

# REAL ESTATE ISSUES®

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THE COUNSELORS OF REAL ESTATE'S 2006 STRATEGIC PLAN CHARTS THE future of our organization.

Though all committees are using the plan as a guide, *Real Estate Issues* is at the forefront in implementing it. By its very nature, *REI* creates an opportunity for members to participate on the

editorial board, and provides a mechanism for CREs and other leading real estate practitioners and academics to share their expertise.

Building on its established reputation as a leading real estate publication, today's *REI* is a blend of feature articles, perspective columns and resource reviews. I strongly encourage all readers to consider contributing to the journal. Share your research findings, project case studies and professional experience in feature articles; offer your opinion or vision for the future in perspective columns; or tell your colleagues about useful books, Web sites and other tools in resource reviews.

This issue of *REI* showcases the wide range of topics that affect the practice of real estate counseling. From taxation issues to case law, from economic forecasts to international development, the journal and its contributors are at the forefront of emerging trends and best practices. Meanwhile, *REI* has embraced the goals of the 2006 strategic plan by expanding the *REI* Editorial Board in number as well as diversity. The board draws from a broad member profile—and includes among its members some of the top names in the field.

Together, the editorial board and CRE staff are launching initiatives that embody the 2006 strategic plan, such as:

- Transcribing presentations from CRE meetings to demonstrate the high quality of presentations at CRE educational functions and disseminate knowledge conveyed at meetings to a larger audience. This issue includes an excerpt of the presentation that William Ramseyer, CRE, delivered at the 2006 Midyear Meetings in Charleston, S.C.

## The Counselors of Real Estate Strategic Plan Adopted April 2006

### MISSION

To be the forum for leaders in real estate.

### GOALS

#### 1. Create

To provide a platform for professional relationships, insight and access to diverse experience.

#### 2. Participate

Through active participation, contribution and camaraderie, members enhance the benefits of a diverse professional community.

#### 3. Communicate

To communicate within the membership and marketplace that our members are the preeminent source of real estate knowledge and advice.

- Improving Web-based access to information published in *REI* to strengthen communications, build interaction with relevant professional organizations and promote awareness of member expertise. A searchable index of articles already is available through the CRE Web site at [www.cre.org/publications/rei.cfm](http://www.cre.org/publications/rei.cfm) (click on "Articles and abstracts"), and board and staff members are investigating new ways to make this resource even more meaningful.

These achievements cannot be accomplished without staff to implement our plans. I am pleased to announce that Marcie Valerio has joined the CRE staff as the new managing editor of *Real Estate Issues*. She comes to The Counselors from The Sherwood Group, an association management firm, where she led the communications and marketing initiatives for two international technology associations. Before her association work, Marcie was a journalist for two daily newspapers in Florida. She brings extensive knowledge and energy to the position. The editorial board and I look forward to working with her.

MAURA M. COCHRAN, CRE  
EDITOR IN CHIEF

# Eminent Domain After *Kelo*: The Battle Continues

BY DAVID B. SNYDER, ESQ.

IN *KELO V. CITY OF NEW LONDON*, THE U.S. SUPREME COURT issued one of its most controversial opinions when it ruled that a local government has the power, under certain circumstances, to condemn private property for the sole purpose of economic development. The decision generated strong reactions as well as misconceptions about the case and the power of eminent domain in general.

Many local governments, developers and others in the real estate community cheered when the court announced the decision. But the backlash that followed has been passionate and widespread. Though the government side of the issue may have won the battle, it is clearly losing the war.

Legislators in Congress and most states have passed or introduced legislation in response to the decision. And on June 23—the first anniversary of the *Kelo* decision—President Bush issued an executive order seeking to restrict the extent to which federal agencies can seize private property “for the purpose of benefitting the general public and not merely for the purpose of advancing the economic interest of private parties to be given ownership or use of the property taken.”

The power of eminent domain, also known as condemnation, authorizes the government to take private property only after meeting two general requirements outlined in the Fifth Amendment of the U.S. Constitution. First, the condemning authority must show that the property is being acquired for a public use; second, the owner of the condemned property must receive just compensation.

An important tool for local governments since colonial times, the power of eminent domain permits a government to acquire properties to achieve important goals such as establishing schools, firehouses and other public facilities. A government also can use the power as an urban planning strategy to redevelop blighted areas.

Yet some observers say that in recent years, governments have gone too far in certain cases and have used the power of eminent domain as a tool for economic development. In *Kelo*, the city of New London tested the boundaries of the power of eminent domain.

## IS ECONOMIC DEVELOPMENT A PUBLIC USE?

In 2000, New London approved a large-scale development plan intended to create more than 1,000 jobs, increase tax and other revenues, and revitalize an economically



## About the Author

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## Eminent Domain After *Kelo*: The Battle Continues

distressed city, including its downtown and waterfront areas. The plan—designed to derive maximum benefit for the city from a \$350 million research center that pharmaceutical company Pfizer Inc. built nearby—would replace a residential neighborhood (which was not blighted) with office space for research and development, a conference hotel, new residences and a pedestrian riverwalk along the Thames River. Private developers would build and lease portions of the project.

In assembling the land needed for this project, the city's development agent purchased properties from willing sellers. But several property owners were unwilling to sell, so the city initiated condemnation proceedings. The property owners fought the condemnations, arguing the city was vio-

lating the Fifth Amendment's public-use requirement.

When the Connecticut Supreme Court upheld the proposed condemnations, property owners appealed to the U.S. Supreme Court.

In a 5-4 decision, the U.S. Supreme Court ruled that the city's proposed disposition of the acquired property for private development and use under its approved development plan qualified as a public use within the meaning of the Fifth Amendment. Justice John Paul Stevens wrote the opinion for the majority, restating the principle expressed in previous opinions that the term "public use" should not be read literally. Rather, the court "has embraced the broader and more natural interpretation of public use as 'public purpose.' ... Promoting economic development is a traditional and long-accepted governmental function,"

*"We emphasize that nothing in our opinion precludes any State from placing further restrictions on its exercise of the takings power. ... the necessity and wisdom of using eminent domain to promote economic development are certainly matters of legitimate public debate."*

—U.S. Supreme Court Justice John Paul Stevens,  
writing for the majority in *Kelo* vs. City of New London

Stevens wrote. Therefore, the condemnations were for a public purpose and met the public use requirement.

Many interested groups filed *amicus curiae* briefs expressing their opinions about the merits of the case. The National League of Cities, National Conference of State Legislatures, U.S. Conference of Mayors, developers and individual governments, such as the City of New York and states from Vermont to Hawaii, were among those who filed briefs in support of New London. The National Association of REALTORS®, National Association of Homebuilders, National Association for the Advancement of Colored People and American Association of Retired Persons were among those who filed briefs in support of property owners.

The *Kelo* case required justices to consider the federal constitutional limits of a government's power of eminent domain in a context the court had not previously addressed. This case was not about taking properties to eliminate blight. Instead, the sole purpose of the city's proj-

ect was spurring economic development largely through private-sector development and use.

### **MAJORITY OPINION DEFERS TO LEGISLATURES AND STATE COURTS**

One of the fundamental bases for the decision was the court's broad deference to local governments. Stevens wrote that it was not the court's role to second-guess the city's judgment regarding the "efficacy of its development plan" or "what lands it needs to acquire in order to effectuate the project." The court noted that the city had carefully formulated a development plan that it believed would provide appreciable benefits to the community, including new jobs and increased tax revenue.

In response to arguments that this holding would have the potential for abuse, the court stressed that there was no evidence of an illegitimate purpose in the *Kelo* case, and cases involving illegitimate purposes would not be permitted. This illegitimacy, of course, may be difficult to prove.

Finally, the court threw the ball back to state courts. The majority stated: "We emphasize that nothing in our opinion

## Eminent Domain After *Kelo*: The Battle Continues

precludes any State from placing further restrictions on its exercise of the takings power. ... the necessity and wisdom of using eminent domain to promote economic development are certainly matters of legitimate public debate.”

Defenders of the *Kelo* decision assert that the holding was consistent with principles outlined in previous court decisions. For example, the *Kelo* court cited *Berman v. Parker*, a 1954 U.S. Supreme Court case that upheld a redevelopment plan targeting a blighted area in Washington, D.C.

Justices in the minority disagreed strongly, and Justice Sandra Day O'Connor issued a particularly stinging dissent. “Any property may now be taken for the benefit of another private party, but the fallout from this decision will not be random,” O'Connor wrote. “The beneficiaries are likely to be those citizens with disproportionate influence and power in the political process, including large corporations and development firms,” she added. “The specter of condemnation hangs over all property. Nothing is to prevent the state from replacing any Motel 6 with a Ritz-Carlton, any home with a shopping mall, or any farm with a factory.”

The practical impacts of the *Kelo* decision remain to be seen. Advocates on both sides of the debate continue to parse the language of the majority opinion—as well as the Justice Anthony Kennedy's concurring opinion—in an attempt to identify legal and factual matters that either support or diminish the justices' positions.

Another factor to consider is that in addition to satisfying any state constitutional requirements, the power to condemn for a particular purpose must appear in a statute. At the time of the ruling, most states did not have a statute permitting condemnation solely for economic development in the absence of a blight determination.

However, many states have redevelopment statutes that give local governments the power to condemn property for redevelopment projects to eliminate blight, which often has been defined very broadly and, in addition to unsafe or unsanitary conditions, can include “economically ... undesirable land uses.” Thus, though *Kelo* expressly did not involve a blighted area, a redevelopment authority may be able to use its redevelopment laws to achieve some of the same goals that were at the heart of *Kelo*.

### DEBATE RAGES ON IN CONGRESS AND STATE LEGISLATURES

The post-*Kelo* dialogue will continue on the federal and state levels. As the court acknowledged, Congress as well as state legislatures and courts are within their rights to pass laws restricting condemnations. Within days of the *Kelo* decision, legislators began introducing bills to prevent *Kelo*-type condemnations.

According to information reported by the National Conference of State Legislatures in mid-June, 43 of the 44 states that have gone into session in 2006 are considering eminent domain legislation in response *Kelo*. To date, 27 states have enacted laws restricting the use of eminent domain for economic development. And of those, 18 were signed into law, three were vetoed, three are sitting on the governor's desk, and voters in three states will decide the issue through constitutional amendments on the ballot. Florida and Georgia also will have measures on the ballot because those states require approval not only from lawmakers and the governor, but also from voters.

Alabama and Texas were among the first states to pass legislation. The Alabama statute prohibits condemnation “for the purposes of private retail, office, commercial, industrial, or residential development; or primarily for enhancement of tax revenue; or for transfer to a person, nongovernmental entity, public-private partnership, corporation, or other business entity.” But it also states that the prohibition does not apply if there is a “finding of blight.” Similarly, the Texas statute prohibits condemnations “for economic development purposes, unless the economic development is a secondary purpose resulting from municipal community development or municipal urban renewal activities to eliminate ... blight.”

More recently, Pennsylvania enacted legislation that prohibits “the exercise by any condemnor of the power of eminent domain to take private property in order to use it for private enterprise.” The exceptions to this prohibition include condemnations to cure blight or to otherwise remove dangerous or abandoned properties. The statute also expressly narrows the definition of blight.

Many of the statutes address issues beyond those covered in *Kelo*. For example, some measures stipulate fair compensation for property owners, provide additional procedural rights for challenging condemnations and establish committees to address eminent domain issues.



## Eminent Domain After *Kelo*: The Battle Continues

Legislation pending in Congress has the most sweeping potential. In late 2005, the U.S. House of Representatives passed HR4128, which prohibits state and local governments from using the power of eminent domain for economic development, which is defined in the bill as: “taking private property ... and conveying or leasing such property from one private person or entity to another private person or entity for commercial enterprise carried on for profit, or to increase tax revenue, tax base, employment, or general economic health.” The bill includes exceptions to that definition such as “removing harmful uses of land,” “acquiring abandoned property” and “redeveloping of a brownfield site.”

A controversial aspect of the federal legislation is its penalty provision. According to HR4128, any state or

local government that violates the statute is “ineligible for any Federal economic development funds for a period of 2 fiscal years.” A similar bill is pending in the U.S. Senate, though it is unclear whether the momentum behind the legislation will continue—especially considering President Bush’s recent executive order.

Clearly, eminent domain will be a hot issue in the years to come. The Institute for Justice, a group that represented the property owners in *Kelo* and opposes condemnations nationally, has begun a campaign called Hands Off My Home to combat the types of condemnations permitted in *Kelo*. In contrast, local governments likely will experiment with using the power of eminent domain to achieve economic goals. The clash of these two forces will play out across the country as the debate continues. ■

# Nuclear Waste Disposal: A Taxing Real Estate Issue

BY JACK P. FRIEDMAN, PH.D., CRE, AND BARRY A. DISKIN, PH.D., MAI

WHEN DEALING WITH ISSUES THAT HAVE THE POTENTIAL TO SIGNIFICANTLY AFFECT a community socially and economically, emotions can run high and civic leaders may not always receive the best or most accurate advice. At such times, objective analysis from real estate counselors can make all the difference. The impact that unbiased CRE expertise can have on negotiations between public and private entities is apparent in a recent ad valorem tax settlement between Maine Yankee Atomic Power Co. reached and the town of Wiscasset, Maine.

Because a national facility for storing high-level nuclear waste still has not received federal approval, spent fuel rods—sealed in stainless steel containers, then enclosed in concrete casks—may need to remain on the site of the decommissioned Maine Yankee nuclear power plant for 20 years or longer. The tax assessment, in a state that calls for market value, asserted that the nine-acre site used for storing this nuclear waste was worth more than \$135 million, which prompted an appeal from the facility owner. Independent analysis indicated that there is no willing buyer of nuclear waste or of land required for its storage, nor can the facility accept nuclear waste from different facilities. The land, therefore, is unlikely be able to serve another purpose for at least 20 years.

Further, the issue of nuclear-waste storage could remain uncertain for many years to come. The June 27 issue of *The Wall Street Journal* (see “Plan for Nuclear-Waste Storage Is Cleared by Senate Subcommittee”) outlines legislation that would require temporary nuclear waste storage facilities in 31 states. These temporary facilities could

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# Nuclear Waste Disposal: A Taxing Real Estate Issue

operate for as long as 25 years before shipping waste to Nevada's Yucca Mountain for permanent storage. The plan addresses the U.S. Department of Energy's unfulfilled contractual obligation to remove radioactive waste from power plant sites—a contract the DOE has breached, courts have determined.

As the price of fossil fuels climb to ever-increasing record highs, officials once again are considering nuclear power as a cost-effective energy source. However, the problem of nuclear waste storage remains, and could have an impact on property valuation at current and potential storage sites.

## INTRODUCTION

For more than two decades, the 820-acre Maine Yankee site in Wiscasset, had housed a nuclear reactor; spent fuel pool inside a concrete building; four-story, 69,000-square-foot staff office building; and various other facilities. By

*When members of the board of tax appeals asked, "How can land used for waste be worth millions?" the town of Wiscasset, Maine, began to reconsider its position.*

April 2005, however, the reactor and all major facilities had been dismantled, and low-level nuclear waste had been hauled off to an approved waste site. The nine-acre nuclear waste storage area, called an independent spent fuel storage installation, or ISFSI, and certain auxiliary facilities used for security were the only physical remnants of the decommissioned nuclear plant.

Maine Yankee was by far the largest taxpayer in Wiscasset for more than 25 years. Even after it stopped generating power in 1997, the company continued to pay millions of dollars of ad valorem tax annually, at a negotiated amount that stepped down annually. Since the early 1980s, the company also had paid the DOE a substantial annual fee so the agency could develop a national nuclear waste repository, but the DOE still has not received approvals for the facility.

This complication means that Maine Yankee will need to store high-level nuclear waste at the plant site for years to come. Before decommissioning, plant administrators planned to send waste to the DOE facility for permanent

storage, not keep the materials onsite. Nevertheless, when the plant closed completely, Maine Yankee had a limited budget to sustain safe storage of nuclear waste for at least 20 years.

A prominent attorney—assisted by experts who he selected—advised Wiscasset's board of selectmen, an elected panel of town officers, that land used to store nuclear waste is scarce and highly valuable. He also extended the term "highest and best use" beyond typical real estate appraisal or consulting vernacular.

Wiscasset could continue to reap huge tax revenues from Maine Yankee, the attorney said, by assessing the nine acres at a value of \$15 million per acre, for a total of \$135 million. In addition, he said the town could tax the 64 casks containing the nuclear waste at their cost, approximately \$70 million.

This recommendation set the stage for a confrontation between Maine Yankee and the town over current and future ad valorem taxation. The case was settled during a hearing of the board of tax appeals. As is often the case with settlements, agreement saves the cost of further trials. In this matter, each side had an opportunity to hear questions and comments by members of the board of tax appeals; and when board members asked, "How can land used for waste be worth millions?" the town began to reconsider its position.

Though some details of the settlement have not been disclosed, the land reportedly was to be taxed at the value of ordinary industrial land, and the casks taxed at their original cost, reduced each year by depreciation.

## HISTORY

Maine Yankee, built between 1968 and 1972, was a single-unit 900-megawatt pressurized water reactor that generated about 119 billion kilowatt-hours of electricity from 1972 through 1996. While operational, the plant was Maine's largest generator of electricity.

The nuclear plant supplied power to a consortium of its owners and employed more than 475 people, plus outside contractors. Maine Yankee was permanently closed in August 1997, allegedly for economic reasons. Officials also cited safety violations. Regional political issues related to

## Nuclear Waste Disposal: A Taxing Real Estate Issue



**The nuclear reactor and spent fuel pool building, pictured above before decommissioning, were less than a quarter mile from Maine Yankee's independent spent fuel storage installation.**

having a nuclear power plant near a population center may have played an important part in its closure.

The dangers of nuclear plants became apparent after radioactive leaks at central Pennsylvania's Three Mile Island in 1979 and the disastrous event at northern Ukraine's Chernobyl in 1986. Wiscasset is about 40 miles northeast of Portland, Maine, and less than 140 miles northeast of Boston, conceivably putting those populations at some risk, or perceived risk.

Discussions leading to Maine Yankee's closure occurred shortly after the Seabrook Nuclear Power Plant in New Hampshire and the Shoreham Nuclear Power Station on Long Island, New York, battled for the right to begin operating. Civic leaders in areas surrounding both plants had concerns about safety and limited evacuation routes. Eventually Seabrook opened, but Shoreham, though prepared for operation, was disassembled.

During the Maine Yankee decommissioning process, low-level nuclear waste, such as the floors and walls of the reactor, were dismantled and trucked to an acceptable facility. The two locations principally used for this purpose are in Clive, Utah, and Barnwell, S.C. Those facilities, however, cannot accommodate greater than Class C, or GTCC, waste.

A fund of approximately \$508 million, including \$128 million earmarked for interim spent fuel storage, had been arranged for the decommissioning of Maine Yankee. By January 2004, approximately \$100 million remained. ISFSI officials expected this fund, with earnings, would be adequate to finance operations until the DOE calls for transport of the spent fuel and to decommission the ISFSI site, possibly in 2027 or even later.

