Fair Market Rents

Court of Appeals Limits Liability to Current Owner

In the recent case of *Fullan v. 142 East 27th Street Associates*,[1] the New York state Court of Appeals held that under the circumstances presented, the current owner of a rent-stabilized apartment would not be responsible for refunding monies owed by two former owners in connection with the tenants' successful Fair Market Rent Appeal.

Although the Court's decision correctly implements well-settled Division of Housing and Community Renewal (DHCR) procedure, it seemingly rewards the current owner for its less-than-diligent due diligence.

Rent Challenges

The Court's decision highlights the distinction between the two types of rent challenges permitted under the Rent Stabilization Law (RSL). The first is a complaint of rent overcharge, which is filed by a tenant who is not the first stabilized tenant of an apartment. The complaint alleges that the owner has unlawfully increased the current rent over the pre-existing stabilized level.

In contrast, a Fair Market Rent Appeal (FMRA) challenges the first stabilized rent for an apartment after the apartment is no longer subject to the more restrictive rent control statute, i.e., after the last rent-controlled tenant has vacated.

FMRAs date back to 1974, when the state Legislature passed the Emergency Tenant Protection Act (ETPA).[2] Before the ETPA was enacted, it was widely known that the Legislature was planning to subject previously rent-controlled apartments to rent stabilization upon vacancy. The question arose as to how the first stabilized rent would be computed. Landlord advocates demanded a market rent. Tenant advocates wanted the first stabilized rent to reflect a small increase over the existing rent-controlled rent.

The Legislature resolved this dispute by a most unsatisfactory compromise. The ETPA provided that the landlord was free to charge the first stabilized tenant a market rent. But the statute also gave the tenant the right to challenge that rent in an FMRA within 90 days of receiving notification of his or her right to do so.

Where an FMRA was timely filed, the stabilized rent would be computed under a specialized formula, using the last controlled rent as a base. Thus, setting the first stabilized rent became a crapshoot for the owner. If the tenant did not file an FMRA, the rent was legal. If the tenant challenged the first rent, the rent reduction was often substantial.

While a rent overcharge results from an unlawful increase over an easily discernable stabilized rent, a refund arising from an FMRA represents little more than an owner's bad guess as to what the "fair market" rent should be, or how the first rent will be calculated under DHCR's arcane formula. Thus, the RSL and code are far more lenient with respect to FMRA refunds. For example, overcharge refunds are subject to treble damages (Rent Stabilization Code § 2526.1[a][1]), whereas FMRA refunds are not.

'Fullan'

In *Fullan*, the tenants moved into an apartment in 1985 at a first stabilized rent of $775 per month. Six years later, the tenants filed an FMRA. The landlord, Dobro Corp., opposed the tenants' rent challenge.

In 1993, DHCR granted the FMRA, reduced the initial rent to $434.34 per month, and directed Dobro to refund $37,480.05 to the tenants.

Dobro promptly filed a Petition for Administrative Review (PAR), which DHCR ultimately denied in January 1997. In the meantime, Dobro had sold the building to 142 East 27th Street Associates. As the Court of Appeals would later observe, Dobro did not "provid[e] notice of the FMRA award" to the purchaser.

In February 1997, Associates sold the building to 27 Realty, LLC, the current owner. Apparently, 27 Realty knew nothing about the recently issued PAR decision.

In late 1998, the tenants brought a plenary action against Associates and 27 Realty for the FMRA refund, which had now grown to over $95,000 with interest and attorney's fees. 27 Realty moved for summary judgment, asserting that it was unaware of the FMRA and could not be held liable for excess rent as a matter of law. Supreme Court denied the motion and held that 27 Realty was indeed liable. The Appellate Division, First Department, affirmed, focusing on 27 Realty's failure to perform adequate due diligence when it elected to purchase the building:

> The motion court correctly observed that a current successor landlord is generally liable for overcharges collected by a predecessor landlord after April 1, 1984. We see no reason to except from this rule, particularly where, as here, due diligence by plaintiffs' present landlord, 27 Realty, in connection with its purchase of the subject premises would have apprised it of the FMRA award and would have enabled it to take steps to avoid the necessity for this enforcement action or, at the very least, to avoid the financial consequences of successor liability.[3]

RENT REGULATIONS

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The Court of Appeals, having granted leave to appeal, unanimously reversed the Appellate Division. The Court first observed that §2522.3(a) of the Rent Stabilization Code provided that once an FMRA is determined:

> '[T]he order shall direct the affected owner to make the refund of any excess rent to the tenant ... and to the extent the present owner is liable for all or any part of the refund, such present owner may credit such refund against future rents.' ... The language of the provision does not direct, or even create a presumption, that the current owner will be liable for the entire FMRA.

