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## MUNICIPAL LAW

BY JEFFREY D. FRIEDLANDER

### *Tax & Bankruptcy Litigation*

Among the divisions of the Law Department, one with particularly broad ranging responsibilities is the Tax and Bankruptcy Litigation Division. Its functions are noteworthy not only for the diversity of issues dealt with but also because they contribute directly and significantly to the city's revenues and foster private activities that benefit the city's economy. It is obvious from the division's title that its attorneys handle tax-related matters and bankruptcy cases. What is not evident (because it is not included in its title) is that an important part of the division's responsibilities involves eminent domain proceedings brought on behalf of the city or in which the city has an interest. Here I will present an overview of the division's recent activities in the areas of tax and bankruptcy, reserving for a future article a discussion of noteworthy recent developments in the work of the division on eminent domain.



#### **Bankruptcy Proceedings**

The four attorneys who work in the division's bankruptcy unit protect the city's interests in bankruptcy proceedings. Most often, the city's interest is in the payment of delinquent taxes owed by the bankruptcy debtor, requiring the unit's attorneys to be active in all phases of bankruptcy proceedings by, among other things, opposing motions to expunge claims, objecting to claimed tax exemptions not authorized by federal bankruptcy law and challenging bankruptcy plans which appear to be filed only to avoid the payment of taxes. Bankruptcy proceedings may also involve preserving the city's interests as a regulatory authority, property owner or landlord, contracting party, franchisor, lessor and licensor. Protecting these interests requires attorneys of the bankruptcy unit to appear in bankruptcy courts throughout the United States.

One of the more interesting bankruptcy proceedings handled by the division involves the future of a historic structure in Harlem, known as the Corn Exchange Bank Building. In *Re Corn Exchange, LLC*, Case No. 08-46822 (JMP) (Bankr. S.D.N.Y. 2009). That case involved the interplay between historic preservation, economic development, public safety and bankruptcy. The late 19th-century Corn Exchange Bank building, located on East 125th Street and constructed of brick and sandstone with brick terracotta and iron detail, was listed in the National Register of Historic Places in 1989 and was designated an individual landmark by the city's Landmarks Preservation Commission in 1993.

In 2003, after the city had acquired title to the building as a result of the tax delinquency of the previous owner, the New York City Economic Development Corporation (EDC), on behalf of the city, conveyed the property to Corn Exchange LLC on condition that the transferee rehabilitate the premises and obtain a certificate of occupancy for a culinary institute to operate there. In 2009, after the transferee had failed to perform within the time period provided by the deed, EDC petitioned the New York County Supreme Court to enforce the deed provision specifying that title would revert to EDC upon default by the transferee. *New York City Economic Development Corp. v. Corn Exchange, LLC*, 22 Misc.3d 1132A (Sup. Ct., N.Y. Co. 2009).

Hours after State Supreme Court Justice Judith Gische had granted EDC's motion for summary judgment and ruled that title had reverted to EDC under the deed, the transferee, while pursuing an appeal of the court's decision, filed for Chapter 11 bankruptcy in the Southern District of New York. The city and EDC requested that the matter be dismissed, arguing that the bankruptcy filing was not made in good faith but rather was an attempt to take advantage of the automatic stay provided in federal bankruptcy law of any proceedings affecting a bankruptcy debtor's property or, in the alternative, that the city be allowed to proceed with its proposed rehabilitation of the building pursuant to the exception to the stay provided for government entities exercising their police or regulatory powers. The city and EDC further argued that the substantive issues before the bankruptcy court (relating primarily to the defaults of Corn Exchange LLC under the deed covenants and its ability to obtain adequate funding for the building's restoration) had already been decided by state Supreme Court and should not be relitigated.

Although Bankruptcy Judge James M. Peck did not rule initially on the city's motion to dismiss and/or to lift the automatic stay and permitted Corn Exchange LLC to proceed with the process of confirming the proposed bankruptcy reorganization plan, following an evidentiary hearing that included testimony from the city's Department of Buildings (DOB) regarding the need for immediate stabilization of the building and from EDC concerning the cost of rehabilitating the building, he declined to approve the proposed reorganization plan and subsequently dismissed the proceeding. In the autumn of 2009, the city's Department of Housing Preservation and Development executed DOB's emergency declaration to stabilize the building by removing the top two floors, and was able to preserve the remainder.

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The division's bankruptcy attorneys have also been actively involved in a number of the major Chapter 11 bankruptcies filed by not-for-profit hospital corporations in the past five years, including *In re Saint Vincents Catholic Medical Centers, et al.*, confirmed Ch. 11, Case No. 05-14945(ASH) (Bankr. S.D.N.Y.) ("the first St. Vincents bankruptcy"); *In re Caritas Health Care Inc.*, Ch. 11, Case No. 09-40901 (CEC) (Bankr. E.D.N.Y.); *In re Our Lady of Mercy Medical Center, et al.*, Ch. 11, Case No. 07-10609 (REG) (Bankr. S.D.N.Y.); *In re Brooklyn Psychiatric Centers Inc., d/b/a Brooklyn Care Works, Converted to Ch. 7*, Case No. 08-42658 (JF) (Bankr. E.D.N.Y.); *In re Cabrini Medical Center*, Ch. 11, Case No. 09-14398 (AJG) (Bankr. S.D.N.Y.); *In re Saint Vincents Catholic Medical Centers, et al.*, Ch. 11, Case No. 10-11963 (CGM)(Bankr. S.D.N.Y.) ("the second St. Vincents bankruptcy"); and *In re North General Hospital, et al.*, Ch. 11, Case No. 10-13553 (SCC) (Bankr. S.D.N.Y.).

