REAL ESTATE ISSUES

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(deadline for manuscript submission - May 13, 2002)

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Articles on general real estate-related topics
(deadline for manuscript submission - August 19, 2002)

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Articles on general real estate-related topics
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Clarification Note: In the last issue, (Vol. 26, No. 4), there was an ommission in output on page 74, last bullet point, of *Focus on Legal Issues: Preliminary Reflections Inspired by the Terrorist Attack.* Full-text of the third bullet point under the "What We Know for Sure" heading follows:

- A difficulty, of course, is the (seemingly universal) client who complains, "I pay 90 percent of my legal bills for the final 10 percent of the legal protection I get." If the legal profession is going to perform adequately in this sector, the client is going to have to step up to the plate, too. In my view, this is a critical factor that will determine the profile of many of the legal consequences resulting from the terrorist attack. Put another way, leaving the money factor out, it is one thing to proclaim, "It seems we have a problem with [say] casualty clauses of our [say] leases." It is quite another to negotiate (even between two parties, much less the multitudes of parties who have come to this realization since September 11) clauses that will make for more just, or simply more businesslike, results.

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EDITOR'S STATEMENT - by Richard Marchitelli, CRE

As the adage goes, "All good things must come to an end." And so, it is with regret I announce that Faye Porter, managing editor, has decided to end her tenure with *Real Estate Issues*, after an almost 12-year affiliation with The Counselors. It is also an appropriate time to announce that in the near future I will be vacating the position of editor in chief. The timing of our departure is unrelated: for me, it is simply the "right time"; for Faye, there is a desire for more "non-working time" in her life, as she also has a full-time position with another association publication. As we pass the baton, I feel compelled to reflect on the last few years.

Evolution . . . When I became editor in chief in 1999, I inherited a publication with a rich 24-year history—a solid foundation upon which to build. Faye and I quickly recognized that we shared a common vision, enthusiasm, and commitment to REI. Fortunately, we have been blessed with supportive and dedicated editorial boards that have embodied the same innovative spirit and objectives.

Innovation . . . Changes initiated were of both form and substance. The format has seen the establishment of a branded look for REI as well as the addition of two new departments that appear regularly at the end of each issue. **"Insiders' Perspectives"** consist of timely discussions on key industry issues. Experts in those fields have honored REI with their commitment to author the columns on a consistent basis, including **CREs Hugh Kelly, Ray Torto, Ken Riggs, Brick Howe, Bjorn Hanson**, and non-member experts **Peter Korpacz, Dale Reiss, Sam Zell, Robin Panovka**, and **Jack Corgel.** Chaired by **Maura Cochran, CRE**, the **"Resource Review"** department was developed to provide a place for a practitioner to espouse an opinion on a particular book, software product, etc.

Broadening the Base . . . A fundamental change has been our focus on seeking authors outside The Counselor organization. This has broadened the author base and improved the diversity and flow of manuscript submissions. There are now a number of contacts and initiatives in place so the pursuit of this objective can go forward. At the same time and in response to the overwhelming preference of our readers, we reaffirmed the uniqueness of our niche—that the emphasis of REI would be on practical applications and applied theory as opposed to a more academic orientation.

With the dedicated efforts of many, Faye and I have added our bricks and mortar to a foundation started in 1976 and trust the collaboration has enhanced REI's substance, image, and success. Throughout the years and many pages, our value proposition has been to deliver meaningful, relevant, and cogent articles on issues of the day. As the continuum advances, we pass on a heightened REI to a new group of caretakers upon which they can continue to build.

Richard Marchitelli, CRE
Editor in chief

Albert Pappalardo, Sr., CRE
2002 National CRE President

Palazzolo v. Rhode Island: Recent Developments in Eminent Domain

by Lara Womack

ABOUT THE AUTHOR

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INTRODUCTION

The inherent right of the U.S. government to take private property is acknowledged in the Fifth Amendment to the U.S. Constitution, which states that "private property [shall not] be taken for public use without just compensation." This is known as the eminent domain clause.

There are several bases upon which a property owner might challenge the government's authority under the eminent domain clause. The most likely challenge is that the compensation offered by the government is inadequate; it is not just. Another possible challenge is that the government's reason for having taken the property does not qualify as a public use. This challenge is difficult to maintain, however, because the standard used to determine the requirement of public use generally favors the government. Both of these challenges assume that a taking has in fact occurred, an occurrence that is itself frequently the subject of litigation.

The clearest cases of takings involve some physical intrusion upon land by the government, but a physical intrusion is not always necessary. The U.S. Supreme Court established in *Pennsylvania Coal Co. v. Mahon*[1] that government action which does not actually encroach upon or result in the physical occupation of property may constitute a taking, and thus trigger the requirement of just compensation, if those actions substantially affect and limit the use of the property. When there is no encroachment or physical occupation, there are two ways in which a landowner can establish a taking. One alternative is to prove that they have been denied all economically beneficial or productive use of the land. The second alternative involves the application of three factors. These are the regulation's economic affect on the owner, the extent to which the regulation interferes with the owner's reasonable investment-backed expectations and the character of the government action. Collectively, these are known as the *Penn Central*[2] factors, a reference to the case in which they were established. When landowners allege that regulations have denied them the use of their property, or have interfered with their investment-backed expectations, the actions are commonly referred to as inverse condemnation cases.

Palazzolo v. Rhode Island[3] is such a case. The petitioner, Anthony Palazzolo, owned a parcel of real estate in Rhode Island, which was subject to that state's wetland regulations.[4] It had been purchased by a corporation, Shore Gardens, Inc. (SGI), in 1959. That corporation was formed by Palazzolo and some associates. SGI made several attempts to develop the property. Because most of the property was salt marsh and subject to tidal flooding, any development would have required filling of the land to some extent. Three different applications were made to state agencies for approval to fill substantial portions of the parcel. All three were eventually denied. At some point, Palazzolo bought out his associates and became the sole shareholder in SGI.

In 1971, Rhode Island created the Rhode Island Coastal Resources Management Council. The council, charged with protecting coastal properties, designated salt marshes as protected property and limited development on such property. In 1978, SGI's charter was revoked and, because he was the sole shareholder, Palazzolo became the owner of the property by operation of law. During the 1980s, Palazzolo again made efforts to develop the property, but the council rejected his applications on two occasions. At this point he filed suit in Rhode Island state court, claiming that the council's regulations constituted a taking of his property, entitling him to just compensation.

The state trial court ruled against Palazzolo and the Rhode Island Supreme Court affirmed that decision.[5] Mr. Palazzolo then appealed to the U.S. Supreme Court. The case raised three interrelated issues. The first was whether the petitioner's claim was ripe for review. The second was whether a property owner should be barred from asserting a

There are several bases upon which a property owner might challenge the government's authority under the eminent domain clause. The most likely challenge is that the compensation offered by the government is inadequate; it is not just. Another possible challenge is that the government's reason for having taken the property does not qualify as a public use.

takings claim when the regulations in question were already in effect at the time the property was acquired. The third was whether the property owner in this case had been denied of all economically beneficial use. Of these three issues, the one that has the greatest potential to impact the progress of environmental regulations is the second. Prior to *Palazzolo,* many lower courts had ruled that pre-acquisition notice was a bar to inverse condemnation proceedings. This case holds to the contrary, and so allows regulations of any type to be challenged for longer periods of time.

ISSUE ONE: RIPENESS

The first issue addressed by the Court was whether the petitioner's claim was ripe for review. The ripeness doctrine is an extension of the general policy that courts in the U.S. do not function in an advisory capacity. They will hear cases only when presented with a present case or controversy. If a case is brought too early, it is not yet ripe for adjudication.[6] The ripeness doctrine prevents courts from engaging in premature adjudication and, where the legitimacy of an administrative agency regulation is at issue, also protects the agency from judicial interference while its decisions are still being formulated.[7]

In *Palazzolo,* the ripeness issue turned upon whether the government agency charged with implementing the regulations had reached a final decision on the application of those regulations to this particular parcel of property. The Rhode Island Supreme Court had ruled against Palazzolo on this issue. It acknowledged that at least four different applications to fill the land had been filed, either by Palazzolo personally or by SGI, and that all had been denied, but noted that these involved filling all or substantially all of the wetlands portion (18 acres) of the property. Further, none of these applications mentioned the particular development that Palazzolo referenced in his claim for compensation, a plan to develop a 74-lot subdivision. Because Palazzolo had not been denied an application for that particular development, and because he had not pursued development options that were "less ambitious" than those requiring fill of so much of the wetlands area, the state Supreme Court ruled that his claim was not ripe.[8]

The U.S. Supreme Court disagreed with the Rhode Island Supreme Court on this issue. As to the determination that the particular development upon which Palazzolo had based his claim was not reflected in the applications, the Court stated that, under these circumstances, it was not necessary for an application of that type to have been filed. Palazzolo had been denied an application to fill the property. Since filling would have been a prerequisite to the 74-lot development, it was clear that the development itself would also have been prohibited.[9]

The Supreme Court focused more extensively on the state court's holding that the claim was not ripe because Palazzolo had not filed applications to develop a smaller portion of his property. The property did not consist entirely of wetlands. There was also a portion of upland property, the development of which would not have been subject to the same degree of restriction as the wetlands portion. The Court first addressed the need for additional applications to develop the wetlands portion. While Palazzolo's applications had involved the development of all, or substantially all, of this portion, it was not the size of the area covered which provided the basis of the denial. The applications were denied because they did not propose an activity that the state agency considered a compelling public purpose. There was no indication that the applications would have been accepted if the development proposed had occupied a smaller area. The agency had clearly communicated that it would allow no filling, and therefore no development, of the wetlands for any purpose, no matter how small or large the portion of the wetlands to be affected. The Court ruled that it was not necessary for additional applications covering smaller portions of the wetlands be filed in order to establish the ripeness of the claim.[10]

As to the uplands portion of Palazzolo's property, the Court explained that some doubt must exist as to the value of this portion of the property in order for the state to succeed on its argument that the takings claim was not ripe. The record reflected that all of the parties had accepted and subsequently cited uncontested testimony that the estimated value of this portion of the property was $200,000. Having accepted this estimate, the state could not later claim that the value was unknown. The Supreme Court ruled that Palazzolo's claim was ripe for adjudication.[11]

ISSUE TWO: PRE-ACQUISITION NOTICE

The pre-acquisition notice of the regulations as a bar to inverse condemnation proceedings was the second issue addressed by the Court. Because Palazzolo had become the owner of the property after the regulations in question became effective, the state courts had rejected his claim that he had been deprived of all beneficial use of the property. Those courts reasoned that, since the regulations pre-dated Palazzolo's acquisition of the property, he had never had the right to fill the property, and so it could not have been taken from him. Further, according to the state courts, the existence of the regulations defeated Palazzolo's claim that he had reasonable investment-backed expectations in the property. Since he had notice of the regulations, he could not reasonably have expected to fill and develop the property.[12]

The U.S. Supreme Court approached the pre-acquisition notice issue differently from the state courts. Rather than intertwining it with the issues of deprivation of all beneficial use and interference with reasonable investment-backed expectations, the Court viewed the notice issue as a preliminary one, much like that of ripeness. It also reduced the state courts' treatment of notice to one single rule: A purchaser or a successive title holder like petitioner is deemed to have notice of an earlier-enacted restriction and is barred from claiming that it effects a taking.[13]

The Court found fault with such a broad rule. It explained that if this rule were applied, transfers of property after the enactment of land-use regulations would absolve the government of its obligations under the eminent domain clause, without inquiry into how extreme or unreasonable those regulations were. If regulations are unreasonable, and constitute a taking, they do not become reasonable with the passage of time or the passage of title to the property affected.[14]

In rejecting the state courts' pre-acquisition rule, the Court noted the effect that it would have had on those who acquire title to property by some means other than an arm's length sale. The holding, however, does not appear to be based upon the manner in which title is acquired. The Court cited the example of the individual whose property becomes subject to regulations, but who dies before an inverse condemnation claim can become ripe. Under the Rhode Island rule, the heir to that property would lose the right to claim compensation even if the claim did progress to the point of ripeness after the original owner's death. This, the Court concluded, would result in a windfall for the government. But the Court also specifically mentioned the effect that the Rhode Island rule would have on those owners who need to sell contrasted with those with sufficient resources to hold on to property.[15] Its rejection of the rule was not limited to those situations in which title passes by inheritance, or by operation of law, as in *Palazzolo*.

While seeming to make no distinction based upon the manner in which title is passed, the Court did make clear that its holding in this regard was not broad enough to apply to those cases involving a physical invasion of property. In such cases, the right to compensation is not passed to a subsequent owner. The difference, the Court explained, is based upon the manner in which the claim becomes ripe. When there is a physical invasion of property, the fact and extent of the taking are known at that time. When the impact on the property is regulatory in nature, it may not be known until a future point that a taking has occurred.[16] Thus, it is the party who owns the property at the time the claim becomes ripe who may bring the action, not necessarily the party who owned the property at the time the takings process began.

Many consider this issue to be the one with the greatest implications for both landowners and those advocating land-use regulations. The holding that notice is not an absolute bar to an inverse condemnation case will be of assistance to those who purchase property already subject to extensive regulations. Although those purchasers still have to carry the burden of proving that the regulations constitute a taking, they now have greater opportunity to initiate lawsuits. Most lower courts had refused to consider the merits of such cases, holding instead that purchasers who took with notice of the regulations were barred from making the claims at all. Knowing that litigation is more likely, governmental agencies may now weaken their regulations and allow more development, an outcome of particular concern to those who support the use of regulations for environmental reasons.[17]

This part of the ruling has already begun to affect other litigation. In *McQueen v. South Carolina Dept. of Health and Environmental Control*, a landowner had purchased property that had been affected by developmental regulation for over a century. The state Supreme Court ruled that the pre-existing regulations defeated the landowner's investment-backed expectations, and thus defeated his claim that a taking had occurred.[18] The day following its opinion in *Palazzolo*, the Court remanded this case to the South Carolina Supreme Court.[19]

Palazzolo ***leaves unanswered, or at least unclear, more questions than it clarifies. The one clear holding in the majority opinion is that pre-acquisition notice of land-use regulations does not bar a purchaser's inverse condemnation lawsuit. However, several questions remain open.***

ISSUE THREE: THE MERITS

Having determined that Palazzolo's claim was ripe, and that it was not barred by his pre-acquisition notice of the regulations, the Court then gave some attention to the merits of his claim that the regulations had resulted in a taking of his property.

As noted above, there are two ways in which a landowner can succeed in the claim that land-use regulations have resulted in a taking of their property. One is to establish that they have been deprived of all economically beneficially use of the property. The other is to establish that a taking has occurred by application of the *Penn Central* factors. In *Palazzolo*, the state Supreme Court found against the landowner on both claims, but intertwined these issues with that of pre-acquisition notice. The Supreme Court took a different approach. After ruling that the landowner could proceed to the merits of his claim, it ruled that there had been no deprivation of the economic benefit, but that the *Penn Central* claim had not been adequately examined by the Court below.

On the issue of whether he had been deprived of all economically beneficial use, the very fact that had worked in favor of Mr. Palazzolo during the Court's analysis of the ripeness issue, worked against him. The Court determined that he had not been deprived of all economically beneficial use because the uplands portion of the property had an established value of $200,000. This value, the Court concluded, was more than a token interest and did not leave the parcel economically idle. On this point, the U.S.

Supreme Court found itself in agreement with the state Supreme Court.[20]

The state Supreme Court, however, had not evaluated the merits of the landowner's claim under the *Penn Central* factors. Although the majority opinion gives no guidance in how those factors ought to be applied in this case, its ultimate conclusion was the case should be remanded for that purpose.[21]

UNANSWERED QUESTIONS

There are two important questions left unanswered by the majority opinion in *Palazzolo*. One is only identified in the opinion, and the other is explored in more than one of the separate opinions, both concurring and dissenting. In addition, the patchwork of separate opinions in the case suggests that the entire subject of regulatory takings is far from settled.

The first unanswered question is presented in the majority opinion. In arguing that he had been denied all economically beneficial use of his property, Palazzolo attempted to segregate the uplands portion of his property, which had an established value of $200,000, from the wetlands portion, which was much more heavily regulated. This would have allowed him to more effectively argue that the wetlands portion had been taken, even though the upland portion retained some value. The Court would not allow him to pursue this argument, however, because he had not pursued it in the state courts.[22]

Although it rejected his attempt to segregate the property, the Court recognized that this argument, when presented in the correct manner, might be meritorious. Some previous cases have indicated that the extent of deprivation caused by a regulation must be measured against the value of the whole property, but other cases have questioned the logic of that rule. Acknowledging all of this, the Court still refused to consider the argument, leaving the issue open for debate in subsequent cases.[23] This issue was not further discussed in any of the five other opinions that were written.

Another important issue is raised by the majority opinion, but then left to be resolved by the lower courts. That is the extent to which the property owner's pre-acquisition notice of the regulations affects their reasonable investment-backed expectations. The majority opinion clearly states that pre-acquisition notice is not a bar to an inverse condemnation case, but give no further guidance on the issue. Three of the justices offered further comment on this matter. In her concurring opinion, Justice O'Connor stated that the timing of the regulations to the acquisition of the property should not be considered immaterial; it should help to shape the reasonableness of the property owner's expectations. Justice Breyer, writing separately, agreed. Scalia also discussed this issue in his concurring opinion, but reached a different conclusion from O'Connor's. Scalia stated that restrictions in existence at the time title was acquired should have no bearing on the determination of whether a taking has occurred.

There were a total of six opinions written in *Palazzolo*. These reflect an array of views on the two primary issues involved in the case—ripeness and pre-acquisition notice as a bar. A bare majority of five justices agreed that the case was ripe and that notice was not a bar to an inverse condemnation action. Those five were Kennedy, Rehnquist, O'Connor, Scalia, and Thomas. Another justice, Stevens, joined with that group on the ripeness issue, but wrote a separate opinion in which he dissented on the notice issue. O'Connor and Scalia both wrote separate opinions to expand upon the impact that notice might have on a property owner's reasonable investment-backed expectations. Ginsberg wrote a dissenting opinion, in which she was joined by Souter and Breyer. They concluded that the case was not ripe for review, but Breyer also wrote a separate dissent in which he agreed with O'Connor on the notice issue. This fragmented approach should raise concern with both those who promote the use of regulations for environmental purposes, and those who favor unrestricted development.

