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Mixed-Use

Buying a Mixed-Use Building in New York City

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According to Forbes.com, Manhattan is one of the 10 most expensive places in the world to call home, and CB Richard Ellis' "Global Market Rents Survey" places New York 12th on its list of the most expensive office markets, despite the extremely discounted price of the dollar. Nevertheless, the dwindling dollar has contributed to the global craze to purchase a piece of Manhattan. In 2007, a typical client purchasing New York City mixed-used buildings had primary residences that included both international venues (Cairo, Egypt; Florence, Italy; Taipei, China) and national venues (Winston Salem, NC; Norfolk, VA; and both Van Nuys and San Francisco, CA).

Searching for a good deal in New York City, these buyers experience shock and dismay at the incredibly burdensome governmental regulations and owners' income limitations that come into play as soon as they consider a mixed-use building that encompasses both residential and commercial units instead of a purely commercial edifice. The failure of some buyers to understand New York City's unique and complicated tenant-friendly governing system has resulted in severe economic losses from negative income-producing properties.

While, of course, there are many buildings in New York City that are exclusively income-producing commercial properties, thousands of properties in New York City are mixed-use buildings, most typically those with retail space on street level and residential space above. Those clients coming to New York from other parts of the globe all too readily assume that the residential tenants' legal rights will be a limited as those of the commercial tenants. This assumption can rapidly translate into financial disaster.

Some new owners of residential property with rent-regulated units have been blindsided by financial risks arising from their (and their attorneys') ignorance of residential rent regulatory laws — an ignorance that can lead to a failure to take even basic precautions to prevent loss. In order to increase a building's income and to prevent a potential financial disaster, the careful negotiation of the contract of sale is essential. Although many of these cases go unreported, the recent decision of *Newport Partners v. DHCR*, [15 Misc3d 1125(A) (NY Sup.Ct.)] is typical of the hazards uninformed transactional attorneys can create for their clients.

In *Newport*, the purchaser of a building had to defend an

overcharge proceeding. The seller of the building had, some time prior to the sale, performed extensive renovation work in two apartments, in order to satisfy regulations that would allow the apartments to be elevated out of rent regulation. Two years after the sale, the purchaser of the building had to defend the legitimacy of the rents charged for those apartments, based on the records of the renovations the purchaser had to obtain from the seller. The seller was uncooperative in providing those records to the purchaser.

New York's residential rental supervisory agency, the Division of Housing and Community Renewal ("DHCR"), found that it is incumbent upon the purchaser of a building containing residential rent-regulated units to secure records from the seller, including leases, rent ledgers, invoices, cancelled checks, orders, and other documents necessary to establish the rents charged and paid. Due to the purchaser's failure to do so, the court sustained a finding of willful overcharge subject to treble damages, totaling more than \$45,000.

In cases like *Newport Partners*, new landlords face hundreds of thousands of dollars in overcharge damages for naive

reliance on the paperwork of their predecessors. This article offers an alternative to naiveté with suggestions for well-written enforceable contract clauses and well-conducted due diligence.

New York's residential rent regulations severely limit the rental income a property owner may collect and restrict a buyer's ability to evict a tenant. There are more than a million rent regulated apartments in New York City, principally under the older more restrictive regulations known as "rent control" and the newer less restrictive scheme known as "rent stabilization." Even in places where there is no control or stabilization, other rent regulatory schemes, e.g., Section 8, make understanding New York's complex residential rent laws crucial when advising a client who is contemplating the purchase of a building containing even only a few residential units. This is true even if the transactional attorney's duty is completed by answering the first question in these deals by determining that the building is completely free of regulation.

RENT STABILIZATION VS. RENT CONTROL

Rent-stabilized units comprise the largest group of regulated tenancies. To qualify, a building must contain six or more units. Rent-stabilized tenants are required to have written leases, and, subject to delineated exceptions, landlords are required to renew these leases perpetually. The regulations do, however, include number of relatively unusual circumstances under which apartments may be removed from rent stabilization. These cases should be handled by highly specialized litigation attorneys.

