

The \$20,000 Stove:

How Fraudulent Rent Increases Undermine New York's Affordable Housing

January, 2009





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Executive Summary

New York is city of renters, with 2.1 million rental apartments. The majority of those apartments — 1.4 million — are regulated under the laws of Rent Stabilization and Rent Control.

One of the key benefits of rent regulation for our city is that it keeps rent levels predictable, an important benefit for working- and middle-class neighborhoods.

There is a major loophole in the system called the “1/40th program”. This loophole allows a landlord to raise the rent on an unoccupied apartment by passing the cost of physical improvements to the next tenant by raising the monthly rent an amount equal to 1/40th of the total cost of the improvements.

There is no oversight of any kind of the 1/40th program. Landlords are allowed to unilaterally impose 1/40th rent increases without prior approval, or even documentation. As a consequence of this lack of oversight, fraudulent abuse of the 1/40th program is increasingly common. This includes, for example, claiming a rent increase based on \$40,000 when only \$10,000 was actually spent on improvements.

The lack of oversight of the 1/40th program has led to widespread fraud, and a significant loss of affordable housing.

The state housing agency must accept a more active oversight role of the 1/40th program by using its current authority to audit increases and inform tenants residing in apartments where the landlord has filed a 1/40th increase.

Additionally, tenants and housing advocates are calling for legislative changes that would extend the amortization formula from 40 months to 84 months and give the state housing agency a stronger oversight role by authorizing it to approve rent increases. These changes are necessary to discourage fraud, ensure that the law is upheld, and preserve affordable housing.

IT HAS become clear that lack of oversight of the 1/40th program by the state housing agency has led to widespread fraud, and a significant loss of affordable housing.

Background:

New York is city of renters, with 2.1 million rental apartments. The majority of those apartments – 1.4 million - are regulated under the laws of Rent Stabilization and Rent Control. Rent regulation is designed to give tenants some stability in a real estate market so tight that, without rent regulation, the interests of tenants and landlords would not be balanced. One of the key benefits of rent regulation for our city is that it keeps rent levels predictable, an important benefit for working- and middle-class neighborhoods. Each year, the Mayor’s appointees to the Rent Guidelines Board set the amount that a rent stabilized rent can be increased when a lease is renewed, and an additional increase when the apartment becomes vacant. These increases averaged 6.7% and 20% respectively over the past five years.

While these Rent Guidelines Board rent increases are not small, there is a major loophole in the system – called the “1/40th program” - that allows almost unlimited rent increases in vacant apartments. In recent years, it has become clear that lack of oversight of the 1/40th program by the state housing agency has led to widespread fraud, and a significant loss of affordable housing.

Abuse of the 1/40th program is increasingly common, especially among many of the “predatory equity” developers who have become notorious for their illegal behavior. Another factor in the rise in abuse of the 1/40th program is the tremendous incentive to raise rents, legally or otherwise, created by High Rent Vacancy Decontrol, which allows landlords to permanently de-regulate a vacant apartment if the rent can be raised to \$2,000.

Tenants and housing advocates are calling for legislative change to tighten the 1/40th program, and calling on the state housing agency to strengthen its oversight of the 1/40th program to discourage fraud, ensure that the law is upheld, and preserve affordable housing.

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The 1/40th Rent Increase Program

The 1/40th loophole, also known as an Individual Apartment Improvement Increase, allows a landlord to raise the rent on an unoccupied Rent Stabilized apartment by making physical improvements to the apartment. The owner is able to pass the cost of that improvement to the next tenant by raising the monthly rent an amount equal to 1/40th of the total cost of the improvements. For example, if a new tenant moves into an apartment where the legal rent should have been set at \$1,000 a month under current guidelines, but the landlord spent \$20,000 on physical improvements to the apartment while it was vacant, then the monthly rent can be set at \$1,500. (1/40th of \$20,000 is \$500). This formula allows for dramatic rent increases, and far exceeds rents increases based on building-wide improvements (the Major Capital Improvement Program), which are based on a 1/84th formula.

WITH its central importance to a developer's profit model and open ended design, the 1/40th should be well-regulated to prevent fraud and abuse. The opposite is true.