CONCLUSION

Palazzolo leaves unanswered, or at least unclear, more questions than it clarifies. The one clear holding in the majority opinion is that pre-acquisition notice of land-use regulations does not bar a purchaser's inverse condemnation lawsuit. Several questions remain open. These include:

- To what extent must a landowner pursue development possibilities, and be denied, before the takings claim becomes ripe? A total of six of the justices ruled that this particular case was ripe. This indicates that it is not necessary to pursue and be denied development possibilities to the extent previously believed, but the case gives little or no guidance for future petitioners to determine whether they will be deemed to have satisfied the ripeness standard.

- To what extent will the pre-acquisition notice defeat the purchaser's claim that the regulations interfered with their reasonable investment-backed expectations? O'Connor's opinion suggests that such notice should have some bearing on the outcome, while Scalia's suggests that it should not.

- Will future inverse condemnation petitioners be allowed to segregate land and successfully claim that regulations have resulted in a taking of one portion, even though the other portion retains some economically beneficial use? This question was clearly identified in the majority opinion, but no possible answers were offered.

What is abundantly clear is that there will be more inverse condemnation litigation after *Palazzolo*. By removing the pre-acquisition bar and lowering the standard for establishing that a claim is ripe, the Court has insured that it will have the opportunity to address those issues identified herein, as well as others in the eminent domain area.[24] REI

NOTES

1. 260 U.S. 393; 67 L.Ed. 322, 43 S.Ct. 158 (1922).
2. *Penn Central Transp. Co. v. New York City*, 438 U.S. 104, 57 L.Ed.2d 631, 98 S.Ct. 2646 (1978).
3. 121 S.Ct. 2448; 150 L.Ed. 2d 592; 2001 U.S. LEXIS 4910 (2001). Hereinafter *Palazzolo*.
4. Although the eminent domain clause applies to the federal government as written, it has been applied to state governments through the fourteenth amendment.
5. *Palazzolo v. State of Rhode Island*, 746 A.2d 707; 2000 R.I. LEXIS 50; (2000).
6. *See*, Ronald D. Rotunda and John E. Nowak, Treatise on Constitutional Law, 3rd Ed., West Group, 1999 at section 2.13(d).
7. *See*, *Abbott Laboratories v. Gardner*, 387 U.S. 136, 87 S.Ct. 1507; 18 L.Ed.2d 681; 1967 U.S. LEXIS 2974 (1967).
8. Palazzolo, 746 A.2d at 714.
9. Palazzolo, 121 S. Ct. at 2461.
10. *Id.* at 2459.
11. *Id.* at 2460.
12. Palazzolo, 746 A.2d at 715–717. Justice Stevens took a similar approach in his separate opinion. He stated that "it is the person who owned the property at the time of the taking that is entitled to the recovery," but also stated that the taking occurred at the time the regulations were adopted. *See*, *Palazzolo v. Rhode Island*, 121 S.Ct. 2448; 150 L.Ed. 2d 592; 2001 U.S. LEXIS 4910 (2001) (Stevens, J., concurring in part and dissenting in part).
13. Palazzola, 121 S.Ct. at 2462.
14. *Id.* at 2462-2463.
15. *Id.* at 2463.
16. *Id.*
17. Marcia Coyle, "Landowners win right to attack rules." *The National Law Journal*, July 16, 2001, p.A1.
18. *McQueen v. South Carolina Dept. of Health and Environmental Control*, 340 S.C. 65, 530 S.E.2d 628, 2000 S.C. LEXIS 88 (2000).
19. *McQueen v. South Carolina Dept. of Health and Environmental Control*, 121 S.Ct. 2581, 150 L.Ed 2d 742, 2001 U.S. LEXIS 4949, (2001).
20. Palazzolo, 121 S.Ct. at 2465.
21. In September of 2001, the Rhode Island Supreme Court remanded the case to the Superior Court for the Penn Central analysis. *Palazzolo v. Rhode Island*, 785 A.2d 561, 2001 R.I. LEXIS 210 (2001).
22. Palazzolo, 121 S.Ct. at 2465.
23. *Id.*
24. *See*, Mark J. Zimmermann, "Decision of Note: Supreme Court Clarifies Takings Clause." *Environmental Compliance and Litigation Strategy*, July 2001, p.4.

Real Estate Prospects Post-9/11

by David L. Peterson

INTRODUCTION

Six months after the events of September 11, 2001, we are beginning to see the dim outlines of longer-term trends affecting American real estate. In some cases they are different from what had been predicted in the immediate aftermath of 9/11.

At the time of this writing, six months have passed since the events of September 11. It is becoming increasingly possible to sort out short-term from long-term effects on America's real estate sector. Also, as the months have passed, other factors have entered the already complicated equation. The FY 2003 Federal Budget appears likely to substitute spending on Homeland Security for spending on more traditional programs that have benefited cities and urban areas. The accounting issues surrounding the Enron collapse have clouded the future for American real estate—and the corporate sector in general—in many ways more pervasively than the events of 9/11. It's becoming apparent that the targets of terrorism are moving targets. As one set of targets is secured and protected, others rise to prominence.

As one example of how short-term thinking evolves into longer-term thinking, witness the changes in attitude about the rebuilding of the World Trade Center 7 site. In February 2002, the *New York Times* editorially expressed concern that Larry Silverstein was moving ahead "too fast" to rebuild there, suggesting that he should wait until more comprehensive planning input had been received for the site. This marks an attitude change from late September 2001, when public opinion questioned whether he would ever rebuild. It also represents a change in perspective from late 2001, when the *New York Post* worried,

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in its "Attack of the Planners" editorial, about all the planners and designers who had stepped forward with proposals for rebuilding of the Trade Center site and Lower Manhattan more generally.

These local and global crosscurrents provide a good backdrop for analyzing American real estate's future in the post-9/11 era. In the past six months, a lot of commentary on this subject has appeared, in print and online, prepared by respected analysts and special interest proponents alike. This article tries to sort out meaning and direction from all the commentary and analysis, and to provide my best guess as to where we may be headed.

ASKING THE RIGHT QUESTIONS

Understanding the impacts of 9/11 requires that we ask a number of interrelated questions, on a variety of subjects.

Each of the following trends will be examined by asking:

- Are they likely to be short-term or long-term? Is the trend merely an acceleration of something that was already happening?
- Is it a reversal of a pre-September 11 trend?
- Is it a totally new trend, not seen before?
- Does the trend affect some cities and regions, all, or just a few?
- Is the "terrorism" issue a moving target?

As we succeed in protecting such targets as buildings, planes and nuclear power plants, will terrorism take other forms and move to other locations—bridges, subway systems, random individual homes via bio-terror or chemical attacks—and how does this movement affect our analysis and conclusions?

Initial statements in the wake of 9/11 were heavily patriotic (described by one commentator as "brave rhetoric"): "We will rebuild; we will survive." Recent months have seen a shift in tone, toward more "cold light of morning," a "recognizing the interests of our shareholders" calculation of what is affordable and realistic, both short term and long. Government rebuilding promises seem to be shifting from "whatever it takes" to "whatever's left, after homeland security expenditures," leaving state and local governments to shift for themselves in a weakened economy.

And finally, as the months pass, more statistical noise complicates the analysis.

Six months after the events of September 11, 2001, we are beginning to see the dim outlines of longer-term trends affecting American real estate. In some cases they are different from what had been predicted in the immediate aftermath of 9/11.

Real estate activity is affected by post-9/11 trends, but also by the collapse of the dotcom boom, accentuated by the more recent "Enron chill" that has been cast over investment more generally.

SOME LESSONS FROM HISTORY

History has a number of lessons to offer. Americans have been dispersing their cities for decades. Occasionally they have rebuilt them. The present concerns with safety and community have revived interest in writings and suggested approaches from 40 and 50 years ago.

Americans have always been ambivalent about their cities and urban places. They may enjoy working in tall towers in urban or suburban office districts, but many enjoy even more coming home to suburban or ex-urban gated communities, far from their offices. If, as some suggest, the events of September 11 will spur decentralization, that merely continues a long-term trend that has been in existence at least since the inauguration of the Federal Defense Interstate Highway System of the 1950s, which was allegedly funded to keep Americans safe from nuclear attack on their cities.

The tragedy has brought back a number of familiar faces from previous eras. The CPTED (crime prevention through environmental design) people are back, wondering if their "defensible cities" principles from 30 years ago need to be retooled to incorporate more anti-terrorism strategies. The 1950's Civil Defense neighborhood watchers are back, often aided by closed circuit TV (CCTV) neighborhood watch technologies. Emergency preparedness efforts are either back, or being mounted for the first time—not just for earthquakes or floods, but also for terrorist contingencies of all kinds. And 40 years after the publication of her landmark neighborhood/community-planning book, *Death and Life of Great American Cities*, Jane Jacobs is back in the news, advising a panel of Canadian major city mayors on how they can make their cities more livable.

Not yet making an appearance are the "bomb shelter" people from the 1950s. Maybe they've morphed into the rural survivalists in the caves of Utah and the distant islands of British Columbia, paying their bills by teleworking and staffing call centers.

Individual American cities have, of course, rebuilt themselves in the past after major disasters—Chicago after the Fire of 1871, San Francisco after the 1906 earthquake. But now we're talking about something qualitatively and quantitatively different—strategizing about future urban form in an environment of great technological possibility, but also pervasive terrorist threat.

WELCOME TO THE WORLD, AMERICA

As we're learning from other times, we're also learning from other places.

Much of the rest of the world watches, perhaps a little bemusedly, as Americans now begin to worry about things that have been front-page issues in their countries for years. The *Resilient Cities* speaker series at MIT examines the experiences of some, but not all, of the cities that have "come back" from disaster, or that have to live in a state of heightened alert: London, Belfast, Berlin, Beirut, Tokyo, Kobe, Sarajevo, Tel Aviv. Post-9/11 women's fashion trends may be coming from Israel as well as Milan and Paris—office wear including gas masks as accessories, pants rather than skirts to facilitate diving under desks, flats rather than heels to enable quick evacuation from buildings.

DIFFERENT IMPACTS BY CITY, REGION, & INDUSTRY

Initial analyses have begun to document who has been affected and how severely; how and for whom things have changed, and in what ways. It's a mixed picture, with some clear but specific negatives, and many more subtle positive trends.

The Milken Institute released, in January 2002, a survey analyzing post-9/11 economic impacts, covering 315 U.S. metropolitan regions. It concludes that impacts are likely to be greater in the larger, first-tier cities than in the smaller, lower-tier cities and regions. As for industries, it concludes that the hardest hit will be those tourism- and recreation-dependent cities that depend on air traffic to deliver customers. For example, Honolulu and Las Vegas are likely to be harder hit than smaller, more regionally dependent tourist communities like Branson, Missouri.

Analysts have come to some tentative conclusions regarding impacts by property type. They can be summarized as follows:

- ***Retail Sector*** - major malls, especially those large enough to serve as community gathering points, will be negatively affected. Online shopping will continue its trend of increasing popularity. Neighborhood shopping will benefit from the increased interest of people in neighborhood and community more generally.

- ***Hotel & Conference*** - high-end luxury facilities will be negatively affected; economy lodging is expected to fare better. Video-conferencing will be increasingly substituted for face-to-face meetings—this an example of a trend that has been accelerated by 9/11 developments, not the least of which was the highly-publicized "Video Relief" effort by the major videoconference equipment suppliers. They provided free use of facilities to people around the world who sought to communicate with their loved ones and co-workers in Manhattan.

- ***Office*** - some rebuilding will take place in Manhattan. However, even in the metropolitan New York region, the trend of relocation to and beyond the suburbs will continue and accelerate. The chief executive of Tenantwise.com was quoted in the *New York Times* in late January 2002, saying that 23,000 New York City office jobs went to the suburbs immediately following the September 11 destruction of over 20 million square feet of space (15 percent of downtown Manhattan's supply), and that another 144,000 jobs were "in jeopardy in a second wave of departures."

A careful reading of recent New York suburban relocation announcements reveals that some of these departures are following through on hedge investments made years ago—like the Goldman Sachs move to the Jersey City Colgate property it had owned since 1999. Facilities such as these, perhaps purchased originally for back office expansion or relocation, are now being considered as well for traditionally face-to-face front office activities like equity trading. Within the office category, the taller, more prestigious trophy buildings will be less favored, with the lower-rise office park buildings relatively better off.

The reason now often given for moving to the suburbs is "business continuity requirements." In layman's terms, that means not having workers and operations dependent on just one set of transportation, telecommunications, and electric power infrastructure. And that kind of diversification can often be achieved even within a major metropolitan area, as in the case of Morgan Stanley's diversification of some of its Manhattan operations to Harrison, Westchester County, NY or American Express' relocations to Parsippany, Morris County, New Jersey. In fact, it can be achieved within New York City itself, as some Manhattan relocations to Queens and Brooklyn attest.

The stock of telecommuting and telework has risen since September 11. It was slowly rising, even before. As with video-conferencing, 9/11 has spurred a trend that was already evident. To the traditional advantages such as cost savings and added flexibility can now be added the fact that "with the threat of anthrax attacks...going to work at all (is) less appealing." And in an ironic technological twist, the "employee locator" software that was, six months ago, being rejected as too intrusive on private liberties, is now being touted as an emergency preparedness technology that makes it easier to find employees after an emergency. Taking this concept a step further, British writer Stephen Graham reports that the UK is considering creation of "a national ID card scheme utilizing smart card technologies which give the potential for real-time human tracking and locating."

Even if people's workplaces and residences are dispersed, and their shopping is done online, there will still be a need to gather, whether as tourists, conventioneers, sports, or corporate event attendees. Therefore, public facilities, especially the trophy tourist attractions like Seattle's Space Needle and major airports like Los Angeles (both reportedly targeted by terrorists) will be most at risk, as will popular gathering places like metropolitan subway tunnels, stadia and arenas, and major meeting facilities and events (such as the Oscar and Emmy award ceremonies).

For major office and public facility structures, the increasing price, or even unavailability, of terrorism insurance, is a current issue for owners. Organizations like the National Association of Real Estate Investment Trusts (NAREIT) are currently petitioning Congress to help them out by providing subsidies. It's reported that, at least in New York City, lack of such insurance will affect or is already affecting "deal flow." Many policies are reported to be coming up for renewal and renegotiation in June 2002.

While various technologies may enhance our security, technology may not have such a positive effect on real estate space markets, and those who make their living creating more structures. The Internet revolution has not been cancelled, just delayed.

In late 2001, a recession triggered by "fear of flying" negatively affected regions that have a heavy concentration of the aircraft and aviation industries and airline-related employment. Some but not all of these will rebound as they benefit from the major defense spending increases that Congress is expected to approve in 2002.

Added costs related to security will adversely affect industrial and distributive industry firms, more in built-up central areas of large cities than in suburban and ex-urban environments, and lower-profile, lower-tier cities. Tulsa, Kansas City, Boise, Raleigh-Durham, and Hartford are cited as examples of the types of cities that are likely to gain competitive advantage in the years ahead.

WILL TECHNOLOGY COME TO OUR RESCUE?

The cities of the future will be much more technology-loaded than those of the present; 9/11 accelerated this trend. While some developers and owners may benefit from some of these technology infusions, they may be a mixed blessing, and, overall, have negative consequences for real estate developers.

We're reading these days not only about the "spread," "decentralized," "strategic," "defensible" and "resilient" city, but also about the "smart" city, or, as one report described it, "the intelligent city that senses danger." Some of the components of such an intelligent city, which seems to mix Orwell's *1984* and RAND Corporation Strangeloveian fantasies, are closed circuit television (CCTV) cameras that might be able to "read" terrorist faces; smart reservoirs which could sense and report the presence of dangerous chemicals and perhaps also seal and shut themselves down; smart bricks equipped with sensors that could report bomb damage; BombCAD™ software that analyzes building designs for their likely explosion resistance. All this, in addition to increased attention to basic building security systems to protect individual structures.

While these technologies and others may enhance our security, technology may not have such a positive effect on real estate space markets and those who make their living creating more structures. The Internet revolution has not been cancelled, just delayed. Online retailing is becoming increasingly popular, though not all online retailers survived the late 90's shakeout. Use of the Internet in business processes, so-called e-business, or business-to-business (B2B) applications, makes it possible for office and manufacturing users to make do with less, to squeeze more efficiency out of existing space, and to operate effectively with distributed networks of facilities. In sum, even if the economy rebounds quickly, real estate recovery may lag behind.

SPRAWLING, BUT SMARTLY

The recent attention that has been paid to the values of urban living will lead, not to massive rebirth of central cities, but rather to increasingly innovative attempts to blend the best features of urban living into suburban and rural environments. Urban form takes shape slowly, even glacially; 9/11 events are one of many influences on it.

The debate has been joined between those who favor continuing decentralization and those who feel that the cultural, social, historical, and traditional values of major urban centers should be preserved. The center city preservers have marshaled comparative death counts, observing that more people die in suburban traffic accidents in a given year than perished in the World Trade Center disaster. Some, like planner Sam Casella, argue that scattered development does not necessarily offer more security, and call attention to the cost implications of a massive program of decentralization, and the economic advantages of face-to-face human interaction. They stress the longer term and indirect negative impacts of the suburban lifestyle, observing that it's our extreme auto and oil use that create vulnerability and dependency on Middle Eastern oil and the regimes that provide it.

Conversely, decentralization supporters advocate "smart growth" or "new urbanism" solutions, development with low density but also multi-use centers that reduce the need for auto trips. They argue that while, in the past, safety was enhanced by people gathering together in large numbers, in today's world, and with today's threats—chemical and biological as well as bombs—safety is enhanced by people spreading out and scattering, while retaining the ability to communicate with one another by phone and Internet, radio, and TV.

Harvard economists Glaeser and Shapiro have concluded, in a recent article, that effects of the September 11 terrorism on American urban form are likely to be minimal. Urban form is the sum of vast amounts of in-place building stock and infrastructure. It changes slowly, perhaps even glacially, and is moved in one direction or another by a number of long-term and short-term forces. Terrorism is just one more in a long list of these forces—and even its impacts are multi-directional.

SKYSCRAPERS: HOW TALL IS TOO TALL?

September 11 led to a great deal of debate on the future of skyscrapers. The questions remain unresolved, though analysts agree that values of trophy skyscrapers may decline.

