REAL ESTATE ISSUES

THE COUNSELORS OF REAL ESTATE™
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LEGAL ISSUES & REAL ESTATE

REAL ESTATE ISSUES

1976 - 2000
Celebrating 25 Years of Publishing Excellence

EDITORIAL CALENDAR

Fall 1999
Focus Edition - Legal Issues & Real Estate

Winter 1999
Articles on general real estate-related topics
(deadline for manuscript submission - November 22)

Spring 2000*
(deadline for manuscript submission - January 1)

Summer 2000*
(deadline for manuscript submission - April 1)

Fall 2000*
(deadline for manuscript submission - July 1)

Winter 2000*
(deadline for manuscript submission - October 1)

(Topics for editions produced in 2000 will be available 11/15/99)

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The Counselors of Real Estate, established in 1953, is an international group of high profile professionals including members of prominent real estate, financial, legal and accounting firms as well as leaders of government and academia who provide expert, objective advice on complex real property situations and land-related matters.

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Clarification Note: In the CRE PERSPECTIVE: *The Real Estate Industry Paradox*, by Scott R. Muldavin, CRE, (Vol. 24, No. 2, pgs. 66-68), *Figure 1*, "Overall Capital Flows Near Historic Norms," is based on information from The Roulac Capital Flows Database created and prepared by Scott Muldavin while previously employed at The Roulac Group.

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REAL ESTATE ISSUES

EDITOR'S STATEMENT - by Richard Marchitelli, CRE

Advocacy and objectivity; paradox and ambiguity; conflict and resolution–these are some of the characteristics of legal disputes. This edition of *Real Estate Issues* is devoted to real estate and the law, common problems in the legal and real estate communities, and strategies designed to solve them.

The first manuscript, authored by **General M. Levy, CRE**, is an in-depth discussion of the many and varied forms of arbitration, mediation, and other forms of alternative dispute resolution (ADR). The second article, which is equally comprehensive in scope, is a compilation and analysis of case law across the nation dealing with property taxes and contamination. The authors, **Robert P. Carver, Esq.**, and **Anthony W. Crowell, Esq.**, provide a balanced presentation in an attempt to lend clarity and understanding to court decisions that are sometimes contradictory and often raise more issues than they put to rest.

Other articles deal with new, important evidentiary rules in qualifying expert witnesses **(McLean, Kilpatrick,** and **Mundy)**, the country's evolving attitude toward property rights **(Joyce, McGuire, Shepard)**, and a number of other interesting topics.

As part of its on-going effort to improve the format and content of *Real Estate Issues*, the Editorial Board has initiated several changes in this issue. They include the introduction of new departments or columns that will be authored by the same individuals on a regular basis. Some columns will appear in every issue; others will appear in every second edition. The columns will be known as **"Insider's Perspectives"** and will focus on REITs, the economy, legal issues, research, the hospitality industry, corporate real estate, etc. To inaugurate this program, **Sam Zell** and **Hugh Kelly, CRE**, have authored columns on REITs and the economy, respectively. Some future contributors include **Peter Korpacz** and **Raymond Torto, CRE,** (research), **Bjorn Hanson, CRE**, (hospitality industry), and **Edwin Howe, Jr., CRE**, (law). Other innovations will be introduced in the Winter edition, which will mark the beginning of the 25th Anniversary year of *Real Estate Issues*.

Richard Marchitelli, CRE
Editor in chief

Jonathan Avery, CRE
1999 National CRE President

Resolving Real Estate Disputes

by Gerald M. Levy, CRE

A man who is master of himself and always acts with sang-froid has a great advantage over him who is of a lively and easily inflamed nature.... for in order to succeed in this kind of work [negotiation], one must rather listen than speak; and... phlegmatic temper, self-restraint, a faultless discretion and a patience which no trial can break down—these are the servants of success.

- François de Callières, Court of Louis XIV
On The Manner of Negotiating with Princes, 1716

Traditionally, real estate industry disputes rely on negotiation for solutions; if negotiation fails, litigation is often initiated. This survey article details generic real estate disputes that fit into this common framework. A subsequent examination of negotiation — the core method of conflict resolution — emphasizes a range of strategies, tactics, behaviors, and processes which permeate a wide range of other dispute resolution methods that are briefly described. The contested assets can be homogeneous or heterogeneous and, individually, can be divisible or indivisible. The assets may be physically embodied or only conceptual rights.

GENERIC REAL ESTATE DISPUTES

Generic disputes include, but are not limited to, the following issues:

- The land value, percentage rate of return, and/or economic land rent for a renewal period of a land lease agreement;
- The economic rent for a renewal term for office, retail, industrial, or special-purpose space when the renewal period is to be set at the "going rate";
- The appropriate remedy for lease disputes involving revenue issues, expense escalation reimbursements, and operational, occupancy, and use issues;
- The market value of land, improvements or both as provided in a

ABOUT THE AUTHOR

Gerald M. Levy, CRE, MAI, *is a real estate counselor in New York City. Previously as a managing director at Chase Manhattan Bank, he led acquisition, disposition, leasing, financing, restructuring, workout, and corporate real estate activities. Mr. Levy drafted the* Arbitration Rules for the Real Estate Industry (Including a Mediation Alternative) *for the American Arbitration Association. (E-mail: GMLEVYLLC @aol.com)*

lease agreement that grants the lessee a purchase option at an unspecified price;
- The market value of a partial interest in real estate including a mortgage or an equity position, leased fee, leasehold estate, sandwich leasehold, sub-leasehold, air rights, transferable development rights, subsurface rights, easement, and life estate and remainderman interests;
- The market value of a fractional ownership interest in a property in order to arrive at a "buyout" price under the terms of a partnership or other joint-ownership agreement;
- The market value, if any, of a future purchase option, right of refusal, right of last offer, and similar features;
- The appropriate remedy concerning a dispute about the terms and conditions of a real estate contract or partnership agreement;
- A decision in the construction phase of a real estate development concerning timing, scope of work, quality, and/or costs and the apportionment of obligations and benefits among the architect, owner, contractor, and tradesmen;
- A decision on whether or not a real estate commission has been earned and is payable;
- The appropriate remedy in a title dispute;
- The appropriate remedy in a dispute about the terms and conditions of a real estate loan or loan default;
- A decision rendered in a condominium, cooperative, or owners' association dispute;
- A decision in a tax *certiorari* dispute;
- A decision concerning just compensation in a property condemnation case;
- The equitable allocation of a portfolio of real estate assets among claimants arising from an estate settlement, divorce settlement, the unwinding of a joint-venture, or the dissolution of a business entity;
- Resolution of a dispute involving land use and zoning issues;
- The relative impact on real estate value of adverse environmental conditions;
- A decision concerning a dispute involving hotels, motel, clubs, or casinos;
- A decision in a dispute between real estate investors residing in different countries.[1]

THE NEGOTIATION PROCESS

Negotiation may resolve many of the generic disputes which have been categorized. It is an interest-based decision-making process with the participants bargaining to resolve differences of opinion concerning the apportionment of responsibilities and benefits. A great dispute resolution practitioner, Theodore W. Kheel has concluded, " It is the primary technique of conflict resolution."[2] Negotiation is a frequently employed resolution method in the economic, political, social, and personal spheres.

Any specific negotiation often begins with no rules and always with no accepted facts. The respective negotiators must reach a consensus concerning a set of rules for conducting the negotiation; otherwise, confusion and chaos are likely and the chance for a positive outcome is much diminished.

Similarly, at the commencement of the negotiation process there are no established facts or non-facts (even if in the greater world beyond the negotiation certain information is so classified). In a particular negotiation, the conversion of information to a "fact" is dependent on its assertion as such by one of the parties and whether or not the other party accepts it, implicitly concedes it, challenges it, or rejects it. This dynamic is one that is constantly experienced in negotiation. Relative degrees of power and persuasiveness determine which assertions become recognized facts.

The stages of the negotiation process can be segmented into phases. This author prefers a four-phase model:

The ***pre-negotiation phase*** consists of exploring, planning, and preparing a detailed presentation concerning the issues to be negotiated and the formulation of strategies and tactics for achieving one's goals. One should rank the relative importance of the range of identified issues. In this phase, one seeks out as much information as possible about the dispute and the composition of the other negotiating team and its viewpoints. Role-playing may be utilized to develop many of the arguments that could be used by the other party. Consequently, the persuasiveness of the presentation can be strengthened.

The ***presentation and negotiation phase*** consists of general comprehensive statements identifying positions and goals, non-negotiable issues, give-ups, and reasons. The goal is to exercise best efforts to achieve the other party's understanding of your point of view; to build trust; constructively question the opposing position; create doubt; and promote changes in points of view. Give and take has hopefully begun and continues.

The ***intense negotiation phase*** includes continual reframing of requirements, heavy bargaining,

and bidding leading to "the crunch" or "...that point in a negotiation when no decision becomes a decision. Until the crunch, the parties will most often hesitate before making any significant changes in their positions. The crunch signals that the time for decision-making has arrived with rewards for the right decision and penalties for the wrong one."[3]

The ***agreement and closing phase*** is based on all the prior activities and leads to a provisional agreement. This agreement is then embodied in a writing which must be ratified by all necessary constituencies including senior management and any third party ratifiers. When all approvals have been obtained, the transaction is closed and any post-closing implementation or monitoring is performed.

COMPETITIVE, COOPERATIVE, INTEGRATIVE, AND COMPOSITE CHOICE STRATEGIES

Competitive, cooperative, integrative, and composite choice strategies may be chosen by a party to a negotiation for the communication of views and implementation of actions that flow from a specific negotiating position.

A negotiator pursuing a ***competitive*** or ***distributive strategy*** presents a very tough and rigid position; provides little information; employs aggressive arguments variously embodying demands, ultimatums, threats, tricks, and bluffs; and offers no or few concessions. A competitive strategy assumes a zero sum game where one side's gain is the other side's loss.

In a ***cooperative strategy*** the negotiator presents his case in a constructive manner; supplies a lot of information; employs seemingly moderate, balanced, and feasible arguments; and may even offer a minor initial unilateral concession. The governing assumption is that a constructive relationship embodying respect, reliability, and trust will produce a fair and equitable solution for both parties. On a trusting basis, each side may be motivated to re-consider its own position as well as the other side's views and make reasonable adjustments to arrive at an agreement and maintain a future relationship.

In an ***integrative strategy,*** the negotiators do not assume a zero sum game and after initial presentations, may use "brainstorming" sessions to try to provide maximum benefits to both parties. In brainstorming, the existing conflict paradigm is broken down and new ways of thinking about the problem are encouraged. This results in additional options for solving the problem, including opportunities for value creation rather than each side just claiming an existing finite value. The basic guidelines of this strategy are: "1). separate the people from the problem; 2). focus on interests not positions; 3). invent options for mutual gain; and 4). insist on objective criteria."[4] The goal of an integrative strategy is a fair settlement arrived at in a friendly and efficient manner. Both parties may equitably share in a larger array of benefits beyond those initially contemplated by the parties.

Any specific negotiation often begins with no rules and always with no accepted facts. The respective negotiators must reach a consensus concerning a set of rules for conducting the negotiation; otherwise, confusion and chaos is likely and the chance for a positive outcome is much diminished.

Utilizing a ***composite choice strategy*** a negotiator must decide at each step of the process whether he should employ a competitive, cooperative, or integrative approach. A composite set of choices may embody leverage and seeking advantage but also involves problem solving, creative thinking, and a convincing rationale combined with balanced judgment. As the parties feel more comfortable with each other and are more willing to modify their positions, a variant of this composite choice strategy may occur wherein the parties move together from a competitive strategy to a cooperative and/or integrative mode. The end goal is a reasonable outcome for each side.[5]

THE NEGOTIATOR'S DILEMMA AND THE NEGOTIATION DANCE

Two other concepts which are worth considering are the ***Negotiator's Dilemma*** and the ***Negotiation Dance.*** Consider: one could choose a cooperative, integrative, or composite choice strategy and energetically think about the existing issues in new ways of creating value. The other side uses a competitive strategy and just claims value. Will the party having taken the high road, necessarily lose in the negotiating process? [6]

No, but they will have to employ tactics which enable them to convince the other side that its aggressive and competitive style will not be allowed to run roughshod over their position. Among the tactics for deflecting an aggressive competitive strategy are taking a breather to maintain one's "cool"; listening, acknowledging, and agreeing, when possible, thereby reinforcing respect for emotions and opinions; but requiring substantiation, reframing views and creating doubts that an aggressive strategy will achieve a total victory in the negotiation. It is wise to leave the other party leeway for a dignified retreat and flexibility for the concessions which are likely to accompany it.[7]

The ***Negotiation Dance*** consists of the pattern of concessions by each side which attempt to close the gap in substantive positions. Negotiation tactics include presentations, offers, probings of evidence, and counter-offers, as well as more aggressive methods such as threats, ultimatums, bluffs, and tricks. Generally, tactics lacking in credibility will work against one's goal of reaching a satisfactory agreement.[8]

THE CONTEXT OF NEGOTIATION

No matter what strategy is selected, many negotiations occur in a complex context with dynamics that may only be partially revealed at the bargaining table. Besides the two or more parties negotiating, there may be other covert factors at work in sidebar conversations, internal constraints, and organizational dialogue.

Often in a sophisticated commercial negotiation, the leader of each negotiating team most also obtain cooperation, support, and agreement from his own team members. Members of the team may be characterized as "stabilizers," "destablilizers," or "quasi-mediators."[9] When a negotiation position is explained and backed up with persuasive data, stabilizers tends to "go along" with the senior team leader. Stabilizers tend to dislike conflict and are flexible "good soldiers" in their organizations.

Destabilizers are more headstrong and volatile. They can disrupt both the other side and their own team and usually believe they have all the right answers and completely distrust the other party. However, within bounds, they may serve a useful purpose in strengthening resolve and in testing reality.

It is often best if the leader of the negotiating team is neither a stabilizer nor a destabilizer but a quasi-mediator who can build a good relationship both with his/her own team and with the leader and members of the other team. He/she must also keep his/her own senior management informed, because, after all, they have the authority to ratify and close on an agreement; they should not be surprised during the negotiation process.

The senior team member must work constructively with the other side and the members of his/her own team. He/she periodically calls a recess from negotiating to caucus with his/her team before stating or agreeing to a change in position in order to think out an issue and maintain and build support among other team members. The team leader must contribute continuously to a reasonable negotiating climate with systematic creation of appropriate doubts about the cogency of the other party's views by employing constant communication, education, and persuasion. He/she often encourages mutual concessions to reach an appropriate businesslike closure. In a dispute which has public interest and visibility, the senior negotiator must perform media and public relations functions effectively.

Ironically, in order to achieve agreement, each team leader must be convinced of the validity of some of the other party's arguments. He/she must become the advocate of some opposing views; otherwise, ratification and closure are unlikely since the leader will fail to convince his/her own management to make concessions.

Before commencing any negotiation, one should formulate the best alternative to a negotiated settlement (BATNA). What are the reasonable alternatives and which is the best one of them? The best alternative is the BATNA. If the negotiated offer is better than BATNA, consider accepting it; if worse, try to obtain improvements; if one is unable to obtain enhancements, exercise BATNA.[10]

The success of a negotiation is often dependent on whether there is an effective bargaining continuum or an overlap in the "ask" and "settle" end points in each side's formulated span of acceptable negotiation results. If there is overlap, there may well be an agreement; if an overlap is not indicated, settlement is unlikely.[11]

DISPUTE RESOLUTION METHODS

If one is aware of the activities embedded in each phase of the negotiation process and is familiar with typical strategies and tactics which can be deployed in a complex and subtle negotiation

context, a professional has a foundation of knowledge for possibly choosing an alternative dispute resolution method in a specific situation. Numerous methods which can be selected are briefly described here:

Fact Finding is a neutral's determination of the basic facts of a dispute and the identification of areas of agreement and disagreement. Depending on the scope of work agreed upon by the claimants, the neutral may or may not make settlement recommendations to the parties.

Mediation is a voluntary, non-binding method of facilitated negotiation under the auspices of a neutral third party. Its features include voluntary exchange of information and presentations. The mediator meets with both parties together and, subsequently, separately. The mediator can employ "shuttle diplomacy" in trying to reach an agreement. The process may feature a non-binding settlement proposal by the mediator. The mediator's proposal may be accepted by the parties or, under the auspices of the mediator, they may reach their own settlement. An agreement, if achieved, is memorialized in writing and signed.

Fact Finding-Mediation provides for a neutral to issue a fact-finding report after using mediation skills to obtain the parties acceptance of his conclusions prior to final issuance of the written document.

Conciliation is similar to mediation, but with a stronger behavioral emphasis on restoring good business relations among the claimants.

Facilitation consists of a neutral using negotiation and mediation skills to structure a process for the mediation of complex bilateral or multilateral disputes. At times, the facilitator's efforts are most intense at the earliest stages of the process when there is an emphasis on creating process rules acceptable to all parties.

Referee is a designated person who insures compliance with agreed upon dispute resolution rules. He/she may or may not participate in the formulation of the process.

Partnering is a non-binding collaborative process that focuses on activities keyed to preventing project disputes or reducing their scope. It is frequently used in the construction industry and usually concentrates on role definition, team building,

No matter what strategy is selected, many negotiations occur in a complex context with dynamics that may only be partially revealed at the bargaining table. Besides the two or more parties negotiating, there may be other covert factors at work in sidebar conversations, internal constraints, and organizational dialogue.

and organizational structure, together with improving information, communication, cooperation, and consensus. The process often takes place before a construction project begins.

Dispute Review Board (DRB) is particularly useful when there is a dynamic, fast moving situation such as the construction phase of a real estate development. Each of the two or more parties involved chooses a panel member; jointly, those chosen pick one or more neutrals. The members of the panel acquire knowledge about the particular development and are available as a group to resolve early or subsequent disagreements in the hope of providing prompt decisions and avoiding the "snow balling" affects of multiple layers of disagreement causing a bad overall result for the real estate development.

Ombudsperson is available to hear complaints and formulates a recommended way of resolving them. The ombudsperson considers "the facts" and issues and provides an advisory opinion leading to a likely settlement of the matter. This method may be particularly useful in landlord/tenant and employer/employee relations.

Fair Division applies game theory to the allocation of a portfolio of assets. There are a number of different possibilities. In "Strict Alternation" the parties take turns choosing assets with the first to choose having an advantage. "Balanced Alternation" provides for variations in the choosing pattern to balance the initial advantage of the first to choose. "Divide and Choose" calls for one claimant to divide the assets into two groups and the other party to choose which group to acquire. "Buy or Sell" calls for a party to state a price at which he will be equally willing to buy or sell a partnership asset. "Adjusted Winner" consists of each party being given the same number of points which they can

individually and privately allocate to the same array of assets; subsequently, tentative winners are identified for each asset based on the highest number of points allocated to the asset and adjustments are then made to even out the total number of points each claimant assigned to assets he/she has won. The tests of a well-executed fair division technique are proportionality, equitability, efficiency, and envy freeness. The greater the variation in the relative pricing perspectives of the claimants, the easier it is to satisfy all the claimants.[12]

Appraisal Proceeding is often a tripartite procedure. Each claimant chooses an appraiser; the two professionals so chosen, agree on a third appraiser; if they fail to agree on the selection, they may resort to an outside selection mechanism. The decision-making process is often on a "documents only" basis. Usually, the parties and their legal counsel are not present and, generally, there is no provision for depositions, discovery, or witnesses. After informal dialogue and discussion, a valuation conclusion is reached by at least two of the three appraisers. This alternative provides less liability protection than arbitration.

Arbitration is a binding process in which knowledgeable professionals, after hearing the presentations of each side, reach a decision which is binding on the parties and may be entered as a court order to ensure enforcement. The arbitrator(s) may have total or partial discretion or may be limited to a "baseball clause" confining the scope of the decision to choosing the exact price submitted by one party or the other. Arbitration often does not include discovery, depositions, a transcript, or strict adherence to the legal rules of evidence or procedure. As contrasted with litigation, arbitration often provides expeditious and inexpensive resolution of disputes by arbitrators possessing expert knowledge acting in a process that maintains confidentiality in business relationships.

Non-Binding or *Advisory Arbitration* is a contradiction in terms. This process is the same as or a constricted version of standard arbitration, except the award is not binding on the parties but may be accepted if they agree.

Mediation-Arbitration (MED-ARB) is, as the name implies, a blend of both mediation and arbitration. The parties attempt to resolve the dispute through mediation. If this phase fails to produce a settlement within a specified time period, the issue is referred to arbitration for a final and binding decision. Based on the agreement of the parties, this arbitrator may or may not be the same person who served as the mediator.

The success of a negotiation is often dependent on whether there is an effective bargaining continuum or an overlap in the "ask" and "settle" end points in each side's formulated span of acceptable negotiation results. If there is overlap, there may well be an agreement; if an overlap is not indicated, settlement is unlikely.

Arbitration-Mediation (ARB-MED) consists of a first phase arbitration which concludes in an award under seal while the neutral attempts to guide the parties to a mutual agreement settling their conflict. Since the experience of the arbitration proceeding is informational and educational for both parties, the chances of a successful mediation are improved. If mediation fails, the arbitrator announces his award and the decision is final. The underlying philosophy is that an agreement by the parties is more satisfying to them than an imposed decision.

Mediation-Arbitration-Mediation (MED/ARB/MED) is a three-stage process utilizing first phase mediation which may narrow the issue. Yet, at strong signs of an impasse, a second phase arbitration process kicks in and serves as an educational discovery experience for the disputants. Subsequently, they may have the motivation to pull back and re-commence negotiations in a third phase mediation process assisted by a mediator who may have served as the arbitrator.

Case Evaluation is performed by a neutral experienced in the subject matter of the dispute. He reviews the substantive case by listening to each side's presentation and by reading appropriate documents and the posing of interrogatories. The neutral highlights the strengths and weaknesses of each position. Under his auspices, the parties may reach a resolution of the dispute. In essence this is a more abbreviated form of mini-trial procedure.

Judge/Lawyers Evaluation Panel consists of a credible judge and two lawyers specializing in litigation. Collectively they render a non-binding opinion after hearing presentations from both sides.

Input from the panel provides predictability about how the matter might be decided in litigation. Subsequently, the parties resume negotiation.

Mini-Trial is a brief and informal "trial" conducted and presided over by a neutral. The parties, working with the neutral, arrive at agreed upon procedural rules; there may be limited discovery and depositions. Each side presents its best case in abbreviated form. A senior executive from each firm is present and is empowered to reach a settlement. If the executives initially fail to agree, the neutral may offer an advisory opinion. If a final agreement is reached, it is reduced to a written document before the proceeding is concluded.

Private "Judge," generally a retired jurist, is hired to hear the presentation of both parties and to issue an advisory opinion outlining how he would have ruled in a formal court proceeding. This document often motivates the respective claimants to reach a settlement without engaging in formal litigation.

Summary Jury Trial consists of an abbreviated non-binding version of a jury trial utilizing jurors drawn from the regular pool who are made available by a judge. After hearing abbreviated presentations from both sides the jurors arrive at an advisory decision. Subsequent to the verdict, the parties and their counsel may ask the jurors questions about their perceptions of positive and negative aspects of each presentation. After that point the jurors are dismissed and the parties resume negotiation with a more realistic view of what an actual jury might decide. Subsequently, if the process fails and a trial takes place, there will be a new judge and jury.

Auctions provide a forum for claimants to bid in dollars or in the allocation of a limited universe of points. Such a process may be open outcry or by sealed bid. In a two-stage auction the bidders may modify their bidding in the second stage based on the education they have received in the first phase. Bidding patterns are classified as English (bidding in ascending order); Dutch (a bid as prices descend); or Vickrey (winning bidder acquires asset but at the second highest bidder's price, thereby encouraging higher bids by attempting to avoid "buyer's curse" or remorse).

Election or Referendum may be called for when there is a large number of parties in the same dispute. After structuring one or more recommended courses of action a vote may occur to choose the alternative to be followed. Voting may be direct, preferentially ranked, proportional, and/or cumulative depending on specific circumstances. Real estate industry conflicts which may require this process include the reorganization or liquidation of a public real estate entity and the merger or acquisition of such an entity.

Negotiated Rule Making is a governmental process inviting key parties in an industry who would be affected by a proposed regulatory rule to provide data and points of view concerning disputed industry issues prior to the issuance of a regulatory rule. The rule issued is likely to be more relevant and effective after use of such a process.

Common Text Negotiation involves a neutral who writes a draft of an agreement with identical copies submitted to each side. The drafter of the document does not ask for acceptance or rejection but only for comments and suggestions for modifications. This process may be repeated many times and progress continually made. This method avoids a partial agreement before knowing the entire structure of the agreement. Only when the neutral believes that the revised draft is the most likely outcome, does he/she look for agreement and closure.

Litigation is a formal legal process, involving the parties, their legal counsel, expert and fact witnesses, judge, and, possibly, a jury. The process almost always involves discovery and, possibly, depositions. Use of this method signifies that the parties will not make the ultimate decision in the matter. Judge or jury may decide a technical dispute outside of their knowledge base. Litigation is the most expensive, lengthy, and potentially aggravating method of resolving a dispute.

Dispute Resolution System Design is a process of evaluating an existing dispute resolution system by identifying typical conflicts, case volumes, resolution processes utilized, and the level of costs and benefits of the existing system. In designing a new system, a focus is put on interests, links to negotiation-like processes, low cost procedures, and building in prior consultation and subsequent feedback activities. Arraying dispute resolution systems on a low to high cost basis and describing the necessary resources, skills, and motivations required for each alternative, provides the basis for choosing a new dispute resolution system.[13]

Dispute Prevention Program provides a review of modes of doing business and the process

which documents transactions and suggests changes to reduce the volume of future disputes. This program is accomplished in association with legal counsel.[14]

An effective participant in any of these dispute resolution methods should exhibit a range of cognitive, behavioral, and process characteristics. An individual's basic traits should include a considerable intelligence; a self-confident and balanced ego; general business and specific industry knowledge; and a constructive focus on important issues.

Useful behavioral dynamics include patience; ability to listen; tolerance of silence; coolness; forbearance combined with firmness in the face of provocation; credibility; reliability; discretion; trustworthiness; ability to educate and persuade; and a respectful and dignified style.

Process skills include clear communication, effective note taking, cogent periodic summaries of progress, and a major contribution to the final written document.

Above all these traits, one must use power wisely: "To resort to power one need not be violent, and to speak to conscience one need not be meek. The most effective action both resorts to power and engages conscience."[15] Sadly, not all participants will be swayed by positions founded on conscience. We must obtain the best result we can in an perfect world.

CONCLUSION

Among these dispute resolution methods common threads include opposing parties; conflicting goals; differences in values and styles; varying degrees of power and control; variations in methods for picking the neutrals; process design; and the binding or non-binding nature of the results.

Which of these methods should be chosen for a specific dispute? One must first evaluate the nature and relative importance of the issues in contention and the dynamics of the individuals and entities involved. Subsequently, one should select the method which provides the highest probability of a cost-effective and timely resolution of the conflict with a minimum of disruption. Yet, it also must be recognized that in many instances, the dispute resolution method to be employed has already been chosen by the parties before any experts have had an opportunity to provide counseling.

In a classic negotiation each side retains control of the outcome. In other methods, some or all control is ceded to others. Yet, negotiation is at the foundation of all methods. If Clausewitz was right when he said that: "War is regarded as nothing but the continuation of politics by other means," then all these dispute resolution methods are just the continuation of negotiation by other means. One goal of a civil society should be to provide peaceful and sensible methods for resolving conflict.

In *Justice Without Law?*, Jerold S. Auerbach provides us with a thought-provoking perspective for considering the future of dispute resolution in America:

> Among Scandinavian fisherman and the Zapotec of Mexico, in Bavarian villages and certain African tribes, among the Sinai Bedouin and in Israeli Kibbutzim, ...the importance of enduring relations have made peace, harmony, and mediation preferable to conflict, victory, and litigation. But in the United States, a nation of competitive individuals and strangers, litigation is encouraged; here, the burden of psychological deviance falls upon those who find adversary relations to be a destructive form of human behavior.[16]

Although it is reported that only four percent of cases ever reach the courtroom with 80 percent being settled and 16 percent dismissed, why does an overwhelming number of disputes pass so easily from negotiation to litigation?[17] The use of alternative dispute resolution methods is, nonetheless and necessarily, gaining momentum in the United States.REI

NOTES & REFERENCES

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15. Barbara Deming as quoted in Herb Cohen, *You Can Negotiate Anything*, New York, Bantam Books, 1980, p. 239.
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Toxic Tax Assessments: the Ad Valorem Taxation of Contaminated Property

by Robert P. Carver, Esq. & Anthony W. Crowell, Esq.

In tax assessment review proceedings involving contaminated property, taxpayers typically contend that property value is substantially impaired or erased by the presence of environmental contamination. Some taxpayers contend contaminated property has no value even when it is fully usable and the taxpayer is liable for the cleanup. These cases present courts with difficult and competing questions of law, equity, and public policy concerning the interplay of *ad valorem* taxation and sound environmental policy. Consequently, the legal premise of *ad valorem* taxation, which is to assess taxes against property at a certain rate upon its value, and the public policy concerning environmental cleanup, namely that the polluter pays, are often seemingly at odds.

