

CITIZENS FOR VOLUNTARY TRADE OFFICIAL REPORTS

REGULATORY BARRIERS TO INTERNET COMMERCE: NEW YORK'S CAMPAIGN AGAINST MLX.COM

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In this report, CVT reviews the case of MLX.com and its president, LaLa Wang, who has spent more than eight years challenging the New York Department of State's regulation of so-called "apartment information vendors."¹

New York's Apartment Information Vendor Law

In 1975, the New York Legislature passed a law to regulate "apartment referral agencies" under the auspices of the Department of State (DOS).² Referral agencies, as the term was then understood, sold hard-copy lists of apartments available for rent in a given area. The Legislature found that many referral agencies sold lists that contained unavailable or nonexistent apartments. Consumer complaints often went unanswered, and thus the Legislature felt it was necessary to require all referral agencies to obtain a license from the DOS before they could sell listings for an advance fee.³

In 1980, the Legislature revised the law, reclassifying the referral agencies as "apartment information vendors."⁴ (The 1975 statute, as amended in 1980, will be referred to henceforth as the AIV law.) The amended AIV law⁵ imposed substantial restrictions on the business practices of licensed vendors: vendors must obtain all listings in writing from landlords prior to distribution; vendors may not advertise specific properties, only a general listing service; all but \$15 of any advance fee must be refunded on request; and all vendors must maintain paper copies of contracts

¹ This report was prepared by CVT staff. Special thanks to Tom Ciavarella for his assistance in editing this report.

² 1975 N.Y. Laws ch. 772.

³ See Governor's Bill Jacket, L. 1975, ch. 772.

⁴ 1980 N.Y. Laws ch. 805.

⁵ N.Y. Real Prop. Law art. 12-C, §§ 446-a, et seq.

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and escrow agreements. Each separate violation of the AIV law is a misdemeanor criminal offense subject to prosecution by the New York attorney general's office, with a maximum fine of \$5,000 per infraction.⁶

In practice, all licensed AIVs in New York (about two dozen currently) do not comply with these mandates. They do not maintain hard copy contracts or escrow agreements, they advertise specific properties, listings are not obtained in writing from landlords, and the mandatory refund policy is circumvented through creative accounting.⁷ In all, the local real estate industry estimates licensed AIVs commit more than six million misdemeanors per month. CVT could not find a single case where the New York DOS prosecuted a licensed AIV for violating the statute's requirements.

Changing the Rules: LaLa Wang and MLX.com

In most cities, local real estate brokers participate in a multiple listing service—or MLS—a common database containing all available properties in the area. A customer patronizes a particular broker, who in turn accesses the MLS on the client's behalf. New York City, however, has not traditionally had an MLS. Because of the city's unusual ratio of rental-to-for-sale properties (almost two to one), and because of the high demand for the best apartment rentals, listings are concentrated among a small number of brokers. These brokers benefit from the highly regulated nature of the New York rental market, and consequently they are able to thwart the growth of smaller brokers, who in other markets could rely on an MLS to level the playing field.

Enter LaLa Wang. A Harvard Business School graduate, Wang started MLX.com (hereinafter MLX) in 1992. MLX provides what New York City's real estate market lacked—an MLS—but does so with a twist. Unlike a traditional MLS that is only accessible to brokers, MLX also provides individual customers with private online accounts to access listings for themselves. Renters and buyers can connect to landlords, sellers, and brokers through Wang's platform. MLX performs some real estate functions, such as assisting negotiations, but it does not show properties as a

⁶ Art. 12-C, § 446-e, h.

⁷ Wang v. Daniels, Motion for Leave to Appeal at 40, (N.Y. 2003) (Index No. 109389/01).

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traditional broker does. Nor does the company earn the traditional commissions of a broker. Instead, MLX charges a flat advance fee of \$149 following a free trial period, during which customers can preview listings (without contact information).

Wang described MLX's service to CVT as follows:

MLX does not replace brokers. It offers options to consumers and brokers. Consumers can choose to connect to a full-service broker and pay a full commission, or to use MLX's online tools and consulting services for only \$149 to locate an apartment by doing their own legwork.

