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Traditional views of the relationships between racial change and neighborhood decline, says Professor Bradford, have permeated the literature and practices of professional appraisers and underwriters. He analyzes the roots of contemporary models of racial change and decline to show that controversial views of the relationship among property values and neighborhood deterioration date back to the literature of the early 1930s. These beliefs are discussed in terms of empirical studies of the factors associated with mortgage default and foreclosure and the relationship between racial change and property values. While these studies have some methodological weaknesses, he finds that they do not support the existence of relationships between the racial composition of a community and either property values or lending risks. Given this lack of a body of empirical work to support the contemporary models, appraisers and lenders find themselves under increased pressure from regulators, community groups, legislators, and even the courts to revise these models and to support all underwriting decisions with hard data on risks and values.

In the "Reply" that follows, Pierre de Vise questions both the premises and the methodology employed by Mr. Bradford and wonders why lenders should have to prove their innocence before anyone has demonstrated that a crime was indeed committed.

Major redistribution of the U.S. population has taken place since 1970: frostbelt to sunbelt, large city to small, and urban to rural, revising the trends of the previous seven decades of the twentieth century. Yet despite a reversal of black migration, in other respects the nation's black population is not on trend, the author claims; there is continuing concentration in big frostbelt central cities where total decline is greatest. The majority reversals are in keeping with deep-seated Anglo-Saxon culture traits, as is the continued segregation of blacks, but the dynamic has changed in the last quarter century. Deliberate discrimination has been replaced by accelerated avoidance as status-conscious white Americans attempt to realize their pastoral ideals.

A new term, *possessory interest*, purporting to describe a lessee's interest in tax-exempt real estate for ad valorem tax purposes, has been coined in California. Use of the term and its application in this connection have resulted in confusion and misunderstanding of appraisal terminology and misapplication of appraisal principle. Assessment officials and courts in some other states have erroneously equated *possessory interest* with *leasehold interest* and have applied incorrect valuation procedures in appraising the market value of the lessee's leasehold interests in leases on tax-exempt property as required by constitution and/or statute. The author clairifes the issues and suggests a rationale to deal with the underlying problem.

The authors offer an update of their article "The Arlington Heights Case: The Exclusion of Exclusionary Zoning Challenges" which appeared in the Summer 1977 edition of *Real Estate Issues*.

The United States Supreme Court is hearing a major case that involves the designation of an individual building as a landmark. The highest court will have the opportunity to express its views on government regulation to protect historic property. The case on appeal involves the proposed construction of a 2,000,000 square-foot office building on the site of Grand Central Terminal in New York City.

REITs as Investment Companies: Advising Independent Trustees of Real Estate Investment Trusts **Richard S. Kraut** *Page 43*

The SEC has sued advisers and managements of REITs and has sued and criticized the performance of directors of operating companies. Independent trustees of REITs, accordingly, should not feel they are immune from SEC actions, much less private actions under the federal securities laws. The author, assistant director of the SEC's Division of Enforcement, examines the bases of potential liability of independent trustees and suggests ways to prevent exposure, including voluntary adherence to certain provisions of the Investment Company Act which generally regulates mutual funds.

The Conundrum of Condominium, or A Critical Look at the Best-Selling Real Estate Exposé **Stephen E. Roulac** *Page 62*

Condominium, a best-selling novel by John D. MacDonald, originator of the Travis McGee mystery stories, provides a provocative and not particularly pleasant look at the real estate development scene. While real estate today is a primary focal point of social pressure and thereby can provide an outstanding context for viewing the change forces occurring in society generally, few arenas of economic activity seem to be as ill-equipped to be the locus of such considerations. These issues are sharply raised in MacDonald's book, and this article explores the often extraordinary chasm between the professionalism that many in the business preach and the standards too often encountered in practice.

When Should Real Estate Be Sold? **Jack P. Friedman** *Page 68*

A total of 729 possible outcomes of income-producing real estate were simulated, taking into account variables including depreciation method, depreciable life, mortgage amortization term, owner tax bracket, and property performance in net operating income and value changes. The simulators indicated that property performance has a profound effect on yield and the suggested year of sale. The author identifies two crossover points in the life of income-producing property: the first when mortgage principal payments exceed tax depreciation, the second when after-tax cash flow becomes negative. Simulations show that the internal rate of return normally peaks between these two points.

Survey of U.S., Europe Reveals Strong Office Market: Rates on Increase Almost Everywhere **Ronald R. Pollina** *Page 77*

As our national economy has indicators which help economists in evaluating economic trends, so does the office market. One of the best of these indicators is rental rates and the best sign of an improving office market is rapidly rising rental rates. This article discusses recent rental rate changes for Class A office buildings in 15 major U.S. and European markets and their importance in evaluating office development trends.

Comparative Investment Performance of Common Stock and Real Estate **Moshe Ben-Horim** *Page 84*

Professor Ben-Horim finds fault with the methodology proposed by Michael S. Young in "Comparative Investment Performance: Common Stock Versus Real Estate—A Proposal on Methodology," which appeared in the Summer 1977 edition of *Real Estate Issues*, for his analysis of real estate risks and returns. A reply by Mr. Young follows.

Real Estate Issues

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American Society of Real Estate Counselors

PRESIDENT'S MESSAGE

Being in the right place at the right time usually yields good tidings of some kind—prosperity, marriage, or recognition. Sharing the limelight as President of the Society during this, our 25th year, brings much pleasure and at times some very sober thoughts as I scan the still relatively brief history of ASREC.

Organized by a handful of prominent real estate personalities scattered throughout North America, we have grown to a body of some 500 specialists devoting the major portion of our work to counseling others for a fee, something almost unheard of prior to World War II. It is still true that many people both inside and outside our industry remain unaware that professional counseling in real estate matters is available to the American public. Fortunately, their number grows smaller each year as our membership grows and our scope of work expands, drawing attention to the value of the services we provide. The word "counselor" seems to have a highfalutin' connotation, creating an image of "the big deal." In hopes of bringing it down to earth we hereby announce to the entire investment community that objective advice is available from our members for all types of properties and all sizes of transactions. Our diversification is considerable and the properties we work on may range from a ranch in western Canada to a condominium in southern Florida. The membership now extends to almost every state in the nation and every province in Canada.

Our progress during these past 25 years can be measured in many ways. It is particularly gratifying to witness the public's increasing acceptance of the role of the counselor in real estate. "Should I lease the store? Is the financing correct for my cash flow requirements? Is the site suitable for an office building?" The list of such questions increases each year as our industry becomes more sophisticated and complex.

The growing need on the part of the public for real estate advice encourages my optimism as we embark upon the next 25 years. At the same time it causes some concern as to whether or not we will be able to fulfill our obligations to our clientele. It is for this reason that our Society actively sponsors numerous educational sessions in disciplines essential to real estate counseling, with the aim of developing among the younger people in the industry a desire to seek a career in a field that can be richly rewarding on a personal as well as business level. In addition, the Society has published monographs and textbooks, all aimed at developing more interest in our specialty. Some two years ago we began publication of this journal which we are proud to announce is beginning to attract a very respectable list of subscribers including Realtors, academicians, attorneys, and professionals in allied industries.

We are all particularly grateful to the past leadership for their devotion to maintaining the standards of practice and code of ethics to which our Society adheres. The next 25 year period will bring us into the 21st century. Numerous thoughts come to one's mind—nuclear energy, solar heating, space travel—terms which we related to science fiction at the beginning of the 20th century. Despite these dramatic changes, real estate will continue to remain one of the principal resources of the nation's wealth and the role of the counselor will be as vital then as it is now.

Abram Barkan, CRE
ASREC President

EDITOR'S STATEMENT

No recent issue has generated more heat in the real estate lending community than redlining. Legislative efforts to reduce or eliminate the alleged discrimination by lenders against minority or "threatened" neighborhoods have done nothing to lower the temperature, and little to clarify the many problems that surround the issue. Calvin Bradford, a leading theoretician of the anti-redlining movement, couches his evaluation of underwriting and appraisal practices in terms of risk analysis, calling for drastic revision in the conventional wisdom concerning neighborhood evolution and change. While real estate professionals will disagree with many of Bradford's assumptions and findings, it is important that they know about them—if only in order to form cogent defenses.

Pierre de Vise, whose landmark article on the same subject led off our Summer 1977 edition, takes the opportunity to rebut key elements of Bradford's thesis in a brief and forceful response. Perhaps readers will be inspired to add their own comments.

On a related issue, Brian J. L. Berry, who recently moved to Harvard after a distinguished career at the University of Chicago, investigates racial separation in terms of broad demographic patterns that have revealed themselves in the United States since 1970, examining the roots of separation in certain fundamental traits of the American culture. As major metropolitan areas lose population to the countryside, blacks are increasingly being left behind in central cities along with other minorities and the poor, leaving newly elected black leaders to cope in many cases with the worst possible economic and demographic circumstances. In a challenging prognostication, Berry points out that 20th century trends have all pointed in the same direction— *creation of nothing less than an urban civilization without cities.* His views are based upon serious investigation and deserve your equally serious attention.

Turning to a subject of interest to every lessor, lessee, advisor, and appraiser of real properties under long-term lease, Walter R. Kuehnle offers much-needed clarification of the distinction between possessory interests and leasehold interests in law and in appraisal terminology. Confusion on this question has led to tremendously damaging court decisions in California and Illinois and created shock waves in the real estate community that make this article timely as well as important. Mr. Kuehnle, a past president of the American Institute of Real Estate Appraisers and a respected member of the American Society of Real Estate Counselors, brings vast practical knowledge and theoretical background to his subject.

David L. Callies and Clifford L. Weaver update their Summer 1977 article on the Arlington Heights case with a clear view of an unclear decision. Readers concerned with zoning, housing, and discrimination matters should find their analysis helpful. It is followed by an update on the Grand Central case by Frank B. Gilbert, counsel to the National Trust for Historic Preservation.

The responsibilities of corporate directors have grown rapidly and in often unpredictable directions. Increasingly, REIT advisors are being caught up in some of the surprises. Richard S. Kraut, assistant director of the Enforcement Division of the Securities and Exchange Commission, provides an authoritative though unofficial reading on the special exposures and burdens of the REIT advisor and on the trends now beginning to surface. Stephen E. Roulac puts needle points on some of Kraut's observations in his amusing review of John D. MacDonald's best-seller *Condominium*, exploring the gulf between the professionalism preached by many in the business and the way real estate is so often perceived, perhaps justifiably, by outsiders.

In a discussion of great practical interest, Jack P. Friedman of the University of Texas provides a research-based rationale for the timing of investment property sales. His thorough study of this key question is followed by Ronald R. Pollina's survey of the international office space market, offering information of immediate use to many practitioners. We close this first of two 25th Anniversary editions of *Real Estate Issues* with a brief exchange between Professor Moshe Ben-Horim and Michael S. Young on the methodology of Mr. Young's article in the Summer 1977 number.

We hope you share with us the excitement generated by many of the articles in this edition of *Issues* and can appreciate the pride we feel in presenting them to you. Our Winter 1978 edition will, we think, be even better. Don't miss it.

Jared Shlaes, CRE
Editor-in-Chief

An Analysis of Underwriting And Appraisal Practices and Their Impact on Credit Availability

by Calvin Bradford

> "The biggest problem with our generation of bankers is that they don't know how to do risk analysis."
> —Ronald Grzywinski, South Shore National Bank of Chicago.

At the heart of the controversy over redlining, disinvestment, and reinvestment is the question of risk analysis. Viewed from a lender's point of view, the decision not to lend, or to lend on more restrictive terms, in certain areas which he perceives as risky may appear to be a wise business decision dictated by his responsibility to protect his depositors and stockholders. Viewed from the community's point of view, such decisions cut that community off from its access to vitally needed credit.

Disinvestment studies (conducted by public officials and community groups) which document the lack of conventional mortgage money in older, minority, or racially changing neighborhoods across the country have served to dramatize the issue and to force public officials to examine it. These studies, however, do not *necessarily* address the question of whether lenders are making unfortunate, but essential, business decisions in order to avoid taking undue risk and incurring excessive losses on loans in these communities. What separates a wise business decision from one which creates a self-fulfilling prophecy of neighborhood decline is the validity and accuracy of the lenders' claim that community conditions create unacceptable credit risks.

It is essential that lenders base their analysis of the risks involved in a loan on sound, well-informed, and trustworthy methods. Many of the professional loan underwriting standards incorporate models of neighborhood life cycles and assumptions about sound neighborhood conditions which are based on little, contradictory, or fragmented evidence. The application of these models or assumptions to a specific loan, in a specific community, at a specific point in time, therefore, is often highly suspect.

State and federal regulations require institutional lenders to base their real

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estate loans on the present appraised value of a property being used as collateral. This is designed to insure that lenders protect their investments by loaning less than the full value of a property and generally requiring some equity (down payment) from the purchaser. Typically, a lender requires about a 20% down payment as a cushion against such risks as foreclosure. If the value of the property decreases rapidly, however, this cushion may not be enough to pay all the costs associated with foreclosure or some other losses. Thus, the lender must estimate the trends in the market and decide whether there are clear and present threats to the value of the property which represent an unreasonable risk for a standard loan. This part of property loan underwriting is similar to appraisal, except that value trends are projected from the present into the future.

Lenders have relied on professional appraisers for standards and techniques of long-term property underwriting. Frequently, lenders train their underwriters by enrolling them in the programs of the professional appraisal organizations. The literature, training manuals, and texts of the professional real estate appraising industry define the standards, assumptions, and models used in judging neighborhood factors and loan risks. A review of the development of this literature reveals the sources upon which these standards, assumptions, and models are based.

THE ORIGINS OF NEIGHBORHOOD LIFE CYCLE MODELS

The early works on appraising and real estate principles reflect views of the relationship between ethnic change, age of the community, and the community life cycles which still appear in much of the professional material today. Two theories of urban decay are commonly used to support the contention that neighborhoods pass through natural life cycles and that racial change indicates a cycle of decline. Both of these theories, or models, were developed at the University of Chicago in the 1920s and 1930s. They are the "human ecology" model and the "filtering" model.

The human ecology model, which became the dominant social model of urban development, was formulated principally by the Chicago School of Sociology in the work of Robert Park, Roderick McKenzie, and Ernest Burgess. It stems from a strong social Darwinistic influence, where not only animals, but people are seen to survive and reach positions of power and status because they are innately the strongest species. This school is also heavily influenced by plant biology, particularly studies of how various plants would take over a piece of land previously occupied by a different species. It is believed that the "invading" plant, as it is called, drives out the original inhabitants because the invaders are better suited to the particular environment.[1]

When applied to human society and the neighborhood development patterns of urban areas, in particular, this model holds that different groups of people "infiltrate" and "invade" territory held by others, and that through a process of "competition"—which is a kind of war of survival—the group most suited to that environment wins out and eventually takes over completely. Neighborhoods and communities, therefore, are seen not so much as conscious man-made environments, but rather as natural phenomena, subject to the laws "of all nature."

As the level of industrial technology in society advances, certain areas are seen as best suited to that level of technology, and thus become the location of the most successful businesses and residents. Areas less suited to advanced technology become inhabited by the businesses and residents least suited for survival at that state in the evolution of society and technology. Thus, areas, neighborhoods, and communities are identified as going through natural life cycles. First they grow to a point of success. But then as the technology of the society develops and favors different locations, the community is invaded and taken over by lower uses and lower class people in continuing waves of invasion, competition, and succession.

There are temporary plateaus of stability when the area is occupied by a homogeneous population or land use, analogous to a single species of plant taking over its most beneficial location. When this homogeneity is interrupted by the "invasion" of a different type of land use, property, or class of persons, this starts the downward cycle. According to the literature based on the human ecology model, the process continues until the area reaches its inevitable place as a slum.

Robert Park's own statement about the Eastern Europeans then occupying Chicago's slums best expresses the Darwinistic and discriminatory biases of this human ecology model of neighborhood dynamics:

> "In the great city of the poor, the vicious and the delinquent, crushed together in an unhealthful and contagious intimacy, breed in and in, soul and body, so that it has often occurred to me that those generations of the Jukes and The Tribes of Ishmael would not show such a persistent and distressing uniformity of vice, crime, and poverty unless they were peculiarly fit for the environment in which they are condemned to exist."[2]

At the same time, a colleague of Park's, Homer Hoyt, was working on real estate models of land values. In an historical analysis of land values in Chicago, Hoyt included a discussion of race and land values. He surveyed some local Realtors® (members of the Chicago Real Estate Board, which prohibited members from selling to a black on a white block). One West Side Realtor gave him a list of ethnic groups ranked in *descending order*, from those which are most desirable to those which have the most adverse effect on property values.

The list was as follows:[3]

1) English, Germans, Scotch, Irish, Scandanavians
2) North Italians
3) Bohemians or Czechs
4) Poles
5) Lithuanians
6) Greeks
7) Russians, Jews (lower class)
8) South Italians
9) Negroes
10) Mexicans

McMichael's Appraising Manual, often called the bible of appraising, is a commonly used appraisal text which was first published in 1931. Appraisers were then advised to determine whether there were "undesirable racial elements" in an area.[4] The 1951 edition responds to a Supreme Court decision striking down racially restrictive covenants by saying it created "further confusion to appraising properties in foreign and negro-occupied districts." The text then praises Hoyt's study of land values in Chicago and reproduces his ranking of ethnic groups and their effect on property values. Following this, there is a discussion of how the "ingress" of certain ethnic groups precedes blight.[5]

This orientation is superimposed on a work which Hoyt did for the FHA in 1939, *The Structure and Growth of Residential Neighborhoods in American Cities*.[6] In this book, Hoyt defines what has come to be known as the "filtering" or "trickle-down" model of neighborhood decline. This model suggests that as properties and neighborhoods get older, they filter down into the hands of poorer and less capable people until they finally become slums. This filtering concept, which transforms the human ecology model into real estate terms, has been the basis for various models of the life cycle of neighborhoods in later real estate and appraisal literature.

Although Hoyt is considered the founder of the filtering model, Frederick Babcock, who gained his real estate experience while working in Chicago during the time the Chicago School of Sociology was developing, implied such a filtering concept in his influential 1932 book, *The Valuation of Real Estate*. After describing six characteristics of neighborhood decline, Babcock states:

> "The process can be described as inevitable in all residential districts. Given time, all such areas become decadent districts or slums occupied by the poorest, the most incompetent, and least desirable groups in the city. Ragged urchins play on marquetry floors."

Two pages later he comments:

> "Most of the variations and differences between people are slight and value declines are, as a result, gradual. But there is one difference in people, namely race, which can result in a very rapid decline. Usually such declines can be partially avoided by segregation and this device has always been in common usage in the South where white and negro populations have been separated."[7]

The first edition of the American Institute of Real Estate Appraisers (AIREA) text, published in 1935, echoes Park, Hoyt, and Babcock by warning of the adverse effects of the "infiltration of inharmonious racial groups."[8] The text suggests that areas can be protected from these adverse effects by deed restrictions "which forbid whites to sell their homes to blacks."[9]

Accompanying his testimony before a HUD meeting on redlining in July of 1976, Walter Winius of the American Institute of Real Estate Appraisers submitted 21 articles which have appeared in the Institute's *Appraisal Journal* since 1938. The Journal does not represent the official position of the Institute, but was described as "a forum for the presentation of new ideas and concepts having to do with the appraisal of real estate, many of which have ultimately appeared in our textbooks." He explained that an article in 1959 by Charles Abrams "issued a clarion call in respect to the analysis of neighborhoods." That article suggested that there had been a bias against integrated neighborhoods and against blacks, and that this bias was unwarranted. Winius cited several articles published prior to 1967 which demonstrated, using statistical studies, that racial change had no adverse effect on property values.[10] Nevertheless, in the 1967 edition of the Institute's basic text, *"The Appraisal of Real Estate,"* the chapter on Neighborhood Analysis reads:

> The value levels in a residential neighborhood are influenced more by the social characteristics of its present and prospective occupants than by any other factor. Therefore, the appraiser must give major consideration to the importance of social data.
>
> The causes of racial and religious conflicts are not the appraiser's responsibility. However, he must recognize the fact that values change when people who are different from those presently occupying an area advance into and infiltrate a neighborhood.[11]

The *Student Outline* used in a 1973 session of the Institute's basic course reads:

> Ethnological information also is significant to real estate analysis. As a general rule, homogeneity of the population contributes to stability of real estate values. Information on the percentage of native born whites, foreign whites, and non-white population is important, and the changes in this composition have a significance. *As a general rule, minority groups are found at the bottom of the socio-economic ladder, and problems associated with minority group segments of the population can hinder community growth.* Similar comments are appropriate for occupational types in a community.[12] (Emphasis added.)

In a slide show on single-family appraising shown during the course, the scene of a burned out store was accompanied by the words: ". . . One exceptional factor which may affect value is the influx of inharmonious social or racial groups."[13]

DEFINITION OF STABLE NEIGHBORHOODS

Changes over a period of time have deleted direct statements that racial change leads to declining communities. The definition of a neighborhood as relatively homogeneous, however, remains.[14] Both the 1967 and the 1977 editions of the AIREA text define a neighborhood as "a homogeneous grouping of individuals, buildings or business enterprises within, or as part of, a larger community."[15] Both versions go on to say:

> Residential neighborhoods assume many of the characteristics of the individuals who live in them. These neighborhoods express the mutual desires of people with compatible interests, related traditions, and similar social and economic status.[16]

The notion that a neighborhood should be homogeneous in order to remain stable or to increase in value is reinforced by what appraisers and underwriters call the *principle of comformity*. The American Institute of Real Estate Appraisers states that "the principle of conformity holds that maximum value is realized when a degree of sociological and economic homogeneity is present."[17] The manual of the Society of Real Estate Appraisers (SREA) presents eight aspects of the principle of conformity:

1) Similar types of houses.
2) Houses of similar utility.
3) Similar age and size of houses.
4) Similar quality of houses.
5) Similar price range of houses.
6) Residents' income in the same general bracket.
7) Residents of similar cultural, educational, *ethnic*, and social backgrounds. (Emphasis added.)
8) Similar land uses.[18]

THE CYCLE OF DECLINE MODEL

The belief that neighborhoods inevitably, or at least typically, pass through a life cycle of birth and death has been extracted from the work of Park and Hoyt and placed at the core of the professional appraisal and underwriting wisdom on neighborhood risk analysis. The model has permeated not only real estate literature, but popular beliefs as well. Nonetheless, surprisingly little research has been done on the causes of decline and improvement since Park first introduced the theory in the 1920s based on his analogy to plant behavior.

To test the theory, a study would have to test all the possible causes of decline against each other over a large number of different communities across the country. Such a study would have to be continually repeated to insure that as time passed and the environment changed, the causes of decline didn't also change. All of these studies would have to favor a single model or set of causes in order to justify the acceptance of the model. Among the things which would have to be taken into account as causes of decline or improvement are not only age and racial change (as is the case with the model used in underwriting texts), but also the individual market behavior of the residents, the actions of government bodies, the impacts of lending decisions on the viability of the neighborhood economy, external conditions such as the state of the regional and national economy, the rate and location of new development, and finally the interrelationships among all of these factors.

No such study exists. What exists are some fragmented, often conflicting, studies of these individual factors. Most research is based on one, or a small group, of communities in one location at one point in time.[19]

Most contemporary descriptions of life cycle models were designed to describe how heavily blighted or abandoned areas progressed to this state.[20] Obviously, such areas declined from an earlier, and healthier, condition. These models can, and do, break down this decline into several stages. There is no indication in such studies, however, that *all* communities should be expected to pass through these cycles.[21]

Although there is a lack of evidence in support of such models, they are clearly stated as facts in the appraisal and underwriting professions. For example, the most recent text of the SREA reads:

> All neighborhoods exhibit a life cycle which varies only in the intensity and duration of each phase. The phases are:
>
> 1) *Development and Growth.* This is the period during which prices are increasing

and the neighborhood is built up.

