file such a bond. One advantage of filing a Lien Law § 37 bond arises from the likelihood that Vendors may not pay enough attention and may still file Liens, instead of claims against the bond. If a Vendor does not re-file correctly within the time allowed for filing, it will no longer have a valid claim against the bond.[74] Although such Vendors may have a malpractice claim against the attorney who was engaged to enforce the Vendors' rights (and forgot to check whether a bond had been filed), they will no longer have a claim against Owner.

Should Owner decide to file such a bond, it should do so as soon as possible. In many cases, a bond under Lien Law § 37 does not discharge Liens that Vendors filed before Owner posted the bond, and Owner will have to file a separate bond for each Lien under Lien Law § 19.[75]

E. Assume Contracts with Vital Vendors and Consider Replacing GC

If Owner can assure access to funds to complete the Project, Owner's next challenge will be to try to stay as close to schedule as reasonably possible in finishing the Project. To do that, Owner may want to try to convince vital Vendors to stay on the job and finish their work. Otherwise, Owner risks further delays to the Project while Owner seeks new Vendors.

Owner's general contract with GC will often allow Owner to assume the contracts of any Vendors it chooses, such as the vital Vendors. Before Owner does so, it should consider three issues:

1. Owner must confirm that its general contract does allow it to pick and choose which Vendor contracts to assume. Many, probably most, general contracts follow the AIA's standard general contract, Form A201. That form gives Owner the ability to obtain the assignment of any Vendor contracts that it so chooses.[76] Owner must first, however, terminate the general contract "for cause."[77] GC's failure to properly pay Vendors constitutes sufficient cause under Form A201.[78]
2. Owner must confirm that the appropriate court allows it the flexibility to choose which contracts it assumes—even if the general contract grants this flexibility—a question outside the scope of this article. Owner should also consider its longer term business relationships with the various Sub-Vendors when deciding which contracts to assume and which to terminate.
3. Third, Owner must be sure not to inadvertently assume any contracts it did not want to assume. Owner should assume the contracts of vital Vendors only if it can do so without assuming the contracts of non-vital Vendors. If Owner can't, then it should try to negotiate new contracts with new vital Vendors. As a practical matter, Owner should try to negotiate these new contracts before it terminates its contract with GC. Otherwise, vital Vendors might stop work, in an attempt to obtain better contract terms from Owner. Owner's agreement with GC should, ideally, require GC to give Owner copies of all contracts with Vendors promptly after being executed, and should state that GC automatically assigns those contracts to Owner following a default, termination of the General Contract, and Owner's election to assume any affected contracts.

Owner should also take steps to try to limit potential recoveries by Vendors whose contracts Owner has assumed. Before assuming a contract, Owner should obtain an estoppel certificate from Vendor confirming the absence of defaults, other than payment, and establishing an agreed schedule for the payment of any balance for work already performed. In some cases, Owners have been known to condition their assumption of a contract upon Vendor's agreeing to first pursue GC for the open balance before asserting any part of that open balance against Owner. In essence, this arrangement gives Vendor a choice between (A) asserting only limited remedies against Owner but being paid to complete the Project and (B) being terminated from the Project, but retaining its Lien rights. If construction lending is involved, any filed Liens will need to be discharged, which in turn may make the first alternative more palatable.

Finally, Owner may want to stop paying the remaining (non-vital) Vendors and GC. Although this will probably precipitate litigation, Owner has techniques available to minimize the resulting liability.

F. Minimize Exposure to Non-Vital Vendors

By selectively taking over contracts with vital Vendors, Owner may increase its chances of completing the Project and doing so on schedule. As its remaining goal, Owner will want to stay as close to budget as it

can. This will require finding ways to pay Lien holders less than what they claim in their Liens—but without violating Article 3-A.

1. Minimize Funds Owner Must Pay to Lien Holders

From Owner's perspective, any payments Owner pays to resolve claims of non-vital Vendors are essentially wasted, because they give Owner very little benefit. These Lien holders will have probably already finished their work—given that otherwise they could not establish "substantial performance" (or "substantial completion" under the construction contract). Thus, any further work they might perform will not deliver to Owner any additional value. Owner should keep in mind, however, that a non-vital Vendor that has demonstrated "substantial performance" or "substantial completion" will have a Lien for the value of its work and/or a claim for breach of contract. Owner must get rid of any filed Liens unless it wishes to have an unmarketable Site, an unhappy lender, and a substantial risk of foreclosure. Thus, to the extent Owner can, it should reduce the amount that it must ultimately pay Lien holders to resolve the Liens. The Lien Law does give Owner several options to mitigate the amount Owner must pay.

As a particular compelling argument, Owner can argue that a Lien holder (or a party to whom the Lien holder has become subrogated) has not substantially performed under its contract. Given the factual scenario—an insolvent GC and a largely incomplete Project—it would seem highly likely that at least some party will have not substantially performed. If Owner can successfully assert that GC or a Vendor (or several) has not substantially performed, Owner can avoid paying the full Liens.[79] Though these Lien holders will be left with a remedy of quantum meruit, they face an uphill battle to collect. Given that Project completion will probably require Owner to pay more than what it agreed to pay GC to complete the Project, Owner may be able to argue that it did not benefit from the Lien holders' work beyond what Owner has already paid.

Owner might also challenge the validity of any Liens. If Owner can successfully claim that a Lien holder does not meet one of the three substantive conditions of having a Lien (as summarized above), Owner may eliminate all payments under Article 2 to that Lien holder.

Owner might also assert that Liens were not properly filed because they violated one of the many technical requirements for filing a Lien.[80]

Before making any substantive or procedural challenge to a Lien, Owner will typically want to wait until after the deadline for filing (or re-filing) a Lien has passed—eight months from Project completion—before asserting its claim.[81] After that point, if Owner successfully challenges a Lien, the Lien holder will probably not be able to re-file.[82]

Finally, Owner can challenge whether the amounts a Vendor claims in its Lien are reasonable. Any Notice of Lien must include the Lien holder's statement of the agreed price or value of the labor performed and materials furnished when the Vendor files its Lien.[83] The Lien holder's claim must be reasonable based on the balance due. Owner can sometimes challenge the Lien amount on that basis. In addition, in the rare case where Owner can demonstrate that the Lien holder willfully exaggerated the amount of the Lien, the court can declare the Lien void and force the Lien holder to pay Owner damages, including bond premiums, and a penalty equal to the exaggerated piece of the Lien.[84] The Lien holder will also have no right to file another Lien for that claim. Unfortunately for Owner, however, Lien claimants do not often willfully exaggerate their claims, and Owner may have trouble proving willfulness,[85] which must be established in the trial of the foreclosure action.[86] The question cannot be determined on motion prior to trial.[87]

2. Avoid Article 3-A Violations

Owner should take great care not to violate Article 3-A, such as by diverting "trust assets" away from the purpose of the trust or by failing to keep proper records. As long as Owner complies with Article 3-A, it can pay its vital Vendors in whatever order it chooses and can pay any remaining "trust beneficiaries" out of any "trust assets" that remain. And, given that Vendors will in most instances be "trust beneficiaries" when they also have claims for valid Liens, Owner will often not owe these "trust beneficiaries" any more than it would have paid to satisfy their Lien claims, anyway. Although this is often the case, Owner should note that Vendors can be considered "trust beneficiaries" whether or not they have filed or had the right to file a valid Lien.[88]

Owner should also bear in mind that if it assumes contracts of vital Vendors, as this article suggests an Owner might consider doing, Owner will become "obligated" to those Vendors under Article 3-A. Thus, those Vendors will become "trust beneficiaries" with trust claims equal to the full amounts of their contracts. Owners should always consider using an intermediary to act as a replacement GC going forward, or entering into separate new contracts if possible.