Wang's business model can be seen on many Internet Web sites. Large portal sites such as Yahoo provide online apartment search services.⁸ Indeed, anyone with Internet access can do general searches to find apartment listings. The old-economy practices that led to the passage of New York's AIV law—fraudulent sales of inaccurate paper listings—have been rendered largely moot by the advent of new technologies pioneered by entrepreneurs like Wang. Sophisticated consumers can now expect rental listings updated 24 hours a day, seven days a week through MLX. Wang's service is precisely the type of interactive, customer-driven product the framers of the AIV law would welcome.

But to the contrary, the AIV law has proven Wang and MLX's greatest barrier to competing in the marketplace. When Wang first learned of the AIV law, she approached the DOS to ensure the statute did not apply to her business, which after all provided a technology platform to facilitate customers and renters, not a static list of rentals. Early on, state officials understood the potential problem for Wang. In April 1995, then-Secretary of State Alexander Treadwell, an appointee of Republican Governor George Pataki, wrote a letter to State Sen. Roy Goodman in support of Wang's call for reviewing the AIV law. Treadwell acknowledged the AIV law had outlived its usefulness and was now serving as an impediment to beneficial commerce.⁹

It is my opinion that [the AIV law's] requirements make it virtually impossible to carry on the business of apartment information vending within New York

⁸ See <http://list.realestate.yahoo.com/re/?rehps=2>.

⁹ The letter is reproduced at http://www.voluntarytrade.org/MLX/goodman_letter.gif.

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State. Consequently, at this time, the Department licenses only seven apartment information vendors. I agree with Ms. Wang that the law is onerous and should be amended.

Despite Secretary Treadwell's encouragement, nothing ever came of AIV reform. The law remained on the books, and in 1999, the DOS's support for Wang and MLX transformed into open regulatory warfare. The DOS issued a complaint against Wang and MLX's parent company, Principal Connections Limited, for operating an unlicensed AIV business.¹⁰ While AIV violations are subject to criminal prosecution by the attorney general, the DOS targeted Wang's real estate broker license, which is governed separately from AIVs. State law gives the DOS wide discretion to revoke a broker's license for "untrustworthy and incompetent" actions. The DOS charged Wang with being untrustworthy solely for her failure to apply for an AIV license.

The DOS's actions created a paradox. Wang would not apply for an AIV license because the law effectively banned most of MLX's practices. This was true for the few AIVs already licensed by the DOS. Wang, however, declared she would not knowingly take a license that she believed did not apply to MLX and with which she couldn't comply. The state, in turn, argued that Wang's failure to knowingly break the law rendered her "untrustworthy" to hold a real estate broker's license, despite the fact that Wang's noncompliance with AIV law had no bearing on her actions as a broker.

In July 1999 the DOS administrative law judge hearing Wang's case issued an unusual order. Although Wang and Principal Connections were both named respondents, the judge only issued a finding against Wang. The judge suspended Wang's license "until such time as she has presented proof satisfactory to the Department of State that she, either directly or through any business controlled by her, is no longer engaged in the business of Apartment Information Vendor."¹¹ No finding was made against MLX—the supposedly illegal AIV—but Wang was personally deemed "untrustworthy" to hold a non-AIV broker's license. The

¹⁰ The DOS complaint, filed on Feb. 8, 1999, is reproduced at http://www.voluntarytrade.org/dos_complaint.gif.

¹¹ Department of State v. Wang, 23 DOS 00, A.L.J. Decision at 5 (Jan. 31, 2000).

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judge found no evidence, as the DOS never alleged, that Wang defrauded or harmed any consumer.

Wang appealed to Secretary Treadwell, who abandoned his earlier support for Wang and affirmed the administrative law judge's decision in January 2001. Treadwell rejected Wang's claim that MLX's business fell outside the scope of the AIV law, nor would the secretary consider any argument that the AIV law was unconstitutional. Treadwell said the DOS could "suspend a real estate broker's license for activities unrelated to the license itself."¹² The secretary refused to consider the validity or constitutionality of the AIV law, despite the administrative judge's observation that the statute "possibly was impossible to comply with."

Four days after Treadwell announced his decision against Wang, State Sen. James Lack introduced legislation to repeal the AIV law and subsume its provisions under the general real estate broker's license law. The Legislature, however, never acted on Sen. Lack's proposal.