Here, the authors review and analyze the reasoning of the courts when addressing these issues in the leading tax assessment review cases involving contaminated property nationwide. The manuscript first addresses issues affecting the marketability of contaminated property in the face of environmental liability statutes. Next, it reviews the methodologies adopted by the courts in adjudicating claims of assessment overvaluation. Finally, it considers the effect of the usability of contaminated property; the cleanup obligation of owners and purchasers of contaminated property; and the public policy concerns of taxing authorities on the outcome in tax assessment review litigation.

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ENVIRONMENTAL LIABILITY AND THE REAL ESTATE MARKET

The impact of environmental liability statutes on the marketability and profitability of contaminated property is central to taxpayer

arguments for assessment reductions. It is generally accepted in the legal and appraisal communities that environmental contamination may affect property value. The threat of liability for cleanup imposed on contaminated property owners by the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA)[1] and its state counterparts, clean up costs, issues of indemnification, and the stigma associated with the actual or perceived risks involved with owning or using contaminated property all yield this conclusion.

CERCLA, commonly known as the Superfund law, is the principal federal statute designed to protect the public and environment from the release of hazardous substances, and to ensure that hazardous substances are cleaned up. Congressional intent behind CERCLA is rooted in the "polluter pays" principle which dictates that: 1). contaminated property which threatens public health and safety be restored to an environmentally acceptable condition; and 2). any parties benefitting from or even involved with the use of hazardous substances that ultimately contaminate property should bear the cost of cleanup, starting though not necessarily ending with the owner or operator of the contaminated property.

CERCLA's liability scheme is strict, joint, several, and retroactive. This means that the entire chain of property owners, including both current and former owners, and other potentially responsible parties, such as lending institutions, other investors, and even transporters who carried hazardous substances to property that is contaminated, may be liable for costs associated with restoring that property to an environmentally acceptable state. CERCLA imposes liability on the current owner of contaminated property regardless of whether the owner caused the contamination. And potential liability remains with former owners who sell contaminated property, even in cases where a purchaser agrees to assume the risk of cleanup liability. Thus, acceptance of liability by one party cannot absolve others of potential liability especially in cases where cleanup costs exceed the financial capabilities of the party assuming the risk.

Two decades of experience under CERCLA have proved that it has a stigmatizing effect on property both before and after cleanup of contamination. In economic terms, stigma is a reduction in value caused by the risk inherent in owning a contaminated property. Thus, the level of risk involved in acquiring or even selling a contaminated or formerly contaminated property — including the uncertainties of liability, as well as often unknown cleanup and transaction costs, increased underwriting costs, litigation costs, indemnification, and ultimately the threat of bankruptcy — may outweigh any potential economic benefit of the transaction. Consequently, CERCLA may dramatically affect the marketability and profitability of contaminated property.

Indeed, real estate investors and lending institutions are apprehensive about such purchases and often demand extensive and costly site investigation before investment. And despite recent lender liability reforms enacted by Congress, lenders remain concerned about underwriting contaminated properties because they view those properties as having questionable collateral value even when the property is fully usable.[2] Lenders fear they may be held liable for cleanup in cases of foreclosure. Moreover, some owners of contaminated property, in an effort to avoid public detection of contamination and liability, may decide not to sell their properties at all, sometimes even opting to mothball them. Consequently, the interplay of impaired marketability of contaminated property, with the statutory scheme that obligates specific parties to clean up contamination, has made the adjudication of claims of overassessment particularly vexing.

ASSESSMENT REVIEW LITIGATION IN THE COURTS

Although the courts have not decided such cases with uniformity, it appears that most if not all courts that have considered the question hold that environmental contamination affects, or at least may affect, property value. Taxpayer challenges to assessments on contaminated property are on the rise, but there are relatively few reported decisions, and those focus on limited legal and policy issues addressing very specific sets of facts. In all the reported decisions reviewed, the taxpayers made one or both of the following arguments: that cleanup costs must be deducted from the value of their property or that their property has no value at all on account of its unmarketability. Some courts have accepted these arguments, while others have rejected them squarely.

The review of the reported decisions below is aimed at providing the real estate community and taxing authorities with an analysis of the practical effects that case law may have on methodologies used to value contaminated property for the purpose of *ad valorem* taxation. Consideration is given to whether

these methodologies are mandated by law, or are simply acceptable approaches to value, under the facts of the case, when posited by credible experts. This review looks behind the decisions to discern which facts might be said to dictate the results in the litigation of a tax assessment of a contaminated property, including the cost, timing, and probability of environmental cleanup; the usability of the property in its contaminated condition; the liability, or potential liability, for cleanup of buyers, sellers, and other parties; the stigma associated with a property upon cleanup; and tax and environmental policy.

California: In *Firestone Tire and Rubber Co. v. County of Monterey* (1990),[3] the soil and groundwater were contaminated from chemical spills at the taxpayer's tire manufacturing plant. Soon after the valuation date, the taxpayer closed the plant for reasons unrelated to the contamination. Then the state health authorities apparently prohibited the taxpayer from selling or using the property until it was cleaned.

The court upheld the property's assessment on the ground that a purchaser of the property on the valuation date would not have been aware of the contamination. Accordingly, the court declined to address whether the cleanup expense would be an appropriate measure of value diminution. The court, however, rejected the taxing authority's contention that the value of the property would be unaffected by contamination on account of the taxpayer's liability for cleanup.

Thereafter, *Dominguez Energy, L.P. v. County of Los Angeles* (1997),[4] addressed the treatment of expenses for environmental cleanup. The taxpayer had a property interest in an oil and gas lease and performed and scheduled ongoing remediation of oil contamination, despite no requirement to remediate until a later date.

In valuing the taxpayer's property interest, the taxing authority took the cleanup cost as an expense in the income approach to value, but hypothetically postponed the remediation by allocating the expense to the latest possible date. This approach diminished the effect of the expenses on the present value of the taxpayer's property interest. The court rejected this approach. Under a standard of prudent property management, the court found that the cleanup costs should have been considered when actually spent by the taxpayer. Additionally, the court noted that it would be poor public policy to adopt a valuation methodology based on imprudent management of environmental cleanup which risked public responsibility for the cleanup.

Taxpayer challenges to assessments on contaminated property are on the rise, but there are relatively few reported decisions, and those focus on limited legal and policy issues addressing very specific sets of facts. In all the reported decisions reviewed, the taxpayers made one or both of the following arguments: that cleanup costs must be deducted from the value of their property or that their property has no value at all on account of its unmarketability. Some courts have accepted these arguments, while others have rejected them squarely.

Iowa: In *Boekeloo v. Bd. of Review of City of Clinton* (1995),[5] the state's highest court rejected the taxpayers' contention that their fully operational tavern was unmarketable on account of groundwater contamination and without value. No government agency required that the taxpayers remediate the contamination, and the cleanup cost was unknown. The court found that the taxpayers failed to meet their burden of proof, since the testimony of the taxpayer's real estate agents suggested that if the cleanup cost were known, the property could in fact be sold.

Massachusetts: In *Reliable Electronic Finishing Co., Inc. v. Bd. of Assessors of Canton* (1991),[6] a chemical spill, from the failure of a secondary containment system, contaminated the taxpayer's property. The taxpayer assumed liability for the cleanup in a consent judgment and had begun some environmental remediation. The state's highest court upheld the assessment on the ground that the taxpayer failed to meet its burden of proof. There was no evidence of the contaminated condition of the property on the valuation date, the anticipated cost of cleanup, or how the contamination would affect the property's value.

The Massachusetts court noted that had the taxpayer established the effects of "proven environmental damage" on value, neither the owner's

liability under the consent judgment, nor the owner's culpability, would be relevant factors in determining value for tax assessment purposes.

Michigan: In *Community Consultants, Inc. v. Bedford Township* (1985),[7] the property whose assessment was at issue was a vacant parcel formerly operated as a domestic refuse and industrial waste landfill. The property could not be put to any other use because of the presence of hazardous waste. It was contaminated by PCBs and lead and was ranked one of the state's top three most dangerous environmental contamination sites. The Michigan Tax Tribunal determined that the appropriate way to value the property was through a market approach, but there was no ascertainable market by which value could be examined or extrapolated because of a lack of comparable sales.

The taxpayer contended that the property was unmarketable. The taxing authority conceded, and the Tax Tribunal found, that it could not conceive of any knowledgeable, prospective buyer who would purchase the property. Moreover, the Tribunal determined that the cost of remediating the site "exceeds even the most optimistic value of an uncontaminated site of similar size, location, and zoning." Consequently, the Tribunal found that the property had only nominal value, and established a bright-line rule that a nominal value must obtain in cases where former hazardous waste disposal sites remain contaminated on any given valuation date, and cannot be used for any lawful purpose. The Tribunal made clear, however, that this rule should not be construed as an indeterminate exemption for such properties, nor did it apply to hazardous waste disposal sites in current lawful operation.

In *Comerica Bank-Detroit v. Metamora Township* (1989),[8] on the default of the taxing authority, the Tax Tribunal determined that certain agricultural land, which supported crops, had nominal value because of stigma that resulted from uncertainties surrounding the site's contaminated status. The groundwater had been contaminated by some three thousand barrels dumped by unknown parties that leaked PCBs and other toxic substances.

The Tax Tribunal considered the property's inclusion on Michigan's priority list of contaminated sites, which is the state's analog to the federal Superfund National Priorities List. It also considered evidence that cleanup costs would amount to $1.3 million, and that the taxpayer had already spent $393,000 on a cleanup effort. Those factors, the Tribunal found, coupled with "the many unanswered questions pertaining to liability, containment, and future uncertainties involving [the] property, situated as it is within the shroud of toxicity, stereotype it as untouchable even for speculative purpose." Finding the property "uncommonly tainted with stigma certain to adversely affect its marketability," the Tribunal valued the parcels at issue at only $100.

In *Sweepster, Inc. v. Township of Scio* (1996),[9] a fully-usable, 47-acre industrial site suffered from groundwater contamination, forcing the closure of one drinking well and the commencement of construction of another. The former owner, Chrysler Corporation, paid for bottled drinking water at the site, as well as the drilling of the new well, pursuant to an indemnity clause in the purchase agreement for the property between Chrysler and the taxpayer.

The taxpayer contended the property had zero value, based on an environmental engineer's testimony that it might cost from $10 million to $20 million to clean up the site, although no amount could be determined with certainty unless further study was done. The taxpayer's value of the property, as if unaffected by contamination, ranged from only $2 million to $3.3 million.

The Tax Tribunal rejected the taxpayer's analysis and affirmed a lower tribunal's adoption of the taxing authority's analysis, which valued the property as follows. From the actual sale price of the property with the indemnity agreement in place, the cost of subsequent improvements to the property was added, and a 10 percent reduction in value for stigma was deducted. The tribunal found that the indemnity clause, which guaranteed cleanup, prohibited any reduction from the purchase price paid by the taxpayer. Any risks of present or future contamination, it reasoned, were reflected by the purchase price.

Minnesota: In *Almor Corp. v. County of Hennepin* (1997),[10] the taxpayer's soil and groundwater were contaminated by wastewater that migrated from a nearby tar plant. The state's highest court rejected a deduction of the cleanup cost from the value of the taxpayer's property to account for the contamination. The court reasoned that no cleanup had been taken or planned, there was no legal requirement to remediate contamination, and a third party was paying for monitoring on the taxpayer's property. The court did, however, approve the lower court's deduction from value for stigma, using the sales

comparison approach to value, and a heightened capitalization rate when using the income approach to value.

However, in *Westling v. County of Mille Lacs (Westling III*, 1996),[11] the same court approved the tax court's finding of zero value for property, contaminated by the taxpayer, who used a degreasing chemical in the re-manufacturing of automotive parts. The property was on the state Superfund list and the taxpayer was named a responsible party liable for cleanup by the state Pollution Control Agency. To value the property as of 1992 and 1993, which earned a substantial income, experts for both the taxpayer and taxing authority took a deduction from value for stigma and cleanup costs. The trial court found the taxpayer's deduction, which exceeded the property's value, to be credible, and the high court affirmed.

Previously, in *Westling v. County of Mille Lacs (Westling I*, 1994),[12] the high court of Minnesota reversed the tax court's finding of only nominal value for the same property, as of 1991, grounded on testimony that contaminated property was neither marketable nor mortgageable. The high court held that the tax court determination of nominal value was against the weight of the evidence because the property was purchased recently by the taxpayers with money lent by banks for that purchase; the property's continued commercial use generated an annual rental income; the presence of a market for the property was never tested since the taxpayers made no effort to sell the property; and the taxpayers were partly responsible for the property's contamination. The court remanded the case to the tax court to consider these factors, as well as traditional appraisal techniques modified to account for the effects of environmental contamination on value.

On remand the tax court considered but gave little or no weight to the factors itemized by the high court, and adopted the taxing authority's expert's valuation analysis.[13] That analysis deducted the present value of the cost to cure, as well as a 20 percent discount for stigma, from the value of the property as if unaffected by contamination. The resulting values warranted an assessment reduction, but were substantially greater than the nominal values previously found by the tax court. The taxpayer offered no alternative valuation methodology.

New Hampshire: In *re Great Lakes Container Corp.* (1985),[14] presented the high court of New Hampshire with the question of whether a former barrel reconditioning plant that was contaminated with hazardous waste, unusable and the subject of litigation to determine liability for cleanup, was entitled to an assessment reduction. The taxpayer contended that the presence of the contaminants, the pending lawsuit and the threat of liability to a future owner, rendered the property unsalable and thus untaxable. The taxpayer proffered an appraisal report that found zero value for the property and claimed that the circumstances did not allow for the application of conventional methodologies for determining value.

The court held that the contaminated property did not have zero value for several reasons. First, the taxpayer made no good faith attempt to sell the property below its assessed value; in fact, the taxpayer marketed the property for an amount in excess of the assessed value. And second, because the property would be cleaned up in the future, as a result of the litigation, the property had the prospect of some future benefit. In response to the taxpayer's contention that potential liability for cleanup effectively precluded any sale of the property, the court found that the taxpayer could have sold the property with title transfer deferred until after any court ordered cleanup was completed, thus freeing a future owner from potential liability. The taxpayer offered no proof of the present value of the property upon the judicial determination of liability for cleanup. Consequently, the court found the taxpayer's evidence insufficient to find that the assessment was excessive.

New Jersey: The first challenge to a tax assessment of contaminated property to reach a state's highest court was in New Jersey. In *Inmar Associates v. Borough of Carlstadt* (1988),[15] two industrial properties were subject to government imposed requirements for environmental cleanup—in one instance, CERCLA, and in the other, a state statute (ECRA), that conditioned the sale of property upon environmental cleanup.

To better understand the high court's determination, a review of the procedural history of the case is in order. The trial court disallowed a deduction of the cleanup cost from value on both properties. For the Superfund site subject to CERCLA, the trial court found that "no firm or fixed obligation" for cleanup had been incurred. For the property subject to ECRA (a usable asphalt plant), the trial court found the taxpayer's proof of the cost of compliance with ECRA—mere estimates by the

taxpayer- corporation's real estate director — to be insufficient to establish the effect of compliance on value. The state's intermediate appellate court upheld the lower court's disallowance of assessment reductions on, among other things, public policy grounds: to allow an abatement of taxes through a reduced assessment, it reasoned, would contravene the statutory scheme requiring the cleanup of contaminated property.

The state's highest court rejected the appellate court's public policy rationale, reversed and remanded for reconsideration the determination regarding the Superfund site, and affirmed the determination regarding the asphalt plant disallowing an assessment reduction. The court acknowledged that federal and state environmental law may affect the value of contaminated property, but rejected a dollar-for-dollar deduction of the cost to cure from value as a matter of law. Instead, the court left to the appraisal community the measure of whatever "adjustment" to value was necessary to account for the cost of cleanup in the face of environmental regulation. The court further directed that "normal assessment techniques" were to be employed to value properties in use, since they have value to their owners, notwithstanding any legal prohibition of their sale.

Subsequently, in *University Plaza Realty Corp. v. Hackensack* (1993),[16] the state's intermediate appellate court approved a dollar-for-dollar deduction of the cost of asbestos abatement from the value of an office building. The court distinguished this case from *Inmar* on the ground that the asbestos abatement was discretionary, subject only to market forces, and not legally mandated.

New York: In *Commerce Holding Corp. v. Bd. of Assessors of the Town of Babylon* (1996),[17] the soil and groundwater were contaminated by the metal plating operations of a former tenant in the taxpayer's industrial building, which was fully operational. The property was designated a Superfund cleanup site, and the taxpayer entered into a consent order with the Environmental Protection Agency to remediate the contamination.

The state's highest court upheld a lower court's deduction of the present value of the remaining cost to cure the contamination from the value of the property in an uncontaminated state. The court rejected the taxing authority's contentions that public policy considerations and the presence of the consent order precluded such a deduction as a matter of law.

While prescribing no particular methodology to value environmentally contaminated property, the court approved the use of cleanup costs to quantify the diminution in value attributed to contamination. Additionally, the court set forth the following factors to be considered in valuing contaminated property:

> The property's status as a Superfund site, the extent of the contamination, the estimated cleanup costs, the present use of the property, the ability to obtain financing and indemnification in connection with the purchase of the property, potential liability to third parties, and the stigma remaining after cleanup.

The court indicated, however, that property capable of productive use should not have a negative value.

North Carolina: In *Appeal of Camel City Laundry Co.* (1996),[18] the taxpayer's soil and groundwater were contaminated by a prior owner's coal gasification operation. An appellate court rejected a deduction of the present value of the cost to cure from value. That analysis resulted in a zero value, which the court held to be legal error when a property is usable. The court approved the taxing authority's value-in-use approach, which consisted of discounting the unimpaired value of the property for stigma and non-liquidity, through a heightened capitalization rate in the income approach, and also subtracted from value the present value of remediation costs that were amortized over 25 years, which was the useful life of the building on the property.

Ohio: In *Vogelgesang v. CECOS Int'l., Inc.* (1993),[19] the groundwater was contaminated at the taxpayer's hazardous waste facility. There was a history of intervention by federal and state environmental authorities at the site, including a consent order under which the taxpayer was required to build structures designed to prevent groundwater contamination. The costs of building these structures were incurred after the valuation date. Additionally, after the valuation date, the taxpayer closed the facility, lost its operating permits, and entered into another consent order under which the taxpayer would permanently close the facility and retain liability for closure and post-closure costs.

The court rejected the taxpayer's negative value conclusion. The court found that the appeals board below properly declined to deduct from value all the remediation and related closure costs, and costs

of compliance with the consent orders, in the absence of evidence of the effect of these costs on value, or evidence of the amount or timing of the costs.

Pennsylvania: In *B.P. Oil Co. v. Bd. of Assessment Appeals of Jefferson County* (1993),[20] the soil and groundwater at a truck stop were contaminated by fuel leaks from underground storage tanks. The lower court upheld the taxing authority's assessment of the property, finding that the taxpayer failed to meet its burden of proof. An appellate court reversed and remanded the case for a new trial. The appellate court held that the taxpayer did meet its initial burden of overcoming the presumptive validity of the assessment through unrebutted expert testimony establishing i). the existence of contamination; ii). the cost and duration of cleanup; and iii). a negative impact on value equal to the cost to cure the contamination.

Earlier, in *Monroe County Bd. of Assessment Appeals v. Miller* (1990),[21] an appellate court affirmed a lower court's finding of a nominal value for property contaminated with benzene. The taxpayer's appraiser testified that the contamination rendered the property unmarketable. The appraiser's testimony was not only unrebutted by the taxing authority, but also corroborated by the taxpayer, who testified that she was forced to abandon her residence on the property, and could neither sell nor even list the property for sale.

Washington: In *Weyerhaeuser Co. v. Easter* (1995),[22] a paper mill required pollution control equipment to continue to operate in compliance with federal and state environmental standards. The mill also contained asbestos and PCBs, which the taxpayer undertook to remediate voluntarily.

The state's highest court held that the anticipated cost of the pollution control equipment represented an item of curable functional obsolescence to be deducted as part of the cost approach to value. The court also allowed a deduction from value of the present value of anticipated remediation costs for the asbestos and PCBs, upon proof of a business necessity for such remediation.

The court set forth the following three factors to be proven by the taxpayer before a claim for pollution control expenses, as a deduction from value, could be considered: 1). the existence of contamination; 2). the existence of a requirement for cleanup; and 3). a reasonably certain estimate of the costs of cleanup, including a formal plan and timetable.

Historically, the lack of marketability has not precluded the assessment of property for ad valorem taxation. . . . Specialty property remains subject to taxation even though there are no buyers for the property. The assessment of specialty property appears to apply the general rule that the market value standard for ad valorem taxation applies only when the property, in fact, has a market value. Absent a market for the property, other tests of value must be used.

The Washington Board of Tax Appeals had occasion to apply the *Weyerhauser* test to determine the value of a shipping terminal in *Salmon Bay Terminals v. Noble* (1996).[23] The terminal, a former plywood manufacturing facility, was contaminated at the time of its purchase by the taxpayer in 1989. The taxpayer negotiated a purchase price that reflected the contaminated condition. Thereafter, pursuant to a consent decree with the Washington Department of Ecology, the taxpayer entered into an environmental agreement with the seller to remediate the contamination.

The Board found that, consistent with *Weyerhaeuser*, the taxing authority was required to consider the environmental contamination in determining value, and had properly done so in valuing the property at issue. The Board adopted the taxing authority's valuation as of 1992, which relied on the 1989 purchase price. To that amount, the cost of capital improvements subsequently undertaken were added, as was the estimated cost of cleanup, which presumably had been undertaken as well.

Previously, in *Fjetland v. Brown* (1990),[24] the Board was presented with a challenge to the assessment of vacant land, used formerly as a log sorting yard, that was contaminated with arsenic, lead, copper, and zinc associated with that former use. The property was designated a Superfund site, was not in use, and would require 10 to 15 years to

restore to an environmentally acceptable state at a cost well in excess of the taxing authority's estimate of the property's value in an uncontaminated state. The owner contended that the property was unmarketable and had no value.

The Board found that parties responsible for cleanup other than the owner had been identified and would pay for most if not all of the cleanup. Relying on the principle of anticipation — that value is created by the expectation of benefits to be derived in the future — the Board found that the property could derive income from future use upon cleanup by the responsible parties, and accordingly, had some value in the present. Thus, the court determined the present value of the property by applying a 10 percent discount rate (sufficient to account for the risks and stigma associated with the contamination), for a 15-year period, to an agreed upon future value as if clean. Since that present value was greater than the assessment at issue, the taxpayer failed to sustain its burden of proof and the assessment was upheld.

THE EFFECT OF USABILITY, LIABILITY, AND ENVIRONMENTAL POLICY ON THE OUTCOME IN ASSESSMENT REVIEW LITIGATION

Usability: Is contaminated property capable of productive use really worth nothing? The case of usable but non-marketable contaminated property presents courts with a dilemma. When the cost of environmental cleanup exceeds the value of the property upon cleanup, a taxpayer may legitimately claim that the property has no market value, which is the usual standard of value for *ad valorem* taxation. If a property is not assessable for taxation, however, it evades responsibility for contribution to the pubic fisc for its impact on public health and the public safety services that the municipality provides, including the police and fire protection that directly benefit the property.

Furthermore, taxing authorities may argue that if a property's value is rendered nominal by virtue of the cost of environmental remediation, the tax abatement resulting from a zero assessment would, in essence, reward the worst polluters most, and penalize careful taxpayers who keep their property free of contamination. Careful taxpayers are not only ineligible for such a "polluter's abatement" of taxes, but are burdened by additional taxes to compensate the municipal treasury for tax revenue lost from the contaminated property.

As described above, the high courts of Iowa and New York, and a North Carolina appellate court, have rejected a zero assessment of contaminated property that is in use, while the high court of Minnesota has approved such a zero assessment. Arguably, the New Jersey and Ohio courts would reject a zero assessment as well, but perhaps not the Pennsylvania courts. The majority that rejects a zero assessment seems to have the better argument.

Historically, the lack of marketability has not precluded the assessment of property for *ad valorem* taxation. For instance, specialty property, which by definition has no market, remains subject to taxation even though there are no buyers for the property. The assessment of specialty property appears to apply the general rule that the market value standard for *ad valorem* taxation applies only when the property, in fact, has a market value.[25] Absent a market for the property, other tests of value must be used.

One such test, promulgated by the International Association of Assessing Officers (IAAO), cited by the North Carolina Court of Appeals, considers a contaminated property's value in use, in contrast to its market value, or value in exchange:

> [t]here is a tendency to discount [the unencumbered] value based on costs related to remediating or isolating the environmental contamination. Fully deducting the costs may overstate the decline in value, because the value in use concept would then be ignored. Value in use suggests that a property which is still in use, or which can be used in the near future, has a value to the owner. This would be true even if the cost to cure environmental problems exceeds the nominal, unencumbered value.[26]

A value in use methodology sanctioned by the IAAO, and used by the taxing authority's expert at trial in *Appeal of Camel City Laundry Co.*, was approved by the North Carolina court, notwithstanding the market value standard for taxation enunciated in the state statutes. The New Jersey high court said it would approve a value in use approach as well.

Indeed, assessing some tax on a usable property better comports with the design of the real property tax, which provides that each taxpayer contribute equitably to the public fisc. A contrary result seems patently unfair.

Liability: Does liability for cleanup affect the value of contaminated property? The various statutes that govern remediation of contamination often cast a wide net holding multiple parties responsible for cleanup. When a responsible party is solvent, the cleanup cost itself should not lower a contaminated property's value, since a purchaser would not expect to bear that cost in its entirety. However, the value of contaminated property may still be affected by the contamination. Certainly no rational purchaser would pay full price and "buy" a lawsuit against a responsible party, particularly when the purchaser, as a new owner, might also become a responsible party by operation of law. Nevertheless, no rational seller of contaminated property, who is a responsible party, would both sell the property discounted by the cost to cure and also expect to pay for the remediation. Clearly, liability for environmental remediation would affect the amount that willing buyers and sellers would agree to as the sales price for contaminated property, and therefore affect value.

In fact, some environmental statutes preclude the sale of contaminated property altogether. Taxpayers may argue that contaminated property subject to such a statute has no value whatsoever; and taxing authorities, in contrast, may argue that the value of such property is unaffected by contamination, since the property may only be sold upon cure.

But should a tax assessment be affected by the liabilities of particular individuals? The courts have a split of opinion. As described above, the high court of Massachusetts rejected outright consideration of the owner's liability for cleanup in determining the assessment of contaminated property. Similarly, an appellate court in California rejected a taxing authority's contention that the owner's liability for cleanup precluded consideration of the contamination in the valuation of the property.

In the same vein, the high court of Washington approved a deduction of the cost of pollution control equipment from value even though the property owner assumed liability for such costs in a consent order. In essence, this deduction nullified the practical effect of the consent order — the allocation of responsibility for cleanup costs — in the marketplace. Similarly, the high court of New York approved a deduction of environmental cleanup costs from value in the face of a consent order under which the owner assumed liability for cleanup; but added that the ability to obtain indemnification in connection with a sale of the property was at least a factor to be considered in determining a tax assessment.

In contrast, the high court of New Hampshire, and the Washington Board of Tax Appeals, have held that when, as a practical matter, the cost of environmental cleanup would not run with the land, a deduction of the cost to cure from value would be unwarranted. These tribunals have upheld assessments that approximated the present value of the contaminated property's value upon remediation by the parties that would pay for the remediation. And the Michigan Tax Tribunal rejected a deduction from value of cleanup costs when the taxpayer had the benefit of an indemnity from the former owner of the contaminated property. There, however, the value found by the tribunal was based on the sale price of the property with the indemnity in place.

Courts have good cause for their reluctance to allow liability for cleanup by particular parties to dictate the value of contaminated property. The real property tax, after all, is assessed on the property, and not on individuals. Ordinarily, value for taxation is based on an objective standard; it is not the value of the property in the hands of any particular taxpayer, or the value of a particular taxpayer's interest in the property. On the other hand, it would be incongruous for courts to ignore the reality of indemnities and liabilities in the marketplace, which lift market values, while approving of zero or nominal values on the ground that property is unmarketable.

Environmental Policy: Should environmental policy override pure appraisal theory? Taxing authorities may argue that reductions in the assessed value of contaminated property that reflect cleanup costs, effectively enable property owners responsible for cleanup to shift the cost of their cleanup obligation to other taxpayers, contrary to the intent of environmental liability statutes to make polluters and other private parties—and not the community—pay for cleanup. In cases where taxpayers seek a nominal or zero tax assessment, which effectively exempts them from taxation, such a result seems perverse, since contaminated property likely poses increased risks to public health as well as an added burden on a taxing authority's public safety resources, such as fire, police, emergency planning and response, and environmental services. Such assessment reductions could be viewed as a reward to owners of contaminated property, some of whom may have caused the

contamination. Assessment reductions may also be viewed as a penalty to the public forced to bear these additional burdens. They especially penalize those taxpayers who take responsible measures and make investments to keep their property free from contamination.

