

Can First Rents Be Fair Rents?

Tim Collins

Before the ink dried on the Governor's signature to the Housing Stability & Tenant Protection Act of 2019 ("HSTPA") howls could be heard from the city's real estate industry about how they were being ripped off by short sighted politicians who would ultimately destroy the city's rental housing stock.

Conveniently ignored in this backlash was the fact that owners had been realizing massive profits from regulated housing for decades while rent burdens and economic evictions of tenants had ascended to record levels.

According to the NYC Rent Guidelines Board's 2019 Income and Expense report, average net operating income for rent stabilized buildings has risen well over 50% after adjusting for inflation since 1990. This was largely the result of deregulation of some 300,000 units (many unlawfully), along with massive (and often fraudulent) special rent increases granted for major capital improvements and individual apartment improvements. Property values were galloping forward driven in large part by speculators backed by predatory equity. The name of the game was to purchase regulated buildings cheap, use every legal (and often illegal) tactic to evict tenants and then take advantage of the state's high rent vacancy deregulation laws to lift rents beyond reason into a market driven by chronic scarcity and relentless demand.

This deregulation regime along with excessive annual rent guideline increases, particularly during the last recession, produced unprecedented rent burdens for tenants. As of 2017 a typical rent stabilized household devoted 36% of its income to rent according to the city's triennial housing and vacancy survey. Poor and lower income families had entered a full blown housing nightmare. According to an analysis by the Community Service Society a typical family of three earning \$38,000 per year carried rent burdens in 2017 in excess of half of their total household income. It's no wonder that over 60,000 people, including families with children, occupied the city's homeless shelters every night.

Most of this deterioration in affordability can be attributed to the social engineering skills of the city's real estate lobby. In the early 1990's, after conventional criticism of rent and eviction protections failed to produce regulatory rollbacks, they began to reconceptualize rent regulation as a poorly structured system of subsidies. Their argument rested on two somewhat contradictory criticisms. First, they argued that rent regulations were really designed to protect middle and lower income tenants and wealthy tenants shouldn't receive such "benefits". Second, they argued that rent regulations were an inefficient way to protect poor tenants, and that low income tenants would be better served by direct government subsidies.

The major premise of both criticisms – that rent regulation should be seen as a subsidy program designed to protect lower income tenants – was simply wrong. New York's

rent regulation system began in 1943 with “rent control” as an effort to prevent wartime profiteering and was expanded in 1969 (adding “rent stabilization”) to deal with sharp rent increases in the city’s “post-war” housing stock. The system was meant to secure fair rents in a market driven by chronic shortages and initially drew no distinctions between wealthy or poor tenants or high and low income units.

Beginning in 1993 the real estate lobby made major gains in their efforts to repurpose the system with new laws regarding high rent vacancy deregulation as well as high income deregulation.

Trimming the system back to serve poor and middle class tenants may sound wonderfully efficient and reasonably altruistic, but only if we ignore the billion ton elephant that occupies the center of the city’s rental market. Various building restrictions like zoning, landmarks and other regulations along with a commitment to preserve green spaces (all laudable and understandable limits on growth designed to make the city more livable) massively suppress housing supply and vastly add to the value of existing structures, placing pressure on rents and resale values and creating windfalls for owners.

By 2005 a typical seven unit Upper West Side brownstone was worth more than seventy times what it sold for in the late 1940's and had grown in value more than twice as fast as national median home values. This occurred, not because owners improved their properties, nor because neighborhoods spontaneously became fashionable, but because the city’s population grew, new construction was limited and this placed both normal and abnormal pressures on rents.

From this skewed market owners of existing structures realized massive windfalls. Owners and investors recognized rent stabilized buildings as one of the best real estate values in the city.¹ Citywide vacancy rates remained low, well below 5%, while national vacancy rates hovered between 8% and 10%.

