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New York Supreme Court

Appellate Division—Fourth Department

BATAVIA TOWNHOUSES, LTD., ARLINGTON HOUSING CORPORATION, and BATAVIA INVESTORS, LTD.

Plaintiffs-Respondents,

– against –

COUNCIL OF CHURCHES HOUSING DEVELOPMENT FUND COMPANY, INC.,

Defendant-Appellant.

Docket No.:
CA 19-01672

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TABLE OF CONTENTS

TABLE OF AUTHORITIES ii

QUESTIONS PRESENTED 1

NATURE OF THE CASE 2

STATEMENT OF FACTS 3

A. PROCEDURAL BACKGROUND 3

B. FACTUAL BACKGROUND 4

C. THE SUPREME COURT'S DECISION 9

ARGUMENT 13

A. THE TOLLING OR REVIVAL OF THE LIMITATIONS PERIOD IS GOVERNED BY GOL § 17-105, WHICH REQUIRES A WRITTEN PROMISE TO PAY THE DEBT 13

B. THE PARTNERSHIP'S FINANCIAL STATEMENTS DID NOT TOLL THE LIMITATIONS PERIOD 17

1. The financial statements are not signed by the debtor 18

2. The financial statements do not promise to pay the mortgage debt 18

C. THE PARTNERSHIP'S TAX RETURNS SHOULD NOT BE CONSIDERED 21

D. THE PARTNERSHIP'S TAX RETURNS DID NOT TOLL THE LIMITATIONS PERIOD 23

E. THE PARTIAL PAYMENTS IN 2019 DID NOT REVIVE THE LIMITATIONS PERIOD 25

CONCLUSION 29

PRINTING SPECIFICATIONS STATEMENT 31

TABLE OF AUTHORITIES

Cases **Page(s)**

20 Plaza Housing Corp. v. 20 Plaza East Realty,
37 Misc.3d 601, 950 N.Y.S.2d 871 (N.Y. Cty. 2012) 18

Artisan Stainless Specialties, Inc. v. Broadway Equities,
294 A.D.2d 385 (2d Dept. 2002) 24

Baily v. Hornthal,
154 N.Y. 648 (1898) 28

Bloodgood v. Bruen,
8 N.Y. 362 (1853) 13

Byrd v. Roneker,
90 A.D.3d 1648 (4th Dept. 2011) 23

CDR Creances S.A. v. Euro-American Lodging Corp.,
43 A.D.3d 45 (1st Dept. 2007) 10

Chase Manhattan Bank v. Polimeni,
258 A.D.2d 361 (1st Dept. 1999) 20

Clarkson Co. Ltd. v. Shaheen,
533 F.Supp. 905 (S.D.N.Y. 1982) 21

Council of Churches Housing Development Fund Company, Inc. v. Arlington Housing Corporation,
No. 6:18-cv-06920 (W.D.N.Y.) 7-8

Curtiss-Wright Corp. v. Intercontinent Corp.,
277 A.D. 13 (1st Dept. 1950) 19

Delphi Healthcare PLLC v. Petrella Phillips LLP,
158 A.D.3d 1329 (4th Dept. 2018) 27

In re Estate of Corriea,
719 A.2d 1234 (D.C. 1998) 27

In re Grotzinger,
81 A.D.2d 268 (1st Dept. 1981) 29

Henry v Root,
33 N.Y. 526 (1865) 13

Kaminski v. Modern Italian Bakery of West Babylon,
270 A.D.2d 232 (2d Dept. 2000) 6

Luft v. Luft,
52 A.D.3d 479 (2d Dept. 2008) 22

Marmac Inv. Co., Inc. v. Wolpe,
759 A.2d 620 (D.C. 2000) 26, 28

Marston v. Gould,
69 N.Y. 220 (1877) 28

May v. Flowers,
106 A.D.2d 873 (4th Dept. 1984) 28

Meacham v Jamestown, F&C.R. Co,
211 N.Y. 346 (1914) 29

In re Meyrowitz' Estate,
114 N.Y.S.2d 541 (N.Y. Cty. Surr. Ct. 1952) 20

Mohsin v. Port Authority of New York,
83 A.D.3d 536 (1st Dept. 2011) 23

Moore v. Candlewood Holdings, Inc.,
714 F.Supp.2d 406 (E.D.N.Y. 2010) 19, 24

O'Sullivan v. O'Sullivan,
206 A.D.2d 960 (4th Dept. 1994) 22

Pentacon, LLC v. 422 Knickerbocker, LLC,
165 A.D.3d 829 (2d Dept. 2018) 22

Petito v. Piffath,
85 N.Y.2d 1 (1994) 17

Prosser v County of Erie,
244 A.D.2d 942 (4th Dept. 1997) 23

Scheur v Scheur,
308 N.Y. 447 (1955) 13

Sharova v. Wells Fargo Bank, N.A.,
62 Misc.3d 925, 92 N.Y.S.3d 546 (Kings Cty. 2019). Justice Walker's Decision and Order 30

Shelley v. Dixon Equities,
300 A.D.2d 566 (2d Dept. 2002) 18

Skiadas v. Terovolas,
271 A.D.2d 521 (2d Dept. 2000) 19, 24

Szelega v. O'Hara,
159 A.D.2d 890 (3d Dept. 1990) 26

Tucker Anthony Realty Corp. v Schlesinger,
888 F.2d 969 (2d Cir. 1989) 21

Varner v. District of Columbia,
891 A.2d 260 (D.C. 2006) 27

Estate of Vengroski v. Garden Inn,
114 A.D.2d 927 (2d Dept. 1985) 19

Washington Med. Cntr., Inc. v Hollei,
537 A.2d 1269 (D.C. 1990) 26

Statutes

CPLR § 213[4] 9

D.C. Code § 29-704.08(b)(2) 28

GOL § 17-101 .... passim

GOL § 17-105 .... passim

RPAPL § 1501(4) 16, 29

1961 Leg. Doc No. 65 (F) reprinted in McKinney's 1961 Session Laws of New York 14

Other Authorities

IRS Instructions for Form 1065 (2018), available at https://www.irs.gov/pub/irs-pdf/i1065.pdf 24

Bergman, *New York Mortgage Foreclosures* (Bender 2019)............................16, 17

31 *Williston on Contracts* § 79:77 (4th ed.)...13

QUESTIONS PRESENTED

1. Whether the six-year limitations period on a mortgage debt was tolled by the unsigned financial statements of the debtor?