III. How Owners Can Plan Ahead to Prevent Lien Problems

The discussion above focuses on steps an Owner can take after a Project goes bad. If Owner could turn back the clock, though, or wanted to try to do better next time, what more could Owner do at the outset of a Project to prevent problems? This article concludes by offering a few suggestions. Some are just reminders of "best practices" in running construction jobs. Others have not been typical in construction projects either because they are expensive or a GC

will refuse to accept them. In today's markets, though—at least until the next construction boom—GCs may decide to accommodate.

First, Owner can insist on monitoring the Project by requiring GC to keep good records and give Owner regular access to those records. Owner might condition any payments to GC on proof that GC has paid Vendors. If owner can persuade GC to agree to such measures, Owner must also bear in mind the possibility of fraud. Such owners should consider engaging a forensic accounting firm to keep an eye on the chicken coop.

Second, Owner can insist on having the right—even before GC gets into visible trouble—to pay Vendors directly, or through joint checks, instead of using GC as the middleman. Again, GC will typically object to any such arrangement. And Owner should note that any such arrangement could make Vendors into Article 3-A "trust beneficiaries," because Owner could be deemed "obligated" to Vendors.[89] But if Owner's payments to Vendors are voluntary, Vendors would probably not have rights until the payment is actually made.

Third, Owner could obtain third-party assurances that GC will pay its Vendors. For example, GC could deliver to Owner a letter of credit, which Owner could draw upon if problems arose. Or Owner could require GC to deliver a payment bond, where a bonding company agrees that if GC does not pay its Vendors, then the surety will, up to the amount of the bond. Measures like these are often expensive. And if a GC's credit is strong enough so GC can arrange measures like these, then traditionally any Owner would conclude that GC's credit is also strong enough to make such measures unnecessary. Regardless of GC's credit, however, Owner should remember that GCs sometimes do play games of the types that lead to trouble. And war stories abound regarding a GC who files a Chapter 11 petition with one entity on Monday and is back in business Tuesday with a new corporate entity using the plant, equipment, and other assets of the bankrupt entity.

Finally, Owner could try to hire a more creditworthy and reliable GC. Such a GC may charge more. But Owner may find that a GC with better credit means less likelihood of trouble. Of course, particularly after the events that have rocked the real estate and financial worlds since late 2007, Owner might conclude that no one is as reliable as he or she seems. Owners may seek credit enhancement in the form of performance bonds that guarantee completion of the project, although the litigation that is needed to realize on these bonds sometimes makes their protection illusory. Other credit enhancements that are gaining acceptance in the construction industry are standby credits, which are beyond the scope of this article.[90]

In any event, Owners must recognize that New York law provides very meaningful rights and remedies for parties whose labor and materials go into a Project. The Lien Law is intended to help assure that those parties receive payment for their work. Owners must have a plan to ensure that these protected parties do not acquire the ability to derail the Project.

Endnotes

1. Owner may engage GC or, more commonly at least in New York City, a construction manager ("CM"). Under a traditional CM structure, Owner bears all financial risks of the Project, and CM enters into contracts with Vendors as Owner's agent. That mitigates many risks this article describes, but replaces them with others. A variation on a CM structure imposes obligations that are similar to conventional contracting, and is known as "Construction Manager at Risk." Even more complications arise if the Owner elects to use the "Design-Build" method of project delivery, where one entity performs both design and construction under a single contract. A CM arrangement will sometimes switch to a GC arrangement once the CM satisfies itself that very little risk remains in costing out the Project. This article considers only the implications of the GC structure for any Project. And this article limits itself to private/commercial Projects, as opposed to Projects undertaken for public agencies.
2. This article uses "Vendor" to refer to everyone—except GC—who may be owed money for a Project. Not every Vendor can always assert the Lien Law rights this article describes. The lines drawn will vary among various routes to recovery. Some Vendors, such as architects, will deal directly with Owner, not GC. The claims of such Vendors will be similar to GC's. Other design professionals, such as engineers, and consultants, stand in a relation to the architect that is analogous to the contractor-subcontractor relationship. This article does not discuss those claims separately.
3. This would violate Lien Law Article 3-A, which prohibits a GC from using funds from one Project to pay debts of another unless GC has paid certain Vendors at the first Project. *See* N.Y. Lien Law §§ 70–79 (McKinney 2007), discussed at length below.
4. Kevin J. Connolly, *Surprises Lurk in the Lien Law*, N.Y. L.J., Aug. 8, 2010, at 9.
5. Such direct contractual rights would include, for example, any Vendor contracts that Owner has guaranteed or assumed. Vendors might have other avenues to claim a direct contractual relationship with Owner. For example, Vendor(s) and GC could enter into a so-called "liquidation agreement," which is an arrangement where GC assumes liability for Owner's actions so as to pursue Owner on behalf of Vendors. For more about these agreements, otherwise beyond this article, *see* Barry, Bette & Duke, Inc. v. New York, 240 A.D.2d 54, 56, 669 N.Y.S.2d 741, 743 (3d Dep't 1998).
6. In an extreme case, diversion of trust assets also constitutes larceny. *See* N.Y. Lien Law § 79-a(1). Other parties, such as GCs and subcontractors, can also constitute "trustees." Although this article does not exhaustively treat the trust fund obligations of these other trustees, any such trust follows the trust assets into the hands of transferees. This can sometimes produce surprises. For more on these surprises, *see* Connolly, *supra* note 4.
7. *See* Aspro Mech. Contracting, Inc. v. Fleet Bank, 1 N.Y.3d 324, 805 N.E.2d 1037 (2004), for an example of how the New York Court of Appeals sent a chill down the spines of construction lenders, as this article will briefly explain below.
8. *See generally* N.Y. Lien Law § 79 (nothing in Article 3-A prevents enforcement of a Lien under Article 2 or 3; and neither such Lien nor its satisfaction amounts to diversion of trust assets or unauthorized preference).

