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IN THE SUPREME COURT OF THE STATE OF DELAWARE

REHOBOTH BAY HOA, Appellant-Below, Appellant, v. HOMETOWN REHOBOTH BAY, LLC, Appellee-Below, Appellee.	:	No. 139,2020 D On Appeal from the Superior Court of the State of Delaware, C.A. No. S18A-03-003 CAK Date Filed: August 17, 2020

APPELLANT'S REPLY BRIEF

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1) Appellant's Argument before this Court Regarding the Distinction Between Capital Improvement and Ordinary Repair is Consistent with its ArgumentsRaised Below

Appellee claims that Appellant is offering a new issue before this Court by referring to US Treasury Regulations[1] that illustrate a reliable mechanism for distinguishing between an improvement and a repair. This is not true. Appellee has truncated Appellant's arguments below and thereby misrepresents them. Appellant has always argued that a capital improvement[2] must add something new to the community: a new asset, a new capability for an existing asset. In its brief before the Arbitrator, Appellant provided dictionary definitions of several ambiguous words used in the statute including "capital improvement",[3] "ordinary repair",[4] "maintenance",[5] "replacement",[6] and "replace".[7] Appellant continued,

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[1] 26 CFR 1.263(a)-3(j) (Appellant's Appendix at 139)

[2] 25 *Del. C.* § 7402(c)(1) states, "One or more of the following factors may justify the increase of rent in an amount greater than the CPI-U: (1) The completion and cost of any capital improvements or rehabilitation work in the manufactured home community, as distinguished from ordinary repair, replacement, and maintenance."

[3] "Capital Improvement - Property improvements that either will enhance the property itself or will increase the useful life of the property." (Appellant's Appendix at 100.)

[4] "Ordinary Repair – repairs to assets caused by day-to-day wear and tear that are required to maintain an assets functionality. These repairs do not increase the value of capital assets, they merely preserve value." (*Id.*)

[5] "Maintenance – …3: The upkeep of property or equipment…" (*Id.*)

> In order for something to be considered a capital improvement under the Act, it must be an improvement to the property. The improvement must enhance the property. The statute distinguishes a capital improvement from ordinary repair, replacement and maintenance. [fn 34 - 25 *Del. C.* § 7402(c)(1). When one looks at the language in this section alongside Section 7402(c)(6) … it is clear that the Legislature intended to allow community owners to increase the rent for new or unexpected repair and improvement expenses. Ordinary, predictable expenses that the community owner could budget for over the life of the asset, are expressly excluded.] *Therefore, work that is done that repairs problems caused by day to day wear and tear, work that constitutes upkeep of the property, work that restores property to a former condition constitutes ordinary repair, replacement and maintenance. It does not matter if the work costs $1, $5 or $500,000. The relevant inquiry goes to whether a change or enhancement is occurring*. For example, if after 30 years a new roof must be put on a building because of deterioration, the roof is being replaced in the ordinary course and is therefore a repair, replacement or maintenance. One would expect that the need for a new roof would be expected, planned for and paid for from the revenues received from the monthly rents. On the other hand, an existing playground would be enhanced by a new attraction (a rock climbing wall!!) and that new attraction is a capital improvement. The annual mulch for the playground is ordinary maintenance. (*Id.* at 101.)

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[6] "Replacement – 1: the action or process of replacing: the state of being replaced 2: one that replaces another especially in a job or function." (*Id.*)

[7] "Replace – 1: to restore to a former place or position…. 3: to put something new in place of." (*Id.*)

Throughout this litigation, Appellant has urged the Arbitrator, the Superior Court[8] and now this Court to interpret this statutory language to mean one thing: that a project must actually improve the manufactured home community in order for a rent increase to be justified under 25 *Del. C.* § 7402(c)(1). In referencing U.S. Treasury Regulations in its Opening Brief to this Court, Appellant simply points out to the Court the process that the Internal Revenue Service uses to make the very same distinction – the distinction between a repair and an improvement - that the General Assembly has made in Section 7042(c)(1). The inquiry effectively differentiates between an improvement and a repair. Reference to the "appropriate comparison" used in the Treasury Regulations is helpful given the obvious ambiguity of the words "improvement" and "ordinary repair".