ISFSI operations would require a skeleton crew of guards, engineers, grounds maintenance staff and financial personnel to monitor the decommissioning fund. Other expenses would include insurance and property taxes. Annual costs were estimated at \$6.8 million. About 400 acres of the 820-acre site would be sold and 200 acres donated to a charitable organization. Maine Yankee would retain

only the ISFSI and minimal land needed for its security—179 acres in all.

### THE VALUATION ISSUE

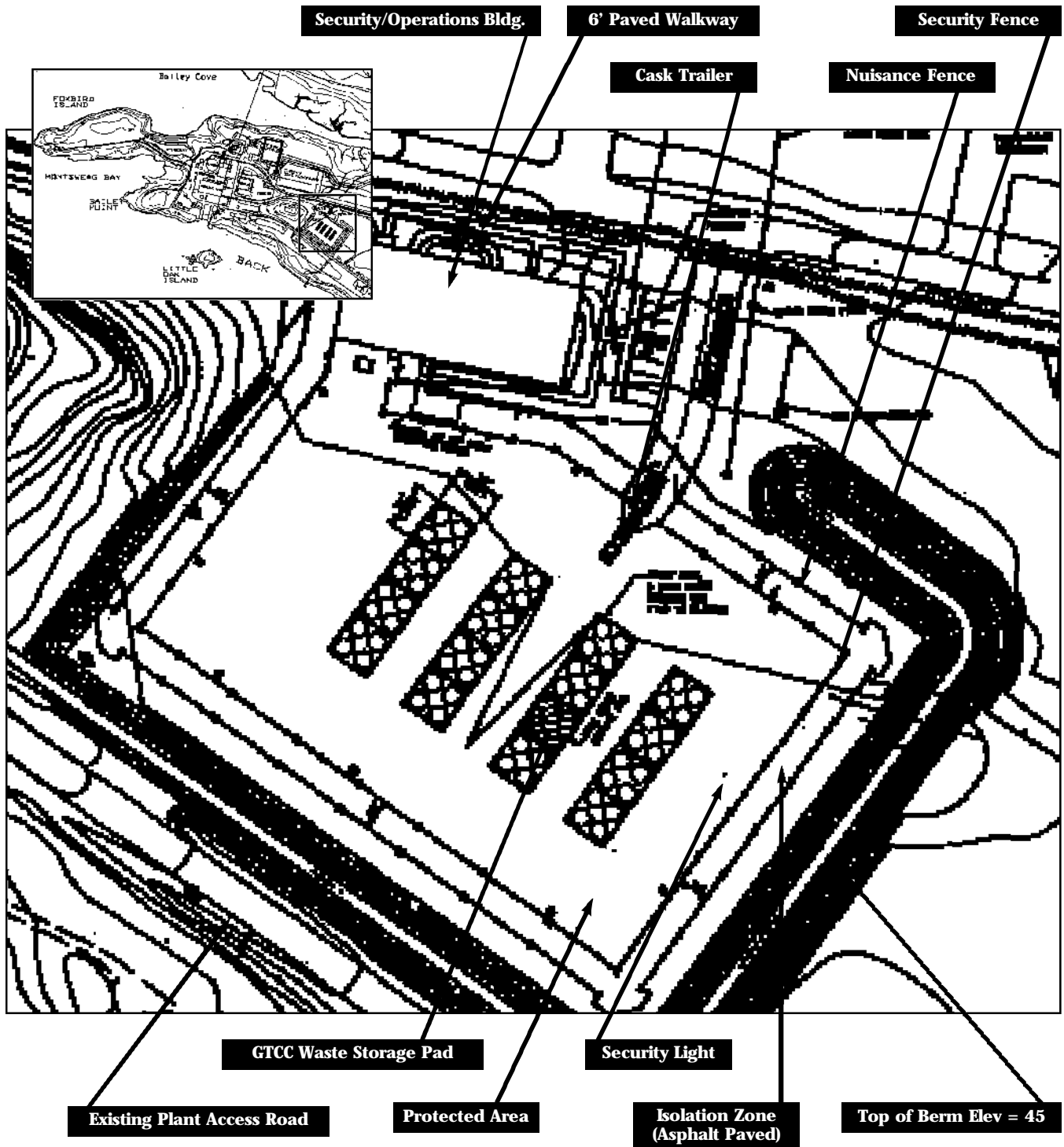
During the decommissioning process, which began in 1997, the Wiscasset board of selectmen recognized that the town was losing what had been by far its largest ad valorem taxpayer. Perhaps alarmed by this fact, the town engaged a lead attorney, who was highly respected in the region, to assist the town in determining a fair and acceptable ad valorem tax value for the remaining physical assets.

The Maine Yankee site included various real and personal properties that could be taxed, including the nuclear waste storage casks. Some of the 820 acres enjoyed terrific scenic views and water frontage. The most contentious taxation issue, however, was the value of the ISFSI site. The lead attorney explained to the town and local newspapers that land on which nuclear waste could be stored was extremely valuable. The town assessed the nine-acre ISFSI site at \$135 million, and Maine Yankee—then under decommissioning—appealed the assessments. The power company engaged independent counselors to assist the appeal, *Maine Yankee Atomic Power Company v. Town of Wiscasset and Board of Assessors for the Town of Wiscasset*, Docket

# Nuclear Waste Disposal: A Taxing Real Estate Issue

## ISFSI Site Plan

*Independent Spent Fuel Storage Installation  
Maine Yankee Atomic Power Co.*



## Nuclear Waste Disposal: A Taxing Real Estate Issue

No. 2004-003, State of Maine, Board of Property Tax Review. The case settled in the middle of the hearing.

### **GTCC WASTE STORAGE**

Since 1983, the DOE has charged a fee to nuclear power providers to establish a permanent repository for GTCC nuclear waste, which the DOE is developing at Nevada's Yucca Mountain. However, opponents have been able to prevent this facility from becoming operational. Critics in Nevada became increasingly vocal after the Sept. 11, 2001, terrorist attacks when Las Vegas hotel and casino owners suffered a sharp drop in vacation traffic.

Civic and tourism officials were concerned about customer reaction to even a minor radioactive leak that could occur within 100 miles of hotels and casinos. Concern about transporting and storing nuclear waste may further delay the timetable for implementing the storage at Yucca, or prevent it altogether. Litigation against the DOE has mounted because of the agency's inability to provide a permanent repository as it had promised, and as power generators have paid for.

Another 10 years or more could elapse before the DOE can begin storage at Yucca. At that time, an orderly process of shipping from various plants to Yucca could result in a further delay of 10 or more years before the DOE will take the waste from Maine Yankee. Hence, expectations are that the ISFSI will remain at Maine Yankee for at least 20 years.

### **NUCLEAR WASTE AT MAINE YANKEE**

From 1972 until 2002, spent fuel rods had been stored in a pool of heavy water called the spent fuel pool, housed in a building adjacent to the nuclear reactor. When a rod was spent, or exhausted, it was carefully moved from the reactor building to the spent fuel pool, where it was submerged in heavy water and placed on a rack in the pool.

By the early 1990s, when it became apparent that the DOE's plans for a permanent repository in Nevada could be stalled, Maine Yankee began studying alternate methods of spent fuel storage. Their efforts accelerated when the plant became slated for closure, and studies indicated that interim storage using an ISFSI at Maine Yankee would be the safest and cheapest storage method for high-level, or GTCC, nuclear waste.

Fewer than 25 ISFSIs exist in the United States, none in prominent locations. They provide interim dry storage of high-level nuclear waste at existing and decommissioned

nuclear plants. An ISFSI typically is in an open field and is smaller than a football field. Parallel rows of vertical concrete casks, or VCCs, stand on three-foot-thick concrete pads. Each concrete cask covers a sealed transportable storage cask, or TSC, filled with spent nuclear fuel, mostly in the form of rods.

At the center of Maine Yankee's nine-acre ISFSI site is a 124-foot-by-224-foot area enclosed on three sides by an earthen berm about 20 feet tall. The berm limits a ground-level view of the VCCs from outside and is joined to a metal building to form the fourth side. It encloses a chain-link fence about 12 feet tall, and a second eight-foot-tall chain-link fence is 20 feet inside the first fence. The fences form a protected area that keeps out stray animals but does not obscure the view of the VCCs from atop the berm or at ground level inside the berm. Within the inner fence are four rows of three-foot-thick concrete pads, each row with four 31-foot-by-31-foot sections, that support a total of 64 vertical concrete casks. Each concrete pad section holds four VCCs, allowing 16 VCCs in each row.

Maine Yankee's ISFSI is located less than 1,200 feet from the reactor site. The particular ISFSI site, which previously had been used as an overflow employee parking lot, was chosen for several reasons including:

- *Proximity to the reactor and spent fuel pool*—The site is less than a quarter mile from the spent fuel pool, with an existing road that connects the two to minimize transportation costs and the distance of hazardous materials shipments.
- *Existing building*—There already was a building at the site, furnished with telephone and electric connections. This building, which had been used as a staging area for materials and supplies, could easily be converted to serve as the security operations building for the ISFSI. Its dimensions are 68 feet by 154 feet by 48 feet tall—10,500 square feet.
- *Existing rail spur*—A railroad spur adjacent to the site could facilitate the eventual shipment of nuclear waste by rail or truck.
- *Absence of natural hazards*—The ISFSI site is not on a known hazard such as an earthquake fault, and the soil is stable.

# Nuclear Waste Disposal: A Taxing Real Estate Issue

An engineering report, prepared later as part of the property tax appeal, indicated at least eight other locations within the 820 acres of Maine Yankee's property could have been used as an ISFSI site.

## TSCs, VCCs AND TRANSPORTATION

Each of Maine Yankee's 64 VCCs encloses other parts, such as a nesting doll. Most VCCs are 17.5 feet tall, with a diameter of 11 feet 4 inches and 28-inch-thick walls. Each VCC encloses a TSC: a stainless steel tube approximately 15 feet long, 5 feet six inches in diameter, and five-eighths of an inch thick. Inside each TSC, which weighs approximately 15 tons, lies 24 spent nuclear fuel rods.

Between 2002 and 2004, specialists carefully removed spent fuel rods from wet storage in the spent fuel pool and inserted each into one of the 24 slots in a TSC. Then, they drained the TSCs of heavy water, welded the containers shut, checked for radioactive leaks and moved them about 1,200 feet to the ISFSI, where they were placed upright to be covered by the VCCs. The VCCs' 28-inch-thick concrete wall protects the TSCs against wind, rain, fire, an accidental plane crash or a potential terrorist attack.

Until the DOE provides permanent storage for GTCC waste and is ready to receive it, virtually all GTCC waste from nuclear plants will remain stored at the site where it was used. Ultimately, the VCCs will be lifted off, and the TSCs will be loaded onto vehicles headed to Yucca or another site for permanent storage. In the interim, nuclear storage remains at the ISFSI in Wiscasset.

## WISCASSET'S CASE

The town hired four parties as experts to work with the lead attorney:

- A local appraiser was engaged to appraise the 820 acres, but not the ISFSI site.
- An expert in nuclear power regulation would explain the history and present status of nuclear power generation and waste storage in the United States.
- An economist who held no specialized appraisal qualifications would offer a fair market value of the ISFSI site, principally using his interpretation of avoided cost and comparable sales.
- An expert on public utility ad valorem taxation, who became affiliated with a state-certified real estate appraiser, would later provide a value opinion.

The lead attorney focused on defining the highest and best use of the ISFSI site. The brief he prepared stated:

"The ISFSI parcel is similarly zoned industrial. This property is now committed by Maine Yankee to long-term storage of spent fuel in a dry cask storage system. This commitment follows exhaustive studies on the most economical means to store spent fuel waste pending receipt and permanent disposal by the U.S. Department of Energy. Maine Yankee has committed millions of dollars of land, improvements and personal property in the form of storage and transport casks, concrete silos, and associated facilities. Our analysis below indicates that the Maine Yankee property has certain characteristics that make it useable as a site for the storage of the Maine Yankee spent fuel waste, an activity with a very high rental value. Based on that analysis, it appears that storage of spent fuel waste is the highest and best use of the ISFSI site parcel as of April 1, 2003."

The town's economist stated that the nine-acre ISFSI site was being used for nuclear waste storage and was licensed by the Nuclear Regulatory Commission for that purpose. He stressed that few sites in the world are accorded the privilege of nuclear waste storage, and those that are legally eligible for such use have an extremely high value. Its value should be measured, he said, by certain comparables and avoided costs.

He provided a set of comparables to derive a land value, applying his concepts of avoided cost and comparable sales. None of these avoided costs or sales comparables had become a reality and was unlikely to ever become reality. The economist's comparable sales or avoided costs included:

- *Mescalero Apache Tribe in New Mexico*—Private Fuel Storage, a consortium of up to 33 nuclear power generating companies, reportedly had offered \$250 million to the Mescalero Apache Tribe in New Mexico to use of part of their reservation as an interim spent nuclear fuel storage. The Mescaleros turned down the offer. The town's economist contended that the Mescaleros' refusal to sell clearly indicated that the Native Americans' land—and by extension the ISFSI site at Maine Yankee as well—was worth more than \$250 million. He did not

## Nuclear Waste Disposal: A Taxing Real Estate Issue



**Maine Yankee's nuclear reactor—which at one time was Maine's largest electricity producer—was dismantled as part of the plant's decommissioning.**

scale the amount for size; that is, he did not allow for the huge difference between the amount of space required for the waste produced by Maine Yankee and required for the total waste of 33 atomic power companies. Nor did he consider other regulatory barriers to approval.

- *Skull Valley Band of Goshutes, Utah*—After the Mescalero Apache Tribe refused the \$250 million offer, the consortium approached the Goshutes in Utah. That transaction would have provided \$90 million to \$300 million worth of combined payments to the tribe and to Tooele County, Utah, but did not materialize.
- *Mdewakanton Dakota Tribe at Prairie Island, Minn.*—A nuclear plant operating in Prairie Island, Minn., was reportedly willing to pay as rental for nuclear storage an

annual amount having a present value of \$135 million. The payments were for the Mdewakanton Dakota Tribe and the Minnesota Renewable Energy Development Fund. Research conducted by independent counselors discovered that the Prairie Island plant had been threatened with closure if it did not arrange for this fuel storage and consequently was under compulsion in the transaction. The Native Americans would receive a small part of the total payment.

- *LIPA-PECO fuel core sale*—Upon disassembly of the Shoreham plant, owner Long Island Power Authority, or LIPA, had a partially used irradiated fuel core that had to be disposed of. LIPA paid \$46 million to Philadelphia Electric Co., or PECO, for its removal. PECO estimated the remaining fuel to be worth \$70 million. The economist concluded that LIPA essentially paid \$116 million—\$46 cash plus \$70 million worth of unused fuel—to remove its waste. The economist compared the amount of remaining fuel to Maine Yankee's storage needs. By extrapolation, he concluded that the \$116 million was the equivalent of a \$335 million value for Maine Yankee's needs. He did not explain the duress that Shoreham endured for the required disposal.
- *British National Fuels and COGEMA*—The economist also discussed shipping spent fuel to British National Fuels in the United Kingdom or COGEMA in France. He concluded that such a transaction would have a present value of \$220 million to Maine Yankee. He did not, however, acknowledge that the United States would not allow shipments of nuclear fuel to be reprocessed in foreign countries. Nor would Britain or France accept nuclear fuel as waste.

The economist concluded that "a reasonable estimate of the fair market value of the Maine Yankee site is approximately \$135,000,000."

### INDEPENDENT TAX ANALYSIS

The standard of value to be taxed was central to the analysis provided by Maine Yankee's independent counselors, who also needed to distinguish market value from value in use and fully explain the concept of highest and best use. To rebut the town economist's report, counselors had to provide clear and understandable explanations supported by theory and practice, and convey them using common sense. So the counselors needed to not only



## Nuclear Waste Disposal: A Taxing Real Estate Issue

support their theories and valuations, but also show where and how the economist deviated from accepted real estate methodology.

According to the Maine Constitution (Article IX, Section 8), just value is the appropriate standard of value to be taxed, and in the state of Maine just value is synonymous with market value. (See *Yusem v. Town of Raymond*, 769A. 2d 865, Me. 2001.) Thus, the market value of Maine Yankee's ISFSI site and ISFSI structure was the key issue to address.

The question was how much a willing buyer would pay, and how much a willing seller would accept, for this land and facility as of April 1, 2003. In this valuation analysis, a number of facts were particularly relevant:

- *Inability to store others facilities' wastes*—Maine Yankee's license to store spent nuclear fuel rods is limited to storing waste from its own nonoperational facility. The site cannot store nuclear waste from other sources.
- *Size*—The Maine Yankee ISFSI land and structure is built to meet Maine Yankee's nuclear waste storage needs only; its size is limited to the 64 casks and has no space available to accept any other waste.
- *Maine Yankee is permanently decommissioned*—Maine Yankee has no continued operations and will not generate any further nuclear waste.
- *ISFSI is a cost center, not a revenue producer*—Maine Yankee's ISFSI produces no goods or services that can be sold to generate income, and it generates no income.
- *There are no known potential buyers of the ISFSI or ISFSI site*—Market analysis also provides a basis for determining the highest and best use of a property. An existing or proposed improvement under a specified use may be put to the test of maximum productivity only after it has been demonstrated that an appropriate level of market support exists for that use.<sup>1</sup> Though a use might be permissible, that does not mean it is the highest and best use. Further, a willing buyer and seller are necessary to have a market value. Without an economic benefit to motivate potential buyers to pay Maine Yankee for the ISFSI site, there are no potential buyers.<sup>2</sup>



**These 64 vertical concrete casks at Maine Yankee's ISFSI enclose sealed transportable storage casks filled with spent nuclear fuel.**

In summary, the ISFSI site is similar to a landfill adjacent to a closed and demolished factory. Its capacity to store waste is fully dedicated to existing waste. It cannot generate income by accepting or storing waste produced by others, and it does not facilitate the generation of any future income.

### COMPETITIVE CHALLENGE

The town's attorney and economist presented what the counselors believed was a competitive challenge. Despite the counselors' professional distinction, the town's attorney and economist seemed to have certain advantages such as:

- A level of trust and local familiarity in the New England area, which could give the impression that the town's witness were more knowledgeable than hired, out-of-state expert witnesses.
- A feeling that government has greater credibility than private industry.
- An absence of state licensing constraints over economists.

Counselors were fortunate that members of the board of tax appeals who heard the case could ask questions and hold open discussions to arrive at a reasonably informed decision. By contrast, if a local panel without expertise in real estate had heard the case, the outcome could have been subject to greater uncertainty.

Entities involved with complex litigation often cling to their positions without acknowledging any validity in their opponent's position. By listening to the opinions

# Nuclear Waste Disposal: A Taxing Real Estate Issue

of objective and independent counselors, reconciliation can occur.