A number of courts, including the high courts of New York and New Jersey, have considered these questions of environmental and tax policy and rejected them. While finding that they have some intellectual appeal, these courts have nonetheless held that public policy concerns cannot subordinate statutory and state constitutional requirements to assess property at its "full" or "true" value. Notwithstanding these results in the courts, however, state legislatures may still elect to tax owners of contaminated property whose assessments have been reduced. In Minnesota, for instance, the legislature enacted a novel "contamination tax" based on the amount of value reduction received on account of the presence of contamination.[27] REI

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Whose Property Is It? The Latest on Regulatory Takings

by R. Michael Joyce, Esq.

It is the core debate surrounding the entitlement of real estate development projects: who sets the limitation on development and how far can the limits go? Inherent in this controversy is the interest of state and local governments to exercise land use controls to promote essential public interests. Competing with this interest are the rights of landowners, who find themselves hurdling ever-rising regulatory barriers delaying, adding-to costs, or barring development altogether—in some cases, effectively "taking" their property. Fueling the controversy is the inexact rendering of the Constitution's Fifth Amendment which prohibits the appropriation of private property without just compensation. In the last 12 years the United States Supreme Court has, in the minds of many critics, actively pursued a policy geared toward restricting the government's right to regulate. However, permits remain in governmental hands. With the latest Supreme Court decision on regulatory takings, the controversy continues.

In *City of Monterey v. Del Monte Dunes* 526 U.S. __ , 119 S.Ct. 1624 (1999), the United States Supreme Court capped nearly 13 years of litigation involving a developer, a city, and a 37-acre oceanfront parcel. In the five years prior to filing the action, the developer had submitted 19 different site plans and received five different denials. Attached to each denial was the City of Monterey's demand for even greater restrictions on the proposed 190-unit housing development project, until the developer gave up and took it to court. A key question from the case was presented to a jury in the United States District Court for the Northern District of California: had the City's

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actions denied the developer the economically-viable use of the property, or did the City's decision to reject the development serve a legitimate public purpose?

The jury awarded the developer $1.45 million in damages and the City appealed to the United States Supreme Court which, in May of this year, upheld the award.

GOVERNMENTAL TAKINGS: THE CONSTITUTIONAL BACKGROUND

The framework of this issue is the Constitution's Fifth Amendment, which prohibits the taking of private property for public use without just compensation. This prohibition is made applicable to the states by way of the Fourteenth Amendment. Underlying the power of regulation is the inherent right of governmental bodies to exercise their "police power," that is, a liberal warrant to regulate private activity to protect the health, safety, and welfare of the public. The fundamental legal authority for state and local governments to regulate real property matters was articulated by Justice William O. Douglas in *Berman v. Parker*, 348 U.S. 26, 33 (1954):

> "The concept of the public welfare is broad and inclusive... the values it represents are spiritual as well as physical, aesthetic as well as monetary. It is within the power of the legislature to determine that the community should be beautiful as well as healthy, spacious as well as clean, well-balanced as well as carefully patrolled."

Adding to the interpretive nature of the argument is the opposing boundary. The limitation on government's right to regulate was articulated by Oliver Wendell Holmes in *Pennsylvania Coal v. McMahon*, 260 U.S. 393, 415 (1922):

> "The general rule... is that while property may be regulated to a certain extent, if the regulation goes too far it will be recognized as a taking."

Until the late 1980s, the Supreme Court's rulings limited the application of the takings doctrine, in matters involving governmental regulation of property rights, to either physical invasions or regulations tantamount to the deprivation of practically all use and enjoyment of the property. *See*, Philip Weinberg, *Del Monte Dunes v. City of Monterey: Will the Supreme Court Stretch the Takings Clause Beyond the Breaking Point?*, 26 B.C. Envtl. Aff. L. Rev. 315 (1999). In 1887, the Supreme Court ruled that a law barring the manufacture or sale of alcoholic beverages was a valid exercise of the state's police power, even though it deprived the owner of the usage of his property, *Mugler v. Kansas*, 123 U.S. 623, 661-662 (1887). The Court held that the state statute which declared that brewing was an improper activity did not involve a taking, because the prohibited activity was the equivalent of a public nuisance. *Id.* at 673.

Later, the Court in *Village of Euclid v. Ambler Realty Co.*, 272 U.S. 365, 397 (1926) upheld a zoning ordinance precluding development of anything other than single-family dwellings in a suburb of Cleveland, even though it deprived the owner of nearly three-quarters of the value of the parcel. Furthermore, in *Penn Central Transportation Co. v. City of New York*, 438 U.S. 104, 124 (1978), the Court found no taking when the City of New York denied a permit to build an office tower over New York City's Grand Central Terminal on the basis that the denial was a mere reduction in the value of the land and did not destroy the owner's "reasonable investment-backed expectations."

At the same time, the Supreme Court rulings did acknowledge a taking where a regulatory infringement either deprived the owner of any realistic use of the property or involved the physical invasion of the property. In *Pennsylvania Coal Co. v. McMahon*, 260 U.S. 393, 413 (1922), the Supreme Court overturned a statute designed to prevent mining by the owner of the subsurface rights, finding that the regulation "has very nearly the same effect for constitutional purposes as appropriating or destroying it." In another example, in *United States v. Causby*, 328 U.S. 256, 261 (1946), the Court found a taking where overflights of military aircraft reduced the value of a farm, in effect causing a physical invasion of the property. Likewise, in *Kaiser Aetna v. the United States*, 444 U.S. 164, 179-180 (1979), the Court found a taking when a permit issued by the United States Army Corps of Engineers, authorizing the dredging of the mouth of a privately-owned lagoon, required the public to be given access to the lagoon.

Despite these examples, prior to the late 1980s, it was very difficult to establish a regulatory taking unless the regulation was so pervasive as to prevent any realistic use of the property, or, even more extreme, the regulation constituted a physical invasion of the property. The basic standard to determine whether a regulatory taking has occurred was outlined in *Agins v. City of Tiburon*, 447 U.S. 255, (1979). This case held that a regulation amounts to

a taking if it does not substantially advance a legitimate state interest or it denies the owner the economically viable use of the land. *Id.* at 260.

LANDMARK CASES: SETTING PRECEDENCE

In the late 1980s, a number of Supreme Court cases began what many consider to be a dangerous erosion of governmental regulating powers.

In *Nollan v. California Coastal Commission*, 483 U.S. 825 (1987), in an opinion written by Justice Antonin Scalia, the Court found a compensable taking when the California State Coastal Commission imposed, as a condition for a coastal permit, the obligation that the landowner dedicate public access along the beach in front of the property owner's home. The requirement was based on the objective of preserving the view to the ocean from the adjacent inland areas. The Court held that there was no essential "nexus" between lateral access to the beach and preserving views of the ocean from the highway behind the residence. *Id.* at 837.

In that same year, the Supreme Court's ruling in *First English Evangelical Lutheran Church vs. County of Los Angeles*, 482 U.S. 304, 318 (1987), further established a right to compensation for regulatory takings based upon the Fifth Amendment. In the aftermath of a flood which destroyed all of the buildings of a church-owned facility for retarded children, the County of Los Angeles adopted an interim ordinance prohibiting construction or reconstruction of any buildings in a designated flood protection area. The decision in this case overruled California precedent, holding that a property owner aggrieved by an invalid regulatory taking was only entitled to set aside the regulation. *Id.* at 312.

Later, in *Dolan v. City of Tigard*, 512 U.S. 374, (1994), the Court struck down a condition imposed upon an owner seeking the expansion of a plumbing supply store, which would have required the owner to dedicate approximately 10 percent of the parcel for flood drainage and a path for pedestrians and cyclists. The Court held that the required dedication was not "roughly proportionate" to the city's goal of avoiding construction in a flood plain and attempting to limit automobile traffic by encouraging the use of bicycling. *Id.* at 391.

In both *Nollan* and *Dolan*, the Court negated requirements that the landowner open its property to physical invasion by strangers as a condition of development approval.

In *Lucas v. South Carolina Coastal Council*, 505 U.S. 1003 (1992), the Court answered the question of whether a governmental authority could justify depriving the owner of all economic value of the owner's land by claiming the protection of public safety. The *Lucas* case involved a state statute which prohibited construction of permanent residences on South Carolina's beachfront areas, predicated on concerns of coastal erosion and flooding. The Court ruled that when a regulation effectively deprives the owner of all reasonable investment-backed expectations, the governmental entity is required to compensate the owner. *Id.* at 1034.

Critics of the Supreme Court's rulings in *Nollan*, *Dolan*, *Lucas*, and *First English*, all of which limited state and local governments' ability to implement land use controls, have variously characterized the decisions as an "assault" on the ability of government to exercise land use controls, or as part of a grander plan to require the government to pay compensation whenever its regulations impose a significant impingement upon a property right. *See*, Weinberg, *supra*, and Douglas T. Kendall & Charles P. Lord, *The Takings Project: A Critical Analysis and Assessment of Progress So Far*, 25 B.C. Envtl. Aff. L. Rev. 315 (1998). These same critics charge that judicial activism drives the majority rulings of *Nollan*, *Dolan*, *Lucas*, and companion decisions. These critics interpret the outcomes as an extraordinary expansion of the takings clause of the Fifth Amendment to unnecessarily restrict the government's regulatory powers.

One of the chief fears of the *Nollan*-era critics is Justice Scalia's theoretical precept that the state's requirement to impose access rights by strangers over private property, as a condition of a development permit, violated an "essential stick" in the bundle of rights that are commonly characterized as property. In that case, it was the right to exclude strangers from one's property. This holding of property rights consisting of individual component parts appears troublesome to the Supreme Court's critics since it would, if expanded, allow landowners to assert that any one or more of the component parts have been taken as a result of governmental regulations.[1]

DEL MONTE DUNES: THE IMPLICATIONS

Del Monte Dunes is a mixed-bag result for those advocating that state and local governments be limited by only minimal restrictions on their regulatory power, as well as those who would urge the Supreme Court to require compensation for any

restriction on ownership or impediment to development rights as a result of government regulation.

On the one hand, the Court specifically denied applying the *Dolan* test of "rough proportionality" to an action challenging a local authority's denial of a development permit. Instead, the Court leaves the test of "rough proportionality" to apply only to cases involving the imposition of exactions or conditions. On the other hand, the Court found it proper to submit to a jury the largely fact-based *Agins* test of whether the developer had been denied all economically-viable use of its land, or whether the city's decision did not substantially advance a legitimate public purpose.

Whether the potential for jury verdicts in cases involving regulatory takings will chill state and local governments from imposing land use controls on private property is an open question. The likely answer to the question, however, is, "doubtful," especially when considering that the developer of the *Del Monte Dunes* project spent five years in governmental processing before it could even establish that its case was ready for a legal challenge, and then had to wait another 12 years for final determination. The stamina and financial resources required to mount such a campaign is staggering.

Critics allege that compensation should continue to be available only for regulations involving physical invasions or de facto takings. However, the fact remains that in light of the painful delays and the difficult tests that must be met to overturn a governmental action, a project proponent is nearly always hopelessly out-matched in a case involving a project denial or challenged exaction or condition. Project proponents are also well aware that when critics of the *Nollan* decision stress the need to preserve government's right to regulate, it is often the disguised effort to grant government the unrestricted regulatory power to prohibit development altogether.

Fear of the government's ongoing willingness or ability to regulate, based on *Nolan*-era decisions, are misplaced or exaggerated: federal, state, and local governments are continually expanding their regulatory powers. All levels of government now routinely use their regulatory power to impose enormous and often crippling "indirect" taxes on property owners and the public at large. For example, federal, state, and local governments have imposed billions of dollars of indirect taxes on the American economy by forcing landowners (under pain of financial ruin) to spend on environmental remediation projects without, in many cases, any connection between the cleanup and the health danger which is said to justify them. In another example, The Americans With Disabilities Act will cause billions to be spent (and paid for by the public) to comply with specific regulatory requirements and for risk avoidance with respect to the open-ended claim opportunities against property owners which are embedded in the Act.

Although safeguarding the environment and ensuring that disabled Americans be included in the workplace are worthy and essential goals, government has largely abandoned the "direct" approach of raising taxes, with specific appropriations for designated projects. Instead, it has adopted broad-based regulations that impose billions of additional indirect taxes on the public in order to achieve loosely-defined legislative agendas. These regulations and indirect taxes rarely receive the open-air debate of law-making and the essential accountability factors which our democratic process requires.

CONCLUSION

The victories for property owners in the *Nollan*-era—invalidating the forced dedication of an easement for public use; invalidating a prohibition of all development rights for property; adding a right of compensation for a regulatory taking to the previously-existing sole remedy of declaring the regulation invalid—were nothing but nicks in government's regulatory armor. The *Del Monte Dunes* decision, which confirms the right to have a jury determine the question of whether a regulation advances a legitimate governmental interest or deprives an owner of the economically viable use of its land will do little to limit governments' regulatory appetite, but will no doubt add to the ongoing debate.[REI]

NOTES

1. Critics here do appear to strike a bull's-eye in arguing that the Supreme Court's decisions in the *Nollan* era reflect a good deal of "judicial activism." Clearly, the Supreme Court handpicked a number of decisions in order to expand the regulatory takings doctrine and in doing so not only expanded existing precedent, but also overlooked a number of procedural defects in the plaintiffs' cases. Kendall & Lord, *supra*.

Summation of Evidentiary Rules for Real Estate Experts Mandated by Daubert v. Merrell Dow Pharmaceuticals, Inc.

by David G. McLean, John F. Kilpatrick, & Bill Mundy, CRE

Introduction

In the wake of the Supreme Court's Daubert ruling, the real estate expert witness faces a stringent new set of criteria for admissibility of expert evidence and testimony. Even experts who have previously been accepted by the courts now find the admissibility of their testimony questioned. As attorneys increasingly realize the potential exclusion of evidence from the opposing side through a Daubert challenge, the bar for expert witness engagement will be raised even higher. The real estate expert who engages in litigation support will find that Daubert has become the governing paradigm for testimony and evidence development.

This article addresses the evolving standards of real estate expert evidence and opinion in Court by developing and discussing the foundations of admissibility. It then discusses realistic guidelines for real estate professionals in preparing evidence and opinion for admission to court.

The Classical Standard for Expert Admissibility—Frye

For many years, the admissibility of an expert's testimony was dependent on the standards set forth in *Frye v. United States*. James Alphonso Frye was accused of murder. Frye claimed that his passing of the systolic blood pressure deception test, an extremely rough precursor to the polygraph, proclaimed his innocence. His expert witness, the scientist who conducted the test, testified on Frye's behalf. However, the Supreme Court ruled that since the systolic blood pressure deception test had not gained "general acceptance" in its field, it was inadmissible. The resulting "general acceptance"

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benchmark became the standard for admissibility of scientific evidence and expert witness testimony.

Seven decades after Frye, the US Supreme Court in *Daubert v. Merrell Dow Pharmaceuticals, Inc.*,[1] announced that the Federal Rules of Evidence had displaced Frye as the standard for admitting expert scientific testimony in a federal trial.

DAUBERT CHANGES THE EVIDENTIARY LANDSCAPE

The Daubert family claimed that the serious birth defects of their two minor children stemmed from the mother's prenatal ingestion of medication produced by Dow. The original decision in appellate court did not allow the Daubert expert witness's testimony into evidence, primarily because the Court ruled the evidence did not meet the "general acceptance" standard for the field. While linkage of birth defects to the drug had been shown clearly in animals, there was not clear documentation of that impact in humans. The Daubert's countered by arguing that the Frye guidelines for the admissibility of expert evidence should not apply and that the Federal Rules of Evidence should take precedence.

The court agreed. It held that "such a rigid standard (in Frye) would be at odds with the rules' liberal thrust and their general approach of relaxing the traditional barriers to 'opinion' testimony."[2] In Daubert, the Court outlined a handful of factors to broaden the judge's analysis relative to the acceptability of expert testimony. If the expert's testimony could not meet the restrictive general acceptability standards set forth in Frye, a court could employ other factors to qualify the expert's testimony for admission. At first glance, the Daubert factors seemingly offered a more liberal approach to scientific expert testimony. If the expert fails one factor, there are other factors under which the expert might qualify. Since *Daubert v. Merrell Dow*, however, far more experts have been excluded from the courtroom than admitted (under Daubert).[3]

Under Daubert, the trial judge must determine at the outset whether the expert is proposing to testify to scientific knowledge that will assist the trier of fact to understand or determine a fact in issue. "This entails, according to the court, a preliminary assessment of whether the reasoning or methodology underlying the testimony is scientifically valid, and of whether that reasoning or methodology properly can be applied to the facts in issue."[4]

The rules—especially Rule 702—place appropriate limits on the admissibility of purportedly scientific evidence by assigning to the trial judge the task of insuring that an expert's testimony both rests on a *reliable* foundation and is *relevant* to the task at hand. Rule 702 provides:

> If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise.[5]

Nothing in Rule 702 establishes "general acceptance" as an absolute prerequisite to admissibility, according to the Court.

The First Admissibility Criterion Under Daubert: Reliability

The court focused on the words "scientific... knowledge" as the basis for the first prong of analysis—"reliability."[6] The court found that the word "scientific" involved a grounding in the "methods and procedures of science," and that the term "knowledge" referred to "any body of known facts or to any body of ideas inferred from such facts or accepted as truths on good grounds."[7]

This interpretation of Rule 702 leaves it up to the trial court, as opposed to the scientific community, to consider the methodology of the evidence for purposes of determining the admissibility of the expert testimony.

The court specifically outlined several "considerations" which will bear on the analysis of admittance:

1. Whether the theory or technique in question can be (and has been) tested;
2. Whether it has been subjected to peer review and publication;
3. It has a known or potential error rate; and
4. Whether it has attracted general acceptance within a relevant scientific community.

In cases of scientific testimony offerings, the Daubert factors can be evaluated like performance statistics: rate of error, publication, etc. The court may then compile scores to determine whether the expert may testify.[8] In testing whether the reasonableness of the data and methodology are appropriate, and in evaluating whether an expert's methodology is reasonable under the circumstances,

the standards of the particular profession can be useful.[9]

The court went on to note that the inquiry should be a flexible one, and its focus must be "solely on principles and methodology, not on the conclusions that they generate."[10]

The Second Admissibility Criterion: Relevance

The court found that even if a trial court finds expert testimony reliable, the court must also comply with the second prong of Rule 702—relevance. This test requires judges to function as "gatekeepers" of scientific expert testimony. The test is that testimony "assist the finder of fact to understand the evidence or to determine the fact in issue." In order to be of assistance to the jury, this testimony must be "sufficiently tied" to the issue in question and the facts of the case. The court called the linkage between testimony and the case at hand, "fit."[11]

The court went on to further state that cross-examination, presentation of contrary evidence, and careful instruction on the burden of proof, rather than wholesale exclusion under an uncompromising "general acceptance" standard, is the appropriate means by which evidence based on valid principles may be challenged.

EXPANSION OF DAUBERT TO NON-SCIENTIFIC EVIDENCE AND TESTIMONY

This year, the Supreme Court extended the Daubert criteria to non-scientific experts in the *Kumho Tire Company v. Carmichael*[12] case. At issue in this case was the testimony of a tire failure expert for the plaintiff who offered the opinion that a tire on the vehicle driven by the plaintiff suffered from a defect and did not fail from misuse by the plaintiff. After decisions and reversals in lower courts, the Supreme Court held that Daubert did apply. In speaking for the court, Justice Breyer wrote that it would be "difficult, if not impossible" for district court judges to sort out experts based on "a distinction between 'scientific' knowledge and 'technical' or 'other specialized' knowledge." Cheered by business, this decision means that non-scientific experts, including real estate appraisers, accountants, social scientists, and others who do not base their opinions on scientific knowledge will be subjected to the same Daubert criteria as scientific experts: testable hypothesis, subject to peer review, rates of error, and general acceptance.

Quasi-scientific experts are also affected by the expansion of the Daubert test. An example of a quasi-scientific expert is a mechanical engineer. Such an engineer bases his opinion on experience and training; training that includes scientific principles at its core. However, the testimony is not "scientific knowledge."[13]

In cases of scientific testimony offerings, the Daubert factors can be evaluated like performance statistics: rate of error, publication, etc. The court may then compile scores to determine whether the expert may testify. In testing whether the reasonableness of the data and methodology are appropriate, and in evaluating whether an expert's methodology is reasonable under the circumstances, the standards of the particular profession can be useful.

Carmichael is especially important to environmental lawyers.[14] Environmental law relies heavily on both applied and environmental sciences. Courts and litigators increasingly call on experts using non-experimental tools to offer opinions on site conditions, environmental affects on health, behavioral implications, and valuation impacts.

EXAMPLES OF TESTIMONY ADMISSIBILITY ADJUDICATED UNDER DAUBERT

Moore Drums, Inc. v. Lockheed Corporation

This real estate appraisal example involved a property contamination case in which Moore Drums alleged that its property had been contaminated as a result of acts and omissions of Lockheed. Moore Drums operated a drum reconditioning business on its property which is located in an industrial park in Charleston, SC. Since 1967, Lockheed operated an airplane parts manufacturing plant on an adjacent property. Moore Drums claimed its property was contaminated with trichloroethylene (TCE), a "degreaser" to remove oil from parts in process by Lockheed.

Lockheed reasoned that the testimony regarding diminution in value offered through Moore Drums' real estate expert failed to establish diminution in value on either a permanent or temporary

basis. Specifically, Lockheed argued that Moore Drums' expert did not appraise the property on the basis of it being contaminated and thus there was no evidence regarding whether there would be any diminution in value of the property after cleanup. The appellate judge, in overturning a jury verdict against Lockheed, stated that "a trial judge must insure that any and all (expert) testimony or evidence admitted is not only relevant but reliable,"[15] citing Daubert. While noting that the plaintiffs' approach to damages in this case was appealing in its simplicity, the court held that his methodology was not the basis upon which any court will allow an expert in real estate appraisal to form an opinion as to value.

Moore Drums' original expert, an MAI, and an acknowledged expert in the appraisal of real estate, performed a full real estate appraisal on the Moore Drums' property in an unimpaired condition. Rather than performing a full appraisal of the property in its actual contaminated condition, the expert instead took the position that the property was worthless because lenders would not readily make loans for the purchase of the property. The only testimony he offered to support that opinion was a small telephone survey limited in scope and time. He did not give respondents the characteristics or description of the contaminated property. He did not tell them that Lockheed had a DHDC approved permit and that it had acknowledged responsibility to remediate the property. He did not differentiate between contamination which Moore had caused to the subject property and the contamination caused by Lockheed. He did not tell them the estimated cost of cleaning up the Moore property. Most of the conversation with bankers took less than five minutes, and some did not take three minutes. Most of the lenders he spoke with were not interested in property that was contaminated at all from any source. Others would have to examine the property on a case-by-case basis and make a risk assessment which included Moore Drums' contamination of its own property. As to what market existed for contaminated properties, the expert was uninformed and made little effort to find out whether there was a market for this particular property.

There are several problems the court cited with the approach of the Moore Drums expert. First, he abandoned the methodology of the professional appraiser, i.e., the three approaches to value, and completely replaced it with a telephone survey of bank and savings and loan officers as to their lending practices. Second, he acknowledged that there was a market for contaminated properties, and conceded that he had no special expertise in valuing contaminated properties (which was not fatal to his rendering an opinion). He further conceded that he did not appraise the property in a contaminated state, which was fatal (according to the Court) to his ability to render an opinion as to its value. Third, even if the bank survey were accepted as an appropriate basis for rendering an expert opinion, the expert acknowledged that the majority of bankers to whom he spoke indicated they would not loan money on any contaminated property. This undermined the plaintiff's approach because Moore contaminated the property itself as did Lockheed. Fourth, the plaintiff's approach ignored the fact that the defendant had acknowledged the responsibility for cleanup of the property and is presently working on-site under DHDC permits from the State of South Carolina.[16]

Whether Moore Drums' expert had any special expertise in appraising contaminated property is a moot issue according to the court, because he did not appraise the property in its contaminated condition. If he had done so using his usual methodology, the court would have accepted his opinion in evidence and allowed the jury to evaluate his expertise of contaminated properties and decide how much weight to give it. The court goes on to say that the second major requirement of Rule 702 is that the expert must testify to scientific, or technical, or other specialized knowledge that will assist the trier of fact per Daubert. "Rule 702 requires that an expert's opinion must be based on the methods and procedures of a science or profession rather than on subjective belief or unsupported speculation. The record is clear that the expert totally disregarded the methods of the appraising profession in reaching his second opinion, i.e., that the property is worthless. Consequently, that part of his testimony was deemed unreliable."[17]

In addition to reliability, the court cited Rule 702 requiring that the expert's testimony must assist the trier of fact, and characterizes this as the "fit" requirement per Daubert. Admissibility depends in part on the connection between the technical research or testing presented, and the particular disputed factual issues in the case. The expert's testimony about the value of this property in its contaminated property does not fit.[18]

In ruling out the expert's testimony, the court found the verdict in favor of Moore Drums could not be allowed to stand, citing that the plaintiff

failed to provide a sufficient basis for assessment of actual damages.[19]

Subaru and Fuji v. Compton and Product Liability Advisory Council, Inc.

This example is instructive due to the arguments offered by Subaru and Fuji which might now be interpreted with a different result under the extension of Daubert to non-scientific experts.

Steven D. Compton brought a products liability action after sustaining severe injuries in an automobile rollover accident. Mr. Compton sued the automobile manufacturer, Fuji Heavy Industries, Ltd., and its distributor, Subaru of America, Inc., alleging the accident vehicle was defectively designed. After a jury trial, Subaru and Fuji were found 56 percent at fault, and a judgment was entered against them in the amount of over $6 million. On appeal, Subaru and Fuji contended the district court erroneously admitted the testimony of Compton's design expert and thus failed to carry out its gatekeeping function as required under Daubert.[20]

Under Daubert's test for the admissibility of scientific evidence, Subaru and Fuji argued that the testimony of plaintiff expert Mr. Bihlmeyer, an aerospace and mechanical engineer, should be have been excluded because it lacked reliability and was not grounded in any particular reasoning or methodology. They contended Bihlmeyer's testimony was nothing more than his personal opinion that the roof of the vehicle was not sufficiently resistant to crush. Further, Subaru and Fuji asserted Bihlmeyer did not rely on industry data and did not refer to any scientific principles or knowledge supporting his personal standard for roof crush resistance. Accordingly, because there was no peer review, no testing, and no evidence of general acceptance of Bihlmeyer's theory, Subaru and Fuji argued that his testimony should be excluded. In response, Compton contended Daubert was inapplicable to Bihlmeyer's non-scientific testimony. The court agreed, stating that Daubert simply "had little bearing on Bihlmeyer's testimony" as a non-scientific expert. The court, ruling prior to expansion of the Daubert principal to all experts, concluded that Daubert was not appropriate to be applied in this case.

FORMAL INTEGRATION OF DAUBERT INTO RULE 702

The Advisory Committee on Evidence Rules of the American Bar Association has approved the post-amendments to Federal Rules of Evidence 701, 702, and 703 considered in light *of Daubert v. Merrell Dow Pharmaceuticals, Inc.*, Issues that appellate courts have addressed since Daubert include:

- How to assess the reliability of research done in anticipation of litigation as opposed to independent from litigation;
- How far an expert can go in extrapolating data to reach an opinion not directly supported by the data;
- When an expert has adequately accounted for obvious alternative explanations for results, and
- Whether experts have been as careful in their paid litigation work as they would be in regular professional work outside of the litigation consulting.[21]

The Advisory Committee has proposed to incorporate Daubert into Rule 702, to state that when scientific, technical, or other specialized knowledge will assist the trier of fact, expert testimony is admissible "provided:

1. The testimony is adequately based upon reliable underlying facts, data or opinions;
2. The testimony is based upon reliable principles and methodology; and
3. The principles and methodology employed by the witness have been applied reliably to the facts of the case."[22]

Intentionally absent from the amendment is any provision regarding the procedure trial judges will follow in making a reliability assessment. Says U.S. District Judge Fern Smith, Chair of the Advisory Committee, "The cases since Daubert have shown that the courts are capable of considerable flexibility and ingenuity in considering Daubert challenges and we expect that to continue under the new rule."[23]

The Advisory Committee was scheduled to present the amendments to the Judicial Conference Standing Committee on Rules of Practice and Procedure in June, 1998. If the Standing Committee approves the proposals, it was to submit them for public comment.

POSSIBLE APPROACH FOR REAL ESTATE EXPERTS IN ADDRESSING THE DAUBERT TEST

A synthesis of current legal opinion sought by Mundy & Associates suggests the following paradigm to organize a real estate expert's case relative to meeting the Daubert challenge.[24] The subjects fall into four categories:

1. What is the applicable relevant body of knowledge?
2. Is the expert truly an expert in the field?
3. What are the appropriate methodologies in the field?
4. Has the expert applied the relevant methodologies appropriately—is the evidence and opinion *reliable* and *relevant?*

The "generally acceptable" criteria of Frye are reflected in the first three issues. Daubert addresses and adds a significant layer of complexity to the fourth question.