2) *Stability.* This period may last from approximately the 10th to 15th year of the life of the neighborhood, perhaps through its 40th year. This is generally the period of highest value and attractiveness of the neighborhood.
3) *Transition and Decline.* This occurs as the attractions of the neighborhood are offset by those of new, competitive areas. The properties become functionally obsolescent, as does the pattern of the neighborhood. New uses begin to move in, and transition frequently results in lower values.
4) *Renewal and Rehabilitation.* In some instances, it is possible to renew and revive a neighborhood. Examples may be found in nearly every city: e.g., Old Town in Chicago, and Society Hill in Philadelphia.[22]

HOMOGENEITY, CONFORMITY, AND MORTGAGE RISKS

In spite of the emphasis which appraisers and underwriters have placed on the need for homogeneity and conformity of land uses, building types, styles of construction, and social characteristics of the residents, and aside from some studies of race and property values, there are no studies which systematically compare homogeneous and heterogeneous communities to assess the risk posed by lack of conformity and uniformity. These notions were based on the human ecology model derived from analogies to plant behavior.

Though there have been no systematic studies, there is some indication that mixed land uses and building types may actually be *beneficial.* A major study carried out for HUD tried to estimate the optimum land mix best suited for environmental impacts. This study, *Costs of Sprawl,* cited a high degree of mix between commercial, industrial, low-rise, and high-rise development as the most beneficial. Moreover, while underwriters have been looking critically at mixed use patterns in older communities, they have viewed the development of the Planned Unit Development (PUD) concept for new development as a sound, even risk-reducing technique. One of the basic tenets of the PUD is that the developer is allowed to mix land uses and combine single-family, multi-family and commercial or industrial uses within the same development area. By not depending upon one particular style of building or one particular market, the developer is supposed to minimize the risk of failure in the project and maximize the development of socially and economically sound communities.

RISKS POSED BY RACE AND RACIAL CHANGE

Property Values and Racial Change

An analysis of the major studies on property values and race reveals that in all but one of the studies, property value trends *either* increased or remained about the same after racial change.[23] In the one study which documents that prices did not *rise* after racial change—"Racial Succession and Changing Property Values in Residential Chicago"—the author notes that values were declining prior to black entry.[24] Seven of the studies which considered the socio-economic factors of the incoming blacks, indicated that blacks had either a higher class level or a higher income level than the whites who already lived in the area.[25] Finally, there are two studies of racially changing areas in

Chicago which arrive at different conclusions about racial change and property values.[26]

The existing studies of property values and racial change do not take account of the effects of disinvestment. There are some areas where racial change has taken place and where property values have declined or risen at rates lower than in comparable white areas. One would expect that disinvestment, once it takes place, would eventually effect property values. There is one study which examined both disinvestment and property values.

A detailed study of disinvestment in northwest Philadelphia compared similar communities, one which changed racially and one which did not.[27] The area which changed racially actually showed increases in family income, level of education, and employment status compared to the area which did not change. The study traced both the level of conventional mortgages and the property values in the two areas. Generally, property values rose more in the racially changing area *prior* to heavy disinvestment by conventional lenders. *After* several years of disinvestment, property values in the racially changing area slowed and increased at a lower rate than properties in the all white area.

Causes of Mortgage Default and Foreclosure

There are a number of studies of factors which predict default and foreclosure. Most of the studies were carried out in the 1960s, during a period of unusually high foreclosure rates throughout the lending industry. Most focused on FHA and VA loans and paid little attention to the factors associated with conventional loans. Since 1970, several more studies have been done but most of them, like the earlier studies, have serious methodological problems such as poor and biased samples, exclusion of several factors believed to be important in delinquency and foreclosures, lack of data on a neighborhood level, and lack of attention to explaining the causes of the statistical relationships presented.[28]

Most of the studies suggested that delinquencies and foreclosures were related to factors representing the individual characteristics of the borrower, the conditions of the loan, or the condition of the property.[29] Of the three studies which suggest that neighborhood factors do influence delinquency and foreclosure rates, two of these studies were carried out in the Pittsburgh area.[30]

The one study which was not carried out in Pittsburgh was done by FNMA.[31] It covered only two FHA low-income programs, and used zip codes as the basic unit of analysis. It did not consider the individual loan characteristics which previous studies had found to correlate with mortgage risk. While there are some correlations with neighborhood (actually zip code) characteristics, they were not strong and race was not one of these factors. Interestingly, this study showed that the level of indictments for illegal use of federal housing programs was one of the most important predictors of foreclosure in one program.[32]

A Pittsburgh study found that no neighborhood characteristics were associated with both delinquency and foreclosures, and that only high neighborhood unemployment was associated with foreclosure.[33] All the neighborhood factors together could explain only 12% of the delinquency levels and 9% of the levels of foreclosures on the loans studied.

A second Pittsburgh study by George von Furstenberg and Jeffrey Green represents the most detailed study of neighborhood characteristics and delinquency in mortgage payments.[34] The study found no conclusive relationships. It could not identify any clear relationship between racial characteristics of an area and delinquency rates. The study did find a relationship between the age of the mortgaged property and delinquency, but this was not consistent with an earlier, more extensive, study made by von Furstenberg alone.[35] The von Furstenberg and Green study suffers from the fact that all the loans studied came from one lender and do not represent the general market, even for Pittsburgh.

The most recent study of mortgage risks was produced by Andrew Brimmer for the U.S. League of Savings Associations. This report, published in April of 1977,[36] attempts to separate risk from racial discrimination. It concludes that inner-city, minority communities represent higher risks. However, the study was not based on any *new* research. His conclusions were based on an earlier study from the FHLBB, which showed that minority-owned S&L's did not perform as well as white-owned S&L's.[37]

Brimmer had no data on the actual location or conditions of *any* loans made by *any* of the white or minority S&L's, but assumed that the white S&L's loaned in white areas and that the minority institutions loaned in inner-city, minority areas. The study Brimmer relies on was not intended to evaluate the lending risks in any area. Like most other such studies, it draws attention to the lack of management expertise—not lending risks—as the major cause of low performance by minority institutions. Thus, this study must be considered of extremely limited value since its findings are based on illogical and unfounded assumptions.

There are several examples of sound lending opportunities in older, minority, racially changing communities for lenders who ignore the conventional wisdom of decline and risk. At HUD's meeting on discrimination in mortgage lending held in Hartford in 1974, Robert Gnaizda, a public interest lawyer, presented a study which showed how the largest savings and loans in California had redlined the Mission District of San Francisco. Then he indicated that a minority-owned institution, formed in the last two years, had placed 88% of its loans in the Mission District with not one current delinquency, default, or foreclosure.[38] In testimony before HUD's Philadelphia Meeting on Redlining in 1976, James Vitarello of the Washington, D.C. Residential Mortgage Investment Commission, gave an example of another minority-owned institution in Washington (Independent Federal Savings and Loan Association) which has 89% of its loans in the city of Washington. It has no defaults on any of these loans.[39]

In the South Shore community of Chicago, which had been defined as being "clearly declining," a local group of investors bought out the bank which was trying to move out of the area because the racial change and alleged decline had made it impossible for them to survive. The new owners set out to make the bank a vehicle for community development. They have reversed the bank's losses and turned larger profits each year. Last year alone, the bank made 52 home loans in its community. It has only two defaults and no foreclosures on these loans.[40]

In Philadephia, there is a program by several of the commercial and mutual savings banks to revise their underwriting practices in order to include older neighborhoods. The new underwriting criteria permit conventional lending in any block which does not have more than 10% of the properties abandoned and vacant. Even if the abandonment rate is higher, conventional loans will be made if there is evidence of community activity to put the block back on its feet.[41] In spite of what many lenders consider to be excessively liberal definitions of sound neighborhood, the delinquency rate for the Philadelphia Plan has been as low or lower than for mortgages in the suburban areas around Philadelphia.[42]

RECENT CHANGES IN THE USE OF ETHNICITY IN APPRAISING AND UNDERWRITING

In the past several years, there have been changes made by some appraisal and underwriting organizations as well as by some federal regulatory agencies. Some of these changes have been significant.

The savings and loan industry is the largest originator of home loans, making more than 50% of all such mortgages. The Federal Home Loan Bank Board (FHLBB) directly regulates federally chartered savings and loan associations; and through its Federal Savings and Loan Insurance Corporation (FSLIC) indirectly regulates the practices of most state chartered savings and loans.

In 1974, an opinion from the general counsel for the FHLBB stated that consideration of the ethnic composition of the area where a loan is to be made is a violation of civil rights law.[43] Moreover, later regulations adopted by the FHLBB state:

> The use of lending standards which have no economic basis and which are discriminatory in effect is a violation of law even in the absence of an actual intent to discriminate. However, a standard which has a discriminatory effect is not necessarily improper if its use achieves a sound business purpose which cannot be achieved by means which are not discriminatory in effect or less discriminatory in effect.
>
> Refusal to lend in a particular area solely because of the age of the homes or the income level in a neighborhood may be discriminatory in effect since minority group persons are more likely to purchase used housing and to live in low-income neighborhoods. *The racial composition of the neighborhood where the loan is to be made is always an improper underwriting consideration.*[44] (Emphasis added.)

The U.S. League of Savings Associations is the trade organization of the savings and loan industry. Among its functions is the training of lenders seeking advancement in the industry. For years the organization has trained its members on the use of its own recommended appraisal form, known as the "Green Hornet." One of the items on this form asked for the "ethnic composition" of the area. The appraiser—either a staff member of the S & L, or a contract appraiser—was to check off either "stable" or "unstable" conditions.

In response to the 1974 opinion of FHLBB's general counsel, this form was changed to replace ethnic information with data on "sales velocity." In the League's underwriting text, the wording surrounding the copy of the Green Hornet form was not changed. In addition, the League's 1975 text, *Lending Principles and Practices*, states that racial change, even fear of racial change, is identified with increased volume of sales—*thus linking sales velocity to ethnic change.*[45]

On April 16, 1976, the Justice Department filed a suit against AIREA, SREA, and two professional associations of lenders charging that these groups were teaching their members discriminatory practices.[46] AIREA, which had already been making some progress in revising its materials, provided its course instructors with a set of sample questions and answers to be used in response to student inquiries about race and property valuation. These sample materials, which were distributed on July 9, 1976, detailed a position that racial change did not necessarily affect property values.[47]

On November 23, 1977, the Institute reached a settlement in the case.[48] The Justice Department dropped its charges without requiring any statement of guilt. For its part, AIREA made extensive, point by point revisions of its forthcoming text and added sections and interpretations to its Code of Professional Ethics and Standards of Professional Conduct. In addition, AIREA developed an Affirmative Action Program, which they had been working on prior to the court suit, and issued a three-point policy statement in regard to neighborhood analysis. The first point reads:

> It is improper to base a conclusion or opinion of value upon the premise that the racial, ethnic or religious homogeneity of the inhabitants of an area or of a property is necessary for maximum value.

The third point reads:

> It is improper to base a conclusion or opinion of value, or a conclusion with respect to neighborhood trends, upon stereotyped or biased presumptions relating to race, color, religion, sex or national origin or upon unsupported presumptions relating to the effective age or remaining life of the property being appraised or the life expectancy of the neighborhood in which it is located.[49]

These statements were incorporated into the detailed revisions of the Institute's text which will soon appear in a new revised edition. The new text contains clear statements that previous notions and statements about race and property values are not considered proper any more. The principle of conformity is redefined to omit references to social homogeneity. While the chapter on neighborhood analysis still presents a general model of cycles of growth and decline, they are not stated as inevitable and are specifically not related to race. The views expressed in the policy statement on neighborhood analysis are also incorporated in the new sections interpreting the Code of Professional Ethics. As part of the settlement, AIREA members and candidates for membership were all sent copies of the settlement agreement, including appendices containing the changes in the text book and Code of Ethics.

SREA, on the other hand, actively sought to block the settlement between AIREA and the Justice Department. In an official policy statement at their national convention, they reasserted their right to teach whatever they thought important as part of their Constitutional right of free speech.[50]

CONCLUSION

The lack of sound evidence for models of racial change and decline, the individual cases of conventional lending successes in some inner-city areas, and the evidence from the literature on mortgage risks and property values all suggest that the existing models are in serious need of revision. Admittedly, the methodological purity of many of the individual studies of foreclosure risks and the relationships between racial change and property values is not impressive. What is striking, however, is the lack of any body of empirical work to *support* the models of race and decline.

In the controversy between the lenders and the community groups and regulators investigating charges of redlining and disinvestment, the burden of proof is shifting to the lenders. In no small measure, this is due to the assumptions and standards expressed in the traditional approaches to racial change and neighborhood decline. When seeking to distinguish between patterns which reflect sound lending and those which indicate discrimination, objective evidence of risk and value trends becomes the determining factor. While it may be clear that traditional assumptions are not appropriate, it is not equally as clear what standards, assumptions, information, or techniques are appropriate. Lenders may have to go through a painful process of learning to do risk analysis under the watchful eyes of both regulators and community groups. Whatever revised underwriting processes are developed, they will have to survive public scrutiny and debate.

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by Pierre de Vise

Although Professor Bradford's article is couched in the language and syntax of objective scientific inquiry, it is in fact a highly polemical piece which discounts conventional analysis of community decline and legitimizes populist critiques of conventional analysis and institutional behavior.

At the very outset, Bradford takes for granted that lenders redline minority neighborhoods. He is charitable enough to recognize the possibility that the redlining may be based on a sound determination of risk, yet he presumes that the problem of redlining is one of lenders not lending to creditworthy applicants rather one of an absence of demand on the part of creditworthy applicants. This presumption is akin to asking why a man beats his wife before determining that he has in fact beaten his wife.

Lenders are accused of determining risk on assumptions based on "little, contradictory, or fragmented evidence." This shortcoming is somewhat diminished a dozen pages later when Bradford admits that there is no comprehensive model of neighborhood change: "What exists [sic] are some fragmented, often conflicting, studies of these individual factors."

Bradford next examines two major explanations of neighborhood change which equate racial transition with decline. These are the "human ecology" model and the "filtering" model. These models are deterministic and are derived from allegedly immutable laws of nature in which human behavior is reduced to the competition of vegetable life for scarce land. Communities of superior people are infiltrated and invaded by inferior people much as inferior weeds infiltrate and replace superior flowers. The racial and religious bias implicit in these concepts is made more explicit by colorful quotes from the 40 and 60-year old pioneering studies of Hoyt and Park.

Bradford shows that underwriting manuals gave credence, until very recently, to models identifying racial change, and "inharmonious population and land use" as factors in community instability and decline. Bradford then cites studies that indicate that black inmigration increased the income level and enhances property values in the neighborhood, and that mixed land uses can be beneficial. (Never mind that most of those studies are based on the

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In this article, Pierre de Vise, author of "The Devil Theory of Redlining" in the Summer 1977 edition (vol. 2 no. 1) of *Real Estate Issues* responds to Mr. Bradford's comments on the subject.

Pierre de Vise is on the faculty of the College of Urban Sciences at the University of Illinois, Chicago Circle Campus. His analysis of the causes of the decline of Chicago and other large cities has been reported in the *New York Times* and *U.S. News and World Report* among others, and his findings were presented to the Senate Banking Committee's oversight hearings of November 23, 1976.

experience of exceptional communities in the tight housing markets of the immediate postwar years).

Bradford accepts uncritically studies that deny the influence of race, poverty, and mixed land uses on neighborhood stability. His critical gaze is focused instead on studies that support the conventional wisdom equating racial change with community decline. These studies are of "extremely limited value" because he believes their findings are based on illogical and unfounded assumptions, have serious methodological problems, biased samples, lack small area data, and ignore relevant factors.

Not so impugned are studies of "sound lending opportunities in older, minority, racially changing communities for lenders who ignore the conventional wisdom of decline and risk." Yet data reported for those studies are too cryptic and unspecified to judge whether these studies are themselves based on unbiased samples and small area data, and take account of all relevant factors. What geographic detail is provided is not reassuring. The city of Washington is larger than a neighborhood, and the elite black communities of the Mission District and South Shore are a biased sample of black communities in San Francisco, Oakland and Chicago. Are 52 home loans given last year in Chicago's South Shore a large number for a community of 4,000 single-family houses? Are these loans mortgage loans or improvement loans? Is a 4% default rate in the first year not much higher than the average default rate? Would foreclosures be expected in the first year when foreclosures legally take two years?

In his conclusion, Bradford says that on the issue of redlining "the burden of proof is shifting to the lenders." Because the lenders cannot be proven guilty ("it is not clear what standards are appropriate"), let us consider them guilty, he seems to urge, until they can prove their innocence. To survive this public inquisition, Bradford says lenders will have to expiate their guilt and undergo the painful redemption of learning correct risk analysis under the watchful eyes of government and community groups.

Separation by Avoidance During Counter-Urbanization

by Brian J. L. Berry

Black gains in the past two decades cannot be gainsayed, yet spatial separation of blacks and whites remains profound. According to the indicators developed by Levitan, Johnston and Taggart, black progress has been substantial in employment, earnings and education; in these realms black Americans gained on white Americans in both absolute and relative terms.[1] In housing, on the other hand, despite marked increases in the quality of units occupied by black Americans, that of white Americans improved even more. The housing gap widened, and residential separation remained as intense as before, although its bases appear to have shifted from deliberate segregation to accelerated avoidance.

This differential progress is part cause and part consequence of the extraordinary demographic shifts that have revealed themselves so dramatically in the United States since 1970. Yet it has roots in certain fundamental traits of the American culture that find their expression in the links between amenity, neighborhood, status and mobility. Both the shifts and their roots will be examined here.

CHANGING DEMOGRAPHICS: THE MIGRATION REVERSAL

While the dominating demographic trends continue to be the long-term decline in the nation's rate of population growth due to a declining birth rate and changing attitudes to the family, marriage, and work leading to decreasing numbers of young and increasing numbers of the elderly, shifts in the nation's settlement geography have been rapid and dramatic, and it is these shifts that lie at the base of the continuing separation of black and white.[2] Signs of a reversal of the long-term pattern whereby metropolitan growth rates exceeded those of nonmetropolitan areas first appeared during the 1960s, surfacing first in central cities with large, rapidly-growing minority populations. During this time, several nonmetropolitan regions experienced a turnaround from population decline to modest increase, and it appeared that at least in some of these areas outmigration had peaked during the previous decade. Despite these sagas of change, however, the number of individuals

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residing in metropolitan areas increased 16.6 percent or 8½ times the rate for nonmetropolitan areas in the period 1960-70. Not so since 1970, however. A reversal has occurred, resulting in the growth rates for nonmetropolitan areas that exceed those of metropolitan areas. Nationwide statistics for the first half of the 1970s indicate that population has increased 6.3 percent in nonmetropolitan areas and only 3.6 percent in metropolitan regions.

When the nation's metropolitan areas are divided between their central cities and surrounding suburbs, the change is revealed more dramatically. The lower metropolitan area population growth of the 1970s resulted from a combination of the depopulation of the central cities and a slackening of the suburban boom. Since 1970, central cities have experienced an absolute population loss of nearly two million persons, or three percent of the total number of residents at the beginning of the decade. Five million persons were added due to an excess of births over deaths, but net outmigration from the central cities to the suburbs and to nonmetropolitan areas exceeded seven million persons, largely white.

What is new, of course, is the current *nationwide* trend of absolute central city population decline; the proportion of metropolitan residents living in the central city rather than the suburbs reached a peak during the 1920s and has declined continually since. Absolute losses of population in *certain* central cities did occur prior to 1970; however gains in the remaining central cities always more than offset these losses to create overall central city growth. The decade of the 1950s saw 56 central cities lose population while the national total of central city residents increased 11.6 percent. During the 1960s, in which nationwide central city population increased 6.5 percent, the number of central cities which lost population increased to 95, or 39 percent of all central cities in the nation.

Central city population losses during the 1950s and 1960s were largely confined to the largest industrial heartland cities of the North Central and Northeast regions of the country, including Baltimore, Boston, Buffalo, Chicago, Cincinnati, Cleveland, Detroit, Minneapolis, Philadelphia, Pittsburgh, and St. Louis. In the 1970s, the greatest concentration of central cities losing residents continues to lie within this northern region. In the South, the central city portions of metropolitan areas containing over one million total residents have joined the losers, as have the largest places in the West, while the central cities of metropolitan areas of less than one million continue to increase.

NONMETROPOLITAN AMERICA: THE NEW GAINER

The experience of nonmetropolitan America has been the opposite of the foregoing. From the 1940s through the 1950s, outmigration from the nation's rural areas continued apace. Certain rural areas reached a turning point during the 1960s, but it was not until the 1970s that nonmetropolitan areas as a whole shifted to the status of gainers through net immigration from metropolitan areas. The number of individuals residing in the nation's nonmetropolitan areas during the 1960s grew by 6.8 percent, a rate of increase that was only half the national average. During the first half of this decade, however, the nonmetropolitan population increase of 6.3 percent was above the national average of 4.4 percent and well above the increase of 3.6 percent for metropolitan areas.

More significant for nonmetropolitan areas than their current faster growth rate is the turnaround that has occurred in migration between the nonmetropolitan and metropolitan portions of the nation. During the 1950s, nonmetropolitan areas lost over five million persons. This high level of outmigration continued into the 1960s as the nation's farm population declined at an annual rate of only 1.8 percent. With fewer outmigrants and greater numbers of inmigrants, nonmetropolitan areas have experienced a net inmigration of approximately two million persons since 1970, thus reversing the trend of population loss that has existed since the 1940s.

This net migration reversal has occurred in almost every nonmetropolitan subregion of the country. Generally, those nonmetropolitan areas located immediately adjacent to metropolitan centers (accounting for 51.5 percent of all nonmetropolitan residents) have experienced the highest nonmetropolitan growth rates during the 1970s: a 4.7 percent increase through 1973 for adjacent counties compared with 3.7 percent for non-adjacent counties. Nonmetropolitan areas that have a high level of integration of their residents into metropolitan labor markets, in particular, have experienced larger recent growth rates due to exurban sprawl beyond metropolitan boundaries. Through 1973, population increased 9.1 percent in those nonmetropolitan areas where 20 percent or more of the residents commute to a metropolitan place for work, but only 4.8 percent in those areas where less than 3 percent of the residents commute to metropolitan places for employment. Even this relatively lower nonmetropolitan growth of 4.8 percent in the latter case is, however, higher than the average growth rate of metropolitan places during this same period.

The subregions of nonmetropolitan America that underwent turnarounds from population decline during the 1960s to growth during the 1970s are quite diverse. In the South, a region extending from the Ozarks through eastern Texas and containing a predominantly white population underwent a shift during the 1960s from reliance upon agricultural employment to development of manufacturing, as well as benefitting from newly developed recreational areas. The Upper Great Lakes area bordering the southern coast of Lake Superior is a second nonmetropolitan region that experienced growth throughout the 1960s and 1970s—again primarily as the result of manufacturing decentralization and the development of recreational facilities and retirement communities. The nonmetropolitan areas of the Blue Ridge-Piedmont, Florida, the Southwest, and the northern Pacific Coast regions all experienced growth in both the 1960s and 1970s as the result of either decentralization of manufacturing, recreational-retirement developments, the opening up of new resources, or the expansion of improved transportation facilities (the interstate highway system) which enable persons to reside in rural areas but participate in metropolitan labor markets.

THE BLACK EXPERIENCE: NOT ON TREND

How have America's blacks generally fared within this overall set of reversals? The major shifts appear to be these:

1. The long-term net outmigration by blacks from the South to the North in search of better opportunities was reversed during the first half of the 1970s. During the five-year period from 1965-1970 the black population of the South decreased by 216,000 due to outmigration, but since 1970 there has been a net migration gain of 14,000 blacks from other regions of the country. During the first half of the 1970s, immigration by blacks to the south has increased 86.4 percent and outmigration decreased 23.8 percent, compared to the last half of the 1960s. In this respect, black Americans have been on trend.

2. Blacks are, however, off trend with all the other reversals. Since 1970, the metropolitan areas of the United States have grown more slowly than the nation as a whole, and substantially less rapidly than nonmetropolitan America, a development that stands in sharp contrast to all preceding decades back to the early nineteenth century. On a net basis, metropolitan areas are now losing migrants to nonmetropolitan territory, although they still show slight population increases due to natural increases and immigration from abroad. The overall decline in metropolitan growth is largely accounted for by the largest metropolitan areas, particularly those located in the Northeast and North Central regions. Through 1974 the eight metropolitan areas exceeding three million population added only 285,000 residents to a 1970 population base of 56 million, while their central cities declined in population absolutely. Yet it is precisely in these central cities that we now find the greatest concentrations of the nation's blacks. In 1974, 58 percent of all black Americans lived in the nation's central cities, 17 percent in metropolitan rings and 24 percent in nonmetropolitan areas, compared with 26, 41 and 33 percent of white Americans respectively. Central cities of the nation's SMSAs grew at an average annual rate of 0.6 percent between 1960 and 1970, but declined at an average annual rate of 0.4 percent since 1970 (annexations excluded). Much of the decrease is attributable to the post-1970 decline in the number of *white* central city residents, which has occurred at a rate of one percent per annum—higher in larger cities, where black concentrations are greatest and/or growing most rapidly, and lower elsewhere.