Rent Control, enacted in response to the housing crisis following World War II, generally applies to older buildings. Under

relatively common circumstances, close relatives can inherit rent-controlled apartments, extending the reach of this highly restrictive system long past the life-time of the original tenant. There is no requirement for a lease in rent-controlled premises and no grounds for eviction based on the absence or expiration of a lease. (The advantage to landlords in having a lease is the presence of a jury waiver clause.) When the last qualified relative has finally vacated a rent-controlled apartment, it may become either unregulated or subject to rent stabilization.

In exchange for receiving large real-estate tax advantages, landlords may voluntarily elect to take on the burdens of rent stabilization by taking advantage of New York City's "J-51" and "421-a" tax abatement programs. While these are supposed to place the buildings temporarily in rent stabilization, if the leases do not contain language warning the tenant that rent stabilization is coming to an end, the regulatory coverage is essentially perpetual. Thus, the purchaser's attorney must examine all of the leases in the building to make sure that they contain the qualifying language.

VACANT IS BEST

For small buildings — and especially those buildings where the purchaser intends to establish the purchaser's New York residence — the goal should be to secure a vacant building at closing. A number of building purchasers have attempted eviction proceedings only to find that the building contains some essentially inevitable tenants.

To avoid this financial nightmare, the contract of sale should include a provision postponing the closing until vacancy of all the occupied units and including daily

penalties for each day the building cannot be delivered vacant, allowing the purchaser rescission of the contract beyond some stated date. In New York, possession constitutes constructive and inquiry notice of a tenancy. Consequently, a buyer should be knocking on every residential door to assure that supposedly vacant apartments really are unoccupied.

Because entirely vacant buildings are so rare, usually a client will be inheriting tenancies. For tenanted buildings, the contract of sale should include due diligence provisions that will allow one to determine the building's potential profits or losses and ensure that a closing does not occur until these problems are resolved.

First, the contract of sale should list:

- 1) The status of all of the building's units;
- 2) The names of all tenants and occupants;
- 3) The amount of the rents being collected;
- 4) Any arrearages owed;
- 5) Representations that no tenant is entitled to rental concessions or abatements; and
- 6) Indications of the status of any proceedings pending involving any existing tenant.

The sales contract should require the disclosure of all past and current litigation. However, even with this provision in the contract of sale, no due diligence report is complete without a search of the records of the various courts having jurisdiction over landlord-tenant issues in order to learn whether the building is subject to any court orders or other litigation. A thorough search will also check on each of the tenants, commercial or residential, to ascertain which of them may present

particular problems or may be chronic non payers.

When counseling clients, the advice you offer them will depend largely on whether the client wants to use the property essentially as is or whether he wants to add to or replace the building with some other kind of structure. Adding to the building will run into relatively few problems with residential tenants, and problems little different from those in any other American city with regard to commercial tenants. However, if demolition is part of the plan, the presence of even a single residential tenant can delay the implementation of the plan for years, entailing filing for numerous permits, and enduring complex dealings with both the DHCR and the court system. Usually in these scenarios, landlords can save substantial money simply by buying out the residential tenants; however, savvy tenants can extort very considerable sums.

To avoid the seller's granting favorite tenants "sweetheart" leases, the contract of sale should restrict the seller from entering into any leases post-contract without the buyer's permission. However, the buyer will have to use that power intelligently since under the residential rent regulations, renewing a tenant's residential lease can shorten the time to regain possession of a unit for an owner's personal use or for the demolition of a building. Therefore, any renewal should be prepared or presented to the buyer for approval before signature.

The contract must not only require that the seller indemnify the buyer for misrepresentations of the status of particular tenancies, but also must require appropriate proof that each vacant unit was the subject of a legal eviction or voluntary surrender. Similarly, the seller must be held to

indemnify the buyer for any judgments or awards from overcharge claims — both residential and commercial — or illegal evictions.

To ensure that the rent listed in the lease matches the rent paid to the landlord, the buyer should demand a copy of all existing and terminated leases of all occupied units as well as recent verification of rent payments, such as copies of checks and tax returns. To avoid losing income, the buyer's attorney should also collector require at closing:

1) A list of security deposits and a provision that provides for transfer of deposits at closing;

2) Copies of bank statement showing those funds are properly deposited;

3) Copies of existing and past litigation, including orders from any governmental agency relating to the property; and

4) Documentation transferring any existing service contracts.