Physical improvements eligible under the rules can include, for example, new bathroom fixtures, new kitchen appliances, and new flooring. Costs associated with maintenance, such as plumbing, sanding floors and painting are not considered to be "improvements" and cannot be counted towards a 1/40th increase. The 1/40th program is intended to reward genuine improvements; basic maintenance such as painting or plaster patching cannot be counted as improvements. A 1/40th rent increase can be taken in addition to any other rent increase to which the landlord is statutorily entitled.

A 1/40th increase is unilaterally imposed by the landlord. A landlord does not have to seek permission or provide any proof of expenses to the state agency that oversees rent regulation, the Division of Housing and Community Renewal (DHCR), in order to apply the 1/40th rent increase. The increase can simply be added onto the apartment rent when a new tenant first moves in. Because it is open-ended and can be applied on a flexible, apartment-by-apartment basis, the 1/40th program is probably the single most important mechanism that developers and landlords use to increase rental income from a building. This is especially clear in predatory equity buildings, where many developers have filed their underwriting terms with the Securities and Exchange Commission. (See below).

There is an enormous incentive for landlords to use the 1/40th program because, while most increases under rent stabilization allow only a moderate rise in the rent, a 1/40th increase can allow huge increases, limited only by how much a landlord can invest to improve a given apartment. With its central importance to a developer's profit model and open-ended design, the 1/40th should be well-regulated to prevent fraud and abuse. The opposite is true.

How the 1/40th System Invites Fraud

The 1/40th system is vulnerable to fraud because there is no oversight or certification of any kind. Landlords are allowed to unilaterally impose 1/40th rent increases without prior approval, or even documentation.

The oversight mechanism intended in the design of the 1/40th program is tenant-initiated complaint. If, for example, a tenant knows that a landlord has based the rent on improvement done to the apartment when it was vacant, but suspects that the value of the work may not actually justify the amount of the increase, the tenant has the right to file a Complaint of Rent Overcharge with the DHCR. If the complaint is accepted for processing by the DHCR, then the DHCR will then ask the landlord to provide evidence of the cost of the improvements in the form of bills, invoice, cancelled checks, and other proof of payments.

This tenant-driven enforcement mechanism is inadequate. Because the improvement occurs in a vacant apartment, the new tenant has no reason to know what the rent should, or should not be.

While a landlord is legally required to provide an apartment rent history as an addendum to a first lease on a rent stabilized apartment, this rent history addendum is rarely provided. Where it is provided, the addendum is most often ignored by the new tenant, who is naturally focused on the current rent that he or she must pay, not the rent paid by the previous tenant. Even when a tenant knows that a landlord has used a 1/40th increase to justify the apartment rent, that tenant is not in a position to know what the prior condition of the apartment was, what improvements were actually made, or what the cost of those improvements realistically should have been.

The tenant-complaint-driven system of oversight is further weakened because many landlords use 1/40th increases to move the apartment rent above the \$2,000 High Rent Vacancy Decontrol threshold that allows them to permanently de-regulate the apartment. Thus, if a tenant in a deregulated apartment files a challenge because he or she believes that the 1/40th increase may be based on fraud, that tenant is especially vulnerable to retaliatory eviction by the landlord. For this reason, even a tenant who has reason to suspect fraud may be unwilling to file a complaint.

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Cases Studies of 1/40th Fraud:

Some recent examples paint a clear picture of the abuse of the 1/40th program, and why a tenant-complaint driven enforcement system is unrealistic and ineffective.

