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Scott E. Mollen, a partner at Herrick, Feinstein, discusses 'Matter of Stahl York Ave. Co. v. City of New York,' where it was held that a buildings' inclusion in FAE landmark designation was not an unconstitutional taking.

By **Scott E. Mollen** | September 25, 2018

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The plaintiff/petitioner (plaintiff) had commenced a “hybrid Article 78/plenary action” against New York City and NYC’s Landmarks Preservation Commission (LPC). The plaintiff appealed from a trial court decision which granted the defendants’/respondents’ (defendants) cross-motion to dismiss the petition/complaint.

The salient issues were whether the LPC’s denial of the plaintiff’s hardship application (application) to demolish two buildings which were included within a designated landmark (two buildings) lacked a “rational basis” and whether the plaintiff “is entitled to money damages on the ground that the inclusion of the two buildings within that designated landmark constitutes an unconstitutional taking." The Appellate Division (court) had previously affirmed the dismissal of plaintiff's action to annul the LPC's determination "to expand a previously designated landmark to include the two buildings…."

In 1990, "the LPC designated an entire block of tenement buildings known as the First Avenue Estate (FAE) as an historic landmark." The block includes "15 six-story buildings that were built in the early 1900s as 'light-court model tenements'—one of only two existing full-block light-court tenement developments in the United States." In 1990, the NYC Board of Estimate approved "the LPC's designation of most of the FAE as a landmark," but excluded the two buildings. However, in 2006, the LPC voted to include the two buildings in the FAE landmark designation and the NYC City Council (council) approved such designation.

In 2014, the plaintiff commenced an Article 78 proceeding, "challenging the LPC's determination and the…council's approval…as arbitrary and capricious," based on "the 1990 determination to exclude the two buildings from the FAE landmark designation." The court previously held that "the LPC and the…council had the power "to revisit the earlier determination." The court had found that the earlier exclusion of the two buildings was "the result of a politically motivated 'bad backroom deal' made under intense pressure from a major developer…."

Thereafter, the plaintiff submitted its application for permission to demolish the two buildings on the ground of "insufficient return." The plaintiff contended that "the expenses incurred in operating the two buildings…, significantly exceeded the income that they generated…." The plaintiff sought "to demolish the buildings, build mixed-income condominium towers in their place, and use the proceeds from that redevelopment to perform renovations at the other buildings in the FAE."

The plaintiff had submitted "two economic feasibility studies" which asserted that the buildings were incapable "of earning a 'reasonable return' within the meaning of the Landmarks Law." The plaintiff argued that the two buildings contained apartments which had "small rooms,…bathrooms that required undersized tubs and toilets, tiny closets, and electrical systems that did not support modern usage, and…the buildings lacked sprinklers and other modern safety and security systems." "Half of the 190 units were occupied and subject to rent stabilization or rent control, and the remaining units were vacant and could be leased at market rent."

The plaintiff's 2010 study also noted that "if the necessary repairs and improvements were performed…their annual net return would be negative 2.87 percent, which would not meet the 6 percent minimum standard for 'reasonable return' set by the LPC." The plaintiff's 2009 study (2009 study), found that if the vacant units in the two buildings were "improved, renovated and rerented," the "annual return would be 1.19 percent." The 2009 study found that "without the improvements, the annual return yielded by the vacant units would be .614 percent. Both studies analyzed the projected return from the combined two buildings separately from the other properties within the FAE."

In 2014, the LPC denied the plaintiff's application, based on its view that "the proper scope for reasonable return analysis was the FAE property as a whole." The LPC asserted that the plaintiff had incorrectly "considered projected renovation costs" for "the 53 apartments that were vacant at the time that the LPC voted" to grant landmark status to the two buildings in 2006, but also "for 44 additional apartments that became vacant," following the inclusion of the two buildings in the landmark designation. The LPC noted that the plaintiff had "warehoused subsequently to the landmark redesignation," 44 additional apartments and that was "a self-imposed hardship." The LPC also rejected the plaintiff's "cost approach" accounting method. The LPC found that "an income approach" was "more appropriate for rental property." The LPC also performed an "alternative reasonable return calculation using [plaintiff's] assumptions and methods, which calculation showed that the two buildings were capable of earning a reasonable return."

The plaintiff also claimed that including the two buildings within the FAE landmark designation amounted to an unconstitutional taking. The plaintiff further alleged that the LPC had incorrectly determined that the plaintiff "could earn more than a 6 percent return from the two buildings" "by misapplying its own standards and by refusing to consider the full costs that [plaintiff] would incur to renovate the buildings." The plaintiff contended that "the entire FAE should not have been considered" and the LPC should have used the cost approach, "as it had done in granting the hardship [application] of another developer in 1988."

