The Warranty of Habitability, an Unexpected Hazard in Foreclosure

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Most owners and nearly all educated tenants in this state are aware of the existence of the warranty of habitability. Few may know that it is statutory in basis, fewer care that it contradicts the common law, but most would be surprised by the types of occupancy to which it does and does not apply. Even more surprising to most would be the effect it has on the mortgage foreclosure process. While this doctrine is not new, it is enjoying a new prominence in the popular and legal press because tenant advocacy groups are finding that the epidemic of foreclosures has brought with it a renewed pandemic of neglected housing. It is no secret that about one in nine multifamily buildings in New York City is financially distressed, meaning the income generated from the building does not meet operating costs and other expenses. Where an owner has lost the ability to pay its mortgage, it follows that the owner has also lost the ability to make repairs to the building. If the tenants seek to have the building maintained, usually through court proceedings, finding a funding source for the repairs can be challenging.

Understanding the Cycle

To put the entire process in perspective, one must realize that neglect of repairs and inability to pay the mortgage is, in most distressed buildings, a self-feeding cycle that creates a negative situation for both owners and tenants. While facially a great benefit to tenants, the warranty of habitability, found in Real Property Law Section 235-b, winds up working against all parties involved once the cycle is initiated.

This is how it goes: The building, for whatever reason, does not generate enough revenue from rents to enable the owner to make repairs. This was a fairly common scenario in the late 1970s and early 1980s and led to the devastation of many square miles of the South Bronx. A number of factors made the Bronx particularly vulnerable, including the construction of the Cross-Bronx Expressway in the 1960s that had destroyed huge swaths of middle-class neighborhoods, rendering previously desirable housing undesirable by reason of the sudden presence of an interstate highway as a next-door neighbor.[i] Similar but less severe results were seen in swaths of Brooklyn disturbed by the earlier construction of the Brooklyn-Queens Expressway.[ii]

Eventually the scars on neighborhoods healed and these neighborhoods, especially those well served by the subway system, became once again desirable places to live and therefore desirable places to invest. That, however, was the set-up for the current wave of neglect. The very desirability of these locations drove the prices of the buildings very high, especially as it appeared increasingly easy to build a cooperative, a condominium, or even a rent-regulated building with the tax breaks associated with the J-51 program.

The financial system melt-down in 2008 only added to the problem, with overpriced, and some over-mortgaged, buildings, all with negative equity, popping up on the market. Even unregulated buildings became unable to carry their own mortgages because tenants lacked the funds to pay the higher rents. And in regulated buildings, so-called "preferential rents," where an owner charges significantly less than the law allows, came very much into vogue, and left owners with less revenue to meet operating costs.

So owners found themselves simply unable to pay for repairs to the building, especially for those buildings carrying a mortgage inflated far beyond the building's recession-adjusted equity. Once the owner could no longer stay current on repairs, tenants started claiming entitlement to an abatement in rent for breach of the warranty of habitability. This meant that the owner got still less rent and had still less ability to effect repairs. So the inability to effect repairs became more severe, leading to still lower rents, and so on. Foreclosure became inevitable.

Dangers from Receivers

With income-producing property, one of the more typical early steps in the foreclosure process is the appointment of a receiver to take in the income of the property and to disburse it for the purpose of the preservation of the property. Preservation of the building is necessary to bring as high a price as possible at the auction that lies near the end of the foreclosure process. Yet, one decision, *Fourth Federal Savings Bank v. 32-22 Owners Corp.*,[iii] lies like an alligator under the surface of a pond waiting to snap its jaws at any passing prey. Under *Fourth Federal*, 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 and before the building is sold in the foreclosure sale – that the foreclosing party invest more money into the building to effect the repairs required by the warranty and by the various municipal codes. However, if the foreclosing party does not move for such a receiver, there is no case imposing that kind of wash-back liability. While the idea of wash-back liability could theoretically discourage the bringing of foreclosure actions in the first place, for foreclosure counsel it should certainly make them think twice about moving for the appointment of a receiver.