- **CASE STUDY 1:** A tenant moved into a one-bedroom apartment in Woodside, Queens, and signed a lease for a monthly rent of \$1,996.07. A form called an Apartment Rent History Rider was attached to the lease that the tenant signed. However, the tenant was not an expert in the laws governing how rents are set in rent stabilized apartments in New York City. She had no reason to be suspicious of, or even understand, the information in the Rider. Some time later, the tenant noticed a pattern of problematic behavior by the landlord, and went back to read the Rider in detail. The Rider stated that the previous tenant had paid a rent of \$730, and that the landlord claimed to have invested \$42,100 in improvements when the apartment was vacant as the basis for a 1/40th increase that raised the monthly rent to \$1,900. Suspicious that the landlord did not spend \$42,100 in her small and shabby apartment, the tenant went to Home Depot and tried to price all the improvements, including parts and labor, that the landlord could have possibly made. According to the tenant's generous estimate, the landlord could not have spent more than \$20,000. The tenant called the landlord's management company to clarify what improvements were made, and the tenant reports that she was told by the building manager that the landlord assessed a 1/40th charge on every vacant apartment based on the same amount - \$42,000 - even though this amount was not actually spent. According to the tenant, the managing agent claimed that this is how the system worked, even though this is contradicted by the law. The tenant filed an overcharge complaint with the DHCR in August 2008, and is awaiting a response.

- **CASE STUDY 2:** A tenant moved into a non-rent-regulated apartment in 2002, paying a rent of \$2,000. The \$2,000 amount is significant because the apartment had previously been rent regulated, but was removed from regulations when the rent climbed to the threshold for "high-rent vacancy de-control", which allows a landlord to permanently remove a vacant apartment from rent regulation when the rent is legally raised to \$2,000 or above. Soon after signing the lease, the tenant learned that the apartment had previously been rent regulated, and that the prior tenant paid \$402. Taking into account normal rent increases to which the landlord would have been entitled, the landlord would have had to have spent over \$60,000 to improve the apartment in order to justify the rent increase. The matter came before a State Supreme Court judge, where the landlord claimed to have done major improvements to the apartment, including electrical, plumbing, and other improvements. At the trial, the landlord was unable to prove the majority of the expenses he claimed. An architect called as a witness by the tenant testified that the most any work done by the landlord could have reasonably cost was less the half of the \$60,000 the landlord was claiming. The court found that the landlord had made fraudulent use of the 1/40th system to willfully overcharge the tenant.

- **CASE STUDY 3:** A tenant moved into an apartment in the Bronx in 2003, with the lease recording a rent of \$967. The tenant became concerned that her rent was not set at the legal amount when she learned that the previous tenant had paid \$497 a month, and that normal rent increases to which the landlord is entitled should only have raised the new rent to \$597. The land-

lord claimed that he had spent \$15,000 in improvement to the apartment when it was vacant, and that this justified the higher rent. Because the apartment did not appear to have been renovated or improved in any meaningful way, the tenant and landlord ended up in housing court. The landlord claimed to have installed new floors, doors, sinks, cabinets, faucets and tile. However, there was no physical evidence of improvement, and the landlord had no proof of any kind of the expenses for which he was charging. After a trial, the court ruled that the landlord had failed to establish any work in the apartment beyond routine maintenance, and that this fraud constituted a willful overcharge of the tenant.

- **CASE STUDY 4:** A tenant moved into an apartment in Sunnyside, Queens and signed a lease to pay a monthly rent of (\$1,700?). As in the first case study, the tenant had been given an Apartment Rent History Rider along with the lease, but paid little attention to the Rider because he was not expert enough in the law to understand what it said. Some time later, he looked over the Rider and became suspicious for two reasons: 1) His apartment was quite modest, yet on the rider the landlord claimed to have spent \$34,000 in improvements in order to justify a 1/40th increase that raised the rent from the \$718 that the prior tenant paid to the current rent of \$1,700. 2) The itemized cost of actual renovations rarely come to round numbers, like \$34,000, suggesting that the claimed cost of the improvement was not based on actual expenses.

- **CASE STUDY 5:** A tenant moved into an apartment in Forrest Hills, Queens 2004, signing a lease for \$2,000 a month. This \$2,000 number is significant because that amount is the threshold that allows a landlord to remove a vacant apartment from the Rent Stabilization system of rent regulation. A few years later, the tenant learned that the prior tenant in the apartment has paid a monthly rent of \$800.34. Calculating the legal rent increases that the landlord would have entitled to in 2004 (vacancy charge and long-term tenancy charge), the tenant determined that the landlord would have been required to spend \$40,360 in improvements to the small, non-luxurious apartment in order to justify the increase in rent. When the tenant priced all the appliances and fixtures in both the kitchen and the bathroom, he determined that the amount that the landlord could have realistically spent on both parts and labor was far below \$40,360, and that both the rent and the deregulation of the apartment was likely to be based on fraud. The tenant filed a rent overcharge complaint with the DHCR in 2008, and is awaiting adjudication.

