New York Law Journal
Real Estate Trends
WWW.NYLJ.COM
An ALM Publication
VOLUME 264—NO. 45
WEDNESDAY, SEPTEMBER 2, 2020

RENT STABILIZATION

Recent Major Capital Improvement Rulings


By **Warren A. Estis** And **Jeffrey Turkel**

MCIs are not what they used to be. Before the Housing Stability and Tenant Protection Act (HSTPA), the amortization period for approved costs was 96 months in buildings with 35 or fewer units, and 108 months in buildings with more than 35 units. Part K of the HSTPA extended those periods to 144 months and 150 months, respectively.

Although the Legislature can change the Rent Stabilization Law (RSL), it cannot change the basic laws of economics. If landlords are not economically incentivized to perform MCIs, they will perform stop-gap repairs instead. Whereas a landlord pre-HSTPA might have replaced a roof that was past its useful life, it will now patch and re-patch that roof for as long as possible.

Where a landlord nevertheless elects to perform an MCI, it must be certain that even its minimal return on investment will be protected. Some recent cases concerning MCIs are discussed below.

Don't Ignore the Two-Year Rule

RSC §2522.4(a)(8) provides in relevant part:

> No increase pursuant to paragraph (2) of this subdivision shall be granted by the DHCR, unless an application is filed no later than two years after the completion of the installation or improvement unless the applicant can demonstrate that the application could not be made within two years due to delay, beyond the applicant's control, in obtaining required governmental approvals for which the applicant has applied within such two-year period.

In *Sutton Assoc. v. New York State Div. of Hous. & Community Renewal*, 183 AD3d 500 (1st Dept. 2020), the landlord applied for MCI rent increases based, *inter alia*, on pointing and waterproofing. The Division of Housing and Community Renewal (DHCR) denied the increase on the ground that the work was completed more than two years before the landlord filed the MCI application on June 15, 2015.

Where a landlord elects to perform an MCI, it must be certain that even its minimal return on investment will be protected.

Specifically, DHCR held that the pointing and waterproofing was completed in May 2013, two years and one month before the MCI filing. The landlord argued that its documentation established that the contractor continued to work after May 23, 2013. DHCR, however, found that although the contractor was paid on that date, it had already completed the work.

WARREN A. ESTIS *is a founding member of Rosenberg & Estis.* JEFFREY TURKEL *is a member of the firm.*

The Supreme Court denied the landlord's Article 78 petition. The First Department affirmed, writing:

> The documents provided by petitioner in support of its MCI application and in response to DHCR inquiries provided a rational basis for DHCR to conclude that the MCI work had been completed in early 2013, more than two years prior to petitioner's submission of the MCI rent increase application.

Notably, the First Department had long ago ruled that DHCR promulgated the two-year rule within the scope of its authority. *See Hampton Mgt. v. New York State Div. of Hous. & Community Renewal*, 255 AD2d 261 (1st Dept 1998), *lv. to appeal denied* 93 NY2d 806 (1999).

DHCR's Order Will Probably Be Affirmed

The Supreme Court's decision in *Sutton* illustrates another key point: it is likely that DHCR's grant or denial of an MCI application will be upheld in any Article 78 proceeding. In *Sutton*, the Supreme Court (Engoron, J.) easily dispatched the landlord's Article 78 petition:

> The Court's function in reviewing DHCR's determinations is limited. Where the interpretation of a statute or its application involves knowledge and understanding of underlying operational practices or entails an evaluation of factual data and inferences to be drawn therefrom, the courts regularly defer to the governmental agency charged with the responsibility for administration of the statute. If its interpretation is not irrational or unreasonable, it will be upheld. (citation and internal quotation marks omitted).

For the most part, an MCI application involves DHCR's evaluation of factual data. Thus, if DHCR's order has a rational basis it will be affirmed in an Article 78 proceeding. This is true even if the court, in the first instance, would have ruled otherwise. *See e.g. Yao v. New York State Div. of Hous. & Community Renewal*, 2020 WL 4037105 (Sup Ct, NY County 2020).

That is not to say that DHCR always prevails. In *Langham Mansions* v. *New York State Div. of Hous. & Community Renewal*, 76 AD3d 855 (1st Dept. 2010), the First Department annulled the agency's denial of MCI rent increases sought for window replacement where "there was no conclusion by the DHCR that the windows could not be repaired or that they could not serve their intended function if minor repairs were performed by the owner." In *925 D Realty LCC* v. *New York State Div. of Hous. & Community Renewal*, 85 AD3d 649 (1st Dept 2011), the First Department annulled DHCR's order on the ground that "it was arbitrary and capricious for respondent to fail to recognize that the 2007 MCI [for elevator upgrading] was completely different from the 1991 MCI [for controller replacement]."