Recognizing the impact of the bankruptcy of voluntary hospitals on the provision of health services to the city's population, it was nonetheless the duty of the Law Department to ensure that the city's statutory liens for unpaid water and sewer charges, which in the hospital bankruptcies have involved millions of dollars and which are "preferred in payment to all other charges," see Administrative Code of the City of New York §11-301, and "take precedence over all other liens or encumbrances," see Public Authorities Law §1045(j)(5), retain their first priority against the debtors' lenders.

The division's bankruptcy attorneys frequently objected to debtors' motions to sell assets under Chapter 11, preventing such liens from being extinguished pursuant to the sale orders of bankruptcy courts, which generally approve asset sales free and clear of all liens, claims and encumbrances, and attempted to obtain satisfaction of the city's liens at the closing of the asset sale. As a result of this involvement, the division was able to secure the collection of more than \$2 million in unpaid water and sewer charges from bankrupt Saint Vincents Catholic Medical Centers of New York during the course of its 2005 and 2010 Chapter 11 bankruptcy, more than \$1 million in water and sewer charges from bankrupt Caritas Health Care, the purchaser at the St. Vincents bankruptcy auction of the Mary Immaculate and St. John's Hospitals, and a substantial portion of the \$4.5 million in water and sewer arrears from bankrupt Cabrini Medical Center.

In addition to this function, the division's bankruptcy attorneys have achieved other city objectives in these proceedings. In the first St. Vincents bankruptcy and the Our Lady of Mercy bankruptcy, the Law Department represented the New York City Fire Department to prevent assignment of the hospitals' 911 non-assignable ambulance agreements without its prior written consent. Following the city's objections, the debtors' motions to assume and assign these executory contracts were resolved on a consensual basis

ensuring that an adequate 911 response was available to the public.

In the first St. Vincents bankruptcy, the division's bankruptcy attorneys advised the Mayor's Office of Management and Budget concerning the city's rights as a contingent secured lender in a transaction among the debtor, the Primary Care Development Corporation (PCDC) and the Dormitory Authority of the State of New York (DASNY) with respect to \$10 million in outstanding tax exempt bonds issued by DASNY to finance the construction of the St. Dominic's health clinic, operated by the debtor in Queens.

The city worked to ensure that the rights of PCDC as the debtor's lessor and mortgagee would continue to be honored and, when the property was sold by the debtor to Caritas Health Care Planning Inc. in January 2007, that the outstanding DASNY bonds, secured by the PCDC mortgage, retained their tax exempt status and the debtor's obligation to make payments on the bonds, which equaled the rent payable to PCDC, was assumed by Caritas. When, subsequently, Caritas filed its own Chapter 11 petition, the division's bankruptcy attorneys, again working with PCDC and DASNY, succeeded in transferring the St. Dominic's clinic as an ongoing concern to the Abbado Family Health Center, without interruption of health care, while once more preserving the tax exempt status of the DASNY bonds and ensuring that the obligation to pay was assumed by the purchaser.

Another recent case involved assuring the uninterrupted transportation of school children. In *In re Caravan Transit Inc., J.D. Transit Inc. and Caravan Safety Corp.*, dismissed Ch. 11, Case No. 08-46822 (ESS) (Bankr. E.D.N.Y.) (2009), the division's bankruptcy attorneys represented the Department of Education's Office of Pupil Transportation (DOE) in the Chapter 11 filing of three companies ("the debtors") operating school buses for special education children pursuant to three multi-year, contracts with DOE. At issue in that case was the debtors' motion for approval of the sale of their assets without repayment of certain moneys owed to DOE and, most important, without the employee protection provisions contained in their contracts with DOE.

DOE's primary concern in this case was to ensure that learning disabled children, who must be provided with transportation by DOE, could continue to be transported to school without interruption by strikes from bus operators that might have resulted in part from omission of the employee protection provisions. After the division's bankruptcy attorneys objected to the debtors' proposed asset sale and the assignment of the DOE contracts to another student transportation provider, the debtors entered into negotiations with DOE and a union representing the debtors' employees.