9. *See, e.g.*, In re Marcus Substructure Corp., 76 A.D.2d 926, 429 N.Y.S.2d 722 (2d Dep't 1980). The court considered a proposal to settle the claims of two classes of creditors—mechanics' lienors under Article 2 and Article 3-A trust beneficiaries who did not hold mechanics' Liens—by paying each creditor pro rata without regard to their class status. The court rejected this proposal, holding that "a class of mechanic's lienholders must take priority over a class of mechanic's nonlienor beneficiaries of a trust fund under [A] rticle 3-A of the Lien Law." *Id*. (collecting cases in support).
10. For more about construction loans, *see* Joshua Stein, Stein on New York Commercial Mortgage Transactions, § 5 (2006); 8 William X. Weed, Warren's Weed New York Real Property § 92.53 (5th ed. 2010) (hereinafter *Warren's Weed*).
11. *See* Brainard v. County of Kings, 155 N.Y. 538, 50 N.E. 263 (1898) (finding that if nothing is due to GC according to the contract when the Lien is filed, but some amount later becomes due under the contract, the Lien attaches to the extent of that sum).
12. *See* N.Y. Lien Law §§ 9–11. Failure to comply with these technicalities can trigger significant problems for a Lien claimant. For example, Lien Law § 9 requires Lien claimants to include certain information in their notice of Lien. If they aren't careful, these Lien claimants might, for example, forget to designate the block or blocks of real property to which the Lien will attach, which is required under Lien Law § 10. In addition, Lien Law § 11 requires Lien claimants to properly serve upon Owner their notices of Lien.
13. The statutory class includes contractors, subcontractors, laborers, materialmen (now often called material suppliers), landscape gardeners, and nurserymen. *See* N.Y. Lien Law § 3. Case law has expanded the list to include, e.g., draftsmen, engineers, surveyors, and architects. *See* 21 Laurence S. Tauber, General Practice in New York § 10.5, n. 1, 2 (Robert L. Ostertag & James D. Benson eds. 1998) (hereinafter *Ostertag & Benson*).
14. *See* N.Y. Lien Law § 2 ("improvement" includes all work on real property and any work done on such property for its permanent improvement). N.Y. Lien Law § 2 defines "improvement" quite broadly. *See Ostertag & Benson*, *supra* note 13, § 10.6. The requirement of a "permanent" improvement distinguishes between works that remain after the Project is completed, and those that are transient. Even more confusion arises because the law treats the value of temporary works as lienable if and when those works are the means by which the permanent improvement is accomplished.
15. *See* N.Y. Lien Law § 3.
16. *See id*. § 4(1).
17. *See, e.g.,* Klinik v. 66 East 80 Realty Corp., 15 Misc. 2d 911, 913-14, 185 N.Y.S.2d 1009, 1012-13 (Sup. Ct. N.Y. Cnty. 1959) (if contractor fails to fully perform under contract, contractor may still recover based on substantial performance). *See id*. for early cases discussing this issue.
18. *See* Frank v. Feiss, 266 A.D.2d 825, 826, 698 N.Y.S.2d 363, 364 (4th Dep't 1999) (absent direct evidence of the reasonable value of the work performed or materials supplied, court can infer such value from the parties' agreement); *see also* Pronti v. Smutzinger, 52 A.D.3d 1015, 1016, 861 N.Y.S.2d 148, 149 (3d Dep't 2008) (price payable under void contract may evidence reasonable value for services).
19. *See* Cassino v. Yacevich, 261 A.D. 685, 687, 27 N.Y.S.2d 95, 98 (3d Dep't 1941) (finding that a builder may recover the contract price where he has in good faith intended to comply with the contract, and has substantially complied with it); *see also* Pfeil Const. Corp. v. Moley, 14 Misc. 2d 379, 382, 179 N.Y.S.2d 443, 448 (Sup. Ct. Erie Cnty. 1958) (contract must be performed according to its terms, but trivial and innocent omissions trigger damages, not forfeiture).
20. *See* Spence v. Ham, 163 N.Y. 220, 226, 57 N.E. 412, 413 (1900) ("[t]he question of substantial performance depends somewhat on the good faith of the contractor. If [the contractor] has intended and tried to comply with the contract and has succeeded, except as to some slight things omitted by inadvertence, he will be allowed to recover the contract price, less the amount necessary to fully compensate the owner for the damages sustained by the omission." (quoting Van Clief v. Van Vechten, 130 N.Y. 571, 579, 29 N.E. 1017, 1019 (1892)).
21. *See* Carefree Building Products, Inc. v. Belina, 169 A.D.2d 956, 957, 564 N.Y.S.2d 852, 854 (3d Dep't 1991) (whether performance was substantial turns upon facts of case). The court in *Carefree* listed a number of cases discussing substantial performance based on varying degrees of deficiency: Fuchs v. Saladino, 133 A.D. 710, 715, 118 N.Y.S. 172, 176 (1st Dep't 1909) (15%); Wilson Roofing & Painting v. Jobco-Kelly Assoc., 128 A.D.2d 953, 955, 513 N.Y.S.2d 263, 265 (3d Dep't 1997) (15%); Gompert v. Healy, 149 A.D. 198, 199, 133 N.Y.S. 689, 690 (2d Dep't 1912) (25%); Mitchell v. Williams, 80 A.D. 527, 529, 80 N.Y.S. 864, 866 (1st Dep't 1903) (1/7th); Fox v. Davidson, 36 A.D. 159, 162, 55 N.Y.S. 524, 524 (1st Dep't 1899) (1/20).
22. Edward Marks, Jensen on the Mechanics' Lien Law of the State of New York § 136 (4th ed. 1963) (hereinafter *Jensen*).
23. *See* AIA Document A201, *General Conditions of the Contract for Construction*, art. 9, § 9.8.1 (2007), *available at* http://www.aia.org/contractdocs/aiab081513 (hereinafter *AIA Document A201*).
24. *Id*.
25. *See generally* Jacob & Youngs, Inc. v. Kent, 230 N.Y. 239, 129 N.E. 889 (1921) (plaintiff requested certificate of completion necessary for final payment).
26. *See AIA Document A201*, *supra* note 23, at § 9.10.1.
27. *See* Nesbit v. Braker, 104 A.D. 393, 394, 93 N.Y.S. 856, 856 (1st Dep't 1905) (absent completion certificate, plaintiff needed to show a demand and unreasonable refusal by architect); *see also* Beecher v. Schuback, 4 Misc. 54, 55, 23 N.Y.S. 604, 606 (N.Y.C. C.P. Gen. T. N.Y. Cnty. 1893) (absent evidence that architect's certificate was fraudulently or unreasonably withheld, recovery under contract was not possible).
28. *See* N.Y. Lien Law § 4(1) (limiting liability to value or agreed price of labor and materials remaining unpaid when notice of Lien filed).
29. Not every state limits Vendors' claims in this way. Absent such a limitation, even if Owner paid GC, Owner still bears the risk that GC won't pay Vendors. In these states, Owner must police GC. In New York, however, Owner has no obligation to see to GC's proper application of funds.
30. *See* Ace Contracting Co. v. Garfield & Arma Assoc., 148 Misc. 2d 475, 477, 560 N.Y.S.2d 382, 383 (Sup. Ct. N.Y. Cnty. 1990) (citing older cases to similar effect).
31. Please see Section B below for a discussion of Vendor's rights under Article 3-A.
32. *See* Electric City Concrete Co. v. Phillips, 100 A.D.2d 1, 4, 473 N.Y.S.2d 608, 610 (3d Dep't 1984) (lienors derive rights from those of GC and cannot exceed Owner's balance due GC).
33. *See* N.Y. Lien Law § 45 (court may adjust and determine equities of all parties).
34. Discussion of the fluid law of foreclosure in New York is beyond the scope of this article, but readers should be aware that the rule that contracts will be generally enforced as written, articulated in *Graf v. Hope Bldg. Corp.*, has been eroded to such an extent that Justice Cardozo's ringing dissent has come to be accepted as the better rule. Justice Cardozo wrote: "however fixed the general rule and the policy of preserving it, there may be extraordinary conditions in which the enforcement of such a clause according to the letter of the covenant will be disloyal to the basic principles for which equity

exists." 254 N.Y. 1, 11, 171 N.E. 884, 887 (1930) (Cardozo, J., dissenting).

35. *See* Brescia Constr. Co. v. Walart Constr. Co., 264 N.Y. 260, 265, 190 N.E. 484, 486 (1934).

36. *See* N.Y. Lien Law § 13(1) (time of filing does not set priority of Liens).

37. *See id*. § 56.

