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REAL ESTATE ISSUES®

EDITOR'S STATEMENT - by Hugh F. Kelly, CRE

CRE Hugh F. Kelly

Over the years, when people ask me that difficult question, "So what is it that you do?", I have become accustomed to describing the fascination I have found in what is now a quarter-century in the field of real estate. For me, this has been a tremendous window onto the world. Because of my own specialization in the discipline of economics, I've found that the real estate industry is a particularly wonderful filter for sorting out all kinds of economic trends and variables. Our successes and failures are really quite out in the open: there's something about an empty building that leaves no plausible deniability about mistakes, the way that, say, creative accounting can at least mask trouble in the corporate world. But there is also great satisfaction, from time to time, in going against the tide in real estate economic forecasting, and finding that events have vindicated your point of view. Counselors of Real Estate have all shared the experience of being able to walk across a cityscape, or some other venue where they have had project involvement, and know that the world looks a little different because of their professional involvement.

The articles in this edition of *Real Estate Issues* are potent reminders of just how fundamental are the forces that come into play in practicing real estate. Two articles on brownfields and one on flood liability issues underscore the degree to which our industry alters the very landscape that supports our endeavor. I am reminded of work I had the privilege to participate in during the mid-1980s, when I was part of the site selection team for the Saturn Corporation automobile plant. One of the elements we kept firmly in mind was that we were seeking a locality that could accept such a huge facility without undue adverse change. There was no point in selecting a location for positive attributes that would be instantly spoiled once the plant was built!

The brownfield developments also remind us of how adaptable basic forms of real estate can be. The very principle of highest and best use implies that improvements on the land are not permanent, and can be subject to obsolescence and replacement as times and conditions change. Unfortunately, for many sites, the task of remediation needed to prepare the land again for another use, given the degradation of the environment is daunting both in a physical and a financial sense. The law is still in a trial and error process of balancing the legitimate interests of real estate industry participants (including developers, users, parties on both sides of the buy/sell agreement, and financing sources) and those of the larger society that is our constitutive context. Our articles keep you updated on key changes in that trial and error process.

While *Real Estate Issues* is not a legal journal, matters of law play a key role for the commercial property sector. In addition to the brownfields and flood liability essays, we have articles exploring the impact of recent federal tax legislation on real estate, from authors who are not afraid to make specific recommendations about how these changes alter the risk/reward menu for investors. Additionally, the case law of letters of intent is evolving, and a recent California decision is discussed from the point of view of parties to retail property transactions. This is particularly timely, as retail assets grow in their share of the overall transaction pie in the present decade.

We are, of course, quite proud to present once again an impressive line-up of authors in our Insiders' Perspective columns. Nicholas Brooke, current president of the Royal Institution of Chartered Surveyors. provides the first of a series of articles, this one on "what makes for a successful city," drawing upon his own international experience. CREs Ray Torto and Mark Levine outline the condition of the property markets and the fundamental economy. And Dr. Jack Corgel of Cornell University contributes his perspective on the hospitality industry and opportunities arise from its own cyclical recovery.

I am very pleased that we can bring you this edition, hard on the heels of the somewhat delayed Fall 2003 number. I must thank our remarkable editorial board and the CRE staff in Chicago for their invaluable help as we seek to accelerate our production schedules in 2004. One thing is certain: as we go forward, there will be further change in our industry, the economic, social and legal context within which we do business, and even in our journal itself. The ever-fascinating world of real estate doesn't allow us to stand still. And who would ever want to!

Hugh F. Kelly, CRE
Editor in Chief

EVOLUTION OF LIABILITY FOR FLOOD DAMAGES: WHERE ARE WE NOW?

By J. Palmer Hutcheson

ABOUT THE AUTHOR

J. PALMER HUTCHESON, *has practiced civil trial law for more than 30 years in Harris County and is the head of Gardere Wynne Sewell LLP's Water Law Practice Group. He represented certain defendants in the Kerr and Anello litigation, routinely handles other complex flooding cases throughout the State of Texas, and works closely with outside experts and clients in favorably resolving flooding claims. He may be contacted through his firm website www.gardere.com.*

Changing weather patterns and several recent catastrophic storms have highlighted the collision between urban redevelopment, suburban expansion, "sunbelt" or "greenfield" growth, and changing governmental philosophies regulating drainage. A population explosion in the Gulf Coast area has exponentially magnified problems with urban sprawl and severely taxed existing drainage and storm water infrastructure resources. Increased demands for commercial and residential housing necessitate funding and building additional flood and storm water control structures. When a neighborhood floods, companies that were engaged in newer upstream commercial and residential real estate development, manufacturing and industrial expansion or modification, property management, design engineering and construction become targets for criminal and civil litigation. While governmental units responsible for drainage management are often able to assert sovereign immunity and other legal protections to limit or eliminate their exposure, developers, engineers, builders, and manufacturers are faced with the task of defending themselves in costly litigation against whole neighborhoods.

These neighborhood suits routinely raise complex practical and legal issues regarding the use, ownership, drainage and disposal of water. They are often complicated by antiquated flood control policies or con-

While governmental units responsible for drainage management are often able to assert sovereign immunity and other legal protections to limit or eliminate their exposure, developers, engineers, builders, and manufacturers are faced with the task of defending themselves in costly litigation against whole neighborhoods.

flicting flood plain and storm water management issues, political tug-of-wars, lack of public financing, governmental immunity defenses and scientific data gaps. At the same time, protection of the environment and real property interests compete at the courthouse regarding land and water use. The result is a growing number of costly claims and lawsuits concerning construction, engineering, drainage, flooding, wetlands destruction, downstream water rights, and water quality.

As with many areas along the Gulf Coast, Houston's (Harris County's) original drainage philosophy was 100 percent "conveyance" or channelization (e.g. "get it to the bayous, then the bay as fast as we can, in big concrete ditches"). Over time, as the capacities of local bayous were met or exceeded, the County started mandating onsite detention ponds to temporarily restrain floodwaters. However, as the City of Austin and many other locales have learned the hard way, a mandatory 100 percent detention philosophy can be catastrophic when it is not closely coordinated and planned—it simply delays the tidal wave. It is far too simplistic to say that one of the two philosophies is right and the other is wrong. In situations where subdivisions are near a large channel, it may be smarter to channelize that runoff so it is out of the way quickly before a larger upstream surge occurs. So, detention may not be the "correct" answer for subdivisions closest to existing bayous or channels. Locally, Harris County has a mixture of subdivisions, some with channels, others with detention ponds. Therefore, in reality, a blending of these two philosophies is necessary in our area and drainage must be coordinated and administered by a single governing authority.

Recently, two Texas appellate courts seized opportunities to begin to clarify the "murky" waters about flooding compensation issues that have plagued developers, engineers, builders and governmental units (including Harris County) throughout the Gulf Coast region. The Houston First Court of Appeals addressed the issue of a County's liability under the theory of "inverse condemnation" and the Fort Worth Court of Appeals addressed the issue of a developer's or engineer's liability when a local governmental entity exercises pervasive control over local drainage plans.

THE KERR AND ANELLO SUITS: THE COUNTY'S LIABILITY

Inverse Condemnation

Very recently the Houston First Court of Appeals issued a watershed opinion stemming from the flooding of White Oak Bayou in Houston during Tropical Storm Frances. Following the storm, two groups totaling over 525 homeowners filed the Kerr and Anello suits in Harris County state court, claiming their homes were "taken" under the legal theory of "inverse condemnation." The homeowners claimed Harris County was liable for their flood damage because it continued to permit upstream development even though it knew that in the stretch of the Bayou where their homes were located, there was insufficient storage capacity to contain the expected increase in storm water runoff from the development activities (at least until they finally built regional detention ponds to be funded by impact fees—see discussion below). The homeowners claimed that their homes were effectively "condemned" by Harris County's decision to allow the upstream development.

According to the homeowners, the developers should have installed onsite detention ponds to temporarily detain the storm water and then dribble it downstream, which, if properly coordinated, minimizes the "tidal wave" effect of unrestrained channelization.

Impact Fees—Are they the answer?

Instead, the Harris County Flood Control District (now Harris County Public Infrastructure Department) collected "impact fees" (also known as "in lieu" fees) from the developers. These impact fees were earmarked to dig large regional detention ponds. The homeowners claim that the County's failure to promptly dig the large-scale ponds caused the floodwaters to essentially turn their neighborhoods into detention ponds. According to Harris County, the supplemental funding needed to build the detention ponds was never appropriated.

One explanation given for Harris County's failure to appropriate the required funds was that the various County commissioners and taxing-authorities placed a practical (political) ceiling on all taxes combined and then "prioritized" the tax pie. Flood control drew the short straw and received far less funding than necessary to timely dig regional detention ponds.

Given extreme political pressures placed on existing tax revenue sources at all levels of government, many local communities have turned to impact or "in lieu" fees to finance new drainage infrastructure and many other types of capital improvements. Considerable disagreement exists over their effectiveness. These fees have been authorized by statute in about half our states, including Texas. Fees collected in lieu of requiring on site drainage improvements are, by law, earmarked to construct infrastructure to accommodate the new development, but there is usually a significant lag time between collection of such fees and construction. Even worse, there is considerable uncertainty regarding collection of the remaining funds necessary to construct this infrastructure. So these improvements do not get built in a timely fashion, and when flooding occurs in the interim, they afford questionable protection from flooding liability claims for everyone involved in the process.

Impact fee statutes usually provide that if the fees are not used to construct the contemplated improvement within a stated number of years, they will be refunded. What protection does this refund provision really give to the developer who has finished the development? We are aware of instances where the regional drainage authority never built the improvement and, years later, refunded the fee, simultaneously demanding the developer retrofit on site detention! Aside from constitutional issues, it will likely be impractical, if not impossible, to retrofit a residential or commercial development at this late stage.

SOVEREIGN IMMUNITY AND "INTENTIONAL TAKING" ISSUES

The County is, for the most part, immune from negligence liability claims under sovereign immunity. Harris County took the position in Kerr that as long as they continued (however slowly) to implement their regional detention pond plan and did not purposefully intend to flood anyone, their interim, de facto appropriation of Plaintiffs' neighborhoods as surrogate detention ponds, even if negligent, was not an "intentional" taking. Thus, Harris County argued that they were not liable for condemnation damages. The trial court agreed and dismissed the inverse condemnation claims against Harris County ruling that Tropical Storm Frances's flooding was an unforeseeable act of God and that a single catastrophic flood did not amount to evidence of intent to condemn. Consequently, Harris County was found not liable under a nuisance theory either.

The Kerr case was ruled upon first, and then was appealed. Although the Houston appellate court held that as a consequence of a single, catastrophic flood event such as Frances (and, more recently tropical storm Allison, which dumped over three feet of rain on central Houston two years ago), the homeowners' property had not been forever "taken" by the County (so homeowners could not recover the entire value of their properties), they had nevertheless been "damaged"; consequently homeowners could recover damages from this single flooding event if they proved that Harris County was or should have been "substantially certain" flooding in this neighborhood would result from changing its drainage projects currently underway in that watershed when the storm hit. Texas' Constitution protects property from being unlawfully "damaged" in addition to protection for unlawful "taking" which permitted this award for a single event flood. These fact issues remain to be tried after the case was sent back to the trial court.

The County also claimed that tropical storm Frances was an unforeseeable act of God that precluded any defendants' liability, but the appellate court, citing testimony of conflicting experts as to the magnitude and foreseeability of this rainfall event based upon all historical records in this watershed, ruled a fact issue was raised that would require a jury's determination. So this issue remains to be tried. Dicta in the appellate opinion, if strictly followed, would preclude summary judgment ever being awarded based on the "act of God" defense, absent a "Noah's Ark" flood.

THE STATUTE OF REPOSE

Another issue highly important to developers, engineers and homeowners in flood damage cases involves the defense afforded by Texas' "statute of repose." Like similar laws in many other states, Texas' statute of repose absolutely bars claims against engineers for improvements that were

"substantially completed" more than 10 years before a suit is filed. The question then becomes one of timing—when does the 10-year limitation begin? With respect to multi-phase planned communities, homeowners claimed that it does not begin until the last sequential phase or section of a multi-phase planned community is finished. This liberal construction, if adopted by the Courts, would create even more uncertainty and extend the tail on the liability dog for periods well beyond 10 years. Fortunately, the Houston appellate court in Kerr ruled that, insofar as multi-phase developments are concerned, the 10-year clock starts to run as soon as each section's drainage is substantially completed. This is welcome news to developers and engineers, who should not remain "on the hook" perpetually.

THE KELLER SUIT: DEVELOPERS' AND ENGINEERS' LIABILITY SUPERCEDED

In City of Keller v. Wilson, 86 S.W.3rd 793 (Tex. App.-Ft. Worth 2002, no pet.) the Fort Worth appellate court held for the first time that a City's or County's exercise of sufficient detailed and mandatory control over a developer's or engineer's proposed drainage design and implementation acts as a superceding, independent, sole cause of homeowners' damages and thus severs allocation of any legal causation to the developer or engineer for downstream impacts. In Keller, the developer was required to comply with the drainage philosophy and master drainage plan of the City as a condition of development. The development plans were prepared to comply with these requirements. The City, in conjunction with its outside engineers, reviewed and approved the plans. The City owned the downstream drainage easement at issue and was required to maintain it. The City had the sole and exclusive right to control the easement, the channel constructed thereon and the water flowing through the channel. Because the exclusive right to control drainage within its city limits rested exclusively with the City of Keller, the developer could do nothing more than comply with the drainage requirements of the City. Since the undisputed evidence in Keller showed that the developer complied with all of the City's requirements, the developer was held not to be liable.

The Keller Court specifically held that if a governing authority (for example, the City of Keller or Harris County) reviews the drainage plans, mandates changes from the original drawings, eliminates proposed onsite detention and, instead, requires the developer to employ specific drainage plans to meet the governing authority's master drainage plan and specified statutory drainage criteria, then such exercise of control can, legally, eliminate potential liability of a developer or engineer. Although Keller was very fact specific, it will be argued broadly in future cases that the City or County's stringent exercise of control over a specific drainage plan may cut off a builder's or developer's liability under theories of wrongful diversion of surface water, negligence, nuisance and similar claims.

BEWARE OF CONTRACTUAL INDEMNITY LIABILITY

One issue not specifically addressed in City of Keller concerns the statutory and contractual liability that may be imposed on homebuilders and developers through city ordinances that require, as a condition for procurement of building permits or plat certification, that the developer provide a letter to the issuing authority indemnifying them for any claims for flooding for "X" number of years following plat approval. Developers and their design engineers who frequently spearhead the interfacing of permitting with the local drainage authorities may neither be aware of, nor fully appreciate the risks involved with this circular liability risk. Frequently the land development department negotiates the engineering and platting without consulting in house counsel on such "routine" matters. So counsel for developers and homebuilders should be alert to this often overlooked risk and alert their outside and in house drainage design engineers and land development departments to consult with the legal department before routinely signing any such letter. Had such an indemnity agreement been required by the City of Keller, it is conceivable that despite the developer's purported independent misconduct being causally severed by the intervening dictates of the city's drainage design engineers, the developer might nevertheless have incurred indirect, indemnity liability for the drainage designs dictated by the City.