Although the Court of Appeals' 'Fullan' decision correctly implements well-settled Division of Housing and Community Renewal procedure, it seemingly rewards the current owner for its less-than-diligent due diligence.

The Court of Appeals next looked to DHCR Policy Statement 93-1 for guidance:

> The Policy Statement lists the three situations in which a current owner will be deemed a party to an FMRA: (1) if the current owner was served with a copy of the FMRA by DHCR and had a chance to submit an answer, (2) if the current owner actually answered, or (3) if the current owner failed to provide DHCR with notice of the change of ownership and DHCR sends a copy of the FMRA to the previous owner.

Using the criteria set forth in the Policy Statement, the Court concluded that 27 Realty was not liable:

> Here, 27 Realty did not have an opportunity to participate in the FMRA. The current owner purchased the property a month after the PAR was decided and was apparently unaware of the existence of the FMRA award. Nor was the FMRA award reduced to a judgment — in which case a lien could have been filed that would have appeared on a title search. Further, 27 Realty has charged plaintiffs rent at the legal rate and has not collected any excess rent. Thus, there is no basis under either the Rent Stabilization Code or DHCR policy for holding 27 Realty liable for the excess rent charged by previous owners. Additionally, a purchaser does not have a statutory obligation of due diligence to investigate the potential existence of FMRA awards."

Successor liability is fundamentally a balancing act. On one hand, it seems inequitable to force an owner to refund monies collected by its predecessor. On the other, it is unfair to compel a tenant to chase a long departed landlord — often a single purpose entity — for monies the tenant is owed. This

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is especially true because DHCR frequently takes many years to decide a rent challenge. In *Fullan*, the Court of Appeals specifically observed that "[i]t is lamentable that the DHCR process from the initial filing of the FMRA to the conclusion of the PAR took six years."

Resolution of the successor liability dilemma would appear to hinge on due diligence, as both the First Department and the Court of Appeals concluded, albeit with different results.

Although the Court of Appeals correctly noted that "a purchaser does not have a statutory obligation of due diligence to investigate the potential existence of FMRA awards," such investigation is in fact a simple matter. Purchasers of rent stabilized buildings routinely obtain from DHCR, under the Freedom of Information Law, a list of all pending and closed agency cases. Because a current owner is indeed liable for overcharge refunds owed by its predecessors, see, *Gaines v. New York State Division of Housing and Community Renewal*,[4] such due diligence is practically standard procedure.

In *Fullan*, a routine investigation would have easily revealed (1) the filing of the FMRA in 1991; (2) the FMRA's initial resolution in 1993, and (3) the 1997 PAR decision. Upon reviewing DHCR's list of open and closed cased, 27 Realty could have demanded copies of the relevant documents. Apparently, 27 Realty did little, if any, due diligence.

Tenants, as opposed to owners, have little opportunity to protect themselves with respect to issues of successor liability. At best, a tenant can enter a judgment for the FMRA refund, but only once a PAR determination is issued. In fact, a tenant may not even be aware that the building has been sold, especially where the purchaser and seller use the same managing agent.

The Court of Appeals implied that 27 Realty would have been liable if the tenants had reduced "the FMRA award ... to judgment — in which case a lien could have been filed that would have appeared on a title search." But a title search is not required by law, and the Court had already observed that there is no statutory obligation "to investigate the potential existence of FMRA awards."

Conclusion

The lesson here is that notwithstanding *Fullan*, purchasers should always determine whether a rent refund is or will be owed, and then demand appropriate protection from the seller. That protection can take the form of a purchase price reduction or an appropriate escrow until the rent challenge is adjudicated.

Court decisions and DHCR Policy Statements come and go, but foresight and due diligence are forever.

(1) NYLJ, Dec. 23, 2003, at 19, col. 4.
(2) L. 1974, ch. 574, §4.
(3) 282 A.D.2d 275, 275, 723 N.Y.S.2d 179 (1st Dep't 2001).
(4) 90 N.Y.2d 545, 664 N.Y.S.2d 249 (1997).