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Economic Infeasibility

Rare Defense Requires Total Cooperation of Client

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Landlords subjected to Housing Part proceedings1 to enforce building codes, where compliance will cause severe economic distress, may attempt to defend themselves by raising the so-called "economic infeasibility" defense, the essence of which is that the cost of correcting the cited code violations is likely to exceed any revenue the landlord can obtain from the tenants after making the required repairs.

Nevertheless, "economic infeasibility" is a rare defense to a Housing Part proceeding. The defense is difficult to establish, and it requires total cooperation from a client, delving, as it often does, into areas most clients would prefer to leave undelved. It is, however, in many cases, the only available defense. This article will provide a thorough overview of the defense, both as to theory and as to the practical problems an attorney will face in attempting to prove "economic infeasibility," seeking to minimize the surprises that a landlord's attorney might encounter. Between the hostility of the lower courts to the defense itself, and the difficulty that exists in meeting the expensive burdens the defense presents, unless a landlord's counsel is extremely thorough and has a very cooperative client, the city Department of Housing Preservation and Development (HPD) will often find it very easy to defeat this defense.

Overview of the Defense

The defense finds its origin in constitutional law, specifically the federal Fifth Amendment which prohibits the government taking private property without just compensation, made applicable to the states through the Fourteenth Amendment2 and has given rise to the idea that when a set of regulations requires someone to remain in a losing business, the government must either pay him or drop the requirement. Since the government never pays in these cases, the result is that courts simply refuse to enforce the government's attempt to compel economically distressed landlords to stay in business.3

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While the courts have had some trouble in deciding how to evaluate a building's costs and revenues in determining "economic infeasibility," the definitive statement of the law now appears to be that, if the repairs ordered will cost more than the estimated value that a sale of the building would produce after the required repairs are effected, then the repairs cannot be ordered.4 This does not mean that the landlord must necessarily show that he is seeking to sell the building. The landlord must simply be able to demonstrate what the honest arm's length price of the building would be on the open market, if fully repaired, as compared with the cost of the repairs.

That said, nonetheless, the courts do require a full economic analysis of the building. While it would seem that the only factors the court should consider would be the fair market value of the building on the open market and the cost of the repairs, the court will want to see the basis of the fair market value of the building on the open market, and that will require a full cash flow analysis, including rent roll, profit and loss statements, and a thorough engineering analysis of the building.5

Liability to Tenants for Damages

The cases make it clear that the "economic infeasibility" defense operates to exempt the landlord only from an Order to Correct, disobedience of which sometimes leads to jail. However, it does not exempt the landlord from a rent-regulated tenant's right to remain in the premises.6 The landlord remains liable for whatever damages the tenant may claim and, of course, an abatement of the rent. Of course, in the monetary ranges we are talking about, these claims are typically tiny compared to the other things that could be happening with the building. Also, while the landlord may not be ordered to repair the building, that does not mean that the landlord is automatically granted the right to evict the tenants who are there.

Sympathetic Higher Courts

The Housing Court tends to look with a very jaundiced eye at claims of economic infeasibility.7 But the appellate courts tend to give the defense a wide berth. We are dealing with fundamental rights of due process and basic freedoms that the higher courts of New York are loath to interfere with, even if the court has serious doubts about whether the landlord properly attended to taking care of the building. The leading cases on the subject are Eyedent v. Vickers Management and HPD,8 and Scharf, supra, both of them from the Appellate Division, First Department. Eyedent sees the defense as existing in theory, but not under the proofs that were presented in that case. Scharf explicitly affirms the existence of the defense as a practical matter. In addition, although by no means a leading case, 153-155 Essex St. Tenants Assocs. v. Kahan,9 serves as something of a textbook on how one should process these cases for a landlord.

Self-Infliction

In Eyedent, supra, the court suggested that the defense will not lie where the economic woe of the building is self-inflicted. The court stated, "In view of the landlords' business acumen in this field, we find that the alleged economic hardship the land-

lords now face in making the repairs required by the trial court order was self-inflicted, since the facts adduced at the trial indicate that the need to make such repairs could have been anticipated."

However, the facts of that case are that the landlord had newly acquired the building and then sought the infeasibility defense nearly immediately thereafter. This is thus readily distinguishable from a situation where the landlord has owned the building for a decade or more. We would anticipate, therefore, that the "self-inflicted" line would be taken by HPD whenever it can show that a landlord allowed a building to fall into disrepair over a lengthy period of time, and Housing Part D may well seek to take another trip to the Appellate Division to get that Court to define just what is and what is not "self-inflicted."

For example, in Rodriguez v. Cziment,10 the Court found that:

Some portion of the economic hardship respondent now faces was self-inflicted. . . . . The fact that respondent's neglect of the premises contributes to the substantial expenditure necessary to repair the property should not inure to his benefit.

The other leading case, Scharf, is clearly not self-inflicted because there was a fire in the building and no evidence to suggest that the landlord was the source of the fire in question. As Scharf found,

the relevant issue is the economic condition of the building, not that of the owners . . . . However, the doctrine of unclean hands is only relevant when the damage itself is the landlord's fault . . . . However, given the extreme disparity between the cost of restoration and the building's apparent value, we find that the option to restore this building should be left to the affected property owner, not commanded by the court. [T]he proper method of valuation is to compare the cost of repairing the building to the anticipated market value of the restored structure, rather than comparing it to the cost of not repairing the building.

There is nothing in the case law to indicate whether lack of "self-infliction" is part of the landlord's burden of proof in establishing the defense prima facie or if the presence of self infliction would be the burden of HPD to disprove the defense. It appears clear that the cautious landlord's practitioner will not wait for such a ruling from the courts but will from the very start seek to establish that the disrepair of the building is caused by factors outside of the landlord's control, such as fire, vandalism, and foiled security efforts.

