CONFLICTS OF INTEREST OR "THOU SHALT NOT STEAL" REVISITED

by John K. Rutledge, CRE

Real estate counselors and other professional practitioners depend on a reputation for ethical conduct to attract and retain clients. For guidance, they rely on codes of ethics, statements of professional standards, personal and corporate policies, and other sets of boundaries. At the most fundamental level, many ethical violations can be described as conflicts of interests. It is not enough, however, to avoid situations in which the counselor's interests are opposed to those of the client. Circumstances which merely hint that such a conflict exists can be as damaging to a counselor as an actual conflict.

A conflict of interest can be as straight forward as an appraiser holding an interest in a property being appraised, an obvious violation of the code of ethics. It may include the acceptance of an assignment with inadequate expertise and the unwillingness to seek assistance; the valuation of assets by a manager in a way to improperly affect fees; the sharing of financial data between lending and trust departments of a bank; the sales of trust assets; the provision of professional services to a corporate officer personally while advising the officer on corporate affairs; and various other activities. Often, conflicts of interest are not intentionally contrived efforts to take advantage of a relationship but rather begin with all appearances of innocence and evolve into an actual or perceived conflict.

Unfortunately, there is no ironclad approach to business (or life) that will guarantee the absence of risk to one's reputation. Awareness of the dangers, however, will sharpen the vigilance, and an unending examination of principles and standards will minimize the danger.

The Dangers Of Conflicts Of Interest

Conflicts of interest are common circumstances encountered frequently by each of us. They are not necessarily esoteric situations but may be as simple as the desire to optimize the relationship between effort expended (work) for a client or employer and reward (fee or salary) received. Failure to recognize and properly address conflicts, both real and perceived, can have extremely serious consequences to a counselor or other professional.

Counselors of Real Estate (CRE—the professional designation of The Counselors of Real Estate), rightfully say they have nothing to sell but their time and expertise. The expertise contributes

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to the delivery of advice which is intended to improve the circumstances of the client. It is implicit that the advice is provided in the context of honesty and integrity. The CRE is compensated for the advice, not as a result of the advice. It is well understood in real estate circles, for example, that an appraiser is paid for the appraisal without regard to the conclusion of value and that the appraisal is conducted with the objectivity that comes with complete independence from the property. It is assumed that the CRE will not stand to benefit from the plan of action proposed to the client. Of course, the successful conclusion of a counseling assignment may lead to further assignments. Repeat business is highly valued. Implementation or execution fees such as brokerage commissions also are common and legitimate, provided the client is fully informed and the work is conducted with no undisclosed interest.

Codes of ethics are adopted by professional organizations to guide the conduct of their members and to give comfort to the public concerning the objectivity and quality of the services offered by their members. Realtors pledge loyalty to their clients. Doctors have their Hippocratic Oath. Securities analysts subscribe to a code of ethics which limits their personal investment opportunities to assure their clients of unbiased advice. Oh, how easy this sounds!

The possibilities for entanglement, however, are everywhere. Further, it is not enough to be as pure as Caesar's wife. In terms of effect, the mere appearance of conflict may be as damaging as the real thing. For a CRE, a reputation of unquestioned honesty and independence is integral to the practice, and any act or circumstance, even unintentional, which brings character into question potentially can end a career.

Counselors are at particular risk. Some of the more difficult problems, for which CREs are particularly well suited to address, involve business and personal relationships among the client and other parties. If the client has fiduciary duties to those other parties, the CRE may become enmeshed in those duties as well and, in trying to serve the client, may unwittingly damage others.

A Simple Case—And One Not So Simple

Some situations are rather easy to conceive. Consider the appraiser who conducts an appraisal of a condominium or residential subdivision for a potential construction lender. Obviously, the appraiser should not accept this assignment if he intends to acquire a unit upon completion. The intent would introduce the possibility that the appraiser would be biased in his conclusion.

Now let's change the facts slightly and assume that the appraiser had no present or contemplated future interest in the property when undertaking and completing a fully objective appraisal. Subsequently, however, he concludes that the property would meet a personal need. He purchases a unit. Skeptics perhaps would say that a future contemplated interest was undisclosed at the time of accepting and conducting the assignment. "Subsequently" is a material consideration in the issue at hand. If the purchase is made 10 years after the appraisal, it would seem that there could be no question about the objectivity of the appraiser, but 30 days present an entirely different picture. How much time must elapse to avoid an appearance of conflict? The dividing line between enough and not enough is subjective and not easily identified.

Competence Equal To The Job

Real estate counseling by definition involves problems. If the solution to a problem was widely known, the services of a CRE most likely would not be necessary. Often, frontiers of knowledge must be explored. The client is entitled to competent service, and yet the answer may not be easily determined, if at all. The CRE who accepts an assignment purports to bring expertise and creativity to the situation. Is the level of the CRE's expertise fully disclosed to and understood by the client? The CRE is faced with the implicit conflict between wanting the assignment and knowing that the solution may thoroughly challenge or even elude him. Further, an assignment may pose a familiar challenge on the surface but turn out to be much more complex. At what point does the counselor admit the need for assistance? Does the need for other, perhaps more specialized, expertise signify incompetence or failure on the part of the counselor in the eyes of the client? Does the need to maintain control of the assignment, and perhaps avoid the costs of a subcontractor, conflict with the best interests of the client? Again, the appearance may be more important than the facts to the CRE's reputation.

