

ASK THE FORMER REGULATOR

Expert Analysis

## Clarifying the Law on Escrow Accounts And Certificates of Occupancy

**Q**uestion: I am a condominium sponsor in New York City, and I am getting conflicting guidance on whether I need to set money aside if I begin to sell condo units with only a temporary certificate of occupancy. Can you explain to me what the law is and what a sponsor needs to do?

Answer: The offer and sale of real estate securities such as cooperatives and condominiums is governed by General Business Law (GBL) §352-e, et seq. (the Martin Act). The Martin Act is a disclosure statute that empowers the Department of Law to promulgate suitable rules and regulations governing disclosure that must be provided to prospective purchasers.

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ERICA F. BUCKLEY is the practice leader for the cooperative and condominium team at Nixon Peabody. She is the former chief of the Real Estate Finance Bureau at the New York Attorney General's office. This column is for informational purposes only and is not a substitute for agency guidance from the Department of Law.

By  
**Erica F.  
Buckley**



While the test of the Martin Act is not overly specific on disclosure, it does in fact explicitly regulate the treatment of purchaser down payments. GBL §352-e(2-b) requires that “[a]ll deposits, down[] payments or advances made by purchasers of residential units shall be held in a special escrow account pending delivery of the completed apartment or unit and a deed or lease[,] whichever is applicable, unless insurance of such funds in a form satisfactory to the attorney general has been obtained prior thereto.” In furtherance of GBL §352-e(2-b), the Department of Law issued guidance on Oct. 13, 2015, which defines a completed apartment

or unit as one that has a permanent certificate of occupancy (a PCO). See Real Estate Finance Memorandum, “Certificates of Occupancy and Part 20 Offering Plans.” Because GBL §352-e(2-b) governs the conversion of both new construction as well as occupied rental properties to cooperative or condominium status, the escrow requirements apply to any type of offering where a sponsor is selling apartments or units without a PCO.

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As written, the regulations do not require a sponsor to establish a separate escrow account from the special escrow account established to maintain purchaser down payments.

In New York City, the Department of Buildings (the DOB) will issue a temporary certificate of occupancy (a TCO) when a building is deemed safe for occupancy, despite the fact that the building is not complete.

However, a sponsor is still obligated to procure a PCO under the Multiple Dwelling Law, as well as the Martin Act. Once all work is complete and administrative filings are made to the DOB, a PCO will be issued.

In addition to the Real Estate Finance Memorandum, the Department of Law has promulgated regulations for new construction and gut-renovated properties to carry out the requirements of GBL §352-e(2-b). Those regulations are as follows:

If the first closing may take place prior to the issuance of a permanent certificate of occupancy for the property:

(i) Sponsor is required to maintain all deposits and funds in any special escrow account required by *General Business Law, section 352-e(2-b)* unless the [s]ponsor's engineer, architect[,] or other qualified expert certifies that a lesser amount will be reasonably necessary to complete the work needed to obtain a permanent certificate of occupancy, in which case the sum exceeding the amount so certified by the [s]ponsor's engineer, architect[,] or other qualified expert may be released from any special escrow account. Alternatively, [s]ponsor must deposit with an escrow agent

an unconditional, irrevocable letter of credit, post a surety bond in the amount so certified, or provide other collateral acceptable to the Department of Law.

13 NYCRR §20.3(t)(13)(i).

As written, the regulations do not require a sponsor to establish a separate escrow account from the special escrow account established to maintain purchaser down payments. This means that the only funds that are set aside to secure a sponsor's obligation to procure a PCO are purchaser down payments. However, under the Martin Act, a sponsor is not entitled to use those funds until it has closed on the apartment or unit. Specifically, GBL §352-h states:

Whenever hereafter any person, partnership, corporation, company, trust[,] or association, offers or sells securities described in subdivision one of section three hundred fifty-two-e of this article to the public in or from the state of New York, then all moneys received in connection therewith, including deposits or advances therefor, shall continue to be the money of the person making such purchase, deposit[,] or advance, and shall be held in trust by the person, partnership, corporation, company,

trust[,] or association offering or selling such securities and shall not be commingled with the personal moneys or become an asset of the person, partnership, corporation, company, trust[,] or association receiving the same, and shall not be subject to attachment, levy[,] or other encumbrance in any action by a third party against such person, partnership, corporation, company, trust[,] or association[,] and said funds shall remain in trust until actually employed in connection with the consummation of the transaction ...

Under the plain language of GBL §352-h, a purchaser's down payment cannot be used by a sponsor until after the purchaser has closed. There are in fact some exceptions to this, in that funds for custom work may be released from escrow because they are being "employed in connection with the consummation of the transaction." *Supra*. Otherwise, the regulations merely require that in order to begin closing on apartments or units with a TCO, a sponsor must have an architect or engineer certify the amount of money needed to procure a PCO, and any monies above that amount may be released from escrow

as soon as closings commence.

Let's consider an example scenario where a sponsor commences sales in a new construction 20-unit building in Brooklyn. Sponsor has entered into contracts with the required 15% purchasers needed to declare the plan effective, and has collected down payments in the amount of \$900,000.00. Prior to the first closing, sponsor's architect certifies that \$150,000 is needed to procure the PCO. At the first closing, sponsor has \$900,000 in escrow, \$300,000 of which is held on behalf of the first purchaser to close. Under the Martin Act, governing regulations, and Department of Law guidance, sponsor can close on the first unit without putting any additional funds in escrow. Furthermore, sponsor may release the \$300,000 from escrow on the date of closing, and may continue to close on units so long as the escrow balance is at least \$150,000.00.

While the above scenario is entirely legal under the Martin Act and Department of Law regulations and guidance, there may be other good reasons to establish a separate escrow account prior to the first closing. For example, in the scenario above, sponsor can arguably only close on one additional unit before issues arise regarding

the amount of money held in escrow. Also, many lenders will want separate assurances that sponsor has the financial means to procure the PCO from funds separate from down payments, which oftentimes go to pay down equity investors or a construction loan at the time of each closing. Finally, it might be preferable for the escrow agent to have upfront assurances that the obligation to procure a PCO is not somehow tied to the escrow agent at the time of unit closings. In other words, it might simply be best practice to ensure that the monies needed to procure the PCO are squared away early in the process so the funds don't fall through the cracks during the closing process.

In sum, while the Martin Act and Department of Law regulations and guidance may not require a sponsor to set up a separate escrow account to insure its obligation to procure a PCO, there may be other very compelling reasons to do so. These reasons may be driven by a lender, equity investor, or legal advice from sponsor's counsel. My best advice to a sponsor would be to set aside the account prior to first closing on an apartment or unit with a TCO, and this includes both new construction or conversion

plans where sales take place without a PCO in place. Moreover, pay close attention to the other requirements set forth in the Real Estate Finance Memorandum entitled "Certificates of Occupancy and Part 20 Offering Plans" and do everything possible to procure the PCO as early on in the process as possible.