When a community owner engages in a project that introduces a new asset to the community, the analysis is obvious. However, when the community owner engages in a project that relates to an asset already in the community, the question about whether the work constitutes a repair or an improvement can be difficult to discern. The words "improve", "improvement" and "ordinary repair" require that a comparison be made between the before and the after. The basis for the comparison is at the crux of the legal issue before the Court. The appropriate

[8]Superior Court Opening Brief, Appellant's Appendix at 129-132.

comparison that provides a meaningful distinction between an improvement and an ordinary repair is the essential inquiry.

Inasmuch as the bulkhead is no longer at risk of failure, the condition of the bulkhead is obviously improved from the condition it was in when it was unstable and at risk of failure. This comparison, however is meaningless because there will be improvement to the community with *every* repair, however modest or extensive.

The appropriate comparison should be between the capability, effectiveness, capacity or other such quality of an asset *when it was in good working order* (ie. when the bulkhead was built or the last time the bulkhead was repaired) and those same qualities after the project is completed. This is an effective means to distinguish between a repair and an improvement and it will provide clarity and consistency in the application of the law. This comparison will avoid the tendency to mischaracterize a repair as an improvement when a repair is made to an asset by means that are visible, obvious, or otherwise impressive to the eye but where there is no evidence that the work actually enhanced the effectiveness of the asset in any way. When the appropriate comparison is made, the determination of whether the project results in a "capital improvement or rehabilitation work" under the statute or an "ordinary repair, replacement or maintenance" will be obvious.

Appellee argues that the bulkhead project did improve the community because the bulkhead was in such bad shape before the project began and now it

has been "stabilized".[9] The Arbitrator was also impressed with the terrible condition of the bulkhead before the project started noting that it "may not survive another storm" (Arbitrator's Decision at 16), that the bulkhead looked stable but the "area below the waterline was not stable" (*Id,* at 17), that "the integrity of the entire bulkhead was in question" (*Id.*), "the old bulkhead could not be removed, so the placement of the new riprap stabilized the bulkhead" (*Id.*), and that photographs of the bulkhead work show significant amounts of riprap added to certain waterfront areas of the community." (*Id.*) Rejecting the HOA's argument that this work amounted to a repair of the bulkhead, the Arbitrator stated that, "[o]n the whole, however, the work that was performed to address the bulkhead's issues went beyond ordinary work by adding a new and better riprap feature that was not there before. (*Id.* at 19) This is not the correct legal analysis. The Arbitrator should not have compared the condition of the bulkhead after the project was completed with the condition of the bulkhead in its dilapidated state. The

[9] Appellee mischaracterizes the record in its Answering Brief in an apparent effort to read into the record evidence that does not exist: "The work performed on the bulkhead … was a vast improvement over the original bulkhead" (Answering Brief at 30, *citing* the transcript at B0186-87) There is nothing on the cited pages and there is nothing in the record otherwise that supports the statement that the work done on the bulkhead improved the bulkhead over the original bulkhead. 2) "…testimony presented at the Arbitration, and part of this record on appeal, characterized the riprap as a 'new and better feature'…" (Answering Brief at 35) There is no such testimony; 3) "the prior bulkhead" *Id.* The bulkhead that has always been there remains in place.

appropriate comparison would be with the bulkhead when it was in a proper functioning condition and the Arbitrator failed to do this.

In this case, when evaluating some of the projects for which Appellee sought a rent increase, the Arbitrator made the appropriate comparison and came to the correct result. Rent increases were granted for projects that actually improved the community[10] and rent increases were denied for those projects that did not improve the property.[11] Although not articulated with these exact words, the Arbitrator compared the new boat launch with a functioning boat launch, not the dilapidated boat launch that existed before the repair was made. "This work restored the community's marina to its original condition – having a useable boat ramp. My conclusion may have been different if the Landlord presented evidence that the new boat ramp was bigger, better, or had improved features compared to the old ramp; i.e. an enhancement." (*Id.* at 26)

After reviewing the testimony and documentary evidence relating to the dilapidated state of the bulkhead and the efforts made to stabilize it by the bulkhead project, the Arbitrator found that "the bulkhead project was done to stabilize the old bulkhead by adding the new supporting riprap… the old bulkhead

[10] A new drainage ditch and a new walkway for kayak launching. (*Id.* at 23-24)