1. What is the relevant body of knowledge?

Probably the simplest and surest answer to this question is to define what is taught under the rubric of "real estate" in the nation's colleges and universities. Real estate is and has been taught at the nation's leading universities for virtually all of this century. It is currently a mainstay of the curriculum at most leading business schools.

Typically, the study of real estate at the college level will include significant coursework in finance, economics, and marketing, with related work in geography (principally GIS and economic geography) and business law.

Clearly this is an important definitional point. The expert witness in real estate values would be a person trained and experienced in these fields. The real estate trained witness would not be expected or allowed to offer testimony or evidence in, for example, structural engineering aspects of a case. Conversely, the valuation testimony offered by a civil engineer would probably be ruled inadmissible.

The pertinent issue for real estate appraisal and the assessment of impaired property is the relevant body of knowledge in that specific field. One approach to defining the relevant body of knowledge is that contained in the *Appraisal Journal;* the *Journal of Real Estate Research; Real Estate Economics*, and appropriate real estate appraisal texts and publications.

Because a survey component is increasingly used as a complement to the traditional appraisal approaches, especially when markets operate without full knowledge (as frequently is the case in impaired property scenarios and where there is a limited market for the property), the applicable relevant body of knowledge is marketing and survey research texts and journals, as well as behavioral research and statistical sources.

Typically, the study of real estate at the college level will include significant coursework in finance, economics, and marketing, with related work in geography (principally GIS and economic geography) and business law. The expert witness in real estate values would be a person trained and experienced in these fields. The real estate trained witness would not be expected or allowed to offer testimony or evidence in, for example, structural engineering aspects of a case. Conversely, the valuation testimony offered by a civil engineer would probably be ruled inadmissible.

The relevant body of knowledge governs both the expert and the evidence. For example, income producing property valuation models are financial in nature, and hence the governing body of knowledge draws upon that field. Engineers may be interested in valuation formulas, and may be perfectly capable of the mathematical manipulation needed to arrive at justifiable results. However, the engineer's training and experience would not lend him or her to be a credible witness as to the reasonableness or appropriateness of the results of that mathematical exercise. Hence both the witness *and* the evidence would be inadmissible.

2. Is the expert truly an expert in that relevant body of knowledge?

What defines a "master" carpenter from a "journeyman" carpenter? It is usually years of experience; a broad array of knowledge in the field; the ability to lead and train others; certification (often through union or craft guild membership and testing). An "expert" witness in property valuation must show credible evidence of expertise within the field of real estate.

In the pre-Daubert era, once an expert testified, he or she was often tenured into the expert fraternity. Beyond simply extending the Frye criteria, however, Daubert has stimulated a whole new look

by judges into the credentials of experts. It is clear that acceptance of an expert will include such criteria as:

- Educational attainment, both preparatory and continuing;
- Scholarly publication in generally recognized real estate journals;
- Licensing;
- Certification by recognized body; and
- Experience as a teacher or practitioner in the field.

This list is neither all-inclusive nor exhaustive, but experts in the major litigation cases will clearly need to have substantial credentials in all five of these areas.

3. What are the appropriate methodologies in the field?

Again, the governing criteria will be most easily met by looking to the academic profession. The texts, journals, and economic societies will set forth the methodologies acceptable to the courts.

In terms of traditional appraisal methodologies, including sales comparison, costs, and income, which one or more is appropriate to the valuation issue for the subject property? Examples of survey methodologies which might be used as complements to the traditional methods are perceived diminution of affected and/or control group property owners or users, contingent valuation, and conjoint analysis. Questions which should be anticipated include the following. Are the methodologies being utilized published in journals in the applicable body of knowledge that are peer reviewed? Have studies using the methodologies been published not only to outline theories, but to also show empirical results which build upon a foundation of theory?

In one recent state court case, valuation testimony was challenged because the expert used multiple regression as a supporting approach. The other side opined that the legal texts and law journals made no provision for use of multiple regression in a valuation model. The expert, however, showed the court that recent issues of the leading real estate journals all contained valuation studies which used regression models. The judge very quickly ruled that the evidence was admissible, and that real estate journals, not law journals, were the governing criteria for admissibility. Notably, this ruling occurred in a state operating under the Frye standard, and so the court was not obliged to determine the proper use of the methods (the step below), but only obliged to determine if the methodologies themselves were relevant.[25]

4. Has the expert applied the relevant methodologies appropriately?

The Daubert ruling has certainly focused additional attention on the first three criteria. However, Daubert adds this additional role to the court's gatekeeper function in the federal courts and in 29 of the states. With the 1999 application of Daubert to non-scientific testimony (e.g., real estate valuation), it is still not apparent just how the courts will rule in real-estate specific evidence and testimony challenges. However, a glance at the Daubert rulings in scientific cases give some indication as to what can be expected.

One of the tests which will be applied in real estate opinion screening by the court is that to be "helpful," the opinion must "fit the facts." That is, the testimony and/or evidence must be "sufficiently tied" to the issue in question and the facts of the case.

Daubert also requires the court to determine whether the offered testimony and evidence is reliable. The four general guidelines which are likely to be employed by a Court in evaluating real estate evidence and opinion include:

- Whether the theory or technique "can be (and has been) tested";
- Whether the theory or technique "has been subjected to peer review and publication";
- The "known or potential rate of error" of the theory; and
- How widely accepted the theory or technique is in the professional appraisal community.

The Daubert factor analysis also dictates that the testimony is not scientific testimony unless it is based on the scientific method.[26] Has the knowledge and testimony regarding the subject issue followed the steps of the scientific method including observation, formulation of hypotheses, prediction and testing?[27] For example, the following will demonstrate the use of the scientific method in applying survey research based components to damage assessment, where such surveys are used due to the lack of full knowledge of the market relative to a contamination situation. The first step, observation, recognizes the contamination situation, including the existence and nature of the

impairment. It may also be observed that property values near the contamination have not been affected by market forces as fully as the analyst might expect. This leads to the hypothesis generating stage. The hypothesis in this case might be that the lack of information about the contamination and its effects has a lower impact than if the market had full knowledge about the impairment. The prediction phase suggests that if the market is given full information that behavior will adjust accordingly and market values will be lower than without full information. The fourth step is testing the prediction through survey-based means in which reliable samples are surveyed and when given full information about the contamination likely behaviors are measured.

The known or potential rate of error of a theory should be clearly expressed in addressing the Daubert test. This not only relates to the validity of the theory or technique, but also to the variance associated with data developed in the testing phase, including such measures as standard deviations and sampling deviations.

The acceptance of the theory or technique in the relevant "scientific" community can be supported by similar studies accepted as evidence in other cases, peer reviewed publication, and following recognized guidelines developed for the specific issue. An example of the latter for contingent valuation and other similar surveys is following the guidelines of the National Oceanic and Atmospheric Administration published in the Federal Register.[28]

Examples of relevant questions to be answered in relation to this dimension of the Daubert test include the following: Have we used these methodologies and approaches in a way that is congruent with the applicable body of knowledge? Have we shown that we have applied the methodologies in the same way that has been exhibited in peer reviewed publications? Does the methodology "fit" the case and the facts? Does the methodology assist the trier of fact to understand or determine a fact and issue? Is the method valid and reliable?

There are still some unanswered questions raised by Daubert:[29]

- Should the Daubert criteria be applied to both the methodology utilized as well as the conclusions offered by a testifying expert?
- What is the most effective procedure for challenging validity of an expert's opinion prior to trial?
- Will Daubert change the law in state court jurisdictions which have a pre-existing body of law on the subject?

SUMMARY

A half century after Frye, Daubert has changed the face of evidence admissibility assessment from expert witnesses in a historical manner. The expansion of the Daubert principles to non-scientific as well as scientific experts broadens its implications and applicability.

While the Daubert ruling was originally intended to promote the admissibility of expert testimony, broadening the umbrella of admissibility beyond the stricter Frye "general acceptability" test, time has proved that much expert testimony has been excluded under Daubert. The court appears to have intended, however, for the courtroom under Daubert to be a battleground of experts to which any particular methodology and opinion will be challenged in order for the trier of fact to determine its admissibility.[REI]

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15. *Moore Drums Inc., v. Lockheed Corporation*, United States District Court for the District of South Carolina, Charleston division, decided June 18, 1998, p. 14.
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Damage Awards as Public Policy in Inverse Condemnation Litigation

by Chester C. McGuire, CRE

Evolution of the Issue

The Fifth Amendment to the Constitution states, among other things, that private property shall not be taken without paying just compensation, a provision known as the "takings clause." Just compensation has usually meant fair market value for the property in its highest and best use. The government has two lawful means to obtain private property: outright purchase and eminent domain. Both measures result in the government purchasing the property and taking title. In eminent domain procedures, the property is legally condemned, and a fair price negotiated through the appraisal process, or litigation. Either way the private property owner is compensated for the loss of the use of the property.

Governments, however, have another way to acquire the use of private property, by regulatory intervention, in the name of the public interest—government regulation to strip away the right of an owner to use a property. This is reasonable when that use is a nuisance or danger to the community. For example, a person may be prohibited from using property as a garbage dump in a residential area. The courts would not consider this a regulatory taking. However, consensus among most legal scholars is that landowners should generally receive compensation for regulations, except when the offending land use would be prohibited by nuisance law (Epstein 1985).

Governments restrict the use of private property for a variety of reasons—for example, zoning regulations. The courts have held that there must be a reason and nexus between the property and a public purpose for the regulation to be lawful. However, when regulations are arbitrary or have no reasonable nexus between the property and a public purpose the regulation may be a "regulatory taking."

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According to Justice Oliver Wendell Holmes in his opinion in the Pennsylvania Coal case:

> A strong public desire to improve the public condition is not enough to warrant achieving the desire by a shorter cut than the constitutional way of paying the charge. . . The general rule at least is that while property may be regulated to a certain extent, if regulation goes too far it will be recognized as a taking.[1]

Many landowners have been so frustrated by local governments that they have taken their grievances to court claiming inverse condemnation. Governments have enormous arsenals of delaying tactics and drawn-out administrative procedures that work against the property owner. Therefore, property owners are increasingly turning to the courts for remedies when they are restricted from using their property. The following description was provided for an actual case currently under review by the Supreme Court (Mandelker 1997):

> In 1981, the property owners submitted a subdivision proposal to build 344 residential units. The plan was rejected, and city planners informed that a plan for 264 units would be reviewed favorably. The owners then submitted a plan for 264 units; city planners rejected it, and informed that a plan for 190 units would be viewed favorably. The owners then submitted a plan for 190 units; city planners rejected it, and the owners appealed to the city council. The city council found the plan "conceptually satisfactory," and granted a conditional 18-month use permit to commence construction for the project. Subsequently, the developer worked with planning board staff to meet the city council's conditions for the 190-unit development. Staff recommended approval of the site plan, but the planning board overrode staff's recommendation and issued a denial. The property owners then appealed this decision to the city council, which this time denied the site plan for 190 units. Meanwhile, a sewer moratorium was imposed, a request to extend the special use permit was rejected, and the permit expired. The local officials thus expected the developer to start from square one. Following this Kafkaesque process, the federal district court dismissed a taking claim for lack of ripeness, but the appellate court then reversed it.[2]

REMEDIES FOR REGULATORY TAKINGS

There are two kinds of remedies available to plaintiffs: 1). invalidating the regulation; or 2). monetary damages. If the plaintiff succeeds in proving inverse condemnation the court may simply invalidate the regulation (ordinance) and allow the property owner to proceed with development or other use of the property. Or, the court may award actual monetary damages.

The Supreme Court has defined temporary regulatory takings as "those regulatory takings that are ultimately invalidated by the courts."[3] But even if the taking is temporary, the delay caused by the regulation may be compensable. If the regulatory action forbids virtually all use of the property, then the taking is complete and compensation for the value of the property is the logical remedy. However, this is not altogether clear, as the courts have ruled on both sides of this issue.

The invalidation remedy has two drawbacks (Fischel 1986).

1. Invalidation provides no relief for delay of development, and the government has no incentive to act in a timely manner.
2. Invalidation merely requires the community to redo the ordinance, which does not always provide relief.

A monetary damages remedy overcomes the problems of the invalidation remedy since it provides relief from delaying tactics. Furthermore, paying damages may induce both parties to settle, which may be the most important aspect of the damage solution (Rolf 1983).

RATIONALE FOR LOST PROFITS AS THE MEASURE OF DAMAGE

Most of the landmark cases in inverse condemnation have concerned individual property owners rather than commercial developers who are in the business of developing real estate. For the noncommercial individual landowner, the appropriate remedy is usually either invalidating the regulation or paying for lost land value as damage. But for the real estate developer, who is in the business of developing property, the regulatory taking eliminates a business opportunity. The proper remedy for lost business opportunity is lost profits, defined as the difference between the firm's actual profits during the damage period and the profits it would have made but for the unlawful regulatory action.

The courts have been reluctant to consider lost profits from real estate development in awarding damages, even when inverse condemnation can be

proved. There are several reasons for this reluctance. One objection is that real estate development is speculative, and the damage claim is based on something that might happen in the future. In this respect, real estate development is different from some other businesses. For example, if the inverse condemnation harmed an existing business, such as a grocery store or factory, that enterprise will have had a history of operations and any forecast of future lost profits can be based on actual experience.

Perhaps courts have been reluctant to award damages because the damage amount looms so large in typical cases, especially involving large projects. Appropriate damages may seem exaggerated because the aggrieved developer may seek payment for the total value of a project, which can run into the millions of dollars, and have the appearance of overcompensation (Fischel 1985).

Another reason may be that lost profits from a land development venture tend to be large amounts of money, and defendants and the courts may consider that amount an "unjust windfall." Note that the words "unjust" and "windfall" are not economic concepts.

Although the real estate developer has a much harder task in proving lost profits, it is not an impossible task. However, a careful case must be made that the land developer has the capacity, capability, and a reasonable project.

DAMAGES AS EFFICIENT PUBLIC POLICY

Public officials have both a public interest and a budgetary interest that must be balanced (Miceli 1995). If government officials view their actions as having zero cost it will create what Justice Holmes described as "fiscal illusion."

Public policy may be best served by litigation that claims damages for lost profits, even if the dollar amount of such claims is large. If the threat of large judicial awards will caution government officials against unreasonable and irresponsible actions it will serve the public purpose, as compensation may curb government excesses. In this sense the damage threat serves the same purpose in inverse condemnation as it does in product liability, medical malpractice, patent infringement, and antitrust.

The threat of damages may also lead the parties constructively toward a negotiated settlement. For example, if the community rezones a parcel of land

A claim for lost profits from an unlawfully foreclosed business opportunity, whether from land development, or any other venture, is firmly grounded in both economics and the law. In some areas of the law, notably antitrust litigation, the concept of lost profits has been accepted and established. Several analytical methods used to quantify lost profits have been vetted successfully in litigation.

to a restrictive degree and the court decides that it is a taking, the community should be given the option of rescinding the regulation or paying damages (Fischel 1985 and Rolf 1983). From a social standpoint this is more efficient than the all-or-nothing approach implied by invalidation alone. Damages remedy provides areas of compromise between the litigants.

A claim for lost profits from an unlawfully foreclosed business opportunity, whether from land development, or any other venture, is firmly grounded in both economics and the law. In some areas of the law, notably antitrust litigation, the concept of lost profits has been accepted and established. Several analytical methods used to quantify lost profits have been vetted successfully in litigation. The antitrust cases provide a useful model that could be emulated in seeking inverse condemnation damages. According the American Bar Association:

> Profit is the cornerstone concept in assessing damages in antitrust cases. When the legal system awards damages to make a plaintiff whole, the award should be the profit that the plaintiff would have made but for the defendant's unlawful conduct. In principle, the plaintiff's damages should be the difference between the plaintiff's profit given the unlawful conduct and the profit that the plaintiff would have earned had it been unaffected by unlawful conduct.[4]

Damages arising from land development losses in unlawful takings should have the same respect in the courts as any other type of litigation. The objective of damages is to leave the landowner, or any other plaintiff, with the same net worth as if the project had not been denied.

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Are Lease Renewal Options a Good Idea?

by Lloyd D. Hanford, Jr., CRE

Lease negotiations, more often than not, lead to a request from the lessee for renewal options. And, just as often, such options are freely given, without much thought or negotiation, by even the most sophisticated owners and managers. Yet, lease renewal options (LROs), like other kinds of options, raise some very fundamental questions. This manuscript examines the question of LROs, from the standpoint of the lessor, with a goal of being able to decide whether or not they are a good idea.

THE POSITION OF THE LESSEE IS EASY TO UNDERSTAND

It is very easy to understand the position of a lessee asking for a renewal option. It is relatively safe to conclude that, for a lessee, a LRO is never a bad idea regardless of the terms of that option. There is no mandatory requirement that the lessee must exercise a renewal option in order to be able to renew a lease. In all cases, a LRO is a "free ride" for the lessee. If the market conditions were such that the option is beneficial to the lessee, then the option would probably be exercised if the lessee intended to remain in the space. On the other hand, if the lessee determines that the terms of the option are not beneficial, the lessee can always opt to renegotiate instead of exercising the option. Accordingly, the lessee has absolutely nothing to lose when granted a renewal option, particularly when, as is most often the case, that option is given free of any charge.

LEASE RENEWAL OPTIONS ARE BINDING ON THE LESSOR

LROs raise some serious questions from the viewpoint of a lessor. There are several different basic option formulas. Each has its own particular set of problems. However, the common problem, regardless of formula, is that the terms and conditions of the option provision are, most probably, absolutely and irrevocably binding on the lessor while being

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binding on the lessee only if the lessee exercises. The possible exception to this would be the case where the option is no more than an agreement to agree without remedy in the event agreement can not be reached. In many jurisdictions options based on an agreement to agree are not enforceable. In short, the lessor is bound by the terms of the renewal option if the lessee wishes it so but, if not, the lessee can choose to renegotiate. This situation transfers some of the control, over the future of the property or space, to the lessee. The fact that the lessee can choose whether to exercise or renegotiate sets up a "playing field" that is not "level" since the lessor has no such right (i.e. the right to decide to let the lessee exercise an option or, instead, to require a new negotiation).

EACH TYPE OF RENEWAL OPTION HAS ITS OWN PROBLEMS

Renewal options at preagreed rents are a problem from the standpoint that market rents at the time of exercise may be substantially higher than the agreed option rent. In this case, the lessee has every inducement to exercise the renewal option. But, in the event that market rents are lower than the agreed rent, there is every reason to believe that the lessee will opt to renegotiate rather than exercising the renewal option. However, a perceived benefit of options at a specified dollar rent amount is that they do not lead to controversy or dispute at the time of exercise.

LROs based on the percentage increase in the CPI or some similar index have the same problem. There is no correlation, other than purely accidental, between the change in the CPI and the change in market rents. Market rent is driven by the forces of supply and demand for the particular type of space in question. During the period of 1986-1996 there is substantial evidence to suggest that rents for office space, in many markets across the country, declined in the face of oversupply while the rate of inflation continued upwards. Similarly, in the period from 1996 to the present, the surge of demand for many types of spaces, in many markets, has pushed rents up in double-digit steps while the CPI has been increasing at a very benign rate. Accordingly, it may be concluded that the probability of a CPI or other index tracking the real estate rental market is minuscule. CPI or index rent adjustments during a lease term are theoretically different from options at specific dollar amounts in that they are perceived to maintain a purchasing power parity of the rent dollar during the period between new negotiations. Like specific dollar options, CPI adjustments do not present any controversy since the determination of adjusted rent is accomplished based on a fixed formula where the inputs are factually established.

The failure of specified dollar options or index adjustments to parallel the actual rental market changes led owners and managers to generally favor some type of market rate renewal option over other types of options. In theory, this is an excellent idea. No owner or manager should expect to get more rent from an existing, renewing lessee, than would be available in the market place if the space were vacant and available for lease. If the lessee moved out, that is the rent that would probably result from the space offering.

THE IMPLEMENTATION OF MARKET RATE OPTIONS IS A MAJOR DIFFICULTY

The major difficulty with market rate renewal options lies in the implementation of the process and procedures for determining market rent. In a different age, before the major shift to institutional ownership, lessor and lessee were both "risking" their own money when they failed to reach agreement and were forced to initiate the remedy spelled out in the lease such as arbitration. In that environment moving to arbitration was viewed by both parties as a risk and reasonable efforts were usually made to forge an agreement. Today, one or both parties have no personal, vested interest in the outcome of arbitration. Either the lessor is a corporate or institutional owner whose manager/negotiator is not personally at risk or the lessee is a corporate lessee with the same characteristics. In these instances, the party negotiator is only at risk of criticism (or second-guessing) for agreeing to a transaction that persons to whom the negotiator reports might challenge. Stated differently, the negotiator's job may be the only real thing at risk as far as the negotiator is concerned. Thus, for one or both party negotiators there may be no personal, economic inducement to agree to any rent other than the rent originally proposed by them. This tends to be the case even where the opening rent number was developed by an independent, outside appraiser or consultant. It is even more forcefully the case when a written, independent appraisal has been procured before the parties begin their negotiations. In this situation, many people on both sides may have reviewed, and signed off, on the respective appraisals, thus creating an expectancy of achieving the rent number established in their appraisal. In the vernacular, the feet of the parties become "set in concrete." The most defensive position for a negotiator or staff person charged with negotiating a

renewal rent under an option exercise may be to force the issue to arbitration by refusing to reach agreement. Under this scenario, an ultimate award decision against that person's position can be explained as beyond their control in that "those" arbitrators (who obviously were in error) decided it. On the other hand, if the arbitration results in a number that is favorable, the negotiator can take full credit for the genius involved in having "engineered" the situation to arbitration.

In recent years, the process has become even more complex with the deep involvement of attorneys beginning with the initial exercise of a market rent renewal option. Attorneys, as advocates, should be expected to seek out any possible interpretation of the lease (or market) that might lead to a favorable outcome for the client, regardless of how plausible or realistic the interpretation might be. Thus, before a disputed rent matter moves forward to arbitration or some other form of dispute resolution, certain issues may have to be legally resolved and/or extensive research must be undertaken to rebut interpretations believed to be in error. In the end, the result of legal maneuvering may be a formal submission agreement containing all party stipulations for use in the arbitration. However, the legal cost of this process can be very substantial.

As indicated above, when market rate options are granted, the lessor should anticipate that the lessee would employ the most favorable interpretation of lease language and develop their rental proposal to fit that interpretation. The use of the words "market rental value" or "fair market rental" etc. will most probably not protect against self-interest interpretations. It is true that self-interest should be expected to motivate both parties. However, since the question being examined is the advisability of a lessor granting a lessee a renewal option at a market rent, the fact that a lessor would act in its own self-interest in negotiations or arbitration is not relevant to the question.

THE "GAME"

Self-interest aside, market rate renewal options have a strong tendency to set up a "game." Assuming that both parties are equally well informed, it is fair to assume that each is aware of what the market is doing. However, the lessor can not expect to achieve a rent higher than market and from the viewpoint of the lessee, market rent is the worst anticipated outcome. Under conditions of this type, the lessee has little to lose in "playing the game." After all, if the matter proceeds to arbitration, isn't there a chance that rent will be concluded at less than market? From the lessee's viewpoint, Isn't there a chance that if enough issues are introduced into the proceedings, by the lessee, the confusion created may obfuscate the facts and result in a more favorable determination for the lessee? The observation of numerous rental arbitrations, over the years, indicates that the "game" is most frequently started when the dollars involved are very significant.

In recent years, the process has become even more complex with the deep involvement of attorneys beginning with the initial exercise of a market rent renewal option. Attorneys, as advocates, should be expected to seek out any possible interpretation of the lease (or market) that might lead to a favorable outcome for the client, regardless of how plausible or realistic the interpretation might be.

OPTION LANGUAGE IS USUALLY THE REAL PROBLEM

The real problem for lessors usually lies in the option language which, more often than not, is lacking in specificity. On the other hand, there is a practical difficulty in developing option language that is specific enough to eliminate any controversy as to how market rent will be determined. In order to illustrate this point, it is useful to examine the issues that might arise when, as is frequently the case, the lease language states nothing more than, "The lessee is granted the option to renew this lease for a period of five years at the then market rent. If lessor and lessee can not agree as to market rent, the matter shall be determined by arbitration (appraisal)."

- How is the term "market rent" or "fair market rent" to be defined? In a case several years ago, the lessee took the position that the word "fair" meant fair for both landlord and tenant and that the economics of the specific tenant's business (i.e. affordability) did come into play.

- Is the reference to "market rent" or "fair market rent" restricted to the specific use? This is an important question in retail situations where the current business may not be the best type of business for the space. If the lease is restrictive as

to use, some jurisdictions have held that the interpretation of "market rent" is to be market rent for that use and not some other use. Thus, if a lessor intends to achieve market rent for the highest and best use of the property, the option language must be very specific.

- Is the reference to "market rent" or "fair market rent" restricted to market rent for renewals only or does it include new leases? There have been cases where the tenant argued that the comparables are restricted to renewal situations and should not include new lease transactions.

- Do references to "market rent" or "fair market rent" mean "net effective" rent to the lessor? There have been numerous situations where tenants have argued the notion that renewals do not expose the landlord to lease commissions or down time between leases. Thus, the market rent indicated by examination of comparables should be adjusted by deducting the lease commission and down time to parallel the net a landlord would receive.

- What is the impact of tenant improvement allowances? For example, if comparable leases include new lease transactions with, say, $25 per square foot in tenant improvements, is the $25 amortized over the renewal term and deducted from "market rent" in determining renewal rent? Or, on renewal, does the tenant receive a tenant improvement (TI) allowance of $25 per square foot? Tenants have argued that, were they a new tenant coming into the property, they would receive the full TI package at the market rent and, that as a renewing tenant, they should receive a credit against market rent in the amount saved by the landlord who does not have to provide these TIs on renewal. In this instance, what the tenant would be seeking is the "net effective" rent to the landlord which, by definition, is different from "market rent" or "fair market rent." This interpretation also overlooks the fact that the landlord, in most instances, provided the tenant improvements when the renewing tenant originally moved into the space being renewed. On the other hand, if lease renewal comparables (vs. new leases) had, as a renewal condition, the provision of paint and new carpets, adjustment for this factor would probably be appropriate in setting renewal rent.

- What size space unit is comparable? If the subject space is 20,000 square feet are space units of 1,000 up to 20,000 square feet reasonable comparables? Or, would units substantially larger than 20,000 square feet be reasonable comparables?

- What are the time limits within which the parties must reach agreement before referring the matter to the alternative dispute resolution method set forth in the lease?

- In cases of long-term ground leases involving development of a project, the issues become very complex. What market conditions might exist and what other conditions and valuation methodologies might be appropriate in 30, 50, 60, or 75 years hence when renewal options might be exercised? If option rent is to be based on the value of the land as if free and clear of improvements, what will happen if, at the time, there are no comparable sales? Or, what might happen if, at the time, the area has been completely built up (no more vacant land) for more than 10 years? Should rental value assume the highest and best use of the land or is the then use to be considered as highest and best use?

  - Where there is an absence of relevant land sales data is the use of a land residual technique appropriate?

- If the matter is referred to an alternative dispute resolution methodology, what format will apply? The following are some of the choices:

  - There are different structures that might apply in an appraisal process where there is no dialog between appraisers. For example: 1). If the appraisals of the two party appointed appraisers are within 10 percent, the average becomes the "market rent." If the difference is greater than 10 percent then the party appraisers select a third appraiser and the appraisal most distant from the middle number is discarded with the remaining two appraisals being averaged. 2). The party appraisal closest to the third appraisal is the market rent. This format is similar to "baseball" arbitration. The major difficulty with any "averaging" of results is that it most probably will produce the wrong answer, either on the high side or low side and the problem of "baseball" is that the selected rent is not necessarily the correct rent based on the market.

  - An appraisal process where the appraisers are directed to meet in order to determine

whether or not they can agree or reconcile their differences to within 10 percent in which event the average would prevail. If no agreement were reached the party appraisers would select a third appraiser with two out of three being decisive. Once the appraisers are directed to meet, the process becomes an arbitration process and may be subject to the arbitration statutes in some jurisdictions.

- Arbitration with mandatory mediation as a pre-condition.

- "Baseball" arbitration where lessor and lessee jointly select an arbitrator and present their respective rental positions to that arbitrator. The arbitrator selects whichever of the two positions that is closest to his or her opinion to be the awarded rent. In theory, "baseball" arbitration is supposed to force both parties to propose a very reasonable position and attempt to agree before arbitrating. However, in practice, the process is often more akin to a poker game than to determining market rent in that, after negotiating, each party knows the other's position. The number finally submitted to the arbitrator becomes a "poker" number.

- An arbitration process conducted under the rules and auspices of the American Arbitration Association (AAA) or a similar alternative dispute resolution organization.