When CREs serve as expert witnesses, they are not client advocates. Instead, they are experts in the litigation matters at hand and can apply their expertise by performing thorough research—including examining and applying the definitions of value provided in the law—and explaining their findings. CREs also can offer critiques of other experts' reports and opinions. This service can improve understanding of the opponent's position, which could help the parties reach a settlement; or explain complicated matters to courts, so they can make better-informed decisions.

## OUTCOME

Maine Yankee and the town of Wiscasset reached a reasonable settlement during a hearing of the board of tax appeals. The land was not credited with extraordinary valuation and, instead, was taxed as ordinary industrial land; the improvements were taxed on original cost less depreciation over time. Though this compromise may seem acceptable to some, one could argue that the improvements have no value in exchange and, therefore, should not be taxed at all.

CREs with cases involving a so-called battle of experts should strive to have tribunals with expertise in the matter hear the cases. This process would potentially reduce dependence on clever presentations and emotions, and increase the importance of appropriate methodology and research. This situation places a burden on CREs to provide the highest level of research, expertise and ethics. ■

1 *The Appraisal of Real Estate, 12th Edition* (Chicago: Appraisal Institute, 2001).

2 The only theoretical, and speculative, buyer would be one who thought it could operate and maintain the ISFSI for less than Maine Yankee's cost. The ISFSI comes with an operating and maintenance liability of approximately \$6.8 million per year in 2003 dollars, estimated through 2023. This liability has been prefunded in Maine Yankee's decommissioning fund or will be by 2008. The only possible bidders would be ones who would purchase the ISFSI and the fund and expect to operate the site with the ISFSI for less than the fund amount and to retain the savings. That, however, would be the purchase of an intangible—the fund, which is not subject to property tax. And there is no indication that someone could operate and maintain the ISFSI for less than Maine Yankee, so even under this scenario there is no purchaser or market value for the ISFSI site or improvements.

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# Evaluating Tenant-In-Common Interests in Real Estate

BY ALEXIS AIKEN, J.D.

ONE OF THE MOST COMMON CONCERNS U.S. INVESTORS AND their professional advisors face when structuring tax-deferred exchange transactions is the difficulty in locating, identifying and acquiring like-kind replacement properties within the unforgiving tax-deferred exchange deadlines. Because many investors wait until the closing of their property sale to start the search for properties, the tax-deferred exchange deadlines already are imminent. Investors are under the gun, and are forced to rush the search for suitable properties and shorten the due-diligence period.

Section 1031 of the Internal Revenue Code places strict time constrictions and rules on designating like-kind replacement properties. Investors typically designate no more than three replacement properties—given the difficulty making a proper identification under the rules—and because of the time limit, they typically evaluate only local or regional properties of the same asset class. Though this manner of identification could meet investors' goals, replacement properties chosen in haste are likely to have the same problems or conditions that originally motivated the investor to sell the relinquished property—inflated sales prices, poor cash flow or intensive property management requirements, for example. Often, investors ultimately face a tough choice: purchasing less-than-ideal properties to complete the tax-deferred exchange or letting the exchange fail and continuing the search for replacement properties that make sense outside 180-calendar-day deadline.

The second practical problem that arises with designating like-kind replacement properties relates to investors' ability to negotiate and close on properties they identify within the 180-calendar-day exchange period. Even where the identification process has been relatively simple—where the investors have no trouble finding properties that make economic sense within the 45-calendar-day identification period—there is no guarantee that the investors will be able to close on the properties in the time remaining.

Real estate transactions fail to close for many reasons: problems discovered during the property inspection, defects in structure, tenant issues, environmental problems and difficult third parties, to name just a few. Though these problems are difficult to redress in the context of a normal real estate closing, they can prove disastrous in the tight time frame of a tax-deferred exchange. Investors who fail to take specific steps to remediate risks to closing their identified properties

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could find themselves in a position where they are unable to close on the property within 180 days and unable to identify any other properties because the 45-day identification period has passed. Their tax-deferred exchange transaction then would be doomed to fail.

To avoid this scenario, investors must reorient themselves to think of identifying replacement properties as a strategic process. Rather than submitting their identification based on a preliminary assessment of potential properties, investors should identify only properties for which they have considered whether they can conduct due diligence in a timely manner, whether the property makes economic sense and whether the transaction has any inherent risks that might prevent closing within the deadline.

These considerations mean investors should start doing due diligence on potential properties very early in the exchange period. Accordingly, investor would have the additional benefit of being able to begin trying to acquire one or more replacement properties during the first 45 days, allowing them to revoke the identification and re-identify additional properties if a contingency were to occur.

### **LACK OF SUITABLE PROPERTIES LEADS TO TIC INTERESTS**

Pursuing a tax-deferred exchange and using a strategic process for identifying replacement property does make one large assumption: that properties meeting investors' particular needs are, in fact, available. However, it is not uncommon for properties on the market to pose a risk to investors in one capacity or another, or to simply not be economically feasible.

In response to this lack of suitable replacement properties, for tax-deferred exchanges and real estate investors in general, an industry has sprung up to develop and offer syndicated property interests as alternative investment vehicles. These fractional ownership arrangements have names such as co-ownership in real estate, or CORE—or more commonly, tenant-in-common, or TIC—interests. Investors should carefully consider and evaluate the merits

of these opportunities instead of rushing into an acquisition that does not ultimately make economic sense.

TIC interests in real estate were introduced when real estate entrepreneurs who understood the advantages of owning syndicated property interests in the form of

*Simply stated, TIC interests allow investors to acquire, together with other investors, a percentage or fractional interest of a larger, institutional-quality property that is potentially more stable, secure and profitable than what they otherwise could have acquired alone within the exchange deadlines.*

triple-net-leased properties recognized that the size of the properties and the liquidity required to get into triple-net-leased property precluded most investors from participating. So they set out to develop a way to make these interests more marketable. These entrepreneurs began individually arranging financing for and purchasing large properties with triple-net leases to large, credit-worthy tenants and dividing the properties into smaller deeded units, referred to as tenant-in-common interests. These smaller deeded interests are then available for direct purchase to investors through private placement offerings and, since the issuance of revenue procedure 2002-22 in 2002, have been expressly declared valid as like-kind replacement properties for investors in tax-deferred exchange transactions.

TIC properties—because of how they are packaged, distributed and sold—can provide an alternative to investors struggling with tax-deferred exchange timing requirements. Simply stated, TIC interests allow investors to acquire, together with other investors, a percentage or fractional interest of a larger, institutional-quality property that is potentially more stable, secure and profitable than what they otherwise could have acquired alone within the exchange deadlines.

The interests are, in essence, prepackaged investment properties; the purchase/sale agreement and financing already is negotiated and set in place. In addition, investors can

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acquire TIC ownership interests in a number of different properties to improve diversification and investment portfolio quality. TIC interests also allow investors to purchase an interest or value in the exact amount necessary to satisfy tax-deferred exchange requirements.

Investors can work with professionals in the syndicated TIC investment arena to ascertain which opportunities are suitable for them. Syndicators, or TIC sponsors, are responsible for locating, evaluating, financing and acquiring TIC properties. Once arrangements to acquire or actual acquisition of the property occurs, the property is ready to take to market. From that point, TIC brokers market the TIC interests in the same manner as other regulated securities. TIC brokers, who typically work with numerous TIC sponsors, can help investors evaluate various investment options and offer advice as to whether a TIC ownership interest is right for a given portfolio.

### **TIC STRUCTURES TYPICALLY COMPLY WITH FEDERAL REGULATIONS**

Putting together a syndicated TIC offering begins with a sponsor, usually a large real estate investment company, using their commercial contacts across the United States to identify properties likely to have good cash-flow potential and that are priced under market value. After identifying a property, the TIC sponsor's acquisition team begins the due diligence process, verifying the representations and projections and justifying the initial assessment of the property's value. When the acquisition team is satisfied that the project is a good acquisition, the sponsor then purchases the property, arranging the purchase/sale agreement and the financing of the property through an institutional lender.

The syndication of the property into TIC investments begins at this point. The sponsor announces the property's availability to a network of brokers who, in turn, analyze the investment to determine whether it's appropriate for their clients. TIC investments that could be characterized as a security under the Securities Act of 1933 and the Securities Exchange Act of 1934 come to market as what are called Regulation D offerings. This procedure allows an exemption to the registration requirements of the Securities Act of 1933, but also means that only people who meet the accredited

investors standard as defined by securities regulations are eligible to invest.

When a prospective investor expresses interest in buying into a particular TIC property, either as a direct purchase or as part of a 1031 tax-deferred exchange, the broker sits down with the investor and his real estate professionals and goes through the private placement memorandum, or PPM, which contains all the information rendered from the sponsor's due diligence process and all disclosures related to the property. The broker and investor decide whether the investment is suitable and, if so, the broker calculates the percentage of the property the investor's purchase money or equity will buy. The investor then acquires that percentage of the property and debt, as outlined in the sponsor's offering.

One of the additional restrictions placed on the sale of many securitized TIC investments by their structure as Regulation D offerings is that the structure brings U.S. Securities and Exchange Commission rules 505 and 506 and 506 into play, which create a prohibition on general solicitation. This restriction is no doubt the most frustrating consequence for many brokers because it prevents them and any person acting on their behalf from announcing the TIC interests in a general solicitation or general advertisement, which includes discussing names and details of specific offerings in publications or at seminars where attendees are invited by general solicitation or advertisement.

A critical factor for determining whether a communication is appropriately limited, so as not to be deemed a general solicitation, is the existence of a substantial pre-existing relationship between the broker and a potential TIC investor. When a broker can substantiate an adequate pre-existing relationship, it is presumed that he will be able to evaluate the investor's level of sophistication and financial circumstances, and make an informed recommendation about whether a TIC investment would be appropriate.

Though Regulation D offerings permit up to 35 investors in any single TIC property transaction, the number of offerings in a particular TIC interest frequently is smaller because the TIC sponsor or lender may want to minimize the number of investors in a particular property to simplify management. In reality, the final decision about the

## Evaluating Tenant-In-Common Interests in Real Estate

number of investors suitable for a particular investment lies with the lender.

### **USE STRATEGY WHEN REVIEWING TIC AGREEMENTS**

Individual investors—whatever number have purchased an interest in the particular TIC property—execute and are governed by a Tenant-In-Common Agreement, which enumerates the conditions and management requirements of the TIC property, and the rights and obligations of each individual investor. It is crucial that investors understand the TIC agreement, and can differentiate between what are standard requirements in TIC agreements and what are extraordinary provisions that may later prove problematic.

#### *Special-Purpose, Single-Member Limited Liability Company*

Individual investors are required to acquire TIC interests through designated special-purpose entities. These SPEs usually are single-member limited-liability companies, which for tax purposes are disregarded entities. The purpose of maintaining each interest in these special purpose entities is to protect investors from liability that might arise from the conduct of other tenants-in-common or the property itself, and to protect individual TIC investors from each other with regard to bankruptcy filings or other legal issues.

#### *Non-Recourse Debt*

In typical TIC investments, the sponsor prearranges financing that is non-recourse to individual investors—a tremendous advantage that TIC properties provide because investors who may experience difficulties qualifying for debt because of earned-income levels can arrange financing that otherwise would be unfeasible. Under the typical financing of TIC properties, investors are liable only for the amount of their investment. In the event of a default on the loan, the lender cannot attach investors' personal assets or other investment properties to satisfy the debt obligation.

#### *Loan Provisions*

TIC properties commonly contain carve-outs, referred to as bad-boy provisions, as a means for lenders to protect themselves from the intentional misbehavior of TIC co-owners. Lenders usually draft these restrictions in the loan documentation and commonly include provisions such as prohibitions on the sale of co-owners' special-purpose entities to other investors without lender approval.

The restrictions stipulate that any misbehavior on the part of a co-tenant that falls into the bad-boy provisions will result in the debt generated by the behavior being recharacterized as recourse to the offending co-tenant.

#### *Professional Property Management*

One of the primary advantages of TIC interests is the significant decrease in active property management responsibilities. When syndicating TIC properties, sponsors use professional in-house property management operations or retain nationally recognized professional commercial property management firms.

#### *Discounts for Estate Tax Purposes*

TIC ownership interests are fractional interests and, as such, are not considered liquid investments. The marketability of TIC interests depends significantly on the performance of the subject properties, current market demand and conditions, the characteristics of the particular interests and whether other co-tenants are interested in acquiring them. The only benefit to the lack of liquidity is that when TIC interests comprise part of a decedent's estate, investors can heavily discount the investment to account for restrained marketability.

The ability to apply this fractional discount to TIC interests presents a potential investment and estate-planning strategy for investors who cannot completely shelter various properties under the maximum trust exclusion amounts. By liquidating some or all of their solely owned property interests, using a tax-deferred 1031 exchange and re-investing equity in fractional property, investors can keep either equity invested and generating income and appreciation until death, but simultaneously give their estates the ability to discount the value of fractional property interests, potentially preventing the application of estate tax to equity that otherwise may have fallen outside the applicable exclusion.

#### *Revenue Procedure 2002-22*

Early investors showed some hesitation before investing in syndicated TIC interests because the tax implications of the investment were unclear; there was a risk that upon auditing the transactions, the U.S. Internal Revenue Service could recharacterize the investment as a partnership interest and, thus, not a qualified-use property eligible for tax-deferral under section 1031. In

# Evaluating Tenant-In-Common Interests in Real Estate

response, the U.S. Department of the Treasury in March 2002 issued revenue procedure 2002-22 to establish guidelines under which the IRS will consider issuing a private-letter ruling on TIC ownership interests acquired as replacement properties within an investor's tax-deferred exchange transaction.

Though revenue procedure 2002-22 does address the specific concerns that arise with syndicated TIC properties, the procedure's guidelines are not specifically limited to TIC investments. It also applies to nonsyndicated TIC interests, such as a single piece of property titled to two investors as tenants-in-common and, arguably, may have more effect in that area because it is much less obvious in that context which particular projects may fall within its scope.

It is also important to note that the guidelines provided by revenue procedure 2002-22 do not offer a safe harbor or guaranteed structure for TIC ownership interests; all the guidelines purport to do is provide guidance about characteristics and factors the IRS will use to determine whether investments constitute true co-tenancy arrangements and, thus, qualify as tax-deferred exchanges.

## *Issues Involved in TIC Investments*

Though revenue procedure 2002-22 established some mainstay components of typical TIC investments, the structure offerings can vary widely. Differences can include terms indicating whether the sponsor might be compensated for later sale of the investment, who will manage the property, whether sponsors retain the ability to refinance properties and other terms. Investors need to know that these differences, in addition to affecting how much control each individual TIC owner retains over certain aspects of the investment, could pose an additional risk that the entity could be recharacterized as a partnership for tax purposes and, thus, jeopardize investors' exchange and tax planning.

## **15 GUIDELINES FOR TIC PROPERTIES AND SPONSORS**

Pursuant to revenue procedure 2002-22, the IRS will consider issuing private-letter rulings to interested parties if the following 15 conditions are met or present in proposed TIC transactions.

1. *TIC ownership*—Each co-owner must hold title to the property, either directly or through a disregarded entity, as tenants-in-common under local law. A single entity as recognized under local law may not hold the title to the property as a whole.
2. *Number of co-owners*—The number of co-owners or investors is limited to 35 people as defined by IRC 7701(a)(1); husband and wife and all persons who acquire interests from co-owners by inheritance are treated as a single person.
3. *No treatment of co-ownership as an entity*—Co-owners may not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying any or all of the co-owners as partners, shareholders or members of a business entity, or otherwise hold itself as a partnership or other form of business entity. Individual co-owners may not hold themselves as partners, shareholders or members of a business entity.
4. *Co-ownership agreement*—Co-owners may enter into a limited co-ownership agreement that runs with the land. Such agreements may require co-owners to offer their interests for sale to other co-owners, sponsors or lessees at fair market value—determined at the time of the offering—before exercising any right to partition (see section 6.06 of revenue procedure 2002-22 for conditions relating to restrictions on alienation). The agreement also could require co-owners holding more than 50 percent of the undivided interests in the property to vote on and approve certain actions taken on behalf of the co-ownership (see section 6.05 of revenue procedure 2002-22 for conditions relating to voting).
5. *Voting*—Co-owners must retain the right to approve the hiring of managers, the sale or other disposition of the property, any leases of a portion or all of the property, or the creation or modification of a blanket lien. Co-owners must unanimously approve any sale, lease or release of a portion or all of the property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of managers or the negotiation of management contracts (or any extension or renewal of such contracts). Co-owners can agree that a vote of those holding more than 50 percent of the

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undivided interests in the property can be binding for all other actions taken on behalf of the co-ownership. Co-owners who consent to actions as outlined in section 6.05 can provide managers or other persons with power of attorney to execute specific documents with respect to those actions, but may not provide managers or other persons with an unlimited power of attorney.

6. *Restrictions on alienation*—Co-owners must have the right to transfer, partition and encumber their own undivided interests in the property without the agreement or approval of any person. Restrictions on the right to transfer, partition or encumber interests—if required by a lender and consistent with customary commercial lending practices—are allowed (see section 6.14 for lender restrictions). Moreover, co-owners, sponsors or lessees may demand the right of first offer—or the first opportunity to offer to purchase co-ownership interests—before any co-owner can exercise the right to transfer his interest in the property. In addition, co-owners can agree to offer co-ownership interests for sale to other co-owners, sponsors or lessees at fair market value before exercising any right to partition.
7. *Sharing proceeds and liabilities upon sale of property*—If the property is sold, any debt secured by a blanket lien must be satisfied and remaining sales proceeds must be distributed among co-owners.
8. *Proportionate sharing of profits and losses*—Co-owners must share in all revenues and costs associated with the property in proportion with their undivided interest in the property. Co-owners, sponsors or property managers are forbidden to advance funds to a co-owner to meet expenses associated with the co-ownership interest, unless the advance is recourse to the co-owner—and, where the co-owner is a disregarded entity, the underlying member of the co-owned interest—and is for a period not to exceed 31 days.
9. *Proportionate sharing of debt*—If the property secures a blanket lien, co-owners must share in the indebtedness in proportion to their undivided interests.
10. *Options*—Co-owners may issue options to purchase their undivided interests, referred to as call options, if the exercise price for call options reflects the fair market value. The fair market value of an undivided interest is equal to the co-owner's percentage interest in the property multiplied by the fair market value of the property as a whole. Co-owners may not acquire options to sell undivided interests, called put options, to sponsors, lessees, lenders, other co-owners or any person related to any of the parties.
11. *No business activities*—Co-owners must limit activities to those customarily performed in connection with the maintenance and repair of rental real property, which the IRS calls customary activities.<sup>1</sup> Activities are customary if the amount an organization receives qualifies as rent (see regulations 511(a)(2), 512(b)(3)(A) and associated regulations). To determine what constitutes co-owner activities, the IRS reviews all activities of co-owners, their agents and any persons related to co-owners with respect to the property, regardless of the capacity in which the activities are performed. For example, if the sponsor or a lessee is a co-owner, the IRS will review all property-related activities of the sponsor or lessee—or any person related to the sponsor or lessee—to determine whether the activities are customary. However, the IRS will not review a co-owner or related person's property-related activities, other than in the co-owner's capacity as a co-owner, if the co-owner owns an undivided interest in the property for less than six months.
12. *Management and brokerage agreements*—Co-owners and agents may enter into management or brokerage agreements, which must be renewable at least annually. Agents can be sponsors or co-owners, or any person related to sponsors or co-owners, but not lessees. Management agreements can authorize managers to maintain common bank accounts for the collection and deposit of rents and to offset expenses against any revenues before distributing net revenues among co-owners. Managers must disburse co-owners' shares of net revenues within three months irrespective of circumstances. Further, agreements can authorize managers to prepare revenue and cost statements, obtain or modify property insurance and negotiate modifications of the terms of any lease or any indebtedness encumbering the property, subject to the approval of co-owners (see section 6.05 for conditions on lease and debt modification approvals). Fees that co-owners



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pay to managers cannot depend in whole or part on the income or profits derived by any person from the property, and cannot exceed the fair market value of managers' services. Any fee co-owners pay to brokers must be comparable to fees that unrelated parties pay brokers for similar services.

