

Pitfalls for Buyers

Careful Drafting, Detailed Inquiries Minimize Risk

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Recent case law demonstrates that buyers of residential property with rent-regulated units have been blind-sided by financial risks arising from their attorneys' ignorance of rent regulatory laws. Although many of these cases go unreported, the recent decision of *Newport Partners v. DHCR*,¹ 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, supposedly elevating those apartments 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.

In the proceedings before the DHCR, the purchaser claimed that it had relied in good faith on the rent registrations filed by the seller. The DHCR found that it is incumbent upon the purchaser of a rent-regulated building 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.

The court sustained a finding of willful overcharge subject to treble damages, totaling more than \$45,000.

Cases like *Newport* show that new landlords face hundreds of thousands of dollars in overcharge damages in naïve reliance on the paperwork of their predecessors. This article offers an alternative to naïveté with suggestions for well written enforceable contract clauses² and well conducted due diligence.

Besides restricting a buyer's ability to evict a tenant, rent regulation also severely limits the rental income a property owner may collect. There are over a million rent-regulated apartments in the City of New York and another seventy-five thousand



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scattered throughout portions of Nassau, Westchester and Rockland counties and certain upstate cities.³ Even in places where there is no rent control or stabilization, other rent regulatory schemes like Section 8 make understanding New York's complex residential rent laws crucial when advising a client contemplating the purchase of a residential building. This is true even if the transactional attorney's duty is completed by answering the first question in these deals by determining the building is unregulated.

In order to increase a building's income and to prevent potentially financially devastating circumstances, the careful negotiation of the contract of sale is essential.

Rent-stabilized units comprise the largest group of regulated tenancies. To qualify, a building must contain six or more units. If it is a New York City building, it must have been built before Dec. 31, 1973. The operative date is Jan. 1, 1974 everywhere else rent stabilization applies.⁴ Rent-stabilized tenants are required to have written leases and, subject to delineated exceptions, landlords are perpetually required to offer renewal leases. Once an apartment becomes vacant and the legal registered rent rises above \$2,000 per month, the apartment is no longer subject to rent stabilization. During a tenancy, an apartment may be taken out of rent stabilization if the tenant has reported annual income of \$175,000 or more for two consecutive years.

Rent control, enacted in response to the housing crisis following World War II, generally applies to residential buildings constructed prior to February, 1947 in municipalities that have not declared an end

to the emergency. For an apartment to be subject to rent control today, the tenant must have been continuously residing in the apartment since before July 1, 1971.⁵ In addition, any immediate family member living with the tenant continuously for at least two years, may succeed to rent-control status. Rent-controlled tenancies are not required to maintain leases.⁶

Once a rent-controlled occupant leaves the apartment vacant, the next tenancy may be either free-market for legal rents above \$2,000 or rent stabilized below \$2,000.

Landlords may elect to take on the burdens of rent stabilization by taking advantage of the "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.

For the smallest buildings and especially those dwellings being converted to personal use by the buyer, 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 unevictable tenants.

To avoid this financial nightmare, the contract of sale should include a provision postponing the closing until vacancy and including daily penalties for each day the building could not be delivered vacant, allowing the purchaser rescission of the contract beyond some stated date. Because possession constitutes constructive and inquiry notice of a tenancy,⁷ a buyer should be knocking on every door to assure that supposedly vacant apartments really are unoccupied.

Since entirely vacant buildings are so rare, usually your 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:

- The status of all of the building's units;
- The names of all tenants and occupants;
- The rents being collected;
- Any arrearages owed;
- Representations that no tenant is entitled to

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