These negotiations resulted in a Consent Order, approved by the Bankruptcy Court (Judge Elizabeth Stong) on Dec. 19, 2008, that authorized the debtors to conduct an auction sale of their assets pursuant to an amended agreement of sale which acknowledged the amounts owed by the debtors to DOE,

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incorporated the employee protection provisions in the proposed sale and required all bidders to consider hiring certain employees. The court approved the sale of all of the debtors' assets by Sale Order dated Feb. 19, 2009, free and clear of all liens but subject to, among other things, the employee protection provisions and repayment, to the extent possible, of the moneys owed to DOE. As a result of the sale, the debtors' prior bus routes continued in operation, transporting learning disabled children with minimal disruption.

### **Tax Matters**

The primary revenue-producing responsibility of the Tax and Bankruptcy Litigation Division is its representation of the city in tax matters. This responsibility consists of three functions: defending the City Department of Finance's levying and collecting of income and excise taxes, primarily as they relate to incorporated and unincorporated businesses; defending the Department of Finance's assessments of real property, which serve as the basis of the city's real property tax revenue; and representing the city against the possible over-assessment of city-owned watershed property by upstate communities with jurisdiction over the watershed. The judicial review of an assessment of real property for tax purposes, whether city-owned or privately owned, and regardless of its location, is known as a "tax certiorari" proceeding.

1. Commercial Rent or Occupancy Tax. The city's Commercial Rent or Occupancy Tax (CRT), imposed pursuant to chapter 7 of Title 11 of the Administrative Code of the City of New York, is generally levied on the amount of base rent paid by a tenant to a landlord in Manhattan for the use or occupancy of commercial premises. The determination of the amount of a tenant's base rent is subject to certain deductions and exemptions, including a deduction for subtenant rents, an exemption for certain governmental and charitable institutions, and an exemption for tenants of the "World Trade Center Area" in Manhattan. Administrative Code §11-704(a).

The general rule in New York is that a tax deduction or exemption must be construed narrowly against a taxpayer. See *Grace v. N.Y. State Tax Comm'n*, 37 N.Y.2d 193, 196-97 (1975). Recently, attorneys in the division's tax unit successfully defended that principle in a case that turned on the distinction between a ferry "landing slip" and a "pier." Administrative Code §11-704(c)(3) provides for a CRT deduction for "piers...used in interstate or foreign commerce." The court held that this deduction could not be read broadly to include a taxpayer ferry service's "landing slips" located at Battery Park in Manhattan. See *Matter of Circle Line Statue of Liberty Ferry*, NYC Tax Appeals Tribunal, TAT (H) 08-82 (CR) (April 27, 2010).

2. Certiorari Matters. The city's Department of Finance classifies and, once each year, assesses the value of over one million tax lots within the city for real property tax purposes.

Pursuant to §1802 of the Real Property Tax Law, these tax lots are classified into four different classes of property. The statutory basis for the assessment of these properties is found in various provisions of the Real Property Law, the Real Property Tax Law, the New York City Charter and the Administrative Code. The property tax income collected as a result of these assessments is one of the city's primary sources of revenue. Therefore, 18 attorneys of the division's Tax Certiorari unit devote their time to protecting this source.

Most of the work of these attorneys is devoted to resolving disputes over property assessments. In order to challenge the assessment of real property, petitions pursuant to Article 7 of the Real Property Tax Law must be timely filed each year. Currently pending in the division are multi-year petitions against almost 12,000 properties. Most such disputes are resolved through settlement, since at trial the city's assessment is presumed valid and the petitioner must prove, by a preponderance of the evidence, that the property at issue was overvalued.

Attorneys of the Tax Certiorari unit also negotiate and litigate disputes over property classification, which arise because of differences in the frequency and amount by which the city may increase assessments for various classes of properties. In addition, these attorneys resolve disputes relating to claims for full or partial exemption from real property taxation, based on statutory provisions for certain exempt uses (e.g., operation by a religious or not-for-profit organization).

The Tax Certiorari unit maintains an office in Kingston, N.Y., which performs the reverse function: the office represents the city's interests as a taxpayer in the upstate watershed, where it owns a substantial amount of real property. The city's watershed, comprising the Delaware, Catskill and Croton systems, currently encompasses approximately 180,000 acres of land in eight New York State counties and 73 towns, villages and hamlets. The city pays approximately \$120 million in property taxes each year on the real property and water supply infrastructure such as dams and dikes, hydroelectric plants, and sewage treatment. In some cases, these properties comprise over half of the entire tax base of some of the upstate jurisdictions in which they are located.

Each year the attorneys in the Kingston unit file approximately 20 certiorari petitions on some of the most highly specialized or unique properties that are difficult to assess. Rather than litigating each case, the emphasis is on settlement negotiations with upstate communities and maintaining good working relationships with the local jurisdictions. These efforts have led to agreement on valuation "templates" or formulas which have enabled the parties to standardize the assessment of the city's wastewater treatment plants. Negotiations on similar templates for determining the valuation of other structures, including reservoirs and lands under water, are under way.

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*Jeffrey D. Friedlander* is first assistant corporation counsel of the City of New York. *Gabriela Cacuci, Robert Paparella, Steven Tishco and Joshua Wolf*, attorneys in the tax and bankruptcy litigation division of the law department, assisted in the preparation of this article.