MANY ISSUES STILL REMAIN FOR HARRIS COUNTY

In Kerr, homeowners alternatively sued a number of upstream developers and engineers, claiming that if Harris County Flood Control District was not liable under a condemnation theory, then these upstream developers, despite having timely paid impact fees as provided by Harris County Flood

Control District regulations, were still liable under theories of negligence and common law and statutory nuisance. The developers and engineers argued that if flooding occurred, then any purported negligence or other wrongdoing of the developers and engineers was cut off by the sole conduct of the County, which prescribed the "impact fee" alternative and dictated the local flood control policies through its implementation of flood control regulations.

Since most of the developers and engineers resolved the homeowners' claims very early on in Kerr, the precise issue of whether Harris County's control of specific drainage plans and flood control policies excuse developers' and engineers' purported misconduct was not decided. Before Keller, prior Texas cases usually held that simple compliance with a jurisdiction's drainage ordinances is not enough to excuse a developer or engineer from potential civil liability for causing flooding under theories of negligence, nuisance, and wrongful diversion of surface water. Keller certainly provides developers and engineers with guidance on how to try to minimize their risks going forward. It is probable that courts will address these defenses on a very fact specific case-by-case basis.

If not further appealed, a fact finder must resolve several remaining factual issues in Kerr. If the County appeals the intermediate appellate court's decision to the Texas Supreme Court, that Court can affirm, modify or completely overturn the intermediate appellate court's decision in Kerr.

Interestingly, the day the Kerr appellate court held the County might be held liable for flooding damages, Houston City Council passed a law setting up an account that permits the City to charge Houstonians with a relatively nominal fee to fund drainage improvements. A hotly contested mayoral election in the interim caused considerable debate over this new "tax" and, ultimately, the "tax" was withdrawn.

Regardless of the outcome of ongoing litigation, Harris County has undertaken significant efforts to solve the problems uncovered by such storms as Tropical Storm Frances and Tropical Storm Allison through the Tropical Storm Allison Recovery Project ("TSARP"—see www.tsarp.org), whereby FEMA and Harris County are remapping the floodplains and re-evaluating flooding risks. They plan to issue new FEMA flood maps for the County in March 2004. These maps are said to be much more precise and reliable than prior maps and are likely to increase the size of the regulatory flood plain. This web site should be visited periodically for further updates.

CONCLUSION

The sovereign immunity-based defenses for governmental entities may not preclude civil damages liability for local bodies charged with administration of flood control in instances where the government knew or is found to have known that their activities were substantially certain to cause damage to adjacent homeowners. Those who suffered flood damage may no longer need to prove a statutory "taking" under an inverse condemnation theory in order to recover for damages for specific flooding events in Texas. Texas courts have finally recognized that, in cases where the developer strictly complies with or even modifies its drainage plans to comply with local governmental drainage dictates, tort damages responsibility should rightfully lie with those in charge of the drainage design, and perhaps not the developer. Impact or "in lieu" fees do not necessarily offer full civil liability protection to developers or governmental entities, as many have heretofore been assumed. As cities become more debt-burdened, impact fees will continue to be favored as a primary source of funding for new infrastructure. Those who decide to pay impact fees should be mindful of their full legal consequences.

THE EFFECT OF THE JOBS AND GROWTH TAX RELIEF RECONCILIATION ACT OF 2003 ON REAL ESTATE INVESTORS

By J. Russell Hardin & Jack R. Fay

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If real estate investors are to maximize after-tax profits and maintain appropriate levels of capital investment, they must have a working knowledge of the latest legislative changes enacted by the United States Congress that pertain to real estate. On May 28, 2003 President George W. Bush signed into law the Jobs and Growth Tax Relief Reconciliation Act of 2003 (hereinafter Act). This sweeping piece of legislation contains numerous amendments to the Internal Revenue Code that will cut Federal taxes by $320 billion over the next several years. Half of the new provisions accelerate tax cuts not set to take effect until 2006. Several of the provisions of the Act have implications for real estate investors.

The purpose of this article is to summarize the provisions of several of the important changes to the Internal Revenue Code that are now the law or that will soon become the law and that pertain to real estate investments. Investors in real estate are urged to look closely at this new tax legislation to seek ways in which they can significantly diminish their future income taxes. The following discussions focus on the major provisions of the new bill which, directly or indirectly, affect real estate investments. Some suggestions for tax planning are also included in the discussions. To determine the particular effect, if any, each of these provisions will have on a particular investment, each investor should consult with his/her CPA, Tax Attorney, or other tax professional.

Exhibit 1

Taxable Years Beginning In:	The corresponding percentages shall be substituted for the following percentages:			
2000-2001	28%	31%	36%	39.6%
2002	27%	30%	35%	38.6%
2003 – 2010	25%	28%	33%	35%
2011 and there-after	28%	31%	36%	39.6%

INCOME TAX RATE CUTS

The Act focuses primarily on individuals and includes reductions in the four top marginal tax rates and expands the two lower tax brackets. The Act does not provide any major corporate tax relief, reflecting the Bush Administration's effort to limit tax relief to individuals. However, the individual rate cuts will provide relief to real estate investors who conduct business through sole proprietorships, partnerships and S Corporations.

Prior to the new law, rates ranged from 10% to 38.6%. The Act makes two major changes to the tax-rate structure:

1. The Act expands the 10% and 15% tax brackets.
2. The Act lowers all other individual tax rates.

The new tax law expands the 10% bracket from $12,000 of taxable income on a joint return to $14,000 and from $6,000 to $7,000 for single taxpayers. This expanded 10% tax bracket provides approximately $100 in additional tax relief for married couples and approximately $50 for single individuals. In addition, the 15% bracket was expanded to cover taxable income over $14,000 but not over $56,800 (formerly $12,000 to $47,450) for married individuals filing jointly. Single individuals will not experience an expansion of the 15% bracket. Their 15% bracket will still top off at $28,400.

The highest tax rate (38.6% for 2002) will be lowered by 3.6 percentage points to 35% while the 35% bracket is lowered to 33% and the 27% bracket is lowered to 25%. However, keep in mind that if Congress does nothing to change future rates, the tax rates revert to the year 2000 levels for 2011 and thereafter (*Exhibit 1*).

Tax Planning Tip:—Since the new tax rates will lower tax liabilities, individuals should be able to lower their estimated tax payments to reflect the lower tax rates. However, not all taxpayers will see a cut in their taxes. For example, the expansion of the 10% bracket does not affect heads of households and the expansion of the 15% bracket only applies to married individuals. In addition, when planning income flows on long-term investments, keep in mind that if the Congress does nothing to make these lower tax rates permanent, they will all increase in the year 2011.

ACCELERATED REDUCTION OF MARRIAGE PENALTY

In an effort to eliminate the marriage penalty imposed on most married couples filing jointly, the Act includes two provisions. First, the standard deduction for married couples is increased to double the amount of the standard deduction for single taxpayers in the years 2003 and 2004. Second, the width of the 15% tax bracket for married couples is increased to twice the width for single taxpayers in 2003 and 2004. These provisions were formerly scheduled to phase in over the period of time between 2005 and 2009. These reductions benefit

married couples who claim the standard deduction or who have taxable income greater than $47,450. The total tax relief provided to married couples by these provisions is estimated to be about $19 billion.

Tax planning tip—The doubling of the 15% bracket for married taxpayers is only effective for tax years 2003 and 2004. In 2005 the 15% bracket will only be 180% of the single bracket. The 15% bracket will be phased back up to 200% of the single bracket in 2008-2010 and will revert to year 2000 levels in 2011. Taxpayers may wish to determine whether items of income or deduction should be recognized in 2004 while the bracket size is double that of the single taxpayer.

INCREASE IN THE ALTERNATIVE MINIMUM TAX EXEMPTION

The Act is a double-edged sword when it comes to the Alternative Minimum Tax (AMT). The Act increases the individual AMT exemption amount by $9,000 (to $58,000) for married couples filing jointly and by $4,500 (to $40,250) for all single taxpayers. Even though this increase in the exemption is effective for 2003 and 2004, the provision expires at the end of 2004. This provision is a stop-gap measure to provide some AMT relief until Congress can address the issue in detail. However, if Congress takes no action to revise (or eliminate) the AMT provisions, the number of higher-income and middle-income taxpayers subject to the AMT could rise from 2.4 million this year to 33 million by 2010 when the AMT provisions of the ACT and the Economic Growth and Tax Relief Reconciliation Act of 2001 are fully phased in. Part of the increase is due to the lack of an inflation adjustment to the AMT exemption and part of it is due to the new lower tax rates. As a result, millions of taxpayers (primarily those making from $100,000 to $500,000) will realize little or no benefit from the new lower tax rates.

Tax planning tip—The Act specifically allows the reduced tax rate on capital gains and dividends for both regular income tax and AMT purposes. Taxpayers may want to consider selling some investments (that would generate capital gains) in 2004 that would have been sold in 2005 to potentially avoid the higher post-2004 AMT.

REDUCTION IN CAPITAL GAINS RATES

Generally, the maximum long-term capital gains tax rate for individuals is 20%. Individuals may use a lower rate of 10% if they are in the 10% or 15% tax brackets. However, if the capital asset has been owned for at least five years, the maximum capital gains rate is 18% for taxpayers who would otherwise be subject to the 20% rate and 8% for taxpayers who would otherwise be subject to the 10% rate.

The 2003 Act lowers the maximum tax rates on long-term capital gains. A 15% rate replaces the 20% rate under prior law and a 5% rate replaces the former 10% rate. A zero percent rate replaces the 5% rate for tax years beginning on January 1, 2008.

Some cautions are in order regarding the effect of the 2003 Act on long-term capital gains taxes. First, the reduction in long-term capital gains rates was not made retroactive to January 1, 2003. Therefore, sales of assets in 2003 that result in long-term capital gains will be subject to a transitional rule. The new lower capital gains rates apply only to long-term capital assets sold or exchanged on or after May 6, 2003. The higher rates are still in effect for sales of capital assets before May 6, 2003. Second, the Act did not reduce the overall maximum long-term capital gains tax rates. The 28% rate that is imposed on long-term capital gains from collectibles and from small business stock is unchanged. In addition, the maximum rate for unrecaptured Section 1250 gains remains at 25%. Finally, long-term capital gains rates revert to 2002 rates (20% and 10%) for tax years beginning in 2009 (if Congress fails to take action on this matter).

Tax Planning Tip—The new 5% long-term capital gains tax rate provides a significant opportunity for income and transfer tax planning. Taxpayers in the higher tax brackets could reduce the rate on long-term capital gains by gifting the appreciated property to children who are 14 years of age or older before selling the appreciated property. Assuming the children are in the lower tax brackets, the capital gains tax rate would be reduced from 15% to 5% of the taxable long-term gain.

ELIMINATION OF FIVE-YEAR HOLDING PERIOD

For tax years beginning after December 31, 2000, individuals could take advantage of special low long-term capital gains tax rates if they held the capital asset for more than five years. The 2003 Act eliminates this special five-year holding period rule. In other words, the new lower long-term cap-

ital gains tax rates discussed above are effective for ordinary long-term capital gains (gains on capital assets held for more than one year).

Tax Planning Tip—Many higher income individuals made a "deemed sale election" on their 2001 tax returns under Section 311 of the Taxpayer Relief Act of 1997 in order to have the five-year property rule apply to capital assets acquired before January 1, 2001. Under the 1997 Act, this election is irrevocable. However, it is likely that Congress overlooked this issue when passing the 2003 Act. If Congress later permits revocation of the election, amended returns should be filed at that time.

TAXABILITY OF DIVIDENDS

The taxation of dividends was an area in which President Bush focused a lot of energy during 2003. His reasoning was that if taxation of dividends is eliminated, the stock market should go up in value and help spur the economy. Dividends paid by corporations to individuals have been taxed as ordinary income for many, many years. Prior to the passage of the 2003 Act, dividends received by higher income individuals in 2003 could have been taxed at a 38.6% tax rate. There had been no rate reductions or other tax breaks for dividends since 1986. In early 2003, President Bush called for the complete elimination of individual taxes on dividends. When the 2003 Act was finally signed into law on May 28, 2003, a provision to reduce, not to eliminate taxes on corporate dividends paid to individuals, was included.

The Act reduces the top federal tax rate for dividends received by individuals to 15% and 5%. These are the same rates that apply to long-term capital gains. The reduced rates apply to qualified dividends received on or after January 1, 2003. A zero percent rate will apply to taxpayers in the 10 or 15% brackets for 2008 only. Dividends that are ineligible for the reduced rates include (but are not limited to) dividends paid by: credit unions, mutual insurance companies, farmers' cooperatives, tax-exempt cemetery companies, and dividends on stock purchased with borrowed funds if the dividends were included in investment income in claiming an interest deduction. If Congress takes no action to make these changes permanent, dividends received in 2009 and later years will be taxed at 2002 rates.

Tax Planning Tip—Corporations which pay little or no income tax due to a large amount of expense deductions may prefer to pay employee-shareholders a portion of their compensation as dividends instead of salaries. The advantage to individuals is that qualified dividends are taxed at lower rates than ordinary income. The advantage to corporations is that no employment taxes are paid on the dividends paid to the employee-shareholders.

DIVIDENDS PASSED THROUGH REITS AND RICS

A regulated investment company (RIC) is a corporation that invests in stocks and other securities and satisfies a number of tests spelled out in the Internal Revenue Code. RICs are taxed as corporations but can deduct their dividends. The shareholders of RICs are usually taxed on their dividends under the general rules applying to dividends. A real estate investment trust (REIT) is similar to a RIC except that it invests in real estate. Like a RIC, a REIT is taxed on its income and can deduct its dividends paid.

The rules regarding dividends passed through RICs and REITs are coordinated with the new rules for taxation of dividends under the 2003 Act. However, dividends from REITs will generally not qualify for the reduced dividend rates. A portion of REIT dividends will be classified as dividend income subject to the lower rates if the dividends are attributable to income which was subject to corporate tax at the REIT level, or they are attributable to dividend income which was received by the REIT from corporations in which the REIT is a shareholder.

INCREASE AND EXTENSION OF BONUS DEPRECIATION

The Job Creation and Worker Assistance Act of 2002 created a 30% additional first-year depreciation allowance for qualifying property. The property must generally be acquired after September 10, 2001 and before September 11, 2004 and be placed in service by December 31, 2004. The allowance is only available for new property that is depreciable under the Modified Accelerated Cost Recovery System (MACRS) and has a useful life of 20 years or less.

