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The Economics of Luxury Deregulation

Rosenberg & Estis partners Warren A. Estis and Jeffrey Turkel discuss the recently enacted Rent Act of 2011, rent regulation, and the interplay between the luxury deregulation changes and the reduction of the individual apartment improvement increase, which makes the former more difficult and expensive to achieve.

Warren A. Estis and Jeffrey Turkel

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On June 24, 2011, Governor Andrew Cuomo signed into law the Rent Act of 2011, also known as L. 2011, ch. 97. The Rent Act was not the mere "extender" of existing rent laws that landlords wanted, but it certainly was not the wholesale "strengthening" of the rent laws that tenants sought. Instead, the Legislature left the fundamentals of rent regulation intact, but tinkered around the edges, particularly with respect to luxury deregulation and individual apartment improvements.

The basics of the Rent Act are easily summarized:

1. The rent laws were extended until June 15, 2015.

2. Threshold rent level for both high income and vacancy luxury deregulation was increased from $2,000 per month to $2,500 per month.

3. The annual income level for high income luxury deregulation was increased from $175,000 to $200,000.

4. Effective Sept. 24, 2011, individual apartment improvements will raise the monthly rent by 1/60th of the total allowable cost (instead of 1/40th) in buildings with 36 units or more. The number remains 1/40th for buildings with 35 or fewer units.

5. The statutory vacancy allowance can only be taken once in a calendar year.

The most interesting aspect of the Rent Act—and the subject of this article—is the interplay between the luxury deregulation changes and the reduction (at least in larger buildings) of the individual apartment improvement increase from 1/40th to 1/60th. The net effect of these changes is to make luxury deregulation more difficult and more expensive to achieve. But given the benefits of luxury deregulation—the right to charge a market rent and freedom from governmental regulation—many landlords will continue to spend whatever it takes to reach the luxury deregulation threshold.

Vacancy Luxury Deregulation

Vacancy Luxury Deregulation (VLD) was added to the RSL pursuant to the Rent Regulation Reform Act of 1993, known as L. 1993, ch. 253. See RSL §26-504.2. Under the original VLD statute, an apartment with "a legal regulated rent of two thousand dollars or more per month" would become permanently exempt from rent stabilization once it became vacant. This was an extraordinary change to the entire rent stabilization scheme, which had been in effect since 1969. Before the advent of VLD, an apartment was rent stabilized forever, unless, for example, the tenant in occupancy purchased the apartment as part of a conversion, or the apartment was temporarily deregulated based on owner or employee occupancy.

VLD was simple where the legal rent was already $2,000 per month when the tenant vacated, but became more complicated

where the rent had not yet reached that threshold at the time of vacancy. DHCR ultimately took the position that VLD would attach as long as the legal rent, by the time the incoming tenant moved in, had reached $2,000 per month. That meant that landlords could use any kind of lawful rent increase to reach the rent threshold—such as the statutory vacancy increase (added to the RSL pursuant to L. 1997, ch. 116) or individual apartment improvements. DHCR's policy was later codified at RSL §26-511(c)(14).

This brings us to individual apartment improvements. Section 20(C)(1) of the original Rent Stabilization Code provided that "the monthly stabilization rate for the dwelling unit shall be increased by 1/40th of the total cost of…added dwelling space, equipment or improvements, including the installation thereof." Pursuant to L. 1993, ch. 253, §19, that rule was codified as RSL §26-511(c)(13).

To gauge the cumulative effect of the Rent Act provisions relating to VLD and individual apartment improvements, let's take the example of an apartment in a building with more than 36 units, where the legal regulated rent was $1,500 per month when the tenant vacated. Further assume that the incoming tenant wants to sign a two-year vacancy lease.

Before the Rent Act, the landlord would take the following steps to insure that VLD attached. First, pursuant to RSL §26-511(c)(5-a), the landlord would be entitled to a vacancy increase of "twenty percent of the previous legal rent." This would bring the legal rent to $1,800. To bridge the $200 gap to $2,000, the landlord would have to spend at least 40 times that amount in individual apartment improvements. Thus, for $8,000, the landlord would be able to free the apartment from rent stabilization forever. Moreover, the money spent (it is usually spent on kitchen and bathroom renovations) would increase the market rent of the apartment; no one will pay top dollar for an apartment with an outdated kitchen or bathroom.

