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RENT REGULATION

Conditional Rentals Can Lead to Default Rent Formula


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In years past, some landlords have inserted clauses into initial leases where the incoming tenant represents that he or she will not be a primary resident of the apartment. Such clauses, even if they accurately reflect where the tenant will or will not live, are illegal, and have resulted in adverse consequences to both individual landlords and the real estate industry as a whole. One recent example is found in *215 W 88th Street Holdings v. New York State Div. of Hous. and Comm. Renewal*, decided by the Appellate Division, First Department on Oct. 27, 2016.

Primary Residence

In 1971, the New York State Legislature determined that certain tenants were abusing rent regulation by using their apartments as pied-à-terres. In response, the Legislature enacted L.1971, ch. 373. Chapter 373 amended L.1962, ch. 21 (the legislation whereby the state enabled New York City to enact rent control and rent stabilization) to exempt such apartments from regulation:

> Notwithstanding the foregoing, no local law or ordinance shall subject to such regulation and control any housing accommodation which is not occupied by the tenant in possession as his primary residence.

Conditional Rentals

Section 2525.3(b) of the Rent Stabilization Code, first enacted in 1987, states:

> No owner or other person shall require a tenant, prospective tenant or a prospective permanent tenant to represent or agree as a condition of renting a housing accommodation that the housing accommodation shall not be used as the tenant's or prospective tenant's primary residence, or the prospective permanent tenant's principal residence.

'Draper'

In *Draper v. Georgia Properties*, 94 NY2d 809 (1999), the tenant alleged rent overcharge, asserting that the lease form presented to her included the false representation that the apartment would not be her primary residence. The Court of Appeals ruled that the tenant had presented convincing evidence that she actually lived in the apartment, and that the conditional rental clause, in any event, was illegal:

> Rent stabilization code §2523.3(b) prohibits an owner from requiring a prospective tenant 'to represent or agree as a condition of renting a housing accommodation that the housing accommodation shall not be used as the … prospective tenant's

Clauses inserted into initial leases by landlords where the incoming tenant represents that he or she will not be a primary resident of the apartment are illegal and have resulted in adverse consequences to both individual landlords and the real estate industry as a whole.

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primary residence.' Moreover, Rent Stabilization Code §2520.13 provides that '[a]n agreement by the tenant to waive the benefit of any provision of the [Rent Stabilization Law] or this Code is void'" (internal citations omitted).

Notwithstanding §2525.3(b), some landlords began inserting these clauses into initial leases, usually as part of a scam to "deregulate" an apartment that was otherwise subject to rent stabilization. For example, in *Levinson v. 390 West End Assoc.*, 22 AD3d 397 (1st Dept 2005), the tenant's initial lease contained a clause stating that he did not intend to use the apartment as his primary residence, such that the apartment would be "exempt" from the Rent Stabilization Law during his tenancy. This maneuver allowed the landlord to charge the tenant a rent far in excess of stabilization rates, which ultimately resulted in a substantial overcharge award.

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A more elaborate scam, in the same building, took place in *390 West End Assoc. v. Baron*, 274 AD2d 330 (1st Dept 2000). There, the landlord leased a rent stabilized apartment to the defendant (Baron) at a grossly inflated rent. Baron thereafter "sublet" the apartment to Cyndi Lauper and her husband, David Thornton, pursuant to a sublease which provided that the Thorntons would not use the apartment as their primary residence. This subjected the Thortons to both an illusory tenancy between the landlord and Baron, and a sublease containing an unlawful conditional rental clause. To make matters worse, the landlord entered into a collusive declaratory judgment action, whereby Baron "consented" to the entry of a judgment declaring that the apartment was exempt from rent stabilization during the term of Baron's tenancy.

'Thornton' and 'Grimm'

In *Thornton v. Baron*, 5 NY3d 175 (2005), an outgrowth of *390 West End Assoc. v. Baron*, the conditional rental clause inaugurated a series of judicial rulings that ultimately devoured the four-year statute of limitation for rent overcharge under the Rent Stabilization Law. Given Baron's illusory prime tenancy, the issue arose as to the proper stabilized rent for the Thorntons, who were Baron's "subtenants." The landlord, citing the four-year rule in RSL §26-516(a), asserted that the Thorntons' rent should be based on the $2,496 rent that was charged to Baron on the November 1996 base date. The Court of Appeals disagreed, holding:

> Reflecting an attempt to circumvent the Rent Stabilization Law in violation of the public policy of New York, the Baron lease was void at its inception. Further, because the rent it purported to establish was illegal, the 1996 rent registration statement listing this illegal rent was also a nullity. Under those circumstances, we agree with Supreme Court and the Appellate Division majority that the default formula used by DHCR to set the rent where no reliable rent records are available was the appropriate vehicle for fixing the base date rent here.

