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Editor's Statement

BY MAURA M. COCHRAN, CRE

I recently enjoyed a lengthy conversation with a friend concerning the operation of our respective firms. She is a land use lawyer with one of the best (and largest) law firms in the Northeast. By comparison, my company, Hartford. Conn.-based Bartram & Cochran, is a small boutique firm with a national consulting practice. One of my questions to her during our discussion focused on what criteria should be used in determining how to equitably set base compensation and bonuses for my firm.

Quickly writing her answer on a paper napkin (gives you a sense of where the conversation was taking place), my friend laid out the following criteria to which her firm subscribes: education, recruiting, governance, participation in the community, new business development, billable hours and general practice. Upon reviewing her criteria a second time, they made even more sense to me, as they are in the DNA of each CRE member. I look forward to incorporating that criteria into our compensation plan going into next year.

As I sat down to write this column, those criteria again came quickly to mind as I reviewed the Roundtable (which can be found on pages 1-6 of this edition of *REI*) with our three incoming 2007-08 leaders: Chairman of the Board Rich Hanson, CRE, principal of Mesa Development of Chicago (a national developer of residential and mixed use properties; CRE First Vice Chairman A. C. Schwethelm, CRE, president of A.C. Schwethelm & Associates (appraisal services and litigation support firm) of Comfort, Texas; and CRE Second Vice Chairman Art Pasquarella, CRE, a principal and chief operating officer of BPG Properties, Ltd. (private equity real estate fund manager) of Philadelphia, Pa.

These three leaders have important characteristics in common. Each believe in education, apparent by their schooling and involvement in CRE conventions and meetings. Each recruits new members to our organization by setting an example by their high caliber and character, and by sponsoring new members. Each believes in governance, demonstrated by the service they have provided their fellow CREs and the industry by their service on many CRE committees. And each participates in his local communities, a trademark of members of our organization.

I'm not quite sure if the new business development refers to all of the members that they will get to know more closely over their respective terms in office or if the billable hours and practice should refer to the hours they are foregoing to be of service to our group, or the fact that they still run and maintain incredibly complex and demanding positions in their own companies. But all three possess the character and professionalism that defines a CRE, and we all benefit from their willingness to serve as CRE leaders.

REI sat down with Rich, A.C. and Art and asked what projects they are currently working on, what they view as key issues that are impacting the real estate environment and how the CRE organization is meeting those challenges. I'm confident you will find their thoughts and comments insightful.

The rest of this issue's articles fall into four broad categories: Law and the Land, Finance, International Issues and Ethics.

In the feature article "Conservation Easement: Windfall or Straightjacket?," co-authors James D. Timmons and Lara Daniel address the various types of easements, how they are being used and legal aspects and tax implications that accompany such easements. For anyone working with local land trusts or conservation groups, this article provides many points for discussion.

Another form of land management is covered in the feature article "Unintentional Redlining? Zoning Ordinances and the Living Wage" by Patricia S. Wall, Esq. The article poses an important question: Are city council proposals to raise the minimum wage for big-box retailers within the limits of most cities a form of unintentional redlining, since the stores and associated jobs would migrate from lower-income sectors to peripheral areas? The Community Reinvestment Act of 1977 outlawed the practice of "redlining," in which lenders deny loans based on the applicant living in certain low-income areas rather than on the applicant's qualifications for their services. The article provides case law in the area and an in-depth analysis of this trend.

Joseph S. Rabianski, Ph.D., CRE, provides further insight into his previously published article "Comments on the Concept and Definition of Highest and Best Use," that appeared in the Spring 2007 edition of *REI* (this article can be accessed online at www.cre.org/publications). The follow-up article, "Comments On the Probability of Rezoning," expands on determination analysis and explains that the analysis can be flawed if legal permissibility is contrary to the economics of the property market.

One of the major benefits of CRE membership is the ability to share ideas and perspectives. It is the hope of the *REI* Board that more members and readers will respond to issues by submitting perspectives for publication in future *REI* editions. We encourage readers of *REI* who see articles of interest to send authors' names to info@cre.org. Board members will locate authors and inquire whether they have articles that are appropriate for *REI*.

The finance feature article "Commercial Real Estate Derivatives: The Developing U.S. Market" by Jim Clayton, Ph.D., is an expansion of "The Dynamics of Derivatives" presentation which Jim delivered at CRE's 2007 Midyear Meeting in Montreal. His presentation was so well attended and the response so high that *REI* wanted to expand on the topic. This piece provides the background for both those who are new to the derivatives market or are more advanced in the use of this finance mechanism.

On the international front, Barry Gilbertson, CRE, PPRICS, presents his perspective on "What Is Driving the Change in the U.K. Retail Market?" As Barry says in his introduction, the purpose of the article is "to draw, in the mind of the reader, a similarity or contrast between the U.K. and the property market in which the reader operates." The restructuring in the U.K. retail market affects all markets and it impacts those who develop or invest in retail development.

This issue concludes with two resource reviews. One review is on a book that deals with international issues, and the other on leadership and ethics. In his review of Michael Ball's *Markets & Institution in Real Estate & Construction,* P. Barton DeLacy, CRE, FRICS, who serves as associate editor of *REI*, notes that the book is important for those working in the field of international comparison analysis. *Markets & Institutions*, according to Barton, "produces an analysis on property markets across Europe in an attempt to integrate academic ideas of international economics, measurements and models into the real world of practitioners."

In his review of real estate icon and CRE Buzz McCoy's *Living Into Leadership, A Journey in Ethics,* Kenneth P. Riggs, Jr., CRE, brings us to the heart of the book. *Living Into Leadership* is not Buzz's autobiography; rather, it is a series of stories that tap into Buzz's remarkable career to help each reader determine his or her own unique legacy.

I want to thank P. Barton DeLacy, CRE, managing director and national practice leader for corporate valuation consulting at New York-based Cushman & Wakefield, for his service as associate editor of *REI.* A long-time member of the *REI* board, Barton brought a vision and energy to *REI*, and his contributions are clearly visible on the pages of this journal.

According to CRE membership surveys, *Real Estate Issues* is consistently rated as one of the most important benefits of belonging to the CRE organization. But survey numbers can never be as meaningful as a sentiment that was recently expressed in a letter from CRE Wayne Grinnell of El Paso, Texas. Wayne writes:

> "One of the items that impressed me years ago when I first was introduced to the CRE organization was the *REI* publication.
>
> "Still does, as a new member. It far outshines my other primary professional publications in terms of variety, practical information and interest."

The editorial board and I are very proud of this publication and gladly offer our time and energy to its creation. We hope that you, like fellow Counselor Wayne Grinnell, find it valuable and insightful.

One of the benefits of serving as *REI*'s editor in chief is reading all of the features, insider perspectives and resource reviews that come across my desk. It makes me proud to be associated with such a unique group of individuals who have so much to offer their fellow CREs and their industry. It also stokes my appetite to read more. My goal and mission, which are shared by the *REI* Board, are to persuade more of my fellow CREs to put their expertise, perspectives and thoughts on the pages of *REI*. *REI* is *our* forum. *REI* is *our* journal. I hope to see your thoughts and perspectives land on my desk in the very near future. ■

Maura M. Cochran

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CRE

Leadership Roundtable: The Real Estate Industry & the CRE Organization

Panelists:

RICHARD A. HANSON, CRE
2008 CRE Chairman of the Board
Principal – Mesa Development, LLC
Chicago, Ill.

A.C. SCHWETHELM, CRE
2008 CRE First Vice Chairman
(to serve as 2009 Chairman)
President – A.C. Schwethelm Associates, Inc.
Comfort, Texas

ARTHUR P. PASQUARELLA, CRE
2008 CRE Second Vice Chairman
(to serve as 2010 Chairman)
Executive Vice President, COO – BPG Properties, Ltd.
Philadelphia, Pa.

Moderator:

MAURA M. COCHRAN, CRE
Editor in Chief
Principal – Bartram & Cochran, Inc.
Hartford, Conn.

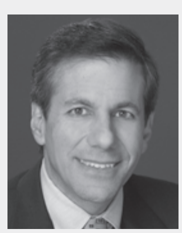
WHILE THE THREE COUNSELORS WHO ARE IN LINE TO SERVE AS CRE Chairman of the Board have many decades of experience in the real estate industry among them, each possesses a unique perspective on the many issues we face each day, including development, appraisal and investment.

How are these CRE leaders and their companies navigating the current real estate environment during this period of change? What challenges do they face? What role do all three see the CRE organization playing as a guiding force? Maura M. Cochran, CRE, editor in chief of *Real Estate Issue*, discusses these issues with the three CRE leaders.

About the Roundtable Participants

Richard A. Hanson, CRE, *is principal of Mesa Development, LLC, a Chicago-based national real estate developer and investor committed to developing significant residential and mixed-use developments in major cities and urban areas. His work is grounded by his belief in creating architecturally stunning urban settings located near civic and cultural centers, allowing individuals greater opportunity to contribute to society and enhance their lives.*

A.C. Schwethelm, CRE, *is president of A.C. Schwethelm Associates, Inc., of Comfort, Texas, a firm which specializes in counseling government entities and others on litigation strategy, eminent domain and taxes. Schwethelm is retained by state agencies, city and county governments, and attorneys for property owners for his appraisal expertise. Schwethelm is a past recipient of CRE's highest honor, the Landauer/White Award, which is presented annually to an individual who has furthered the ideals of The Counselors of Real Estate organization, who has advanced the position of the "CRE" designation and who has demonstrated outstanding professionalism in real estate.*



Arthur P. Pasquarella, CRE, *is a principal and chief operating officer of Philadelphia, Pa.-based BPG Properties, Ltd., a private equity value-added fund manager directly operating a diversified national property portfolio. Pasquarella oversees all of the firm's real estate investment and property activities. He holds a master's degree in real estate and investment analysis from the University of Wisconsin-Madison and a bachelor's degree in finance from The Pennsylvania State University.*

COCHRAN: ***What are the major projects you're working on right now?***

HANSON: We're in the process of constructing two buildings. One is a 72-story condominium in Chicago called the Legacy at Millennium Park. The second, in San Jose, Calif., is the 360 Residences, a 213-unit, 23-story condominium tower.

PASQUARELLA: We are a private equity real estate fund manager and just closed our eighth investment fund — at $850 million, our largest by far. In July, we commenced investing it, and we have three to four years to invest that capital in an intelligent way. Since it's a leveraged pool of capital, we'll wind up having to buy about $1 billion of acquisitions throughout the country in each of the next three years, diversifying among the main four groups — office, retail, industrial and multifamily.

SCHWETHELM: My work most recently has been in the courtroom as a result of appraisal issues. I recently testified as a consultant, not as an appraiser, for a property owner in a hearing critiquing the appraisal prepared for the condemning authority. The commissioners gave an award approximately five times the testimony of the appraiser, although I gave no opinion of value, merely an analysis of an appraisal that defied reason. The next day the attorney for the condemner called and hired me to "do for them what I did to them." I believe it will result in a lengthy assignment in which I can help the condemner avoid the kind of situation they faced in that case by careful examination of their appraisals before hearings or trials. Obviously, I will not be involved in any further consideration of the case in which I testified, nor any other parcels in that project.

COCHRAN: ***What is the impact of today's market volatility and credit crunch on your work and your business plans? It's a big news story.***

HANSON: The credit crunch has finally started to affect the business I'm in. Everything you've read in the papers is true — there was way too much credit and, unfortunately, too many people buying homes who couldn't afford them. Now we have to deal with it. For a long time, though, the effect was really only in the subprime market, the lower end of the housing market. However, that has now bubbled up to luxury condominiums.

Almost all housing is a move-up market. You buy your first home, you sell it, buy a better home, sell it, and buy a better home, and so on. So, if someone is moving up from their house in the suburbs to buy a luxury condominium, down the housing chain they need the entry-level people. Our buyers have now realized how much trouble they're having selling their homes, and so they're hesitant to buy a condo downtown.

PASQUARELLA: On the commercial front, I don't see earth-shattering changes, but market volatility and the credit crunch *are* having an impact on my business. I think it actually helps me and my firm. It's keeping out of the game the real estate investor who would borrow 90 to 100 percent of the purchase price from a whole host of financing sources.

The real estate market in many ways is relatively efficient and, despite the media reports to the contrary, is rather orderly. On a macro level, the markets throughout the country among the different property types are all relatively healthy and improving, primarily because new supply has been kept to a relative minimum. Certain markets have more speculative commercial development than others, but they're few and far between. Most U.S. markets have improving occupancy and improving rental rates among the different property types. So, things continue to stabilize and improve and it's increasingly expensive to build new products, so to see rampant overbuilding would be very surprising.

COCHRAN: ***What about the impact on financing?***

HANSON: The jumbo mortgage market (any mortgage for more than $417,000 which makes it ineligible for purchase by Fannie Mae and Freddie Mac) is feeling the adverse effects of the credit crunch. Since each of our condos is averaging around $1 million, the investor appetite for our type of mortgage loan has dropped significantly. Our typical buyer who usually enjoys a very high credit score is finding it difficult to secure a loan due to the lack of federally-sponsored guarantees.

In addition, from talking to our banking sources, we're beginning to see that project underwriters are taking a much closer look at the whole condo business, getting much more particular on what projects they'll finance, hiking their requirements for presales in order to start to fund the debt and scrutinizing location and competitors much more thoroughly. They're certainly going to developers with track records, developers they have a relationship with. I'd say, if you are relatively new to the business, you'll have a much more difficult time.

PASQUARELLA: The adage in the real estate business definitely applies that when you use other people's money, you don't have any skin in the game. People become very undisciplined with their capital and injudiciously acquire assets just to make deals and get fees. That being said, we're only looking for lenders to finance two-thirds of the cost, not 80, 90 or 100 percent. In today's financing environment, the net effect is that some of the higher leveraged investors, buyers and competitors are kept out of the game. In turn, that lessened competition means less demand and slightly more attractive pricing for me. We were seeing some extraordinarily crazy pricing and deals that you scratch your head and say, "This doesn't make sense." Even lenders were doing some pretty outrageous things. If they go back to the fundamentals — reasonable loan underwriting, requiring borrowers to invest some cash, making sure that there are loan-to-value covenants and strict debt cover ratio covenants — it brings sanity to the market. And that's healthy for the industry. It's not good for any investment class when there's rampant speculation and an undisciplined, excessive supply of capital.

COCHRAN: ***Foreclosures have been a big item in the news recently. How important do you see that being?***

PASQUARELLA: It's mostly limited to the residential sector, but it does affect investment real estate, particularly in the multifamily market. I recently went on a multi-city tour in Florida, and they were talking about "re-version." A few years ago developers came in *en force* to convert apartment houses from rentals to condos. Then the market fell apart. They're reacting by converting back, reverting, to rental products. It's a local phenomenon, by no means national; yet it is occurring in pockets around the country. It's a good lesson to keep in mind: Real estate doesn't always develop linearly, and smart real estate professionals always have to adapt.

COCHRAN: ***Globalization is clearly an intriguing subject in today's market. Are your firms moving into the international arena?***

PASQUARELLA: Our fund's strategy is to create a diversified pool of U.S.-based real estate assets, probably a third of our acquisitions or development will be in office space, another third in multifamily property and a third a mix of industrial and retail. Likewise, in terms of location, everything else being equal, we'd like to be highly diversified. But that being said, it never happens that way; you go with where the opportunities are at that point when you're looking to make an investment.

Being based in Philadelphia, our investments 10 years ago were more east coast-oriented. But over the last seven years, we've opened up several offices, including a large one in Chicago. So our portfolio has shifted towards the midwest and now the west, as we opened an office a year ago in Los Angeles. When we complete assembling this portfolio in three or four years, you'll see a pretty diverse *national* portfolio.

HANSON: Is my firm moving into the international scene? In one sense, no. In another sense, definitely yes. At this time, we would not consider building outside of the United States. If I can't get to a site on a plane in four hours, I don't want to do a development there. We're in a business that requires an amazing amount of attention to detail. Either you have to be a very big company with resources wherever you're going to build or you don't do it.

As the saying goes: "You make money in your own backyard and you lose it in other people's." For instance, in San Jose, we opened an office, hired full-time people, and we've bought a second lot to build a second building. We didn't just go to San Jose to build one building. We went to start a business. It links back to the earlier comment about lenders wanting people with a track record and people with a relationship.

So, internationally, if I were to go storming into, name a country, they would say, who the heck is he? What do we know about him? But there is another aspect to your question and that is buying our buildings' parts and materials overseas. Our second biggest cost, after the concrete frame, for the Legacy at Millennium Park is our curtain wall — the whole cladding on the building, plus all the glass and windows and frame. We're buying it all from China, and that's created a whole set of interesting questions about currency fluctuations, insurance, warranties and payment procedures in the United States.

COCHRAN: ***Is that what's happening across the board if you went to almost any developer these days? They would be getting most of their curtain wall materials from China?***

HANSON: I think it's a new trend. We're buying our curtain wall from a company called Yuanda, and when we did that a year ago, we were the company's second North American buyer. Now they have more than 20. And the glass is coming from a company called China Glass. They're using brand new facilities, state-of-the-art machinery and equipment, and our architects and contractors, who have visited two, three, four times, are very pleased so far. Of course, there are added delivery challenges. We have to ship 700 crates from China and store them, but so far so good.

COCHRAN: ***How do you compare the most recent years in the real estate industry with the real estate cycle from 20 years ago?***

PASQUARELLA: They're not even close, for some fundamental reasons. This market aberration and the adjustments are capital driven, not supply driven. Back in the mid- and late '80s, we had a period of about four to five years of explosive development — you name the property type, as an industry, we were building it. And underwriting was being done on ridiculous premises. In hindsight, it was like you were drinking too much and you woke up and said, "What did we do?" People were underwriting and capitalizing office building rents pretending that they were $20 per square foot, when in reality tenants were getting two years free rent on a five-year lease, so the real net rent, the effective rent, was overstated by 40 percent. The whole thing was a house of cards.