38. The mere fact that a conveyance recites the required trust fund covenant may not give it priority over Liens filed later, if no fund was actually created. *See* Monroe Sav. Bank v. First Nat'l Bank of Waterloo, 50 A.D.2d 314, 317-18, 377 N.Y.S.2d 827, 830-31 (4th Dep't 1976).

39. *See* N.Y. Lien Law § 13(1).

40. *See id*. § 56.

41. *See id.*

42. *See generally Warren's Weed*, *supra* note 10, at § 92.50[3] (referencing N.Y. Lien Law §§ 13, 56; subcontractor has priority over subcontractor with whom he contracted and also over contractor with whom he contracted).

43. *See* N.Y Lien Law § 13(1).

44. *See id.*

45. *Id.* § 56 .

46. *See generally* M.F. Hickey Co. v. Imperial Realty Co., 65 Misc. 2d 1088, 1094, 319 N.Y.S.2d 972, 979 (N.Y. Civ. Ct. N.Y. Cnty. 1970) (suggesting that if voluntary payments can defeat or diminish Lien rights of other Vendors, this seems inconsistent with N.Y. Lien Law § 56).

47. Many parties involved in a Project other than Owner can become trustees under Article 3-A.

    For instance, GCs and subcontractors who hire others on the Project also constitute trustees. *See also* N.Y. Lien Law § 71.

48. For a full list of Owner's trust assets, s*ee* N.Y. Lien Law §§ 70(5)(a)-(e), 71-a.

49. *See* Bristol, Litynski, Wojcik, P.C. v. Elliot, 107 Misc. 2d 1005, 436 N.Y.S.2d 190 (Sup. Ct. Albany Cnty. 1981) (funds to pay consideration expressed in the contract do not originate from any source described in N.Y Lien Law § 70(5), hence that section does not apply to the contract).

50. N.Y. Lien Law § 79-a provides: "Any trustee of a trust arising under this article, and any officer, director or agent of such trust, who applies or consents to the application of trust funds received by the trustee as money or an instrument for the payment of money for any purpose other than the purposes of that trust… is guilty of larceny and punishable as provided in the penal law…" *See also* People v. Chesler, 50 N.Y.2d 203, 205, 406. N.E.2d 455, 456, 428 N.Y.S.2d 639, 640 (1980) (discussing defenses to a charge of larceny in violation of Lien Law § 79-a).

51. *See supra* note 48 and accompanying text.

52. *See* N.Y. Lien Law § 70(2).

53. *See id*. § 70(4).

54. § 71(3)(a) (emphasis added).

55. A court may also find Owner "obligated" to a Vendor if Owner agrees to pay GC and that Vendor by joint check. *See* Sabol & Rice, Inc. v. Poughkeepsie Galleria Co., 175 A.D.2d 555, 572 N.Y.S.2d 811 (3d Dep't 1991).

56. *See* Weber v. Welch, 246 A.D.2d 782, 784, 668 N.Y.S.2d 71, 72 (3d Dep't 1998). In *Weber,* Owner argued for dismissal of the "trust claim" of a Vendor who held a valid Lien. The court rejected Owner's argument, holding that Vendor's Lien made Owner potentially obligated to Vendor. For that argument to work, however, Vendor's Lien must be valid. *But see* Innovative Drywall Inc. v. Crown Plastering Corp., 224 A.D.2d 664, 664, 638 N.Y.S2d 722, 722-23 (2d Dep't 1996) (Owner not "obligated" to a Vendor because Vendor's Lien was defective and Vendor could not show Owner had any other contractual obligation to Vendor).

57. *See* Onondaga Commercial Dry Wall Corp. v. Sylvan Glen Co., 26 A.D.2d 130, 133, 271 N.Y.S.2d 523, 525 (4th Dep't 1966) (plaintiff could not show it was beneficiary of trust assets held by Owner, but could for trust assets received by contractor).

58. N.Y. Lien Law § 74(1).

59. Fortunately for Owner, if a trust beneficiary wants to show Owner diverted trust assets, the beneficiary must prove exactly that—actual diversion of trust assets. Mere failure to pay the trust beneficiary does not suffice. *See* Ryan Ready Mixed Concrete Corp. v. Caristo, 158 N.Y.S.2d 451 (Sup. Ct. Kings Cnty. 1959)

60. Article 3-A does, however, contain a priority scheme if Owner "diverted" trust assets. *See* N.Y. Lien Law §77(8).

61. *Id*. § 71(1).

62. *See* Schwadron v. Freund, 69 Misc. 2d 342, 345, 329 N.Y.S.2d 945, 950-51 (N.Y. Sup. Ct. Rockland Cnty. 1972) ("costs of improvements" did not include corporate administrative expenses, attorneys' fees, or unrelated union benefits).

63. A court will not automatically find that Owner diverted trust assets merely because Owner cannot provide the records. Such failure does, however, constitute "presumptive evidence" of diversion, placing on Owner the burden of proving a negative. *See* N.Y. Lien Law § 75(4).

64. *See* N.Y. Lien Law § 75(2) (Owner must keep records for its trust, and allocate amounts based on any commingled bank accounts); *see id.* § 75(3) (listing records—trust assets receivable, payable, received and payments made—Owner must provide to trust beneficiary upon demand). Owner doesn't have very much time to comply with any such demand, so should have the records ready.

65. *See generally* N.Y. Lien Law § 76 (entitling any trust beneficiary, upon request, to examine the books or records, to make copies, or to opt for a verified statement setting forth information in such books or records).

66. *See id.* § 77(3)(a).

67. *See id.* § 79-a; *see also* People v. Miller, 23 A.D.3d 699, 803 N.Y.S.2d 734 (3d Dep't 2005). In *Miller*, a GC that used "trust assets" to pay bills and expenses associated with unrelated construction projects was convicted of 32 counts of grand larceny and sentenced to concurrent prison sentences, the maximum of which was 5 to 15 years.

68. In a Notice of Lien, Vendor must allege (among other things) the work it has done, the unpaid balance for that work, and Vendor's right to a Lien. When someone says colloquially that a Vendor filed a Lien, that usually means they filed a Notice of Lien. *See generally* N.Y. Lien Law § 9 (required contents of notice of Lien).

69. *Id.* § 37(1).

70. The lender will need to make sure that any loan to pay for "costs of improvement" qualifies as a "building loan" under the Lien Law. If the lender later modifies the terms of the loan, this may require further nonintuitive measures to retain "building loan" qualification. *See generally id*. § 2(5).

71. In Aspro Mech. Contracting, Inc. v. Fleet Bank, N.A., 1 N.Y.3d 324, 330, 805 N.E.2d 1037, 1040 (2004), the New York Court of Appeals held that a mortgage lender that takes a security interest in Owner's construction contract steps into the shoes of Owner and is thus a "trustee" under Article 3-A. The construction lender can solve the problem by filing a Notice of Lending. Such a filing only protects advances made up to five days before the filing, on the date of filing or after the filing until the termination date specified in the Notice. *See* N.Y. Lien Law § 73; *see also*, 33 Robert Rubin, Sarah Biser & Catherine Kettle Brown, New York Construction Law Manual § 9.76 (2011 ed.).

72. *See* N.Y. Lien Law § 37 (upon approval of a bond, court shall discharge the property from Lien claims arising from contract described in such bond); *see also Jensen*, *supra* note 22, §268.