Thus, the conditional rental clause invalidated the lease, which, in turn, invalidated the registrations setting forth the rent in that lease.

Thornton thereafter led to *Grimm v. New York State Div. of Hous. and Comm. Renewal*, 15 NY3d 358 (2010). *Grimm*, expanding upon *Thornton*, held that the rental history of an apartment more than four years prior to the complaint can be examined where (1) the tenant alleges circumstances that indicate the landlord has charged an illegal rent in violation of law; (2) the evidence indicates a fraudulent scheme to remove the rental unit from regulation; and (3) the rent registration history is inconsistent with the lease history.

'215 W 88th'

In *215 W. 88th Street Holdings v. New York State Div. of Hous. and Comm. Renewal*, supra, a rent-controlled tenant vacated the apartment in question in 1993. The landlord's predecessor set the new

rent at $1,947.17 per month pursuant to a lease which contained a clause stating that (1) the tenants would not use the apartment as their primary residence; and (2) if the tenants notified the landlord that they intended to live in the apartment, the tenants would either have to vacate the apartment or pay a higher rent. This clause, presumably, discouraged the tenants—the first rent-stabilized tenants of the apartment—from filing a fair market rent appeal challenging the initial stabilized rent.

The tenants filed an overcharge complaint with DHCR in 2005, claiming that the landlord's predecessor had engaged in fraud. DHCR found no overcharge, and thereafter denied the tenants' petition for administrative review.

In the subsequent Article 78 proceeding, *Pehrson v. New York State Div. of Hous. and Comm. Renewal*, 34 Misc3d 1220(A) (Sup. Ct., N.Y. Co. 2011), Supreme Court, relying in part on the conditional rental clause, found that "the current record supports the requisite factors set forth in *Grimm* to trigger DHCR's duty to ascertain whether those allegations of fraud in the record, in turn, warrant the use of the default formula in calculating any rent overcharge, and, if so, to apply the default formula."

DHCR issued a new order on May 5, 2014, finding that the landlord's predecessor had violated the Rent Stabilization Law by requiring the tenants to execute the conditional rental clause. DHCR also found that the landlord's predecessor had engaged in a scheme to deregulate the apartment, and that the registrations were at odds with the rental history. Having determined that the Grimm test was satisfied, DHCR employed the default rent formula and awarded the tenants $332,730 in overcharges. Notably, DHCR (1) did not assess treble damages; (2) allowed the landlord to collect annual guideline increases; and (3) held that under the particular circumstances of the case, the landlord was not required to refund the overcharges that its predecessor had collected.

Both the landlord and the tenants thereafter commenced Article 78 proceedings. Justice Michael D. Stallman affirmed DHCR's order in all respects. On appeal, the First Department modified DHCR's order. Initially, the court observed that the conditional rental clause had warranted use of the default rent formula:

> The court properly upheld DHCR's determination that the inclusion of a fraudulent nonprimary residence rider in the tenants' initial lease rendered it a legal nullity and required that the base date rent, for purposes of calculating the rent overcharge, be arrived at using the 'default method.' The court also correctly upheld DHCR's determination that the owner—which purchased the building twelve years after the initial legal lease, and could not reasonably be deemed to have been aware of it—did not act willfully, and thus treble damages were not warranted (internal citations omitted).

The court, however, held that DHCR had erred in allowing the landlord annual guidelines increases:

> The practice of imposing a 'rent freeze' when the default method applies—that is, calculating the overcharge based on the default method base rent, without adjustments, throughout the relevant period—is not a matter merely of customary practice that the agency may deviate from when equitable considerations so demand. Rather, it reflects a statutory requirement. RSC §2528.4 provides that an owner who filed an improper rent registration is barred from collecting rent in excess of the base date rent, and is retroactively relieved of that penalty upon filing a proper registration only when 'increases in the legal regulated rent were lawful except for the failure to file a timely registration.' That clearly is not the case here.