[11] The complete replacement of a boat launch, resulted in the community enjoying a boat launch , just as it had before. By repaving driveways, and adding millings to a road, the community still had the same driveways and the same road. (*Id.* at 20-23)

was left in place with the riprap added in front of it. All of this evidence shows that the bulkhead project enhanced the community's protective bulkhead with new riprap. This project protects the community, increases its value and adds to the useful life of the bulkhead." (*Id.* at 17-18) The Arbitrator is clearly comparing the condition of the bulkhead after the project with the condition of the bulkhead just before the project started rather than when the bulkhead was in proper working order. This is how the Arbitrator's analysis differs from his analysis of the other projects and this is where the Arbitrator errs. Furthermore, there was no evidence in the record to suggest that the stabilization of the bulkhead with the riprap increased the value of the community or bulkhead over the value of the bulkhead or the community with an otherwise properly functioning bulkhead. Certainly, the installation of the riprap increased the value of the community and the bulkhead over the value of the community with a dilapidated bulkhead that was about to fall into Rehoboth Bay but that is not the appropriate comparison.

2. Appellee's Characterization of What Constitutes a Constitutes a Capital Improvement or an Ordinary Repair Should be Rejected by this Court.

Despite some mischaracterizations by Appellee of the record[12] and Appellant's Opening Brief,[13] the Appellant takes no issue with Appellee's representations and the Arbitrator's findings that "the bulkhead was at the end of its useful life" and had deteriorated to the point where it was vulnerable to failure. (Answering Brief at 30) Appellant accepts that the project was necessary to the integrity of the bulkhead and that the repairs were made to protect the HOA members' homes as well as the entire community. (Answering Brief at 32) These facts, however, reveal that the repair project was long overdue, not that the work resulted in a capital improvement or was anything other than an ordinary repair.

[12] "The work performed on the bulkhead … was a vast improvement over the original bulkhead" (Answering Brief at 30), *citing* the transcript at B0186-87. There is nothing in the record generally and there is nothing on the cited pagers specifically that supports the statement that the work done on the bulkhead improved the functioning of the bulkhead *at all;* "…testimony presented at the Arbitration, and part of this record on appeal, characterized the riprap as a 'new and better feature'…" (Answering Brief at 35) There is no such testimony; "the prior bulkhead" *Id.* The bulkhead remains in place.

[13] "Indeed, as Appellant itself acknowledges, the work performed made the bulkhead 'stronger and better.'"(Answering Brief at 30) Appellant does not acknowledge this and it is a blatantly incorrect. Appellant stated, "…*there is no evidence* that the riprap, even if it is a "better technology", created a stronger, better bulkhead than existed when the bulkhead was built." (Opening Brief at30)

Appellee states, "That the [bulkhead] Project was 'not just a simple repair,'[14] is fully supported by the record created at Arbitration." (Answering Brief at 33.) This is not the standard that should be applied pursuant to 25 *Del. C.* § 7402(c)(1). *Any* repair, big or small, simple or complex, is an "ordinary repair" within the meaning of 25 *Del. C.* § 7402(c)(1) if repairing the asset that is all that happens. Repair costs are recoverable under the Act if they are required by an unanticipated event (an act of God)[15] or there is an overall increase in costs relating to maintenance.[16] Costs for repairs caused by normal wear and tear should be covered by the rents tenants pay every month. 25 *Del. C.* § 7402(c)(1) provides for recovery of costs that are expended for improvements.

[14] The quotation marks exist in the Answering Brief but no citation is given.
[15] 25 *Del. C.* § 7402(c)(6).
[16] 25 *Del. C.* § 7402(c)(5).

3. <u>There is No Evidence in the Record that the Installation of Riprap Resulted in a Better Bulkhead.</u>

As outlined above, the Arbitrator was impressed with the installation of riprap next to the failing bulkhead. Appellee's manager testified that the riprap was a "better technology". While this witness was not found to be an expert on bulkheads, her testimony was accepted by the Arbitrator. Nevertheless, even accepting as true that riprap is "better technology", there is *no* evidence that this "better technology" actually enhanced any of the qualities the community enjoyed over the years when the bulkhead was in proper working condition. There is *no* evidence that the bulkhead's protective capability is better than when the bulkhead was built or was last in good condition. Based upon this testimony, the Arbitrator concluded that the addition of riprap "created a new feature of the bulkhead." The Arbitrator went so far as to say that "there was no dispute" that the project created this "new feature". No one denies that there is now rock in front of the old bulkhead and that there is something new to look at. What is disputed and what there is no evidence to support is the conclusion that that riprap, "better technology" or not, created a better, more capable bulkhead. This essential element of proof is missing and therefore the Arbitrator's decision that the riprap constituted a capital improvement is not supported by any, much less substantial, evidence.