3. Metropolitan decline is not universal. Rapid growth has taken place in smaller metropolitan areas, particularly in Florida, the South, and the West, and in exurban counties located immediately outside metropolitan areas as currently defined, but with substantially daily commuting to metropolitan areas, but these are essentially white areas; blacks have not contributed to the growth.

4. Particularly impressive are the reversals in migration trends between the largest metropolitan areas and the furthermost peripheral counties; the metropolitan regions with populations exceeding three million gained migrants between 1960 and 1970 but have lost residents since 1970; the nation's peripheral nonmetropolitan counties lost migrants between 1960 and 1970 but have gained migrants since 1970. The balance of migration flows has been reversed. But the losers have the greatest black concentrations and continue to gain blacks via natural increase; the gainers are predominantly white, via immigration. High growth rates prevail in nonmetropolitan areas with manufacturing, centers of higher education, resources for recreational development, and retirement communities. The nonmetropolitan areas *not* benefitting from this new growth have the greatest rural black concentrations.

COUNTER-URBANIZATION AND AMERICAN CULTURAL PREDISPOSITIONS

The evidence is clear. An increasing number of U.S. central cities and a widening ring of their older suburbs must now learn to cope with population decline, especially within the nation's largest metropolitan areas. As mobile whites move away, the remaining populations are increasingly homogeneous: black and other minorities and/or poor and disadvantaged. New black leaders elected to political office as minorities become local majorities must thus cope with the worst possible economic and demographic circumstances. Halfway through the decade, the central cities of U.S. metropolitan areas already have lost 3.1 percent of their 1970 residential population. Suburban areas have grown by 15 percent in five years. In short, a turning point has been reached in the American urban experience. *Counter-urbanization* has replaced urbanization as the dominant force shaping the nation's settlement patterns. To those who wrote about nineteenth and early twentieth-century industrial urbanization, the essence was increasing size, density, and heterogeneity (via immigration). "Urbanization is a process of population concentration," wrote Hope Tisdale in 1942. "It implies a movement from a state of less concentration to a state of more concentration."[3] But since 1970 American metropolitan regions have grown less rapidly than the nation, and have actually lost population to nonmetropolitan territory. And because this outmigration has been selective of upwardly-mobile social and economic groups, very specific sub-groups have been left behind—blacks and other minorities, and various disadvantaged groups of whites.

The process of counter-urbanization has as its essence *decreasing* size, *decreasing* density, and *decreasing* heterogeneity. To mimic Tisdale: *counter-urbanization is a process of population deconcentration; it implies a movement from a state of more concentration to a state of less concentration.* Yet this is a process only. For the black minority, concentration remains the rule.

NOT A PASSING PHASE

There are some who argue that the trends are a temporary perturbation, a product of recession that will vanish when the health of the economy improves. But such an attitude is hardly credible; twentieth-century trends have all pointed in the same direction—*creation of nothing less than an urban civilization without cities,* at least in the classical sense. As early as 1902, H. G. Wells wrote that the giant cities he knew were "in all probability destined to such a process of dissection and diffusion as to amount almost to obliteration within a measurable further space of years. These coming cities will present a new and entirely different phase of human distribution. The city will diffuse itself until it has taken up considerable areas and many of the characteristics of what is now country. The country will take itself many of the qualities of the city. The old antithesis will cease, the boundary lines will altogether disappear."[4] Similarly, Adna Weber suggested in his remarkable 1899 study that "the most encouraging feature of the whole situation is the tendency [towards] a diminution in the *intensity* of concentration, which furnishes the solid basis of hope that the evils of city life, so far as they result from over-crowding, may in large part be removed. If concentration of population seems desired to continue, it will be a modified concentration which offers the advantages of both city and country life."[5] Later Frank Lloyd Wright argued that "Broadacre City" was the most desirable settlement pattern for mankind, and Lewis Mumford called for a new reintegration of men and nature in dispersed urban regions, to cite but a few cases.

Throughout the twentieth century all trends have pointed in the directions suggested by these writers. Every public opinion survey has indicated that popular preferences are for smaller places and lower densities, with richer environmental amenities.[6] The trend has been one leading unremittingly towards the reversal of the processes of population concentration unleashed by technologies of the industrial revolution, a reversal finally achieved after 1970.

REAFFIRMING AN AMERICAN TRADITION

Viewed more generally, though, what finally has been achieved in the 1970s is not something new, but something old, the reassertion of fundamental predispositions of the majority American culture that, because they are antithetical to the urban concentration that was produced by large-scale industry and primitive intra-urban transportation during the nineteenth and early twentieth century, have resulted in many of the contradictions and conflicts of recent decades.

It was 200 years ago that Hector de Crèvecoeur outlined these fundamental values in his *Letters from an American Farmer*. "Who, then, is this new man, the American?" he asked, and his answer was a description of basic Amercan culture traits. Foremost among these was a love of newness. Second was the overwhelming desire to be near to nature. Freedom to move was essential if goals were to be realized, and individualism was basic to the self-made man's pursuit of his goals, yet violence was the accompaniment if not the condition of success—the competitive urge, the struggle to succeed, the fight to win.[7]

There has been no more evocative description of the consequences of the love of newness for American metropolitan structure, in a context of upward mobility and growth, than Homer Hoyt's discussion of *The Structure and Growth of Residential Neighborhoods in American Cities*, published in 1939.[8] Hoyt said that,

> the erection of new dwellings on the periphery sets in motion forces tending to draw population from older houses and to cause all groups to move up a step, leaving the oldest and cheapest houses to be occupied by the poorest families or to be vacated. The constant competition of new areas is in itself a cause of neighborhood shifts. Every building boom, with its crop of structures equipped with the latest modern devices, pushes all existing structures a notch down in the scale of desirability. The high grade areas tend to preempt the most desirable residential land, intermediate rental groups tend to occupy the sectors in each city that are adjacent to the high rent area. Occupants of houses in the low rent categories tend to move out in bands from the center of the city by filtering up. There is a constant outward movement

of neighborhoods because as neighborhoods become older they tend to be less desirable. A neighborhood composed of new houses in the latest modern style is at its apex. Physical deterioration of structures and the aging of families constantly lessen the vital powers of the neighborhood. The steady process of deterioration is hastened by obsolescence; a new and more modern type of structure relegates all existing structures to lower ranks of desirability.

Hoyt's perceptions cut right to the core of much of that which has transpired, for the accompaniment of the process of counter-urbanization, driven by upward social mobility and outward spatial mobility, is urban decay. And so long as there is a link between status and race, Hoyt's model applies not simply to neighborhood filtering, but to the outward move of upper-status whites and the relegation of blacks—perceived to be of lower status even if attainment is equal—to neighborhoods on the lower rungs of the desirability ladder.

The love of newness joins with the desire to be near nature and away from urban disamenities—including crowding, crime, poverty, and minorities. H. G. Wells' 1902 forecasts should be recalled.

Many of our railway-begotten giant cities are destined to such a process of dissection and diffusion as to amount almost to obliteration within a measurable further space of years. These coming cities will present a new and entirely different phase of human distribution: The social history of the middle and later thirds of the nineteenth century all over the civilized world has been the history of a gigantic rush of population into the magic radius of—for most people—four miles, to suffer there physical and moral disaster far more appalling than any famine or pestilence that ever swept the world. But new forces bring with them the distinct promise of a centrifugal application that may finally be equal to the complete reduction of all our present congestions. What will be the forces acting upon the prosperous household? The passion for nature and that craving for a little private *imperium* are the chief centrifugal inducements. The city will diffuse itself until it has taken upon considerable areas and many of the characteristics of what is now country.

THE AMERICAN LIFE—A PROLONGED ODYSSEY

To occupy this new frontier, close to nature, and to keep on adjusting to succeeding waves of growth has demanded freedom to move. Americans are the world's most mobile people. Forty million Americans change residence each year. The typical American's life might be characterized as a prolonged odyssey. Marriage, childbearing, military service, higher education, changes from one employer to another or shifts from one plant or office location to another with the same employer, divorce, retirement—all may bring a change in residence and locale. The resulting migration is an *assortive* mechanism, filtering and sifting the population as its members undergo social mobility. Yet there are antiphonal notes. Minorities have generally not had the same opportunities as whites to use mobility as an adjustment mechanism. And filtering in housing markets, for example, is a process that has positive welfare consequences if new construction exceeds the rate necessary to house normal growth and produces an excess housing supply at the point where the filtering originates; if such new construction exerts a downward pressure on the rents and prices of existing housing, permitting lower income families to obtain better housing bargains relative to their existing housing quarters; if the upward mobility is apart from any changes caused by rising incomes and/or declining rent/income ratios and if a decline in quality is not necessarily forced by reductions in maintenance and repair to the extent that rents and prices are forced down; and finally if a mechanism exists to remove the worst housing from the market without adversely affecting rents and prices of housing at the lowest level. Part of the reason for urban decay is that the last two conditions have not been met: deterioration has accelerated in many older neighborhoods occupied by members of minority groups. Social malaise has set in, crime rates have risen, abandonment has become contagious, frequently adversely affecting access by low-income residents to the better-quality housing available locally.[9] And the disease has become associated with the skin color of the inner city residents; fear and avoidance behavior—movement towards the pastoral "elsewhere"—has been the response of the white majority.

AMERICAN PRIVATISM AND URBAN DECAY

Contrary to the views of most radicals, however, urban expansion and urban decay are not caused by a single-minded conspiracy among large-scale institutions and investors. They result instead from myriad decisions made individually, within a tradition of privatism. This tradition has been called by Sam Bass Warner "the most important element of American culture for understanding the development of cities. It has meant that the cities of the United States depended for their wages, employment, and general prosperity on the aggregate successes and failures of thousands of individual enterprises, not upon community action. It has also meant that the physical forms of American cities, their lots, houses, factories and streets have been the outcome of a real estate market of profit-seeking builders, land speculators, and large investors. And it has meant that the local politics of American cities have depended for their actors, and for a good deal of their subject matter, on the changing focus of men's private economic activities."[10] Privatism has prevailed throughout America's history, and a consequence is a preference for governmental fragmentation and for interest-group politics under presumed conditions of democratic pluralism. This has set the stage for the availability of a myriad of opportunities for avoidance and escape by central-city whites, and a myriad of like-minded decisions based upon common perceptions of central-city problems.

While achievement in the mainstream has involved an individual fight to succeed, violence also is a pervasive underpinning of American life. It surfaces in the fight to succeed and achieve status, and in the acrimonious confrontations that mark the fights to control turf within cities, as the least advantaged whites seek to exclude minority group members, and preserve their perceived status—for regardless of socio-economic characteristics, a concentration of blacks is perceived negatively by whites as a threat to their own status. In other words, so long as race remains a status-determining trait, it is likely that racial separation will remain profound, eliciting either white flight to avoid the threat of neighborhood decline, or violent attempts to protect a neighborhood turf against minority intrusion in the case of the least mobile whites.

For the underclass abandoned in deteriorating ghettos, crime and violence is a way of life, and this contributes to white fears. President Johnson's *Commission on Crimes of Violence* sensed the directions of change correctly when it reported that if present trends continue "we can expect further social fragmentation of the urban environment, greater segregation of different racial groups and economic classes, and the polarization of attitudes on a variety of issues. It is logical to expect the establishment of the 'defensive city' consisting of a declining central business district in the inner city protected by people shopping or working in buildings during daylight hours and 'sealed off' by police during night-time hours. Highrise apartments and residential 'compounds' will be fortified cells for upper, middle, and high income populations living in prime locations. Suburban neighborhoods, geographically removed from the central city, will be 'safe areas,' protected by racial and economic homogeneity."

THE CONSEQUENCES OF RACE AND STATUS

In the expanding frontiers of suburban and exurban America, upwardly-mobile individuals from a variety of backgrounds have been readily integrated into the achievement-oriented mainstream of society, there to resegregate themselves along lines of age and status. When the heterogeneity of American cities was caused primarily by the influx of successive waves of European immigrants, the policy of encouraging such assimilation was taken for granted ideologically. But the marriage of race and status in the racist mind has meant that the assimilating and resegregating process of the traditional melting pot has not been available to the nation's blacks. Without the intervening opportunity to be fully assimilated into the nation's mainstream, and regardless of socio-economic achievement, darker pigmentation is equated with lower status. The perception extends further, to an equation of the ills bred out of enslavement of the most disadvantaged to all who share the same skin color. And out of this perception comes fear—fear that, in the eyes of others, one will lose status because one's neighborhood loses status as a consequence of minority entry. The response is to oppose entry and, failing, to flee—away from "urban problems" and towards the exurban/small town ideal.

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Possessory Versus Leasehold Interest

By Walter R. Kuehnle, C.R.E.

A new term, *possessory interest*, purporting to describe a lessee's interest in tax-exempt real estate for ad valorem[1] tax purposes, has been coined in California. Use of the term and its application in this connection have resulted in confusion and misunderstanding of appraisal terminology and misapplication of appraisal principle. Assessment officials and courts in some other states have erroneously equated *possessory interest* with *leasehold interest* and have applied incorrect valuation procedures in appraising the market value of the lessee's leasehold interests in leases on tax-exempt property as required by constitution and/or statute.

CONFUSION OF TERMINOLOGY

Professional real estate appraisers and counselors do not object to the philosophy of taxation of tax-exempt property when leased to non-exempt entities. We do disagree, however, with efforts in some states to twist appraisal terminology and practice to accomplish this purpose by indirect methods—methods initiated by state departmental regulations or court decisions—rather than through open and forthright legislative measures to tax exempt property when leased to non-exempt entities.

How did the current situation come about? Many states of our Union have statutory ad valorem taxation of real estate. In some, leasehold interests are held to be taxable. Where tax-spending bodies are diligently seeking new sources of tax revenues, the California method of calculating the value of a lessee's possessory interest is an attractive potential source of revenue. Airlines, for example, are lessees of airport facilities from tax-exempt airport authorities, and have been a principal target.

EVOLUTION OF THE "POSSESSORY INTEREST" CONCEPT IN CALIFORNIA

In the State of California, by legal decision and later by statute, a calculated taxable possessory interest, which is greater than the market leasehold value in leased tax-exempt property, is assessed to the lessee. The effect of this

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has been to remove the tax exemption (except for a reversionary interest) of the lessor's interest when it leases its property to a non-exempt lessee. The justification for so doing is a matter of philosophy rather than appraisal technique and is a subject for another paper. However, I will observe in passing that the philosophy of exempting certain public bodies from the ad valorem tax is this: the financial advantage of tax exemption reduces the amount of taxes which these bodies must levy to cover their expenses. Tax-exempt lessors can exact a higher rental for their property from prospective lessees by passing on to them the advantage of tax exemption. California recognizes this by applying the new taxation of a possessory interest only to leases made after a fixed date. This frees lessees from double taxation when they have signed leases with public bodies which assumed complete tax exemption.

The term *possessory interest* is now a part of the California statutory property tax laws. The term is described in these laws *(Property Taxation 107)* as follows:

1) Possession of, claim to, or right to the possession of land or improvements, except when coupled with ownership of the land or improvements in the same person.
2) Taxable improvements on tax-exempt land.

Use of the term "possessory interest" in ad valorem tax law originated in the final decision of the California Supreme Court in the case of *DeLuz Homes, Inc. v. County of San Diego* (1955) 45 Cal. 2d 546. For the exact details the reader is referred to this case, but the outline of the circumstances is as follows: DeLuz Homes, Inc. contracted during World War II to build a "Wherry" housing project for the military. In order to assure lower rent to military personnel, the government leased a valuable site, which it owned, to a developer for fifty years at a nominal rental of only $100 per year.

DeLuz Homes, Inc., the lessee-developer, constructed a large apartment project on the site. Apparently the lessee claimed ad valorem tax exemption of the entire property—land and building—because the land was owned by the tax-exempt U. S. Government.

In this decision, the California Supreme Court rejected this concept and decided that when a tax-exempt lessor leases some of its real estate to a non-exempt lessee, the value of the interest leased becomes taxable to the lessee. The effect of this decision was to limit and substantially reverse the basic philosophy of tax exemption which is that leased property of public bodies, who must levy taxes to pay their operating costs, ought not to be itself taxed.

As a result of the DeLuz decision and subsequent statutes, the property of tax-exempt bodies remained exempt *only when used by the tax-exempt body itself.* As a result, the benefits of higher rentals which could be obtained by the exempt body from prospective lessees who would not be required to pay real estate taxes were eliminated. It follows that the loss of such higher rents is a charge which must ultimately be made up by additional taxes.

A further problem developed. Existing lessees who were paying these higher rents to the public body were now additionally required to pay real estate taxes. The lessee was thus paying double ad valorem taxes on the leased property. However, the State of California recognized this inequity when incorporating the decision of the DeLuz case into their property tax laws. The new law limited assessment of "possessory interests" in tax-exempt properties only to those leased subsequent to the date when decision on the DeLuz case became effective. (See. Cal. Stat. 107.1.) For pre-DeLuz decision leases, lessee's interests under existing leases from public bodies are still valued for ad valorem tax assessment on the basis of the value of the lessee's *leasehold interest*, computed in accordance with standard appraisal technique: the present value of the leasehold subject to all of the terms of the lease, *including* the lessee's obligation to pay rent. This differs from the calculation in post-DeLuz leases under which a lessee's *possessory interest* is calculated as its value subject to all of the terms of the lease *except* the lessee's obligation to pay rent.

In the DeLuz decision, Chief Justice Traynor described the case as actions to recover taxes, levied against "possessory interests" in tax-exempt land and improvements, and so forth. He states at 290 P. 2d 554-55: "Since non-exempt possessory interests in land and improvements, such as the leasehold estates involved in the present actions, are taxable property [citations omitted] they too must be assessed at 'full cash value.'" From this it appears that, by using the term "possessory interests," Chief Justice Traynor simply was trying to make his decision applicable to a broader array of property interests than just leasehold estates. It does not appear that he was trying to create anything different from what normally would be understood by the phrase "possessory interest."

Chief Justice Traynor decided that the conventional approach to valuing leaseholds and other possessory interests produced a result that was unacceptable, and so in his opinion he overruled the earlier decision of his court in *Blinn Lumber Co. v. County of Los Angeles*, 216 Cal. 474, 14 P. 2d 512, characterizing the conventional approach to valuation of leasehold interests as acceptable for appraisal or accounting purposes, but not for tax purposes.

Accordingly, the term "possessory interest," as first coined in California, seems to be used as a shorthand reference to the valuation approach espoused by Chief Justice Traynor in the DeLuz case. Of course, what he did say was that the leasehold estate should be valued by subtracting the value of the reversion from the value of the leased fee interest without taking into account the obligation of the lessee to pay rent. There does not appear to be any intent to say that the value so calculated constitutes a "possessory interest" that is different from a "leasehold." However, the Traynor approach is absolutely untenable as the proper method of valuing a leasehold interest because it attributes the right to collect rent to the tenant, whereas it is being paid by the tenant and properly belongs to the owner of the leased fee. Nevertheless, that is what Traynor did, and he has been copied by judges in other states who similarly desired to obtain tax revenue from leasehold estates *irrespective of their market value*.

The basic concept of the possessory interest has been to try to tax the market value of the property leased less the present discounted worth of the reversion of the property to the lessor at the end of the lease term. By twisting appraisal terms, certain states, their departments, and their courts have equated the value of a "possessory interest" (an interest all or partially owned by the lessor), coined and computed in California by law and statute, with the value of a leasehold interest (an interest owned by the lessee).

VALUATION OF LEASEHOLD INTERESTS IN OTHER STATES

Some states have a constitutional ad valorem basis of taxation of leasehold interests (according to their value) but have no legal basis for assessing possessory interests by the method proscribed by California statute. Efforts, successful in some states and not in others, have been made through court decisions to circumvent this lack of legal basis to assess possessory interests through this equation of the value of such computed possessory interest with the value of the lessee's leasehold interest, as was done by law in California. In appraisal practice the word "leasehold" is a term of specific meaning. The value of a leasehold interest, owned by the lessee, to be valued for taxation in most ad valorem states is the *market value* at which the lessee could sell his interest.

Appraisal Terminology and Handbook[2] defines a leasehold value as follows:

> The value of a leasehold interest; that is, right to the use, enjoyment, and profit existing by virtue of the rights granted under a lease instrument. The value of a leasehold interest is the present (discounted) worth of the rent saving, when the contractual rent at the time of appraisal is less than the current market rent. If land is improved by the lessee, then the value of the leasehold interest is the present value of the saving in ground rent, if any, in addition to the value (not cost) of the improvements of the lessee. If the contractual rent is greater than the currently established market rent, the present worth of the difference is subtracted from the value of the improvements.

The value of a leasehold interest is defined as:

> The market value of the property less the value of the lessor's interest.

In Illinois, Section 20 of the Revenue Act (in the part authorizing taxation) provides that "each taxable leasehold estate shall be valued at its fair cash value."[3]

The issue of the method of assessment of a taxable leasehold in Illinois was finally fully considered in a decision of the Illinois Supreme Court, *People ex rel. v. American Airlines,* 39 Ill. 2d 16-18. In this case the court held the lessee's leasehold should be valued for tax purposes at the capitalized value of the entire rental value of the property regardless of the rental which the lessee was paying. Judge Schaefer commented:

> "American, however, would have us construe Section 20 to authorize a tax upon the potential profit available upon assignment of that interest, *rather than upon the fair cash value* [emphasis added] of the interest. But, that is not what the statute says."

Here again we have "weasel" wording that confuses accepted real estate appraisal terminology. The *fair cash value of the interest* to be valued is indeed the value of the interest of the lessee, his leasehold estate, when the statute provides it should be valued "at its fair cash value." This is in direct conflict with Justice Schaefer's comment that the statute does not accept as a valuation basis "the potential profit available upon assignment [sale] of the [lessee's] interest."

This prompts me to ask three questions:

1) What better measure of the fair cash value of the lessee's interest is there than its market value?
2) Would the price at which the lessee could sell his interest vary with the duration, rental, and other terms provided in his lease?
3) As the lessee owns only the leasehold interest in the lease, is it not the cash value of his leasehold interest that is to be valued for "ad valorem" real estate tax?

In Illinois, Section 26 of the Revenue Act (in the part authorizing taxation) was amended to provide that the land and improvements on exempt property "shall be listed as property of the lessee thereof, or his assignee, as real estate."[4] However, the Illinois Supreme Court held this to be a "use or privilege tax" and declared it to be unconstitutional.[5]

Therefore, the Illinois Supreme Court decision in the American Airlines case remains the present legal justification in Illinois for using the California "possessory interest" approach in computing a valuation of the leasehold interest in property owned by a tax-exempt lessor for ad valorem tax purposes.

In the State of Missouri the Supreme Court took the opposite view, i.e. that the value of the leasehold interest was its fair cash value in the market (for sale or assignment) considering the duration, rental, and other terms of the lease.[6]

So it may be noted that the term "leasehold interest," as defined in standard real estate appraisal practice, and the term "possessory interest," as defined under the California statutes (107), are not synonymous, and that in any particular case the difference between the computed value of a possessory interest, under the DeLuz decision method, and the actual fair market value of the lessee's leasehold interest may differ narrowly or widely.

VALUE OF LESSEE'S "POSSESSORY" AND "LEASEHOLD" INTERESTS DIFFER

Let us examine the DeLuz case as it applies to the valuation of real estate. As the exempt rental under the fifty-year lease was only $100 per year, the actual value of lessee's interest closely approximated the market value of the entire property, land, and building, less only the present worth of the U.S. Government's reversionary right to get the property back in fifty years. As the rental is nominal, so is the lessor's interest and the value of the leasehold was practically equal to the value of the entire property free and clear of the lease.