13. *Leasing agreements*—All leasing arrangements must be bona fide leases for federal tax purposes. Rents paid by lessees must reflect the fair market value for the use of the property and may not depend, in whole or part, on income or profits from the leased property—other than an amount based on a fixed percentage or percentages of receipts or sales (see section 856(d)(2)(A)). Thus, rent cannot be based on a percentage of net income from the property, cash flow, increases in equity or similar arrangements.
14. *Loan agreements*—Lenders involved with debt that encumbers the property or is incurred to acquire undivided interests in the property cannot be related to any co-owner, sponsor, manager or lessee.
15. *Payments to sponsor*—Except as otherwise provided, the amount of any payment to a sponsor for the acquisition of the co-ownership interest—and the amount of any fees paid to a sponsor for services—must reflect the fair market value of the acquired co-ownership interest and cannot depend, in whole or part, on the income or profits from the property.

### **TICS SPUR DEBATE ABOUT REGULATORY AND SECURITY REQUIREMENTS**

Despite the issuance of revenue procedure 2002-22, the structure and sale of TIC interests continues to elicit professional debate. Much of the current discussion focuses on whether TIC interests in real estate constitute investment contracts as defined by the 1933 and 1934 securities acts, and the ramifications that classification would have on TIC investments and other ancillary fields of law.

To understand the expansive nature of what qualifies as securities under the 1933 and 1934 securities acts, and how TIC investments may be classified as securities, one must understand the need that the U.S. Congress intended to address with the legislation. The securities acts were designed “to prevent further exploitation of the public by the sale of unsound, fraudulent and worthless securities

through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion.”<sup>2</sup> Because the primary aim of the legislation is consumer protection, courts have interpreted the acts liberally to retain the flexibility necessary to address new and novel investment opportunities that pose risks to consumers and investors. Accordingly, the definition of a security must “embody a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.”<sup>3</sup>

The case that defines a security according to the Securities Act of 1933 is *Securities and Exchange Commission v. Howey*, 328 U.S. 293 (1946). In *Howey*, the court defined an investment contract as “a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or a third party, it being immaterial whether shares in the enterprise are evidenced by a certificate or by nominal interests in physical assets employed in the enterprise.”

The court also held that the determination of whether an investment complies with Securities Act of 1933 regulations, the form of the economic reality of the transaction should be disregarded—an action that widens the definition to encompass potentially any situation where individuals elect to invest money in a common enterprise where profit is derived solely through the effort of a third party, rather than investors' own knowledge and capacity to manage the investment. “Congress' purpose in enacting the securities laws was to regulate ‘investments,’ in whatever form they are made and by whatever name they are called.”<sup>4</sup> To that end, the court enacted a broad definition of security, sufficient “to encompass virtually any instrument that might be sold as an investment.”<sup>5</sup>

### **CASE LAW PROVIDES GUIDELINES FOR TIC INVESTMENTS**

Because existing legal precedent supports a broad definition of the idea of investment contracts and because interests sold as TIC investments may, in fact, qualify as a type of investment under current common-law understanding,

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identifying whether particular TIC interests may be classified as securities depends predominantly on whether the investment itself is structured so that investors derive their profit from the efforts of others.

In *Securities and Exchange Commission v. Glen Turner Enterprises Inc.*, the 9th U.S. Circuit Court of Appeals ruled that for an investment to not “rely on the efforts of others” and, hence, avoid characterization as a security, investors themselves must be responsible for making key managerial decisions. “Within the definition of ‘investment contracts,’ which are ‘securities’ within the federal securities laws as schemes which involve an investment of money in a common enterprise with profits to come solely from the efforts of others, word ‘solely’ should not be strictly construed; rather the test is whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.”<sup>6</sup>

In *Williamson v. Tucker*, the 5th U.S. Circuit Court of Appeals held that investors who retain control over the respective investment have not purchased interests in a common venture “premised on the reasonable expectation of profits to be derived from the entrepreneurial and managerial efforts of others.” An investment contract exists even if investors have outsourced day-to-day management of the property to an outside vendor.<sup>7</sup> Under *Williamson*, the key in determining reliance on the efforts of others is dependence.

The *Williamson* court established a three-part test to determine investors’ dependence on third-party efforts. Investments that meet any of the following criteria may be characterized as a security:

- An agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement distributes power as would a limited partnership.
- The partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers.
- The partner or venturer is so dependent on some unique entrepreneurial or management ability of the promoter or manager that he cannot replace the man-

ager of the enterprise or otherwise exercise meaningful partnership or venture powers.

In all three scenarios, investors have little or no control over the investment, and the profitability or success of the investment relies on the efforts of a third party. Hence, it may be classified and regulated as a security under the securities acts.

The *Williamson* ruling clarifies that in determining whether a particular TIC interest constitutes a security interest, analysis must consider the actions of the sponsoring entity and the co-investors in each individual project. If the sponsoring entity proclaims extraordinary expertise or capacity at managing TIC offerings, or requires investors to use management companies the sponsoring entity is related to or has a pre-existing relationship with, the sponsor likely is violating the third prong under *Williamson* and co-tenants likely are relying on the efforts of others. Alternatively, where co-tenants are so inexperienced and unknowledgeable in business affairs that they may be deemed incapable of intelligently exercising their rights under the project’s operating agreement, or co-tenants are so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that they cannot replace the manager of the enterprise or otherwise meaningfully exercise the rights reserved to them under the operating agreement, then again the profitability of the investment relies on the management of a third party, and may be classified as a security.

In addition to elucidating what characteristics are necessary for an investment to be deemed a security, *Howey* and *Williamson* explain circumstances when a TIC investment is not a security. If the sponsoring entity structures a TIC offering so that the operating agreement provides co-tenants with sufficient legal powers to actively participate in the management of the investment, and co-tenants are sophisticated investors capable of understanding the nature of the investment and exercising the rights reserved to them in the investment documents, the sponsor of the project can argue that TIC investors are relying solely on their own expertise to render the project profitable. Thus, the investment contract does not rely on the efforts of others for securities law purposes.

An even stronger case occurs when the sponsor does not participate in the TIC investment after the initial offering

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to investors. In that situation, co-tenants must actively participate in all decisions underlying the management of the investment, and will individually be responsible for the ultimate success and profitability of the investment—clearly not relying on the efforts of others.

### **NATIONAL ASSOCIATION OF SECURITIES DEALERS OFFERS AN OPINION**

In March 2005, the National Association of Securities Dealers, or NASD, issued a notice to members titled “Private Placements of Tenants-in-Common Interests” that addresses the consequences of classifying TIC interests sold as securities. The notice explains that when viewed in the light of securities laws and NASD rules, investments sold as TIC investments do qualify as investment contracts for securities law purposes and, therefore, must be sold pursuant to securities regulations.

The NASD’s rationale is that when TICs are offered and sold together with other arrangements, including the prepackaged financing and contract for third-party management of the investment, the passive nature and third-party reliance are sufficient to classify the interests as investment contracts, despite the fact that investors are purchasing into real estate and receiving a fractional interest in the underlying property. From the NASD’s perspective, TIC investments typically involve the tenants-in-common investing in an undivided fractional interest in the rental real property by pooling their assets and sharing in the risks and benefits of the enterprise. The objective of the investment is sharing in the profits derived predominantly from third party leasing, management and operation of the acquired property as well as the sponsoring company’s negotiation of the sale price and the loan.

Opponents to the NASD’s characterization point to the fact that investors in a particular TIC program might have authority to terminate a management contract, or maintain or repair the property. But because operating agreements typically do not assign primary responsibility for these activities to tenants-in-common, evidence is lacking that the TIC interests are not investment contracts as defined in securities laws.

The classification of TIC interests as investment contracts gives rise to uncertainty about how these interests should be treated in other areas of law, particularly tax-deferral provisions. If TIC investments are truly investment con-

tracts, section 1031 might not apply to transactions where investors want to reinvest in a TIC property. Section 1031 specifically excludes any exchange of investment property for “interests in a partnership,” “stocks, bonds, notes” or “other securities.”

Thankfully for investors, brokers and sponsors, though federal securities law definitions are applicable in determining whether TIC investments may be characterized as securities, that characterization does not mean that the same TIC will be treated as a security under federal tax law. This means that the NASD and SEC may declare TIC interests to be investment contracts under securities laws without inherently disqualifying them from being considered real property under tax law.

For most investors’ purposes, this dual characterization is the best of both worlds. Because many TIC interests do fall under securities laws, consumer protection mechanisms such as NASD general sales conduct obligations apply to the sale of TIC interests; at the same time, that characterization does not prevent them from being treated as real property for the sake of federal tax law and tax-deferral mechanisms such as section 1031.

### **THE SECURITIES DEBATE RAGES ON**

Despite the NASD’s position, the issue of whether TIC interests constitute securities under the Securities Act of 1933 is far from settled. As the number of TIC projects available steadily increases and the structures that TIC sponsors use begin to differ, it is fair to say that some offerings are beginning to blur the line between securities and real estate. Individual investors must carefully evaluate offerings before investing, and consult with legal, tax and financial advisors to determine whether a particular investment is in compliance with securities laws; or if offered as a real estate investment, that its structure falls outside the guidelines established in *Howey* and *Williamson*.

Given the varied nature of tenants-in-common offerings, brokers’ required due diligence varies from investment to investment. At a minimum, brokers should:

- Ensure the private placement memorandum does not contain any false or misleading information.
- Conduct a preliminary background check on the sponsoring entity and its principals.

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- Review all investment agreements including the purchase and sales agreement, financing agreements, property management agreement and lease agreements.

Real estate professionals should be aware that reviewing lease agreements is crucial in TIC investments. Not all agreements associated with TIC offerings are drafted with due care from a tax perspective, and it is not uncommon for offerings to include language that might not be problematic from an investment perspective, but could be deleterious from a tax perspective. Examples of problematic inclusions can include an option exercisable by some party other than the investor, or provisions for a master lease agreement with a real estate investment trust or its operating partnership or a transaction mandated after the acquisition of the TIC interest. These inclusions could prompt the IRS or state Franchise Tax Board to view the agreement as vitiating investors' intent to hold the TIC interests, and disqualify the investors' tax-deferred exchange.

One of the most intensely debated subjects related to the sale of TIC interests is brokers' and sponsors' ability to pay referral fees to third parties for business they refer. If TIC interests qualify as investment contracts under securities laws, such fees are not permissible under NASD rule 2420, which prohibits payment of commissions and fees to entities that operate as unregistered broker-dealers. Section 3(a)(4)(A) of the Securities Act of 1934 defines a broker as a person "engaged in the business of effecting transactions in securities for the account of others," which means that the SEC may be able to characterize payment of a referral fee from a broker-dealer to a real estate agent in connection with the sale of a TIC interest to be the type of activity that would render the real estate agent an unregistered broker-dealer.

As the situation stands now, broker-dealers who consider TIC interests to be investment contracts under securities laws cannot pay real estate agents who are not registered as broker-dealers for referring clients who subsequently purchase TIC interests. Further, broker-dealers cannot evade NASD rule 2420 restrictions through indirect compensation such as reducing normal commissions on TIC investments and requiring the investors to pay the difference to the real estate agent for referring the business to the broker-dealer.

The inability to pay a referral fee to real estate agents often prompts them to view TIC interests as competition to their

business and makes them hesitant to refer clients to TIC investments even when they meet investors' objectives. The competition with traditional real estate has to some degree hampered the growth the TIC industry, and is an issue the industry's professional organization is lobbying the SEC to address. However, the restriction preventing referral fee payments is related solely to securities regulations; sponsoring companies may be allowed to pay real estate professionals referral fees in TIC offerings structured so the investment is not a nonconventional investment under securities laws.

### EXPECT TO SEE A SURGE IN TIC INVESTMENTS

Despite some uncertainty related to the structure of TIC projects and the evaluation of law regulating the sale of these investments, it is fair to say the field has not yet seen the peak of its growth. After revenue procedure 2002-22 provided the prerequisite assurance that TIC investments are valid replacement property options for tax-deferred like-kind exchanges under section 1031, the market saw a surge in growth.

Investors are taking advantage of TIC investments' prepackaged nature to reduce the anxiety inherent in the tax-deferred exchange deadlines and acquire a percentage or fractional interest of a larger, institutional-quality property that is potentially more stable, secure and profitable than a previously held property. The next wave of growth could very well be driven by future legislation and by educating real estate professionals about the nature and utility of TIC investments. ■

1 Revenue Ruling 75-374, 1975-2 C.B. 261.

2 Senate Committee on Banking and Currency, S.Rep. No. 47, 73d Cong., 1st Sess. 1 (1933).

3 *Securities and Exchange Commission v. Howey*, 328 U.S. 293, 299 (1946).

4 *Reves v. Ernst & Young*, 494 U.S. 56 (1990).

5 *Securities and Exchange Commission v. Edwards*, 540 U.S. 389, 896 (2004).

6 *Securities and Exchange Commission v. Glenn W. Turner Enterprises Inc.*, 474 F.2d 476 (9 Cir. 1973) citing the Securities Act of 1933, section 2(1), 15 U.S.C.A. section 77b(1); Securities Exchange Act of 1934, section 3(a)(10), 15 U.S.C.A. section 78c(a)(10).

7 *Williamson v. Tucker*, 645 F.2d 404 (1981).

# Real Property Damages and Rubber Rulers

BY ALBERT R. WILSON

DURING THE PAST TWO DECADES, MANY ARTICLES AND COURT cases have involved alleged diminution and damages to the value of real property resulting from a disamenity that influences a geographic area of values. “Alleged” is the key word because highly suspect analytical techniques frequently are the basis of the argument that a given disamenity results in a diminution or damage. Notably, at least two of these techniques—hedonic analysis and contingent valuation—are “rubber rulers,” techniques that may be deliberately or inadvertently manipulated to achieve a preconceived result.

This article discusses the fundamental concepts of damage and diminution to value, and appropriate and inappropriate methods for identifying and measuring diminution and damage if they exist. It also describes a set of three analytical steps required to demonstrate a damage to value.

## **CONSISTENTLY LOWER SALES PRICES AND DIMINUTION IN VALUE**

The first step is determining if properties in a given area sell for less than comparable properties in an otherwise similar area. Analysts can demonstrate consistently lower sales prices in a given geographic area using methods such as paired sales analysis for properties in the subject area and similar properties not in the area, or by testing the null hypothesis that property is not selling for a lower price in the subject area using appropriate statistical tests on validated sales data. Other methods could include comparison of sales prices to appraisals based on comparable properties from other similar areas.

A lower sales price level is not necessarily a diminution in value or a damage to value. It is possible that an area may simply be a lower-valued area; that is, an area subject to a locational premium.<sup>1</sup> A diminution in value implies that a higher price level existed before a typical market participant recognizes a disamenity, and a lower price level emerges after the disamenity becomes known. To establish a diminution in value related to a disamenity, analysts would need to demonstrate that higher values prevailed in the area before market knowledge of the disamenity; and that no other negative-value



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influencing conditions occurred or, if other influences did exist, to account for all of them to isolate the influence of the relevant disamenity.

A diminution in value is a necessary but not sufficient condition for a damage.

### **DISAMENITY DOESN'T ALWAYS CAUSE DAMAGE TO VALUE**

Damage to value is a time-sensitive, ownership-specific issue. Though the value of a property may decrease because of market recognition of a disamenity, a property owner does not automatically suffer damage. Consider the following definitions.

- *Real estate value*—"The present worth of the future benefits that accrue to real property ownership."<sup>2</sup>
- *Market value*—"The most probable price, as of a specified date, in cash, or in terms equivalent to cash, or in other precisely revealed terms, for which the specified property rights should sell after reasonable exposure in a competitive market under all conditions requisite to a fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under undue duress."<sup>3</sup> Note: "A market value appraisal is also based on whatever the 'normal' or 'typical' conditions are in the marketplace for the property appraised in a time frame that is consistent with the date of value in the appraisal."<sup>4</sup>
- *Damage*—"Loss or harm due to injury to persons, property, or reputation."<sup>5</sup>

*Damage to market value* can then be defined as a diminution in the market value imposed on an owner resulting from an injury recognized by the market after the purchase of property.

A damage is specific to an owner who purchases a property before the condition that led to a diminution becomes apparent to the market, and is limited to the amount by which that owner's "present worth of future benefits" is diminished. A damage to a subsequent owner generally is not possible if the normal or typical market participant was aware of the disamenity. It is the knowledge of the market that governs, not the knowledge of the individual owner—unless that owner knows of the

disamenity and its likely impact on value before it becomes general market knowledge (an insider-knowledge issue).

A researcher can quantify a damage by analyzing the property's market value as if the disamenity does not exist; and given that it exists, the unimpaired or less impaired vs. the impaired market values.<sup>6</sup>

Analysts should not assume that a given disamenity causes a diminution or damage to value. For example, consider a plant site that had groundwater contaminated with chlorinated solvents, a nitric acid spill in surface water and allegations that radioactive waste was buried on the plant site with residential properties on two sides. These issues were highly publicized and accompanied by a local real estate recession, but during a study covering a 10-year period, analysts could not show that this situation diminished nearby residential property values using an appropriate set of statistical tests. Anecdotal interviews of buyers and sellers further supported this finding.<sup>7</sup> Similarly, analysts frequently cite high-voltage power lines as a cause of nearby property value diminution, but authors Martin Wolverton and Steven Bottemiller, among others, have shown exceptions to that rule.<sup>8</sup>

Many allegations of a diminution in value are based on hedonic analysis and contingent valuation techniques. Neither technique is scientifically valid or reliable, and both are subject to manipulation to achieve desired results. They are rubber rulers that can be stretched to provide results compatible with the objectives of the researcher, client or lawyer.