4. There Is No Testimony at All about the Pilings and Tie Rods ("Deadmen") and the Effect of This Installation upon the Bulkhead.

In its Answering Brief Appellee misrepresents the record when it says, that Appellant did not argue "before the Arbitrator or the Superior Court, that the cost of the installation of the 'pilings' and the "tie rods/deadmen' should have been removed from the cost of the bulkhead Project for the purposes of Rent Justification." This issue was expressly raised before the Superior Court.[17] The issue was raised before the Arbitrator in that the HOA argued that the entire bulkhead project was not a capital improvement because the entire project was a repair.

A review of the transcript reveals that there was no testimony about the pilings and tie rods that were installed to support the failing bulkhead. This evidence is only found in in the exhibits submitted by the community owner.

[17] "In addition to placing riprap next to the bulkhead to shore it up, other work was done on the bulkhead that the Arbitrator failed to consider. Over one half of the money spent on the bulkhead project was for repair work other than the riprap. Hometown's invoices reveal that $245,802 of the $441,189 total project cost was for the installation of pilings, not riprap… Therefore, even if the riprap were a capital improvement, there is no evidence in the record demonstrating that the installation of the pilings and other non-riprap bulkhead work was anything other than a repair. The Arbitrator did not make a finding in this regard. Consequently, there is no evidence in the record to support the award of the $245,802 relating to installation of the pilings or $40,000 for the startup costs." (Superior Court Opening Brief, Appellant's Appendix at 133)

(Appellant's Appendix at 57-91) The contract Appellee entered with Precision Marine to complete the bulkhead project and the invoices showing payment for that work were admitted in evidence and reviewed by the Arbitrator. The Contract describes the bulkhead project as,

> Installing Riprap in front of the existing bulkhead beginning at the end of Phase II and continuing for approximately 448 linear feet. As well as, installing Piling and Deadmen to stabilize the bulkhead along the Lagoon and continue for approximately 1535 linear feet. (Appellant's Appendix at 57)

Appellee's invoices reveal that the "Bulkhead Repair W/Riprap" was completed in January 2017 with the installation of riprap along one part of the bulkhead (Appellant's Appendix at 064 through 084) and that the "Lagoon Bulkhead Repair" was completed between early February 2017 and April 15, 2017 with the installation of 304 "sets of piling" or "deadmen" installed in the Lagoon section of the bulkhead. (Appellant's Appendix at 085 – 091)

If the Court accepts that the addition of riprap constitutes a capital improvement because creates a new feature and improves the bulkhead, the Court should not do so with regard to the expenses for the installation of the pilings. There is no evidence at all that this work went beyond "ordinary repair" of the seriously dilapidated bulkhead.

In his decision, the Arbitrator clearly states that it is the presence of the riprap that "creates a new feature" of the bulkhead. Every one of the Arbitrator's

findings supporting his holding that the bulkhead project was a capital improvement all related to the addition of the riprap. None of the findings relate to the pilings and tie rods. "There is no dispute that the work done by the contractors, including adding significant amounts of riprap, created a new feature of the bulkhead." (Arbitrator's Decision at 17) "On the whole, however, the work that was performed to address the bulkhead's issues went beyond ordinary work *by adding a new and better riprap feature that was not there before*." (Arbitrator's Decision at 19, emphasis added)

There is no evidence that the pilings and tie rods added a new or better feature. There is not even any testimony that the pilings and tie rods are a "better technology". Consequently, the only evidence before the Arbitrator regarding the pilings consisted of the contract and the invoices that revealed that the bulkhead project, as a whole, was done to repair and therefore stabilize the failing bulkhead.