The Courts Look the Other Way

Wang sought reinstatement of her suspended broker's license through the New York courts, challenging Secretary Treadwell's administrative decision in what's known as an article 78 proceeding. (In 2001, Treadwell was succeeded as secretary of state by Randy Daniels, who continued the action against Wang on appeal.) Wang's petition was heard by the Appellate Division, First Department, of the New York Supreme Court, the state's intermediate appellate court for cases arising in New York City.

As her state appeal was pending, Wang filed suit in December 2000 in the U.S. District Court for the Southern District of New York against Gov. Pataki and state Attorney General Eliot Spitzer. Wang's federal suit charged the AIV law compromised Congress's exclusive power to regulate interstate commerce and violated Wang's individual rights under the First, Fifth, and Fourteenth Amendments to the federal Constitution. District Judge Robert Sweet declined to decide these claims, however, before the New York state courts ruled on Wang's article 78

¹² Wang v. Department of State, 1 DOS App. 01, Decision and Order at 2 (Jan. 4, 2001).

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petition, which also incorporated the federal constitutional arguments.¹³

Unfortunately for Wang, the Appellate Division was in no mood to hear constitutional arguments against the AIV law. In a two-paragraph opinion issued in May 2003, a five-judge panel held that all of Wang's claims failed "for lack of standing" and that "no basis exists" for overruling the secretary's overall decision.¹⁴ On September 11, 2003, the New York Court of Appeals, the state's highest court, declined to review the Appellate Division's decision.¹⁵ Wang is now considering an appeal of the federal constitutional issues to the United States Supreme Court.¹⁶

The AIV Law: Unconstitutional and Anticompetitive

To date, Wang's constitutional arguments have not been adjudicated by any authority, either in the DOS or the three courts in which Wang has sought review. This does not mean her claims are without merit. Quite the contrary, New York's AIV law raises substantial free speech and due process issues that should have been resolved in Wang's favor. Furthermore, the DOS's stated objective of protecting consumers from fraudulent businessmen clearly bears no rational connection to Wang's prosecution, leading CVT to question the motives of Secretary Daniels's office in maintaining its position in this case.

The AIV law has raised judicial concern in the past. In 1982 a five-judge panel of the Appellate Division's Fourth Department (sitting in Buffalo) partially granted a request by an AIV to temporarily enjoin a provision of the AIV law also challenged by Wang. In *Galaxy Rental Service v. New York*¹⁷, the Fourth Department found there was a "strong likelihood" that the AIV law's ban on advertising specific properties would likely be found unconstitutional. The court applied the U.S. Supreme Court's precedents governing state restrictions of "commercial speech," and found that the Legislature should not have imposed a total ban on advertising specific properties when less restrictive

¹³ Wang v. Pataki, 164 F. Supp. 2d 406 (S.D.N.Y. 2001).

¹⁴ 757 N.Y.S.2d 857 (N.Y. App. Div. 1st Dept., 2003)

¹⁵ 2003 N.Y. LEXIS 2319 (N.Y. 2003).

¹⁶ Wang has until December 10, 2003, to file a petition for a writ of certiorari. See SUP. Ct. R. 13.

¹⁷ 452 N.Y.S.2d. 921 (N.Y. App. Div. 4th Dept., 1982).

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options to combat actual fraud were available. Unfortunately, CVT could not find any subsequent documentation regarding the Galaxy case, and it appears no court entered a final judgment on this question, since the advertising ban remains in force today.

The core constitutional problem is that the AIV imposes a prior restraint on the free flow of information. Because the Legislature found some businesses were selling fraudulent or inaccurate apartment listings, the AIV law makes it effectively impossible for individuals like Wang to disseminate apartment rental information for an advance fee. The state assumes all AIVs are inherently dishonest and that only through compulsory licensing can consumers be protected. Such an assumption is too broad to survive basic First Amendment scrutiny, even under the restrictive terms adopted by the Supreme Court regarding "commercial" speech.

In *Central Hudson Gas & Electric Corp. v. Public Service Commission*¹⁸—coincidentally, a case challenging a New York regulation¹⁹—the Supreme Court created a series of tests to determine whether commercial speech restrictions were invalid under the First Amendment. The first test is whether the speech at issue is false, deceptive, or related to illegal activity; these classes of speech are obviously afforded no First Amendment protection. Where the speech is commercial in nature but not misleading, the state may restrict or regulate such speech if (1) the state asserts a "substantial interest," (2) the restriction directly advances the state's interest, and (3) the state cannot reasonably advance its interest without adopting the speech restriction at issue.