Limits of the Warranty

While the enhanced liability accompanying receivership is designed to be tenant-friendly, consider how hostile it is to both owners and tenants in actual practice. If there is a receiver, the receiver is as liable on the warranty of habitability as anyone else.[iv] 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.[v] If the building is sold for taxes and the building comes under New York City ownership, the City is still bound to the same rigors of the warranty of habitability.[vi] If after the building is sold for taxes, the City sponsors a cooperative apartment corporation and returns the building to private ownership, the cooperative apartment corporation is bound by the warranty of habitability,[vii] even as to the common areas.[viii] While condominium units are not directly subject to the warranty of habitability,[ix] when the City re-privatizes a building, it is always in the form of a cooperative, never a condominium.

Unconventional Wash-back Liability

In all the scenarios we have discussed, there is no question that the tenant is a tenant; but it is the owner who may be somewhat difficult to recognize, particularly with condominium ownership. A condominium owner is no species of tenant at all, but rather the owner of a dwelling in fee simple absolute, the vertical equivalent of owning a one family home. Yet even for these owners, the warranty of habitability can become an issue, but not running in favor of the unit owner. That is to say, when a condominium unit owner rents out the unit to someone who we would be inclined to call a "subtenant," but who is in fact a tenant, the unit owner takes on the warranty of habitability, being the warrantor, rather than the warrantee.[x] The situation is somewhat different in a cooperative, however. There the unit owner normally is a tenant. If, however, that tenant rents the place out to a subtenant, the unit owner, being out of possession, has no claim to the warranty of habitability,[xi] but rather is responsible for the warranty to the subtenant.[xii] The unit owner bears the liability to the subletting occupant; the cooperative itself has no such liability.[xiii]

When we look at all of this through the lens of wash-back liability under *Fourth Federal*,

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we see that in a foreclosure on a cooperative apartment building, the foreclosing bank may want to think twice before appointing a receiver. In foreclosing on an individual cooperative unit, the procedure does not call for a receiver; so there is no issue. In foreclosing on a condominium unit, the only wash-back liability issues could come from persons to whom the individual unit owners have rented their units.

Other Sources of Liability

Of course, when looking at the questions of repairs to a building, the warranty of habitability only speaks to contract liability. One should not ignore the questions of tort liability, specifically what happens if someone gets hurt by the shoddy condition of the building. This question cannot be answered purely in terms of who owns the building, but also in terms of who controls the building.[xiv] So, when a mortgagee brings a foreclosure proceeding against the mortgagor, if there is 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.[xv] Further, there is no responsibility on the part of an out of possession mortgagee (foreclosure plaintiff) to comply with State and local building or housing codes or to make any other repairs.[xvi] However, any receiver would have such liability both with respect to complying with building and housing codes and in tort if someone is injured.[xvii]

Mortgagees in Possession

Many older mortgages and some new ones allow for the mortgagee to short-circuit the receiver process and step directly into possession. However, this gives the mortgagee the worst of both worlds. First, it makes the mortgagee personally liable to its last penny for anything in the building, warranty of habitability, building codes, injuries – anything. Secondly, it places the building in a legal position where nobody has the statutory authority to bring a summary proceeding for unpaid rent.[xviii]

Conclusion

It is easy in all the situations we have discussed to look for villains. Yet there is nothing villainous about an honest tenant wanting decent housing; nothing villainous about a bank wanting its loan repaid; nothing villainous about an honest owner not being able to make ends meet. So without anyone to blame, who is to pay for any damage that may occur? Several decisions have hinted that the only possible solution lies in legislation. Unfortunately, government finances at the moment may not be better than those of the distressed building, so the legislative response would likely only reallocate the pain rather than provide a solution. ◆

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i Rooney, *Organizing the South Bronx*, (Albany, NY 1995).

ii http://www.nycroads.com/roads/brooklyn-queens (Last visited 8/10/2010).

iii 236 A.D.2d 300, 653 NYS.2d 588 (1st Dept 1997).