Another controversial thread in the discourse is the "end of the skyscraper" debate. In an article written in late September, James Howard Kunstler and Nikos Salingaros argued that in the aftermath of September 11, the skyscraper was "an experimental building topology that failed," citing its wind shear and fire hazard aspects, among other faults. California writer Joel Kotkin, on the other hand, says it's very much an American non-issue, since no American city other than Charlotte, NC, added significantly to its skyline during the '90s. (This contrasts, of course, with the situation in cities like Kuala Lumpur, Malaysia, and Shanghai, where major megastructures were completed during the decade.)

It seems to be agreed that prospective tenants will now see less prestige and more risk in what had been previously regarded as a high prestige, high-rent building. However, there is less agreement on the question of how tall is too tall, or on whether tall is the problem or tall plus something else. Recent memos from the Al-Qaeda network, in fact, suggest that they regard "sentimental or symbolic value" as a targeting criterion—so that London's Big Ben, or the Golden Gate Bridge, or other low-rise landmarks would be equally or more at risk. As Neal Peirce noted, "any successful urban building that makes a statement—economic, civic or artistic—may attract terrorist attack." The result could be, to quote British writer Stephen Graham, more "featureless, generic urban landscapes," with "relatively anonymous, low-level, fortressed business spaces that are heavily networked by multiple data infrastructures."

In any case, it is clear that major office buildings and complexes will be with us for the foreseeable future, though perhaps valued less highly and somewhat differently than before 9/11. However, office supply and leasing trends play out slowly, at the margin, as leases expire, in large quantities of in-place stock.

THROUGH THE FUTURE TO THE PAST: A NEW MEDIEVALISM?

It may be important or desirable to open up cities and let them breathe. This can take the form of gradual inner-city deconstruction or metropolitan decentralization.

Finally, some analysts are noting that gradual, as opposed to cataclysmic, deconstruction of some dense inner city environments can be a "good thing." The demolition of monster public housing projects, like St. Louis's Pruitt Igoe, provides one example of the move toward opening up and rebuilding neighborhoods at more human scale. Another example is provided by the Deconstruction Enterprise initiative of the Washington-based Institute for Local Self-Reliance, which sponsors demonstration projects and training to show inner-city residents how to create small businesses and jobs by recycling and reusing materials from salvage and deconstruction projects.

Writers like Steven Johnson and Dan Glover have pointed out that this destruction of towers and other dense development, to open up cities and let them breathe, has its roots deep in urban history, citing the example of Bologna, Italy in the 1300s, where towers were toppled to good effect after 200 years of high-density civilization. They note that this, together with the upsurge of community-level neighborliness that others have noted, could be the beginning of a "new new urbanism" or a human-scale "new medievalism."

Johnson cites as a model the distributed density of the hill towns of northern Italy, suggesting that relatively more secure major cities of 2 million or more could be formed as a network of smaller, loosely integrated multi-use nodes of 50,000–100,000 persons each. In one sense, the model may be medieval, but in other respects it mirrors the island-wide new town strategy of the post-modern city-state of Singapore.

While all skyscrapers as a class may not be obsolete, selective downsizing to remove some instances of "megastructure blight" may be in order, as well as planning for more human scale structures in the next round of center city development.

SUMMARY & CONCLUSIONS

The short-term negative effects of 9/11 have been rather localized, affecting real estate development and management in a relatively small number of cities and metropolitan areas—most notably New York and Las Vegas. Tourism- and aviation-related properties have been affected negatively. Some symbolically important trophy properties have suffered declines in value.

September 11 caused the acceleration of some trends that had been slowly gathering force and momentum before the events of that date. Telework, online shopping and video-conferencing gained in popularity. This has had negative consequences for traditional forms of officing, shopping, and meeting, but has benefited developers and owners who have been able to provide or tailor facilities to serve these new types of activity.

From the perspective of "six months later," much of the American real estate community has returned to business as usual, with buildings' functionality more important than their images, and added costs of operation being factored into values and calculations of rates of return.

The recent attention that has been paid to the values of urban living will lead, not to massive rebirth of central cities, but rather to increasingly innovative attempts to blend the best features of urban living into suburban and rural environments. To quote San Jose's Dan Gillmor, "Emerging technology will help bring virtually all of what makes cities great to smaller places where people can live more sanely, not to mention more safely." REI

AN INTRODUCTION TO STRATEGIC FACILITIES PLANNING

by John R. Glagola

WHAT IS STRATEGIC FACILITIES PLANNING?

For many corporations and organizations, the first reaction to any perceived facilities need is to hire an architect or a design-build contractor. However, the design skills that architects offer are only one factor in creating wise, cost-effective, and long-term facilities solutions. Design and construction are expensive acts of execution; major expenses—and major mistakes—can be avoided by starting with the most fundamental steps of planning and following them in sequence, making certain that all of the right questions are asked. More often than not, the needs and answers that initially seem obvious often miss the real opportunities. In actuality, a corporation's needs for facilities begin long before they actually consider constructing new buildings, and in fact are driven by the corporation's specific, unique business needs. Strategic facilities planning can address these needs. This discipline, comprised of planners and architects dedicated to delivering customized sets of applicable processes and methodologies, has grown at many firms to include the input of social scientists, MBA graduates, real estate experts, and data managers. When successfully undertaken, strategic facilities planning designs are integrated, comprehensive, transparent processes and introduce each discipline of specialized expertise at the appropriate moment, and position corporations to better develop, produce, and deliver their products, whatever and wherever they may be.

Effective strategic facilities planning methods align the business needs of a corporation with its physical needs, thus working to ensure that a corporation's facilities actively strive to support the company's business mission, rather than hinder their goals. These plans are also flexible and living documents, appropriate and applicable to both immediate and

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long-term facilities goals. They address overlapping needs and potential shared capacities, and are by definition proactive. An effective strategic facilities plan includes data and recommendations to guide companies through relocations, consolidations, downsizing, mergers and acquisitions, new construction and renovations, site and facility selection, and contractual real estate decisions. In short, they are a vital and often under-used tool available to today's business leaders seeking to better manage and grow their companies.

HOW IS A STRATEGIC FACILITIES PLAN ACCOMPLISHED?

Facilities planning recognizes that every business plan decision has a direct impact on a corporation's real estate assets and needs. The mission of the plan, therefore, is to develop an implementable, adaptable real estate plan based upon the specific and unique considerations of the individual business. This mission is accomplished by a step-by-step process of understanding, analysis, planning, and acting.

Planners begin to develop the strategic facilities plan by understanding the needs of the client's business, building on whatever internal analysis an institution has already completed itself or with other consultants, and define the corporation's short-, mid-, and long-term goals, considering the range of their products and services, and learning about their goals, limitations, and opportunities. The work planners do for a client is entirely dependent upon these specific needs, and should address both strategic and long-range planning, and, conversely, the evaluation of current facilities and the conceptualization, planning, and implementation of new facilities, depending on their requirements. Most commonly, strategic plans provide a combination and range of services, as required by the client to maximize the value of their assets. The team considers such factors as the current position of the business and its current real estate asset base, its overall direction and the projects currently underway within the company, how the business may change, and how those changes may affect the real estate needs of the corporation.

Once these questions are answered, the planners and designers can then take a business-driven approach to analyzing the company's facilities that sets tangible goals and planned targets. Often, corporations take a cost-driven approach to their facilities, which although quick to implement and often cost-effective, is nevertheless lacking in vision, fails

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to address the actual delivery of the business's goods and/or services, and has only a moderate long-term impact on improving the overall performance of the business as a whole.

In contrast, a business-driven approach, despite necessitating a more deliberate time frame, delivers a clear vision for the future, earns employee support, and strengthens the business competitively and enhances performance. Using this approach, the planners study the real estate assets the corporation currently holds using gathered data, modeling tools, and scenario alternatives. This data often includes lease and ownership data, building assessments, square footages, space utilization standards, and location characteristics.

Following these steps, the team explores the various business goals of each unit in the business, and integrates these goals into the facility plan portfolio. This defines future space and real estate needs based on overall corporate goals, starting with anticipated services, expected staffing changes, and potential new technologies. The team uses these needs to predict future headcounts, demographics, space utilization, maintenance, and capital and operating costs.

Once a clear definition of the business's situation has been established, the planners and designers begin to consider how to balance current facility needs with long-term needs and issues. These needs and issues may include workforce demographics, manufacturing processes, structure organization, community and government relationships and requirements, market position, and capacity rates and volumes. All of these forces combine to define the individual elements of the strategic facilities plan.

The final product of this process is not an inflexible document, but an insight into how different decisions will affect the client's return on investment, cash flow, debt load, and work processes. The plan is a single, living document that reports its findings and makes concise recommendations for implementing the results of the plan within a realistic time frame.

CASE STUDY

A specific example of an effective strategic plan involves work undertaken for one of the Big Three American Automakers. This company, burdened with a codified and unresponsive hierarchical structure, used a strategic facilities plan to spark change throughout the company. Management identified their operational goals as optimizing workflow, especially within particular product development groups, increasing creative teamwork throughout the organization, achieving the highest possible return-on-net-assets (RONA), and the implementation of common systems and processes to foster maximum efficiency and speed.

The project team partnered with the client's strategic facilities planning team to establish an ongoing strategic facilities planning activity directed at reaching these goals. The team's work included:

- A situation analysis that identifies available base data on current space use and building conditions, facilities costs, and related financial accounting and planning processes and facilities planning and management systems, procedures, and staff organization.
- Identification of key influences on the corporation's business, such as product times to market, brand identity, employee satisfaction, RONA, and how facilities link with these business issues.
- Long-range business and facilities strategic visioning, including evaluation of alternative location scenarios based on business needs, regional demographics, costs, identity, labor, community, and other drivers.
- Development of common definitions and metrics for space measurement and creation of a graphic and numeric database of information comprised of existing space use by type and business unit.
- Calculation of actual space used by function and space utilization efficiency.
- Strategic oversight of development of new workplace standards.
- Site framework master planning for several sites in several cities.

Based upon these recommendations, the company divested in certain real estate assets while they chose to invest more heavily in others. Perhaps the greatest advantage in this particular case was that the company was able to consolidate various and diverse work groups in greater concentrations, facilitating communication and interaction among the different groups, and greatly reducing the "fiefdom" mentality that had existed in the far-flung and inflexible facilities arrangement.

Ultimately, the plan resulted in smarter engineering and a more streamlined corporation. The plan also helped the company with such bottom-line factors as managing structural costs, eliminating facilities redundancies, and creating facility adjacencies.

Work continues towards aligning the company's facilities strategies with its facilities planning. Perhaps most significant to the client are the benefits incurred from bringing together their diverse business units to discuss strategic facilities issues and macroprograms. These sessions have become a forum for interchange of business planning ideas to move the company's future vision forward.

In today's business environment, change is the only constant: new channels, competitors, and business models are emerging, the balance of power is invariably shifting toward customers, and the pace of business is accelerating exponentially. Amidst this turbulence, companies need strategies for their real estate assets that will help them simultaneously manage their growth and provide for the present. Strategic facilities planning, by aligning a business's real estate assets with its corporate mission, can help today's corporations maximize agility, increase their return on investment, and ultimately help position the company to better compete and deliver its products and services, regardless of its business. REI

Lawyer-Broker Collaboration in Commercial Real Estate Lease Transactions

by Gary L. Lozoff & Shelby R. Lozoff, CRE

A sea change has occurred over the last 15 years in the approach to real estate taken by large, publicly owned businesses in the United States. Companies with large-scale needs for office and industrial real estate have generally shifted from owners and operators to tenants of such properties.

Many factors drive a decision whether to own or rent real estate. The chief reasons to rent include the decision to use working capital in the company's primary business and the long-term flexibility of leasing rather than owning an illiquid asset. Publicly owned firms in particular, with the discipline of the public capital markets to maximize current earnings, often find sale-leaseback transactions advantageous for corporate-owned real estate, and seek leasing opportunities to satisfy additional real estate requirements. Unfavorable federal tax laws concerning depreciation of improvements to real estate are another factor.

Some large companies devote sophisticated internal resources to the company's real estate requirements. These include staffing real estate departments for the site selection, leasing, acquisition/disposition, and management of the company's real estate needs. Many other companies, however, especially those with relatively static real estate requirements, do not have experienced internal real estate professionals. Those

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companies instead rely heavily upon their commercial real estate brokers, consultants, and attorneys as the company makes the relatively rare (and usually anxious) steps into the "minefield" of a commercial real estate lease transactions.

How can real estate brokers and transaction attorneys work together at the outset of the process to better serve the goals of their shared clients? The authors offer the following guidelines for attorneys and brokers representing tenants in user-based corporate real estate transactions.

KNOW THE CLIENT—KNOW THE DEAL

To best serve our shared clients, we must strive to know their normal business operations—and their expectations arising from the proposed real estate transaction. But rarely does the typical terms sheet or letter of intent for a commercial lease transaction reflect a complete understanding of the nexus between the new space requirements and the client's normal business operations. For example, if the client's sales or inventory build is seasonal, or if the space is to be filled with inventory with exotic or unpredictable sourcing, project delivery lock-out periods have to be negotiated into the transaction. Sufficient leverage should be supplied to cause the space to be delivered during the period of time that best corresponds with the user's capacity (and willingness) to absorb the new location.

An out-of-cycle delivery of the real estate can not only create unusual (and generally avoidable) disruption in the user's business operations, it can threaten one or more of the essential economic assumptions on which these transactions are advocated to senior management of the company. That is, of course, unless the broker, attorney and client, collaboratively rather than antagonistically, develop program requirements well in advance of the site selection and lease negotiation processes. This approach emphasizes the shared understanding of how the real estate transaction harmonizes with the tactical and strategic goals of the company.

IMPORTANT ISSUES

Material issues to be discussed and evaluated by the team before the lease negotiations include, among others, the following:

- **Development Risks** — Is the project new construction? If so, the client will require a candid and complete assessment of practical risks of the land development process. These include special zoning, building and fire safety, environmental, sewage and other permitting issues or, more unusually, risks attendant to proposed phased delivery of the improvements or risks inherent in developing a project located in multiple jurisdictions. This assessment should be made regardless of whether the client's manager assigned to the real estate project understands this at the outset of the process.

- **Identity of the Landlord** — Record ownership of existing office and industrial property inventory and equitable ownership of prime development sites often are held by special-purpose entities that are affiliated with large, well-capitalized real estate companies. As such, the user should determine early in the process whether an unconditional guaranty from a "net worth" affiliate of the landlord is prudent to assure timely, complete performance of the landlord's construction obligations—all within budget.

- **Special Building Requirements** — All of the user's representatives, including its attorneys, brokers, architects, and engineers, need to be fully informed of the company's unique spatial and fit-up requirements for the project, such as clear floor height, HVAC and project security systems, 24/7 vehicular and pedestrian access, telecommunications, lighting, vehicle loading and parking facilities, special sanitary sewage, and toxic waste disposal. Will the architects or engineers be engaged by the client or the landlord? This can be a major issue, particularly, regarding the duty and loyalty of these professionals.

- **Signage** — Significant (and unusual) signage requirements are often present in large-space office and industrial lease negotiations. We underestimate our clients' commitment to promote their corporate identities on-site at our mutual peril. The user's broker and legal team should coordinate their efforts to ascertain the client's signage requirements as soon as practicable in the process—if only to obtain a relatively painless concession by the landlord to satisfy these requirements. Of course, quite often the landlord is powerless in this matter, as the municipality's signage requirements can be onerous and require a long lead time to complete (including frequent resort to an appeal process).

- **Project Plans and Specifications** — If the project's plans and specifications are not to be agreed upon at the time the lease is delivered by the parties, a fair, understandable, and responsive process for review and approval of the project plans and specifications should be in included in the lease, and agreed upon early in the lease negotiation process. In addition, the effect of change orders on the basic rent structure, whether proposed by the landlord or the tenant, should also be determined early in the negotiation process. Recommend that the client engage a qualified construction or design representative to review the construction plans, specifications, and contracts, and to represent the client throughout the construction process.

- **Size of the Premises** — The economic return to the landlord is pegged to the area of the space being rented. The prudent user should require independent verification of the area of the leased space to be performed by a licensed professional in accordance with an agreed upon, objective written standard of measurement, such as the Standard Method for Measuring Floor Areas in Office Buildings approved June 7, 1996, by the American National Standards Institute, Inc. and the Building Owners and Managers Association International. The lease should permit adjustment of the basic rent and proportionate share attributable to such space (for computing the user's liability for its share of common area maintenance costs and real estate taxes assessed against the project), all in accordance with such as-built measurement.

- **Delivery Dates** — As discussed in the example above, a determination should be made about when the user requires delivery of the space, and whether phased delivery of portions of the project is sensible given the project timetable and the company's fit-up and use requirements. Due consideration in the early negotiations should be given to the economic and other consequences of a delay in the project's completion, whether caused by the tenant or developer, or arising from *force majeure*.

- **Common Area Maintenance and Real Estate Taxes** — Corporate users are sometimes reluctant to negotiate late in the deal over such points as exclusions from or limitations on the landlord's common area maintenance charges and real estate taxes assessed against the site, or audit rights and consequences pertaining to such charges or taxes. The best way to deal with this predisposition is to resolve early in the lease negotiations the limitations/exclusions, audit rights, right to contest tax assessments for which the tenant is contractually liable under the lease, and consequences of overpayment.

For the commercial real estate broker and transaction attorney alike, their engagement on behalf of corporate users of real estate is different in many important aspects from their work undertaken on behalf of sophisticated real estate companies or corporate users with large internal real estate groups. An important difference lies in the extent to which the client must be educated about the basic limitations—and opportunities—the leasehold relationship present to the user of the property.

- **Lease Term** — Companies that only occasionally transact in real estate generally require some schooling on the range of realistic alternatives for the length of the lease term. In addition, these users are rarely attuned to the range of preferences to extend the term, expand the leased premises, or purchase the project. These preferences, when applied to term extension, expansion of the premises, or purchase of the property, include a firm option, a right of first offer, or a right of first refusal.

