

## Less Developable NY Property Requires More Innovation

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With less developable property available in Manhattan, developers have had to become more innovative in their quest for acquisitions that will provide a rate of return that makes economic sense to pursue. Some of that innovation has resulted in broadening development to neighborhoods in outer boroughs that were previously off the grid as undesirable, unattractive, unfashionable and, in some instances, viewed as simply unsafe. Some of that innovation has resulted in developers looking at deals that they would never previously have considered because of potential problems in developing the property. As an example, there are sometimes problem tenants in buildings that are otherwise in good locations and have the potential, if vacated, to allow a tear-down or to be able to build up because of the availability of excess floor area ratio and air rights.



Luise A. Barrack

That there may be more risk associated with an acquisition should not necessarily result in a "no thank you" to the party who has unearthed the possible deal. In fact, there may be a substantial amount of potential value in developing, repurposing or repositioning an asset that has been neglected by the current owner or that the owner simply did not want to address. However, to ascertain whether untapped value exists and whether enough value exists to move forward with a possible acquisition of the property, despite the problems attendant to the development, the property should be thoroughly analyzed from top to bottom and the likelihood of being able to achieve the developer's goals should be evaluated. Nothing that is set forth in the offering should be taken as a given.

In order to assess and, in some fashion, quantify the risks associated with the potential plans, it is critical that the developer have due diligence performed. Some diligence can be easily performed by the click of a key on a public website and some requires an in-depth analysis by experienced counsel.

The analysis should begin with evaluating the legal status of the property. In order to understand what can legally be done with the property, one of the first pieces of information collected should be what the property's current certificate of occupancy provides and if the property can be converted to another use group. Additionally, the property should be examined to see if it is otherwise subject to government agency restrictions that may limit what can be done with the property. For example, if the property is a landmark and is subject to the Landmarks Preservation Committee, the developer will be restricted in its ability to alter the exterior of the property or the property could be in a historic zone which has limitations as well. There may be a regulatory agreement in place with the Housing Development Corporation, which governs what can be done with the property and may restrict any alterations or ownership changes. Or the property could be subject to single room

occupancy restrictions that require an owner to apply to Housing Preservation and Development for a certificate of no harassment in order to be able to perform certain construction work in the building.

If the developer has other ideas as to what they would like to do with the property, based upon its location, etc., they will have to evaluate the zoning to see if those other possibilities are realistic. Clearly, it is a major advantage for the developer to be able to do “as of right” whatever has been determined to be the highest and best use of the property. Having to go through community board meetings or an administrative agency, such as the Board of Standards and Appeals, in order to be able to achieve what one wants to do, will take time, cost money and result in uncertainty about achieving goals. This may be problematic for the lender or the party providing the equity in the deal.

Another critical component in evaluating the property is knowing who and what the tenants are in the building. If there are residential tenants in the building, it must be ascertained if they are subject to any rent regulation. If there are tenants who are subject to rent regulation, the propriety of the rents those tenants are paying must be examined as well as the potential for the developer to increase those rents in the future. If causes of action exist that have not been pursued, those should be evaluated as well. All of the leases should be reviewed and the commercial leases dissected to ascertain the use clause, the term of the leases along with any extension options that exist, and the dates by which those options must be exercised. It is also very important to review whether recapture rights exist that are triggered by the sale of the building or a demolition clause that would permit the prospective owner to exit the landlord-tenant relationship and if doing so requires a buyout payment to the tenant. The tenants’ ability to exit the relationship should also be examined; for example, the tenant’s ability to sublet or assign the lease. A review of the rents being paid and charged should be made, including whether the correct amounts are actually being charged including all escalations and real estate tax charges and confirmation should be made that the tenant is the entity that has been tendering rent and that the tenants are not otherwise in breach of any nonmonetary obligations of their leases.

If the property contains rent-regulated tenants, a further evaluation should be made as to whether the owner has properly registered the property with the requisite administrative agencies and registered the apartments and the rent-stabilized rents at the Division of Housing and Community Renewal. Once that is ascertained, if applicable, an analysis should be conducted as to the consequences for failure to have done so. In addition, if the property owner is marketing the property or units in the property as unrestricted by any rent regulatory system and the rents as unregulated, the accuracy of those claims must be scrutinized and verified. Anyone interested in the property would also want to know if any litigation is pending against the building owner in connection with the property — either in the courts or before administrative agencies, that, as a purchaser, they would be stepping into and what their exposure could be.

It is important to recognize that value can be derived from property that is undervalued because of potential problems with developing the property but that risk exists as well. If you are prepared to travel down the road less traveled, you have to make sure that you are prepared to do so. The more unusual the project, the more that developers need specialized advice in order to navigate the challenges and risks attendant to acquiring and developing properties — especially mixed use properties.

—By Luise A. Barrack, Rosenberg & Estis PC

*Luise A. Barrack is the managing member of New York real estate firm Rosenberg & Estis PC.*

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