- **CASE STUDY 6:** A tenant moved into a apartment in Washington Heights, Manhattan, in 2004. Her lease stated that the legal rent for the apartment registered with the DHCR was \$2,539, although the tenant was asked to pay a lower “preferential” rent of \$1,400 that was more in-line with the actual market value of the apartment. The tenant became suspicious that the rent may not have been legally set, and discovered that the tenant prior to her paid only \$992 a month. When the apartment became

DATA obtained from the DHCR shows that overcharge complaints to that agency have risen 37% in the last 18 months, and that may suggest that there is a growing problem, and that these few rent overcharge complaints are the small tip of a large iceberg.

vacant, the landlord would have been automatically allowed to raise the rent to \$1,249. But to justify the additional \$1,290 to get to the registered rent, the landlord would have had to have spent \$51,600 in 1/40th improvements. Upon investigation, the tenant discovered that the landlord may have modernized the kitchen appliances and bathroom fixtures, but pricing out the work, it should have cost far less than the \$51,600 claimed by the landlord. The tenant has filed an overcharge complaint with the DHCR and is waiting a response.

- **CASE STUDY 7:** A tenant in upper Manhattan moved into an apartment in 2002, paying a monthly rent of \$1,504. Upon examination of rent documents, the tenant discovered that part of the rent was based on \$12,000 in 1/40th improvements for work that it was clear to the tenant had never been performed. The tenant filed an overcharge complaint with the DHCR alleging 1/40th fraud. In 2008, the DHCR found an illegal overcharge and issued an order in the tenant favor.

- **CASE STUDY 8:** A tenant in a rent-stabilized building on Manhattan's West Side investigated why the lease she was given stated that her apartment was not rent stabilized. After inquiring with the DHCR, she discovered that her apartment may have been fraudulently removed from rent stabilization because the registered rent had doubled from what the previous tenant had paid.

Factoring in the vacancy increase for a new lease and the increase for a one or two year lease, the landlord would have had to have spent \$60,000 improving her apartment in order to legally bring the rent up to what he was charging. It was apparent, however, that very little work had been done on the apartment. The tenant filed an overcharge complaint with the DHCR and is waiting a response.

ACCORDING to an analysis by ANHD, there has been an “unnatural” decrease in moderate-rent apartments.

Contrasting the Major Capital Improvement Rent Increase Program:

The lax oversight mechanism of the 1/40th program stands in sharp contrast with the Major Capital Improvement (MCI) rent increase program. The 1/40th program is designed to allow a rent increase for an individual apartment because of physical improvements to that apartment. The MCI program is designed to allow across-the-board rent increases in a building because of improvements in major, building-wide systems such as a new roof, new boiler, or new windows for the entire building. The oversight structures of the programs are very different.

Before a landlord can collect an MCI rent increase, the landlord must first submit proof of expenses to the DHCR for review. The DHCR then informs the tenants in writing that the landlord has filed for an MCI, and invites them provide further information to the DHCR, which the DHCR takes into account when the agency approves or rejects the MCI increase application. There are clear standards to the MCI program, and the DHCR oversees and upholds those standards.

Landlord compliance with the rules of the MCI program compare favorably to compliance with the rules of the 1/40th loophole. This is a result of the proactive role that the DHCR plays in administering MCIs, along with the proactive notice provided to tenants.

THE PROBLEM of fraudulent 1/40th increases is made worse by the pressure to increase rent that comes from the phenomena known as “predatory equity”.

Estimating the Scale of the 1/40th Fraud Problem:

Because the core of the problem is that there is no effective oversight of the 1/40th program, it is difficult to find official statistics that indicate the scale of the problem. Data obtained from the DHCR shows that overcharge complaints to that agency have risen 37% in the last 18 months, and that may suggest that there is a growing problem, and that these few rent overcharge complaints are the small tip of a large iceberg.