However, let us now assume that the circumstances were different. Suppose the government constructed the apartment building on the land and leased the improved property to a lessee-operator at its fair current economic (full) rent. Now the lessee would have no bonus rental value in the lease and would own a leasehold interest with a market value of zero. Both the calculated value of the possessory interests and the true value of the lessee's leasehold interest, however, would be computed under the California concept at a figure that would almost equal the entire value of both land and apartment building. In this case the difference between the value of the lessee's *leasehold* interest and a *possessory* interest valuation (interest possessed), as computed by the California method, is practically equal to the entire value of the property free of lease. AIREA's textbook (6th edition)[7] has a comprehensive discussion on this point in the chapter on "partial interest."

Actually, it was not necessary to put forth the concept of "possessory interest" in the DeLuz case when the same objective and valuation would have been achieved by appraisal of the lessee's leasehold interest by correct leasehold valuation techniques. The reason for this is that a correct leasehold valuation method gives effect to only the fair market value of the lessee's leasehold interest subject to all of the provisions in the lease including the obligation to pay a stipulated rent. The California method of calculating a possessory interest value, however, gives effect not only to the market value of the interest of the lessee, but also to a principal interest of the lessor: the present worth of his right to receive the stipulated rent for the remaining term of the lease.[8] *Appraisal Terminology* defines the lessor's interest under a lease as follows:

> The present (discounted) value of the contract (lease) rents in addition to the present (discounted) value of the reversion: a leased fee.[9]

To summarize, the market value of the lessee's leasehold includes only the lessee's ownership. The "possessory interest" value calculation in California includes the market value of ownerships of both the lessee and the lessor. This is demonstrated in the following outline:

Leased Property Interest	Owned By	Resulting Value Is
1. Present worth of contract rent	Lessor	Positive
2. Present worth of reversion	Lessor	Positive
3. Present worth of bonus (or excess) rent	Lessee	Positive or negative
4. Total property value		Positive
5. Excess value (or penalty) due to favorable (or unfavorable) lease		Positive or negative

Only items 3 and 5 comprise the measure of the market value of a lessee's leasehold interest. The valuation of a lessee's "possessory interest" as computed in California, however, includes not only item 3, the market value of the lessee's leasehold interest, but also item 1, the market value of the lessor's right to receive the rent. This is demonstrated in the following hypothetical examples showing values of interests of lessors and lessees with increasing and decreasing values (economic rent):

Example 1

Assume an owner and a prospective lessee agree on a 25-year lease of real estate with a market value of $100,000, for 25 years at an annual rental of $7,088. For simplicity, let us assume payable annually at end of year.)

Total property value	$100,000
Assuming a market interest rate of 7%, the value of the lessor's (owner's) interest may be calculated as follows:	
Present worth of 25 years' rental payments $7,000 x 11.654 (factor 7%, 25 years)	$81,600
Present worth of reversion (owner-lessor's right to recover the property free of lease in 25 years) $100,000 x .184 (factor 7%, 25 years)	18,400
Total value of the leased fee interest owned by the lessor-owner	$100,000
Value of the leasehold interest owned by the lessee	0

(See Figure A-*1*.)

Example 2

Now let us assume an *existing* lease where the remaining term and terms are the same as for the term of 25 years in *Example 1* but the property value and rental value have increased 10%. The value of the lessor's and lessee's interest in the current property value of $110,000 is as follows:

Total property value	$110,000
Present worth of 25 years' rental payments required by lessee (same as *Example 1*)	81,600
Present worth of reversion (owner-lessor's right to recover the property free of lease in 25 years) $110,000 x .184 (factor 7%, 25 years)	20,240
Total value of leased fee interest owned by owner-lessor	$101,840
Present worth of lessee's interest as a result of increase in property and resulting rental value $700 x 11.653 (factor 7%*, 25 years)	8,160
Total value all interests	$110,000

(See Figure A-*2*.)

*Same interest rate assumed for all interests. However, they may vary in an actual case.

Example 3

In this example the property value and rental value are 10% less with a remaining term and terms the same as in *Example 1*.

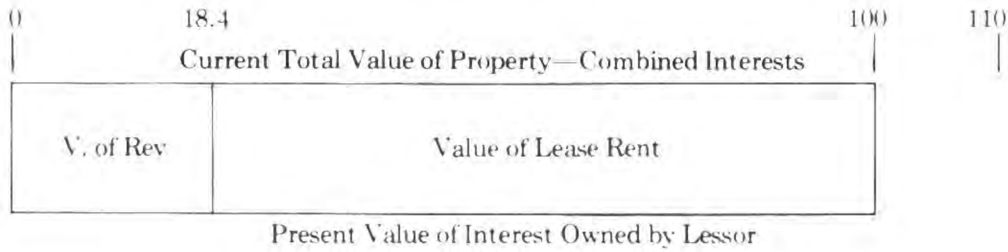
Total property value	$90,000
The value of the lessor's and lessee's interest in the current property value of $90,000 would now be as follows:	
Present worth of 25-year rental payments (Same as 1)	$81,600
Present worth of reversion (owner-lessor's right to get property back in 25 years) $90,000 x .184 (factor 7%, 25 years)	16,560
Total value of leased fee interest owned by lessor-owner	$98,160
Present worth of lessee's interest as a result of decrease in property value—negative ($700) x 11.653 (factor 7%, 25 years)	($8,160)
Total value all interests	$90,000

(See Figure A-3.)

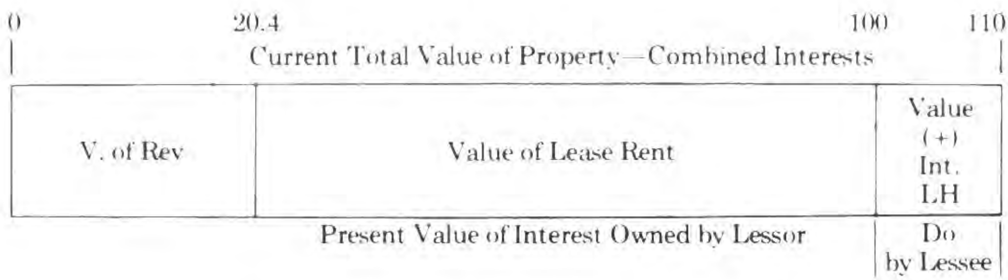
FIGURE A

Chart Illustrating Division of Ownership of Lessor and Lessee Under a Lease with Increasing and Decreasing Value (Economic Rent)

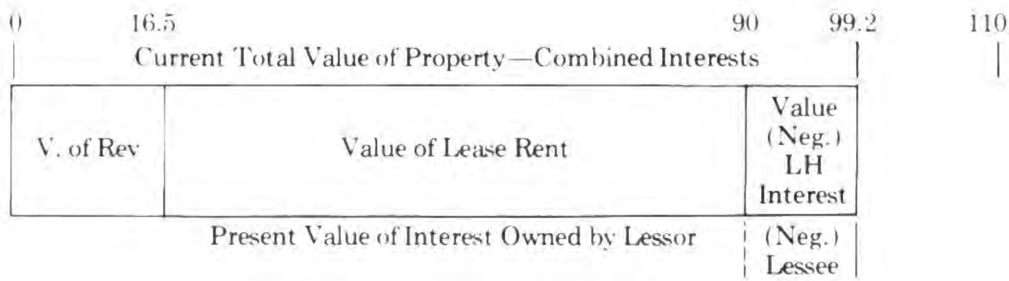
1. Assume No Bonus Value in Lease



2. Assume a 10% Increase in Property Value



3. Assume a 10% Decrease in Property Value



Assumptions:
1. No change in applicable risk interest rate.
2. Value of the property at reversion will be equal to current property value.
3. No depreciation of improvements.

REFERENCES

1. According to value.
2. American Institute of Real Estate Appraisers, *Appraisal Terminology and Handbook*, 5th ed. (Chicago: American Institute of Real Estate Appraisers, 1967).
3. Ill. Rev. Stat., ch. 120, par. 501 (1975).
4. *Ibid.*
5. *Dee-El Garage v. Korzen* 53 Ill. 2d 11 (1972).
6. *Frontier Airlines et al. v. The State Tax Commission of Missouri et al.*, 528 S.W. 2d 943-947.
7. American Institute of Real Estate Appraisers, *The Appraisal of Real Estate*, 6th ed. (Chicago: American Institute of Real Estate Appraisers, 1973), p.465.
8. The other is the right of reversion, i.e. repossession of the property at the end of the lease term.
9. *Supra*, note 2.

The Arlington Heights Case: A Reprise

by David L. Callies and Clifford L. Weaver

> [I]t is important to note that the Supreme Court's decision does not require us to change our previous conclusion that the village's action had a racially discriminatory effect.
>
> U.S. Court of Appeals for the 7th Circuit *Metropolitan Housing Development Corp. v. Village of Arlington Heights*, July 7, 1977.

With these words, the 7th Circuit Court of Appeals commenced its dissertation upon Title VIII of the Civil Rights Act of 1968 (the Fair Housing Act), in which it concluded once again that Arlington Heights may have illegally refused to rezone 15 acres of land, resulting in racial discrimination. The U.S. Supreme Court has denied the village's petition for certiorari review (January 9, 1978), thus letting stand the latest appellate court decision in this now protracted litigation. The tests laid down by the 7th Circuit Court in that decision thus assume a national significance.

We set out the facts of the case at length in the Summer 1977 edition of *Real Estate Issues*. It is enough here to recall that the village of Arlington Heights refused to rezone 15 acres of land from a single-family to a multiple-family zoning classification so that the Metropolitan Housing Development Corporation (MHDC) could construct 190 townhouse units for senior citizens and low- or moderate-income families. MHDC brought suit in federal court and successfully convinced the 7th Circuit Court that the effect of the village's action was to discriminate on the basis of race and that, regardless of intent,

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This article is an update of "The Arlington Heights Case: The Exclusion of Exclusionary Zoning Challenges" by Messrs. Callies and Weaver, which appeared in the Summer 1977 edition (vol. 2, no. 1) of *Real Estate Issues*.

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the racially discriminatory effect was a violation of the Equal Protection Clause of the U.S. Constitution. The U.S. Supreme Court disagreed, reversing on the basis of *Washington v. Davis*, 426 U.S. 229 (1976), decided after the 7th Circuit's decision, and holding that an official action would not be held unconstitutional solely because it resulted in a racially disproportionate impact. But the Supreme Court did remand the case to the 7th Circuit to determine whether the Fair Housing Act had been violated. The issue, then, has shifted from deciding whether there has been a *constitutional* violation to deciding whether there has been a *statutory* one.

When the 7th Circuit Court again considered the case on remand, it wrote another long opinion, *Metropolitan Housing Development Corp. v. Village of Arlington Heights*, 558 F2d 1283 (1977), in which it sent the case back to the district court, the finder of fact in the litigation, to determine:

1) Whether funds still existed to construct the subsidized housing. If they do not, the case is moot. The program under which the project was to be constructed no longer exists, but MHDC claims other subsidies are available.

2) Whether there is any other land in Arlington Heights that is both appropriately zoned and otherwise "suitable" (by which the circuit court seemed at very least to mean available at a price consistent with a subsidized project) for federally subsidized low-cost housing.

If MHDC can demonstrate it has the money, and if Arlington Heights fails to come up with an alternative "suitable" site, then, the circuit court says, "the village's refusal to rezone effectively precluded plaintiffs from constructing low-cost housing within Arlington Heights, and [the district court] should grant plaintiffs the relief they seek." The result for both MHDC and Arlington Heights would then be the same as if the U.S. Supreme Court had agreed with the 7th Circuit that the village's refusal to rezone was unconstitutional; only the legal technicalities along the way would be different.

In reconsidering the case, the 7th Circuit was stuck with the earlier determination that Arlington Heights did not *intend* to discriminate and had to decide whether, even absent that intent, its actions could be found to violate the Fair Housing Act. Given the Supreme Court's attitude about the importance of intent to establish a constitutional claim, it is understandable that the 7th Circuit approached the statutory issue with some caution.

The circuit court first noted that the portion of the Fair Housing Act making it unlawful to make unavailable or deny dwelling to any person because of race, color, religion, or national origin could be interpreted either narrowly or broadly:

> The major obstacle to concluding that action taken without discriminatory intent can violate [the Act] is the phrase "because of race" contained in the statutory provision. The *narrow view* of the phrase is that a party cannot commit an act "because of race" unless he intends to discriminate between races. By hypothesis, this approach would excuse the village from liability because it acted without discriminatory intent. The *broad view* is that a party commits an act "because of race" whenever the natural and foreseeable consequence of that act is to discriminate between races, regardless of his intent. Under this statistical, effect-oriented view of causality, the village could be liable since the natural and foreseeable conse-

quence of its failure to rezone was to adversely affect black people seeking low-cost housing and to perpetuate segregation in Arlington Heights. (Emphasis added.)

The 7th Circuit then reminded Arlington Heights (and the Supreme Court . . . ?) that although the Supreme Court had announced a new "intent" requirement for constitutional equal protection cases, it specifically reaffirmed other cases in which it had held that practices which produced racially discriminatory effects were invalid under a different section of the Civil Rights Act:

> Thus, a prima facie case of unemployment discrimination can still be established under Title VII by statistical evidence of discriminatory impact, without a showing of discriminatory intent.

Having thus rejected the "narrow view" espoused by Arlington Heights, the court was quick to say that it also saw no merit in the "broad view" that simple proof of discriminatory effect would suffice to show a Fair Housing Act violation in every case. It held instead that only "under some circumstances" would conduct that produces an "unintentional" discriminatory impact violate the Fair Housing Act:

1. *Is there some evidence of discriminatory intent?* The court held that while there appeared to be little evidence of such intent, it considered this criterion to be "the least important of the four factors that we are examining."

2. *What is the defendant's interest in taking the action complained of?* The court noted that when a governmental body (as opposed to a private group) is acting "within the ambit of its legitimately derived authority, we will less readily find that its action violates the Fair Housing Act." The court found that as the village was acting within the scope of its authority to zone, and given the wide discretion "traditionally afforded" municipalities in zoning, "this factor weakens plaintiff's claim for relief."

3. *How strong is plaintiff's showing of discriminatory effect?* In terms of future precedent, the court's discussion of this criterion is of critical importance. It started by noting that there are two types of "racial impact":

> There are two kinds of racially discriminatory effects which a facially neutral decision about housing can produce. The first occurs when that decision has a greater adverse impact on one racial group than on another. The second is the effect which the decision has on the community involved; if it perpetuates segregation and thereby prevents interracial association it will be considered invidious under the Fair Housing Act independently of the extent to which it produces a disparate effect on different racial groups.

The court acknowledged that there was only weak proof of the first type of impact in this case but went on to stress the importance of the second type:

> What was present in [earlier cases finding a violation of the Act] was a strong argument supporting racially discriminatory impact in the second sense. In each case the municipality or section of the municipality in which the proposed project was to be built was overwhelmingly white. Moreover, in each case construction of low-cost housing was effectively precluded throughout the municipality or section of the municipality which was rigidly segregated. Thus, the effect of the municipal action in both cases was to foreclose the possibility of ending racial segregation in housing within those municipalities.

The court said it wasn't clear whether the refusal to rezone here "would necessarily perpetuate segregated housing in Arlington Heights." It noted its earlier findings relating to the apparent patterns of segregation in the village but acknowledged Arlington's claims that other sites for low-income housing were available and zoned in the village. It remanded with instructions that the village would have the burden to prove that claim and that, if it could not, it would lose:

> We hold that, if there is no land other than plaintiffs' property within Arlington Heights which is both properly zoned and suitable for federally subsidized low-cost housing, the village's refusal to rezone constituted a violation of section 3604(a). Accordingly, we remand the case to the district court for a determination of this question subject to the guidelines which we shall lay down. Since the village's zoning powers must give way to the Fair Housing Act, the district court should grant plaintiffs the relief they request if it finds that the Act has been violated.

4. *Does the plaintiff seek to compel the defendant to affirmatively provide housing for members of minority groups or merely to restrain the defendant from interfering with individual property owners who wish to provide such housing?* The court decided that "this factor favors the plaintiffs in this case" inasmuch as they were not asking Arlington Heights to do anything except get out of the way:

> To require a defendant to appropriate money, utilize his land for a particular purpose, or take other affirmative steps toward integrated housing is a massive judicial intrusion on private autonomy. By contrast, the courts are far more willing to prohibit even nonintentional action by the state which interferes with an individual's plan to use his own land to provide integrated housing.

Having gone that long way around, it is clear that the 7th Circuit got right back to the place where it had started and the message to municipal governments is the same: If a municipality that historically has been segregated—even unintentionally—does nothing affirmative to promote low-income housing and if a developer proposes such a project to "help" the community break down its patterns of segregation, the federal courts (or at least one of them), are going to require the community to accept the project unless it has very compelling reasons to show why it should not.

U.S. Supreme Court to Hear Grand Central Terminal Case

by Frank B. Gilbert

On December 5 the United States Supreme Court granted review of the New York State Court of Appeals decision in the case involving the proposed construction of a 2,000,000 square-foot office building on the site of Grand Central Terminal, a designated New York City landmark. The decision by the Supreme Court in this case, *Penn Central Transportation Co. v. City of New York*, may have great impact on municipal landmark and historic district ordinances and the entire field of historic preservation. The case was brought because the New York City Landmarks Preservation Commission turned down the proposed construction.

Briefs have now been filed in the Supreme Court by the parties in the case, and oral argument before the Court was to be scheduled for April.

In its brief the Penn Central argued that its right to construct an office building over Grand Central is valuable private property fully protected by the Constitution and that it is entitled to receive compensation for the taking away of its development rights. Penn Central also questioned the view of Chief Judge Breitel of the Court of Appeals that the owner of a landmark "is not absolutely entitled to receive a return on so much of the property's value as was created by social investment." Breitel has said that government had created much of the value of the terminal property through its investment in the building, the railroads, and connecting transportation.

The City of New York argued that the designation of Grand Central Terminal as a landmark was a proper exercise of the police power by government. It said, "The power in restricting land use has been extended to legislation for aesthetic and other similar purposes having to do with the quality of life."

This article is an update of Mr. Gilbert's "The Grand Central Case: The Preservation of Individual Historic Landmarks," which appeared in the Summer 1977 edition (vol. 2, no. 1) of *Real Estate Issues*.

Frank B. Gilbert, landmarks and preservation law counsel for the National Trust for Historic Preservation, participated in amicus curiae briefs in favor of the preservation of Grand Central Terminal during the litigation described in his article. From 1965 to 1974 he was secretary and then executive director of the New York City Landmarks Preservation Commission; in those years much of his time was spent on the Grand Central proceedings. He received his J. D. degree from Harvard Law School.

The city also said that the property owner failed to show that the landmark designation interfered with continued use of the terminal or prevented it from earning a reasonable rate of return. The brief observed that it was "insufficient to show that the regulation deprived the property owner of the most profitable use of his property."

The Real Estate Board of New York filed an amicus curiae brief in support of the Penn Central. Several friend of the court briefs have been filed backing New York City, including ones by the U.S. Department of Justice, the State of New York, the State of California, and the National Trust for Historic Preservation.

REITS as Investment Companies: Advising the Independent Trustee of Real Estate Investment Trusts

by Richard S. Kraut

As a result of the 1960 amendments to the Internal Revenue Code,[1] REITs and their beneficial owners have enjoyed the same conduit tax treatment for income as mutual fund shareholders. This parity of tax treatment with mutual funds is probably logical considering the similarity of objectives and similarity of the forms of the two entities. They are treated differently, however, by federal regulatory agencies, which pay far more attention to investment companies than to REITs.

If REITs obtain the same or similar benefits and are structured in much the same way as investment companies, it is unclear that investors in REITs should not be entitled to the same protections provided investors in registered investment companies. REITs are now specifically excepted from the definition of "investment company" under the Investment Company Act.[2] It appears, though, that abuses that have come to light recently involving REITs[3] may, if not actually jeopardize the exception, at least qualify the REIT as a candidate for additional regulation for the protection of investors. Independent trustees of REITs can play a significant role in determining whether such regulation will eventuate. If the independent trustee properly performs his role he will also achieve the concomitant effect of avoiding personal liability, as well as affording protection to investors.

What, then, are the proper roles and responsibilities, as well as potential liabilities, of the independent trustee?

This article is adapted from a speech delivered before the Seventeenth Annual Conference, National Association of Real Estate Investment Trusts, Boston, Massachusetts, October 12, 1977, in substantially this form, under the title "The Role, Responsibility, and Liability of the Independent Trustee of Real Estate Investment Trusts."

The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or speech by any of its members or employees.

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RESPONSIBILITIES AND LIABILITIES OF INDEPENDENT DIRECTORS

All would agree that the roles and responsibilities of independent directors, to whom independent trustees have been likened, have changed enormously in recent years. While in years past directors were frequently chosen to decorate the boards of directors with impressive names and titles, to honor certain individuals and possibly to utilize their business contacts, independent directors now clearly have weighty affirmative responsibilities.

Illustrative of the Commission's attitude toward such past practices is a situation considered by the Commission in its early years in which the Commission administratively refused to permit amendments to a registration statement to become effective. The company involved[4] had an impressive board of directors, and a first prospectus prominently displayed photographs and biographies of the directors. They included a past Supreme Director of the Royal Order of the Moose, a contractor-builder who was described as having built a larger number of public and private buildings than any other contractor in the Washington, D.C. area, and a brigadier general and director of the United States Marine Corps, whose ". . . name is familiar to all students of American history" and whose "great grandfather . . . adopted and educated David Farragut who became the first Admiral of the American Navy . . ." Said the Commission: "The purpose of a display of this character is not difficult to penetrate . . . It gives the impression to innocent investors that this group of well known and presumably successful persons is giving its time and effort to building a highly worthy enterprise and that some safety to the investors springs from that fact. But the record illustrates that this was far from the truth. The use of these names in this manner is thus misleading." While the outside directors clearly only lent their names to the company, they nevertheless signed the registration statements. The Commission presumed that those signing were familiar with the nature and conduct of the business and also with the content of the registration statement and prospectus. However, generalizing from the testimony of one of such independent directors, the Commission concluded that the contrary was the case. Quoting from the record:

"Q. Are you familiar with the National Invested Savings Corporation?
A. Yes sir, to some extent.
Q. Are you associated with that company?
A. I was, and I suppose I still am.
Q. In what capacity were you associated?
A. I believe I was selected to be a director.
Q. Were you elected a director?
A. I suppose so, so far as I know.
Q. Did you ever serve?
A. No, sir.
Q. Did you ever attend any meetings?
A. No, sir."

While the only sanction imposed in this 1936 case was a stop order, today there is little doubt that such directors themselves would have been held liable for violations of the federal securities laws.

Negligence, Recklessness, and Intent

Leaving aside questions such as trading on inside information and short-swing profits, directors most frequently become targets of law suits in connection with registration statements and prospectuses, annual and interim reports, and proxy materials that are alleged to have been false and misleading. Allegations, findings, and holdings run the gamut from active participation to knowledge to reckless disregard of facts to mere negligence. In 1976, however, the Supreme Court held in the famous Hochfelder case[5] that intent is required to sustain a private action for damages under Rule 10b-5, the general anti-fraud provision. The Supreme Court left open the question as to whether negligence would suffice in an SEC action under that rule[6] or whether reckless disregard would satisfy the intent requirement. Since *Hochfelder*, several district and appellate courts have held that negligence will support an SEC action[7] although three district courts have held it will not.[8] The courts seem split on the negligence-"reckless disregard" issue.[9] But since the point at which negligence becomes reckless disregard is not susceptible to clear delineation in my opinion, the issue will be decided on a case by case basis and the debate among the bar will rage on. In the writer's opinion the Commission, however, will continue to urge that negligence is the proper standard in its cases, although the actual conduct involved in its cases is, more often than not, knowing and willful.