Investment Management Fee Structures

Historically, most real estate practitioners have been paid for services based on transactions. For the sale of a property, a broker is paid a commission based on the sale price. Managers receive a percentage of the gross revenues, and leasing agents are paid a percentage of the lease consideration. Institutional investment managers, conversely, have charged their clients a percentage of assets under management. In the marketable securities business, this is understandable because transaction costs are minimal compared to the asset value.

As real estate professionals have expanded their client base by entering the realm of institutional investment management, assisting pension fund managers to invest in real estate along with stocks

and bonds, an interesting conflict has appeared. To follow practices familiar to their new clients, and in some cases to comply with regulatory requirements, real estate investment managers have adapted to their new surroundings by eliminating acquisition and sale fees (brokerage commissions in the old days) and replacing them with fees based on the value of the real estate under management.

As honest and well intentioned as the manager may be, he has a double financial incentive to influence the appraisal process. First, appraisals play a principal role in measuring investment performance. Price quotations similar to those available for securities do not exist for individual properties and probably never will. The appraisal is the only source of a valuation. An appraisal with an upward bias has a direct and favorable bearing on reported investment performance, and investment performance is critical to the success of a manager's future business survival and growth.

Second, fees which are a percentage of asset values under management obviously respond directly to appraised values. This is not a problem if valuations are drawn from public securities markets. It certainly can create the appearance of a conflict, however, if the asset valuation involves an estimate prepared under the control or direction of the investment manager, regardless of the estimate's objectivity.

Investment managers address this question by, among other things, diversifying and rotating appraisers. Others establish "independent" appraisal audit bodies composed of appraisers and advisors otherwise unaffiliated with the appraisers doing the actual valuation work. There is a question about how independent anyone can be, of course, if continued retention in a position is dependent on the will of the employer, client, or principal.

Indeed, the appraiser himself may have every intention of maintaining complete objectivity and independence. It cannot be far from his mind, however, that his client, the investment manager, will be both evaluated and compensated in the marketplace based partly on the results of the appraisal. With the manager at least subconsciously hoping for an appraisal showing a rising value, the appraiser is put in the position of desiring to please his client with a high value while remaining objective.

Acquisition Volume Vs. Prudence

The investment manager has another set of conflicts. If fees are based on assets under management, the manager is torn between "getting the money out" and prudence in the underwriting process. The former was all too evident a few years ago during the reign of tax shelter syndicators and their financiers. Limited partnership interests were sold by brokers who were paid for bringing in the money. Developers were paid by delivering finished projects to their investors. Prudence got short shrift.

Today's investment managers are observed and evaluated more closely by sophisticated institutional clients and their consultants. The quality and integrity of their work generally are very good. Nevertheless, they are subject to the same conflicting forces.

Banking

Banks face a potential for conflict between trust and commercial lending functions. A lending officer typically gets far more detailed financial and management information than is made available publicly for the benefit of securities holders. This is inside information and, shared with a trust investment division, offers an advantage to the customers of the trust department over other investors. Use of such nonpublic information is illegal, of course, but the opportunity for its use creates the need for the so-called "Chinese Wall" to assure the avoidance of using inside information.

Banks face other potential conflicts as a result of their effort to provide a full range of services to their customers. The trust department may be named trustee or executor of an estate, a victory for the trust department sales staff. This becomes a nightmare when it is discovered that the decedent's estate owes money to the lending department, and particularly so if it is a troubled loan. Individual employees generally take great pride in their work. The trust officer in this dilemma will do his very best to carry out his fiduciary duties and to defend the estate against all creditors. Likewise, the lending officer will vigorously represent the bank's shareholders by taking every possible measure to collect the loan. Regardless of the best intentions and efforts of the officers involved, and the mandated isolation of the two sides from each other within the bank, the institution is seen by the public as a single entity with a clear conflict of interest. The final outcome will be criticized by the trust beneficiaries, the bank's shareholders, or (most likely) both.

A more easily managed problem arises when the trust department is liquidating an estate and another customer wants to purchase a property in the estate. Policy may call for a marketing program which includes thorough exposure through advertising and other means, with a competitive sale. In practice, it becomes more complex. Trust officers must maintain a very independent attitude toward such situations, and must be fully supported by management. After all, the trust department relies on its reputation as a loyal representative of the client. Any action which compromises or appears

to compromise the relationship with the trust client causes great harm to the reputation of the bank. Obviously, sound policy precludes sale to the bank or its employees.