Now, the industry is much more transparent. The presence of public REITs (Real Estate Investment Trust) in the market has added to that. True, REITs are getting hammered right now, but the advent of securitized mortgage products has helped create additional transparencies in the market. I think funds like ours provide a lot of transparency to our investors as to the real conditions of their investments; what the real prospects of new investments look like. The industry is much more mature now in how it operates. Even though many companies are still private, including mine, we all operate more publicly than ever.

COCHRAN: ***Do you foresee potential trouble, as in the late '80s, when Japan was moving in on the U.S. real estate market so much that people were starting to get concerned about the Japanese having too much control over the U.S. market?***

HANSON: No, it's different, though not an entirely right-field concern. Where we might have to worry is China's level of purchases of U.S. Treasuries. China is responsible for our interest rates being so low because it takes all its surplus and buys our Treasuries. So we depend on them in a totally different way, but still in a significant way. However, the Chinese aren't here buying our office buildings, hotels and golf courses. No one is saying about China what we said in the late '80s, when we were saying that Japan would own all of New York and San Francisco . . . which, in any case, didn't happen.

PASQUARELLA: Recently, Bloomberg.com published a prediction that commercial real estate prices will drop something like 15 percent over the next 18 months. I don't see that at all. That's headline grabbing. What people fail to understand is that the real driver of value in any asset is its earnings potential. And in that regard the underlying fundamentals of real estate remain sound.

Most property types and most regions are seeing increasing rents, which means there are increasing earnings. And when you have increasing earnings in any investment, whether they are stocks or real estate, you're seeing valuation grow in the long term. There will always be some aberrations bouncing around because of capital market swings, but long term, it's growing in value. So I think such predictions are a bunch of nonsense.

Everybody is talking about dislocations in the financial markets, but no one is talking about the fact that Treasury rates have fallen probably 75 to 100 basis points over the last few months, and that has a huge impact on the borrowing cost of real estate because all of our debt instruments are ultimately tied to spreads over Treasury bills. So when you look at the 10-year Treasury rate and see that it's down to 4.5 percent from 5.2 or 5.3 percent just 60 days earlier, the cost of money has come way down, and it has a significant impact on how you value your assets.

COCHRAN: ***A major point of conversation recently has been about green concerns. How are you responding to green development issues?***

HANSON: We made the decision that all our buildings will be LEED-certified. I think green is terrific. Having said that, it can also go too far or get ahead of itself. Cities such as San Francisco, Seattle and Boston are now mandating that all new buildings be green. That's okay in today's environment of what it takes to be green, but if these cities continue to mandate this and if the green standards continue to go up in a crazy way, it will get very difficult and very expensive.

PASQUARELLA: I think that's why there's a continued allure to mixed-use development. I keep remembering back when I first came out of school in the early '80s, the talk was all about urban living, 24/7 environments, being able to work and play within a few blocks of where you live. Maybe that vision was ahead of its time then. But I see that vision now getting legs. Some of it is just the convenience, of course, but the concept of the 24/7 environment also ties very nicely into the green movement. There's a lot to be said for keeping people out of their cars, where they consume fuel and contribute to today's worsening congestion.

COCHRAN: ***What are the most challenging issues facing your business?***

HANSON: We have a housing market that's very soft, which affects people's ability to buy on the revenue side of our equation. Then on the expense side, we have ever-increasing costs, at a rate of 1 percent per month — in some places a bit slower at 10 percent per year and in many places you'll hear 15 and 20 percent. It's amazing how fast costs are increasing and that's frankly why we are turning to China and other places; even with the cost of transportation and added storage costs, it's still net less expensive.

Then we have a demographic factor driving the multi-family market on the positive side. The empty-nest baby boomers — an enormously wealthy generation of people who are now in or approaching their 50s who I've heard have $2 trillion of cash lying around and who want to live in cities. They're astute and much more urban than their parents. They want to be near the orchestra and the museums and restaurants and work. We aren't selling them shelter; we are selling them choice. We don't sell to somebody who just needs a roof over his or her head; we sell to somebody who already has a roof overhead but who wants a different roof … or a second one. How much are those people who have that choice going to be affected by the current economy? Right now, not much. Our Legacy building is 83 percent sold with two years to go, and our San Jose building is 50 percent sold, four months after opening the sales office.

SCHWETHELM: When I became active as an appraiser for eminent domain some 45 years ago, I assumed that, since eminent domain had been going on for so many years, the legal procedures were well established and static. How naïve that was. I soon learned that the eminent domain process is ever changing. Increasingly, appraisers are being asked to critique appraisals made for the opposing side. During my early years in the business, the appraisal organizations very strongly opposed this. The appraiser was to appear in court, testify to his or her opinion — without concern for what the other side testified to — and leave the courtroom. If there were disparities between opinions, the appraisal organization would address that issue through its ethics procedures. As time went on, however, this position was relaxed. As long as the appraiser acted as an independent expert without bias for the client, or against the opposition, it was considered all right to consult with the attorney about the opposing appraisals, the theory being that you were an advocate of your position, not of the client.

As my reputation grew as an expert witness, the attorney general's office requested offices of the Highway Department to engage my services for cases in many parts of the state. More and more I was asked to involve myself in reviewing the other appraisals and advise the attorneys about weaknesses and errors in them. I was also asked to help prepare other witnesses to testify. Through that process, I become more of a consultant than an appraiser, although I was very careful to remain objective in performing my appraisals.

PASQUARELLA: For my firm, developmental approval processes in many municipalities are becoming more cumbersome, more expensive and very, very time consuming. There's more study required, and in some respects, of course, I understand. Interestingly, that ties back to what I said in talking about going green. These days we often ask, "Can we add amenities — such as retail or a hotel, or both, on an office complex site — to make it more attractive in today's environment?" If I can't get the threesome of live, work and play, can I get two of the three? That still sets my project apart from the projects competing with me and fits in with the green movement.

COCHRAN: ***How do you see CRE helping its members meet today's challenges?***

SCHWETHELM: There is a great opportunity for Counselors in eminent domain. I sincerely believe that attorneys should be engaging Counselors solely for the purpose of providing consulting services instead of using the appraisers who appear as witnesses. I do not contend that appraisers necessarily become advocates by providing these ancillary services, but there is that appearance to judges, juries and commissioners.

I believe the CRE organization should make a concerted effort to illustrate the importance of these services on a very frequent basis. This can be done through our members who specialize in eminent domain and Counselors who are also attorneys. When appropriate, Counselors can assist the attorney in helping the client understand the case, the likelihood of prevailing and the probable range of compensation, which can result in the settlement of cases at considerable savings. When settlement is not accomplished, the services Counselors provide can assist in trial preparation and during trial.

PASQUARELLA: To some degree, I see the CRE organization helping its members just as it has in the past. There is tremendous value and high gain to be had from simply associating with the best people working in our business, and CRE provides many networking opportunities, both formal and casual.

In my 16 years as a Counselor, the professional makeup of the CRE membership has become more diverse, as has the real estate industry in general. Years ago, the real estate community was made up of lenders, appraisers and brokers. Today, you have all sorts of specialty groups, and we have Wall Street involved in real estate in a big way. CRE includes developers, investment fund managers such as myself, tenant specialists, consultants, investment consultants, etc. It's a very broad membership base, which I think is fabulous. The skill set of the organization has expanded to meet today's needs very, very well.

HANSON: I believe the CRE organization can best help its members through education. The whole concept is that we're an organization of professionals, that we and our fellow CREs are leading-edge thinkers and will bring best practices to one another's discussions. That, in summary, is why I like CRE. I like going to meetings and conventions, and networking in general, because I think the people here are incredibly smart and the conversations you have make the difference. ■

FEATURE

Conservation Easements: Windfall or Straitjacket?

BY JAMES D. TIMMONS AND LARA DANIEL

A CONSERVATION EASEMENT CREATES A NON-POSSESSORY interest in land. In granting or donating a conservation easement, a landowner normally transfers certain property rights to a nonprofit conservation organization or government agency. People who create conservation easements on their land often do so because they wish to ensure long-term conservation of land, which they value and which contains important natural features. This type of easement is a tool for preventing intensification of land use on property having important natural, agricultural, scenic or historic value. The landowner retains legal title to the property but agrees to forgo certain uses, such as residential or commercial development.

There are several good financial reasons for entering into conservation easements. Landowners are often paid substantial amounts of money for the conservation easement. Additionally, if a conservation easement is granted in perpetuity, the landowner is entitled to claim a deduction on his or her federal income taxes. Furthermore, since the conservation easement lowers the value of the property, it also lowers the value of the landowner's estate and, ultimately, the estate tax burden as well as the property tax burden.

In reality, conservation easements are more like restrictive covenants than easements. A grantor who enters into a conservation easement agrees to dedicate the portion of his or her property encumbered by the easement to a specified use (or non-use, as the case may be) or agrees to adhere to specified practices thereon . . . in perpetuity. Perpetuity is a long time, so a landowner who enters into such an agreement not only signs away his right to change the use of the land, but also gives away the rights of any future owner to change the use of the land.

This paper will define conservation easements and comment on the rationale for their use. We will also provide a summary of the various types of conservation easements and survey how widely they are being used. Additionally, and most importantly, the legal aspects and tax implications of their use will be analyzed. Our intent is to provide landowners a framework for evaluating the prudence of encumbering their land with conservation easements.

INTRODUCTION

Urban sprawl is consuming millions of acres of open space, farms and forest land to development each year in the United States. There is, however, a growing effort to combat the loss of so much green space. Rather than see local rural space, rugged outdoor areas or wetlands or other environmentally sensitive areas gobbled up by strip malls or subdivisions, many private land owners are increasingly preserving their land. One of the tools being

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used extensively to save the land is the conservation easement. Conservation easements are a legal tool designed to extinguish most or all of the development potential of land in the interest of conservation.

For a landowner, the decision to sell or donate a conservation easement is a momentous action that should not be made lightly or quickly. Placing restrictive covenants on a property will not only have consequences for the current landowner, but will also have long-lasting effects on all future owners of the property. Negotiated voluntarily with a nonprofit or public land-trust agency or government entity, conservation easements restrict the use of a particular parcel; the landowner can continue using the land after the easement is purchased, but the land will be restricted as to subdivision or development. Land in easements can be bought or sold, but the restrictions remain in perpetuity.

The decision to sell or donate conservation easements, then, depends on many factors, including the landowner's willingness to forego the profitable option of selling the land for urban development in return for more modest economic gains and other benefits. The idea is often appealing to farm families who want to continue a farming operation over future generations, but need cash that would otherwise only be available by selling the land. There are also those who wish to protect the natural character of land from any future development. In either case, while current cash or tax advantages provide immediate benefits to the present landowner, future generations and owners carry the costs in terms of restrictions and limited land development opportunities.

This paper will provide additional information about the growing number of conservation easements being used to save green space from urban sprawl. We will document not only the number of easements, but also the regions of the country where they are most widely used. It will be seen that a major incentive for allowing one's land to be "preserved" relates to new tax law that provides several possible tax breaks. There will also be a discussion of land appraisal issues, which have complicated the conservation easement process. Finally, there are many legal issues that must be, or should be, considered when one is contemplating the use of conservation easements.

PRIVATE LAND CONSERVATION IN THE UNITED STATES — THE 2005 NATIONAL LAND TRUST CENSUS REPORT

The National Land Trust Census, conducted every five years by the Land Trust Alliance, an umbrella organization for land conservation groups, says private land under protective trusts and easements now totals 37 million acres, a 54 percent increase from the last count in 2000.[1] This includes both land protected by local and state land trusts and by the largest national land conservation groups. Between 2000 and 2005, conservation of private land averaged 2.6 million acres a year. This acreage would equal approximately half the land mass of New Jersey. The average annual number of acres of land protected during this five-year period exceeds the 2.2 million acres

Chart 1

Acres Conserved by Local and State Land Trusts by Method of Conservation (2000 and 2005)

	Acres Owned by Land Trusts	Acres under Easement by Land Trusts	Acres Acquired and Reconveyed and Conserved by Other Means	Total Acres Conserved
2000	1,219,632	2,514,545	2,322,447	6,056,624
2005	1,703,212	6,245,969	3,940,928	11,890,109
Increase (acres)	483,580	3,731,424	1,618,481	5,833,485
% Increase	40%	148%	70%	96%

For the period ended December 31, 2005, Chart 1 compares the total acres conserved by three mechanisms: acres owned in fee by the land trust, acres protected by conservation easement and acres conserved by other means.

Chart 2

Number of Land Trusts and Acres Protected by Local and State Land Trusts as of December 31, 2005

	No. of Land Trusts	Acres owned	Acres under Easement	Acres Acquired and Reconvened and Conserved by Other Means	Total Acres
AK	7	1,057	4,854	37,251	43,162
AL	7	4,940	48.428	43,526	96,894
AR	2	1,018	2,320	884	4,222
AZ	21	1,129	35,645	69,790	106,564
CA	198	304,393	427,411	1,000,667	1,732,471
CO	38	4,822	849,825	104,677	959,324
CT	128	50,349	24,164	21,094	95,607
DC	4	1	3	-	4
DE	5	21,273	2,394	79,042	103,159
FL	36	9,653	37,458	39,610	86,721
GA	24	5,303	87,643	10,110	103,056
HI	14	289	212	43	544
IA	8	12,396	6,000	69,265	87,661
ID	12	4,127	29,987	24,792	58,906
IL	35	7,708	7,532	49,080	64,320
IN	27	11,743	5,648	3,200	20,591
KS	7	184	4,583	1,000	5,767
KY	10	1,721	5,026	4,682	11,429
LA	4	257	24,042	543	24,842
MA	161	118,240	61,569	104,518	284,327
MD	58	5,334	191,330	17,136	213,800
ME	85	84,274	1,492,279	141,104	1,717,657
MI	44	33,024	54,762	17,633	105,419
MN	5	2,171	24,500	7,108	33,779
MO	19	10,302	9,460	2,672	22,434
MS	6	782	48,423	5,183	54,388
MT	15	8,793	714,993	224,427	948,213
NC	32	23,199	112,874	92,451	228,524
ND	-	-	-	965	965
NE	5	17,338	12,916	4,403	34,657
NH	35	79,719	133,836	50,078	263,633
NJ	43	55,331	11,832	145,858	213,021
NM	9	402,735	142,072	29,677	574,484
NV	5	490	-	14,148	14,638
NY	90	168,259	191,095	264,887	624,241
OH	44	11,379	35,262	4,061	50,702
OK	3	5,263	3,507	384	9,154
OR	20	7,440	50,627	16,535	74,602
PA	95	35,432	139,309	265,916	440,657
RI	47	15,378	7,863	1,482	24,723
SC	24	7,673	98,349	70,439	176,461
SD	2	280	10,769	9,484	20,533
TN	21	12,988	21,075	131,765	165,828
TX	32	28,597	131,520	83,246	243,363
UT	6	2,242	34,418	39,985	76,645
VA	32	12,135	365,355	284,812	662,302
VT	35	69,204	399,681	107,848	576,733
WA	36	22,889	43,701	153,395	219,985
WI	54	18,121	33,903	25,934	77,958
WV	8	726	16,156	8,397	25,279
WY	5	661	49,358	55,741	105,760
Totals	1,663	1,703,212	6,245,969	3,940,928	11,890,109

that the Department of Agriculture has estimated is converted annually into "developed land."

Most of the preserved land was saved through the use of conservation easements, legal pacts between landowners and trusts, or governmental agencies that permanently limit the land's use. The Land Trust Alliance says easements have risen 148 percent since the last National Land Trust Census Report in 2000.[2] (Refer to Chart 1 on page 8 for the data.) It is all part of a huge new boom in conservation of private lands in which landowners voluntarily give up rights to develop their land — often in return for tax breaks, but also in many cases to save rugged landscapes or farmland they love.

Little known just two decades ago, land trusts are now one of the fastest growing, and seemingly, most successful conservation movements in U.S. history. Key findings from the 2005 National Land Trust Census are as follows:

- From 1995 to 2000, an average of 337,037 acres per year of private land was conserved by local and state land trusts. During the 2000–2005 period, the pace soared to 1,166,697 acres per year. In all, 11.9 million acres have been conserved by these groups through 2005. (Refer to Chart 2 on page 9 for data.)
- The fastest-growing region in America, in both the number of acres preserved and the number of land trusts, is the west. The southeast is the second fastest growing region. The northeast added the most acreage, nearly tripling the acres held under easement in the past five years. (See Charts 3 and 4 on pages 11 and 12.)
- These states have the most acres conserved—California, Maine, Colorado, Montana, Virginia, New York, Vermont, New Mexico, Pennsylvania and Massachusetts.
- The primary type of land being protected is natural areas and wildlife habitat (39 percent), followed by open space (38 percent) and water resources, mostly wetlands (26 percent).

THE NATURE OF CONSERVATION EASEMENTS

Owning property entitles owners to exercise certain rights over their land. The gift or sale of a conservation easement involves giving up some of these rights, such as the right to develop the land, in order to protect the conservation values of the land. Each conservation easement is unique. While the terms of a conservation easement are explicit and legally binding, they are also negotiable so that the needs of the landowner, the conservation agency and the land itself are accommodated. Sometimes the restrictions totally prohibit construction or any type of development, but this is often not the case. Even the most restrictive easements typically permit landowners to continue such traditional uses of the land as farming and ranching. Through the agreement, the landowner retains title to the property and the right to restrict access.

Conservation easements can take many forms, including:

- a limitation on the property's use,
- a limitation on the number of building sites on an undeveloped real estate parcel,
- a prohibition against depleting the land's natural resources, such as timber, and
- a prohibition against fishing or hunting.

Conservation easements must be entered into between the owner of the real estate and a qualified organization. A qualified organization is one committed to conservation purposes with the resources to enforce the easement. Treasury regulations identify four classes of organizations which qualify as "qualified organizations:"[3]

1) A governmental unit described as a state, a possession of the United States or any political subdivision of any of the foregoing, or the United States or the District of Columbia, but only if the contribution or gift is made exclusively for public purposes;

2) An organization described as one that normally receives a substantial part of its support from a governmental unit or from direct or indirect contributions from the general public;

3) A charitable organization described in I.R.C. (section) 501(c)(3) — i.e. tax-exempt, that meets the public support test of (section) 509(a)(2); or

4) A charitable organization described in section 501(c)(3) that meets the requirements of that section and is controlled by an organization described in paragraphs (c)(1)(i), (ii) or (iii) of this section.

