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RENT REGULATION

'Grimm v. DHCR': R.I.P. Four-Year Rule?

By Warren A. Estis And Jeffrey Turkel

In *Grimm v. DHCR*,[1] issued on Oct. 19, 2010, a sharply divided Court of Appeals ruled that when it appears that the "base rent" in an overcharge case is "fraudulent," the Division of Housing and Community Renewal (DHCR) must investigate such fraud and may not use the base rent for further calculations if fraud is indeed present. Judge Robert S. Smith, who authored the three-judge dissenting opinion, wrote that by virtue of the majority's decision, "the four-year limitation [on rent overcharge claims] has largely ceased to exist."

History

The tortured 27-year history of the so-called four-year rule, first enacted pursuant to L. 1983, ch. 403, is beyond the scope of this article. It is sufficient to note that as amended by the Rent Regulation Reform Act of 1997 (L. 1997, ch. 116), RSL §26-516(a) states in relevant part:

> Where the amount of rent set forth in the annual rent registration statement filed four years prior to the most recent registration statement is not challenged within four years of its filing, neither such rent nor service of any registration shall be subject to challenge at any time thereafter.
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> * * *
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> This paragraph shall preclude examination of the rental history of the housing accommodation prior to the four-year period preceding the filing of a complaint pursuant to this subdivision.

The Legislature's 1997 amendment and clarification of the four-year rule appeared to put all prior controversies—and there were many—to rest. The base rent—i.e., the rent charged and paid on the date four years before the filing of an overcharge complaint, was set in stone, and constituted the basis for all rental calculations going forward.

'Thornton'

Controversy, however, arose several years later. In *Thornton v. Baron*, 5 N.Y.3d 175, 800 N.Y.S.2d 118 (2005), the landlord at 390 West End Ave. in Manhattan hit upon a scheme whereby it would lease a rent stabilized apartment to a tenant at an illegal rent, pursuant to a lease that would contain a provision whereby the tenant represented that he or she would not use the apartment as a primary residence. The owner would then commence a declaratory judgment action against the tenant, which the parties would collusively settle pursuant to a stipulation calling for the entry of a consent judgment upholding the terms of the parties' bargain. The tenant, in turn, would often "sublease" the apartment to yet another party, at an even higher rent.

In 1996, the subtenant in *Thornton* commenced an action against the prime tenant, claiming rent overcharges under the RSL. The question then became, how, under this peculiar fact pattern, was the regulated rent of the apartment to be established? The owner argued for a strict application of the four year rule, such that the rent in effect four years prior to the 2000 overcharge complaint—even if patently illegal—should be the base rent. The aggrieved subtenants argued that the base rent should be the last lawful rent: $507.85 per month, as charged in 1992.

The Court of Appeals, by a 4-2 margin, held that the collusive lease was void at its inception, and that the 1996 registration reciting the unlawful rent in that lease was a nullity. The Court concluded that in light of the unlawful scheme, the "base rent" for the apartment would not be the rent charged and paid four years prior to the filing of the overcharge complaint, but would instead be calculated pursuant to DHCR's so-called "default rent formula." That formula uses as the base rent the lowest stabilized rent in the building "line" in existence on the base date. Invariably, a rent calculated under the default rent formula is far lower than the rent actually charged and paid on that date.

'Grimm'

In *Grimm*, the apartment in question was registered as rent stabilized in 1999 at a legal rent of $587.86. In 2000, the owner increased the rent to $2,000 per month, and informed the incoming tenants that if they agreed to make certain repairs and improvements, the monthly rent would only be $1,450. The incoming tenants agreed to this arrangement.

In 2004, Sylvie Grimm moved into the apartment, also paying $1,450 per month. She filed an overcharge complaint with DHCR in July of 2005, recounting the rental history described above.

Observing that the rent four years prior to the filing of Ms. Grimm's complaint was $1,450, and had not increased thereafter,

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DHCR dismissed the complaint and later affirmed that determination on administration review. The tenant then commenced an Article 78 proceeding.

The Supreme court (Korneich, J.) annulled DHCR's determination and remanded the matter for DHCR to consider the tenant's allegations of fraud and the reliability of the rent charged on the base date. The Appellate Division, in a split decision, affirmed. *Grimm v. DHCR*, 68 A.D.3d 29, 886 N.Y.S.2d 111 (2009).