The Supreme Court held that the limitations period was not tolled because the financial statements were unsigned, were not promises to pay the debt, and were not acknowledgements of the debt.

2. Whether a mortgage debt was revived by partial payments made after the expiration of the limitations period where those payments were instigated by the creditor, which was also the general partner of the debtor, in breach of its fiduciary duty to the debtor limited partnership?

The Supreme Court held that the payments did not revive the obligation and that the funds must be restored to the limited partnership.

3. Whether the federal tax returns of a debtor limited partnership tolled the limitations period on a mortgage debt by listing a figure for nonrecourse loans on line 18 of IRS Form 1065?

The Supreme Court did not address this issue in its decision, evidently because the issue had been improperly raised for the first time in the creditor's reply brief.

NATURE OF THE CASE

New York, by statute, has established a limitations period for the enforcement of mortgage debts, and clear rules for how this limitations period may be tolled or revived. It has also authorized an affirmative action to cancel and discharge a mortgage that is barred by the statute of limitations.

In this case, the creditor (mortgagee) was also the general partner of the limited partnership which was the debtor (mortgagor). After the mortgage debt matured, the general partner/creditor stopped making payments on it and allowed the limitations period for enforcing the mortgage debt to expire. Then the general partner/creditor caused the partnership to resume making payments on the expired mortgage debt to further its own interest, not the partnership's interest. The limited partners initiated this litigation to have the debt declared unenforceable and the $330,000 in improper mortgage payments returned to the partnership.

The Supreme Court ruled in favor of the limited partners. The general partner/creditor desperately seeks to avoid this result, arguing that the limitations period on the mortgage debt was either tolled or else revived. Because its arguments fly in the face of the facts and the applicable law, the general partner/creditor seeks to overcome these deficiencies by appealing to the sympathy of this Court.

STATEMENT OF FACTS

A. Procedural Background

This is a derivative action by the limited partners of respondent Batavia Townhouses, Ltd. (the "Partnership") to establish that a note and its associated mortgage ("WrapAround Note and Mortgage") made by the Partnership and held by the general partner of the Partnership, appellant Council of Churches Housing Development Fund Company, Inc. ("Council"),[1] is unenforceable because the statute of limitations has expired. The limited partners sought cancellation and discharge of the WrapAround Note and Mortgage, together with associated declaratory and injunctive relief.

Council moved for summary judgment at the same time it answered the complaint, arguing that the six-year limitations period had been tolled by the Partnership's annual financial statements, which listed the mortgage debt. The limited partners then filed a cross-motion for summary judgment and argued, among other things, that the financial statements did not toll the limitations period because they were not signed by the debtor as required by the governing statute. In its reply brief, Council argued for the first time that the limitations period was also tolled by the Partnership's federal tax returns, which were signed by a representative of the

[1] Appellant styles itself as the "Churches" in its brief although it does not have any church or clergy members. Justice Walker referred to it as the "Council" in his decision and respondents shall do so here to avoid confusion.

Partnership. (R. 31, lines 10-24). At the motions hearing, Justice Walker noted that courts do not consider a new reply brief argument. (*Id.*). Nonetheless, Justice Walker explored the merits of the tax return argument in a colloquy with counsel for the limited partners. (R. 35, line 11 – R. 38, line 25). At the conclusion of this colloquy, Justice Walker said "[s]ounds like [case law that tax returns do not toll the limitations period] would do it for you [the limited partners], even if I do consider the tax returns." (R. 39, lines 1-2). His written decision, however, did not discuss the tax returns.

B. Factual Background

The relevant undisputed facts, as summarized by Justice Walker, are as follows. In 1971, Council borrowed more than $4.7 million from a private lender to develop Birchwood Village Apartments in Batavia, New York. This loan was insured by the U.S. Department of Housing and Urban Development ("HUD"). Council owned and managed Birchwood Village until 1979, but failed to adequately service the loan and ultimately defaulted. At that point the private lender filed a claim under its FHA loan insurance policy and HUD paid off the lender, thereby acquiring the note and associated mortgage. Thereafter, Council continued to default on loan payments and HUD was about to foreclose. (R. 4).

At this juncture, plaintiff Batavia Investors, Ltd. ("Investors"), in conjunction with Council, proposed to HUD that the ownership of the property be changed to

bring in private investors. HUD approved this proposal, but required that a new owner replace Council as the entity managing Birchwood Village. Accordingly, the Partnership was established to acquire and operate Birchwood Village. The Partnership purchased Birchwood Village from Council in 1979 for $5,500,000, and executed the WrapAround Note and Mortgage in that amount.

The WrapAround Note and Mortgage was subordinate to, and "wrapped around," the separate HUD loan. Council remained the obligor on the HUD loan which amounted to $5,588,357.75 as of June 1, 1985. (R. 4-5). Thus, the Partnership owned Birchwood Village but owed $5.5 million to Council to pay for the property, while Council in turn owed HUD a slightly greater amount on the loan it had taken out originally to construct the property.

The Partnership is a for-profit entity. The Partnership Agreement provided that the Partnership would operate the property "in such manner as will conform to all rules and regulations of [HUD], and insofar as is consistent therewith, will maximize the Federal, state and local income tax benefits available to the Partnership." It further provided that the limited partners would receive almost all of the tax benefits and a <u>primary</u> share of any Partnership profits and/or residual equity. (R. 5).

