



Deregulating a rent stabilized property by “Substantial Rehabilitation” - by Steven Kirkpatrick

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Following enactment of the Housing Stability and Tenant Protection Act of 2019 (HSTPA), “substantial rehabilitation” is one of the only remaining ways that an owner can deregulate a rent stabilized building. The scope of work required for a substantial rehabilitation is essentially a gut renovation, but there are specific requirements concerning the property’s condition before the renovation, the scope of the required work, and record keeping that must be complied with for deregulation to occur.

The Substandard/Seriously Deteriorated Condition Requirement

The first requirement is that the property must be in “substandard” or “seriously deteriorated” condition before the renovation. Until November 8, 2023, there was a presumption of substandard condition where at least 80% of the residential units were vacant but Rent Stabilization Code Section (RSC) 2520.11(e)(2) was amended to remove this presumption, and now owners must actually be able to prove that the building was in substandard/seriously deteriorated condition.

However, the terms “substandard” and “seriously deteriorated” are not defined in the RSC or in DHCR Operational Bulletin 2023-3 (which replaced Operational Bulletin 95-2), and because of the previous presumption there is little case law or DHCR authority discussing the standard. It is therefore important to take a hard look at the condition of the property to evaluate whether it is actually in substandard condition by reviewing violations for the property as well as its actual physical condition, and the condition should be carefully documented before any work is performed.

In addition, pursuant to amended RSC Section 2520.11(e)(3), a building will not be considered to be in substandard condition if there was a finding of harassment by DHCR, another governmental body or court within the most recent three-year period unless there is proof that the finding was lifted.

Scope Of Work Required

In order for a building to be considered to have been substantially rehabilitated, at least 75% of the following building-wide and apartment systems must be completely replaced with new systems: (1) plumbing, (2) heating, (3) gas supply, (4) electrical wiring, (5) intercoms, (6) windows, (7) roof, (8) elevators, (9) incinerators or waste compactors, (10) fire escapes, (11) interior stairways, (12) kitchens, (13) bathrooms, (14) floors, (15) ceilings and wall surfaces, (16) pointing or exterior surface repair as needed, and (17) all doors and frames, including the replacement of non-fire rated items with fire rated ones.

If a building does not contain all 17 of the above systems, the owner is only required to replace 75% of the existing systems for the work to be considered a substantial rehabilitation. Additionally, all building systems must comply with applicable codes and requirements, and the owner must obtain a new certificate of occupancy if one is required by law.

Prior to November 8, 2023, DHCR could waive the requirement that a particular system or building component had to be replaced if the owner demonstrated that it had been recently installed or upgraded, did not require replacement, or that it had aesthetic or historical merit. However, this

provision was removed when the Rent Stabilization Code was amended and now the systems or components actually have to be replaced for them to count toward the 75% requirement.

In addition to the 75% replacement requirement, all ceilings, flooring and plasterboard or wall surfaces in common areas must be replaced; and ceiling, wall and floor surfaces in apartments, if not replaced, must be “made new.”

Apartments That Remain Occupied

If a building is substantially rehabilitated but some apartments remain occupied by stabilized tenants, those apartments will remain stabilized for the duration of the tenant’s occupancy. Since a requirement for substantial rehabilitation is that all ceiling, wall and floor surfaces in apartments either be replaced or “made new,” some renovation of the occupied apartments is likely necessary.

Documenting The Substantial Rehabilitation And Record Keeping

Prior permission or an order from DHCR is not required for apartments of a substantially rehabilitated building to become deregulated. All that is required is simply completion of the required substantial rehabilitation work in a qualifying substandard building. However, “exit” registrations should be filed to document the deregulation.

If a tenant files a complaint with DHCR or otherwise challenges the deregulated status of an apartment, the owner will need to prove that the apartment is exempt based upon a substantial rehabilitation of the building, by submitting sufficient documentary evidence. Moreover, since there is no statute of limitations applicable to a claim that an apartment remains subject to rent regulation, DHCR or a court will determine the unit’s rent-regulatory status regardless of how far in the future such a complaint or application is filed.

Operational Bulletin 2023-3 outlines some of the documentary evidence required to demonstrate the scope of the work performed, which include an itemized description of replacements and installations, copies of approved plans, architect’s or general contractor’s statements, contracts, appropriate government approvals, and photographs of conditions before, during, and after the work was performed. Proof of payment for the rehabilitation work, such as copies of cancelled checks, may also be required. For projects completed before issuance of the applicable operational bulletins, DHCR and the courts may require less documentation where undue hardship or prejudice would otherwise result. However, we always recommend keeping extensive documentation for the work and building’s prior condition, not relying on having to prove undue hardship or prejudice.

In addition, since the same documentation requirements apply even if a prior owner performed the rehabilitation work, it is crucial that owners purchasing substantially rehabilitated buildings perform through pre-purchase diligence and obtain all required documentation when purchasing these buildings.

Conclusion

Notwithstanding the recent RSC amendments, substantial rehabilitation remains a viable strategy to deregulate apartments following the elimination of other deregulation methods by the

HSTPA. However, given the strict requirements, it is important to understand them and take proactive steps to document the before, during, and after condition of the building and to make sure that the scope of work satisfies all requirements for deregulation.

We have seen owners do extensive renovations that end up not qualifying, so it is important to consider some extra work to be safe rather than not replacing an item that could mean the difference between having a deregulated building and one that remains rent regulated. It is better to consult with counsel before embarking on a substantial rehabilitation project to take proactive steps to confirm qualification and to avoid some common pitfalls, instead of risking needing to defend against a tenant challenge, possibly years after the renovation was completed, and fighting an uphill battle because proper records were not kept, and/or the proper steps were not take before, during and after the renovation.

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