Chart 3

Total Acres Protected by Local and State Land Trusts, Increase in Acreage, and Percentage Change (2000 and 2005)

	TOTAL ACRES PROTECTED			
REGION/STATE	2005	2000	INCREASE	% CHANGE
Mid-Atlantic				
DC	4	3	1	38%
DE	103,159	102,041	1,118	1%
MD	213,800	141,673	72,127	51%
NJ	213,021	138,628	74,393	54%
PA	440,659	336,788	103,871	31%
VA	662,302	204,660	457,642	224%
WV	25,279	58,321*	-33,042	N/A
	1,658,224	982,114	676,110	69%
Midwest				
IA	87,661	65,212	22,449	34%
IL	64,321	45,683	18,638	41%
IN	20,591	9,754	10,837	111%
KS	5,767	2,451	3,316	135%
MI	105,419	71,156	34,263	48%
MN	33,779	16,788	163991	101%
MO	22,434	9,347	13,088	140%
ND	695	758	207	27%
NE	34,657	16,772	17,885	107%
OH	50,702	20,255	30,447	150%
SD	20,533	9,625	10,908	113%
WI	77,958	25,262	52,696	209%
	524,787	293,062	231,725	79%
Northeast				
CT	95,607	70,879	24,728	35%
MA	284,327	216,001	68,326	32%
ME	1,717,656	136,712	1,580,944	1156%
NH	263,633	193,563	70,070	36%
NY	624,241	571,519	52,722	9%
RI	24,723	16,770	7,953	47%
VT	576,733	444,770	131,963	30%
	3,586,920	1,650,214	1,936,706	117%

*An organization based in WV works in several states but reported all acres saved only under WV for 2000.

Chart 4

Total Acres Protected by Local and State Land Trusts, Increase in Acreage, and Percentage Change (2000 and 2005)

	TOTAL ACRES PROTECTED			
REGION/STATE	2005	2000	INCREASE	% CHANGE
Northwest				
AK	43,161	28,939	14,222	49%
ID	58,906	36,532	22,374	61%
MT	948,213	505,659	442,554	888%
OR	74,602	24,572	50,031	204%
WA	219,985	41,728	178,258	427%
WY	405,760	40,759	65,001	159%
	1450627	678,188	772,439	114%
Pacific				
CA	1,732,471	1,250,509	481,962	39%
HI	544	8	536	6700%
NV	14,638	12,225	2,413	20%
	1,747,653	1,262,742	484,911	38%
Southeast				
AL	96,894	29,916	66,978	224%
AR	4,222	1,496	2,726	182%
FL	86,720	63,460	23,260	37%
GA	103,057	36,901	66,156	179%
KY	11,429	4,012	7,417	185%
LA	24,842	13,645	11,197	82%
MS	54,388	4,405	49,983	1135%
NC	228,524	102,226	126,298	124%
SC	176,461	97,381	79,080	81%
TN	165,828	43,804	122,024	279%
	952,365	397,247	555,118	140%
Southwest				
AZ	106,564	38,175	68,389	179%
CO	959,324	338,650	620,674	183%
NM	574,484	268,923	305,561	114%
OK	9,154	5,151	4,003	78%
TX	243,363	85,675	157,688	184%
UT	76,645	56,483	20,163	36%
	1,969,534	793,055	5,833,486	148%
Totals 2005	11,890,110	6,056,624	5,833,486	96%

A conservation easement is created like any other permanent interest in land, by having both parties agree to and sign a contract, which is recorded in the land records. It should be remembered that most easements "run with the land," binding the original owner and, more importantly, all subsequent owners to the easement's restrictions. The landowner who enters into such an agreement not only signs away his or her right to change the use of the land, but also constrains the rights of any future owner to change the use of the land. Only gifts of perpetual easements will qualify for income and estate tax benefits.

In reality, conservation easements are more like restrictive deed covenants than traditional real estate easements. If the landowner dies and the property is acquired by inheritance, or if the land is sold, the new owner will own the property with whatever affirmative obligation is required by the terms of the conservation easement. The management practices that the original owner had agreed to must be continued. If the new owner does not meet the terms of the agreement, the conservation agency may sue for breach of contract.

Unlike many deed restrictions, conservation easements are closely monitored to assure that the limitations on the property are strictly being adhered to. Typically, the land trust will be responsible for enforcing the restrictions that are spelled out in the easement document. Usually, once a year the land trust will do an on-site inspection of the land to determine that the property remains in the condition prescribed by the easement contract. Written records are maintained by the trust and the landowner receives written notification of compliance. In the event that the terms of the easement are breached, restoration of the property to its prior condition complying with the easement is required.

One of the authors of this paper is a stockholder of a closely held Subchapter S corporation that owns agricultural and timberland on the eastern shore of Maryland. The corporation and the Maryland Environmental Trust entered into an agreement in 2002 whereby the corporation sold a conservation easement on one of its farms. The property consists of approximately 350 acres of farmland, timber and marshland. The land borders both a bay and creek. The Maryland Environmental Trust has purchased easements on several thousand acres in the area to protect fragile wetlands and rural property from residential development. The easement restricts the number of residential structures that can be constructed on the property and the future sub-division of the parcel. The corporation received several hundred thousand dollars for agreeing to these restrictions.

TAX INCENTIVES

Why would anyone voluntarily give up development rights on his land? Some owners may be motivated by strictly altruistic conservation reasons, but most seek to take advantage of one of the many forms of tax compensation that can make the donation or sale of conservation easements a smart move. Aside from the fact that money might be received from the sale of the easement, the possibility exists of income tax, estate tax, capital gains tax and property tax benefits. Whether or not these benefits apply to a particular easement depends on the conditions of the easement, the landowner's income and estate value, whether the easement is purchased or donated, and other factors. Recent changes in federal and state tax law have, however, significantly increased the tax benefits associated with the donation of conservation easements.

In order to qualify for a tax deduction, easements must be donated to a federal, state or local government agency. The federal rules also allow a private, charitable organization with the ability to enforce the terms of the easement to hold deductible easements. Private easement holders, under the terms of the federal rules, need not be environmental organizations to qualify the easements they hold for tax benefits. The key is that the organization be a charitable organization qualified under IRC 501(c)(3); have the ability to enforce the easements it holds over time; and be organized, at least in part, for the conservation of the property subject to easements it holds. Before entering into a conservation easement of any kind, landowners should consult with their attorneys. If the easement donor hopes to capitalize on tax advantages, the services of a tax professional and a certified land appraiser will also be needed.

The package of tax benefits that is newly available for conservation easement donations can turn the conservation of family land into an effective tool for the conservation of family wealth as well. The value of the donation for tax purposes can be determined by an appraiser, who compares the value of the unrestricted land with its value subject to the easement. If the owner decides that the appraised value of the easement is sufficiently large, he or she should file the easement and take advantage of the tax benefits.

INCOME TAX BENEFITS

Donors may deduct from taxable income the full market value of a conservation easement that was granted in perpetuity. If the property has been owned for less than one year, the deduction is based on the percentage of easement value as it is applied to the basis of the property. Of course, the donor's basis in the property is reduced by the value of the easement. As a result of new legislation signed by the president on August 17, 2006, easements donated in 2006 and 2007 can be deducted at the rate of 50 percent of the donor's adjusted gross income per year and the unused portion of the gift may be carried forward for an additional 15 years or until the value of the donation is fully expended (whichever comes first). Farmers who receive more than 50 percent of their income from agricultural activities may claim deductions of up to 100 percent of their income.[4] On January 31, 2007, Sen. Max Baucus (D-Mont.) introduced S. 469, a bill that would make the newly expanded tax incentive for conservation easement donations permanent.

It also should be remembered that in addition to the federal income tax incentives, most state income tax laws provide for charitable deductions of conservation easements. There are currently nine states that offer an even better income tax incentive — tax credits — for easement donations on agricultural property.[5]

It also should be mentioned that landowners who sell conservation easements might consider a tax-deferred exchange instead of actually receiving cash from a land trust. It is possible to arrange having the purchasing agency buy another property, which they trade for a property owner's easement rights. The conservation easement and a fee interest in land have been ruled to be sufficiently similar to constitute property of "like kind" for purposes of section 1031(a) of the IRS Code. This process delays the recognition of income and defers the payment of taxes on easement rights that were sold.

ESTATE TAX BENEFITS

Estate taxes in 2006 were as high as 46 percent of the value of the donor's estate. In many cases, a landowner's heirs must sell their inherited property in order to pay the estate taxes. By donating an easement, landowners can reduce estate taxes in two ways. First, to the extent that the restricted value is lower than the fair market value, the estate will be subject to a lower estate tax. There will be cases where an easement can reduce the value of an estate below the level that is taxable, thereby eliminating any estate tax liability. The American Farm and Ranch Protection Act of 1997 and amendments found in the Economic Growth and Tax Relief Reconciliation Act of 2001 allow heirs to exclude up to an additional 40 percent of the remaining value of their land subject to a donated qualified conservation easement from the taxable estate regardless of the property's location. For example, if land is worth $1 million prior to the easement and $600,000 after the easement, the exclusion would allow 40 percent of the remainder value of $600,000, or $240,000, to be excluded. The exclusion is limited to $500,000, but is in addition to any reduction in the value of the estate as a result of placing a conservation easement on the land. If the fair market value of the property is reduced by at least 30 percent, the full benefit is available. Smaller exclusions are available when easements reduce the land value by less than 30 percent.[6] The exclusion is available not only to the estate of the donor, but also to the estates of any of the donor's family members and descendants so long as the land remains in the family (IRC 2031[c][8][c]).

PROPERTY TAX BENEFITS

In jurisdictions where property taxes are assessed on the basis of potential use rather than actual use, a conservation easement can provide substantial savings. Land cannot be taxed for a use that the property owner legally cannot perform. Therefore, land that is restricted by a conservation easement should not pay a property tax based on its highest and best use.

TAX ABUSES

Starting in 2003, David Ottaway and Joe Stephens of *The Washington Post* published a series of articles questioning some of the practices employed by some of the nation's largest and most well-funded land trusts. Those articles raised the ire of Congress and the IRS. In 2004, the IRS issued a nationwide notice that it was aware of improper claims of charitable deductions involving conservation easements and, as a result, was initiating a series of audits around the country. Until this time, conservation easements had received little IRS attention. With the increased use of this type of easement, and the possibility of sufficient tax implications, the IRS has started to see abuses.

The Senate Finance Committee also has held hearings on the perceived abuses in charitable contribution deductions claimed for gifts of conservation easements. A series of scandals has revealed major abuses of the use of conservation easements. There is evidence that some landowners who donated easements to nonprofit land trusts have used inflated appraisals to take huge tax write-offs at the expense of taxpayers. Additionally, some property owners have used easements to protect swamps and mountaintops that could never have been developed, or golf courses and private lots that have little or no conservation value. There is a fear that lawmakers will crack down on these abuses by curtailing the tax benefits associated with conservation easements. Land trust agencies argue that cutting tax incentives is the wrong approach to solving tax abuse. They suggest that laws that require more realistic appraisals can provide safeguards against this problem. There is little doubt that appraisers who value conservation easements, land trusts that help set up conservation easements, and those receiving tax benefits from the easements are now being more closely scrutinized.

APPRAISAL CONSIDERATIONS

Fair market value of the conservation easement can be determined through a comparable sales appraisal approach using sales of similar easements in the area. Such information, however, is often limited. Therefore, the value of a conservation easement is assumed to equal the difference between the fair market value (highest and best use) of the property before and after the easement is donated. The valuation problem for conservation easements arises because of excessive claims of income, estate and property tax deductions.

To take a tax deduction for gifts worth more than $5,000, including land or conservation easements, the donor must obtain a "qualified appraisal" by a "qualified appraiser."

A qualified appraiser is one who holds him/herself out to the public as an appraiser who is qualified to make appraisals of the specific type in question (such as a conservation easement) and whose relationship to the taxpayer and donator would not cause a reasonable person to question the appraiser's independence. Land trust agencies cannot provide the appraisal itself, but can give donors a list of appraisers with experience in valuing gifts of land and conservation easements. The appraisal is necessary only if the donor is seeking a charitable contribution tax deduction for their land or easement donation.

The IRS requires that the appraisal must not be completed earlier than 60 days before the date of the gift and must state the fair market value of the gift as of the date of the contribution. Alternatively, an appraisal may be done at any time after the gift, retroactive as to the date of the gift. The appraiser's report must meet IRS standards, and a summary of the appraisal (IRS Form 8283) signed by the land trust and the appraiser must be attached to the donor's income tax return. Section 1219 of the Pension Protection Act of 2006 also adds a new penalty provision. If the claimed value of property based on an appraisal results in a substantial or gross valuation misstatement, a penalty is imposed on any person who prepared the appraisal and who knew, or reasonably should have known, the appraisal would be used in connection with a return or claim for refund.

LEGAL ISSUES

Conservation easements represent a significant departure from common law property principles. Under those principles, there are two general types of easements — easements appurtenant and easements in gross. Easements appurtenant are those in which the owner of one piece of land has a liberty, privilege or advantage in the land of another. The land for which the privilege is created is the "dominant estate" and the land subject to the privilege is the "servient estate." An easement in gross is a personal right in the land of another; it is not appurtenant to a second parcel of land. It benefits an entity rather than a parcel of land. While there is a servient estate, one burdened by the easement, there is no dominant estate.[7]

In addition to being either appurtenant or in gross, common law easements are either affirmative or negative. Affirmative easements convey to one person the privilege to use the land of another. Negative easements convey a right to demand that the servient owner refrain from certain uses of his property that would otherwise be permissible.[8]

A conservation easement is in gross, and negative. It favors an entity rather than a second parcel of land, and it grants to that entity the right to demand that the owner of the servient estate, the party who gave the easement, refrain from certain activities that would have been permissible in the absence of the conservation easement. As such, a conservation easement finds no favor in common law principles; in common law, easements appurtenant were favored over easements in gross, and affirmative easements were favored over negative ones.[9]

In order to minimize the threats that common law principles would pose to the use of conservation easements, the national Conference of Commissioners on Uniform State Laws approved and recommended for enactment the Uniform Conservation Easement Act (referred to as the UCEA, or Act) in 1981. There are now at least 32 states that have statutes authorizing the use of conservation easements, many of them incorporating the provisions of the UCEA.[10] Some, however, have deviated from the provisions of the UCEA, making it essential that the code of a particular state be consulted before the creation of a conservation easement encumbering land in that state.

The "relatively narrow purpose"[11] of the UCEA is to remove the common law impediments to the use of conservation easement. The Act includes six sections:

- Section 1 defines *conservation easement* and who may be a holder of one. This section also defines the term *third party right of enforcement*.
- Section 2 addresses the methods of creating conservation easements, their duration and their effect on preexisting interests.
- Section 3 lists those who may bring an action to enforce the conservation easement.
- Section 4 directly focuses on the characteristics of a conservation easement that might have caused it to be challenged in common law.
- Section 5 deals with applicability of the Act.
- Section 6 deals with uniformity.

CONCLUSION

Conservation easements are relatively modern creations in real estate law, and they represent a marked departure from common law principles. Common law principles are based on the theory that real property should be put to its highest and best use, and that this goal is frustrated by restrictions that one generation might place on future decision makers. The assumption underlying conservation easements is that people are capable of making decisions today that will benefit the public in perpetuity.

In addition to the perpetual nature of conservation easements, they are also distinguished by the differing roles of the public in the transaction versus their common law counterparts. Because the public good, rather than the interests of the property holder, is the motivation for creating these restrictions, these restrictions should be subject to greater scrutiny. There is understandable concern about the nature of the holder of a conservation easement, because that party is acting in a representative capacity for the public.

The UCEA provides a meaningful framework for the creation of conservation easements, primarily by removing the common law threats to their perpetual existence. But the omissions from that statute, the state statutes that are based upon it, and the lack of guidance from courts on the meaning of the terms used in conservation easements make it imperative that landowners carefully consider the consequences of their actions. In areas where development seems to be suffocating green pastures and, where the owners of pastures feel their convictions about open space are becoming more and more expensive to maintain, the conservation easement is a tempting solution. It allows the landowner to realize a financial advantage now and ensures that their property will remain the same forever. However, conservation easements represent a departure from the traditional approach that attempts to strike a balance between the interests of today's landowners and those that might arise in the future. They seem instead to assume that what is good today will always be so. If the interests of future landowners have not been estimated accurately by those creating conservation easements, the results may create more problems than would otherwise have occurred.

The attractiveness of conservation easements is obvious by the explosive growth of land trusts established to accept easements. Land trusts have become big business based on their enormous land holdings, increasing membership and finances. You and I as taxpayers, and therefore government at all levels, should care about how conservation easements are created and managed. Although most easements are donated by private landowners to private land trusts, they almost always result in public subsidies in the form of income tax deductions to the easement donors. Also in many cases, a further subsidy comes in the form of reduced estate and property taxes. Additionally, much of the funding used to purchase conservation easements is increasingly coming from public money. ■

ENDNOTES

1 Land Trust Alliance, "2005 National Land Trust Census Report," page 4.

2 Id, page 8.

3 Land Trust Alliance, "2005 National Land Trust Census Report," page 4.

4 http://www.uvlt.org/html/taxbenefitsoflandconservation.html

5 Id.

6 Id.

7 See generally, Ephrata Area School District v. County of Lancaster, 886 A.2d 1169 (2005).

8 Id.

9 Uniform Law Commissioners Summary, Uniform Conservation Easement Act, http://www.nccusl.org/Update/uniformact_summaries/ (last visited Jan 2, 2007). See also, Lincoln Institute of Land Policy, Reinventing Conservation Easements, page 5.