73. N.Y. Lien Law § 37(5).

74. *Id.* § 37(5) (claimant must perfect Lien claim within statutory deadline for filing notice of Lien).

75. *Compare* In re Rockefeller Center, Inc., 238 A.D. 736, 738, 265 N.Y.S. 546, 548 (3d Dep't 1933) (§ 37 not intended to provide a method to discharge Liens filed before delivery of bond) *with* Trustees of Hanover Square Realty Investors v. Weintraub, 52 A.D.2d 600, 600-01, 382 N.Y.S.2d 110, 110 (2d Dep't 1976) (suggesting a § 37 bond also discharges previously filed Liens). *See generally* N.Y. Lien Law § 19 (discharge of a Lien for private improvement).

76. *See AIA Document A201*, *supra* note 23, § 14.2.2

77. *See id*. § 5.4.1. To terminate the AIA standard General Contract for cause, Owner must (a) have the architect certify that sufficient cause exists to justify such action and (b) give GC seven days' written notice. *See id*. § 14.2.2

78. *Id*. §14.2.1. Cause would also arise if GC "repeatedly refuses or fails to supply enough properly skilled workers or proper materials; fails to make payment to Subcontractors for materials or labor in accordance with the respective agreements between the Contractor and the Subcontractors; repeatedly disregards applicable laws, statutes, ordinances, codes, rules and regulations, or lawful orders of a public authority; or otherwise is guilty of substantial breach of a provision of the Contract Documents."

79. The Lien claimant bears the burden of proof on the amount and validity of its claim, thus must prove substantial performance. *See* Nesbit v. Braker, 104 A.D. 393, 394, 93 N.Y.S. 856, 857 (1st Dep't 1905) (plaintiff bore burden of proof of substantial performance).

80. *See supra* note 12 and accompanying text for more details on these technicalities.

81. *See* N.Y. Lien Law § 10 (notice of Lien may be filed at any time during progress of work, or within eight months after completion of contract).

82. The deadlines in N.Y. Lien Law § 10 differ dramatically for a Project that constitutes a "public improvement." *See id.* § 12 (deadline is 30 days after completion and acceptance of public improvement).

83. *See id.* § 9(4).

84. *See id.* §§ 39 and 39-a.

85. Walker v. Security Trust Co., 85 Misc. 2d 614, 622, 379 N.Y.S.2d 308, 316 (Sup. Ct. Monroe Cnty. 1976) ("willful" means more than just doing the act or failing to do the act, but rather an intentional and deliberate doing of the act or failing to do the act with a certain awareness).

86. *See* Durand Realty Co. Inc. v. Stolman, 197 Misc. 208, 211, 94 N.Y.S.2d 358, 361 (Sup. Ct. N.Y. Cnty. 1949), *aff'd*, 280 A.D. 758, 113 N.Y.S.2d 644 (1st Dep't 1952); *see also* Guzman v. Estate of Fluker, 226 A.D.2d 676, 678, 641 N.Y.S.2d 721, 724 (2d Dep't 1996) (citing *Durand*, willful exaggeration must be established at trial of foreclosure action).

87. *But see generally* Joe Smith Inc. v. Otis-Charles Inc., 279 A.D. 1, 5 107 N.Y.S.2d 233, 236 (4th Dep't 1951) (when appellant succeeded in having Lien discharged at commencement of trial, this terminated foreclosure action, leaving court without authority to declare Lien void for willful exaggeration).

88. N.Y. Lien Law § 71(4).

89. *See id.* § 71(3)(a) ("trust claims" can also mean any obligation of Owner incurred in connection with the improvement for a payment or expenditure defined as cost of improvement).

90. *See, e.g.*, Kevin J. Connolly, *Security for Contract Performance*, 24 John Liner Rev. 2 (Summer 2010).

Joshua Stein, the sole principal of Joshua Stein PLLC, has written five books and over 200 articles about commercial real estate law and practice. For more information, visit www.joshuastein.com. Colin Bumby is an associate at Latham & Watkins LLP ("L&W") and a 2007 graduate of University of Chicago Law School. **The authors started this article while they worked together at L&W. They thank Kevin J. Connolly of Anderson Kill & Olick, P.C., for his helpful suggestions; Aviania Iliadis, an associate at L&W and a 2009 graduate of Seton Hall University School of Law, for her research assistance; Robert Gorrie, a J.D. candidate at Pace University School of Law, for his research assistance; Helaina Stein for her editing; Peter Labuza for his editing; and Alfredo R. Lagamon, Jr. of Ernst & Young, for his general assistance with the article. Blame only the authors for any mistakes.**

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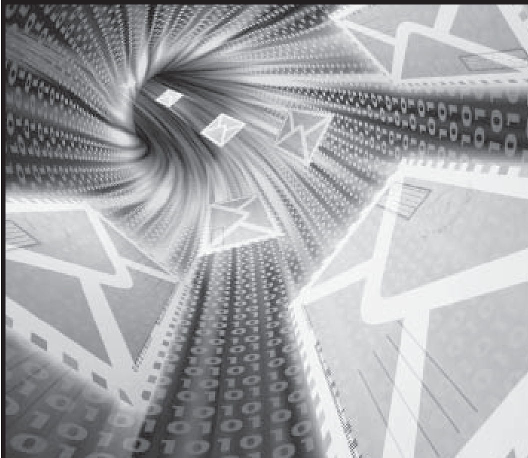

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Medicaid Expands Definition of "Estate" for Recovery Purposes

By Anthony J. Enea

The following is the first of a two-part article. Pursuant to 42 U.S.C. 1396p (b)(4)(A) the definition of "estate" for the recovery of Medicaid properly paid includes all real and personal property and other assets of the decedent as defined for purposes of State probate law.[1] Additionally, at the option of the States, the definition of "estate" can include any other real and personal property (and other assets) in which the decedent had any legal title or interest in at the time of death (to the extent of said interest). The States, at their option, can include such assets conveyed to a survivor, heir, or assign of the deceased individual through joint tenancy, tenancy-in-common, life estate, living trust or other arrangement.[2]

As part of the recommendations made by the Medicaid Redesign Team appointed by Governor Andrew Cuomo, the legislature amended 360-7.11(d) of the N.Y.C.R.R. by adding new paragraphs (7) (8) and (9) on April 1, 2011, *subject to* the promulgation of regulations by the N.Y.S. Dept. of Health.[3] Pursuant to this new legislation, the definition of "estate" was expanded to include any property in which the individual has any legal title or beneficial interest at the time of death, including jointly held property, retained life estate, beneficial interest in a trust to the extent of such interest. However, the claim against the recipient of property received by descent, distribution, or survival shall be limited to the value of the property received by the recipient and in no events greater than the Medicaid benefits otherwise recoverable.

Since April 1, 2011, the elder law bar has been waiting for the Department of Health to promulgate the implementing regulations. On June 21, 2011 the Department of Health issued State Plan Amendment transmittal # 11-42 to Title XIX attachment 4.17 A: Page 1.[4] The Governor's office reported no comment to transmittal # 11-42. While as of the date of this writing, the Regulation has not yet been officially promulgated, the aforesaid transmittal # 11-42 provides the best view of the regulation we have been awaiting. If it is not, or is modified in any way, I will report same in the second part of this article.