- **Alterations/Assignment and Subletting** — The mantra from our user clients on these related issues typically is "we're not going to let the landlord control our business." As such, every significant lease negotiation includes substantial discussion on the permitted scope of tenant alterations to the building and the conditions under which removal of these improvements is required upon surrender of the leased premises at the end of the term. These negotiations also include what has become a major item for most companies—permitted corporate transfers. Regardless of the size or complexity of the underlying real estate transaction, users uniformly require the discretion to engage in "change of control" or "going public" transactions without interference from institutional or other landlords. Because of the comparative importance of this issue to our mutual clients, brokers and attorneys should strive to learn of any landlord resistance on this point during the initial phase of the negotiations, and communicate any obstacles to their client.

- **Broker's Compensation** — Experienced practitioners' reports from the field on this issue read like war stories with the user (or broker) as the ultimate victim. The corporate user typically presents the prospective real estate transaction to the attorneys, along with a general economic arrangement in place between the company and the broker. The broker and user (we hope with the assistance of counsel) then must complete the documentation that reflects all of the terms of the business deal. Concurrently, with the commencement of active lease negotiations, (rather than after eight hours of deliberation at the lease signing event, for example), the broker, user, landlord, and user's attorney should complete a simple written recognition agreement to cap this needlessly combustible issue, unless it has been previously agreed upon. Commercial real estate brokers often act as a "tenant representative" and usually are compensated by the landlord, unless initially agreed to be compensated by the client.

- **Lease Subordination** — The standard landlord-form lease subordination provision is unacceptable for most tenants. Large-space users and their landlords often agree, in the alternative, that subordination of the lease is conditioned upon the existing and any future mortgage holders' (and ground lessors') agreement not to disturb possession, absent a continuing tenant default. The form of this separate agreement, known as an SNDA, should not be left to negotiate until after the lease is signed.

- **Waiver of Landlord's Lien** — In many jurisdictions, a superior statutory lien on the tenant's personal property located on-site is granted to the landlord. As such, if the tenant intends to institutionally finance inventory, equipment, or other personal property to be stored or used at the leased property and its lender requires a first priority lien over such items, the landlord will be asked to waive (or subordinate) the statutory as well as any contractual liens on this personal property. Don't count on the landlord's beneficence in granting such a request absent, of course, an express agreement to do the same contained in the lease.

- **Landlord's Default** — Should the tenant be permitted to engage in self-help (with the ancillary right of set-off against next rents due) for a continuing default of the landlord? This is a simple, and often provocative, question raised during traditional lease (as distinguished from synthetic lease) negotiations. Based on our experience in lease negotiations, this question has a reasonable probability of being favorably resolved for the user in the lease only if raised *before* the landlord perceives the tenant has committed to the overall transaction.

- **Estoppels** — The typical form lease obligates the tenant (but not the landlord) to deliver a written statement, upon request from the other party, confirming certain factual information pertaining to the lease and disclosing any known defaults of the requesting party. The tenant's need, from time to time, to obtain this statement from the landlord is equally important and useful, especially in larger corporate financing or transfer transactions. Accordingly, this obligation should be made mutual in the lease.

WHAT TO AVOID

For the commercial real estate broker and transaction attorney alike, their engagement on behalf of corporate users of real estate is different in many important aspects from their work undertaken on behalf of sophisticated real estate companies or corporate users with large internal real estate groups.

An important difference lies in the extent to which the client must be educated about the basic limitations—and opportunities—the leasehold relationship present to the user of the property. As such, all of us intuitively know what to avoid in these representations—that is, anything less than an unconditional mutual commitment:

1. To inform the client about the effects of each contingency upon the prospective user's expectations of the underlying business deal; and
2. To assure that the final bargain struck between the parties is reflected accurately in the documents.

Both are more effectively achieved when commercial real estate brokers, transaction attorneys, and their clients communicate candidly and analytically from the outset of the site selection process about the transaction at hand.$_{\text{REI}}$

NOTE

The article above is an adaptation of an article appearing in American Lawyer Media publications: *The Legal Intelligencer* and *Commercial Leasing Law*.

THE INSURANCE INDUSTRY AFTER 9/11: PLANNING FOR THE FUTURE

by Frank Caruso

Throughout the insurance industry, it is ***not*** business as usual. The attacks on the World Trade Center on September 11, 2001, sent shock waves through society and the business community that will significantly impact the availability and cost of insurance for years to come. An in-depth analysis of the consequences of these events and the resulting market will hopefully enable consumers to more accurately anticipate, plan, and budget for insurance costs.

PRE–SEPTEMBER 11, 2001

Prior to September 11, the insurance industry was heading into a "hard" (as opposed to "soft") market cycle. During the mid-1990s, insurance providers were aggressively writing and pricing business so that premium income could be invested in the financial markets. Underwriting profits were not as important as bottom-line results. In 2000, as investment income disappeared and the flow of loss activity continued, underwriters realized that if they were to survive they needed to adjust their pricing upward, restrict coverage terms, and cancel those accounts that were unprofitable. Many insurers were counting on 2001 as the beginning of a return to normalcy.

In the Tennessee/Kentucky region, we were beginning to feel these exact changes. Rates were increasing, primarily based on the class of

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business, the loss history, and the line of coverage. A 15 percent to 20 percent increase was not out of the norm. We saw several accounts with poor claims experience and severe exposure experience premium increases of 50 percent or more. Non-renewal notices began showing up more frequently than anticipated. Workers Compensation Insurance led the way for most carriers to take the appropriate underwriting action in order to maximize rates. Pre-9/11/01, the hard market had arrived, but it was a gradual build up of price increases and changing terms and conditions. Many underwriters still listened to the agents' case and made some attempts to adjust their own positions.

THE TRAGEDY OF SEPTEMBER 11

September 11, 2001, was a loss no one could conceive. As of March 2002, cost estimates ranged from $30 billion to $72 billion. As noted by Morgan Stanley, it will be the largest workers compensation loss in history (by multiples); the most expensive aviation disaster in history (by multiples); one of the largest property losses in history; the most expensive business interruption loss in history (by multiples); the largest life insurance catastrophe loss in history (by multiples); and potentially one of the largest liability claims in history. In insurance circles, this is referred to as a "clash" event – where multiple losses, in different lines of coverage, arise from the same underlying cause. Clash events are outside of an insurance carrier's normal actuarial assessment of its aggregate loss exposures, so the catastrophic impact is exponential.

According to *Business Insurance* magazine, the financial shock will leave most insurers and reinsurers damaged, but solvent. The extent of financial damage will depend on the ultimate industry-wide loss. As this number increases, greater is the risk of insolvencies. According to Standard & Poors, however, the industry likely has the capability to manage itself out of the problem. Should the costs rise above $50 billion, the outlook would indeed change with regard to the solvency of insurers.

One of the problems that will grow as losses escalate is unrecoverable reinsurance, though it should not prove crippling for most insurers. At the very least, insurers may face delays on reinsurance recoveries as disputes arise over coverage terms. Now brewing is the debate over whether each plane that crashed into the World Trade Center constitutes a separate loss occurrence. Combined, the towers had insurance limits of $3.5 billion, however each 9/11 occurrence on the actual building complex coupled with property loss is being estimated at over $10 billion. Therefore, resolution of issues such as this will be critical to the industry's financial well-being. As the size of the loss grows, these disputes will grow. For some reinsurers, the resolution will determine their business survival.

The current major concern is the possibility of another terrorist attack or a natural calamity such as an earthquake, hurricane, or flood. The insurance industry's financial resources are finite and the impact of September 11 has hit carriers' balance sheets hard.

WHAT DOES ALL THIS MEAN?

- Reinsurance capacity will shrink significantly. Retail carriers will buy from only the most credit-worthy reinsurers. Their "approved" list will be shorter and scrutinized more regularly. At the same time, fear and greater recognition of higher risk factors will result in reinsurers being less willing to assume and retain certain types of risk. Additionally, capital markets will only be willing to reinvest their money in the large and financially strong reinsurers, thereby drying up the capacity previously provided by the mid- and smaller-sized reinsurers.

- Pricing will rise significantly. Hank Greenburg, chairman and CEO of American International Group (AIG), warns that insurance buyers can expect to see rates "going up by leaps and bounds." Premium increase estimates are now predicted to range from 15 percent—30 percent or even higher depending on risk factors and loss experience. In specialty lines such as earthquake insurance, directors and officers liability and workers compensation costs could soar by 50 percent—75 percent because:

    1. Underwriters are now fearful of new types of risks and larger potential losses.
    2. The amount of premium that is required to support insurance risk is greater than previously understood. Add to this skyrocketing reinsurance costs.
    3. The industry's liquidity needs are also greater than previously envisioned. Investors and stockholders are demanding profitable underwriting results and greater than the historical three percent return on their investment.

The interaction of supply, demand, and price will be dramatic.

- Insurance carriers are re-evaluating and re-pricing their catastrophic loss exposures in earthquake, flood, and hurricane zones as well as in high-risk operations or products. Already some carriers have either withdrawn from the market or cut back their limits and increased their pricing. Depending on what happens with reinsurance renewals in 2002, insurance consumers may not be able to purchase limits or coverage enhancements maintained previously.

  This year, expect to receive "Notices of Non-Renewal," 60- to 90-days before policy expirations. Even though carriers may be willing to renew coverage, they will issue these letters to avoid regulatory renewal restrictions such as capping premium increases at 25 percent.

- More coverage restrictions will be imposed and greater underwriting focus will be instituted. In a soft market, underwriters attempt to attract business by offering broad coverage terms and high limits without asking many questions. This has now changed. Here are some examples:

  - *We expect reinsurers will exclude terrorism coverage in their 2002 renewals.* The concept of a federally-backed reinsurance pool for terrorism and war risk-related losses has positive support throughout the insurance industry and within the government. Nothing has been solidified yet, but it appears that there will be a vehicle created to protect business and property owners against such risks.
  - *Underwriters will be cautious about writing risks with a high concentration of property values.* Probable Maximum Loss (PML) and Maximum Foreseeable Loss (MFL) estimates are no longer credible to underwriters. For example, in the case of the World Trade Center, the PML was around five percent and the MFL was about 20 percent.
  - *Property replacement cost values and loss of income estimates must be verified.* In many cases, underwriters will require some form of property appraisal or business income worksheet to make certain the risks they write are insured to their full insurable value.
  - *Blanket limits may no longer be offered.* This feature historically has provided clients a great deal of protection from under-reported values but has exposed carriers to losses far greater than they had anticipated.
  - *Deductibles will increase.* Not too many years ago a $100 deductible was the norm. In recent years this increased to $1,000. We now expect underwriters will request $5,000 or $10,000 *minimum* deductibles. Applications now must provide far greater detail as to the ownership, operations, and exposures of a risk. Five-year "hard copy" loss runs must be provided prior to binding.
  - *Carriers will entertain new business but may refuse to quote if they feel the account is being shopped.* Adequate lead time will be necessary for their loss control consultant to do an underwriting inspection *before* they release their quote.
  - *Carriers will demand loss control commitments from clients.* They will non-renew accounts who fail to curtail unsafe operations or exposures.

... it is no longer business as usual and the industry is now fighting to preserve its financial integrity. No one expects a quick fix.

- Distribution channels will be restricted. With their limited capacity, carriers will cut back the number of brokers with whom they will do business. This will benefit an organization such as Gallagher but will seriously hurt smaller local brokers.

- Rating agencies such as A.M. Best and Standard & Poors will closely monitor the financial performance and liquidity of insurance carriers and there will be a number of downgrades. Lenders and others will also pay close attention to these changes, as it may affect their loan security or contractual provisions. Ideally, they will be understanding of current market conditions.

CONCLUSION

This author has been in the insurance business for more than 25 years and has seen soft and hard markets come and go. However, it is no longer business as usual and the industry is now fighting to preserve its financial integrity. No one expects a quick fix.

While there may not be much good news right now in the insurance industry, the author's hope is that this information will provide better insight as to what has or will be changing and the reasons why. REI

Hidden Treasures & Hidden Traps:

A New Meaning to Due Diligence After January 2002 & How to Make the Most of the Bottom-Line Benefits of Brownfield Tax Treatment & Accounting

by Bruce A. Keyes

For Sale: 2000 gallons of paint - various colors.
Will throw in six acres of land for free...

The brownfield laws enacted during the last decade are not enough to make this an appealing offer to any but the most daring or determined. In fact, very few people ever find themselves choosing to be involved in a transaction involving a poster property for the brownfield cause. Nevertheless, the widespread impact from a number of brownfield laws may also benefit even the most mundane transactions.

This article discusses two issues of interest to anyone involved in acquiring or managing real estate:

1. Why does federal brownfields' legislation enacted on January 11, 2002, require more due diligence to discover and disclose environmental liabilities on property? Will it lead to greater corporate disclosure obligations in the wake of Enron and SEC Regulation FD?

2. When there is something to disclose, a few often overlooked brownfield tricks-of-the-trade can bring real value to the bottom line:

ABOUT THE AUTHOR

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(Continued on page 27)

- A benefit for the buyer—the rare instance when the IRS will let you treat environmental cleanup expenses on a newly acquired property as a deduction.

- Enjoying a one- to two-year reduction in the annual property tax assessment of a property.

- If share price is a concern, cost-effective remediation can remove an environmental liability and better the bottom line for shareholders to see.

PART 1: TELLING ALL - WHY Enron IS THE MIDDLE NAME OF ENviRONmental DISCLOSURE AND THE BROWNFIELDS REVITALIZATION ACT OF 2001

The meaning of due diligence in real estate transactions will change as a result of the Small Business Liability Relief and Brownfields Revitalization Act ("Brownfields Act") that went into effect on January 11, 2002

The Brownfields Act is part hype, part ripe. But when the dust settles, there are a few provisions that may significantly affect the way we do business.

For the most part, the Brownfields Act will have only subtle effects on the real estate world since much of the Brownfields Act embodies existing policy, with many of the provisions applying to only the most contaminated of properties. However, by amending the Superfund law (formally known as CERCLA, or the Comprehensive Environmental Response, Compensation and Liability Act) the Brownfields Act is likely to change the meaning of due diligence in every real estate transaction.

Section 223 of the Brownfields Act clarifies the standards and practices for conducting "all appropriate inquiry" in order to be protected by an innocent owner defense under federal CERCLA law (and likely under state laws, by extension). In general, the new law recognizes the common 1997 standard for Phase I site investigations, known as the American Society for Testing and Materials ("ASTM") Standard E1527 – 97 (1997). Parties to a due diligence review are likely to be using the more expansive ASTM Standard E1527 – 00 (2000), which contemplates an evaluation by the environmental professional of "business environmental risk" in the context of the commercial real estate transaction and requires greater detail as to potential risks that are not being evaluated within the scope of services.

The Brownfields Act is part hype, part ripe. But when the dust settles, there are a few provisions that may significantly affect the way we do business.

Both ASTM 1527 standards require the identification of "Recognized Environmental Conditions." Notably, however, the 2000 standard relies upon a greater degree of environmental professional judgment, and would allow some risks to be characterized solely as a "Historical Recognized Environmental Condition," which may or may not (in the professional's judgment) impact a property. Likewise, the 2000 standard would allow some conditions to be excluded from Recognized Environmental Conditions because they are only de minimis. Until the difference between the standards mandated by the Brownfields Act and the ASTM Standard E-1527-00 (2000) has been reconciled, parties conducting due diligence may wish to use the 2000 standard, but specifically require an identification and discussion of any historical and de minimis matters that would constitute Recognized Environmental Conditions under the 1997 standard.

The real changes to due diligence could come about, within two years, once the EPA satisfies its obligation to establish standards and practices for conducting "all appropriate inquiry" and as the changes work their way into the related state programs. "All appropriate inquiry" will include a review of matters such as chain of title, building department records, the relationship of the purchase price to the value of the property, specialized knowledge that the purchaser may have, and the results of an inquiry by an environmental professional.[1] Failure to conduct this level of due diligence may deprive an owner of an innocent purchaser defense. Purchasers should also be aware, however, of continuing obligations they will have after acquiring property in order to preserve the innocent owner protection. These obligations include complying with information requests, providing access to persons authorized to undertake cleanup, actions and complying with land use restrictions and institutional controls. In most cases, these obligations already exist where a cleanup has been undertaken.[2]

The Enron Connection

For publicly traded companies, SEC requirements have been increasingly strict about disclosing environmental liabilities associated with real estate you own. In January 2000, the Securities and Exchange Commission proposed a new Item 302(c) to Regulation S-K regarding Supplementary Financial Information (Release Nos. 33-7793; 34-42354). The proposed rule would provide investors with more transparent and better-detailed disclosures concerning changes in valuation of long-lived assets, including real estate and applying, in particular, to environmental impairments. This rule has not moved into final form. Nevertheless, in October 2001, the U.S. EPA Office of Regulatory Enforcement issued an Enforcement Alert (EPA 300-N-01-008) highlighting environmental disclosure requirements under SEC Regulation S-K.

More recently, in the wake of the Enron collapse and the SEC's October 23, 2000, fair disclosure rule, (Regulation FD), investor's are demanding heightened transparency in corporate disclosures. The trend is clearly toward increasing disclosure of known liabilities and the Brownfields Act may set a new standard for knowledge—because it takes into account factors such as a below market price paid for real estate and legislates minimum requirements for "appropriate inquiry."

PART 2: GETTING BOTTOM-LINE BENEFITS FROM DISCLOSURE

In a recent transaction, due diligence disclosed that a property our client was to acquire had 2000 gallons of paint stored underground—in the soil and groundwater. Facing a cleanup costing around $1.2 Million, we were able to secure a combination of grants, tax credits, and TIF funding to cover the majority of the costs. However, these funds were available because we represented the innocent purchaser—very few programs are available to the current owner of property. Furthermore, grant funds often have difficult strings attached or may be otherwise unavailable for a particular project.

Whether you own or are purchasing real estate, one of the most overlooked sources for improving the bottom line of a project relates to tax treatment. If you have disclosed environmental liabilities associated with a property you own or if you think you may spend a few thousand dollars or more in the coming year on environmental issues related to a piece of real estate that you may purchase or currently own, you should consider the following strategies:

- When are you eligible to treat environmental cleanup expenses as a deduction?
- If a property is to be cleaned up in conjunction with a sale, who receives the tax benefit of the cleanup?
- Can you enjoy a one- to two-year reduction in the annual property tax assessment of a property?
- If share price is a concern, is it cost effective to clean up a property, and remove an environmental liability, thus bettering the bottom line for shareholders to see?

These strategies, discussed in detail below, are generally simple to implement. However, timing is often critical and the benefits will vary based on your particular circumstances. Evaluating the benefits and consequences of these strategies for your circumstances should be done in consultation with counsel.