No contract should be signed with-out a permission letter signed by a seller permitting the buyer to review a copy of the building's records at the DHCR. Upon presentment, DHCR will provide a registration statement listing every registered residential ten-ant since 1984, as well as every ten-ant's registered rent for each year. More detailed DHCR records will list any pertinent orders, such as findings, judgments, or orders reducing a tenant's rent for reduction of services.

As *Newport Partners, supra*, teaches, however, reliance on these reports is not enough. They should be compared with the leases provided by the seller, all renewal leases, and the deal sheet. Such a comparison will assist in:

1) Determining whether the ten-ants have been charged the corrector legal rent;

2) Verifying the legality of the apartments listed as deregulated or free market apartments;

3) Obtaining data on any tenants without leases; and

4) Discovering any illegal occupancies.

Furthermore, such an inquiry will assist in revealing any potential over-charge claims that could result in treble damages against the buyer and provide the ability to understand any inconsistencies or questions regarding the data.

A SOLID CONTRACT AND DUE DILIGENCE

While it is essential to put appropriate clauses in the contract of sale to protect the purchaser, no purchaser's counsel should place too much reliance upon them. The shrewd practitioner will not believe seller assurances of cooperation after closing, assuming instead that once the seller has the proceeds of the sale in hand, he will no longer participate in building affairs. Thus, it may be necessary to escrow part of the proceeds to secure against known pending problems in the building.

Similarly, the purchaser's attorney cannot believe representations of deregulation. Instead, the purchaser should attempt to obtain proof that none of the existing tenancies are rent-regulated and that it was never enrolled in any program that subjected it to voluntary regulation.

All New York City buildings built after 1938 and buildings with completed alterations pursuant to a building permit are required to have certificates of occupancy. The purchaser's counsel must obtain a copy of the building's certificate to ensure that all of the units are being

used only in their legally permitted ways.

The extent to which a buyer will assume violations and liens must be negotiated. One must also search the records at the Department of Buildings and the City's Environmental Control Board and Department of Housing Preservation and Development. While it is not essential that all these violations be cleared before title passes, appropriate arrangements for their financial consequences are vital. There is no substitute for thorough physical inspections of the property; however, these records will often reveal illegal occupancies, violating the certificate of occupancy.

Single Room Occupancy buildings ("SROs") and lofts may present occupancy problems. In order for an SRO to undergo structural repairs and renovations, such as conversion to greater commercial use, it is necessary to obtain from the City certificate of No Harassment, stating that there have been no efforts by the prior owners or the

seller to harass the tenants out of the building.

If the building being purchased was previously used as a factory or warehouse, particularly if it has cast-iron architecture, even if the purchaser believes the building is being used strictly for commercial purposes, one must check for any proceedings pending before the New York City Loft Board. Many of these buildings have hidden residential tenancies, and, in a minority of these buildings, residential occupancy is limited to "artists in residence." To be a qualifying artist, the tenant must be certified by the New York City Department of Cultural Affairs. The failure of such certification leads to the eviction of that tenant, but leaves the landlord only able to rent residentially to one who is so certified or to a commercial tenant.

Even for indisputably commercial units, special care is necessary. The leases for any such units should be thoroughly reviewed with a search for options to renew, rights of first refusal, and any services

or repairs the new owner will be required to provide. Most commercial leases require tenants to sign estoppels letters confirming the tenancy and stating that the tenant has no claim against the landlord. The sales contract should require the seller to have the tenants complete these letters.

CONCLUSION

It is a complicated task to purchase a New York City commercial building with known or potential residential tenancies. However, with careful physical and documentary investigation, most of the potential traps for an unwary buyer can be revealed. The real crux is for the purchaser's attorney to commit sufficient time and resources to take all the necessary steps to maximize the client's profits and minimize the client's risks. There is no formula for doing due diligence in these purchases. This article merely presents the starting place. Any full report will have to note the circumstances peculiar to each unique piece of property.