

Help For Office-To-Residential Conversions

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Removing lingering commercial tenants in an otherwise vacant office building should be easier than it is.
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We hear a lot about opportunities to convert some of New York’s outdated (and often unwanted) office buildings into rental or condominium apartment projects. Those conversions are correctly seen as a sensible part of the response to New York’s long-term “housing crisis.” That “crisis” is, of course, largely self-inflicted through decades of well-intentioned government programs such as rent regulation, protracted and difficult approval requirements for any major development project, zoning sometimes made more restrictive over time, and excessive landmarking.

Legislators seem to like the idea of office-to-residential conversions and have discussed various methods to incentivize those conversions. Those discussions are important – and potentially very expensive for taxpayers already paying some of the highest taxes in the United States – but beyond the present topic. In the meantime, government can take one very reasonable, limited, and inexpensive step to help make office-to-residential conversions work better. That one governmental step doesn’t involve creating a single new program,

subsidy, tax abatement, incentive, or large budget line item. Instead, it just requires a thoughtful understanding of the dynamics of some conversions and some simple steps government can take to improve those dynamics.

In many of the troubled and obsolete office buildings ripe for conversion, most of the few remaining office tenants are often in default under their leases, or their leases have already expired, or the building owner has the right to give a termination notice to require the tenant to move out on fairly short notice. In any of those cases (let's call them "lingering" leases or tenants), a residential converter will want to know that it can in fact achieve vacant possession quickly. A building owner that wants to try to sell for residential conversion will share these concerns. As a business matter, that seller and the residential converter will need to figure out how to allocate the risks and burdens of lingering tenants. It won't necessarily be easy.

That's because New York's landlord-tenant courts often move very slowly. Even if the building owner (or the buyer for conversion) has airtight cases to remove all the lingering tenants, the courts will often make it an ordeal. The duration of that ordeal is utterly unpredictable. It sometimes seems the landlord-tenant courts don't quite believe in private property or capitalism. As a result of potential judicial delays, any tenant – even a tenant under a lingering lease – has tremendous leverage. They can hold up eviction proceedings for months or years through procedural skirmishing, multiple adjournments, bogus defenses, and creative claims against owners.

In practice, lingering tenants with smart lawyers can force a converter or building owner to pay up in exchange for quick cooperation. The bill can become quite expensive. And if the converter or building owner must deal with multiple holdout lingering tenants at once, it can quickly become a complex chess game. In effect, the converter or seller must write a big check to bypass a court system that otherwise destroys value through sheer passage of time.

The ability of the owner or residential converter to achieve vacant possession is vital to any conversion. That's because a typical conversion strategy will require 100% vacancy so the converter can demolish most or all of the interior improvements efficiently as a single integrated and well-organized construction project. The converter must do that in order to prepare to reconfigure utilities, building systems, and demising walls--and often elevators and lobbies--in the entire building to accommodate a residential change of use. Any such demolition and reconfiguration is a big and very disruptive job. It often really does require 100% vacancy.

If vacant possession can take a long but unpredictable time to achieve, even if the only leases in the building are lingering leases, then the converter may need to pay interest and carrying costs, as well as predevelopment expenses such as architectural and engineering

services, for a long but unpredictable time. That burden – or even the risk of having to bear that burden – may itself make a conversion project economically impossible. The uncertainties about timing and outcome in dealing with lingering leases also expose the converter to risks of a change in the market.

Government can easily mitigate this problem, thus making residential conversions more likely to pencil out financially, by figuring out a way to speed up the landlord-tenant courts, at least as they relate to lingering tenants in buildings ripe for residential conversion. It would be even better to speed up those courts more generally, but that's probably a bridge too far, at least in the current century and the current political environment in New York.

If legislators truly want to encourage residential conversions of office buildings, they might, for example, come up with very expedited procedures to remove lingering tenants in office buildings that are at least 50% vacant where the owner intends to convert (or have a buyer convert) the entire building above the first floor to residential use. To make those procedures work well, the legislators might increase the budget for the judicial system by a tiny amount earmarked just to speed along these proceedings.

It wouldn't take much money, nor much new law, to liberate residential conversion projects from the judicial delays that otherwise often burden any property owner trying to remove lingering tenants and that can, in the worst case, derail a conversion project that would otherwise make sense. Those relatively minor measures could significantly improve the financial, timing, and risk profiles of residential conversion projects, thus making them more likely to happen.

The government wouldn't need to give up a penny of tax revenue, or provide a penny of subsidies, to do it. On the other hand, expedited court procedures to deal with lingering leases wouldn't require residential converters to obtain any discretionary governmental approvals, so perhaps the idea is dead in the water.

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