Case Highlights Fact-Specific Nature of Repair Issues

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One of the primary features of the Rent Stabilization Law—at least for owners—is the rent increase awarded for an Individual Apartment Improvement ("IAI"). IAIs relate to new equipment and improvements that an owner, usually upon vacancy, adds to an apartment, such as new kitchen cabinets, a new stove or refrigerator, or a complete bathroom renovation. In contrast, Major Capital Improvements ("MCIs") concern the installation of new building systems, such as a new elevator, roof or boiler.

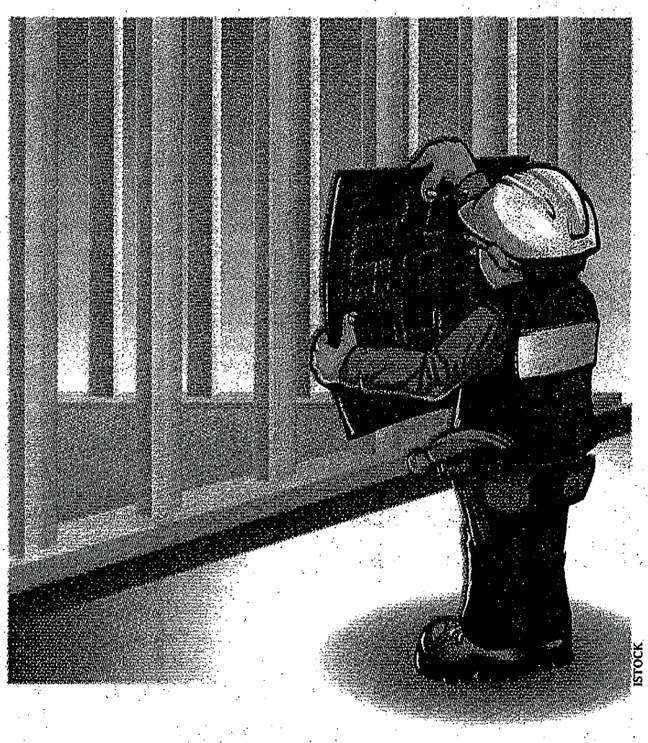
Both IAIs and MCIs allow an owner to increase a stabilization rent, but IAIs are the better investment. The installation of IAIs allows an owner to increase the stabilized rent by ¼oth of their cost. Thus, if an apartment rents for $1,200 per month and the owner installs a new bathroom at a cost of $20,000, the owner can increase the rent by $500 per month, i.e., by ¼oth of the $20,000 expenditure. MCIs, in contrast, are amortized over 84 months.

Origins

IAIs were not part of the original Rent Stabilization Law of 1969, now codified at §26-501 et seq. of the Administrative Code of the City of New York. Instead, IAIs were first authorized in §20(C)(1) of the original Rent Stabilization Code. Section 20(C)(1) provided that where there has been:

> ...an increase in dwelling space or the installation of new equipment or improvements in a particular dwelling unit other than a major capital improvement, the monthly stabilization rent for the dwelling unit shall be increased by ¼oth of the total cost of such added dwelling space, equipment or improvements, including the cost of installation thereof; provided, however, that such increase shall not be collectible during the term of a lease that in event or any renewal thereof except upon the written consent of the tenant.

In one very early case, *103 Prospect Park West Inc. v. New York Conciliation & Appeals Bd.*, 67 Misc.2d 553, 324 N.Y.S.2d 395 (Sup. Ct. 1971), Supreme Court ruled that where the cost of an IAI is at issue, the rent agency must determine the amount based on proofs submitted by the owner.



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In *985 Fifth Ave. Inc. v. New York State Div. of Housing & Community Renewal*, 171 A.D.2d 572, 567 N.Y.S.2d 657 (1st Dep't 1991), the Appellate Division, First Department added:

> ...the burden is upon the owner to justify the increase sought by presenting documentary support therefor, and it must submit all relevant invoices, bills, cancelled checks and/or other materials to the Administrator....[1]

In 1987, DHCR promulgated a new Rent Stabilization Code (9 NYCRR 2520 et seq.). New §2520.4(a)(1) continued the policy set forth in section 20(C)(1) of the superseded Code.