10 Uniform Law Commissioners, A Few Facts About the Uniform Conservation Easement Act, http://www.lta.org/Update?informact_factsheets (last visited Jan. 2, 2007). The Act has also been adopted in the District of Columbia and the U.S. Virgin Islands.

11 Uniform Conservation Easement Act, Commissioners' Prefatory Note.

12 IRS, Treasury 1.170A-14; www.Ita.orgpublicpolicy/treasury-regs-on-ce.pdf.

Unintentional Redlining? Zoning Ordinances and the Living Wage

BY PATRICIA S. WALL, JD, MBA, CPA, Ed.D.

AS SOCIETY BECOMES INCREASINGLY MULTICULTURAL, LAWSUITS involving discrimination by race and national origin are likely to become more prevalent. While many such cases are filed under the 14th Amendment Title VII, and Section 1981 of the Civil Rights Act of 1991, other types of discrimination cases may be filed under the Fair Housing Act of 1968, which prohibits discrimination based upon race, color, religion or national origin in the sale or leasing of housing. The Community Reinvestment Act of 1977 outlawed the practice of "redlining" in which lenders and insurers deny loans or insurance on property in certain low-income areas rather than the decision on the applicant's qualifications for their services. Of course, anything that restricts or inhibits the use of property or imposes extra costs on its use will unambiguously reduce the value of the real estate. Mayor Richard M. Daley of Chicago recently opposed a city council proposal to raise the minimum wage for big-box retailers within the city limits as a form of redlining, since the stores and associated jobs would migrate from lower-income sectors to peripheral areas. While the intention to raise wages may be good, the overall effect is the same as redlining, which is so vilified. Thus, this may be considered unintentional redlining. Further, the overall effect may change the social composition of the neighborhood. This paper will review case law in the area.

USE OF ZONING ORDINANCES TO LIMIT BIG-BOX RETAILERS IN THE INNER CITY

If government officials choose to enact zoning ordinances in order to limit big-box retailers in inner cities, they must be prepared to defend their actions legally. The Fifth and 14th Amendments provide that no person shall be deprived "of life, liberty or property without due process of law." Further, under the 14th Amendment, a state may not "deny to any person within its jurisdiction the equal protection of the laws." The U.S. Supreme Court has made the equal protection clause applicable to the federal government through the due process clause of the Fifth Amendment.[1] If government officials appear to be treating big-box retailers differently from other businesses, they may face challenges based on the Equal Protection Clause. To prove a violation of equal protection, the litigating party must show that he or she is "similarly situated" to other applicants in the same time period and is being treated differently.

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The test for matters of economic or social welfare under the Equal Protection Clause is the "rational basis test," which requires that the zoning classification be based upon a legitimate governmental interest in these types of zoning. If the ordinance appears to be merely a pretext for reducing competition, it may be challenged as being discriminatory and possibly even compared to a type of redlining. (Mayor Daley made just such a comparison.) Cities passing such ordinances should be prepared to defend their positions with specially commissioned zoning studies showing substantial evidence, e.g., traffic patterns. Such studies are often expensive and time-consuming. The government must show that it is exercising its state police powers through the zoning ordinance — in other words, that it is merely regulating the use of the land, for the health, safety and welfare of its citizens.[2] Most states require that land-use laws be in compliance with a local government's general or long-term plan. Further, most jurisdictions have more specific plans for some areas, such as downtown redevelopment zones.[3] Although the federal government controls only federal lands, it may still be in violation of equal protection for state and city zoning ordinances through the issuance of grants for redevelopment.

Three types of common zoning ordinances are normally used in order to limit expansion of big-box retailers:[4]

1) a ban on superstores that sell groceries,

2) a conditional-use permit (CUP) and

3) an economic impact statement with mitigation.

USE OF WAGE CONTROLS TO LIMIT BIG-BOX RETAILERS IN THE INNER CITY

Labor unions have aligned their interests with those of environmentalists, preservationists and local merchants in order to lobby local governments to enact ordinances concerning wages and benefits and/or location of big-box stores.[5] This is especially true in the union representation of grocery workers as they attempt to compete with stores — for example, Wal-Mart — that merge grocery and retail operations in inner-city areas.[6] Since the National Labor Relations Act (NLRA) has been held to apply to "concerted activity" of non-union workers,[7] even non-union workers should be protected when assisting unionized supermarkets in fighting the competition of Wal-Mart and other big-box super centers by influencing government leaders concerning zoning and wage ordinances.

In Chamber of Commerce of the United States v. Bragdon,[8] the Ninth Circuit found that the NLRA preempts prevailing wage laws made applicable to the private sector, except in the context of government contracting. The Chamber of Commerce of the United States sued Contra Costa County, California, and officials concerning the validity of a prevailing wage ordinance. Most states have enacted prevailing-wage statutes to protect employees from unfair practices regarding pay on state-funded building and highway projects. The Contra Costa County ordinance covered both private construction contracts over $500,000 and government contracts with private companies.

The Ninth Circuit determined that Contra Costa County's prevailing wage ordinance was unenforceable. The court reasoned that the ordinance conflicted with collective bargaining agreements in the construction industry and was preempted by the NLRA. The Court reviewed the U.S. Supreme Court decision in Lodge 76, International Association of Machinists v. Wisconsin Employment Relations Comm'n,[9] and reasoned that this was the type of conduct that the Supreme Court intended to be governed by the market. According to the statutory law, the prevailing wage in Contra Costa County was determined by the director of the Department of Industrial Relations, who considered the terms and conditions agreed upon by workers and employers in the same market. If these conditions were then imposed upon the private construction industry (as the Contra Costa ordinance required), the court found that there would be no free negotiations in the industry and that this would violate the NLRA. The Bragdon court quoted the Lodge 76 Machinists case to the effect that the Supreme Court had found that

> state attempts to influence the substantive terms of collective bargaining agreements are as inconsistent with the federal regulatory scheme as are such attempts by the NLRB: Since the federal law operates here, in an area where its authority is paramount, to leave the parties free, the inconsistent application of state law is necessarily outside the power of the State.[10]

A proprietor exemption exception to the NLRA exists that allows government to set a prevailing wage. In order for this exemption to apply, the government must be acting in a proprietary capacity instead of a regulatory one. That is, the government must be acting as owner, developer or financial manager of a public project in order to be acting in a proprietary capacity.[11] (This is analogous to the exemption for sovereign immunity when a foreign government is acting as a private company.) This exception is construed liberally by courts. In Metropolitan Milwaukee Ass'n of Commerce v. Milwaukee County,[12] the court determined that the government must show only reasonable evidence that it is acting in a proprietary capacity. The government met the burden in this case by demonstrating it had a reasonable proprietary interest in ensuring that treatment and transportation for elderly or disabled residents was not disrupted by union organization.[13]

In Associated Builders & Contractors of S. Cal, Inc. v. Nunn,[14] the Ninth Circuit found that "living wage laws," unlike prevailing wage laws, are not preempted by the NLRA. The court reasoned that there should be no preemption by the NLRA in the case of minimum or living wage laws enacted by governments, because employers and employees are still able to negotiate. A living wage has been defined as the "minimum hourly wage necessary for a person to achieve some specific standard of living."[15] The exact level of such a wage will vary depending upon the geographic area.

Living wages are not statutory, thus they do not violate the NLRA. If a local government tried to enact a "living wage" ordinance that applied only to big-box retailers, however, this could still be challenged as a violation of the Equal Protection Clause, which provides that the government must treat similarly situated parties in the same manner. Most union and non-union advocates of governmental control over the big-box stores prefer the use of the prevailing wage instead of the living wage because they feel it will more effectively equalize wages between union and non-union workers.[16] The question of whether an ordinance requiring minimum health-care benefits for grocery workers is preempted by the NLRA has not been decided by the courts.

ABSOLUTE BAN

Absolute bans on superstores normally apply to stores larger than a specified square footage. Further, some of these bans also add a provision to target big-box retailers that sell a certain percentage of groceries. Some retailers have built two adjacent smaller stores to circumvent such ordinances. Wal-Mart is even using its new concept of the neighborhood grocery to scale down its stores and avoid such ordinances.[17]

CONDITIONAL-USE BAN

Conditional-use permit ordinances require big-box retailers to blend into the neighborhood, and thus be less intrusive. Ordinances may restrict the architectural design, the use of billboards and signs, and so forth. For example, a conditional use permit might require all inner-city businesses to use a certain color of exterior paint—e.g., courts in Santa Fe, N.M., normally enforce these types of restrictions.

The party challenging the constitutionality of aesthetic zoning usually claims that the ordinance is an unconstitutional exercise of police power that does not regulate the use of the land for the health, safety, morals and welfare of their citizens.[18] Further, the litigating party can challenge the ordinance as being so burdensome that it constitutes a taking of property by the government without just compensation, in violation of the Fifth Amendment. In other words, the government has confiscated the property. This was the case in Penn Central Transportation Co. v. New York City.[19] The U.S. Supreme Court upheld the decision of the New York Court of Appeals that a refusal of the New York Landmarks Preservation Commission to allow construction of a 50-story office building over Grand Central Station (a designated landmark) was not a taking of property without just compensation and due process of law. Justice Brennan wrote the decision for the Supreme Court, holding that

> owners could not establish a "taking" merely by showing that they had been denied the right to exploit the superadjacent airspace, irrespective of remainder of the parcel; (2) landmark laws which embody a comprehensive plan to preserve structures of historic or aesthetic interest are not discriminatory, like "reverse spot" zoning; (3) that the law affected some owners more

> severely than others did not itself result in a "taking," and (4) the law did not interfere with owners' present use or prevent it from realizing a reasonable rate of return on its investment, especially since preexisting air rights were transferable to other parcels in the vicinity.[20]

ECONOMIC IMPACT STATEMENT WITH MITIGATION

An ordinance requiring a big-box retailer to prepare an economic impact statement covering a radius of several miles around the store and to accept mitigating conditions, such as a prevailing or living wage, is generally more acceptable to unions than just an ordinary CUP.[21] In some states, environmental impact statements are already required by statute for public projects. (These state laws are patterned after the environmental impact studies required by the National Environmental Policy Act [NEPA].[22]) For example, the California Environmental Quality Act (CEQA) requires California agencies to produce environmental impact reports (EIRs), in which agencies describe the environmental impacts of their actions and identify other actions which may mitigate those impacts.[23] In Los Angeles, the City Council approved a zoning ordinance requiring an economic impact study for any store larger than 100,000 square feet.[24]

In Breckinridge v. Rumsfeld,[25] the Sixth Circuit refused to extend NEPA to the employment-related effects on the human environment of the federal closure of a military base in Lexington, Ky. The District Court had required the Army to prepare and distribute a formal environmental impact statement before proceeding with the closure. The Sixth Circuit reversed the decision and found that NEPA should not be transformed into a law "promoting full employment."[26]

However, in Bakersfield Citizens For Local Control v. City of Bakersfield,[27] the California Court of Appeals held that the effect of urban decay on competition could require an environmental assessment under CEQA.[28] The City of Bakersfield had rezoned land for two new shopping centers containing Wal-Mart Supercenters. The plaintiffs were a group of concerned citizens, local merchants and unions. They asserted that the rezoning could cause urban decay, including store closures.[29] The plaintiffs' expert, Professor Dan Vencill, an economics professor from San Francisco State University, prepared a study of the area within five miles of the proposed new shopping centers and found vacant commercial property and indications that other businesses might fail if the shopping centers were completed as planned.[30] The Court of Appeals found that the city should have prepared a counter-study and remanded the case to the trial judge so that a new EIR could be prepared.[31]

IMPLICATIONS

City council proposals to raise the minimum wage for big-box retailers within the limits of most cities may be seen as a form of unintentional redlining, since the stores and associated jobs would migrate from inner-city neighborhoods to peripheral areas. Zoning ordinances used to control economic competition may be challenged as abusive. Case law has shown that the government's best defense to such challenges is thorough studies that support the rationale of the ordinance. ■

ENDNOTES

1 Frank B. Cross and Roger Leroy Miller, West's Legal Environment of Business, 6th ed. (Thomson Learning/South-Western College/West, 2006), p. 120.

2 Cross and Miller, 2006, p. 598.

3 Cross and Miller, 2006, p. 599.

4 Lefcoe, 2006.

5 George Lefcoe, "The Regulation of Superstores: The Legality of Zoning Ordinances Emerging from the Skirmishes between Wal-Mart and the United Food and Commercial Workers Union," 58 Arkansas Law Review 833 2006

6 Lefcoe, 2006.

7 NLRB v. McEver Eng'g, Inc., 784 F.2d 634 (5th Cir. 1986).

8 Chamber of Commerce of the United States v. Bragdon, 64 F. 3d 497 (1995).

9 Lodge 76, International Association of Machinists v. Wisconsin Employment Relations Comm'n, 427 U.S. 132 (1976).

10 Id., p. 500.

11 Lefcoe, 2006.

12 Metropolitan Milwaukee Ass'n of Commerce v. Milwaukee County, 359 F. Supp 2d 749, 759 (2005).

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14 Associated Builders & Contractors of S. Cal, Inc. v. Nunn, 356 F. 3d 979, 991 (9th Cir. 2004).

15 http://en.wikipedia.org/wiki/Living_wage.

16 Lefcoe, 2006.

17 Lefcoe, 2006.

18 Reid v. Architectural Bd. of Review of City of Cleveland Heights, 192 N.E. 2d 74 (Ohio Ct. App. 1963).

19 Penn Central Transportation Co. v. New York City, 438 U.S. 104 (1978).

20 Id., 104.

21 Lefcoe, 2006.

22 National Environmental Policy Act of 1969, Pub. L. No. 91-190, 83 Stat. 852 (1970) (codified at 42 U.S.C. §§ 4321–4347 (2000).

23 http://www.sdcwa.org/infra/EIR_101.phtml.

24 Sprawl-Busters, City Council Takes First Vote on Big Box Impact Ordinance (Aug. 10, 2004), at http://www.sprawl-busters.com/search.php.

25 Breckinridge v. Rumsfeld, 537 F. 2d 864 (1976).

26 Id., p. 865.

27 Bakersfield Citizens For Local Control v. City of Bakersfield, 22 Cal. Rptr. 3d 203 (2004).

28 Lefcoe, 2006.

29 Bakersfield Citizens, pp. 210–211.

30 Id., p. 222.

31 Id.

FOCUS ON REAL ESTATE ANALYSIS

Comments on the Probability of Rezoning

BY JOSEPH S. RABIANSKI, Ph.D., CRE

IN THE SPRING 2007 EDITION OF *REAL ESTATE ISSUES*, THE concept and definition of highest and best use was discussed in the article, "Comments on the Concept and Definition of Highest and Best Use." which can be accessed online at www.cre.org/publications. Several conclusions regarding highest and best use (HBU) were discussed, including the definition of market value and legal permissibility's impact on HBUs. The definition of market value is based on the economist's perfectly competitive market in which there are no barriers or obstacles to the entry of new firms or the exit of existing firms. Legal permissibility in the HBU process often is a barrier to entry. Because legal permissibility contains an element of manipulation, it could negatively influence the HBU, thus retarding the highest present value to the land or return on improved property. HBU determination and analysis can be flawed if legal permissibility is contrary to the economics of the property market.

THE PROBABILITY OF REZONING

The "probability of rezoning" rests on the issue of legal permissibility, which can be used as a barrier to entry. The result is a flawed rezoning process. The barrier violates the perfectly competitive conditions in the market. The idea and use of legal permissibility will not disappear from the zoning ordinance or the HBU definition, so its existence must be recognized. We must, however, eliminate legal permissibility's effect on HBU analysis by the market analyst and the appraiser.

The "probability of rezoning" is an educated evaluation (an expert's judgment) about the action that will be taken by the authorities of a local jurisdiction who have the power in the zoning ordinance to impose restrictions on land use. Local authorities base their decisions on any number of factors, such as the best interests of the property owner, the needs of the community, their personal preferences and biases and, in some instances, personal gain. The analyst or appraiser should not be involved in judging the "probability of rezoning" in this context. The analyst, a market expert, should not have to ponder the possible non-market motives of a set of individuals who

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may have non-market motives. The analyst should not judge and attempt to forecast the results of various underlying motives not expressed in the financial feasibility of a property's use.

The appraiser or the analyst, however, is a vital player in determining the financial feasibility of a property. These market experts have the knowledge to gather, array and interpret the facts to make the evaluation. While their knowledge is property market based, their evaluations should not be recognized as a study of the proclivities of the local authorities who may act counter to the desires of the market and the needs of the community.

The Appraisal Institute's *The Appraisal of Real Estate* (12th edition)[1], on pages 311-312, provides the appraiser with ideas about handling the probability of rezoning. The six statements are easily divided into two categories that represent the Appraisal Institute's interpretation. The appraiser is provided four "must considerations" when evaluating market needs:

- Trends in the market area
- The history of zoning requests
- Uses that are not compatible with the existing land uses in the area
- Land assemblage, removal of structures and new construction in the area

He or she must, in reality, keep in mind that the above four items are generally considered to be market driven but in reality each consideration can be subject to direct manipulation by the local jurisdiction.

Two additional items are presented that are subject to direct manipulation by the local jurisdiction:

- Documents such as the comprehensive or master plan
- Uses for which zoning requests have been denied.

According to *The Appraisal of Real Estate*, an appraiser preparing a "land development forecast" for the area "must fully disclose all pertinent factors relating to a possible zoning change, including the time and expense involved and the risk that the change will not be granted." This statement of disclosure should refer to market conditions and financial feasibility and not the personal views of individuals (zoning officials) who may or may not consider market conditions and financial feasibility.

The appraiser is instructed to "fully disclose all pertinent factors relating to a possible zoning change …." Such reporting of the facts requires expert knowledge about the property market and the financial feasibility of the uses on the property. The appraiser can report the value of the property in a current and legal use, as well as in a future use, be it legal or not. The difference in value gives the owner important information that can be used in the decision to seek a rezoning. The appraiser can report a rate of return on the use of the property in a current and legal use as well as in a future use, be it legal or not. The difference in these yield rates gives the owner important information that can be used in the decision to seek a rezoning.