- An arbitration process where each party appoints its arbitrator and the two party arbitrators appoint the third arbitrator. This process raises its own issues:
  - Do the arbitrators prepare formal appraisals before commencing the process?
  - Will other experts present the market rent positions?
  - Will the process call for an open hearing where the parties present evidence to the arbitrators?
  - If the arbitrators are also the appraisers, should they share all data (but not analysis) before meeting?
  - Are there any appropriate party stipulations?
  - What qualifications must an arbitrator (or appraiser in an appraisal process) posses?
  - Must the third arbitrator be someone without any business or social relationship with the parties?
  - What time constraints will operate?

For the multitude of smaller lease transactions, the legal costs of negotiating and drafting detailed, specific language and the cost of implementing a highly-structured process for resolving any dispute may be unacceptable to both landlord and tenant.

The above are some, but by no means all, of the issues that can come up under lease renewal options at market rent. Market rate renewal options may contain some guidelines for determining rent. But, what happens when a guideline is no longer applicable? Several years ago an arbitration involving an older lease was conducted under lease guidelines specifying that market rent was to be based on recent leases in ***comparable one-story buildings*** within a defined area. However, at the time of arbitration there were no more one-story buildings within the defined area.

MARKET RATE RENEWAL OPTIONS SHOULD BE DETAILED AND SPECIFIC

In order for a lessor to be assured that market rate renewal option provisions contain adequate protections against unintended interpretations, it becomes necessary for those provisions to be very detailed and specific. In effect, the lease provisions setting forth the option terms and remedies if the parties fail to agree (i.e. arbitration) would take on many of the characteristics of a detailed arbitration submission agreement. Where lease transactions are large and involve major rent dollars, such specificity may be practical and affordable. However, for the multitude of smaller lease transactions the legal costs of negotiating and drafting detailed, specific language and the cost of implementing a highly-structured process for resolving any dispute may be unacceptable to both landlord and tenant.

Absent specific lease language that has the character of a submission agreement or absent a formal submission agreement, party arbitrators (or an arbitration panel) may have to develop a submission agreement for approval by the parties, before commencing the process, in order to protect the integrity of any award. Such an agreement would spell out the matter or matters to be decided as well as detail the rules and procedures under which the arbitration will be conducted. This process, in and

of itself, may increase the cost of arbitration, as well as protracting the time for reaching a decision. Further, if the arbitrators (or parties) cannot agree on the language of the submission agreement, the matter may have to be resolved by a court before the arbitration itself can move forward.

AN ALTERNATIVE TO RENEWAL OPTIONS

Aside from attempting to gain an advantage, the main concern of the lessee, in seeking renewal options, is being able to provide for continuity of occupancy in the leased space. One means of providing a lessee comfort relative to the future is to include a "First Right to Negotiate." This type of provision assures that the lessor will not lease the space to someone else before negotiating with the present lessee. This type of "right" does not bind the lessor to any rent but probably does bind the lessor to conduct "good faith" negotiations whether or not such is spelled out in the "Right." Provisions of this type usually include a date by which the lessee must opt to commence negotiations and a date by which the lessor is free to begin negotiating with others.

CONCLUSION

The conclusion that must be reached is that lessors' should avoid freely granting lease renewal options, as usually, they are not a very good idea. Renewal options are only of benefit to a tenant. They can cause some very complex and unanticipated problems in arriving at the future rental value. They do not enhance the value of the property or the owner's position. And, they may give the tenant an element of control over the future that may be unintended. There is no question that lessors are frequently compelled, by competitive pressures to grant renewal options. And, equally often, the lessor makes a business decision to undertake whatever risks the LRO may present because of the competitive pressures. The larger the tenant the greater the pressure on the lessor to provide inducements to the tenant when the rental market is highly competitive. However, in markets where the lessor is in the stronger position, inducements are unnecessary. And, where tenants are occupying small amounts of space there may be many reasons for avoiding LROs—not the least of which is providing for the possible expansion of other tenants.

If lease renewal options are considered by lessors, for whatever motivating reason, they should be very carefully thought out and negotiated as vigorously as any other material business terms of the lease. Treating lease renewal options as benign and customary may, in the future when the option is exercised, prove to be a very serious error for the lessor.$_{REI}$

Real Estate Experts: Some Further Observations

by Rocky A. Tarantello, CRE

In the December 1994 Edition of *Real Estate Issues*, I presented several issues pertaining to the proper role of real estate Counselors as expert witnesses and suggested how Counselors could resolve the real estate expert versus client advocate conflict. This manuscript attempts to go one step further in distinguishing how real estate counseling differs from real estate appraisal and how attorneys may better utilize real estate Counselors as experts.

The great majority of real estate Counselors are not real estate appraisers. They typically do not write or certify appraisal reports. However, they are still real estate valuation, feasibility, and investment experts. They frequently offer expert advice regarding the valuation of fee interests, mortgage instruments, leaseholds, easements, cash flows, rights of way, profitability, feasibility, pricing strategies, phasing plans, and a myriad of other opinions regarding the value or the investment performance of real estate assets. I think the time has come to clarify the common view that valuation analysis and appraisal are one and the same. They are not! Most real estate analyses are not drafted as certified appraisal reports. Frequently, the total work product consists of nothing more than a summary of data, statement of assumptions, calculations, and conclusions. On other occasions, a certified or narrative report may be inapplicable as the following case illustrates.

A few years ago, a moderate oil spill along the Southern California coastline had forced the closure of several miles of public beaches. In addition to direct clean-up costs and lost tax revenues from temporary business closures, the city attorney felt the city was also entitled to the value of the temporary loss of use (*i.e.* recreational use) of the public beach. As with any claim for damage, appropriate technical analysis and foundation is requisite to establish a defensible claim. It so happens

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that there are economic theories, specifically hedonic pricing theory, which deal with the valuation of "lost recreational pleasure" or "use." Standard appraisal methodology is not designed for or even remotely applicable to this unusual case. The case ultimately settled, eliminating the need for each side to prepare the necessary analysis. Despite the "land use" character of the claim, an appraisal report employing traditional appraisal methods would hardly apply to the valuation of such a claim. And although hedonic pricing and property values have been considered in appraisal literature before, it is doubtful that even the most accomplished appraisers have even considered its use, much less applied it as a possible valuation tool. I am not advocating hedonic pricing or any other specific analytical methodology. But I do believe that valuation analyses go beyond "appraisal" and often require the education, skills, and experience of real estate analysts, institutional managers, or real estate forensic specialists outside the appraisal profession.

All appraisals are founded on the principles of economic valuation theory. But the vast majority of real estate analyses do not require strict adherence to appraisal standards or methods. Perhaps the best example of this point is the valuation process exhibited by the public securities markets. On any given business day, every publicly traded business enterprise is revalued resulting in the repricing of all classes of outstanding stock. Reappraisal would require adherence to prescribed appraisal methodology and documentation. For each issue traded, every parcel of property, business asset, and expected earnings stream is revalued on virtually a minute-to-minute basis. Various securities analysts, researchers, and economists collect and interpret the new information; make assumptions about future economic conditions; and apply stringent economic models and theories as every shred of new market information is instantaneously digested and repriced with each stock transaction. In the U.S. alone, some 1.5 to 2 billion equity shares change hands every business day. To the extent that real estate debt and equity markets are increasingly securitized and the nature of the underlying assets fall into institutional ownership and management, the analysis and valuation process must also evolve to reflect the changing nature of the industry. The legal community should recognize these changes as well as the appropriate use of traditional appraisals. More importantly, the securitization and globalization of real estate has ushered in an entirely new generation of investment bankers, capital market analysts, regional economists, institutional managers, and a host of other real estate experts able to employ financial, economic, and real estate valuation methods more suitable to the current legal environment and its constituencies.

COUNSELORS AND APPRAISERS CAN TAKE ADVANTAGE OF THE TECHNOLOGY

According to a recent research report published by the U.C. Berkeley Fisher Center for Real Estate Studies, analysts estimate that by the year 2000, there will be approximately 400-500 million Internet users in the world, and the total number of Web sites will exceed seven million. Willingly or not, every lawyer, professional practice, or real estate expert is being led or dragged into the information age. Some experts will make the shift smoothly while others will fail by continuing to rely upon stale experience and armchair wisdom.

The best experts have embraced Web technology not merely for its e-mail or e-commerce value, but for the enormous information access it provides. Government records and statistics, university research centers, professional trade organizations, and numerous private organizations routinely put their data or information on the Web, much of it at no cost to the user. In sum, the volume of available and accessible information has increased geometrically, while the cost of compilation has fallen accordingly. As real estate analysts, we can do more in one hour at the computer than could be accomplished in days at the desk or the library.

Armed with the capacity to search a global Web network for empirical data provides at least two immediate benefits to our attorney clients. First, we are able to present a more comprehensive empirical basis for value conclusions. Correctly or not, an expert is often viewed as an advocate of the client rather than an expert to the court. Solid empirical foundation significantly helps to overcome this perception. Nothing speaks louder than the "numbers." This allows the expert to be the messenger, not the message. In the way that the federal courts have imposed "Daubert" standards for expert testimony to insure the proper foundation and reliability of expert testimony, the World Wide Web gives us a new and effective weapon to meet and even exceed the highest standards at an effective cost. Secondly, the speed at which opinions may be reached has been drastically accelerated. Prior to Internet access, data was both expensive and time-consuming to collect. In the absence of adequate information, expert opinions were often delayed

until sufficient data had been gathered or the analysis had been completed. Until then, many experts withheld opinions that may or may not have supported a particular claim or position. That process is now accelerated by Web technology. Real estate experts will better serve their attorney clients by providing timely opinions to assist in settlement negotiations or to establish their willingness and ability to support positions favorable to the client. Conversely, if unable to support the client, sufficient time remains to search for an expert of differing opinion. In either case, the trial attorney is provided with valuable advance notice. In effect, real estate experts are now able to utilize Web technology to customize research and work product without the encumbrance of unnecessary, costly, and time-consuming research. Remembering our example of the public securities markets, surely real property is no more or less financially or physically complex than a business enterprise. Why not streamline the analysis while lowering cost and adding data?

Prior to Internet access, data was both expensive and time-consuming to collect. In the absence of adequate information, expert opinions were often delayed until sufficient data had been gathered or the analysis had been completed. Until then, many experts withheld opinions that may or may not have supported a particular claim or position. That process is now accelerated by Web technology. Real estate experts will better serve their attorney clients by providing timely opinions to assist in settlement negotiations or to establish their willingness and ability to support positions favorable to the client.

MAINTAINING EXPERT CREDIBILITY: SET REALISTIC BOUNDARIES

For one reason or another, appraisals are a fact of life throughout the real estate industry. Lender appraisals, tax assessment appraisals, insurance appraisals, and a host of other transaction-based situations clearly require the preparation of an appraisal report drafted in accordance with trade organization appraisal standards, Uniform Standards of Professional Appraisal Practice (USPAP), or state licensure requirements. The purpose of this article is not to diminish the importance of the appraisal process or the professional appraisers charged with the responsibility of their preparation. Instead, my purpose is to point out the advantages of utilizing real estate experts outside the appraisal profession when the required analysis falls clearly outside the scope of an appraisal document.

Cost and timeliness provide obvious advantages to attorneys and their clients. But an equally, if not more important advantage, lies in the area of expert credibility. Notwithstanding the inherent credibility of a member of The Counselors of Real Estate, the Appraisal Institute, or other credentialed individual members of professional real estate organizations, the analytical technique, theory employed, or presentation of the result may add meaning and reasonableness to the expert's opinion.

When subjective opinions are called for, they should be given within a reasonable range of possibilities. The traditional appraisal format typically presents a single estimated value. No one expects a real estate Counselor or any other expert to provide perfect answers. We rely on observations, forecasts, and historical data. Simple point estimates are very often counterproductive. Attorneys and the courts appreciate candor, reason, and the inherent difficulty of providing perfect answers to subjective questions. Hence, while the analysis may be generally close to what the true answers are, the probability that any single point estimate is correct, is nearly zero. In my view, certified appraisals suffer from two inherent flaws rendering them less useful to attorneys and the courts. First, they are drafted according to narrow standards of appraisal practice which can frequently lead to the collection of unnecessary general information which adds to the cost of the document and time of preparation. Secondly, the conclusions are nearly always presented as single point estimates which invite opposing scrutiny and claims of inaccuracy or bias.

A much more practical and defensible valuation analysis would present a damage claim, value, or performance measure conclusion within a plausible range of values. By presenting expert opinions within a range of possible values, the real estate expert is demonstrating his or her willingness to consider alternative assumptions and possibilities without sacrificing credibility to the court. Simply put, the best real estate experts carefully present what they know and freely admit what cannot be

known with certainty. However, it is essential to establish a strong empirical foundation in the estimation of the value boundaries, and every effort should be made to establish as narrow a range as possible. This is intended to provide helpful guidance to the court in reaching a fair and reasonable conclusion without having to "buy" into a single value.

CONCLUSION

Starting with the first offering of GNMA securities in the early 1970s, the real estate industry has been in a state of rapid change. The securitization of the mortgage markets, institutional ownership, investment trusts, globalization, and information technology have fostered a new era in valuation analysis and the people who do it. The scope of real estate valuation has grown beyond the original boundaries defined by traditional appraisals. The parallel growth in litigation counseling has created demand for real estate analysts who bring specialized knowledge of valuation theories, capital markets, and other emerging real estate issues to the litigation process. The traditional use of appraisals is not diminished, but merely used only when and where appropriate. The Counselors of Real Estate is a unique organization composed of real estate experts from numerous disciplines. Many members of The Counselors come from these emerging real estate market segments and can offer the legal community an enhanced array of economic, financial, and real estate valuation methods.[REI]

LEGISLATING LIVABILITY: CAN GROWTH MANAGEMENT SUCCEED?

by Eric S. Laschever, Esq.

A livable suburb or city is one that lets us get home after work fast—so we can spend more time with friends and family, and less time stuck in traffic. ...It is one that preserves among the new development some new family farms and green spaces—so that even in the age of cyberspace, kids can still grow up knowing what it's like to eat locally-grown produce, or toss a ball in an open field on a summer evening. ...A livable community cares about parks as well as parking lots, and develops in a way that draws on local strength and uniqueness—resisting the 'cookie-cutter monster' that has made so much of our country look all the same.

- Vice President Al Gore
"Livable Communities for the 21st Century"

INTRODUCTION

On January 11, 1999, Vice President Al Gore unveiled the "Livability Agenda," which is designed to help communities across America grow in ways that ensure a high quality of life and strong, sustainable economic growth. This initiative could ultimately have a substantial impact not only on real estate developers and sellers but on the way we practice land use and real estate law. Washington State's decade long experience with its Growth Management Act[1] highlights the promise and pitfalls of "Legislating Livability."

THE CLINTON-GORE LIVABILITY AGENDA

According to a White House press release, the goals of the Livability Agenda are to:

- Preserve green spaces that promote clean air and clean water, sustain wildlife, and provide families with places to walk, play, and relax.
- Ease traffic congestion by improving road planning, strengthening

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existing transportation systems, and expanding use of alternative transportation.
- Restore a sense of community by fostering citizen and private sector involvement in local planning, including the placement of schools and other public facilities.
- Promote collaboration among neighboring communities—cities, suburbs, or rural areas—to develop regional growth strategies and address common issues like crime.
- Enhance economic competitiveness by nurturing a high quality of life that attracts well-trained workers and cutting-edge industries.

President Clinton has asked Congress to approve nearly a billion dollars in *new* spending (nearly 10 billion overall for livability initiatives) as part of the FY 2000 budget. He has also asked for $6.1 billion for public transit projects, a 16 percent increase over last year, including $1.6 billion for state and local projects that reduce traffic congestion and improve air quality.[2] State and local officials, who recognize an opportunity to receive money for their states and cities by supporting the plan, have begun unveiling their own proposals for managed growth and livable communities. Trade organizations such as the National Association of Home Builders (NAHB) and National Association of REALTORS (NAR) have also established or are working to establish "smart growth" policies, recognizing the need to adapt to a rapidly changing development climate.

However, before the Clinton administration ever announced the Livability Agenda, more than 40 states already had begun to implement legislation to manage growth and contain urban sprawl.[3] Washington State enacted its Growth Management Act (GMA) in 1990. Since then, many local jurisdictions across the state have adopted comprehensive plans to implement the GMA.

As Vice President Gore makes "livability" one of the main focuses of his campaign, many people are asking just how effective is growth management? How well do comprehensive plans, the cornerstones of many growth management strategies, help communities balance economic concerns and environmental ideas to achieve livability? Nearly a decade after the State of Washington passed its Growth Management Act, these questions remain a source of debate. Several key questions are at the heart of this debate: who pays for what? How do land developers and real estate planners navigate the new regulations required to manage growth? And what are businesses and/or home buyers willing to give up to achieve what everyone seems to want in theory? While the Puget Sound region faces some unique land use issues as a result of geography, as one of the fastest growing regions in the country, it can also serve as a useful case study for communities elsewhere as they attempt to make the Livability Agenda a functional reality.

RECORD GROWTH IN AMERICA'S CITIES

According to the *State of the Nation's Housing 1999 Report* issued by Harvard University's Joint Center for Housing Studies, home ownership rates, home sales, and the value of residential construction reached all time highs in 1998. The eight fastest growing metropolitan areas added more than 200,000 homes between 1990 and 1997 and another 21 areas added more than 100,000 homes.[4] This has raised strong concerns about urban sprawl, especially since the report indicates that most new construction is occurring in medium- and lower-density counties at the metropolitan fringe.

Washington's Growth Management Act

The Puget Sound region is a poster-child for what is happening nationwide. Traffic congestion in the greater-Seattle area, having increased by more than 21 percent in the last decade, is among the worst in the nation, not far behind that of much larger cities such as Los Angeles and New York.[5] Population growth is projected at 22 percent over the next decade, with more than 400,000 new state residents arriving in the next four years. Seattle itself is only expected to grow by 24,000-72,000 people, which means many new residents will be moving to other areas in King, Snohomish, and Pierce Counties, all of which are within 20-30 miles of downtown Seattle.[6] Other parts of the state are also growing quickly. Where newcomers and current residents will be able to live and work is significantly affected by Washington State's Growth Management Act, which includes guidelines for transportation, land use, and environmental protection.

In an effort to responsibly accommodate significant growth, Washington's GMA requires cities and counties to:

- designate and protect critical areas such as wetlands, steep slopes, river corridors, and flood plans.[7]
- designate and conserve farm, timber, and mineral resource lands.[8]
- identify urban growth areas within which to concentrate new population growth.[9]

Figure 1

Population Growth in Large Cities and Their Surrounding Areas: 1990-1996

Metropolitan Areas	City Area (Square Miles)	Population (Thousands) 1990 Central City	1990 Surrounding Area	1996 Central City	1996 Surrounding Area	Absolute Change 1990-96 Central City	Absolute Change 1990-96 Surrounding Area	Annual Percent Change 1990-96 Central City	Annual Percent Change 1990-96 Surrounding Area
Total	7697.0	39,414	91,323	39,916	99,001	502	7,678	0.2	1.4
Atlanta	131.8	394	2,566	402	3,139	8	573	0.3	3.7
Baltimore	80.8	736	1,646	675	1,799	-61	153	-1.4	1.5
Boston	48.4	574	4,881	558	5,005	-16	124	-0.5	0.4
Buffalo	40.6	328	861	311	864	-17	3	-0.9	0.1
Charlotte	174.3	420	742	441	880	21	138	0.8	3.1
Chicago	227.2	2,784	5,456	2,721	5,879	-63	423	-0.4	1.3
Cincinnati	77.2	364	1,454	346	1,575	-18	121	-0.8	1.4
Cleveland/Akron	139.2	729	2,131	715	2,198	-14	67	-0.3	0.5
Columbus	190.9	633	712	657	791	24	79	0.6	1.8
Dallas	716.3	1,716	2,321	1,828	2,747	112	426	1.1	3.1
Denver/Aurora	285.8	690	1,290	750	1,527	60	237	1.4	3.1
Detroit	138.7	1,028	4,159	1,000	4,284	-28	125	-0.5	0.5
Hartford	17.3	140	1,018	133	1,012	-7	-6	-0.8	-0.1
Houston	539.9	1,639	2,092	1,744	2,509	105	417	1.1	3.3
Indianapolis	361.7	731	649	747	745	16	96	0.4	2.5
Kansas City	311.5	435	1,148	441	1,249	6	101	0.2	1.5
Los Angeles*	668.4	4,702	9,830	4,822	10,673	120	843	0.4	1.4
Miami	35.6	359	2,834	365	3,149	6	315	0.3	1.9
Milwaukee	96.1	628	979	591	1,052	-37	73	-1.0	1.2
Minneapolis/St. Paul	107.7	641	1,898	618	2,147	-23	249	-0.6	2.2
New Orleans	180.6	497	788	477	836	-20	48	-0.7	1.0
New York*	347.6	7,826	11,724	7,878	12,060	52	336	0.1	0.5
Norfolk	302.1	654	791	664	876	10	85	0.3	1.8
Orlando	67.3	165	1,060	174	1,243	9	183	0.9	2.9
Philadelphia	135.1	1,586	4,307	1,478	4,495	-108	188	-1.1	0.7
Phoenix/Mesa	528.5	1,273	965	1,504	1,243	231	278	3.0	4.8
Pittsburgh	55.6	370	2,025	350	2,029	-20	4	-0.9	0.0
Portland, OR	124.7	464	1,329	481	1,597	17	268	0.6	3.4
Providence	18.5	161	973	153	971	-8	-2	-0.8	0.0
Rochester, NY	35.8	230	832	222	866	-8	34	-0.6	0.7
Sacramento	96.3	369	1,112	376	1,256	7	144	0.3	2.2
Salt Lake City	109.0	160	912	173	1,045	13	133	1.4	2.4
San Antonio	333.0	959	366	1,068	422	109	56	1.9	2.6
San Diego	324.0	1,111	1,387	1,171	1,484	60	97	0.9	1.2
San Francisco*	274.1	1,878	4,372	1,941	4,664	63	292	0.6	1.1
Seattle	83.9	516	2,454	525	2,796	9	342	0.3	2.3
St. Louis	61.9	397	2,095	352	2,196	-45	101	-1.9	0.8
Tampa/St. Petersburg	167.9	520	1,548	521	1,678	1	130	0.0	1.4
Washington, DC	61.4	607	3,616	543	4,020	-64	404	-1.8	1.9

Notes: Metropolitan areas shown are those with population over 1 million in 1990. Metropolitan boundaries are as of 1996. Central city includes named central city and all other cities in the metro area with population over 200,000 in 1990. New York includes Newark and Jersey City. Los Angeles includes Long Beach, Anaheim, Santa Ana, and Riverside. San Francisco includes San Jose and Oakland. Dallas includes Ft. Worth and Arlington.

Source: U.S. Bureau of the Census, "Estimates of the Population of Cities with Populations of 100,000 and Greater," July 1, 1996; "Estimates of the Population of Metropolitan Areas," July 1, 1996; and "County and City Databook," 1994.

Figure 2

Smart Growth Trend

(May, June 1999)

States with Smart Growth Initiatives

Alaska
Arizona
California
Colorado
Connecticut
District of Columbia
Florida
Georgia
Illinois
Louisiana
Maryland
Massachusetts
Michigan
Minnesota
Mississippi
Missouri
Nebraska
New Hampshire
New Jersey
New Mexico
Ohio
New York
North Carolina
Oregon
Pennsylvania
Texas
Utah
Virginia
Wisconsin
Washington

- develop comprehensive plans to guide state projected growth over 20 years.[10]

The GMA's objective is to give local jurisdictions the tools with which to plan for and manage development in accordance with state goals. The GMA requires local governments to conserve resource lands for agriculture, timber, and mineral extraction, and protect environmentally sensitive areas. The GMA also promotes steady "smart" growth within already existing cities and towns and designated regions resulting in "urban growth areas" that are served by the necessary infrastructure to support that growth, like transportation systems and public utilities.

The concept of the "urban growth area," one of the GMA's most significant provisions, has obvious implications for commercial and residential development. Each urban growth area specifies geographical boundaries. While urban growth areas will help curb sprawl, some people identify a number of down sides. Opponents say that growth management raises the costs of development and housing by creating an artificial scarcity of land, and it reduces the value of property excluded from development. Also, cities must choose to provide the services and facilities necessary to implement the urban growth area concept, and people must choose to live and work within them. This is not a "given" and requires creativity, flexibility, and even modified expectations about property development, property ownership, and our understanding of "community."

The past decade of experience identifies the challenges of implementing the Livability Agenda at the state level and provides lessons as the issue "goes national."

Who sets the standards? Preserving green spaces, promoting clean water, and sustaining fish and wildlife (the Livability Agenda's first goal) are key goals of Washington's GMA. The Act requires that local governments designate critical areas such as wetlands and creek and river corridors and to protect such areas from development. The GMA leaves it up to local governments to determine what constitutes sufficient protection.

Gore's Livability Agenda currently appears to be focused on incentives to encourage the goals rather than new regulations; however, if the federal government becomes more involved in managing growth, the question of what level of government sets the standards for protecting habitat will become a central issue.

Limits on changing behavior. Even the most comprehensive growth planning cannot address all the variables necessary to change people's fundamental choice of where to live. As discussed above, a principle tenet of Washington's growth strategy is focusing growth in dense urban areas. Families with children choose their homes in large part based on the quality of the school system, a variable not directly addressed by the GMA. Seattle, Washington's largest city, has taken major steps to build confidence in its public schools. Success at this task will be a major element in encouraging growth in the urban centers.

Property rights issues. Culturally, Americans place considerable importance on individual liberties. Property ownership and the rights of property are as strongly held as the desire for livability. In Washington State, a potent property rights movement emerged after the first five years of implementing the GMA. While many factors explain this political trend, the movement focused much of its efforts on enacting an initiative that would have dramatically increased municipal liability for regulations, such as those required under the GMA, and their impacts on property values. Striking the balance between individual property rights and the desire for liveable communities will be key to advancing the "Livability Agenda."

Economic competitiveness. The Livability Agenda gives a nod to economic competitiveness by "nurturing a high quality of life that attracts well-trained workers and cutting-edge industries." In practice, effective environmental protection is only half of the equation. Cutting-edge industries, as is the case with other businesses, place a premium on local governments that have predictable land use codes that can efficiently process approvals. Growth management must increase permitting predictability and certainty, as well as protect environmental amenities to gain the support of the business community.

Comprehensive plans that are thorough and well documented can lead to fast, legally defensible permitting. For example, when Intel sought to locate a major new facility, it required local governments to commit to expedited permit review and processing. Intel ultimately selected the City of DuPont, a small community, 30 miles south of Seattle, which had a complete comprehensive plan that the City had successfully used before to quickly approve major development. For the last five years, Washington State has tried to build on the concept of using growth management as a principal engine for consolidating many of its environmental processes. Any national effort to promote livability in the name of economic competitiveness still should include further efforts to eliminate unnecessary inefficiencies in the regulatory process.

Funding infrastructure. One of the most difficult issues is obtaining sufficient funds for infrastructure and public services to absorb growth. Washington's GMA requires local governments to identify needed infrastructure and funding. In practice, obtaining necessary funds in time to respond to growth is very difficult.

In theory, most Americans support the idea of growth management and limiting urban sprawl. Most strongly favor cleaner air and water, shorter commute times, lots of green spaces, and parks in which to enjoy leisure and recreational activities. However, theory and reality do not always go hand in hand.

Hillsboro, Oregon, also offers one of the more unusual examples of a municipality raising the funds necessary to meet the demands of growth. The city struck a deal with the Intel Corporation to limit the number of jobs it would create at its new plant. Intel will pay a "growth impact fee" of $1,000 per excess worker if it exceeds a ceiling of 1,000 new jobs on top of the 4,000 it already employs in the area. In theory, the fees would be used to ease the strain on schools, roads, utilities, and other services. But the message that is heard loud and clear is that the city does not want the growth – period.

Other states have become property owners in the interest of managing growth. Last November, 68 percent of the voters in New Jersey supported Governor Christine Whitman's $1 billion bond issue to set aside half of the state's remaining two million acres of open space over the next 10 years.

Ownership in the planning process. The Livability Agenda properly identifies the importance of public and private involvement in local planning. In practice, it is difficult to stimulate sustained interest in conceptual comprehensive planning. People understandably, but unfortunately, are most likely to get involved when development in their immediate neighborhood is imminent. For example, neighborhood opposition is currently delaying a major redevelopment in Seattle's Northgate urban center, despite the fact that the proposal, as approved by the City, would comply with the local plan. Washington's GMA tries to resolve major disputes during the planning stage by making it difficult to change comprehensive plans and development regulations to address specific projects.

Fostering community ownership in the planning process is a "work in progress." In Tucson, Arizona, the "Back to Basics" plan engaged residents in planning their own downtown revitalization.

