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RENT REGULATION

Commercial to Residential Substantial Rehabilitation


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Section 5(a)(5) of the Emergency Tenant Protection Act (ETPA) exempts from stabilization "housing accommodations in buildings completed or buildings substantially rehabilitated as family units on or after January first, nineteen hundred seventy-four." Over the years, courts and the Division of Housing and Community Renewal (DHCR) have developed guidelines for determining whether a landlord, when rehabilitating a residential building, has performed work sufficient to warrant the exemption. Thus, while a total gut renovation would plainly qualify, a building that has undergone a superficial, incomplete, or inexpensive renovation will not.

In *Bartis v. Harbor Tech*, __ AD3d __, 45 NYS3d 116 (2d Dept. 2016), the Appellate Division, Second Department considered the issue of whether those guidelines apply where the landlord converts the building from commercial to residential use. The Second Department, following First Department precedent, held that commercial to residential renovation constitutes a substantial rehabilitation per se, and that the guidelines applicable to residential renovation work do not apply.

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Some History

The purpose of ETPA 5(a)(5) is not controversial or mysterious. In *Eastern Pork v. New York Div. of Housing & Community Renewal*, 187 AD2d 320, 324 (1st Dept 1992), the First Department held that the provision was intended:

> …to increase the number of habitable family units available to the residents of our city. The mechanism by which this is accomplished is to encourage building owners to substantially rehabilitate commercial, or substandard or deteriorated housing stock by permitting them to recoup their expenses free of stabilized rents.

'Eastern Pork'

By 1990, DHCR had adopted an interpretation of ETPA 5(a)(5) that made it difficult, if not impossible, for any renovation to qualify for the exemption. In *Eastern Pork*, supra, the landlord renovated a building, but left unrenovated a basement apartment occupied by two rent-controlled apartments. DHCR rejected the landlord's substantial rehabilitation claim, holding that the

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exemption would not apply unless (1) every apartment in the building was renovated; (2) the building was totally vacant during the work; and (3) the entire building had been gutted.

The Appellate Division held that the words "substantially rehabilitated" in ETPA 5(a)(5) "are not technical terms, but are rather general, commonly used terms which may not be limited by judicial or administrative construction, and should be accorded their commonly understood meaning." 187 AD2d at 323. The court held that DHCR's interpretation was ultra vires the statute, and remanded the matter to DHCR for further proceedings.

Operational Bulletin 95-2

Three years later, DHCR promulgated Operational Bulletin 95-2 (OB 95-2) which set forth DHCR's revised substantial rehabilitation criteria. In summary, OB 95-2 provided that a building would be deemed substantially rehabilitated if at least 75 percent of 17 enumerated building-wide and apartment systems had been replaced. OB 95-2 also provided that the rehabilitation had to have been commenced in a building that was in a substandard or seriously deteriorated condition. Such condition would be presumed where the building was at least 80 percent vacant of residential tenants when the work took place.

Conversion to Residential

The exacting criteria set forth in OB 95-2 makes sense where a residential building is substantially rehabilitated as family units. There, formerly regulated units are being converted to presumptively deregulated units, which diminishes New York City's rent-regulated housing stock. In such instances, DHCR or a court must make sure that the landlord has earned the exemption by engaging in a comprehensive rehabilitation.

The situation is different, however, where a former commercial building is converted to residential units. There, there is no potential loss of rent-regulated units. In addition, a conversion from commercial to residential use necessarily entails a comprehensive rehabilitation, as commercial buildings are inherently unsuitable for residential use, and do not contain such routine apartment amenities as kitchens and individual bathrooms.

The question thus arose as to whether the requirements in OB 95-2 apply where the renovation is from commercial to residential. The first such case, *Jordan Mfg. v. Lledos*, 153 Misc 2d 296 (Sup. Ct. Kings Co. 1992) predated OB 95-2, but is nevertheless instructive. In *Jordan*, the landlord renovated a commercial building so as to create seven residential apartments. The Supreme Court held that these units qualified under the substantial rehabilitation exemption:

> …the renovations served only to change purely commercial space into purely residential space. Under such circumstances, where there has been no renovation to the part of the building maintaining its commercial use, the recoupment for the landlord can only come from the rent charged for the residential units. In addition, there is no need to protect existing tenancies with rent regulation as such tenancies did not exist prior to the renovation. In such cases, the creation of residential units where none existed is a substantial rehabilitation so as to exempt these buildings from stabilization.

The issue next arose in *22 CPS Owner v. Carter*, 84 AD3d 456 (1st Dept. 2011). There, the building was converted from a primarily commercial building to a primarily residential building. One of the newly created apartments was a penthouse. Years after the conversion, the landlord commenced an action in Supreme Court seeking a declaration that the penthouse was exempt from rent stabilization. Supreme Court (Edmead, J.) so declared, and was thereafter

affirmed. The First Department wrote:

> The penthouse has not been subject to rent stabilization since its creation, when the building was converted from a purely commercial space to an almost exclusively residential space (except as to the ground floor which remained commercial). Because the purpose of the exemption from rent stabilization based on the substantial rehabilitation of the building is to encourage landlords to renovate buildings and add new residential units to the housing stock, the conversion of a purely commercial space into an almost purely residential space, creating 23 residential units where none existed, is a substantial rehabilitation so as to exempt the building from rent stabilization (internal citations omitted).

The First Department, however, did not address the issue of whether the criteria in OB 95-2 applied to a commercial to residential renovation.

The Second Department, however, explicitly addressed this issue in *Bartis*, supra, decided on Dec. 28, 2016. There, several interconnected buildings, formerly used as a commercial warehouse, were converted to residential use. In 2013, 35 tenants at the building sought a declaration that their apartments were rent stabilized. Supreme Court, Kings County (Silber, J.) granted summary judgment in favor of the landlord. The Second Department affirmed, holding that OB 95-2 did not apply to commercial to residential renovation:

> The most natural reading of the DHCR's 75 percent requirement is that it is applicable in situations where an owner purports to substantially rehabilitate an existing residential building, and not in situations where a commercial building is converted to residential use. As the defendant argues, the requirement that 'a specified percentage…of listed building-wide and individual housing systems' be 'replaced' makes little sense where the existing building is a purely commercial building that has no existing 'individual housing systems' (internal citation omitted).

The Second Department continued:

> Where a commercial building is converted to residential use, the 'individual housing systems,' as well as many residential-specific building-wide systems, would generally be created, not 'replaced.' The apparent purpose of the 75 percent requirement is to ensure that existing residential tenants of an apartment building not lose the benefits of rent stabilization unless the owner of the building truly makes a substantial renovation. This concern is not present where residential units are created where none had existed before.
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> For the purposes of rent stabilization laws, the conversion of a commercial building to a residential building is akin to the construction of a new residential building.

On Feb. 10, 2017, this issue arose in *885 Park Avenue Brooklyn v. Goddard*, 2017 WL 669645 (App. T. 2d Dept, 2, 11 and 13 Jud. Dist.). Citing *220 CPS Owner v. Carter*—but, oddly, not the Second Department's ruling in *Bartis*—the court held that the substantial rehabilitation exemption applied where the landlord has converted a building from commercial to residential use.