iv *Bankers Federal Savings, FSB v. 247 W. 11th St. Owners Corp.*, 19 HCR 345A, NYLJ 6/5/91, 22:6 (Sup NY Evans).

v *HPD v. Sartor*, 109 AD2d 665, 487 NYS2d 1 (AD1 1985); *Westway Plaza Assocs. v. Doe*, 179 AD2d 408, 578 NYS2d 166 (AD1 1992).

vi *HPD v. Sartor, supra*; *City of NY v. Jones*, 20 HCR 319A, NYLJ 5/28/92, 24:5 (AT 2 & 11); *City of NY v. Lewis*, 20 HCR 319B, NYLJ 5/28/92, 24:6 (AT 2 & 11); *City of NY v. Rodriguez*, 117 Misc2d 986, 461 NYS2d 149 (AT1 1983).

vii *31171 Owners Corp. v. Thach*, 21 HCR 169B, NYLJ 4/21/93, 21:2 (AT1); *Granirer v. Bakery, Inc.*, 54 AD3d 269, 863 NYS2d 396 (AD1 2008).

viii *2121 Shore Condo [Bd. of Mgrs.] v. Pennachio*, 19 HCR 605A, NYLJ 10/4/91, 25:3 (AT 2 & 11).

ix *Abbady, et al. v. Abbady*, 216 AD2d 115, 629 NYS2d 6 (AD1 1995); *Frisch v. Bellmarc Mgt., Inc.*, 190 AD2d 383, 597 NYS2d 962 (AD1 1993); *Parkchester North Condo [Bd. of Mgrs.] v. Quiles*, 234 AD2d 130, 651 NYS2d 36 (AD1 1996); *Strathmore Homeowners Assoc. v. Colon*, 28 HCR 356A, NYLJ 5/30/00, 27:1 (AT 9 & 10).

x *Itskov v. Rosenblum*, 7 Misc3d 135(A), 801 NYS2d 235 (AT1 2005).

xi *Park South Tenants Corp. v. Chapman*, 19 HCR 522A, NYLJ 8/26/91, 24:2 (AT1); *Clinton Hill Apt. Owners v. Gooden*, 20 HCR 393B, NYLJ 6/26/92, 24:6, HCR Serial #00003086 (AT 2 & 11); *142 E. 16 Coop Owners, Inc. v. Jacobson*, 26 HCR 345A, NYLJ 6/5/98, 29:3 (AT1).

xii *Pickman Realty Corp. v. Hess*, 21 HCR 328B, NYLJ 6/22/93, 27:4, HCR Serial #00000640 (AT 2 & 11).

xiii *Wright v. Catcendix Corp.*, 248 AD2d 186, 670 NYS2d 15 (AD1 1998); *McCarthy v. Bromley Condo [Bd. of Mgrs.]*, 271 AD2d 247, 706 NYS2d 104 (AD1 2000).

xiv *Mortimer v. East Side Savings Bank*, 251 A.D. 97, 295 N.Y.S. 695 (4th Dept. 1937).

xv *Forbes v. Aaron*, 27 Misc.3d 719, 897 N.Y.S.2d 849 (Sup Kings 2010).

xvi *Greenpoint Bank v. John*, 256 A.D.2d 548, 682 N.Y.S.2D 438 (2d Dept. 1998); *and see 207 Realty Assocs., LLC v. DHCR*, 45 AD3d 364, 845 NYS2d 285 (AD1 2007).

xvii Multiple Dwelling Law §4 (44) casts liability for effecting repairs and as a consequence tort liability on "owner or owners of the freehold of the premises or lesser estate therein, a mortgagee or vendee in possession, assignee of rents, receiver, executor, trustee, lessee, agent, or any other person, firm or corporation, directly or indirectly in control of a dwelling."

xviii *Singer v. Bermudez*, 117 Misc2d 708, 458 NYS2d 1018, TLC Mortgagee In Possession 1, TLC Serial #0041 (Civ NY Lehner 1983).