The Court of Appeals, also by a split decision, affirmed the Appellate Division. The majority opinion was authored by Judge Carmen B. Ciparick, and was joined by Judges Jonathan Lippman, Theodore T. Jones and Eugene F. Piggott. Judge Ciparick framed the issue to be determined as follows:

> On this appeal, we are asked to determine whether the rationale employed in *Thornton v. Baron*, which allowed the parties to look back farther than four years, applies in a situation where it is alleged that the standard base date rent is tainted by fraudulent conduct on the part of a landlord. We conclude that it does, and that such base date rent may not be used as a basis for calculating subsequent regulated rent if fraud is indeed present (internal citation omitted).

The majority explained its conclusion as follows:

> DHCR contends that our holding in *Thornton* should be constrained to the narrow set of circumstances described in that case and that we should limit its application to cases involving illusory tenancies. We disagree and conclude that, where the overcharge complaint alleges fraud, as here, DHCR has an obligation to ascertain whether the rent on the base date is a lawful rent.

The majority then took pains to explain those instances where an allegation of "fraud" would warrant investigation by DHCR:

> DHCR also argues that, under the Appellate Division's holding, any 'bump' in an apartment's rent—even those authorized without prior DHCR approval, such as rent increases upon installation of improvements to an apartment—will establish a colorable claim of fraud requiring DHCR investigation. Again, we disagree. Generally, an increase in the rent alone will not be sufficient to establish a 'colorable claim of fraud,' and a mere allegation of fraud, without more, will not be sufficient to require DHCR to inquire further. What is required is evidence of a landlord's fraudulent deregulation scheme to remove an apartment from the protections of rent stabilization. As in *Thornton*, the rental history may be examined for the limited purpose of determining whether a fraudulent scheme to destabilize the apartment tainted the reliability of the rent on the base date (internal citations omitted).

A sharply divided Court of Appeals ruled that when it appears that the "base rent" in an overcharge case is "fraudulent," DHCR must investigate such fraud and may not use the base rent for further calculations if fraud is indeed present.

The majority concluded:

> In sum, the Appellate Division correctly applied *Thornton* to this rent overcharge proceeding and properly concluded that DHCR has an obligation to ascertain whether petitioner's allegations of fraud warrant the use of the default formula when calculating any rent overcharge that may have occurred.

Judge Robert B. Smith authored the dissenting opinion, and was joined by Judges Victoria A. Graffeo and Susan P. Read. Judge Smith, who wrote the dissenting opinion in *Thornton*, pulled no punches with respect to his belief that the majority's extension of *Thornton* effectively put an end to the four year rule:

> ...this is a garden-variety overcharge case—perhaps the paradigm of the situation for which the four-year limitation was intended. The landlord charged an illegal rent, and the illegality went undetected for more than four years. The statute says plainly that in such a case, the rent charged four years previously 'shall not be subject to challenge.' But the majority holds that a challenge is allowed.

The dissent continued:

> The majority's justification for this result is that 'the overcharge complaint alleges fraud' and that there are 'indicia of fraud'—consisting essentially of allegations that the landlord lied to previous tenants about what the legal maximum rent was. In other words, the majority seems to equate 'fraud' with a willful overcharge—as though the four year limit were applicable only to landlords who overcharge by mistake. In fact, the statute contains its own remedy for willful overcharges: treble damages. It does not make the four-year limitation inapplicable in willful overcharge cases—cases which, as the Legislature certainly knew, are a large number of the cases to which the limitation on its face applies (internal citations omitted).

The dissent next addressed the majority's reassurance that more than just a mere allegation of "fraud" is required to justify a DHCR "investigation:"

> The majority adds that what DHCR is supposed to 'inquire' about is whether there was a 'fraudulent scheme to destabilize the apartment'. It does not say what it takes to prove such a 'fraudulent scheme.' Simply a wilful overcharge? Or wilful overcharge coupled with the hope that the overcharge will eventually result in the apartment's escape from rent stabilization?

The dissent concluded:

> The majority opinion can be read to mean either that the four-year limitation has largely ceased to exist, or that any case to which the limit applies on its face must lead to a mini-litigation, in which DHCR tries to figure out whether the overcharge was 'fraudulent' enough to escape the time limit. If the former, the majority has simply tossed aside the Legislature's command. If the latter, I do not envy DHCR's its task.

The next big battle in the four year rule war will be how *Grimm* will be applied to a *Roberts*-type situation, i.e., where a landlord, believing that the existence of J-51 benefits did not prevent luxury deregulation, charged market rents for apartments that otherwise qualified for such deregulation. Tenants and their attorneys will no doubt argue that such conduct

constitutes a fraudulent attempt to deregulate a unit, such that DHCR must investigate. They will further argue that such "fraud" mandates the use of the default rent formula. This column will closely follow any future developments.

1. In the interest of full disclosure, Rosenberg & Estis submitted an amicus brief on behalf of the landlord in *Grimm*.