After the Rent Act, the calculation is far different. The vacancy increase, again, brings the rent to $1,800 per month. But now, the gap is $700, not $200, as the rent threshold is now $2,500 per month. Worse still, the individual apartment improvement ratio is now 1/60th, so the landlord would have to spend $42,000—not $8,000—to achieve luxury deregulation. The path to deregulation still exists, but it is far more expensive. (In a building with fewer than 36 units, the landlord would only have to spend $28,000.)

Does it make sense in our example for the landlord to spend the $42,000? It depends on what the apartment will be worth once the work is done. If the market rent for the renovated apartment will be $5,000 per month (i.e., $3,200 per month more than $1,800), then the $42,000 expenditure will be recouped in less than 14 months. If the market rate will be only $2,600 per month, the investment will be recouped in 52 months, still a good investment. If the landlord did not care to spend the $42,000, another strategy would be to re-rent the apartment as stabilized at $1,800 per month, wait for the next vacancy, and use the vacancy increase to help bridge the gap to $2,500.

'HILD'

High Income Luxury Deregulation (HILD) was also added to the RSL in 1993. See RSL §§26-504.1 and 26-504.3. Under the original HILD provision, the apartment of a tenant in occupancy could be deregulated where (1) the legal rent for the apartment was $2,000 or more per month, and (2) the tenant's income for the proceeding two years was in excess of $250,000. In 1997, the Legislature decreased the income level to $175,000. In the Rent Act, the income level was raised to $200,000, and the rent threshold was increased to $2,500 per month.

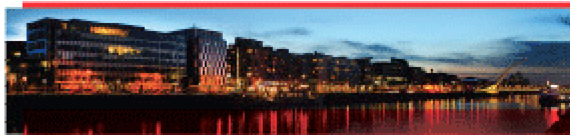
The income threshold issue for HILD is less complicated than it is for VLD; the rent is the legal rent the tenant is paying, and vacancy increases are, naturally, irrelevant. Individual apartment improvement increases are also irrelevant, because where the tenant is in occupancy, the landlord can only get such increases where the tenant consents to them. Few tenants will allow a landlord to raise their rent in this fashion, especially where such increase could result in deregulation. The immediate beneficiaries of the Rent Act with respect to HILD are (1) tenants with high incomes whose rents are above $2,000 per month but below $2,500 per month, and (2) tenants whose annual incomes are more than $175,000, but less than $200,000. The number of tenants in the latter category is probably quite small, but the number in the former category is no doubt substantial.

This is not to say that high income tenants will be protected from HILD forever; eventually their rents will reach $2,500 per month. For example, pursuant to Rent Guidelines Board Order No. 43, the renewal increase for a one-year lease is 3.75 percent and 7.25 percent for a two-year lease. Thus, if the tenant paying $2,100 per month takes a two-year renewal, his or her rent has now increased to $2,252.25 per month. One or two more similar increases will bring the rent over $2,500 per month. Moreover, Major Capital Improvement (MCI) increases can also increase a tenant's rent, sometimes as much as, for example, $20.00 per room per month. Thus, a combination of renewal increases or MCI increases may soon place a high income tenant in jeopardy.

There is another factor at play here: the more rent a tenant pays, the more money that tenant probably earns. While a relatively small percentage of tenants paying $2,000 per month may earn the prior income level of $175,000, it is likely that a much higher percentage of tenants paying $2,500 per month—i.e., rents 25 percent higher—earn $200,000 per year. Accordingly, once an apartment hits the $2,500 threshold, the likelihood of obtaining high income deregulation is substantial. As such, any landlord would be well-advised to file for luxury deregulation each year once the rent threshold is reached.

With the rent laws up for renewal last month, one of the major goals of tenant advocates was to do away with luxury deregulation altogether; that certainly did not happen. Some tenant advocates argued instead for a rent threshold of $3,000 or $2,700 per month, and an income threshold of $300,000. But those numbers were problematic; rent regulation is supposed to protect low-and middle-income tenants, and those numbers seemed geared toward tenants who are upper middle class if not outright wealthy. Hence the compromise figures of $2,500 and $200,000.

Warren A. Estis *is a founding partner at Rosenberg & Estis, and* **Jeffrey Turkel** *is a partner at the firm.*



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