There is no accurate government record of the frequency with which 1/40th increases are used because there is no oversight of the program. However, it is clear that rent regulated apartments are moving out of affordability at a rate faster than statutory rent increases would allow.

According to an analysis by ANHD, there has been an “unnatural” decrease in moderate-rent apartments: There was a 20 percent decrease in the number of units renting for less than \$1000 between 2002 and 2005 according to the NYC Housing Vacancy Survey.

- 9 percent of these apartments should have migrated out of the less than \$1,000 category due to the annual rent increases allowed by the New York Rent Guidelines Board.

- The other 11 percent—164,013 apartments—is an “unnatural” movement that cannot be explained by market forces alone and is likely a result of other factors, including harassment.

There has also been a sharp decrease in the number of rent-regulated apartments: Between 2002 and 2005, the NYC Housing Vacancy Survey reported that 44,000 apartments were removed from rent regulation using various legal loopholes. This number has accelerated dramatically every year, with almost 14,000 rent stabilized units lost in 2006 alone. The accelerating rate of the loss of rent-regulated units coincides with an increased use by landlords of High Rent Vacancy Decontrol. Passed in 1997, but only widely used in recent years, High Rent Vacancy Decontrol allows landlords to permanently remove a vacant apartment from rent regulation if it has a legal regulated rent of \$2,000 or more per month.

THE CURRENT program formula and complaint-driven system of oversight is inadequate.

1/40th Fraud and Predatory Equity:

The problem of fraudulent 1/40th increases is made worse by the pressure to increase rent that comes from the phenomena known as “predatory equity”. In recent years, neighborhoods around New York City have seen a dramatic rise in the harassment of tenants as landlords try to illegally remove working families so they can raise the rent using the 1/40th mechanism. There is a direct connection between this increase in harassment and the rise of a new type of buyer of New York City real estate. These new buyers are private equity-backed investors who are raising money from Wall Street-type funds that create a pressure for profit levels that, in rent regulated buildings, can only be achieved by illegally displacing tenants and undermining affordable rents. Many of the lending institutions that are providing the huge loans for the purchase of these buildings are pooling and re-selling the loans in mortgage-backed securities.

Private equity-backed developers have, in the past four years, purchased an estimated 90,000 units of affordable, rent regulated housing. This is a significant percentage – almost 10% - of our rent-regulated housing and represents a major threat to affordable housing and stable communities. This “predatory equity”, is undermining the best attempts of New York City and State elected officials to slow the loss of affordable housing.

The growth in rental income from a well-managed rent-regulated building can be expected to rise in a steady, but moderate line. Under rent regulation, leases must be renewed and rents can only be increased by a moderate amount (as set by a city Rent Guidelines Board) with each lease renewal. Although dramatic increases in rent can be taken on vacant apartments, the “natural” turnover rate for tenants in rent regulated apartments averages between 5% -10%, which does not translate to the huge jump in rental income that speculative purchasers need to satisfy their debt obligations.

The premise of an illegally high tenant turnover is made clear in loan underwriting documents filed with the Securities and Exchange Commission (SEC) for a group of buildings in Washington Heights owned by Vantage Properties, which state that Vantage “anticipates to recapture approximately 20-30% of the units [within the first year], and 10% a year thereafter” in order to pay the debt service on their loan. However, these targets seem unjustifiable since only 1% of the apartments in these buildings were vacant at the time the loan was made, according to the SEC documents, and the annual rate of turnover for rent-regulated buildings is only 5.6%, according to the Rent Guidelines Board. The reason that high tenant turnover is an explicit goal of these predatory equity landlords is that sudden and dramatic rent increases be taken on vacant apartments through the use of the 1/40th program.

The planned use of 1/40th increases is specified in the same SEC underwriting documents. A typical plan filed with the SEC states, “The sponsors plan to improve the [building] portfolio’s performance by making capital improvements to individual units and raising rents to market levels...The sponsors are permitted to increase rents by approximately 17-20% on rent stabilized units each time a unit is vacated. In addition, the sponsor’s (sic) are permitted to increase the monthly rent of stabilized units by 1/40th of the amount spent on renovations of such units. The sponsor’s current plans calls for renovations to individual units...which would, on average, bring the vacated units to market level rent.”