The record does not support Council's assertion that "the WrapAround Note and Mortgage always was intended to serve as the mechanism that ensured the

Limited Partners would receive no more than the tax benefits for which they bargained … and permit[] [Council] to insist that the Apartments be returned to their ownership upon dissolution of the Partnership." (Br. 15-16). The Partnership could pay off (or pay down) the WrapAround Note and Mortgage if it had the funds to do so. And Birchwood Village could be sold to a third party, rather than reverting to Council pursuant to the mortgage, if its sale value was sufficient to pay off the note and generate a profit for the Partnership.

Originally, the Partnership had two general partners, Council and David C. Green, and one limited partner, Investors. In 1982, plaintiff Arlington Housing Corporation ("Arlington") replaced Mr. Green as a general partner. In 2004, Arlington converted to a limited partner, leaving Council as the sole general partner.[2] (R. 5).

Both the HUD mortgage loan and the WrapAround Note and Mortgage matured on March 1, 2012. Until that time, income generated by Birchwood Village was used by the Partnership (controlled by Council) to pay debt service on the WrapAround Note and Mortgage and, in turn, those funds were used by Council to pay debt service on the HUD mortgage loan in the monthly amount of $25,288.40.

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[2] The reason why Arlington converted to a limited partner is irrelevant to the issues in this case and so was not discussed by Justice Walker. Yet Council dwells in its brief on the unproven claims that led to Arlington's change in partnership status as part of a settlement agreement. (Br. 6-7, 8). It is, of course, improper to impugn a party's character by referring to irrelevant matters. *See Kaminski v. Modern Italian Bakery of West Babylon*, 270 A.D.2d 232, 232-33 (2d Dept. 2000). Such advocacy has no place either in a trial or an appellate brief.

The HUD mortgage loan was paid off on schedule in February 2012, leaving the WrapAround Note and Mortgage as the sole encumbrance on Birchwood Village. (R. 5).

After March 1, 2012, Council stopped using the income generated by Birchwood Village to make any debt service payments on the WrapAround Note and Mortgage. (R. 5).

In August 2018, Arlington and Investors accused Council of violating its duties as the general partner by keeping the rents at Birchwood Village artificially low[3] and preventing the Partnership from paying off the WrapAround Note and Mortgage, thereby siphoning the equity interest of Arlington and Investors to its own account.[4] On November 19, 2018, Arlington and Investors moved to remove Council as general partner of the Partnership pursuant to the Partnership Agreement by sending a 30-day notice of removal to Council that would take effect on December 19, 2018. On December 17, 2018, Council filed suit in federal court seeking to block its removal. *Council of Churches Housing Development Fund*

[3] After the HUD mortgage note was repaid in 2012, HUD rules and regulations, including rent limits, ceased to apply to Birchwood Village.

[4] Raising the rents at Birchwood Village and paying off the WrapAround Note and Mortgage would increase the equity value of the Partnership, which would be distributed primarily to the limited partners upon a sale of the property or dissolution of the Partnership. Conversely, by restricting the rents and allowing the size of the mortgage debt to increase each year, Council decreased the equity value of the Partnership and increased its ability to regain ownership of Birchwood Village through foreclosure because any third party purchaser would have to bid more than the amount of the mortgage.

Company, Inc. v. Arlington Housing Corporation, No. 6:18-cv-06920 (W.D.N.Y.). Arlington and Investors filed a counterclaim to enforce the removal of Council as general partner. (R. 6).

Although the WrapAround Note and Mortgage matured on March 1, 2012, Council never instituted an action to foreclose on it. No payments on the WrapAround Note and Mortgage were made by the Partnership from March 1, 2012, when it matured, until seven years later, on March 6, 2019, after litigation between the parties had commenced. (R. 6).

Council, as the creditor, had made no demand for payment from the Partnership, as the debtor, at any time from March 1, 2012 until February 7, 2019. On that date, Council's Board of Directors adopted a resolution stating that Council, as holder of the note, demanded that the Partnership "resume monthly debt service payments of interest on the Note & Mortgage in the amount of $27,500.00 per month in accordance with paragraph 3 of the Note & Mortgage, commencing August 2018."[5] The resolution stated that the purpose for demanding resumption of the mortgage payments was because Council "has an immediate need for cash resources in order to defend itself and assert its interests in the litigation with the [limited partners]." *Id.*

[5] This portion of the resolution appears at R. 214.

Then Council, acting in its capacity as general partner of the Partnership, made a series of "mortgage payments" to itself in its capacity as holder of the note. These payments started on March 6, 2019, and totaled $330,000. These "mortgage payments" were made without the consent of the limited partners. (R. 6).

Pursuant to Sections 14.1 and 14.2 of the Partnership Agreement,[6] the general partner is required each year to prepare a written financial statement for the Partnership and distribute it to the limited partners. Accordingly, annual written financial statements were prepared under the oversight of a certified public accounting firm and were provided to the general and limited partners, together with an auditor's report certifying that the financial statement fairly presented the financial position of the Partnership. These financial statements list the WrapAround Note and Mortgage as a liability of the Partnership. (R. 7).

Justice Walker noted that, "[i]mportant here, the financial statements are not signed. The auditor's reports are signed by the accounting firm." (R. 7).[7]

C. The Supreme Court's Decision

Justice Walker commenced his legal analysis by noting that an action to foreclose a mortgage is subject to a six-year statute of limitations. CPLR 213[4].

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[6] These provisions appear at R. 99-101.

[7] The Partnership's financial statements and auditor's reports appear in the record as follows: 2012-2013 at R. 129-42; 2013-2014 at R. 143-56; 2014-2015 at R. 157-70; 2015-2016 at R. 171-84; 2016-2017 at R. 185-98; and 2017-2018 at R. 199-212.