The exact "probability of rezoning" is the concern of the property owner, not the analyst or the appraiser. The analyst and the appraiser provide facts about the financial feasibility of the project in the form of property market value, residual values to the land and/or rates of return. The property owner evaluates these facts (with or without the advice and assistance of the analyst or appraiser) and makes the judgment about the "probability of rezoning."

However, if the market analyst or the appraiser has to step into the issue of the "probability of rezoning" (an educated guess about the action of the entity with powers of manipulation), a standard practice, or "well documented technique" is needed for making the determination. This is the discussion of a subsequent section. But first, a short discussion of the zoning ordinance and the rezoning request seem to be in order.

THE ZONING ORDINANCE AND THE COMPREHENSIVE LAND USE MAP

The zoning ordinance and the comprehensive land use map are developed with the best of intentions. As a police power of the local jurisdiction, the zoning ordinance serves the public interest by eliminating incompatible land uses that would reduce the property values of the citizens of the local jurisdiction. The key word is "incompatible" and the connotation of the word, which economists term "negative externalities," is a land use that has a reducing effect on the market values of adjacent and proximate properties. Often the intent of a zoning ordinance is interpreted as a deliberate act to separate different land uses from each other. Residential land use here, commercial land use there. As a matter of fact, this is the underlying premise when the zoning map is drawn. But economic sense must be applied to the boundaries between land uses. Property value is not singularly affected by the land use on the adjacent property. It also is affected by the land uses in close proximity as well.[2]

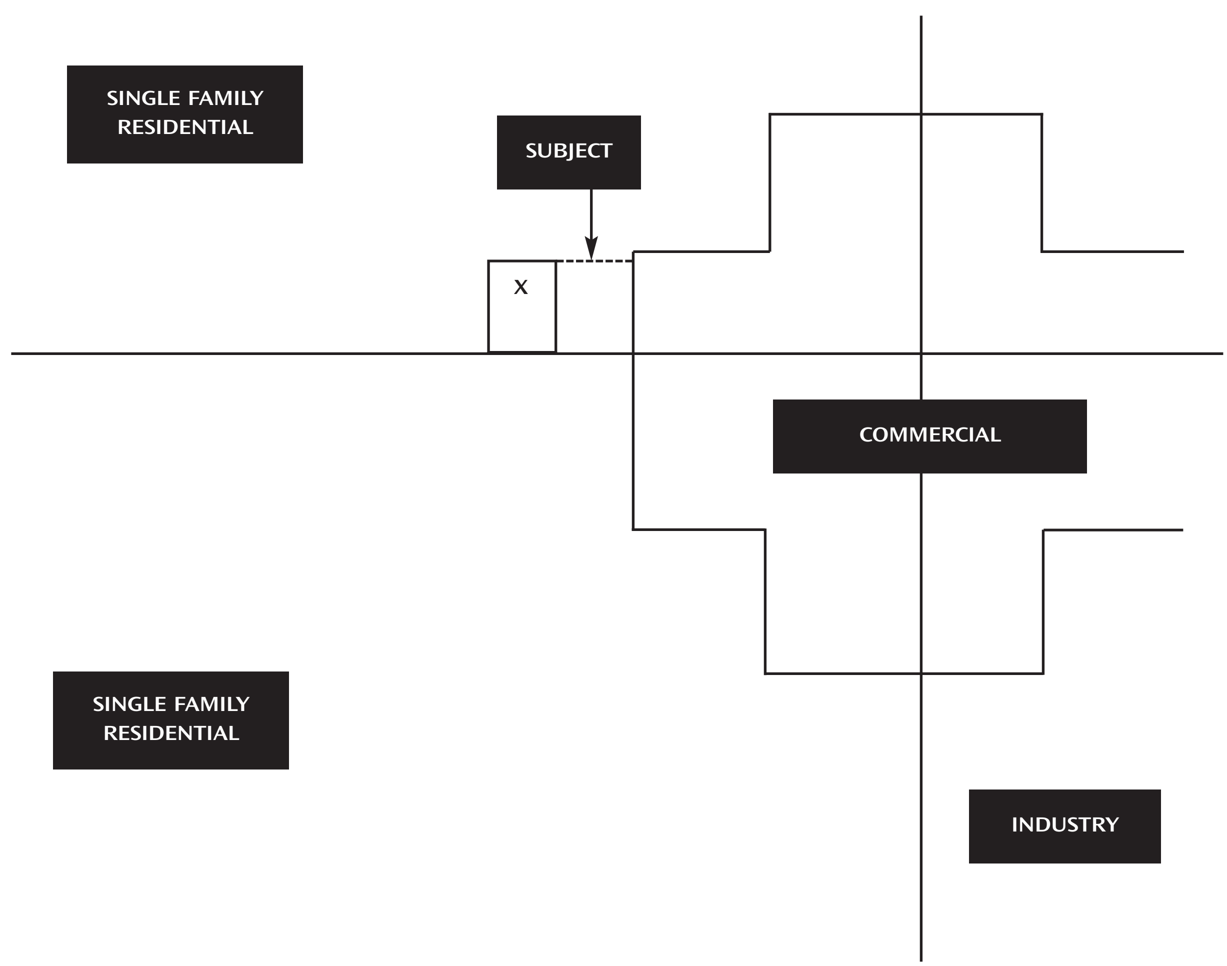
Let us consider a hypothetical illustration (Exhibit A below) to explain how zoning ordinances can separate different land uses. In our hypothetical situation, residential and commercial land uses are economically compatible. Households need retail and retail needs customers.

A subject site, let's call it "Commercial Site S," is being considered for rezoning from residential to commercial. Will the rezoning of the subject property negatively affect the property values in the residential area? Not if the commercial use is needed by the community and is generally in line with the existing retail and other commercial uses in the commercial district. Will the rezoning of the subject property to commercial negatively affect the property value of property "X"? No more so than if the subject was affected by its location adjacent to the commercial district. If any negative effect occurs, it would be minor because the property is already located in close proximity to the commercial land users.

If the commercial district does pose a negative impact on the residential area, the property values should increase with distance away from the commercial land use. This

Exhibit A

Hypothetical Zoning Map



consequence can be investigated in the market area. Observation will generally show that value change will be gradual with small differences among the properties in close proximity to the commercial land uses. At a certain distance, say 1,000 feet, the negative effect should dissipate.

Should the subject property be rezoned? Yes, as long as the proposed commercial use is compatible with both the residential area and the existing commercial district, and the market demands the use to which the subject will be put.

The point of this example? The zoning ordinance is an economic tool. It is driven by the desire to maintain and protect property values and it affects property values. It is supposed to take the market into consideration when the zoning map is drawn and when rezoning requests are being considered. If the local economy and the local property market are dynamic and the changes are for the better and compatible and conform to the existing conditions, the zoning ordinance should be able to change to reflect the economic changes in the geographic market area.

EXPERT DETERMINATION OF THE 'PROBABILITY OF REZONING'

Author J.D. Eaton stated in his book "*Real Estate Valuation in Litigation*" that the "probability of rezoning is fertile ground for the unscrupulous, the naive and the dreamer."[3] This statement can reflect the motivation of both parties to a rezoning situation. The property owner and the rezoning decision authority, in addition to being biased, can both be guilty of these traits. Under current thinking, the probability of rezoning needs to be determined by an unbiased and knowledgeable third party to the process with documented support for the conclusion. This third party is the appraiser and/or the market analyst. It should not be the owner of the property. It should not be an official of the local jurisdiction who could be protecting the status quo of the comprehensive plan when it does not make economic sense to do so. The judgment about the probability of rezoning should come from a market analysis of the immediate economic and physical environment of the subject property.

The current legal land use restrictions on the subject property and the immediate environment are considerations in the analysis. The more important considerations are the existing land uses and financial feasibility of improved neighboring properties and the financial feasibility of neighboring vacant land. In the end, however, the probability of rezoning is an estimate of the local jurisdiction's willingness to allow the land use change. This willingness to change may not reflect current or future market conditions, and it allows the local jurisdiction to manipulate the HBU decision.

The determination of the market analyst or appraiser of the probability of rezoning should not be determined by the judgment of what the zoning authority might or might not allow. Pragmatism currently forces market analysts and appraisers to make such a judgment to assess the probability of rezoning. Their task is to judge the actions of individuals but not the actions of the property market. The economist will say that the market impediment, the zoning authority, dictates the conclusion instead of the free and unobstructed operation of the real property market. The economist will say that the zoning authority is a barrier to entry. Such barriers are an important element in a monopolistic market situation. It is not the perfectly competitive market situation discussed in Part I of this article, "Comments on the Concept and Definition of Highest and Best Use" that is the underlying economic theory for the definition of market value. The zoning authority through the operation of the zoning ordinance can impede the operation of the competitive market and thereby affect HBU and market value of the property.

REZONING JUSTIFICATION ANALYSIS

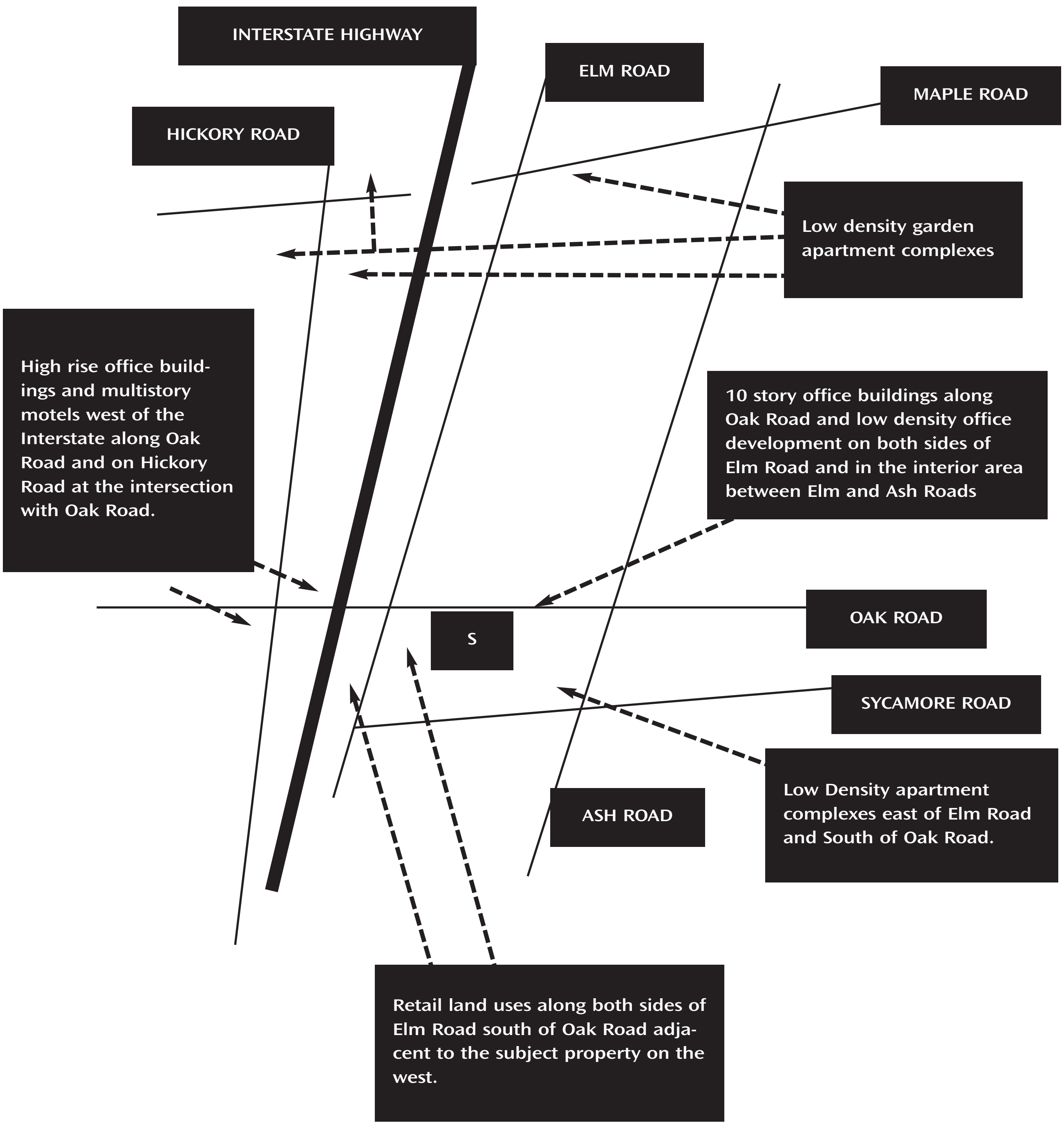
What is needed is a new phrase to identify the role of the market analyst or appraiser and to replace "the probability of rezoning." "Rezoning justification analysis" is a term that would meet this requirement. There are no probabilities; there are no judgments about the actions of specific local officials. It is an evaluation of the facts drawn from the property market. Is it financially feasible to use a currently illegal use at some point in time – now or in the future? The financial feasibility of the illegal use is estimated and compared to the financial feasibility of the current legal use. If the illegal use is "maximally productive," then a rezoning request could be warranted. The financial return from the rezoning should exceed the cost of the rezoning process.

AN ASSIGNMENT

A recent evaluation assignment of a partial taking brings this issue to the forefront. Let us take a look at another

Exhibit B

Map of the Hypothetical Space Used in the Assignment



example of rezoning. Exhibit B (on page 29) provides a map of the immediate area next to the subject property. The subject property is a seven-acre site serving as a single family residence but is zoned as multifamily residential. It has substantial frontage on Oak Road, just east of the intersection with the Interstate. The local jurisdiction has taken in excess of one acre of the site by taking a 120-foot wide strip of land from the entire front of the site along the 360 feet of frontage the site has along Oak Road. Adjacent to the west of the subject site are two recently developed retail outparcels along Oak Road: a new neighborhood shopping center and a power center are under construction along the east side of Elm Road heading south. Across Elm Street are free-standing retail establishments. Across Oak Road from the subject property are recent high-rise office buildings facing Oak Road with mid-rise office buildings in the area behind the high-rise office buildings. East of the subject property are the entrances to two low density garden apartment complexes that are 10 to 15 years old. Further east along both sides of Oak Road is a mixture of free-standing retail establishments, motels, unanchored strip centers and more garden apartment complexes. Apartment complexes also exist further north of Oak Road, on both Elm Road and Hickory Road. The subject site is the high ground in the neighborhood. The land slopes down east of the subject property along Oak Road and southeast through the low rise apartment complexes. This topological feature provides the subject property with a scenic view of two high-rise office nodes to the north, one to the south, and one office node to the east.

Without the benefit of financial analysis, what is your judgment about the process of determining the HBU of the subject property based on a qualitative analysis of the economic and physical environment in which the subject property exists?

Here is my opinion about the HBU process based on the development of compatible and complimentary adjacent and proximate properties: The subject site should be tested for high-rise office use and high-rise, high-density apartment use. Also, it should be tested for general retail use. These three property types are financially feasible in the immediate area of the subject property and these three uses for the subject property have a high probability of being financially feasible in this market. One of them could be the maximally productive use for the site, but this will not be known without the analysis.

The representatives of the local jurisdiction (planning director and county attorney) insist that the comprehensive plan will not change with regard to this site. This decision was made without any formal financial analysis; there was no HBU consideration and their opinion of value was based solely on continuation of the existing zoning and thus the development of the site as a low density apartment complex. These local representatives determined that this would be consistent with the existing apartment developments on that side of the road and behind the subject site. All three land use prospects for the HBU that appear to be good prospects for a financial feasibility test are eliminated by the power of the local jurisdiction. Moreover, by dictating the ultimate use, the local jurisdiction controls the price for the land by stating that only low-rise, low density apartment-comparable properties are permitted in the sales-comparable method. The value of land for garden apartment development was approximately $200,000 per acre, while the value of commercial land was in the range of $600,000 to $900,000 per acre.

The county appraiser's HBU analysis was limited to low-rise apartment development, not by the market but by administrative fiat. This is not HBU analysis in a free and competitive market. The authorities of the local jurisdiction imposed a substantial barrier to the value of the land analysis in order to control the price they had to pay for the taking.

The market analyst or the appraiser cannot change the authority of a local jurisdiction to impose a zoning ordinance or to allow a rezoning. But, the appraisal and market analysis professional can change the way it defines the market potential of a property in our free market economy. Consider the following suggestions for the HBU as vacant and HBU as improved definitions. They are the same definitions offered in Part I of this article, "Comments on the Concept and Definition of Highest and Best Use," but they contain new clauses, which are underlined:

The HBU of a vacant land is the most financially feasible use from all uses that can be supported by <u>freely competitive and (legally and physically) unobstructed</u> current and future property market conditions, <u>that is compatible with</u>

existing adjacent and proximate land uses, that serves the economic needs of the local community, and that generates the highest present value to the land.

The HBU of an improved property is the most financially feasible use from all uses supported by freely competitive and (legally and physically) unobstructed current and future property market conditions that is compatible with existing adjacent and proximate land uses, that serves the economic needs of the local community, and that geneates the highest financial return to the property.

These definitions can be modified to specify the need for compatibility and conformity among property types by adding the following phrases to the definitions: "compatible with existing adjacent and proximate land uses, and serving the economic needs of the local community."

Under these definitions, the HBU is the use of the property, based on free market factors, judged by the appraiser to be the most financially feasible, compatible and economically desired use in the various current and prospective property markets.

What if the HBU is not a "legally permissible use" but an "illegal" use that the market will support? In terms compatible with the above definition, what if the HBU is not a current use that conforms to the zoning ordinance but its use is financially feasible but does not conform to the existing zoning ordinance? The appraiser's responsibility to the client, the property owner in this situation, is to report the HBU. If the HBU is not a legal use, then the appraiser's analysis can be used in the public hearing to request (appeal, beg or plead) to have the local zoning authority convert the illegal use to legal. On the other hand, if the local jurisdiction is the client, the appraiser's responsibility to the client is also to report the HBU. To do otherwise would be unethical.

