ANALYSIS

Fraud and the Default Formula: Still in Need of Clarification

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Landlord Tenant Law

By Nativ Winiarsky

It has been over two years since the Court of Appeals decided *Regina Metro. Co. v. New York State Div. of Hous. & Community Renewal*, 35 N.Y.3d 332 (2020), which was supposed to be the court's definitive case on rent overcharge. This was to be especially so as it related to the thousands of units in buildings which were deregulated while in receipt of J-51 benefits.

Unfortunately, as seminal a case as *Regina* may have been, there has been a sharp divergence of opinions in regard to its application as seen by recent decisions issued from both the Appellate Division and trial court levels.

By way of brief background, in *Roberts v. Tishman Speyer Props., L.P.*, 13 N.Y.3d 270 (2009), the Court of Appeals held that luxury deregulation, which allowed landlords to raise rents from rent stabilized levels to market rates, was unavailable in buildings that had received tax benefits, pursuant to the J-51 Program.

In *Gersten v. 56 7111 Ave.*, 88 A.D.3d 189 (1st Dept. 2011), the court held that *Roberts* applied retroactively, and that all apartments that had been luxury decontrolled in buildings receiving J-51 tax benefits had to be promptly registered with the New York State Department of Housing and Community Renewal (DHCR).

In November 2014, the retroactivity of the *Roberts* decision was apparently recognized by the Court of Appeals in *Borden v. 400 E. 55th St. Assoc., L.P.*, 24 N.Y 3d 382.

As a result of the widespread uncertainty as to how landlords should re-register previously deregulated units, the DHCR, in 2016, notified approximately 4,000 landlords of buildings which received J-51 tax benefits that "any apartment that was subject to stabilization at the date of the receipt of the J-51 benefits" must be registered as rent-stabilized and the methodology of setting the rents (2016 DHCR Notice).

Since then, there has been a slew of cases filed by tenants resulting from improperly treating apartments as exempt from rent stabilization while accepting J-51 tax benefits. In many of these cases, tenants have sought application of what is known as the "default formula" to compute the rent. The default formula, codified in 9 NYCRR 2520.1 et seq. provides, in pertinent part, that if the base date rent is the product of a fraudulent scheme to deregulate the apartment the rent shall be established at the lowest rent registered for a comparable apartment in the building in effect on the date the complaining tenant first occupied the apartment. See §2522.6[b][2][iii] and [b][3][i].

Needless to say, use of the default formula is an incredibly punitive penalty which, if applied, precipitously drops both the rents and the value of a building, and can possibly cause a landlord to be subject to a foreclosure proceeding as such reduction in rents very often triggers a default under a landlord's mortgage obligations.

In *Regina*, the Court of Appeals clarified that use of the default formula was only available upon establishment of a common law fraud claim whereby a fictitious (i.e., fraudulent) rent event is manufactured to artificially inflate the rent history to deregulate an apartment thereby corrupting the reliability of the base date rent. In taking pains to define fraud, the Court of Appeals stated "[f]raud consists of 'evidence [of] a representation of material fact, falsity, scienter, reliance and injury.'" Id. at 356 n.7.

Since *Regina*, recent cases have centered around whether a landlord's continued failure to register the apartment after *Roberts* and *Gersten* are sufficient indicia of fraud to warrant review of an apartment history beyond the statutory lookback period and implementation of the default formula. The Appellate Division, First Department, has generally found that such failure could possibly warrant a finding of fraud while the Second Department has taken a different view.

For example, in *Montera v. KMR Amsterdam*, 193 A.D.3d 102 (1st Dept. 2021), the court found that the landlord: (a) deregulated numerous apartments after *Roberts* (id. at 108); (b) waited until one year after the tenants interposed their complaint before registering the formally deregulated units (id.); (c) failed to submit any proof that its failure to register was done as a result of mistake or error (id. at 109); (d) failed to refute evidence of improper rental increases taken as a result of major capital and individual apartment improvements (id.). In the face of these factors, the court denied the owner's motion for summary judgment and ruled that "the apartment history beyond the four-year lookback may be reviewed to determine whether fraud occurred." Id.

It bears note that *Montera* did not find that said factors necessarily mandated a finding of fraud but rather such facts raised a sufficient issue of fact as to "whether fraud occurred." The recent case of *Austin v. 25 Grove Street*, 202 A.D.3d 429 (1st Dept. 2022) emphasized this point. In that case, the tenant claimed that landlord was treating the regulated units in the J-51 building as deregulated and was registering purportedly "fictitious" lease in 2018.

In reversing that portion of the lower court order which granted the tenant summary judgment, *Austin* held that "[w]hile these irregularities in the DHCR rent history and defendant's failure to provide proper rent-stabilized renewal leases raise questions of fact as to defendant's adherence to the rent stabilization laws, summary judgment in plaintiff's favor based on a finding of fraud is not warranted at this stage, given the parties' competing contentions as to the reasons for the discrepancies in the DHCR history and questions of scienter." Id. at 431.

Such questions of culpable state of mind as to whether the landlord knew the act to be wrongful and had an intent to act despite that knowledge are rarely resolved at the summary judgment level.