The limitations period on the WrapAround Note and Mortgage began to run the day after its maturity date, i.e., on March 2, 2012, and expired on March 2, 2018. (R. 7, citing *CDR Creances S.A. v. Euro-American Lodging Corp.*, 43 A.D.3d 45, 51 (1st Dept. 2007)). Thus, the WrapAround Note and Mortgage were *prima facie* unenforceable, and the burden shifted to Council to show that the limitations period had either been tolled or revived. (R. 8). Council conceded these points at oral argument. (R. 28-31).

Council contended in its motion for summary judgment that the WrapAround Note and Mortgage remained enforceable because, during the period after March 1, 2012, the Partnership had continued to include the debt in its annual financial statements and because, since March 6, 2019, it had made partial payments of the debt. Justice Walker ruled that "these facts are insufficient to toll or revive the statute of limitations." (R. 8).

Justice Walker rejected Council's argument that GOL § 17-101 governs whether the WrapAround Note and Mortgage had been tolled or revived. He noted that this statute, by its explicit terms, does not cover an action for the recovery of real property. (R. 8). Instead, the tolling or revival of a mortgage debt is governed by GOL § 17-105, which provides:

> A waiver of the expiration of the time limited for commencement of an action to foreclose a mortgage of real property or a mortgage of a lease of real property, or a waiver of the time that has expired, or a promise not to plead the expiration of the time limited, or not to plead the time

> that has expired, or *a promise to pay* the mortgage debt, if made after the accrual of a right of action to foreclose the mortgage and made, either with or without consideration, by the express terms of a writing signed by the party to be charged is effective, subject to any conditions expressed in the writing, to make the time limited for commencement of the action run from the date of the waiver or promise." (emphasis added).

Section 17-105 is narrower than § 17-101 because it provides that only a written "promise to pay the mortgage debt" can toll or revive the debt. (R. 8-9). In contrast, § 17-101 provides that either "an acknowledgement or promise" can revive other forms of debt:

> *An acknowledgment or promise* contained in a writing signed by the party to be charged thereby is the only competent evidence of a new or continuing contract whereby to take an action out of the operation of the provisions of limitations of time for commencing actions other than an action for the recovery of real property. This section does not alter the effect of a payment of principal or interest. (emphasis added).

Justice Walker concluded that "the omission of an 'acknowledgement' as a means of tolling or reviving a mortgage debt [in § 17-105] must be construed as a deliberate policy choice by the legislature; only a written promise to pay the debt will suffice." (R. 10).

Justice Walker then analyzed whether the Partnership's annual financial statements constitute a written express promise to pay the mortgage debt, signed by the Partnership as the debtor. He identified two reasons why the financial statements do not satisfy § 17-105. First, they were not signed by the Partnership. Second, they

did not promise to pay the debt; rather, they merely list the WrapAround Note and Mortgage as a liability. (R. 11).

Furthermore, Justice Walker found that the financial statements do not constitute even an "acknowledgement" of the debt. First, because they were not signed by the Partnership, as required even under § 17-101. (R. 11). Second, because merely carrying the debt on the Partnership's books did not evidence a clear intention to pay the debt. (R. 11-12). Third, because the financial statements were not communicated to the debt-holder with an intent to influence the debt-holder's conduct. Instead, Council, as the general partner of the debtor, prepared them for internal distribution to the limited partners (to whom the debt is not owed) pursuant to Sections 14.1 and 14.2 of the Partnership Agreement. (R. 13).

Finally, Justice Walker found that "Council's [2019] actions to re-commence [mortgage] payments a year [after the limitations period expired] -- in the midst of litigation over whether it should be removed as general partner -- constitutes a breach of its fiduciary duty as general partner of the Partnership." (R. 14). He cited both New York and District of Columbia cases in support of this conclusion. He ruled that "the 2019 payments are invalid and must be set aside, and the funds restored to the Partnership." (*Id.*).

ARGUMENT

A. The Tolling Or Revival Of The Limitations Period Is Governed By GOL § 17-105, Which Requires A Written Promise To Pay The Debt

On this appeal, Council contends that Justice Walker's decision is "mistaken because it did not fully understand the interplay between General Obligations Law 17-101 and 17-105." (Br. 38). To the contrary, Justice Walker understood the interplay perfectly. He correctly concluded that this case is governed by § 17-105, not by § 17-101.

Justice Walker recognized that, "'[a]t common law, an acknowledgment or promise to perform a previously defaulted contract obligation was effectual, whether oral or in writing, at least in certain types of cases, to start the statute of limitations running anew.'" (R. 9, quoting *Scheur v. Scheur*, 308 N.Y. 447, 450-51 (1955)). "Although an acknowledgement of a debt is not a promise to repay it, the acknowledgement provides a basis from which the common law would imply such a promise." (R. 9-10, citing *Henry v. Root*, 33 N.Y. 526, 530 (1865); *Bloodgood v. Bruen*, 8 N.Y. 362, 368 (1853); 31 *Williston on Contracts* § 79:77 (4th ed.)).

Justice Walker reasoned that, "[a]gainst this background, the legislature provided in GOL § 17-101 that a written 'acknowledgement or promise' is sufficient to revive most contracts and debts, but adopted a different standard with respect to reviving debts involving real property. For the latter category, it provided that only 'a promise to pay the mortgage debt … made … by the express terms of a writing

signed by the party to be charged is effective.' GOL § 17-105." (R. 10). He correctly concluded that "the omission of an 'acknowledgement' as a means of tolling or reviving a mortgage debt must be construed as a deliberate policy choice by the legislature; only a written promise to pay the debt will suffice." (*Id.*).

Taking issue with Justice Walker's analysis, Council invokes the legislative history of GOL § 17-105 and quotes selectively from the 1961 report of the Legislative Revision Commission explaining the rationale for the provision. In fact, however, the Commission's report squarely supports Justice Walker's conclusion.