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Solutions:

Any program as lucrative as the 1/40th program, but where there is no oversight and no enforcement, will inevitably invite fraud and abuse. The current program formula and complaint-driven system of oversight is inadequate. The state statute must be changed to tighten the loophole and extend the amortization period. The DHCR must accept a more active role in the 1/40th loophole in order to fulfill the agency mandate that it enforce the rules of the rent regulation system and prevent the loss of affordable housing due to fraud. Tenants and community advocates are proposing five solutions.

Solutions that require state legislative change:

1. EXTEND THE AMORTIZATION PERIOD OF THE PROGRAM:

- The state statute should be changed to extending the amortization formula from 40 months to 84 months, mirroring the MCI statute.

2. TIGHTEN OVERSIGHT OF THE PROGRAM:

- The state statute should be changed to specifically allow the DHCR to require proof of expenses and prior approval for rent increases under the loophole, mirroring the MCI statute.

Solutions the state housing agency can implement immediately:

3. STRENGTHEN OVERSIGHT THROUGH DHCR AUDITS:

- In order to deter landlords from filing fraudulent 1/40th increases, DHCR should audit 30% of the vacancy increase filings on an annual basis.
- When a landlord is found by the DHCR to have used a 1/40th increase as the basis for an illegal overcharge, the DHCR should audit all recent 1/40th rent increases imposed by that landlord.

4. STRENGTHEN OVERSIGHT BY EVALUATING PROOF OF EXPENSES:

- Where the landlord reports an increase in the rent of a vacant apartment of 25% or more (on top of the 20% vacancy increase that is automatically allowed by the guidelines), and that increase is based in part on an asserted 1/40th increase, the DHCR should retroactively review proof of the cost of the improvement to determine if the expenses already claimed are legitimate.

5. STRENGTHEN OVERSIGHT THROUGH ADDITIONAL NOTIFICATION TO TENANTS:

- Where the landlord reports an increase in the rent of a vacant apartment of 25% or more based on an asserted 1/40th increase, the DHCR should send written notification to the tenant, along with a copy of the apartment rent history, informing them of the landlord's 1/40th claim and advising the tenant of their right to file a Complaint of Rent Overcharge if they believe that the claimed 1/40th cost do not reflect the actual work done.

The DHCR's Current Legal Authority:

The steps outlined above can be taken by the DHCR without any change to the law. The DHCR has the power to issue orders on its own initiative determining the legal regulated rent for an apartment when the legal rent is "in doubt or is not known." RSC § 2522.6(a). DHCR may "institute a proceeding on its own initiative whenever the DHCR deems it necessary or appropriate pursuant to the RSL." RSC § 2527.2. DHCR may "administer oaths, issue subpoenas, conduct investigations, make inspections and designate officers to hear and report." RSC § 2526.4. DHCR may require owners to "furnish information under oath or affirmation ... permit inspection and copying of records and other documents, and permit inspection of any housing accommodations." RSC § 2526.6(a). Owners may be required to "make and keep records and other documents and make reports." RSC § 2526.6(b). These RSC provisions are authorized under Sections 26-516(b) and (f) of the RSL.

Under this authority, DHCR may investigate patterns of conduct calculated to subvert the RSL or to prevent profiteering, speculation and other disruptive practices. RSL § 26-501; RSC § 2520.3. DHCR's authority should extend to investigations of the legality of vacancy increases that exceed the statutory 20 percent allowance. *McGoey v. Holland*, 237 A.D.2d 523 (2nd Dep't 1997) (DHCR revokes increase after investigation shows MCIs were fraudulent); *Clermont York Associates v. Lynch*, 271 A.D.2d 262, (1st Dep't 2000) (collapse of façade warrants revocation of MCI increase); *Mauro v. DHCR*, 250 A.D.2d 392 (1st Dep't 1998) (combination of investigatory, prosecutory and quasi-judicial functions in a single administrative agency is not in itself violative of due process).

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