Neighbors, city planners, community agencies, and local businesses worked on committees to choose from a list of possible restoration projects including tree planting, street paving, sign improvements, low- and no-interest home loans. The city contributed $4.8 million to the project, which helped to revitalize six of Tucson's older neighborhoods. The rest of the project was funded by private enterprise and sweat equity contributed by residents.

In other areas of the country, new initiatives will give the public increased power in basic land use decision-making used in their community planning. For example, voters in Ventura County, California, overwhelmingly approved the Save Open Space and Agricultural Resources initiative (SOAR) in November 1999. SOAR requires every proposed development that needs a zoning change to be approved by a public referendum. Similar measures were passed in four individual cities within the county.

GMA vs. ESA: A TALE OF URBAN DENSITIES UNDER STATE AND FEDERAL LAW

The Puget Sound region also offers a unique example of how state and federal laws may be working toward similar environmental objectives, but at cross-purposes in terms of their impact on growth management and livability. Where contradictions occur, communities face complex choices and developers and land owners may face yet another series of complications and restrictions.

In March 1999, the Puget Sound Chinook salmon and several other salmon species were listed under the Endangered Species Act (ESA).[11] In the 26 years since Congress passed the ESA, no other listing has affected such a large, urbanized region—currently populated by more than three million people and growing. Chinook salmon habitat extends along Puget Sound's waterfront, into western Washington's most densely populated urban and suburban centers, and into the farm, timber, and natural areas. More than 20,000 miles of watershed, shoreline, and streams will likely be protected under the ESA, which has obvious land use and permitting implications for commercial, residential, and industrial development.

Setting urban densities dramatically illustrates the challenges posed by competing livability objectives framed by the GMA and ESA.

On the one hand, the GMA generally requires residential densities of at least four units per acre in urban growth areas. Densities of one or two homes per acre are generally not allowed because of the high costs of providing urban services at such densities.

On the other hand, scientists have found a correlation between residential density and the health of aquatic habitat needed for salmon. Densities of over four units per acre statistically have greater adverse impacts on water courses than the one unit per acre densities that are to hard to efficiently serve.

The ESA is also likely to shift the role of standard setting from the local level to the state and federal governments. If not done carefully, we can expect the new regulations to generate a property rights backlash that will add pressure in Congress to amend the ESA.

Land use attorneys, real estate agents, and developers face significant challenges in keeping up-to-speed on changes in local and state development regulations. It can often be overwhelming to understand the legalities and accommodate the practicalities of multiple layers of growth-related legislation, some of which is contradictory and much of which places clear limits on land use, growth, and development. Federal statutes introduce further complexities relative to smart growth and comprehensive planning. Nonetheless, compliance at all levels is necessary. It is not yet clear how the salmon crisis will be resolved, or how similar situations will play out in other regions. But, as growth occurs in other densely populated areas, some of which are also home to unique animal and plant life, it is likely that the ESA and other federal legislation will similarly impact state and local growth management initiatives across the nation.

PUBLIC AND POLITICAL WILL AT THE HEART OF THE ISSUE

In theory, most Americans support the idea of growth management and limiting urban sprawl. Most strongly favor cleaner air and water, shorter commute times, lots of green spaces, and parks in which to enjoy leisure and recreational activities. However, theory and reality do not always go hand in hand. A recent national survey conducted by the National Association of Home Builders (NAHB) showed that 75 percent of those polled felt that when managed properly, growth is good for the community; 54 percent said it creates jobs; 48 percent said it generates economic growth; and 44 percent said it results in better shopping and services.

At the same time, only one-third of those polled chose making more public transportation available. Even though many respondents advocated the use of public transportation, and had access to it, they chose to use their own car for commuting. When asked what buyers want in a new home, 69 percent said more energy efficiency; 42 percent said they wanted a bigger house; and an equal number said they would look for an area with less traffic. Yet when asked what they would be willing to accept if they could not afford to purchase the house of their choice, 58 percent chose a location farther from shopping, entertainment, and other services; 40 percent chose a longer commute to work; and a whopping 83 percent said they would choose a single-family home in outlying suburbs over an equally priced townhouse in an urban setting.[12]

The Growth Management Act, the Endangered Species Act, and local ordinances all provide Washington State with a legal framework in which to accomplish "smart" growth and preserve natural resources — in other words, to create livable communities. This framework, like any other livability legislation throughout the country, is not without controversy and contradictions, nor is it carved in stone. Washington's experience has been a mixture of success and challenge, and therefore effectively illustrates the complexity of implementing growth management initiatives. Beyond the legalities of growth management, cooperation and creativity are perhaps the most critical elements to achieving the objectives of the Livability Agenda and those set out in detailed, comprehensive plans. Developers and landowners expect reasonable profits. Residents and businesses expect to be able to live and operate in desirable areas. The salmon's need for habitat to migrate, spawn, and grow affects all these expectations. The challenge, as always, is arriving at a suitable compromise so that everyone gets at least some of what they want in a sustainable way.REI

NOTES

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3. www.smartgrowth.org
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8. RCW 36.70A.060 and .170.
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Real Estate Counseling in Litigation: Illustrated by Eminent Domain

by Richard C. Shepard, CRE

Growing Role of the Real Estate Counselor in Litigation Including Eminent Domain

Increasing complexities of both law and real estate, including its valuation, created a growing need for real estate counselors in litigation, particularly in eminent domain or condemnation. This manuscript presents the perspectives and observations of a Counselor of Real Estate (CRE) who serves as an expert witness in support of real estate litigation.

As a profession, real estate counselors have responded to this increased real estate complexity in all aspects, not just litigation. Counselors of Real Estate are increasingly involved in high impact decisions and complex transactions. More high-profile and respected industry leaders have joined the ranks of The Counselors of Real Estate, further expanding the capabilities and network of its members. The Counselors of Real Estate was founded in 1953 by real estate leaders seeking to enhance the quality of respected professional advice available on real property matters. Their CRE Designation recognizes the invited counselor's demonstrated judgment, integrity, and experience in real estate.

There are many aspects of real estate subject to litigation which require the insights of experts. Eminent domain has been a dominant field for real estate counselors in support of litigation, usually as an expert witness, but also as a litigation consultant to the attorney and his or her client. However, other complexities of modern real estate, as they involve litigation, have also pulled upon the real estate counselor's talents and experience. Governmental regulations, tax increment financing, and regulatory takings are prominent current-day examples.

ABOUT THE AUTHOR

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Typically, in eminent domain, the legal system relied upon the appraiser as the primary expert, usually testifying to value or changes in value. Primary disputes were over value itself, the ultimate determining factor of compensation for a taking. A traditional example would be the difference in values before and after a partial taking for highway right-of-way in order to determine just compensation. In an uncomplicated taking of an entire tract of ground, relying solely upon an appraiser may be satisfactory. Even then, highest and best use is always relevant and can complicate the valuation. Partial takings can become more difficult. Claimed changes from present use can drastically affect value. These and other complicating circumstances affecting valuation and analysis call for more innovative thinking in order to address the overall challenge, going beyond conventional appraisal and into the field of real estate counseling.[1]

Real estate counseling surfaced as an enlightened and encompassing approach to current real estate complexities. A determination of highest and best use serves as a foundation for valuation. The firmness of this foundation is a key. The real estate counselor can focus not only on an experienced and relevant approach to highest and best use but also on the many other factors affecting value. These factors include market and marketability, economic viability, developability, accessibility, traffic conditions, governmental regulations, and community wants and needs, just to name a few.

Attorneys, juries, and judges are often not satisfied with an over-simplistic approach, yet share a need for lucid and simple explanations to facilitate their understanding of the facts and the issues. The issues have broadened in perspective. For example, judges in Missouri have permitted juries to hear any testimony that a buyer or seller would consider or that clarifies factors affecting value. Real estate counseling has emerged as an answer. Increasingly, our complicated economic and real estate issues require complementary litigation consultants and testimony — from both appraisers and real estate counselors, as well as engineers, land planners, or architects, depending upon the issues involved.

While this manuscript relies upon eminent domain for its focus and illustrations, the same characteristics of a real estate counselor offer similar advantages for other real estate litigation. The seasoned CRE's reputation, credibility, professional presence, and ability to persuasively communicate his or her expertise to those outside of the field, strengthens his/her role on the stand.

THE STEPS

In using a Counselor of Real Estate, the attorney should pursue the following steps:

- Determine the need for a Real Estate Counselor—the particular skills and knowledge needed relevant to the issues involved, especially those not provided by traditional appraisers, whose valuations are still a necessary part of the eminent domain process;

- Select and qualify the Counselor — recognizing his or her ability on the witness stand, not only in terms of past litigation support or reference checks with other attorneys, but also his/her real estate experience and reputation, particularly in the issues likely to be encountered in the case;

- Define the assignment—customize and adapt the qualifications of the Counselor to the case, but also broaden to allow the Counselor to pursue avenues of knowledge and insight as they unfold, including full use of the Counselor's network of resources;

- Question and challenge the Counselor—demand to be taught, not only to be in a position to present the Counselor and his or her insights and opinions, but also to learn and understand the Counselor's perspective of real estate in order to develop and best present the case in trial;

- Seek strategic input from the Counselor—relating to the real estate issues involved; the approaches being considered in presenting the case; the other witnesses on both sides; the strategy and possible testimony of the other side; and cross examination; and,

- Confidently present the Counselor as an integral part of the case—the real estate counselor can help the attorney tie the case together.

ATTRIBUTES OF A SUCCESSFUL EXPERT WITNESS

The needs of the litigator dictate the attributes required or desired in a real estate counselor to serve well as an expert witness. Expertise in the field of the particular litigation or property is essential, but that expertise alone is not all that is needed.

Not all real estate experts are well suited to be expert

witnesses — not all are willing. Many experts do not want the exposure, potential conflicts, adversarial challenges of cross examination, and schedules subject to the timing of the judicial system. Many do not want to commit the time nor wish to appear in opposition to others in their own industry. Some cannot endure the frustration sometimes resulting from the legal process. Properly executed litigation support is demanding work — detailed, thorough, and tedious, and frequently pursued solo during preparation. The expert needs to be able to testify thoroughly regarding his or her view and how he or she got there. Over reliance on subordinates or detachment from the discovery and analyses can be catastrophic in cross examination.

Obviously, credentials such as education, experience, and professional acceptance and recognition provide a key foundation. They are the trappings and initial measures of the counselor's expertise. However, such credentials must not be exaggerated or over-stated, or they can backfire. Rather, these credentials can be reinforced by the expert's testimony at trial.

Most important of all is an expert's credibility and the perception of that credibility by the judge and jury when on the stand. A lot depends upon the expert's confidence in his or her opinions and the foundation for those opinions. The expert should be perceived as fair and unbiased. The opposing counsel will try to negate, damage, or at least question that perception. That perception will be the ultimate measure of the Counselor's expertise as far as the trial is concerned. Perceptions become reality in the minds of the jury, just as they do in the real market place.

Good expert witnesses are committed to and comfortable with their role. They form firm opinions, demonstrably supportable and defendable. Expert witnesses should prepare thoroughly. An opinion based solely upon an egotistical view of their own competence likely will not stand up before a judge or a jury. Real estate counselors must be qualified to understand and perform the detailed and analytical studies, research, and investigations needed to form and support an opinion, soundly based upon years of experience as well as the data discovered. They are inquisitive, dig for more insight, and know where and what to look for in the investigation and preparation. They recognize the 'red' and 'yellow' flags. They stay current through education, professional participation, review of the current literature, maintenance of a network of professionals in real estate and related fields, and a diverse practice which increases and broadens experience.

Capable experts do not stretch a weak point. They admit when they do not know an answer, rather than bluff. Effective experts communicate with the judge and jury, demonstrating firmness in a courteous and non-abusive manner. They realize that perceptions of the jury and the judge can become reality. Expert witnesses teach, inform, and persuade, rather than sell.

Experienced trial attorneys know the rules of litigation and the legal aspects of the cases they present. But real estate counselors serving as expert witnesses know real estate, their subject, too. Neither judge, jurors, nor attorneys are likely to know as much about many of the technical and practical aspects of real estate. Counselors, as real estate experts in the courtroom, grasp and present the big picture, yet can get into detail when needed. However, the expert witness recognizes that the attorney is the captain, the manager, and the quarterback. The expert witness surrenders a degree of control to the court and the attorneys — and shows respect for both. Good expert witnesses are not arrogant, yet have a deserved confidence in their competence and their opinion, because they are both knowledgeable and well prepared. These same attributes in turn help the attorney feel confident and well prepared. Capable experts do not stretch a weak point. They admit when they do not know an answer, rather than bluff. Effective experts communicate with the judge and jury, demonstrating firmness in a courteous and non-abusive manner. They realize that perceptions of the jury and the judge can become reality. Expert witnesses teach, inform, and persuade, rather than sell.

Expert witnesses should not fear the challenges of the witness stand, including the adversarial questions of cross examination, and need to take the heat, the abuse, and the hostility, when it occurs. Cross examination can be an opportunity to find beneficial openings and reinforce key points. Most helpful openings occur with questions aimed to

refute the expert's actual testimony and to challenge his or her opinions. The questions and the permitted answers deal with the facts and opinions in the case. The ability to recognize and capitalize on such openings and use them to broaden and reinforce the expert's testimony discourages further aggression from the opposing attorney. Other questions target the witness' credibility and reputation, often by inferring bias. Rates and compensation are often a prime target to imply prejudice. These are normal frontal challenges which should be anticipated. The capable expert witness prepares for such attacks and addresses them calmly.

THE ASSIGNMENT

Frequently, real estate counselors fill in the missing pieces of the puzzle, sometimes by taking the issues apart piece by piece and then putting them back together in a way that is easily understood. Counselors help the attorney tie together the overall picture, then portray a broader, more easily understood view. Counselors serve as real estate mentors teaching attorneys some of the unique real estate issues and the answers: for example, the varied factors affecting value in a condemnation case. Attorneys should demand such a learning opportunity.

Usually, the real estate counselor brings multiple areas of expertise and experience to litigation. Real estate counselors are not created from a single mold. Each applies his or her own education, experiences, and professional networks to the thought processes needed. CREs are diverse in their backgrounds and abilities, enabling an attorney to customize available advice and testimony, once they understand the particular CRE's talents.

Some CREs are also certified appraisers. Counseling can be conducted in conjunction with valuation testimony. However, some of the complementary benefits of the two separate roles in a complex case could be lost. The attorney may prefer to keep the real estate counselor, as an expert witness, from being limited by the previously established rules of appraisal, some of which have been subject to challenge.

Thus, in eminent domain cases, a counselor's assignments may exclude valuation but include providing input which provides a foundation and support for an appraisal being prepared by a recognized appraiser. Examples include highest and best use; factors affecting value; feasibility and economic viability of contemplated or proposed uses; and land or building economics, (including challenges and costs to develop, as well as the likelihood of success if developed). The assignment can also include the review of appraisals. "The counselor can help the attorney understand the premise on which an appraisal is based and its strengths and weaknesses; the counselor also apprises the attorney of mathematical errors, unrealistic assumptions, etc."[2]

Counselors can contribute and suggest challenges to the other side, possible rebuttals, and questions for cross examinations. These contributions can include critique and review of the other side's experts, including their reports, depositions, testimony, designs, and assumptions. The opposing testimony may suggest other countering witnesses for the counselor to recommend.

From a more positive view, the counselor, using the insight and knowledge gained, can help develop strategies for negotiations and settlements, which may save the costs of further litigation. The counselor often can provide an understanding of the other side's reasoning, motivations and concerns, strengths and weaknesses, and even their mistakes. However, settlement also may require the counselor to provide a candid evaluation that could differ from the client's perceptions, suggesting values which may be higher or lower.

APPROACHES AND METHODS

A broad list of the approaches and methods used to gather insight and draw conclusions reflects the comprehensiveness of investigation. While focus can be important, blinders are not appropriate. A generalized list of resources and approaches used by a counselor in an eminent domain engagement might include, but not be limited to, the following:

Property visits
Area tours
History of the property and area
Photographs
Documents
Property files
Transactions
Studies/Analyses
Research
Database search and review
Governmental agencies & officials
Ordinances & regulations
Tax appeals
Loan applications
Marketing efforts

Designs
Consultants
Engineers
Architects
Planners
Attorneys
Experience
Real estate networks

Repeated visits to the property and tours of the surrounding area broaden discoveries and deepen knowledge; they are essential to be ready for cross examination where lack of first-hand insight can be damaging. Some expert witnesses prefer to shoot their own photographs as field notes and future exhibits in order to capture what is needed; to significantly ease introduction; to support testimony; and to participate in exhibit selection and design. Candor and rapport with city and county officials, coupled with knowledge of what to seek in government documents and records, provide vital evidence and insight. Recent tax appeals and loan documents on income property can provide both insight and relevant data. The attorney and counselor may be looking for evidence of the propensity of a community to allow a change in use or deny the development of a property. Although it may seem remote, history of the subject property and the surrounding area can be very enlightening and can lead to further discoveries. Attorneys should encourage their experts' further investigation and pursuit of relevant evidence for preparation and trial, setting a tenor for expansion of resources and continued search. A final visit to the property and the surrounding area just before testimony at trial often results not only in reinforcement but also in additional discovery.

THE PROCESS — THE REAL ESTATE COUNSELOR AT WORK AS AN EXPERT WITNESS

Obviously, the attorney and the expert need to temper the depth of the process and preparation to cost-effectively match the magnitude of the case and the roles of other experts, while ensuring sufficient information and preparation to draw valid and supportable conclusions. The attorney can gain from understanding the stages of a real estate counselor's approach to a litigation engagement involving eminent domain. Although the approach to each case should be customized, the following outlines steps to pursue.

Stage I - Initialization: Starting the Process

Consideration - The attorney determines the applicability of a particular real estate counselor as an expert witness. This requires a candid discussion of the case, the basic issues, the expert's credentials, and potential conflicts.

Engagement — Clear understandings are required about the objectives in engaging the expert; the working relationship between the attorney and the expert, as well as other experts in the case; and the expert's compensation and the party responsible for payment, particularly if it is a new relationship.

Assignment — Ideally, the assignment should be reasonably well-defined, but subject to further modification as investigation and discovery proceeds. Almost invariably, the scope will increase beyond that originally anticipated. Sometimes the Counselor is engaged initially as a consultant in support of the litigation, with the decision deferred until later on whether to use the Counselor as an expert witness. There are cases where the Counselor may be used for support and discovery, but not for testimony.

Stage II — Basic Foundation: Gathering the Initial Insight

Assemblage of the basic facts — This should include a preliminary understanding of the subject property. This view should incorporate the expert's basic real estate background; a property visit and inspection; initial review of property descriptions and data available from the attorney; and review of readily available documents. These documents could include such basics as USGS topographic maps; street maps; municipal or county ownership maps; zoning maps; municipal or county land use or comprehensive plans; agricultural soil mapping and reports; utility maps; and flood insurance maps.

Stage III — The Discovery Chain or Loop: Finding Facts and Reaching Opinions

Many of the most relevant facts and insights, as well as evidence and exhibits, come from this core part of the process.

Discovery of additional facts and insights — Information can come from a number of sources. Examples include depositions, appraisals, municipal or county documents regarding the specific property or surrounding area, interviews with planning and zoning officials, analysis of proposed development, demographic studies and reports, etc. The Internet can provide a source for research which should not be overlooked.

Revisits to the subject property — Subsequent revisits to and photographing of the property and surrounding area frequently lead to new discoveries. Sometimes such visits are needed to further verify, explore, or expand upon insight gained elsewhere.

Review of and visits to comparable properties—Visiting and analyzing comparable properties used by the appraisers, especially the adversary's comparables, can shed some light and produce real ammunition.

Networking — Networks of other professionals and officials usually produce new information relevant to the case or suggest other areas for further exploration. Access to such networks of expertise is an invaluable asset provided by the real estate counselor which is greatly appreciated by the attorney.

Solo brainstorming — Some may view this as mental gymnastics. The process needs to fit the individual expert and his or her mental style but great rewards can come from this technique. Personal computers with word processing, spreadsheet, desktop publishing and graphics software, and Internet access can be most useful. Depending upon the case, this step could include calculations and analyses. After assembling as much insight as possible, often in outline format, the counselor can reorganize and rearrange such intelligence to coincide with mental paths, and look for 'connections' or 'mental leaps.' Highlighting the most significant insights or returning to an outline helps, discarding that which may mislead or sideline direction. In this way, a path to opinions and conclusions can be forged.

Group discussions — Sharing of insight among the attorneys and other experts involved helps each participant understand, learn, confirm, and challenge. However, the potential brainstorming which could occur should be done only with the concurrence and guidance of the attorney. The attorney may wish to avoid direct communications between independent consultants before initial opinions are determined.

Exploring new channels — The foregoing steps will point to other sources to pursue for insight.

Repeats of the discovery chain — This consists of repeating all or parts of the above chain, as needed, in an iterative process, but without prejudgment. Once armed with the broader and more complete picture, new details and insights can become apparent.

Recent tax appeals and loan documents on income property can provide both insight and relevant data. The attorney and counselor may be looking for evidence of the propensity of a community to allow a change in use or deny the development of a property. Although it may seem remote, history of the subject property and the surrounding area can be very enlightening and can lead to further discoveries.

Stage IV — Deposition Process: Being Discovered

The Deposition — The opposing attorney will try to determine the expert's conclusions and the basis for those conclusions, while also trying to box or confine the scope of later testimony at trial. Prior guidance from the witness' attorney can be important. The expert, in response, should limit the information disclosed in deposition to responses to the specific questions, not volunteering added insights, while trying to expand the dimensions of the assignment when the questions attempt to limit such scope. The witness should listen to the questions and avoid confirming any mis-characterizations of his or her testimony, which may be offered by the opposing attorney in the form of questions misleadingly restating the testimony. The witness can respond by carefully restating the testimony in his or her own words.

Review and correction — Recognizing that the transcript can be used to benefit the opposing attorney in trial, even in subsequent trials, the expert witness normally should not waive signature but rather review and correct the record. Reviews of depositions also can become tools to learn more about the other side and their strategy. (The witness should advise his or her attorney if his or her position subsequently changes, so the attorney can conform to court rules.)

Stage V — Trial Preparation: Preparing for the Witness Stand

Repeats of the discovery chain — If needed, this step can be beneficial.

Exhibit preparation — Visual aids can be great tools with which to inform, (and hopefully persuade), the judge and jury and serve as excellent reminders for the attorney and the expert. These may include photographs, maps, lists, demographics, calculations, tables, graphs, etc. The attorney will make the final selection, sometimes altered during the trial, and will plan his or her introduction and acceptance by the Court as identified exhibits for the record. In these days of computer-based geographic information systems, customized mapping can be economically available, sometimes through on-line services, through governmental agencies such as planning or assessor/revenue functions, or through some colleges and universities.

Organizing, outlining, and highlighting thoughts — This list can be mental or written, depending upon not only the expert's preferences, but more importantly, those of the attorney. If the list is a written outline, it should be sufficient to trigger key points, but not detailed enough to cause canned answers or provide a discoverable treasure map for the opposing attorney. The attorney may request a report to use in the trial. Whether using a report, outline, or neither, the expert witness still must know his or her subject thoroughly — an outline or report does not replace or relieve the need for the expert's knowledge. The expert's opinions and their foundation need to be firmly in his or her mind.

Stage VI — The Trial:
The Culmination of the Process

Discovery during trial — The attorney can call upon the expert for counsel or for further pursuit and discovery as a result of testimony brought out during other parts of the trial.

Direct examination — The witness responds to the questions from his or her attorney. This is the expert's opportunity to teach using his or her expertise by presenting facts uncovered and opinions formed during the foregoing steps of this process. However, the court has different rules than the classroom — this is not an opportunity to lecture beyond the scope of the questions asked by the attorneys. The judge sets the rules and the attorney calls the plays. A firm and courteous manner creates positive perceptions in the minds of both the judge and the jury, thereby reinforcing credibility.

Cross examination — The opposing attorney tries to refute the evidence offered by the expert or to damage the expert's credibility. The expert witness, aided by the attorney, should anticipate the areas of cross examination and possible lines of questioning. Calm, solid answers to opposing counsel enhance credibility. Again, the expert listens carefully to the questions. Expert witnesses are entitled to explain their answers and should not compromise their concluded opinions nor accept any mis-characterizations of their testimony. From a positive perspective, reinforcement of key points through answers to questions from opposing counsel discourages further aggression. Cross examination may be followed by redirect examination by the client's attorney to help draw out and frame those answers and to take further advantage of openings which may appear during cross examination.

WHY A COUNSELOR OF REAL ESTATE (CRE)?

The growing need for real estate counselors in litigation, including eminent domain, results from the expanding infrastructure and redevelopment of our cities, coupled with the increasing complexities of modern day real estate and its valuation. An experienced counselor provides added flexibility to customize the preparation and presentation of a case. While not all are suited and not all are willing, many times appropriately qualified real estate counselors provide the needed attributes. However, they must be disciplined to the challenges and rigors of such litigation and be comfortable with that role. Ultimately, credibility becomes the real key in the courtroom. Commitment and adherence to the Code of Ethics and the Standards of Professional Practice[3] of The Counselors of Real Estate provide an excellent foundation.REI

NOTES

1. A.C. Schwethelm, CRE: "Counseling and Eminent Domain," *Real Estate Issues*, Volume 14, Number 1, Spring/Summer 1989, The Counselors of Real Estate (*a.k.a.*: American Society of Real Estate Counselors).
2. *Ibid.*
3. *1999 Member Directory*, The Counselors of Real Estate.

Intersections Between Real Estate & Telecommunications: Turning Copper Into Gold

by Paul S. Rutter, Esq.

Building owners are in the position today to reap additional income and value from their buildings through the surge of new telecommunications technologies and the demand for access to building tenants and users by an expanding number of telecommunications companies. The intersections between buildings and telecommunications are providing property owners with the ability, literally, to turn copper into gold.

THE DEMAND FOR TELECOMMUNICATIONS SERVICES IS EXPLODING

The demand for high-speed, broadband telecommunications is dramatically increasing, and the telecommunications industry is responding with new technologies at a faster pace. Tenants want Internet access; wireless telecom service; paging; cellular; and traditional hard wired telecom services. Data transmission is now exceeding voice transmission across telecom lines. Data traffic is growing at an annual rate of 30 percent or more. Video conferencing is becoming more common as the technology improves, and video and audio messages are going to be an increasing part of e-mail communications. Building owners are facing explosive growth in demand by their tenants for access to new telecommunications services, and demands for access by competing telecom providers to get to those tenants; these demands will only increase as the latest communications networks come on-line, with telecom providers seeking more customers and with businesses demanding full-time Internet access and the right to choose among telecom providers.

WHAT IS HAPPENING ON THE TECHNOLOGICAL FRONT?

A variety of technologies are available for broad bandwidth users that

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are creating greater demand by building tenants for access to telecommunications services. These new technologies will allow data transfer up to 25 times faster than the current rate for most users. Some of the technologies now being offered are:

Wireless Broadband - wireless, competitive local exchange carriers (CLECs) offer telecom services to users at lower costs and faster speeds than the incumbent local exchange carriers (ILECs). Wireless CLECs offer voice, data, local area network interconnections, video, and other advanced uses. This technology uses microwave dishes to transmit wireless signals between a central switch and building rooftops that are within one to three miles of the switch. From the building rooftop, the signals are transmitted to users through existing wiring (fiber-optic or copper) in the building.

In 1998, the Federal Communications Commission (FCC) auctioned a large spectrum of wavelengths for communications, permitting the wireless CLECs to offer "fiber-in-the-sky" quality service to users. The wireless CLECs, such as WinStar and Teligent, have increasing requirements for access to building rooftops to locate their antennae and equipment in order to bridge the so-called "last mile" between their central switches and the buildings housing the users.

Digital Subscriber Line - Both CLECs and ILECs offer Digital Subscriber Line (DSL) service. DSL provides advanced broadband telecom services over existing building wiring, allowing both voice and data to travel as digitized packets over the same analog-twisted pair line. DSL service is less expensive than the T-1 lines currently being offered by most ILECs. However, DSL service is currently limited to areas within three miles of the provider's central switch. Therefore, it is not offered in more outlying areas and DSL is subject to technical limitations on the number of circuits available over the same wires. DSL providers have to access the buildings using either fiber-optic cable or traditional copper wiring in the streets.

There are a variety of DSL technologies now being offered, with new ones being developed which will further expand the bandwidth capacity of copper wires, making the existing wiring in buildings more valuable than ever to owners, tenants, and telecom providers.

T-Carrier Lines - T-Carrier lines are offered by most ILECs to provide broad bandwidth and speed over Category 5 copper wiring or fiber optic cable. There is a hierarchy of T-Carrier lines (T-1, T-2, and T-3) offering different transmission speeds. T-Carrier lines use a digital system carrying both voice and data. Like DSL and wireless services, T-Carrier lines make the existing wiring in buildings more valuable as competition for access to services increases.

ISDN Lines - Integrated Services Digital Network (ISDN) service is offered by ILECs over the existing copper wiring. This was one of the first technologies offered by ILECs to increase data transmission over existing wiring. While ISDN technology does not have some of the technical limitations of DSL, it is becoming outdated in many areas as other services are becoming more widely available.