REZONING JUSTIFICATION ANALYSIS REVISITED

This article calls for the appraiser to move away from attempting to judge the "probability of rezoning" because it is a judgment about an impediment in the free market that is subject to manipulation and monopolistic control by the local government. The market analyst and the appraiser are well qualified to judge the financial feasibility of a vacant or improved property use. The judgment is well grounded in market factors rather than in the powers of government that can be easily manipulated.

In order to eliminate confusion, "rezoning justification analysis" should replace the "probability of rezoning"" in the appraisal literature. Consider the following definition for "rezoning justification analysis:"

Rezoning justification analysis is the application of financial feasibility as determined by the market analyst's or appraiser's expert judgment. The rezoning justification is high if the proposed use for the subject property is financially feasible whether it is permitted or not by the current zoning for the subject property.

Under this concept of "rezoning justification analysis," the appraiser can test financial feasibility of any and all "illegal" uses and show the extent of the effects of the rezoning on the subject property and the market area. The rezoning itself is beyond the scope of the market analyst's or appraiser's assignment. The market expert provides the evidence to evaluate the rezoning request. The financial feasibility can be tested. The compatibility and conformity can be evaluated. The rezoning justification is a matter that the market expert can research, evaluate and report.

The actual rezoning decision is a different matter. The probability for rezoning is a situation faced by the owner of the property and the decision rests in the hands of others. The rezoning justification rests on the facts provided by the market expert. The decision to rezone can pass or fail for other reasons not covered in the market expert's analysis.

Consider the following simple cases as an example of rezoning justification analysis.

Case I: The value of the land in apartment use in the current market is $400,000 per acre for high density apartment development. Land value is $350,000 per acre in office use, which is not legal for the site and not prevalent in the area. A rezoning request is not financially appropriate in this case because the land value in the illegal case is less than the current legal use.

Case II: The value of the land in apartment use in the current market is $340,000 per acre for high density apartment development. Land value is $380,000 per acre in office use, which is not legal for the site but does exist in close proximity. A rezoning request is financially appropriate but only if the cost to obtain the rezoning is less than $40,000 per acre.

In these cases, the market expert reports what is obtained from market evidence. The property owner can determine if the benefits from rezoning will cover the costs of obtaining the rezoning.

CONCLUSION AND SUMMARY

The judgment about the "probability" of rezoning relies, in part, on market information. Zoning officials can affect the outcome of a rezoning request for a variety of reasons. Some of these reasons are based on market considerations and sometimes community concerns. Personal bias also can play a part. When personal bias comes into play, the zoning process is manipulated and thereby a violation of the perfectly competitive market situation. The analyst or appraiser should not have to make this judgment about probability. He or she should provide evidence concerning a rezoning. Is it financially feasible for the landowner? This form of the analysis is rezoning justification analysis; it considers only the market information to judge the HBU of the land or the improved property. ■

ENDNOTES

1 The Appraisal of Real Estate, 12th edition. (Chicago: Appraisal Institute)

2 The Principles of Conformity and Externalities come into consideration here. "Conformity holds that the real property value is created and sustained when the characteristics of the property conform to the demands of the market (*Appraisal of Real Estate,* p. 41) "The principle of externalities states that factors external to a property can have positive or negative effect on its value". (*Appraisal of Real Estate,* p. 42)

3 J.D. Eaton. *Real Estate Valuation in Litigation,* 2nd edition (Chicago: Appraisal Institute, 1995, p. 143)

Commercial Real Estate Derivatives: The Developing U.S. Market

BY JIM CLAYTON, Ph.D.

"Derivatives make markets more complete — that is, they make it possible to hedge risks that otherwise would be unhedgeable. … [R]isks are born by those who are in the best position to bear them and firms and individuals can take on riskier but more profitable projects by hedging those risks that can be hedged. As a result, the economy is more productive and welfare is higher."

— René Stulz, "Should We Fear Derivatives?" *Journal of Economic Perspectives*, Summer 2004

OVER THE PAST DECADE, U.S. INSTITUTIONAL REAL ESTATE HAS evolved into a dynamic, more widely accepted mainstream asset class. The securitization revolution of the 1990s helped produce today's robust public real estate investment trust (REIT) and commercial mortgage-backed securities (CMBS) markets. It also has facilitated major capital flows into real estate in recent years that have strengthened linkages between private real estate asset markets and wider national and global capital markets. This shift has transformed real estate financial structures, capital sources and investment products.

The real estate sector continues to evolve at a rapid pace, with the emerging commercial property derivatives market being the latest innovation. There is significant interest by many real estate market participants in the development of commercial property derivatives. Investors are watching with interest to see if this new way to gain exposure to the real estate asset class and hedge private real estate risk will materialize and revolutionize the institutional real estate world, as it has in stock and bond markets around the world. Real estate is the last major asset class without a significant derivatives market.

Property derivatives represent a new way for investors to gain or reduce exposure to the real estate asset class, quickly and without directly buying or selling properties, while relying on the performance of a real estate return index. The speed and ease of execution, reduced upfront capital requirement and ability to protect real estate portfolios on the downside provide added flexibility in

About the Author

Jim Clayton, Ph.D., *is the director of research at the Pension Real Estate Association (PREA), a nonprofit trade group representing more than 500 member firms, including tax-exempt investors (pension funds, endowments, foundations and more), real estate asset managers, advisors, consultants, investment bankers, real estate investment trusts and others. Working closely with the PREA Research Committee, he leads PREA's research efforts through original applied research, coordination of sponsored external research and participation in other PREA educational and outreach activities. He also writes a regular capital markets column in the* PREA Quarterly *member magazine. Prior to joining PREA in the fall of 2006, Clayton was a faculty member in the department of finance and real estate at the University of Cincinnati. His research has been published in the major academic and practitioner real estate journals and he has presented at numerous industry events, in the U.S. and abroad. He is a past recipient of the Homer-Hoyt Institute post-doctoral fellowship and serves on the editorial boards of several leading research publications, as well as the advisory board of the Real Estate Research Institute (RERI).*

executing real estate investment and portfolio risk management strategies. It seems to be a natural next step in the evolution of real capital markets, continuing the transition from a private asset class characterized by high transaction costs and the inability to sell short to one with significant public market integration and the associated fast pace of financial innovation. With it would come improvement in price discovery and market pricing.

In 2005, the National Council of Real Estate Investment Fiduciaries (NCREIF) gave Credit Suisse an exclusive license to offer derivative contracts, in the form of return swaps, based on NCREIF property return indices. Significant trading of NCREIF-based swaps did not materialize, and in October 2006, Credit Suisse relinquished the exclusive license it received from NCREIF. It is widely believed that the exclusive arrangement hampered growth and development because it prevented needed competition between investment banks and other players wishing to create liquidity in derivatives on NCREIF indices. Since then the "buzz" about derivatives has intensified.

In March 2007, NCREIF began licensing its indices on a non-exclusive basis. This is more along the lines of the successful model adopted in the United Kingdom, where the property derivatives market has experienced rapid growth and development over the past two years. Today, seven investment banks have agreements with NCREIF, and trading in derivatives is taking place, with approximately $300 million traded as of early September 2007. While clearly in the early stages of development, there is significant momentum as new players and other tradable indexes have emerged and jostle for position in this young market.

While many are excited about the new investment and risk management possibilities offered by property derivatives, others are skeptical about investors' willingness to embrace these new tools. There is also concern that trading by nontraditional real estate investors with a short-term focus (e.g., hedge funds) will add volatility to and potentially destabilize the private property market. To these market participants, real estate represents tangible, bricks and mortar assets, whereas derivatives are seen as complex financial instruments created by Wall Street investment bankers.

Is there a need for commercial property derivatives? What are the implications of growth in real estate derivatives for investment in traditional real vehicles? This article aims to bridge the knowledge gap that exists between traditional real estate players and the Wall Street derivatives world. It will serve as a primer on both the basic structure of property return swaps written on real estate return indexes and the real estate investment performance indices upon which derivative contracts may be based.

PROPERTY RETURN INDEX SWAP BASICS[2]

A "derivative" asset is one whose value is determined by, or derives from, the value of another asset or bundle of assets. Financial derivatives come in a variety of forms, including options (calls and puts), futures and swaps, as well as more exotic complex instruments. Exhibit 1 (below) provides an overview of financial option terminology for readers unfamiliar with this area of the finance world. The derivatives offered to date on the NCREIF index are "swaps" that come in two forms. One allows investors to take a position in either the NPI appreciation

Exhibit 1

Background on Financial Derivatives: Terminology and Concepts

DEFINITION

A derivative is an asset that derives its value from the value of another asset (e.g., a stock) or a bundle of assets (e.g., a stock index).

TYPE OF DERIVATIVE

Option	The "right" but not obligation to buy (call) or sell (put) an asset at a specified price
Forward/Future	Obligation to exchange an asset at a specified price on a specified date in the future
Swap	Contract to exchange cash flows over a specified period of time; based on a "notional" principal.

MOTIVATION: *Why do investors use derivatives?*

- Synthetic investment: receive asset return without acquiring the asset
- Hedging/risk management: downside risk insurance
- Portable "alpha" strategy: eliminate/reduce systematic risk from a portfolio
- Speculation: make a leveraged bet on the direction of value change

or total return, buying ("going long on") or selling ("going short on") the NCREIF index return. The second type of product allows investors to swap total returns on two different NCREIF property sectors (e.g., swap office for retail).

Exhibit 2 (below) shows how the appreciation return swap works. Investor L takes a long position in the index, meaning it receives the real estate return each period (quarter or year depending on how the contract is specified) in exchange for paying the London Interbank Offered Rate (LIBOR — the interest rate that banks charge one another for lending money) plus a spread. On the other side of the exchange, Investor S agrees to pay (i.e., sell) the index return and in return receives LIBOR plus a spread. There is no upfront principal involved. The swap contract is based on a notional principal amount upon which cash flows to be exchanged (or swapped) are calculated. In this example, the trade takes place in the over-the-counter (OTC) market — that is, not in an organized options exchange such as the Chicago Mercantile Exchange. An investment bank executes the trade.[3] One or both parties may work with an "inter-dealer" broker, a specialist firm that facilitates the execution of derivative contract trades, fosters price discovery and creates liquidity in the marketplace. The contract term is specified upfront and typically would be for two or three years, with cash settlement every quarter (or possibly annually) shortly after the index numbers are made available.

The return swap allows the two investors to execute real estate strategies that they cannot accomplish in the private real estate market. Investor S might be a large pension fund that is over allocated to real estate, possibly because of relatively poor performance in stock and bond markets. S can reduce exposure to the real estate asset class without having to sell properties. The swap allows Investor S to execute this strategy quickly while retaining ownership of the physical assets. Investor L could be a small pension fund looking to gain exposure to the real estate asset class. The swap allows L to get into the real estate game quickly with exposure to a diversified portfolio, such as the NCREIF index.

In another scenario, L and S could be two investors with different expectations about the direction of the market, with L betting on the market rising and S the market taking a downward turn. The two might be investment managers or pension funds with existing real estate portfolios using derivatives to fine tune real estate allocations and manage portfolio risk as part of the overall real estate strategy. In this case, S uses the swap to reduce or possibly even eliminate, with a large enough notional position, the systematic real estate market component of its portfolio. This might be motivated by the goal of focusing on alpha, or the desire to buy portfolio level insurance against a real estate downturn. This is similar to buying a "put" option on the index to provide downside protection. Of course, this story assumes that the investors have portfolios that closely track the index.

Exhibit 2

Structure of a Basic Property Total Return Swap

***Spread** $_{Ask}$ **— Spread** $_{Bid}$* **is the BID-ASK SPREAD — reflects the intermediary's costs of doing business, including compensation for taking risk and creating liquidity (i.e. making the market), plus differences in expectations about future returns.**

Alternatively, S and L could be more opportunistic players (e.g., hedge funds), possibly without real estate holdings at all, looking to speculate on short-term movements in the real estate index. Of course, it is crucial that demand exists on both the long and short sides of the market, deriving from either portfolio adjustment motivations, or disagreement about the direction of the market, or both; it is a two-sided market that requires enough breadth and depth to create the requisite liquidity.

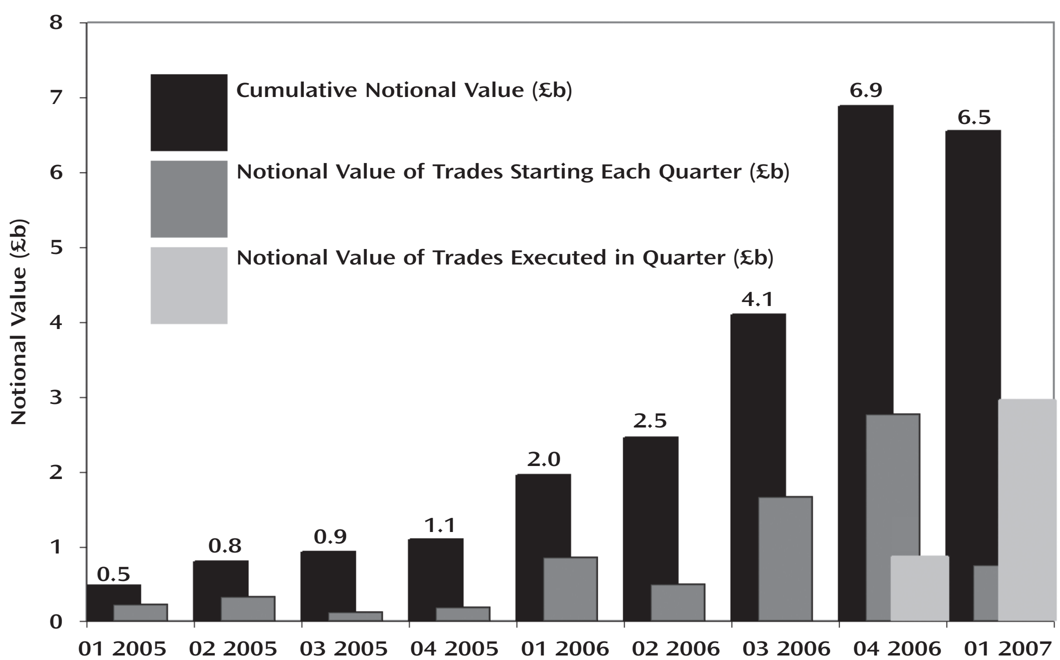
This might all sound good in theory, but is it needed and will it work in practice? The main determinant of the long-term viability of a robust, liquid property derivatives market is the value it has to investors. What does the real estate investment industry gain? Index return swaps allow investors to adjust exposure to real estate without buying or selling properties, thereby creating flexibility for portfolio management, while eliminating the required physical delivery of the asset. Derivatives, therefore, help to overcome the main disadvantages of private real estate investment, including high transaction costs, long transaction lead time, lack of liquidity and inability to sell real estate "short."[4] Once sufficient liquidity is achieved in the marketplace, investors will be able to act quickly on both the short and long sides of the market. The result will be significant improvement in price discovery and ultimately efficiency in the private real estate market. In addition, as derivate markets continue to develop around the world, swaps should prove to be an efficient and economical way to gain exposure to international real estate markets.

Experience in other asset classes suggests that it is needed and it will work, and also that the market could develop rapidly once it gains momentum. Property sector evidence comes from the recent experience of the U.K. commercial derivatives market, where the market has gained significant momentum.[5] At last count, more than 15 banks are licensed to trade index return swaps based on Investment Property Databank (IPD) return indices.[6] Exhibit 3 (below) provides U.K. trading volume data. Since the end of 2004, trades totaling almost $14.1 billion (£7 billion) in notational value of IPD index swaps have

(continued on page 38)

Exhibit 3

UK Property Derivative Contract Trading Volume



Source: Investment Property Databank (IPD)

Exhibit 4

The Four Emerging U.S. Commercial Real Estate Indices for Derivative Trading

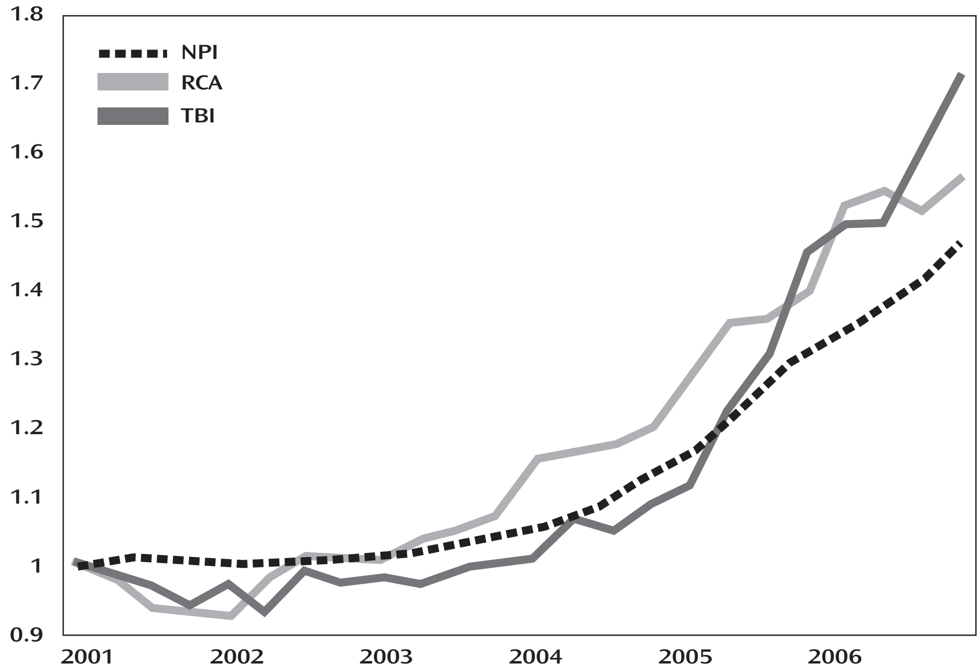
Indices	Provider Information	Basic Index Characteristics
NCREIF	National Council of Real Estate Investment Fiduciaries Property Index (NPI) is derived from the performance of institutional class properties owned by investment managers and pension funds (plan sponsors). www.ncreif.org	• *Quarterly* unlevered returns (total, income and appreciation) at the national and regional level by property type back to 1978. MSA level returns as well. • *Appraisal-based:* Capital returns are derived from changes in appraised values. NCREIF returns tend to lag "true" market returns, due to the nature of the appraisal process and the fact that not all properties are reappraised each quarter. • As of 1st quarter 2007 comprising 5,466 properties with an estimated aggregate market value of $267 billion. • The benchmark for most institutional core real estate portfolios.
S&P/GRA	Standard & Poor's (S&P) has partnered with Global Real Analytics (GRA) to produce the S&P/GRA Commercial Real Estate Indices (SPCREX™), which are to begin trading on the Chicago Mercantile Exchange (CME). www.graglobal.com/index.php?section=products&page=aboutCREX	• *Quarterly price* indices and capital returns at the national and regional levels, as well as property type on a national basis, back to 1994. • *Transaction-based:* Price index is derived as the 3-month moving average of average sale price per square foot. Average sale price per square foot figures are derived using a proprietary algorithm applied to property-level transaction price per square foot data observations.
RCA-based	Real Capital Analytics (RCA), a national real estate data vendor specializing in tracking commercial real estate transaction activity and prices, has partnered with the MIT Center for Real Estate (MIT/CRE) and the firm Real Estate Analytics LLC (REAL) to produce a series of property price indices. http://web.mit.edu/cre/research/credl/rca.html www.realindices.com	• *Monthly price* indices and capital returns at the national level back to 2000; quarterly indices for core property types and annual indices for select MSAs. • *Transaction-based:* Constructed using a statistical/econometric methodology applied to repeat sales of individual properties (same-property realized price changes) in the RCA database. Similar to methodology used to construct the Case-Shiller/S&P housing prices indices that are traded on the CME. • RCA database includes most property sales of more than $2.5 million.
REXX	Rexx Index venture includes Cushman & Wakefield and Newmark, Knight, Frank as minority owners and data contributors. www.rexxindex.com	• *Quarterly* returns (total, rent and capital) at the national level as well as for 15 major metro areas, back to 1994. Office only at the current time. • *Proprietary model* based on current micro (space market) variables including rents, vacancy rates and leasing activity, as well as key macro variables such as interest rates and inflation. • Focus on metro level rent indices to allow investors to hedge or leverage on performance in specific local markets.

