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REAL ESTATE ISSUES

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(American Society of Real Estate Counselors)

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SHLAES NAMED 1993 RECIPIENT OF THE LANDAUER AWARD

Jared Shlaes, CRE

Jared Shlaes, CRE, president of Shlaes & Co., Chicago, is credited with many notable contributions to the field of real estate counseling. *Real Estate Issues*, the professional journal published by The Counselors of Real Estate, was established, guided and directed by his efforts as editor in chief for the first 10 years of its publishing history. Shlaes set the standards for what is now recognized as a leading industry publication.

Shlaes, a widely published author, wrote *Real Estate Counseling in a Plain Brown Wrapper*, a practical guide to the art and business of real estate counseling. He has been a contributor to other books including *The Office Building From Concept to Investment Reality, Real Estate Counseling,* and *The Appraisal of Real Estate*, as well as *The Appraisal Journal* with numerous articles. Besides his talents as a writer, Shlaes the speaker has designed, mounted and led many important educational programs for The Counselors and other organizations, including CRE seminars on condominium conversion and office buildings.

Nationally recognized as an authority on real estate and planning topics, Shlaes is well known by appraisers for his many articles in that field and to planners and preservationists for his creative work in the use of transferable development rights (TDRs) for landmark preservation. For this work he was recognized by the Appraisal Institute with its Louise L. and Y.T. Lum Award and the Robert H. Armstrong Award. The Counselors of Real Estate previously recognized Shlaes with its Louise L. and Y.T. Lum Award for his contributions to the counseling field.

Shlaes has served as the original land economist and planning advisor to the Main Street Project of the National Trust for Historic Preservation. This project has helped hundreds of towns and cities across America to revitalize their deteriorating business districts. With his Shlaes & Co. associates, he wrote key articles on the valuation and use of preservation easements which led to landmark studies and appraisals in many parts of the country. While employed by Arthur Andersen & Co. as Director of Special Real Estate Services, Shlaes conceptualized and made important contributions as project editor to *Managing the Future: Real Estate in the 1990s*, a major guide to the future of the industry.

Shlaes holds the MAI and CRE designations, and is a member of the American Planning Association. He has BA and MBA degrees from the University of Chicago, speaks excellent French, and has three wonderful children who, so far, have given him three wonderful grandchildren.

The Landauer Award is named for the late James D. Landauer, CRE, who played a key role in the establishment of The Counselors of Real Estate and the preeminence of the real estate counseling profession. Other recipients have included CREs Roland Rodrock Randall (1986), James E. Gibbons (1987), Roy P. Drachman (1988), John Robert White (1989), Boyd T. Barnard (1990), George M. Lovejoy, Jr. (1991) and Daniel Rose (1992).

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THANKS FOR A JOB WELL DONE

As real estate professionals, we are aware of the daily convergence of the real estate industry and the legal profession. The Counselor membership represents a pool of vast experience as litigation consultants, valuation and market analysts and expert witnesses. This special edition of *Real Estate Issues* is intended to inform our membership and our constituents about the diversity and capabilities of The Counselors of Real Estate.

I am especially pleased that the authors contributing to this special edition include CREs (Counselors of Real Estate) and attorneys, symbolizing the close working relationship many of us enjoy with members of the legal profession. I wish to thank each author for his hard work and commitment in assembling a fine collection of articles on a variety of topics. Among the topics discussed are litigation strategy, broker liability, eminent domain, bankruptcy, environmental hazards, alternative dispute resolution, lease charge error consultants, eleemosynary organizations and the role of the counselor as expert. I am certain you will enjoy the depth, experience and insights of our talented authors.

Finally, as editor in chief of *Real Estate Issues*, I would like to wish a sad farewell to you, our readers. This edition marks the end of a seven-year term in that capacity. While I will miss the opportunity to serve you as editor in chief, I will step into my new role as a vice president of The Counselors for 1994. New challenges mean new opportunities which I am eager to discover. Fellow Counselor Halbert C. Smith, CRE, and professor at the University of Florida, has agreed to lend his capable hands to the continued growth and success of our journal. His unique insights and experience are sure to make a major contribution.

I must express my very special thanks to Linda Magad, managing editor of *Real Estate Issues*, whose help and constant energy made my job possible; to Jared Shlaes, CRE, who as first editor in chief had the courage to believe I was capable of filling his role; to all the authors who devoted the time and energy to fill our pages; and to all the readers of *Real Estate Issues* who provide the encouragement and incentive to do the job right.

Thank you,

R. Tarantello, CRE
Editor in chief
Real Estate Issues

THE PRESIDENT SPEAKS

A PARTNERSHIP THAT MAKES SENSE

The Counselor of Real Estate and the attorney are natural partners. Counselors are uniquely qualified to supply litigation support and to serve as real estate advisors for a wide variety of attorney/client needs.

The world of the law and real estate is changing, as witness the recent revisions to the tax laws, the currently pending revisions to the Environmental Protection Act and the Americans with Disabilities Act, as well as the myriad of regional, state and local regulations which affect the use, transfer and ownership of real estate.

The partnership of the Counselor of Real Estate and the attorney can provide a highly skilled team to analyze the advantages and disadvantages of attempting a zoning change or appealing a change which has been proposed by a regulatory body. The Counselor's expertise in real estate economics can be utilized by the attorney to quantify the effects of the proposed change or to reassure elected officials that granting a zoning waver will not have an adverse affect on adjoining or nearby properties.

Many cases which are litigated today result in a jury trial. It is becoming an increasing necessity to use witnesses who can clearly communicate the intricacies of very complex real estate problems to a jury whose expertise is usually not in the field of real estate. The Counselor, who typically has expertise in one or more real estate specialties, is in a unique position to assist the litigators in both trial preparation and, if required, in testimony. Many Counselors have backgrounds in a wide variety of real estate specialties ranging from appraisal and brokerage to property management. Not only is the Counselor able to draw from his own personal experience, but he also is able to call on other specialists when needed for a team effort.

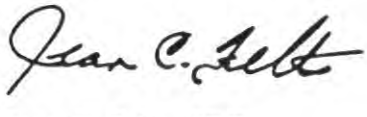
The Counselor's role in assisting the attorney is not limited to litigation. Estate or probate cases are also a field in which the Counselor can provide an overview of the importance of real estate to the total estate, make recommendations on the order in which real estate should be disposed, allocate the real estate for distribution among the heirs and arbitrate disputes among the heirs as to the value of real estate.

The corporate counsel can benefit from the advice of the Counselor in selection of plant or office locations, preparation of market and feasibility studies on disposition of owned assets, or financial analyses to assist in lease, sell or retain decision making.

The Counselor serves as an invaluable resource for the law firms assisting in the development process. Frequently, studies are needed to determine the optimum location for development and the price which should be paid in a community and, of particular importance to most development projects, to provide invaluable local insight in the regulatory process, whether this necessitates a zoning change or simply proceeding through the inevitable permit process. The wide experience and knowledge of a Counselor, coupled with local expertise and contacts, can serve a developer and his counsel as one of the most important resources in minimizing the time and therefore the cost of creating a project.

The Counselor can serve the attorney as a team leader for projects in which more than one real estate discipline is required. Typically, a Counselor will be knowledgeable as to the most qualified experts in a variety of real estate related specialties, including engineering, architecture, land planning, appraisal, property management, brokerage and other real estate specialties. The Counselor is in a position to serve as the real estate department for the attorney and his client without the necessity of hiring and maintaining a highly paid group of multi-disciplinary specialists.

The Counselor can serve as an advisor to the attorney and his client in a wide variety of situations ranging from the simple to the extremely complex. The partnership of the attorney and the Counselor can assist the attorney and the attorney's client in reaching the optimum solution to the real estate related portions of the case.



Jean C. Felts, CRE
President
The Counselors of Real Estate

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THE COUNSELOR AS EXPERT WITNESS: HAZARDS, PITFALLS AND DEFENSES

by William N. Kinnard, Jr., CRE

There is a rich and varied literature on the topic of How To Be An Effective Expert Witness. In the real estate field, most of the material appears in professional journal articles, papers or monographs which focus on real estate appraisers and the handling of valuation issues. There is an even richer and fuller literature in law journals and texts that deals with *How to Handle Expert Witnesses*, obviously addressed to attorneys specializing in litigation.

Real estate litigators regularly publish articles addressed to real estate professionals (again, mostly appraisers), with checklists of Dos and Don'ts for the real estate expert whose opinions will be given in court or before any hearing board or tribunal. These checklists tend to have two important features in common. First, they generally cover the same content, although organized differently and frequently using different words. Second, they are always presented from the point of view of the attorney, to ease the professional burden on the attorney. Few if any of these written statements by attorneys appear to be aimed at easing the burden or pain of the expert real estate witness.

Real estate counseling is different from appraisal, and The Counselors of Real Estate are different from professional real estate appraisers. Yet there admittedly is considerable overlap between the two disciplines and their practitioners. This might help explain why almost nothing has been published on the particular needs and requirements of real estate *counselors* when they are called upon to give expert testimony in their capacity as real estate *counselors*.

This article is specifically directed toward four issues that are likely to confront any Counselor of Real Estate (CRE) called upon to give expert testimony in his capacity as a counselor.

Review Of General Rules And Admonitions For Expert Witnesses

The published lists of Dos and Don'ts for expert witnesses generally, for real estate appraisers, for real estate academics and for other real estate professionals can serve well as an appropriate starting point for any CRE about to give expert testimony. Participating in a deposition is every bit as important as providing formal court testimony. Indeed, a deposition is simply one type of formal testimony in a different format: It consists almost exclusively of

William N. Kinnard, Jr., CRE, *is president of the Real Estate Counseling Group of Connecticut. He is also Professor Emeritus at the University of Connecticut. Kinnard has qualified as an expert witness in federal courts, state courts at several levels, and before statewide and local property tax boards, as well as zoning boards, in over 20 states. He serves frequently as a witness on valuation methodology and standards, land use, and the effect of both on-site and nearby contamination on property values and use. He has published in both academic and professional journals, and is the author of widely used texts on real property valuation and industrial real estate practice.*

questioning of the expert witness, in an adversarial mode, by the attorney(s) for the opposing side.

Whether involved in direct testimony, cross-examination, rebuttal testimony, deposition or simply serving as an informed observer of the testimony of others (when permitted by the rules of the particular jurisdiction), the CRE serving as an expert witness needs to follow certain general rules and guidelines. The literature on expert testimony is full of long checklists for expert witnesses to follow. There are very few short lists.

A good rule for memorization of facts, including checklists, is: Don't do it. When one memorizes, one typically gets the materials *almost* right. In court proceedings, "almost right" is not good enough for the counselor serving as an expert witness.

Nevertheless, there are a few points that need to be emphasized as "rules to live by" for CREs serving as expert witnesses.

1. *Tell the truth.* Remember, a witness has sworn to "tell the truth, the whole truth, and nothing but the truth."
2. *Be prepared.* Indeed, be over-prepared (hyperprepared).
3. *Be skeptical.* Don't believe anything that is presented during deposition or trial proceedings as *fact.* Always treat the *facts* presented by anyone else as assumed conditions in a hypothetical case.
4. *Answer only the question asked.* Don't embellish. Above all, do not volunteer information beyond the direct answer to the question asked. (This can be particularly difficult, especially when it is manifestly clear to the CRE that he knows so much more about the topic than the examining attorney does.)
5. *When a question is asked, think first,* pause (take a deep breath), answer fully and honestly, then shut up.
6. To the extent possible, try to *keep answers straightforward and understandable* to the court: the judge(s) and/or the jury. It is not necessary for opposing counsel to understand your answers. (Indeed, he will feign confusion or lack of understanding on many occasions.) However, it *is* necessary for members of the jury or any tribunal to understand you.
7. To the extent possible, *address answers to the jury, the judge or the tribunal.*
8. *Keep answers short.* Remember that the vast majority of questions can be answered "Yes," "No," "I don't know," "I don't remember," or "I don't understand; please rephrase the question." If a question can be answered that way, it should be.
9. *Keep to the point.* Try not to stray. Once again, do not volunteer information.
10. Difficult as it may be, work hard *never* to *become visibly upset.* Do not treat negative comments or implications about oneself as personal assaults or affronts. Always strive to be polite and courteous, no matter what the provocation.
11. *Avoid making assumptions or drawing inferences from questions asked.* Accept any assumptions provided in the statement of a question, and be sure to label them as "assumptions" in your response. Also, recognize that the answer to any question that begins "Isn't it true that . . ." is probably "No."
12. In the courtroom, the hearing room, the deposition room and nearby, *maintain an outward appearance of independence, objectivity, even aloofness.*
13. *Be prepared* and *tell the truth.*

Within the framework of these general guidelines, four (4) major concerns require particular attention by real estate counselors who serve as expert witnesses.

Professional And Ethical Standards

Real estate counseling is not as widely recognized or as carefully delineated a discipline as are, for example, real estate appraisal, real estate management and real estate brokerage. Indeed, the necessarily broad, sometimes comprehensive, nature of counseling means that it is perceived and interpreted differently by clients, observers and practitioners alike. It may appear somewhat as the elephant did to the blind men in the fable. For Counselors of Real Estate, both the CRE Code of Ethics and the Code of Ethics of the National Association of Realtors (NAR) are applicable to their behavior in the preparation and presentation of testimony as an expert witness.

Many attorneys are unfamiliar with the Codes of Ethics and Standards of Professional Practice applicable to the work of the CRE. It is the obligation and responsibility of CRE members to make attorneys with whom they are working aware of the contents and implications of applicable professional standards and ethical codes.

The situation of the individual CRE may be more involved if the individual is professionally designated in any other organization(s) that also has a Code of Ethics and Standards of Professional Practice. This is particularly true if the CRE is a professionally designated appraiser in an organization that subscribes to the *Uniform Standards of Professional Appraisal Practice (USPAP),* which are listed in the "Suggested Readings" at the end of this article.

The reason for this particular concern is that, within *USPAP,* Standards IV and V deal specifically with "Real Estate Consulting." *USPAP* establishes requirements and specifications for the conduct of a "Real Estate Consulting" assignment and for reporting the results of that assignment. Offering testimony in a trial, a hearing or a deposition as an expert witness constitutes reporting the results of a real estate consulting assignment, within the framework of *USPAP.*

The situation is further complicated by the fact that real estate appraisers must be licensed or certified in every state, the District of Columbia and Puerto Rico as a result of Section XI of the federal

Financial Institutions Reform, Recovery and Enforcement Act of 1989. In many states, it is a misdemeanor (or worse) to practice real estate appraisal without a license or certification. Moreover, some states define "real estate appraisal" so broadly that it encompasses many activities that would ordinarily be regarded as real estate counseling. Examples include feasibility analysis, market analysis, marketability analysis, investment analysis, and highest and best use analysis, to cite a few. In those states, it is necessary to become licensed or certified as a real estate appraiser in order to carry out such counseling activities for a fee. That includes testifying about them in court or at hearings.

In addition, a handful of states include real estate counseling as an activity that requires a real estate broker's (or salesperson's) license.

It is therefore critically necessary for a CRE contemplating an assignment that is expected to require expert witness testimony in a state in which the CRE is not currently licensed or certified as a real estate broker or real estate appraiser, to investigate carefully the requirements of that state. Licensing and certification can be a time-consuming and expensive process. The client and the client's attorney should be aware of any time and expense required for licensing or certification, and, from the outset, that should be included in the counseling fee agreement.

One implication of having *USPAP* apply to the real estate counseling assignment is that CREs would be required to develop and maintain a written record of the data, notes and analyses. That written file must be made available in any court proceedings (including depositions). The expert often cannot legally respond positively to an instruction not to put anything in writing. This is simply one example of the concerns that may confront a CRE serving as an expert witness, as well as the attorney(s) with whom he is working.

Hyperpreparation

It is axiomatic that expert witnesses should be thoroughly and fully prepared. For the real estate counselor, this means more than simply reviewing any factual information, notes of meetings or field inspections and reports prepared by others. Particularly if no written report (as opposed to the *USPAP* required written file) is to be prepared, and therefore referred to during the course of deposition or trial testimony, the counselors and the attorneys with whom they are working must thoroughly understand not only the problem and its proposed solution, but each other's mindset and approach to that problem.

Depending on the experience and knowledge of the attorney with the particular topic at issue, it may be necessary for the CRE to instruct the attorney in the technical and analytical aspects of the problem, at least to the extent that the work and testimony of the CRE impinge on the resolution of that problem. This takes time which needs to be built into the original proposal and budget.

An important rule in dealing with clients and attorneys in litigation is: "No surprises." Therefore, the CRE has a responsibility to identify the apparent level of expertise and technical understanding that the attorney possesses. This needs to be done at an early meeting before the final work schedule and budget are completed.

Ample time must be budgeted to cover any necessary education of the attorney, review of the counselor's own deposition, review and discussion of technical reports of others, and preparation for the counselor's testimony. When reports of others are to be reviewed, it is imperative to make sure that complete copies of the reports, including *all* appendix or addendum materials, are received for review. The text alone is rarely enough. Failure to review everything that is presented in the reports of others, as well as the complete transcript of any depositions of other experts or participants in the proceeding, can lead to embarrassment at least and impeachment of the counselor's position and testimony at worst.

If the counselor is to provide independent, objective, technical, professional opinion testimony, then he should not simultaneously serve as an advocate for the client and the client's attorney. The objectivity and credibility of excellent testimony can be undermined quickly if the counselor is seen passing notes to the client's attorney or conferring with the attorney while the trial is in progress. This is particularly true if it occurs while experts for the opposing side are being examined or cross-examined.

It is perfectly acceptable and appropriate under any standards to serve as an advocate for the client's interest. This should be done openly from the outset and not in conflict with an initial appearance of disinterested objectivity and independence.

Hyperpreparation in advance of testimony can pay substantial dividends when the counselor testifies, both on direct and cross-examination. If the CRE takes the witness stand with no notes or documents in his possession, the impression of thorough knowledge and understanding of both the counselor's field of expertise and the facts of the case is greatly enhanced. Any materials that need to be consulted can be provided by the attorney for the client, or even by the opposing counsel.

In the first instance, the importance of thorough advance preparation is underscored. If the attorney with whom the counselor is working has all the documents needed to support and sustain the counselor's direct testimony readily at hand and is thoroughly familiar with their use and application in the presentation, there is no need for the counselor to have any extra notes in his possession (especially since they are all discoverable). Everything required for reference will be available through the client's attorney.

On cross-examination, it is always permissible for the witness to request a document to which the cross-examining attorney is referring or from which that attorney is reading. That request will not always be granted, but the overall result is that a

well-prepared expert witness need not have any document with him unless it is provided by one of the attorneys involved.

Maintain Focus

No one individual is an expert in everything. Moreover, the scope of the problem which is the source of the litigation, coupled with the scope of the counselor's assignment, sets the limits of expertise and knowledge that a qualified professional counselor can and should claim in any proceeding. If unchallenged or allowed questions on cross-examination go beyond the scope of the assignment, especially if they go beyond the scope of the counselor's factual knowledge, then the best response is simply "I don't know." Assuming knowledge beyond one's level, stretching the limits of one's actual experiences or claiming expertise in areas where one is *not* a *bona fide* expert, almost inevitably leads to discomfort, lost credibility and disaster.

There is a natural tendency to want to accommodate a questioner, and, of course, not to admit one's own limitations in public. Nevertheless, sharp and clear limits to the claimed expertise, knowledge and opinions of the real estate counselor need to be set. This is part of the hyperpreparation already discussed. It is the responsibility of CREs alone, however, when they are on the witness stand being cross-examined.

This sharp and narrow focus is especially important when the cross-examining attorney presents hypothetical situations based on assumed facts and fails to identify them as hypothetical conditions or assumptions. Recognizing this potential hazard takes experience and continuous alertness on the part of the CRE being cross-examined. An important part of one's education to become an expert witness is to be a spectator at trials relating to problems in which the counselor is not personally or professionally involved. Also, participating in a deposition frequently gives important clues to the approach, technique and mind set of the opposing counsel. This can be an important learning experience for the expert witness CRE, prior to cross-examination before a judge and possibly a jury as well.

Maintain Poise And Objectivity

The real purpose of cross-examination is to discredit the expert witnesses and their opinions. In addition to eliciting facts and information, the cross-examining attorney will frequently call into question the counselor's skill and training, experience, objectivity and integrity. If CREs have given expert witness testimony previously in similar cases, excerpts from the transcript of that testimony, often read out of context, may be used in an attempt to impeach the counselors with their own words. Worse still, if the CRE has published articles in journals or books, similar excerpts out of context may well be read to try to demonstrate inconsistency and therefore untoward advocacy on the part of the counselor.

This tactic by opposing counsel requires the counselor to be particularly alert and to focus on the precise wording of every question. This is particularly the case when the question is a lengthy oral essay with a rising inflection or "Isn't that right?" at the end. The longer and more involved the question, the greater the probability that it makes sense for the counselor to ask that the question be reread, repeated or rephrased.

Also, it is quite important to be aware that the attorney with whom the counselor is working may (and undoubtedly will) raise objections to questions, or statements disguised as questions, posed by the cross-examining attorney. This is yet another reason why it is important to develop the habit of pausing before answering *any* question and to do so regularly and consistently. Once an objection is raised, the counselor should remain silent until instructed to proceed. If the argument over any objection is prolonged and distracting, it is both proper and wise to ask to have the question reread or rephrased.

One particular hazard in cross-examination is to permit the cross-examining attorney to misuse or adapt technical terminology without challenge to suit the purposes of the question. The CRE as expert witness must be sensitive to this and, before responding to the substance of the question, correct any such misuse or abuse of technical real estate terminology.

Similarly, opposing counsel may misstate facts on the record or mischaracterize previous testimony, both of the CRE expert witness or of others. To the extent that the counselor has knowledge that a misstatement or mischaracterization has been made, any such error should be corrected before the question is answered. If the counselor does not have such knowledge, or is not sure, then response to the question should be prefaced with "On the assumption that the assertions that you have made are correct . . ."

Counselors should never take any attempts to impugn their testimony, opinions, skill, experience, objectivity or integrity as personal attacks. This may well be difficult in some circumstances, but as expert witnesses on the stand, they should never show upset, annoyance or aggravation. That is easier to say than to do, but it is important. The objective must always be to appear calm, in control, thoughtful, objective, courteous and totally believable.

Knowledge, skill and hyperpreparation can lead to this posture. One should try to emulate Tennyson's Sir Galahad: "My strength is as the strength of ten, because my heart is pure."

Conclusions

Whether for the first or fiftieth time, CREs called upon to serve as expert witnesses, to present their professional opinion, should first identify whether they are qualified to accept the assignment. In this instance, qualification includes identifying whether some form of license or certification is required in the state in which the testimony is to be given. If the CRE decide to go ahead with the assignment, then

the necessity for hyperpreparation must be recognized from the outset in preliminary discussions and budgetary allocations with the client and the client's attorney. CREs should study their favorite list of Dos and Don'ts as a refresher.

As an objective, independent expert, the CRE must create and maintain an aura of impeccable integrity, skill and expertise based on experience in order to develop and maintain credibility.

Continuing alertness and care in responding to *all* questions (especially under cross-examination) should be the unflagging approach to serving as an expert witness. Moreover, as an independent, objective expert, the counselor serving as an expert witness is literally alone. One may be employed by a party, but such employment does not mean that the counselor has been "bought." Rather, the counselor's knowledge, experience and expertise have only been rented for the duration of the case. Consistency of thought, of oral presentation and of conclusions in similar circumstances is an absolute necessity.

None of this is easy, but if it were, the demand for really capable counselor expert witnesses would not be as great, nor would the rewards and satisfactions. There is, in all probability, no better opportunity for the CRE to expand knowledge, sharpen analytical skills and gain experience in such an intensive, concentrated fashion.

Throughout the entire process of preparation and participation in litigation requiring expert witness testimony by a CRE, the words of Polonius to Laertes in *Hamlet* can serve the counselor well: "This above all: To thine own self be true, and it must follow, as the night the day, thou canst not then be false to any man."

SUGGESTED READING

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THE CLEAN SHOES SYNDROME & OTHER PITFALLS IN REAL ESTATE LITIGATION

Alan A. Herd, CRE

Trial attorneys know there are unwritten protocols and customs in the use of expert witnesses: protocols and customs outside of codes and rulings. Not the easy ones, like hiring the expert early[1] or reading his resume before interviewing, but the more arcane: protocols recognizable in operation, but ones which can't be tagged with any kind of precise description or legal term.

Over time, however, these unwritten rules have acquired descriptive names. Medical cases, securities cases, product liability cases—even dog bite cases: each area has developed its own customs and conventions which, in turn, have acquired buzz words, aphorisms and slang. Real estate terms are among the most colorful.

Used or abused, their application and observance can be winning gambits or Achilles heels, making or breaking the effectiveness of expert testimony and changing the outcome of lawsuits. Knowledge of how and why they operate can provide valuable insights to trial attorneys.

The author has drawn on his own background and has surveyed a number of his fellow real estate expert witnesses for examples. Here are a few.

The Clean Shoes Syndrome

Too often both the attorney and real estate expert overlook a fundamental rule: to be a credible witness, the expert should first walk the land before he attempts to opine what happened on it.

The omission of a property inspection early in the engagement flies in the face of a fundamental truth: you can't safely or authoritatively opine on negotiations, representations, or omissions without actually looking at the subject of them—the property.

Further, without looking at the property how can you opine on what the deal's terms were about, let alone if they were appropriate or relevant? Many times the expert will find an omission, new theory, or an actual absurdity in the paper trail or in the structuring of the transaction simply by walking the scene of the transaction and comparing what can be seen versus what's in the paper trail.

> ***Example:*** A commercial tenant abandons the premises with four years left on a lease. The landlord is obligated to mitigate lost rent by attempting to re-rent, but turns down a new lease because the prospective tenant wants five spaces

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[1] "The Clean Shoes Syndrome & Other Common Pitfalls For Expert Witnesses And Attorneys In Real Estate Litigation" will be included in a forthcoming book on litigation support written by Mr. Herd.

more parking than the landlord has available. The expert visits the property and finds 75 weekday spaces open at a church four doors away. This new find, inserted into negotiations, ultimately gives the original tenant a more favorable settlement.

The Clean Shoes Syndrome occurs (and gets its name) from the tendency of both the expert and attorney to regard the expert's activity as "forensic," the case issues as "legal" (as opposed to "practical" or "custom and usage"), and the expert's role as something more appropriately carried out in the comfort of an air-conditioned office reviewing paperwork. Hence, the expression originates in the reluctance not to get one's shoes dirty by leaving the office and walking the land.

The attorney should request an inspection and the expert should show up at the first meeting having walked the property and prepared to discuss it.

The Shotgun Engagement Letter

Facts and issues have a way of transmogrifying themselves in the discovery process. An emphasis on one set of facts in a case can give way to another.

Example: An expert is hired to give testimony in an industrial real estate transaction. In witness disclosure the expert is described as qualified to testify on standard of care in *industrial real estate transactions*. As discovery progresses, issues of commission or omission in the negotiation of the transaction somehow become dependent on standard of care in previous property management activities. On the stand, the expert, even though a distinguished marketing agent, is challenged on his qualifications to testify on common aspects of property management of industrial property because he was not so designated.