The plaintiff alleged that prior to 2006, the two properties "could have been sold for more than $100 million—and twice that much had they been redeveloped." The plaintiff argued that the 2006 LPC public hearing had "improperly focused on concerns of politically influential local residents who sought to block any development in order to protect their own special interests and that LPC commissioners repeatedly made comments that prejudiced its application." The plaintiff also argued that "the LPC's 2006…landmark designation had…a severe economic impact on the value of the buildings, preventing it from earning a reasonable rate of return, and had interfered with its investment-backed expectations."

The defendants argued that "the LPC had properly denied [plaintiff's]…[application]," "the relevant improvement parcel for purposes of determining the…[application] embraced the whole FAE, that the LPC's use of the income approach was proper, and that there was no unconstitutional taking because [plaintiff] could continue to operate the buildings with low-scale rental units." However, the court found that "the relevant property for both the hardship and taking analyses was the FAE as a whole, that the income approach was not improper, and that the LPC had rationally concluded that [plaintiff] failed to demonstrate a hardship."

After reviewing pertinent Landmarks Law provisions, the court opined that "the Landmarks Law definitions, read together, appear ambiguous as to how to define a relevant 'improvement parcel' for purposes of the instant…[application]…." However, the court held that "the LPC's interpretation was rational." The court explained:

> The entire FAE constitutes one landmark and one landmark site. Thus, the entire FAE development contains one "improvement," which is defined as "a physical betterment of real property, or any part of such betterment"…. Stated otherwise, the FAE constitutes one unit of real property that includes that physical betterment.
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> … the LPC did not confer a landmark designation on the two buildings…that is separate from the earlier designation of the other 13 buildings within the FAE. Rather, the LPC chose to protect the FAE in its entirety by conferring a single landmark redesignation on the entire parcel.

Thus, although the plaintiff sought to demolish only two buildings within the FAE, the plaintiff "was still required to prove that the entire 'improvement parcel,' which includes the improvement in question, was not capable of earning a reasonable return."

The court noted that "the entire FAE was one 'unit of real property' treated as a single entity for purpose of levying real estate taxes, i.e., the 'improvement parcel.'" The FAE's "four tax lots are within the one tax block comprising the FAE landmark site." Between 2007 and 2012, the plaintiff had made "a single tax filing applicable to the entire tax block." Futhermore, the LPC "also analyzed the [application] solely with respect to tax lot 22 (which contains only the two buildings in question) and rationally determined that no hardship was demonstrated under a separate analysis of that tax lot because [plaintiff] failed to demonstrate that those buildings, considered alone, were 'not capable of earning a reasonable return.'"

The court held that "it was not irrational for the LPC to exclude…the renovation costs" for the "warehoused" 44 apartments within the two buildings and that the LPC had "rationally chose values for the relevant variables," *e.g.*, rental and vacancy rates and operating expenses in conducting its reasonable return analysis. The court also stated that the LPC had "appropriately concluded that [plaintiff] had demonstrated inefficient management, by, *inter alia*, its imprudent decision to warehouse 44 apartments…in the hope of demolition," that "the LPC's use of the 'income approach' rather than the 'cost approach'…was rational" and the LPC had not "contradicted its own precedent nor acted arbitrarily and capriciously" in using the income approach to measure assessed value…."

The LPC had argued that its income approach was "used by taxing authorities, whereas the cost approach would generate a higher assessed value for the buildings, resulting in higher real estate taxes…." Although the LPC, in a 1998 hardship decision, had "used the cost approach…, in that case the owner sought to recoup its renovation costs by selling, rather than by renting…." Here, the LPC had "performed more than 20 additional reasonable-return calculations…all of which showed that the buildings were capable of earning a reasonable return." The court found that even using the plaintiff's "values and proposed methodology, the property's rate of return would still be above the 6 percent threshold for hardship relief…." The court also found that the record did not demonstrate that the LPC had "evinced prejudice" against the plaintiff.

With respect to the takings claim, the U.S. Supreme Court, in *Penn Cent. Transp. Co. v. City of New York*, (438 U.S. 104 [1978]), held that "most regulatory takings cases should be considered on an ad hoc basis, with three primary factors to be weighed: the regulation's economic impact on the claimant, the regulation's interference with the claimant's reasonable investment-backed expectations, and the character of the government action."

In the recent Supreme Court case of *Murr v. Wisconsin*, (137 S. Ct. 1933 [2017]), "the owners of two adjacent lots (…) located alongside a river" sought to sell one lot, but could not sell it separately from the other lot, because "state regulations…forbade the sale of a parcel with less than an acre of land suitable for development." The owners sued the state, claiming that the state's regulatory action amounted to an unconstitutional taking." "The Murr court treated the two lots as a single parcel in concluding that regulations preventing the separate sale of the two adjacent lots did not amount to an uncompensated taking." *Murr* noted that "the establishment of lot lines was not dispositive of whether parcels should be considered separately or as a whole in a takings analysis." *Murr* "reasoned that lot lines are established with varying degrees of formality among the states, and are often subject to easy adjustment by landowners with minimal governmental oversight, leading to the risk of gamesmanship by landowners…."