The IAI rule, however, still had no predicate in the Rent Stabilization Law itself. That changed in 1993, pursuant to L. 1993, ch. 253, the so-called Rent Regulation Reform Act of 1993 (the "act"). Section 19 of the act added §26-511(c)(13) to the RSL to provide that:

> ...an owner is entitled to a rent increase where there has been a substantial modification or increase of dwelling space or an increase in the services, or installation of new equipment or improvements or new furniture or furnishings provided in or to a tenant's housing accommodation, on written tenant consent to the rent increase. In the case of a vacant housing accommodation, tenant consent shall not be required. The permanent increase in the legal regulated rent for the affected housing accommodation shall be one-fortieth of the total cost incurred by the landlord in providing such modification or increase in dwelling space, services, furniture, furnishings or equipment, including the cost of installation, but excluding finance charges.

For years, tenant advocates had complained that owners—who usually performed IAI work when an apartment was vacant—were inflating costs, and that in any event the 40-month amortization period was too short. In a memorandum in opposition to the act, the New York State Tenant & Neighbor Coalition wrote:

> This formula is now ¼oth of the total cost, resulting in a complete payback to the landlord in three years and four months. The increase remains in the base rent for determining future rent increases, on which rent guidelines are compounded.
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> This formula is in fact quite generous to the landlord, resulting in hefty rent increases. [Tenant & Neighbor] has long campaigned for a change to ½nd of the total cost of monthly rent increase, resulting in full payback in six years. The increase still would remain in the base rent for determining periodic general rent increases. The Governor has committed himself to this ½nd formula, and the State Division of Housing and Community Renewal is working on the necessary administrative implementation. Enshrining the ¼oth factor is regressive.

The best policy for owners, as it has been since 1969, is to carefully document and itemize each individual item of expense, especially if the work is being used to increase the rent above the $2,000 per month threshold.

The Legislature, apparently, felt otherwise, and made the ¼oth increase a part of the RSL itself. While the 72-month amortization period would have been a boon to tenants, it was an economic threat to the contractors and » Page 9

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laborers who actually performed IAI work, and the appliance dealers who supplied the necessary equipment and improvements. Joining landlords, these groups successfully lobbied for statutory enshrinement of the existing IAI rule.

Indeed, IAIs became increasingly important with the enactment of luxury vacancy deregulation, also a part of the 1993 act. The act added §26-504.2 to the RSL, providing that an apartment would become permanently deregulated if vacated when the legal stabilized rent was $2,000 or more per month. Early on, DHCR ruled that even if the apartment rented for less than $2,000 per month at the time of vacancy, the apartment would be deregulated as long as the legal stabilized rent was $2,000 or more per month by the time it was re-rented. Owners thus liberally used IAIs to help close the gap between the existing stabilized rent and the $2,000 threshold.

Throughout the 40-year history of IAIs, one source of controversy has been the distinction between actual improvements, such as new appliances, and mere repairs, such as painting and plastering. It is well-settled that while the cost of improvements can be added to the stabilized rent, the cost of repairs usually cannot. See, e.g., *Linden v. New York State Div. of Housing & Comm. Renewal*, 217 A.D.2d 407, 629 N.Y.S.2d 32 (1st Dep't 1995).

One problem, however, is that improvements or repairs are often done at the same time, by the same contractor, and pursuant to the same contract; as such, it is not always possible to break out the cost of improvements as opposed to the cost of mere repairs. That issue arose in the Appellate Division, First Department's recent split decision in *Jemrock Realty Co. LLC v. Krugman*, NYLJ, May 20, 2009, at 30, col. 1, discussed below.

'Jemrock'

In *Jemrock*, a rent stabilized apartment became vacant in January of 2004. The owner then hired a contractor to renovate the apartment (which had been in very poor condition) at a cost of $50,000. The work included rewiring and re-plumbing the entire apartment, as well as fully renovating the kitchen and bathroom. The work also included such routine repair items as painting, plastering, and refinishing the wood floors. There is no dispute that the work was performed, or that the contractor was paid in full.