Experts engaged to give testimony in one area, such as industrial real estate or, say, an agent's standard of care in a transaction, should not be excluded from giving testimony on subjects ancillary to his main testimony—subjects which are part of most experts' everyday work background, such as marketing, office administration, escrows, title insurance, basic property management, financing and mortgage loan practices. If the expert has a broad transactional background, the experience in related activities follows.

Both the engagement letter and witness disclosure should list a broad scope of ancillary activities as potential areas of expert testimony.

Example: An expert's description of the assignment in an engagement letter might be ". . . will testify as an expert witness in matters concerning real estate agents' conduct, responsibilities and standard of care in industrial real estate transactions and activities directly related thereto, such as, but not limited to, transactional documentation, escrow practices, marketing practices, common property management practices, landlord and tenant practices, lease documentation, title insurance, loan underwriting and escrow.

In the witness disclosure statement, the attorney simply lifts the language from the engagement letter. Let the opposing counsel worry about challenging the expert's qualifications and/or sorting out all the areas of expertise.

This broad scope should be considered early by the attorney in selecting a witness. An in-depth analysis of the expert's transaction experience should be one of the first objectives in the engagement interview. Also, as part of the process, the expert should be warned of potential challenges to his credentials in any of these ancillary expertises.

The Engagement Letter Bug-out Clause

The tactic of designating experts at the last possible moment and the difference between "consultant" and "expert" and its effect on discovery are well known to trial attorneys, but anticipating the sequence in the expert's engagement letter is often overlooked. The assignment letter should be "staged" as to employment, with the consultant/expert hired as a "consultant" initially and then as an "expert witness if necessary and subsequently so engaged." The device is not only for the paper trail, but to reconfirm to the expert his status and responsibilities. This gives the consultant latitude in forming his opinions: a chance to review and discuss the case even-handedly with the attorney and then make a clean getaway if his findings are negative to the client. For practical purposes, the negative communications will not be discovered.

Mushrooming The Expert

How much do you give the expert to review? "Mushrooming" refers to inadequate preparation of a witness. Often the attorney will give the expert only selected and self-serving pleadings and discovery. The reasons (or excuses) vary; sometimes the attorney is trying to save the client money, other times the facts are not entirely on the client's side. Frequently the attorney is simply trying to micromanage the expert's testimony—a practice directly opposed to the proper way to work with an expert.[2] As a result, the expert is then unprepared and blind to both the actual facts and the subtleties of cleverly-phrased hypotheticals on cross-examination.

Too many attorneys prepare the expert for testimony on favorable issues and slight the logic of the other side's case. They forget that the expert's real exposure in testimony comes more from opposing counsel's hard-edged questions in deposition and cross-examination than from the expert's own meticulously-prepared presentation of the client's assertions. A good expert can not only handle both sides of a tough issue, but often can find the flaws in the other side's arguments and offer suggestions to exploit them. *But he at least deserves to be prepared for ambush based on facts and theory supporting the opposition's point of view.*

The biggest contribution of an expert, particularly in a difficult case, is what he finds in the paper trail that the attorney hasn't recognized. Even in anticipation of limited testimony, the expert should be prepared with the facts in the transaction and made aware of the opposing side's theory. If it is a "standard of care" matter, the expert should be aware of everything impacting on the conduct and actions of both the agents and principals. Further, in almost every instance it is better that the expert extract this information directly from reading discovery than second hand from the attorney.

The expert should be furnished with pertinent pleadings and discovery, especially relevant depositions and motions. The expert needs an overview to (a) become familiar with the case, (b) inventory strong points to support the client's case, (c) prepare defenses and rebuttals to key opposition issues both in direct and cross-examination, and (d) offer his own informed opinion to the attorney which often can add something significant to the way the attorney sees the case.

Boutiqueing The Expert

"Boutiqueing" is somewhat similar to "mushrooming" but the motivation is different, sometimes even subliminal, in that the attorney presents his best theories to the expert and asks the expert to support them (even parts of them), regardless of context, as if they were to be presented in a vacuum instead of in open court with opposing counsel trying to shoot holes in them with hypotheticals. Boutiqueing asks the expert to support and testify on selected theory like an idiot savant. Limiting an expert's testimony to a few narrowly defined issues to orchestrate an intricate lawsuit is okay—boutiqueing is not. Experts deserve combat pay for enduring this technique.

In the process, the attorney commits nearly the same sin as in mushrooming—asking the expert to testify effectively without knowledge of the context and the full facts in the case. Again, the expert becomes hostage to lack of information. Denied a full set of facts, the expert suffers the same potentially lethal exposure to opposing counsel's questions in deposition and cross-examination while the jury watches him sweat through testimony.

The "Fat Cat" Or "Hired Gun" Ambush

"How much are you being paid to testify here today?" An ugly question, sometimes more so when asked of a real estate agent. Fairly or unfairly, real estate agents are typically regarded by the public as making too much money for what they do. Put on the stand to testify and receive high hourly fees, their compensation is an issue that can create culture shock with most juries.

In a jury trial, every attorney should pre-empt the question before the other attorney has the chance to ask it—"de-sleazing" the issue before leaving opposing counsel to ask the question and run amok with it. If opposing counsel then wants to re-ask (and "re-sleaze") it on cross, at least he suffers the disadvantage of looking redundant. Asked twice, the question loses much of its impact.

In one actual instance, an attorney made the following recovery after opposing counsel flabbergasted the novice witness with the hired gun accusation:

Attorney: You've served on numerous arbitration and ethical standards committees, have you not?
Witness: Yes.
Attorney: And the same with holding offices in your local board and the state board of Realtors?
Witness: Yes.
Attorney: How many hours do you estimate you spent serving on these committees and offices?
Witness: Hundreds. Probably thousands.
Attorney: How much were you paid for serving on these committees?
Witness: Nothing.

But for the most part, in dealing with the "hired gun" question there is no foolproof way to finesse it. Every expert runs the risk of being painted a hired gun. Consequently the expert should be prepared to answer the question honestly, completely, quickly and matter-of-factly. If inexperienced, the expert should be briefed before the question is asked in order to think through and become comfortable with his answer. The attorney should consider integrity as part of the expert's credentials in order to harden the target always presented by the ambush's potential.

The Andy Hardy Witness

In the old Andy Hardy movies one of Andy's friends would get an expensive-to-cure disease and Andy (Mickey Rooney) would ask Judy Garland what to do. Judy would inevitably reply: "Hey, kids! Let's put on a show!"

They would then put on an amateur musical with production values to make Busby Berkeley envious, a converted barn full of cheering people would appear, the necessary money would be raised and the cure would be found by the closing scene. Some attorneys try the same approach in selecting their expert witnesses.

An Andy Hardy witness is one hired primarily because he will work cheaply. ("Why not call that nice lady who sold you your house? She's a broker!") The results are often unpredictable. On the other hand, many untried experts exist who can testify credibly in court if properly prepared and given the chance.

Nevertheless, it's a good rule to let the other attorney break them in first.

Stonewall Versus Artichoke Appraisals

Conventional appraisal formats don't always work best in court. The typical appraisal gives a value based on comparable sales adjusted to the subject property. The appraiser's position: "I looked, I compared, I valued!" Factors such as size of improvements, lot size, quality of construction and amenities are not given specific values. Instead they are

lumped together and simply "taken into account in determining value." The appraiser "stonewalls" his premises.

An artichoke appraisal can be described as a stonewall appraisal with an attitude (or vice versa). It takes the conventional appraisal a step further by assigning a specific amount in dollars or by a percentage to each of the components making up value, e.g., the front part of the lot is worth $500,000, the back part $400,000 because you can use it differently, etc., the improvements $400,000, etc. The conclusions are presented to the court in this form.

Why is this important in litigation? The argument is somewhat circuitous. Take two premises:

Premise #1. Every attorney believes (1) he has the best appraiser, (2) his appraiser's report and supporting information are unimpeachable, (3) the other side's appraiser is a charlatan who not only greatly exaggerates, but dresses funny and therefore will make a bad impression on the jury.

Premise #2. No other profession offers a greater opportunity for two professionals appraising the same property to arrive at widely differing estimates of value, with both being technically correct—Appraiser Jones uses comparable sales #1, #3, #5 and #7; Appraiser Smith uses comparable sales #2, #4, #6 and #8—they are both correct (on the premises given). And unless one of them fails to show up in court to testify, the jury will have to make a decision as to which appraiser is right (or wrong) and by how much.

Why the artichoke appraisal? It has to do with taking away one leaf and having several more left underneath. If one component fails, the others are still intact. Consider the following:

> ***Example.*** The litigation concerns a lot size negligently misrepresented to a buyer by a real estate agent. The buyer discovers this, sues and an appraisal is made to determine damages at the time of purchase. The buyer brings in an appraisal done by his expert which is far less than the buyer paid. The seller brings in an appraisal done by his expert which is much more than the buyer paid—the seller's attorney takes the position that there are no damages. Or are there?
>
> What if the seller's appraisal is right and the buyer paid less than the property was actually worth, but not according to law? *Will the jury buy the seller's appraisal? More appropriately, will they buy all of it, particularly the part about the lot size not making a big difference?* Highly unlikely. Even if the actual value was greater (here we're granting that the seller's expert is right) and the correct size was discovered, say, during escrow, wouldn't the buyer have been given an opportunity to back out of escrow, thus having a strong bargaining position to ask for a better price, sue or withdraw?

Here the artichoke approach is a defense in-depth, compartmentalizing the lot-size question to a relatively small portion of total value. Then if the seller's general assertion of value fails, the jury has a method by which to recompute a part. A recomputation limited only to the part in question, rather than being faced with validating (or even recomputing) all the other elements of value, is a tough job with an uncertain outcome. The jury, offered an easy way to solve a contentious dilemma, usually appreciates and responds to the help.

"They All Look The Same To Me" Mistake

What does it mean to be a real estate expert. All real estate experts are not alike in their activity, protocols, clientele and standard of care. These distinctions are obvious to counselors, but not always to attorneys. In court the differences can be perilous.

Real estate is actually about two dozen or more different business activities. The variety of subcategories and specialties is analogous to medicine and engineering. Real estate activities can vary according to property type—land, homes, apartments, office and industrial; and according to function—brokerage, appraisal, property management, syndication and lending. And that's just the variation among licensed agents. Bring in title people, surveyors, zoning consultants, contractors, developers and more, and you begin to get the idea of the great diversity.

The implications of this variety present a convenient target for expert witness impeachment on credentials.

> ***Example.*** Commercial real estate agents obviously should not testify about residential property. More subtle is the protocol that commercial (and most other) real estate agents should not testify on nearly most aspects of valuation, even if opining on the value of commercial property, *unless they are formally qualified as appraisers.* Standards of care—particularly presumption of sophistication—can vary between residential and industrial agents. The differences are subtle, but unsupported by the appropriate credentials they can be case killers in testimony.

Given all of the above, add to the mix other relatively new areas such as affirmative action in office administration and environmental due diligence in transactions—all of which require the expert to have additional hands-on experience in each area to be credible.

Then there's the "damned if they do, damned if they don't" corollary. In another dimension of potential challenges, every witness who is a specialist is subject, in some degree, to impeachment by virtue of not being a generalist. Conversely, generalists (particularly many teachers) are subject to impeachment for not being streetwise in a given specialty. This attack is usually rebuttable, but best accomplished when the expert and attorney have considered their response beforehand.

Most experienced experts will not take a case if they know that their qualifications in a particular specialty area are shaky. Most will refer to another

expert or simply pass. The test and the testing, however, are up to the trial attorney. Pat solutions rarely exist in selecting experts—the choices are usually a trade-off in available qualifications.

The attorney should be familiar with the differences in specialties and subject areas, make sure the expert is warned of this kind of challenge and insure that preparations are made to defend his credentials across the widest possible spectrum. However, if the attorney doesn't recognize the potential implications, the counselor should bring it to his attention.

Experts And Attorneys Are In This Together

How these customs and protocols can be avoided or used to the attorney's advantage and the counselor's obligation to explain them at the appropriate place in the assignment are self-evident. For the most part the lessons are not unique to real estate experts.

Aside from giving the expert the tools to do the job, there is one other element that can work greatly to the attorney's advantage. Experts want to feel part of a team and the trial attorney sets the tone that provides for this. Whether for communication ability with the expert, for examination skills in bringing out the expert's testimony or simply for old-fashioned courtesy and consideration during the case's progress, attorneys can increase the expert's effectiveness by making him feel part of a team effort.

Properly applied, as the expert proceeds into the deposition and court testimony stages, the rules—in their observance or avoidance—can produce gratifying results.

NOTES

1. Three real estate experts, including the author, surveyed their most recent cases—45 in all. In 22 instances, the experts were hired within ten days of mandatory exchange of witnesses.
2. A correlation exists between "mushrooming" and inexperienced witnesses. The experts surveyed (by definition "experienced") typically request and are allowed a full review of case materials. In short, they can see the mushrooming happening and act to limit it. In only three of the 45 cases previously cited was available information significantly limited by counsel. On the other hand, incidence of *opposing* experts being given limited information was observed in at least 15 of the cases.

TEAMWORK

by James E. Gibbons, CRE
and Richard Marchitelli, CRE

Real estate counseling services can assist the attorney and the client in the decision-making process in a wide range of situations involving litigation, due diligence activities and general problem solving. When utilized properly, the counselor brings insights and experience that few others possess. The counselor not only complements the talents of the other professionals on the client-team, but he can provide a competitive advantage that is often decisive. Although attorneys are results-driven and always in search of ways to achieve tactical leverage, many are unaware of the full scope of services that counselors offer or the advantages conferred by this type of professional assistance. But improvement is in progress and better lines of communication are opening by professional counseling associations and practitioners to provide information on the extraordinary benefits available from the cooperative efforts of counselors and attorneys. The value of teamwork is underscored by The Counselors of Real Estate, the preeminent professional consulting group, consisting of 1,000 highly trained, deeply experienced real estate experts. Each member has the ability to provide his clients with unbeatable services through a most effective networking arrangement which accesses the expertise of all other members.

Counselors' backgrounds vary. Generally they include years of practical experience in one or more of the real estate disciplines which constitute *counseling* (e.g., market analysis, investment analysis, asset or property management, brokerage, appraisal, etc.). In addition, they are schooled in the fundamentals of real estate and receive technical training by attending formal courses, seminars and continuing education programs offered by organizations and universities. Some counselors are licensed or certified by the states in which they practice; others have earned designations conferred by respected professional organizations. In the final analysis, counselors are reservoirs of knowledge and experience from which attorneys and their clients can draw. Counselors can offer imaginative approaches and innovative solutions to real estate problems tempered by a theoretical and practical understanding of the dynamics that shape the marketplace.

Workouts

There is a growing recognition that active participation by counselors in workouts and restructuring loans is invaluable. Real estate counselors may represent the lender or the borrower. The key to a

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counselor's effectiveness in such situations is the extent to which they become involved. Attorneys have learned it is important to retain counselors at the outset because many technical questions arise that are beyond the expertise of the lawyer and/or client. Early retention of the counselor also ensures that the attorney will operate from an informed position and that the client will not be placed at a tactical disadvantage.

A look at what is really involved in real estate matters will highlight the need and importance of attorney/counselor teamwork. A parcel of real estate is not a homogenous unit; it is a package of real property interests, each having its separate qualities and existence. This has come to be known as the Bundle of Rights proposition. The task of problem solving begins with accurate identification of the interests involved. Since these rights are created in legal documents, the attorney plays the lead role in interpretations. The counselor will, of course, examine them in the context of the entire real estate market, but particularly in the sector that relates to the type of interest under examination. The study will reveal the benefits and liabilities of ownership. Very frequently the issue of timing arises. The various interests in a package have differing priorities of claim on the benefits the real estate generates. Usually they follow the chronology of their creation, but this can be altered by subordination agreements that rearrange priorities. Here again the attorney interprets and guides. The counselor then examines this priority framework and relates it to the flow of events in observed real estate markets. Vitally important risk rating of property interests is the product of such study. Only this sort of cooperative effort can supply a client with winning advice.

The counselor can assist in developing several restructuring plans, not all of which need be shared with the opposing side. This is a sensitivity exercise testing the feasibility and desirability of a particular restructuring proposal and whether it is in the client's best interests. Because restructuring plans are property specific, it is important for the attorney to receive professional advice that starts with an understanding of the real estate, its ability to service new debt, supply and demand, and current and future conditions likely to affect the asset (collateral).

In addition to modification of the debt, the counselor examines other options so they can be evaluated on a risk/reward basis. These alternatives would include the likelihood of financing obtained from other sources, whether the property could or should be sold, or whether foreclosure is the most prudent course of action.

Bankruptcy

Bankruptcy filings normally complicate foreclosure proceedings and present the counselor with a series of other issues to be addressed. Sometimes a counselor may not be retained until this stage. The counselor may be requested to study the reorganization plan and comment on its adequacy and reasonableness. While this may appear to be relatively simple, it can often become a complex undertaking which tests the counselor's forecasting abilities as well as his knowledge of the social, economic, and political influences affecting the property. This may require detailed consideration of the local and regional economies, employment trends, age distribution of residents in the market area, income statistics and spending patterns, existing and future supply of space or product, job and family formations, etc. It is also likely to require a series of computer-generated cash flow analyses. Quantifying values usually is a process of discounting expected earnings. If valuations are to be believable or defensible, two important counselor functions must be ably performed. First, *forecasting skills* are needed to predict cash flows, and second, *knowledge of financial market conditions* is required for plausible discount rate selection. If an attorney hopes to be a successful advocate for his client's cause, he should buttress his performance by teaming up with a counselor who has expertise in these two fields.

Forecasting is not merely inserting numbers in a software program; it is the product of in-depth knowledge of economic activities throughout a specific real estate market. Existing and probable future competition as well as business expansions and population income are of paramount consideration. Trends are identified and projected into future periods. Capable execution of these operations requires strong foundations in understanding and awareness of the business cycle's movements.

Discount rates are selected based on their bringing competitively attractive earnings to the investors involved. How can attractive competitiveness be judged other than by thorough knowledge of alternative financial opportunities? Rates commonly selected are both current and future. To deal capably with the future variety, a counselor must be knowledgeable of the monetary policy operations of the Federal Reserve. Here will be found a clear cyclical pattern: monetary ease and low interest rates in business recessions followed by gradual tightening and rising rates as recovery proceeds, then a repetition when the next recession occurs.

The counselor's ultimate objective is to form an opinion, with the necessary support for that position, on the reasonableness or unworkability of the proffered reorganization plan. An attorney who plans to convince a court of the merit in his client's position needs to be supported by the real estate and financial market knowledge and data that are the counselor's stock in trade. Again, the value of teamwork is evident.

Tenant Representation

An area of real estate counseling that has grown enormously in the past 10 years is tenant representation. Simply stated, the counselor acts as the tenant's representative in lease negotiations directly with the landlord or with the landlord's broker or

agent. Clients can be large space users such as major national corporations or smaller local companies with more modest needs. Because of the financial implications to the tenant and the relatively long length of the lease term, many companies are realizing that representation by a counselor has become a necessity. Often, tenant representation extends beyond mere negotiations. The counselor frequently draws up option plans and comparisons. Sensitivity analyses and cost-benefit studies are performed. Alternatives are evaluated not only in economic terms (i.e., effective rents, concessions, workletters, etc.), but also in human terms (i.e., neighborhood environment and amenities, accessibility, labor pool, etc.).

In the current real estate market, as rents have fallen substantially below contract levels, counselors are being retained to renegotiate rents downward through lease modifications and extensions. Attorneys are expected to be masters of lease draftsmanship and to thoroughly understand the legal force and effect of all the document's provisions, down to the most minute element. But reality cannot be ignored. Counselors know that a voluminous 100-page lease providing for above market rent to a tenant of medium to lower credit standing is tantamount to no lease. Default in such situations occurs frequently, requiring the lessor to think seriously about restructuring. Also, a long lease to a highly rated tenant at a below market rent is a burden on the fee position, similar to a mortgage. Counselors know it will survive through thick and thin and that it offers little or no prospect of getting tenant consent for modification.

As conditions have worsened, landlords have been receptive to such proposals. A counselor's assistance in negotiating or renegotiating a lease can result in substantial savings to the tenant over the term of the lease. Because counselors are familiar with local customs (i.e., rentable vs. usable areas, passthroughs, concessions, etc.), needless posturing is often eliminated and negotiations tend to become substantive more quickly. Most important, the playing field is level and the client's needs are protected.

In such situations, real estate counselors negotiate the preliminary terms of the transaction and review drafts of the lease as well as the final documents. However, the final responsibility of closing the deal is turned over to the client's attorney. The counselor and attorney work in close association throughout this phase to avoid misunderstanding and to clarify any last minute issues that arise.

Litigation Support

Litigation support is a broad-ranging term that often reflects the most intense interaction between real estate consultants and attorneys. Again, lawyers draw on the knowledge, experience and training of the counselor so they can better understand technical issues. Counselors assist attorneys in preparing and reviewing interrogatories and attending depositions and reviewing transcripts of such proceedings. Litigation support services can be rendered orally or in writing. Usually they are a combination of both. Typically these services consist of verbal advice offered spontaneously during a hearing or in the more reflective moments of a conference or meeting. A counselor may also be requested to prepare a memoranda or a more formal report to assist the attorney. Often testimony is required.

Real estate consultants also are called upon to review the reports of other professionals and to provide written or verbal critiques relative to their adquacy and accuracy. Such reports could be concerned with property or site contamination, leasing or marketing plans prepared for the subject property with specific performance expectations, market or feasibility studies or appraisals. In addition, counselors may be requested to review the work of other professionals in financial matters such as lending operations securities underwriting or investment banking activities (e.g., REITs, industrial bonds, etc.).

Before litigation support services are rendered, the attorney will usually confer with the real estate expert to explain the scope of the assignment, to frame the legal issues and to inform the counselor of his role. The real estate counselor must not only thoroughly understand the proceedings and the relevant legal issues, but also be perceptive enough to offer suggestions and alternatives. Communication is a key ingredient to success. Too often in real estate matters the true nature of a complex item is poorly understood and mistakenly regarded as a unitary entity. For example, a realty parcel is called a property rather than a package of rights. Also, the term "value" is often regarded as having one meaning when, in fact, there are a multitude of value types. Too often in real estate transactions experts are brought in by third parties rather than the principals. This limits communication and exacerbates misunderstanding problems. In the counselor/attorney relationship such carelessness cannot be tolerated. A client is entitled and has the right to expect excellence in the services he receives. To achieve this the professionals engaged must be in direct contact and share full understanding of all aspects of the issues.

Site Selection Studies

Counselors also frequently work with attorneys who represent domestic or foreign corporations seeking to develop a manufacturing plant, retail property or corporate or regional headquarters. Examples would be an auto or similar manufacturer in search of a new plant location; a department store seeking to enter a new market area; or a bank, insurance company, securities firm, law firm or accounting firm weighing a possible move to new quarters. In addition to the real estate issues (i.e., rent concessions, work letter, etc.), counselors involved here also will address other considerations such as the character of the work force, purchasing power of the area and competing properties. It is often necessary to research quality of life issues like infrastructure, reputation of local schools, affordability and housing prices, recreational facilities and similar amenities.

Frequently in such situations a series of sites will be identified and evaluated so the client has a series of options. Each option then is systematically explored in a series of meetings with the counselor, other professionals involved in the process, the attorney and the client.

Estates And Large Real Estate Holdings

Attorneys also use the services of counselors to manage real estate portfolios, develop exit strategies based on tax liability and market conditions, establish asking prices and rents, procure new financing, and make specific recommendations relative to value enhancement techniques and more efficient property operation. Many of the same services are needed in estate proceedings and in estate planning. Formal appraisals are usually required in such situations for legal and other reasons.

Conclusions

As the benefits of counselor/attorney interaction become more widely recognized, professionals from each discipline will work together with greater frequency. Communication, respect and proper understanding of the role that each plays are essential to ensure that the client's interests are effectively served. Demand for counselors' services will be driven by the realization that such interaction is absolutely vital in the current business environment.

PERFORMANCE ANALYSIS IN BROKER LIABILITY LITIGATION

by Richard J. Rosenthal, CRE

Recognizing the emergence of real estate practitioners as *professionals* and the impact of this change on relationships with clients and customers is a must if we are to understand the analysis of broker liability in today's world. Broker performance is measured against a different set of standards than it was in the past. Brokers were merely perceived as salespeople. Transactions were simple and straightforward. You need only compare the document package created in an ordinary brokerage transaction with the paperwork required two decades ago to sense the demand for technical competence on the real estate professional of today.

How Is Performance Measured In Broker Liability Litigation?

In each litigation assignment, the consulting expert must analyze the matter in order to determine the framework of duties and obligations imposed on the licensee and where they are derived. He must establish the standard of care that a licensee must meet in order to perform each duty or obligation imposed on him in a satisfactory manner. Then, using the evidence, testimony and facts which he was asked to assume, he must formulate an opinion of broker performance for the duties and obligations at issue in the subject dispute.

If one is to assess the potential liability of a defendant broker, it is necessary to be familiar with the ruler used to measure broker performance. Once comfortable with this ruler, the analysis of liability and measurement of performance by the consulting expert becomes only a matter of employing the proper methodology. Let's break down the ruler into three parts, and look at them one at a time.

Determining Broker Duties And Obligations

Broker duties and obligations are derived from four basic sources: 1) The relationship with the client, 2) Statutory and common law, 3) Custom and practice in the industry and 4) Contract obligations. If a broker wishes to be relieved of specific duties or obligations he must affirmatively take action to avoid a principal's reliance on or false expectations regarding his acts. This can be accomplished through disclosure of the broker's intention not to perform or his inability to do so. The principal must discharge the broker from performing those certain specific duties. Silence on the matter may result in the broker being held accountable for a failure.

Duties imposed by the relationship with the client (fiduciary duties)

Whether or not the broker is an agent of the principal is a question of fact. An agency relationship can be deliberately created based on the intent of the

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parties, and can be memorialized as a written agreement (a listing contract) or as an oral agreement (often done between a buyer's broker and a buyer; or a tenant's agent and a lessee). An agency relationship can also be created unintentionally based on the broker's words, acts and deeds ("I can get you the loan you need," or "I will find the perfect property for you."). All it takes is the broker creating an expectation of performance in the mind of a prospective client and you have the makings of an implied and unwitting agency relationship with that principal.

It is critical to remember that when an agency relationship is created accidentally or intentionally, it imposes a fiduciary duty of utmost care, integrity, honesty and loyalty on the broker in all dealings with that client. A fiduciary duty is the highest duty an employee can have to an employer, equal to that of a trustee to his principal. The broker must interpret this duty to mean *that his client's best interests take precedence over his or any other person's interest*, and he must do everything possible to insure the well-being and success of his client in the subject transaction. If the broker chooses to represent more than one principal in any transaction, he will owe this high duty to all clients with whom he creates an agency relationship.

