New York
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MARCH 2011

Q&A

Effects of Warranty of Habitability on Mortgage Foreclosures

Q Since the financial crisis in 2008, it seems as though more and more owners are becoming unable to pay for repairs to their over-mortgaged buildings. These owners may be unable to borrow additional money to finance repairs because they have negative equity in their buildings or because they have collected less rent in the past few years as a result of giving away too many "preferential rents" in order to entice tenants to occupy apartments.

As building maintenance deteriorates, tenants start claiming that the warranty of habitability has been breached and are awarded rent abatements—making it even more difficult for owners to pay their mortgages. What effect do tenants claiming rights under the warranty of habitability have on the mortgage foreclosure process? Would owners bidding on a building at a foreclosure sale be bound by the warranty after the sale?

A According to attorneys **Adam Leitman Bailey** and **Dov Treiman**, the neglect of repairs and the inability to pay the mortgage are, in most buildings, a self-feeding cycle that virtually guarantees that the tenants will live in ever-increasing squalor until the building itself is, of public necessity, torn down.

While intended to be a great benefit to tenants, the warranty of habitability winds up working against tenants and for nobody once this cycle initiates. Here's how the process usually unfolds:

With income-producing property, an early step in the foreclosure process typically is the appointment of a receiver to collect the income of the property and disburse it for the purpose of preserving the property so it will bring as high a price as possible at the auction that lies near the end of the foreclosure process.

Yet, one court decision provides that if a receiver seeks to collect rent where there has been a violation of the warranty of habitability, not only is the receiver's claim for rent defeated, but the tenant can procure an order from the receiver's appointing court—during the term of the receivership, before the building is sold in the foreclosure sale—directing the foreclosing party to pour more money into the building to effect the repairs required by the warranty (and, of course, required by the various municipal codes) [Fourth Federal Savings Bank v. 32-22 Owners Corp., February 1997].

While this outcome is supposed to be tenant friendly, consider how tenant hostile it is in actual practice, say Bailey and Treiman. If there's a receiver, the receiver is as liable for the warranty of habitability as anyone else. If, on the other hand, the

tenants start a rent strike under Article 7A of the Real Property Actions and Proceedings Law, the Administrator appointed by the civil court is also equally subject to the warranty of habitability.

As a result of the receiver's or Administrator's inability to collect enough rent to make the required repairs, it becomes less likely that a private buyer will bid on the building at auction, especially considering that any buyer would also be bound by the warranty of habitability and any rent abatement orders in effect. It then becomes more likely that the building will be sold for taxes and come under New York City ownership.

But the city is still bound to the same rigors of the warranty of habitability. If the city sponsors a cooperative apartment corporation and returns the building to private ownership, it doesn't help the tenants any. Cooperative apartment corporations are also bound by the warranty of habitability, even with respect to the common areas. And while condominium units are not directly subject to the warranty of habitability, when the city re-privatizes a building, it's always in the form of a cooperative, never a condominium.

Risk of Personal Injury Claims

There are other sources of liability, too. When looking at the questions of repairs to a building, the warranty of habitability speaks only to contract liability. But the questions of tort liability shouldn't be ignored—specifically, what happens if someone gets hurt by the shoddy condition of the building?

The answer to this question is a matter of who owns the building, but also who *controls* the building is a determining factor. So, when a mortgagee brings a foreclosure proceeding against the mortgagor, if there's no appointment of a receiver, tort liability remains that of the mortgagor alone up until the very moment the title to the building passes by the execution of the deed as a result of the foreclosure auction. Further, there's no responsibility on the part of an out-of-possession mortgagee (usually a bank) to comply with state and local building or housing codes or to make any other repairs. But any receiver would have such liability both with respect to complying with building and housing codes and in tort if someone is injured.

In these foreclosure situations, it is almost inevitable that the tenants will live in ever-increasing squalor, and the parties involved in the foreclosure—mortgagor, receiver, Administrator, city, or newly formed coop— will be unable to afford repairs and the greater liability for personal injury claims. Therefore, eventually, the building is likely to be torn down.

Pay Mortgage or Make Repairs?

As long as the law is as it is, the owner is pretty much trapped once the cycle begins, say Bailey and Treiman. Although it runs completely contrary to instinct, the only hope to get out of this situation is to pay for repairs before paying the mortgage, they advise. While the bank's own enlightened self-interest may push it to renegotiate the mortgage or enter a forbearance agreement to try to get the owner back on financial track, the owner can expect no such cooperation from the tenants. To them, abatements mean free rent, and it's just too enticing to forgo. Of course, even that won't do any good against a tenant who smells blood and purposely sabotages the building or an individual apartment.

Check for Violations Before Bidding

It's important to realize that even if you're buying a building at foreclosure, it doesn't have to be a pig in a poke. Go to HPD's Web site and DOB's Web site to check for violations. If the building is violation heavy, steer clear unless you have enormous capital to

bring the building completely up to snuff as soon as you buy it. And even if you do, be aware that there are parts of the city where stealing a building from owners through a fraudulent 7A process is an everyday occurrence.

The only change in the law that could prevent this situation would be to limit the warranty of habitability to standard rental arrangements and not have it apply to the city, 7A Administrators, receivers, or cooperatives.