The Commission recognized that, as of 1961, "[i]n New York and most states a barred mortgage may … be revived by an 'acknowledgement.'" 1961 Leg. Doc. No. 65(F), reprinted in *McKinney's 1961 Session Laws of New York* at 1873. After discussing the existing case law regarding "acknowledgements," however, the Commission cautioned that "it is doubtful whether a satisfactory clarification on this area of the law can be accomplished by decisional development without a prolonged period of uncertainty or without repeated litigation." *Id.* at 1875. To avoid this outcome, "[t]he Commission believes that legislation is needed to provide a coherent set of rules which will give effect, within limits clearly defined, to transactions intended to toll the statute of limitation … without requiring litigation of difficult questions of fact or impairing the security of titles and of real property financing." *Id.*

The Commission believed that, in formulating this new legislation, "two factors should be controlling: first, whether the transaction manifested an intention to waive the statute or not to plead it, and second whether the transaction expressing such intent is sufficiently evidenced." *Id.* at 1876. Applying these factors, the Commission concluded that "[a]n intention to waive the bar of the statute or the time that has expired is also reasonably to be inferred from an express promise to pay the mortgage debt, made after the accrual of a right of action to foreclose the mortgage." *Id.* (emphasis added).

Thus, the Commission explained that GOL § 17-105 deliberately abandoned the litigation-breeding common law rules about tolling or reviving a mortgage debt by a sufficient "acknowledgement." Instead, § 17-105 instituted a bright line rule requiring an express promise to pay the mortgage debt. Council completely misconstrues the Commission's report, arguing that § 17-105 did "not … eliminate the possibility that an intention to pay a mortgage debt could be inferred by something other than an express promise." (Br. 22). To the contrary, the new provision was expressly designed to eliminate litigation and uncertainty over whether a mortgage debt remains enforceable based on an "inference" from something less than an express, written promise to pay the debt.

Council also cites Professor Bergman's treatise in support of its argument that GOL § 17-105 did not make any significant change in the law regarding the tolling

or revival of mortgage debts. However, it fails to cite the relevant portions of the treatise which state that "[t]he authority under which an effective written acknowledgment of a mortgage obligation serves as a revival of the statute of limitations time period has been codified in General Obligations Law (G.O.L.) section 17-105" and, under this provision, "[i]nsufficient as a writing … is an acknowledgment of the debt which does not also contain an unconditional promise to pay the debt." Bergman, *New York Mortgage Foreclosures* § 5.11[6][a] (Bender 2019) (emphasis added). Professor Bergman adds that, "[v]ital though most of the recited case law is and remains, reference to statutes on the point is essential. Moreover, the statutes must be read carefully …." *Id.* § 5.11[7].

Finally, Council suggests in a footnote, without authority, that GOL § 17-105 may be inapplicable to this case because it is not an action for foreclosure but, rather, an action to declare the WrapAround Note and Mortgage unenforceable. (Br. 24 n. 4). But § 17-105 is not limited to foreclosure actions. Rather, by its terms, it provides that the limitations period on mortgage debts may be tolled or revived by either (1) a waiver of (or promise not to plead) the limitations period on a foreclosure action, or (2) a promise to pay the mortgage debt. It therefore applies to any action in which tolling or revival of the limitations period is an issue. RPAPL § 1501(4) provides for an affirmative action to cancel and discharge a mortgage barred by the statute of limitations, and GOL § 17-105 necessarily applies to such an action.

Council notes that courts have sometimes analyzed the enforceability of mortgage debts under § 17-101 instead of, or in addition to, § 17-105. Those courts (or the litigants who framed the issue for them) may have taken "a cursory look" at § 17-101 and been led "to the erroneous conclusion that [it is] applicable to mortgage foreclosure." Bergman, *New York Mortgage Foreclosures* § 5.11[7]. Nonetheless, they may have reached the right decision because (as in this case) it often makes no difference to the outcome whether the analysis is performed under § 17-105 or § 17-101. However, their analyses were flawed to the extent that they purported to apply § 17-101 to a mortgage debt in disregard of the explicit statutory language. No reported decision has ever carefully examined the language of § 17-101 and ruled that it has any applicability to a mortgage debt.[8]

In summary, Justice Walker correctly concluded that the issue of whether the WrapAround Note and Mortgage was tolled or revived is governed exclusively by GOL § 17-105.

B. The Partnership's Financial Statements Did Not Toll The Limitations Period

There are two distinct reasons why the Partnership's financial statements do not satisfy the requirements of GOL § 17-105 to toll the limitations period for

[8] In *Petito v. Piffath*, 85 N.Y.2d 1 (1994), the court ruled that a mortgage debt had not been revived under either GOL § 17-101 or § 17-105, but it failed to note that § 17-101, by its terms, does not apply to an action for the recovery of real property. *Id.* at 7.

enforcing the WrapAround Note and Mortgage. First, the statements are not "signed by the party to be charged," i.e., the Partnership. Second, the financial statements do not constitute an express promise to pay the mortgage debt.

1. The financial statements are not signed by the debtor

The Partnership's financial statements are not "signed by the party to be charged," as required by GOL § 17-105. Indeed, the statements are not signed by anyone. Painting with a broad brush, Council argues that the statements were "signed by the accountants who were directed by the Partnership to prepare them." (Br. 27). But only the Independent Auditors' Reports were signed by the accounting firm. This does not suffice. Nor would it suffice even if the accountants had signed the financial statements. The outside accountants are not "the party to be charged." *See Shelley v. Dixon Equities*, 300 A.D.2d 566, 567 (2d Dept. 2002) (financial records prepared by accountant, and not certified or signed by a principal of the debtor, were not an acknowledgement of a debt); *20 Plaza Housing Corp. v. 20 Plaza East Realty*, 37 Misc.3d 601, 950 N.Y.S.2d 871, 874 (N.Y. Cty. 2012) (annual reports prepared by accountant and not signed by defendant were not an acknowledgement of a debt).