In our analysis, we must be sensitive to what was said and what was done by the broker as he dealt with prospective clients. Most lawsuits involving brokers include a breach of fiduciary duty cause of action, and the breach of fiduciary duty becomes the focus of discovery in assessment of liability. This is especially true where the broker was working with a buyer.[1] Therefore, dealing with prospective buyers require particular care as the unwritten nature of the relationship can often result in unfulfilled buyer expectations. The creation of agency relationships without the specific intent of the broker to do so, happens more often than one might imagine. Each time such a relationship is created, a fiduciary duty to the client is imposed on the broker. In analyzing liability we have consistently found brokers failing to perform their duties because they did not realize they had them in the first place.

Dual agency relationships

On the subject of representation of multiple parties in a single transaction, in many states such as California and Hawaii, brokers have statutory and/or regulatory authority to represent more than one party in a transaction as long as they disclose their intent to do so and gain the informed consent of the parties prior to acting as agent of more than one. Brokers in California have served their clients for decades in this capacity (in hundreds of thousands of transactions) with only a small percentage resulting in disputes. Nevertheless, once a broker becomes a disclosed and authorized dual agent, he must recognize the significant burden that he has undertaken in accepting a fiduciary duty to all parties in the transaction. It is mandatory that he place his principals' interests above all others and recognize that *there will be occasions when the conflicting interests of the parties will preclude his ability to represent them all.* When those occasions occur, the best course of action is for the broker to explain the situation to all principals and withdraw from a dual agency position. The potential for breach of fiduciary duty by the agent makes any other course of action very foolish and an analysis of liability will tend to focus in this area.

Undisclosed and/or unauthorized dual agency (especially one emanating from the Multiple Listing Service unilateral offer of subagency) is, of course, the single greatest threat to the economic and professional well being of a broker. The legal remedies available to a principal for this breach are wide-ranging and severe in their impact on the broker.[2] Today, a course of action exists in many state statutes that, if followed, will prevent an undisclosed or unauthorized dual agency, or at least create a presumption in favor of the broker's proper performance. While the disclosure provisions required by these code sections are generally mandatory only for residential and certain other transactions, many brokers have voluntarily adopted this form of disclosure in all transactions (emerging custom and practice). This voluntary adoption of written disclosure is occurring to document the actions taken by the broker to avoid undisclosed or unauthorized dual agency, without regard to the type of property or engagement involved.

Duties imposed by statutory and common law

Today, the practice of real estate is highly regulated, and real property related disputes have been extensively litigated for decades. The result is a substantial body of case law and an overwhelming array of regulations and statutes.[3] This body of law imposes substantial affirmative duties and obligations on the real estate professional. For liability analysis purposes, we generally classify these duties into three main categories. It is worthy to note that these duties apply to all principals with whom the broker deals, without regard to the broker's status as an agent.

- A duty to diligently exercise reasonable skill and care in the performance of a broker's duties.
- A duty of honest and fair dealing and good faith.
- A duty to disclose all material facts that affect the value or desirability of the subject property, especially that which is not known to or within the diligent attention and observation of the parties, including those facts that would affect the buyer's decision in the subject transaction.

Duties imposed by custom and practice

Definition Custom & Practice: *A group pattern of habitual activity, usually transmitted from one generation to another and is so established that it has the force of law.[4] Principals have the right to expect a broker's performance to conform to the custom and practice in the field, and that he will use reasonable skill and care in doing so.*

Custom and practice may be local, regional, statewide or national. Custom and practice also differ from one real estate discipline to another. As such, a broker must do the homework necessary, to

be competent and capable, especially, when operating out of his normal market area or real estate discipline.

Duties imposed by contract obligations

In accepting employment as the agent of a principal, the broker accepts certain obligations and agrees to perform certain duties. These duties and obligations may be memorialized in an express written contract as with a seller in the listing agreement. They may also be contained in an oral or implied agreement with a seller or buyer, or in some combination of both. It is worthy to note that many brokers are never consciously aware of their contract duties to a client until there is a dispute over an act or omission. Failure to perform a contract duty (breach of contract) can result in the court requiring a party to perform, or in the alternative, to pay damages incurred by the other party due to the breach.

The Analysis

From a broker liability point of view, our analysis would focus on whether the broker appeared to know what was expected and required of him and, if it appears that he accepted an assignment that he was not qualified to perform. In working with a buyer, the broker has an affirmative duty to understand the client's wants, needs and desires in the pending transaction. Moreover, the broker should have documented all mutual points of understanding in order to guard against false expectations and unjustified reliance on the part of the principal. With the proper lines of questioning we can generally determine, during discovery, the state of mind of the parties during the transaction.

Establishing The Standards Of Care

There is no all encompassing "Standard of Care" for a transaction. Rather, for each duty or obligation that is owed to a principal there is an appropriate standard of care. The standards of care operative in any transaction are based on the transaction itself. Moreover, the standard of care for any given duty or obligation is not automatically the same from transaction to transaction. It can and will vary depending on the circumstances. In establishing the standards of care which a licensee's performance must meet in order to satisfactorily execute the duties and obligations to a principal, we must consider what would be required to assure that the client was provided with the information necessary to make an informed decision (based on their knowledge and sophistication; wants, needs and desires; and, the competence and capability of the licensee himself). For example, a broker working with an elderly, unsophisticated person who had never before owned real estate and who desired to invest their nest egg conservatively, would have a standard of care very different than that of a broker working with a sophisticated developer of major properties whose staff would be responsible for all analysis, zoning, financing, conveyancing and negotiations for terms and conditions.

Analyzing Performance

It is critical to any analysis of performance that an evaluation of the licensee's professional competence be made. It is well settled that a licensee is unlikely to diligently exercise reasonable skill and care, if they do not have the requisite level of skills. The errors and omissions encountered in broker liability litigation are generally due to the licensee's lack of competence and capability, not their desire to perform intentional misdeeds. In doing a thorough evaluation of broker liability, whether for plaintiff or defendant, the consulting expert must search for indicators of professional competence in the evidence, testimony and facts alleged by the parties. Obtaining and understanding the significance of information available is of critical importance to positioning the case. A discovery plan must be developed to insure receipt of all information necessary to evaluate the licensee's business practices.

Evaluating the brokers professional competence

In evaluating professional competence, two areas of investigation and review are of great significance. How the licensee went about doing what he did should be documented as the analysis progresses. The presence of a consistent pattern of good business practices and the use of risk management techniques by the licensee will often demonstrate his level of competence and capability, and should also be documented as the analysis progresses.

Business practices

Writing in *Professional Business Practices*, attorney Debra Fink says, "Real estate licensees must learn to develop and maintain business practices which stress professionalism. Basically this requires the licensee to do three things. First, a real estate licensee must recognize key areas in which potential problems arise. Second, the licensee must acquire a broad base and depth of knowledge concerning those areas. And, third, he must commit to staying abreast of the current developments in those areas. Because the real estate industry changes so rapidly, a continuous monitoring of issues must be undertaken in order to be able to uphold good business practices consistently."[5]

A consistent pattern of good business practices is generally indicative of proper performance in the real estate profession and usually indicates an appropriate understanding of the standards to be met. Insightful discovery techniques enable us to explore both the specific performance as well as the normal business practices of brokers participating in the matter at hand.

It is worthy to note that a broker has many ways of staying abreast of changes these days. State and local Realtor associations provide high quality continuing education on broker liability and risk management. In California, the C.A.R. Leader Program examines key issues, changes in the law, standard forms, and techniques to improve professional competence, while the CARNET computer system provides late breaking industry bulletins, legal memoranda, and legislative and technical alerts. And, the Realtor Legal Services Plan assists its members in obtaining legal opinions on any transactional problems that may arise in the course of a

transaction. *A broker's familiarity with resources and techniques available, exposed during discovery, will provide an insight into his professional competence.*

Risk management techniques

Today, real estate professionals in all disciplines incorporate some level of risk management technique into their practices. *Recognizing the use of these techniques by brokers in the performance of their duties, especially where their words, acts and deeds create a presumption of proper performance, is critical to any analysis of liability.* Let's explore then, the profile and performance of a real estate professional operating within the scope of currently recommended risk management techniques.

Assume, if you will, that the licensee is a real estate professional, a broker who is up on all the latest issues, laws and techniques. Let's also assume that he is very sensitive about his agency relationships and works carefully with his clients to be aware of their wants, needs and desires. Knowing their degree of understanding and competence in real estate and financial matters, he determines the level of attention required to perform his duties and obligations in a satisfactory manner. Does this profile indicate a liability-proof broker performing his duties and obligations? Frankly, it only indicates a broker with the proper foundation for a real estate professional's activities. In today's environment it is critical that the broker organize his practice into a consistent pattern of good business practices. Consistency is a key virtue and documentation provides one of the best defenses against broker liability. This approach does not demand a change in what brokers do with their clients, just in the way they organize and document their activities. A broker who has not adopted this approach tends to create risk of liability, not manage and minimize it. Risk management is developed in three parts: risk shifting, risk anticipation and risk control.

Risk shifting

The fine art of shifting risk from the broker to another party is a matter of attitude and attention. There are a number of key ways to begin the process. Errors and omissions and legal defense insurance policies both are methods of shifting the risk of economic loss from the broker to an insurance company for a predetermined number of dollars (the premium). This is the simplest and most pervasive of the risk shifting techniques.

In many states the proper use of a seller's disclosure statement[6] is a method of shifting the risk of non-disclosure of material facts about the subject property from the broker to the seller (especially concerning things of which the seller has knowledge).

The appropriate use of third party experts (such as pest control and home inspectors, civil engineers and architects, attorneys and accountants) and obtaining information from appropriate sources (such as the assessor's office, title companies, the city engineers or the planning department) give the real estate professional a myriad of ways to shift the risk on technical subjects and information away from himself to the appropriate expert, without losing control of the transaction.[7] Throughout this process, the development of a consistent pattern of good business practices will provide the proper framework and detailed documentation for each transaction. Risk shifting loses its impact if each shift is not documented in writing. Generally in real estate, if you don't have it in writing, you don't have it.

If the broker's use of risk shifting techniques can be identified in the evidence and testimony reviewed during analysis, it will provide a basis for the presumption of a number of performance related conclusions such as: the brokers determine their competence and capability to perform services for their clients, and the brokers recommend reliance on appropriate professionals to provide information or advice to their clients. This would be in sharp contrast to evidence and testimony which suggested the broker gave advice and information without a reasonable basis to believe it was true or that no professionals were employed to provide expert advice or information on which the client could rely in making a decision on how to proceed in the transaction. Risk shifting techniques identified during analysis should be documented for use in formulating opinions of performance.

Risk anticipation

This is a technique for standardizing responses to liability producing elements in a broker's normal practice (such as, known material facts in the marketplace and various technical aspects of the real estate discipline practiced). These risks can be managed by anticipating their occurrence and developing standard responses for dealing with them. Utilizing a consistent pattern of good business practices to implement standard responses provides the framework for anticipating risk. Checklists, form disclosures, standard analytical forms and preprepared contingency recitals for purchase contracts are all examples of risk anticipation tools that should be consistently implemented. Confirmation letters which document recommendations, commitments or questions to clients and other parties is another key practice through which a broker creates a presumption of proper professional conduct. Likewise, delivering copies of all transactional documents to the client is a key practice. *We would always check to see if the broker knows which documents the law requires him to deliver to his client.* If not, he may have created a presumption of doubt as to whether he did deliver a copy.

Risk control

Communications with all transactional players on a regular basis is a must. In my opinion, the most important risk shifting phone call a broker can make in the course of a transaction is one in which he says, "I really don't have anything important to report." If a broker made that phone call at least once each week, I believe most client complaints would disappear, especially if the phone calls were documented in a phone log. *If a broker is consistent*

in the aforementioned practices, there is a compelling argument that he knows exactly what he is doing at all times. It becomes very difficult then, for a principal experiencing a case of intermittent alzheimers to claim that the broker did not perform properly if all communications have been consistently documented on a routine basis.

Understanding and recognizing the practice of risk management, or lack thereof, in a broker's performance will lead to effective evaluation of the preliminary liability analysis in a real property dispute.

The Broker's Litigation Mentality

The most startling environmental change for the real estate industry over the last few decades is the increasing incidence of litigation filed against real estate brokers. It is true, but not comforting, that real estate has not been singled out as an industry, but the volume of litigation reflects an attitude held by the general population. In a recent article in the *Los Angeles Times*, a headline proclaimed, "The Land of the Free Is Evolving Into the Home of the Lawsuit". The article went on to say, "there used to be a common retort when one was accused of some infringement or wrong: Sue me! It is not often heard today. The chances are too good that the person challenged will do just that."

Obviously, you can't stop someone from filing a lawsuit if they choose to do so. And, if they do, you can't ignore the complaint or you will lose by default. A broker who has experienced the disruption of litigation knows that even if you win, you really lose. If your law practice includes broker liability defense work, *it is important to understand the psyche of the practitioner as well as the normal structure of the defendant's business operation.* Your guidance in the face of threatened litigation or in advance of an actual dispute is important as is the defense of an actual claim.

From a broker liability perspective, it is critical for the real estate broker to have a plan for handling complaints. Generally, this responsibility falls on the broker's shoulders because he is the agent of all the firm's clients. The sales associate is technically the agent of the designated broker.[8] It is worthy to note that the sales associate providing real estate services to the client is the one with the personal relationship and the first-hand knowledge of the specific facts surrounding the dispute. He is the one at whom any accusations of wrong-doing are normally aimed, yet the complaint is usually directed toward the firm. The receipt of a formal complaint typically results in a predictable emotional response: first anger and indignation, then fear and frustration. And, all of this usually occurs at a time when a cool head and good business perspective is needed most. Any response must be a team effort and must have a team leader. Hopefully, risk control procedures will have alerted the broker to the impending litigation, and he will have already done a preliminary review of the facts and the file. It is highly unlikely that a lawsuit would be filed without preliminary contact and negotiations between the parties. However, there have been many occasions where the sale associate has hidden the dispute and attempts of the client or his attorney to reach an agreement to avoid litigation, leaving the firm to first discover the problem when the suit is filed.

From a broker liability perspective, every real estate professional, prior to any dispute arising, should have selected an attorney who he could rely on if he is sued. Brokers must understand, when faced with a lawsuit, the importance of being represented by an attorney who is competent in litigation matters. All members of the real estate firm who are involved in this dispute must immediately sit down with their attorneys and review the situation. It must be an honest analysis; this is not the time for excuses or emotions. A careful review of the facts often show that real estate professionals have performed up to the standards which are contemplated in the law for their duties and obligations. If, however, an analysis reveals they have made an honest mistake and someone was damaged by their actions, the broker must consider the wisdom of accepting responsibility for his firm's performance and authorize the negotiation of a reasonable settlement.

Bruce Armstrong, a litigating attorney for whom I consult, wrote the following in a successful trial brief: "The essence of the duty of a real estate agent, however, is service to his client. And those who sell their services for the guidance of others in the economic, financial and personal affairs are not liable in the absence of negligence or intentional misconduct. Of course the broker has a duty to the plaintiff to exercise the ordinary skill and care of members of the real estate profession and, upon failure to discharge that duty would be liable to the plaintiff for negligence. But, since the plaintiff accepted the services of the broker because of his special skill as a real estate broker, the plaintiff is entitled to expect only reasonable care, not infallibility. He accepted service not insurance". (Emphasis added.)[9]

Conclusion

Plaintiff's counsel in broker liability litigation generally know how his clients believe they were damaged. Often, however, he does not know if there was a proximate cause for his client's problems. As technology develops and consumerism increases, the complexity of this business will demand a continual increase in the competence of those practicing in the real estate profession. It is easy to accuse a professional of intentional or negligent errors and omissions, and the potential for a broker to be accused of a failure for which he has no responsibility becomes more and more likely. Therefore, an increase in broker liability litigation is inevitable, making the analysis of broker liability and the ability to competently measure broker performance crucial to attorneys practicing in the field.

NOTES

1. The California Civil Code defines a buyer as "one who seeks the services of an agent in more than a *casual, transitory or preliminary* manner, with the objective of entering into a real property transaction" (CA civil code § 2373 et. seq.).
2. In California a principal may be granted: avoidance of compensation to the broker, even if the transaction was successfully completed; recision of the transaction even if a transfer of title has occurred; recovery of damages suffered by the principals, even if the broker is not the proximate cause; and lastly, the regulatory threat of suspension or revocation of the broker's license under CA Business & Professions Code § 10176d.
3. In California, found primarily in the Civil Code, the Business and Professions Code and the Administrative Code [which houses the Real Estate Commissioners regulations.]
4. Random House Dictionary of The English Language, The Unabridged Edition.
5. Fink, Debra. *Professional Practices in Real Estate* (California Association of Realtors, 1989).
6. See Calif. Civil Code § 1102 et. seq.
7. See Calif. Civil Code § 1102.4.
8. In Calif. see Restatement of Agency 2d.
9. *Sweet v Gribaldo, Jones & Assoc.*, 40 CAL. APP. 3de 573, 576 (1974).

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FIXED FEE LEASE CHARGE ERROR CONSULTANTS VS. CONTINGENT FEE CONSULTANTS

by Theodore H. Hellmuth

The old KISS (Keep it Simple Stupid) principle applies to modern real estate transactions as it does to everything else. Violate this principle and dispute is imminent. An example which has been much in the news relates to calculations of amounts due under adjustable rate mortgages. Significant error easily arises in such calculations because the concepts underlying adjustable rate mortgages are inherently complex. A similar potential for error exists in the assessment of rent under commercial leases.

There already has been considerable recrimination over ARM calculations.[1] A similar, or greater, potential exists for dispute in connection with lease calculations. At least one company has taken dead aim at this latter issue. According to published accounts, this company is training associates from throughout the country to solicit tenants on a 50% contingency fee basis to challenge rent charges, particularly regarding common area maintenance (CAM) assessments and square footage calculations.[2] Presumably, if initial lease rental and charge audits are successful, the successes will breed competition and the popularity of lease charge audits will increase.

Modern commercial leases tend to be complex documents. Among their complexities are numerous subtleties relating to the rent to be charged. The simple days of fixed rent as the tenant's major occupancy expense are long gone. Rent escalations, often designed not only for present property configurations but also for dimly perceived future changes, are a way of life. In addition to escalated rent, commercial leases routinely incorporate complex formulas by which the landlord seeks to pass on to the tenant many of the financial risks attendant upon price increases for services which landlords provide to the commercial tenants.[3]

All the ingredients are in place for rental and lease charge errors to occur. As is true of any complex system, there is a lot of room for error in the asessment of the varied charges which make up the package of obligations labeled "rent" in a typical commercial lease. This potential for error magnifies as landlords and tenants change management structure, wash through bankruptcies and insolvencies, and experience turnover in key personnel.

Shifting agendas and practice, management error and clerical mistakes are not the only sources of

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The article is extracted, with modification, from an upcoming book to be published in 1994 by Statelaw Guides, Inc. The book is preliminarily titled American Handbook of Rent and Lease Charge Analysis.

problems in connection with the proper assessment of rent. In some instances, the rent structure in commercial leases is sufficiently obtuse to attribute the problem not to lease administration, but to lease language. Lengthy lease documents often include language which creates an ambiguity in a given instance. Worse, a lease may contain an outright error, either in concept or in phraseology. In any case, landlord and tenant may not discover the problem until after some significant delay, thereby heightening the problem and creating the potential for the multiplier effect to turn a manageable problem into a much more serious situation.[4]

Knowledgeable tenants with multiple retail locations have long realized this potential for error, whether it be in drafting or administration, and have had their leases audited from time to time to assure they are accurately assessed.[5] Other tenants follow a more simplistic approach, only challenging assessments when they seem out of sync with historic practices.[6]

It should not be thought, however, that all errors are made by landlords in their own favor. Significant errors may be made by a landlord in the tenant's favor, which the landlord may identify on a self-audit or a defensive audit following the tenant's claim for reimbursement of another error. Indeed, landlords are not the source of all errors in rent charges. The landlord is usually the party who formulates CAM charges and cost of living (CPI) escalations. However, the landlord of a retail facility will often have very little or nothing to do with calculation of percentage rent, which typically is based on calculations by the tenant and may include significant error.[7]

Hard Times Breed Contingent Fee Error Discovery Consultants

Prevailing adverse conditions in the economy have created two situations which tend to shed more light on the phenomenon of error in assessment of rental charges. The first situation has to do with the renewed focus on cost reduction by many tenants and landlords alike. The second relates to the structural unemployment problems in the economy. Structural unemployment puts a regrettable number of talented and energetic people out of work or causes them to lose full employment. These talented people may have prior job experiences which enable them to know that error generated by lease complexity offers a potential source of revenue. If they do not have any background in this area, there are others who can help them out.

One approach to generating revenue from errors in rent calculation is for consultants to sell services to tenants on a "can't lose" basis. The pitch to the tenant is that the consultant will investigate the tenant's leases and discover any errors in square foot measurement, CAM charges or otherwise. Although the arrangements under which the consultants operate can vary considerably in detail, the outline for a contingent rent and lease charge analysis consultancy arrangement is not hard to develop.

Contingent Fee Contracts Are An Easy Sale

The old saw urges one to "sell the sizzle, not the steak." Contingent fee lease charge error consultancy contracts claim the most compelling sizzle of something for nothing. This makes such contracts a relatively easy sell. It is always easy to hype the alleged risk-free nature of these contracts. Unfortunately, few things are truly risk-free.

Typically, contracts for contingent fee lease charge error analysis will be quite brief. Brevity minimizes sign-up resistance grounded in legal phobia. If the consultant agrees to perform an analysis without risk to the tenant, the consultancy arrangement will likely provide that the consultant only recovers a fee if he is able to collect an overcharge from the landlord. Typically, consultants receive a hefty percentage, say 50%, of any recovery made. In some cases, a consultant will require the client to pay some amount of the consultant's out-of-pocket costs.

Contingent fee consultants justify large contingent fees on the basis that they are taking the risk of working in vain and of being unable to recover any money for the client and thus nothing for themselves. They further justify the fee on the theory that they only earn a fee if they create value. Absent the contingent consultant's successful intercession to alert his principal to challenge lease assessments, the tenant would have continued to make payments under his lease as he did previously.

Such contingency arrangements have been in existence for years. Contingent fees of 50% of savings, if any, are quite common for businesses that contest real estate tax charges on a contingency basis. Similar arrangements are promoted by consultants who analyze utility bills for overcharges. In the context of leases, one can visualize tenants' consultants who specialize in challenging assessments by landlords and landlords' consultants who specialize in contesting percentage rent calculations by tenants. Either could charge a contingent fee of 50% of the amount saved, with no recovery if no savings occur.

Fixed Fee Service Arrangements Are Preferable For Clients

Contingency fee lease charge error consultancy contracts have different types of risk for the client. They carry the obvious risk that the client will pay a substantial amount for minor efforts by the consultant. This would occur if a consultant reviewed a lease, quickly discovered a major error and was able to convince the landlord to settle it without undue delay. This risk is open for all to see and should not be a cause to object to contingent fee arrangements. In fact, many tenants might hope this was the case, although it might diminish as the consultant claimed his bounty, not only for past years in which the error appeared, but also in all the remaining lease years to which the consultant might claim the fee under the contingent fee arrangement.

There are other less obvious risks which can beset those who succumb to the blandishments of

something for nothing. It is these less obvious risks which underlay the thesis of this article, that contingency fee lease charge error discovery contracts are undesirable for principals. Such contracts are filled with potential for conflict and legerdemain, all to the client's disadvantage. Insolvent clients have no choice. If they are going to hire a consultant, it must be on a contingent basis. Given the choice, clients not facing insolvency should opt for fixed fee consultancy agreements.

This is not to say there is anything inherently illegal or disreputable about contingency fee error discovery consultancy agreements. Absent state or local law restrictions and assuming the consultant is not acting without a license to perform a function requiring licensure, contingency fee lease charge consulting usually is perfectly legal. Being legal and being sensible for the client are not necessarily the same thing.

Once the sale (i.e., execution of the contingency consulting contract) is achieved, principals often will begin to appreciate the potential problems inherent in contingent fee lease charge error analysis. There are significant opportunities for disagreement inherent in contingent fee arrangements of any kind. Contingent fee lease charge error discovery consulting contracts are particularly difficult.

Appropriate Role For Contingent Fee Contracts

Certain types of contingent fee contracts are inherently less subject to abuse than others. For example, typical listing agreements, whereby the broker receives a commission of less than 10% of the sale price of the property, are a proven acceptable type of contingency contract. Both the broker and the seller have similar motivations to sell the property. In the vast run of transactions, the respective duties and performance of the parties are well understood. Seldom will an event occur which severely tests the commonality of the sales goal in a way which effectively causes the broker to work against the interests of the client.

Just because certain types of contingent contracts are appropriate does not mean that other similar types of contingent agreements make sense. For example, change the arrangement from the standard 1% to 10% fixed contingency listing fee and you can dramatically alter the mix of motivations, even in a listing contract.

Net listing contracts, which are agreements whereby a broker convinces a client to permit the broker to keep all or some substantial percentage of the excess over a predetermined sales price, have engendered huge abuse over the years. They have caused sufficient controversy for many states to have outlawed such arrangements.[8] A principal difference between normal listing agreements and the trouble-prone, often illegal net listing agreement is the very high percentage participation (often 100%) which the broker realizes on any sale price over the net listing amount.

Real Estate Tax Contest Contingency Contracts Are Appropriate

One cannot isolate any single factor as the one element which causes problems. High percentage realization does not always measure the difference between a contingency arrangement which works and one which offers pitfalls. For example, contrast a contingent fee real estate tax consultancy agreement with an agreement for contingent fee lease charge error analysis. Assume the agent's percentage recovery in both instances is 50% of the savings for some stipulated period of time. A contingent fee real estate tax consultancy agreement is far less likely to result in conflict between agent and principal than is a contingent fee lease charge error discovery arrangement.

The real estate tax consultant makes the claim for tax reduction to a public bureaucracy which expects a significant number of taxpayers to challenge the assessment. This means that the process will not have a tendency to be tendentious. Tax assessors have only one task, tax assessment. Make one mad and you have little risk. If a hired tax consultant legitimately angers the assessor, or more likely someone on his staff, the prospect for meaningful revenge is slim. Further, the process of tax appeal usually has a predictability, if not of outcome at least of procedure. The process of challenging a tax assessment is usually governed by state law. It has a definite beginning, middle and end. Most commercial property owners have a basic familiarity with the controlling issue in such a real estate tax challenge which deals most often with the single issue of property valuation.

Lease charge error analysis is a far more uncertain task. Even in these times when tenants are king, the landlord-tenant relationship is a delicate one. Neither party can afford to gratuitously irritate the other. Tenants should think twice before hiring a gunslinging stranger to challenge the income stream which the landlord is getting from his property. This is particularly so if the stranger has a contingency contract, which means the consultant may claim a vested right to continue a challenge even if the tenant is not fully agreeable.