Cable - With recent acquisitions and mergers in the telecommunications industry, it is clear that cable service will be a strong competitor for telecom users, with cable subscribers being able to use their cable not only for television reception, but also for full-time Internet connection and telephonic and data communications. The cable industry infrastructure is not as extensive and reliable as that of the ILECs or CLECs, but cable service is often less expensive than DSL service (although there is heated price competition among DSL and cable providers).

REGULATING THE RIGHTS OF BUILDING OWNERS, TENANTS AND TELECOM PROVIDERS

Federal and state regulators and the courts have issued regulations and made rulings that have significant impacts on the respective rights of building owners, tenants, and telecom providers. One central issue is who has control of access to a building's wiring, the crucial link between providers and the end-users of telecommunications services.

Demarcation Points - In 1997, the FCC ruled that a building owner can declare the point where telecom wiring enters the building, known as the minimum point of entry (MPOE), as the "demarcation point," marking where the owner takes ownership and control of telecommunications cabling. If the building owner or the ILEC declares the MPOE as the demarcation point, the owner takes ownership and control of the cabling inside his building, allowing the owner to set fees for telecom providers to use the wiring, equipment rooms, and the building rooftop, and to control access to the building by telecom providers. At the same time, the owner also assumes responsibility for the maintenance and

integrity of the wiring and may have potential liability to tenants for any failure in the wiring, depending on the language in the tenant leases.

The FCC has clarified that ILECs cannot unilaterally change the demarcation point to the MPOE (and thereby force a building owner to take responsibility for the building's cabling and wiring), if the ILEC provided service to the building as of 1992, when the FCC initially issued its rules on demarcation points. The FCC does permit ILECs to establish the MPOE as the demarcation point in new or renovated buildings from and after 1992.

If the building owner has responsibility for the building's wiring, tenant leases should address the issues of who has liability for any service interruption; who maintains insurance on the wiring and how the cost is shared; and the allocation of responsibility between landlord and tenant for any work on wiring within or outside of a tenant's premises, including rules on access to building telephone closets and risers.

Antenna Installation - A 1998 FCC ruling expanded prohibitions on antennae restrictions to include both residential and commercial property rented by the viewer. The FCC ruling preempts any lease restrictions that unreasonably restrict a viewer's ability to receive a signal. However, reasonable restrictions by the building owners on antennae and equipment, (such as limitations on changes to the building structure and regulations protecting safety), are enforceable. The ruling does *not* allow tenants to use common areas (such as a building rooftop) to place antennae or equipment. Also, an owner may restrict the installation of individual antennae if there is a central antenna available to all tenants without unreasonable delay or expense.

Forced Access - Prior to the Telecommunications Act of 1996, some states passed mandatory access laws or regulations to force building owners to allow competitive telecom services to their tenants. Texas, Ohio, and Connecticut passed such laws, granting CLECs the right to access a building's wiring infrastructure, on a non-discriminatory basis, in return for reasonable compensation. As many as 12 states are considering this issue; however, legislatures in Illinois, Colorado, Maryland, and Indiana have rejected these proposals as violative of the United States and state constitutions. Congress rejected mandatory access laws when the Telecommunications Act was passed. In *Loretto v. TelePrompter Manhattan CATV*, the United States Supreme Court, in 1982, invalidated a mandatory access television cable statute in the State of New York, and courts have similarly rejected mandatory access laws for television cable and telecom providers over the past several years.

Federal and state regulators and the courts have issued regulations and made rulings that have significant impacts on the respective rights of building owners, tenants, and telecom providers. One central issue is who has control of access to a building's wiring, the crucial link between providers and the end-users of telecommunications services.

Most commentators believe that the Telecommunications Act of 1996 has created market forces sufficient to assure competition within the telecom industry, so that mandatory access laws are not necessary for a healthy competitive environment. In fact, there appears to be no greater competition among telecom providers in states in which mandatory access laws have been passed than in other states.

The California Public Utilities Commission (PUC) issued an order in October 1998, that prohibited telecom providers (including ILECs) from entering into agreements with building owners that have the effect of restricting access by other telecom providers to a multi-tenant building. If a telecom provider is unable to reach a mutually satisfactory agreement with the building owner to permit access to the wiring, or if it claims it has been unfairly discriminated against, it can seek redress with a court or file a complaint with the PUC. The PUC also stated in its ruling that telecom providers that are "telephone companies" have the right of eminent domain and can gain access to private property to offer their services.

In response to this PUC ruling, Senate Bill 177 (Peace and Burton) and Assembly Bill 651 (Wright) were introduced in the California Legislature:

i). SB 177 would eliminate the right of a telecom provider to use the power of eminent domain for

competitive purposes, unless the provider has an affirmative obligation to provide telecom services and is seeking to serve an unserviced area. SB 177 also prohibits exclusive telecom access agreements (which owners generally resist anyway).

ii). While AB 651 was originally introduced to prohibit the PUC from adopting orders or making decisions that interfere with the ability of owners of private property to freely negotiate with telecom providers, it has been amended so it now would require building owners to allow telecom access to their buildings. AB 651 denies owners the right to allocate riser and closet space, denies owners fair compensation for space used by providers, and imposes costs on owners for responding to provider access requests. This bill would also require owners of new buildings to provide space to accommodate all future telecom provider equipment and would permit the first provider in a building to grab as much space as possible, effectively shutting out future competitors from that building, who will need space in risers and closets.

These bills are now being considered by the California legislature and would have a dramatic impact on building owners in California, if passed.

IMPORTANT BUSINESS ISSUES FOR BUILDING OWNERS AND MANAGERS AND THEIR ADVISERS

It is imperative that building owners and managers review the physical infrastructure of their buildings and review their policies affecting telecom services to tenants. Real estate consultants who advise owners and managers need to be familiar with the new telecommunications technologies and the options available to their clients in dealing with the demands of both telecom providers and the tenants/users.

Rooftop and Communications Closets - Owners and managers should make sure they know what capacity and space their buildings have available for rooftop antennae and what areas can be used for supporting communications equipment. Owners of buildings with valuable rooftops must carefully allocate the rooftop area and available equipment room space among tenants and outside telecom providers for antennae and equipment only after careful study of the value of the rights being granted. Too often, owners and their agents give tenants rooftop antenna rights or rights to equipment rooms for little or no rental, giving up

Real estate consultants who advise owners and managers need to be familiar with the new telecommunications technologies and the options available to their clients in dealing with the demands of both telecom providers and the tenants/users.

the right to significant future revenue streams from that space during the lease term. In addition, owners often undercharge for the use of their building infrastructure by telecom providers, on the basis that it is more important to offer the services to tenants rather than charge a higher fee for access to the building. With the proliferation of telecom service providers and the scarcity of prime rooftop space in many urban areas, building owners should be very careful not to give away valuable rooftop access or equipment room rights without a thorough understanding of the market for those rights.

Owners also must avoid giving one provider or one tenant rights to an entire rooftop or to all of the equipment space available: the space must be rationed so the owner retains the flexibility to offer space to new tenants or to introduce new services or providers to the building in the future, permitting future CLECs to compete for access to the building. Obviously, these issues are more important if the owner commits to telecom licenses for any significant term without early termination rights.

Risers, Shafts, and Sleeves - Owners and managers need to inventory their riser space and the cabling and wiring in the riser space so it can be properly allocated to competing users. The vertical and horizontal pathways in buildings are the routes for telecom providers to access tenants for all technologies, whether it is over copper or fiber optic cable, and whether it is from a rooftop wireless antenna, a cable or a traditional telephone line. Consultants can assist owners in projecting future demand for building riser space and survey competing buildings to assign values to the use of the risers, so the owner/manager can properly allocate and charge for access to the space. Building managers should require tenants who vacate space or replace their systems or telecom providers who are no longer providing service to the building to make sure decommissioned cable is removed from the building risers.

Long distance telephone companies, computer networks, wireless networks, CLECs, ILECs, and Internet service providers all require access to riser space, but this space is finite and often cannot be increased without enormous cost to the building owner. Owners are now charging tenants separate rent for use of riser space in addition to rent for their premises, and are charging telecom providers for access to the riser space, in addition to charges for use of equipment rooms and rooftops. As new technologies come on-line, the pressure on riser space will only increase, and owners need to retain the right to charge for access to that space in their leases, especially if the demand for riser space overtakes the supply.

Power and Cooling Capacity - Owners/managers that are contemplating agreements with tenants or telecom providers that will permit access to equipment rooms, the rooftop, and riser areas, must consider the electrical power and cooling capacity of the building. Telecom switches are high power users, generating significant heat in concentrated areas, often beyond the specifications for which building cooling and power systems were designed, especially in older buildings. This means that the power and cooling systems in the building may have to be upgraded (and air conditioning must often be supplemented with additional units) in order to accommodate the equipment that comes with the new telecom technologies, especially if the provider is locating a switch in the building. Owners should consult with their advisers and agents to determine the ability of owners in the local market to pass the costs of these upgrades on to the telecom providers.

In addition to demanding significant electrical power capacity from a building, telecom providers also often need access to an uninterrupted power supply (UPS) system and a backup emergency power generator, in order to assure their users continuous service even in local emergencies. If the telecom company is installing a major switch, it may want to install its own generator and UPS system, but this adds to the space requirements and may not be feasible in many existing buildings. Building generators can usually be dedicated to provide emergency power to specific tenants or telecom providers, but owners must carefully ration access to the limited generator capacity of their buildings to avoid depleting the power necessary for essential building functions and future demands by new tenants or outside providers. Any tenant or telecom provider who is given dedicated capacity from the building generator or UPS system should be charged for that access. Owners should have their consultants determine how to charge for this access in the local market: the charge could be based on the cost savings to the tenant or the telecom provider of connecting to the existing system as compared to installing a separate system, or the charge could be based on the actual cost to the owner of providing and maintaining the generator and UPS systems, including labor, depreciation and administrative costs, and a profit factor.

Impact on Building and Tenants - Owners and managers need to consider the impact of telecom agreements on their building and its tenants, beyond the obvious advantages of providing desirable telecommunications services. For example, owners should carefully analyze whether a proposed antenna will be visible from street level, or from other adjacent buildings, and whether such a visible antenna would detract from the value of the building. Also, the owner should consider the issues of equipment weight; safety of other activities on the rooftop (such as window cleaning equipment use); damage to waterproofing and the integrity of the rooftop (including by the penetration of the rooftop for cables and conduits); and any associated environmental concerns caused by the telecom equipment. Finally, consideration should be given to the perceptions of other tenants in the building if large portions of the office space in an office building are leased to telecom providers for equipment rooms, switches and the like: other tenants may perceive these uses as less desirable than office uses, which could negatively impact the value of the building.

IMPORTANT LEGAL ISSUES FOR BUILDING OWNERS AND MANAGERS

Building owners and managers who are considering entering into an agreement with a telecom provider or a tenant to allow access to the rooftop or other area of the building for telecom purposes face all of the legal issues they deal with in leasing space to a tenant. In addition, they will face some issues unique to the telecom world:

License vs Lease - A license is a contract right, and does not create a leasehold interest in the building. A lease creates a leasehold estate, giving the exclusive right of possession of the space to the tenant during the term of the leasehold. Telecom agreements with tenants and telecom providers are usually structured as licenses, and not as leases, because the area or space being provided for the

antennae or equipment is often not exclusive (i.e., several antennae can be located in an area of the rooftop, multiple cables occupy the riser space, and more than one telecom switch may be located in an equipment room). If space is dedicated exclusively to the telecom company (e.g., where the telecom provider takes possession of a dedicated equipment room or closet), the agreement is often structured as a lease. Whenever possible, the owner will want to avoid creating a leasehold interest in favor of the telecom company and will want to grant only a license to use portions of the building for antennae, equipment, cabling, and the like, so the owner, at least theoretically, retains the right to control the conditions under which the space can be used and to terminate the license if the conditions of use are violated, without the telecom company claiming the legal protections available to tenants. However, if the telecom agreement is structured as a license but ends up giving the user rights equivalent to a tenant, the agreement may be construed by a court as a lease, with the telecom company having a leasehold estate in the building.

Permits and Approvals - Building owners and managers should require, in their license agreements with tenants or telecom companies, that the users assume all responsibility for procuring and maintaining, in effect, all permits and approvals required by any governmental authority for the installation and operation of the antennae and equipment. For example, in many cities, the installation of an antenna on the building rooftop requires the issuance of a Conditional Use Permit or other variance or permit. Also, FCC licenses are required to use telecom transmission equipment. Owners should consult with their lawyers or code consultants to determine if the telecom user is in compliance with the required permits, and the users should produce copies of the issued permits to the owners or managers for their approval prior to any installation of equipment.

No Interference; Right to Relocate - The telecom licensee should be required under the license agreement to avoid any interference caused by its equipment or antennae with any other equipment or antennae installed in or on the building by other licensees. The license agreement should give the owner the right to relocate a licensee's antenna or other equipment to another suitable place on the rooftop or in the building if that equipment interferes with the owner's ability to provide space for future telecom users, as long as the operation of the antenna and equipment are not impaired.

Real estate brokers and consultants can provide an understanding of the marketplace so an owner can accurately assess the value of each part of the building to tenants and telecom providers. Real estate lawyers should be consulted to assure that agreements with tenants and telecom companies are drafted with proper protections for the owner.

Term; Right to Terminate - One of the most important issues for the building owner and manager to consider in entering into a license agreement is what term the license should have and what circumstances should permit termination of the agreement. If the license agreement produces significant revenue, the owner will want that revenue to be included as part of the building's net cash flow for purposes of future loans or investments by third parties in the building. In this case, the license agreement should have a specific term so a potential lender or investor can count on the license revenue during that period. On the other hand, if the revenue from the license is not significant and the owner foresees increasing demand by telecom users for access to the building's rooftop, risers, or equipment rooms, the owner will want to keep the term of the license shorter, or have right to terminate the license early, or increase the license fee if the market license fees increase. For major telecom facilities (such as switch rooms or major fiber optic installations in a building involving a large capital investment), the licensee will generally insist on a longer license term so the capital investment can be recouped. Regardless of the term agreed upon with the licensee, the owner will need the right to terminate the license agreement upon a monetary or nonmonetary breach by the user, or if the telecom facility is ever found to cause harm to tenants of the building or third parties (including, without limitation, through the release of any hazardous materials or other contamination).

Assignment and Subleasing - The owner should retain the right in the license agreement to approve any transfer of rights, whether by assignment or sublease, by the telecom user. Owners often permit the licensee to assign the license as

part of the transfer of all of its assets in a merger or sale, and where the applicable FCC license is transferred.

Costs and Liabilities - The owners of Class "A" buildings can generally pass all costs of the telecom installation, and the associated costs of any telecom deals, including all installation costs, upgrades to building systems, permit fees, and operating costs of the telecom system, through to the telecom companies. However, some Class "B" building owners who seek upgraded services for their tenants have to pay CLECs to bring new telecom systems and services to their buildings, since the CLECs are not convinced that the tenant base will have adequate demand for their services. In a typical license agreement, the building owner is generally not obligated to make representations or warranties, or otherwise assume any liability to the tenant or telecom company, other than to permit access by the telecom user, on a limited basis, to the rooftop or other designated equipment areas of the building. On the other hand, the telecom licensee should give the owner and manager full insurance for its activities in and about the building, together with an indemnity in favor of the owner, the manager, their partners, and any lender on the building.

Credit - The credit of the telecom licensee must be evaluated by the building owner and manager before entering into a license agreement. Under the agreement, the licensee's credit must be adequate to assure the performance of its undertakings. Owners have learned that although there are some highly capitalized telecom companies, there are also many start-up telecom companies without any real net assets, many of whom will not survive as the industry matures. Owners of Class "A" buildings, where demand for access by providers is high, can be selective in dealing with telecom companies; owners of Class "B" buildings may not have the luxury of screening out the smaller providers, and thereby take a higher credit risk.

TURNING COPPER INTO GOLD

Smart building owners and managers consult with telecommunications experts to become familiar with the emerging telecom technologies and to determine how these technologies will intersect with their buildings. Owners and managers can create new revenue streams and add value to their buildings by leveraging off of the new technologies, whether by providing a rooftop antenna site, leasing out unused basement or mechanical floor space as a telecom equipment room, or licensing multiple telecom companies to have access over the building's cabling infrastructure.

Increasingly, owners are turning to telecom professionals, such as rooftop management companies, to market and manage the telecommunications facilities in their buildings. These professionals offer expertise not available to most building owners, allowing them to maximize the revenues from telecom opportunities. Many large property owners have brought the telecom expertise in-house, and are undertaking regional or national programs to increase the telecom revenues from their buildings. Real estate investment trusts (REITs) have been permitted, under a series of recent Internal Revenue Service Letter Rulings, to receive revenues from telecom providers for providing their tenants with a menu of non-customized telecommunication services that are customarily offered or provided to tenants of similar office properties located in the same geographic markets where the REITs own properties — without losing their REIT status. These Rulings will encourage REITs to explore more revenue streams from offering telecom services to their tenants.

Real estate brokers and consultants can provide an understanding of the marketplace so an owner can accurately assess the value of each part of the building to tenants and telecom providers. Real estate lawyers should be consulted to assure that agreements with tenants and telecom companies are drafted with proper protections for the owner.

Through these steps, building owners and managers have opportunities like never before to perform the ultimate alchemy: turning their copper wire into gold.$_{REI}$

CRE PERSPECTIVE

The Changing Role of the Counselor

by Oakleigh J. Thorne, CRE

The practice of consulting/counseling, whereby an individual studies population, housing, employment, income, and consumer trends in advance of formulating a real estate decision, began in the late 1920s. The first formal step in real estate analysis was documented by William J. Reilly in his 1929 treatise on the "Law of Retail Gravitation."[1] Reilly concluded that there was an inverse relationship between relative population densities and the distance consumers will travel to access retail goods and services. Over time, more sophisticated efforts, aimed at fostering a better understanding of retail markets and consumer spending patterns, were promoted, initially by national food store chains looking for new grocery store locations. Although regional hardware and lumber (home improvement) stores followed the lead, advances in retail store analysis were slow to develop.

The first suburban shopping center was delivered in Dallas, Texas, in 1931, and the first enclosed shopping mall was delivered in 1956 in Southdale, Minnesota. The rudimentary information and untested methodologies used to select both locations signified that efforts were being taken to better understand the household income and consumer spending patterns observed in Reilly's work. After the invention of the automobile which quickly gave rise to suburban areas outside urban cores, "retail vacuums" were created. In other words, demand was presence as evidenced by the population shifts; however, there were no corresponding retail sites or stores in these newly developed areas to satisfy consumer demand. Nelson *(see bibliography)* expanded upon Reilly's prior work and added to the body of knowledge about how to improve the drawing and analysis of suburban retail trade areas. As retail developers gained operational experience, increasingly detailed information and historical data were used to locate and develop expansion stores. Grocery and department stores relied on "productivity" numbers (sales per foot per year) from existing operations to supply the grist for future feasibility analyses, (now referred to as "volume expectancy studies"), or projected sales volumes per foot by merchandise line.

The budding advisory industry began to mature, and concepts were formed to define such factors as "primary and secondary trade areas" (formerly known as "sectors"), "projection techniques," "travel time studies," "disposable household income," "absorption elements," and "site capture." Large department stores were the pioneers, and Macy's was the leader in acknowledging the benefits of investigating consumer spending habits and demographics in order to control the best and most successful locations. In the late 1940s, J.C Penneys, Hudsons, and Sears followed suit.

Following World War II, the advisory industry evolved slowly. As real estate developers and lending industries gained experience and knowledge, each group (the builders and the lenders) developed procedures to protect their specific interests, and seldom was advisory talent sought. As long as real estate market conditions moved forward and upward, the actual health of a specific project was of little concern. Nevertheless, as general economic business cycles waxed and waned, anxiety over flawed real estate decisions became more commonplace, and attempts were made to safeguard against repeated and potential future missteps. Most often, rather than study the causative factors leading to failure, corrective action was taken and those involved moved on to other ventures. The deeper and more prolonged the economic trough, however, the greater the retrospective analysis. At some point in the late 1950s, lenders began requesting "feasibility studies" for proposed new construction. Most reports offered in response were market supply-oriented with a modest effort at forecasting site-specific absorption. Without access to computers, simple cash flow projections resulted in the use of a single-year pro forma.

During the early 1960s, lenders concerned about their collateral in motels and hotels initiated requests for demand studies for new lodging projects thereby giving rise to specialists with a concentration in hotel and motel feasibility analyses. Developers of retail projects, on the other hand, were not questioned about economics as anchor stores completed in-house trade area consumer spending analyses for proposed locations. Likewise, lenders seldom required feasibility studies for proposed office, residential, and industrial projects.

During the late 1960s and early 1970s, retailers and other developers finally accepted that more

formal approaches to demographic analysis were required to reduce the risk inherent in real estate decision-making. A number of white papers, economic reports, books, and demographic studies were published on a wide variety of subjects, which elevated the awareness that economic data could, and should, be employed to predict the success of real estate projects. *(See the bibliography for a list of some of the ground-breaking publications.)*

Contemporaneously, a number of universities established real estate programs chaired by highly regarded professors, including **Paul F. Wendt, Arthur M. Weimer, William N. Kinnard, Jr., CRE**, the late **James Graaskamp, CRE**, and **Homer Hoyt**. One or two well-known universities initiated degree-granting programs with a concentration in real estate, and the Urban Land Institute published its *Community Builders Handbook* in the late 1960s, offering the best approaches to development of residential, industrial, and retail land uses.

Business opportunities for consultants and counselors evolved more rapidly during the late 1970s and early 1980s as their expertise began to transcend the typical feasibility study. Numerous forces combined to promote the industry's growth. For instance, more information became available for use in analytical assignments, and well-defined paradigms were tested and accepted by the advisory/consulting community, lenders, and developers in response to feasibility questions. Further, the market (traders and users) became more sophisticated in its approach to decision-making, and lenders seeking to reduce collateral risks turned to third-party vendors (consultants) for advice.

Structural changes in the capital markets forced consultants to adapt during the 1990s as new financing products gained in prominence including CMBS pools; T.I.F. (Tax Increment Financing); public/private joint-ventures (fiscal impacts); and MUDs (Municipal Utility Districts), all of which required innovative approaches to market analysis and valuation. The rise in sophisticated land use controls and related litigation also fostered a demand for counselors. Emerging new trends suggest that counselors must broaden their skill base, increase their knowledge of industry specialties, think globally, and continue to maintain technological and information resource awareness.

Today, consulting/advisory/counseling activities generally fall into the following categories:

Consulting is the catch-all definition that may or may not include all of the following: delivery of *information* only, *advice and recommendations* (action plans), and *implementation*.

Information delivery is considered consulting by many in the real estate industry. Market information vendors offer current state-of-the-market reports without site-specific recommendations; additionally, a number of vendors offer intuitive observations about future market conditions. The reports concentrate on past trends and present supply and demand factors. Some vendors project future market conditions, but most merely report the current market situation.

Advisory consulting assumes that the assignment's objective is to offer advice, opinions, recommendations, or an action plan for the client. Issues such as whether to lease, build, demolish, expand, abandon, reorganize, own, renovate, arbitrate, and even litigate or disengage the client from any one of the above actions represent advisory assignments. The amount of information, selection of its source, and the analytical treatment to support the advisor's opinions are unbounded and result from the complex nature of the work identified by the client's unique situation.

Counseling activities differ from writing and/or expressing opinions in that they concentrate on implementation tasks. Although the counselor may or may not have been previously engaged in the collection and analysis of information, the primary focus here is to make the event occur to the satisfaction of, or on behalf of, the client. Several practitioners in the real estate industry refer to implementation tasks as consulting.

The following tables reveal two situations typical of today's consulting/counseling industry. *Table 1* describes four study types where a site or sites are known to the parties, *i.e.*, the client and vendor. *Table 2* assumes that no specific site is under study, and four different client groups are listed.

Table 1

GIVEN A SPECIFIC SITE
Corporate Strategies
Impact Statements
Certificates of Need
Dispute Resolution/Arbitration

Table 2

GIVEN NO SPECIFIC SITE
The Fortune 1000 Companies
Merchant Builder/Developer
The Public Sector
Risk Analysis (Institutions)

Figure 1 and *Figure 2* (pages 71 and 72) are an extension of the two tables illustrated on page 69. The flow chart is not a data dump of all known consulting activities but a representation of the most prevalent assignment types. Site-specific feasibility studies have been ignored in this effort as an adequate number of publications already address most land uses.

The parallel blocks in the flow chart have only a common thread when corporate assignments are involved. The two columns, however, concentrate on two different situations. *Figure 1* illustrates a few assignments where there is a known site, and *Figure 2* presents those assignments when there is no specific parcel under study, but where regional or national issues are under review.

The explanation below is not intended to be an exhaustive recitation of infinite detail. Rather, the intent is to educate readers about the breadth, depth, and diversity within today's consulting/counseling industry and the opportunities for business expansion. Each column offers only four primary clients *(Figure 1)* or study groups *(Figure 2)*.

ASSIGNMENTS WITH A KNOWN SITE

Corporate Strategies as a study group frequently involve companies retaining outside vendors to assist facility managers with decisions about both contraction and expansion plans. Regardless of the mission's nature, the consultant vendor's participation is governed by the needs of his or her client. When plants are abandoned, the effort by the consultant may be limited to recommending an agency to list the plant for sale. By contrast, the consultant's role in a plant expansion or relocation is much more intensive and demanding. Relocation studies are more prevalent where the company's objectives are to reduce business costs, capture lower wages for the same skills, or achieve lower transportation costs for its products.

Impact Studies are, at least now and in the foreseeable future, keeping vendor consultants much busier than typical site-specific feasibility reports. What is intriguing about these endeavors is that: a). the contractor has its own reporting guidelines; b). the scope of work is defined by legal counsel; or c). the work tasks and deliverable are defined by legislative bodies.

New Hotel Impact Statements - All hotel chains complete an analysis of the supply and demand for room nights in markets where a new proposed hotel of the same flag might compete with existing hotels of the same franchise. The objective is to assure the existing competition that sufficient demand exists for the new facility to avoid injurious competition among the franchisees. The vendor (Marriott seldom goes outside its company to complete the analysis) must comply with the due diligence and reporting requirements of each of his or her clients.

All chains have different recommended processes and reporting requirements. As an example, Holiday Inn requires a study restricted to the proposed hotel's impact on the occupancy levels of existing facilities; other chains seek the vendor's opinion on both occupancy and rates, and still others require redistribution of fair shares, rack rates, occupancy levels, and cash projection calculations.

The hotel chains do not use a common process for their competitive surveys. In fact, the International Society of Hospitality Consultants recently published a white paper for its members' review to better clarify and standardize the methodologies relating to competitive impact studies.

Branch Bank Applications - Admittedly, some states have no mandates regarding how and where competing branch banks locate. Moreover, consolidation of the banking industry has reduced the number of consulting opportunities. In light of potential public harm, the objective in the investigative work is to assure the banking commission that adding a new branch will not generate injurious competition for deposits. Each state has its unique lexicon and legislative process for communicating the vendor's opinions and testimony before the banking commission. Common threads exist among the studies; however, there are substantive variations among the jurisdictions, making the use of uniform guidelines ineffective.

Land Use Impact - In regions where land use controls are complex and a developer or property owner seeks to obtain a special exception or variance from by-right zoning, a number of studies may be completed by several experts, and testimony may be required before approval is granted to change the by-right zoning. Each land use appeal is different and is orchestrated by the attorney responsible for presenting the case to the pertinent land use authority. Study methodologies vary by case—"before and after" and "echo sounding" methods are commonly practiced by vendor experts. Property types include dog kennels; drive-thru, fast-service restaurants; table-service restaurants; communications structures; adult care facilities; all types of medical, surgical, detox, and drug rehab centers; and more.