Attempts have also been made to hold directors liable as controlling persons. There is a split of authority as to whether a directorate raises a rebuttable presumption of control for purposes of liability.[10] The question running throughout, however, is what duty was owed by the director and what actions or failures to act in the circumstances resulted in liability. While formulations of that duty have generally been all over the lot, the best formulation is contained in the *White v. Abrams*[11] case which rejected the negligence versus intent analysis of other courts and adopted the "flexible duty standard." Said the court:

> The proper analysis, as we see it, is not only to focus on the duty of the defendant, but to allow a flexible standard to meet the varied factual contexts without inhibiting the standard with traditional fault concepts which tend to cloud rather than clarify. By adopting such a duty analysis, we avoid the confusion that arises from classifying the transactions as direct and indirect. This flexible approach, as compared to the compartmentalized approach, does away with the necessity of creating a separate pigeonhole for each defendant whose involvement in the transaction in question may not fit nicely into one of the previously defined classes.
>
> We believe that . . . any attempt to limit the scope of duty in all 10b-5 cases by the use of one standard for state of mind or scienter is confusing and unworkable.

While a former chairman of the Commission publicly indicated several years ago that the Commission would endeavor to publish guidelines with respect to duties and responsibilities of independent directors,[12] that chairman's successor acknowledged that the endeavor would be substantially delayed because the resolution of such issues was not susceptible to a clear formulation. Rather, he indicated that the Commission would take a case by case approach to issues involving possible director liability,[13] thus limiting a tacit acceptance of the flexible duty standard. Accordingly, the Commission has made its views known through its lawsuits, through occasional releases in connection with other enforcement action and through amicus briefs filed in private actions.

Thus, in a private case, *Lanza v. Drexel & Company,*[14] involving Rule 10b-5 under the Exchange Act, the Commission articulated its position in its amicus brief, which stated:

> It is the Commission's view that in the context of a securities transaction a director who approves, or does not otherwise participate in, the transaction would not be liable to a third party unless he knew, or *had reasonable cause to believe,* that the responsible corporate officers had engaged in improper conduct in connection with the transaction. Absent circumstances which would put him on notice of a material failure in disclosure by the corporation, a director, acting with *due care* and relying in *good faith* on officers whom he has no reason to believe are acting improperly, would not incur liability under Rule 10b-5 or Section 20(a) [the controlling person provision] merely by reason of his having authorized or approved the transaction.

The majority in the Lanza case, which was a six to four decision and which accurately anticipated the Hochfelder outcome, held that the independent director, who was a partner in the company's investment banking firm, was not liable in damages to plaintiffs who had received stock in exchange for stock in a company acquired by the issuer. The issue articulated by the majority was whether the independent director had a duty under Rule 10b-5 "to insure" that all material adverse information was conveyed to prospective purchasers of the corporation's stock where the director did not know that the prospective purchasers were not receiving all such information. The independent director had an awareness that the company was having financial problems. Nevertheless, the court held that, since proof of a willful or reckless disregard was necessary to establish liability under Rule 10b-5, he was not liable for the failure of the company to make proper disclosure because the court could not conclude that the director "willfully closed his eyes to or turned his back on the fraudulent nature of the . . . negotiations."[15] To the contrary, the court found that the director displayed an attitude not ordinarily found in outside directors and played an active role in the company's affairs. The majority held that he had no duty "to insure." The majority also said that to be liable he had to be a culpable participant in some meaningful sense.

The dissent on the other hand focused upon whether he had a duty "to inquire," rather than "to insure," concerning the information the company's management furnished to the shareholders. The dissent concluded that he should have been held liable on the grounds that his financial sophistication and his awareness of the increasing problems imposed upon him a duty to inquire, which he failed to do, as to whether the shareholders of the acquired company were fully informed of the problems. One dissenting judge noted that,

> the independent director was the most experienced member of the board with regard to financial and business matters. He was aware that [the company] was acquiring [the other company] through an exchange of stock since he had voted for the acquisition in his capacity as a director. He was aware that [the company] had suffered many business reversals and had suffered from severe intracorporate dissension. Yet he did not know whether this unfavorable position had been disclosed to [the acquired company]. . . . [The independent director's] experience should have told him that, . . . since certain mistakes and problems had just recently been discovered, management obviously had not revealed these matters to outsiders such as [the acquired company].

Particularly because of his financial sophistication, he should have wondered how, if all the adverse facts were known to the shareholders of the company being acquired, they were induced to take stock of the acquiring company, which, in turn, should have led him to be skeptical as to whether all material facts had been diclosed to the shareholders of the company being acquired.

While commentators[16] and an SEC commissioner[17] indicated that *Lanza* would not be a great source of comfort to independent directors and that the view of the dissent in the Lanza decision would ultimately become the majority, *Hochfelder* has probably proved them wrong, but only with respect to private actions for damages and not with respect to Commission cases for injunctive relief. In any event, it still appears that directors will not be dealt with on an undifferentiated basis under the federal securities laws. Inquiry will be made by the courts to determine which of the independent directors—because of experience, knowledge, educational background, training, expertise in particular fields such as accounting, relationship to the corporation and its officers, length of service on the board, intimacy of involvement in the corporation's affairs, access to information, and awareness of the consequences of the corporate acts—should reasonably have been expected to heed warning signals, comprehend them, pursue questions, obtain information, and assure proper disclosure. In other words, a flexible duty standard will be imposed.

SEC Cases Involving Directors

The Commission may have applied the flexible duty standard in deciding to name only three of numerous outside directors in the Penn Central case. The three directors named were charged with violating the antifraud provisions. While acting as directors and controlling persons of Penn Central and two of its subsidiaries, they were alleged to have known or to have had reason to know of Penn Central's serious financial condition and of activities designed to conceal from investors and creditors the critical condition of the company, and to have known or to have had reason to know that information disseminated by Penn Central and its subsidiaries to investors was materially misleading.

While the case was settled with the directors by a consent undertaking, the role of the board was extensively discussed in the Commission's report of the collapse of the Penn Central.[18] In the report the Commission concluded that the outside directors failed in their obligation to the shareholders of the company to properly monitor the company's affairs, to select competent management and to review the performance and integrity of management, including compliance with the federal securities laws. It was found that after the merger with the New York Central Railroad, the directors were furnished only with voluminous dockets of routine capital expenditure authorizations for numerous individual transactions, a treasurer's report giving the current cash balance and a sheet listing revenues and expenses for the railroad for the period between the board meetings. The directors had no cash or income forecasts or budget, no guidelines to measure performance, no capital budgets, no information describing the earnings or cash performance of the subsidiaries to judge the progress of the merger or the effectiveness of management, and no cash flow budget to see the rate of cash drain, which was substantial. For this information, they relied on oral presentation by management. The Commission found that the board meetings were formal affairs which were not conducive to discussions or interrogation of management. Some of the directors had little opportunity to consult with other directors outside of the environment of the board meetings.

The board was further at fault in failing to establish procedures, including a flow of adequate financial information, to permit the board to understand what was happening and to enable it to exercise some control over the conduct of the senior officers. According to the Commission, the board also failed to respond to specific warnings about the true condition of the company and about the questionable conduct of the most important officers, but rather continued to accept the assurances of management that the company was under control. A more critical examination of management's statements, the Commission concluded, would have uncovered the enormity of the problems and the urgent need for corrective action. Even if corrective action were impossible, the directors would thus have assured that the investors were informed of the magnitude of the problems, rather than continuing to receive optimistic projections. The Commission concluded that the board caused investors to be deprived of adequate and accurate information about the condition of the company.

One bright spot deserves mentioning: Louis Cabot, a new director who had attended his first board meeting in May, 1969, responded in writing to a request of the chairman of the board and chief executive officer for suggestions on the presentation of information to the board. I quote from his letter,[19] which I think has particular relevance to REITs today:

> I believe directors should not be the managers of a business, but they should insure the excellency of its management by appraising the management's performance. To do this they have to measure that performance against agreed upon yardsticks.
>
> My first suggestion is that it would be most useful to the directors to have management tell us in quantitative terms what it is trying to accomplish . . .
>
> My second suggestion is that the directors be given, perhaps annually, an opportunity to review objectives with the management, and endorse them . . . This is the only way we can give any input at all as directors without being in the position of second guessing after the facts. Furthermore, it can give management some assurance that the board supports what it is trying to do.

My third suggestion is that the directors be told periodically how actual results are working out as against the short-term targets. Where are there shortfalls? What were the reasons? Were they some things not foreseen and beyond our control, or were they Penn Central shortcomings that need more attention?

To take a specific example, how does the $40 million we have lost in transportation so far this year compare with what it should have been? Did the directors know what anyone thought we would earn or lose? And on the basis of the expectation did they agree with what management was planning to do; that is, capital investment, cost cutting, services added or abandoned, organization changes? Why did we miss? It is not very helpful to be told the railroad business is terrible. [Parenthetically, it would not be very helpful to tell REIT trustees that the real estate business is terrible and that interest rates are skyrocketing.]

. . . Furthermore, if these kinds of losses are unacceptable, which I presume is the case, what shall we do different to reverse them? How and when can we tell whether the changes are working?

I do not think directors should know about every real estate deal, but I do think they should know what we are trying to accomplish. Are we trying to use up tax credits, or make large capital gains, or add to current earnings by a steady stream of profitable small trades, or what? . . . How much capital should we devote to real estate? And what do we think lies ahead?

I am more concerned about our overall finances. How much longer are we going to invest vastly more than our cash flow? Are we trying to borrow all the money we possibly can or is there a prudent limit? If so, what is it? Are our plans consistent with it?

I think I can defend myself as having been diligent as a director if I have the opportunity to participate in and vote on such issues as I have listed. If not, I don't think I can. I certainly cannot merely by listening to a long list of railroad capital expenditures once a month.

Unfortunately, according to the Commission's report, the information requested by Cabot was not supplied.

The Commission also faulted the independent directors in a report of investigation[20] in the Stirling Homex case where it separately sued the company, members of its management, its investment banker, and its independent auditors. The complaint charged recordation of fictitious sales, earnings, and assets by Stirling Homex, which was engaged in manufacturing and installing modular dwelling units. The report noted that management and others intentionally deceived the independent directors by making untrue representations and furnishing false and misleading financial and other information to them. However, the Commission concluded, again appearing to apply the flexible duty standard, that the outside directors did not play any significant role in the direction of Stirling Homex's affairs even though they possessed considerable business experience and sophistication, and did not provide any significant protection to shareholders in fact. Without detailing all the deficiencies here, suffice it to say that the independent directors did not obtain timely, accurate, or complete information with respect to the business operations of the company. As a result, they could not and did not make probing inquiries, and thus did not realize that the company was suffering serious operating and financial difficulties. Notwithstanding such problems, the independent directors signed a registration statement offering securities to the public and did not raise any further questions about the business operations and accounting practices.

In connection with *SEC v. Gould, Inc., et al.*, the Commission issued a report of investigation pursuant to Section 21(a) of the Exchange Act concerning the conduct of the directors.[21] Members of Gould management had a personal interest in a real estate transaction involving the company. The board of directors was informed of the transaction after the fact. The Commission found that:

> (the) directors considered the fairness of the price paid by Gould for the seven-acre parcel and the offer by the partnership [consisting chiefly of Gould management] to sell the 32-acre parcel to the company at the price paid by the partnership, but did not address the question whether the allocation of the total purchase price between the two parcels resulted in the partnership receiving a benefit at Gould's expense. The board of directors, without additional investigation beyond inquiry of financially interested management at the board meeting, decided the purchase price for the seven-acre parcel was fair to Gould and that Gould should not purchase the 32-acre parcel.

The Commission concluded:

> With regard to the review by the board of directors of management involvement in a transaction affecting the company, the Commission is of the opinion that in such instances, the board should carefully ascertain all of the relevant facts to determine whether the transaction is in all ways fair to the company and to assure that it has been fully disclosed to shareholders as required by the federal securities laws. In ascertaining facts, the board should not rely solely on information from non-interested sources when available.

Had such information been sought, the directors would have likely learned that the prices asked by the single seller of the two parcels were $350,000 for the seven-acre parcel and $1,050,000 for the 32-acre parcel. However, Gould purchased the former for $940,000 and the partnership purchased the latter for $460,000.

Most recently, in connection with the Commission's injunctive action involving National Telephone Company, Inc., the Commission issued a report of investigation under Section 21(a) of the Exchange Act with respect to "basic questions concerning the obligations of 'outside' directors" to inform stockholders "on a timely basis, of material facts concerning the basic operations of the company."[22] National Telephone had reported high earnings and issued rosy public projections of growth, in fact, it was in serious financial condition and eventually filed in bankruptcy. The Commission found that:

> [the outside directors] were aware . . . of significant facts concerning National's troublesome financial condition. Moreover, they were also aware of the optimistic nature of the company's public disclosures, disclosures which were in direct contrast with the true state of the company's affairs. Under these circumstances, the company's outside directors had an affirmative duty to see to it that proper disclosures were made. The Commission is not saying that the directors of a company are responsible for approving every line of every press release and periodic filing made by a company; rather, the Commission is saying that, at a time of distress in a company's existence, the directors have an affirmative duty to assure

that the market place be provided accurate and full disclosures concerning the basic viability of the company and the continuity of its operations.

This language appears particularly apposite to outside trustees of REITs in light of the problems which appeared on the REIT scene beginning in 1973. Given the roller-coaster nature of the building industry in recent years and its sensitivity to developments in the money markets, outside trustees should be particularly sensitive to the problems of disclosure.[23]

A LOOK AT DIRECTORS OF MUTUAL FUNDS

In examining the duties and sources of liabilities of independent trustees, Benjamin Lopez, in his excellent monograph entitled "The Role of the Independent Trustee in a REIT," notes, and this writer would agree, that the role played by the independent REIT trustee is virtually identical with the role assigned to the independent director of a regulated investment company. Accordingly, it would be instructive to look at pronouncements of the Commission, the courts and commentators in this area.

In 1966 the Commission noted in its report entitled "Public Policy Implications of Investment Company Growth" that nonaffiliated directors were generally ineffective in safeguarding the interests of mutual fund shareholders. It has been commented that "their ineffectiveness in the past may be attributable more to their failure to identify their responsibilities, their lack of time and information, and their close identification with the adviser, as well as their lack of bargaining power needed to effect meaningful controls over the adviser, than to any conscious abdication of their duties."[24] It may also result from a misconception that their role is substantially similar to that of the unaffiliated corporate director, which misconception does not adequately reflect the special nature of mutual funds,[25] nor, I should add, of REITs.

The Management Agreement and Conflicts of Interest

It has been observed[26] that in the usual corporate situation the interests of management and shareholders are identical on most matters. Management and shareholders alike are interested in having the products or services sold by the corporation produced at the lowest possible cost and sold at the highest possible price. A REIT, like a mutual fund, primarily sells professional management of a diversified investment or loan portfolio. Although the advisers and the shareholders have parallel interests, there are important areas where their interests may conflict—particularly in the setting of management fees. In this area the shareholders' interest in low cost conflicts with management's interest in maximization of its fee and thereby its profits. This important conflict of interest defines the special problems and responsibilities of the independent trustees.

Section 15(a) of the Investment Company Act provides that the management agreement may not continue in effect for more than two years unless the continuance is approved at least annually by the board of directors or by a majority of the outstanding voting securities of the fund. Section 15(c) requires express approval by a majority of the directors who are not parties to the contract or "interested persons" of the investment adviser and imposes on directors the duty to request from the adviser and evaluate such information as may reasonably be necessary to evaluate the terms of the advisory contract.

The unaffiliated directors' and unaffiliated trustees' major task, then, consists of evaluating the quality of the investment advice received from the adviser and the fairness of the fee.[27] All too often, this review seems to be made on the assumption that the existing investment adviser, particularly when it is the sponsor of the fund or REIT, has a vested right to remain the investment adviser, which assumption runs counter to the provisions of the Investment Company Act.[28] The independent trustees, like unaffiliated directors, should apply standards which are the same as those applied by a prudent individual investor in considering an arrangement for securing outside advice with respect to the management of his personal assets.[29]

The independent trustees should not shrink from considering available alternatives. They should determine whether or not the REIT, without undue cost or risk, can be sufficiently flexible to change its arrangements for securing investment advice if for any reason such a change is thought desirable, and should consider whether the most satisfactory arrangement involves internalizing the system for providing investment advice, that is, transforming the REIT into an internally-managed company. The NAREIT Fact Book for 1975 points out that REITs need not have an external adviser. In this regard, it should be noted that, as part of the relief obtained by consent in the Commission's suit against First Mortgage Investors,[30] its adviser and their principals, FMI agreed to discontinue its external adviser and to internalize the advisory functions.

Advisers' Compensation

The amount paid for the advisory service is, of course, a key item, for it is likely that shareholders of REITs will challenge advisory fees, if they have not already done so, on the ground of excessiveness. Similar challenges have been made in the mutual fund area.

For example, in the landmark case, *Brown v. Bullock,*[31] the complaint charged, among other things, that the independent directors were tools of the investment adviser and were "beholden" to the adviser for putting them on the board; that the insiders dominated and controlled the board of directors; that the contract and its respective yearly extensions were not the result of arm's length bargaining but were adopted as a result of arbitrary action, collusion, gross negligence, or reckless disregard of duty; that the directors made no effort to ascertain whether services similar to those supplied by the adviser could be secured elsewhere on more advantageous terms or whether the adviser itself could not have been persuaded to take less; that the directors were acting in the interests of the adviser and not the fund; and ultimately that the fees were excessive and out of proportion to the value of the services performed. The court held that the complaint, which also named the investment adviser and its principals, stated a cause of action under the Investment Company Act and under that section which made it unlawful for the investment adviser to act as such for more than two years after execution of the contract unless continuance of the contract was approved at least annually by the board of directors or a majority of the outstanding securities. While the court noted that the independent directors had voted in favor of the contract, the court held that Section 15 was concerned with the *substance* of oversight by the directors and not simply with the form. Therefore, the complaint stated a cause of action since it alleged that the directors' approval was given without any real consideration of the merits.

Accordingly, independent trustees would be well advised to thoroughly review the setting of fees and the renewal of advisory contracts and not merely rubber stamp the proposal submitted by the adviser. Since it is generally conceded that growth in asset size of the REIT is not accompanied by a proportionate growth in the cost of managing such assets, and since fees paid to REIT advisers have not generally been scaled down based on size, independent trustees should not consider as sacred the percentage of assets as the basis for the fee but rather should consider other possible alternatives. The independent trustees should look at the cost of comparable services. It is appropriate to inquire how much it costs the adviser to provide the REIT with the services it has agreed to furnish. In this regard, it would not only be appropriate but advisable to look at the profit made by the adviser. The trustees should consider the expenses incurred by the adviser attributable to the REIT and the general profitability to the adviser of its services to the REIT. They should consider their REIT's performance with that of other REITs with similar objectives. Independent trustees should consider the actual amount of all compensation paid to the adviser, including any indirect forms of compensation, such as income received from tie-in business, from interest on loans to the REIT where a bank owns the adviser, from the use of the REITs' deposits, and from use of the bank parent as the registrar or transfer agent. They should also obtain and evaluate information with respect to how the adviser allocates investment opportunities between the REIT in question and any other funds that the adviser may manage or in which it may directly invest.

It may be said with equal application to independent trustees that, like unaffiliated directors of mutual funds, they may not realize the strength of their bargaining positions which arises from the fact that "businessmen want to do what is 'right'—or at least they want to appear to their peers to be doing what is right."[32] Accordingly, "strong and reasoned objections" by independent trustees to an advisory contract "on the ground of unfairness to . . . shareholders will, in many cases, produce modifications of the contract."[33] If modifications are not produced, it would seem that independent trustees have a right to have their disapproval of the advisory contract disclosed in the proxy statement submitted to shareholders. Threat of public statements that a particular contract is unfair to REIT shareholders provides an effective bargaining weapon because the REIT sponsor or adviser will be reluctant to incur the risk of unfavorable publicity which such a public statement would produce.[34]

In testimony before a Senate committee investigating the impact of the REIT industry on banks, it was commented that the "honey which drew the commercial banks, along with many others, into sponsorship of REITs was a generous fee structure."[35] It was noted that the fee structure "obviously provided a strong incentive for REIT advisers to recommend ever higher levels of leveraging; for the more invested assets, the higher the fee."[36] The Commission's staff has been concerned that investment advisers may have caused their REITs to extend high risk loans for the purpose of increasing the size of the loan portfolios and thereby the size of the advisers' fees without disclosure of that fact to the unaffiliated trustees of the REIT. Independent trustees, therefore, should consider this in determining investment policy in view of the obvious relation between investment policy and the fee. In one case history noted in testimony before the Senate committee, the REIT during a one-year period had expanded its portfolio of short-term mortgages by over 400%, while the advisory fee increased by 13.7%. However, net income had decreased by 13.5% and the share price had decreased by 44.6%. It was asserted that this was not an isolated case.[37] Recognizing the reduction in fees in most recent years to either actual costs of operation or a fixed amount above such actual costs paid by some REITs in view of their losses, the pre-tax profit margins for many advisers in previous years, in the area of 60 to 70% of the total advisory fee[38] may very well be found to have been excessive.

Legislative Policies and Declarations of Trust

This article makes no attempt to compare the performance of internally managed REITs with externally managed REITs, or of externally managed REITs with different fee structures. The point is merely that independent trustees must consider available alternatives, in good faith, if they are to do their jobs as well as successfully insulate themselves against liability. It would also appear prudent for independent trustees to bring certain policies expressed in their declarations of trust into line with policies expressed through legislation contained in the Investment Company Act.

For example, the typical REIT declaration of trust contained in the NAREIT Fact Book provides: "No person shall be prohibited for any reason from transferring all or any portion of such securities to another person by sale, exchange, or otherwise, or shall be required to obtain the consent of the trust or any of the shareholders for such transfer." Under Section 15(a) of the Investment Company Act, however, any assignment of the advisory contract must result in automatic termination of such contract. Sale of the controlling block of securities of the adviser would constitute an assignment of the contract under the Act.[39] In view of the crucial relationship between the REIT and the investment adviser, it would seem that the 1940 Act provision should govern the relationship, and not the quoted provision from the declaration of trust.

The declaration of trust also provides that trustees may participate in a meeting of trustees "by means of conference telephone or similar communications equipment . . . and participation in a meeting pursuant to such communications shall constitute presence in person at such meeting." Presumably, the REIT's advisory contract could be approved at such a meeting. Under Section

15(c) of the Investment Company Act the advisory contract and its renewal must be approved by a vote of the majority of the independent directors cast in person at a meeting called for the purpose of voting on such approval. The Commission has publicly indicated that the "in person" provision cannot be complied with by voting over the telephone, by the use of a closed circuit television conference, by proxy, or otherwise than by personal appearance.[40] Selection of the independent accountant is also subject to a similar provision.[41] Such provisions are designed to insure that the discussions pertaining to and review of the advisory contract and selection of accountant are thorough and not perfunctory. To fulfill their duties to their beneficiaries, as well as to avoid liability, independent REIT trustees should insist on "in person" meetings of trustees to consider in detail these vital matters.

Conflicts of Interest

Such detailed and informed discussions are particularly important where conflict of interest is involved. The recapture of brokerage commission cases involving conflicts between mutual funds and their investment advisers illustrate such importance. The issue in these cases was whether the adviser, through a broker-dealer affiliate, should have recaptured commissions for offset against the advisory fee charged the fund or used the commissions to reward other dealers who sold fund shares or provided the adviser with research and other services.

In *Moses v. Burgin,*[42] the management company had not set up a structure for the recapture of brokerage commissions and testimony was that the outside directors of the fund were not aware of the ability to recapture. The court held that the management company and the affiliated directors, motivated by self-interest, had breached their fiduciary duty to the fund in intentionally not disclosing to the outside directors the ability to recapture and in not having the outside directors consider and pass on the issue, and thus they were liable. The court held the unaffiliated directors not liable since they were not shown to have had any knowledge of the possibility of recapture nor any personal conflicting interest "which should have sharpened their attention."[43] The court did admonish, however, that "unaffiliated directors are not free of all obligations to consider matters on their own."[44]

In contrast with the Moses case, no liability was found in the *Tannenbaum v. Zeller* case.[45] The court found full disclosure by the management company and the inside directors to the outside directors and extensive periodic and physically documented review by the board of directors, which had been regularly supplied by management with the latest information about developments in the field of recapture of commissions each time there was a significant development in the area. A subcommittee of outside directors was established to consider the question and no management directors were involved in the direct consideration. Moreover, the subcommittee sought the advice of outside counsel. Based on such a record, the court was able to conclude that good faith business judgment was exercised. While the Commission's amicus brief in the case questioned the business decision, it urged no liability if the court could find that the board was informed and acted in good faith.