2. The financial statements do not promise to pay the mortgage debt

Furthermore, the financial statements do not constitute an express promise to pay the mortgage debt. As Justice Walker noted, "[t]he annual financial statements

merely list the WrapAround Note and Mortgage as a liability; this does not constitute a promise to pay the debt." (R. 11).

Council argues that "a debtor's financial statements, prepared and signed by a person authorized to do so by the debtor, will serve as an acknowledgement that revives a debt under [GOL § 17-101]." (Br. 27). But, as discussed above, a mere acknowledgement of a mortgage debt does not satisfy GOL § 17-105; instead, an express promise to pay the debt is required.

Moreover, contrary to Council's contention, courts have not found that a debtor acknowledges, and thereby revives, a non-mortgage debt simply by carrying the debt on its books. *See Skiadas v. Terovolas*, 271 A.D.2d 521 (2d Dept. 2000) ("The mere fact that the debt was carried on the defendants' books and tax returns would not, in and of itself, constitute the required acknowledgment."); *Estate of Vengroski v. Garden Inn,* 114 A.D.2d 927, 928 (2d Dept. 1985) (same); *Curtiss-Wright Corp. v. Intercontinent Corp.*, 277 A.D. 13, 18 (1st Dept. 1950)(Van Voorhis, J., concurring) ("Merely carrying an account payable to plaintiff on defendant's books, would not constitute an acknowledgment or promise"). "In general, [New York] courts have concluded that financial statements and tax returns *alone* are insufficient to restart the statute of limitations." *Moore v. Candlewood Holdings, Inc.*, 714 F.Supp.2d 406, 410 (E.D.N.Y. 2010) (emphasis in the original).

Justice Walker correctly concluded that the three decisions on which Council relies do not support its argument. The first decision, *Chase Manhattan Bank v. Polimeni*, 258 A.D.2d 361 (1st Dept. 1999), "held that the defendant's personal financial statement, which carried his debts to plaintiff, constituted an acknowledgement where the defendant authorized his secretary to sign a transmittal letter covering the financial statement and to send those documents to plaintiff. It was the debtor's formal transmission of the financial statement to the creditor, not the statement by itself, that constituted the acknowledgement." (R. 12). Here, the financial statements were prepared by the Partnership for internal use. Council, as the general partner, received a copy. But the statements were never transmitted to Council, as the creditor, for the purpose of acknowledging the mortgage debt.

The second decision, *In re Meyrowitz' Estate*, 114 N.Y.S.2d 541 (N.Y. Cty. Surr. Ct. 1952), held that the inclusion of debts owed by the deceased president to a corporation in the corporate balance sheets constituted an acknowledgement by the president where he was also the controlling stockholder and the other directors were corporate employees under his supervision and control. Justice Walker noted that these were "unusual facts" and the rationale for the decision was that, "'[i]n the manner in which this corporation conducted its affairs, there was no occasion for the debtor to acknowledge the continued existence of the debt and to reiterate his promises to pay, except in the annual balance sheets.'" (R. 12, quoting 114 N.Y.S.2d

at 547). In contrast, as Justice Walker observed, "[t]he facts here present the opposite situation," (R. 12), i.e., the creditor controls the debtor and so could have obtained a formal extension of the debt whenever it wanted.[9]

The final decision is *Clarkson Co. Ltd. v. Shaheen*, 533 F.Supp. 905, 932 (S.D.N.Y. 1982). Justice Walker ruled that, "to the extent this federal decision concludes that merely carrying a debt on a debtor's books constitutes an acknowledgement, this Court does not follow it, because it is at odds with prior and subsequent New York appellate decisions." (R. 13).

In sum, the Partnership's annual financial statements do not toll the limitations period for two distinct reasons: (1) they were not signed by the Partnership, and (2) they did not promise to pay the debt; they merely listed it as a liability.

C. The Partnership's Tax Returns Should Not Be Considered

Justice Walker did not err by disregarding the Partnership's tax returns in his decision because Council failed to raise them in a timely manner. Council said nothing about tax returns in its motion for summary judgment; it relied solely on the financial statements. The limited partners, in their cross-motion for summary

[9] Justice Walker explained that "Council could have protected its interest as debt-holder, either by foreclosing on the WrapAround Note and Mortgage or by causing the Partnership to explicitly reaffirm the debt." (R. 13). But "Council owes a fiduciary duty to the limited partners, and it was incumbent on Council to have the Partnership reaffirm the debt openly and formally, with full disclosure." (*Id.*, citing *Tucker Anthony Realty Corp. v. Schlesinger*, 888 F.2d 969, 973-74 (2d Cir. 1989)). "Having failed to do so, Council cannot now claim that the Partnership implicitly acknowledged the debt to it, as debt-holder, simply by continuing to list the WrapAround Note and Mortgage on internal financial statements." (R. 14).

judgment, pointed out that the financial statements were not signed by the Partnership. Council then invoked the tax returns for the first time in its reply brief, filed two days before the scheduled hearing on the cross-motions.[10] It submitted copies of the Partnership's 2016 and 2017 tax returns with its reply brief.[11]

"The practice of raising a new substantive issue in a reply brief at a time when an adversary can no longer respond to it is improper." *O'Sullivan v. O'Sullivan*, 206 A.D.2d 960 (4th Dept. 1994) (citation omitted). The Supreme Court should not consider arguments that are improperly raised for the first time in reply papers. *See Luft v. Luft*, 52 A.D.3d 479, 480 (2d Dept. 2008). Likewise, this Court does not consider contentions that were improperly raised for the first time in reply papers before the Supreme Court. *See Pentacon, LLC v. 422 Knickerbocker, LLC*, 165 A.D.3d 829, 832 (2d Dept. 2018).