A growing practice of entities

Figure 1

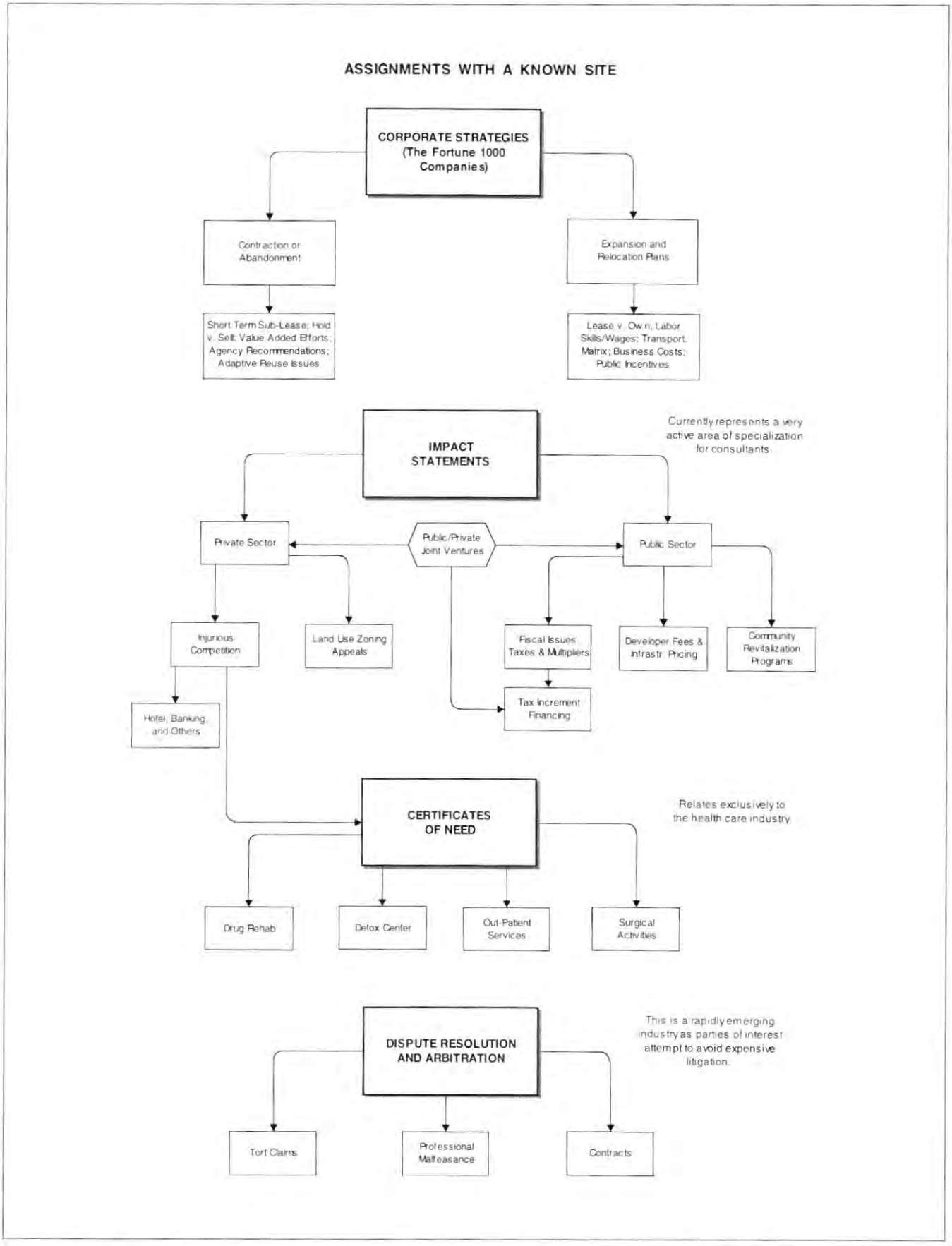
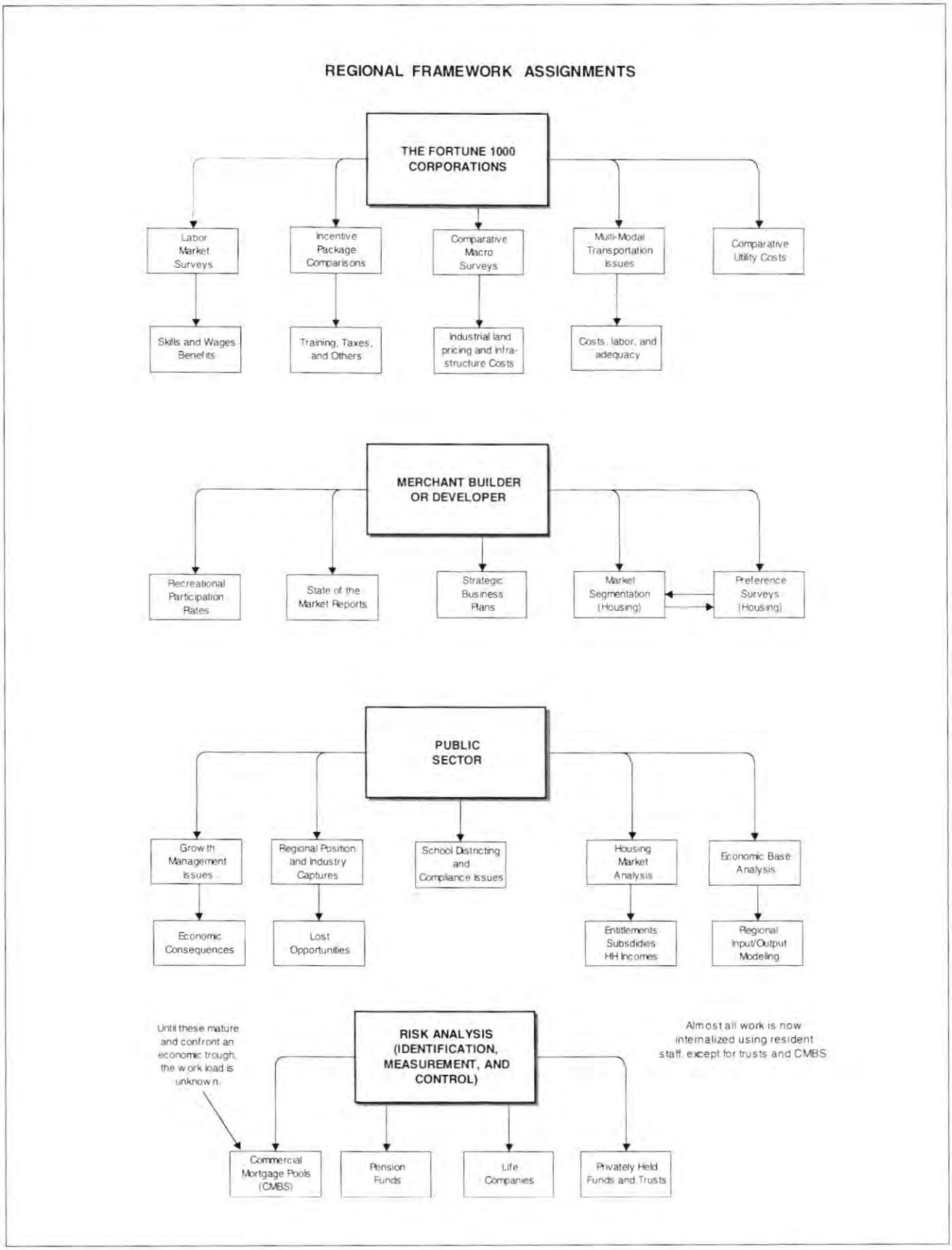

ASSIGNMENTS WITH A KNOWN SITE
CORPORATE STRATEGIES (The Fortune 1000 Companies)
Contraction or Abandonment
Expansion and Relocation Plans
Short Term Sub-Lease; Hold v. Sell; Value Added Efforts; Agency Recommendations; Adaptive Reuse Issues
Lease v. Own; Labor Skills/Wages; Transport. Matrix; Business Costs; Public Incentives
IMPACT STATEMENTS
Currently represents a very active area of specialization for consultants.
Private Sector
Public/Private Joint Ventures
Public Sector
Injurious Competition
Land Use Zoning Appeals
Fiscal Issues: Taxes & Multipliers
Developer Fees & Infrastr. Pricing
Community Revitalization Programs
Tax Increment Financing
Hotel, Banking, and Others
CERTIFICATES OF NEED
Relates exclusively to the health care industry.
Drug Rehab
Detox Center
Out-Patient Services
Surgical Activities
DISPUTE RESOLUTION AND ARBITRATION
This is a rapidly emerging industry as parties of interest attempt to avoid expensive litigation.
Tort Claims
Professional Malfeasance
Contracts

Figure 2


REGIONAL FRAMEWORK ASSIGNMENTS
THE FORTUNE 1000 CORPORATIONS
Labor Market Surveys
Incentive Package Comparisons
Comparative Macro Surveys
Multi-Modal Transportation Issues
Comparative Utility Costs
Skills and Wages Benefits
Training, Taxes, and Others
Industrial land pricing and infra-structure Costs
Costs, labor, and adequacy
MERCHANT BUILDER OR DEVELOPER
Recreational Participation Rates
State of the Market Reports
Strategic Business Plans
Market Segmentation (Housing)
Preference Surveys (Housing)
PUBLIC SECTOR
Growth Management Issues
Regional Position and Industry Captures
School Districting and Compliance Issues
Housing Market Analysis
Economic Base Analysis
Economic Consequences
Lost Opportunities
Entitlements Subsidies HH Incomes
Regional Input/Output Modeling
Until these mature and confront an economic trough, the work load is unknown.
RISK ANALYSIS (IDENTIFICATION, MEASUREMENT, AND CONTROL)
Almost all work is now internalized using resident staff, except for trusts and CMBS
Commercial Mortgage Pools (CMBS)
Pension Funds
Life Companies
Privately Held Funds and Trusts

proposing or opposing sports stadiums is to engage consultants to illustrate the proposed (or existing) stadium's effect on the local community's quality of life, regional employment figures, and increased tax revenues.

The Public Sector and Public/Private Joint-Ventures have produced this decade's greatest demand for highly skilled and analytical professionals. Many studies are fiscal-related, addressing employment, gross and net multiplier, and tax revenue issues. Tax increment financing (T.I.F.) is fairly common when a jurisdiction seeks to offer its credit to finance part or all of a new development at a lower cost by using the state's bond rating to sell tax-exempt bonds. T.I.F. requires the consultant vendor to project the incremental benefit to the community and bond holders to retire the floated bonds. Moreover, as the public sector seeks to enjoin the development community to revitalize neighborhoods, brown fields, waterfronts, and abandoned rail stations, economic and fiscal impact statements will become more in demand.

Certificates of Need studies are similar to hotel franchise issues in that standardized formats are nonexistent. Testimony is generally not required; however, as the general public is at risk, legislative agendas of several states in the Northeast and Midwest dictate well-defined processes prior to issuance of permits to build a wide range of health care facilities. As with injurious competition studies for branch bank applications, the presence of adequate demand is required.

Dispute Resolution/Arbitration is an emerging industry that produces $100 million or more in annual fees for the top five national accounting firms. Skills usually associated with the staffing of these departments encompass economics, engineering, architecture, construction and construction management, and finance. Although real estate prices or values may be impacted by the decision of the panel, appraisers are seldom, if ever, part of the process. Each case is unique, and the dollar amount varies from modest to millions. The complexity of the cases and the dollars at risk define the methods used by the arbitrators to reach equitable determinations. This sector is expected to offer great opportunities for counselors over the next decade.

REGIONAL FRAMEWORK ASSIGNMENTS

Entities searching for a site require a large geographic framework and demand extensive preliminary information before making a decision regarding a region's opportunities, assets, and viability.

Corporations expanding and/or relocating pursue a number of avenues to obtain information on labor markets, public incentives offered to induce companies to locate, comparative land and utility costs, and transportation issues. The continuing pressure on increasing shareholder values implies cost-effective site selection and expansion programs that meet facility budgets. In prior years, the work was completed by contacting and traveling to the E.D.A. of the counties comprising the regions under review. Today, almost all the work, except for site selection, can be done remotely on the Internet. Not all the factors listed are studied by expanding companies. The firm may be concerned only with labor supply issues or access to new and specific skills.

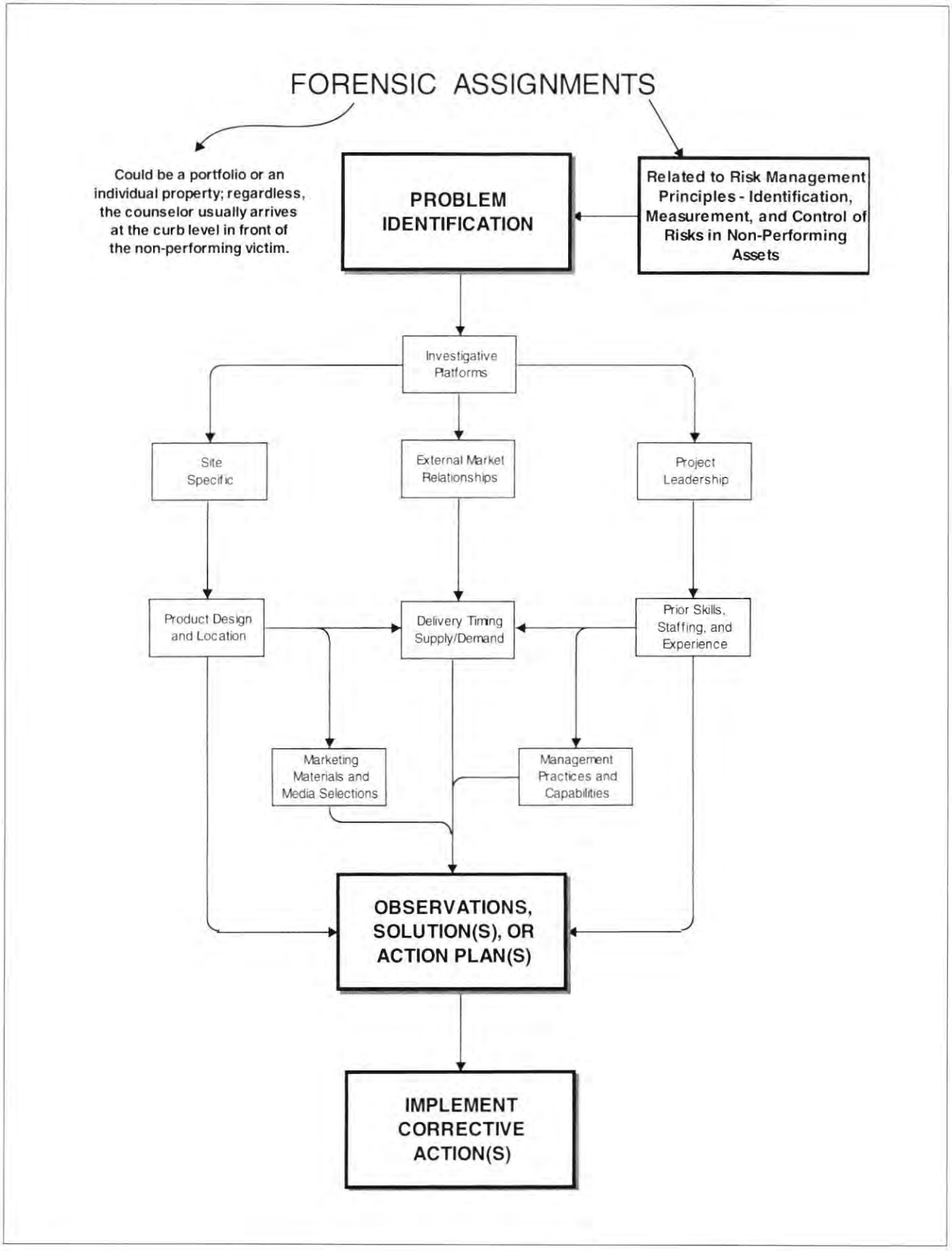
Merchant Builders or Developers (especially national firms) have an equally diverse set of needs, only five of which are illustrated in the chart and some of which may overlap. For example, a firm interested in sport and recreational activities may retain a consultant to study regional participation rates for golf, skiing, water sports, soccer, and tennis before considering whether there is sufficient demand to generate further interest in their project.

Market Segmentation and Preference Surveys - Local and national home builders qualify markets with preference surveys and segmentation studies. The preference surveys can be post-transaction interviews of home buyers to determine consumer satisfaction. Segmentation studies uncover the depth and purchasing power of the market usually targeted to high-end products and different life styles.

The ***Public Sector*** offers the greatest opportunities for consultants/counselors due to the need for studies that relate to economic base analysis, regional competition surveys and industry capture rates, and land revitalization issues. *Figure 2* is relatively self-explanatory. However, the RFP published by the jurisdiction defines the scope and deliverable. The public body knows the problem, and the consulting vendor supplies the solution within the bid and scope.

Regional Studies are used by cities, counties, and county groups to assert or improve their competitive position in an effort to induce new and relocating industries to select their community. Adequacy of serviced land, schools, inexpensive transportation, resident employment skills, and housing are key factors in the site selection process. As communities witness the capture of new and relocating industries by other regions, they seek to reposition and redefine the competitive odds by implementing

Figure 3


FORENSIC ASSIGNMENTS
Could be a portfolio or an individual property; regardless, the counselor usually arrives at the curb level in front of the non-performing victim.
PROBLEM IDENTIFICATION
Related to Risk Management Principles - Identification, Measurement, and Control of Risks in Non-Performing Assets
Investigative Platforms
Site Specific
External Market Relationships
Project Leadership
Product Design and Location
Delivery Timing Supply/Demand
Prior Skills, Staffing, and Experience
Marketing Materials and Media Selections
Management Practices and Capabilities
OBSERVATIONS, SOLUTION(S), OR ACTION PLAN(S)
IMPLEMENT CORRECTIVE ACTION(S)

needed changes to attract the firms.

Risk Analysis represents the next horizon for the advisory industry. Although a large amount of current work is performed inside institutions (pension funds and life companies), considerable expertise will soon be demanded from consultants/counselors by private trusts, limited partnerships, and public commercial mortgage pools (CMBS). Our capital-rich nation and the five percent who control 70 percent of the nation's real estate will need superior advice. CMBS pools are leaderless and have not matured. Although investors in the high-risk tranche may write off losses, a deep economic trough will effect low-risk investors, prompting a need to review and re-price portfolios within regional markets and by product condition (occupancy, leasing status, and capital needs).

Two additional business lines are considered, including forensic assignments *(Figure 3)* and litigation support.

Forensic Assignments are directly related to **Risk Analysis** mentioned above. When an asset or group of assets fails to meet expectations (financial or absorption), individuals with appropriate skills are directed to investigate why intended goals were not achieved.

Real estate investment and/or development is a complex mix of ingredients, some of which can be isolated while others are inextricably entwined with larger issues. Regardless, the common or isolated platforms for analysis include site specific issues, exogenous (external) or market-related factors, and project leadership.

Attention is usually directed toward product design and location decisions that are identified as errors. In some cases, both the location and product are unsuitable for the market. Inappropriate project scale and amenities appear to be major factors in the collapse of projects.

Externalities may also lead to failure, including poor timing with respect to construction, renovation, or acquisition. Between the decision to construct and the actual delivery of the product, supply-side factors may worsen beyond a plan's expectations.

Finally, the qualifications of the developer or team leader may result in an asset's poor performance. It is rare to find a developer with solid credentials in the development, marketing, and management of all phases of residential, hotel, retail, and office land uses, yet attempts at such broad-reaching activities are frequently made. Occasionally, a homebuilder decides to construct an office building. No matter what the scale, something in the design, timing of delivery, location, or marketing of the project comes unglued in the process. Moreover, developers have a tendency to overextend staff responsibilities, often resulting in delays which cost the project lost opportunities.

In other situations, marketing materials completely miss the intended user. The promotion of a project can be instrumental in its success or failure. Moreover, advertising methods are very complex as consumers become more sophisticated.

Litigation activities have always been profitable endeavors for the counselor/consultant. However, support has moved beyond testimony to the initial decision whether to litigate.

Beyond the scope of this article is the growing use of GIS and its impact on consulting and site selection teams used as vendors by the grocery, food service, auto, and communications industries.

CONCLUSION

What does the future hold? Outstanding prospects lie ahead for the real estate advisor if efforts are made to increase skills, adapt to changing technology, develop new data sources, and enhance global perspectives. Dispute resolution, portfolio risk analysis, and forensic assignments offer vast opportunities for counselors and consultants in the future. REI

NOTES

1. Reilly, William J. "Methods for the Study of Retail Relationships" (Austin: Bureau of Business Research, University of Texas, 1929), p.16.

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FOCUS ON REITs

From Evolution to Revolution

by Samuel Zell

The near-demise of the commercial real estate industry in 1990 was a watershed in the evolution of the business. The excesses of the 80s not only resulted in the greatest losses ever suffered by the lending community, but they also eliminated the primary role played by banks, insurance companies, and savings & loans in the financing of real estate.

With traditional sources of capital effectively out of the business, the industry was forced to approach the public capital markets for both debt and equity financing. The capital markets allocated funds to publicly traded companies, but on terms no longer exclusive to the attributes of a single asset class. The criteria for debt and equity execution shifted from evaluation of a specific asset to the assessment of a company and its ability to execute its strategies.

The vehicles created were variations on the REIT template created in 1960 but not fully accepted until the early 90s. As these entities were launched, easily accessible capital created public real estate companies with size and sophistication not previously seen. Far from being merely an evolution in financing, the shift to public ownership has set in motion a process of consolidation that represents a revolution on the landscape of commercial real estate.

Capital intensive industries have traditionally been dominated by a few, very large, very efficient players. Auto, steel, aluminum, and semiconductor manufacturing, as examples, all have evolved from highly fragmented groups to oligopolies as capital requirements make greater demands on ownership. The real estate industry, although capital intensive by nature, has historically been highly fragmented and local in practice. This fragmentation contributed to wide, cyclical swings and the excessive nature of development cycles as neither developers nor lenders had any ability to understand the "big picture." With the emergence of public reporting, the vastly improved flow of information acts swiftly to correct market imbalance, real or perceived, as capital market activities in fall 1998 vividly demonstrated.

This long overdue consolidation of the commercial real estate industry represents a recognition that it — just as other capital intensive industries — is oligopolistic in nature. Bringing scale and operating efficiencies to the real estate community represented new challenges, however, to building ownership and operation. As the definition of competition changed from the building across the street to a network of commonly owned buildings, economies of scale and scope have become more and more relevant in the competitive environment. Tenants recognize and benefit from operating efficiencies as professional management has taken on extraordinary significance.

The effects of public disclosure and transparency have reduced real estate's purely transactional opportunities. Competitive advantages stemming from sophisticated positioning of products and services to users of real estate now fuel differentiation and drive consolidation. Predictors of success include customer satisfaction, ability to build a value-added brand, and other performance measures associated with operating company models.

The real estate marketplace is also far less likely to sin again. The consolidation of the banking industry, well on its way to completion, has continued to diminish the sources of funding for new projects. The reduction in the number of banks competing in any given market should preclude the kinds of competition that in previous cycles resulted in capital consumption, not capital investment. As an industry tends toward fewer and more cautious players, supply and demand imbalance decreases and volatility diminishes.

This oligopolization will have very positive long-term benefits for the commercial real estate market. The revolution in progress will reduce the number of participants, and create a transparent market where both lenders and developers have a much more realistic perception of the risks and rewards of the commercial real estate market.[REI]

ABOUT OUR FEATURED COLUMNIST

Samuel Zell, *Chicago, is chairman of the board of Equity Office Properties Trust, Equity Residential Properties Trust, Manufactured Home Communities Inc., and Capital Trust. He manages the two largest REITs in existence and is a much sought-after contributor and speaker for various real estate-related publications and programs.*

FOCUS ON THE ECONOMY

Stability: the Realpolitik of the Coming Decade

by Hugh F. Kelly, CRE

Streetwise New Yorkers have their own rules of economic forecasting. One ironclad axiom is, "Betting your money on three-card monte is a definite leading indicator of a personal recession." The game is all about misdirection, and few are those who can penetrate the dealer's sleight of hand.

Most traditional economists have little better success in predicting the direction and magnitude of interest rate changes. And for a similar reason. Fed watchers, financial journalists, and the public markets continue to look intently at widely-published inflation indicators, including the monthly *Consumer Price Index* and *Producer Price Index* reports, expecting that Alan Greenspan and company will use these as guides in adjusting the price of money.

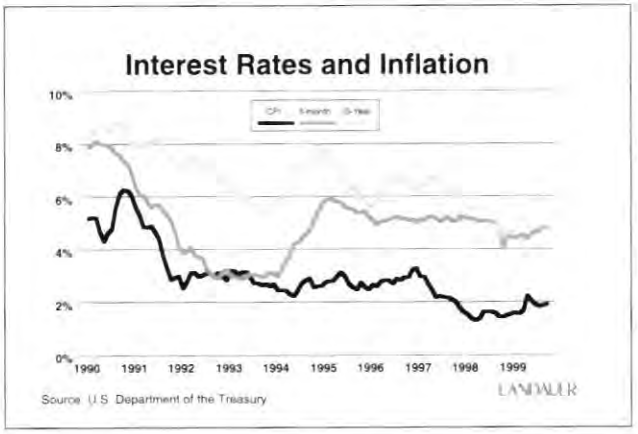
Such an assumption is, of course, the result of received academic training and learned experience. We have all been taught that interest rates are built up from a base of risk-free return on capital, an inflation premium, and additional compensation for the risk assumed regarding return of capital. This is the classical pricing model for bond rates. Furthermore, most of us have grown up in the business world since 1967, when inflation became a significant factor in the economy. For more than a quarter of a century, we have watched interest rates rise and fall in consonance with shifts in the level of consumer prices. We have bought into the notion of a necessary correlation between the two.

What has not been generally appreciated, though, is the degree to which that relationship has been severed in the middle- to late-1990s. With only modest exaggeration, I will state that since 1993 there has been *no relation whatsoever* between the direction and size of interest rate swings and underlying inflation. *Figure 1* is familiar to CREs, as it has been a regular feature in *The Counselor* newsletter. Note how the slope of short-term Treasuries dropped steeply between 1990 and 1992, following the CPI down to an interest rate trough in 1993 and early 1994. Over the same period, the 10-year T-Bond also showed a decline in its yield, albeit in a more gradual trend.

Then a peculiar thing happened: inflation remained stable and low over the course of the next year, but both long and short Treasury rates shot up dramatically. What was going on? Simply this: the Fed, during the early Nineties, kept its discount rate low to enable banks to borrow cheap capital for reinvestment in Treasury issues, allowing teetering financial institutions to rebuild their capital bases using the arbitrage on the rates. By 1994, all large U.S. banks had sufficiently rebuilt their capital to meet the Bank of International Settlements reserve requirements, and the Fed raised rates to eliminate the subsidized arbitrage. This was a quiet strategy, and some may think it was a bit of a shell game. But it was, in my view, a brilliantly conceived and executed policy of Greenspan and the Board of Governors; it rescued the banking system when a repeat of the 1930s was a real possibility.

Between 1995 and 1997, the relationship between inflation and interest rates

Figure 1



stayed basically stable, especially if we use the three-month bill rate as a benchmark. In 1997, a drop in sensitive materials prices caused inflation to drop to nearly the vanishing point. Short-term rates didn't budge, though, as all of the so-called "managed rates" (bankers' prime, the Fed Funds rate, and the Fed discount rate) were held tight. I believe that our central bankers recognized the combination of suddenly increased risks on the international scene and the massive momentum sustaining the domestic economy. The decision was to keep U.S. "real" (inflation-adjusted) rates high to draw capital toward the U.S. as a "safe harbor" while avoiding the untimely stimulation of an already robust business cycle.

In the autumn of 1998, of course, U.S. financial markets were quaking as a result of Asian banking difficulties and the default in Russia's sovereign bonds. The Fed adroitly engineered a three-step drop in rates, using the flexibility afforded by the immediately previous policy of keeping real rates high. The concept was that the U.S. economy would be stimulated to forestall any potential recession and that we would serve as the market of final resort for the world's goods. The gambit worked, markets stabilized, and the Fed (in due course) has moved rates back toward the *status quo ante*. Meanwhile, inflation has stayed benignly in the same range it has been since the start of 1997.

At this point, we should remind ourselves that all of the post-1993 moves in interest rates caught the financial markets only in a reactive mode. Stock prices, in particular, failed to anticipate the changes, although they derived quite salutary effects once the Fed's policies were put into place. Against that general upward trend in stock prices, though, the market saw tremendous day-to-day volatility as investors, Wall Street analysts, and financial commentators continued to react to periodic signals of some change in the inflation outlook.

What are the lessons? The first is that we need to re-learn the nature of the inflation/interest rate relationship. Our intellectual context needs to get beyond the bounds of the 1967 – 1990 period, when inflation was indeed the greatest of economic issues. As we look at 2000 and beyond, the key issues will be world economic stability as a platform for improved living standards. Stability is the *realpolitik* of the coming decade. Central banking policy will be driven by this imperative.

The second lesson returns us to the fundamentals of supply and demand in determining the price of money. Just as the huge federal deficits of the Eighties and early Nineties bid rates upward, the present and anticipated budget surpluses of the next few years will enable the Treasury to retire debt. This will free capital for more productive use, promoting real economic growth, and putting downward pressure on rates.

This is not a prediction of unremitting decline in interest rates. Such a forecast would be as foolish as trying to beat the monte-dealers at their own game. Although I fully expect levels of interest rates in the coming decade to resemble those of the Fifties more than those of the Seventies, a lot could go wrong to thwart such a hopeful outlook. My point is much more modest. In this era – now already six years old – the direction and magnitude of interest rate change will be primarily a tool of international policy, and only secondarily about consumer prices. Those who continue to read the traditional inflation indicators will only leave the table shaking their heads, wondering why they can't keep track of the elusive cards. Those who base their investment strategies on the rate/price correlation will, I'm afraid, also wonder why their wallets seem continually lighter.REI

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REAL ESTATE ISSUES

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