Legal And Corporate Relationships

Other examples of potential or real conflicts abound. Is the law firm advising a merger or takeover candidate also throwing in some free advice to the senior management on a golden parachute? Since such advice independently obtained could be costly, it must be assumed that such "free" counsel is provided ultimately at the expense of the company. Is this additional compensation in the form of legal advice properly included in proxy statement disclosures? More significantly, does the advice lead toward improving the situation of the manager at the expense of the shareholders?

Senior corporate leaders may devote extensive time and effort to official duties while commuting, working at home, and attending evening functions. The line between personal and business expenses may be quite fuzzy to the executive. Are questions resolved in favor of the company or the manager? News reports from time to time explore the lapses of judgment and the moral failures of executives who face the rather simple conflict of whether to absorb a cost or charge it to the company.

Corporate directors have a fiduciary duty to all shareholders. However, the owner of a substantial block of shares may elect a representative to serve as a director. This is particularly common in the case of smaller companies. It is not uncommon for a major shareholder to have an objective that may differ from the objectives of the shareholders at large. Despite the best intentions of the director to represent all shareholders, the interests of his employer (the major shareholder) will cast doubt on the director's motives.

The Reality Of Perception

Perception becomes reality. An observer perceives improper behavior and responds accordingly. The perception may have been erroneous, but the response occurs nevertheless. The response is a reality which will have a direct result. The result may be the taking of business elsewhere, the loss of credibility on the witness stand, or the influencing of other clients or prospects, all very real effects. A reputation, which took years to build and nurture, can be demolished in an instant. In reality, the behavior may have been perfectly innocent, but the appearance of impropriety can have an impact equal to that of an actual violation of fiduciary duties.

Society is filled with traps. Where is the dividing line between a common courtesy such as a cup of coffee and a more substantive gratuity intended to influence the recipient? Some organizations attempt to legislate this line at some value, such as $50, $100, or even zero. Each individual, however, has a different outlook on such matters. Further, appropriateness depends on the context. An acceptable expression of sincere appreciation for going beyond the call of duty on an extended and difficult project may, in a more simple situation, appear to be nothing more than a bribe or a payoff. A friendship which develops over a lengthy and mutually prosperous business relationship may, in the minds of those involved, justify gifts that would be unacceptable in other circumstances. Perceptions by others, however, can have very real and unexpected consequences. Appropriateness therefore, is judged not only by the parties directly involved but by observers who may have no apparent interest in the situation but who may influence others.

The appearance of a conflict can be even more dangerous than an actual conflict because it may not be recognized. The parties to a situation may be thoroughly innocent and may not even be aware of a nonexistent but apparent conflict. The result may be a complete surprise with serious consequences. Picture the congressman and his long time friend who now happens to be in a senior business position. The two equitably share the cost of a hunting trip. How will it be described in the front page story on an ethics investigation?

Minimizing The Danger

Clearly, conflicts of interest cannot be avoided completely. A clear set of rules for handling conflicts is rendered unlikely by the infinite shadings of circumstances. The problem is further aggravated by changing moral and ethical standards and expectations. This is illustrated frequently by the travails of elected officials who discover, to their chagrin, that formerly tolerated behavior and practices have become unacceptable. Previously overlooked as mere human foibles, these lapses suddenly become the stuff of campaign attacks or the subject of investigation by a special counsel. As standards of expected conduct change, past activities can fall outside the new code of conduct and a good reputation can be destroyed. While real estate counseling often involves confidential work, actions may be profitably guided by the possibility of being described on the front page of the local paper.

Human nature is inclined toward fairness and integrity. Various religions have taken root and survived for millennia. Commonly, they promote conduct typified by the Ten Commandments. Charities receive billions of dollars with no expectation by the donors of personal gain other than a tax deduction and perhaps some recognition. Yet within every person lies a bit of the devil which must be continually subdued.

Perfection is too much to expect, and the perception of perfection is even less likely. The only solution is to maintain a wide margin between conduct and the boundary of impropriety, and to treat appearance as reality. Every action must be directed toward the further development of a character that abhors mistreatment of those who rely on us. Constant consideration must be given to appearances, regardless of our view of reality, because the perception by others leads to their actions which create our reality. We must conduct ourselves in an exemplary manner, and be sure that appearances do not contradict the reality of that conduct.

While all conflicts of interest cannot be completely avoided, it is essential that they be acknowledged, and every effort must be made to prevent harm to the client. A material conflict may require withdrawing from the assignment, an alternative preferable to risking one's reputation. Recognition of the potential for damage is the first step toward neutralizing the risk, and full disclosure to the client, in advance, is a demonstration of good faith and an expression of paramount concern for his best interest.

Conclusion

The potential for conflicts of interest pose a major threat to the reputation for integrity and honesty so treasured by the professional, and the appearance of such a conflict can be as dangerous as an actual conflict. Some are easily recognized while others may be quite subtle and insidious. Ultimately, success in dealing with conflicts of interest, as with other ethical questions, depends on an unending examination of one's own principles and standards of conduct and a continuing firm commitment to defend them. Simply put, thou shalt not steal, and thou shalt not present the appearance of stealing.