It makes sense that the higher the contingency fee, the greater the risk for dispute between principal and agent. From this standpoint, a contingency lease charge error fee of 50% is easily of sufficient size to foster disputes. This potential for dispute drops in degree when lease charge error consultants charge a significantly smaller contingency amount as a fee. The size of the contingency is not, however, the only issue, as is clear when one compares the potential for dispute between clients who sign up for a 50% real estate tax reduction consultant as opposed to clients who sign up for a lease charge error consultant.

Specific Problems With Contingent Fee Lease Charge Error Contracts

Other issues which make contingent fee lease error challenges riskier for the principal are not hard to

catalogue. Obviously different contract forms will have these risks in differing degrees. However, all lease charge error contingency contracts should be analyzed based on the following points:

1. Contingent fee lease charge error consultants have significant incentive to oversell the "no risk" aspect of the arrangement. In fact, the client risks severe damage to his landlord/tenant relationship if an overly aggressive consultant overstates the client position or if the consultant acts in a way the client otherwise finds objectionable.
2. The landlord/tenant relationship involves many potential deals which lack obvious price tags. If a landlord wants to settle out tenant's challenge to the landlord's lease charges, the landlord may prefer a noncash quid pro quo, such as relieving the tenant from a burdensome lease covenant. This type of arrangement is easy to work out when a fixed fee consultant is involved, but is not easy to do when a contingent fee consultant enters the picture.
3. Even in cases when a landlord tries to settle a tenant lease charge complaint with cash which can be easily divided between the tenant and the consultant, it may be unclear as to whether this cash is new money or is money which the landlord had budgeted to use as a rent concession for the tenant to induce renewal of the lease or for some other purpose.
4. The decision of how hard to push and when to settle can easily be skewed in a contingent fee situation in which the consultant has an incentive to score quickly and often, even if the amounts are less than might be obtained if the incentives were placed differently. The risks may go either way. The consultant may push too hard or not hard enough. In either case, the consultant is going to want some degree of control because of the contingent fee. In a fixed fee scenario, the principal has a much greater degree of control.
5. The best defense is a good offense. A contingent fee consultant's aggressive assault may breed a counterclaim by the landlord, resulting in the potential that the consultant will recover 50% of his client's positive recovery, while the client is responsible for 100% of any liability which the other party uncovers.

There are likely to be many specific examples in which a principal engages a contingent fee error discovery consultant without encountering any of the listed problems. Nonetheless, principals who wish to hire a consultant to analyze their leases for proper assessment of rent and charges are far more likely to have a satisfactory arrangement if they hire a professional consultant for a fixed fee. In most instances, hiring a consultant for a fixed fee will avoid the most perplexing of the problems set out in this article.

The Game Merits A Fixed Fee Consultant

Fixed fee lease charge error consulting contracts need not expose the principal to a major unrecouped fee, even if the consultant's fixed hourly rate is quite high and even though the principal owes the fee regardless of results.

A knowledgeable consultant with experience should be able to assess quickly the potential for recovery in a given situation. Once this is done, the consultant can advise the client of the cost to pursue the matter further and the likelihood of success. The client then can decide whether or not it is worthwhile to proceed further. The client can monitor the situation as it proceeds and fire the consultant without penalty when he wishes to do so, effectively cutting off any responsibility for additional fees.

In most cases, lease rent and charges involve significant expenses for a tenant. If this is true for one year, how much more is it true when one considers the multiplier effect. If a landlord has mischarged a tenant for one year or if the tenant has misrepresented percentage rents for one year, chances are similar errors occurred in past years and are quite likely to occur in future years. If such is true, then the amount in issue becomes multiplied by the number of years involved. This can quickly add up to serious money, even if the amount for a single year is not considerable. Add interest and you really have something to think about. Therein lies the rub. The best way to proceed should be determined by the principal, unfettered by large contingent claims by a contingent fee consultant. This is why fixed fee consultants are preferable.

NOTES

1. Kobliner, Beth. "Avoid the Pickpocket Bank's Wrong ARMS and Round HELs", *Money*, vol. 22, p. 43 March 1993; Forster, Eric. Are ARM Borrowers Overpaying? 25 *Real Estate Today*, Vol. 25 Sept. '92 p. 27.
2. Dekok, David. "Measuring Up, Firm Checks Leased Space Dimensions", Harrisburg, *The Patriot*, Vol. 152, March 29, 1993, p. 1; "Four Partners Thrive Offering A Service That Every Commercial Tenant Needs!" *Opportunity Digest*, March, 1993, p. 39.
3. *See e.g. LaSalle National Bank v. Service Merchandise Co.*, 827 F.2d 74 (7th Cir. 1987) (*LaSalle* sets out the complexities of CAM assessments as they appear in a modern shopping center lease.)
4. The multiplier effect comes into play when an error which has recurred for a number of years multiplies for each of those years, often with interest added. *See e.g. Goldstein v. City of St. Louis*, 552 N.Y.S.2d 594 (A.D. 1 Dept. 1990).
5. The rationale behind an ongoing policy of lease charge audit is reviewed in Jeffrey Newman, "Common Area Costs—The Hidden Rent", Winter, 1990, *Real Estate Review*. For tips on the hazards of doing self audits in the area of ARMs, which are applicable in many instances to lease charge self-audits see Gary Tepper, "Don't Compound ARM Errors with Misguided Audits", *ABA Banking Journal*, Vol. 83, Nov. '91, p. 24.
6. *See e.g.* "Commission Cautions Consultants", June 1993, *Missouri Real Estate Commission Newsletter*, p. 3, which states: "The functions of a real estate consultant are not always completely clear, and those who operate in that capacity can very easily step into the arena of licensed activities . . . "
7. *See e.g. Michigan Ave. National Bank v. Evans, Inc.*, 531 N.E.2d 872 (Ill App. 1 Dist. 1988) (Landlord forced tenant to include wholesale sales in percentage rent calculations.)
8. *See e.g.* Missouri Real Estate Commission Regulations §250-8.090.

ADR: A NEW NAME FOR AN OLD GAME

by Ronald M. Sturtz

The purpose of this article is to explain the application of some well known methods of resolving disputes which may be familiar, but probably are less understood than expected. Most of you are acquainted with or perhaps have been involved in traditional litigation in the federal or state court systems. You are also undoubtedly aware that most disputes do not ever reach an actual trial before a judge or jury. Those concluded short of trial are helped by various alternatives to be discussed here, such as early neutral evaluation, mediation, negotiation, private judging, mini-trial, summary jury trial and arbitration. These alternative means of aiding dispute resolution have received the acronym "ADR". Some of these methods are well known and understood. Some are innovative. As we explore this recent explosion of interest in ADR, consider where you fit into the picture: as a party, an expert, a party-appointed arbitrator or neutral.

The year 2000 is rapidly approaching. In recent years much of accepted business methodologies, and for that matter social procedure, have been changing at warp speed. If any one thing could be singled out as the impetus, it would be computerization and the resultant realization of developments in daily living almost as fast as the events happen. The electronic age has made most business leaders and the consuming public come to expect prompt, efficient and complete conclusions to every problem or concern as soon as their attention focuses on the issues. The legal profession and business of dispute resolution have been infected with the same virus.

Continuing the trend of societal modernization, dispute resolution has reached new heights and dimensions in speed and efficacy. No longer are parties to a dispute constrained to exhaust time and money pursuing litigation. Today, disputants are increasingly availing themselves of ADR techniques.

The primary need to resolve the dispute, quickly, efficiently and most importantly, qualitatively, has replaced courtroom adjudication. Parties who choose ADR as a means of resolving disputes find they reach as satisfactory a result as with pursuing litigation, but without unnecessary temporal and fiscal expenditures.The most frequently asked questions by clients are "Who is the judge?," and "When will this case come to trial and be concluded?" With resort to ADR, the answers to such questions are in the parties' control.

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What's Wrong With Traditional Litigation

Several centuries ago Shakespeare wrote, "The first thing we do, let's kill all the lawyers." (*Henry VI*, Part III.) Some would assert that things have not changed, and the impetus to this misused statement is as appropriate now as it was alleged to be in the 16th century. But, in fact, society has changed. Indeed, life has grown infinitely more complex since Elizabethan times, and the legal profession has responded.

Perhaps one of the most common form of dispute resolution, the filing of a complaint in a state or federal court, has grown painfully complex not to mention exhaustive-both physically and fiscally. Learned Hand, former Chief Judge of the Court of Appeals for the Second Circuit during the early and middle parts of this century, once quipped, "[a]s a litigant, I should dread a lawsuit beyond anything else short of sickness and death."

There is no question that in most parts of this country we are presented with an overburdened federal judiciary and its growing inability to process and adjudicate cases in a timely efficient fashion. In the federal system, there are over 280,000 civil and criminal cases filed each year, and the number continues to grow. The federal experience is mirrored in the states to a great degree, but the numbers are more dramatic.

Adding to the judiciary's incapacity to cope with the immense number of civil case filings, litigation delays are exacerbated by extensive and sometimes extraordinary pretrial activity. Parties will typically file many motions which seek rulings on issues well before the actual trial begins. In addition, the present discovery process can be drawn out consuming inordinate amounts of time and money. Studies show that up to 60% of litigation costs are attributed to this activity. ADR reduces and in many cases eliminates this pretrial activity, but in any event certainly brings focus to the process thereby reducing temporal and monetary expenditures arriving at the dispute resolution stage earlier.

In response to the challenge, the legal profession, in the federal and state systems has been actively promoting ways to deal with the problem. Since so many cases are settling without going to trial, reaching the settlement stage more quickly, efficiently and gracefully became the goal. Client demands over the past 30 years have prodded the legal profession to revisit alternative methods of resolving disputes. ADR is more practical, less expensive and obtains results vastly quicker than litigation. Disputants can pick and choose the nature of their forum, choose their decision-maker and achieve a resolution expending a fraction of the time and resources that litigation would consume. ADR provides parties with viable, efficient alternatives to litigation and methods to settle disputes.

ADR: A National Movement

National policy favors ADR. Congress and most states have enacted statutes which can be classified as involving ADR. The American Bar Association (ABA), notably its Section of Litigation, is a strong and vibrant supporter of ADR. At the August 1993 American Bar Association meeting, a new Dispute Resolution Section was authorized and is now being organized. By ABA House of Delegates resolution, non-lawyer associate members are welcome to join.

Two major national not-for-profit organizations and many private ADR providers actively promote and facilitate the use of ADR. The American Arbitration Association (AAA) is a public service, nonprofit national membership organization. It was founded in 1926 shortly after the adoption of the first of a number of arbitration laws patterned after a model act which was adopted in different versions around the nation. The organization's primary function is to encourage and facilitate the use of arbitration and other voluntary techniques of dispute resolution. This is done through education, training, and research for all forms of out-of-court settlement methods. The AAA actively assists business in designing custom-tailored dispute settlement systems. In addition, nationally the AAA is instrumental in its role of compiling and providing lists of arbitrators, including non-lawyers, who are available to private parties for use in resolving their own disputes.

The Center for Public Resources (CPR), a New York-based national public policy organization, is another organization actively involved in the promotion of ADR. The CPR Legal Program was founded in 1979, and it consists of several hundred general counsel of major corporations, law firm practitioners and legal scholars. Recently, the CPR was nationally recognized for developing and implementing among its corporate members a written pledge committing a signatory to explore ADR methods before proceeding with or in lieu of litigation. Over 600 of the nation's largest corporations have signed and abide by the pledge. In addition, the CPR developed a similar national initiative among law firms, whereby the CPR's law firm members drafted and 1,425 law firms signed the *CPR Law Firm Policy Statement*.

How ADR Works And Different Types Of ADR

The decision to submit a dispute to arbitration, or another form of ADR, is usually manifested by a contractual provision between the parties. The contract clause defines the scope and limits of ADR for the parties who select the type of ADR, establish the procedure by which a neutral is selected and determine whether and to what extent the process and decisions are final and binding. The parties are free to specify parameters delineating their ADR according to their own individual needs. For example, the parties may specify that only certain, as opposed to all, issues arising from the contract or transaction are subject to ADR. Importantly, the parties may bind the neutral to base his decision on state law, federal law or even generally accepted commercial standards as defined by the parties. The ADR clause can be as limiting or broad, as specific or vague as the parties' desire. The shape ADR takes is limited only by the parties' imagination.

Arbitration Clause

A very simplistic (and *not* recommended) standard arbitration/ADR clause to be inserted in contract could be:

> Any controversy or claim arising out of or relating to this contract, or the breach thereof, shall be settled by arbitration [parties can specify any form of ADR] and judgment upon the award rendered by the Arbitrator(s) may be entered in any Court having jurisdiction thereof.

What is missing from this provision is minimal references to a chosen state or federal arbitration law, designated rules and substantive law, whether the arbitration is to be administered and perhaps most importantly, designation of the arbitrator(s) or the method of selection.

If the parties fail to include an arbitration clause in their contract or where the dispute does not involve a prior contract, the parties may still submit their dispute to arbitration by entering into an appropriate agreement signifying the specific dispute to be resolved. Submitting a matter to ADR may invoke the operation of an ADR statute.

Award

The contract clauses generally provide for a judgment upon the award to be entered by a court having jurisdiction of the parties. There is no difference between a judgment procured through litigation and one obtained following an ADR proceeding. Accordingly, such a judgment is enforceable like any other court-won judgment.

Some state statutes authorize courts to review ADR awards, whether or not judicial review is provided in the ADR clause. Generally, awards will be vacated only upon grounds of corruption, fraud, partiality of the neutral, or other similar wrongdoing. The New Jersey arbitration statute, for example, provides that the award will be confirmed unless "the award is vacated, modified or corrected"[1] for any of the following reasons:

1. Where the award was procured by corruption, fraud or undue means;
2. Where there was either evident partiality or corruption in the arbitrators or any thereof;
3. Where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause being shown therefore, or in refusing to hear evidence, pertinent and material to the controversy, or of any other misbehavior prejudicial to the rights of any party;
4. Where the arbitrators exceeded or so imperfectly executed their powers that a mutual, final and definite award upon the subject matter submitted was not made.

Even where an award is vacated, spending the time and expense going through ADR is *not* wasted. Having engaged in the ADR process, the parties accomplish several things which should assist and expedite the litigation. Much of the work necessary for trial will have been done in preparation for ADR. Some discovery will probably be done, issues will have been focused and sharpened, perhaps many of the elements of the underlying dispute will have been settled or at the very least, progress toward settlement will have been made. In any event, ADR serves the parties' needs by reducing time and expense associated with going to court.

Different Types Of ADR

One of ADR's most attractive elements is its flexibility. The shape and format of any alternative proceedings are limited only by the party's imagination. While there are more standard or recognizable forms of ADR, each with distinct characteristics adaptable to a variety of circumstances, the parties are free to fashion a framework which suits their particular needs. This is typically done in an ADR clause either in the underlying contract or through a post dispute agreement.

The standard forms of ADR are recognized as negotiation, early neutral evaluation, mediation, private judging, summary jury trial, mini-trial, and arbitration. Arbitration can be court-ordered, (presumptively mandatory and typically non-binding) often with minimally coercive features to give the parties incentive to allow the result to become final. With the adoption of the Civil Justice Reform Act of 1990, (CJRA) virtually all United States District Courts around the nation adopted local rules which mandate or at least provide for participation in one of the ADR methodologies, although no litigant can be forced to accept a result or settlement proposal. The statistics seem to prove that since 96% of all court filed cases settle before trial, the effort to introduce dispute resolution discussions into the process at the earliest time will lead to more expeditious and less costly litigation - perhaps even a higher percentage of consensual dispositions. The effect of an agreed upon result or mandated award is usually the same, a final disposition of the dispute or case, similar in respect to the finality of a court-ordered judgment which can be enforced as one fully tried to an imposed determination.

Since ADR is the product of an agreement among parties, the bounds are defined only by legality and public policy. Fortunately, neither constraint significantly encroaches upon the parties' rights to fashion a dispute resolution process. There are the classical or traditional forms already discussed but the parties may mix and match, (with some care and planning) or even dispose of them altogether and define a completely unique process. The parties are virtually unfettered in their ability to selectively implement elements from one type in concert with one or more elements of another type or develop something entirely new and unique. The name ascribed to the process by the parties is practically meaningless. The ultimate concern centers upon the definitions and powers prescribed. The ADR process will follow whatever rules are established by the parties, unless the named process adopts a statutorily prescribed format.

Negotiation

The term negotiation derives from a Latin word which means "carrying on business." Negotiation has been employed in everyone's daily living. Society, increasingly disenchanted with the cost and adversarial nature of litigation, is turning to the negotiation alternative. The parties usually attempt negotiation prior to the pursuit of any other form of dispute resolution. However, it can be attempted in tandem with other dispute resolution processes as well. In fact, the parties can engage in negotiation settlements at any stage of the litigation process.

While the negotiation process is varied, there are phases which most negotiation proceedings follow. During this first orientation phase, the parties establish initial contact, set the tone for their future interaction and form impressions as to the style, integrity and expertise of the other party. In this phase, the parties also decide upon procedural matters.

The second phase consists of the information exchange or argument where the parties concentrate on substantive issues. The length of this stage depends on the relationship of the parties and on the complexity of the issues.

The third phase of the process is triggered by the crisis point which can be an approaching deadline, a trial date or the running of the statute of limitations. Many negotiations produce settlements immediately prior to the crisis point.

The final phase of the negotiation process is the settlement or, conversely, the breakdown of the negotiation proceedings. If the negotiation process has failed, the parties must pursue another form of dispute resolution.

There is no third party in the negotiation process. As a result, resolving procedural problems can prove difficult. The parties involved in the dispute or their representatives must be able to communicate, work together and compromise. If the parties reach an agreement, it is binding and final. Since the parties themselves have crafted the settlement, there is no danger of an appeal. If one of the parties breaches the contract or fails to perform, the parties may either return to negotiation or seek relief through the courts. In addition, legislation has been enacted which encourages finality in the decision. Rule 68 of the Federal Rules of Civil Procedure allows one party to offer a settlement to the other side. If the offer is not accepted, and the rejecting party receives less at trial than the amount offered, then that party must pay the costs incurred by the offeror from the date of the offer.

Like mediation, negotiation which is also completely private, does not produce predictable results. It also requires nondisclosure and a tailoring of the process to that particular dispute. Thus, any subsequent dispute must proceed through a separate dispute resolution process. A party in the negotiation process could not depend on the outcome to prevent subsequent litigation of similar disputes. As with other settlement efforts, statements made during negotiation are not admissible in subsequent court proceedings. However, the facts learned are not secret or confidential (unless otherwise carefully and properly provided in an explicit agreement). This enables parties who want to avoid unnecessary public review or criticism to iron out their differences in a confidential manner. This is particularly attractive to disputants involved in a patent or trademark infringement. Negotiation saves money. The parties conduct the proceedings themselves, so there are no third-party neutral fees. In addition, attorneys' fees are greatly reduced. Negotiation also saves the costs inevitably committed to continued litigation.

Mediation

In a successful mediation, everyone comes away a winner. Mediation is not a procedural alternative to litigation, it is a settlement device. Unlike adjudication which focuses on the past, mediation looks to the future and is used now in virtually any kind of dispute. Most of the federal district court plans filed pursuant to the CJRA have mediation as a significant component. It is the least threatening ADR method and often gets the parties talking for the first time.

The parties decide the format of the proceeding. They may decide to submit written materials or a brief statement of the case. The mediator, the parties and their attorneys usually meet prior to the mediation to exchange facts and to summarize their positions. This meeting provides the parties with the full picture in an efficient and relaxed manner. Witnesses are permitted, indeed encouraged to attend and to elaborate upon their positions in complete confidence without the constraints of any evidentiary rules.

After the fact exchange, the mediator continues to meet separately with each party. Their discussions are completely private unless the disclosing party permits the mediator to relate any part. The mediator offers advice and insight to each party in turn. An attempt is made to bring each side to accept compromise of its position(s), but the key ingredient is the skill of the mediator to understand how the parties can be brought to a position where they agree with the adverse party's needs. This process is repeated until settlement is reached or until the parties decide to pursue other means of resolving the dispute. If a settlement is reached, or a joint session appears to be appropriate, the parties are brought together to hear the views of the other side and eventually if successful, to formally agree to terms and signing an agreement. The end product is similar in nature and effect to a consent decree obtained in court. Unlike arbitration, there is no judgment or award in mediation.

Except in court mandated ADR programs, the parties choose the mediator. They may locate a mediator in a variety of ways including public advertisement, referrals from lawyers, counselors or clergy, from academia, governmental agencies, state mediation and conciliation services and the AAA. In the real estate world, mediation can be extremely

useful in arriving at settlement of valuation issues and perhaps in disputes regarding the efficient producing cause of a sale. Mediators generally participate actively in the negotiations, make suggestions, offer alternatives and help the parties resolve their dispute and reach settlement. However, some situations dictate that the mediator merely act as a conciliator, providing a forum for the parties to come together, and allowing the parties to shape the result.

The mediator's initial task is to inform the parties how the process works and to establish the ground rules. After the ground rules have been laid, the mediator will assist the parties in identifying the facts and issues in their dispute. It is eye-opening to see how often the parties have never had a prior dialogue, as mentioned above.

The success of mediation is usually dependent on the selection of the mediator. Parties generally pick a mediator with a relevant business background or legal expertise. In addition to actual experience, the mediator should be organized and able to efficiently streamline the facts and issues presented. He should also be objective and unbiased, patient, professional, trustworthy and independent. Finally, the mediator should be perceptive and able to recognize the parties' priorities and problems and help them structure an appropriate settlement. An independent real estate counselor with knowledge of the relevant issues can be a valuable resource as a mediator.

Mediation obviously does not produce predictable results. First, it depends on nondisclosure: even the parties to the dispute are unaware of all the statements made and the facts produced. Second, the ultimate agreement is based on the needs and goals of the parties rather than on an identifiable legal standard. Thus, a party participating in the mediation could not bind an unrelated party to that agreement in subsequent litigation even if the facts were identical. Since the mediation process is private, the discussions and the substance of the sessions are protected from public scrutiny. Documents produced during mediation and the substance of information disclosed in the mediation, can be discoverable in subsequent litigation. However, the content of mediation proceedings are afforded much greater protection from discovery than are evidentiary and fact documents. To avoid any confidentiality problems, the parties simply sign an agreement that any and all discussions made during the proceeding as part of settlement negotiations will be inadmissible in any future litigation under well understood federal and state evidence rules.

Mediation saves money. It is attractive for smaller cases in which the amount litigated is quickly consumed by expended executive time as well as attorneys' fees and costs. Mediation is also attractive for larger cases which involve a long discovery period and spiraling legal fees. The mediator's hourly fee is comparable to that of a good attorney. Usually, it is divided equally among the parties. However, if one party favors mediation more than the others, it may choose to bear a larger portion of the cost.

Arbitration

Arbitration is the submission of a controversy to a nonjudicial, neutral decision maker sometimes comprised of three persons, but often only one. The process and problems to be described here are well rooted in many societies as a way of resolving disputes. Arbitration is particularly common in business and labor disputes, professional sports, union grievances, international commercial disputes and consumer disputes. It is gaining favor in banking matters, and there is no reason why it should not continue to gain extensive acceptance in all manner of real property related agreements. The money and time saved through arbitration make it particularly well suited to the modern business world. The proceedings are not usually public and, if properly administered by an organization or the arbitrator(s), speedy. The *key ingredient* is in the drafting of the arbitration clause when each party to the agreement is free to insist upon appropriate safeguards and procedures to assure these goals are attained. Contrary to often heard criticism, recent studies show it does not frequently result in compromise dividing the pot awards. Again, the arbitration agreement will control the result.

A party seeking relief initiates the proceeding by a written demand for arbitration which resembles the complaint filed in normal litigation. It does not need to state any formal cause of action. Instead, the short demand form streamlines the proceeding from the outset. After the claim has been filed with the administering authority or the adversary and the matter is agreed or determined to be arbitrable, both parties begin the process of choosing arbitrators. An agreed upon restricted discovery period may thereafter commence, assuming the contract or selected rules provide for such discovery, or the arbitrator(s) concur.

The arbitration hearing is conducted privately usually by legal counsel. Although considerably shorter and less formal, the format of the arbitration proceeding resembles a trial. Usually, both sides are allowed to make opening statements, present their cases and cross-examine the other party's witnesses. Since facts can be presented by affidavit this may not always be possible.

An arbitrator(s) presides over the process. They may be selected by the parties—each party chooses one arbitrator (i.e. "party arbitrators") who then select a third. The third appointed to the tribunal is often referred to as the umpire. This does not mean that the umpire has the task of choosing between the other two arbitrators' decisions; any award must be made by at least a majority of the arbitrators.

Arbitrators may also be appointed under the rules of an arbitration entity such as AAA when that organization has been designated to administer the arbitration. Under AAA's commercial arbitration guidelines, a roster of arbitrators, often experts in

their field, is maintained by AAA. Similarly, the CPR has compiled a number of national and regional panels of distinguished neutrals, some specialized in various fields, available for such service.

Depending on the jurisdiction, the party arbitrators may and in fact are expected to confer with the party who selected them; they may be biased but not corrupt. Great care should be taken to consider the role of the arbitrators, their qualifications and their ethics. Generally speaking, independence of all members of a panel is preferred, but not mandatory unless the contract or applicable arbitration statute permits or otherwise applies. It must be emphasized that, since arbitration is the product of contract (except for court-mandated programs which are essentially non-binding), the parties are free to fashion their own rules and criteria. Whenever a method to select arbitrators has failed in identifying the person(s) to act, applicable federal and state statutes provide for designation by a judge in a summary expedited procedure.

Arbitrators are given great control over the arbitration proceeding except to the extent the contract otherwise provides. They determine when to schedule the arbitration hearings, establish procedural rules, grant postponements and issue subpoenas which can be enforced by court orders with the power of contempt. The arbitrators can also admit any evidence the parties wish to present through either witnesses or documents. In addition, if the arbitrators are dissatisfied with the evidence offered, they may solicit additional evidence by questioning a witness themselves. Alternatively, they may request that a party's attorney produces evidence which they consider necessary for resolution of the dispute.

The arbitrator's ability, expertise and fairness is the foundation of the success or failure of the process. A conscientious and knowledgeable arbitrator can move the dispute quickly and satisfactorily, conduct the proceedings with integrity, render a just award and facilitate the continuation and improvement of a productive business relationship. Arbitration cannot guarantee predictability. Because arbitrators usually do not provide written explanations of their awards, it is difficult for a party to ascertain what factors went into the result and to order its behavior accordingly.[2] Likewise, a party is unable to rely on that decision as precedent and is unable to avoid similar litigation. This outcome can easily be avoided, however, by requiring the arbitrators to document the reasons for their decision and thus determine what behavior to avoid in the future.

The arbitration proceeding ensures confidentiality. It allows the parties to avoid unwanted and counterproductive publicity absent a confidentiality agreement to the contrary. This usually facilitates the continuation of that business relationship and also protects the reputation of the parties. Another advantage is the informality which characterizes the arbitration proceeding. Unlike the courtroom which demands compliance with numerous rules, the arbitration proceeding allows the parties to resolve their dispute in a somewhat less formal, relaxed though adversarial atmosphere. Again, the parties are free to design, modify and agree upon these rules in their arbitration contract or clause prior to the commencement of the proceeding.