The Act of 2003 raises the provision for additional first-year depreciation to an amount equal to 50% of the adjusted basis of qualified property (taxpayers may elect to continue to use the 30% rate). Generally, to qualify, the property must

have been acquired on or after May 6, 2003 and before January 1, 2005. Property does not qualify if there was a binding written contract for the acquisition in effect before May 6, 2003.

Tax Planning Tip—Bonus depreciation is not a deduction for "earnings and profits" purposes. Therefore, a REIT can only benefit from bonus depreciation if its taxable income exceeds its dividends paid deduction. A REIT may then be able to use bonus depreciation to reduce its taxable income so that its taxable income is equal to its dividends paid deduction.

INCREASED SECTION 179 EXPENSING

The Act provides that the maximum dollar amount that may be deducted under Internal Revenue Code Section 179 is increased from $25,000 to $100,000 for property placed in service in tax years beginning after 2002 and before 2006. The deduction will also be adjusted for inflation each year. The amount eligible to be expensed may not exceed the taxable income derived by the taxpayer from the active conduct of a trade or business. The deduction disallowed by this limitation may be carried forward. The Act also increased the point at which phase-out of the qualifying investment begins from $200,000 to $400,000. This phase-out threshold will also be indexed for inflation.

Tax Planning Tips

1. Off-the-shelf computer software now qualifies for the deduction.
2. Equipment purchases should be structured, whenever possible, to make sure the $400,000 phase-out threshold is not surpassed.
3. If a taxpayer purchases assets which have different useful lives, it is usually better to apply Section 179 to the assets with the longest lives to maximize depreciation deductions.
4. Before deciding to elect Section 179, a firm should give consideration to long-range tax planning. For example, if a taxpayer is currently in the 15% tax bracket but expects to be in a higher bracket in the near future, the taxpayer may choose to forgo the Section 179 deduction in the current year so that larger depreciation deductions may be taken in later years when the tax rate is higher.

MISCELLANEOUS PROVISIONS

Taxpayers who have a child, stepchild, sibling, step-sibling or a descendant of any of these, or an eligible foster child who is under age 17 at the close of the calendar year, who is a U.S. citizen or resident alien, and for whom the taxpayer is allowed a dependency exemption, is eligible for the child tax credit. The Act of 2003 increases the amount of the child tax credit from $600 to $1,000 for tax years 2003 and 2004. However, the child tax credit will reduce to $700 for 2005 through 2008, and then rise to $800 for 2009, and return to $1,000 for tax year 2010. Without action by Congress, the child tax credit drops back down to $500 per qualifying child in 2011 and thereafter.

The accumulated earnings tax, a tax imposed on corporations that accumulate too much in earnings and profits while paying little in dividends, is lowered from the highest individual tax rate to a rate of 15%. The accumulated earnings tax rate is equal to the tax rate on dividends that will apply to most shareholders. The rate will revert back to the highest individual rate for tax years beginning after December 31, 2008.

Personal holding company rules penalize closely held corporations for earnings that remain undistributed to shareholders. These rules are designed to prevent corporations from being used to accumulate investment income or salaries on behalf of shareholders. A personal holding company is a corporation which at any time during the last half of the tax year had more than 50% of its stock owned by not more than five individuals and 60% or more of the corporation's income is personal holding company income. The Act of 2003 reduces the personal holding company tax rate to 15%. However, in 2009, the personal holding company tax rates will return to ordinary income tax levels (currently forecasted to be 35%).

CONCLUSION

This article has attempted to summarize some of the tax changes in the 2003 Tax Act. The focus has been on the changes that would directly or indirectly affect real estate investors and small businesses. The authors see no movement toward tax simplification by the U.S. Congress and the President, but the Jobs and Growth Tax Relief Reconciliation Act of 2003, hopefully, will meet the objectives of improving the economy and providing some relief to taxpayers. Real estate investors have many opportunities created by the new tax rules to reduce their tax burdens. However, a law as complicated as this Act commands a great deal of study by investors who desire to maximize returns and minimize the tax burden. Real estate investors should consult with appropriate tax professionals to assure proper application and maximum benefit from this new tax Act.

Appendix

The table below summarizes several of the tax changes discussed in this article.

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Capital Gains										
Capital Gains Rate	20%	15%	15%	15%	15%	15%	15%	20%	20%	20%
Rate for taxpayers in 10% or 15% bracket	10%	5%	5%	5%	5%	5%	0%	10%	10%	10%
Dividends										
Dividends Rate	*	15%	15%	15%	15%	15%	15%	*	*	*
Rate for taxpayers in 10% or 15% bracket	*	5%	5%	5%	5%	5%	5%	*	*	*
*Ordinary rates apply										
Income Tax Rates										
Highest Bracket	38.6%	35%	35%	35%	35%	35%	35%	35%	35%	39.6%
Fifth Bracket	35%	33%	33%	33%	33%	33%	33%	33%	33%	36%
Fourth Bracket	30%	28%	28%	28%	28%	28%	28%	28%	28%	31%
Third Bracket	27%	25%	25%	25%	25%	25%	25%	25%	25%	28%
Second Bracket	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%
Lowest Bracket	10%	10%	10%	10%	10%	10%	10%	10%	10%	**
**No 10% bracket										
AMT Exemption										
Joint Filers	$49,000	$58,000	$58,000	$45,000	$45,000	$45,000	$45,000	$45,000	$45,000	$45,000
Single Filers	$35,750	$40,250	$40,250	$33,750	$33,750	$33,750	$33,750	$33,750	$33,750	$33,750
Section 179 Expensing										
Deduction Amount	$24,000	$100,000	$100,000	$100,000	$25,000	$25,000	$25,000	$25,000	$25,000	$25,000

ADVANCE DUE-DILIGENCE ACTIVITIES BENEFIT CONTAMINATED REAL ESTATE TRANSACTIONS

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Brownfields have been defined by the Environmental Protection Agency as: abandoned, idled or underused industrial and commercial facilities where expansion or redevelopment is complicated by real or perceived environmental contamination.[1] The number of brownfields in the United States has been estimated to be between 400,000 and 600,000 sites.[2]

Investing in, owning, developing, or making a loan on contaminated real estate entails risks which can be difficult to quantify and evaluate. Much of the excess risk facing brownfield investors and lenders stems from federal and state statutes and rules. Federal legislation passed in 1980 known as the Comprehensive Environmental Compensation and Liability Act (CERCLA), also called the "superfund" law, cast a broad net which covered many potentially "responsible parties" for brownfields related liability.[3]

The CERCLA legislation has had some unfortunate and unintended consequences. Fear of becoming a "responsible party", under CERCLA, has caused investors and developers to ignore brownfield sites and build in outlying "greenfield" locations causing sprawl, decentralization of employment and reduction of property tax base. Some owners of contaminated property tried to avoid the "strict liability" doctrine of CERCLA by hiding information and not publicly reporting environmental financial exposures in their financial statements.[4] Lenders have resisted financing brownfield projects fearing that they may eventually become owners through foreclosure. In addition, some municipalities have refused to take possession of tax delinquent contaminated prop-

erties because of the potential environmental liabilities. The fear of becoming a potentially "responsible party" under CERCLA has precluded many attempts to remediate, redevelop, or to sell brownfield sites.

The many uncertainties involved in selling contaminated real estate often make the transactions expensive, lengthy, and at high risk of not being completed. Uncertainties such as: the cost of environmental due-diligence, the cost of cleanup, the likelihood of obtaining approvals of closure from regulatory agencies, and the risk of acquiring or retaining the environmental legal liability often make selling a brownfield site a low percentage real estate transaction. Sellers of contaminated real estate often become discouraged as buyers are reluctant to make offers to purchase due to the potentially high cost of environmental investigation, cleanup, and other risks. In addition, lengthy time delays resulting from false starts and a series of failed transactions add to the frustration and cost of selling contaminated real estate.

Beginning in the 1990s, a new focus on combating urban sprawl and a backlash against perceived unrealistic cleanup standards encouraged federal and state regulators to remove some of the impediments to brownfield redevelopment. The effort included: lender and buyer liability reform, widespread adoption of "risk-based" cleanup standards, and new approaches to site closure. At the same time, technical advances in site investigation and remediation technology, and the maturation of the environmental engineering market, have helped reduce or moderate the costs of environmental due-diligence and cleanup. Environmental insurance companies responded to regulatory reform and moderating remediation costs by creating several new insurance products to manage and transfer environmental risks.

The recent changes in brownfield regulation, technology, and environmental liability insurance have ameliorated risk and uncertainty and created new opportunities to sell properties that would have been unsalable in the past. However, access to these brownfield tools, whether regulatory, technical, or financial, requires an understanding of site conditions that few sellers obtain prior to their entry into the marketplace. As a result, sellers experience a greater risk of offers failing to close and of higher transaction costs.

Uncertainties such as: the cost of environmental due-diligence, the cost of cleanup, the likelihood of obtaining approvals of closure from regulatory agencies, and the risk of acquiring or retaining the environmental legal liability often make selling a brownfield site a low percentage real estate transaction. Sellers of contaminated real estate often become discouraged as buyers are reluctant to make offers to purchase due to the potentially high cost of environmental investigation, cleanup, and other risks.

PURPOSE

This article illustrates the benefits, from the seller's perspective, of performing some of the critical due-diligence activities prior to, and in preparation for, marketing real estate. The sellers advance due-diligence will be shown to be a prudent and reasonable method of overcoming buyers reluctance to submit offers to purchase as well as providing the seller with a more solid basis upon which to value the property, quantify the environmental risk and evaluate the offers which are made. Through the use of advance due-diligence, it will be argued and illustrated that sellers may be better able to evaluate and select the "best" offer and reduce time delays and transactional costs.

METHODOLOGY

A transactional review will be made of a recent sale of a manufacturing Brownfield site located in a medium-sized midwestern city. The seller was a company involved in federal bankruptcy proceedings and was highly motivated to make a timely sale at a price and terms that were acceptable to the creditors committee. Since time was of the essence, and local investors were aware of perceived environmental problems at the site, the seller decided to perform many of the due-diligence activities in advance of soliciting offers to purchase.

The effect of performing sellers advance due-diligence will be evaluated and reviewed within the context of the eight offers to purchase which were

received on the property. All of the eight offers were drafted by attorneys skilled in real estate environmental law and were received during the submittal periods established by the bankruptcy court. By tabulating the important issues of the offers to purchase, it will be possible to see how, from the seller's perspective, the advance due-diligence expedited the evaluation and negotiation of the offers, and ultimately the closing of the transaction.

THE BROWNFIELD PROPERTY

The subject property is located close to the downtown business district in a rapidly growing Midwestern city. The site borders an area of light manufacturing, utility, and industrial service businesses and is surrounded by a transitional residential neighborhood.

To prepare the property for sale, the owners commissioned Phase 1, Phase 2, and Supplemental Phase 2 environmental site assessments (ESAs). Phase 1 ESAs are generally the starting point in the environmental due-diligence process. A principal goal of a Phase 1 report is to identify if past environmental management practices have created the presence of Recognized Environmental Conditions (RECs). RECs refer to the presence or likely presence of hazardous substances or petroleum under conditions that might indicate a release into the ground, groundwater or surface water.[5] For many sites with long histories of commercial or industrial use, RECs are commonly identified, and follow-up investigation is needed to determine if the potential releases have actually occurred. At the subject property, RECs were found. They included: potential soil and groundwater contamination from underground petroleum storage tanks, historical use of solvents, and releases at nearby properties.

Based on the phase 1 results, the seller elected to perform a Phase 2 investigation to assess concerns identified by the Phase 1 report. The Phase 2 investigation included more detailed reviews of environmental files for several off-site releases on neighboring properties to learn if they might be contaminating the seller's property. Several RECs on the subject property were also investigated. In particular, a magnetometer survey was performed on areas where underground storage tanks were suspected and 10 borings were made to collect soil and groundwater samples near the current and suspected historic underground tanks and a bordering rail corridor.

To prepare the property for sale and remove as much uncertainty as possible, three underground tanks were removed and some contaminated soil from each tank basin was excavated. The Phase 2 report concluded that limited soil contamination remained at one former tank location, and that shallow groundwater was contaminated in excess of state standards at two former tank locations. The groundwater impacts were thought not to have migrated off the property. In addition, an area with solvent contamination was identified, but the source was thought to be coming from off-site.

The Phase 2 report concluded that two areas could be submitted to state regulatory authorities for closure, and one area was likely eligible for reimbursement under a state fund that pays for cleanup of releases from petroleum tanks. However, additional borings and four groundwater monitoring wells were recommended to identify the extent of soil and groundwater contamination. Without the additional data, it would be difficult to present closure requests to regulators or remediation cost estimates to potential buyers and environmental liability insurance underwriters.

The seller agreed with the consultant's recommendations for additional site investigation to remove or reduce uncertainty regarding remediation costs and to get regulatory approval to close as many areas on the site as possible. In addition, the consultant was asked to perform supplementary historical research to identify the possible location of two fuel oil tanks identified in an older report and potentially still present on the site.

During Supplemental Phase 2 work, four groundwater wells were installed and six borings were done. The sampling results showed that the previously identified groundwater solvent contamination was coming from off-site. With this information, the property owner applied to regulators for an exemption to liability for that issue. Regulators also closed two tank areas, under the condition that residual soil impacts not fully removed be identified on the property deed. Another historic tank area, which was installed under a thick concrete floor in an interior space, was shown by borings to have contaminated soil and groundwater that exceeded standards. Because of its location, a decision was made not to attempt remediation, and a request for closure was submitted with the understanding that a notice of the contamination might have to be placed on the property deed. Finally, lead was detected in soil, which was under

Exhibit 1

Summary of Price and Terms of Offers to Purchase Made on Subject Property

Price	Pays for Future Testing Prior to Close	Pays for Remediation Costs	Responsible For Obtaining Case Closure	Environmental Liability After Closing	Seller Escrow for Remediation Costs	Action Taken
Offer 1 $6.0 million	Seller	Seller	Seller	Seller- capped	150% of estimated costs	Rejected
Offer 2 $4.25 million	If required, seller pays	Seller	Buyer	Seller	150% of estimated costs	Accepted Closed
Offer 3 $4.0 million	Seller	Buyer	Buyer	Buyer	150% of estimated costs	Accepted Failed on Zoning Variance
Offer 4 $2.61 million	Buyer	Seller	Seller	Buyer	150% of estimated costs	Rejected
Offer 5 $2.16 million	Seller	Buyer	Seller	Seller	No	Rejected
Offer 6 $2.0 million	Buyer	Seller	Seller	Buyer	No	Rejected
Offer 7 $1.9 million	Buyer	Buyer	Seller	Buyer	No	Rejected
Offer 8 $1.0 million	Buyer	Buyer	Buyer	Buyer	No	Rejected

industrial standards but over residential standards, and some low levels of volatile organic compounds (VOCs) in groundwater were attributed to nearby abandoned tanks.