Source: PREA

Note: As of press time, the NCREIF index is the only index licensed for trading. Recent developments indicate this may change in the near future. As of the 3rd quarter of 2007, Moody's Investor Services has taken over production of the REAL indices. These are now the "Moodys/REAL Commercial Property Price Indices" or Moody's CPPI. REAL is working to establish a platform or trading derivatives on this index. On September 19th, the CME Group announced that futures and options based on the S&P/GRA indices would begin trading on the exchange on October 28th.

Exhibit 5

U.S. Valuation Indices: NCREIF and Transaction-Based Indices



Notes: **NPI is the capital (value) component of the NCREIF property return index; TBI is the capital component of a transaction-based version of the NCREIF index, and RCA is a value index based on transactions track by Real Capital Analytics (RCA).**

Source: National Council of Real Estate Investment Fiduciaries (NCREIF) and MIT Center for Real Estate

taken place. After a slow start, in the first quarter of 2005, over-the-counter trading exhibited a sharp uptick in 2006, and in the first quarter of 2007, trades worth nearly £3 billion were executed. The increased activity in 2006 and 2007 U.K. derivative trading suggests a growing familiarity and acceptance of property derivatives.

COMMERCIAL PROPERTY RETURN INDICES FOR DERIVATIVES TRADING

To date, both the U.K. and U.S. property derivative markets have developed as index return swap markets, with contracts written on only IPD and NCREIF appraisal-based, benchmark return indices in each respective country. This may change in the United States, as there are (at least) three additional indices hoping to compete for derivative trading business to allow investors to create synthetic positions in private real estate.[7] It seems logical that the NPI was the first index to be licensed for trading in the United States, given its familiarity to institutional investors and widespread use as a benchmark return index. There is some concern, however, that the NPI does not represent the ideal index upon which to grow the derivatives market, or that it should not be the only option available to investors.

The NPI is the primary index used by institutional investors to analyze the performance of U.S. commercial real estate and used as a benchmark for actively managed core real estate portfolios. It is well known that the use of quarterly appraised values results in "smoothing" and lagging of the returns compared with indices based on actual transactions. Smoothing derives from the valuation techniques employed by appraisers, the staggered timing of appraisals conducted within any given quarter, and the fact that not all properties in the index are valued each quarter. The upshot is that the NPI is in many ways an annual index that is partially updated each quarter, making it an imperfect tool for analyzing current performance. In addition, compared with the IPD index, the NPI covers a relatively small proportion of the overall commercial real estate market.[8]

These potential problems with the NPI as an indicator of current return dynamics have helped stimulate the development of other types of indices that hope to compete in the derivatives trading space. These include:

- Global Real Analytics (GRA) indices based on average sale price per square foot. The GRA indices are being developed through a partner ship with Standard & Poor's (S&P).
- Real Estate Analytics (REAL) indices derived from repeat sales (same property realized price changes) of properties in the Real Capital Analytics (RCA) transaction database.
- REXX indices based on metropolitan area rents as well as capital values changes.

Exhibit 4 (on page 37) provides an overview of each of these indices, including information about the index provider, as well as index characteristics, with an emphasis on the features that differ between the indices. It also contains links to the index providers where readers can obtain data, as well as additional details and in many cases, "white papers" on the index methodology.

Exhibit 5 (on page 38) compares the capital or value component of the appraisal-based NPI with a transaction-based value index derived from the Real Capital Analytics (RCA) transaction database, one of the indices discussed in Exhibit 4. It also plots a transaction-based version of the NCREIF index (TBI). While the TBI has not been licensed for derivative trading, there is no reason it could not be in the future. Academic researchers have adopted several approaches to deal with the appraisal issues, the most promising of which are techniques that employ sales of properties to develop transaction-based indices for private commercial real estate.

The TBI, or transaction-based index, is a quarterly "hedonic" index derived from the sale prices of properties in the NCREIF database. The hedonic-price approach uses regression techniques to control for differing property characteristics, and what is called sample selection bias, to create a constant quality price index.[9] The RCA-based index derives from the application of a repeat sales econometric methodology to transaction prices of properties that have sold multiple times during the period covered by the data. The TBI is based on properties sold from the NCREIF index database, whereas the RCA index derives from a much broader and encompassing sample, since the RCA database tracks transactions of all properties in the United States with sale price of $5 million and greater. As might be expected, the three value indices share a common trend. The transaction indices, however, are more volatile than the smooth NPI and have different slopes at times, as evidenced by the crossing of the indices at different points in time. This suggests that institutional class properties held by NCREIF members perform differently at times that the broader property asset market in terms of appreciation returns.

The presence of multiple indices appears to be causing confusion, especially amongst non-traditional real estate players. These multiple indices potentially inhibit the growth of the market. With four indices at the outset, the market could be spread too thin, and this will inhibit the scale and liquidity each needs to achieve market development. However, upon further reflection, it seems that, for two reasons, the presence of multiple indices could be a positive in terms of the long-term development of the market. First, at the micro or individual investor level, investors can choose to execute derivative strategies on the index that best suits their specific situation. Second, at the macro level their coexistence may help to quicken the pace of development of the derivatives market.

Specifically, the presence of multiple indices with differing characteristics allows investors to trade across the indices to exploit arbitrage opportunities that might exist. Consider the differential movement in the indices shown in Exhibit 5. This type of trading should bring additional capital into the real estate investment industry quickly, through derivative, not property, transactions. This would improve price discovery and the efficiency of the private property market.

What is needed is continued objective debate and education about the swap products and the various indices. It is hoped this article has made a positive contribution in this regard.

SUMMING UP

This article examined the development of the commercial real estate derivatives market in the United States. It aims to bridge the knowledge gap that exists between traditional real estate players and the Wall Street derivatives world. It does so by providing a primer on both the basic structure of property return swaps written on real estate return indexes and the real estate investment performance indices upon which derivative contracts may be based. It details potential uses for individual investors and implications for the real estate market as a whole. Having a basic understanding of commercial property derivatives and the indices upon which contracts are written is important, even for real estate investors who do not plan to buy or sell property derivatives. ■

ENDNOTES

1 This article is based on a presentation given by the author at The Counselors of Real Estate's Midyear Meeting in Montreal in April, and is an expanded and updated version of the article, "Commercial Real Estate Derivatives: They're Here … Well, Almost," which appeared in the Winter 2007 issue of the *PREA Quarterly.* The author thanks Marc Louargand, the moderator of the derivatives session at the CRE Midyear Meeting, for helpful discussions and comments.

2 This section is based in part on material presented in Jeff Fisher's, "New Strategies for Commercial Real Estate Investment and Risk Management," PREA-sponsored special issue of *The Journal of Portfolio Management,* Fall 2005; and David M. Geltner, Norman G. Miller, Jim Clayton and Piet Eichholtz, "Real Estate Investment Management and Derivatives," *Commercial Real Estate Analysis and Investments,* Chapter 26 (2nd ed.) (South-Western Educational Publishing, 2007).

3 Exhibit 2 makes it seem as though Investors S and L want to take exact opposite positions in the index swap in terms of the same notional value. In practice this does not have to be the case. If, for example, Investor L wanted to go long $30 million but Investor S wanted to go short $50 million, then the investment bank would execute the $30 million notational swap and then execute another swap for the remaining $20 million short position. Alternatively, the bank could take the $20 million long position itself to facilitate the trade and possibly swap this with an investor looking to short the index at a later date.

4 Property derivatives would therefore help investors manage the two top risk factors in real estate — liquidity risk and lack of reliable valuation data — as identified in a recent survey of institutional investors. See Exhibit 8 in Ravi Dhar and William N. Goetzmann, "Institutional Perspectives on Real Estate Investing: The Role of Risk and Uncertainty," *PREA Research,* May 2005.

5 In thinking about the prospects for the real estate derivative market, some market watchers have drawn parallels to the growth and development of the credit default swaps (CDS) market. The CDS market grew from about $180 billion in notional amount in 1997 to $5 trillion in 2004 to an estimated $17 trillion as of mid-2006 (Sources: British Bankers Association [BBA] and the International Swaps and Derivatives Association [ISDA].)

6 Information about IPD indices is available at www.ipdglobal.com.

7 Derivatives on a public REIT index began trading earlier this year, as the Chicago Board of Trade (CBOT) launched a new futures contract based on the Dow Jones U.S. Real Estate Index.

8 The NPI is derived from a sample of the population of stabilized, unleveraged, institutional class properties. The main use of the NPI is as a benchmark for portfolios of core properties. It makes perfect sense that investors benchmarked against the NPI will be drawn to NPI index swaps. Other investors who want to trade on more timely changes in property market conditions may prefer transaction-based indices that might come to the market. For an excellent discussion of benchmark and market condition indices, see David Geltner and David Ling's, "Indices for Investment Benchmarking and Return Performance Analysis in Private Real Estate," *International Real Estate Review,* Vol. 10 (1), 2007.

9 Both the TBI and RCA-based data are publicly available at the MIT Center for Real Estate website: http://web.mit.edu/cre/research/credl/tbi.html. Readers who want more details might want to check out the following two practical overviews of NPI transaction-based indices: Donald Haurin's, "US Commercial Real Estate Indices: Transaction-Based and Constant Liquidity Indices," Bank of International Settlement (BIS) Paper No. 21; and David Geltner's, "Transaction Price Indexes and Derivatives: A Revolution in the Real Estate Industry?" *International Council of Shopping Centers Research Review,* Vol. 14, No. 1, 2007.

FOCUS ON THE UNITED KINGDOM

What Is Driving the Change in the U.K. Retail Market?

BY BARRY GILBERTSON, CRE, PPRICS

One of the reasons for writing these Insider's Perspective articles is to draw, in the mind of the reader, a similarity or contrast between the U.K. and the property market in which the reader operates. It seems to me that property markets function in very similar ways around the world, and we can all benefit by experienced practitioners and commentators sharing their opinions and expertise.

If one word was needed to describe the retail market in the United Kingdom, "restructuring" would fit that bill. The U.K.'s retail market is undergoing a dramatic change, bringing about sustained restructuring and closed stores, as well as a cautious approach by banks and other investors who normally invest in the retail market.

During the last six months, my firm has been involved in the restructuring of seven national retailers, sectors ranging from electronics to children's wear to greeting cards. Of more than 2,000 stores reviewed, on average some 27 percent were left behind as the retailer emerged from the restructuring process.

Current indications show that the store restructuring trend will continue. Even major retailers such as Gap and Thomas Cook are not immune to the restructuring, as both have announced that they will be closing stores. The latest addition to the list is Fopp Music, with 81 stores. It acquired 68 former MusicZone stores earlier this year, and has closed 37 (or 54 percent) outlets. Earlier this year, MusicZone acquired the stores from MVC.

In the U.K., retailers comprise 11 percent of all enterprises, with 182,475 Value Added Tax (VAT)-registered businesses operating from 278,365 retail outlets in 2006.[1] Pulling together statistics from retailers and market data sources[2] suggests that there are approximately

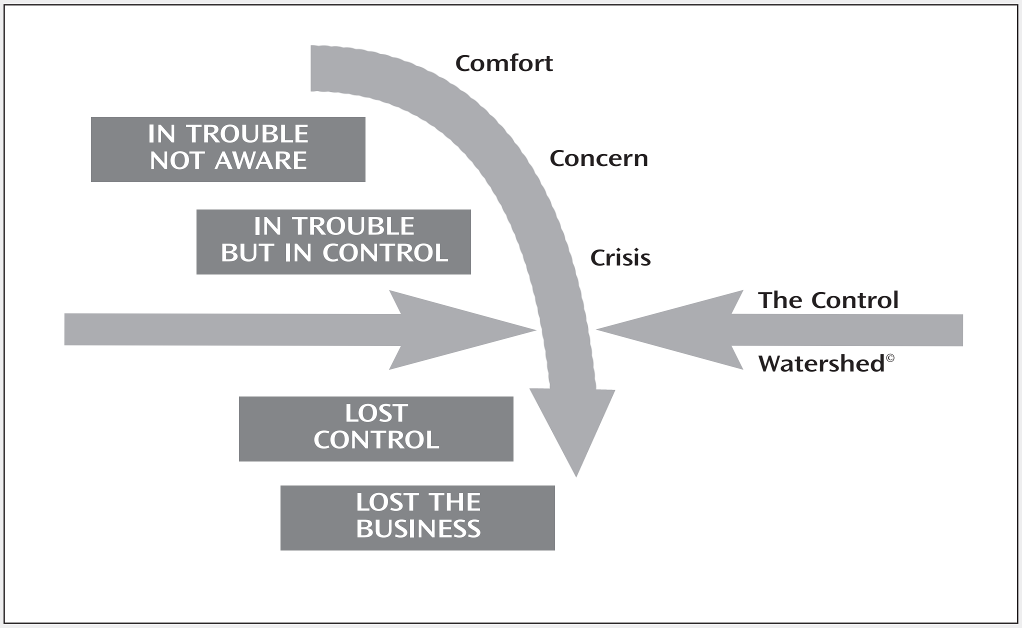
- 850 retailers with more than 20 stores, plus
- 110 retailers with more than100 stores, plus
- 140 retailers with more than 200 stores

About the Author

Barry Gilbertson, CRE, PPRICS, *a partner at PricewaterhouseCoopers, is past chair of the United Nations Real Estate Advisory Group's International Valuation Forum, a member of the Bank of England's Property Committee and visiting professor of the Built Environment at the University of Northumbria, located in Newcastle, U.K. He earned the CRE designation in 2000. Gilbertson is also a past president of the Royal Institution of Chartered Surveyors (RICS), a standards and membership organization for property professionals with whom The Counselors of Real Estate has a formal alliance to promote information exchange and foster an international network of like-minded professionals. Read more about RICS at www.rics.org.*

If just 10 percent of the retailers in each category were to experience financial difficulties, and find the need to jettison or otherwise dispose of their leases, there could be, over the next year, more than 2,700 retail units coming onto the market. Such a flood of shops could be disastrous for the levels of rent achievable going forward, with a consequent knock-on effect on property investment values in the retail sector.

This potentially alarming picture is reinforced when Morgan Stanley's prediction of overly optimistic retail sales forecast is taken into account. If the forecasts are 20 percent too high for next year, as Morgan Stanley predicts, continued pressure on consumer retail spending by further increased interest rates will only exacerbate the problem, potentially causing further stores to come onto the market and remain vacant with little or no demand.



The Corporate Demise Curve©

The Corporate Demise Curve demonstrates why it is so important to consider early what to do when things go wrong. All companies start from an enthusiastic base, and some become truly profitable over time. However, it is equally true to say that most companies' profitability and cash receipts will plateau at some point in their development. The successful company leaders will recognize this truism and be preparing for the plateau on their way up towards the crest. When their plans are implemented, it becomes possible to push on up again, towards the summit of success.

Company leadership that is blind to the approaching plateau may not even recognize it when they get there. They may think that their flat line trading is a blip, or that they are still profitable, so what does it matter? Cash is why it matters. Without consistently strong cash flow, no company can survive for long, and it certainly cannot grow. Instead of climbing onwards and upwards, these companies slip down the Corporate Demise Curve, sometimes at an alarming pace, as the vortex of cash deficiency spins ever faster. Comfort becomes Concern and Concern becomes Crisis. At this point, The Control Watershed, the company usually loses control of its affairs into the grips of their lenders, creditors, shareholders and other stakeholders.

Once a company's destiny is no longer in the hands of its own leadership, the end may be near. So, the lesson is to recognize the plateau before you can see it, then plan on how to get safely across it. If you find yourself slipping out of control down the demise curve, seek help sooner than you think you need to do so. With the right ropes, karabiners and winching gear, you might just be able to haul yourself back onto the plateau, and be helped to navigate your way to the foothills of Success Mountain. ■ *©PricewaterhouseCoopers*

U.K. retail sales were £256 billion ($516.9 billion) in 2006, which is larger than the combined economies of Denmark and Portugal, generating 6 percent of the U.K. Gross Domestic Product. After several years of strong growth—evidenced by retail employment growing by more than 98,000 people over the past five years—the retail sector seems to be faltering, at least in the High Street (generically referred to as Main Street in the United States) and in out-of-town stores (known as suburban shopping plazas or strips in the U.S.). At the end of 2006, the retail industry employed three million people, which equates to 11.2 percent of the total U.K. workforce, or 1 in 9 people.

