New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM
An ALM Publication
FRIDAY, FEBRUARY 7, 2020

Commercial Rent Control Effort Defined by Confusion and Unintended Consequences

New York City's real estate community, particularly the commercial and retail sector, has struggled mightily in recent years, and particularly since June 14, 2019.

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Just hearing the date still sends shockwaves throughout the New York real estate community. The day state government showed its true colors. The day Albany outdid itself. The day sweeping legislation instantly turned real estate upside down.

No, not June 14, 2019.

The day was Jan. 24, 1945. World War II dominated any and all headlines nationwide. The European inferno was raging. Roosevelt had just taken his record fourth oath of office. The Allies were closing in on victory in the watershed Battle of the Bulge. And in other big news, Commercial Rent Control became effective in the Empire State. Come again?

Indeed, in the winter of 1945, two legislative acts, respectively titled the Emergency Commercial Space Rent Control Law of the State of New York and the Emergency Business Space Rent Control Law of the State of New York, became effective to "curb the evils arising from" a declared public emergency brought about by war. In justifying the need for such legislation, the legislature described "[u]njust, unreasonable and oppressive leases and agreements for the payment of rent" for commercial space, office space, stores and other business space "under stress of prevailing conditions, accelerated by war, whereby a breakdown has taken place in normal processes of bargaining and freedom of contract has become an illusory concept." See McKinney's Unconsol. §§8521, 8551.

The two acts, which in classic Albany fashion applied to "cities having a population of more than one million" (i.e., New York City and no others), were subsequently amended at various points but ultimately met their end naturally by expiration. The brief history of commercial rent control in New York can be best summarized as follows: The Legislature acted in a time of real emergency and responsibly refrained from acting once the emergency subsided.

Fast forward 75 years. The retail sector is experiencing unprecedented challenges due to the rising popularity and consumer convenience of e-commerce. It is widely accepted

that as a result, retail vacancies are rampant throughout the Big Apple. On top of this, New York City is still trying to process and adapt to both the intended and purportedly unintended effects of the June 14, 2019 passage of the HSTPA, Albany's own "turning point" in its cold war against business.

Not wanting to appear out-democratic-socialized by its upstate big brother, the New York City Council now wishes to make some noise by turning the clock back to the Greatest Generation. Although the City Council has made several attempts over the last three decades to reintroduce a system of commercial rent control, none has made it all that far. For example, the Small Business Jobs Survival Act, which sought to regulate commercial lease renewal terms and require arbitration if parties disagree on renewal terms, has sat idle since October 2018 without a vote.

Yet this time it is different, with a proposal aimed at replicating certain parts of the residential Rent Stabilization Law. On Nov. 14, 2019, New York City Councilman Stephen T. Levin introduced Intro. No. 1796, a proposed Local Law titled "Commercial Rent Stabilization." The bill applies to any "commercial space" in New York City with a rental agreement that expires on or after July 1, 2020. A "commercial space" is defined as either: (1) retail stores of 10,000 square feet or less; (2) manufacturing establishments of 25,000 square feet or less; or (3) professional, services or other offices of 10,000 square feet or less.

Notably, the bill does not on its face seek to distinguish between "mom and pop" establishments and large corporate enterprises. In theory, a Wal-Mart store of 10,000 square feet would be subject to regulation, yet a "mom and pop" store of 10,001 square feet would not be subject to regulation. Further, given the reality that a small Wells Fargo Bank is a more attractive tenant than a "Joe's Shoe Repair" of equal square footage, why would any landlord rent a regulated commercial space to the latter?

The local law fares no better in its administration. The bill calls for the establishment of a nine-member commercial rent guidelines board, each of whom shall be appointed by the mayor, as follows: (1) one "public" member with at least eight years of "experience" in "finance or economics"; (2) two members representing commercial tenants which are not chain businesses; (3) two members representing commercial landlords; and (4) four "public" members, each of whom has at least five years of "experience" in "finance, economics, real property management or community development."