In a vain effort to avoid the impact of this rule, Council now contends that its reply papers should have been considered because they were "directly responsive to the argument in the Limited Partners' motion that no acknowledgement was signed by an authorized representative of the Partnership." (Br. 31). However, Council did not make this contention before the Supreme Court (R. 44-49) and so it is not

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[10] The motions hearing was originally scheduled for July 24, 2019, but was postponed that day because of a bomb scare at the courthouse and rescheduled for July 30, 2019.

[11] The 2016 tax returns appear at R. 270-83; the 2017 tax returns appear at R. 284-96.

properly before this Court. *See Prosser v. County of Erie*, 244 A.D.2d 942, 943 (4th Dept. 1997).

Furthermore, the tax returns were not directly responsive to an argument made by the limited partners, as Council asserts. The limited partners did not argue that no acknowledgement exists anywhere that was signed by the Partnership. Rather, they rebutted Council's contention that the financial statements constitute acknowledgements by noting that these statements were not signed by the Partnership. The limited partners "merely highlighted the deficiency of [Council's] initial papers." *Mohsin v. Port Authority of New York*, 83 A.D.3d 536 (1st Dept. 2011). Council then raised new facts – the tax returns – in its reply papers which were not directly responsive to the limited partners' argument and should not be considered. *Id.* Justice Walker properly disregarded the tax returns and so should this Court.[12]

D. The Partnership's Tax Returns Did Not Toll The Limitations Period

In any event, the tax returns plainly do not satisfy the requirements of GOL § 17-105 in order to toll the limitations period. While the tax returns, unlike the financial statements, are signed by a representative of the Partnership, they do not

[12] In addition, Council has not properly preserved this argument because it did not include the relevant motion papers in the record on appeal. Although legal memoranda are normally excluded from the record, they are properly included for the limited purpose of determining whether certain contentions within them are preserved for appellate review. *See Byrd v. Roneker*, 90 A.D.3d 1648, 1649 (4th Dept. 2011).

satisfy the other condition of Section 17-105 – they do not constitute an express promise to pay the mortgage debt. Indeed, tax returns do not constitute even an "acknowledgement" of a debt for purposes of tolling or reviving a statute of limitations. *See Artisan Stainless Specialties, Inc. v. Broadway Equities*, 294 A.D.2d 385, 386 (2d Dept. 2002); *Skiadas v. Terovolas*, *supra,* 271 A.D.2d at 521; *Moore v. Candlewood Holdings, Inc.*, 714 F.Supp.2d at 410.

Council's argument that "[t]he Partnership's tax returns were … adequate under controlling precedent to reaffirm the obligations memorialized in the WrapAround Note and Mortgage," (Br. 28), is especially far-fetched. Council relies on the entries made on line 18 of Schedule L of IRS Form 1065. This form is used to report the income of every domestic partnership and every foreign partnership doing business in the U.S. or getting income from U.S. sources. Schedule L covers "Balance Sheets per Books," and line 18 covers "All nonrecourse loans." The instructions for Schedule L state that "[t]he balance sheets should agree with the partnership's books and records." IRS Instructions for Form 1065 (2018) at p. 49.[13] The Partnership's tax returns for 2016 and 2017 reflect two entries (figures) on Line 18 – one for "Beginning of tax year" and one for "End of tax year." (R. 274, 288).

Council contends that "[e]ach year, the returns reflected the exact amount of the WrapAround Note and Mortgage as an 'outstanding non-recourse loan,' a

[13] Available at https://www.irs.gov/pub/irs-pdf/i1065.pdf.

reference that, under all the circumstances of this case, is sufficient the [*sic*] reaffirm the WrapAround Note and Mortgage." (Br. 28). To the contrary, these entries simply reported to the IRS the total amount of all nonrecourse loans that appeared on the Partnership's books at the beginning and end of each tax year. They say nothing about the number of such loans, their validity, or the Partnership's intentions about paying them.

The argument that, by filling out its federal tax return, a partnership thereby tolls or revives the limitations period on all the debts referenced therein would effectively eliminate the statute of limitations on partnership debts in New York. This is preposterous. It contradicts the plain language of GOL § 17-105, which requires an express promise to pay a mortgage debt, as well as the body of law interpreting an acknowledgement of a debt under GOL § 17-101. It grasps at straws to invent an express promise to pay the mortgage debt. But the inescapable conclusion is that the Partnership's tax returns did not toll the statute of limitations.

E. The Partial Payments In 2019 Did Not Revive The Limitations Period

Since neither the financial statements nor the tax returns tolled the limitations period, the WrapAround Note and Mortgage became unenforceable on March 3, 2018. Justice Walker correctly ruled that "Council's actions to re-commence payments a year later -- in the midst of litigation over whether it should be removed as general partner -- constitutes a breach of its fiduciary duty as general partner of

the Partnership." (R. 14). He cited a decision holding that an officer and majority shareholder of a small corporation had breached her fiduciary duty to the corporation by causing it to repay time-barred debts to her. *See Szelega v. O'Hara*, 159 A.D.2d 890, 891 (3d Dept. 1990).

Council argues that the payments do not constitute a breach of fiduciary duty under District of Columbia law, which governs the Partnership Agreement. But D.C. law is no more tolerant of fiduciary misconduct than is New York law. Under D.C. law, as Justice Walker noted, "'partners owe each other the duty of the utmost good faith in all that pertains to their relationship,' especially 'in the case of managing general partners in a limited partnership, on whose good faith the other partners depend entirely.'" (R. 14 n. 3, quoting *Washington Med. Cntr., Inc. v. Holle*, 573 A.2d 1269, 1285 & n. 26 (D.C. 1990). Further, "'[g]ood faith will not permit any one partner to advantage himself singly and alone, at the expense of the firm.'" (*Id.*, quoting *Marmac Inv. Co., Inc. v. Wolpe*, 759 A.2d 620, 626 (D.C. 2000)).