In summary, the seller undertook Phase 1 and Phase 2 due-diligence to remove as much uncertainty as possible prior to the sale. Actual remediation was limited to tank removals, some minor excavation, and monitoring to demonstrate that residual contamination had not spread off-site. The seller took advantage of "flexible closure" options by leaving low concentrations of contaminated soil and groundwater in place at the "cost" of several deed restrictions which future buyers were certain to discover in their search of title. To further reduce uncertainty, the seller undertook additional historical reviews of two unconfirmed underground tanks.

MARKETING AND SELLERS DUE-DILIGENCE

When a seller markets contaminated real estate without first completing environmental due-diligence, a common sequence of events is: seller negotiates listing contract with broker, broker markets property, buyer writes offer to purchase with contingencies and due-diligence conditions so that relevant information about the property and the contamination can be gathered and evaluated by the buyer, offer(s) to purchase is negotiated to an accepted offer, buyer performs and pays for environmental due-diligence reports (i.e. Phase 1 and if necessary Phase 2 environmental studies). The potential outcomes of the transaction are:

a.) Buyer removes contingencies and due-diligence conditions and transaction closes
b.) Buyer and seller re-negotiate contract terms and price based on due-diligence results
c.) Buyer requests additional time for further testing or evaluation or to obtain approvals or closure from regulatory agencies
d.) Buyer fails to remove contingencies and due-diligence conditions and contract fails

From the seller's perspective, this process contains four inherent flaws. First, the prospective purchasers are reluctant to write offers since they have little or no information about the type or extent of the contamination on the site. The buyers may waste time and expend large sums of money investigating the environmental aspects of a property in a transaction which ultimately does not close.

Without adequate information, sellers can waste time and money negotiating with buyers whose proposed use is incompatible with environmental conditions existing at the site.

Experienced buyers recognize this threat and typically reduce offer prices to reflect potentially excessive due-diligence costs, or attempt to share or transfer costs to sellers. Second, the seller lacks important information necessary to quantify the cost of remediating the contamination or the diminished value of the property as a result of the existence of contamination. Without this critical information, it is difficult or impossible for sellers to negotiate from an informed position, or to select the most appropriate offer. Third, costly time delays and re-opening of contract price negotiations are built into a system which has a buyer pricing a property and entering into future expensive due-diligence with very little information available at the time of writing the offer. Finally, under flexible and risk based closure regulations, some site uses, for example residential housing, may be prohibited or conditionally limited if residual contamination exceeds threshold limits. Without adequate information, sellers can waste time and money negotiating with buyers whose proposed use is incompatible with environmental conditions existing at the site.

EVALUATING OFFERS TO PURCHASE ON THE SUBJECT PROPERTY

During the submittal period, the marketing efforts of the seller's real estate broker produced eight offers to purchase which ranged from a low of $1 million to a high of $6 million with the mean offer being $3.1 million. (See Table 1.) The Brownfield transaction reviewed in this article was characterized by high offer to purchase variability, partly because of differences in buyer's use values and risk tolerances, but primarily because appraisals done for the buyers produced highly inconsistent estimates of market values.

The appraisal done for the seller included a review of the phase 1 and phase 2 studies, and the seller's appraiser consulted with the environmental engineers who performed the studies and understood the nature of the contamination present. The sell-

er's environmental engineers had estimated the costs to remediate the contamination, and the seller's appraisal was for $4.1 million.

Table 1 displays the key elements of each of the eight offers to purchase. The highest offer to purchase of $6 million was based on an M.A.I. (Member of Appraisal Institute) appraisal, which did not review or take into consideration the Phase 1 or Phase 2 environmental audits. The offer was rejected since it was contingent on obtaining federal and state grants within eighteen months of the acceptance of offer. The take as is, no contingency, no due-diligence offer of $1 million was rejected for being too low, as were the $1.9, $2.0, $2.16, and $2.61 million dollar offers.

Most of the lower offers provided that the buyer would:

1.) Pay for additional testing
2.) Pay remediation costs to obtain case closure
3.) Assume all environmental liability
4.) Not require any seller escrows

By having the advance due-diligence information, the seller was able to objectively diminish the value of these perceived benefits and reject the offers. Without the information, the seller would not have had a solid basis for quantifying or estimating the value of the above variables.

After reviewing the environmental studies, the seller felt that having the buyer pay for remediation costs and be responsible for closure was worth the $250,000 differential between the $4.0 million offer and the $4.25 million offer. Since the seller was in bankruptcy, the liability after closing became a moot issue. Although offer number three (of $4.0million) was accepted, the buyer was unable to obtain necessary zoning changes, and the offer died for failure to remove the zoning contingency.

Offer number two, which had been accepted in a secondary position, became primary and all contingencies were removed. The sellers advance due-diligence documents, which were reviewed by the purchaser of offer number two prior to writing the offer to purchase, were turned over to the buyer's environmental engineer for final review. No further environmental due-diligence beyond what the seller had performed was necessary. The transaction closed 3 months after the offer to purchase was made.

CONCLUSION

The conveyance of contaminated real estate is an extremely difficult and complicated transaction. The common approach of putting a property on the market for sale and waiting for offers to purchase, which typically contain lengthy due-diligence provisions, increases the risk that the transaction will ultimately fail. Buyers need quality information about the nature and extent of the contamination in order to be able to make informed offers. Sellers, buyers, and appraisers require a solid base of environmental information to be able to objectively quantify the diminished value of the property that results from the existence of real or perceived environmental problems.

From the seller's perspective, having the important environmental information in advance of marketing the property will assist in the evaluation process as the appraiser and/or broker can be counseled by the seller's environmental engineers. By going into the transactions with a solid basis from which to make decisions, there is less opportunity for costly time delays, reopening contract negotiations, and unnecessary or redundant environmental investigations.

By working together prior to marketing a brownfield property, the appraiser, the environmental engineer, the broker and the seller can create a solid foundation for both the valuation of the property and the subsequent negotiation of the offers to purchase. In the transaction reviewed in this article, the seller's advance-of-sale appraised value of $4.1 million was very close to the two offers that were accepted ($4.0 million and $4.25 million).

Brownfield transactions require advance cooperation and coordination of all of the professionals hired by the seller and involved in advanced due-diligence activities. The result will be a transaction that has a higher probability of reaching the closing table, in a shorter period of time, with lower environmentally related transactional costs.

ENDNOTES

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WHO'S LIABLE NOW?— NEW FEDERAL BROWNFIELDS LEGISLATION

By Jeff Civins and Bane Phillippi

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On January 11, 2002, President Bush signed the Small Business Liability Relief and Brownfields Revitalization Act[1] (the "Brownfields Amendments"). As its name suggests, the act provides relief to small businesses and funding for "brownfields"—"real property, the expansion, re-development, or re-use of which may be complicated by the presence or potential presence of a hazardous substance, pollutant, or contaminant."[2] The Brownfields Amendments also significantly amend certain liability-related provisions of the Comprehensive Environmental Response Compensation Liability Act ("CERCLA" or "Superfund"),[3] the environmental statute that dramatically changed the scope of liability for parties owning or dealing with contaminated properties. This article briefly provides background on CERCLA, and then discusses the Brownfields Amendments' liability-related provisions, specifically, new exemptions for generators of waste, provisions for settlement by small businesses, clarifications relating to the innocent land owner exemption, new landowner exemptions and their limitations, and windfall liens.

BACKGROUND

Since the enactment of Superfund in 1980, those performing due diligence in connection with business and real estate transactions should

Since the enactment of Superfund in 1980, those performing due diligence in connection with business and real estate transactions should be looking not only at liabilities attributable to violations of law, but also at liabilities that arise under Superfund.

be looking not only at liabilities attributable to violations of law, but also at liabilities that arise under Superfund. Unlike other environmental laws, Superfund imposes liability based not on a violation of law, but rather on a person's relationship to a site from which there was a release or threat of release of a "hazardous substance."[4] Those liable under Superfund are referred to as potentially responsible parties or PRPs and include present and certain past owners and operators of a contaminated site, transporters who selected the site, and generators of waste who arranged for disposal of their wastes at the site.[5] Liability is strict—irrespective of fault—and generally, joint and several,[6] and includes costs of investigating and remediating hazardous substance-contaminated sites and natural resource damages attributable to that contamination.[7] The worst of sites containing hazardous substances are included on an ongoing list developed by the United States Environmental Protection Agency (EPA) called the National Priorities List (NPL).[8] The NPL is significant because in addition to bringing an administrative or civil action to compel clean up,[9] EPA may utilize funds from the "Superfund" to investigate and remediate NPL sites and pursue cost recovery. [10]

Many states have adopted programs comparable to Superfund. In Texas, the Texas Solid Waste Disposal Act creates an alternative basis of liability, modeled after Superfund.[11] The state Superfund program, however, differs from the federal program in a number of ways; for example, it applies to sites contaminated with solid waste, including petroleum.

The effect of Superfund and its state analogs was to discourage parties from participating in transactions involving contaminated properties. Although CERCLA was amended in 1986, by the Superfund Amendments and Reauthorization Act (SARA),[12] to include some business-friendly changes,[13] it continued to impede transactions. In response, EPA developed policies to ameliorate the effects of CERCLA on real estate transactions and development involving Brownfields.

Recognizing the inequity of holding landowners responsible for contamination that migrated in aquifers under their properties from off-site sources, EPA published guidance that protected them, relying on the agency's statutory de minimis settlement authority.[14] To encourage prospective purchasers to participate in transactions involving contaminated properties, EPA also developed a "prospective purchaser" program applicable to properties for which Superfund enforcement was imminent, which allowed purchasers to enter into "prospective purchaser agreements" to obtain a release from liability in exchange for a cash payment and other commitments to EPA.[15] The Brownfields Amendments, among other things, added two new generator and two new land owner exemptions, clarifying and codifying aspects of the policies that EPA had developed.

NEW GENERATOR PRP EXEMPTIONS

The Brownfields Amendments newly exempt two classes of generator PRPs from liability for NPL sites: (1) arrangers (and transporters) of de micromis amounts of materials, if the amounts of the materials they disposed of are under prescribed quantities,[16] and (2) specified arrangers, i.e., residential property owners or operators, small businesses, and tax exempt institutions, that generated municipal solid waste.[17] These exemptions operate as defenses and are conditional. Among other things: (1) the waste must not have contributed significantly to the costs of response and natural resource restoration; (2) the person must not have failed to comply with information requests; (3) the person must not have interfered with the remedial action; and (4) with respect to the de micromis exemption, all or part of the disposal, treatment, or transport of the wastes must have occurred before April 1, 2001.[18]

In general, the Brownfields Amendments proscribe contribution actions against these two classes of PRPs, other than by governmental entities, and impose the burden of establishing that these PRPs are not within the exemption on those seeking to recover from them.[19] They further authorize those newly-exempted PRPs to recover reasonable costs of defending the action, including attorneys and expert fees, if they are found not liable for contribution based on the exemption.[20] The exemptions do not on their face apply to contaminated sites not on the NPL, limiting their value.

SETTLEMENT BY SMALL BUSINESSES

For small businesses, the Brownfields Amendments provide another benefit. They amend CERCLA to allow parties who are unable or of limited ability to pay response costs to expeditiously settle for small amounts.[21] They also authorize them to use alternative payment methods. To qualify, the business also must not fail to provide information or access.

INNOCENT LAND OWNERS—ALL APPROPRIATE INQUIRY

Under CERCLA as originally enacted, PRPs can avoid liability if they can show that the release or threat of release of hazardous substances and the resulting damages were caused solely by: (1) an act of God; (2) an act of war; (3) an act or omission of a third party; or (4) any combination of these causes.[22] In addition, they must show that they exercised due care with respect to the hazardous substances and took precautions against foreseeable acts or omissions of any such third party and the consequences that could foreseeably result from such acts or omissions.[23] The so-called third-party defense is not available if the third party is one whose act or omission occurred in connection with the contractual relationship with the PRP.[24] While some courts have required that there be a nexus between the act or omission of the seller and the contractual relationship with the PRP,[25] others have ignored this requirement and have found the defense inapplicable if any contractual relationship exists.[26]

Because of concern that a contractual relationship could vitiate the third party defense, SARA added the so-called innocent landowner defense. Under this defense, even if the proscribed contractual relationship were present, the PRP nonetheless can avoid liability if it can show that it satisfied the requirements for being an innocent landowner: at the time of acquisition, the PRP did not know and had no reason to know that any hazardous substances were disposed at the facility.[27] The standard for determining the adequacy of the due diligence investigation is whether the PRP made "all appropriate inquiry."[28] The Brownfields Amendments clarify the definition of contractual relationship and the due diligence standard.

The Brownfields Amendments include easements and leases as well as deeds as examples of the type of contractual relationship that may trigger the need for the innocent land owner defense.[29] They require a person seeking protection under this exemption: to fully cooperate with the response actions and natural resource restoration; to comply with land use restrictions; and to not impede the integrity of institutional controls.[30] They also expand upon the "all appropriate inquiry" standard by explaining that the defendant must carry out all appropriate inquiry into the previous ownership and uses of the facility in accordance with generally accepted good commercial and customary standards and practices and, significantly, take reasonable steps to stop any continuing release, prevent any threatened future release, or prevent or limit any human, environmental, or natural resource exposure to any released hazardous substances, going beyond the "due care" requirement of the original act.[31]

Within two years of enactment, the EPA Administrator must promulgate regulations describing "all appropriate inquiry," which are to include: (1) results of an inquiry by an environmental professional; (2) interviews with past and present owners, operators, and occupants; (3) reviews of historical sources; (4) searches for recorded environmental cleanup liens; (5) reviews of governmental and other records; (6) visual inspection of the facility and adjoining properties; (7) specialized knowledge or experience on the part of the defendant; (8) the relationship of the purchase price to the value of the property if the property was not contaminated; (9) commonly known or reasonably ascertainable information about the property; and (10) the degree of obviousness of the presence or likely presence of contamination of the property, and the ability to detect the contamination by appropriate investigation.[32]

With respect to property purchased before May 31, 1997, the court is required to take into account a subset of the prescribed factors.[33] With respect to property purchased on or after that date, until the Administrator promulgates regulations, the ASTM 1997 standards for environmental site assessments satisfy the requirements for "all appropriate inquiry."[34] For a residential property, a facility inspection and title search that reveal no basis for further investigation are generally adequate.[35]

OWNERS OF PROPERTIES CONTIGUOUS TO CONTAMINATION SOURCES

The Brownfields Amendments create a new landowner exemption from Superfund liability

applicable to a person who owns real property that is contiguous to[36] and that is or may be contaminated by a release or threatened release of a hazardous substance from real property not owned by that person, provided certain conditions are met.[37] This exemption applies to circumstances similar to those addressed in EPA's landowner policy regarding liability for subsurface migration from off-site sources.[38]

To qualify for the exemption, the person must, among other things: (1) not have caused, contributed, or consented to the release; (2) not be potentially liable or affiliated with any person potentially liable for the release; (3) take reasonable steps to stop any continuing release, to prevent any threatened release, and to prevent or limit human, environmental, or natural resource exposure to any hazardous substances released from that person's property; (4) provide full cooperation and access to persons authorized to conduct response actions or natural resource restoration; (5) comply with any applicable land use restrictions and not interfere with any institutional controls; (6) comply with requests for information; (7) provide all legally required notices; (8) and at the time at which the person acquired the property, have conducted all appropriate inquiry and not know or have reason to know that the property was or could be contaminated by the adjacent property. [39]

The Brownfields Amendments clarify that owners of property whose groundwater is contaminated from offsite sources generally need not conduct groundwater investigations or install groundwater remediation systems.[40] For these types of newly exempted PRPs, the Administrator is authorized to issue an assurance of no enforcement action or "comfort letter," and to enter into settlements that would confer contribution protection.[41]

In Texas, the Innocent Owner/Operator Program ("IOP") is available for the purchaser of contaminated property who can demonstrate that the contamination on its property is solely attributable to a third party. [42] Unlike the Brownfields Amendment contiguous property owner exemption, under the IOP, the property owner or operator may obtain a release from liability to the state, not merely a defense to liability. Moreover, unlike the Brownfields Amendments' exemption, the IOP does not require due diligence prior to purchase and is not lost by pre-acquisition knowledge of contamination; it may be obtained after the property is purchased.