Pursuant to transmittal # 11-42, the term "estate" for Medicaid recovery purposes is defined to include all real and personal property and other assets included within the Medicaid recipient's estate and passing pursuant to the terms of a valid Last Will or by intestacy.[5] It also includes any other property in which the individual has any legal title or beneficial interest at the time of death including jointly held property, retained life estates and beneficial interests in trusts, to the extent of such beneficial interest. However, the claim against the recipient of such property by descent distribution or survival shall be limited to the value of the property received by the recipient and in no event greater than the amount of medical assistance benefits otherwise receivable, whichever is less.[6]

Interestingly, Transmittal # 11-42 also defines what is not part of the Medicaid recipient's "estate" for recovery purposes. For example: (a) interests in real or personal property, irrevocable trust, life estate or joint interest where the transfer or conveyance was made prior to the adoption of the regulation or within 60 days thereafter or where the interest was held prior to adoption of the regulation, except those assets included within the individuals probate estate and passing under the terms of a valid Will or by intestacy; (b) an irrevocable trust where the recipient has no interest in the principal of the trust, but only a right to income or the right to the use of trust property. However, if such individual has the right to trust income, the individual's estate shall include any trust income that has not yet been distributed on the date of death of such individual; (c) any beneficial interest in any trust or life estate created by someone other than the individual, a life estate purchased for consideration by the individual, or a retained life estate owned by the individual as of his or her death; (d) any beneficial interest created in a Special Needs Trust (except first party trusts with payback provisions); (e) any beneficial interest in a pension plan, IRA's, 401(k), 403(b), 457 plans or any work-related pension plan for self-employed such as Keogh plans, except to the extent that an individual's estate is the beneficiary of such account or plan; (f) any beneficial interest in a life insurance policy and/or annuity payable to anyone other than the individual or his or her estate, (g) any remainder interest in real property owned by a person other than the individual Medicaid recipient; (h) any power that is not a beneficial interest, including, but not limited to, a limited power of appointment, power to substitute property of equivalent value or other grantor trust powers under Sections 671 through 679 of the IRC which are not beneficial interests; (i) any jointly owned bank account to the extent of the surviving joint owner's verifiable deposits thereto; and (j) any jointly owned securities account to the extent of the surviving joint owner per capita share thereof.[7]

Additionally, within 30 days of receipt of a written notice of death from the representative of the estate of a Medicaid recipient or any party with an interest in the estate, the Department of Health shall file a Notice of Claim or Waiver of Claim upon the

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estate. If the Department of Health fails to file a Notice of Claim within 30 days, this failure to do so shall constitute a waiver.[8]

From the above stated it is clear that the use of retained life estate, revocable living trusts and retaining title to real property jointly will not be able to shield a Medicaid recipient from the claims for Medicaid paid. It's also clear that the use of an Irrevocable Income Only Trust continues to remain a viable long-term care planning tool. Whether or not any further changes to the proposed Regulations will be made remains to be seen. It is also anticipated that litigation challenging the legislation and regulations may be forthcoming.

In the second part of the article I will address the planning options available in light of the new legislation and its implementing regulations as well as bringing you up to date on any changes in the regulation.

Editor's Note: since the article's submission date, the New York State Department of Health has issued new regulations. The author will address these new regulations in a second article.

Endnotes

1. 42 U.S.C. § 1396p (b)(4)(A) (2006).
2. *See id.* § 1396p (b)(4)(B).
3. *See* N.Y.S. 2809, 234th Sess, (2011) (amending N.Y. Soc. Serv. § 369, N.Y. Comp. Codes, Rules & Regs. § 360-7.11 (2011)) (emphasis added) (harmonizing the definition of "estate" in each statute).
4. Amendment #11-42 to the Title XIX Medicaid State Plan, N.Y.S. Dept't of Health (June 21, 2011), http://www.health.state.ny.us/regulations/state_plans/status/coverage/original/docs/os_2011-06-21_spa_11-42.pdf.
5. *Id*.
6. *Id*.
7. *Id*.
8. *See supra* note 3.

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Report on Real Property Law Section Legislation Efforts in 2011

By Karl B. Holtzschue

Our legislation effort had another good year!

1. **2010-2011 RPLS Legislation Memoranda Scorecard.** During the first year of this two-year session, the Real Property Law Section (RPLS) issued 15 RPLS memos and wrote 1 NYSBA memo (disclosure of service charges). Over 19 members have written memos. So far, none of the bills we opposed has been enacted. Here is a scorecard for this first session in the two-year cycle:

   - **Bills RPLS Memo in Opposition; NOT enacted: 12**
   - **Bills RPLS Memo in Support; ENACTED: 2**
   - A6870/S2373. Authorizes electronic recording. RPLS #10A; RPL 291-I [Chap 549]
   - A7358/S5203. Prohibition of private transfer fees. RPLS #14; RPL 470-476 [Chap 552]
   - **Bills RPLS Memo in Support; NOT enacted: 2**
   - A8300/S2906. Permits assignment of mortgage in lieu of discharge. RPLS #15
   - A8361/S4920. Requires disclosure of title insurance service charges. NYSBA #10

2. **Real Property Bills Passed by Assembly and Senate in 2011.**

   - A0373/S5759. Provides for land banks [Chap 257]
   - A1777/S0397. Provides condo owners access to application for bldg assm't [Chap 453]
   - A1913/S4038. Prohibits home improvement contractors from acting for mortgage brokers
   - A5028/S3176. Extends exemptions for first-time homebuyers to 12/31/16 [Chap 77]
   - A6274/S4732. Extends transfer tax rate reductions for conveyances to existing REITs [Chap 493]
   - A6870/S2373. Authorizes electronic recording. RPLS #10A; RPL 291-I [Chap 549]
   - A7358/S5203. Prohibition of private transfer fees. RPLS #14; RPL 470-476 [Chap 552]
   - A8510/S5844. Establishes retrofit financing on utility bills [no RPLS memo] [Chap 388]
   - A8518/S5856. Enacts real property tax levies, rent regulation, local taxation exemption [Chap 97]

3. **Notable Bills Not Passed**

   - A0626/S0667. Requires every assignment of mortgage to be recorded. RPLS #1
   - A0629/S0697. Only owner of mortgage has standing to foreclose [no RPLS memo]
   - A2560/S1095. Provides for notice of illegal restrictive covenant language. RPLS #6
   - A4168/S3565. Creates government title insurance. RPLS #7
   - A5700/S1998. Makes practicing law without admission a Class-E felony [no RPLS memo]
   - A6458/S4203. Provides for licensing of title agents (NYSLTA). RPLS #9
   - A6941/S0395. Creates office of coop/condo ombudsman. RPLS #13
   - A8300/S2906. Permits assignment of mortgage in lieu of discharge. RPLS #15
   - A8361/S4920. Requires disclosure of title insurance service charges. NYSBA #10
   - A2163. Requires applications for coops to be acted on in 45 days. RPLS #2
   - S4919. Requires county highway acquisitions to be made under the EDPL

4. **RPLS Bills**

   - A8361/S4920. Requires disclosure of title insurance service charges. This bill has been sponsored by Assemblyman Morelle and Senator DeFrancisco.
   - S4919. Requires county highway acquisitions to be made under the EDPL. This bill has been sponsored by Senator DeFrancisco.

5. **6th Annual Trip to the Legislature.** Our best trip yet, described in an earlier report. The photo of our group with the Governor was featured on the cover of the Spring/Summer 2011 issue of our *N.Y. Real Property Law Journal*, to show our members what we have been up to.