When you are eligible to treat environmental cleanup expenses as a deduction.

A 1994 IRS ruling allows property owners who caused contamination on their property to deduct their environmental cleanup costs as a current expense, on the premise that these cleanup costs are considered to be repairs to the property. This deduction may also be allowed where contamination is discovered after taking ownership, when the cause of the contamination is unclear.

If you purchase a contaminated property, you will generally be required to capitalize the cleanup costs and depreciate them over the life of the property. That is, remediation expenditures generally must be added to the cost of the taxpayer's land acquisition (*i.e.,* basis) and often cannot be fully recovered for tax purposes until the land is sold.

The Brownfield Tax Incentive, Section 198 of the Internal Revenue Code, overrides capitalization requirements and allows a current deduction that can be used to offset other current income or result in a net operating loss.

Who Qualifies? The Brownfields Tax Incentive, created in 1997 and significantly expanded in December 2000, now applies to expenditures incurred between December 22, 2000, and December 31, 2003. In order to qualify under the expanded Brownfields Tax Incentive, there must have been a release, or threat of release, of a hazardous substance. Properties contaminated or threatened solely by a release of petroleum products (gasoline, diesel, heating oil, etc.) do not qualify. However, properties contaminated or threatened by a mixture of petroleum products and other hazardous substances may still qualify for the Brownfields Tax Incentive. Also, the property must not be listed on, or be proposed for listing on, the Environmental Protection Agency's National Priorities List (NPL or Superfund site list).

In order to take advantage of the Brownfields Tax Incentive, taxpayers must receive a certification statement from their state's environmental agency. The state is likely to require at least minimal sampling results to determine eligibility. The 1997 version of the law included other geographical limitations relating to poverty levels that were difficult to implement and were dropped in the 2000 amendments.

What Expenses Qualify? The category of allowable expenses is potentially very broad. Taxpayers should consult with tax counsel to determine whether specific cost items are allowable expenses. Generally, expenditures for assessment and monitoring of a release (or threat of release), abatement, control, or disposal of a hazardous substance do qualify for the Brownfields Tax Incentive. Expenditures for asbestos abatement, which is part of or within a structure, do not qualify unless there is a release, or a threat of release, into the environment outside of the structure.

Working the tax benefits of a cleanup into a property transaction

In the example of our paint-contaminated property, we were faced with the choice of trying to force the seller to clean up the property and pay the seller's asking price, or offering to reduce the purchase price by the amount it would cost to clean it up. So, which is a better deal?

From a liability standpoint, the two deals are very different. To minimize the liability of a buyer, we often require that the seller clean up a property to standards that we set before the buyer assumes title. Liability issues themselves are very complex and may drive a deal.

From a cost standpoint, these may also be very different deals. The grossly oversimplified example illustrated below assumes purchase of a $740,000 property, requiring $240,000 in environmental investigation and cleanup costs:

- If the seller spends $240,000 to clean up contamination, seller will be able to expense the cleanup cost. In effect, the seller will be taxed on net income of $500,000 and in the world of a one-third tax bracket, the seller's pain of cleanup is reduced $80,000 as a result of the deduction.

Through a coordinated effort, environmental, real estate, and tax counsel may be able to improve the terms of a transaction, create an unexpected windfall for a client, or generally improve the bottom line for shareholders through special tax treatment available as a result of federal brownfield initiatives.

- If the buyer negotiates a purchase price reduction to $500,000 and then spends $240,000 on cleanup, the seller is still taxed on a net income of $500,000 and seller's tax liability is still $80,000 less than if the sale had been at the higher price. The buyer capitalizes its costs and the basis of the property is $740,000 for purposes of depreciation.

- Using the Brownfield Tax Benefit, the buyer negotiates a purchase price reduction to $500,000 and then spends $240,000 on cleanup. The seller is still taxed on a net income of $500,000. However, the buyer can make use of the deduction to offset against other current income or carry forward as net operating losses. The buyer has also succeeded in controlling the quality of the cleanup.

Can you enjoy a one- to two-year reduction in the annual property tax assessment of a property?

Under generally accepted property appraisal guidelines, detrimental conditions such as environmental liability will result in a reduction of the fair market value of the property based upon the cost of repair, including ongoing operation and maintenance costs, as well as the perceived risk.

Often, a temporary reduction in the assessed value of real estate is available, but:

- Timing is critical, since many jurisdictions limit challenges to assessed values to specific times of the year;

- You will need reliable information to demonstrate the cleanup costs. This typically requires a

Phase II site investigation and an estimate from an environmental consultant;

- The reduction in price may be limited to reflect costs that will be reimbursed, such as from petroleum tank funds;
- You may create an undesirable, albeit temporary, stigma associated with the property.

In the context of our client's paint-contaminated property discussed above, the site investigation report and a cleanup cost estimate from an environmental consultant was enough to satisfy the property assessor to grant a temporary reduction in the assessment. The timing is critical and a sophisticated assessor is likely to consider any known reduction in the purchase price as reflecting the diminished value of the property.

A reduction in assessed value of the paint-contaminated property resulted in more than $40,000 in savings to our client. In that case, the assessed value dropped from around $500,000 to $300 during the period that it took to piece together a viable transaction and we were able to stop the clock on the accumulation of property tax debt.

If share price is a concern, is it cost-effective to clean up a property, remove an environmental liability and better the bottom line for shareholders to see?

Environmental liabilities that you may now be carrying on your books are, in all likelihood, based upon estimated cleanup costs. In light of the recent brownfield reforms and the move toward risk-based remediation, you may be carrying these costs far in excess of the actual cleanup cost. By addressing your environmental problems you may benefit by removing a liability (perhaps overestimated) from your books while being able to deduct the related cleanup expenses.

For conditions that may yet need to be disclosed or evaluated, it is important to accurately quantify the scope of the issue in light of the more rational cleanup standards in current use. Finally, any time an environmental liability is disclosed is a good time to think about negotiating for a reduction in the assessed value of the property.

CONCLUSIONS

The term "brownfield" may apply to any property that has issues—real or perceived—relating to environmental contamination. The recent brownfield initiatives may offer benefits available to the traditional owner of real estate and not just the high-risk brownfield sites.

Through a coordinated effort, environmental, real estate, and tax counsel may be able to improve the terms of a transaction, create an unexpected windfall for a client, or generally improve the bottom line for shareholders through special tax treatment available as a result of federal brownfield initiatives.

Strategies to help the bottom line will be increasingly important as companies more fully evaluate their disclosure obligations in light of the legislated standards for due diligence found in the Brownfields Act of 2001 and in the aftermath of Enron and the SEC's fair disclosure regulations. REI

NOTES

1. Brownfields Act at Section 223; CERCLA, Section 101(35)(B).
2. The Brownfield Act also includes increased federal funding, liability reform for those unlucky enough to be involved in a National Priorities List site and better integration with state programs.

ABOUT THE AUTHOR

(continued from page 23)

finance; development and enterprise zones; local, state, and federal grants; and innovative remediation and financing structures employing the use of Business Improvement Districts. (E-mail: bkeyes@foleylaw.com)

WHY THE EMERGING ECONOMY WILL MEAN MORE SYSTEMIC RISK IN REAL ESTATE LENDING

by Alan R. Winger

Despite the recession—albeit a very weak one so far—along with the recent jump in security concerns, the economic world continues to evolve into something that, in time, will differ substantially in certain important respects from what it was. As these changes filter down to local real estate markets, lenders and borrowers will be confronted with increased systemic risk, and that, given the recent changes in our real estate finance market, is likely to put upward pressure on the cost to finance a real estate transaction. What's involved here and how it will to come into play in real estate finance markets is the subject of what is to follow.

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SYSTEMIC RISKS IN REAL ESTATE LENDING

Risk, of course, refers to potential volatility, which in the case of a real estate loan means volatility in the returns that flow from interest payments and return of principal. If there is uncertainty about these returns, the lender is exposed to risk.[1] The rational thing to do in this circumstance is to charge a higher rate of interest to cover the cost of the risk. One key to successful real estate lending then is an accurate assessment of risk exposure, which means making reasonable estimates of the probabilities of the likely possible outcomes of a loan's performance.

The problem here is that risk assessment is difficult, which is why, despite all of the sophisticated research on the subject, in real world financial decisions it is often treated in a way that incorporates a large subjective element. This is especially so in real estate, largely because of the heterogeneity of the product and the complexities that often arise in financing its acquisition.

In real estate, much of the lender's concern is with credit or default risk. The focus is on the question of whether the borrower will live up to the interest and repayment provisions of the loan agreement. As real estate loan originators look at this, the answer is to be found in things that are specific to the borrower and the real estate being acquired. What about the borrower's ability to pay? Are his income or profit prospects good? What about the property? Is the proposed acquisition price reasonable relative to its location and state of repair? And what are the probabilities with respect to the answers to all such questions?

All of the above is very important at the level of loan origination. But to those who ultimately provide the funds,[2] these are risks that can be diversified away. Even so, risks that come from more general economic forces remain. Such risks are often dubbed systemic—so named, because they have a presence in all loans.

Consider, by way of example, the risk exposure created by the business cycle. Cyclical movements in the economy affect the performance of real estate loans. Downturns lead to more problem loans; upswings lead to fewer such loans. These are possibilities with probabilities (our measure of risk exposure) because of the uncertainty there is about the timing and amplitude of such cyclical movements. We know they're coming. We just don't know exactly when or how severe the movements will be.

Because this cycle has impact on most, if not all local economies, the lending risks it generates are spread throughout all local real estate markets. This means we are dealing with risks that, because they are everywhere, cannot be diversified away. But, like any other set of risks, they have a cost that must be recouped. Students of finance tell us that premiums for such risk are incorporated into loan rates through the operation of markets, which gets done properly if those markets are efficient.

All of this is standard stuff in finance. It's also something that has become increasingly relevant in the real estate finance market. This is a market that has become more competitive largely because of the growing use of derivative instruments to finance real estate transactions, *e.g.*, mortgage-backed securities. Twenty-five years ago, most real estate loans were originated by and went into the loan portfolios of savings institutions, commercial banks, and insurance companies. In 1980, for example, more than two-thirds of the nation's mortgage loans were in the portfolios of these lenders, loans that, for the most part, they had originated. Secondary market activity back then consisted primarily of loans originated by mortgage bankers that went into the portfolios of three federal agencies—Fannie Mae, Freddie Mac, and Ginnie Mae. What's more likely to happen today is that loan originations, mostly made by mortgage banks, savings institutions, and commercial banks, will be put into pools on the basis of which securities will be issued that work their way into the portfolios of a much broader base of lenders / investors.

The magnitude of this change in how funds get from the nation's pool of savings to real estate borrowers is well reflected in a couple of statistics. One is the mortgage loan holdings of thrifts, banks and insurance companies, which by year-2000 had fallen to just a little more the one-third of total mortgage debt. The other is in the growing importance of the mortgage-backed security through which long-term funds flow to the real estate borrower. These securities, which take more than a few forms,[3] now constitute close to 50 percent of the total mortgage debt outstanding, compared with almost nothing back in 1980.[4] While the major issuers of this debt have been and continue to be Fannie Mae, Freddie Mac, and Ginnie Mae, private issuers have been growing in number and in volume of operations in recent years.

That derivative instruments have come to dominate real estate finance has greatly strengthened the links between this market and the nation's money and capital market—indeed the world's money and capital markets. One result has been more efficiency in the way in which funds are allocated to real estate borrowers, the net effect of which has been a decline in mortgage rates relative to other long-term capital rates.[5] More important to the subject of this manuscript is the increased sensitivity of mortgage rates to financial market developments brought about by this tighter link to the broader markets, the significance of which is that risks, including systemic risks, are now more likely to be properly reflected in real estate finance loans.

What then about the systemic risk in real estate lending?

Obviously the business cycle was and remains an important source of such risk. This seems to be well recognized. What doesn't seem to be recognized is the systemic risk beginning to flow out of the dynamics of our emerging economy. There are roots taking hold here that are and will continue to generate systemic risk in real estate finance, a development and outcome that needs to be worked into the mind-set of both real estate lenders and borrowers.

THE EMERGING ECONOMY

While it's easy to exaggerate the degree of current change in the nation's economy, there can be no doubting the fact that we are in a period of significant economic change. Whether what's happening now will in time be taken as a revolution in the sense that we experienced during the industrial revolution remains to be seen. What we do know is that the ingredients for change in how we do things and what we do in the economy have been put in place. And there is much more to come. Our information/communication technologies, our biotechnologies, our materials and new fuel technologies, and something we call nanotechnology, promise us an economic world that could be absent a good deal of what we had as we entered the second half of the 20th century.[6]

As the transformation has taken place to date, we now have an economic world that, compared to just a short while ago, is much less regulated by government and filled with markets that are more global part in part because of the "digital" revolution. It is also a world with production processes where information is fast becoming a critical input.[7] And what we do with information increasingly involves putting the knowledge we get from it into what we produce and how we produce it.[8]

How all this works out will be played out in markets that have become both much more competitive and connected. They are arenas filled with intense pressures that increasingly take the form of non-price competition. Product innovation is fast becoming the primary means of competing, the aim of which is to bring new and better products to market more quickly than competitors. But doing so in today's world often complicates the production process, giving rise to the need for smarter inputs. Hence the growing importance of knowledge as an input to a successful operation.

Knowledge, intense competition and innovation; these are the key parts of the new economy story.

Not only must there be the skills to deal with any of the activities that might become a part of the core of a successful business operation, but there is the matter of choosing what activity this might be. This is a difficult matter that requires vision and a willingness to take risks—sometimes, big risks.

But there is more to the story as it is continues to unfold. Firms currently on the cutting-edge of today's technology frequently operate on the basis of destinations that are more uncertain than the traditional firm. They often do not know, in terms of particulars, where some of their activities are headed. There is a lot of haze that has to be worked through, giving rise to many cloudy linkages in what is often characterized as a web of activities. Furthermore, these activities often involve more than one firm, which adds to the complexity of the process and uncertainty of the outcome.[9]

Success in such business situations is not easy. Not only must there be the skills to deal with any of the activities that might become a part of the core of a successful business operation, but there is the matter of choosing what activity this might be. This is a difficult matter that requires vision and a willingness to take risks—sometimes, big risks.

It almost goes without saying that success in putting these kinds of elements together requires organizations that are flexible and agile. Hierarchical structures are becoming increasingly less relevant. What we need are organizations with teams of skilled operatives who have the authority and ability to act decisively when the need arises, folks who must be brought together in a way that reflects a sensible understanding of the big picture—the vision, the willingness, and even the eagerness to take risks. The overall outcome is, more likely than not, to be one in which there are substantive and substantial changes in the relationships between firms, employees, suppliers, and customers.[10]

This is the kind of economic world that appears to be emerging. But it is not yet the world in which most of us currently live and work. Life has changed for those who do not live in the Silicon Valley or those other islands of high tech fervor and excitement, but it is by no stretch of the imagination radically different from what it was a decade or two ago. Most of us still have bosses and follow prescribed procedures in some if not in much of what we do. And we work in businesses that locate many of their operations near their customers or where there is the specialized labor or services they need—the traditional reasons for the location of their activities.

Still, even in firms that appear to be operating in much the same way as they have in the past, there have been changes. The recent successes of most "traditional" firms stem in part from adjustments they have made to the reality of operating in more dynamic and competitive markets. Almost all firms are now more focused on making innovative product improvements and cost reductions with effort that is concentrated largely around innovations coming out of our information technologies. Many are trying to take advantage of the opportunities for change in such information-centered activities as accounting, inventory management, legal affairs, R&D, purchasing, and marketing. Thus, even though many firms seem to continue to operate in traditional ways, the successful ones do not do it exactly as they have in the past.

That we have only begun to scratch the surface of what's possible in most areas of business (and government) seems, paradoxically, apparent in the recent problems of those dotcom firms. Much of what was promised through such firms during the go-go years of the late 1990s failed to materialize. This was not so much because the promises were empty ones, but rather the result of investment made on the basis of technologies that had yet to be developed enough to deliver what was promised. The changes that will move us toward that digital vision of our economic activities continue, albeit at a much slower pace. And they are currently concentrated in the activities of existing brick and mortar firms.[11]

There is still a high probability that the economy, in time, will evolve into something that will differ significantly in many ways from what it was throughout most of the second half of the twentieth century. What it will look like in 40 to 50 years from now is a matter of speculation, however, it is predicted that more significant changes will be forthcoming. And what this implies is a period of more than the usual amount of uncertainty in the outcomes of the upcoming competitive market struggles that bring the change about. There will be winners and losers and identifying those that will come out on top will be more difficult to do in a setting where so much of the activity is driven by innovation. How all this might impact the systemic risk in real estate lending is a matter to which we now turn.

MORE SYSTEMIC RISK IN REAL ESTATE LENDING?

The systemic risk that comes from cyclical movements in the economy remains a risk element in real estate lending. While there may have been a time in the late 1990s when some believed the business cycle was a dead issue, this is not the case now. Business cycle concerns remain a source of systemic risk to the real estate lender. But it is also something that will be supplemented with added uncertainty coming from structural change in the nation's economy. Such change, especially when it results from a technical revolution, comes into fruition in a setting of uncertainty. The outcome of innovative activities aimed at translating new technical possibilities into operational realities is never certain. Spurts of such activity, as we are now experiencing, thus mean an increase in the uncertainty surrounding the operations of the firms involved. This in turn filters down to real estate finance transactions through events that occur in local economies.

There are two aspects to this filtration process. First there is the innovative activity itself which generates business opportunities that could add significantly to the growth of the local economies in which the innovative activity flourishes. But given the uncertainties surrounding the outcome of such activity, it might not.

Then there is the other side of these opportunities to consider. They represent threats to the existence of firms that fail to take advantage of them, which, in turn, can threaten the economic health of the communities that are the locus of these firms. But then again, it might not.

Since we don't know exactly who the winners and losers will be, outcomes for particular communities are shrouded with more than the usual amount of uncertainty. And when the innovations giving rise to such activity are pervasive in their impact, (as they are and will continue to be with innovations in our information / communication technologies and a number of others), this uncertainty works its way down to most all local economies. What it means at this level is more uncertainty with respect to elements in the local economy that have such important bearing on the ability of real estate borrowers to meet the obligations of their loan agreements—jobs, income, and profits. This implies more systemic risk exposure for real estate lenders.