Arbitration can be a more cost efficient and less expensive process than traditional court adjudication provided the parties and counsel understand the process. In addition to potential savings for executive or client time diverted from business, legal fees, the financial consequences of the lost business relationship, should also be considered. The additional costs incurred in arbitration are the payment of the initial fee for commencing the arbitration paid to the administering organization (if any), the cost of producing witnesses, and the cost for the stenographic record, if one is made.

Private Judging

The private judge process, dubbed "rent-a-judge", is analogous to arbitration, yet retains many of the characteristics of a traditional judicial proceeding. It is flexible and efficient and has proven especially helpful in complex commercial real estate cases where particularly contentious parties seem to abound.

Many states have enacted statutes allowing parties to choose the private judge process. In New Jersey, a procedure fashioned after prevalent California practice, the Alternative Procedure for Dispute Resolution Act[3], provides for resolution of controversies by means of private judges called umpires. The act was intended to provide parties with a quicker, less costly but more predictable process for dispute resolution than traditional civil litigation and to provide the parties' rights not usually available to them through arbitration.

The key elements of the law provide that the result must be arrived at in accordance with applicable principles of law, and the determination must be in writing with findings of fact and law readily reviewable. It reduces the possibility that an umpire will apply his own notions of justice and render an award bearing no resemblance to that which results in a judicial resolution of the matter. In this way, private judging differs greatly from an arbitration proceeding in which the arbitrator is free to fashion the award even in a manner inconsistent with applicable substantive law.[4] Unlike traditional litigation however, there is only one appeal to a trial level judge. Thus the process can be swift, predictable and inexpensive since extensive discovery is not contemplated.

The proceeding is initiated upon filing of a demand which must set forth the claim, any defenses and the amount of damages sought. The party demanding resolution must also initiate the process of umpire selection. Once the umpire has been selected or appointed, each party submits to the umpire and to the adversary, statements of factual and legal positions which govern the issues to be determined. The umpire may allow modification if such changes

do not unduly prejudice the opposing parties. Unlike arbitration which does not expressly authorize discovery, the private judge process anticipates some discovery to be completed within 60 days following the receipt of the demand, unless the umpire or the parties otherwise provide. Such discovery may be through oral depositions, inspection of documents and interrogatories (when so authorized by the umpire). At the hearing, the parties are entitled to be heard, to present evidence relevant to the controversy and to cross examine any witnesses appearing.

The private judging proceeding is conducted by a single umpire unless the parties have agreed otherwise. If an agreement designates an umpire, then that person conducts the proceeding. If an agreement describes a method by which the umpire is to be selected, this method is followed as well. However, if a method is not provided, or if a method proves unworkable, then, as with traditional arbitration, the Superior Court (New Jersey's trial level court) will appoint an umpire in a summary action.

The umpire has full jurisdiction to provide all relief and to determine all claims and disputes arising under the contract. The umpire is not competent to testify in any subsequent court action related to the private judging proceeding. The umpire also has the authority to allow the parties to have discovery through interrogatories and to shorten or lengthen the 60 day period allotted for discovery. The umpire may require the testimony of any witness or the production of any evidence, and the umpire may direct that such evidence be obtained. The umpire fixes the time and place for the hearing (unless the parties have otherwise agreed) and may adjourn the hearing from time-to-time.

The parties may choose the third-party neutral. This makes the rent-a-judge process an attractive alternative to normal adjudication in which the neutral (i.e. a judge or a jury) is assigned through a luck-of-the-draw. The disputants should select a third party with business or technical expertise who can recognize and understand the complexities of the dispute. If a dispute turns solely on a legal issue, then a retired judge might be the best qualified, although a real estate professional might well perform such duties in the right circumstances.

As in arbitration, the umpire must comply with a code of ethics. The umpire is required to disclose any interest or relationship which would bias his evaluation of the case. The rent-a-judge process differs from a normal court proceeding in that it is private. While many other formalities of the courtroom are present, the parties are assured that their disputes will be free of public review and scrutiny. The private judging process is less expensive than a normal court trial, however the parties must still prepare the case as if proceeding to a normal trial, though the limits placed on discovery greatly reduces cost.

An umpire's compensation is similar to that of an arbitrator. The umpire's expenses and fees and all other expenses including the cost of the facilities, the deposition and hearing transcripts, and expert witness fees are paid as provided in the award. In addition, the *parties may* allow the umpire to award attorneys' fees.

While the New Jersey ADR statute is applicable only in that state, there is nothing to prevent contracting parties from adopting by reference the substance of the law. Care should be taken to review the law with local counsel, but there is no policy reason which would prevent enforcement of this ADR technique in any other jurisdiction.

Early Neutral Evaluation

The paramount objective of the early neutral evaluation process is to reduce the cost and time spent in prolonged litigation. The process was developed in 1982 by the Federal District Court for the Northern District of California and it has grown steadily in popularity. It is now a cornerstone of court administration in many states and other federal districts. Early neutral evaluation recognizes that the most money can be saved in the early stages of litigation. The patterns and expectations for the litigation process are set in this early stage. Therefore, direct communication, cooperation and common sense have the most beneficial effect in the earliest stages as well.

The early neutral evaluation process forces parties to analyze the strengths and weaknesses of their arguments, to focus on the critical issues and to confront the concerns of their opponents. It has been used most successfully in cases involving civil rights, contract disputes, insurance coverage disputes, labor disputes, personal injury and patent infringements.

Early neutral evaluation takes place at the outset of the litigation process, usually within four months after a complaint has been filed in court. In some cases, the session may even be held before the first judicial pre-trial status conference. In other cases, the court allows a very abbreviated period of discovery prior to the evaluation session.

At the start of the session, the evaluator (usually very experienced lawyers in the field of the dispute, or a special judge assigned for this task) briefly discusses the goals and establishes the tone which is to control the proceedings. The parties mutually select the third-party neutral to conduct the evaluation. In addition, the court, under its power to appoint a special master, can also appoint the third-party neutral, who most often serves pro bono. The neutral is referred to as the evaluator. The parties then make a 15 to 30 minute presentation explaining their views of the facts and describing the evidence upon which they rely. Documents may be used where appropriate. After hearing each party's position and evaluating the evidence presented, the neutral offers an assessment of the case.

The third party plays a very critical role in the early neutral evaluation proceeding as an evaluator as well as a counselor, mediator and advisor. The evaluator helps the parties narrow the scope of the

dispute by identifying areas of consensus and by isolating areas critical to resolving the dispute. The evaluator also assesses the strengths and weaknesses of the arguments and offers an assessment of the likely outcome. In addition, without imposing or relaying his analysis, the evaluator attempts to facilitate a settlement. If the parties seem interested, the evaluator can host a settlement discussion. Finally, if the parties seem disinterested in a settlement, or if the settlement fails, then the evaluator can help the parties devise a strategy for sharing information and conducting discovery in contemplation of a future settlement discussion.

As in arbitration, it is most effective if the evaluator is familiar with the nature of the dispute. Thus, the evaluator should be an individual with business experience or technological expertise who can identify the parties' concerns and priorities. Equally important, the evaluator should be creative and perceptive so he can introduce issues or contentions. The early evaluation process also requires an individual who is a problem solver and a solution-oriented person, able to recognize the goals of the parties and steer the conversation accordingly. If the evaluator has the requisite credibility, the views expressed can be very persuasive.

The evaluator should ordinarily have legal knowledge. This enables the evaluator to distinguish between the information necessary for settlement negotiations and the information necessary for a full trial. Often, private attorneys are better suited than judges to serve as evaluators. The attorneys have more time to devote to the process. In addition, there is some concern about having a judge assigned to the case to formulate his opinion from the outset.

The early neutral evaluation is a private proceeding. There is no formal testimony, and oral communications during the session are privileged as part of settlement discussions. The evaluators are prohibited from discussing with the court, or anyone else, anything which took place in the session.

The early neutral evaluation process is very flexible and informal. Based on the schedules of the parties, the evaluator picks the time and place for the sessions to be conducted. The environment of the session should be as casual and informal as possible with no procedural or evidentiary rules.

The early neutral evaluation is a cost-effective device in which litigants can learn about their opponents' cases. It reduces the length of the litigation process and the resulting expenses. It focuses the parties on the critical issues and prevents the parties from wasting money on unnecessary and unproductive discovery.

Mini-trial

The first case to ever use the mini-trial was *Tele-Credit, Inc. v. TRW, Inc.* which involved a legally and technically complex patent infringement dispute. After nearly three years of litigation, and very substantial legal fees, a trial date had not been set. The parties agreed to give the mini-trial a chance. Two days after the mini-trial began, the parties had reached a settlement.

The mini-trial is especially attractive for business people, because it gets them involved in the process from the outset. It forces them to recognize the strengths and weaknesses of their arguments and to be reasonable in their demands and concessions. The mini-trial is a sophisticated process which requires the presence and commitment of high-level business persons. It is best suited for larger disputes in areas such as antitrust, patents, construction, breach of contract, complex technical issues, unfair competition and employee grievances. Recent studies demonstrate that mini-trials result in prompt settlement in more than 95% of the instances it is used. A recent very well written article describing this technique can be found in *Litigation*, the Journal of Section of Litigation.[5] The following is a distilled analysis of this ADR method:

1. A mini-trial usually does, and should, directly involve the principals. Those individuals who are and will be most affected by the outcome of the underlying dispute should be present (and not simply available by telephone).
2. A mini-trial is an early intervention technique; ideally it should occur well before the actual trial of the case.
3. A mini-trial should save the parties litigation costs or at least offer a real prospect of such savings if it results in a settlement.
4. A mini-trial should give the parties a taste of litigation for the psychological benefits and cathartic effects this can provide.
5. A mini-trial is a voluntary, consensual undertaking.
6. A mini-trial, though more structured than pure mediation, can be as formal or informal as the parties wish, with the tilt toward informality tending to dampen the antagonism real litigation often promotes.
7. A mini-trial is nonbinding, leaving the parties free to return to the supervision and enforcement power of the courts.
8. A mini-trial is flexible, reflecting the consensus of the parties on how to structure the event or events to best serve their needs.
9. It is important to emphasize that, as with other forms of consensual ADR methods, a mini-trial can be confidential, freeing the parties from the prying eyes of a public or press intent on reviewing dockets, pleadings, deposition transcripts, and the trial itself.

When should you consider a mini-trial? Only certain cases are suited for the technique. It depends, on the size of the matter. A mini-trial requires significant effort and carries no guarantee of success, no certainty that the dispute will be resolved. The parties also must agree on how the mini-trial itself will be conducted. All these points may be subject to negotiation:

- The amount of time to be allotted to each party.
- The availability of rebuttal time.

- Whether the presentations will be made solely through counsel or whether testimony (or less formal oral presentations) from key witnesses will be allowed.
- The extent to which normal evidentiary rules should apply.
- Whether experts will be used.
- The extent to which streamlining procedures will be used.

The role of the neutral should also be defined in the mini-trial agreement. Will the neutral supervise and monitor, or even enforce, the discovery process? What will the neutral do at the mini-trial itself? The neutral could act like a judge and supervise the presentations or act as a go-between in facilitating the negotiations. The neutral could issue an advisory opinion of his view of the case at the close of the presentations or after a predetermined period of negotiation.

None of this is preordained. The neutral is available to serve the parties to the extent they mutually agree and are willing to pay. The only essential point is that the neutral's role must be defined so that each party's expectations are clear. Once the agreement is signed, the parties must quickly move into action and continue the momentum toward the hoped for resolution. This observation should apply equally to all ADR methods. The important thing in preparing for a mini-trial is that it is not a final adjudication, yet if well done it will help to shape the eventual outcome of the dispute. If nothing else it will affect the psyche of all of the participants, clients and lawyers alike.

If it is consistent with the agreement, counsel should not hesitate to enlist the aid of the neutral in facilitating discovery and ensuring (to the extent possible) that discovery obligations are being honored. A critical issue for the parties is whether and when they will have the neutral share his evaluation of the presentations. This can be a delicate question. The neutral's evaluation can have a sobering effect, dashing the unrealistic view of at least one of the parties. It also carries the risk (one that successful neutrals avoid by building trust and confidence) that the neutral will no longer be perceived as disinterested.

Thus, the mini-trial is a hybrid which merges characteristics of adjudication, arbitration, mediation and negotiation into a unique creation. The parties to the dispute set forth the framework in the mini-trial agreement. They determine procedural rules, rules governing acceptable behavior and what role the neutral should play. At the mini-trial hearing, attorneys and experts for both sides usually make summary presentations of their cases to the neutral and to the panel, comprised of one representative for each disputing party, explaining why their side should win. Documents and other evidence can be submitted, and witnesses may also testify. Each side's presentation is followed by rebuttal and questions by the opposing side. After the weaknesses of both sides have been exposed, the business persons on the panel analyze, negotiate and possibly resolve their dispute. If the business persons fail to reach an agreement, the neutral may be called on to assist. Generally, the court action is stayed while the mini-trial process is proceeding. The mini-trial does make the outcome of the instant dispute predictable. Generally, the neutral's opinion of that probable outcome of litigation is consistent with the ultimate verdict rendered by the court. Thus, the mini-trial encourages the parties to settle rather than continue costly and counterproductive litigation.

Summary Jury Trial

The summary jury trial (SJT) is a short, inexpensive form of trial which allows the parties to look into the future. Conceived in 1980 by a federal judge, its use has grown markedly throughout the country. A summary jury trial, unlike all other forms of ADR, provides the parties with an opportunity to present their cases before empaneled jurors who are not told their deliberations aren't real. The jurors have no special qualifications or expertise. Rather, they are lay people usually taken from the otherwise empaneled pool of jurors who are viewing this case and the legal issues presented for the first time. The purpose of a summary jury trial is to find out what an average jury thinks about the dispute. The summary jury trial is an effective means of ascertaining the probability of a result. The uncertainty of an outcome can interfere with the settlement of a dispute. This situation arises most often in the context of liability, but as mentioned above, most often involves damages. The mock jury serves as the third-party neutral. Since the jury is selected from the general population, it's role is exactly the same as in a normal adjudication. It listens to summaries of the case, followed by instructions of the court, and decides accordingly. The summary jury trial educates the parties on how a jury will comprehend, analyze and react to the numerous issues of law and fact and what a jury thinks without being bound by its decision. It informs the parties what they risk in taking the case to full trial in accordance with complete procedural safeguards.

The summary jury trial is presided over by a judge or a magistrate upon assignment from the court. In order to be indicative, the case should be in a posture suitable for a full trial. This means that the summary jury trial should follow completion of discovery. However, when discovery has not yet been completed, parties can conduct fast-track discovery which focuses the parties on the most critical issues, resulting in a considerable savings of time and money.

The summary jury trial itself consists of a *voir dire* (opening statements) presentation of summary evidence (although nothing would prevent the parties from having minimal live testimony), rebuttal and closing statements. Each presentation is subject to a time limit, and the entire trial usually takes no longer than a day. All evidence, including the testimony of witnesses, is usually presented by counsel in narrative form. Once the parties have completed

their presentations, the jury is charged and instructed by the court in the same manner as a normal trial.

Post-SJT conferencing begins after the SJT concludes. The parties, their counsel and the judge are present. The parties, now better informed of the strength of their cases, negotiate with one another. If after the SJT the parties have not been able to settle within a time fixed by the court or the parties, the court usually sets the case for a full trial.

Summary jury trials have proven helpful in cases involving negligence, product liability, personal injury, mass toxic tort, contract disputes, age, gender, race discrimination and anti-trust, but there is no limit to its use where a jury trial has been duly demanded. The process is utilized most often in complex cases where the parties are anxious to have a dry run on the issue of damages. The exercise has been found useful in helping the parties move to discuss settlement.

Summary jury trial provides insight into how a jury perceives the strengths and weaknesses of each side. Studies conducted demonstrate that cases which proceeded to trial resulted in verdicts remarkably consistent with those reached in the summary jury trial. Liability findings and damage awards were almost identical. The only difference was the additional time and money devoted to reaching that verdict.

The summary jury trial proceeding is not usually open to the public, nor is it recorded unless specifically ordered by the court. However with agreement, counsel may arrange for a court reporter to be in attendance. Flexibility is essential to the effectiveness and efficiency of a summary jury trial. Nonetheless, a summary jury trial should resemble a real trial as much as possible. The presence of a judicial officer and a jury helps create this aura. In addition, while the summary jury trial does not require procedural and evidentiary rules as strict as those in a normal trial, it does adhere to similar standards. Evidence inadmissible or unavailable at trial may not be used.

Whether or not the summary jury trial results in a settlement, it can save the parties money. If the case settles, all adjudication costs are avoided. Studies have shown that upwards of 40% of litigation costs result from the trial. Thus, the parties get all they would in a full trial at a fraction of the cost. If the case proceeds, the parties have lost nothing. They still would have had to conduct discovery and all other pretrial preparation. The parties have simply engaged in a low-cost dress rehearsal which has made them better informed and more prepared.

Conclusion

The foregoing presentation illustrated the flexibility of the many varieties of ADR. One common theme that pervades each form of ADR is that it achieves settlement or resolution quicker and more efficiently than litigation. None of these methods approach the formality of traditional adjudication, but with effort the parties can be very impressed with the process with much less cost. ADR places primacy on satisfying the needs of the disputants—achieving a legitimate resolution to their dispute in a timely and cost-effective manner. The legal profession has from time immemorial had the duty to conclude litigation in the most efficient way possible.[6] The stress placed upon utilization of ADR methods in the federal and state court systems is the natural outgrowth of increased court backlogs, rising litigation costs and a recognition by clients that litigation takes a toll on their business and professional lives. Often all of this transcends measurable out-of-pocket costs to the attorneys and expert advisors. Discussion of settlement and methods to reach that goal are no longer a sign of weakness; rather it has become a regular and anticipated event in the course of dispute resolution. Indeed, consideration of carefully drawn dispute resolution contract provisions is a must no longer relegated to boiler plate language added to the bargain as an after-thought.

Real estate professionals engaged in the process which often gives rise to the deal, have the opportunity to urge their clients to *insist* upon attention to such matters. *Indeed you will be well served if you demand such attention in your own affairs as none of us are immune from the litigation virus.* By pursuing ADR, parties are not journeying down an unknown path. Widespread use of ADR may be new, but ADR itself certainly is not. As indicated at the outset, ADR has been widely used in many areas of the law to avoid the pitfalls of litigation. Real estate counselors can do their clients great service by educating them on the availability, uses and benefits of ADR as a means to resolve disputes.

NOTES

1. See N.J.S.A. 2A:24-7. New Jersey has also adopted an ADR statute, N.J.S.A. 2A:23A-1 et. seq. with a similar provision.
2. The standard for review of an arbitral award differs among federal and many state jurisdictions. In California, the highest court ruled in 1992 "an error of law apparent on the face of the award that causes substantial injustice *does not* provide grounds for judicial review." *Monchharsh v. Heily & Blase*, 3 Cal.4th 733 (1992) (emphasis added). Within the same week, the New Jersey Supreme Court in *Perini Corp. v. Greate Bay Hotel & Casino* (the Sands Hotel) 129 N.J. 479 (1992) by a split vote determined that a court can invalidate an arbitration award that was based upon gross, unmistakable error of law. Other courts have rules which would only interfere if the award were irrational, or a "manifest disregard of the law", but what seems to be clear is that all courts would follow whatever standard the parties choose.
3. N.J.S.A. 2A:23A-1 et. seq.
4. See discussion set forth in end note 3.
5. The following outline has been adopted and taken with permission from an article on Mini-Trial authored by Lawrence J. Fox, a partner in Drinker Biddle & Reath, Philadelphia, Pa. which appeared in "Litigation", Vol.19, Number 4, Summer 1993, *The Journal of the Section of Litigation*, American Bar Association. Mr. Fox is vice chair of the section.
6. Former Chief Justice Warren E. Burger made this point in his 1986 speech before the American Law Institute where he observed: "The true function of our profession should be to gain an acceptable result in the shortest possible time with the least amount of stress and at the lowest possible cost to the client. To accomplish that is the true role of the advocate."

DETERMINING THE APPROPRIATE INTEREST RATE IN MORTGAGE LOAN CRAM-DOWNS

by Rocky Tarantello, CRE and Jess R. Bressi

This article is based on an earlier examination of bankruptcy rate determinations in an article co-authored by Rocky Tarantello and Jess R. Bressi titled "Determining the Appropriate Discount Rate for Calculating the Present Value of Deferred Payment Plans: Historical Experience and Theoretical Underpinnings," California Bankruptcy Journal, *Volume 17, Summer 1989, Number 2.*

Because of the commercial real estate building boom of the 1980s, a mountain of outstanding mortgage credit has been extended to the nation's commercial real estate lenders. At year end 1991, a total of $1,056.8 billion of total commercial mortgage debt was outstanding. Commercial banks accounted for $274.8 billion, while life insurance companies held $243.7 billion. By the end of the second quarter of 1992, 6.75% of all life company loans were delinquent, in foreclosure or foreclosed, while U.S. commercial banks struggled with an 8.20% commercial real estate loan delinquency rate. By simple calculation, and without any consideration of the infamous savings and loan industry collapse, nearly $40 billion of commercial real estate held by those lender groups was delinquent or in foreclosure. Billions of dollars in additional debt are maturing each year, while the availability of new mortgage capital is virtually nonexistent. Commercial real estate lenders are forced to either work-out (restructure) existing loans or commence foreclosure proceedings against the collateral properties.[1]

In many of these cases, the borrower's inability to meet his repayment obligation is not simply the result of reduced or declining real estate values, but also the result of regulations discouraging or prohibiting lenders from refinancing existing loans and the near total absence of new institutions willing to extend credit to "take out" existing lenders. If the mortgage borrower is confronted with foreclosure and regardless of whether substantial equity remains in the property, his only possible recourse may be to file a bankruptcy petition to forestall the foreclosure and effect a reorganization plan destined to be a "cram-down." This is particularly likely in the real estate industry since most large properties are structured as single asset ventures allowing restructuring of individual properties without disturbing other properties or assets which may be held by the owner.

Unless a mortgage lender agrees to lesser or inferior treatment, provisions of Chapters 11, 12 and 13[2] of the Bankruptcy Code provide that a creditor is entitled to receive, as of the effective date of the plan, the value of the lender's allowed secured claim.[3] If the plan of reorganization provides for periodic payments to the secured creditor over the life of the plan, these periodic payments must be subjected to a net present value calculation or "discounting" to calculate their present worth.[4]

This article examines the basis for the determination of cram-down interest rates, including

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factors influencing interest rates, and also surveys some of the case law on the interest rate issue. The article further examines how current loan market conditions cause the near absence of similar loans at market rates thus requiring the courts to expand and modify their approach to the determination of a rate appropriate for a coerced loan where no real market exists.

Economic Theory And Interest Rates

If a secured lender is to receive the present value of its claim at the time of plan confirmation, then micro-economic theory dictates that the interest rate paid by the debtor on the deferred payments should correspond to a rate of interest that could be obtained by a lender making a loan to a third party upon similar terms, for the same duration, secured by collateral of equal value and with a comparable risk of default (the "third party loan" test). As a practical matter, this is a test which is impossible to meet under current market conditions. Before we discuss how the rate may be determined by cross reference to alternative debt markets, the theorectical foundation of the appropriate rate is first presented. In order to satisfy the requirement of the "third party loan" test stated above, which is comparable to the legal requirement that the secured lender receive the "indubitable equivalent" of its claim, one must be able to compare the wide range of interest rates observed in the marketplace, understand their relationship to the risks born by the lenders in question and select the appropriate interest rate as required under law.

Term Structure, Liquidity And The Influence Of Inflation

All interest rate determinations begin with considering the maturity of the debt and the frequency of any installment payments. This notion relates the level of interest rates to the period of time the capital obligation is outstanding. It further assumes that the risk class of a particular group of obligations is homogeneous, since mixing high-risk subordinated corporate bond yields (junk bonds) with low-risk U.S. Treasury obligations would significantly skew a rate/term relationship.

Comparing alternative rates and maturities not only demonstrates the gross difference in short and longer term interest rates (the ordinal difference), but makes it possible to calibrate and determine rate differentials within specific maturities. This provides a direct basis upon which specific maturities of secured obligations may be "priced."

Lenders will significantly alter their interest rate requirements in terms of their past experience with inflationary impact and to the extent that these experiences influence their future inflationary expectations. Simply put, lenders systematically require higher interest rates to compensate for inflation. Hence, market interest rates of all maturities are continuously adjusting to inflationary expectations which extend over the term of the obligation. Therefore, it is impossible to properly apply an interest rate to an obligation without taking inflation into account.

Since the yields for a given class of obligations change from day to day as economic information is internalized by the marketplace, a few tendencies can be observed. First, lenders are much more willing to lend short than long. This is known as the "liquidity preference" and refers directly to the concept of default risk. In other words, the shorter the term of obligation, the less likely the borrower is to default. Hence, the lender has a liquidity preference and will accept lower rates (yields) in the short-term. This would justify the use of lower interest rates in the valuation of short-term secured obligations.

Secondly, much more is known about the present and immediate economic future than events several years hence. Consequently, borrowers and lenders formulate expectations on the basis of increasing uncertainty about the future. The marketplace is essentially confessing its inability to anticipate future economic events. Therefore, interest rates of all maturities beyond a certain point in time fall within a very narrow range of interest rates. A comparison of 15, 20 or even 30 year U.S. Treasury securities is unlikely to illustrate much rate difference. Of course, the same is true for other risk classed obligations. Consequently, secured claims of approximately ten years or more would all tend to be valued at roughly the same rate of interest within a given risk class.

Finally, the marketplace in the United States never seems to expect inflation to last for very long. This is not to suggest that inflation is not a problem or cannot get out of control. It simply means that borrowers and lenders in the marketplace price their obligations in a manner which seems to always assume that inflation can and will be brought under control at some point. Moreover, they are so uncertain about economic events at that point in the future, they have no basis for differential rate pricing.

Assessing Risk

The concept of interest rates is entirely a function of expectations about the future. However, three possibilities exist when looking into the future: certainty, uncertainty and risk. Each refers to a different level of expectation (and comfort level) and would be rate-priced accordingly. An individual is certain about the future when the precise outcome of an event is known. The very nature of a bankruptcy proceeding completely precludes such an assumption. The individual is uncertain when he knows all the possible outcomes, but does not know which will be the final result. This is still an unlikely scenario within the context of a bankruptcy proceeding. Finally, the individual is at risk when even the possible outcomes are not known for sure, much less which outcome will be the final result and, as a matter of practicality, this is inevitably the situation in which a secured creditor finds himself. Since interest rates, economic events and expectations about the future

are constantly changing, lenders are at risk even when holding U.S. Treasury obligations, the value of which will fluctuate in reaction to changes in market interest rates. In a nutshell, nothing is without risk.