Council asserts that "District of Columbia law does not preclude a fiduciary partner from benefitting as a result of its transactions with the partnership, so long as those transactions are not to the detriment of the partnership." (Br. 35). It contends that the payments "did not involve any detriment to the Partnership (but rather paid an existing obligation)." (Br. 36). However, this argument lost its validity once the statute of limitations expired and the WrapAround Note and

Mortgage became unenforceable on March 3, 2018. Payments on a time-barred debt are indeed to the detriment of the Partnership. The 2019 payments transferred $330,000 from the Partnership to Council before the Supreme Court called a halt to them. Furthermore, were Council's argument to be accepted, those partial payments would also revive the balance of the multi-million dollar debt to the detriment of the Partnership and to the benefit of Council.

Council notes that Section 8.3 of the Partnership Agreement provides that general partners are not liable for actions taken in good faith which do not constitute negligence. It proceeds to argue that the limited partners cannot demonstrate any bad faith or negligence on its part and so cannot establish that the partial payments were a breach of fiduciary duty and avoid those payments. (Br. 36). This contention misstates both the applicable law and the operative facts.

"[T]he standard of fiduciary conduct is objective. If the [defendant] committed a breach, ignorance [or] honorable intentions … cannot remedy or excuse the wrong that occurred." *In re Estate of Corriea*, 719 A.2d 1234, 1243 (D.C. 1998) (internal quotation marks and citation omitted). Likewise, negligence is measured against an objective standard of care. *See Varner v. District of Columbia*, 891 A.2d 260, 267 (D.C. 2006).[14] In this case, the standard of care required Council, as the

[14] Because of their similarity, it is not uncommon to see claims for both breach of fiduciary duty and negligence based on the same set of facts. *See Delphi Healthcare PLLC v. Petrella Phillips LLP*, 158 A.D.3d 1329, 1330 (4th Dept. 2018).

general partner, to ascertain the enforceability of the WrapAround Note and Mortgage before resuming payments seven years after the mortgage debt had matured. General partners have no right to make a payment where they have "knowledge of such facts as would put a prudent man upon inquiry." *Baily v. Hornthal*, 154 N.Y. 648, 656 (1898). Council either failed to ascertain the enforceability of the mortgage debt, in which event it was negligent, or else it acted in bad faith by making payments on a debt it knew to be unenforceable. In either event, Council breached its fiduciary duty to the Partnership, and Section 8.3 of the Partnership Agreement does not shelter its conduct.

Moreover, the Partnership Agreement does not relieve Council from its duty of loyalty. The District of Columbia, by statute, forbids a general partner from dealing with the partnership when having an interest adverse to the partnership. D.C. Code § 29-704.08(b)(2). And D.C. law provides that "[w]hen a partner has engaged in self-dealing, that partner has the burden to prove the fairness of his actions...." *Marmac Inv. Co., Inc. v. Wolpe*, 759 A.2d at 625 n. 4 (internal quotation marks and citation omitted). Here, Council cannot possibly prove that its use of Partnership funds to make payments to itself on the unenforceable debt was fair to the Partnership.

Because the payments were a patent breach of fiduciary duty, they are invalid and must be set aside. *See May v. Flowers*, 106 A.D.2d 873, 874-75 (4th Dept. 1984)

(where a general partner breaches its fiduciary duty to limited partners, the transaction is invalid and should be set aside). Council was correctly required to restore the funds to the Partnership. *See Marston v. Gould*, 69 N.Y. 220, 225 (1877) ("Courts of equity hold each partner responsible to the other for all losses sustained by the misconduct [breach of trust] or a misapplication of the partnership funds."); *In re Grotzinger*, 81 A.D.2d 268, 281 (1st Dept. 1981).[15] Likewise, because they were invalid and must be set aside, these payments did not revive the limitations period on the unenforceable mortgage debt.

CONCLUSION

Council's legal arguments were correctly rejected by Justice Walker. Council's repeated assertion that this Court should apply "ordinary business understanding and rules of common sense" to adjudicate this case (Br. 12, 15, 25, 27, 30, 38), is an implicit admission that a straightforward application of the law to the facts does not produce the result it seeks. Hoping to elicit the Court's sympathy, Council laments that a ruling against it would "produc[e] an unexpected windfall to the Limited Partners and an undeserved benefit no party ever anticipated they might obtain." (Br. 13). However, this is the result whenever a time-barred mortgage is cancelled and discharged pursuant to RPAPL § 1501(4). As another court recently

[15] As Justice Walker noted, New York law governs remedies in this matter. (R. 15 n. 4, citing *Meacham v. Jamestown, F. & C.R. Co.*, 211 N.Y. 346, 352 (1914) (Cardozo, J., concurring)).

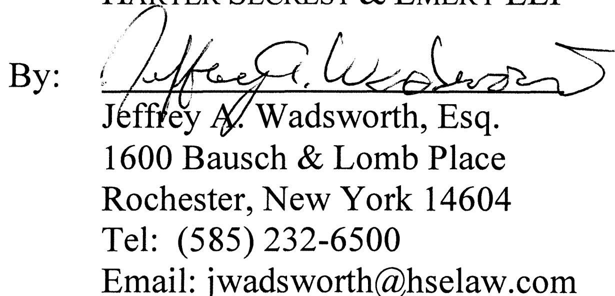
observed, in rejecting a similar "windfall" argument, "it is not for this court to create the law, but only to follow it. It has long been the case that 'sitting on one's rights' has consequences." *Sharova v. Wells Fargo Bank, N.A.*, 62 Misc.3d 925, 939, 92 N.Y.S.3d 546, 557 (Kings Cty. 2019).

Justice Walker's Decision and Order is sound. It should be affirmed.

Dated: November 22, 2019
Rochester, New York

Respectfully submitted,

HARTER SECREST & EMERY LLP

By: 

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