### **THE FIRST RUBBER RULER: REGRESSION MATHEMATICS AND HEDONIC ANALYSIS**

Regression is a statistical method for the estimation of the dependent variable from a set of independent variables. To form the regression relationship, the analyst chooses a set of independent variables from—in the case of real estate—a very large set of possible variables. This hypothetical relationship hopefully expresses the analyst's interest and research objectives.<sup>9</sup> It can never totally and completely represent all the independent variables influencing the price of a specific piece of real estate.

There are three basic components of a regression relationship important to the following discussion: the dependent variable, for our purposes generally the sale price; the

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independent variables, generally factors chosen by the analyst that are believed to influence the value of the dependent variable; and the coefficients of the independent variables, the multipliers estimated by the regression mathematics in a manner that will minimize the difference between the calculated value of the sale price using the regression model and the actual value of the sale price from the database used in developing the model.

Hedonic analysis is an interpretive technique put forth by economists, not competent statisticians. This method argues that the coefficients of the regression may be quantitatively interpreted as the marginal contribution of the specific independent variable to the sale price. This requires that two interrelated assumptions be satisfied. First, that the predictor variable have a cause-effect relationship to the sale price, a relationship allegedly measured by the statistical significance of the coefficient.<sup>10</sup> Second, that the coefficient is quantitatively accurate; that is, it represents only the contribution of that variable to the sale price. The interrelationship is that the size of the coefficient may be inflated by omitted variables, among other things, causing the statistical significance and apparent impact on sale price to increase. This contribution from omitted variables may influence the statistical significance to the point where the omission of variables makes an otherwise totally insignificant variable appear to be significant.

The claim of a causal relationship based on the statistical significance of the predictor variable in the hypothetical regression relationship is unsupported by regression mathematics.

“The existence of a statistical relation between the response variable Y and the explanatory or predictor variable X does not imply in any way that Y depends causally on X. No matter how strong is the statistical relation between X and Y, no cause-and-effect pattern is necessarily implied by the regression model. ... Regression analysis by itself provides no information about causal patterns and must be supplemented by additional analyses to obtain insight about causal relations. ... A major limitation of observational data is that they often do not provide adequate information about cause-and-effect relationships.”<sup>11</sup>

Of 37 frequently cited hedonic analysis papers indicating damage to value, none based that assertion on any analytical tests other than the claimed statistical significance of the independent variable said to represent damage or diminution. For these alleged independent variables, it was found that the mean 95 percent confidence interval was plus or minus 139 percent.<sup>12</sup> Mathematically, a confidence interval greater than or equal to 100 percent includes zero and the coefficient must be treated in the regression analysis as a zero value.

If any variable that makes an actual contribution to the sale price is excluded from the hypothetical regression relationship, some of its contribution will be included in the coefficients of those variables that remain. How much will be included in a given coefficient is unknown and unknowable. Therefore the coefficient of the included variables do not represent just the contribution of that variable to the sale price, but the contribution of that variable and the omitted variables, and is not quantitatively meaningful in the sense required by the hedonic analysis. Note that the inflation of the coefficients by omission of variables may not be of any major importance to the prediction of the sale prices, just to hedonic analysis.

“HPV (Hedonic Property Value) regressions have two characteristics making them a fertile area for data mining (specification searching) to obtain desired signs as well as the selective reporting of unrepresentative results,” authors Scott Atkinson and Thomas Crocker state. “A pattern of considerable data mining in order to obtain significant coefficients with desired signs seems to pervade the HPV literature. ... Our empirical results indicate that the specification uncertainty caused by co-linearity is small for structural variables (e.g. floor space, age, and lot size) but substantial for neighborhood variables (e.g. air pollution, school quality, and crime); intolerance to measurement error is great for both types of variables.”<sup>13</sup>

To illustrate the frailties of hedonic analysis, consider an investigation of a water utility benzene contamination incident on property values. Analysts used approximately 1,900 sales in the regression, but several sales were missing the year built—a datum necessary for calculating the age variable. In cases where it was missing, the regression considered the properties to be some 87 years older than their actual age. After the hedonic analyst corrected the

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year built for all homes except the one that was in the allegedly impacted area, the analyst concluded to a 13 percent diminution in property values in the area that the utility served. When the one remaining missing year built was corrected using the analyst's correction procedure, the diminution in value disappeared. The correction of one single item of data in the approximately 20,900 items of data used in the study resulted in a reversal of findings with virtually no change in the regression's explanatory power or precision as measured by the proponent's measure of  $r^2$ .<sup>14</sup>

This particular hedonic analysis also improperly uses dummy variables in a cross-product independent variable that would independently lead to incorrect results. The error is common in hedonic analysis, and well documented.<sup>15</sup>

In examining the hedonic analysis for the *DeSario v. Industrial Excess Landfill* case, covered in several articles published in *The Appraisal Journal*,<sup>16</sup> authors report that the analysis used geographic bands defined radially outward from the landfill location and assigned each property location according the band it fell within. Using this method, hedonic analysis shows a diminution in value for properties in all but the most distant measurement band. However, if instead of bands the analysis uses the measured distance of each property to the landfill, the diminution in value disappears except for the very closest properties, reducing the estimated property damages from millions to tens of thousands. The two approaches had virtually the same  $r^2$ .<sup>17</sup> This same phenomena appears in an analysis by author Arthur Nelson.<sup>18</sup>

For any given set of data and regression specification, analysts can show that a simple change in specification or small adjustment in data can provide significantly different values for the coefficient of the independent variable of interest, generally without a significant change in the usual measures of the appropriateness of the hedonic analysis that economists use, such as  $r^2$ . Manipulating hedonic analysis to achieve a desired result is not difficult and, therefore, hedonic analysis is a rubber ruler with the appearance of scientific precision—an appearance that is wholly unjustified.

### **A SECOND RUBBER RULER: CONTINGENT VALUATION**

The use of the contingent valuation method, or hypothetical market survey, has gained prominence recently in valuation literature. This method calls for setting up a hypothetical transaction involving an alleged disamenity such as a cell phone tower, adjacent gas station or pipeline right-of-way, then surveying individuals who play the part of buyers to determine how much they would discount a property's value when close to the alleged disamenity. This methodology is based on the contingent valuation, or CV, method sometimes used in natural resource damage cases where rights that are assigned values are not traded in a traditional market.

The list of requirements outlining how to properly conduct a CV study is quite lengthy and very expensive to fulfill.<sup>19</sup> Failing to meet the requirements results in the degradation of the results even beyond the already high error rates normal to the method. Essentially, however, they are moot because even strong advocates of CV as an approach for valuing public and quasi-public goods clearly state that the methodology is not applicable to private goods.<sup>20</sup>

The results of a hypothetical market survey tend to be useless for other reasons as well. For example, most hypothetical market surveys consider only the buyer's side of the relationship; that is, how much the buyer wants the seller to take off the purchase price. Surveys rarely examine the seller's side and collect little or no information about whether a discount would receive serious consideration, let alone acceptance.<sup>21</sup>

Through manipulation of specific words or phrases, interviewer bias, respondent selection and other methods, researchers can obtain virtually any desired result.

### **A SPECIFIC EXAMPLE: THE EFFECT OF CELL PHONE TOWERS ON RESIDENTIAL PROPERTY VALUES**

An article investigating the value of residential properties near cell phone towers reports: "The opinion survey results were generally confirmed by the market sales analysis using a hedonic house price approach. The results of the sales analysis show prices of properties were reduced by around 21 percent after a CPBS (Cellular Phone Base Station) was built in the neighborhood."<sup>22</sup> This article provides an excellent example of issues outlined previously:



## Real Property Damages and Rubber Rulers

### *Bias*

The article appears to be biased in favor of a high damage result. First, it rejects two studies conducted by professional appraisers who could find no statistically significant differences among property values of homes near and not near cell phone towers.<sup>23</sup> Second, because they believed respondents close to cell phone towers were unwilling to provide honest answers, authors discounted survey results from respondents near the towers in favor of significantly higher results from respondents who were in areas without towers.<sup>24</sup>

### *Survey*

The article contains no evidence that the survey was pre-tested to measure respondent understanding, bias or other critical issues as recognized survey protocols require. Further, there is no evidence of testing to ensure the survey would provide a comprehensive understanding of respondents' answers. For example, the survey included no questions to determine if respondents were providing unbiased and well-considered answers, and no questions about whether an owner would accept the indicated discount.

The results of the survey also are inconsistent. For example, many of the respondents with homes near towers—51.4 percent—said the cell towers had no influence on value; but 71 percent said that they would pay less for a home in the area. If the survey is honestly representative of the area residents, these results would strongly indicate something other than a cell phone tower is undesirable about the area. Researchers apparently do not investigate this issue.

Another major concern is that survey results are not statistically meaningful with respect to the universe of residents. The survey was conducted by mail and—though the response rate after prompting was reasonable at 46 percent—by definition, mail survey respondents are not randomly selected; they are self-selected. As the Blue Ribbon Panel report and the *Reference Guide on Survey Research*<sup>25</sup> note, a mail survey does not provide a scientifically reliable basis for drawing any generally applicable conclusions concerning the population as a whole.

### *Hedonic analysis*

There is no reported attempt to test the null hypothesis of no effect except by the professional appraisers, and authors discount these analyses. Therefore, they are assuming, in the face of contrary evidence, that the cell towers negatively influence value.

Authors use at least six regression models to achieve the four reported results. This practice strongly implies specification searching to achieve a desired result. It appears the authors choose to ignore the survey's indications of another problem in the area and keep searching for specifications that support preconceived notions. Hedonic analysis is a nearly perfect tool for exactly this type of manipulation, whether conscious or unconscious.

Except for gross land area, gross living area and age, no other recognized factors of value consistently appear in the regressions. In the reported models, authors inconsistently use factors such as whether the property is single family or multifamily, the type of siding or roof construction and the quality of the property. Authors also fail to consider other key value-influencing factors including the number of bedrooms, bathrooms and garage spaces. In addition, authors include income-producing property such as rental units in the same regression database as owner-occupied property sales. A regression model that does not consistently use recognized factors of market value and clearly separate distinct types of property—income producing vs. owner-occupied—is highly suspect.

### *General*

In their literature review, authors note that high-voltage overhead transmission lines have a reported impact on value ranging from positive—i.e., increasing the value of neighboring properties—to negative. In a separate study, one of the paper's authors cite a maximum negative influence on value of 20 percent for properties 10 meters from a high-voltage tower, declining rapidly to zero at 100 meters.<sup>26</sup> Further, authors state that according to another study, 50 percent of all high-voltage studies indicate no impact on value and 50 percent indicate between 2 percent and 10 percent negative impact.<sup>27</sup> For a less obtrusive artifact, the authors report a significantly greater damage estimate: 10 percent to 23 percent for properties within 300 meters.

# Real Property Damages and Rubber Rulers

## CONCLUSION

It is relatively common for damage to be confused with diminution, and a diminution to be confused with a simple locational preference. But these phenomena are not the same—a locational preference is not necessarily a diminution, and a damage cannot exist without a diminution in value. Damage is specific to the owner and the period of ownership relative to market recognition of the event that allegedly causes the damage.

Analysts must use proven methods such as classic market data analysis of arms-length and verified sales or specific statistical tests of the null hypothesis of no lower value to identify an area of lower values. Demonstrating diminution relies on these methods, which provide sound indications that—but for the alleged disamenity—a higher value would reasonably be expected in the area of demonstrated lower values.

Damage to value is specific to the property owner who purchases the property before the disamenity causing the damage becomes known in the market, and is specific only to that owner, and not to successors, because the future market will have recognized the disamenity and adjusted values accordingly. The damage may not affect an owner immediately; market recognition of a damaging impact determines the date of damage.

Therefore, three steps necessary to demonstrate a damage to value resulting from a disamenity are:

1. Does an area of lower values exist? That is, are values in the subject area lower than the norm for the property type and market?
2. Are the lower values a result of a specific disamenity? Because of the complexity of forces operating in the real estate market, this point may be difficult to demonstrate. One key factor would be to show that higher values in the area preceded the diminishment in values, and the decline followed market recognition of the disamenity.
3. Did the owner purchase before the disamenity became known in the market? If the purchase occurred after market knowledge, analysts can presume that the price paid reflects the existence of the disamenity and no damage to that owner exists.

Hedonic analysis and hypothetical market surveys are no better than rubber rulers—measurement devices that ana-

lysts can stretch knowingly or unknowingly to achieve a desired result while maintaining the superficial appearance of scientific validity. These methods are not scientifically valid or reliable.

That they are not reliable usually can be demonstrated by simply repeating the experiment, but using a slight legitimate alteration—in the wording of a CV survey, for example. A lack of reliability in hedonic analysis models may be demonstrated by changing a model specification to include common and well-understood value influences such as bedrooms, baths, age or other variables that were omitted in the original hedonic analysis. This will almost always result in an important reduction in the size and apparent significance of the damage variable. Occasionally, it may be necessary to critically examine the database or look at alternative model specifications, changing the distance measurement from artificial distance bands to more natural direct distance, for instance. These simple and very logical changes generally will provide very different results, and very frequently with the same measure of reliability as claimed in the original analysis. ■

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- 4 *Uniform Standards of Professional Appraisal Practice, 2002 Edition*, Advisory Opinion 22 (Washington, D.C.: The Appraisal Foundation, 2002).
- 5 *The Merriam-Webster Dictionary*, (Springfield, Mass.: Merriam-Webster Inc., 1998).
- 6 The phrase "less impaired" addresses the emerging issue of properties that have been remediated to a standard appropriate for a specific use, but not remediated to an unimpaired environmental condition.
- 7 Albert R. Wilson, "Proximity Stigma: Testing the Hypothesis," *The Appraisal Journal*, June 2004.
- 8 Marvin L. Wolverton, Steven Bottemiller, "Further Analysis of Transmission Line Impact on Residential Property Values," *The Appraisal Journal*, July 2003.
- 9 Note: All regression relationships are hypothetical expressions of the analyst's idea of how various elements as represented by predictor variables might influence the value of the dependent variable. This

# Real Property Damages and Rubber Rulers

statement becomes obvious when one considers the variation among real estate regression models. Some regressions use a relationship that includes bathrooms and half-baths but not bedrooms; others include house size, lot size, number of bedrooms and baths, and size of garage—but not house style, age, condition, type of heat or other variables cited frequently as important to value. Published regression relationships used in hedonic analysis may contain from one or two to 90 or more independent variables. Leading textbooks on the issue of multiple regression model construction and application generally agree that such models are hypothetical in the sense that analysts choose which variables to include or exclude. Also see endnote 11.

- 10 Statistical significance is normally measured by the studentized t-value. The t-value is a ratio that indicates the relative contribution of the coefficient to a reduction in the variance between the calculated and actual values of the dependent variable. The larger the coefficient, the greater the significance of that coefficient to the minimization of the variance.
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- 21 Albert R. Wilson, "Contingent Valuation: Not an Appropriate Valuation Tool," *The Appraisal Journal*, Winter 2006.
- 22 Sandy Bond, Ph.D., Ko-Kang Wang, "The Impact of Cell Phone Towers on House Prices in Residential Neighborhoods," *The Appraisal Journal*, Summer 2005.
- 23 "Two studies have been conducted to ascertain the adverse health and visual effects of CPBSs on property values. Telecom commissioned Knight Frank (NZ) Ltd to undertake a study in Auckland in 1998/00 and commissioned Telfer Young (Canterbury) Ltd to undertake a similar study in Christchurch in 2001. Although the studies show that there is not a statistically significant effect on property prices where CPBSs are present, the research in both cases involves only limited sales data analysis. Further, no surveys of residents' perceptions were undertaken, and the studies did not examine media attention to the sites and the impact this may have on salability of properties in close proximity to CPBSs. Finally, as the sponsoring party to the research was a telecommunications company it is questionable whether the results are completely free from bias." Bond, *ibid*, pages 260-261.
- 24 "In general, those people living in areas farther from CPBSs were much more concerned about issues related to proximity to CPBSs that residents who lived near CPBSs. ... Alternatively, the apparent lower sensitivity to CPBSs of case study residents compared to the control group residents may be due to cognitive dissonance reduction. In this case, respondents may be unwilling to admit, due to the large amounts of money already paid, that they may have made a poor purchase or rental decision in buying or renting property located near a CPBS. Similarly, the homeowners may be unwilling to admit there are concerns about CPBSs when the CPBSs were built after they had purchased their homes, because to do so might have a negative impact on property values." Bond, *ibid*, pages 265-266.
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FOCUS ON CAPITAL MARKETS

# The Capital Markets Outlook Is Good—But What Can Go Wrong?

BY WILLIAM L. RAMSEYER, CRE

*Editor's Note: The following commentary was excerpted from remarks made during the Capital Markets Panel at The Counselors of Real Estate Midyear Meetings in Charleston, S.C., in April 2006.*



With the NCREIF property index averaging 11–12 percent over the past 10 years, availability of debt through an active commercial mortgage-backed securities market, growing foreign investment and aggressive bidding by pension funds, the capital market view today is

euphoric. Real estate continues to generate competitive returns relative to other asset classes. As a result, the river of capital continues to flow. Our firm is active and typifies the major players in the business, having invested more than \$1 billion in 2005.

Why is investment interest in real estate so persistent? Without question, we are living in a time of improved fundamentals, however real estate seems to be priced to perfection. Even with prevalent headlines about compressed cap rates, low cash flows and tumultuous world events, we've seen an upward bias in allocations from current institutional investors. Returns are usually in the 7–8 percent range; disappointing relative to the past, but to some institutional or offshore investors, it's a totally acceptable and relatively competitive range. In addition, investors are increasing their risk exposure by moving into value-added and opportunistic investments.

The influx of new investors allocating to real estate most likely is because of enhancements in transparency and disclosure. Historically, the real estate industry has been absolutely abysmal at transparency and disclosure, but when the public real estate investment trust, or REIT, market began its renaissance in 1995, and with the Sarbanes-Oxley Act of 2002, the amount of information available to the public has improved substantially. We can analyze real estate now. There are enough numbers around. Investors are more confident because the investment management industry has matured; it's been through several painful cycles.

If you look at the reasons why people are interested in real estate—returns, strong fundamentals, pricing, confidence, transparency—then you also have to ask yourself: Can the enthusiasm be dampened?

I am not here to be a harbinger of doom, just to take a little bit of wind out of the sails. Navigation requires the

## About the Columnist

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ability to see what's next and adjust your course accordingly, so I offer these cautions:

- *Watch the other sectors*—We need to keep a close watch on what other asset class expectations are and try to

*If you look at the reasons why people are interested in real estate—returns, strong fundamentals, pricing, confidence, transparency—then you also have to ask yourself: Can the enthusiasm be dampened?*

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anticipate how real estate on a relative basis will perform going forward. There are mounds of historical data, but not many scenario models are actively tracking and anticipating how real estate will play out going forward. What's happening with corporate profits? What's next in the bond market? How are the international global equity markets moving?