Innovative behavior in American enterprise is, of course, nothing new. Innovation that both provides significant new opportunities and threats to business has been a part of the American business experience off and on throughout the course of our history. What's different now is the magnitude and pervasiveness of the current level of innovation, which is considerably greater than it was throughout much of the 20th century.[12] What's also different is the fact that the potential impact of any added uncertainty, as it shows up in the macro performance of local economies, is likely to be greater. If the added innovative effort of local firms to compete doesn't work out now, the impact on the local economy will be more severe. Or if it does work out, the growth spurt could dwarf any of those realized in the past.

This is because we are operating in an economic world that has fast become more global, increasingly powered more by digitized transmission networks, and more infused with knowledge as a critical input in what we do and how we do it. One consequence of all this is that businesses are less constrained in the decisions they make with respect to where they carry out their activities. Knowledge, for example, is something that is much easier and less costly to take elsewhere than were the materials that dominated production processes in the industrial era. Thus, what is rapidly becoming the dominant element in much of what we now do in the economy is embedded in activity that no longer needs to be as closely tied to a specific location. It's activity that can be more easily moved away to other places.

While there is nothing new in the movement of business operations elsewhere, the possibilities are greater and the costs of doing so are less. Furthermore, globalization has greatly increased the number of locations that might be suitable points of operation or market entry even though they may be great distances away. What needs to be recognized is that this is something occurring in physical settings—local economies—that are simultaneously experiencing more uncertain macroeconomic performances. The net result is and will continue to be an increase in the probability of more extreme results in macroeconomic outcomes. This means greater variance in those outcomes, which implies more systemic risk of real estate loans.

SOME OBVIOUS QUALIFICATIONS

The impact of innovative firm behavior on the macro performance of a local economy is, of course, not a

Dealing with risk in real life decisions in real estate finance still remains more of an art than a science. It is also an art that has become more important in its application as competitiveness in the real estate finance market has intensified. While imperfections remain, we are now dealing with a market that is more responsive to economic change at a time when the pace of that change has accelerated.

completely random outcome. The very nature of the process, as it has evolved in recent years, has given rise to flexible organizations that are staffed with entrepreneurial leaders who have vision and a willingness to take risks. They are also staffed with a large contingent of very smart people possessed with the knowledge needed to solve what often turn out to be very complicated problems. As these organizations take shape, they operate in web-like networks often found concentrated in particular places. The Silicon Valley in northern California is the most cited example of such a concentration. These are places that exist because of the economies that flourish in such agglomerations when certain sets of circumstances and behaviors are present.[13]

That innovators are attracted to such places implies positive macroeconomic growth consequences. Clearly, this happens. But given the magnitude and pervasiveness of the current and expected levels of innovation, the explosive economic growth of those Silicon Valleys will by no means account for the lion's share of the innovation-induced growth that flourishes in the nation. Moreover, traditional constraints on local growth, such as rising housing costs and congestion, will moderate that growth in such places.

There is every reason to believe that a good deal of the uncertainty underlying the innovation process is and will continue to be reflected in the macroeconomic performances of most if not all local economies. While we may have a pretty good notion as to how it will affect some local economies, there is a substantial element of uncertainty about what the outcome will be in most places. In periods of rapid and pervasive technological change, the crystal balls that tell us something about a community's future economic growth cloud up more than they do during periods of relative stability in our technologies.

Since there is much more uncertainty in such periods, there will be more systemic risk in real estate lending.

DO WE REALLY HAVE TO WORRY ABOUT ALL THIS?

This question needs to be raised because of history. Business innovation has, historically, been wave-like, rising rapidly during certain periods and then declining to lower levels.[14] The bursts of activity have been concentrated around radical innovations such as those that developed around the steam engine and electricity. One might argue that what's happening now is simply another burst that will, in time, dissipate as we fully exploit the technologies that are now significantly improving the way we are able to communicate with one another. On the other hand, one could just as easily argue that there is much more to come out of those emerging information / communication technologies. And innovation is expected to flourish in a number of other areas. There are developments in biotechnology, for example, that promise a lot of innovative activity in a wide range of businesses operating in this area. There are also things going on in materials and new fuel technologies that could lead to much more innovative behavior in a lot of businesses. And there are ideas being developed in an area called nanotechnology—materials miniaturization—that are trumpeted as notions that could underpin innovation of a magnitude unseen to date. Not surprisingly then, there are more than a few who argue that what's currently in the invention pipeline and what seems likely to get there shortly will keep innovative activity at least at its recent high level well into the future.[15]

Of course, predicting technological change is a fool's game. The activity itself is complicated and involved and the models we have to guide us through the task are incredibly naive. In the past, the outcome of efforts to predict our technological future have turned out to be far off the mark much more often than not.[16] Still, it's hard not to be impressed with the scope of certain scientific developments as they are currently working their way into our technologies. It's hard not to be pushed toward the conclusion that if everything works out as it could, our future research and development efforts should keep innovation at least at those recent high levels for as far as the eye can see.[17] While this may not happen, it certainly could. It's not unreasonable to suggest to real estate lenders and borrowers that they should begin to pay more attention to this source of systemic risk if they have not already begun to do so. The level of such risk in real estate lending is increasing, which should raise the cost of such lending.

Suppose it does. Is this something real estate borrowers and lenders should worry about? Is it something that will require a good deal of time and effort to deal with effectively?

The answer here depends in part on the kind of market through which funds will flow from real estate lenders to borrowers.

THE REAL ESTATE FINANCE MARKET: HOW EFFICIENT IS IT?

Were the real estate finance market efficient in the textbook sense, this impending increase in systemic risk and its impact on financing costs would just happen. Down at the level of loan origination, lenders would continue to be concerned with risks that arise from elements specific to the loans being made. These loans would then work their way into portfolios of the funds' providers, a process that would diversify away much of the specific risk. What would remain is systemic risk. If the real estate finance market were efficient in the textbook sense—that is, it was a perfectly competitive market—this risk would be properly priced as a consequence of the operation of the market. Those who provided the funds, having full knowledge of market circumstances, would require a higher rate that compensated them for any added risk being assumed. If they didn't get it, they'd move their funds elsewhere, going after the best rate from among what would be many borrowers competing for their business in a highly competitive market.

IT WILL PROBABLY NOT HAPPEN THIS WAY

While the real estate finance market is more competitive than it was, it is by no means efficient in the textbook sense of the word.[18] To most real world lenders in any segment of the real estate market, but especially in the commercial market, risk management is not now or is it likely ever to be a passive activity. Market participants, despite knowing more than they did, don't have all the information they need. Questions arise for which there are no simple answers. While there are sophisticated risk assessment models and measures used today in real world decisions, a great deal of the work still incorporates subjective evaluations of the risk involved. This should come as no surprise in real estate—particularly in income property. The product underlying a financial transaction in this market is heterogeneous and complicated, which means a market with little breadth and depth. The problem of figuring the probabilities of the return possibilities of such a variegated item that is exchanged in a thin market is not an easy one. Moreover, with real estate, we are dealing with something that, because of its durability, is very sensitive to changes in the economy of which it is a part. This means market dynamics that further complicate efforts to assess the risk in this market.

Dealing with risk in real life decisions in real estate finance still remains more of an art than a science. It is also an art that has become more important in its application as competitiveness in the real estate finance market has intensified. While imperfections remain, we are now dealing with a market that is more responsive to economic change at a time when the pace of that change has accelerated.

There is now good reason for lenders and borrowers in the real estate finance market to be aware of and consciously concerned with systemic risk. Whatever science we have in the form of models that seem appropriate to the task of evaluating such risk should, of course, be used. It is likely, however, that what will turn out to be the most effective way of dealing with it will involve a good deal of subjective analysis. And a key element in such an analysis will be an understanding of how the economy is evolving and what this implies with respect to the probabilities that have bearing on loan performance. Such understanding should give rise to sensible subjective assessments that in the decisions they underpin should translate into reasonable risk premiums. This, of course, implies upward pressure on loan rates in this market. While it may not turn out exactly as it is portrayed in the textbook presentations of operation of efficient financial markets, the direction of change should be much the same.

SUMMING UP

The dynamics of the economy have always spilled over into real estate finance. They will continue to do so in the future, probably at an accelerated pace. Much of this spillover in the future will come to focus in risk exposure arising out of the upcoming structural changes in the economy. Ignoring the risk consequences of the dynamics of an economy that is developing technologies that could radically change what we do and how we do it could lead to some unpleasant financing surprises. Being aware of and having some understanding of these dynamics, as it is reflected in the character and pace of business innovation, could help minimize such surprises.REI

NOTES

1. Lenders are said to be exposed to risk in a setting of uncertainty when they can assign probabilities to the likely possible outcomes of the decisions they make.
2. Secondary market transactions or transactions that involve the sale of loans originated by one party to another who, in effect, provides the long-term funds to finance a real estate transaction have long been an important part of the real estate finance market. That importance, however, increased significantly with the securitization of much real estate debt.
3. The variety in these instruments is documented and discussed in Frank J. Fabozzie (ed,) *The Handbook of Mortgage-Backed Securities* (5th ed.) (New York: McGraw-Hill 2001).
4. While most of this increase in securities activity has been concentrated in the residential sector, the securitization of nonresidential debt has increased rapidly over the past few years now accounting for about 15 percent of the mortgage debt in this sector.
5. Studies of the effects of the securitization of mortgage debt on mortgage yields show these yields have been reduced. See Patric Hendershott and James Shilling, "The Impact of Agencies on Conventional Fixed Rate Mortgage Yields," *Journal of real Estate Finance and Economics*, (1989) Vol. 2, pp.101-115 and James Kolari, Donald Fraser and Ali Anari, "Effects of Securitization on Mortgage market Yields: A Cointegration Analysis," *Real Estate Economics* (1998) Vol. 26, pp.677-693. A rough and simple comparison of the average spread between home mortgage rates and 30-year governments between 1980s and the 1990s show a reduction in that spread of about 30 basis points.
6. For a succinct yet comprehensive discussion of what seems to lie ahead with respect to our technologies see R. G. Lipsey, "Sources of Continued Long Run Dynamism in the 21st Century" in *The Future of the Global Economy: Towards a Long Boom?* (Paris: Organization for Economic Cooperation and Development 1999).
7. This growing importance of information, of course, has roots that go back well into our past. Information handling, which at the turn of the 20th century accounted for about 20 percent of all economic activity, grew to close to 50 percent by 1980. The recent acceleration in its importance and its expected continued growth is reflected in estimates that have this figure up to 80 percent by year 2020.
8. While absent any comprehensive measures of knowledge as an input in our production processes that tell us precisely how important it is and how that importance is changing, there are more than a few books that provide insights into what's going on. Two of the better of these are Alan Burton-Jones, *Knowledge Capitalism* (Oxford: Oxford University Press 2001) and David J. Teece, *Managing Intellectual Capital* (Oxford: Oxford University Press 2000.
9. An earlier characterization of the nature of economic activity in such a cutting edge setting that still seems to be on target is in B. Arthur, "Increasing Returns and the New World of Business," *Harvard Business Review*, pp.100-109 (July / August 1996).
10. A more detailed discussion of the kind of operations likely to be found in such a setting, see C. Lee, W. F. Miller, M. G. Hancock and J. S Rowen, *The Silicon Valley Edge*, (Stanford: Stanford University Press 2000).
11. The Economist in a recent issue discusses some of the reasons why the greatest impact of the web is now being concentrated in brick and mortar firms. *The Economist*. "Older, Wiser and Webbier," June 30, 2001, p.10.
12. See *Economic Report of the President (January 2001)*, (Washington: U.S. Government Printing Office), Chapters 1 through 5.
13. The notion of agglomeration economies is not a new concept.

It has been offered for years as an explanation of why certain businesses locate close to one another. Recent discussions of it emphasize those economies that arise from "knowledge spillovers" of the kind to be found in places like the Silicon Valley. For a recent discussion of these economies and what gives rise to them see J. S. Brown and P. Duguid, "Mysteries of the Region: Knowledge Dynamics in Silicon Valley" in *The Silicon Valley Edge*, op. cit., pp.16-39.

14. For one view of this phenomenon see R.U. Ayers, *Technological Transformations and Long Waves: Parts I and II*, p.36. "Technological Forecasting & Social Change," pp.1-37 and pp.111-137 (1990).
15. Of course, the current worldwide slow down in economic growth has reduced current levels of innovative activity. If we assume such a slow down is temporary, business innovation should so be at least back up its earlier level if this view of underlying conditions is correct.
16. Arthur Clark once commented that those who make such predictions tend to be over-optimistic in the short run and under-optimistic in the long run. He argued that they do this because they can only extrapolate linearly and progress is always an exponential curve. S. Griffiths (Ed.), *Predictions*, (Oxford: Oxford University Press 1999, pp.35-46).
17. There are more than a few prognosticators who subscribe to the notion that we are in the midst of a long boom that has it roots in innovation. One set of these include P. Schwartz, P. Leyden and J. Hyatt, who have written the book *The Long Boom*, (Reading, Mass.: Perseus Books, 1999).
18. Financial markets in general, while more competitive than most nonfinancial markets, by no means measure up to the textbook version of a market than generates efficient results. That this is so is reflected in the controversy that still swirls around the beta coefficient, a measure that was offered as a way of measuring systemic risk in the portfolio of the investor. It is also reflected in the pragmatic approaches that are found in books concerned with financial risk management. M. Crouch, R. Mark and D. Galai, *Risk Management*, (New York: McGraw-Hill Publishing 2000) and A.R. Winger, *Risk*, (Chicago: International Publishing Company 1995).

CRE PERSPECTIVE

Complexity in the Federal Income Tax Law

Mark Lee Levine, CRE

An issue that arises at tax time is the constant barrage of complaints as to the complexity, involvement, and inter-workings of the federal income tax law. We often refer to this law as the "Code," referencing 26 U.S. Code Annotated, which is the portion of the United States Code that relates to the federal income tax laws.

Numerous arguments and presentations have been made for the need to reduce the complexity of the Tax Code. There was an entire Institute presented in February 2001, at the *New York University/Tax Analysts Government Tax Policy* workshop on simply the topic of tax code complexity. Numerous papers were presented at that Workshop regarding the complexity in the tax law and possible alternatives that should be reviewed to reduce this complexity. Those alternatives certainly address the total repeal of the tax law, as well as approaches that would allow for modifications on a substantial basis, of the federal income tax law.

One article has stated that the venerable Tax Code is 9,451 pages. ("Tax Reform Fever May Be Spreading: After VA Sweep, GOP Congressional Candidates Take Aim At IRS Code," *The Washington Post*, November 13, 1997, Page D5.)

Others argue that "the Code" is actually much less than 9,451 pages. They point out that the *Index* itself is 200 pages and there are various Tables and numerous other adjustments to the number indicated. In one article that reviewed this page count, the conclusion was that the "true" Code is about 2,000 pages. [For a discussion on this page count, see the short note by Robert Wells, "Meet the 9,451-page Internal Revenue Code," *Tax Notes 453* (July 23, 2001).]

Whatever the length of the Code, it is too long, say many, and certainly too complex, say most.

One of the issues is how we weigh "complexity." Is that the number of calculations or the number of tables that have to be used? Is it the number of rules that have to be memorized and employed? Or is it simply the amount of time it takes to complete a tax return?

An article by William Gale, ("Tax Simplification: Issues and Options" *Tax Notes* 1463. September 10, 2001), reviews of some of these issues. Gale noted the surveys of some individual taxpayers as to the time it took them to record items, "learn" the rules, and physically prepare the return. (There were also estimates prepared by Gale as to the cost to operate the income tax law itself, considering the parties that are involved, whether Internal Revenue Service or others.) Within the article, he also cited approximately 50 other articles as resources that commented on the issue of complexity.

The move for simplification, at least by the Federal Joint Committee on Taxation, has produced a "Summary," printed in *Tax Notes* 861 (May 7, 2001), which lists pages of areas where reduction in complexity would be most beneficial, assuming the entire Code was not replaced.

Major areas for simplification were targeted, at least by the Joint Committee on Taxation, including Alternative Minimum Tax (AMT); changes as to Adjusted Gross Income (AGI); changes relative to Social Security calculations as they work into the income tax field, and capital gain calculations in some settings, among others. The suggested areas are certainly much more detailed than these comments as to areas that are in need of clarification or elimination.

The same concern and suggestions for reducing complexities in the tax law was examined in a recent article by Philip Harmleink and William VanDenburgh, ("An Appeal for Individual Tax Simplification," *Tax Notes* 107. January 7, 2002). In this article, the authors recognized the concern for simplification by stating: "The overwhelming need for tax simplification is nationally recognized. Unfortunately, achieving this objective has proven impossible."

If tax simplification is much needed but impossible to reach, most taxpayers would not be equipped to lessen the complexity and would have to continue to file their tax returns under the existing system. How soon we will have tax simplification resulting in complexity reduction in the tax laws remains uncertain, especially with the focus for raising taxes, given the "surplus" reversal that we have faced in the last six months as to the government fisc and the loss of revenue with the downturn in the economy.

However, it is clear that taxpayers are becoming extremely frustrated with complexities in the tax system. If the tax system frustrates taxpayers, it is difficult to undertake necessary calculations for filing a return. Many taxpayers throw up their hands and do not file. Thus, they, of course, often do not pay taxes. This would not be the first time such result has occurred in this country and in other countries.

The need to reduce the complexity is not simply an esoteric discussion. If the laws cannot be reasonably enforced, there will be a breakdown of the economic system.REI

ABOUT THE AUTHOR

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FOCUS ON THE ECONOMY

The Public Policy Piece of the Economics Puzzle

by Hugh F. Kelly, CRE

There once was a barroom prohibition against discussions of religion or politics—a rule no doubt instituted for the protection of both the inventory and the real estate. The pages of *Real Estate Issues* are a more sober context, though, and I am going to hazard an economic discussion that may cross over the line into politics, at least implicitly. In the Winter edition of *REI*, this column attempted to offer some diagnostics on the U.S. economic cycle. At that time, I suggested that we'd deal with public policy, business management, and world affairs in a series of essays. What follows are some observations on the public policy dimension of the economy.