The advisability of independent trustees retaining separate counsel, or at least retaining separate counsel from the adviser, to represent the REIT is illustrated in the *Papilsky v. Berndt*,[46] case, another "recapture" case. The court held that the insiders were liable on the recapture question but did not reach the outside directors who had been sued, since the case against them was dismissed on procedural grounds. Unlike *Tannenbaum*, the outside directors did not have separate counsel. Noting the inherent conflict of interest between the adviser and the fund and the dependency on the flow of information to the independent directors to enable them to perform their role, the court indicated that " 'investigation of recapture methods and their legal consequences [should have been] performed by disinterested counsel furnished to the independent directors,' "[47] the same admonition given in yet another recapture case.[48] The court in *Papilsky* found that the insiders did not suggest to the independent directors that they seek independent counsel. Moreover, the court found that the adviser "funnel[led] to the Board business reasons why recapture was a poor idea,"[49] with concurrent legal opinions from counsel which also represented the adviser—a pretty persuasive one-two punch. The court found that the legal opinions conflicted in some instances with a Commission report on mutual funds, which report was "brushed aside"[50] in meetings with the fund's board. The significance of the effect of the legal advice was unequivocally noted: "Where business reasons would probably not have provided a bar to recapture efforts, the unwavering nature of the legal advice presented to the independent directors became crucial."[51]

In light of these cases, it would seem incomprehensible why independent trustees would not set up special committees and retain independent counsel in conflict situations. Of course, good faith is crucial; retaining counsel merely to go through the motions will not afford relief to the trustees or protection to investors.

Trustees may want to consider prohibiting conflict of interest transactions involving the REIT, other than the advisory fee, since "the only certain way to insure full compliance with [the fiduciary duty] is to eliminate any possibility of personal gain."[52] Even though certain transactions in which conflicts are inherent may be explicitly permitted under the declaration of trust, and therefore may be within the morals of the market place, "equity imposes a higher standard" than " 'the morals of the market place.' "[53] Chief Judge Cardozo once stated: "Many forms of conduct permissible in a work-a-day world for those acting at arm's length, are forbidden to those bound by fiduciary ties . . ."[54]

Valuation of Portfolio

The declaration of trust also provides that the trustees shall have the power to determine conclusively the value of any assets of the trust property and to provide for reserves. A substantial duty as well as authority is thus imposed. This duty may give rise to liability. Again, drawing on the mutual fund area, "fair value" is determined in good faith by the board of directors under the Investment Company Act,[55] with respect to securities and assets for which market quotations are not readily available. The Commission has stated[56] that it is incumbent upon the board of directors to consider all appropriate factors relevant to such value and to determine the method of arriving at the fair value of each such security. To the extent considered necessary, the Commission said that the board may appoint persons to assist them in the determination of such value to make the actual calculations pursuant to the board's direction. However, the board must also continuously review the appropriateness of the method of valuation. The directors must also carefully review the findings of such other persons to satisfy themselves that the resulting valuations are fair. While recognizing that no single standard for determining "fair value in good faith" can be laid down, since fair value depends upon the circumstances of each individual case, the Commission said that as a general principle "fair value" would appear to be the amount which the owner might reasonably expect to receive upon current sale. Such determination would involve hard information as well as judgment factors.

Since a REIT is an investment company, the foregoing would be applicable to valuation of a REIT's portfolio. It is critically important that REITs properly value their portfolios. Any distortion in the valuation of properties, overvaluation of loan collateral, or failure to write down or reserve against probable losses from loans will result in inflation of the investment adviser's fee where he is compensated on the basis of net asset value. It also will result in overstatement of the REIT's income, in false and misleading reports to investors—and in liability.

The Commission has recently taken enforcement action in this area. On January 16, 1978, the Commission filed suit against Continental Advisers[57] and various former members of that REIT's senior management, as well as against CMI's independent auditor.[58] CMI, now in bankruptcy, was a short-term mortgage trust which financed the construction and development of a broad variety of real estate projects. The Commission charged, in essence and among other things, that CMI's earnings were falsely inflated, that its reserves for probable losses were materially understated, and that it continued to accrue interest on loans upon which no further accrual could be justified. The case is presently being litigated. Previously, in the Franklin National Bank[59] case, the Commission charged that the defendants failed to disclose the deterioration and the quality of the bank's loan portfolio, a situation analogous to that of mortgage REITs. In another Commission case involving an offshore unregistered fund managed by a domestic adviser,[60] the Commission found material overvaluations over a period of time, with a peak overstatement of 43.5% in one month. The Commission held that the overvaluations were fraudulent since "they deceived investors who bought on the strength of illusory performance records." Significantly, the Commission observed that even an unregistered investment company, which could just as easily have been a REIT, "does not acquire a license to deceive because it happens to fall outside the purview of the Investment Company Act." In a third case, the Commission criticized the performance of a mutual fund's board in ratifying the evaluation of restricted or non-freely tradeable securities in the fund's portfolio.[61] While the board considered the possibility of giving separate consideration to each restricted security, it rejected such approach after the adviser "represented that such procedure would create a time-consuming administrative burden." Instead, the board chose to apply a predetermined discount from the market quote automatically, and thus did not determine fair market value in good faith. A similar "automatic" approach used by REITs in establishing reserves for losses has come to the Commission staff's attention. Some have used percentage of assets as a basis for computing reserves. Others have used another basis, the percentage of net income, an approach which makes no sense at all, since as net income goes up reserves go up, but as net income goes down, indicating that the REIT is in trouble, reserves also go down. Independent trustees should approach valuation of the portfolio and establishment of reserves for losses with the utmost seriousness and avoid the automatic use of formulas.

Concealment

The Commission has sued a REIT in connection with the REIT's efforts to conceal an adverse and deteriorating loan portfolio. First Mortgage Investors, the first REIT formed under the 1960 tax provisions, was charged with having arranged for the purchase by others at inflated prices of certain real properties and outstanding loans in FMI's portfolio which were on the brink of foreclosure. FMI booked profits on several such sales.[62] In connection with such transactions, the complaint charged that FMI provided 100% financing, indemnification agreements and commitments for future loans to the purchasers which were not disclosed. Also alleged was that FMI employed real estate appraisers who were instructed to issue appraisals for predetermined amounts. The complaint further alleged that FMI accrued as income interest on outstanding loans at a time when it knew or should have known that collectibility was in doubt.

It is with respect to such conduct that independent trustees may have the greatest exposure. I cannot urge too strongly that trustees should adopt a healthy skepticism in reviewing, for example, portfolio transactions at year end that generate profits, or transactions involving "dogs" in the portfolio that are somehow miraculously disposed of without loss. The Commission's staff intends to review additional situations involving concealment of the true shape of REITs' portfolios and it is reasonable to expect that additional enforcement action will be taken.

Exercise of Discretion Over Portfolio Transactions

Other provisions in the declaration of trust may expose independent trustees to substantial risk of liability if they do not perform their functions. The declaration grants the trustees substantial powers over the trust property and they have "full power to make any investments . . . that they in their discretion shall determine." That phrase implies that they *will* exercise discretion and make determinations.

In a Commission stop order proceeding involving an investment company,[63] the prospectus represented that "it shall be the definite policy of the board of directors in selecting securities for all industry classes of shares to limit selections to those industries that are obviously engaged in a character of business indicated by the class." The Commission found that this statement implied that the directors gave consideration to suitable investments by the various classes and that the statement was materially misleading since nearly all the discussions at board meetings was concerned with dividends, there were no discussions concerning selection of securities for purchase, the independent directors did not know who selected securities for purchase or sale for the fund, and the directors failed to discharge their duties and responsibilities as directors and failed to perform the functions which the prospectus impliedly represented they were performing.

Accordingly, if it is to be represented that the independent trustees will act, they must act.

CONCLUSION

The foregoing identification of problem areas is not intended to be exhaustive. Space, unfortunately, does not permit mention of other possible conflicts between provisions and policies under the Investment Company Act and the ways in which REITs are operated as indicated in the sample declaration of trust. A detailed comparison of those provisions under the Act and the declarations of trust governing REITs that deal with comparable subjects should be made with a view toward bringing the declarations into line with the Act.

REFERENCES

1. P.L. 86-799, Section 10(a), which added Sections 856-858 to Chapter 1, Subchapter M of the Internal Revenue Code of 1954; amended by the Tax Reform Act of 1976, which also added Sections 859 and 860 to Chapter 1, Subchapter M.
2. Sec. 3(c)(5)(C).
3. See, for example, *SEC v. Continental Advisers, et al.*, Civil No. 78-0066 (D.D.C.), Litigation Rel. No. 8256 (Jan. 16, 1978).
4. National Invested Savings Corp., 1 SEC 825 (1936).
5. *Hochfelder v. Ernst & Ernst*, 425 U.S. 185 (1976).
6. Before *Hochfelder*, negligence was clearly sufficient in most circuits which had considered the question. See, e.g., *SEC v. Management Dynamics Inc.*, 515 F.2d 801 (2d Cir. 1975); *SEC v. Dolnick*, 501 F.2d 1279 (7th Cir. 1974); *SEC v. Spectrum, Ltd.*, 489 F.2d 535 (2nd Cir. 1973); *SEC v. Pearson*, 426 F.2d 1339 (10th Cir. 1970); *Contra, SEC v. Coffey*, 493 F.2d 1304 (6th Cir. 1974).
7. *SEC v. Universal Major Industries*, 546 F.2d 1044 (2d Cir. 1976) (involving the registration provisions); *SEC v. World Radio Mission, Inc.* 544 F.2d 535 (1st Cir. 1976) (involving the antifraud provisions); *SEC v. Shiell, et al.*, CCH Fed. Sec. L. Rep. [Current] para. 96,190 (N.D. Fla. Sept. 27, 1977). See also *SEC v. Lummis, et al.*, No. C-75-0589 (N.D. Cal.), where, in partially granting the Commission's motion for summary judgment against one defendant, the court appeared to accept the rationale of *World Radio Mission* in some instances, i.e., where "the action to be enjoined is itself, without regard to the defendant's state of mind, a violation of the securities laws, e.g., material misstatements made in connection with stock sales." However, in other instances, including the one under consideration, the court held that "the legality of defendant's acts cannot be evaluated in isolation from his state of mind. The sale of stock was illegal only if done with the proscribed motive, i.e., to drive down the market price of the stock, thereby putting pressure on the Air West directors to accede to the Hughes offer." Memorandum Opinion and Order Re Summary Judgment, Nov. 23, 1977, p. 6, n. 3. The court found such intent on the basis of the undisputed facts.

8. *SEC v. American Realty Trust*, CCH Fed. Sec. L. Rep. [Current] para. 95,913 (E. D. Va. 1977), appeal docketed, Docket No. 77-1839 (4th Cir. Sept. 9, 1977); *SEC v. Bausch & Lomb, Inc.*, 420 F. Supp. 1226 (S.D.N.Y. 1976), *aff'd*, Docket No. 76-6189 (2d Cir. Sept. 30, 1977) (the Circuit Court did not reach the *scienter* issue); *SEC v. Cenco, Inc.*, CCH Fed. Sec. L. Rep. [Current] para. 96,133 (N.D. Ill., 1977).
9. *Compare, Wright, et al. v. Heizer, et al.*, No. 76-1140 et al. (7th Cir. June 30, 1977); *Sanders v. Nuveen & Co.*, 554 F.2d 790 (7th Cir. 1977); *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033 (7th Cir. 1977); *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, CCH Fed. Sec. L. Rep. [Current] ¶95,660 (2d Cir. 1976); *Bailey v. Meister Brau, Inc.*, 535 F.2d 982 (7th Cir. 1976); *SEC v. Cenco, Inc.*, CCH Fed. Sec. L. Rep. [Current] ¶96,133 (N.D. Ill. 1977); *McLean v. Alexander*, CCH Fed. Sec. L. Rep. [Current] ¶95,725 (D. Del. 1976); *Kaback v. Schweickart & Co.*, CCH Fed. Sec. L. Rep. [Current] ¶95,619 (S.D.N.Y. 1976); *Carroll v. Bear, Stearns & Co.*, CCH Fed. Sec. L. Rep. [Current] ¶95,642 (S.D.N.Y. 1976); *Siclari v. Rio de Oro Mining Co., Inc.*, CCH Fed. Sec. L. Rep. [Current] ¶95,672 (S.D.N.Y. 1976); *Rich v. Touche, Ross & Co.*, CCH Fed. Sec. L. Rep. [Current] ¶95,514 (S.D.N.Y. 1976); *Coleco Industries, Inc. v. Berman*, CCH Fed. Sec. L. Rep. [Current] ¶95,764 (E.D.Pa. 1976); *Franke v. Midwestern Oklahoma Development Authority*, 428 F. Supp. 719 (W.D. Okla. 1976).
10. See, e.g., *Camrose v. The Intervestor U.S. Real Estate Fund*, CCH Fed. Sec. L. Rep ¶95,469 (S.D.N.Y. 1976); *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967); *Moerman v. Zipco, Inc.*, 302 F. Supp. 439 (E.D.N.Y. 1969).
11. 495 F.2d 724 (9th Cir. 1975). *Hochfelder* may have overruled *White v. Abrams, sub silentio*, to the extent that the latter case would support liability for damages based on negligent conduct under Rule 10b-5.
12. G. Bradford Cook, "Directors' Responsibilities," CCH Fed. Sec. L. Rep. [1973 Transfer Binder] para. 79,302 at 82,916, April 6, 1973.
13. Ray Garrett, Jr., "A Commission Dilemma: Directors' Guidelines Revisited," San Francisco, Cal., May 7, 1974.
14. 479 F.2d 1277 (2nd Cir. 1973).
15. *Ibid.*; p. 1306.
16. Sonde and Freedman, "*Seagulls on the Water—Some Ships in a Storm": A Comment on Lanza v. Drexel, N.Y.U. Law Rev.* (May-June 1974), pp. 270 *et. seq.*
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22. *S.E.C. v. Hart, et al.*, Civil No. 78-0065 (D.D.C.), Litigation Rel. No. 8256 (Jan. 16, 1978) and Exchange Act Release No. 14380 (Jan. 16, 1978).
23. An outside trustee is by no means immune from suit by the Commission. On facts or rationales similar to *Stirling Homex* and *National Telephone*, non-management directors, as well as management, were charged with violating the antifraud provisions in *SEC v. Shiell, et al.*, (N.D. Fla.), Litigation Rel. No. 7763 (Jan. 31, 1977), a case involving The Commonwealth Corporation, a Florida mortgage banker.
24. Glazer, *A Study of Mutual Fund Complexes*, 119 *U. of Pa. L. Rev.* 205, 234 (1970).
25. Mundheim, *Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds*, 115 *U. of Pa. L. Rev.* 1058, 1059 (1967).
26. *Ibid.*
27. See Mundheim, *Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds*, 115 *U. of Pa. L. Rev.* 1058, 1063 (1967).
28. *Ibid.*
29. *Ibid.*, p. 1064.
30. Litigation Rel. No. 7072 (Sept. 8, 1975).
31. 294 F.2d 415 (2d Cir. 1961).
32. Mundheim, p. 1067.
33. *Ibid.*
34. *Ibid.*
35. Statement of Kenneth D. Campbell, Hearing Before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 94th Cong., May 27, 1976.
36. *Ibid.*
37. Neuberger and Hughes, *The REITs: Operating Losses and Conflicts of Interest*, Hearing Before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 94th Cong. May 27, 1976, pp. 19-20.
38. Statement of Kenneth D. Campbell, p. 26.

39. Sec. 2(a)(4).
40. Investment Company Act Rel. No. 6336 (Feb. 2, 1971).
41. Sec. 32(a).
42. 445 F. 2d 369 (1st Cir. 1971).
43. 445 F. 2d at 384
44. *Ibid*
45. 552 F. 2d 402 (2d Cir. 1976).
46. CCH Fed. Sec. L. Rep. [Current] ¶95,627 (S.D.N.Y. 1976).
47. CCH Fed. Sec. L. Rep. [Current] ¶95,627 at 90,133.
48. *Fogel v. Chestnutt*, CCH Fed. Sec. L. Rep. ¶95,393 (2nd Cir. 1975).
49. CCH Fed. Sec. L. Rep. [Current] ¶95,627 at 90,133.
50. *Ibid*.
51. *Ibid*. pp. 90,134.
52. *Rosenfeld v. Black*, 445 F.2d 1337, 1342 (2d Cir. 1971).
53. *Ibid*. p. 1343.
54. *Meinhard v. Salmon*, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928).
55. Sec. 2(a) (41).
56. Investment Company Act. Rel. No. 6295 (Dec. 23, 1970).
57. Continental Advisers was the investment adviser to Continental Mortgage Investors.
58. Litigation Rel. No. 8256 (Jan. 16, 1978).
59. Litigation Rel. No. 6551 (Oct. 17, 1974).
60. *Matter of Robert F. Lynch*, Exchange Act Rel. No. 11737 (Oct. 15, 1975).
61. *Matter of Winfield & Co., Inc.*, Exchange Act Rel. No. 9478 (Feb. 9, 1972).
62. Litigation Rel. No. 7072 (Sept. 8, 1975).
63. *Matter of Managed Funds, Inc.*, 39 SEC 313 (1959).

The Conundrum of *Condominium**,
or
A Critical Look at the Best-selling Real Estate Exposé

by Stephen E. Roulac

John D. MacDonald, originator of the Travis McGee mystery novels, describes in a hard-hitting style much of what is wrong with that portion of the economy known as the "real estate industry." MacDonald's narrative was selected by Book-of-the-Month Club, whose reviewer describes the book as referring:

> ". . . not only to a very mixed bunch of condominium dwellers but also to the hustling real estate developer who put up Golden Sands in the first place, to the contractor, to a brood of buyable politicians, to some fornicating wives, to more than one spiffy mistress, to a shifty banker and other far from life-enhancing types. Florida's fabled sun, it would appear, fosters corruption and sexual appetite as well as oranges. Furthermore, even as the hurricane gathers energy out at sea, MacDonald educates us on the sly, as it were, painlessly telling us more about shoddy construction and real estate shenanigans than I ever thought it possible to make absorbing."

How the real estate sector came to be in a position to deserve such treatment is the subject of this article.

The disaster theme is "big" in entertainment these days and MacDonald's book is a commentary on disaster at many levels. Disaster is perhaps the best description for the personal lives of the majority of the characters in the book. In social terms, disaster is not undescriptive of the sad plight of a distressingly large group of retirees. In fact, promotional literature for the book described the condominium dwellers collectively as "a landlocked ship of fools."

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*John D. MacDonald, *Condominium* (New York: J. B. Lippincott Company, 1977), 447 pages.

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Condominium focuses a sharp spotlight on the folly of searching for something in retirement that was not or could not be achieved in one's earlier working life. On the level of personal relationships, the households of many of the characters reflect the strained, silent truce of unarticulated and undeclared, but allconsuming, wars. The personal side of the book adds an important backdrop to the physical—the narrative builds to the multifaceted destruction wrought by a hurricane of unprecedented force—and economic disasters that befall the involved parties in this story.

MORAL OFFENSES

Although many in the real estate business assert their professionalism and proclaim their sensitivity to higher values, the behavior patterns related in *Condominium* are stark and dark commentary on how society perceives the real estate business and those involved in it. As sociological commentary, the book highlights the gross insensitivity of many in this field.

Among behavior patterns described, which range from peccadillos to extreme peccancies, are the following:

1) The fast talking broker who pressures the unsuspecting owner to sell because "there are problems on the horizon" and simultaneously steers the buyer towards her project because the preferred house purchase is in a neighborhood sinisterly described as "changing."
2) The sullen property manager who is non-responsive to tenants' complaints and needs, unless they be those of lonely and sexually frustrated women.
3) The property management company with a long-term management contract taking a "you can't do anything about it" attitude to owners' complaints.
4) The unconscionable sales contract with the fine-print clause wherein buyers "sign off" that everything is satisfactory, and having the effect of exempting the builder from any obligation to make good and do the standard completion work that accompanies any move-in "punch list," in the worst tradition of a perverse adhesion contract.
5) The Homeowner's Association fee turning out to be more than double the projections because the actual project included many fewer units than were in the original plan, from which the original fee was derived, with the explanation that "the accountant forgot to make the adjustment for the smaller number of units."
6) Payoffs for public agency approvals, both in cash and sexual services, and the accompanying deceit to obtain the official approvals. Specifically, major clearing and grubbing and land preparation work is misconstrued as "minor dredge and fill" and buried in the middle of a full agenda of otherwise innocuous and nonsignificant items. And then, adding insult to injury, the developers schedule the major land clearing for "Saturday because the government is all closed down for the weekend."
7) The pathetic situation of the retirement family on a fixed income who, after having fine-tuned their budget, and allowing less margin than they probably should, are faced by the financial impossibility of responding to monthly maintenance charges that have escalated from the $81.50 promised to the $168.50 required to meet current costs, not to mention additional assessments for accumulated deficits.

8) The frustrations, aggravations, and lack of appreciation that accompany the role of serving on the board of a condominium association.

Condominium is in the tradition of *Airport* and *Hotel* and other similar books that describe the "inside story" of a significant industry. The author, who is a graduate of Harvard Business School, observes that the prime lesson he learned was the importance of behavioral influences on decision-making. His personality study of the developer is particularly well done and will cause many to speculate as to the author's role models.

"CREATIVE FINANCING"

Although the treatment of subtleties and nuances of character development fall well short of Louis Auchincloss' novels, the quality and depth of John MacDonald's research is impressive. His treatment of the gimmicked financing and structuring used for the proposed Harbor Pointe project will convey to many in the industry a sense of *deja vu*. The scenario commences when Martin Liss is informed by his banker that his $11,000,000 credit line is no longer available to him. The banker justifies the withdrawal of this commitment as being necessary in the face of problems with other loans and suggests that an "introduction" be made to a real estate investment trust that might solve the problem. To set the stage, it is appropriate to relate MacDonald's description of the chief executive of the Equity Mortgage Management Shares:

> "Sherman Grome was tall. He was very tan. He had a hard protruding shelf of brow above deep-set eyes. His hairdo was spray-shaped to cover his ears and most of his forehead. His nose was imperial. He wore a brush denim leisure suit and a blue work shirt open at the throat. His manner was one of total indolent assurance and half-concealed amusement. He wore oval sunglasses with blue lenses. To get to the Athens Airport lounge they had to pass the car rental desk. The rental girls glanced at him, came to attention and stared. Sherm had the celebrity look."

As would be expected, Sherman Grome arrived in a Lear jet.

Although Martin Liss had requested $11,000,000 in financing for his project, Grome proposed to make a $12,000,000 loan out of which $1,200,000 would immediately be paid as prepaid interest with no principal due until the end of the second year. There was a string attached, however. A condition of the loan called for the borrower to take over a troubled project in default on its mortgage. Grome proposed to advance $500,000 at a favorable 8% interest with the funds to be used to bring $100,000 of defaulted mortgage interest current, buy out the developer for $100,000, and the balance for working capital.

But Martin Liss balked at these terms. He asserted that the proposed deal narrowed his margin and increased his risk; consequently, "sweetening" was needed. Grome's response to Liss's need for sweetening is to suggest that the land, which the developer had planned to contribute to the deal at a $200,000 profit, be priced so as to provide a $1,000,000 profit, the extra funds to come from a corresponding increase in the loan to $13,000,000.

Of course, there is a missing link: in response to Liss's query as to whether he can take down the funds as needed, Grome stipulates that they be held in certificates of deposit at the bank which had initiated the deal by withdrawing the developer's credit line. The developer and his executives, on reflection, conclude that the deal is so flaky that Grome must be under extreme pressure to put money out and likely is making similar uneconomic deals elsewhere, leading them to question the probability of the sustained viability of Grome's operation. So, to complete the financial daisy chain, they sell the REIT's shares short.

Significantly, while the developer possesses the ability to see weaknesses in other projects, albeit a transaction in which he was involved, and to act upon that information to his advantage, he is myopic about the financial feasibiity of his own project. Consistent with the internal self-deception of the ever-optimistic developer, the Harbor Pointe deal is premised upon hoped-for strength in a market in which few if any sales are presently being consummated, let alone sales of luxury units at the top end of the price scale. Yet, not surprisingly, the developer himself is aware of his own duplicity and inconsistency when his contractor notifies him that he had "cut back on the specs everywhere I could. It isn't first class anymore, Marty."