If the amelioration of the effects of this shortage on rents was the primary purpose of the rent laws, removing protections from high rent units for over twenty five years did little good but blow smoke over that purpose. Hundreds of thousands of units left the system, rents skyrocketed and an angry city finally pushed back by making rent law reform a legislative priority.

The HSTPA restored the original purpose of the law: to preserve fair rents in an otherwise skewed and abnormal housing market – for all tenants regardless of incomes or rent levels.

High rent vacancy deregulation was repealed. High income deregulation was repealed. Both major capital improvement and individual apartment improvement rent increases were drastically cut back. Vacancy allowances were eliminated. The incentives for

¹ Why Investors and Landlords Still Find Rent-Regulation Attractive, <https://commercialobserver.com/author/lauren-elkies-schram/> Lauren Elkies Schram, Crains, July 15, 2015.

pushing tenants out – through both lawful and illegal means -- were dramatically reduced. And penalties for rent overcharges were dramatically increased.

The full reach of these new laws is still being unpacked. Here I will explore two areas where prior administrative policies and code provisions may be impacted: The setting of “first rents” when vacant units are combined or subdivided and when units experience “deconversion” from co-op or condominium status.²

First Rents for “New” Units

It is a fact that while the HSTPA does an effective job protecting those who occupy rent stabilized apartments, it does not address demand for more rental housing (no rent regulation system does). It targets the preservation of affordable apartments, not the production of new units – the function other housing programs. Nor will the HSTPA eliminate the desire of landlords to fully exploit existing demand. Though the HSTPA eliminated many abuses, owners will continue to seek new ways to legally raise rents.

With vacancy allowances eliminated, MCI’s capped at 2% per year and individual apartment improvement increases limited to a tiny fraction of \$15,000 spread out over a 15 year period, there is only one way left to significantly and legally increase rents. Under a longstanding administrative doctrine concerning apartments that undergo significant changes in size – in outer “perimeter” – such that the original apartment is effectively eliminated, owners may charge a “first rent” which is effectively a market rent.

Consider a typical situation. Two rent stabilized units – both with rents of \$1,500 each – are combined to form a new unit. Under established policy the owner may ask \$5,000 or \$10,000 or any amount as a new monthly rent (the same if the units are subdivided). Under the HSTPA the unit will thereafter be stabilized and subject to annual guideline limits. The courts have recognized that the distinct rent histories of the prior units are effectively wiped out when a unit is combined or subdivided. The only limit imposed is what a willing new tenant will pay.

The Rent Stabilization Code §2522.4(a)(i), does provide a more precise standard for dealing with increases in dwelling space by treating them like individual apartment improvements. That section provides that “[a]n owner is entitled to a rent increase where there has been a substantial increase ... of dwelling space or an increase in the services, or installation of new equipment or improvements ... provided in or to the tenant's housing accommodation ...” That language suggests that such changes should be treated as mere apartment improvements. If those (now greatly limited) adjustments apply, the rent increase permitted for changing the perimeter would be capped at a small fraction of the cost of the change. There would be no first rent.

² A third significant source of large rent increases occurs through demolition (including gut rehabilitation) which, if code standards are met, results in full deregulation. See RSC §2524.5(a)(2). It does not appear that the HSTPA will have any effect on this area of regulation.

Nonetheless, DHCR and the courts have recognized that this approach would ignore the fact that the rent history of the combined unit is no longer reliable. As stated by the Appellate Division, First Department, in *300 W. 49th St. Assoc. v NY State Div. of Hous. & Community Renewal, Off. of Rent Admin.*, 212 AD2d 250 (1st Dept 1995):

The mechanism pursuant to which a landlord may charge a "first" or "free market" rent is an administratively created policy implemented by DHCR in its capacity as the administrative agency which regulates residential rents. The policy applies only when the perimeter walls of the apartment have been substantially moved and changed and where the previous apartment, essentially, ceases to exist, thereby rendering its rental history meaningless. If the rental history of a stabilized apartment is no longer applicable due to the creation of a new unit with completely different perimeter walls, there would be no rational method which DHCR could utilize to calculate the legal rent since the stabilized rent is based upon a continuous chain of rental history. By way of example, such allowance might be granted if a two-bedroom apartment were split into two studio apartments or two smaller dwellings were consolidated to form one large apartment.