The language describing qualifications for board members is ambiguous at best. What exactly does "experience" in "economics" or "finance" even mean? According to the bill, a mayor may legally stack the rent guidelines board with six members with backgrounds in academia but not in actual business: think high school economics teachers and retired bank tellers. Nor does the bill mandate any Big Apple business

experience of the board members; on the contrary, a property manager from Honolulu easily checks off all the boxes. A building superintendent from Wichita with a decade of experience qualifies as much as a seasoned real estate investor from Manhattan.

The financial aspects of the bill are also troubling. According to the bill, the initial legal regulated rent for a commercial space is the first "rent" charged pursuant to a rental agreement on the effective date of the local law. "Rent" is "any consideration, including but not limited to pass-alongs, received by the owner in connection with the use or occupancy" of the commercial space. The bill defines a "pass-along" as "any taxes, sewer, water or utility fee, or operating charges apportioned to a tenant in connection with the use or occupancy" of the commercial space. Therefore, as long as a rental agreement is in effect on the effective date of the local law, the initial legal regulated rent includes any pass-alongs charged with the base rent on that date.

If, however, the commercial space is vacant or no rental agreement is in effect on the effective date of the local law, the language of the bill is at best open to interpretation.

In such a case, the bill inexplicably sets a grand limitation to the initial legal regulated rent, which shall be the base rent charged in the first rental agreement which becomes effective after the effective date, "provided that such rent shall not include any pass-alongs." Put differently, in such case, the law can be interpreted as prohibiting collection of any charges above the base rent. Of course, no landlord can be expected to maintain a commercial property without passing along charges such as real estate taxes, water, sewer and utility fees to tenants; it is simply a non-starter.

Perhaps the City Council intends to put pressure on landlords to rent vacant commercial spaces prior to the effective date, with the incentive of having pass-alongs included in the initial legal regulated rent. The City Council clearly has blamed the rising vacancy rate on landlords rather than on e-commerce or shared workspaces, by introducing two currently pending bills (Intro No. 1472, which proposes a database of commercial properties, and Intro No. 1473, which proposes registration of vacant properties). However, in the real world outside City Hall, renting vacant commercial space is no simple matter, especially in today's climate of rising e-commerce giants such as Amazon.

Say, for example, that the effective date of the local law is July 1, 2020. A commercial tenant vacates the space on June 30, 2020. The landlord then proceeds to negotiate a rental agreement with a new commercial tenant for a vacancy lease set to commence one month later, on August 1, 2020. Unfortunately, because the commercial space was vacant on July 1, 2020, no rent was charged pursuant to a rental agreement on that date. Consequently, this landlord, who most definitely cannot be accused of "warehousing" vacant commercial space, has now forever lost out on the inclusion of pass-alongs in the legal regulated rent. The landlord will now have no choice but to figure out a way to increase the initial base rent in order to make up for the lost pass-alongs. This may result in lease negotiations dragging out well past Aug. 1, 2020, which causes a longer vacancy of the commercial space. Indeed, the only tenants which may ultimately be willing to pay the higher base rent will not be the mom-and-pops but rather the large, national corporate establishments. This is yet another example of how greater government regulation (unintentionally) forces out the small in favor of the large and powerful.

Alternatively, if the bill were to be interpreted as shifting pass-along charges to those increases promulgated annually by a commercial rent guidelines board, the system will resemble that of residential rent stabilization, in which rent guidelines increases are purportedly intended to offset landlords' increasing real estate taxes. Needless to say, that has not exactly worked out.

When Albany passed commercial rent control during World War II, a real emergency existed which mandated legislative action. The current legislative proposals by the New York City Council, however, fail to address any actual emergency, fail to improve problems currently ailing the retail sector, and in fact will have the opposite effect of exacerbating such issues by driving out mom and pop commercial tenants.

Three years prior to the 1945 enactment of commercial rent control in New York state, Winston Churchill shared very wise words with his nation. Following the Allies' first victory at El Alamein, Churchill famously said "this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning."

New York City's real estate community, particularly the commercial and retail sector, has struggled mightily in recent years, and particularly since June 14, 2019. Let us hope the City Council reconsiders its position and that we remember today as the end of the beginning of New York's skirmish with the real estate community.

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