CHANGING INDUSTRY STRUCTURE

As with all economic phenomena, real estate financing activity moves in cycles. The depression of the 1930s marked the end of easy money, available during the 1920s in the form of mortgage bonds, and from that period until the early 1950s the control of property resided in the hands of major financial institutions. Over the last quarter century there has been a gradual erosion of the quality of those controlling property, as such control has moved from strong institutions guided by fiduciary motives to "weaker hands," in both the financial and integrity sense. While *Condominium* is set at perhaps the bottom point of the "control transition" cycle, it is instructive for what is said about where the business has been, changes that must be made, and prospects for the future.

To a very large degree the approach of a distressingly significant portion of persons in the real estate business has been characterized by a gross lack of sensitivity. For too many years land was treated as a raw material, which had no costs and could be wantonly debauched, rather than the precious and unique "endangered species" that it is. Many projects reflect no sense of user needs and certainly no design conscience. All too often building quality reflects a lack of pride in craftsmanship and technical workmanship. The financial, legal, and economic relationships that characterize many ventures reflect no appreciation for fiduciary responsibility.

The real estate business generally, and particularly those portions of it involving the conversion of a land use in the creation of new physical structures, is a very serious and sober undertaking. The importance of personal space in all facets of one's life cannot be underestimated. Physical environments have profound behavioral influences. Buildings themselves are symbolic, and actual, monuments. To a very large degree, how man relates to his built environment is a statement about his respect for himself and his respect for his society. Though building merits the best of society's talents and potential, it seems to bring out the worst.

Just as many of society's institutions are experiencing rapid change, so also has dramatic change occurred in the real estate sector. No longer are the critical issues of study tied to "title, title, who has the title?" or other dusty, dull feudal concepts of olde English common law. To a very large degree, the accelerating pace of change in society is consolidated in urban property.

A DISTURBING MICROCOSM

Real estate is today a primary focal point of social pressure and can provide an outstanding context for viewing the change forces occurring in society generally. Yet few arenas of economic activity are as ill-equipped to be the locus of such considerations. Most simply stated, many in the industry seem neither prepared for nor inclined to behave responsibly.

Viewed strictly from the perspective of the party in question, discounting of course a questionable moral context, behavior patterns of various individual actors in the real estate drama appear to be rational. The problem is that the interaction of the many actors produces a unique and disturbing negative synergy. It is potential unrealized, talents squandered, expectations disappointed.

MacDonald accurately pinpoints the importance of the behavioral approach to decision making. As he observed in a "W" interview: "whatever course of action you take, the decision is going to be affected by our inner feelings, emotions, prejudices and self-deceit." This is the real estate industry, and then some.

The business suffers from an image that is unfavorable in the extreme. The confused self-deception of the real estate broker seeking to "do right," tempted by the "quick buck" and totally lacking the requisite training for the significance of his calling, was skillfully portrayed by Sinclair Lewis in *Babbitt*. The pompous, inflated self-perception of many in the business was artfully reflected by Kurt Vonnegut's Doctor Pond in *Player Piano*. Notably, the real estate industry is unique in having been the subject of a feature analysis ("Is Babbitt Dead?") on its self-image in the *Harvard Business Review*. All too many are attracted by the high leverage opportunity to engage in larceny on a grand scale. Although for many years there has been a clear indication that many prevalent behavior patterns have no legal underpinnings, too many think that association with real estate is a license to engage in dubious business practices.

CAREER CHOICE BY DEFAULT

While the conditions in the business as portrayed by John MacDonald in *Condominium* are attributable to many forces, there is no question that a major problem is the extraordinary chasm between the professional theme that so many preach but do not practice. Too many participants have an insufficient educational background and, indeed, real estate is not exactly a primary career choice. The incidence of college graduates selecting real estate as a primary career choice is only a relatively recent phenomenon and as one participant observed, "real estate is the kind of career you fail into." After many become disenchanted or do not achieve what they aspire to in other business areas, they go into real estate.

Given the poor state of preparation for real estate, it is not surprising that the problems are as severe as they are. Indeed, most participants are distressingly naive as to the role economic analysis can play in decision making. Analysis that is done is too often characterized by questionable assumptions, incorrect data, conceptually illegitimate models, dubious motives, perverse ethics, fraudulent representations.

CHALLENGE TO THE INDUSTRY

The real estate sector faces a major challenge. To date, the trade association's role can hardly be characterized as in the vanguard of change. Dominated by change opponents, they more often exacerbate than alleviate the problems. Of course, whether or not those in the real estate sector choose to change on their own is essentially immaterial—for society is changing the groundrules under which the game is played. Those who don't learn the new rules will be left sitting on the bench of if they persist in their outmoded ways, evicted from the games. For some in the business, it is a shocking readjustment. As an offset, recent economic events and legal development have thinned the ranks to the point where the quality level of those new in the business has been materially upgraded.

It is notable that *Condominium* has generated relatively little comment in real estate circles. Few have heard of the book, let alone read it. Of those who have read *Condominium,* only a handful see any relationship of its message to forces of change that are transforming the business. This lack of appreciation of the message, and worse, ignorance of the book's existence are a sad reflection of the attitudes of many in the business.

While *Condominium* is not "great literature," it does represent provocative social comment on a major sector of the economy. It will influence public attitudes and suggest directions of future regulation and litigation. The book's reception in the real estate community is consistent with its portrayal of that community. Effective participation in the real estate business requires sensitivity to significant public policy issues and major changes in the social and cultural environment.

When Should Real Estate Be Sold?

by Jack P. Friedman

Determining the best holding period for income-producing real estate is a major concern of realty owners, property managers, investment counselors, and mortgage lenders. Owners want high yields, yet many of them dispose of real estate so quickly that, after they settle with their broker and Uncle Sam, their yields are negative. Property managers and investment counselors, in advising on matters pertaining to the resale of real estate, sometimes find themselves relying on rules of thumb. Mortgage lenders are also concerned with the resale of real estate, chiefly because they need to be able to estimate when loans will be repaid, and frequently a sale dictates property refinancing.

Numerous events can affect financial results from real estate ownership by causing property appreciation, an economic decline in value, or changes in operating income. The proportions of certain variables can be expected to affect after-tax equity yield rates. Such variables include the improvement ratio and the ever-changing loan-to-value ratio. And, since each parcel of realty is unique and so is its owner, generalizations about income-producing realty can be quite misleading.

Still, recognized authorities have written that it is best to sell income-producing real estate after ten years of ownership, partially because of income tax considerations.[1] Since the analysis used by many of them is based on before-tax equity yield rates, their conclusions are unsupported by their methodology.

The main purpose of this paper is to describe some of the findings of a study of certain variables that affect after-tax yields and holding periods for income-producing real estate. In addition, applicable current tax law and some of its evolution are described.

TAX LAW CHANGES

In July 1969, permissible depreciation methods for all income-producing real estate except new residential property were changed to the methods shown

1. James E. Gibbons, "Ellwood Capitalization Concept in Appraisal of Investment Property," *Appraisal Journal*, vol. 32 (July 1964), pp. 358-62; Robert C. Cox, "Mortgage Equity Capitalization: A Leader's Look," *The Real Estate Appraiser*, vol. 39 (March-April 1973), pp. 41-48.

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in *Table 1.* Section 1250 of the *Internal Revenue Code* (a section presumably intended to affect the holding of real estate) was also modified.

The purpose of Section 1250 is to prevent realty owners from enjoying capital gains rates of taxation on the profit from a quick turnover of realty that has been depreciated using a rapid method. This section was introduced in 1963 to prevent the conversion of ordinary deductions (depreciation) into capital gains. The section prescribes what is commonly called "depreciation recapture." It requires the recapture, as ordinary income, of excess accelerated depreciation. Excess accelerated depreciation is the difference between the depreciation claimed by using an accelerated method and the amount that straight-line depreciation would have been on the same asset, with the same salvage value and useful life (see *Figure 1*). Before Section 1250 was added, all depreciation claimed on real estate held over six months was taxed at capital gains rates. When Section 1250 was introduced, capital gains rates could still be achieved in time: ten years became the minimum holding period required to avoid all recapture.

In 1969, Section 1250 was modified to extend the holding period necessary to avoid recapture of post-1969 accelerated depreciation. The 1976 Tax Reform Act tightened Section 1250 even more. *Table 2* summarizes depreciation recapture periods.

From 1963 through 1969, holding depreciable real estate for ten years was significant in that it assured all capital gains tax rates upon a sale. Presently, the figure of ten years is not nearly so significant. It is now a factor only for property that is still under the same ownership as before 1970 and on which accelerated depreciation was claimed before 1970. The law that applied to 1963-69 depreciation now has a diminishing overall impact; so ten years has lost much of its significance as a suggested holding period, at least from an income tax standpoint.

VARIABLES LIKELY TO AFFECT FINANCIAL RESULTS

Some important variables that are likely to affect the financial results from income-producing real estate include the following:

1) The overall rate of return at the time of purchase and resale. This is the ratio of net operating income to the sales price.
2) The loan-to-value ratio. This ratio will change over time.
3) The interest rate of the mortgage(s).
4) The amortization term of the mortgage(s).
5) The owner's marginalncome tax bracket.
6) The minimum tax on preference income.
7) The improvement ratio and costs of various assets.
8) The depreciation method used.
9) The depreciable life (or lives) claimed for income tax purposes.
10) Forecast changes in net operating income.
11) Forecast changes in property value.

When the values of these variables are known, it is possible to forecast the amounts of before-and after-tax cash flow which the property can be expected to generate and the proceeds from a resale. These 11 variables, since they may vary independently of one another for any given project, could result in an astronomical number of possible combinations. In view of all the possible variations, it is obviously dangerous to apply a general rule in suggesting a holding period for all income-producing real estate.

SCOPE OF THE STUDY

The study focused on holding periods of from one to 30 years for hypothetical improved income-producing real estate. A single self-amortizing conventional level-monthly-payment mortgage loan encumbered the hypothetical properties. Physically, the hypothetical properties were composed of one depreciable asset (improvement) and one non-depreciable asset (land).

The number of possible combinations was reduced to 27 likely possibilities for each of three "types" of income-producing property (see *Table 3*) under three different depreciable lives and three alternative mortgage loan amortization periods. Other variables were changing or constant as indicated in *Tables 4* and *5*.

The variables used were judiciously selected for various reasons, including tax law, lending institution policy, market data, and purposes of sensitivity analysis. Each of five variables was allowed to take on three values for the three types of property *(Table 3)*, which resulted in 729 possible outcomes ($3^5 \cdot 3$). Each outcome was simulated for 30 years by using a computer.

FINDINGS OF THE STUDY

The performance of the property, in terms of changes in net operating income or value, had a profound effect on the internal rate of return and the year that this measure peaked.

Income and Value Increasing

When net operating income and the fair market value of the property were both increasing, a short optimal holding period resulted, and after-tax internal rates of return were high. Under such conditions, the average suggested holding period was 8.3 years, with the range from 6 to 14 years for the 81 trials under these simulated conditions.

The early year of sale was suggested by the decreasing financial leverage. With property appreciation, the loan-to-value ratio was declining rapidly. In order to maintain the high leverage ratio required to sustain such high yields, the property must be sold in favor of more levered property or refinanced.

Income and Value Decreasing

When net operating income and the fair market value of the property were both decreasing, an average suggested holding period of over 28 years was recorded. In most cases, the related after-tax rates of return had been slowly rising from the start and had not reached their crest by the thirtieth year, when rates below 7% were being attained. This indicated that the property owner should have acquired other investments (such as municipal bonds or other investments in the same risk category that offer competitive after-tax rates). However, once the hypothetical subject property was acquired, capital losses and operating income declines were sustained immediately. When combined with the potential selling costs (stipulated to be 3% of the gross sales price), the early losses depleted purchase capital to the extent that there was no reason to sell. Investment inflows from the property, no matter how small, were handsome compared to the remaining amount of equity. In such cases, a long holding period is suggested.

Shortest and Longest Holding Periods

The shortest average suggested holding period was recorded in the category where operating income was increasing and property value declining. Such a situation may occur, for example, when the only hotel in a town reaches old age. The value declines for various reasons, including anticipated modern competition, but, because of the present local monopoly, operating income remains high. Such a building should be sold before the declining value severely depletes the equity.

When value was increasing but operating income declining, the longest suggested holding period was recorded. An example would be an older office building or theater in a key location on land that is steadily appreciating in value. The owner could hold out for further property value increases for an indefinite time but, whenever an offer is tendered, he should review alternative investment opportunities and consider a sale.

OTHER VARIABLES

The depreciation method, depreciable life, and mortgage amortization term each had a surprisingly slight effect on the suggested holding period.

Depreciation Method

The use of the sum of the years' digits method of depreciation (with 1969-75 recapture rules applied for conventionally financed residential property) extended the suggested holding periods slightly, as compared to other methods of depreciation. Despite the full depreciation recapture provision that was applied when the 150% declining balance depreciation method was used, the suggested holding periods under that method of depreciation were slightly shorter than when either of the other depreciation methods was used.

Ranges of suggested holding periods under the three methods of depreciation were very narrow and indicated that the method of depreciation has only a minor effect on the suggested holding period for income-producing real estate. This also implies that a property owner need not be particularly concerned with Section 1250 in determining whether to hold or sell income-producing property. It also implies that the best year of sale should be sought on an individual case basis, considering known amounts and rates, expected or forecast occurrences, and the individual situation of the owner.

Depreciable Life

The use of a 25 year depreciable life (rather than one of 35 or 45 years) tends to decrease the suggested holding period, but only slightly. Within any of the three depreciation methods considered, a 20 year change in the depreciable life (25 years versus 45 years) did not affect the average suggested holding period by more than one year. The widest range (based on averages of results from nine combinations of net operating income and value change) was 5.6 years. The range of years in that case was from a low of 14.8 years to a high of 20.4 years.

Mortgage Amortization Term

The findings of this study indicate that, as the mortgage amortization term increases, so does the suggested holding period. This is because the longer mortgages provide a greater degree of leverage over an extended time period, allow more tax deductions per dollar of debt service paid, and provide more cash flow, though at the sacrifice of proceeds from a sale. Typically, however, a five-year increase in the mortgage term led to only a one-year increase in the suggested holding period, which might be considered a minor effect.

Effect of Income Tax Brackets

Those in the highest tax bracket considered (50%)[2] have shorter suggested holding periods, especially when both mortgage terms and depreciable lives used are short. This shows that a high-tax-bracket income-property owner who uses a short depreciable life and mortgage term reaps after-tax benefits early and should consider a relatively early disposition; otherwise the tax-shelter situation will be reversed. Should either the mortgage term or the depreciable life be extended, benefits will accrue over an extended period. In that case, the high-tax-bracket owner should retain the property to claim more depreciation and interest deductions while postponing capital gains taxes. Longer depreciable lives tended to increase the suggested holding period for tax-paying property owners. Results for those in lower tax brackets were shown to be less sensitive to changes in variables which affect taxable income. The minimum tax was not considered because the amount of tax due (if any) depends upon the personal situation of the individual investor.

The Interaction of Mortgage Principal Payments with Depreciation Charges

Depreciation charges and mortgage principal payments have opposite effects on cash flow and project taxable income. Depreciation charges are permitted as income tax deductions, whereas loan repayment is not a tax-deductible item. Cash payments are needed to reduce the principal balance of a loan. In contrast, depreciation claimed for income tax purposes requires only a bookkeeping entry that involves no transfer of funds. Therefore, tax-paying property owners who are interested in retaining cash would prefer to claim tax-deductible depreciation expense rather than pay non-deductible cash to reduce a mortgage loan.

As stated above, mortgage principal payments and depreciation charges have

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2. Tax brackets above 50% were not considered. The minimum tax on preference income was not considered because the amount of tax due (if any) depends upon the particular situation of the individual taxpayer.

opposite effects on cash flow and the taxable income that is generated by the property. As long as the depreciation claimed for the year is greater than the mortgage principal payment for that year, before-tax cash flow will exceed the amount of property-generated cash flow that is subject to income taxes. In those years when the reverse holds true (that is, when mortgage principal payments exceed depreciation charges), the taxable income generated by the property will exceed before-tax cash flow. This will occur with time, as depreciation declines under accelerated methods and the mortgage principal increases. When accelerated depreciation is claimed and the property owner is in a high tax bracket, income taxes attributable to ownership of the property may exceed the cash flow generated by the property. In other words, after-tax cash flow may become negative.

TWO TURNING POINTS

The effects of depreciation charges and mortgage principal payments combine to create two turning points in the ownership of income-producing property. One of these is the point at which principal payments for a given year exceed depreciation for the year. The other is reached when after-tax cash flow becomes negative. These two points and their implications are discussed below.

First Turning Point

Test results showed that property should normally be held at least until the time when principal payments exceed depreciation charges. Before that time, the amount of taxable income will be less than the amount of cash flow, and at least some of the annual cash flow will be tax-free.

Second Turning Point

Test results also showed that income-producing property should be sold before the time when after-tax cash flow becomes negative. Although this point did not occur in all of the trials, when it does occur the owner must pay cash to retain the property. If the property is held beyond this point, greater after-tax proceeds of sale can be realized but the trade-off (cash outflows first, additional proceeds later) is not normally worthwhile because of the time value of money.[3]

A GOOD POLICY

An important financial reason for the sale of income-producing property (other than in distress situations or to settle estates, etc.) involves the principal of substitution. It is a good policy to be continually evaluating alternative investments, particularly those considered to be in the same category of risk as the subject investment. The "pull factor"[4] shows the after-tax rate of return needed by competing alternative investments to match forecast financial results for the next year of the subject property. It is computed

3. This depends upon the personal situation of the property owner. Some owners may prefer to postpone a sale until retirement or other circumstances may cause the gain on a sale to be taxed at a low rate.

4. See "The IRR Plus the Pull Factor," *The Real Estate Appraiser* (March-April 1976).

for any given year by dividing the sum of forecast after-tax cash flow and the forecast change in after-tax reversion for any year by the ending equity of the preceding year.

Any subject property considered may have "peaked out" or just begun to gain momentum in terms of the financial benefits provided. Still, the decision to hold or sell should rest on the anticipated future project income compared to alternative investment opportunities. Past performance does not give this information: it is the expected future income that is important.

CONCLUSION

Rapid depreciation methods, longer asset depreciable lives and longer mortgage amortization periods tend to lengthen suggested holding periods for income-producing real estate. Property performance in terms of value and operating income changes have a significant effect on holding periods. Under conditions of property appreciation and operating income increase, shorter holding periods were shown to be preferable since the use of favorable financial leverage diminished rapidly. Longer holding periods were suggested under other conditions, especially when large unrealized capital losses were incurred shortly after property acquisition. Favorable mortgage refinancing tends to extend the suggested holding period.

There are many variables which have an effect on income-property holding periods. Some variables arise from within the property, others are external. Some are uncontrollable whereas at least some control may be exercised over variables. Since determining the best year of sale is a complex matter, that determination is better performed on a case-by-case basis, considering all relevant factors including the personal situation of the individual property owner.

FIGURE 1
EXCESS ACCELERATED DEPRECIATION

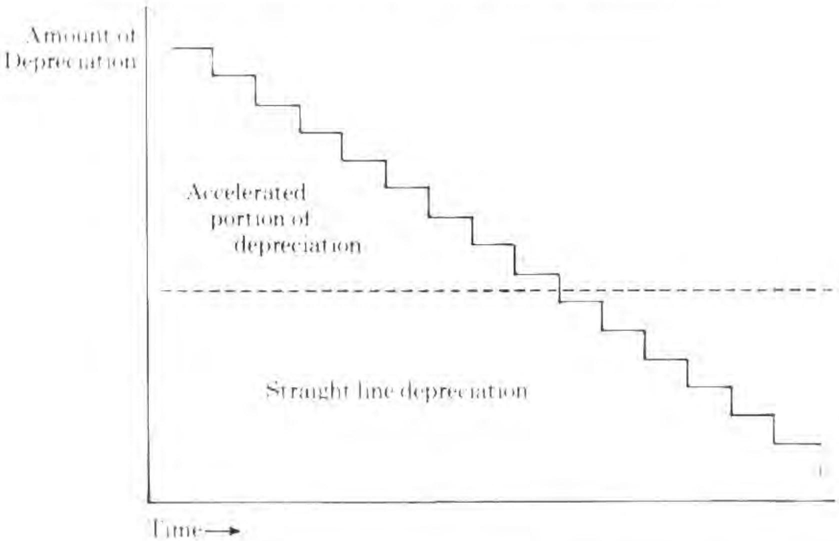


TABLE 1

DEPRECIATION METHODS ALLOWED FOR REAL ESTATE ACQUIRED AFTER JULY 1969

Type of Property	New (The original use begins with the taxpayer.)	Used (Acquired with a tenant physically occupying.)
Apartments (at least 80% of income is derived from dwelling units)	Sum of the years' digits Double declining balance 150% declining balance Straight line	125% declining balance (if remaining life is at least 20 years) Straight line
Other (office buildings, shopping centers)	150% declining balance Straight line	Straight line

TABLE 2

HOLDING PERIODS NECESSARY TO AVOID DEPRECIATION RECAPTURE

		When Depreciation Claimed	
	1964-69	1970-75	After 1975
Commercial property	120 months	Always ordinary income	
Residential property	120 months	200 months	Always ordinary income
Low-income residential	120 months	120 months	200 months
Five-year rehabilitation	N/A	200 months	200 months

Notes: 1) All depreciation (both excess accelerated and straight line) is recaptured as ordinary income for property sold within 12 months of acquisition. 2) For each month short of the required number of months, 1% of the excess accelerated depreciation would be recaptured as ordinary income to the extent of the gain recognized upon a sale.

TABLE 3

TYPES OF INCOME-PRODUCING PROPERTY CONSIDERED

Type of Property	Method of Depreciation Accounting
New residential	Sum of the years' digits
New non-residential	150% declining balance
Used property	Straight-line

TABLE 4

VARIABLES THAT CHANGED WITHIN THE STUDY

Depreciable lives considered for tax purposes	25, 35, and 45 years
Mortgage loan full amortization periods considered	20, 25, and 30 years
Income tax brackets (Capital gains rates at one-half of each of these)	0%, 25%, 50%
Net operating income; compound annual change	−2%, 0%, 2%
Total property value; compound annual change	−2%, 0%, 2%

TABLE 5

VARIABLES HELD CONSTANT THROUGHOUT THE STUDY

Loan to value ratio	75%
Mortgage interest rate	9%
Overall rate of return on total property	10%
Ratio of improvements to total property	80%

Survey of U.S., Europe Reveals Strong Office Market: Rates on Increase Almost Everywhere

by Ronald R. Pollina

The excess of office space which, in recent years, has characterized the office markets in almost every major city across the nation is rapidly being absorbed. As occupancy rates have risen in the nation's principal business centers, so also have rental rates. Important to the reversal of the previous trend has been the improved economy and the lack of office building construction. With the tightening market, developers across the country are gearing up for a new wave of construction.

As our national economy has indicators which help economists in evaluating economic trends, so does the office market. One of the best of these indicators is rental rates and the best sign of an improving office market is rapidly rising rental rates. *Figure 1* represents rental rate changes over the last year for Class A office space in ten of the United States' major office markets. This figure also provides comparative data for five major European markets.

The rental ranges depicted in *Figure 1* are based on a survey of the European market conducted by the International Division of Romanek-Golub and Company. The data gathered illustrate the relative differences between the cities listed and provide an indication of rate changes over a one-year period. In the U.S. and abroad, local practices vary as to the criteria on which rental rates are based. In Europe, for example, common area costs are not included in quoted rental rates. Appropriate adjustments were made to the data in *Figure 1* to make the European rates more comparable to those in the U.S., where common area costs are generally reflected in quoted rental rates.

Ronald R. Pollina, Ph.d., is a real estate economist and director of corporate location and market research for Romanek-Golub and Company, Chicago. The firm's chief spokesman in the area of real estate market research, trends, and projections, he served in a similar capacity as area research officer for the Continental Illinois Bank before joining Romanek-Golub. He received his doctoral degree in economic geography from the University of Illinois and is on the faculty of De Paul University's geography department.