Notably, this allowance has not been found to apply to minor self serving adjustments in unit perimeters. Where the movement of a single wall resulted in an 86 square foot shift in living space, the Appellate Division, First Department, in rather strong language, found it insufficient to defer to DHCR's first rent policy:

[This is] not the type of project for which we can allow a DHCR order, that myopically adhered to its own agency criteria while ignoring the consequences or even the larger logic of that result, to effectively undermine the very statutory regime that it was charged with administering.

For these reasons, our usual deference to DHCR, regarding its administrative policies undertaken in furtherance of its statutory responsibilities, is insufficient to sustain its order in this case.

Devlin v. N.Y. State Div. of Hous. & Cmty. Renewal, 309 A.D.2d 191 (2003)

In *Devlin* the First Department emphasized that "DHCR's policy was a means of acknowledging that significant alterations might simply eliminate any rational basis for carrying an apartment's rental history forward." The court found that "the policy applies only when the perimeter walls of the apartment have been substantially moved and changed and where the previous apartment, essentially, ceases to exist, thereby rendering its rental history meaningless". (Quoting *300 W. 49th St. Assoc.*)

Notwithstanding the court's logic, given the continuing housing shortage and a renewed legislative recognition that fair rents cannot be achieved without reasonable regulations, it still seems to be an arbitrary standard. A better standard might be to amend the Rent Stabilization Code to establish first rents that are similar to regulated units of comparable size in the building or area. An even more workable approach would involve legislative reforms which place a cap on first rents based upon the rents of units

combined or subdivided. Where two \$1,000 apartments are combined the new rent might be \$2,000 plus a fixed cap of something like 10% or 20%. Where a \$2,500 unit is subdivided the two new rents might be \$1,250 each plus a similar capped increase.

In sum, the city can expect a wave of newly combined or subdivided units driven by owners seeking market rate “first rents”. These increases are likely to undergo court challenges, administrative revision and quite possibly, further legislative reforms.

First Rents for “Deconverted” Units

Though “deconversion” from cooperative or condominium status back to rental status is seldom seen today, an economic downturn could dramatically affect the economic stability of thousands of households in co-operatives and condominiums causing defaults and mortgage foreclosures leaving banks and future owners with an increasing number of “deconverted” rental buildings. Given longstanding precedent recognizing that deconverted units are subject to rent stabilization,³ and the fact that the HSTPA has now eliminated high rent and high income deregulation, the setting of “first rents” upon deconversion is worth examining.

Current DHCR regulations include provisions governing rent setting upon deconversion and, under most scenarios, permit the setting of first rents (i.e. “the initial regulated rent shall be as agreed upon by the parties and reserved in a vacancy lease”). This, of course, gives the new owner total (and arguably arbitrary) control over whether a former shareholder is able to stay or is priced out. The HSTPA quite clearly eliminates the administrative rationale for “first rents” in this context.

It should be noted at the outset that two critical points distinguish first rents where new units are created (as in combined or subdivided units) and first rents under deconversion.

When an apartment is combined or subdivided there is no tenant remaining in occupancy vulnerable to an excessive first rent sought to be extracted by the owner. By contrast, in a deconversion situation the apartment is likely to be occupied by a long time former shareholder or condo owner. Facing a new owner with the power to set a first rent may place a special hardship and possibly result in economic evictions for elderly occupants and others who seek stability in their homes.

The second distinction is that unlike newly created units, most deconverted units do have reliable rent histories. Unlike combined or subdivided apartments, these apartments have remained intact. Hence, neither the courts nor DHCR are in a position to say that the rent histories have been rendered meaningless.