Finally, in its Answering Brief, Appellee seeks to introduce evidence, not in the record, of the effects of climate change on coastal communities. While on the one hand Appellee asserts that flooding and erosion are real and significant threats…," it hedges this statement by claiming "that [the issue] has been widely debated in the public." While Appellee's statement may be true, there is no evidence that the bulkhead project *increased* the ability of the bulkhead (when it was in proper functioning condition) to protect the community from these rising

threats. It appears that this footnote is included for the purpose of suggesting that, because the dangers of coastal erosion may be increasing, the bulkhead project was designed to meet this increased threat. However, there is no evidence in the record that this is so. There is no evidence in the record that the bulkhead is any better at protecting the community than it ever was.[18]

In holding that the entire bulkhead project was a capital improvement and the Superior Court erred as a matter of law in its affirmance.

[18] Appellee goes on to say, "There is nothing more significant that Hometown could do; they were under no obligation to do so; they undertook this massive project to protect its investment and the homeowners' investments." Appellee most certainly did have an obligation to maintain and repair the bulkhead. 25 *Del. C.* § 7008(13). Appellee's repeated admissions throughout this litigation that the bulkhead was in such an unstable condition that *it may not survive another storm* reveals Appellee's utter failure to replace or repair the bulkhead in a timely manner, before its condition became such a threat to the 525 households in the community. The fact that Appellee allowed the bulkhead to deteriorate to such a degree is a clear breach of its duties as a community owner to maintain the community. Thankfully, there was no catastrophe.

5. The Rent Justification Act Does Not Mandate the Approval of the Requested Rent Increase.

Appellee argues there was no legal error in the Arbitrator's decision to allow the full cost of the capital improvements to be recovered in one year *and* that increase continue in perpetuity. (Answering Brief at 38-43) Appellee quotes the Arbitrator saying that the Superior Court's decision in *December Corp v. Wild Meadows HOA* [19] is "directly on point" and therefore the decision was not legal error. (Answering Brief at 43)

The Arbitrator actually said,

> The HOA argues that, if I approve a rental increase based on the Landlord's capital improvements, the Landlord will be able to recover that cost year after year resulting in a 'shocking windfall'. The HOA claims that is an absurd result that the General Assembly did not intend. The HOA admits that the Superior Court rejected this argument in *December Corp.* The HOA contends that decision was wrong, and the subsequent *Bon Ayre II*[20] interpretation of the Act changed the landscape. In my view I am bound by *December Corp.* – I am a lower tribunal required to follow a higher court's decision. *December Corp.* is directly on-point, and *Bon Ayre II* did not involve capital improvements. The HOA's argument is preserved for appeal, but I cannot agree with it here.

[19] *December Corp v. Wild Meadows HOA,* 2016 WL 3866272 (Del. Super. July 12, 2016).

[20] Referring to *Bon Ayre Land, LLC v. Bon Ayre Cmty. Ass'n ("Bon Ayre II")*, 149 A.3d 227 at 234 (Del. 2016).

As outlined fully in its Opening Brief (Opening Brief at 35-45), the Superior Court's decision in *December Corp.* was wrongly decided and this Court should reverse it. All of the arguments raised in Appellee's Answering Brief (the "natural way to read and understand" the Act mandates an Arbitrator to grant a rent increase demanded by the community owner regardless of whether the rent increase provides the community owner with multiple recoveries of one-time expenses (Answering Brief at 41); The Rent Justification Act, which contains the permissive "may" two different times imposes upon an Arbitrator a "mandatory obligation" to award a rent increase (Answering Brief at 40)) are clearly at odds with the stated purposes and the remedial nature of the Act. The Superior Court's decision clearly leads to absurd results and therefore its interpretation of the Act cannot be countenanced.[21]

[21] *LeVan v. Independence Mall, Inc.* 940 A.2d 929, 932-3 (Del.2007)

CONCLUSION

For the reasons outlined in its' Opening Brief, Appellant respectfully requests that this Court reverse the decision of the Superior Court affirming the decision of the Arbitrator because

1) the bulkhead project was not a capital improvement within the meaning of 25 *Del. C.* 7042(c)(1);
2) if the addition of the riprap constitutes a capital improvement, the remaining part of the bulkhead project was not a capital improvement;
3) the Superior Court's decision in *December Corp. v. Wild Meadows HOA* was wrongly decided and the Appellee should not have been awarded the full cost of the capital improvements in one year's rental increase and made permanent, thereby assuring multiple recovery of one-time expenditures.

Respectfully submitted,

/s/ Olga Beskrone

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