Murr enunciated "a three-factor test" for determining whether parcels should be treated separately or as a whole for takings analysis purposes.

First, courts should give substantial weight to the property's treatment, and in particular how it is bounded or divided, under state and local law. Second, courts should look to the property's physical characteristics, including the physical relationship of any distinguishable tracts, the topography, and the surrounding human and ecological environment. Third, courts should assess the property's value under the challenged regulation, with special attention to the effect of burdened land on the value of other holdings….

Murr found that the "state and local regulations had effectively merged the two lots into one parcel." The two Murr lots were "contiguous and…their narrow shape made it reasonable to expect that their potential uses would be limited." The court reasoned that since "the lots were located along a river, the owners could reasonably anticipate that the lots would be subject to…regulations that would affect their enjoyment of the property." It also held that "the prospective value that [the smaller lot] brought to [the larger lot] supported considering them as one parcel."

Murr held that "there had been no taking," since the subject regulations did not deprive "the owners of all economically beneficial use of their property." It had also applied "the 'more general test of *Penn Central*.'" An appraisal in *Murr*, "refuted any claim that the economic impact of the regulation was severe" and "the owners could not have claimed that they reasonably expected to sell or develop their lots separately, given that the lots were subject to regulations forbidding such separate sale and development, which regulations predated the owners' acquisition of both lots." *Murr* concluded that the subject "governmental action…was a reasonable land-use regulation, enacted…to preserve the river and surrounding land."

In the subject case, the court found that "application of the Murr analysis leads to the conclusion that all of the lots within the FAE, including the two buildings…, should be treated as one parcel for taking analysis purposes." The court noted that "the FAE is divided by lot lines" (which *Murr* held), "is not a proper basis for determining whether the land in question should be treated as one unified parcel), the city…placed all of those lots within one tax block and…designated it as one unified landmark" and "the lots are contiguous and contained within one city block…."

All of the buildings "within the FAE share a common historical and architectural significance when treated as a unified parcel…." The court opined that "the only discernable adverse effect of including the two buildings…within the designated landmark on the value of the property as a whole is one manufactured by the owner itself in warehousing the 44 apartments within those two buildings."

The court then held that, "[c]onsidering the FAE property as a whole," the LPC amendment "did not result in complete deprivation of the owner's economically beneficial use of its property. The owner may "rent units within all of the buildings in the FAE, including the two buildings…." The court also found that "the 'more general' Penn Central test…supports the conclusion that [plaintiff] has not suffered a taking."

The court explained that the inclusion of the two buildings in the FAE, did not have "any further economic impact" on plaintiff's property "beyond that resulting from preexisting legal restrictions limiting [plaintiff's] use of the property even absent landmark status, such as rent control and rent stabilization."

The court also found that the plaintiff's "reasonable investment-backed expectations were not destroyed by the inclusion of the two buildings within the FAE landmark designation" and the two buildings "are capable of earning a reasonable return." Finally, the court stated that “the character” of the subject government action “favors the LPC, since,...the ‘preservation of landmarks benefits all New York citizens and all structures’ and ‘improv[es] the quality of life in the city....’” Accordingly, the trial court’s decision was affirmed.

Comment: Alexandra A.E. Shapiro of Shapiro Arato LLP, a counsel for the plaintiff, stated, “[t]he decision is inconsistent with the U.S. Supreme Court’s interpretation of the Takings Clause in *Murr v. Wisconsin*. The Supreme Court created a test that balances the government’s regulatory power against property holders’ Fifth Amendment right to compensation for a taking. The decision disregarded critical aspects of this test, tipping the balance in favor of the government and trampling on constitutionally-protected property rights.” Ms. Shapiro also noted that “this case would provide the New York Court of Appeals with its first opportunity to apply the Murr analysis. This is an important issue, especially because about 25 percent of Manhattan is designated as a ‘landmark,’ even though many of these properties lack historical or architectural significance, because there is often political pressure that leads to landmarking as a pretext to prevent new construction.” Ms. Shapiro advised that the plaintiff will pursue an appeal in the New York Court of Appeals.

The New York City Law Department declined to comment at this time.

Matter of Stahl York Ave. Co. v. City of New York, App. Div., First Dep’t, Case No. 100999/14, decided May 22, 2018, Renwick, J.P., Richter, Manzanet-Daniels, Kahn, Kern, JJ. Opinion by Kahn, J. All concur.

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