New York Law Journal

Commercial Rent Control: Back Again?

As retail vacancies have multiplied in New York City in recent years, some in the City Council have advocated for the reconsideration of commercial rent control, as set out in a proposed piece of legislation, the Small Business Jobs Survival Act. This article provides a brief, non-technical review of the bill and the legal and practical hurdles it faces if enacted.

By **David B. Saxe and Brett Dockwell** | November 28, 2018

For generations, New York's Rent Control and Rent Stabilization Laws, which limit the amount of rent residential tenants may be charged and provide other protections, have been fixtures of New York real estate. For a time (1945-1963), New York City (the City) had a rent control statute applicable to commercial tenants, but that law expired, after which commercial rent control disappeared from the policy landscape. However, as retail vacancies have multiplied in the City in recent years, some in the City Council have advocated for the reconsideration of

commercial rent control, as set out in a proposed piece of legislation, the Small Business Jobs Survival Act (Intro 737). §22-1202, et seq. This article provides a brief, non-technical review of the bill and the legal and practical hurdles it faces if enacted.

The sharp increase in empty storefronts is not a mirage. Availability rates in many Manhattan submarkets exceed 20 percent. Nevertheless, the causes are unclear. While some claim that landlords are to blame for allegedly holding out for higher rents, the bankruptcies of retailers such as Toys"R"Us and Sears, and the growth of online shopping, suggest structural factors are at play. The response to Intro 737 from the Real Estate Board of New York (REBNY) has been decidedly negative. REBNY and others have argued that commercial rent control is not the cure for retail vacancies and that its enactment might exacerbate the problem, as it could disincentivize landlords from modernizing existing commercial space or creating new space, and it might make it harder for less-established tenants to find space, as landlords would seek to avoid being saddled with a long-term, under-productive tenant.

Under Intro 737, tenants occupying commercial properties would have a statutory right to renew their leases for an additional 10-year term. §22-1206. The bill would require landlords to notify each of their commercial tenants at least 180 days before the expiration of their leases whether the landlord is willing to renew the lease (§22-1206(e)) and if so, the parties have 90 days to agree upon renewal terms. Id. If the parties are unable to agree, the tenant may refer the matter to arbitration. Id. Alternatively, if the landlord is unwilling to renew the lease, the landlord must explain its reasons for non-renewal, which the tenant may then challenge through arbitration. Id. If the arbitrator finds for the tenant, the tenant is then entitled to renew the lease, and the parties are obligated to attempt to agree upon the terms of the renewal, with the matter returning to arbitration at the tenant's option if the parties cannot agree. Id.

Intro 737 would apply to all buildings or spaces within the City that are occupied for non-residential purposes pursuant to a valid commercial lease. §22-1203. (As currently drafted, the bill would apply to all commercial properties within New York City.

However, following a hearing on the bill on Oct. 22, 2018, Council Speaker Corey Johnson indicated that the bill should be revised to apply only to "mom and pop" tenants and not large tenants such as WeWork and Goldman Sachs.) Arbitration is to be conducted through the American Arbitration Association (the AAA), before a single arbitrator who will receive documents and reports from the parties and then hold hearings. §22-1206(e). No timeframe is specified for the commencement of hearings, or their length, but the bill provides that the entire process is to be completed before the tenant's current lease expires.

Upon receipt of the arbitrator's decision, the tenant may elect either to pay the specified rent or to pay an alternative rent of no more than 110 percent of the final year's rent under the existing lease. §22-1206(g). In such a situation, the landlord can market the premises to a new tenant. Id. However, the landlord cannot rent the space to the new tenant without first offering the premises to the existing tenant upon the same terms agreed to by the prospective tenant. Id. If the existing tenant refused those terms, then, and only then, would the existing tenant be required to vacate. Id. If the existing tenant were to agree to those terms, then the landlord would be required to enter into a new lease with the existing tenant on the agreed-upon terms. Id.

Intro 737 faces challenges both legal and practical. A committee of the New York City Bar Association that has examined the bill concluded that the City lacks the authority to enact the bill as drafted, rendering it unconstitutional. (The prior commercial rent control law was enacted by the State Assembly, not the City Council, and thus the issue of legislative authority did not arise.) It is generally thought that the only way for the City Council to validly legislate in the area of commercial rent control would be under its general "health and welfare" power, but even that authority is open to question in this area, and the issue has not been considered by the courts.

Even if the bill survived legal challenge, other legal questions remain. For example, it is unclear how the bill would affect the countless commercial leases that already call for the arbitration of rent disputes. Intro 737, as drafted, declares as invalid any Lease

provision that "waives or diminishes the right of a Tenant" under the bill. §22-1209. If broadly applied, this restriction could wreak havoc on existing commercial leases. In addition, the bill applies to "building[s] and space," which would seemingly exclude ground leases, in which the tenant leases only land. Most ground tenants operate buildings on the land that they lease, and rent space in their buildings to commercial users. Thus, the bill appears to create the anomalous situation in which ground tenants would be excluded from rent control on the land that they lease, but subject to rent control on the space that they rent to others. Residential co-ops that occupy leased land and have commercial units within their buildings would likely fall into this category.

The bill would also be difficult to administer; it provides eight express exclusions to a tenant's right to renew, depending on the landlord's intentions at the end of the existing lease, or the tenant's conduct. §22-1206(e). For example, if the landlord intends to demolish or substantially reconstruct the premises at the end of the current lease, or if the landlord intends to occupy the premises for its own business, the tenant is not entitled to renew. Id. Similarly, the tenant is not entitled to renew its lease if the tenant has been persistently late in paying rent "without cause" or has engaged in misconduct. Id. These exclusions, however sensible, create the possibility of factual disputes that might not be adjudicated without some discovery, and almost certainly not within 90 or even 180 days. Many commercial landlords and tenants are likely to hang in limbo as to the tenant's renewal rights even after the lease has expired.

Similarly, even when a tenant's renewal right is unquestioned, the parties are likely to face a protracted arbitration in the event they cannot agree on the renewal rent. The bill lists 12 non-exclusive factors that the arbitrator must consider in determining the rent, including certain types of market data and considerations specific to the parties and the property. Id. For example, the arbitrator must consider the fair market rents for comparable properties and "the cost of leasing similar premises within a one-mile radius of the property." Id. In most of Manhattan, a one-mile radius encompasses a huge number of properties, stretching from river to river. Such information is not only

of questionable relevance in setting the rent for a particular space within a particular submarket, but also very hard to compile. There is no central database of commercial lease information from which an appraiser can obtain reliable leasing costs for similar properties. Such information is typically obtained through word of mouth and subject to challenge. Likewise, in setting the rent, the arbitrator must consider, among other things, the cost of maintaining and operating the property, the services furnished by the landlord and "the extent to which the business is bound to its particular location." Id. One or all of these factors is likely to be sharply disputed by the parties. An arbitrator obligated to consider all of these factors, plus several more, will likely be inundated with conflicting factual submissions by the parties. Arbitration hearings could easily take far more than a week.

In summary, although Intro 737 aims to remedy the very real issue of retail vacancies in the City, the bill does not appear workable and would likely engender more distress than it relieves.

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