On March 28, 2002, the U.S. Bureau of Economic Analysis (BEA) released its "final" revision of fourth quarter 2001 GDP statistics. The BEA reported that the national economy had expanded at a 1.7 percent annual rate, posting a net growth of 1.2 percent for all of 2001, despite the third quarter's contraction of 1.3 percent. In the year's final three months, the turnaround was led by a 6.1 percent advance in personal consumption expenditures and a 10.2 percent rise in government expenditures from third quarter levels.

To determine the implications for real estate, let's take a look at that 10.2 percent increase in government spending, first on a policy basis. Next, in some detail, we'll unpack how budgetary choices—fiscal policy—affect the business cycle. Finally, we'll examine the complementary tool available in Washington—monetary policy—exercised through the Federal Reserve Board, also with an eye to cycles and local effects.

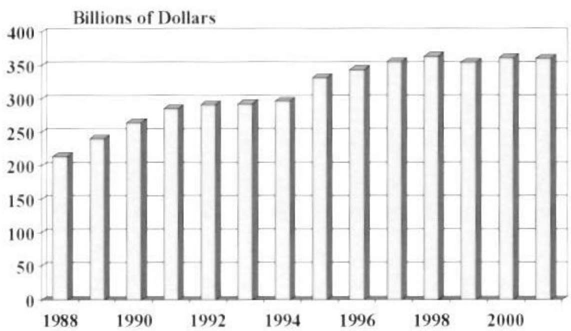
First of all, it is always a good idea to be wary of quarter-to-quarter shifts, (and even more wary of month-to-month changes). The shorter the period, the more volatile the figures are likely to be when they are reported in the economists' standard measure of the "seasonally adjusted annual rate" (SAAR). Nevertheless, when we look at the "real" (*i.e.*, constant dollar) annual percentage change in government spending for the year, we do see an increase in spending of 3.6 percent. The fourth quarter surge followed a change in government expenditure in the third quarter that was just 0.3 percent, betraying a "Johnny-come-lately" response by budgeteers to a recession that the National Bureau of Economic Research says began in March 2001. A classic headline was published in the *New York Times* last month: "Fed Chief Sees Decline Over; House Passes Recovery Bill" (March 8, 2002).

However late, though, an increase in governmental spending at points of national economic weakness is a fully appropriate action at the federal level. This is true even if it means running a federal budget deficit. The right time to run deficits is in recession; the right time to run surpluses is during expansions.

Exhibits 1 - 4

Exhibit 1

Interest Payments on U.S. Federal Debt

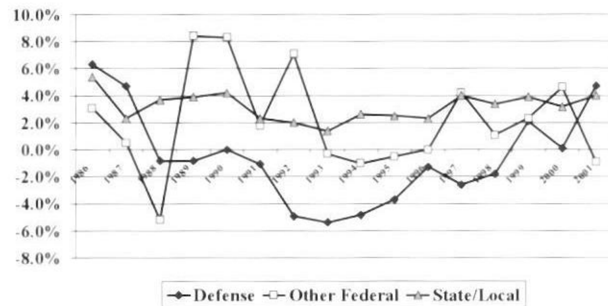


Source: U.S. Treasury Dept.

Exhibit 2

Government Expenditures

Real Annual Percentage Change



Source: U.S. Bureau of Economic Analysis

Exhibit 3

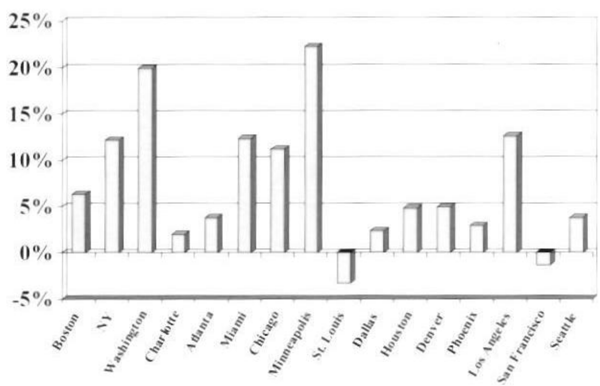
Commercial Mortgage Leverage Advantage Widens in 2001

Source: CCIM/Landauer Investment Trends Quarterly

Exhibit 4

Change in Median Home Prices

4th Q 2000 - 4th Q 2001



Source: National Association of Realtors

This rule of thumb is something that had been neglected for a quarter century, as we ran federal budget deficits in good times and in bad. The national debt is now about $6 trillion, and in fiscal year 2001 the U.S. Treasury had an interest expense on that debt of $360 billion. *(See Exhibit 1).* That is roughly equivalent to the entire Defense budget for consumption and investment for the year. So, in terms of policy, while the counter-cyclical spending surge is the right move, it should not be made permanent. One key to keeping policy options optimal in future downturns is to return to running a prudent surplus once the economy is safely back in growth mode. It would be a major mistake to back future policymakers into a corner by broad-based tax cutting that seeks to starve the government of revenue. That was the philosophy of Arthur Laffer and other "supply-side economists" of the 1980s—intellectually bankrupt and disastrous in application.

Budgets are planning documents and government money is actually spent by appropriations bills. Funds for the military, for highways, for unemployment insurance, and for Medicaid, all grew at double-digit rates by the end of 2001, despite the inability to negotiate a stimulus package in Washington until early March 2002. That bill extends unemployment benefits for a longer period, and offers investment incentives for business plant and equipment spending. As it happens, such a modest approach may be exactly right for this cycle.

That money will be spent according to national priorities, and the tenor of discussions now suggests that military spending will be at the front of the line for the next several years. The "peace dividend" of the early '90s shrank away long ago *(see Exhibit 2)*, but the domestic economic expansion allowed non-defense government spending to increase roughly in line with GDP growth from 1997 to 2000. In 2001, however, it turned negative, even as defense expenditures jumped more than 4 percent in real terms. That relationship—faster growth for the military than for domestic governmental programs—is likely to be a hallmark of the Bush Administration.

Localities with major bases and/or significant defense contracting in their economic base will be seeing the positive effect of federal spending stimulus well into the recovery period for the U.S. economy as a whole. Also, given the high-technology predilections of military procurement, tech-based areas should also see sharp rebounds in 2002 and 2003, far better than most analysts are forecasting right now. Cities now suffering, including Phoenix, San Jose, Seattle, and Austin, could find themselves in an encouraging rebound before this year is through, with thanks to federal fiscal policy. Other areas that have held up rather well—such as Southern California markets like San Diego and Orange Counties, San Antonio in Texas, and Raleigh-Durham's Research Triangle—might find themselves poised to accelerate their growth. These are areas where real estate professionals should be looking closely at economic trends to discover opportunities stemming from improved demand.

If the players on the fiscal side of government policy—namely, Congress and the executive branch—were laggards in addressing last year's economic threat, the Federal Reserve can at least be credited with instituting its regime of interest rate reduction at the beginning of 2001 when, officially at least, the recession had not yet arrived. A year ago in this column I predicted that the nation would avoid a recession if the Fed continued its rate-cut program. Absent the September 11 attacks, it now seems evident that we could have had a "soft landing" in 2001 and that we might have avoided even a single quarter of negative GDP. But that is unknowable now, and it is fruitless to speculate on what might have been.

It is worth at least a short look at the impact of the sustained reduction in interest rates on economic activity, especially as it has affected real estate markets. The Fed is charged with being an independent (that is, non-political) agent, assuring the safety and soundness of the banking system and, by management of inflationary forces, of the currency itself. In practice, the Fed has become more and more a "nuanced" force in shaping the domestic and indeed the international economy by its decisions about interest rates and its moves to provide or withdraw liquidity from the capital markets at critical moments (*"kairos,"* as I described the situation in the Spring 2001 column).

Generally speaking, the reason why commercial property values have remained "sticky" in the present cycle (that is, they have not deteriorated to the degree that rising vacancies and falling rents suggest they might) is that the markets have stayed quite liquid throughout the nation. Ample and very cheap debt capital is very much part of this reason. When commercial property can be purchased at cap rates of 9 percent - 10 percent, but mortgage debt is available at 7 percent, transaction markets can remain healthy. *(See Exhibit 3).* And the reason lenders can put out mortgage money at 7 percent is that their own cost of funds is even less. Equity spreads, in fact, widened sharply over the course of 2001 and this is an under-appreciated consequence of monetary policy and a reason why real estate is not being blamed for contributing to the 2001 recession.

Home values also were buoyed by low mortgage rates. Freddie Mac reports that the average 30-year fixed rate mortgage for all of 2001 was 6.97 percent, which helped push existing home sales up to a record 5.25 million units. And, while new mortgage originations for 2001 were a strong $882 billion, refinancing accounted for 55 percent of all mortgage lending on one-to-four family residential properties, a total of $1,149 billion in such loans, according to the Mortgage Bankers Association of America. That represented a huge cash infusion for the economy, and makes the extraordinary performance of the consumer sector much more understandable than the year's weak employment statistics do.

As in the case of fiscal policy, the impact of monetary easing did not land equally on all parts of the country. Data from the National Association of Realtors on median home prices demonstrate the uneven impacts *(see Exhibit 4).* Low interest rates were not enough to salvage the year for St. Louis and San Francisco. And a variety of Sunbelt cities (such as Atlanta and Charlotte in the Southeast, and boom/bust energy and technology cities like Dallas, Houston, Denver, Seattle, and Phoenix) had fairly tepid home price increases. But at least a half-dozen of the nation's largest market areas had housing prices posting gains of 10 percent or more: New York, Washington, D.C., Miami, Chicago, Minneapolis, and Los Angeles.

Short-term interest rates should be rising as 2002 progresses and the economy gets back on its feet. It is unlikely that the Fed will drive rates up with the enthusiasm that it propelled them downward, though. More likely, we'll see a flattening yield curve, fewer adjustable rate home mortgages, and some slowing in housing transaction and refinancing velocity. That's okay, as long as fundamentals in other segments of the economy come back. Those segments are industrial production, economic productivity, corporate profits, and employment. We'll turn our attention to those in the next column. REI

ABOUT OUR FEATURED COLUMNIST

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FOCUS ON INVESTMENT CONDITIONS

INVESTMENT PROSPECTS STILL BLEAK, BUT HOPE IS ON THE HORIZON

by Kenneth P. Riggs, Jr., CRE

If the fall of the tech sector, the September 11 terrorist attacks, and the decline in the stock and bond markets weren't enough, now investors have to deal with doubt associated with the financial scandals accompanying industry giants like Enron, Global Crossing, Arthur Andersen, and Waste Management. It's no wonder that real estate as an investment looks good by comparison, despite the millions of square feet of office and industrial space dumped back into the market. As reported in the winter 2002 issue of the *RERC Real Estate Report*, "at least commercial real estate deals involve tangible assets that are what they are and cannot be masked in accounting mumbo jumbo."

In addition, real estate finds itself in a much stronger position during this slowdown than it was in during the recession of the early 1990s. First, although commercial real estate vacancies are high, the supply vs. demand equation is more balanced than it was 10 years ago. New construction has slowed, and some older and nearly obsolete commercial buildings are being taken out of the market. Secondly, the public market display of real estate equities and debt is being carefully watched by analysts, rating agencies, and investors, offering a level of transparency that was unavailable 10 years ago. Finally, commercial real estate is not over-leveraged, and there is liquidity at a price.

That's not to say that investing in real estate is without risk. While real estate may be positioned better than other investment vehicles to withstand the uncertainty brought on by this economy, there are many factors negatively affecting returns. Safety and security—issues brought to the forefront after the terrorist attacks last fall—are detracting from performance as building owners (at least initially) absorb the expenses associated with securing office ventilation and water systems, setting up electronic surveillance equipment, and/or evaluating mail handling processes. Further, there have been numerous reports of property and casualty risk insurers charging 40 percent to 300 percent more per premium than a year ago. Such increases in expenses, along with a noticeable downward shift in the amount of space that many businesses are requiring in this tenants' market, all factor into reducing values.

Another concern is the fact that 45 of our 50 states are facing budget deficits. Since many states cannot operate at a deficit level and have already been making drastic cuts in services, they will have little choice but to raise taxes (either sales or property taxes, or both). States like Pennsylvania and Illinois are already freezing various growth management initiatives, while Utah and Wisconsin are cutting grants and other funds for open space purchases or preservation. Property owners, however, are lodging their own wars to have real estate taxes reduced in the face of declining property values. This creates a conundrum for states and property owners which can lead to the eventual decay in the quality of services available in various communities.

Although there are many issues the real estate industry must deal with in 2002, there are also reasons to be optimistic. Foremost is the ongoing consumer need for typical old economy purchases like homes, automobiles and parts, furniture, appliances, and other household goods. Consumers are still spending on these items, albeit modestly. In addition, although new unemployment is still occurring, some industries, like the airlines, are beginning to re-hire some of the workers laid off last fall. Even Congress has entered the picture by passing an economic stimulus package that allows businesses to take a 30 percent tax deduction in the first year on the cost of leasehold tenant improvement projects undertaken during the next three years.

And as reported in the winter 2002 issue of the *RERC Real Estate Report*, there are some solid real estate investment opportunities for the year ahead:

- **Core debt lending.** Underwriters are carefully being watched and monitored, and although real estate returns aren't huge, core debt lending is safe compared to other investments.
- **Leveraged-equity positions.** Risk-adjusted total returns of 15 percent or more are available with leveraged-equity positions for capital-starved property types in some markets.
- **Re-priced class A apartments.** Lower rents and higher vacancies today should lead to opportunities later in the year as these properties are repriced.
- **Well-located class B apartments.** Current market conditions and the expectation that economic recovery will be slow make class B apartments a safe bet.
- **Leverage equity assets.** Throwing cheap debt on an existing well-leased 100 percent equity asset or portfolio can work to your benefit if you can accept leverage.
- **Class A- office properties.** Class A+ offices will not be offered for sale at bargain prices and class C is not a good deal, but finding something in between, especially in battered markets like San Francisco, Boston, and New York, could prove profitable.
- **Well-leased commercial real estate.** With 10-year treasuries at historical lows, the spread between commercial real estate yields and treasuries makes commercial real estate more attractive today than 10 years ago. Unfortunately, the upside for asset and rent growth is not there as it was in the last recession.
- **Commercial mortgage-backed securities (CMBS).** B pieces and unrated tranches of CMBS offer high risk-adjusted rates of return, although there are only a few players.

Although I anticipate choppy waters ahead for the next few quarters, commercial real estate is poised to weather the storm. An economic recovery is underway, the stock market is beginning to rebound, and the housing market remains strong due to demographics and low interest rates. As the economy continues to strengthen and market fundamentals solidify, those with plenty of capital will be ready to make their move into those areas where demand is increasing, probably in early 2003. Given recent news events, however, it is important to add that the entire U.S. economic recovery can be derailed in an instant and the outlook would change if the violence in the Middle East intensifies, if an oil crisis develops, or if there are additional widespread terrorist attacks—all of which could lead to a global recession. REI

ABOUT OUR FEATURED COLUMNIST

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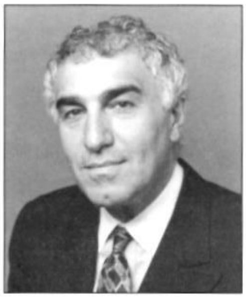
FOCUS ON OFFICE MARKETS

Record Office Rent Declines Recorded in 2001

by Raymond G. Torto, CRE



On the tail end of double-digit rent growth in 2000, office rents declined at a record pace in 2001. The TW Office Rent Index retreated to levels seen at the end of 1999 (or 1998 levels when accounting for inflation). This decline constituted a 10.9 percent decrease in the TW Rent Index for the year, bringing the current level of the index 3.2 percent below the long-term real average. The only previous year with a similar decline is 1992 when the index dropped 10.6 percent.

While the rates of decline are similar between 1992 and 2001, how the markets entered into these declines is very different as are the growth paths for the markets going forward. *(See Exhibit 1).*

Office rents were brought down to such low levels in the early 1990s by the convergence of excessive overbuilding over a number of years, reduced demand following a recession, and elements of corporate reorganization. While there are some similarities, the rent declines seen in 2001 are driven by a different combination of the factors seen in the early 1990s, plus some new ones. The following table highlights some of the different factors in each period, noting the positive (+) and negative (-) aspects of the rent declines in each period.

In brief, the office market is not due for years of continued rent declines as the trends in supply are not as extreme, while demand, from both a space use and an economic perspective, is not likely to be hit as hard. The declines in 2001 were, in part, exacerbated by the strong gains of 2000. With the supply and economic conditions of 2001 alone, the TW Rent Index would not have seen such an intense decrease in 2001. *(See Exhibit 2).*

Looking at changes in individual markets in 2001, the usual suspects come in at the top of the list when looking at year over year changes. The high profile markets that exhibited rent surges in 2000 are generally those that saw the largest rent declines in 2001. *(See Exhibit 3).*

Some exceptions stand out, however. Columbus is generally not thought of as a market driven by the high-tech sectors, but the TW Rent Index declined some 13 percent in 2001 in this market. Here the culprit is largely supply, not demand, with construction of nearly 1.8 million square feet last year, in a market that would normally deliver on the order of 700,000 square feet. Following a few years of stronger than average construction in Columbus, rent growth in the near term will be hampered by this excess supply.