Of greatest significance, the Brownfields Amendments address a shortcoming of the innocent landowner defense, by affording a defense to prospective purchasers who, upon all appropriate inquiry, discover contamination, by institutionalizing some of the benefits of a prospective purchaser agreement.

BONA FIDE PROSPECTIVE PURCHASER DEFENSE

Both the innocent land owner defense and the new contiguous land owner defense of CERCLA are unavailable if the person performs the investigation and determines that contamination is present. In other words, prospective purchasers who conduct all appropriate inquiry and discover contamination are not protected from CERCLA liability. To assist this type of purchaser, EPA's prospective purchaser policy allowed that person to enter into prospective purchaser agreements or PPAs, on a case-by-case basis, pursuant to which the agency would release the purchaser from liability in exchange for monetary and other consideration. The Brownfields Amendments, to some extent, institutionalize this practice by exempting so-called bona fide prospective purchasers from liability.[43]

The term "bona fide prospective purchaser" is defined as a person (or a tenant of a person) that acquires ownership of a facility and that can establish certain elements by a preponderance of the evidence.[44] These elements include : (1) that disposal occurred prior to acquisition; (2) that the person made all appropriate inquiry into the previous ownership and uses of the facility in accordance with generally accepted good commercial and customary standards and practices; (3) that the person provided all legally required notices; (4) that the person is exercising appropriate care with respect to the hazardous substances by taking reasonable steps to stop any continuing release, prevent any threatened future release, and prevent or limit human, environmental, or natural resource exposure to any previously released hazardous substances; (5) that the person is fully cooperating with the party authorized to conduct response or

natural resource restoration actions; (6) that the person is complying with land use restrictions and is not impeding any institutional controls; and (7) that the person is responding to information requests. The exemption is not available if the person is affiliated with the party liable for the contamination.[45]

EPA recently issued a policy expressing its belief that, in most cases, the Brownfields Amendments make PPAs unnecessary.[46] The two situations the agency acknowledges where PPAs still would be available are if there is likely to be a significant windfall, as a mechanism to address it, and if the PPA is necessary to ensure that a project that would benefit a local community will go forward. Texas has a voluntary cleanup program that allows prospective purchasers of contaminated properties to obtain a release of liability to the state for costs of investigation and remediation, but this program, unlike the CERCLA exemptions, does require that the purchaser remediate the site.[47]

LIMITATIONS ON NEW LANDOWNER EXEMPTIONS

The two new landowner exemptions—the contiguous property owner and bona fide prospective purchaser exemptions—have some limitations in common. Unlike the PPA, which provides a release from liability, the new exemptions provide a defense, which must be asserted and proved. Also, the exemptions operate as defenses under Superfund, but not other federal statutes, like the Resource Conservation and Recovery Act (RCRA), and not under state statutes, like the Texas Solid Waste Disposal Act. The defenses also do not protect against common law claims, e.g., based on trespass or nuisance. In addition, because of the CERCLA petroleum exclusion, sites contaminated with gasoline or other petroleum products generally are excluded from Superfund coverage and are generally addressed under other statutes, e.g., RCRA. For that reason, purchasers of those sites cannot obtain protection under the exemptions.

WINDFALL LIENS

If there are unrecovered federal response costs at a site, the United States may impose a lien on the site, or negotiate some other assurance of payment with the site owner, for the unrecovered response costs.[48] The amount of the lien, however, may not exceed the increase in fair market value of the site attributable to the response action, as of the time of sale.

CONCLUSION

The Brownfields Amendments provide relief to small businesses and revitalize brownfields. They also significantly amend certain of the liability provisions of CERCLA, providing, among other things, two new landowner exemptions, which should encourage Brownfields transactions. Of greatest significance, they address a shortcoming of the innocent landowner defense, by affording a defense to prospective purchasers who, upon all appropriate inquiry, discover contamination, by institutionalizing some of the benefits of a prospective purchaser agreement.

ENDNOTES

1. Small Business Liability Relief And Brownfields Revitalization Act, Pub. L. No. 107-118, 115 Stat. 2356 (2002) (codified in various sections at 42 U.S.C. §§ 9601-9675).
2. Brownfields Amendments § 211(a) (codified at 42 U.S.C. § 9601(39)). The Senate Committee Report cites an estimate that there are more than 450,000 brownfield sites nationwide. S. Rep. 107-2 (2001).
3. 42 U.S.C. §§ 9601-9675 (2002).
4. 42 U.S.C. § 9601(14) (2002). Although Superfund broadly defines the term "hazardous substance," it excludes from that definition petroleum and petroleum products, and thus sites contaminated by gasoline and other petroleum products do not fall within its ambit.
5. 42 U.S.C. § 9607(a). Past owners and operators of a contaminated site who are liable under CERCLA are those who owned or operated the site at the time of disposal of hazardous substances.
6. Jeff Knebel & Mary Reagan, Texas Superfund, 45 Texas Environmental Law 405, West Group's Texas Practice Series (1997) (2001 pocket update).
7. 42 U.S.C. § 9607(a) (2002).
8. 42 U.S.C. § 9605(a)(8)(B) (2002).
9. 42 U.S.C. §§ 9606(a) and 9607(a) (2002).
10. 42 U.S.C. § 9611 (2002).
11. TEX. HEALTH & SAFETY CODE ANN. §§ 361.271-345 (Vernon 2001 & Supp. 2002).
12. Superfund Amendments and Reauthorization Act (SARA) of 1986, Pub. L. No. 99-499, 100 Stat. 1613 (codified as amended at 42 U.S.C. §§ 9601-9675).
13. The 1986 SARA amendments added an "innocent landowner defense." 42 U.S.C. § 9601(35)(A) (defining the term "contractual relationship.")They also authorized EPA to enter into de minimis settlements with the owner of a contaminated property if that person did not conduct hazardous substance management activities and did not contribute to the release of hazardous substances. 42 U.S.C. § 9622(g).
14. Diamond, EPA Office of Site Remediation Enforcement, to EPA Regional Counsel, et. al.(May 24, 1995) ("Final Policy Toward Owners of Property Containing Contaminated Aquifers"); see also 60 Fed. Reg. 31,995 (July 3, 1995).
15. See Guidance on Settlements with Prospective Purchasers of Contaminated Property (OSWER Directive No. 9835.9, and 54 Fed. Reg. 34,235 (Aug. 18, 1989)); see also Breen, EPA, & Bruce Gelber, DOJ, to Superfund Senior Policy Managers et al. (Jan. 10, 2001) ("Support of Regional Efforts to Negotiate Prospective Purchaser Agreements (PPAs) at Superfund Sites and Clarification of PPA Guidance").
16. See Brownfields Amendments § 102(a) (codified at 42 U.S.C. § 9607(o)).
17. See id. (codified at 42 U.S.C. § 9607(p)).
18. See id. (codified at 42 U.S.C. §§ 9607 (o) and (p)).
19. See id.
20. See id. (codified at 42 U.S.C. § 9607(p)(7)).
21. See id. (codified at 42 U.S.C. § 9622(g)).
22. 42 U.S.C. § 9607(b) (2002).
23. Id. at § 9607(b)(3).
24. Id.

25. See State of N.Y. v. Lashins Arcade Co., 91 F. 3d 353, 360 (2nd Cir. 1996); Westwood Pharmaceuticals, Inc. v. Nat'l Fuel Gas Dist. Corp, 767 F. Supp. 456, 460 (W.D.N.Y. 1991), aff'd 964 F. 2d 85, 89 (2nd Cir. 1992).
26. See, e.g, Idylwoods Assoc. v. Mader Capital, Inc., 915 F. Supp. 1290, 1299-1300 (W.D.N.Y. 1996); United States v. Pacific Hide & Fur Depot, Inc., 716 F. Supp. 1341 (D. Id. 1989). It should be noted that an owner of a property who has actual knowledge of the presence of a hazardous substance and transfers ownership of that property without disclosing that fact becomes liable under 9607(a)(i) and loses any defense under 9607(b)(13). 42 U.S.C. §9601(35)(C).
27. 42 U.S.C. § 9607(b)(3) and § 9601(35)(A)(i).
28. 42 U.S.C. § 9601(35)(B).
29. Brownfields Amendments § 223 (codified at 42 U.S.C. § 9601(35)).
30. Id.
31. Id.
32. Id. (codified at 42 U.S.C. § 9601(35)(B)).
33. Id.(codified at 42 U.S.C. § 9601(35)(B)(iv)(I)). Specifically, factors (7) through (10).
34. Id. (codified at 42 U.S.C. § 9601(35)(B)(iv)(II)).
35. Id. (codified at 42 U.S.C. § 9601(35)(B)(v)).
36. The exemption also includes properties that are "otherwise similarly situated." Id. (codified at 42 U.S.C. § 9607(q)). It is unclear in what way the quoted language is intended to modify the contiguity requirement.
37. Id. (codified at 42 U.S.C. § 9607(q)).
38. See Diamond, supra note 14.
39. Id. (codified at 42 U.S.C. § 9607(q)(1)(A)).
40. Id. (codified at 42 U.S.C. § 9607(q)(1)(D)).
41. Id. (codified at 42 U.S.C. § 9607(q)(3)).
42. TEX. HEALTH & SAFETY CODE ANN. §§ 361.751-754 (Vernon 2001 & Supp. 2002).
43. See Brownfields Amendments § 223 (codified at 42 U.S.C. § 9607(r)).
44. Id. (codified at 42 U.S.C. § 9601(40)).
45. Id.
46. Breen, EPA Office of Site Remediation Enforcement, to EPA Superfund Senior Policy Managers, et. al.(May 31, 2002) ("Bona Fide Prospective Purchasers and the New Amendments to CERCLA").
47. TEX. HEALTH & SAFETY CODE ANN. §§ 361.601-613 (Vernon 2001 & Supp. 2002).
48. See Brownfields Amendments § 223 (codified at 42 U.S.C. § 9607(r)(2)).

USE OF LETTERS OF INTENT IN RETAIL LEASING: WHEN IS A NON-BINDING LETTER OF INTENT REALLY BINDING?

By Dana I. Schiffman and Ben Hirasawa

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New case law may add a new, unexpected twist to "non-binding" letters of intent. Landlords, tenants and brokers are well advised to consider the pitfalls created by Copeland v. Baskin Robbins, U.S.A., (96 Cal.App.4th 1251 (2002)) and to reexamine their use of letters of intent in light of such new law.

In Copeland, the California Court of Appeals imposed liability for the breach of an implied covenant of good faith and fair dealing on a party who terminated negotiations under a letter of intent. Even though the Court in Copeland recognized the letter of intent itself was not a binding expression of the transaction, it did hold that the letter of intent constituted a contract to negotiate. Copeland also recognized that where a contract to negotiate exists, California law will imply a covenant of good faith and fair dealing to the contract negotiations and the party who breaches such a covenant will be responsible for "reliance" damages. The Court reasoned that since business negotiations can be a slow, complex and expensive process, public policy favors protecting parties to a business negotiation from bad faith practices of the other party in terminating the negotiations or making capricious demands. This article analyzes this subject in the context of retail leasing and provides suggestions for both using and avoiding Copeland's perverse holding.

The Court reasoned that since business negotiations can be a slow, complex and expensive process, public policy favors protecting parties to a business negotiation from bad faith practices of the other party in terminating the negotiations or making capricious demands.

1. FINDING A CONTRACT TO NEGOTIATE IN GOOD FAITH IN THE LETTER OF INTENT.

In its Copeland opinion, the Court clearly stated that an implied covenant of good faith and fair dealing does not apply to all contract negotiations. Rather, in its view, such an implied covenant only applies if the parties have entered into an agreement to negotiate. Therefore, to avoid an implied obligation of good faith and fair dealing, letter of intent language expressing an agreement to negotiate should be avoided. However, even absent such express language, an agreement to negotiate might easily be implied from other language in the letter of intent or the very context of the letter of intent. For instance, language which falls short of an express agreement to negotiate could in fact be construed as an agreement to negotiate, e.g. "Upon Landlord's receipt of copy of this letter signed by Tenant, Landlord will arrange for its counsel to prepare a lease reflecting the terms and conditions contained herein" or "Landlord and Tenant agree that the terms set forth herein are intended as an outline for negotiation of terms to be documented by a formal written lease." Most letters of intent involve a phasing of negotiations by which an expression of primary terms in the letter of intent is followed by negotiation and documentation of full terms. This context and purpose implies that most letters of intent could probably be construed as contracts to negotiate notwithstanding the absence of explicit language so stating. This appears to be the view of the Court in Copeland. Although the Copeland case lacks discussion of what constitutes an agreement to negotiate absent express language to that effect, the only conclusion that can be drawn from Copeland is that letters of intent, by their very nature, normally contain an implied agreement to negotiate.