Lenders generally perceive two broad classes of risk exposure—default risk and rate risk. Default risk not only refers to whether or not the borrower pays the obligation back, but also considers the adherence to the timing and interest rate of the original obligation. Any departure from the original loan agreement causes the lender to suffer economic loss in present value terms. Lenders attempt to mitigate this form of risk exposure through strict underwriting guidelines and borrower analysis. Of course, the greater the perception of default risk, the higher the interest rate (risk premium) for a given maturity of obligation. This is the basis for all bond rating systems, and explains why obligations of equal maturities provide different yields.

Rate risk is the other form of exposure lenders must bear. It is the risk that market interest rates rise above the rate currently being earned on a loan previously made. The present value of the future principal and interest payments of the existing obligation will be reduced in relation to the spread between a rising current market rate and the contract rate of the obligation. The lender can do nothing[5] to mitigate this risk other than try to anticipate these future changes and price the loan rate accordingly. Hence, even U.S. Treasury obligations, while nearly free from default risk, still suffer from rate risk exposure and possible loss in value to the lender.

Case Law Analysis Of Appropriate Interest Rates

Along with the valuation of collateral to determine the amount of an allowed secured claim,[6] litigation over determining an appropriate interest rate in a plan of reorganization has been one of the more hotly contested issues under the Bankruptcy Code. Despite the best efforts of the courts, rate determination has become more a matter of mechanical convenience than a serious probe of the capital market and economic theory so critical to a defensible rate selection. As one bankruptcy judge opined, the determination of appropriate interest rates has "produced so many opinions with such varied results"[7] that a survey of all published opinions is not very instructive.

Generally, one of four approaches has been selected by the courts to determine appropriate interest rates: (1) market rate for similar loans (i.e., the third party loan test),[8] (2) contract rate,[9] (3) statutory rates such as the *legal rate* or § 6621 of the Internal Revenue Code for rates on delinquent taxes,[10] and (4) the coupon yield rate of 52-week Treasury Bills auctioned by the Treasury Department every four weeks.[11] Each of these dominant approaches should reveal the current lack of economic logic in the selection of the appropriate rate. In addition to these four approaches, various courts have created hybrids, which start with the base rates such as the Treasury Bill rate or other market rates and then add various risk premiums to reflect the increased risk of loaning to a Chapter 11 debtor. A theoretically sound approach to this process has been described as follows:

> The determination of an appropriate interest rate is not conceptually difficult. The rate compensates a creditor for both the time value of his money and the risk of lending to the debtor on the terms proposed in the plan. Risk will be influenced by the postconfirmation capital structure of the debtor, the debtor's need to borrow additional funds, together with planned convenants restricting future debt, and the timing of both future cash flow and payments under the plan.[12]

However, the determination of the appropriate risk premium is difficult in the absence of observable market information upon which to base a comparison to the case at hand. One must *derive* a risk premium based on economic principles and cross-correlation with observable alternative debt market instruments. One way or another, the appropriate interest rate becomes a function of the risk premium and the other theoretical economic factors (liquidity, term, inflation) described earlier. Moreover, in determining market rate, various courts have looked to such things as statutory rates, prime rates, treasury bill rates, and the contract rate to determine an appropriate market rate. In general, it appears that the convenience in determining the rate has overshadowed the requirement to select a rate which satisfies the indubitable equivalence standard.

All four of the circuit courts, which have considered the interest rate question, have applied a so-called market rate to determining the appropriate interest rate.[13] Though many courts give lip service to a market rate approach, no consistent explication appears in the case law of how to apply the market rate approach. Moreover, no consistent definition of the term appears to have emerged. The predominant factors discussed by the market rate cases are the length of the deferred pay-out period under the plan, the quality of the collateral for the obligation (i.e., appreciating versus depreciating), and the risk of subsequent default.[14] It would at least appear that recognition of economic principles, as the foundation of rate determination, has already been accomplished. However, the case law fails to specify what economic principles underlie the guidelines. Other market rate cases have found *market conditions* to be the predominant factor in determining an appropriate interest rate considering inflation expectations, prime rate, and comparable third-party rates (when and if they may be observed).[15] We presume that the reference to *market conditions* was in fact further acceptance of economic theory as the basis for rate determination. Market conditions and information would be of little value in the absence of a theoretical framework to interpret the information and formulate decisions about current and future rates.

A serious conceptual problem with the market rate approach is that it presupposes there is a real market for loans to debtors under Title II for guidance. Yet any bankruptcy practitioner who has attempted to obtain financing for debtors, whether secured by a senior lien or otherwise, knows that the market for debtor financing is at best "thin," and under current conditions, nonexistent. Hopefully this is changing and a competitive market is developing. In any event, debtors pay substantial premiums for financing either in Chapter 11 or in connection with a confirmed plan. The term *market approach* is a misnomer because no true "market," with market forces at work, exists for borrowers in bankruptcy cases. *Risk premium* approach more aptly describes the case law and the methodology used in arriving at a market rate. As proposed below, a cross-correlated or composite loan rate approach presents a more theoretically defensible and legally consistent approach to interest rate determination.

Alternative Approaches To Rate Determination

Once commercial loan markets have virtually dried up and the false premise upon which most interest rate approaches are based is exposed (namely, that there is not a true market for loans to Title 11 debtors), an approach which fairly allocates the risks and rewards of a forced loan may be made. Consistent both with the foundations of economic theory and the case law, the authors suggest that a real world approach to this problem would use either a blended rate to weigh risk-adjusted, economically determined, third party loan rates to the situations encountered under Title II, or depend upon observable interest rates earned on alternative debt instruments (securities) properly adjusted to their mortgage loan equivalent.

The more defensible approach to the interest rate question, using a blended third party loan rate, is found in the real property case of *In re Landmark at Plaza Park Ltd.*[16] In *Landmark*, the "forced loan proposed by the debtor includes terms less favorable to [the secured party] than would typically be found in the market. . . "[17] The court recognized the economic environment and the unavailability of 100% financing and calculated a composite loan rate using primary long-term market rate financing at a 75% loan to value ratio and secondary short-term market rate financing at a higher rate for the remaining 25%. The court, after hearing economic testimony at the confirmation hearing, "indicated that interest on such [secondary] mortgages is generally five points over prime. With the prime rate approximately 14% at the time of confirmation, the Court believes that 19% is the minimum interest rate on this portion of the loan."[18]

The plan proposed by the debtor in *Landmark* included a loan in the amount of $2.26 million, a 100% loan to value ratio repayable in three years, with the first 15 months of interest deferred and with no amortization of principal over the life of the loan.[19] Testimony presented at the confirmation hearing revealed that institutions such as thrifts, life insurance companies and pension funds would make mortgage loans on properties of the type present in *Landmark* with an interest rate ranging from 12.5% to 14%.[20] The typical first mortgage loan would have a term of 3-10 years, with amortization calculated on a 25-year basis and a 75% maximum loan to value ratio.[21] Secondary mortgage financing would be available for additional borrowing requirements at a premium of five points over prime.[22] The court treated the secured creditor "as . . .[a] holder of two mortgages: a first mortgage to the extent of 75% of the loan and a second mortgage to the extent of 25% of the loan."[23] The court reached a composite or blended loan rate of 15% by multiplying the highest first mortgage loan rate to third parties of 14% times a loan to value ratio of 75% and adding it to the product of the secondary mortgage rate of 19% times the balance of the loan ratio of 25%.[24] Because the rate proposed by the debtor in *Landmark* was below the blended 15% minimum rate established by the court, confirmation of the plan was denied on the basis that the plan did not comply with § 1129(b)(2)(A)(i)(II).[25]

Another thoughtful approach to the interest rate question, using an adjusted third-party loan approach, is found in the case of *In re McCombs Properties VIII, Ltd.*[26] In *McCombs*, the debtor proposed to cram-down various secured creditors and force the creditors "to accept an accrual market rate of interest at 10.5% with a base rate for current payments of 9%.[27] The debtor in *McCombs* suggested that "interest rates for seller financed loans on comparable properties" were the appropriate "market" to look to for an appropriate interest rate or rate under the loan.[28] In rejecting both the debtor's contention that inexpensive seller financing was a revelant market and the creditor's contention that substantial additional interest premiums were required, the court analyzed the loan-to-value ratios and coverage ratios for each of four creditors. The third party loan rate utilized by the court was the Federal National Mortgage Association (FNMA) interest rate on fixed-rate loans secured by multi-family properties of the kind present in the *McCombs* case and adjusted upward for any deficiency in loan-to-value ratio.[29] Thus, in *McCombs*, the bankruptcy judge increased each interest rate upward from the debtor's proposal of 10.5% to reflect a third party or market rate of interest for the forced loans.[30]

In both *Landmark* and *McCombs* the blended rate approach depended on observable mortgage market rates, whether primary or subordinate. In either case, it should be obvious that the court was able to depend upon and reference specific loan terms and lenders who were actually in the market. Notwithstanding the separate issue of whether a Chapter 11 petitioner could even find financing at market rates at any loan-to-value ratio, at least third party loans to qualified borrowers were observable to the court.

Possible recognition that a market for reorganizing bankruptcy debtors does not exist is found in *Farm Credit Bank of Spokane v. John Fowler (In re Fowler)*, 903 F.2d 694 (9th Cir. 1990). In *Fowler*, the Ninth Circuit Court of Appeals approved the use of a formula to determine the appropriate market rate. The court described the formula approach as follows: "[u]nder this approach, the Court starts with a base rate, either the prime rate or the rate on treasury obligations, and adds a factor based on the risk of default and the nature of the security (the "Risk Factor")." The debtor in *Fowler* owed a senior lender $159,000 on two 35-year variable promissory notes and a junior lender approximately $22,000 on a one-year note. After filing his bankruptcy petition, the debtor proposed a plan for reorganization. After hearing testimony regarding the appropriate rates, the court approved a rate for both the senior and junior lenders of 9.5% over 25 years. The court based the 9.5% interest rate on the prime rate at plan confirmation (8.75%), plus a .75% risk factor. The district court, sitting as an intermediate court of appeal, reversed the bankruptcy court's interest rate determination in an unpublished order and set the rate at 10.5%. All parties appealed because of the district court's determination of the 10.5% rate.

The Ninth Circuit Court of Appeals reversed the district court's decision and ordered the case remanded to the bankruptcy court "to make explicit findings regarding how the [Bankruptcy Court] assesses the risk of default and the nature of the security and explain its reasons for applying a specific risk factor." The court stated that "[e]vidence of market rates for similar loans is relevant for arriving at the appropriate risk factor." Presumably, the court acknowledged that comparing rates for similar loans is not always possible, and even when it is, such comparison is merely a factor to consider. The court also directed the bankruptcy court to engage in additional fact-finding, if necessary, on how it assesses the risk of default and the nature of the security, and to explain its reasons for applying a specific risk factor. This direction and the requirement of explicit findings seem to indicate that the court requires an economic analysis when determining the risk factor.

What we are now suggesting is that since current market conditions provide little if any evidence of third party commercial loans to anyone, qualified or not, the court should rely on alternative debt instrument interest rates and yields by comparing the debt of a secured lender to the class of alternative debt instrument which most closely resembles the risk characteristics and maturities of the restructured loan. In *Fowler*, the court seemingly identified the prime rate and treasury obligation rate as the only alternatives.

We have found that several classes of alternative debt instruments provide the best basis for comparison of rate determinations. High yield bonds, U.S. Treasury securities, investment grade corporate bonds, mortgage backed bonds and collateralized mortgage obligations (CMOs) are all freely traded on a daily basis. Interest rate and yield data are reported daily and every major financial institution makes a market in some if not all classes. Consequently, yield and price data obtained through observation of these various debt markets represent actual transactions of borrowers and lenders and also provide clear and irrefutable evidence of market yield (rate) requirements. Interest rates derived from actual market transactions are surely preferable to rates derived from hypothetical lenders, hypothetical loan terms and non-existent transactions.

The only concern of the court should be whether the most comparable alternative debt information has been utilized in the calculation of the new blended rate.

In a recent case pending before the United States Bankruptcy Court for the Central District of California, the following analysis was provided to the court in the form of an affidavit of expert witness testimony:

Analysis:
An initial step in the procedure of deriving appropriate interest rates for a petitioner is a search for comparable transactions. Due to the state of the economy, the federal regulatory environment and the real estate loan markets, debt capital is virtually unavailable for projects of this type at this time.

In fashioning an interest rate, a risk premium is added to a specified base rate. The perceived degree of risk would determine the interest rate and other terms of the loan.

Rate Recommendation:
The appropriate rate for a five-year loan on the subject apartment project would be the current yield on secured liquid mortgage backed securities, plus a risk premium for credit worthiness/default risk, value and liquidity of the underlying property, and the liquidity/salability of the loan. The petitioner seeks a five-year extension of an existing loan, currently due and in default. The five-year Treasury rate as per the May 25, 1993, *Wall Street Journal*, was approximately 5.36%. In the absence of numerous current apartment loan transactions, it is reasonable to assume that an appropriate rate risk premium should not be less than the bond yield premium earned by lower credit rated bonds over equivalent term Treasury obligations. The May 25, 1993, *Wall Street Journal*, page C23, cites high yield bonds. The average of all high yield bond quotes was 9.69%, or 4.33% above the five-year Treasury yield. Since both classes are highly liquid, the rate premium is due entirely to the inherent risks of default and to loss associated with risky corporate obligations versus U.S. bonds and notes.

The May 25, 1993, *Wall Street Journal* also provides current yield information regarding conventional single-family residential mortgage loans and mortgage backed securities. Page C17 provides a money rate summary which reports

that posted yields on 30-year mortgage commitments for standard conventional fixed-rate mortgages were 7.32% to 7.42% at the Federal National Mortgage Association and 7.39% to 7.49% at the Federal Home Loan Mortgage Corporation. These loans are highly liquid and suffer far less mortgage default risk since these are loans on owner-occupied, single-family homes.

Page C20 of the May 25, 1993, *Wall Street Journal* cites current mortgage backed security yields. These securities are secured, liquid and issued or guaranteed by federal or federally related agencies. Despite the overwhelmingly low degree of illiquidity and risk associated with these mortgage derivative investments, obligations with 5.7 to 5.9 year weighted-average life yielded 6.54% to 7.01%.

Taking a somewhat longer view of a five-year loan request, a comparison was performed of the average interest rates on a cross-section of investment instruments from January 1977 through December 1992. The table below summarizes some of these comparisons:

	Average Interest Rate			
	Prime Rate	30-Year Treasury	Corporate Bonds	Conventional Mortgages
1/77-12/92 (16 years)	10.77	9.73	10.37	11.53
1/87-12/92 (6 years)	8.85	8.40	9.10	9.77
1/90-12/92 (3 years)	8.23	8.14	8.24	9.26

As shown in the above table displaying both short- and longer-term average interest rates, a 10% to 11% range is not a significant departure from past market conditions. This range is supportable either on current market yield/risk premium information or in terms of longer-term average market rates.

In conclusion, since high risk bonds command a 4.3% risk premium over U.S. Treasury obligations, it is reasonable to expect high risk mortgages to yield a similar risk premium over guaranteed liquid mortgage backed securities. As previously stated, government backed mortgage securities are currently yielding from 6.5% to 7.0%. When a 4.3% default/liquidity risk premium is added to the range above, an appropriate rate for the subject property would be between 10.8% and 11.3%."

The purpose of the above testimony was to provide the court with a preponderance of evidence which would lead to the same conclusion. Once a base rate and risk premium are determined, provide concurring evidence to illustrate the reasonableness of the forced rate.

Conclusion

Vastly reduced mortgage lending activity has led to the virtual absence of third-party loan transactions to serve as a benchmark in determining appropriate mortgage cram-down rates. Yet in each plan of reorganization, the court must find a rate which provides the secured lender with the same present value as the original loan. Alternative debt instruments, such as bonds and mortgage derivatives, give the court a basis for rational risk premium and rate comparisons. In doing so, sheer speculation on vague hypothetical rates is avoided and a more accurate, empirically based determination is more likely for equal treatment of debtors and creditors alike.

NOTES

1. Brueggeman, William B. "A Progress Report on Conditions in the Commercial Mortgage Market" (Goldman Sacks), Jan. 1993.
2. Due to the similarity of the statutory language, courts have accorded precedential weight to discount (interest) rate cases decided under chapters of the Bankruptcy Code *other* than the chapter then before the court (i.e., Chapter 13 in Chapter 11, Chapter 13 in Chapter 12). *See, e.g., in re Edwardson*, 74 Bankr. 831, 836 (Bankr. D.N.D. 1987); *In re Doud*, 74 Bankr. 865, 867 (Bankr. S.D. Iowa 1987).
3. *See, e.g.* 11 U.S.C. §§ 1129(b)(2)(A), 1225(a)(5)(B) & 1325(a)(5).
4. *Collier On Bankruptcy* defines present value as follows: "Present value" is a term of art for an almost self-evident proposition: a dollar in hand today is worth more than a dollar to be received a day, a month or a year hence. Part of the "present value" concept may be expressed by a corollary proposition: a dollar in hand today is worth exactly the same as (1) a dollar to be received a day, a month, or a year hence, plus (2) the rate of interest which the dollar would earn if invested at an appropriate interest rate.
5. In a nonbankruptcy context, the lender can hedge the rate risk by making a variable rate loan. Such a loan transfers all rate risks to the borrower, making it extremely difficult to meet the reorganization plan confirmation requirement that the plan of reorganization be shown to be feasible. *See*, e.g. Bankruptcy Code Section 1129(a)11 and *United States v. Neal Pharmacal Co.*, 789 F.2d 1283 (8th Cir. 1986).
6. 11 U.S.C. § 506(a).
7. *In re Jones*, 32 Bankr. 951, 958, n.12 (Bankr. D. Utah 1983).
8. *See United States v. Southern States Motor Inns, Inc.* 709 F.2d 647, 651-53 (11th Cir. 1983) [use market rate without reduction for "rehabilitative aspects"]; *Memphis Bank and Trust Co. v. Whitman*, 692 F.2d 427, 431 (6th Cir. 1982) [current market rate for similar loans in the same geographic region—Chapter 13 case]; *In re Camino Real Landscape Maint. Contractors (United States v. Camino Real Maint. Contracts, Inc.)*, 818 F.2d 1503-1506 (9th Cir. 1987) [". . . the rate of interest on deferred taxes should be the rate of interest that the debtor would pay to borrow a similar amount on similar terms in the commercial loan market."]; and *In re Patterson*, 86 Bankr. 226 (Bankr. 9th Cir. 1988).
9. *See, In re Einspahr*, 30 Bankr. 356 (Bankr. E.D. Pa. 1983) [". . . the parties agreed [that the contract rate] was a fair return to the secured creditor over an extended period of time."]; *In re Frey*, 34 Bankr. 607, 611 (Bankr. M.D. Pa. 1983); *In re Smith*, 4 Bankr. 12-13 (Bankr. E.D.N.Y. 1980) [presumption that contract rate and discount (interest) rate are the same–Chapter 13 case]; *Prudential Ins. Co. v. Monnier (In re Monnier)*, 755 F.2d 1336, 1339 (8th Cir. 1985) [contract rate reflective of the market rate and therefore an appropriate discount (interest) rate].
10. *See, In re Johnston*, 44 Bankr. 667, 670 (Bankr. W.D. Mo. 1984) [Chapter 13 case]; *In re Marx*, 11 Bankr. 819, 822 (Bankr. S.D. Ohio 1981) [8% legal rate provided for under Ohio state law—Chapter 13 cases]; and *In re C & P Gray Farms, Inc.*, 70 Bankr. 704, 707 (Bankr. W.D. Mo. 1987) [market rate presumed to be legal rate].

11. *In re Jewell*, 25 Bankr. 44, 46 (Bankr. D. Kan. 1982) [the treasury bill rate "best reflects the value of money invested and [the court] holds that this rate on 52-week treasury bills is the interest rate on which the discount factor in Chapter 13 cases should be based."] *See*, also, *In re Smith Field Estates, Inc.*, 52 Bankr. 220, 225 n.5 (Bankr. D. R.I.1985) [adjusted t-bill]; *In re Corliss*, 43 Bankr. 176, 179 (Bankr. D. Or. 1984) [Treasury bill rate without adjustment]; and *In re Wilkinson*, 33 Bankr. 933, 936-37 (Bankr. S.D.N.Y. 1983) [treasury bill rate without adjustment].
12. Fortgang and Mayer, *Valuation in Bankruptcy*, 32 U.C.L.A. L. Rev. 1061, 1118 (1985)(cites omitted).
13. *In re Camino Real Landscape Maint. Contractors*, 818 F.2d 1503, 1506 (9th Cir. 1987); *United States v. Neal Pharmacal Co.*, 789 F.2d 1283, 1285 (8th Cir. 1986); *In re Southern States Motor Inns, Inc.*, 709 F.2d 647, 651 (11th Cir. 1983), *cert. denied*, 465 U.S. 1022 (1984); and *Memphis Bank and Trust Co. v. Whitman*, 692 F.2d 427, 431 (6th Cir. 1982).
14. *See, United States v. Neal Pharmacal Co.*, 789 F.2d at 1285; *United States v. Southern States Motor Inns, Inc.*, 709 F.2d at 651.
15. *See, e.g., In re Fisher*, 29 Bankr. 542, 543-44 (Bankr. D. Kan. 1983); *United States v. Welco Indus., Inc. (In re Welco Industries)*, 60 Bankr. 880, 883 (Bankr. 9th Cir. 1986).
16. 7 Bankr. 653 (Bankr. N.J. 1980).
17. *id. at 658*
18. *id.*
19. *id.* at 657.
20. *id.* at 658.
21. *id.*
22. *id.*
23. *id.* at 658.
24. (75% x 14%) + (25% x 19%) or (.75 x .14) + (.25 x .19) = .1525 = 15.25%.
25. *id.*
26. 91 Bankr. 907 (Bankr. C.D. Cal. 1988).
27. *id.* at 908-09.
28. *id.* at 911.
29. *id.* at 912.
30. In *McCombs*, the bankruptcy judge observed that "[a] basic assumption in performing this present value analysis is that there is a hypothetical lender who will make a loan at a rate that reflects current market conditions and the associated risks." *McCombs Properties*, 91 Bankr. at 912. As noted above, the authors believe, especially in the case of 100% loan to value ratios, that this basic assumption is a false one. Rather than using the blended rate analysis of the court in *Landmark*, the bankruptcy court in *McCombs* implicitly recognized the lack of a market for loans that exceeded prudent loan to value ratios by ratcheting up the discount (interest) rates from 10.5% to 12.25% in the case of one lender with a loan-to-value ratio of 100%.

REAL ESTATE COUNSELING IN LITIGATION— EMINENT DOMAIN

by Paul R. Ferber
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Growing Role Of The Real Estate Counselor In Litigation And Eminent Domain
The increasing complexities of both law and real estate, including its valuation, have created a growing need for real estate counselors in the litigation arena and particularly in eminent domain or condemnation. This article presents the combined perspectives and observations of two professionals who have worked together in eminent domain. To illustrate their perspectives, a specific case of litigation support involving condemnation is presented.

As professionals, real estate counselors have responded to the increased complexity in real estate. The Counselors of Real Estate (American Society of Real Estate Counselors) was founded in 1953 by real estate leaders seeking to enhance the quality of respected professional advice available on real property matters. The CRE designation, awarded to the members by The Counselors, recognizes the counselor's demonstrated judgment, integrity and experience in real estate. Acceptance of the designation commits the recipient to a strict Code of Ethics and Standards of Professional Practice.[1]

There are many aspects of real estate subject to litigation which require the insight of experts. However, eminent domain has been a dominant field for the real estate counselor in support of litigation, usually as an expert witness.

To illustrate, in 1991 the St. Louis District Counsel for the Missouri Highway and Transportation Commission (MHTC) sought a real estate consultant to serve as an expert witness for a backlog of high dollar claim cases, many of which involved highest and best use issues or development aspects. The MHTC's District Counsel engaged a Counselor of Real Estate to focus on what eventually grew to be 18 cases. The results of the first 13 cases settled or determined in court with a CRE, appraisers and in some cases engineers supporting MHTC litigation attorneys, clearly demonstrated the benefits. Landowners who initially sought over $25 million reduced their demands to over $20 million by trial and were awarded or accepted in settlement less than $4 million.

Historically, in eminent domain the legal system has relied upon the appraiser as the primary expert testifying to value or changes in value. A

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traditional example is 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 can call for more innovative thinking in order to address the overall challenge, going beyond appraisal and into the field of real estate counseling.[2]

The real estate counselor has surfaced with an enlightened and encompassing approach to current real estate complexities. While appraisers have rendered opinions of value and focused on the traditional three methods of valuation, their conclusions are sometimes based on a somewhat summary determination of highest and best use as a foundation for their 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 can include market and marketability, economic viability, developability, accessibility, traffic conditions and community wants and needs, to name a few.

The public and the legal profession have been exposed to appraisal concerns and questions of credibility as a result of the S & L debacle. Markets changed more rapidly than in the past. Widely divergent appraisals of the same property on opposite sides of a court case have not helped plausibility with the jury. These credibility factors are compounded by the changing litigation environment.

Attorneys, juries and judges, not satisfied with an oversimplified approach, share a need for lucid and simple explanations to facilitate their understanding of the facts and the issues. And the issues have broadened in perspective. For example, the courts in Missouri have held that it is proper to permit the juries to hear any testimony that a buyer or seller would consider or anything that affects value. 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.

Why A Counselor Of Real Estate?

There are a number of reasons why an attorney should consider using a Counselor of Real Estate for litigation support and as an expert witness particularly in eminent domain cases involving complex real estate issues. Such an expert can bring to the attorney:

- Recognized and tested judgment;
- Ability to communicate and coordinate with other experts, e.g., appraisers, engineers, governmental agencies, attorneys;
- Credentials including designation as a Counselor of Real Estate, CRE;
- Integrity and dedication to a strict Code of Ethics and Standards of Professional Practice;
- Diversity and breadth of both talents and experience in the real estate industry, in some cases including development, managing, financing, and/or marketing;
- Credibility and presence within the real estate industry;
- Professionalism and expertise;
- Ability to focus as a real estate counselor;
- Access to a network of well respected professionals and other resources, all of which are invaluable treasures during discovery and preparation;
- Proficiency to perform complex economic analyses;
- Comprehension of the complex and interrelated aspects affecting real estate;
- Strategic insight as well as tactical ability;
- Experience presenting real estate concepts, ideas, and analyses to clients, lenders, governmental agencies, political bodies, assemblies, and juries; and,
- Ability to persuasively communicate his expertise to those outside of the field.

There are other ways to express these proficiencies and competencies, but the important concept is the totality of what can be available through a real estate counselor experienced in litigation support and as an expert witness.

While this article relies upon eminent domain for its focus and illustrations, the same characteristics of a real estate counselor which contribute so well to condemnation can offer similar advantages for other real estate litigation. The seasoned CRE's reputation, credibility and professional presence strengthen his role on the stand.