FIGURE 1

QUOTED RENTAL RATE RANGES FOR CLASS A OFFICE SPACE IN SELECTED CITIES IN THE UNITED STATES AND EUROPE

City	Range 1976*	1977*	Change 1976-1977
Atlanta, GA	\$ 6.50-\$ 9.00	\$ 7.00-\$ 9.00	\$ .50-\$ 0
Boston, MA	\$10.00-\$13.00	\$10.00-\$13.00	\$ 0-\$ 0
Chicago, IL	\$ 8.00-\$13.00	\$ 8.50-\$16.00	\$ .50-\$3.00
Dallas, TX	\$ 7.00-\$10.50	\$ 7.50-\$11.00	\$ .50-\$ .50
Denver, CO	\$ 8.50-\$10.00	\$ 9.50-\$12.50	\$1.00-\$2.50
Houston, TX	\$ 7.25-\$10.75	\$ 9.00-\$13.85	\$1.75-\$3.10
Minneapolis, MN	\$ 7.00-\$11.00	\$ 8.00-\$14.00	\$1.00-\$3.00
New York, NY	\$ 8.00-\$15.00	\$ 9.00-\$20.00	\$1.00-\$5.00
San Francisco, CA	\$ 9.00-\$15.00	\$10.20-\$16.00	\$1.20-\$1.00
Washington, DC	\$ 9.50-\$12.00	\$10.50-\$13.00	\$1.00-\$1.00
Amsterdam	\$ 9.50-\$11.25	\$10.50-\$11.75	\$1.00-\$ .50
Brussels	\$10.00-\$12.25	\$12.00-\$13.50	\$2.00-\$1.25
Frankfurt	\$12.00-\$16.00	\$12.00-\$16.00	\$ 0-\$ 0
London	\$21.00-\$25.50	\$29.00-\$33.75	\$8.00-\$8.25
Paris	\$20.50-\$25.50	\$20.50-\$24.00	\$ 0-\$ 0

*Fourth Quarter

Based on a survey conducted by Romanek-Golub and Company, fourth quarter, 1977

LONDON, PARIS SUBSTANTIALLY HIGHER THAN U.S.

In comparing the U.S. markets listed to those abroad, it can be seen that rental rates for Class A office space in London and Paris are substantially higher than those of U.S. cities. London, which has the highest rental rates (\$29.00-\$33.75) of the surveyed European cities experienced a substantial increase in its rental rates between year-end 1976 and 1977. Rental rates for Paris, while high (\$20.50-\$25.50), remained stable during 1977. With the exception of London, the other European cities listed have had little or no increases. The overall range for rental rates in the U.S. is \$7.00 (Atlanta) to \$20.00 (New York) while the rental rates for the European cities listed range from \$10.50 (Amsterdam) to \$33.75 (London). While London's and Paris' rental rates are much higher than those of most U.S. cities, Brussels, Amsterdam, and Frankfurt are more closely aligned to the U.S. rates.

While most major American cities are showing signs of improvement, some cities are progressing much more rapidly than others. New York, which had one of the most depressed office markets in the nation at the height of the office market slump (1975), is currently experiencing a strong recovery in mid-town Manhattan. An improved leasing pace has resulted in the removal of most large blocks of contiguous space in prime mid-town buildings. Rental rates for Class A buildings have firmed up in the \$9.00-\$20.00 per square foot range in the better locations and many local experts foresee an increase of 25% or more in the next one to two years.

Unlike New York's market, Atlanta's market is rebounding more slowly. Recent signs indicate that the rate of recovery is increasing; however, Atlanta's office absorption rate is still lagging far behind what it was during the pre-recessionary boom years. Rental rates for Class A buildings remain low, in the \$7.00-\$9.00 range, and concessions such as free rent and above-standard tenant improvements are still frequently offered.

DENVER MARKET CURRENTLY STRONG

Denver, on the other hand, a city which did not experience the massive building programs characteristic of most other major cities, maintained a relatively healthy market through the recession and currently has a very strong market. Because of the overall smaller market in Denver, the little overbuilding that did occur during the pre-recessionary period was readily absorbed by the recent rapid growth in demand. Helpful in holding the vacancy rate down has been the steady influx of engineers, scientists, and other specialists who are making Denver their home base in their efforts to unlock the energy stockpiles of the Rocky Mountains. Rental rates for Class A Denver office buildings increased from a year-end range of \$8.50-\$10.00 in 1976 to \$9.50-\$12.50 at year-end 1977, according to James F. Hurlbert, Jr., senior vice president of Romanek-Golub and Company. Unlike other major cities which are on the verge of renewed building activity, Denver is currently experiencing a boom in construction of new office buildings.

CHICAGO'S RECOVERY RANKS AMONG STRONGEST

While Chicago's office market was not as healthy as Denver's during the recession, Chicago's occupancy rate remained above average when compared to other major office markets across the nation. The recovery of Chicago's downtown office market certainly ranks among the strongest in the nation. The city's economic vitality as a business and financial center is in a large part responsible for its rapid recovery. In addition, the lack of new building openings and improved economic conditions have resulted in a downtown occupancy rate which began to inch upward during 1976 and continued upward at an increasing rate through 1977. The remainder of this report will examine the cycle of rental rate changes in Chicago. In many respects, the trends in Chicago's rental rates reflect those of most major urban office markets in the United States.

Figures 2 and *3* illustrate the trends for the most frequently quoted rental rates (mode) for Classes A, B, C, and D office buildings in Chicago's Central Business District (CBD). The data from which this chart was developed are taken from Romanek-Golub and Company's computerized office leasing survey. Every building in Chicago's CBD is surveyed three times per year by Romanek-Golub to determine the existence of available space and current rental rates. These data are used to assist corporate clients with their relocation plans. The classification of buildings into four groups is based on the concensus of opinions of leading office leasing experts. The classification was subjective, in that the experts were asked to group the buildings according to the way in which most office space users perceive them. Variables entering into and affecting the perception of a building commonly include such factors as location, interior and exterior condition, building prestige and name recognition, and rental rates.

FIGURE 2

RANGE AND MOST FREQUENTLY QUOTED RENTAL RATES FOR CLASSES A-D CHICAGO OFFICE BUILDINGS

	1976*		1977*	
	Range	Most Frequently Quoted Rental Rate	Range	Most Frequently Quoted Rental Rate
Class A	$13.00-$8.00	$10.00	$16.00-$8.50	$12.00
Class B	$10.00-$6.50	$ 8.50	$10.50-$7.75	$ 9.50
Class C	$ 9.00-$5.00	$ 6.00	$ 9.75-$2.50	$ 6.50
Class D	$ 6.50-$1.50	$ 5.00	$ 6.50-$1.50	$ 5.00

Change in Most Frequently Quoted Rental Rate, 1976-1977:
Class A-+$2.00; Class B-+$1.00; Class C-+$.50; Class D-$0
*Fourth Quarter

AGE NOT ONLY CRITERION FOR CLASSIFICATION

Classification of buildings has been done in the past, however, most of these classification schemes have depended quite heavily on age as the principal or only criterion. While there is certainly a high correlation between newer buildings and the buildings classified here as A and B there are many exceptions. For example, there are a number of buildings in Chicago's financial district that are quite old but are highly competitive with many newer buildings located throughout the CBD. These buildings are not only competing for the same types of tenants but they are also, in some cases, charging similar rental rates. A building's relative newness (post-1970) did not guarantee its classification as a Class A building, although all newer buildings did receive at least a Class B designation.

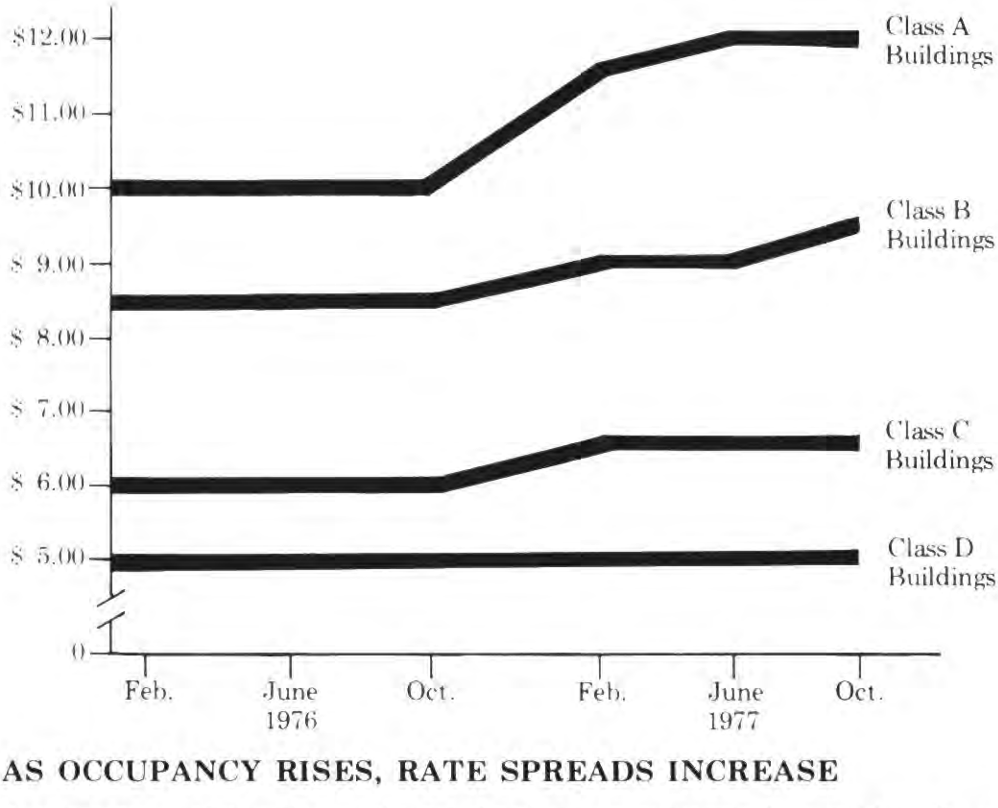
NINETEEN CBD BUILDINGS RATE CLASS A

Of the 179 CBD office buildings for which data were available, 19 were classified as A, 33 were classified as B, 78 as C, and 49 as D. Of all the Class A and B buildings, 14 were constructed prior to 1950. The oldest Class A building was constructed in 1933 and two Class B buildings were opened prior to 1900.

Rental rate changes for each class of buildings has an effect on the rental rates of the other classes. When occupancy rates are low, the differences between rental rates for each class of building tend to be closer. For example, as *Figure* 2 illustrates, there was a difference of $1.50 per square foot between Classes A and B office buildings in October, 1976. Since then the market has improved, and the difference has risen to $2.50 per square foot. During periods of low occupancy, many firms find that they can afford space in higher quality buildings than they normally might during a tight office market. The result is that the total potential market for Class A buildings is greater as is true for the total market for Classes B and C buildings. The potential market for Class D buildings contracts as it loses many of its prospective tenants to Class C buildings. The increases in the potential markets for Classes A, B, and C buildings do not necessarily mean that more space will be leased; it simply means that many tenants who would normally be financially restricted to a lower class of space have the option of leasing higher class space during a tight market.

FIGURE 3

TREND IN MOST FREQUENTLY QUOTED RATES FOR CLASSES A-D OFFICE BUILDINGS—1976-1977



AS OCCUPANCY RISES, RATE SPREADS INCREASE

As a greater variation in rental rates develops, many users who would prefer a higher class of space are restricted by price to lower priced space. As occupancy rates rise, the spread of rental rates between the various classes of buildings tends to increase. Competition for as many tenants as possible tends to keep the spread in rental rates between classes at a minimum during periods of low occupancy rates.

When the market begins to improve, space in the higher class buildings is generally absorbed first. As this occurs each class of building tends to raise its rental rates at a different pace, with increases in Class A buildings occurring first and being the highest followed by Classes B, C, and D in that order. *Figures 2* and *3* illustrate this phenomenon. *Figure 2* shows that the most frequently quoted rental rates increased by $2.00 per square foot for Class A buildings, $1.00 per square foot for Class B, $.50 for Class C, and no increase for Class D for the period October, 1976 to October, 1977.

LAG PERIOD DEVELOPS IN RATE INCREASES

Figure 3 illustrates that a lag period develops. In the beginning, Class A demand is highest followed by Classes B and C. As a result of higher demand and decreasing space availability, the price of Class A space rises and the difference in price between Classes A and B space broadens. More prospective tenants then eliminate Class A space as an alternative and seek Class B space. Certainly there are some users who will pay whatever the cost to have better space, but many will take the lower priced space if the difference in cost is great enough. The wave that is created begins with Class A space and affects each successive class to a decreasing degree. As the cycle runs its course the rate of increases in rents for Class A space will slow. The rate of rental rate increases for Classes B, C, and D will also gradually decrease in turn as each class's rental rates come closer to approaching the rates of the next higher class.

For the developer this is a very important phenomenon; as rental rates for new Class A buildings rise, the size of his potential market diminishes. However, countering this decrease in the size of his potential market is often an increase in the number of tenants who actually relocate, provided the economy remains strong.

THREE FACTORS CAUSE RATE DECREASE

The three principal factors that will cause a decrease in the rate of rental rate growth are: 1) overbuilding of new Class A office buildings, 2) downturn in the economy which cuts back demand, and 3) Classes B, C, and D rates which lag far behind increasing Class A rates. For the tenant seeking space the best time to negotiate a lease is when the spread between rental rates for various classes of buildings is at a minimum. Chicago's office market has moved past that point and is now entering a period in which the spread will widen.

For the prospective tenant seeking office space, one of the most complicated tasks he has is to determine which office facility offers the most for his firm's rental dollar. Certainly, one of the most difficult problems in comparison shopping for office space is that there are no two buildings that are truly identical. All buildings vary in degree of prestige, location advantage, condition, services, and so forth. If we assume that two identical buildings could be found, it is highly unlikely that both buildings would quote rental rates calculated in the same manner. Comparison shopping would be greatly simplified if all rental rates were calculated based on a comparable list of lease terms including such items as utilities, maintenance, operations, and building standards.

DETERMINATION OF "RENTABLE" VERSUS "USABLE" IMPORTANT

One of the most important considerations in comparison shopping of rental rates is determining whether the rental rate per square foot per year is for "rentable area" or for "usable area" and how they are calculated in a particular building. "Rentable area" reflects a lower per square foot rate because it may include space such as washrooms, corridors, and other areas common to all building tenants. "Usable area" on the other hand often refers only to the space which is used solely by the tenants. Within Chicago a firm can be safe in assuming that most Class A and Class B buildings and many Class C buildings calculate their rental rates based on rentable area.

Even if a tenant knew that all of the buildings he was considering used rentable area as their criterion for quoting rental rates, the tenant would still find it necessary to compare many other costs that may or may not be included in the rate. Generally items such as utilities, maintenance, and security are included in the quoted rate while electricity costs are not. With rising energy costs, the energy efficiency of a building becomes a very important consideration when comparing the short and long-range costs of occupancy space in different buildings.

DIFFERENCES IN VALUE FOUND IN BUILDING STANDARDS

Differences in value for a firm's rental dollar can often be found in the area of building standards. Building standards refer to those items such as floor covering, partitions, painting, air conditioning, window coverings, telephone outlets, lighting fixtures, and other such items that may or may not be included in the rent. The tenant must determine which of these items are included, the quality of the items, and which he will have to install or pay extra to upgrade in order to meet his own needs. Some prospective tenants may find it essential to be represented by a professional in order to insure the greatest value for his rental dollar.

CRITIQUE

Comparative Investment Performance of Common Stock and Real Estate

by *Moshe Ben-Horim*

In a recent article, Michael S. Young suggested a methodology for comparing common stock and real estate investment returns. His proposal deserves several comments.

We shall start with Young's proposal for a measure of investment returns. He suggests to make "the simplifying assumptions that the starting value is the purchase price of the asset and that the income generated adds dollar-to-dollar to the value, while money to cover operating losses decreases the value." He recognizes the fact that the resulting measured returns are naive but says that ". . . we will take comfort in Professor Milton Friedman's comments: 'the relevant question to ask about the assumptions of a theory is not whether they are descriptively realistic, for they never are, but whether they are sufficiently good approximations for the purpose in hand. And this question can be answered only by seeing whether the theory works, which means whether it yields sufficiently accurate predictions.'" With naive assumptions, it is hard to see how we can "take comfort" in Friedman's comments when we have not yet seen whether or not the measure suggested by Young really "works."

As a measure of central tendency, Young suggests the geometric mean return on assets, which equals the *n*th root of the product of *n* wealth relatives minus 1.00. He says that whether the wealth relatives used are monthly, quarterly, or annual is a matter of "convenience, accuracy and availability." The fact is, however, that as long as the average is taken over a given period, the choice between monthly, quarterly, annual, or other wealth relative will yield the very same results. To illustrate, suppose nine end-of-quarter wealth levels are

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This article is a critique of "Comparative Investment Performance: Common Stocks Versus Real Estate—A Proposal on Methodology" by Michael S. Young, which appeared in the Summer 1977 edition (Vol. 2, No. 1) of *Real Estate Issues*.

Moshe Ben-Horim is a visiting assistant professor at the University of Florida in Gainesville.

denoted by $W_0, W_1, \ldots W_7, W_8$. The respective quarterly wealth relatives (WR) will be as follows:

$$WR_1 = \frac{W_1}{W_0}$$

$$WR_2 = \frac{W_2}{W_1}$$

$$\cdot$$
$$\cdot$$
$$\cdot$$
$$\cdot$$

$$WR_8 = \frac{W_8}{W_7}$$

and the quarterly geometric mean return is given by:

$$1) \quad \bar{R} = \sqrt[8]{(WR_1)\ (WR_2)\ \ldots\ldots\ (WR_8)} - 1.00 = \sqrt[8]{\frac{W_8}{W_0}} - 1.00$$

As we see, the intermediate wealth relatives do *not* add any accuracy to the calculation since $\bar{R}$ is a function of the wealth at the beginning and at the end of the entire period and the *number* of intermediate sub-periods in between. As an example, the monthly geometric mean return in the above example is $\sqrt[24]{\frac{W_8}{W_0}} - 1.00$, and the information on wealth levels of end of months for the period will add nothing to that measure.

Let us turn now to the risk measure and the measure of diversification. Young recommends using the beta coefficient in combination with the correlation coefficient; he advocates total reliance on these two measures and abandonment of traditional policies, particularly the self-imposed constraints of a maximum percentage of investment allowed in any one company or industry. Young demonstrated—using a hypothetical example—that the increased proportion of investment in real estate could reduce portfolio risk.

I do not wish to argue that Young's hypothetical example could not have a real life counterpart. But I do want to examine some potential problems with the approach he advocates.

Consider a portfolio consisting of a real estate investment yielding return $\tilde{R}_i$ and the "market portfolio" yielding return $\tilde{R}_m$. Denoting the proportions of investment by z_i and z_m respectively ($z_i + z_m = 1$) we may write the return on the portfolio ($\tilde{R}_p$) as follows:

$$2) \quad \tilde{R}_p = z_i \tilde{R}_i + z_m \tilde{R}_m$$

The expected return and variance of the portfolio are given by:

$$3) \quad \bar{R}_p = z_i \bar{R}_i + z_m \bar{R}_m$$

$$4) \quad \sigma_p^2 = z_i^2 \sigma_i^2 + z_m^2 \sigma_m^2 + 2 z_i z_m \operatorname{cov}(\tilde{R}_i, \tilde{R}_m)$$

where a bar over a random variable denotes expected value and where σ_i^2, and σ_m^2 and σ_p^2 are the variances of $\tilde{R}_i$, $\tilde{R}_m$ and $\tilde{R}_p$ respectively, and cov ($\tilde{R}_i$, $\tilde{R}_m$) is the covariance between $\tilde{R}_i$ and $\tilde{R}_m$. The *marginal contribution* of asset *i* to the portfolio variance is given by: [1]

$$5) \quad \frac{d\sigma_p^2}{dz_i} = 2\,[z_i\,(\sigma_i^2 - 2\beta_i\sigma_m^2) + \beta_i\sigma_m^2 - \sigma_m^2(1 - z_i)\,]$$

When z_i is very close to zero, the asset's own variance (σ_i^2) is a negligible element in the marginal contribution to the portfolio risk. As z_i rises, the variance of $\tilde{R}_i$ becomes more and more important in measuring the marginal contribution of asset *i* to the riskiness of the portfolio. It seems unjustified then, to recommend total reliance on β as a measure of risk on one hand and to allow z_i to rise with no restriction on the other. The above expression for marginal risk (i.e., $d\sigma_p^2 / dz_i$ is an improvement over β as a risk measure of those cases.

Other problems with the beta coefficient are related to its estimation. As we know, true beta coefficients are unobservable. We can only obtain *estimates* of true beta coefficients, and those are subject to sampling errors. Furthermore, even regardless of the sampling errors, there exists the question of the stability of beta: is next period beta going to be the same as today's beta?

Several stock market studies[2] indicate that the beta coefficient is not really stable, and thus the ex-ante beta coefficient would have been subject to uncertainty even if we knew the the ex-post beta with certainty. The sampling errors of the beta measures of real estate investments as well as their stability over time have not as yet been evaluated and thus it seems somewhat premature to make investment policies so dependent on quantities whose qualities are still unknown.

The best protection against sampling errors and uncertainty of other types is diversification. Thus the self-imposed constraints on maximum investment in any one asset company or industry should still make a lot of sense for portfolio managers.

1. In taking the derivative in equation 5 we made use of the following relationship:

$$\beta_i = \frac{\text{cov}(\tilde{R}_i, \tilde{R}_m)}{\sigma_m^2} \quad \text{so that } \text{cov}(\tilde{R}_i, \tilde{R}_m) = \beta_i\sigma_m^2$$

2. See Marshall E. Blume, "On the Assessment of Risk," *Journal of Finance* (March, 1971) and "Betas and Their Regression Tendencies," *Journal of Finance* (June, 1975); Stuart L. Meyers, "The Stationarity Problem in the Use of the Market Model of Security Price Behavior," *Accounting Review* (April, 1973), pp. 318-322.

REPLY

by Michael S. Young

Without going into an elaborate discussion of all the issues raised by Professor Ben-Horim in his Critique, let me say that we are not in disagreement with regard to the possible instabiilty or unpredictability of "beta" as a measure of risk or the occasional usefulness of marginal analysis. His argument is not wrong; we are simply talking about different things. He is delving into areas beyond the rudimentary presentation I made, and into regions of academic theory and research in which debate especially with regard to beta estimation and stability is currently raging.

In other areas of Professor Ben-Horim's comment he appears to have misinterpreted my intent or my English. For instance, I suggested that both betas *and* correlation coefficients be used to specify investment policy for holders of portfolios. In his discussion following the marginal contribution formula, he has lost sight of that which he earlier recognized. However, irrespective of the correlation coefficient restriction in the model, those who wish to try the computation will quickly discover that successive additions of an asset whose beta is lower than that of the portfolio to which it is added will not consume the entire portfolio but will reach a point of equilibrium unless constrained earlier by physical limitations.

Perhaps I got a little ahead of myself when I said that the choice of the periodicity of wealth relatives is a "matter of convenience, accuracy, and availability." Obviously, the geometric mean does not depend upon the intermediate wealth relatives but other computations such as the variance clearly do. In a paper addressed to a wide, generally non-academic audience, there is never the opportunity to go into all the minute details of proof.

Professor Ben-Horim's closing paragraph gives me reason to believe that the myth that diversification is enforced by specifying maximum percentages of a portfolio that should be invested in various assets will persist. Specifying percentages or quotes will *never* ensure diversification. Professor Ben-Horim and doubtless many others are guilty of this misunderstanding.

My article was intended to stimulate further discussion of advanced analytical techniques that might be applied to real estate. As a profession, real estate lags decades behind finance and economics. I had hoped that some institutional holder of real estate assets such as the insurance companies who maintain real estate portfolios for pension funds would submit or subject their portfolio to the kind of analysis necessary to substantiate or refute the proposition that real estate assets behave like common stock assets in such a way that useful comparisons could be made. Unfortunately no one has taken up the challenge.

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