The AIV law clearly fails the Central Hudson tests. First, New York does not directly advance its interest in preventing consumer fraud through the selective—indeed, arbitrary—enforcement of the law against Wang while allowing licensed AIVs to repeatedly violate the statute's mandates. Second, as Wang points out in her court filings, the state could employ less restrictive disclosure requirements to advance its interests without resorting to the outright ban on advertising specific properties contained in the AIV law. For example, AIVs could

¹⁸ 447 U.S. 557 (1980).

¹⁹ The regulation was a ban on advertising by state-regulated electric utilities; the government's objective was to discourage excessive energy consumption.

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advertise specific properties with written statements detailing the source of the property's information. This would directly advance the state's interest in protecting consumer welfare without resorting to the heavy-handed paternalism embodied in the current law.

The First Amendment defects with the AIV law become quite transparent when it's revealed that a major source of apartment information listings—newspapers—are not subject at all to the AIV law. Wang has frequently cited the Village Voice's online service, (www.villagevoice.com), as a major source of apartment information that is not subject to the AIV law. CVT believes New York officials have exempted traditional newspaper publishers like the Voice from AIV rules to avoid First Amendment issues. Since traditional newspaper publishers are generally afforded full constitutional protection by the courts, the state would almost certainly fail in any effort to require AIV licensing of those publications.

This dichotomy between newspapers like the Voice and commercial entrepreneurs like Wang demonstrates a key flaw in the judicial doctrine segregating commercial and noncommercial speech. The state distinguishes the two by arguing Wang has a greater motive to defraud the public because her business relies on apartment information sales as a primary revenue source, while the Voice relies primarily on sales of its newspaper. This is a meaningless distinction. The First Amendment does not discriminate among classes of speech based on the motive of a particular speaker. Similarly, the state's power to punish fraud does not depend on the motive of the individual committing the fraudulent act. Economic motives are not inherently evil, nor do political or philosophical motives excuse acts that violate the rights of others.

It is also important to note that Wang's MLX service does not function as an "apartment information vendor" within the strict meaning of the statute. The 1975 law was written long before the technology existed to provide consumers with direct access to a multiple-listing database that is updated continuously. The DOS recognized as much when then-Secretary of State Treadwell acknowledged the "onerous" burdens the AIV law placed on Wang and MLX. Despite this understanding, the DOS insisted on applying an overly broad reading of the law that included Wang's

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innovative business while excluding other, larger businesses that performed exactly the same function as MLX. Businesses such as America Online.

AOL is obviously not in business to sell apartment listings in New York. AOL provides customers with access to the Internet for an advance fee. Once online, however, customers can access information about apartment listings utilizing one or more search engines. While AOL provides access to information, it does not vouch for the accuracy or integrity of most of the information that a customer may actually access. The same is essentially true of MLX. Rather than provide a static listing of available apartments—the type of information product covered by the AIV law—MLX sells access to a database (and services) that allows customers to search and decide for themselves what information to use.

If New York can use the AIV law to regulate access providers like MLX, it could also regulate any Internet access provider or Web site, such as a portal, that allows customers to search for information. After all, to accept the 1975 legislative justification, because customers might obtain misleading or fraudulent information through the use of an online service, the state should have the power to require advanced licenses and to impose restrictive business practices upon access providers. Such power would undoubtedly strengthen state authority. It would also make Internet commerce a practical impossibility.

Consider the AIV law's mandatory refund provision. The law requires all but \$15 of an advance fee to be refunded to a customer upon request. MLX charges \$149 for access to its service, which means all but \$15 of that must be refunded to an unsuccessful apartment-seeker. (Note that the refund amount is fixed by statute, and \$15 in 1975 roughly equals \$100 today.) The state is thus forcing MLX to take a loss of \$134 for each person who accesses its database, searches it to the fullest extent, and demands a refund because they did not find the exact information they wanted. If all Internet databases and fee-for-service Web portals were subject to such a legal mandate, it is unlikely such services could operate profitably. Indeed, MLX is subject to the refund policy despite offering customers a free trial account so they can "try before you buy" with full access. The AIV law, however, recognizes no flexibility in the assumed business model,

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because it was designed at a time before MLX's business could even be conceived.