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

- *Determine the need for a real estate counselor*—the particular skills and knowledge needed, especially those which are not provided by traditional appraisers whose valuations are still a necessary part of the process;
- *Select and qualify the counselor*—not only in terms of past litigation support or reference checking with other attorneys, but also his real estate experience particularly in the issues likely to be encountered in the case;
- *Define the assignment*—customizing to the case and to the qualifications of the counselor, but also broadening to allow the counselor the flexibility to truly pursue avenues of knowledge and insight as they unfold, including full use of the counselor's network of resources;

- *Question and challenge the counselor*—not only to present the counselor and his insight and opinions, but also to learn and understand real estate from the perspective of developing and presenting the case in trial;
- *Seek strategic input from the counselor*—relating to 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 a key part of the case*—the real estate counselor can be the witness who can directly 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 who serves as an expert witness. Expertise in the desired field for 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 being expert witnesses and not all are willing. Many experts do not want the exposure, potential conflicts, adversarial challenges of cross examination and schedules subject to the timing uncertainties 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 which sometimes results from the legal process. Litigation support is demanding work—detailed, thorough, tedious and frequently done alone during most preparation.

Credentials And Credibility

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. Such credentials must not be exaggerated or overstated.

Most important is an expert's true credibility when on the stand and the perception of that credibility by the judge and jury. The expert should be perceived as fair and unbiased. The opposing counsel will try to negate or damage that perception. However, it will be the ultimate measure of the counselor's expertise as far as the trial is concerned.

Preparation And Knowledge

Expert witnesses are committed to and comfortable with their role. They form firm opinions which are demonstrably supportable and defendable. Expert witnesses should prepare thoroughly. An opinion based solely upon an egotistical view of their own competence will not stand up before 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 based soundly upon years of experience as well as the data discovered. Real estate counselors are inquisitive, dig for more insight, and know where and what to look for in the investigation and preparation. They stay current through education, professional participation, review of the current literature, maintenance of a professional network in real estate and related fields, and a diverse practice which increases and broadens experience.

Experienced trial attorneys know the rules of litigation and the legal aspects of the cases they present. Real estate counselors who serve as expert witnesses also know their subject. The judge, jurors and attorneys are not likely to know as much about the technical and practical aspects of real estate. As real estate experts in the courtroom, counselors grasp and present the big picture as well as the needed detail. The expert witness recognizes that the attorney is the captain, the manager and the quarterback. Good expert witnesses are competent, knowledgeable and well prepared. These same attributes, in turn, help the attorney feel confident and well prepared. Rather than bluff, capable experts do not stretch a weak point; instead, they admit when they do not know an answer. Effective experts communicate with the judge and jury, demonstrating firmness in a courteous and nonabusive 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 during cross examination and the heat, abuse and hostility when they occur. 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 challenge his 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 will discourage further aggression from the opposing attorney. Other questions target the credibility and reputation of the witness, often inferring bias. Rates and compensation are often a prime target to imply prejudice. These are normal frontal challenges to expect and anticipate. The capable expert witness prepares for such attacks.

Ideally, the real estate counselor's expert witness fees are appropriate to his expertise and experience. Hourly rates for real estate counselors can range up to $500, with higher rates commanded by senior counselors in major cities. Rates for court time and special services can run higher.[3]

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 which is easily understood. Counselors help the attorney tie together the overall picture, then portray a broader, more easily understood view. Counselors can serve as real estate mentors by teaching attorneys about unique real estate issues

such as 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 own education, experience and professional network to the needed thought processes. Many CREs are diverse in their backgrounds and abilities, enabling an attorney to customize available advice and testimony.

Evaluation And Valuation

Some CREs are also certified appraisers. Counseling can be conducted in conjunction with valuation testimony. In a complex case, however, some of the complementary benefits could be lost. It may be preferable to keep the real estate counselor as an expert witness who is not limited by the previously established rules of appraisal, some of which have been subject to challenge within the real estate industry.

Thus, in eminent domain cases a counselor's assignments may exclude valuation but include providing input for the foundation and support of an appraisal. 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, and the likelihood of success if developed. The assignment can also include review of appraisals. "The counselor can help the attorney understand the premise on which an appraisal is based along with its strengths and weaknesses; the counselor also apprises the attorney of mathematical errors, unrealistic assumptions, etc."[4]

Counselors can contribute and suggest challenges to the other side, e.g., 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 perspective, the counselor can use his insight and knowledge to 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, concerns, strengths, weaknesses and even their mistakes. However, settlement also may require the counselor to provide a very candid evaluation that could differ from the client's present perceptions, e.g., suggesting values which may be higher or lower.

Approaches And Methods

A broad list of approaches and methods used to gather insight and draw conclusions reflects the comprehensiveness of investigation. A generalized list of resources and approaches used by a counselor in an eminent domain engagement might include the following:

- Property visits
- Photographs
- Studies/analysis
- Ordinances & regulations
- Consultants
- Attorneys
- Area tours
- Documents
- Research
- Engineers
- Networks
- History
- Property files
- Database search & review
- Governmental agencies & officials
- Architects
- Experience

To illustrate, repeated visits to the property and tours of the surrounding area will broaden discoveries and deepen knowledge. Some counselors prefer to shoot their own photographs as field notes and future exhibits to capture what is needed, significantly ease future introduction, support testimony and 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. The attorney and counselor may look for evidence of the community's propensity 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 lead to further discoveries. Attorneys should encourage their experts to further investigate and pursue relevant evidence for preparation and trial. 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 match the magnitude of the case, 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 is customized, the following are 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

A clear understanding is required on the objectives of engaging the expert; the working relationship between the attorney, the expert and other experts in the case; and the expert's compensation.

Assignment

Ideally, the assignment should be reasonably well defined but subject to further modification as investigation and discovery proceed.

Stage II—Basic Foundation: Gathering the Initial Insight

Assemblage of the basic facts
This should include a preliminary understanding of the subject property. This should incorporate the expert's basic real estate background, a property visit and inspection, an initial review of property descriptions and data available from the attorney, and a review of readily available documents. These documents could include such basics as USGS topographic maps, street maps, municipal or county ownership and zoning maps, agricultural soil maps and reports, 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.

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 comparables used by the adversaries, can shed 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. Attorneys find access to such networks of expertise to be an invaluable asset.

Solo brainstorming
Some may view this as mental gymnastics. The process needs to fit the individual expert and his mental style but great rewards can come from this technique. Personal computers with word processing, spreadsheet, and even graphic software 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 information to coincide with mental paths and look for connections or mental leaps. Highlighting what is most significant or returning to an outline helps discard that which may mislead or sideline direction. In this manner, a path to opinions and conclusions can be forged.

Group discussions
Sharing insight among the attorneys and other experts involved can help each participant understand, learn, confirm and challenge. However, the potential brainstorming should be done with the concurrence and guidance of the attorney.

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

Repeating the discovery chain
Repeat all or parts of the above-mentioned chain, as needed, in an iterative process but without prejudgment. Once armed with the broader and more complete picture, new details and insights become apparent.

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 attorney of the witness can be important. In response, the expert should limit the information disclosed in deposition to responses to the specific questions, while not volunteering added insights but at the same time 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 mischaracterizations of his testimony which may be offered by the opposing attorney in the form of questions which misleadingly restate the testimony. The witness can respond by carefully restating the testimony in his own words.

Review and correction
Recognizing that the transcript can be used to benefit the opposing attorney in trial, and 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. (The witness should advise his attorney if his position subsequently changes so the attorney can conform to court rules.)

Stage V—Trial Preparation: Preparing for the Witness Stand

Repeating the discovery chain
If needed, this step can be beneficial.

Exhibit preparation
Visual aids can be great tools with which to inform or persuade the judge and jury and excellent reminders for the attorney and the expert. They may include photographs, lists, calculations, tables, graphs, etc. The attorney will make the final selection, sometimes altered during the trial, and will plan their introduction and acceptance by the court as identified exhibits for the record.

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 trigger key points but not cause canned answers or provide a discoverable treasure chest 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 must know his subject thoroughly—an outline or report does not replace or relieve the need for the expert's knowledge. The opinions and their foundation need to be firmly blunted in the expert's mind.

Stage VI—The Trial: The Culmination of the Process

Discovery during trial
As a result of aspects brought out during other parts of the trial, the attorney can call upon the expert for counsel or for further pursuit and discovery.

Direct examination
The witness responds to the questions from his attorney. This is the expert's opportunity to use his expertise by presenting facts uncovered and opinions formed during the foregoing steps of this process. A firm and courteous manner creates positive perceptions in the judge's and jury's minds and reinforces credibility and believability.

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 mischaracterizations 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.

An Illustrative Case

Several of the foregoing points and suggestions are illustrated with a recent Missouri Highway and Transportation Commission case, *MHTC v. Behle, exceptions of Roth*. The MHTC attorneys engaged a Counselor of Real Estate to support their litigation as an expert witness. Other experts testifying for the state included two senior real estate appraisers and a senior officer of a St. Louis engineering firm experienced in civil engineering and hydrology as applied to real estate development.

Missouri Highway 115 was being relocated and established as a limited access highway with a new bridge over the Missouri River from St. Louis County to St. Charles County. The right of way for this relocated Missouri Highway 115 required 20.6 acres of the 176-acre Roth parcel. The state had offered $70,000. The owner presented a claim of $6 million. The parties failed to reach agreement. The appointed condemnation commissioners awarded Roth more than $1.47 million to which both parties filed exceptions and asked for trial, thus bringing the case before a jury in St. Louis County Circuit Court in March 1992. In the trial the owner presented a reduced claim of almost $4.3 million. After a week-and-a-half trial, the jury found that the landowner was entitled to $68,900. An appeal was filed by the attorney for the landowner, but it was later dropped as a result of a higher settlement agreement.

Property Location

The subject property was located in the alluvial floodplain of the Missouri River, a large part of it within the regulatory 100-year floodplain established by the Federal Emergency Management Agency (FEMA). (For reference, this trial took place before the famed flood of 1993.) The property had been farmed for decades. The bulk of the property was in unincorporated St. Louis County and had been zoned Non-Urban and Non-Urban Flood Plain, NU and NUFP. However, St. Louis County had rezoned this land just prior to the taking—about two-thirds to M-3, Planned Industrial, for the portion claimed to be out of the 100-year FEMA floodplain, and the rest to FPM-3, subject to the overlying floodplain regulations, for the part within the 100-year floodplain. The much smaller part of the property that occupied frontage on Missouri Bottom Road was in the city of Bridgeton. It had been zoned for decades as M-1, Limited Industrial, even before the land was acquired by Roth in 1971.

The landowner's attorney presented as his key witnesses the landowner who was a local real estate developer, an appraiser and a landscape architect/engineer with a local engineering firm which developed and recorded a plan for a subdivided industrial park and flood protection system on the subject property.

The appraiser for the landowner presented industrial land values well in excess of $1 per square foot, using some comparables within a reclaimed, flood-protected floodplain in the same general area. The state's retained appraisers reflected farmland values on the order of $2,500 per acre (less than $0.06 per square foot) based upon agricultural comparables in the floodplain.

Even though the property had been zoned industrial and platted, the issues focused primarily on the highest and best use and the land's value in the before condition. The owner also claimed damages to all of his remaining land while the state conceded loss of use for about eight acres which were severed from the balance. The state maintained agricultural

as the highest and best use both before and after the taking and the landowner claimed industrial in both instances. Major value differences resulted primarily from this disagreement. Much of the argument focused on the suitability of the land for industrial use and the demand for such use at that location.

Highest And Best Use Of The Property

The real estate counselor's assignment in this case was not only to determine the highest and best use but also to investigate and review the viability of this subject property as an industrial site or for industrial development both prior to and after the taking. The following describes some of the more pertinent discoveries, opinions and conclusions reached by the CRE as a litigation consultant. The MHTC attorney determined whether, when and by whom to introduce this material in the trial.

Based upon his review, the real estate counselor believed this subject property was not viable as an industrial property nor for industrial development before the taking, nor would he recommend such use after the taking, zoning notwithstanding. Before the highway taking, the highest and best use of this property was clearly agricultural, which is what the majority of the property had been. After the highway taking, the basic agricultural nature of the land would not have changed, despite the zoning.

Road Access

A significant objection to the industrial use of this property was inadequate truck access in the before condition. This was easily portrayed photographically. Routes to the property were all narrow rural roads, most of them clearly subject to flooding except for Missouri Bottom Road which dropped into the floodplain from the higher ground and passed through an indisputably residential area with limited visibility. One route through the floodplain, which the landowner highlighted as his anticipated major truck access to his "industrial" park in the before condition, included a very narrow bridge over descriptively named Cowmire Creek which was next to a difficult 130 degree turn—an impassable turn for full-sized highway rigs. This challenge was illustrated by the CRE's still photographs, by drawings of truck-turning radii and most vividly by a video developed by MHTC attorneys of a truck driver-instructor unsuccessfully trying to maneuver a tractor trailer around this turn.

St. Louis County files disclosed their Planning Department's written comments regarding this property, explaining the reasoning for some of the conditions proposed for and included in the 1989 rezoning. They flagged the unsuitability of then present Missouri Bottom Road as it existed prior to the taking. The professionals in the Planning Department believed that the relocation of Highway 115 and contruction of the accompanying outer road system would be essential to industrial development of any site in the area including the subject property. After the taking and completion of the highway improvements, this subject property would enjoy highway visibility and frontage previously lacking and would have simplified and improved access as a result of the new local service road constructed above the regulatory floodplain.

Floodplains And Levees

The flat topography of the subject property unquestionably was within the floodplain of the Missouri River, as confirmed by visual inspection, aerial photographs, topographic maps of the U.S. Geological Service, St. Louis County Mapping, and Flood Insurance Rate Maps of FEMA. Most sources showed a majority of the site subject to the 100-year flood. Various agricultural levees had been built along stretches of Cowmire Creek but, based upon the CRE's inspection, such levees in the area affecting this subject property were not designed for industrial use.

The proposed development of this property contemplated a future levee to protect against the projected elevation of a 100-year frequency flood. In the CRE's opinion, this would continue to be inadequate for a business and industrial park in this area. Industry would be concerned not only with flood damage to real property, equipment and inventory, but also with production interruption and loss of income resulting from flooding of access roads. Existing nearby levee-protected areas, which had hundreds of acres of land already zoned for industrial use, are protected against a more severe 500-year flood. Rather than accept the lesser calibre 100-year frequency flood protection, industrialists should and would seek these better protected, available locations.

The proposed design for this flood protection system for the subject property had not been approved by the Corps of Engineers, as required by the St. Louis County specific zoning ordinance or by Bridgeton. The CRE's review raised concerns over and above the issue of adequacy of 100-year protection compared to 500-year protection, including the adequacy of designed freeboard, pump size, needed easement across adjoining property for the stormwater outflow to reach Cowmire Creek, and alternate sources of pumping power.

Soil Conditions

Recognizing concern over alluvial soil conditions in a floodplain, the Missouri Highway and Transportation Department previously made a subsurface investigation on the Roth tract to verify earlier estimated settlements and foundation stability before placing the fill to elevate the highway above the 100-year flood. Examination of these tests indicated settlement on the order of 0.5 feet under 14 feet of fill. The soil problem was aptly represented to the jury by sharing the results of four power auger test borings taken along the Highway 115 alignment to bedrock 24 to 25 feet below the surface. For three of the borings the drillers noted "PAWT" (pushed augers without turning); in other words, they did not need to turn the drill to penetrate below the first 6 to 10 feet until they hit bedrock. These soils could effect compaction, foundations, pads and paving.

Photo Evidence

The surrounding area, even that zoned industrially for decades by Bridgeton, was primarily occupied by farms with a few exceptions—an idled sewage lagoon, an unsightly auto storage yard, a small isolated industrial building elevated on fill in the floodplain and accessed by boat during major floods and the nearby Bridgeton Municipal Athletic Complex, partly protected by a levee. Some scattered industrial uses could be found above the floodplain, for example, the Bridgeton Industrial Park which had taken more than 20 years to market and then develop 10 small buildings on 20 acres. The non-industrial surrounding uses were portrayed photographically, including flooded roads, soybean fields and pumpkin patches—highlighted by high water markers and signs hawking farm products and riding stables.

The CRE shared some observations resulting from review of the landowners' proposed development, market insights and his own experiences. The costs to develop and flood-protect this property would approach the retail price of already subdivided and better-located sites, leaving no room for marketing costs or interest expense, much less suggesting any residual value attributable to the raw land.

The CRE's first-hand knowledge of transactions which had occurred and their timing led to discovery that several comparables used by the opposing side's appraiser either were simply erroneous or not truly comparable to the subject property and not arms-length transactions. In one, the appraiser had reported a land-sale price which, in reality, was the price for which an investor bought land and a new building with a netted lease in place, but with an erroneous placement of the decimal point. An aerial photo at the time of the purported sale clearly showed the presence of the building. In another of his comparables, a lawsuit had been settled between the seller and the buyer relative to the particular parcel.

At several points during presentation of the trial, the real estate counselor's field photographs provided easily understood evidence demonstrating the inadequacy of industrial access, the flooding of access roads and the agricultural nature of the subject property and the surrounding area. The lead MHTC attorney reviewed these photos in his closing arguments. The opposing attorney attributed much of the state's victory to the convincing evidence provided by these photos and the aforementioned video showing blocked truck access.

Why A Counselor Of Real Estate?

The Roth Case clearly illustrates the benefits of a complementary combination of experts and particularly the contribution of a real estate counselor.

The growing need for real estate counselors in litigation, especially 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. However, the counselor must be disciplined to the challenges and rigors of such litigation and comfortable with that role. Ultimately, credibility becomes the real key in the courtroom.

NOTES

1. The Counselors of Real Estate (American Society of Real Estate Counselors) *1993 Member Directory*, pp. 5-6.
2. Schwethelm, A.C.: "Counseling and Eminent Domain," *Real Estate Issues*, (American Society of Real Estate Counselors) Vol. 14, No. 1, (Spring/Summer 1989): pp 25-27.
3. Shlaes, Jared: *Real Estate Counseling in a Plain Brown Wrapper*. (Chicago: American Society of Real Estate Counselors, 1992.)
4. Schwethelm, A.C., ibid, pp 25-27.

COUNSELING IN EMINENT DOMAIN LITIGATION

by A. C. Schwethelm, CRE

Whether it is medicine, automobile design, construction or real estate appraisal, a legal practitioner who specializes in a particular area must have a working knowledge of it, e.g., a familiarity with the terminology. However, it is usually rare to find a lawyer who is also an expert in the specialized field. How, then, does the trial attorney assemble the expert witnesses, exhibits, depositions, etc. in an expeditious manner? More and more frequently this is being accomplished with the assistance of specialized consultants. Just a few months ago the State of Texas Attorney General's office asked for a memo which outlined the services that could be provided by a real estate counselor for a trial attorney in the preparation of an eminent domain case. The following is an expansion of that memo.

A Counselor's Skills In Advocacy

The counselor must be experienced in eminent domain appraisal and expert testimony. He must be familiar with eminent domain law and the requirements in the local jurisdiction, especially regarding admissibility, discovery, trial procedure deposition procedure, and other matters which vary from case to case. The ability to think and react quickly and confidently under pressure is important. Above average analytical and math skills, the ability to articulate complex matters in understandable terms and a pleasing personality are key attributes. He must have credibility with the attorney and the client, whether property owner or condemnor, as well as a standing within the profession. Understand that the consultant is not a potential expert witness, but acts in an advocacy position for the client.

The counselor's scope of involvement will vary from case to case, depending upon a number of factors including its complexity and size, the attorneys, appraisers and other witnesses involved, the caseload of the attorney, etc. Perhaps the easiest method for exploring the matter is to start with the assumption that it is a large, complex case warranting the counselor's involvement in a comprehensive manner from the onset.

The Process

The hypothetical jurisdiction is one where the matter is first heard by a special commission of three disinterested citizens appointed by a judge who hear the evidence and render an award to be deposited with the court. Upon such deposit, the condemning authority can take possession of the property and either side can appeal. The discovery process begins only after the hearing. Discovery is the procedure by

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which each side is allowed to obtain evidence the other side is prepared to present. It includes taking depositions (sworn testimony) from the prospective witnesses and obtaining copies of documents.

The condemnor attorney (C.A.) is advised by his client, the condemnor, that an offer has been made and rejected. C.A. recommends employment of a real estate counselor, who after accepting the case meets with the C.A. Together they review the basics of the case—the rights to be taken, the ownership of the property, the proposed pleadings, route map, property plat, memos of meetings between the condemnor's representatives and the owner and/or owner representatives. Many questions will be posed: Has the owner employed legal counsel, an appraiser, other potential witnesses, etc.? What is the area reaction to the project? Who supports and who opposes? What is the settlement record so far?

Commissioners Appointed

Often the judge asks the attorneys for suggested commissioners to be appointed. The counselor may have experience with individuals who have served previously. Which of the commissioners would best serve our interest? Are there any potential commissioners who may have a bias against the condemnor? The counselor may investigate and provide information which enables the C.A. to successfully object to a commissioner's appointment.

Real Estate Appraisal Reviewed

The counselor then carefully examines the real estate appraisal prepared for the condemnor. Is it consistent with other information—rights taken, route and area taken, assumptions as to purpose of the taking and possible remedial actions to be taken by the condemnor? Is the highest and best use reasonable and well supported, the sale appropriate, properly adjusted and fully described? Is the part taken properly and completely described and the value supported? Is the effect on the remaining property considered, described and addressed economically? In short, is the appraisal reasonable and convincing? The real estate counselor conveys his findings to the C.A. and suggests corrective action if necessary.

The counselor and the C.A. then meet with the appraiser for hearing preparation. The C.A. develops his line of direct examination and, with the counselor's assistance, prepares the appraiser for expected cross examination. The counselor's role will be to play devil's advocate, and he will develop likely questions for the appraiser to answer.

Discovery

Joint decisions involving the C.A., real estate counselor, appraiser, and condemnor's staff are made concerning what exhibits are to be used (maps, photos, plats, etc.) and who will prepare them. The counselor also meets with the C.A. to assist in developing cross examination questions of the condemnee's appraiser, probably by exploring various possible scenarios. This is an important step because it is the first opportunity for discovery. Also, if one of the explored scenarios is on target the cross examination may catch the witness unprepared for probing questions. The counselor may attend the hearing, providing observations to the C.A., and possible additional lines of questioning and preparation for the next step, if necessary. After the hearing, a postmortem is often helpful to assess the strengths and weaknesses of both sides of the case while the information is fresh on everyone's mind.

Hearing Review And Case Preparation

Assume that the hearing is over, the award deposited and an appeal filed. C.A. and the real estate counselor meet again to assess their present position, probably with the condemnor's representatives. Should consideration be given to employ additional and/or substitute witnesses? Are there changes to be made in the pleadings? What went right and what went wrong in the hearing? Is the landowner likely to change or add witnesses? How can cross examination be improved? The counselor would follow much the same preparation procedure as before, except now it would be directed toward a trial before a judge or jury. In addition, the counselor would assist in preparing discovery requests. This can be as crucial an area as discovery, even more detailed and exacting. Conversely, the discovery request must be broad enough to secure the information, yet not so broad as to allow the court to deny the request. The counselor may obtain information on other work the appraiser has done in the geographic area and also look for inconsistencies. Possibly copies of those real estate appraisals and the supporting sales should be requested. If the appraiser used the income approach, income and expense records on the subject property may be requested. The counselor will have a good insight by this time as to the theory the other side is using. The meeting with the witness (or witnesses) is repeated. Even more emphasis is placed on the proposed testimony, both direct and expected cross. The counselor will assist the witness to frame his answers to mean what is intended. In no respect does a counselor change the testimony of the witness; however, witnesses frequently express themselves in a manner which conveys other than what is meant. The jargon of the industry must be set aside and rephrased with words that are meaningful to the judge or jury.

After the discovery documents are received, the counselor examines them before meeting again with the C.A. and conveying the findings. Perhaps they reveal a new tactic. Every calculation is verified, every adjustment to a sale is carefully examined. Frequently math errors are found, as well as adjustments made upward when they should have been downward, or vice versa. This procedure should be performed on the work product of witnesses for both sides. Surprises are fun only when the other side makes the mistake. The counselor carefully compares the proposed testimony, obtained through depositions and requests for production, of the witnesses for the other side. Are the opinions consistent? Does one of their appraisers find a highest and best use? Are the property descriptions consistent,

both legal and physical? If other witnesses (engineers, negotiators, surveyors, or other experts) are to be used, does their testimony support the findings of the appraisers? Exactly the same procedure is followed on witnesses for "our side."

A final pretrial meeting is usually held to be sure everything is ready, including exhibits and witnesses.

The Trial

During the trial, the real estate counselor attends and carefully monitors the proceedings. Notes are made of any misstatements, errors, inconsistencies, etc., by any witness. The C.A. is made aware of these observations at the appropriate time, at break or immediately if necessary. Sometimes matters arise during the trial which must be investigated immediately. Witnesses occasionally testify to sales without having complete information, or they make other blunders. A quick inquiry by or directed by the real estate counselor may reveal conflicting data or someone to testify thereto. A rebuttal witness can be devastating. Although the jury argument is entirely the responsibility of the C.A., occasionally a review by the counselor of the testimony can be helpful in deciding on the emphasis desired.

After the trial, a post-trial conference is usually held especially if an appeal by either side is likely. Although the legal questions are entirely the domain of the C.A., certain fact questions can be addressed by the counselor which can be of great assistance in preparing a brief.

The Offer

If the same case is addressed from the condemnee's point of view, almost the identical comments would apply. Perhaps the most significant difference is that the condemnor's offer is clearly submitted before much work needs to begin. The counselor may be involved in assessing the pros and cons of accepting the offer or in seeking to negotiate upward before employing an appraiser. Sometimes the condemnor will make the real estate appraisal available during the negotiations. A careful analysis may reveal serious errors or a lack of understanding the problem. With this information, the attorney may be able to negotiate a much higher offer without the expense of litigation.

Although illustrative of the possibilities, this narrative merely touches the surface. The use of a real estate counselor can be a wise choice when litigation involves eminent domain. The very nature of the topic requires careful planning and the utilization of all available expertise to achieve a successful outcome. In cases which justify the expense, the use of an experienced, knowledgeable real estate counselor can pay big dividends and enable the attorney to be much more effective.

ASBESTOS: HOW YOU FRAME THE ISSUE DOES MAKE A DIFFERENCE

by Mark L. Troen, CRE

Introduction: A Fictional Story*

One day in a real estate developer's corporate offices, the financial officers noticed that company-wide operations had been wanting, given the weak real estate marketplace of the late 1980s and early 1990s. The chief finance officer gave his underlings a difficult charge: improve returns and financial performance or expect wholesale portfolio—and people—adjustments. The financial team realized that its options were limited. Undeveloped properties and parcels under development offered little hope for change. Even existing income properties seemed to provide little opportunity for improvement. Although cash flows were steady and substantial, the increasing age of the buildings and strong competition for tenants required continued capital improvements. Consequently, free cash flows were smaller than ever to support increasing debt burdens.