In addition, a DHCR MCI order can always be reversed on due process grounds. In *Broadway Bretton, Inc.* v. *New York State Div. of Hous. & Community Renewal*, 146 AD3d 406 (1st Dept. 2017), the First Department annulled DHCR's order, finding that the agency arbitrarily and capriciously failed to consider the requested architect's report, even though it had been untimely submitted. *See also London Leasing, Ltd. Partnership* v. *New York State Div. of Hous. & Community Renewal*, 98 AD3d 668 (2d Dept 2012) (arbitrary and capricious for DHCR "to have excluded certain costs without providing the petitioner a final opportunity to establish that those costs were related to the MCI"); *305 W. 18 Assoc.* v. *New York State Div. of Hous. & Community Renewal*, 156 AD2d 377 (1990).

Raise All Arguments Before DHCR

Because DHCR has exclusive jurisdiction to determine MCI applications, a challenge to a DHCR MCI order will necessarily be an Article 78 proceeding. In such a proceeding, a reviewing court will not entertain an argument not previously raised to the

agency. *See 333 E. 49th Partnership, LP v. New York State Div. of Hous. & Community Renewal*, 165 AD3d 93 (1st Dept. 2018).

The point is illustrated by the First Department's recent decision in *Wages v. New York State Div. of Hous. & Community Renewal*, 185 AD3d 446 (1st Dept 2020). There, DHCR granted the landlord's application for MCI increases based on new carpeting throughout the building. Supreme Court affirmed DHCR's ruling and was affirmed, in turn, by the First Department. The First Department wrote:

> The court properly declined to consider petitioner's remaining arguments. Petitioner did not claim in the verified petition that carpeting cannot qualify as an MCI, and improperly raised that issue in reply. Petitioner did not argue before either the RA or in the PAR that the MCI application should have been denied because the owner did not obtain a waiver of the useful life requirement as set forth in 9 NYCRR 2522.4(a)(2)(i)(d)-(e). Petitioner did not argue before the RA that the MCI application should have been denied because of the owner's alleged history of misconduct and because the owner allegedly caused damages to the previous carpeting, and did not establish why it could not have done so. (internal citations omitted).

Lobbies Don't Count

In *Sydney Leasing, L.P. v. New York State Div. of Hous. & Community Renewal*, 185 AD3d 942 (1st Dept. 2020), the landlord sought MCI rent increases based on $1,043,007.41 in lobby renovations. DHCR denied the application relating to this work, holding that it was not building-wide in nature. The First Department, affirming the Supreme Court, upheld DHCR's ruling:

> As relevant herein, section 26-511(c)(6)(b) of the Rent Stabilization Law of 1969 requires the DHCR to provide 'criteria whereby the Commissioner may act upon applications by owners for increases in excess of the level of fair rent increase established under this law' where such owner has 'completed *building-wide* major capital improvements.'
>
> * * *
>
> In interpreting the relevant provisions of the RSL and the RSC, it is the DHCR's long-standing policy that the renovation or modernization of a lobby is considered an ordinary repair, maintenance, and/or a cosmetic upgrade rather than a building-wide MCI. Giving due deference to the DHCR's reasonable interpretation of the RSL and the RSC in that regard, the DHCR's determination that petitioner's lobby renovation and modernization work did not constitute an MCI … had a rational basis and was not arbitrary and capricious. Contrary to the petitioner's contention, their decision to demolish and rebuild the entire lobby as part of the subject repair and modernization project did not transform the work into an MCI, nor does the fact that the lobby is a separate structure connected to the residential buildings render the DHCR's determination to deny costs for what remains lobby renovation work unreasonable. (internal citations omitted, emphasis in original).

Sydney Leasing is a cautionary tale for landlords. Before undertaking a renovation project, the landlord should check with counsel to determine whether the work will qualify as an MCI. If it will not, the landlord should not perform the work, or should perform the work as cheaply as possible.

Reprinted with permission from the September 2, 2020 edition of the NEW YORK LAW JOURNAL © 2020 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited. For information, contact 877-257-3382 or reprints@alm.com. # NYLJ-09022020-458710