Exhibits 1 - 3

Exhibit 1

National Office, Rent Index Retreats to 1998-1999 levels

Source: Torto Wheaton Reserach

Exhibit 2

Early 1990s		2001	
-	Stock of office space grew 93% in preceding decade and continued strong for some time into early 1990s	+	Stock of office space grew 14% in preceding decade and market not gearing up to build much space
-	Office using job declines of 270,200 represented a 3.2% reduction in employment base	+	Declines to date less severe but even if they come to 270,200 would represent only a 2.3% reduction
-	Demand growth post recession limited as firms became lean and mean on space use	+	Firms mostly lean and mean, fewer cuts to make post-recession however...
+	Speculative leasing not a feature of market, wasn't needed then always a developer ready to build	-	Technology boom in 2000 spurred speculative leasing and rent spikes exacerbating 2001 declines

Exhibit 3

Rent Changes in Selected Markets: 2001

	2001.4	2001.2	2000.4	Six Month Change	Annual Change
San Jose	$32.65	$47.28	$52.67	-30.9%	-38.0%
Boston	31.75	37.55	42.30	-15.4%	-24.9%
San Francisco	33.22	37.37	43.12	-11.1%	-23.0%
Austin	19.70	22.79	25.32	-13.6%	-22.2%
Miami	23.06	24.55	28.18	-6.1%	-18.2%
Sacramento	19.55	19.63	18.51	-0.4%	5.6%
Philadelphia	24.74	24.31	23.28	1.8%	6.3%
Minneapolis	20.52	20.56	19.12	-0.2%	7.3%
Honolulu	26.74	25.38	24.19	5.4%	10.5%
Northern New Jersey	28.64	25.61	25.81	11.8%	11.0%

Exhibit 4

TW Rent Index by Market Sorted by Market Name

	2001.4	2001.2	2000.4	Six Month Change	Annual Change
Albuquerque	14.38	14.56	14.60	-1.2%	-1.5%
Atlanta	20.96	20.92	21.51	0.2%	-2.6%
Austin	19.70	22.79	25.32	-13.6%	-22.2%
Baltimore	22.96	23.54	23.65	-2.4%	-2.9%
Boston	31.75	37.55	42.30	-15.4%	-24.9%
Charlotte	18.03	18.31	18.22	-1.5%	-1.0%
Chicago	23.75	24.64	23.49	-3.6%	1.1%
Cincinnati	15.95	16.16	16.73	-1.3%	-4.7%
Cleveland	19.37	19.79	20.05	-2.1%	-3.4%
Columbus	16.96	18.39	19.51	-7.8%	-13.1%
Dallas	22.82	22.96	23.20	-0.6%	-1.7%
Denver	18.10	18.87	19.56	-4.1%	-7.5%
Detroit	18.15	20.13	19.78	-9.8%	-8.2%
Fort Lauderdale	20.23	22.00	22.10	-8.0%	-8.5%
Fort Worth	16.71	17.00	17.50	-1.7%	-4.5%
Fresno	16.09	16.32	16.37	-1.4%	-1.7%
Hartford	17.10	18.03	18.04	-5.1%	-5.2%
Honolulu	26.74	25.38	24.19	5.4%	10.5%
Houston	18.49	18.99	19.09	-2.6%	-3.1%
Indianapolis	14.23	14.23	14.14	0.0%	0.6%
Jacksonville	17.22	17.79	18.21	-3.2%	-5.4%
Kansas City	15.45	14.92	15.06	3.6%	2.6%
Las Vegas	22.79	24.46	24.43	-6.8%	-6.7%
Long Island	25.74	26.07	25.68	-1.3%	0.2%
Los Angeles	23.81	25.15	24.76	-5.3%	-3.8%
Miami	23.06	24.55	28.18	-6.1%	-18.2%
Minneapolis	20.52	20.56	19.12	-0.2%	7.3%
Nashville	18.96	18.27	18.83	3.8%	0.7%
New York	43.01	54.42	52.13	-21.0%	-17.5%
Northern New Jersey	28.64	25.61	25.81	11.8%	11.0%
Oakland	29.29	29.95	29.27	-2.2%	0.1%
Oklahoma City	12.59	12.42	12.24	1.4%	2.9%
Orange County	26.24	26.44	26.09	-0.8%	0.6%
Orlando	19.41	19.28	19.85	0.7%	-2.2%
Philadelphia	24.74	24.31	23.28	1.8%	6.3%
Phoenix	19.57	20.15	19.78	-2.9%	-1.1%
Portland	22.03	21.94	21.89	0.4%	0.6%
Riverside	16.55	16.29	15.89	1.6%	4.2%
Sacramento	19.55	19.63	18.51	-0.4%	5.6%
Salt Lake City	16.23	16.70	16.76	-2.8%	-3.2%
San Diego	29.33	29.15	30.35	0.6%	-3.4%
San Francisco	33.22	37.37	43.12	-11.1%	-23.0%
San Jose	32.65	47.28	52.67	-30.9%	-38.0%
Seattle	22.25	24.22	25.44	-8.1%	-12.5%
St. Louis	19.52	20.27	20.52	-3.7%	-4.9%
Stamford	26.40	26.79	28.12	-1.5%	-6.1%
Tampa	19.62	18.82	20.46	4.2%	-4.1%
Tucson	19.55	20.27	20.50	-3.6%	-4.6%
Ventura County	21.31	22.12	21.92	-3.7%	-2.8%
Washington, D.C.	29.15	31.01	32.33	-6.0%	-9.8%
West Palm Beach	26.46	25.90	28.88	2.2%	-8.4%
Westchester County	22.03	23.24	25.42	-5.2%	-13.3%
Wilmington	18.90	19.69	19.23	-4.0%	-1.7%
National Model	25.75	28.60	28.90	-10.0%	-10.9%

Northern New Jersey comes in at the bottom of the list, which, given the sorting, is actually a good thing. This market saw an 11 percent increase between the 4th quarter of 2000 and the 4th quarter of 2001. Compared to the other markets, this growth would seem to be overstated—perhaps some calculation or numerical error. However, much of this growth happened in the last two quarters of 2001, and was mostly a function of an influx of demand.

In their Précis reports, Economy.com notes that in the Jersey City MSA, industry payrolls grew 11 percent between August and December in 2001 because of Manhattan relocations. Also, the 4th quarter employment data shows a 12.6 percent growth (4750 jobs) in the FIRE sector in the 4th quarter after growing between 2 percent to 3 percent per quarter for last few years. Across the six metropolitan areas we call Northern New Jersey, 11,115 FIRE sector jobs were added in the 4th quarter, after average growth of between 1,000 to 2,000 jobs per quarter since 1998.

Overall 2001 was as bad as 2000 was good. But the numbers show great variation around the country. For 2002 the numbers should be tamer! REI

ABOUT OUR FEATURED COLUMNIST

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FOCUS ON THE MARKETS

Challenges & Opportunities Mark Real Estate Sector

by Dale Anne Reiss

Even though the national real estate market maintained equilibrium throughout most of the 1990s, the sudden slump the national economy underwent in 2001 has placed significant stress on many segments of the real estate market. As a result, the real estate industry in 2002 is fraught with challenges. Adding to the challenges facing the industry as a whole has been the ongoing impact from the September 11 tragedies and the continuing fallout from the Enron debacle.

September 11, in particular, continues to rattle the real estate industry. After the initial shock over the vulnerability of one of the world's most visible structures—and resulting questions as to whether tenants would ever again go back into tall buildings—it is clear that high profile buildings have not witnessed a mass exodus. However, issues of security (too much or too little?) weigh heavy among owners of such buildings. The resulting uncertainty over the availability of adequate insurance coverage against acts of terrorism also threatens to cast a pall over the ownership of high-end office buildings, malls, and even hotels. Many owners of real estate and high-end users, especially Fortune 500 corporations, are conducting threat assessment and security audits to determine their vulnerability to devastating events. For real estate investors this has added a new risk profile beyond the typical real estate risk they have learned to underwrite. Now they must also learn to underwrite against potential loss.

The threat is not always from physical attack. The Enron debacle has shown how one corporation can turn an entire stock market—not just its industry sector—upside down. As many other corporations that entered into synthetic lease transactions in the 1980s and 1990s are now finding out, even legitimate, accepted financial vehicles can become tainted if they are misused. One of the major dominoes to come crashing down on real estate from Enron is that synthetic leases are now tainted in the eyes of investors. It will be difficult for some public corporations to execute such transactions in the future without attracting skepticism from Wall Street. Yet, now more than ever, corporations are under pressure to monetize their real estate assets and unlock capital to fuel corporate growth in the next economic expansion. Likely many will fall back on the more traditional sale/leaseback (despite its increased cost to the shareholder) or an outright sale—with its uncertainty of being able to control the space being leased.

The bright side to the current market is that where there are challenges there are also opportunities. A recent survey by Ernst & Young revealed that private equity funds—also known as opportunity funds—are holding about $20 billion in equity for investment in real estate over the next 24 months or so. This is a huge investment pool even when viewed globally, as the survey suggests that

60 percent of this equity may be headed abroad. For an insight into where the opportunities might be for these funds and others in the future, let's look at the major sectors of the real estate economy.

RESIDENTIAL

After a decade of steady growth, the construction market is expected to slow but homebuilders are still likely to prosper from strength in the single-family home construction market. Low mortgage rates have brought a surge in refinancing. Last year, new home sales increased against expectations. The 946,000 units sold during December 2001 were the fastest pace of sales since the beginning of the year. Sales for 2001 hit a new record of 5.25 million units, an extraordinary performance considering that the economy was in recession for 10 months out of the year. That performance is expected to continue, albeit at a slower pace.

In the multi-family housing sector, apartment conditions are softening. The National Multi Housing Council's market index fell for the 6th consecutive quarter to the lowest reading in the survey's two-and-a-half year history. Hardest hit are the luxury buildings in downtown areas. Managers are reporting occupancy rates in the 85 percent range—the lowest since the recession of the early 1990s. As the economic slump continues, roommate doubling-up is increasing and younger adults are moving back home. Marginally maintained units or properties saddled with poor leasing agents will suffer. Look for the recession to weed-out poorly capitalized, less efficient operators.

OFFICE & INDUSTRIAL

Companies have quickly responded to the slowing economy by placing their excess space on the market for sublease. This poses one of the real estate industry's biggest problems. Subleased space—offered at substantially discounted rents—is putting pressure on asking rents for primary space. National office vacancy rates soared to 13 percent in the later part of 2001 and are expected to continue to rise before peaking later this year. At the same time, the cost of ownership is rising. Post-9/11, security has become a way of life and an increased cost. Firms across the country are reevaluating and shoring up their security protocols and infrastructures. Property-insurance premiums have also increased. Additionally, the lack of terrorism insurance is impacting the sales and financing of major properties. Increasingly, office landlords are passing along additional expenses for security and insurance to tenants.

In the industrial market, the sluggish economy is having somewhat of a negative impact. Many corporations are divesting excess facilities—a major shift from the last five years, where many companies were frantically seeking new space. However, this in turn is providing the opportunity for real estate operators with skills to reposition assets.

HOSPITALITY

Lodging is among the most vulnerable real estate sectors in economic downturns. U.S. hotel room revenues fell almost 7 percent in 2001—more than twice that predicted by analysts. The post-9/11 travel crisis hurt an industry already hit hard by the economic slowdown. U.S. revenue per available room (RevPAR) showed the worst decline in 34 years. Analysts predict U.S. hotel occupancy levels for 2002 will be flat to slightly higher than 2001. Many hotel operators have been cutting costs and renegotiating loan covenants in an effort to preserve cash and avoid bankruptcy. Only those with the strongest balance sheets will be in a position to weather the coming year and so it is likely that some will become acquisition candidates.

RETAIL

While the retail property sector continues to weather the nation's current recession, the outlook is not entirely cloud-free. Unlike past recessions, consumer spending this time around appears strong. Should the recession deepen, and consumers scale back spending, more retailers could feel the brunt of the downturn. Mall owners should be cautious. Kmart has filed for Chapter 11 and will shutter 300 stores. Dillard's and The Gap also continue to struggle. Toys "R" Us recently announced plans to close 64 under performing stores and eliminate 1,900 jobs. Cinemas are also closing their doors. Grocery-anchored shopping centers may see more appeal because they are perceived as largely recession-proof.

CONSTRUCTION

Finally, construction companies are also facing challenges from the sluggish economy. Many banks are no longer offering working capital credit facilities to construction companies. As existing credit facilities expire, construction companies could be forced to turn to expensive capital sources to meet working capital needs. At the same time, insurance costs are rising, putting greater financial pressure on the sector.

CONCLUSION

In summary, the real estate markets will be challenging for the foreseeable future. Just when some in the industry were starting to believe that the nature of the sector had changed from a volatile, cyclical industry to a more stable sector, the cycle rolled through again. Yet, there are reasons to be hopeful: Housing markets appear robust. Today, as corporations begin to emerge from the recession, they see a market returned to the rent levels of 1999-2000 and, for many tenants, that means there are space bargains to be had. It won't take too long for corporate expansion to begin again in earnest and put in motion a more modest pace of growth in the real estate sector.REI

ABOUT OUR FEATURED COLUMNIST

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Bowling Alone

By Robert D. Putnam
Simon & Schuster, © 2000
541 pages

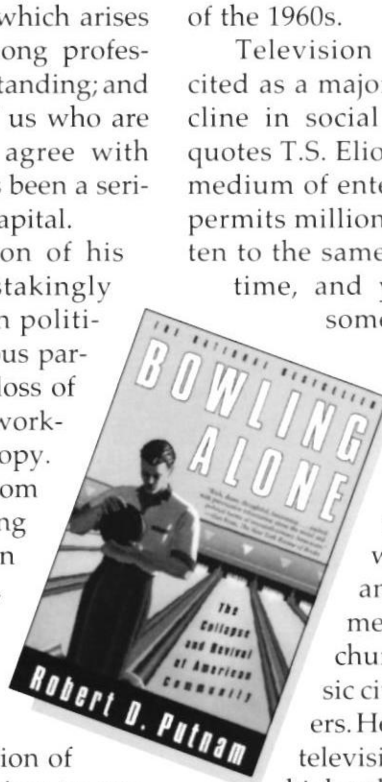
As Reviewed by
Bowen H. "Buzz" McCoy, CRE

RELATED READING RECOMMENDED BY THE REVIEWER

- Dietrich Bonhoeffer
  Life Together
  Harper & Row, 1954
- John Gardner
  Self Renewal
  Harper & Row, 1963
- Thomas Peters & Robert H. Waterman
  In Search of Excellence
  Harper & Row, 1982
- David Steindle-Rast
  Gratefulness, The Heart of Prayer
  Paulist Press, 1980
- Paul Tillich
  The Courage To Be
  Yale University Press, 1952
- George E. Valliant
  Adaptation to Life
  Little Brown & Co, 1977

Robert D. Putnam, a professor of public policy at Harvard and president of the American Political Science Association, chose the rather flip title, *Bowling Alone*, for his treatise on the decline of "social capital" in America. He defines social capital as connections among individuals, or social networking, and the norm of reciprocity and trustworthiness that arise from them. We CREs are well aware of the trust and reciprocity which arises from networking among professionals of the highest standing; and it is unlikely those of us who are active CREs would agree with Putnam that there has been a serious decline in social capital.

In the first section of his book, Putnam painstakingly defines the decline in political, civic, and religious participation, as well as loss of social capital in the workplace and in philanthropy. His research ranges from the decline in bowling leagues to decreases in voter participation, church attendance, bridge clubs, book reading groups, and the like.



In the second section of the book, Putnam claims to analyze the reasons for the decline in sociability. He concludes that the decline may be apportioned as follows: pressure of time and money, including two-career families (10 percent); suburbanization, commuting, and sprawl (10 percent); television (25 percent); and the replacement of the civic generation venerated by Tom Brokaw by their less involved children and grandchildren—the "baby boomers" and the "gen-X" (50 percent). Miscellaneous other factors cited might include higher divorce rates, growth of the welfare state, globalization, and the social turmoil of the 1960s.

Television viewing is thus cited as a major factor in the decline in social capital. Putnam quotes T.S. Eliot: "Television is a medium of entertainment which permits millions of people to listen to the same joke at the same time, and yet remain lonesome." Putnam cites statistics depicting negative correlations between television watching and volunteering, letter writing to friends and relatives, club meeting attendance, churchgoing, and basic civility towards others. He states that chronic television watchers have higher than usual incidents of headaches, indigestion, and sleeplessness. After reading this book, one ponders why Lydia Pinckham's potion is not advertised on television. Putnam states that Americans are watching more television, watching it more habitually, more often alone and watching more programs that can be associated specifically with civic disengagement. Television is thus a major factor in increased civil disengagement.

The major factor, however, is age related. There is a long civic generation, born between 1910 and 1940, who are substantially more engaged in community affairs and more trusting than those who are younger. Since national polling began, this cohort has been exceptionally civic, voting more, joining more, reading more, trusting more, and giving more. It is noteworthy that most of them did not see their first television until they were in their late twenties. The younger age cohort, according to Putnam, reads fewer newspapers, signs fewer petitions, votes less, volunteers less, attends church less, and is demonstrably less civic-minded.

As a solution to the problem he as diagnosed, Putnam suggests a broad scale agenda for social engineering. He recommends improved civics education, more public service, more extracurricular activities, more settlement houses, more day care at the work place, a clamp down on urban sprawl, a religious "great awakening," a mandated reduction in television viewing, more dance groups and community sing-alongs, broader volunteer participation in the political process, and the like.

Through his choice of title alone, Putnam has made his point. His book is high on the "most quoted, least read" list. We all need to be in various communities. We also need to time to be alone. Some of the great theologians, including Dietrich Bonhoeffer, have written beautifully about the tension between solitude and community. We cannot have one without the other. David Steindl-Rast has written an anecdote: "even hermits have conventions." His notion is that hermits living in huts for 24 days will then congregate over a meal and share "best practices" in a boisterous fashion.

Some of the characteristics Putnam cites may be age related. Young adults often drop out of church until they have young children, at which point they find their way back into those communities once again. It is much easier for a semi-retired 60–something to read three daily newspapers than a 30-year-old balancing work, courtship, and recreation. Sociologists have written profoundly about long societal swings in behavior. Just think how we regarded race, appropriate female behavior, dress, language, and smoking 40 years ago.

Certainly, since September 11, 2001, the nation's deepest feelings about patriotism, heroes, civility, and community have come to the surface for all of us, regardless of our age cohort. I would state that the terrorist attack on the World Trade Center has made much of Putnam's book less relevant.

Putnam's solutions would involve an enormous extension of social control over the lives of private individuals, and they would require massive government bureaucracies. There is no proof that the benefits of his agenda would outweigh the loss of liberty involved. The book is filled with inconsistencies. While it is probably deploring that Ozzie and Harriet have been replaced by the extended Soprano family, it is also true that Timothy McVeigh and his companions plotted the Oklahoma City tragedy in a bowling alley. One must take care in becoming the arbiter of popular culture. Those "good old boys" in the Elk's Club 40 years ago had strange and interesting views on black Americans, women's rights, gay rights, and a host of other issues. I think Putnam should be careful of what he wishes for. REI

ABOUT OUR REVIEWER

Bowen H. "Buzz" McCoy, CRE, *is a retired managing director of Morgan Stanley and past president of The Counselors of Real Estate. In addition to real estate counseling he engages in teaching and philanthropy. Buzz educates on business ethics in graduate business schools and Christian ethics and theology in churches. (E-mail: buzzmccoy@compuserve.com)*

CONTRIBUTOR INFORMATION

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