However, one office building in particular attracted the staff's attention. It had been held in the company portfolio for over a decade and generated substantial free cash flow. It had been marked as a facility with asbestos containing materials, even though no problems or other concerns had arisen due to their presence. But that day a light bulb went off in the company offices. Since litigating asbestos issues was the current rage, why not improve the cash flow even further by suing for damages from the asbestos? What better way to improve real estate returns without changing the way business is done? And based upon that fateful day, a case was filed in court to recover damages for tens of millions of dollars from a certain manufacturer of asbestos containing material.

Background

Ajax, the plaintiff and a domestic subsidiary of an overseas real estate company, sued Cablecorp, the defendant and a manufacturer of asbestos containing materials, to seek damages for the presence of asbestos containing materials manufactured by the defendant in a high rise office building owned by the plaintiff and located in a major U.S. city. Ajax contended that its property was damaged by the materials and that the property value was diminished by their presence. The building was constructed in the early 1960s by a respected national real estate partnership. The property was acquired by Ajax in the late 1970s. The asbestos containing materials were identified as an issue of concern by Ajax in the mid 1980s, and the suit was brought a few years later.

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**While this article is about an actual case, the names of the parties and some of the particulars have been changed due to the confidential nature of the issues involved. However, the substance of the case remains true to the facts.*

It is interesting to note that the plaintiff did not pursue the building seller, the original owner/developer, the building contractor, the subcontractors or any other party involved in the specification and installation of the asbestos containing material. Instead, it sought to obtain damages and restitution from the alleged manufacturer of the material placed in the building. Such a course of litigation and burden of responsibility is a common strategy in asbestos litigation.

Working With Legal Counsel

At this point, the defendant hired legal counsel and assigned it the task of assembling the expert team to defend its interests in court. As a team member, a Counselor of Real Estate is engaged by attorneys as an expert witness and real estate advisor in a variety of legal issues and concerns. Oftentimes, the real estate counselor is enlisted as a member of the team as the result of a predetermined legal strategy. Occasionally, a Counselor's expertise is sought only as an afterthought or in response to the opposition's strategy. It is within this framework that the Counselor must determine how to best function and provide optimal advice to the legal team.

The case study which follows demonstrates that success is achieved by either working within the established framework or realizing when it is necessary to reinvent the foundation by asking questions, be it winning the case or solving any number of problems in real estate and business at large.

In this particular case, I was engaged by legal counsel with a good general understanding of the need for real estate advice and its importance to the issues. Often, the plaintiff's case adheres to a straightforward and now common formula amongst asbestos litigants: to prove knowledge, cause and resulting damages. Layered on top of these fundamentals are the emotional, physical and valuation related arguments. With a potentially damaging property valuation presented by the plaintiff, legal counsel realized that knowledgeable real estate rebuttal and independent expertise were required. There was much more to a successful case than simply reviewing a valuation and presenting differing, even opposite, conclusions. Had the defense consisted of little more than another valuation, the case might easily have shifted away from intelligent expertise determining the outcome and returned to the simpler, much more difficult ground of proving knowledge, cause and resulting damages.

It is often the Counselor's role to educate, inform and communicate actively to legal counsel the benefits and consequences of successful real estate counsel. Of course, for a Counselor to take an active, even presumptive approach is entirely a judgment call. However, only by defining a clear strategic role can a Counselor demonstrate the value of real estate counsel and make the merits of the case work for the benefit of the defendant. By providing the ongoing support and critical resources needed to benefit the defendant, the legal counsel's strategy and positioning can become focused.

Setting strategic direction in this case required consent from all parties on the team. It was at this time that the Counselor became an advocate for his professional insight and knowledge. Our first team meetings began by reviewing the physical facts. Although I was not an expert in asbestos testimony and its related issues, it was clear that the defendant's legal counsel was largely responding to the plaintiff's allegations and building a defense only in response to these issues. Our diverse team of experts in cost estimating, engineering, asbestos materials and building construction were also responding in kind.

At that point, I decided a different approach was needed. I asked the team to step back from the case and allow me to pursue a line of questions based upon real estate criteria, such as the marketing, management, operational and financial issues that determine a building's position and subsequently its value in the competitive environment.

Executive Summary

I presented a case outline to the team which adhered to the following line of reasoning. We first reviewed the plaintiff's arguments, which were:

- The building value had been diminished only due to the presence of asbestos containing materials.
- The building value would be greater without the presence of asbestos.
- The cost to remove the asbestos would be substantial and have an injurious financial impact.
- The cost to remove the asbestos should be an independent factor in determining value unrelated to other capital and operational expenditures. In addition, the presence of asbestos should be isolated from all other ownership issues.
- Damages were owed based on a rational approach to costs that identified only the expense of removing the asbestos.

However, the plaintiff did not address the idea that removal of asbestos is a capital expenditure to be treated as a routine part and cost of owning and maintaining buildings. Furthermore, building value and how it should be calculated became a critical issue in discussing damages, if any, in this case. Therefore, the removal of asbestos should be evaluated within a comprehensive building valuation that considers it as part of ongoing operations, a normal cost of ownership and scheduled capital expenditures. When considering these factors, it was entirely possible that no costs or damages would be due the plaintiff.

The larger issue yet to be identified was whether the plaintiff was using the presence of asbestos as a smokescreen and a diversion from the real problems of the building. An initial review of the property revealed its diminished competitive position in the marketplace, loss of Class A status, high vacancy rates and increased tenant turnover. A sensible conclusion was that proper management and capital investment would have maintained the building's market position. The current problems

may have resulted from a lack of responsible ownership. Appropriate action, including asbestos removal, could restore the building's position in the marketplace and result in increased value despite the expenditures required.

Therefore, I postulated a restated case that centered on three points:

- This was not a case about asbestos and whether it was an environmental hazard with compensation due the plaintiff. This case was about a building that had a number of marketing and management problems of which one might be the presence of asbestos (and how to deal with it).
- The defendant should demonstrate that no damages were owed the plaintiff because the increase in value from undertaking the capital expenditures (general rehabilitation including removal of asbestos) would offset the cost of the building improvements.
- Furthermore, the plaintiff was attempting to receive double benefits by creating a sale escrow to fund the alleged clean up costs (in its efforts to dispose of the property) and having the defendant pay to fund the escrow. However, good management practices should have generated sufficient cash flows to fund these expenditures without the need to seek restitution from the defendant.

Issues (Our Methodology And Attack)

The real estate was analyzed in a comprehensive manner that went beyond just the physical rehabilitation effort of removing asbestos to determine the property's underlying market position and value. This required an analysis of the plaintiff's appraisal, a review of the market and financial assumptions and the likely need for a new valuation to ascertain the impact of the asbestos.

The foundation of any good appraisal rests on establishing an appropriate framework for the valuation. Market value is a reflection of a property's present condition and its future expectations. Both must be assessed thoroughly in order to determine value. In almost all analyses, the present conditions provide a common starting point. When future expectations diverge, alternative scenarios are developed to more accurately project value.

In the Ajax/Cablecorp case, the plaintiff's appraiser provided valuation estimates for two scenarios: "If No Asbestos" and "As Is With Asbestos." Were the appraiser's two scenarios germane and appropriate to this case?

- The "If No Asbestos" case assumed from the start that there was no asbestos in this building and no expense related to its removal. This case did not exist and never had or will. The building always had and currently did contain asbestos. Therefore, the only scenario without asbestos was a valuation of this building whereby the asbestos would be removed in the future.
- The appraiser's "As Is With Asbestos" case was the one with removal of asbestos. Not only was this scenario confusing, but there was further confusion in its terminology. This scenario was also identified elsewhere by "as is market value." "As is" generally means the continuation of existing building operations during the analysis (ten years in this case) to assess current market value. Of course, "as is" was inappropriate nomenclature because this scenario indicated a substantial change in building condition.

I believe the appraiser, using the two scenarios noted above, established an inappropriate foundation for the valuation. The proper comparison, with a common starting point for each scenario which reflected existing conditions, should have been:

- Building with asbestos—as maintained, enclosed or encapsulated, and
- Building with asbestos removed.

The first scenario would result in a valuation of a structure in its existing condition and a projection of its normal and routine operation during the period of the analysis (traditionally a ten year projection). The second case would be one of valuing the building starting in its existing condition and projecting its operation during the next ten years whereby the asbestos is ultimately eliminated from the premises (and the valuation accounts for all the costs involved). These scenarios would enable us to demonstrate whether asbestos abatement would diminish, maintain or increase the value of the building.

Creating new scenarios mandated a review of the assumptions. No matter what scenario was used in the valuation, there must be solid support for physical, operational, market and financial criteria. With existing conditions, the facts are generally not in dispute. However, projections about the future have a dramatic impact on market value. As a result, marketplace, investment and building management assumptions must be carefully established if investors are to view the appraisal with credibility.

The plaintiff's appraiser used identical assumptions in both scenarios ("If No Asbestos" and "As Is With Asbestos"). However, a completely renovated building, with no asbestos, improved tenant spaces, building systems and new marketplace image, should exhibit a superior absorption of vacant space. A building with asbestos, due to tenant perceptions, would probably exhibit a slower absorption of vacant space and possibly a permanently reduced occupancy level.

In an "as is" scenario such as "Building with asbestos—as maintained, enclosed or encapsulated," the occupancy rate should remain at about the current level unless the market changes. Unfortunately, the market continued to deteriorate, especially for older lower grade buildings such as the subject property. Thus, with fewer tenants, rental income would be less and the value should be correspondingly lower.

In a scenario of "Building with asbestos removed," the opportunity exists to fully renovate building systems and tenant spaces while removing asbestos containing materials. As a result, the

building can be repositioned as a superior facility in the marketplace and equivalent to Class A properties. This would mean a stabilized occupancy which is equal or better than the general market. With more tenants, rental income would be greater and the value would be correspondingly higher.

Why did the plaintiff's appraiser set identical new tenant rental rates in both scenarios? As noted above, the improved property should also command higher market rentals. As a result, higher income would translate directly into higher value. Conversely, an older property with outdated accommodations would need to offer lower rental rates or tenant inducements to compete effectively. The result in this case would be less income and a lower value.

All other market issues such as tenant concessions, finish allowances and the like would also be effected by the nature of the scenario. By properly stating these fundamental assumptions, one can establish a realistic and credible cash flow projection and building valuation. However, value will change accordingly, depending on the "as is" or a repositioned market scenario.

In addition, all these assumptions were tempered further by an assessment of area economic conditions, local real estate market factors and the nature of the immediate competition regarding property age, location, occupancy rate, floor plate size, presence of asbestos, tenant finishes and actual rental rates. There was even the complicating factor of a ground lease and its impact on building value, but that is another story.

Plaintiff's Strategy

During the proceedings, the plaintiff hired a noted real estate brokerage and financial services firm to market the property for sale. This unusual move made me suspect that the building was not seriously being considered for actual sale. It was my judgment that the marketing approach was another attempt by the plaintiff to demonstrate the "loss" in building value due to the presence of asbestos. To further this idea, the plaintiff constructed an offering memorandum and sale package that included an escrow which would be set aside by the seller to pay for the removal of the asbestos material. This escrow was similar to the amount being sued for as damages.

In response to this tactic, I recommended that legal counsel depose the plaintiff's selling agent. Our goal was to determine how the building was positioned in the marketplace, how asbestos may have affected this strategy and how to ascertain the selling agent's opinion and recommendations about this property.

The deposition revealed that the selling agent had discussed with Ajax the impact the asbestos might have on the sale of the building. However, no price reduction and no removal recommendations were made concerning the asbestos other than mentioning that the cost of abatement would be an issue in the sale negotiations. As a result, the selling agent stressed only a narrow market would be interested in the building—"value added buyers, bottomfishers and vulture funds." This statement supported my contention that Ajax hoped for lowball offers from prospective buyers to demonstrate a diminished value and supposed damages.

More important, the selling agent emphasized that other significant issues in selling and marketing the office building had to be addressed. These issues included: blocked floor views by the adjacent building; price sensitivity of tenants to renting space in older properties; the oversupply of office space and intense competition; the exodus of firms from lower grade buildings into new Class A space; the absence of on-site parking; and the lack of sprinklers. In fact, he noted that the city had passed an ordinance requiring sprinklers in renovation and that it would not be economical to put sprinklers in the building without removing the asbestos.

Finally, the escrow fund was explained as a vehicle to pay for the asbestos removal. The rationale offered for the escrow was to separate the impact of the asbestos from the building. However, prospective buyers were unlikely to view asbestos as an issue apart from the property. Thus, it appeared this selling tactic was just another attempt to demonstrate loss and damages. Furthermore, no formula was established for creating this escrow nor was there an explanation made to determine how the escrow would be funded and financed.

Conclusion (An Increase In Value)

All of the information and ideas concerning our recommended approach pointed in the right direction. When complete, our valuation of the property showed that the expenditure of funds to remove the asbestos would result in an *increase* in building value, with all the costs being fully repaid in addition to realizing the greater equity value upon future sale.

The evaluation was based upon the two scenarios: (1) "As Is," whereby the property continued operations as a Class B office facility and the asbestos containing material remained in place, and (2) "With Asbestos Removed," whereby the property is repositioned as a Class A office facility and the asbestos containing material is removed.

The value of the property "With Asbestos Removed" was substantially more than the estimated value of the property in the "As Is" scenario. To further confirm the validity of these findings, a sensitivity analysis was run whereby important assumptions were changed for both better and worse. The analysis showed that the evaluation was primarily dependent on three critical assumptions: the vacancy loss allowance, the amount and extent of free rent provided tenants, and the size of capital expenditures, especially in regard to asbestos, sprinkler installation and general building improvements. But even with this cost (and appropriate revision in market position for higher rents and lower vacancy rate), the building value was consistently more with the asbestos removed.

Conclusion (No Damages Due)
We then found the smoking gun that solidly proved our case against damages. We could justify the conclusions of our valuation based upon market, management and financial due diligence. But the big break on the issues came during routine discovery proceedings. Through careful research and diligent review of the documents, I had noticed a story could be pieced together about financial returns and damages (or the lack thereof).

By analyzing the consolidated trial balances for all years of operations, I realized that the substantial cash flows appeared in every year, regardless of expenses incurred due to operations, management, or even the threat of asbestos abatement. I then recalled that an initial review of the original purchase and sale documents revealed the price, mortgage amount and the equity invested. By measuring these cash flows against purchase price and equity invested, return on investment and return on equity could be determined.

The results of the analysis were telling. The total return on assets was over 100% during the past ten-year holding period. The return on equity was an even more substantial 400% during the same period. This resulted in an internal rate of return, to date, greater than 30%, an excellent return without yet accounting for the future sale proceeds when the property is eventually sold. These results proved there were no damages suffered by the plaintiff during ownership. To the contrary, the impressive returns demonstrated that ample funds were available to pay for renovation, rehabilitation and asbestos removal as well as secure the building's market position.

Resolution and Postscript (Lessons Learned)
The defendant's legal counsel filed a motion for a summary judgment by the court. The court responded affirmatively and dismissed the suit. By and large, this success could be credited to our efforts to establish how to manage the litigation and solve the problems. We did not fall prey to the temptation of asking why the situation existed and, as a result, respond only to the facts at hand. Of course, nothing is final about asbestos issues, litigation or real estate in general. The circumstances always are changing and the personalities of the people involved are always different as well.

We broke out of the box which so often constrains our thinking on difficult issues, such as this litigation. Stephen Jay Gould, the noted biologist, natural historian and science writer said that the resolution of the problem does not lie in more research within an established framework but rather in identifying the framework itself as a flawed view of life. Therefore, it was incumbent upon us to establish how the job was to be done and, if necessary, choose a different point of view to accomplish it. Legal counsel has a formidable task in real estate related litigation because of the complex technical issues often at stake. Real estate counselors can provide the knowledgeable experience and direction to develop a strategy.

LEGAL INTERACTION WITH THE OWNER'S REPRESENTATIVE OF AN ELEEMOSYNARY ORGANIZATION

by Frank J. Parker, CRE

As a Counselor of Real Estate (CRE), I serve as an owner's representative for eleemosynary institutions. In this capacity I act on the client's behalf as the individual owner, purchaser or seller of the real estate properties which must be bought, sold, adapted or maintained by the eleemosynary organization. Owner's representatives receive virtually unfettered delegation orders from the principal or the employing non-profit organization. Because he is not usually experienced in property dealings, a non-profit client rarely disputes the advice offered by the owner's representative. This state of affairs is not an unmixed blessing. Frequently, a more successful outcome is expected than when a for-profit corporation is involved. Subsequent disillusion can be severe. There is no reason why an owner's representative couldn't be engaged by large non-profit corporations, however, the board of directors and chief executive officers often will not cede real estate decision making to others.

Eleemosynary, the Latin word whose definition is, according to the American Heritage Dictionary, "of or pertaining to alms or the giving of alms; dependent upon or supported by alms; contributed as an act of charity; gratuitous." Organizations commonly referred to as eleemosynary include churches, religious orders, schools, museums, small hospitals, etc. In each instance the organization has applied for and received Section (501(C) (3) status from the United States Internal Revenue Service.

Non-profits often have significant real estate holdings. Many such organizations, including Roman Catholic denominations and dioceses, either purchased or were given large parcels of land at a time when property values were a fraction of their current worth. Many of these holdings are underutilized. Sale or adaptation of such properties often provides the last chance for these organizations to pay off their debt, add to their asset base or, as is the case for many religious congregations, provide for the retirement and hospitalization needs of their members.

To carry out the direction of the non-profit client, the owner's representative might need to assemble a team of experts including environmental engineers, appraisers, architects, real estate brokers, mortgage brokers, engineers, construction companies, accountants and attorneys. This is one of the most important duties with which an owner's representative is charged. It should not be delegated to the attorney or any other member of the team. The owner's representative must serve with the highest level of professional skill and integrity with the best interests of the client always in mind. The

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organization involved has, for all purposes, abdicated its authority and placed it in the hands of an outsider.

Ownership Interests Clarification

The owner's representative usually will employ an outside law firm to handle the legal matters involved. The first step in the working relationship between an owner's representative and the law firm handling the matter, is to verify, with accuracy, the true state of ownership for the parcel under consideration. What property does the non-profit organization own and who else might possess an ownership interest which could cloud the title if transfer of the property is contemplated?

Until recently many smaller sized non-profit organizations were known for their casual management practices especially in dealing with real estate. Previously it was not unusual for properties to be bought and sold without legal representation. Benefactions were received without being recorded. Restrictive covenants in bequests were accepted, then ignored. Easements were granted, then forgotten. Amendments were made to the charter of incorporation or bylaws of the organization without altering the underlying real estate documentation. Environmental commitments were made to regulatory authorities. Leases with options to purchase were granted.

A proposed agreement could be scuttled if the items listed are not discovered and addressed in time. Whether acting for the buyer or the seller, the owner's representative and the attorney must pay the closest attention to ownership issues and decide on the best solution to address the problem in question.

Chain Of Command Clarifications

In many smaller non-profit organizations the question of who is in charge can be difficult to answer. Failure to identify someone could lead to both practical and legal difficulties. Here the owner's representative must know that the person at the non-profit who employed the agent might not be the ultimate evaluator of his work. Sometimes the name of the ultimate decision-makers is not even known to the owner's representative. Establishing trust with the true decision-maker is essential and the attorney often can assist in cementing the relationship. This is especially true if the attorney has previously represented the non-profit organization. Both in negotiations and in contract drafting, the chief decision-maker question is important. Otherwise the deal agreed upon, and in some cases its legal effect, is placed in jeopardy.

The chain of command question is most crucial to owner's representatives when dealing with an entity of the Roman Catholic Church. In most dioceses, for purposes of civil law, the bishop owns all the property as a corporation sole. However, exceptions exist, such as in the state of New York. There the local parish itself is the legal owner for purposes of civil law. Canon Law, the law of the Catholic Church, is otherwise not recognized in New York courts.

To further confuse matters, a separate second group exists, often referred to by the not totally accurate designation as "exempt religious orders." In Canon Law, the proper designation for these groupings of men is "orders of clerical religious groups of pontifical right." They include Jesuits, Dominicans, Franciscans, Carmelites, Carthusians and Benedictines. These priests and brothers work in a diocese but are answerable primarily to their own superiors and only secondarily to their local bishop. It is not unusual for legal ownership of properties held by these orders to be vested in the name of the superior general of the order in Rome.

A third group are men's religious congregations comprised of officially recognized groups of religious priests and/or brothers who are neither diocesan priests nor members of religious orders. Their land could be owned by the local diocesan bishop, or by the congregation in Rome, or by their American headquarters, or by the local house of the congregation itself, or perhaps even by the current local superior as a corporation sole.

The fourth group are orders and congregations of religious women whose property, for purposes of legal ownership, could be held in any combinations applicable to the other three groups. And, fifth and finally, is separate incorporation. In the past, many Catholic colleges and universities were owned by orders, congregations and dioceses, but in the early 1970s a large number of these schools and religious entities separated into two separate non-profit organizations in the eyes of the state. Consequently, it is absolutely essential to read closely the separate documents of incorporation. The attorneys who drafted these separate incorporation agreements were trying to provide for the future needs of elderly members of the order. As a result they often resorted to complicated documents of trust to achieve their objective.

Mission Statement Clarification

My father had a friend who was the managing partner for one of Wall Street's most prestigious law firms. Among his duties was to interview promising candidates for positions with the firm. One day a superstar appeared who was at the top of his class at a major law school. He indicated that he had already received many, many offers from other law firms. In order to qualify the current firm for his august consideration, he asked the managing partner in a supercilious tone, "What is your firm's raison d'être (mission)?" The managing partner snapped back, "That's simple son, to make money."

The raison d'être of a non-profit organization rarely lends itself to such a direct answer. Many times the non-profit has never taken the time to articulate the organization's mission. Even if it did, the mission statement usually needs to be updated to account for changes in the world situation. Sometimes the board and administration have their own

agenda which does not coincide with the mission statement.

An owner's representative must understand and be able to articulate the client's mission. Otherwise, inappropriate deals could be proposed and wrong advice given. This maxim is applicable for the attorney, as well. There is an equal responsibility for the attorney drawing up the papers to understand the non-profit's goals. This understanding often will clarify the ownership interests and chain of command issues which might be unresolved. Early in the process the representatives of the non-profit organization should hold a meeting with the owner's representative and the attorney to clarify the scope of the mission and how it affects the real estate decisions which need to be made.

Risk Toleration Clarification

If there is one generalization that holds true for most non-profit organizations, it is they do not understand the risk-reward relationship. Almost by nature, non-profit organizations are risk adverse, sometimes to a degree of acute paranoia. If the real estate project in question is one which contemplates a joint venture with a commercial developer, it is almost guaranteed that the non-profit organization will expect the developer to take all the risks of loss and at the same time turn over a high percentage of the potential gains to the non-profit. Here, the owner's representative needs to act deftly to convince the client about the reality of the developer's position. The real estate attorney can play a useful role in working with the owner's representative to educate the client regarding the risks inherent in any real estate development.

Legal Situation Clarification

Often situations will occur in dealing with a non-profit which require special attention from the law firm which has been engaged. Thus, it generally is a mistake to hire an attorney who has not had previous experience in dealing with non-profit organizations, no matter how extensive this person's experience might have been in representing for-profit corporations. An offshoot of this problem comes about if the law firm's senior partner, with experience in dealing with the non-profit, delegates decision-making authority to a junior associate lacking any such experience. The owner's representative should be slow to approve legal bills when dissatisfied with the amount of time the senior partner actually devoted to the transaction.

There are a whole range of special problems that occur in dealing with church organizations. Churches and other eleemosynary still are corporations able to sign legally binding documents. In the early 1970s, during the day of "Philadelphia Plans" in the construction industry, a number of these non-profit organizations signed binding agreements with labor unions and other groups involving minority hiring on projects. Consequently, these documents still exist and with a court order can hinder the completion of work on a project while the problem is being resolved.

Second, in some states anything done by a church organization which is not purely religious in nature probably will be taxed. Generally, churches still think of taxation as somehow lacking in piety, somewhat less than spiritual. Even if the developer and the owner's representative are able to convince the church to set up a for-profit subsidiary, holdover resistance might still surface resulting in an otherwise excellent joint venture project being rejected. It may be necessary to accede to their wishes and have them remain as a completely non-profit institution. If so, everyone will have to be very careful about the tax questions involved; particularly in real estate syndications, religious orders have had trouble with the IRS on tax questions.

Third, because land has been given to non-profits over time, a whole group of restrictive covenants could apply which are not found in other dealings. A developer and the non-profit's advisors must be resigned to expect problems not ordinarily encountered in a for-profit venture. Some of these covenants, especially if they are racially restrictive in nature, often will not withstand contemporary court challenge. This is especially true if they came into effect many years ago. However, the time and expense involved in removing them from the deed can be most burdensome.

Fourth, members of many churches and other conservative charitable groups now demand that their institutions act as corporately responsible citizens. For example, a very reputable company with a limited amount of construction business in South Africa was trying to form a real estate joint venture with a church to build an apartment complex. Suddenly members of the church's congregation were sitting in front of the potential joint venture partner's corporate headquarters waving placards. Any developer entering a joint venture with a non-profit must pay attention to this issue of corporate responsibility. Some demands will be fair, some not, but the developer's political and environmental record will be carefully scrutinized.

Fifth, zoning is a greater problem in dealing with a former seminary or school than with almost any other type of land used for joint ventures. Most schools and churches have allowed the surrounding town to think of the facility as its own. Over the years, institutions have permitted town residents use of school and/or church playing fields, golf courses and skating rinks. The town often does not wish to give up what it considers public property—the possibility of increased tax revenues notwithstanding. Zoning battles could be fierce. A similar problem concerns increasingly onerous landmark commission regulations. The legal limits on prohibitions against changing or destroying historic buildings still are being contested in the courts. Many otherwise profitable joint ventures will be stillborn if these structures are approved.

Opportunity Quotient Clarification

When the owner's representative for the non-profit organization and the attorney establish a

professional working relationship, it benefits all concerned. Most importantly, the non-profit is the big winner. On a secondary level, however, the owner's representative—lawyer relationship often leads to close cooperation between these professionals in new ventures, not only for the present client but for new clients either might bring to the table.

Trading on the axiom that nothing succeeds like success, once the first transaction for the non-profit client has been completed to everyone's satisfaction, it is wise for both the owner's representative and the attorney to sit down with the officers and directors of the non-profit organization in order to map out further strategies for future acquisitions, dispositions, new ventures and financing vehicles. Non-profit status can present significant zoning and subdivision advantages. If these benefits are utilized at the outset, the property will be significantly enhanced in value for later joint venturing or disposition.

Conclusion

Non-profit organizations in this country have been awarded a particularly favored status by the lawmakers. Unfortunately only a few with significant real estate holdings have made the effort to employ sophisticated professional assistance to administer these holdings. A sense of responsibility on the part of the non-profits to those who support their organization, either in currency or in kind, should be motivated to seek outside professional help.

There is an equal obligation on those employed for this purpose to respect each other's talents and competencies so the client is best served. This article has described how the owner's representative and attorney can work together to obtain the desired result for the non-profit organization client.

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