By putting Wang in the logically impossible position of defending a business model that clearly benefits consumers from an inflexible law intended to prevent consumer harm, the New York DOS effectively denied Wang her right to due process of law. Wang has a vested property interest not just in her real estate broker's license but in her overall professional reputation, and the state took both away from her through arbitrary and capricious means. Wang never had any realistic chance to defend herself; state officials targeted her and her business for selective prosecution under a law that has not been enforced against licensed AIVs that openly violate that statute. This denial of due process was compounded by the Appellate Division's refusal to address Wang's constitutional arguments, and the subsequent decision by the Court of Appeals not to conduct its own review of the matter.

A Role for Federal Regulators?

State regulatory barriers to Internet and electronic commerce affect more businesses than just New York's apartment information vendors. In recent years, the Federal Trade Commission has examined state barriers to interstate electronic commerce in various industries, notably online sales of wine, funeral caskets, contact lenses, automobiles, legal services, and educational products.²⁰ The Commission and its staff have encouraged state legislatures to remove barriers that discriminate against out-of-state online merchants, and to ensure the market is able to offer customers new and innovative services.

For example, the FTC and Department of Justice jointly opposed legislation in Georgia²¹ and Rhode Island²² that would have required attorneys to be physically present at any real estate

²⁰ See, e.g., Federal Trade Commission, "Possible Anticompetitive Efforts to Restrict Competition on the Internet," (Public workshop, October 2002). Transcript available at <http://www.ftc.gov/opp/ecommerce/anticompetitive/agenda.htm>.

²¹ Letter from R. Hewitt Pate and Timothy J. Muris to the State Bar of Georgia, Standing Committee on the Unauthorized Practice of Law (March 20, 2003) (available at <http://www.ftc.gov/be/v030007.htm>).

²² Letter from R. Hewitt Pate and Timothy J. Muris to William J. Murphy, Speaker of the Rhode Island House of Representatives (March 28, 2003) (available at <http://www.ftc.gov/be/v020013.htm>).

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closing or refinancing. The FTC and DOJ correctly observed that such a rule discriminates against online mortgage lenders that rely primarily on lay closers rather than attorneys physically present in the state. The agencies noted that online mortgage services provide added convenience and cost savings that benefit customers without increasing the risk of fraud.

This example also demonstrates another factor that contributes to the propagation of state regulatory regimes: protecting established competitors. In the Georgia-Rhode Island scenario, the legislatures attempted to create a legal barrier to protect the state's attorneys—the bar—from outside competition. Similarly, Wang alleges her efforts to repeal the AIV law have been thwarted by New York's large, established real estate brokers. These brokers, after all, benefit from the lack of an MLX-type service that allows customers and landlords to directly connect without the need for an intermediary broker.

The established brokers could argue that the AIV law is necessary to ensure integrity within their profession. But as we've seen, the DOS has not enforced violations of the AIV law committed by the few licensed vendors. Instead the Department has expended its substantial resources to drive Wang and MLX out of business. This despite the DOS's inability to identify any tangible harm to customers posed by MLX, and despite the fact many newspaper publishers operate essentially the same type of service without holding an AIV license.

Should the FTC continue its assault on state barriers to Internet commerce, the Commission should strongly consider taking up Wang's cause. While the FTC cannot order New York to do anything, Commission staff can lobby the state Legislature to revive efforts to amend or repeal the AIV law. CVT has strongly encouraged the FTC to do this, and will work with the Commission in the future should it express interest in this matter.

Conclusion

As for LaLa Wang, her state appeals have been exhausted, leaving only federal judicial remedies. The U.S. Supreme Court could take up an appeal of the state courts' refusals to hear the federal constitutional questions Wang raised, and her original

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federal lawsuit in U.S. district court could be revived. By her account, Wang has already spent more than \$500,000 fighting New York's DOS for the simple right to conduct her business, and she shows no signs of giving up the fight. CVT will continue to actively monitor this case and take additional actions as circumstances warrant.

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