Yet, in *Goldfeder v. CenPark Realty*, 187 A.D.3d 572 (1st Dept. 2020), the Appellate Division did just that in favor of the landlord. In that case, the landlord gave tenants deregulated leases and failed to disclose that it was receiving J-51 benefits through 2015. In addition, the landlord represented to the Attorney General's office in a condominium conversion plan that the tenants' apartments were market rate tenants, neglecting to reveal either the J-51 benefits or the fact that *Roberts* would apply to these apartments.

It was not until 2016 that the landlord did a retroactive mass filing of DHCR registration forms. Notwithstanding those facts, *Goldfeder*, citing to the *Regina* definition of fraud, dismissed the tenants' case on summary judgment holding "plaintiffs do not show that a fraudulent scheme to destabilize the apartment tainted the reliability of the base date … [landlord's] action seeking to declare the unit deregulated due to their reliance on the pre-*Roberts* regulations, though unsuccessful, was not fraudulent. Id. at 573.

The Appellate Division, Second Department, has taken a strong view on this issue as seen by its decision in *Gridley v. Turnbury Vil.*, 196 A.D.3d 95 (2d Dept. 2021). In *Gridley*, the owner registered apartments with DHCR as exempt from rent stabilization due to high-rent, vacancy decontrol. Beginning however in 2016 and through 2017, the owner in *Gridley* re-registered with DHCR the previously deregulated units.

In rejecting the tenants' claim that the late re-filing of registrations with the DHCR years after *Roberts,* and tendering of non-stabilized leases during that period, was sufficient to make out a finding of fraud, the court found "[h]ere, the deregulation of the plaintiff's apartment was made in good faith … the late registration of the apartment as rent-stabilized, only after notification by the DHCR of a change in the law several years in the making, does not indicate that Turnbury was engaged in a fraudulent scheme to deregulate the apartment." Id.

It based this finding on the fact that the rent stabilization code specifically affirms that subsequent correction of an initial failure to file precludes the imposition of any penalty (citing to RSL §26-517[e]) and that "[t]herefore, a late registration, standing alone, is generally insufficient to establish a rent overcharge" Id. at 103. Thus, the court in *Gridley* fully recognized that an independent statutory remedy already exists should an owner fail to register apartments and thus there is no reason to devise an alternative method of relief like the imposition of a default remedy.

Recently there have been two decisions from the trial court by two well respected jurists which warrant review. In *Chester v. Cleo Realty Associates*, Supreme Court of the State of New York, County of New York, Index No. 151972/2017 (Nervo, J.) (July 6, 2022), the property manager for the building participated in previous law suits in which the need to re-register previously deregulated J-51 units

was already established. In addition, the owner was a party in proceedings before DHCR where it acknowledged receipt of J-51 benefits requiring rent stabilized leases. Lastly, the owner continued to fail to provide rent-stabilized leases even after the interposition of the lawsuit by the plaintiff-tenants.

Based thereon, *Chester* held "defendant's failure to properly correct known overcharges, *under those circumstances*, amounts to a willful and fraudulent scheme to deregulate the subject apartments. Stated differently, defendants have not established the overcharges not willful." While the decision granting summary judgment is questionably at odds with *Montera*, *Austin* and *Goldfeder*, the more troubling aspect of the ruling is that portion which read "defendant has not established the overcharges were not willful."

Here, *Chester* seems to conflate two different penalties resulting from rent overcharges. Specifically, if it is found that a landlord has collected an overcharge, the landlord will be liable for treble damages (see RSL §26-516 [a]) and it is the landlord's burden to prove that the overcharge was not willful.

In *Chester* however, the question was whether the overcharge collected was done as part of a fraudulent scheme to deregulate and in answering that question, the standard is not whether the landlord has established that the overcharges were not willful but rather *whether the tenant* has preponderantly established, "evidence [of] a representation of material fact, falsity, scienter, reliance and injury'" *Regina*, at 356 n.7. In seeming to suggest that it was the defendant-landlord's burden to prove that it did not commit fraud, *Chester* turned the standard established in *Regina* on its head.

In *Woodson v. Convent 1*, Supreme Court of the State of New York, New York County, Index No. 160547/2017 (Tisch, J.) (July 7, 2022), the court relied upon *Montera* to hold, on a motion for summary judgment, that "the evidence demonstrates that defendants perpetuated the same 'fraudulent scheme to deregulate' any of the building's apartments as did the landlord in *Montera*." However, *Montera* did not rule, as a matter of law, that the landlord did in fact commit a fraudulent scheme but rather ruled that the landlord may have participated in such a scheme and ordered further discovery on that issue.

Also of note is that despite the assertion made by the landlord in *Woodson* that it re-registered all of the building's apartments with the DHCR promptly after receiving the 2016 DHCR Notice, the court rejected this argument, holding "the *Montera* holding made it clear that a five to seven year delay in re-registration cannot be deemed 'prompt compliance.'" That's not exactly correct. Rather, in *Montera*, the "defendant waited *until 2018* to re-register the apartment, or years after receipt of the 2016 DHCR Notice. More to the point, *Gridley* and *Goldfeder* made clear that filing shortly after receipt of the 2016 DHCR Notice can be deemed prompt compliance.

If nothing else, one thing is unfortunately clear as concerning fraud and use of the default formula—that things are rather unclear. The Court of Appeals will soon get a chance to weigh in on these issues in an appeal of a decision, *Casey v. Whitehouse Estates,* 197 A.D.3d 401 (1st Dept. 2021). Inasmuch as these issues impact thousands of units, we all hope that further clarity and sound reasoning is provided in the very near future.

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