6. **Legislation Chart and RPLS Website.** The RPLS Website has a new box in the middle of the page entitled "Legislative Information." It has been updated by moving all the legislation items from the left side of the RPLS web page into the new box, including "Chart of Pending Legislation," "Status of Pending Legislation," "Guidelines for Reviewing Legislation," "Guidelines for RPLS Legislation Memos" and "2011-2012 Legislation Memos." What we have been calling our "Legislation Chart" appears as "Chart of Pending Legislation." "Status of Pending Legislation" shows daily action on bills. Having all the legislation topics in one place should make it easier to find them and shows the scope of our effort.

7. **No Lobbying New York City Council**. Kevin Kerwin has informed us that we, as a Section of NYSBA, cannot lobby the New York City Council because NYSBA is not registered to do so.

Karl B. Holtzschue is Co-Chair of the Legislation Committee.

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Bergman on Mortgage Foreclosures: The Newspaper Said the Foreclosure Was No Good

By Bruce J. Bergman

A recent case is likely a harbinger of what is to come for foreclosing lenders.[1]

Mortgage holders well recognize that the media is filled with stories about lender and servicer mistakes—robo-signing, incorrect notarizations, part of an unfortunately longer list (the "recent crisis"). There is no doubt that this avalanche of unfortunate publicity creates some biases in the courts about the legitimacy of some foreclosure actions—a different and lengthier subject not to be explored here.

Lenders and servicers will readily attest to the bent of borrowers to use the system to delay foreclosures as long as possible. To the extent that genuine resolution is being pursued, protraction is less offensive if the end result is a settlement beneficial to both sides. Where the borrowers' methodologies, however, are designed to remain at the premises free of mortgage payments, taxes and insurance, it is certainly unpalatable for lenders. (That the imposition of time upon the foreclosure process is abetted by a continuum of new statutes is yet another subject for another day.)

Although borrowers may have availed themselves of the various weapons used to detain foreclosures, ultimately the unsettled default ripens into a foreclosure sale. The process will often take years, but eventually there is an end. Energized by media reports of lender errors, borrowers may have one more arrow in their respective quivers: assaults on completed foreclosures founded upon claimed lender miscues. The source of these attacks, though, may just be the media reports.

So, the question arises, can a borrower—or other party to a foreclosure—use a newspaper article as a defensive tactic? While as an addition to an otherwise legitimate defensive posture it may offer some moral suasion, the answer to the question is no, the newspaper article cannot provide a defense.

This was the issue in a recent eviction after foreclosure case where a holdover borrower not only declined to leave the foreclosed premises, but filed an order to show cause seeking a stay of the eviction proceeding.[2] In support of that effort, the borrower justified his posture by offering an article taken from the *New York Times* talking about errors in foreclosure cases.

The important point is that the court rejected such evidence. The holding was that it is well known in both federal and state courts that newspaper articles are generally inadmissible to prove the facts of the case because those articles are simply hearsay.[3]

So while these newspaper reports—and articles in other media—are certainly more than troublesome, they are not evidence, so in and of themselves cannot provide a defense in a mortgage foreclosure action.

Endnotes

1. *Federal Nat'l Mtg. Association v. Gomelsky*, 29 Misc.3d 1215(A), 2010 WL 4188042 (N.Y. Dist. Ct.).
2. *Id.*
3. Citing *Downs v. New York Cent. R. Co.*, 47 N.Y. 83 (1871); *McAllister v. New York City Police Dept.*, 49 F.Supp.2d 688 (S.D.N.Y. 1999).

Mr. Bergman, author of the three-volume treatise, *Bergman on New York Mortgage Foreclosures*, LexisNexis Matthew Bender, is a member of Berkman, Henoch, Peterson, Peddy & Fenchel in Garden City. He is a fellow of the American College of Mortgage Attorneys and a member of the American College of Real Estate Lawyers and the USFN. His biography appears in Who's Who in American Law and he is listed in Best Lawyers in America and New York Super Lawyers.

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Student Case Comment: Sex Plus Discrimination Claims Are Viable Under the Fair Housing Act: *Lax v. 29 Woodmere Boulevard Owners, Inc.*

By Nicki Neidich

On September 23, 2011 the District Court for the Eastern District of New York held, in *Lax v. 29 Woodmere Boulevard Owners, Inc.*, that "plaintiff has asserted a plausible 'sex plus' housing discrimination claim" in violation of the Fair Housing Act ("FHA") by concluding that "plaintiff can bring a claim based on his membership in a class of single males, who are a protected class under the FHA."[1]

On April 30, 2010, plaintiff contracted to purchase a co-operative apartment at 29 Woodmere Boulevard for $200,000 from the unit's owners, subject to approval of the defendant co-op board ("Board").[2] Plaintiff's completed application was "denied without reason" by the Board, and similarly denied after reconsideration at a higher price.[3] Around July 23, 2010, the co-op's managing agent told the sellers' agent that plaintiff was rejected because he was a single male and that the Board would not approve plaintiff's purchase of the apartment no matter what price he was willing to pay for the apartment.[4] On August 10, 2010, the sellers' agent told plaintiff that he was rejected for "discriminatory reasons," but two weeks later, plaintiff received a letter from the co-op's counsel that his rejection was "solely based on the 'negotiated purchase price.'"[5] Plaintiff then inquired into why the Board was unwilling to consider a higher price from him, receiving no answer from the defendants' counsel.[6]

On September 1, 2010, plaintiff commenced suit, alleging sex plus discrimination by the Board and the cooperative housing corporation, as well as the managing agent for participation in the discriminatory conduct. After a pre-trial conference and an amended complaint, defendants moved to dismiss for failure to state a claim for which relief can be granted.[7] Relying on a number of Title VII discrimination cases the district court found that sex plus discrimination is cognizable under the FHA. The court noted that a discrimination claim can be based on membership in a class based on gender, plus another characteristic, where gender is itself a protected category. In this case the court concluded that an alleged denial of approval of an application to purchase the cooperative apartment based on "gender plus marital status" was a basis for a possible violation of the FHA.[8] For plaintiff, the alleged sex plus discrimination was in the form of disparate treatment because he was male and single.[9]

In addition, the court disagreed with defendant's argument that the plaintiff was subject to a heightened pleading requirement, namely that plaintiff must allege specific facts in his complaint to establish a prima facie case of discrimination.[10] The Supreme Court has said that, in the employment context, the plaintiff does not have to include specific facts in order to survive a motion to dismiss, and the Second Circuit has extended this ruling to FHA claims.[11] Thus, the court held that plaintiff's pleading was sufficient under Federal Rule of Civil Procedure 8(a) because plaintiff pled, in his amended complaint, that the Board "systematically denied […] single and male" individuals, he was qualified to purchase the unit, he completed the application package, and that the unit was placed back on the market at the same price for which he had contracted to purchase the unit.[12]

Extending the protections of the FHA to individuals who may face sex plus discrimination when buying a cooperative apartment is a new development. This may afford prospective purchasers another avenue of redress in the case of discriminatory action by a co-op board. It also puts co-op boards on notice that the court is willing to look to Title VII cases when analyzing a claim under the FHA.