- *Watch the fundamentals and cycles*—Real gross domestic product growth is a fundamental driver of jobs as well as occupancy of space. The last time we had negative real GDP growth, in 1991, is when we saw the beginning of some real problems for the real estate industry. Every year from 1988 to 1990 the industry put 100 million square feet of office space into the market, which led to about five years of vacancies above 18 percent. The NCREIF index had its best year last year at about 20 percent, and that's not sustainable.
- *Watch labor policy*—Liberal U.S. immigration policy has supported impressive growth in our economy. However, our country is struggling with immigration policy that might restrict job growth. This could definitely create some wide-ranging problems with our economy down the line.
- *Watch the balance between supply and demand*—The struggle to balance supply and demand for space has

led to trouble in the past. One of the real blessings in our business today, though developers may see it as a curse, is that increased construction costs have exerted a dampening effect on the potential for oversupply.

Because of the tremendous amount of capital going into real estate, there is a classic potential for overbuilding. Replacement rents coupled with high construction costs are keeping the volume of new construction down. When you start to see construction costs ease—or if you start to see market rents go up so everyone can start developing again—that could indicate a major problem on the horizon. We also are seeing some excesses in the condo sector that could cause reverberations in the debt markets going forward.

- *Watch operating costs*—Managing operating costs has arguably never been so important as cash flows are on the lower end of an accepted range. Investors go into real estate for good cash flows, and if operating costs rise, decreasing cash flows become a plausible area for concern.
- *Watch for a reduction in long-term investors*—We've been blessed in the past several years with long-term investor mentality. However, as we move into shorter and shorter investment timeframes, a bit of concern likely will arise. Many value-added and opportunistic funds have two-, three- and four-year horizons, which create great initial rates of return but have the potential to be volatile. Today we have the right market conditions, but if we continue shortening the time horizon, it could portend some problems.
- *Watch for reduced liquidity in debt markets*—We also could face challenges if there's reduced liquidity in the debt markets. A substantial number of lenders in the marketplace will lend you a lot of money, but if cash flows start to tighten for any reason, it's going to wreak havoc. Suggestion: Keep an eye on the lending policies and views of the major lenders.
- *Watch interest rates*—As interest rates increase, some money is going to be pulled out of real estate and into

## INSIDER'S PERSPECTIVE

the fixed-income sector. If you study demographics and look at all the people in 50-something and 60-something age groups, the demand for income is very high. And if interest rates continue to rise, fixed-income investments are going to be increasingly attractive. Rate hikes will result in some investor equity, and eventually some money is going to be pulled out. I don't think we should discount the notion that increased rates may cause some changes in our business.

Euphoria should make us cautious. We have been assuming for too long that there will always be a viable capital market and sustainable liquidity. But be watchful and wary. We've seen this movie before. ■

FOCUS ON THE ECONOMY

# Expect Big Changes in the Next Five Years

BY HUGH F. KELLY, CRE



TO HEAR THE GENERAL RUN OF ECONOMIC COMMENTARY, you might think that its primary article of faith was penned by Sir Isaac Newton: "Objects in motion tend to remain in motion; objects at rest tend to remain at rest." Following Newton's law of inertia, we might expect that

tomorrow will be like today, only more so.

For optimists, the governing expectations derive from the relatively high-growth, low-inflation economy the U.S. has enjoyed, with just a couple of interruptions, since the mid-1980s. Based on that experience, today's employment generation of more than 2 million jobs annually, an unemployment rate of less than 5 percent, sustainable real gross domestic product expansion of 3.5 percent or more, high productivity and vigorous consumption should frame our baseline for the coming years.

Not so fast, say more dour types. Look at trends in the national debt—now pushing toward \$9 trillion—a trade deficit soaring past 6 percent of gross domestic product, looming shortfalls in Social Security, and the ever-growing debt of U.S. households. Factor those patterns into the future and abandon hope.

## MAPPING THE ECONOMIC FUTURE

Rather than choose sides, I'd like to challenge myself to consider how the next five years will be different from the last five. Though all forecasting is fraught with uncertainty, I am quite confident that 2006–2010 will be different from 2001–2005. The issue, of course, is just how. I'd like to

sketch several changes that seem highly probable to me, with the promise that I will provide greater detail about those changes in future columns.

Here goes:

### 1. The later years of this decade will consist mostly of the expansion-to-peak phase of the business cycle.

The year 2001 marked the onset of a recession, the end of the great bull market of the 1980s and 1990s on Wall Street, and the catastrophic events of Sept. 11. Though GDP growth resumed with surprising swiftness, employment losses persisted, the technology sector remained depressed and stocks spent years declining or stagnant. Corporate strategies seemed driven more by anxiety than ambition.

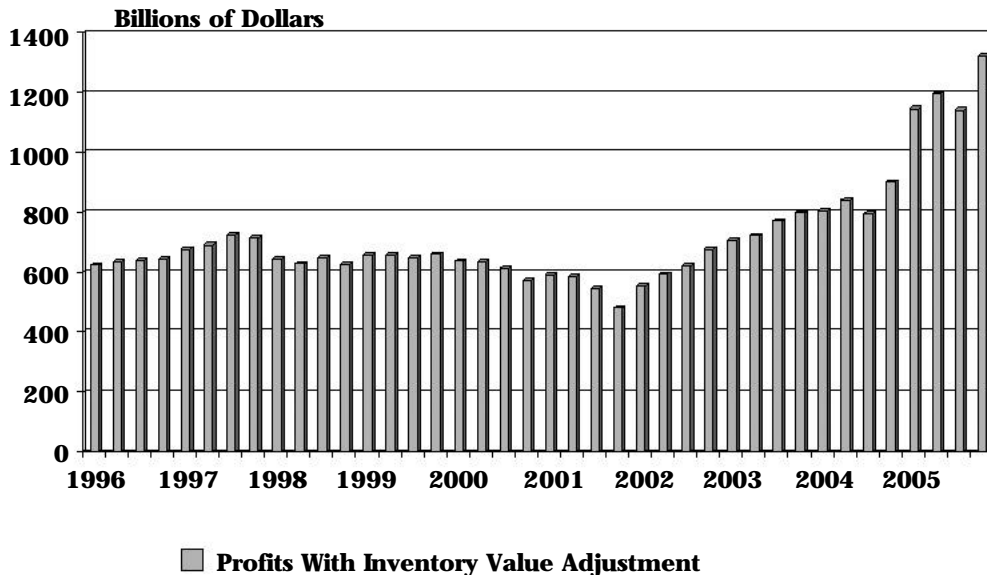
Real estate was one of the few bright spots, but even in our industry worry shadowed any sign of strength. Common portents of doom included the so-called

## About the Columnist

Hugh F. Kelly, CRE, is the principal of an independent counseling practice specializing in applied real estate economics for clients with domestic and international commercial property interests. Based in Brooklyn, N.Y., Kelly is well known as a writer and public speaker. Formerly, he was chief economist for Landauer Realty Group and author of the Landauer Forecast from 1986 to 2000. He was a national vice president of The Counselors of Real Estate in 2000, chair of its New York Metropolitan Chapter in 1999 and 2000, editor in chief of The Counselor newsletter from 1997 to 1999 and editor in chief of Real Estate Issues from 2003 to 2005.

Table 1

## U.S. Corporate Profits Have Enjoyed an Extraordinary Surge Since 2002



disconnect between capital appreciation and weak market fundamentals and the alleged bubble market.

By 2005, most Americans understood that we had truly dug out of the hole we entered in 2001, and were not about to fall right back in. At mid-decade, we could talk comfortably about an economy in recovery.

We can expect several transitions as that recovery matures. Consumption no longer will be the sole driver of growth, and may indeed give up a couple of points in its share of GDP as business-fixed investment increases. Strong corporate profits—now at their highest rate in 40 years as a percent of national income—can readily fund those investments. But more important, businesses will have a strong motivation to make those investments.

Businesses will realize that making investments that drive stock prices upward through earnings growth can no longer be primarily about expense control, but instead should spur improved output and increased market share. That dynamic is very different from the first half of the decade. It implies investments in plants and equipment, surely, and suggests personnel increases

as well. Price-earnings ratios, in the stratosphere in the late 1990s, have come back to more normal levels, so companies will need to be aggressive in pursuing earnings opportunities and will spend money to make more money—until we hit the next peak.

### 2. Commercial construction slacked quickly in the early 2000s and stayed down for years. The later years of the decade will see an acceleration in construction.

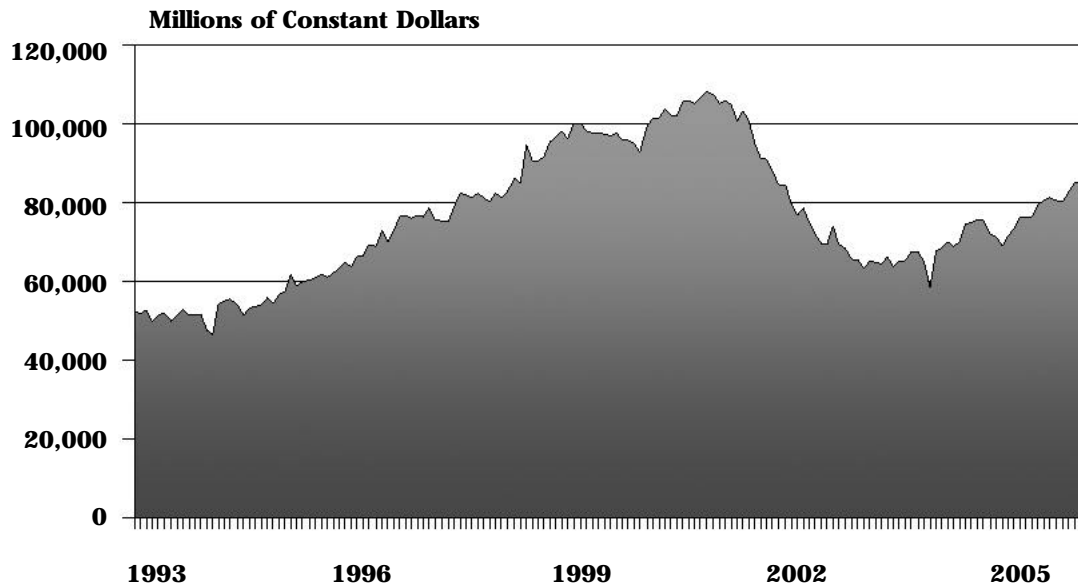
The so-called weak fundamentals for commercial real estate came about for the usual reason: Demand contracted suddenly, but the supply chain could not shift gears quickly enough. Vacancy, consequently, skyrocketed and rents plummeted. This was especially true in offices and hotels, but industrial properties were affected as well—especially research and development and flex space. Of the nonresidential property types, only retail avoided a steep development contraction because consumer spending remained high thanks to a stimulating monetary policy.

In 2006, office, industrial and hotel occupancies are improving steadily. Rents are beginning to creep



Table 2

## Nonresidential Building Construction Already in Substantial Rebound



**Source: U.S. Census Bureau; constant dollar adjustment by Hugh Kelly, CRE**

upward. But in most market areas, construction has not yet hit its stride. The most powerful reason for this hesitancy is that market rents do not yet stand at the level where developers can pencil out “feasibility” when they run construction cost numbers.

Rents are one problem, but the explosion in cost for building materials and, to a lesser extent, labor, keep raising the feasibility bar. Most markets are not prepared for the likely result: several years of double-digit rent increases once vacancy rates drop below frictional levels. That reality is coming, though, and faster than many expect. It will be a huge difference from the recent past, and even the present, but I believe we can count on such a phenomenon in most major markets.

### **3. The extreme volatility of early-decade interest rates will give way to much narrower fluctuations.**

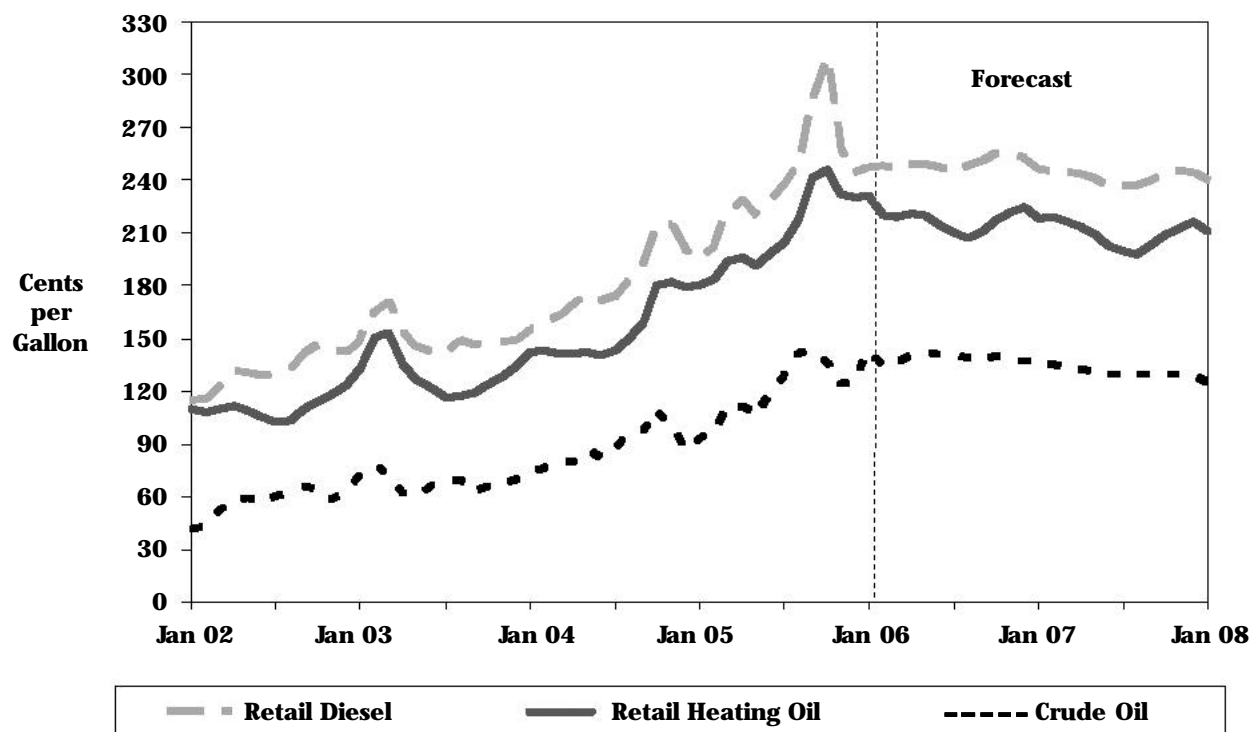
Though the Federal Reserve System’s management of interest rates following the tech wreck and especially in the aftermath of the Sept. 11 terrorist attacks was espe-

cially dramatic, it applied well-established remedies for recession and recovery. The Fed lowered interest rates until it was well assured that the contraction in the economy had been halted, then it began to hit the brakes to forestall any threat of overheating.

The key difference in former Fed Chairman Alan Greenspan’s approach, as opposed to his predecessors, was that he signaled boldly to the markets what he intended to do and had the courage to bring rates down to uncharted lows—prolonged negative real interest rates (i.e., rates below the concurrent consumer price index)—to deal with the dangerous combination of a stock market collapse, a nation anxious about the disruption of terrorism and a deep dislocation in the labor markets. Then, he showed real discipline in introducing a regime of rate increases that was steady, predictable and significant in overall magnitude, while looking past short-run fluctuations in the economic data. Rarely have I seen a policy-maker execute strategy so skillfully, insightfully and purposefully. It was a tour de force.

Table 3

## U.S. Distillate Fuel Prices



Source: U.S. Department of Energy, chart gallery for March 2006

We stand in early 2006 at a very different place for monetary policy. Fed Chairman Ben Bernanke, thankfully, is working within the context of less volatile economic times. The yield curve is exceptionally flat, but likely will not remain so for an extended period of time. The Fed can now entertain a *laissez-faire* rate period, allowing market forces in the treasury arena direct the price of risk-free assets.

Absent serious shocks, I would expect the yield curve to return to a moderately upward slope within the next year. Within two years, I suspect we will find short rates dropping again of their own accord, and long rates stepping up 100–125 basis points. From there, I would not be surprised to experience little change in rates for a year or more. Any significant upward movement in rates in the last years of the decade could be a precursor to the next recession.

#### 4. Increases in energy costs, tempered by the low cost of consumer imports, have fueled inflation. That relationship will reverse in the years ahead.

Just a decade ago, the Organization of the Petroleum Exporting Countries, or OPEC, was worried that overproduction had created an oil glut that virtually robbed the energy industry of pricing power in the market. I can recall, in late spring 2000, driving up to a gas pump in eastern Indiana where unleaded regular was 99 cents a gallon and thinking that I was paying substantially more for a bottle of water in the service station's convenience store. Iraq and Hurricane Katrina changed that picture in a hurry. But, the finite supply of oil in the ground notwithstanding, energy prices through 2010 could decrease.

The U.S. Department of Energy's most recent projections show 2010 crude prices at about \$50 per barrel

and natural gas prices approximately 20 percent below 2006 levels. Remember that volatility could prompt significant price swings, and the direction of change can be down as well as up. Consumers waiting in long lines to pay \$2 for a gallon of gasoline in 1979 probably never imagined that price would be cut in half two decades later, but that's what happened. It can happen again.

Meanwhile, a flood of imported goods has held down consumer prices—the positive side of our enormous and unsustainable trade deficit. The CPI sub-index for shoes, for example, was 128 in 1996 and is 124 as of the first quarter of 2006. Declines in apparel prices have been even more dramatic, dropping from 132 in early 1996 to 119 this spring. Recreational products such as toys and video games also have dropped steeply in price, from a CPI sub-index of 125 a decade ago to 75 today.

Even if we don't see the coordinated effort to bring down the current account deficit that the G-7 central bankers managed in the Plaza Accord of 1985, expect some adjust-

ment in exchange rates and targeted trade agreements designed to make a dent in the trade imbalance. Such moves will put upward pressure on the import prices for many consumer goods, counterbalancing the anticipated drop in energy prices. The net effect on the CPI is that inflation should fluctuate in the 2 percent to 3.5 percent range, giving interest rates the opportunity to shift to the yield curve described previously.

Economic dynamics, and their implications for real estate, are endlessly fascinating. They also are complex and almost always can shift in unexpected ways. Nevertheless, I find it important to think about the economic future in concrete ways to anticipate specific changes. Otherwise, how can we make rational decisions? I'm sure some readers will find my perspective highly debatable, and others will agree with me. In future columns, I will explain in greater detail the data on which I base my arguments. ■

FOCUS ON CHINA

# A New Era for Real Estate Professionals in Mainland China:

## Blending the Best of Local and International Experience

BY C. NICHOLAS BROOKE, FRICS, CRE



THE PACE OF ECONOMIC AND INFRASTRUCTURAL DEVELOPMENT in Mainland China can only be described as phenomenal, but progress is advancing at a scale and speed that frequently induces errors and solutions that are inappropriate socially, economically or environmental-

ly. As a result, real estate and construction professionals have an opportunity to contribute added-value services combining the best of local knowledge, expertise and international experience.