Upon completion, the owner rented the apartment to Jay Krugman at a free market rent of $3,600 per month. The owner asserted that when ¼oth of the cost of the work was added to the existing stabilized rent of $920.12, the legal rent exceeded $2,000 per month, such that the apartment was deregulated.

In 2005, the tenant stopped paying rent and the owner commenced a non-payment proceeding. At trial, the owner's representative testified as to the scope and cost of the work. Civil Court (Schneider, J.) agreed that the work had been performed, but ruled that the owner was not entitled to an increase because the owner could not break out the respective costs of the improvements and the repairs. The court declared that Krugman was stabilized, and directed a refund of $42,339.60, minus the tenant's rent arrears. Civil Court declined to award the tenant treble damages.

Both parties appealed, and the Appellate Term issued a split decision in December 2007.[2] The majority (Justices Douglas McKeon and William J. Davis) found for the owner, citing DHCR precedent that "an itemization of costs is not required where the work performed is part of the total renovation of the subject apartment."[3] Justice William P. McCooe dissented, writing that the owner had failed to sustain its burden of proving the cost of the eligible work. Justice McCooe found significant the fact that the managing agent accounted for 80 percent of the contractor's total business, that there had been no competitive bidding, and that the owner had unilaterally established the $50,000 price.

The tenant appealed to the Appellate Division, First Department, but lost before a sharply divided Court. Justice James M. McGuire, writing for a majority that included Justices David B. Saxe and John W. Sweeny, Jr., summarized the Court's holding as follows:

> The issue of whether landlord is entitled to a rent increase based on the improvements turns on whether landlord was required to itemize the costs it incurred during the renovation, distinguishing between amounts spent on improvements, on the one hand, and repairs, on the other. Because landlord was not obligated to itemize the costs, we agree with Appellate Term that landlord is entitled to a rent increase based on the renovations.

The Appellate Division majority, like the Appellate Term majority, deferred to DHCR's existing policy regarding mixed improvements and repair work:

> DHCR's interpretation of the regulations implementing the Rent Stabilization Law are entitled to deference. DHCR has determined that a landlord is not required to 'submit a breakdown of the cost of each item in...*extensive* renovation work' if the landlord 'submitted the required evidence to show that the claimed work was done' and 'that it spent the claimed costs.'
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> Here, the renovations performed by the contractor unquestionably were extensive. Indeed, the trial court repeatedly characterized the renovations as 'extensive.' Moreover, we agree with the trial court's findings of fact regarding the scope of the renovations, that they were in fact performed and that they cost at least $50,000 (italics in original, internal citations omitted).

Justice Dianne T. Renwick dissented in an opinion joined by Justice Helen E. Freedman. The dissent wrote that deference should be accorded to Civil Court, the trier of fact, which found that "the owner's proof lacked the specificity required to enable the court to distinguish the cost of significant improvements from the cost of significant repairs." The dissent also disagreed with the majority's characterizations of DHCR's existing policy:

> ...the majority relies on DHCR's precedents...holding such a breakdown unnecessary. However, what the majority overlooks is that...DHCR has held that an itemization of costs is obviated only where ordinary repairs are performed along with significant repairs for a total renovation of the apartment. That is not the situation here, where there were both significant repairs and significant renovations.
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> We simply cannot overlook that Civil Court, as the fact finder, found that the work on the subject apartment was not a total or gut renovation.

Given how fact specific these types of cases are, and the inherent difficulty of distinguishing between "ordinary" and "significant" repairs, as well as "extensive" or non-extensive renovations, *Jemrock* provides little comfort to owners. The best policy for owners, as it has been since 1969, is to carefully document and itemize each individual item of expense, especially if the work is being used to increase the rent above the $2,000 per month threshold, so as to deregulate the apartment. Given the possibility of a finding of regulated status, refunds and treble damages, there is no reason why owners should be anything less than scrupulous in documenting the scope and cost of IAI work.