Is the downturn on High Street caused simply by the Bank of England's rising interest rates, which are squeezing disposable incomes? A recent report by PricewaterhouseCoopers (PwC), titled "The Internet: This Time It's For Real," suggests that the Internet has been a key driver of change. Online sales in the U.K. this year are expected to reach £14 billion ($28.2 billion), and indications point toward double digit growth in the years ahead. For High Street retailers without effective Internet offerings, this has a negative effect. By 2011, PwC expects the market to be worth up to £35 billion ($70.7 billion). As the U.K. retail market is expected to grow by around 15 percent between now and 2011, the majority of this growth will be in the volume of sales online (around 60 percent). It is increasingly likely that consumers will shop for products in the stores, which enable them to physically touch the items. They then are more likely to buy the product online at a lower price. This obviously is to the detriment of the retailer that provided the store in which the consumer viewed the item.

Airline and other travel have rapidly migrated from a face-to-face transaction to an impersonal search for the best deal on the Internet, causing travel agencies to increasingly move online, away from High Street stores.

So, if the move to bricks and clicks is going to save some retailers from extinction, it is clear that the stores that are retained should be the ones in the best locations, even if they are smaller in size with stock management by just-in-time delivery, and larger more impressive websites to attract the browsers, making it easier to buy online and collect in store. If the retailer can position their stores in an easily accessible location, then the consumer will collect in-store rather than wait for delivery, which for anything more than a small parcel, may need them to wait, perhaps inconveniently, at home to take delivery. The good thing for the retailer is that once the consumer comes into the shop (importantly having parked their car nearby rather than a hurried collection with the car on yellow lines) then the retailer has the opportunity to on-sell accessories, complementary goods or insurance/maintenance agreements where profit margins are often better.

With such clear evidence of weakness in the retail property market, it is vital for retailers to continually review and churn their store portfolios. Underperforming stores need to be identified quickly and a clear decision taken to turn around the trading or to dispose of the individual shop or portfolio of stores.

BE WARY OF MISPLACED OPTIMISM

Retailers should be wary of misplaced optimism resulting in the turnaround option becoming the default choice. Any turnaround plan requires a detailed timetable with measurable milestones of success. Failure to act will eventually necessitate more radical measures. In one of the seven retailer restructurings undertaken by my organization this year, a retailer had been seeking to sell its lease of a store in Gateshead, a town in the north of England, by offering a £1 million ($2 million) incentive (or reverse premium) to the buyer of that individual lease, as part of its restructuring plan to dispose of 20 percent of its store portfolio to return the overall business to profitability. At a cost of £1 million a store – an extreme example to make the point – it is easy to see that restructuring can be an expensive process in order to save the trading business of a troubled retailer.

There are important lessons for landlords who will need to revise their design considerations to build smaller stores in well positioned locations, with or very near car-parking. Some may even consider drive-thru collection points.

There also are important lessons for banks and other lenders who may need to rethink their strategy regarding funding further store openings or industry consolidation when the retailer may end up with more than one shop in any town. Large investments and consolidation may not be the way of the future for in-store retailing.

There are important warning signs for investors, too. At its recent high, the retail investment market for individual shops peaked at a return of around 3 percent. Without rental growth, it will take 33 years to get the investor's money back. At the same time, the investor will be desperately hoping for capital growth by the time the investor decides to sell.

The changing profile of shopping trends will mean that investment returns will suffer as rental growth slows following a changing demand by retailers for fewer stores from which to trade.

In the out-of-town market, rental growth has slowed dramatically. Press reports have indicated that, for example, British retailer B&Q has recently negotiated zero increases in the five-year rent reviews at three of their megastores. For the next five years, B&Q will be paying the same per square foot rent that it agreed to five years ago—or, in reality, a static rent for 10 years. The consequence for property investors will be diminishing investment returns and a certain nervousness concerning any desire to build or buy more out-of-town investments.

It will be interesting to see what happens to interest rates if inflation is not reigned in, as the Bank of England believes will be the case. Increased interest rates have upped the mortgage rates, but the problem lies in that many homeowners have fixed interest rate mortgages. These fixed rates currently protect them against the storm of higher mortgage payments. Unless borrowers save for the day when their fixed-rate mortgage expires, then their disposable income has not, so far, been unduly hit by rising interest rates. However, when the higher rates bite into the amount of money left in the weekly pay packet after paying for their mortgage, then it is almost inevitable that consumer retail demand will cool and less money will be spent on retail, in store and online.

This reduction in demand and changing consumer buying habits could lead to an increased percentage of stores being left behind after the future restructuring of struggling retailers, causing more misery for the freehold owners of the units, which may remain unlet in the short- and mid-term. This will harm their cash-flow and indeed their own ability to service the loans that they used for their initial shop investment.

The longer term prospect for retail store owners, investors, lenders and other stakeholders looks more challenging right now than it has been over the past few years. ■

ENDNOTES

Note: This article is a variant of a piece previously printed in E*states Gazette* and includes comments from a recent interview with *Retail Week*.

[1] With thanks to The British Retail Consortium www.brc.org.uk

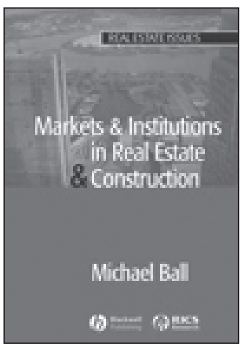
[2] With thanks to Jones Lang LaSalle, Experian and Goad

RECOMMENDED READING

Markets & Institutions in Real Estate & Construction

By Michael Ball (2006, Blackwell Publishing, RICS Research, 280 pages)

REVIEWED BY P. BARTON DeLACY, CRE, FRICS



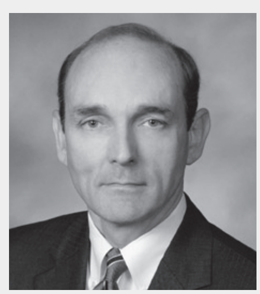
THE GLOBALIZATION OF REAL ESTATE investing is a growing trend, one that requires among all of us a broader understanding of overseas markets. Michael Ball, in writing the handy manual *Markets & Institutions in Real Estate & Construction,* produces an analysis on property markets across Europe and how they compare to markets in the United States.

At a time when a rising number of American investors are adding foreign properties to their portfolios, Ball was concerned about the lack of reference literature that addressed international comparative analyses exploring housing markets and their relation to planning systems and real estate institutions, such as the construction industry and brokerage houses. As a result, he studied how markets are allowed to respond to demand and how different government programs or industrial institutions impact delivery of real estate products, especially housing.

Ball, a professor of property economics and urban studies at the University of Reading (west of London), has long edited the *European Housing Review,* which is published by the Royal Institution of Chartered Surveyors (RICS). *Markets & Institutions in Real Estate & Construction* has been published as part of a RICS research grant.

One of the areas of Ball's focus in this book is on the stifling housing markets of the U.K. and other European nations. Long delays in new construction have resulted in housing shortages in the U.K., where it takes six or more years to deliver new homes. Most other European countries experience similar, if not longer, timeframes. Extensive time lags, aggravated by planning rules or lack of suitable sites, can miss upswings in demand.

Markets & Institutions concludes that of the larger, growing economies, the U.K. trails all of its European Union counterparts in meeting housing demands. Stagnant home ownership is the perverse result of rigid planning policies coupled with government incentives.



About the Reviewer

P. Barton DeLacy, CRE, FRICS, *is managing director and national practice leader for corporate valuation consulting at Cushman & Wakefield, a New York-based global commercial real estate services firm. DeLacy also has a masters degree in urban and regional planning from Portland State University and has served as an adjunct professor in its business school.*

Rising prices and values are among the barriers to entry for prospective homebuyers. With barely a trickle of new land brought into production, U.K. homebuilders cannot respond to increases in demand.

Ball points out that the U.K. is not alone in failing to ease housing woes or increasing home ownership within its borders. With the possible exception of Ireland (now of Celtic Tiger fame, which refers to Ireland's economic boom of the 1990s), few European countries have been able to find a way of jumpstarting the housing industry. In addition, *Markets & Institutions* also points out that the old Soviet block economies, still reeling from central planning, have been extremely slow to respond to rising prices, and no new supply is being produced.

Ball contrasts the homebuilding industries among European countries with that of the entrepreneurial homebuilding institution here in the U.S. Statewide homebuilder associations, comprised of small and large companies, have created an effective lobbying force at all government levels. This involvement in the legislative process has assured favorable tax policies for American homeowners, including home mortgage deductions. These associations also have balanced the influence of slow-growth planning organizations that seek to limit urban sprawl.

Ball also addresses the impact that home ownership subsidies have on property economics for both the construction and brokerage industries in Europe. Subsidizing increases the incidence of home ownership only when there is a supply of land and the presence of a local homebuilding industry to meet the demand. Minus these two components, those with homes simply get richer, since the infusion of money or easy credit created by the subsidy simply increases prices without a commensurate increase in supply.

Ball, in limiting *Markets & Institution's* focus on EU surveys, whets our appetite for a similar overview of other international markets, particularly in Asia. One wonders how the phenomenal residential construction boom in China, for instance, would be sustained if that nation's market encountered the same restraints faced by most EU nations. Ball's study explores select topics that may have less interest to those hoping to better discern global megatrends. Thus, the chapter on the controversy revolving around banks and financial institutions getting into brokerage lacks immediacy, if not relevance.

On balance, Ball and RICS are part of a professional movement to integrate academic ideas of economics, measurements and models to the real world of practitioners. Watch for more from Ball and his colleagues at RICS as the study of "property economics" begins to eclipse traditional real estate studies. ■

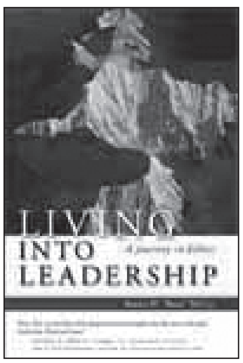
Markets & Institutions in Real Estate & Construction *is available for purchase through Blackwell Publishing. Order online at www.blackwellpublishing.com or call 800.862.6657.*

RECOMMENDED READING

Living Into Leadership: A Journey in Ethics

By Bowen H. "Buzz" McCoy, CRE (2007, Stanford University Press, 232 pages)

REVIEWED BY KENNETH P. RIGGS, JR., CRE



"Who are you and what do you want?"

Who hasn't sought the answer to that profound question? Real estate icon Buzz McCoy, tapping into his deep well of knowledge, teachings, writings and life experiences, lays out a valuable roadmap to seek the answer to this age-old question in his book, *Living Into Leadership – A Journey in Ethics.*

Living Into Leadership is not Buzz's autobiography. It is a series of stories that chronicles Buzz's guided life experiences grounded in friendship, family, religion and love – all in the pursuit of happiness and a life worth living. He taps into his vast experiences from the beginning of his distinguished career to his shift toward giving back to the world through his teachings and writings.

Living Into Leadership provides a snapshot of a man who has the tremendous amount of courage required to be honest with himself and with those around him, and explores how this honesty has paid handsomely by always allowing him to be true to himself and to build lifelong relationships with colleagues in business settings, spiritual places and intriguing physical settings.

One such snapshot has Buzz describing his first investment banking interview at Morgan Stanley. At the interviewer's request, Buzz explained his family background, and the interviewer responded with dead silence. Buzz, in turn, bluntly suggested that if the interviewer didn't have any more questions, the two should adjourn to the lounge and observe John Glenn on the initial manned space flight. Buzz was not being glib. He was simply providing a glimpse of an element to his personality that served him well during an extremely successful 27-year career at Morgan Stanley.

Living Into Leadership reveals the profound impact Buzz has already made on the business world. However, the greatest legacy of the book may very well rest in the lessons of leadership and ethics that he imparts to generations yet to come.

One can almost hear Buzz challenging each reader, in a Socratic manner, to determine his or her own legacy by making critical responses to the many opportunities life

About the Reviewer

Kenneth P. Riggs, Jr., CRE, *is president and CEO of Real Estate Research Corp. (RERC), in Chicago, Ill. He specializes in independent fiduciary services, investment research, institutional valuation strategies and consulting for major institutional investors. RERC provides services in acquisitions, dispositions, appraisals, expert witness/litigation support, feasibility studies, investment analysis, market studies and pension fund consulting.*

presents. To achieve quality of life, McCoy encourages his readers to conduct candid self-examination and to be willing to make hard decisions. And make no mistake about it. McCoy stresses that there are tough decisions in life, such as those described in *The Parable of the Sadhu,* a renowned case study that Buzz wrote to chronicle an ethical dilemma he and others faced while traversing an 18,000 foot Himalayan peak. *The Parable* explores the group's willingness to help a fellow man and the realization that such a decision is not as clear as it might appear.

Unlike typical professional training material on subjects such as financial and accounting issues, management challenges or administrative processes, *Living Into Leadership* focuses on the pursuit of happiness and the search for meaning without compromising the deepest of personal values.

With his wonderful teaching approach, Buzz challenges his reader to live a deliberate life. He talks of developing business relationships that go beyond the office and that connect at a human level. He shows his readers how to strip away the facades that are built over a lifetime to protect the inner shell and to develop personal moments with colleagues to create some of the most meaningful and humbling moments of life. The book reveals the close relationships and learning experiences Buzz has shared with business icons such as Trammel Crow. The lesson from Crow, as told through the prism of Buzz, is not a lesson about real estate investing but a lesson of love. Love, as stated by Crow, is the most important quality that a business leader needs to possess.

As a man who has enjoyed enormous success, Buzz also uses *Living Into Leadership* to illustrate how the most glamorous business moments can be potentially overshadowed by the unpredictable and unglamorous, such as Buzz, in a hut in the Himalaya Mountains, drinking home-made beer and eating popcorn with a family that spans three generations and recognizing at that moment that there was no other place he would want to be.

Humor and balance as an undertone to life resonate throughout this book, and readers will enjoy the stories about social graces learned on the job by accidentally eating another person's salad and even being ornery once in awhile.

According to *Living Into Leadership*, ethics are contextual and experiential. Buzz believes that we learn more from our failures than our successes. "Ethics is what you are willing to lose for," he says. Living with values and ethics is not something that is practiced just once in awhile on an as-needed basis. Rather, living with values and ethics means being in a constant state of thinking and doing what one believes is right and being open, consistent and just.

Buzz provides commentary on values and ethics from many different sources, all carefully crafted from readings published by Dante, Drucker, Bonhoeffer, T.S. Eliot and others, to lead us through a journey until: "Finally, there is the deep level of religious and spiritual growth and formation, of attempting to live out one's deepest values in the workplace, which becomes the source of one's courage and steadfastness when all else seems to fail."

In addition to business relationships, McCoy notes that family and parental guidance are keys to molding our character. Buzz speaks to the levels of respect that we have for our parents and how that perspective is incorporated into individual ideologies. Buzz is also careful to point out that we should temper our admiration for those we tend to place on pedestals. He reminds his readers that no one – including parents – is perfect.

Throughout the book, Buzz consistently demonstrates how essential it has been for him to show respect and curiosity for everyone with whom he has come into contact, and he reminds us that there is always an opportunity to go past a surface or allegorical level and form a deeper relationship of learning from each situation and each person encountered in life.

I was so moved by Buzz's words that I believe *Living Into Leadership* should be retained as a constant companion and as a reference to living a full and complete life. *Living Into Leadership* can be read in different ways at different times in one's life — as a quick perusal, a careful read of selective sections or a very thorough read of the entire book.

In addition, I also think that individuals should read this book at three points in their lives: right after college; at the midpoint of their careers; and, at the end of their careers. In keeping with this spirit and advice, I will give a copy of this book to each of my three sons when he graduates from college so that each will understand that a life lived with deliberate intent is a life worth living. According to Buzz, it is important for all individuals to make their intent known to themselves and to work at the relationships around them.

This is the perfect book for those who find themselves, like me, at the midpoint of a career. While helping broaden my appreciation of my career thus far, Buzz further opened my eyes to areas that may be further improved. This book would also benefit those in the autumn of their careers to help them reflect — as every individual has something to give to the world. While few – if any – of us have had the level of experiences enjoyed by Buzz, all of us have rich experiences that run parallel to those described in this book.

Buzz's lesson is that we can all choose to make life a glorious journey that is uniquely our own. He concludes *Living Into Leadership* with a quote from his friend and mentor, John Gardner, who offers the ingredients for and offers the wish for a life filled with meaning. "…. Meaning is something you build into your life … out of your own past, out of your affections and loyalties, out of your experience of humankind as it is passed on to you, out of your own talent and understanding, out of the things you believe in, out of the things and people you love, out of the values for which you are willing to sacrifice something … You are the only one who can put them together into that unique pattern that will be your life…." ■

Living Into Leadership: A Journey in Ethics is available for purchase through the Stanford University Press. Order online at www.sup.org or call 800.621.2736.

THE COUNSELORS OF REAL ESTATE

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The William S. Ballard Award is presented annually to the author or authors whose work best exemplifies the high standards of William S. Ballard, CRE, and the high standards of content maintained in *Real Estate Issues*. The award-winning manuscript, selected by a three-person committee, is chosen from the published articles that appear in an annual volume of the journal. CRE and nonmember authors are eligible. The award, which is funded by the William S. Ballard Scholarship Fund, includes a $500 honorarium and is presented at a national meeting of The Counselors.

The award is named in honor of William S. Ballard, who was a leading real estate counselor in Boston in the 1950s and 1960s. He was best known for the creation of the "industrial park" concept and developing the HUD format for feasibility studies. He was an educator who broke new ground during his time in the real estate business, and whose life ended prematurely in 1971 at the age of 53.

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