Statistics that illustrate, in very obvious terms, the size and scale of that opportunity include:

- *Gross domestic product growth*—Averaged 9 percent or more for last 10 years, and even higher in the main cities
- *Housing*—150 million square meters constructed each year
- *Foreign direct investment*—Likely to exceed US\$60 billion in 2006
- *Small and medium-size enterprises*—27 million SMEs employ 200 million people
- *New foreign-funded enterprises*—Averaging more than 20,000 every six months

To fully understand the opportunity, this article will first define what professional services are, then differentiate these from the traditional trading and technical services that are familiar to Mainland leaders and businessmen. The services are best defined as advice and recommendations provided by members of professional organizations that have high-level entry requirements, high ethical standards and codes of conduct, and require lifelong learning to keep members aware of evolving practices and trends.

Until recently, the pattern of cooperation between international firms and local service providers in Mainland China was somewhat erratic, with lawyers and accountants leading the way, followed by architects and those involved with construction—who often have no alternative but to enter into partnerships with design institutes and construction units to meet local regulatory requirements.

However, as a result of reforms arising from Mainland China's entry into the World Trade Organization and initiatives such as the Closer Economic Partnership Arrangement between Hong Kong and China, under

### About the Columnist

Nicholas Brooke, FRICS, CRE, is a past president of the Royal Institution of Chartered Surveyors and chairman of Professional Property Services Group, based in Hong Kong.

which Hong Kong-registered companies have accelerated access to Mainland markets, a very different attitude and environment exists today. The needs of the client now determine the most appropriate service provider, and this sea change encourages and enables professionals such as CREs with relevant experience to respond with the optimum team reflecting the best of local and international expertise.

From a personal perspective, there are many areas where local and international professionals can come together in

*From a personal perspective, there are many areas where local and international professionals can come together in Mainland China to offer the relevant, best-practice solution to the client. Relevance is a key word and stems from a clear understanding of the client and his objectives.*

Mainland China to offer the relevant, best-practice solution to the client. Relevance is a key word and stems from a clear understanding of the client and his objectives. Relevance comes not only from an appreciation of the challenge and the opportunity, but also from an understanding of the national, regional and local economic and regulatory environment as it affects the case in question. Hence, input from the local professional is essential.

Yet knowledge of best international practice—what works and doesn't and how that experience can be adapted in a way that is relevant in the context of the Mainland—is a crucial component to any well-conceived and balanced professional recommendation.

In simple terms, it involves combining the best of local and global to the advantage of the client. My profession is that of chartered surveyor and counselor, for ease of translation I am often called a property doctor, and my role in Mainland China has been to work alongside and in partnership with Mainland counterparts primarily to deliver added-value services in the following areas:

1. *The sustainability of cities*—Many cities wish to develop a more market-driven business plan that is framed around and driven by the principles of sustainability and economic fundamentals. Similarly, cities have

moved from copying one another to differentiating themselves, and there is the need to identify core drivers and specialties. Working with local professionals in the fields of strategic planning and sustainable development, we have produced business plans that are the basis for infrastructure provision, land-use allocation and prioritizing cities' objectives.

2. *Land-use planning*—At the provincial and city level, conceptual drawings that reflect the hopes and aspirations of a succession of senior officials and mayors are in abundance. But few in reality are action plans capable of delivery. Arguably, the vision is the easy part; the challenge is devising a holistic approach to the implementation and management of that action plan, and gaining the support of the community. The plan needs to be flexible and responsive to changing market circumstances, which is where combining the best of local and international experience works at its best.

3. *Optimization of development*—The “build and they will come” or “Mall Mania” mentality hopefully is a reflection of the past, but many still pay insufficient regard to project viability and feasibility. Working with local development professionals, we have analyzed the aspirations of the end-user—purchaser or tenant—examined the choice of materials in terms of quality and maintenance costs; critiqued layouts to maximize efficiency of floor space; and established mechanisms to ensure prompt delivery to the required quality and within budget. These achievements require local knowledge as well as the experience of development across a wide spectrum of international markets. What is particularly important is the ability and experience to give the client the best advice, even though it might not always be what he wants to hear.

4. *Valuation to international standards*—Foreign direct investment, or FDI, is targeting Mainland China in a significant way, and a growing portion of that funding is going toward existing or new businesses, development and construction projects. However, an essential ingredient from the international investor's perspective

is a common valuation platform that will value all assets and businesses on the basis of recognized international standards. Providing opinions of value that will withstand close scrutiny requires a detailed understanding of the local market and all issues that have an impact on value—and an appreciation of what the investor expects in terms of a robust report and opinion that institutions and advisors around the world can understand. Again, real estate professionals, working with appraisal counterparts in Mainland China, are responding to the challenge. They now are producing reports and opinions that will withstand the scrutiny of the best international experts, and anticipating the questions and issues that will require expert advice.

5. *Affordability of residential accommodation*—This issue is important not only in Mainland China, but also in many mature economies of the world. Whether the government should intervene—and, if so, how and when and how it should provide for those unable to get onto the housing ladder—is a challenge for many societies. Working with the relevant government ministries

and various city authorities, we have contributed international case studies ranging from extensive involvement to a leave-alone approach, and to suggest a range of measures ranging from the provision of social housing to the levy of a development charge to fund or subsidize homes for those who are less well-off.

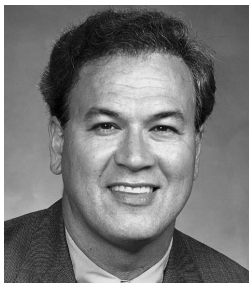
This overview offers just a few examples of how blending the best of local and international experience already is having an impact in Mainland China. I genuinely believe that this is a new era of opportunity for Mainland professionals and their international counterparts.

Responding to this opportunity will be a challenge for The Counselors of Real Estate. Very few counselors currently work or reside in the region. As a result, an effective response will require a commitment of resources, and a shift of mindset and culture. It will be interesting to see whether there is the appetite, energy and willingness on the part of The Counselors of Real Estate to step up to the plate. ■

FOCUS ON INVESTMENT CONDITIONS

# Managing Expectations in a Riskier World

BY KENNETH P. RIGGS, CRE



HALF WAY INTO THE YEAR, WE ARE ENJOYING A SURPRISINGLY stronger economy than many of us could have imagined only one year earlier. Despite a series of unexpected economic challenges during the past several years—including high deficits, critical terrorist attacks, accounting

scandals, wars in Afghanistan and Iraq, high fuel prices, and last summer's hurricane damage to New Orleans and other communities along the Gulf Coast—the U.S. economy has not just survived, it has performed remarkably well. Gross domestic product is growing, job creation is strong, business investment is increasing, Americans are still shopping, and we citizens are wealthier than we have been in the history of this country. Further, some of the wealth lost after the tech bubble burst is finally starting to reappear in the form of improving stock returns. Even the housing market, which has slowed slightly from last year, continues to grow. Despite media reports about an impending housing bubble, home sales are on track for the third largest year on record, according to the National Association of REALTORS®.

Unfortunately, even in such strength, the risk affecting our economic growth—and commercial real estate returns—is growing as well. Long- and short-term interest rates are increasing. Inflation appears to be on the verge of taking hold. High fuel prices have resurfaced and likely will stay with us for a year or more. As a new government begins to

take shape in Iraq, geopolitical risk seems to be increasing in Iran, North Korea and other parts of the world.

## PREPARE FOR DECLINE IN CAPITAL APPRECIATION

In the commercial real estate arena, capital appreciation remained strong in the first quarter of 2006. However, the chance that the capital or appreciation component will reverse its trend is not merely likely, but inevitable. This risk will continue to mount through 2006 and into 2007 as capitalization rates experience upward pressure from rising rates and improving returns on alternative investments such as stock and bond markets.

This economic climate has prompted the Federal Reserve System to keep a watchful eye on the real estate market for the last year or two. The residential market has cooled in certain areas, but fundamental indicators in the commercial real estate market are generally positive. Demand remains strong, vacancy rates are declining and rents are

## About the Columnist

**Kenneth Riggs Jr., CRE**, is president and chief executive officer of Real Estate Research Corporation. RERC offers research, valuation, independent fiduciary services, portfolio services, corporate advisory services, litigation support and other real estate-related consulting services. RERC also provides research, analysis and investment criteria—including cap rates, yield rates, expense and growth expectations and recommendations—for nine property types on national and regional levels, and for 40 major U.S. markets through the quarterly RERC Real Estate Report, the annual Expectations & Market Realities in Real Estate, the RERC/CCIM Investment Trends Quarterly and the RERC DataCenter.

## INSIDER'S PERSPECTIVE

starting to edge upward. However, speaking to a convention of bankers in early March 2006, Fed Chairman Ben Bernanke expressed concern that the “rapid growth in commercial real estate exposures relative to capital and assets raised the possibility that risk-management practices” may not have kept pace with changes in the economy.

Therein lies the greatest advice for investors: Focus on true risk-management strategies. Heretofore, commercial real estate has done very little in this arena; the Real Estate Research Corporation agrees that investors who focus on competent risk-management strategies will be the winners going forward in commercial real estate.

### STOCKS EDGE OUT COMMERCIAL REAL ESTATE

Though real estate returns remain strong, returns on other investments are certainly improving (see Table 1). In fact, RERC's first quarter research survey respondents gave stocks a slight edge over commercial real estate as an investment option. It was the second consecutive quarter that survey respondents rated stocks first, real estate second, cash third and bonds fourth among the major investment alternatives.

RERC's spring 2006 research respondents presented an interesting view of the investment climate for real estate. The majority of respondents stated that nearly all real estate was excessively priced. One respondent noted,

“There is no ‘best’ investment anymore,” and another said that investors must look for niche opportunities where they can buy at a price that makes sense. Another respondent suggested looking for long-term credit net lease properties because of low interest rates and an uncertain market.

Among the major property types, the industrial warehouse sector received the highest investment conditions rating (7.0 on a scale of 1 to 10 with 10 being high) for first quarter 2006; retail power centers received the lowest rating (see Table 2). In addition, the investment conditions for all three retail property types declined since the previous quarter.

Research findings indicate that capitalization rates have stopped declining and have stabilized at approximately 7 percent. RERC's first quarter 2006 required going-in capitalization rates are still inching downward for industrial research and development, retail regional malls and suburban office property types; but required going-in capitalization rates have leveled off or are increasing 10 to 20 basis points for the other property types RERC tracks. Further, terminal capitalization rates are stable or increasing for all major property types (see Table 3).

As the capitalization rate compression era comes to an end, a strong space market will become imperative to

Table 1  
What Do The Financial Markets Tell Us?  
Compounded Annual Rates of Return as of 3/31/2006

| MARKET INDICES               | 1-YEAR | 3-YEAR | 5-YEAR | 10-YEAR |
|------------------------------|--------|--------|--------|---------|
| Consumer Price Index         | 2.73%  | 2.37%  | 2.70%  | 2.79%   |
| 10-Year Treasury Bond*       | 4.36%  | 4.25%  | 4.42%  | 5.16%   |
| Dow Jones Industrial Average | 5.77%  | 11.60% | 2.54%  | 7.11%   |
| NASDAQ Composite             | 13.29% | 19.48% | 2.97%  | 7.73%   |
| NYSE Composite               | 13.16% | 20.34% | 5.23%  | 8.43%   |
| S&P 500                      | 9.68%  | 15.14% | 2.22%  | 7.21%   |
| NCREIF Index                 | 20.19% | 15.15% | 11.80% | 12.30%  |

\*Based on Average End of Month T-Bond Rates  
Sources: Economy.com, NCREIF, compiled by RERC



## INSIDER'S PERSPECTIVE

Table 2  
Investment Condition Ratings

Rated on a scale of 1 to 10, with 1 being low and 10 being high.

| PROPERTY TYPE                        | 1Q2006 RATING |
|--------------------------------------|---------------|
| <b>CBD Office</b>                    | <b>5.9</b>    |
| <b>Suburban Office</b>               | <b>6.0</b>    |
| <b>Industrial Warehouse</b>          | <b>7.0</b>    |
| <b>Industrial R&amp;D</b>            | <b>5.9</b>    |
| <b>Regional Retail Mall</b>          | <b>5.7</b>    |
| <b>Retail Power Center</b>           | <b>5.5</b>    |
| <b>Neighborhood/Community Retail</b> | <b>6.0</b>    |
| <b>Apartment</b>                     | <b>6.4</b>    |
| <b>Hotel</b>                         | <b>6.0</b>    |

receive moderate returns. Decreased vacancy rates, increased absorption, restrained new construction and rent increases will be critical.

### OFFICE SECTOR REMAINS STRONG

The national office market remains relatively strong overall from a fundamentals perspective. Demand continues to increase, the national vacancy rate continues to decline and new construction has been restrained. Torto Wheaton Research reports that the national CBD office vacancy rate has declined to 11.6 percent and the national suburban office vacancy rate declined to 14.5 percent. The Washington, D.C., New York City, Miami, San Diego and Los Angeles metro markets have some of the lowest office vacancy rates in the country; the highest office vacancy

Table 3  
RERC Required Return Expectations<sup>1</sup> by Property Type

|                                     | OFFICE  |          | INDUSTRIAL |          | RETAIL        |              |            |           |          |                |                      |
|-------------------------------------|---------|----------|------------|----------|---------------|--------------|------------|-----------|----------|----------------|----------------------|
|                                     | CBD     | Suburban | Warehouse  | R&D      | Regional Mall | Power Center | Neigh/Comm | Apartment | Hotel    | Avg. All Types | RERC Portfolio Index |
| <b>PRE-TAX YIELD (IRR) (%)</b>      |         |          |            |          |               |              |            |           |          |                |                      |
| <b>Range</b>                        | 7.3-11  | 7.3-11.5 | 7.0-11     | 7.5-11.5 | 7.0-11        | 7.0-11       | 7.0-11     | 7.0-10    | 9.5-12   | 7.0-12         | 7.0-12               |
| <b>Average<sup>2</sup></b>          | 8.6     | 8.9      | 8.6        | 9.2      | 8.8           | 8.5          | 8.6        | 8.5       | 10.8     | 9              | 8.7                  |
| <b>Weighted Average<sup>3</sup></b> | 8.8     |          | 8.6        |          | 8.7           |              |            |           |          |                |                      |
| <b>GOING-IN CAP RATE (%)</b>        |         |          |            |          |               |              |            |           |          |                |                      |
| <b>Range</b>                        | 5.0-9.0 | 6.3-9.5  | 5.8-10     | 6.5-10   | 5.5-9         | 6-8.8        | 5.0-9.0    | 5.0-9.0   | 7.5-10.5 | 5-10.5         | 5-10.5               |
| <b>Average<sup>2</sup></b>          | 7       | 7.3      | 7          | 7.6      | 7             | 6.9          | 6.9        | 6.4       | 8.5      | 7.2            | 7                    |
| <b>Weighted Average<sup>3</sup></b> | 7.2     |          | 7          |          | 7             |              |            |           |          |                |                      |
| <b>TERMINAL CAP RATE (%)</b>        |         |          |            |          |               |              |            |           |          |                |                      |
| <b>Range</b>                        | 6.5-10  | 6.8-10   | 6.5-10.5   | 7-10.5   | 6.3-10        | 6.8-9.5      | 6.5-9.5    | 6-9.5     | 8.0-11   | 6.0-11         | 6.0-11               |
| <b>Average<sup>2</sup></b>          | 7.6     | 8        | 7.8        | 8.3      | 7.8           | 7.6          | 7.6        | 7.2       | 9.4      | 8              | 7.7                  |
| <b>Weighted Average<sup>3</sup></b> | 7.8     |          | 7.8        |          | 7.7           |              |            |           |          |                |                      |
| <b>RENTAL GROWTH (%)</b>            |         |          |            |          |               |              |            |           |          |                |                      |
| <b>Range</b>                        | 0-6     | -6.5     | 0-6        | 0-6      | 2.0-4.0       | 2.0-4.0      | 2.0-4.0    | 0-5       | 1.5-5    | -7.5           | -7.5                 |
| <b>Average<sup>2</sup></b>          | 3.4     | 3.2      | 2.8        | 2.7      | 2.8           | 2.9          | 3          | 3.1       | 3.2      | 2.9            | 3.1                  |
| <b>Expense Growth (%)</b>           |         |          |            |          |               |              |            |           |          |                |                      |
| <b>Range</b>                        | 2.0-4.0 | 2.0-4.0  | 2-3.5      | 1.5-3.5  | 2-3.5         | 2.0-4.0      | 2.0-4.0    | 2.0-4.0   | 2.0-4.0  | 1.5-4          | 0.5-4                |
| <b>Average<sup>2</sup></b>          | 3       | 3.1      | 2.8        | 2.7      | 3             | 3.1          | 3.1        | 3         | 3        | 3              | 3                    |

<sup>1</sup> This survey was conducted in January, February and March 2006 and reflects expected returns for First Quarter 2006 investments.

<sup>2</sup> Ranges and other data reflect the central tendencies of respondents: unusually high and low responses have been eliminated.

<sup>3</sup> Weighting based on 1Q06 NCREIF Portfolio market values.

Source: Spring 2006 RERC Real Estate Report

rate among major metropolitan areas is in Dallas at more than 23 percent.

RERC's first quarter 2006 required going-in and terminal capitalization rates for the CBD office sector increased 20 and 10 basis points, respectively, compared with the previous quarter. However, the required going-in capitalization rate for the suburban office market declined another 10 basis points, and the terminal capitalization rate remained stable.

First quarter 2006 expected rental growth is higher, by percentage, for the office market than for any other property sector RERC tracks. According to RERC's institutional survey respondents, rental growth is expected to increase 3.4 percent for the CBD office market and 3.2 percent for the suburban office sector.

### **INDUSTRIAL SPACE DEVELOPMENT OFFSETS DEMAND**

New development and construction of industrial space is offsetting strong demand, slowing the decline in industrial availability rates. Nonetheless, Torto Wheaton Research reports that the national industrial warehouse availability rate stands at 10.1 percent and the industrial R&D availability rate is 14.4 percent. The port cities and high population growth cities such as Los Angeles, Miami, Tampa and Las Vegas show the lowest industrial availability rates; Pittsburgh, Detroit and Boston have the highest availability rates.

RERC's required going-in and terminal capitalization rates for industrial warehouse space began increasing during first quarter 2006. The required going-in capitalization rate for industrial R&D space declined another 10 basis points from last quarter, and the required terminal capitalization rate remained flat at 8.3 percent.