When assessing the costs of repairing the building versus the gains one would achieve by doing so, only those costs associated with the removal of violations will be considered by the court.11 Cosmetic work or enhancement of the premises would not be allowed in the calculation.

Required Proofs

In order to establish the defense, the landlord will have the burden to prove:12

1. The current value of the premises.13

2. The cost of the repairs that would be ordered, including both materials and labor,14 or restoring the building.15

3. The assessed value of the building.16

4. Any current offers for the property.17

5. The financial operating statement of the premises,18 including the rent roll.19

6. The total economic viability of the building.20

7. Income tax consequences of repairing the building.21

8. Whether the alleged economic hardship the owner now faces in making the needed repairs was self inflicted by its failure to properly maintain the building over the years.22

9. If the owner violated its statutory obligation or withheld services illegally to force residents to leave.23

To establish these proofs, the courts require documentation, accountants, and other experts.24 The appraiser may not merely offer his appraisal of the building, but must give the basis for that appraisal, including inspections both of the exterior and of the interior operating systems of the building.25

Procedural Note

Since all of the data in these cases is peculiarly within the hands of the landlord, if at all, but not in the hands of HPD, it has been held that HPD is entitled to discovery if it wants it.26 Few landlords would welcome the kind of delving analysis by government accountants that this could entail, especially if there are any questionable tax deductions.27

Where the factors can be shown, however, economic infeasibility is a viable defense to Housing Part proceedings, although it will nearly never be sustained at the trial court level and will only likely be sustained at the appellate level. But, in order to sustain it at any level, a client must be willing to present extremely thorough and convincing economic data, full accounts of business operations, and expert witnesses (a) as to the accounting side, (b) as to the real estate side, and (c) as to the engineering side as to what has to be accomplished and what the costs would be.

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Endnotes:

1. These are proceedings brought in the Housing Part of the New York City Civil Court to enforce the various housing codes. See, NYC Civil Court Act §110(a).

2. And NYS Const. Article I, §7(a).

3. In Bernard v. Scharf, 246 AD2d 171 (First Department) the court wrote:

The Court of Appeals has held that a burden-shifting regulation amounts to a taking without just compensation "(1) if it denies an owner economically viable use of his property, or (2) if it does not substantially advance legitimate State interests" . . .

Compelling appellants to restore the building fails both of these tests. An order to spend over $4 million to create $1 million of value certainly denies the owner any reasonable return on his investment. Additionally, notwithstanding the State's legitimate interest in making affordable housing available for the general public, the restoration order merely "bestows a State-enacted indirect gift" to a preferred supplicant

4. Scharf, supra, says: The proper method of valuation is to compare the cost of repairing the building to the anticipated market value of the restored structure, rather than comparing it to the cost of not repairing the building.

5. This necessary assemblage of experts which could include accountants, engineers, realtors, and general contractors does not come cheaply.

6. Eyedent v. Vickers Management and HPD, 150 AD2d 202, 541 NYS2d 210, TLC Housing Part Actions 1, TLC Serial #0071 (AD1 1989).

7. For example, Gonzalez v. Navarro, 22 HCR 474A, NYLJ 8/10/94, 25:2 (Civ Kings); Rodriguez v. Cardonia, 19 HCR 648A, (Civ Bx); Rodriguez v. Cziment, 20 HCR 222A, NYLJ 4/22/92, 25:5, (Civ Kings).

8. 150 AD2d 202 (First Department 1989).

9. 32 HCR 365A, NYLJ 6/9/04, 22:1 (Civ NY).

10. 20 HCR 222A, NYLJ 4/22/92, 25:5 (Civ Kings).

11. HPD v. St. Thomas Equities Corp., 128 Misc2d 645 (AT 2 & 11).

12. Carrasquillo v. 197 Columbia Realty Corp., 20 HCR 722A, NYLJ 12/2/92, 25:2, (Civ Kings); Navarro, supra; Cziment, supra; Buchanan v. Toa Construction Co., Inc., 17 HCR 192A, NYLJ 5/31/89, 21:1, (AT1).

13. Eyedent, supra; 153-155 Essex St. Tenants Assocs. v. Kahan, 32 HCR 365A, NYLJ 6/9/04, 22:1, (Civ NY); Gonzalez v. Navarro, 22 HCR 474A, NYLJ 8/10/94, 25:2 (Civ Kings); Cziment, supra; Buchanan v. Toa, supra.

14. Carrasquillo v. 197 Columbia Realty Corp., 20 HCR 722A, NYLJ 12/2/92, 25:2 (Civ Kings).

15. Bernard v. Scharf, supra.

16. 153-155 Essex, supra; Scharf, supra; Navarro, supra; Cziment, supra; Buchanan v. Toa, supra.

17. 153-155 Essex, supra; Navarro, supra; Cziment, supra.

18. Navarro, supra; Cziment, supra.

19. 153-155 Essex, supra.

20. 153-155 Essex, supra; Navarro, supra; Cziment, supra.

21. Navarro, supra.

22. 153-155 Essex, supra.

23. 153-155 Essex, supra.

24. Cziment, supra.

25. Cziment, supra.

26. 153-155 Essex St. Tenants Assocs. v. Kahan, 32 HCR 365A, NYLJ 6/9/04, 22:1, HCR Serial #00014361 (Civ NY McClanahan).

27. On the other hand, disclosure being, by nature a delaying process, it does buy the landlord time to assemble all the requisite proofs.