Regardless of whether a landlord, tenant or broker would characterize the letter of intent as an agreement to negotiate, they usually have the expectation that general "non-binding language" in a letter of intent is sufficient to negate any obligation to negotiate. This is where Copeland has the most potential for being inconsistent with the usual expectations of the parties who regularly utilize non-binding letters of intent. Unfortunately, the reasoning of the Copeland case strongly suggests the notion that the Court would construe general non-binding language (e.g., "this letter does not constitute a formal or binding agreement and the provisions hereof are not binding on either party," or words to similar effect) as only establishing that the letter of intent itself does not serve as the definitive documentation for the transaction . Therefore, safely avoiding the characterization of the letter of intent as a contract to negotiate to which an implied covenant of good faith and fair dealing attaches is best accomplished by adding specific language such as the following: "Notwithstanding any provision to the contrary contained herein, this letter shall not constitute an agreement to negotiate and solely constitutes an outline of certain key terms. Landlord and Tenant each acknowledge and agree that each party is proceeding with negotiations relating to the proposed lease at its sole cost and expense and that either party may terminate negotiations at any time and for any reason without any liability or obligation whatsoever."

2. DAMAGES FOR BREACH OF THE "CONTRACT TO NEGOTIATE."

Copeland establishes that the party responsible for a bad faith termination of negotiations will be liable for the other party's injuries suffered in relying upon the negotiations being conducted in good faith. In Copeland, the Court labeled such damages as "reliance" damages. This measure encompasses the plaintiff's out-of-pocket costs in conducting the negotiations and "may or may not include loss of opportunity costs" but does not include any damages for the injured party's lost expectations under the prospective lease or contract (Copeland at 1259). In this context, opportunity costs could include indirect losses by reason of the transaction not occurring. In most situations, establishing indirect losses could be difficult and their recovery may be a function of whether or not such indirect losses were reasonably foreseeable by the other party to the "contract." In Copeland, the plaintiff did not allege or attempt to prove any reliance damages. Therefore, whether "loss of opportunity costs" could be recovered did not need to be decid-

ed by the Court in the Copeland case and is left open for future consideration.

Liability for the other party's out of pocket costs and expenses could be painful enough. More disturbing is the lost time, cost and expense of defending a claim for a breach of agreement to negotiate in good faith. The idea of a court or jury determining whether a party terminated negotiations in bad faith seems problematic. Given the inherent ambiguity of what constitutes a good faith termination of negotiations, the likely complexity of the parties' motivations and business considerations and the questionable qualifications of a judge or jury to appropriately assess all these issues, one must wonder how often the "right" result will be realized.

The notion that "loss of opportunity costs" may be recoverable is an even more serious concern. These damages could be many times greater than liability for out-of-pocket costs and expenses incurred in connection with the negotiation. Because of the speculative nature of such damages, a court may be unlikely to expand the measure of "reliance" damages to include loss of opportunity costs. In any event, the court would probably limit the damages to those that would be reasonably foreseeable to arise from a breach of the covenant to negotiate. Nevertheless, this potential exists and, given the right facts, could be a significant risk. For instance, in circumstances where the tenant has informed the landlord of a time requirement in order to avoid holdover rent and/or other costs relating to the transition of its business from its old premises to the proposed new premises, the tenant may be in a good position to successfully include such losses in its "reliance" damages.

3. IMPLICATIONS OF COPELAND FOR RETAIL LEASE LETTERS OF INTENT.

The proposition that a party may recover reliance damages for breach of an express or implied promise in a letter of intent to negotiate in good faith is now the law in California. Other jurisdictions often eventually follow theories of contract liability first developed in California. In Copeland, the Court cited New York, Pennsylvania and Illinois cases that also recognize a cause of action for breach of a contract to negotiate. Assuming the subject transaction is governed by the laws of these states, or that the law of the jurisdiction that governs the subject transaction could evolve to follow Copeland, landlords, tenants and brokers should consider the implications of this important legal development.

Ultimately, the Copeland decision requires that the parties to the letter of intent have a clear vision of their objectives in using a letter of intent and that they employ precise language to protect their interests. Failure to do so could result in unanticipated financial liability and defeated expectations.

Given the uncertainty of a proper determination by a court or jury and the significant expense and exposure to liability incident to litigating a contract to negotiate, the holding of Copeland could provide leverage for the party to a failed negotiation who considers itself to be aggrieved by bringing or threatening to bring a claim for the breach of the covenant to negotiate in good faith. Therefore, depending upon the strategic interests and leverage of the landlord and the tenant, they should each consider whether to use a letter of intent versus a minimal term sheet, whether to sign a letter of intent and, when it is appropriate to enter into a letter of intent, whether to expressly include or exclude each of the following concepts:

- Express language by which the parties agree to negotiate;
- Language disclaiming any agreement to negotiate and explicitly recognizing a right to terminate negotiations for any reason or no reason. Alternatively, a time limitation on negotiations after which either party may cease negotiations for any reason or for no reason may be appropriate;
- Language stating that the letter of intent is nonbinding in the sense of being ineffective to constitute an actual agreement on the subject lease transaction;
- Language specifically addressing each party's responsibility for costs and expenses incurred in the negotiation and other possible "reliance" damages. In some circumstances it may also be appropriate to address enforcement costs and to specify that the prevailing party is entitled to recover its enforcement costs; and
- Language in subsequent correspondence between the parties and their agents reiterating

that there is no agreement to negotiate.

A landlord who has properties subject to a large number of small leases with non-credit tenants has a strong incentive to avoid any argument that the landlord has entered into a contract to negotiate in good faith. A smaller lease with a non-credit tenant is a less complex and less time consuming transaction than a major lease transaction with a more sophisticated and creditworthy entity. As such, some of the reasons for implying a duty to negotiate may not exist or may not be as strong. In addition given landlord-favorable market conditions, several alternatives to a specific small tenant may be available. The landlord may quite literally wish to preserve its ability to cease negotiations in favor of a better offer.

The implications of Copeland may also be particularly important in lease transactions where the leverage of the parties might shift in a major way between the commencement and completion of negotiations. This could be the case when tenants who are direct competitors are attempting to secure the few suitable locations within a particular market area or where a tenant's objective is to secure a certain number of expansion sites within a specific market and timeframe.

4. CONCLUSION

Ultimately, the Copeland decision requires that the parties to the letter of intent have a clear vision of their objectives in using a letter of intent and that they employ precise language to protect their interests. Failure to do so could result in unanticipated financial liability and defeated expectations.

FOCUS ON GLOBAL ISSUES

WHAT MAKES FOR A SUCCESSFUL CITY

by Nicholas Brooke

Nicholas Brooke

Perhaps I should start by introducing myself. I am proud to be the 135th President of the Royal Institution of Chartered Surveyors, with whom CRE enjoys a close and cordial strategic relationship. We share a common objective which is to promote the highest standards of professionalism in real estate worldwide. In this connection therefore it is my pleasure to contribute the first of a series of articles which I hope will contribute to the ongoing debate of what makes for a successful city.

Given that half the world's population now lives in cities, compared with only 2% in the year 1800 and 35% in 1970, it is important to understand what are the key factors that are crucial to the long-term success of any city. Within ten years it is estimated that there will be at least 30 cities with a population of over 10 million people, of which at least 22 will be in developing countries and the majority of these in Asia.

The reality is that cities can turn their fortunes around, often with surprising speed if they get the formula right. Examples which come to mind include Dublin, Barcelona, and Helsinki in Europe and Shanghai, Sydney, and Dubai further afield.

Over the last few months I have been fortunate to visit many of these successful cities and I have identified a number of key components and drivers that I believe have put these cities ahead of the rest.

DIVERSITY

Economic, cultural and social diversity make for a vibrant city. Cities dependent on a single economic sector are always going to be vulnerable during an economic downturn. Diversifying its economic base must, therefore, be a top priority for any city. Moreover, cities that embrace diversity in all its forms—including cultural and ethnic diversity—seem better equipped to generate the creativity that cities need, making themselves attractive to the skilled migrants that have been so integral to the economic success of cities around the world.

GOOD GOVERNANCE

Cities—particularly rapidly growing ones—need an understanding of how to install and maintain the infrastructure and services that underpin good quality city environments. All this needs competent, effective local governance structures, something all too lacking in many developing countries and not a few developed ones. Good governance demands strong civic leaders with a vision of where they want to take their city and an economic strategy that embraces partnership with local businesses.

A SKILLED WORKFORCE
Businesses today need skilled and dependable workers and will go wherever they must to find them. This means that cities need to invest in education and training and develop close working relationships between their schools, universities and business. They also need to create the kind of environment that will attract skilled workers to them and put the best of talent from the academic world and foster a culture of innovation, research and development.

QUALITY OF LIFE
In a globalising world the creative people that cities need have many choices. The evidence is that they are attracted to cities which offer not just financial rewards but the quality of life to which they aspire. Many of the cities, such as Barcelona ,which consistently score highly in inter-city comparisons have capitalised on their historic assets whilst renewing their city and underpinning its cultural institutions.

CONNECTIVITY
Good communications both to the outside world and within the city are crucial. Without a good airport and, where appropriate, international rail links no city can make the leap to world league status. Similarly, good internal communications, underpinned by adequately funded public transport provide the essential infrastructure for the movement of people, goods and services.

PHYSICAL RENEWAL
The physical regeneration of cities—the renewal of its buildings and infrastructure—is almost invariably a key part of any successful urban strategy. In many cases the renewal of a key area of the city acts as a focus for national and international attention as well as generating civic pride and the 'buzz' that the city is on the move. But physical regeneration only works if it is combined with social regeneration—the creation of real communities with the services including health and education needed to support them.

A CULTURE OF INNOVATION
Innovation—the introduction of new techniques and processes—is the key to creating the knowledge-based industries that generate high standards of living. Over the last 30 years a large part of the growth in output in developed countries has resulted from innovation. Innovation depends on a strong research and innovation base and the creation of networks, involving both the public and private sectors, for generating and sharing knowledge.

A BUSINESS FRIENDLY CULTURE
If a city is to compete effectively it must seek to create a business-friendly environment. Unless it can generate large scale employment then it will not create the wealth that must underpin every aspect of its life and culture. This is no longer simply a matter of light regulation and low taxes, important as these are, but also requires the fostering of a culture of research, innovation and education.

A DISTINCTIVE BRAND
If a city aspires to be a player on the global stage then it must carve out a distinctive identity. The threat through globalisation and other factors of cities being transformed into "anywhereville" must be resisted. Cities must fight hard to preserve their distinctive character or "soul" and development must be in tune with the spirit of the place.

THE CITY-REGION RELATIONSHIP
Successful cities almost invariably lie at the heart of successful regions. Understanding the relationship and how it can work to the mutual benefit of both the city and region is crucial. Increasingly the trend is to develop city-regional solutions on an informal or formal basis that can develop the spatial framework needed to achieve economic competitiveness.

In summary: success, if it is to be sustainable, must not be built on too narrow a base. For instance, simply to offer a cheap pool of labour is no longer enough. Long-term success has to be founded on, and demands, the transformation of a city into a place that is economically and culturally diverse and offers a high quality of life. Getting the balance right also requires civic leaders with a strategic vision for their cities. In essence this is the challenge to which all cities that aspire to elite status, must respond.

ABOUT OUR FEATURED COLUMNIST
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FOCUS ON MARKET RETURNS

WHAT RETURNS WILL THE MARKET DELIVER?

by Raymond G. Torto, Ph.D, CRE

Raymond G. Torto, Ph.D, CRE

In 2003 capital market positives and space market fundamentals negatives combined to lower real estate investor return expectations. Today, investors face both the challenge of sustaining net income and understanding the future pricing multiple on that income. Together these elements will determine future returns.

One question we have been asking at Torto Wheaton Research is what will be the average market returns that investors can expected. Certainly, looking back we know that these investors did well. But, as they say on Wall Street, past performance is not a guarantee of future performance.

CONTRIBUTIONS TO HISTORIC AND FUTURE RETURNS

One way to look at this question of what the market will return in the future is to not only look at total returns but to study the components of that return-- going in yield, NOI growth, and cap rate changes.

Using the Torto Wheaton Research Investment Database, we have combined the four major "food groups" of retail, office, industrial, and multi-housing properties to examine historic information and to forecast what the market will deliver over the next five years as shown in Figure 1.

Historically, total return over the last five years averaged 13.5%. Looking at the components, lower capitalization rates accounted for 131 basis points of the total of 13500 basis points return, and we are sure that much of the contribution from capitalization rates came in the last two years. Importantly, yield and NOI growth (rents and occupancy increases) were the major contributors to the strong returns over the last five years.

Over the next five years, investors should consider whether they expect to see NOI growth and capitalization rate compression repeat their performance of the last five years. We think not, and therefore our fundamentals forecasts and capitalization rate forecasts combine to give us a five-year return of just 5.3%.

This column is based on research prepared for "Expectations & Market Realities in Real Estate: 2004", a joint report of Principal Real Estate Investors, Real Estate Research Corporation and Torto Wheaton Research

It is the going in yield that contributes the most to the future return, with NOI growth flat and our capitalization rate forecast rising slightly and hence subtracting from return.

More important is the components to the historic and forecasted returns. Historically, we see that over the last five years there was tremendous run-up in NOI due to rent and occupancy increases. Additionally, there was about a

Figure 1. Five Year Returns for Commercial Real Estate

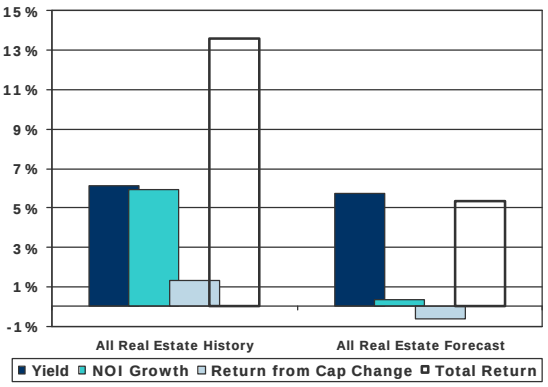
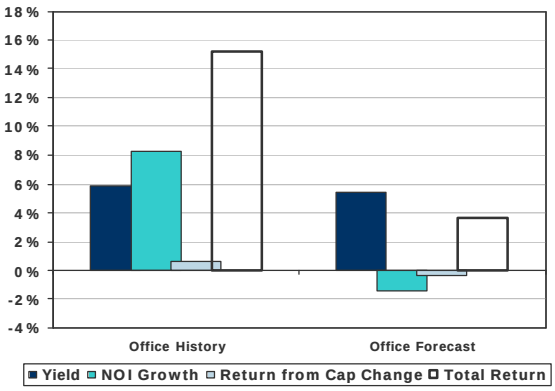


Figure 2. Total Returns for Office on Five Year Holds



100 basis point contribution to returns due to cap rates falling.

For the future our market return estimates are all provided by the going in yield. We have little hope of NOI growth from the market as we expect some roll down of NOI due to above market leases in place. And unlike the last five years we would expect some small rise in cap rates which will also reduce total return.

This market expectation is, again, for the real estate equivalent of the Russell 3000. However, better return estimates can be achieved for other portfolios and not one that reflects the overall market. For instance we get 9% returns for office investments which are positioning to ride up the market rents that are expected in future years rather than a ride down in NOI due to lease rollover. Essentially the difference between paying for income-in-place vs. buying vacancy as the bet!