### **RETAIL AVAILABILITY BEGINS TO INCREASE**

Considered the darling of property types during the past few years, the increase in new retail construction will place upward pressure on the availability rate for this sector in the coming quarters. In fact, on a national level, first quarter 2006 retail availability has already started to increase, partially because of new construction outpacing demand. The Midwest states have the highest retail availability rates; coastal markets have some of the lowest retail availability rates recorded.

### **A summary of risk factors to determine the best investment strategy:**

- *Space markets improving*—Shift to shorter durations of leasing time with pricing power.
- *Capital market pushing capitalization rates and total returns up*—Shift to properties that experienced the least amount of rate compression and have growth potential.
- *Financial market returns increase*—Move out of tactical and cyclical investment arenas.
- *Economic climate increasingly uncertain*—Shift to industries and properties that have pricing power.
- *Overall investments*—Move to more of a value-added-strategy, rather than a core strategy from a risk-adjusted return perspective.

RERC's institutional survey respondents reported mixed results for the retail sector in first quarter 2006. Required going-in capitalization rates for regional retail malls declined 20 basis points from last quarter, remained flat at 6.9 percent for retail power centers and increased 10 basis points for neighborhood/community centers.

### **APARTMENT CONSTRUCTION SPURS SLIGHT HIKE IN VACANCY RATES**

New apartment construction continues, with the majority of new building occurring along the East and West coasts—areas that also have experienced some of the greatest capital appreciation and major condominium conversion. Much of the new apartment development should come online in 2007 and 2008. As such, first quarter 2006 apartment vacancy rates increased to 5.8 percent from 5.7 percent the previous quarter, according to Reis Inc. The slight increase in the overall vacancy rate is the first increase since 2004 for the apartment sector.

RERC's first quarter 2006 required going-in capitalization rate for the apartment sector increased 10 basis points from the previous quarter; the required terminal capitalization rate holds at 7.2 percent.

### **HOTEL SECTOR EXPERIENCES UPTICK**

Though the hotel sector is considered the riskiest of the core property sectors, it has the most pricing power and

upside investment potential in today's market. According to Smith Travel Research, hotel occupancy increased 3.8 percent and revenue per available room, or RevPAR, increased 10.7 percent in early 2006.

RERC's first quarter 2006 required going-in and terminal capitalization rates for hotels increased 10 basis points in last quarter. RERC's expected rental growth for hotels declined to 3.1 percent in first quarter, 70 basis points lower than last quarter and 130 basis points lower than two quarters ago, suggesting that some of the growth momentum will slow for this sector. Expense growth has remained relatively flat during this time period.

### CONCLUSIONS

- In this very strong economy, various risk factors—which require appropriate management—will challenge the ability to maintain expected returns on real estate. In the capital market, low capitalization rates are causing real estate prices to climb and are driving up risk. However, investors can still rely on real estate to cushion their portfolios, and should pursue properties with reasonable capitalization rates within low-vacancy areas.
- In today's investment environment, real estate assets with long-term, fixed-rate leases are likely the riskiest

investment. Savvy investors are paying premiums for assets with near-term rollover and quality assets with vacancy problems. This investment strategy provides investors with the ability to generate quality returns through increased rents and decreased vacancies, as returns generated from decreasing capitalization rates are rare.

- Double-digit returns should continue through 2006, as commercial real estate likely remains a favorable investment. The retail sector, which served as a leading indicator in the real estate run-up, is now the first sector to begin cooling off, though still recording a strong 18.8 percent return. In the coming months, the total return associated with the retail sector should continue to decrease at a steady and measured pace.
- Overall, the investment demand associated with commercial real estate remains strong and should remain so as the world continues to shrink. The U.S. real estate market has attracted significant investment attention from the global market, which is not surprising given the high prices paid and the low cash-on-cash returns generated in some overseas markets as well as the attractiveness of the U.S. economy and real estate market. ■

## RECOMMENDED READING

# Politics, Religion and the Global Community

REVIEWED BY BOWEN H. “BUZZ” MCCOY, CRE



**America at the Crossroads: Democracy, Power and the Neoconservative Legacy**  
by Francis Fukuyama (2006, Yale University Press, New Haven, Conn., 240 pages)

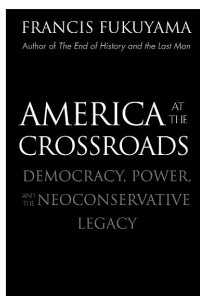
FRANCIS FUKUYAMA—the Bernard L. Schwartz Professor of International Political Economy

and director of the International Development Program at Johns Hopkins University's School of Advanced International Studies—has written widely on political and economic development. His previous books include *State-*

*Building: Governance and World Order in the 21st Century* (2004, Cornell University Press) and *The End of History and the Last Man* (1992, Simon & Schuster).

He considers himself a neoconservative and has friendships and working relationships with others who, he thought, shared his views, including former U.S. Deputy Secretary of

Defense Paul Wolfowitz, national security strategist Albert Wohlstetter, author Alan Bloom and *Weekly Standard* editor Bill Kristol. The book, more a long essay, is based on lectures Fukuyama gave at Yale University in spring 2005. His criticism of the Iraq conflict has put him at odds with many of his former associates.



Fukuyama argues that the announcement of a broad preemptive doctrine and the invasion of Iraq were not obvious responses to the Sept. 11 terrorist attacks. Most controversial was President George W. Bush's emphasis on regime change in Iraq and the assertion of U.S. exceptionalism, which gave the Bush administration the duty to take care of the terrorist problem. In addition, Fukuyama asserts that Bush and his advisors gave little thought to post-war reconstruction.

### MORAL, POLITICAL AND SECURITY ISSUES ARE KEY CONCERNS

What precisely is a neoconservative? Fukuyama specifies four common characteristics:

- A concern with democracy, human rights and the internal policies of foreign states
- A belief that U. S. power can be used for moral purposes
- A skepticism about the ability of international law and institutions to solve serious security problems
- A view that ambitious social engineering often leads to unexpected consequences and undermines its own ends

### About the Columnist

**Bowen H. “Buzz” McCoy, CRE**, is a retired investment banker and former chairman of the Counselors of Real Estate.

## RECOMMENDED READING

Neoconservatism can be viewed as in contrast with:

- Realists in the tradition of Henry Kissinger, who respect power and tend to downplay the internal natures of other regimes and human-rights concerns.
- Liberal internationalists, who hope to transcend power politics and move to an international order based on law and institutions.
- Jacksonian American nationalists, who tend to take a narrow security-related view of national interests, distrust multilateralism and tend toward isolationism.

Unlike realists, liberal internationalists and Jacksonians, Fukuyama describes himself as a Wilsonian neoconservative, relying more heavily on the role of multinational organizations.

Ironically, Fukuyama indicates that neoconservatism originated from a small group of liberals, mostly Jewish and New York-based, who were converted to conservative thought by the threat of the Soviet Union. Shortly afterward, opposition to utopian social engineering entered the political sphere, led by former U.S. Sen. Daniel Moynihan, political scientist James Q. Wilson and author Charles Murray, among others. This influential group opposed policies related to state interference, including forced busing, and argued that affirmative action carried negative consequences, welfare corroded the character of the poor, and physical surroundings such as graffiti and broken windows contributed to increased crime rates.

On a larger scale, regime change, even by force, became a neoconservative policy. Yet regimes shape and are shaped by the societies underlying them. The unwritten rules by which people operate—based on religion, kinships and shared historical experience—also are part of the regime. Founding a new political order is, thus, a difficult business, especially for those who are not immersed in the habits, mores and traditions of the people for whom they are legislating.

Probably incorrectly, the models of Germany and Japan were used to predict the multi-national troop force's welcome in Iraq. What was forgotten was that in both nations the defeat and feelings of guilt for war crimes was so deep that each experienced not only a regime change, but also a deep cultural shift including a ten-

dency toward pacifism. In Iraq, to date, the regime change has done little but to release pre-existing cultural tensions.

### NEOCONSERVATIVES POINT TO THE RISE OF DEMOCRACY AND FALL OF COMMUNISM

His previous book, *The End of History and the Last Man*, has been interpreted to mean that the inexorable power of modernization and democracy will cause all totalitarian regimes to eventually fall, leaving the world more like the West in general and the United States in particular.

Though Poland and other states have embraced democracy, these rapid transitions are the exception, not the rule. At one time, popular belief was that the contagious appeal of democracy and the importance of U.S. power would prompt a global conversion to democracy. The modern-day reality, however, is that neither is persuasive in all cases, and most Americans do not believe that the exceptionalism of the United States gives it the duty to govern the world.

The collapse of communism reinforced the neoconservative point of view. In a beautifully written passage, Fukuyama writes:

“But great leadership often involves putting aside self-doubt, bucking conventional wisdom and listening only to an inner voice that tells you the right things to do. That is the essence of strong character. The problem is that bad leadership can flow from the same characteristics: steely determination can become stubbornness; the willingness to flout conventional wisdom can amount to a lack of common sense; the inner voice can become delusional. The fact that one was proven unexpectedly right under a surprising set of circumstances does not necessarily mean that one will be right the next time around. It probably does mean, however, that one will be psychologically handicapped in recognizing that one is wrong in future cases.”

Fukuyama also discusses *Globalized Islam: The Search for a New Ummah*, by Oliver Roy, which asserts that we are not engaged in a worldwide clash of civilizations, but rather with a group of alienated and uprooted young people in Hamburg, London or Amsterdam who see

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*jihad* as the answer to a personal search for identity. If Roy's thesis is true, the major battlegrounds are as likely to evolve in Western Europe as in the Middle East. Many European countries will face stronger threats than the United States. Rather than field armies, counter-terrorism will become the work of intelligence agencies and police.

A failure of the neoconservatives in Iraq would no doubt lead to a return to realism, à la Kissinger, and less intervention—and perhaps even a return to isolation-

climate similar to pre-World War I years, and could spur the formation of coalitions of former enemies and current friends who are horrified at the role the U.S. has come to play in world hegemony.

No one would deny that fulfillment of President Bush's vision of a democratic, well educated, economically secure, peace-loving Middle East—of which Iraq would be the showcase—would be highly desirable.

Unfortunately, even if the situation ends positively, it likely will be messy and ambiguous.

*“Francis Fukuyama here gives the most lucid and knowledgeable account of the neoconservative vision of America’s place and role in world affairs, and where it has overreached disastrously. He argues effectively for an American foreign policy more aware of the limits of American power, less depended on the military, and more respectful of the interests and opinions of other countries and emerging international norms and institutions.”*

—Nathan Glazer, professor emeritus  
Harvard University

ism. This shift would mean a demilitarization of U.S. foreign policy. Preventive war and regime change would stay in the list of options, but only as very extreme measures. The global war on terrorism overstates the scope of the problem, suggesting the United States is taking on a large part of the Arab and Muslim worlds. U.S. power often is the most effective when it is invisible, Fukuyama writes; thus, policymakers should rely more on soft power.

### SUCCESS COULD STILL LEAD TO INSTABILITY

My own comments include the obvious fact that Fukuyama does not consider the possibility of neoconservative strategies succeeding in Iraq. We will pass over defining what constitutes success but, if achieved, one outcome could be a rolling series of preemptive wars and regime changes including power shifts in the so-called evil states of Iran, North Korea and Syria, among others.

In this instance, the United States' self-perceived exceptionalism could indeed be perceived as governing the world. This perception, in turn, could yield a political

It appears to me that Fukuyama's call for less military activity and more diplomacy is becoming reality, at least in part. U.S. Secretary of State Condoleezza Rice has traveled far more frequently than former Secretary of State Colin Powell, and perhaps more effectively. She seems to favor the soft approach, at least initially. The Pentagon, meanwhile, is beginning to realize the limits of the military and, perhaps, beginning to withdraw from the theory that it can fight two regional wars simultaneously.

Overall, Fukuyama seems to have shifted from a militaristic world-power view to a more Hegelian dialectic of gradual, sometimes destructive, evolution.<sup>1</sup> In Fukuyama's last two books, he argues both sides brilliantly.

*America at the Crossroads* gives fresh ammunition to all those opposed to U.S. military action in Iraq. For those who support a role for the power and cultural values of the United States as a part of the world order, the book presents a challenging test of the intellectual premises underlying their point of view.

## RECOMMENDED READING

### Globalized Islam:

#### The Search for a New Ummah

by Oliver Roy (2004, Columbia University Press, New York City, 349 pages)

OLIVER ROY, A PROFESSOR AT THE SCHOOL OF ADVANCED Studies in Social Sciences in Paris, has written previously about Islam in a global context. In *Globalized Islam: The Search for a New Ummah*, he argues that the spread of Islam around the globe has blurred the connection between a religion, a specific society and a territory.



One-third of the world's Muslims now live as members of a minority. Though millions of Muslims have settled voluntarily in the West, they are concerned about the pervasiveness and influence of Western culture, and the effect its models and social norms have on Islam as a system of values and ethics. The return to the Islamic tradition has been

accompanied by a growth in westernization. Thus the revival of Islam has been a consequence of westernization, not a clash with it. This thesis clashes with the views of political scientist and author Samuel Huntington, whose books have been reviewed in previous editions of *Real Estate Issues*.

Neofundamentalism has been gaining ground among a rootless Muslim youth, especially second- and third-generation migrants in the West, Roy notes. This trend has produced new forms of radicalism, including Al Qaeda, and rejection of integration into Western society. The uprooted militants wish to establish an imaginary *umma*, a Muslim community built around Islamic values, that isn't embedded in any particular society or territory.

Roy also asks how we can reconcile hatred for the West with the long lines for visas outside Western consulates. This reality appears to be a dichotomy until readers realize the neofundamentalist *umma* has nothing to do with territorial integrity, and instead should be considered in abstract terms.

The quest for Islamic authenticity begins with debunking Western culture and values, Roy asserts. However, without territory, leaders cannot sustain religious or social dogmas through civic authority. For these reasons, creating an

abstract worldwide community, or *umma*, is far more important than creating a state. The violence of Islamic terrorists is less a product of their religion than their identification with recent leftist and Third World radical movements. The war on terrorism is a metaphor, not a real policy, Roy writes—more a police and intelligence issue than a military one.

The author also stresses that groups such as Al Qaeda need not recruit from the Middle East; thousands of candidates are in Western Europe where Muslims, unlike those in the U.S., are mainly from the working class. Roy points out that Muslims comprise 10 percent of the Berlin population; Muslims also were a large portion of the crowds participating in recent demonstrations in France. He also suggests the openness of the United Kingdom's legal system toward political asylum and free speech has prompted French antiterrorist police officials to give London the new nickname of Londonistan.

### SECULAR SOCIETIES ELICIT NEOFUNDAMENTALISTS' RANCOR

Westernized Muslims may have lost their culture, but not their religion. A distinction, again, at odds with Huntington's views. Though most European Christians have endorsed secularism, Muslims see Europe as Christian, so much so that one UK militant group has called for all UK politicians and other leaders to convert to Islam. Meanwhile in U.S. mosques, 97 percent of attendees speak English as their primary language. To live as a minority is to experience Islam as only a religion confined to one's private life, Roy writes.

By rejecting the Western culture in which they live, neofundamentalists are unable to create a Muslim culture. Neofundamentalists stress the gap between culture and religion—they have no popular Muslim novelists, comedians, film-makers or poets in the West—which contributes to the secularization they abhor. Then, they reconstruct themselves with veils, beards and language.

Insecurity about the limits of the community drives fanaticism, Roy writes, and leads to the rejection of Western social rules. A French radical summarized this psychological phenomenon when he announced: "I am not French; I am not an Arab; I am a Muslim." Muslim neofundamentalists have created a virtual world—an imaginary, purely religious community surrounded by a

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hostile or indifferent secular world. And they must declare a *jihad* to defend the frontiers of the ummah.

Al Qaeda has no strategic vision, Roy writes; it fights against Babylon. Most Al Qaeda targets have no military or strategic value: a nightclub in Bali or a Spanish restaurant in Casablanca. Instead, Al Qaeda is an organization and a trademark that can operate directly, in a joint venture or through a franchise.

*The violence of Islamic terrorists is less a product of their religion than their identification with recent leftist and Third World radical movements. The war on terrorism is a metaphor, not a real policy, Roy writes—more a police and intelligence issue than a military one.*

Since the fall of the Taliban, Al Qaeda has lost its sanctuary in Afghanistan and has had difficulty gaining support from any significant local population. So it moves around the world from *jihad* to *jihad*, its leaders becoming the *jihad* jet set. Its base is mosques in London and Hamburg as much as the *madrassa*. Its history has nothing to do with Middle East conflicts, and its members are a combination of educated middle class leaders and working class drop outs, similar to leftist radical groups. Many are born-again Muslims or jail-house converts, and they behave in Western ways: They drink, smoke, go clubbing and chase girls. Al Qaeda is more a mafia or a sect than a professional underground organization. The enemy is elusive and sometime merely our own shadow.

### RISE OF TERRORISM FORESHADOWS A LARGER ISSUE

Roy argues that religion and culture are not as interconnected as Huntington believes. The values of the Christian faith can remain embedded in a culture even when the religion wanes and the culture otherwise turns secular, Roy writes. There are Jews who are cultural without being religious and conservative Protestants who use religion to try to establish social mores without the concept of a shared culture. Secularization does not mean the end of religion, but the separation of religion from the other

spheres of social life. Thus, a religious revival can be compatible with growing secularization.

Roy's book concludes with the story of the Baghdad caliph's tailor. The caliph wanted to punish a tailor who had overcharged him so he ordered a henchman to hang the tailor at the gate of his house. The henchman returned, saying the tailor was too tall for the gate. "Find a smaller tailor and hang him," the caliph answered. In a similar fashion, the military apparatus tailors the enemy.

Terrorists have no long-term strategy, Roy writes, and terrorism is a marginal symptom of a larger problem that deserves a response. But radical violence is better understood within a larger framework: the relationship of all modern religions with secularization, individualization, culture and politics.

Roy's work is a catalyst for thinking about terrorism as well as other societal issues in a way that is intelligent and provocative regardless of readers' position on current events in the Middle East and elsewhere.

Reflecting on the book reminds me of a speech that former U.S. Secretary of State George Shultz delivered several years ago. He cited two primary functions of a nation state as controlling currency and waging war. But in today's world, the globalization of money and capital markets together with the roles played by George Soros and the hedge funds make it increasingly difficult to control a nation's monetary base. And real-time news coverage provided by CNN and others makes it increasingly difficult to sustain long and bloody conflicts. The new brand of jet-age *jihad* operating outside of national boundaries could be added to Schultz's list. ■

- 1 Georg Wilhelm Friedrich Hegel (1770–1831) was a German scholar whose philosophy of history is essentially that of a dialectical progression. This model begins with an existing element, or thesis, with contradictions inherent to its structure. These contradictions create the thesis' direct opposite, or antithesis, bringing about a period of conflict between the two. The new element, or synthesis, that emerges from this conflict then discovers its own internal contradictions, and starts the process anew.





## THE COUNSELORS OF REAL ESTATE

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