The latter point had little resonance under pre HSTPA rules because older rent histories were precluded from review by the “four year” rule. That evidentiary limitation has been repealed and the establishment of legal rents is more closely tethered to the last reliable registered rent, updated by intervening guideline increases.

Almost all cooperatives and condominiums have rent histories which established legal rents at some point prior to conversion and beyond. Updating such histories by

³ See *Fed. Home Loan Mortg. Corp. v. DHCR*, 87 N.Y.2d 325 (1995).

applying Rent Guidelines Board and other lawful increases is a simple and robust way to set new rents. Where rents were not registered (the case with units converted and occupied by a proprietary lessee prior to 1984) other sources of rental histories or DHCR's method for establishing first rents could be applied.

The existing deconversion rules (which must now be updated under the HSTPA) distinguish between buildings deconverted more than four years after the acceptance of an offering plan (i.e. conversion) and those deconverted within four years of conversion.

Under §2520.11(l) of the RSC, occupied units that underwent deconversion within four years of conversion faced limited rent increases under the "bridge the gap" approach. Specifically the section provides "the initial regulated rent shall be the most recent legal regulated rent for the housing accommodation increased by all lawful adjustments that would have been permitted had the housing accommodation been continuously subject to the RSL and this Code." That is, DHCR recognized the soundness of relying on the "bridge the gap" approach where it was not precluded from doing so by the four year rule (simply because the rent records were less than four years old).

Under the current (yet to be revised) rules, buildings undergoing deconversion more than four years after conversion (the vast majority of all cooperative and condominium units) are treated as if the rent histories have been obliterated. The current rules provide that "the initial regulated rent shall be as agreed upon by the parties and reserved in a vacancy lease" - in other words, a "first rent".

The new HSTPA provides that "in determining legal regulated rents" the courts and DHCR shall consider "all available rent history" including rent registration history, orders of public agencies and records maintained by owners and tenants and public agencies. Moreover, the new six year limit on calculating overcharge damages mandates that the legal regulated rent for determining overcharges "shall be deemed to be the rent indicated in the most recent reliable annual registration statement for a rent stabilized tenant filed and served upon the tenant six or more years prior to the most recent registration statement... plus in each case any subsequent lawful increases and adjustments."

By eliminating the four year look back limitation, the HSTPA has eliminated the basis for distinguishing between deconversions within four years of conversion and those more than four years from conversion.

This is a game changer. Because HSTPA permits an unlimited review of past rent and registration information, the basis for a "first rent" on deconversion is wholly eliminated in favor of a "bridge the gap" approach in most cases (and, where necessary, a broader review of lease histories).

Also because of this, other formulas for setting first rents where the new owner caused the deconversion to occur [See §2520.11(l)(iv)] are effectively rendered moot. (Those formulas under §2522.6 will, in any event, also have to undergo significant changes under the HSTPA.)

In short, the HSTPA has eliminated the legal basis for distinguishing between deconversions occurring within four years of initial conversion and beyond four years from conversion. With that there is no need for owner established "first rents" on deconversion. New regulations are very likely to codify the "bridge the gap" approach in

all cases wherever reliable rent registrations (or other reliable rent histories) can be produced. Where neither registrations nor leases supply a reliable rent history, a revised system for administratively setting initial rents will be required.

Much Accomplished and Much Left to be Done

Overall, the HSTPA has restored the original “fair rent” purpose of New York’s rent control and rent stabilization systems, eliminated several embarrassing restrictions on reviewing rent histories, reined in excessive rent growth and given hope to those who long ago assumed Albany had sold out to the city’s powerful real estate interests. Left is the specter that owners will turn to apartment subdivisions and combinations to beat the new restrictions. Beyond that, the now outdated Rent Stabilization Code will need to be harmonized with the HSTPA in a number of areas – including the elimination of first rents in co-op and condominium deconversions.