The TWR analysis is based on a real estate portfolio that is akin to the Wilshire 3000. It is not an investment grade portfolio, or a NCREIF portfolio, which may be akin to the S&P 500. In other words, it is what the wider market will deliver. We are sure that real estate investment managers are making a difference in the outcomes. Remember, in real estate, alpha matters.

Figure 2 shows the historic and forecast total returns for a five year hold and also the components of that return for office space which is one property type that has certainly turned the corner on fundamentals as of the end of 2003. Based on the Torto Wheaton Research Investment Database we estimate the five year historic total return to be about 15%.

Again, the geographic and property mix in this portfolio is not the same as NCREIF. Going forward, if this office portfolio was assembled and purchased today at today's prices and on today's income in place, we would expect the market portfolio to return only about 4%.

The bottom line: real estate investors had a tail wind during the last five years, but are facing a headwind today! But the message is be careful, not chicken!

ABOUT OUR FEATURED COLUMNIST

Raymond G. Torto, PhD, CRE, , *is principal at Torto Wheaton Research in Boston, where he specializes in market research analysis and economic forecasting. He has been a member of The Counselors of Real Estate since 1988. (E-mail: Rtorto@TortoWheatonResearch.com)*

FOCUS ON HOSPITALITY

PREDICTIVE POWERS OF HOTEL CYCLES

by John (Jack) B. Corgel, Ph. D

GET FROM REI Winter 2003 p. 44

John (Jack) B. Corgel, Ph. D

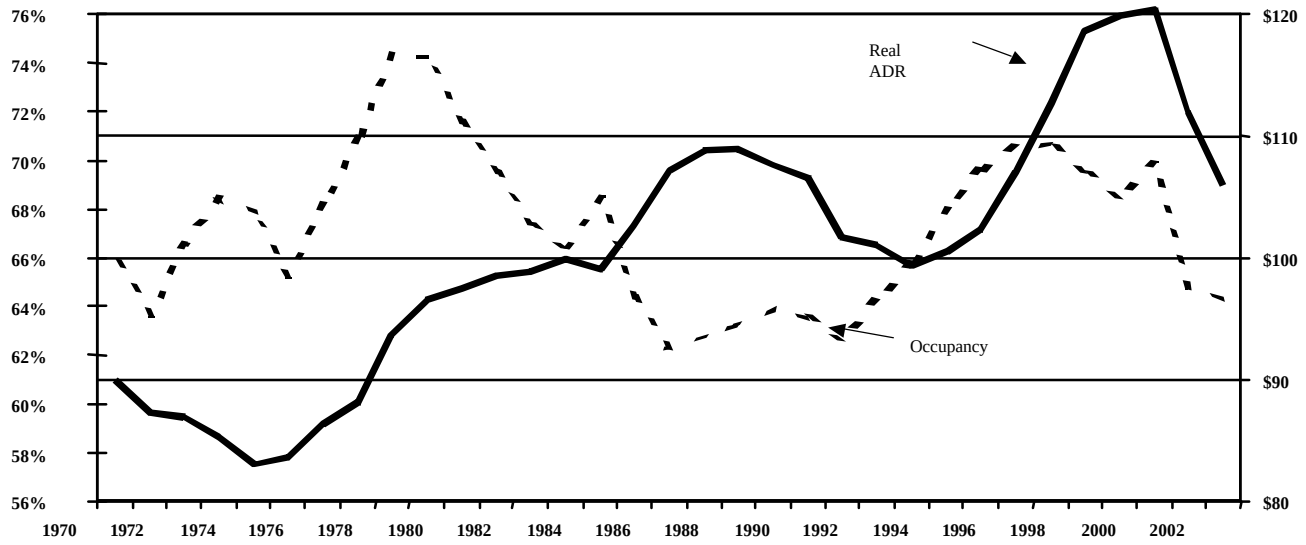
Whether we want to accept the fact or not the hotel business (both the sale of rooms and assets) is a cyclical business. Cycles exist in the hotel business for some good and well documented reasons. Most importantly, hotels are not the same as most other commodities like, say, tooth paste. By this I mean that when the demand for rooms suddenly spikes, as it did during the recent holiday season in New York City, the supply of rooms cannot correspondingly expand within a short period to satisfy the new level of demand. Should the same circumstances occur in the market for tooth paste, producers will turn up the machinery not operating at full capacity, add another work shift, and turn out more tubes before you can say 'dental bills.' Thus, hotel supply change lags demand in both the upward and downward directions meaning that RevPAR persists at relatively high levels and growth rates following an upward movement in demand and RevPAR persists at low levels and growth rates following a decline in demand.

The cycle's story just told appears quite tragic unless participants are somehow clever enough to predict the turning points and avoid downturns and troughs. Despite the financial wreckage they created in the past, hotel cycles now generate some underappreciated predictive powers. These powers are fueled by the availability of Smith Travel Research and other data covering a complete cycle (i.e., down from 1987 to 1992, up from 1992 to 2001, and down from 2001 until quite recently). During the latest complete cycle, all the moving parts behaved much as economic theory suggests. If the hotel market recently made an upward turn at the bottom of the cycle as many feel, then we have in our possession the map of how a recovery will unfold. In this article, I attempt to use the knowledge gained during the latest complete cycle to chart a near-term course of events in the U.S. hotel market.

OCCUPANCY AND ADR CYCLING THROUGH TIME

The existence of hotel market cycles is a well-recognized phenomenon.[1] Smooth and regular fluctuations around an equilibrium level may occur for two reasons. First, a strong correlation exists between measures of national and local market economic activity (e.g., GDP, real personal income, and employment) and hotel demand. Consequently, cyclical patterns in hotel performance measures emanate from business cycle patterns through the demand side of the market. Second, supply changes should logically follow shifts in demand, albeit with long delivery lags. If the business cycle is smooth and construction predictably responds, then the hotel market cycle will have a correspondingly smooth appearance over time. [2]

Exhibit 1—Patterns of U.S. Hotel Occupancy and Real Average Daily Rate (ADR), 1970-2002



Source: PKF Consulting

Abnormally wide swings in hotel market performance observed during recent decades occurred because of shocks to the economy and hotel markets. These events either impacted the supply of hotel rooms, demand for hotel room nights, or both. Government intervention of the early 1980s, for example, artificially inflated the supply of hotels. With occupancy already below normal levels in the late 1980s, the recession and Gulf War in the early 1990s stymied the market recovery. Similarly, the combined effects of the demand-based general economic recession beginning in 2001, the terrorist attacks in September 2001 that created a stigma on domestic and international travel caused demand for air travel to plummet, and the Iraqi war produced steep declines in hotel occupancy and average daily rate (ADR) during 2001 and 2002.

Exhibit 1 shows the cyclical patterns of occupancy and real ADR for U.S. hotels during the past few decades. The following observations come from an examination of these trends:

1. Occupancy has a definite cyclical pattern. This pattern appears smoother since the late 1980s, which may be the consequence of lower information costs. [3]
2. The pattern of real ADR also appears cyclical, albeit with an upward trend.
3. During two periods, 1972-1974 and 1985-1987, occupancy and real ADR moved in opposite directions. These atypical and anomalous movements are likely the result of the federal government policies in place during those respective times. [4]
4. Since the early 1990s, and for some years before 1990, occupancy leads ADR just as economic theory predicts.

EVENTS DURING THE HOTEL CYCLE

The economics of hotel markets suggest that occupancy represents the current relationship between demand and supply. Occupancy reaches levels above (below) normal when demand exceeds (less than) supply. During periods of abnormally high (low) occupancy, ADR increases (decreases) causing occupancy to fall (rise). The economics of hotel markets also suggest that ADR represents the current relationship between demand and supply, and accordingly, ADR reaches levels above (below) normal when demand exceeds (less than) supply. Once ADR reaches a level in the market for which development becomes feasible. To complete the market process, hotel construction eventually satisfies the excess demand that drove occupancy and ADR above normal. As more rooms are added to the stock, occupancy and ADR fall back to normal levels. At the peak of the cycle the market may become unstable with supply growth continuing after demand is satisfied (i.e., overshooting). This problem of overbuilding is an unfortunate byproduct of cyclical markets.

Exhibit 2—Hotel Market Cycle

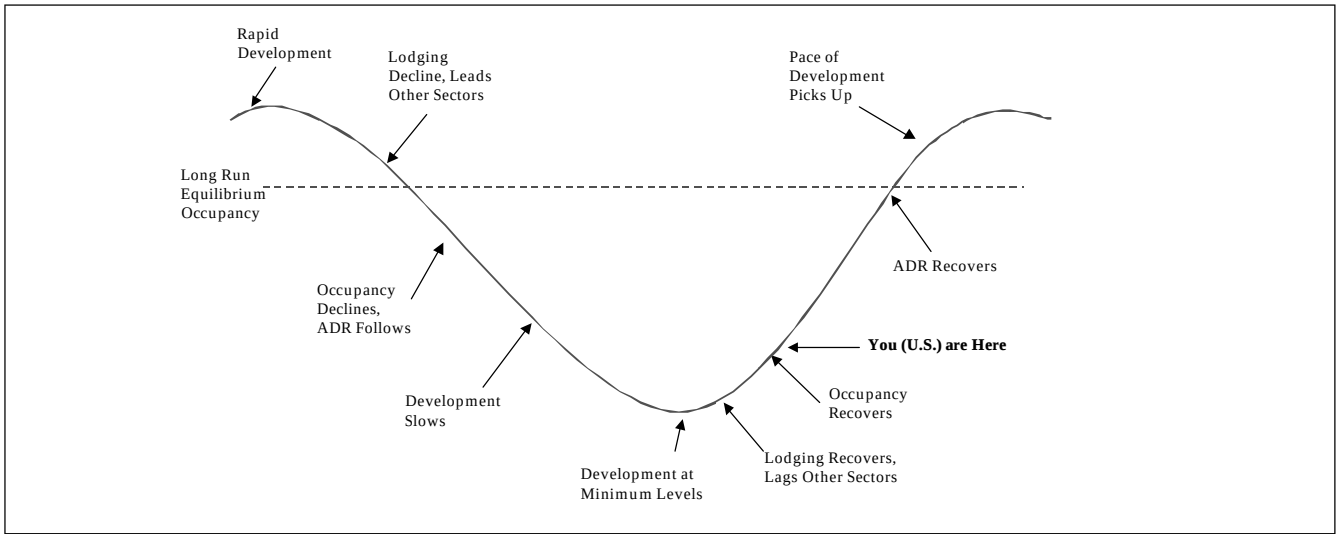


Exhibit 3—Hotel Market Processes in a Normal Cycle and Following Extraordinary Events

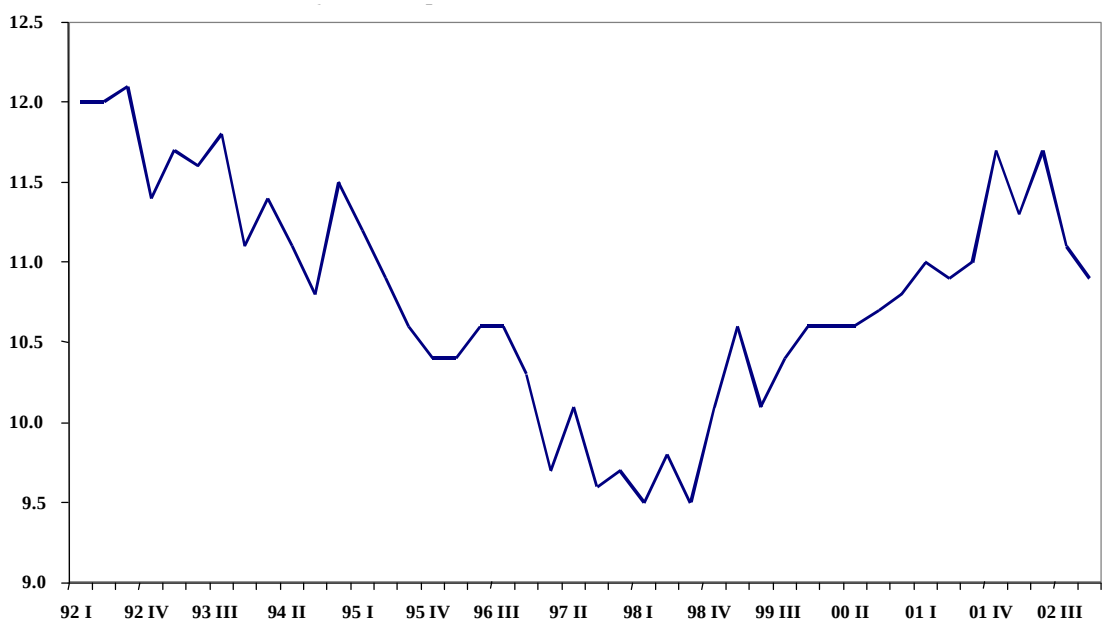
Market Condition	Demand Response	Occupancy	ADR	Supply
Upward Movement Toward Peak	Normal rate of increase	Immediately increases with increase in demand	Increases lag occupancy, accelerates as occupancy approaches natural level	Construction begins as ADR approaches feasibility level
Downward Movement From Peak	Normal decline	Decrease occurs immediately	Decrease occurs with a definite lag	Construction slowly comes to a halt
Severe Demand-Based Recession	Rapid decline	Immediate and rapid decline	Decrease with short lag	Construction stops abruptly
War or Catastrophic Event	Rapid decline	Immediate and rapid decline	May be frozen until duration is determined	Construction delayed until duration is determined

Exhibit 2 presents a graphical representation of the hotel market cycle. The hotel market process involves an observable lag between occupancy change and ADR adjustment. [5] As markets move from the peak of the cycle to the trough, such as during the recent cycle phase from 1998 to 2002, softness in demand forces hotel managers to reduce room rates in an effort to maintain occupancy percent. [6] These actions retard the decline in occupancy during periods when demand drops. The opposite of this process occurs as markets move from the trough of the cycle to the peak. An increase in the demand for hotel rooms causes immediate improvements in occupancy. The upward trend in occupancy moderates as hotel managers begin to raise room rates, which begins occurring as occupancy approaches the natural level of the market. Exhibit 3 provides a summary of how markets 'should' behave through an ordinary cycle and in response to external events.

HOTEL CAP RATES APPEAR COUNTER CYCLICAL

Hotel construction reacts to two market signals. The first signal, discussed above, comes from the market for rooms in the form of occupancy and ADR growth reaching levels that make debt and equity financing of hotel development feasible. The second comes from the asset market in the form of pricing that makes it profitable to build and sell hotels. If these two signals conflict then

Exhibit 4—Quarterly Hotel Capitalization Rates, 1992 I—2002 IV



prediction becomes quite difficult.