Endnotes

1. *See* Lax v. 29 Woodmere Boulevard Owners, Inc., No 10-CV-4008 (JFB) (WDW), 2011 U.S. Dist. LEXIS 107546, at *10-12 (E.D.N.Y. Sept. 23, 2011). "Sex plus discrimination occurs when an individual is subjected to disparate treatment based on gender considered in conjunction with a second characteristic." *Id*. at *12.
2. *See id*. at *2.
3. *See id*. at *3. Also, around June 25, 2010, plaintiff learned from a "current owner and resident of the co-op that the Board had a pattern of discrimination against single men." *Id*.
4. *See id*. at *3-4.
5. *See id*.
6. *See id*. at *5.
7. *See Lax*, 2011 U.S. Dist. LEXIS 107546, at *10-12.
8. *See id*. at *11-16; *see also* Tsombanidis v. W. Haven Fire Dep't, 352 F3d 565, 575 (2d Cir. 2003).
9. *See id*. at *12 (quoting Fisher v. Vasser College, 70 F.3d 1420, 1433 (2d Cir. 1995)).
10. *See id*. at *17-18.
11. *See id*; *see also* Swierkiewicz v. Sorema N.A., 534 U.S. 506, 510; Boykin v. Keycorp, 521 F.3d 202, 213 (2d Cir. 2008).
12. *See id*. at *23-28.

Nicki Neidich is a second-year student at St. John's University School of Law and a staff member of the *N.Y. Real Property Law Journal.*

Student Case Comment:
Hogan v. Kelly: Second Department Agrees with the Third and Fourth Departments—2008 Adverse Possession Amendments Are Not to Be Retroactively Applied

By Danny Ramrattan

In *Hogan v. Kelly*,[1] defendants Dorothy and Camille Kelly moved in with Ferdinand Powell ("decedent") in September 1992 to assist him because of his old age and poor health.[2] Decedent held title to the property he and defendants occupied. Defendants thereafter lived with decedent until his death on March 26, 1995. Decedent died intestate. His sole heir was his daughter Carmen Powell, a Panamanian citizen living outside the United States. Although Carmen Powell was decedent's sole heir, decedent's brother executed a deed conveying title to the property to Dorothy Kelly on March 7, 1996. The deed conveying title was subsequently recorded on June 27, 1996. From 1996 onward, defendants resided at the property.[3]

During the summer of 2008, decedent's sole heir—Carmen Powell—traveled to the United States for the first time, and allegedly discovered that her father had owned real property.[4] In September 2009, plaintiff was appointed administrator of decedent's estate. Upon his appointment, plaintiff commenced an action to determine who had ownership of the property. Defendants moved for summary judgment dismissing the complaint and declaring themselves owners of the premises because they adversely possessed it. Plaintiff cross-moved for summary judgment declaring him to be the owner of the premises. On June 4, 2010, the Supreme Court, Kings County granted defendants' motion for summary judgment and denied plaintiff's cross motion.[5]

The Second Department began its analysis of the parties' claims by noting that to establish a claim of adverse possession a claimant must prove "that possession of the property was: (1) hostile and under a *claim of right*; (2) actual, (3) open and notorious, (4) exclusive, and (5) continuous for the required period."[6] Because the Legislature enacted changes to RPAPL Article 5 in 2008,[7] the question raised was what was necessary to satisfy the "claim of right" requirement.

The court found that prior to the 2008 amendments, parties claiming adverse possession could satisfy the "claim of right" requirement even if they had actual knowledge of the true owner at the time of the possession.[8] In contrast, new RPAPL §501 provided a statutory definition of the "claim of right" requirement—namely "a reasonable basis for the belief that the property belongs to the adverse possessor or property owner, as the case may be."[9] The 2008 amendments to Article 5 took effect on July 7, 2008, and apply to all claims filed on or after the effective date of the amendments.[10]

Plaintiff contended that under the 2008 amendments, defendants did not acquire title to the premises by adverse possession because they were aware that Ms. Powell was the rightful heir, and therefore could not have had a reasonable basis to believe that the property belonged to them.[11] The Second Department disagreed. Although the action was commenced after the effective date of the 2008 amendments, the court concluded that the amendments cannot be retroactively applied to deprive a claimant of a property right which vested prior to their enactment. Therefore, the version of the law in effect at the time the purported adverse possession allegedly ripened into title is the law applicable to the claim even if the action was commenced after the effective date of the new legislation. Since title would have vested in the defendants prior to the enactment of the 2008 amendments, the new statutory definition of "claim of right" was not controlling.[12] Notwithstanding this ruling, the court found a triable issue of fact existed as to whether the defendants' possession of the premises was hostile.[13]

The Second Department's ruling in *Hogan* is consistent with prior decisions by the Third[14] and Fourth Departments.[15] These Departments have ruled that the 2008 amendments to RPAPL Article 5 "cannot be retroactively applied to deprive a claimant of property which [may have] vested prior to their enactment."[16]

Endnotes

1. 86 A.D.3d 590, 927 N.Y.S.2d 157 (2d Dep't 2011).
2. *See id.* at 591, 927 N.Y.S.2d at 158.
3. *See id.* at 590-91, 927 N.Y.S.2d at 158. The residential real property was located at 191½ 8th Street in Brooklyn. *Id*.
4. *See id.* at 591, 927 N.Y.S.2d at 158.
5. *See id*.
6. *Id*. (emphasis added).
7. *See* Ch. 269, 2008 N.Y. Laws 1.
8. *See Hogan*, 86 A.D.3d at 592, 927 N.Y.S.2d at 159.
9. *See id*. (citing N.Y. Real Prop. Acts § 501).
10. *See id*.
11. *See id*.
12. *See id*.

13. *See id.* at 593, 927 N.Y.S.2d at 160. The court looked to whether checks drawn by defendants and payable to the decedent could be considered rent, thereby raising the issue as to whether defendants initially occupied the premises as tenants. If considered tenants, there would be a presumption of nonadversity for 10 years from the last payment. *See id*.

14. *See* Barra v. Norfolk S. Ry. Co., 75 A.D.3d 821, 907 N.Y.S.2d 70 (3d Dep't 2010) (stating a newly enacted or amended legislation cannot disturb a title to an easement that was vested prior to the enactment).

15. Franza v. Olin, 73 A.D.3d 44, 897 N.Y.S.2d 804 (4th Dep't 2010); *see also* Perry v. Edwards, 79 A.D.3d 1629, 913 N.Y.S.2d 460 (4th Dep't 2010) (stating the 2008 amendments are inapplicable when title by adverse possession is gained prior to these amendments).

16. *Hogan*, 86 A.D.3d at 592, 927 N.Y.S.2d at 159.

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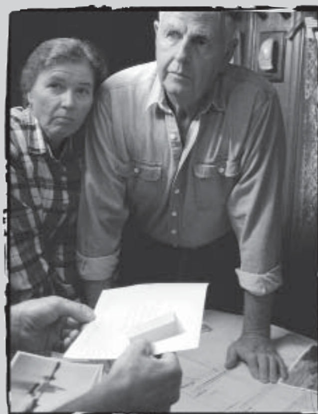

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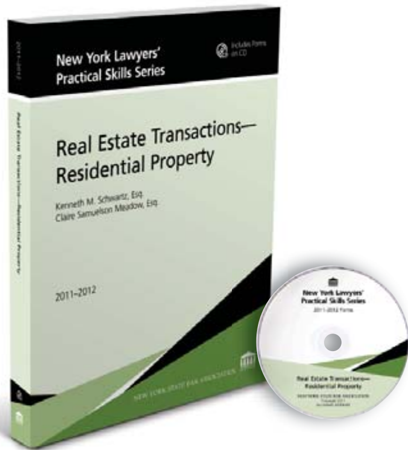

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