Exhibit 4 presents a ten-year history of full-service hotel cap in the U.S. Fortunately, hotel cap rates appear to move in a counter-cyclical pattern, and thus valuations in the capital market follow the same pattern as occupancy and ADR. The highest rate of slightly above 12% occurred at the end of the early-1990s recession. The average rate reached 11.7% during the recent recession, but fell sharply over the past two quarters. Hotel cap rates moved downward and broke through the 10% barrier for several quarters in 1997 and 1998 when the economy and market for hotel rooms was rapidly expanding. In theory, hotel cap rates should continue to conform to the counter-cyclical pattern they followed during the past ten years because hotel property values logically decline (rise) as incomes become more (less) risky.

PREPARING THE MAP FOR 2004 AND 2005

Armed with recent evidence about the cyclical behavior of the hotel markets can we make any predictions? Returning to Exhibits 2, it appears that the U.S. hotel market at the start of 2004 is in the early stage of an upward movement toward a peak. This movement is conditioned by the general economic recovery which governs its direction. Theory suggests that modest increases in occupancy starting in 2003 IV will continue until occupancy percents reach the long- run average (i.e., somewhere between 65 to 70% in most local markets). As the market approaches this point, hotels will be able to begin increasing room rates.

From thereon up the slope, occupancy gains will slow and room rate increases will begin to dominate RevPAR growth. In some metropolitan markets, such as New York, occupancy is already near the long-run average. Econometric forecasts from the Hospitality Research Group and Torto Wheaton Research Hotel Outlook indicate that many major markets in the U.S. will experience occupancy at long-run average levels by the end of 2004, meaning there will be room rate growth in 2004 as well. During 2005, room rates will begin approaching development feasibility levels.

What does the cycle pattern not help predict? First, cycles have turning points that are nearly impossible to forecast because they often occur as a consequence of unpredictable external stimuli. Second, the extent of overbuilding cannot be anticipated. Academics and financial institution regulators are focusing considerable attention to the problem of real estate market overbuilding today. [7]

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ENDNOTES

1. See Mueller (2002) for a recent literature review of the real estate cycle literature. Wheaton and Rosoff (1998) is the seminal work on hotel market cycles.
2. Some argue that construction of hotels and certain other property types does not respond predictability, but instead, supply behaves with a 'mind of with a mind of its own'. See Torto and Wheaton (2002).
3. In 1987, Smith Travel Research began regular and public reporting of hotel rooms available, rooms sold, and ADR for the U.S and local markets. The availability of these data immediately enabled developers and capital suppliers to begin making better decisions about supply additions in response to changing demand.
4. For a discussion of real estate cycle effects from policies in the early 1970s, see King and McCue (1987). The disruptive effects of federal policies from the early 1980s on real estate markets are documented in Corcoran (1987) and Hendershott and Kane (1992).
5. This lag is documented in PriceWaterhouseCoopers (2002).
6. Estimates of the price elasticity of demand for hotel rooms place the value at approximately -.4. This means that when ADR falls revenue will likely fall because the positive revenue effect of the increase in the number of rooms sold will not offset the negative revenue effect of ADR erosion.
7. See Corgel (2003b) for a review.

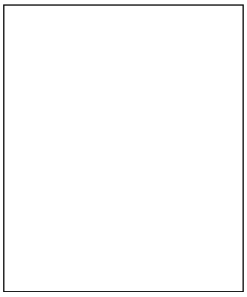
ABOUT OUR FEATURED COLUMNIST

John "Jack" B. Corgel, Ph.D., joined the Hospitality Research Group (HRG) of PKF Consulting in 1999 as managing director of applied research. There, he is developing new products for the hotel industry based on property-level financial performance information. Prior to joining HRG, he was a member of the Cornell Hotel School faculty for 10 years and served as the first director of the Center for Hospitality Research from 1992-1994. He is widely published in academic and professional journals and is a fellow of the Homer Hoyt Institute. (E-mail: jc1616@pkfc.com)

FOCUS ON THE ECONOMY

ECONOMIC REPORT CARD: PROGNOSTICATION

by Mark Lee Levine, CRE, PhD



Mark Lee Levine, CRE, PhD

The purpose of this short note is to provide decision-making information regarding economic indicators relative to the broad market, especially with regard to real estate markets. Many factors create concern for local economies, as well as for national and international economies.

Consumers have been given a strong dose of uncertainty, due to such factors as terrorism, SARS, mad cow, inconsistencies in real estate markets, war issues (notwithstanding the termination of "formal war" in Iraq), lingering impacts of the technology collapse throughout the world (and certainly throughout the United States), financial issues (including tax cuts that impact economic recovery for the U.S.), increases in medical expenses, pharmaceutical costs, other medical treatments, etc. The good news is that unemployment has recently declined somewhat when compared with one year ago. Continued concern with economic positions in and outside the United States seems to result in inconsistent consumer spending patterns.

With an upward movement in the stock market, the comfort and assurance of a trend line moving up, and staying up, is still in question. However, as of January, 2004, the stock market was looking much stronger. The market continued to rise through December and showed very favorable increase to a consistent position above 10,500. The question remains as to whether the stock market, and general markets, can sustain a growth position, especially into the first half of 2004. On the other hand, the favorable growth rate toward the end of 2003, low interest rates that persist, the strong housing market, strong consumer confidence and the election year all bode well for a good year 2004, absent other major negative forces, such as terrorism.

Some hesitancy for consumers to spend results in some monies being kept on the "sidelines." However, the strong increase in the stock market supports more commitments to equity positions, and less money waiting on the "sidelines" for investment opportunities, especially with bond and savings rates at very low earning levels.

As most economists note, there is little doubt that the economy would be in an extremely difficult position, far below the current posture, were it not for low interest rates currently enjoyed in many sectors of our economy, especially with recent real estate refinancing.

Although the housing market has generally remained strong (within Colorado, and in general throughout the U.S.), current figures indicate that those numbers are changing somewhat, especially with higher-priced homes.

The National Association of Realtors (NAR) and the National Association of Home Builders (NAHB) have supported the position of continuing strength in housing markets, even if the pace was slowing somewhat in some areas of the United States, and in some pricing markets for homes.

Many leading U.S. economists are predicting a 4% to 5% Gross Domestic Product (GDP) range of growth for 2004.

In The Economist, p. 75 (November 29, 2003), there was a notation on the broad scope for the world housing market that, although housing prices are strong in many areas, there is some concern with an overbuilt position. This does not mean that prices are ready to crash, as noted in this article. Citing John Wrigglesworth, an economist at Hometrack, a British property firm, "There is more chance of finding Elvis on the moon than there is of a house-price crash next year." This also does not mean that the housing market is not overpriced in some areas.

As noted in The Economist magazine, real house prices have increased at an average annual rate of between 8% to 12% in Australia, Britain, Ireland, The Netherlands, and Spain. As such, the argument is that such position cannot be sustained. In fact, The Economist article noted: "House prices look unsustainable in Australia, Britain, Ireland, The Netherlands, Spain and large parts of America." However, this article also noted that the existence of such bubble does not mean that there will be a crash. How much prices will change, if any, whether in the United States or these other countries, remains the key question.

With limited opportunities to invest in other areas for a favorable return, low interest rates, and consumer confidence at a high level, at least speaking relative to the United States overall, it is likely that the larger housing market, on a macro basis, will remain fairly strong for 2004. Nevertheless, certain markets remain somewhat weak, or are weakening, such as high-priced homes in many markets.

According to the Meyers Group Report (November 7, 2003), the housing market remains strong. The Report noted that prices for existing homes climbed to an annualized level of almost $6.7 million. The national median price of the resale home moved down to $172,300. On the other hand, new home sales continued a strong pace and showed a median price at $187,400 on a national level.

On the commercial side, it is incongruous when the Net Operating Income (NOI) has been dropping in many markets, yet sales prices have been increasing in those same markets with various types of commercial property. In other words, the capitalization rate has been dropping with the income also dropping. This inconsistent position can be explained in part by the low interest rates, positive attitude for appreciation, and lack of alternatives to place money, from an investment standpoint. Where 8% might not have been an acceptable return two years ago for commercial real estate, whether that be for office buildings, retail, industrial or otherwise, 8% is now an acceptable rate, and even a rate sought after in many markets today, especially given the slower returns in the bond market.

If the appreciation in real estate does not materialize, if interest rates increase rapidly, and/or if other non-real estate alternatives are available for investments, such as the stock market, one will most likely see a termination of the inconsistent behavior noted (NOI dropping and cap rates dropping), and a return to a more routine and historically acceptable relationship of capitalization rates and Net Operating Income (NOI).

Most retail investment real estate rates continue to be tied to a (strong or weak) job market position. If jobs are plentiful and at favorable compensation rates, there is more opportunity for consumption. Jobs drive the marketplace in both commercial and residential real estate.

The job market position has been improving, overall. Absent other negative signs, this, alone, is a positive factor that supports an increase in both residential and commercial markets.

The residential market has been strong in the last two years, even in a weaker commercial setting. Therefore, greater improvement will probably come about in the commercial markets, assuming that other positive signs remain, such as unemployment dropping and favorable, low interest rates continue.

Certainly markets vary throughout the country. In Denver, Colorado, the median-priced home is substantially higher than the national average, as indi-

cated earlier. The median price for a home in the Denver Metropolitan Area for existing single-family homes is approximately $236,000, whereas the national average is substantially less. Obviously the median-priced home will vary throughout the country, e.g., where one looks to a higher-priced market, such as New York or San Francisco, as compared with a more limited market in smaller communities throughout the United States.

What remains in the market is still uncertainty due to many factors which impact the market. Nevertheless, there are some trends that many are predicting are taking place. For example, Mr. Sam Zell, Chairman of Equity Office Properties Trust, was quoted in the Texas Commercial Real Estate Outlook Conference in December, 2003, that there is tremendous risk of obsolescence within the market. Mr. Zell also noted that real estate is competing for capital in other markets, and the transparent nature of financial positions is making the competition that much more apparent, especially in light of major real estate investment vehicles, such as REITs.

IN SUMMARY, it appears that the real estate market, the stock market, and generally the investment side of the market are gaining steam and indicate signs for a very positive 2004, absent major negative changes, such as a substantial increase in interest rates, terrorism, budget deficits, or anything else that might create a negative consumer confidence position and hesitancy by major businesses to further stimulate and grow in the market.

There remains concern in the marketplace with the amount of personal debt that has increased in the last two years as a result of the favorable lower interest rates. This issue was recently noted by many economists. This same point was raised by Mr. John Talbott, the author of "The Coming Crash In the Housing Market." Concern with increased leverage and debt positions by consumers and some businesses raise a specter of worry, if continuing negative signs are incurred as the economy begins to pick up steam.

It will remain problematic for some commercial office space positions to show strong growth, given the lower rates that have persisted for office rentals in the last two years, coupled with increased vacancy rates. It will be at least several years in some major markets throughout the United States to absorb the inventory of office space now present.

GRADE	RANGE	PERCENTAGE
A	"Superior," great shape	90% and up
B	"Above Average," good shape	89%-80%
C	"Average," O.K.	79%-70%
D	"Below Average," poor shape	69%-60%
F	"Failed," troubled areas	59%-down

Concern with the economic recovery and growth positions hinges largely on favorable lower interest rates. As those interest rates increase, the evidence clearly indicates an increase in default positions, especially with regard to leveraged acquisitions that have been created in the last few years. This point was illustrated very clearly in an article by John Salustri, "Recovery's Downside," Real Estate Forum, p. 49 (November, 2003). The author noted in this article: "One of the oddest facts of this rather strange recession is that, as the economy once again gets back on its feet, the number of defaults is likely to increase." The author noted that the strong causation factor of such defaults is generally increasing interest rates.

The economy will swallow hard, hiccup, burp, cough, have indigestion problems, face a few headaches, and possibly need the Heimlich maneuver, but it will recover. Some of the questions are: How soon it will recover? In which markets will it recover the fastest? Who will be the beneficiaries of such recovery? Who will suffer the losses when parts of the market are damaged because of increased interest rates that, apparently, will be with us in the near future? The "answers" will follow—in time!

The grading scale for performance of the economy relative to the real estate market utilizes the following grading letters and percentages. The grading, succinctly stated in the following areas, might be considered to be as follows:

Further, gradations within these areas are indicated by a plus (+) sign for a higher grade, such as B+ (meaning higher than just "Above Average" or better than just in "good" shape).

To the contrary, a minus sign (-) indicates below the level of that letter, such as a B- (indicating somewhat below than just "good" shape).

GRADE:

A- SINGLE FAMILY HOMES: Although sales of single-family homes have slowed in some of the higher-priced homes, the market is extremely strong and continues to be strong in many areas throughout the United States. There are weaker pockets of some housing U.S. markets, and especially in the higher-priced homes.

C+ MULTI-UNIT RESIDENTIAL PROPERTY: Vacancy rates have increased in many areas, but other areas are seeing a leveling out, or even a slight dip in vacancy rates. It is anticipated that these rates will continue to drop in many markets in 2004.

C OFFICES: Offices in many metropolitan areas have larger inventories and higher vacancy rates than most investors would like to see. However, there seems to be a leveling out of some of the vacancy rate positions in some Class A space.

B- RETAIL/SHOPPING CENTERS: Retail space seems to be surprisingly resilient, and stronger consumer confidence levels speak generally well for the retail market, even though in some sectors of the U.S. markets an overabundance of retail space exists. The continuing concern with terrorism raises questions of confidence levels, although recent events, such as the capture of Saddam Hussein in Iraq, seem to lend support to increasing consumer confidence, with the hope that markets settle throughout the world.

B INDUSTRIAL/WAREHOUSES: Industrial/warehouse space seems to show a reasonable pattern of occupancy. Although some pockets have increased vacancies, occupancy seems to be holding, and even reducing in several areas.

C HOTELS/MOTELS: Hotel and motel vacancy rates are dropping somewhat. However, this is still not a strong market. Recovery will take some time in this area of the investment field.

C+ SPECIAL-USE PROPERTY: Other special-use properties, such as in resort areas, continue to be reasonably supported as a result of some increasing consumer confidence. However, it is a tenuous area, given general volatile consumer confidence as well as overbuilding in some areas. Therefore, this area remains of concern in 2004.

A FINANCING RATES: Lower interest rates remain strong and favorable, despite a slight increase lately in interest rates.

A REFINANCING RATES: Likewise, refinancing rates remain favorable and also are supportive of a general good economic outlook. However, most of the refinancing of the residential market has taken place; therefore, there will be weakening volume in this area.

IN SUMMARY: The real estate market is, at best, in a very lethargic position. It will likely continue such posture, on a macro basis, until there is even more improvement in general consumer outlook, elimination or reduction of war issues and terrorism issues, and an absorption of existing real estate products that exist in many sectors.

ABOUT OUR FEATURED COLUMNIST

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