REAL ESTATE ISSUES

THE COUNSELORS OF REAL ESTATE™
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SUMMER 2001
Volume 26, Number Two

1976 - 2001
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(deadline for manuscript submission - August 20)

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Articles on general real estate-related topics
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REI INDEX OF ARTICLES

The *Real Estate Issues "Index of Articles"* provides over 100 alphabetical subject listings for articles published in the journal during its 26-year history, along with a second alphabetical listing of authors. Access the *Index* through The Counselors' home page at **www.cre.org**

SUBSCRIPTION INFORMATION

Real Estate Issues publishes **four times per year** (Spring, Summer, Fall, Winter). To subscribe to *Real Estate Issues* or for additional information, contact The Counselors at **www.cre.org**; 312.329.8427.

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

Membership is selective, extended by invitation only on either a sponsored or self-initiated basis. The **CRE Designation** (Counselor of Real Estate) is awarded to all members in recognition of superior problem solving ability in various areas of specialization such as litigation support, asset management, valuation, feasibility studies, acquisitions/dispositions and general analysis.

CREs achieve results, acting in key roles in annual transactions and/or real estate decisions valued at over $41.5 billion. Over 300 of the Fortune 500 companies retain CREs for advice on real estate holdings and investments. CRE clients include public and private property owners, investors, attorneys, accountants, financial institutions, pension funds and advisors, government institutions, health care facilities, and developers.

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A Counselor of Real Estate is a real estate professional whose primary business is providing expert advisory services to clients. Compensation is often on an hourly or total fixed fee basis, although partial or total contingent fee arrangements are sometimes used. Any possibility of actual or perceived conflict of interest is resolved before acceptance of an assignment. In any event, the Counselor places the interests of the client first and foremost in any advice provided, regardless of the method of compensation. CREs have acquired a broad range of experience in the real estate field and possess technical competency in more than one real estate discipline.

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Whether sole practitioners, CEOs of consulting firms, or real estate department heads for major corporations, CREs are seriously committed to applying their extensive knowledge and resources to craft real estate solutions of measurable economic value to clients' businesses. CREs assess the real estate situation by gathering the facts behind the issue, thoroughly analyzing the collected data, and then recommending key courses of action that best fit the client's goals and objectives. These real estate professionals honor the confidentiality and fiduciary responsibility of the client-counselor relationship.

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EDITOR'S STATEMENT - by Richard Marchitelli, CRE

The role of institutional investment managers could become more complicated after a recent study conducted by Ibbotson Associates and the National Association of Real Estate Investment Trusts (NAREIT). This study is likely to renew the debate over whether real estate is an industry or an asset class. While the controversy no longer commands the attention that it did in the early 1990s, it is likely to be revisited if only for one side to use the Ibbotson NAREIT findings as validation of its position.

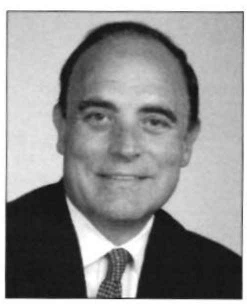
Those of us older than 30 will recall, some experts argued that buying REIT shares was a proxy for outright ownership of real estate. According to this school, the major difference was that holding REIT stock was far less management- and resource-intensive than direct ownership of a real estate asset, but the equivalent of owning real estate nonetheless.

Others contended that real estate was an industry consisting of far more than hard assets such as office buildings and malls. They maintained that real estate was a broad industry category influenced by smaller industries such as construction, among others.

The reason why the debate was so important was that it directly influenced funding allocations. If decision-makers believed the position of the first school (*i.e.*, real estate was an asset class), then the real estate professionals would be given a greater allocation of funds. If they were to agree with the second argument, then the securities people were given more funds to invest. Of course, this is an oversimplification of the problem, but in a world where success is often measured by size, neither group wished for its investment allocation to be diminished.

A decade later, Ibbotson Associates and NAREIT may have clarified the argument or at least provided the basis for one side to claim victory. According to the results of the study as reported in the July 6, 2001, edition of *Financial Times*, ("Global Investing—Reits Lose Correlation with Broader Market—Weaker Link Makes Real Estate Investment Stock A Potential Diversification Tool" by Alison Beard), the correlation between REIT stocks and other stocks reached as high as 0.69 during the 1970s. Stated another way, 69 percent of the changes in REIT stocks could be explained by changes in the larger market for all stocks. The study found that since 1993, this correlation has declined to 25 percent and that in relation to the bond market, it has been steady at below 20 percent. *Financial Times* further reported that "because Reits do not mimic stocks and bonds, investors can treat them almost like direct property investments, diversifying their portfolios and minimising the risk without taking on the burden of managing an actual building."

If anyone cares to weigh in on the subject, I would encourage you to do so by sending a letter to the editor*, which may be published, or to submit a more in-depth manuscript+ directly to *Real Estate Issues*.



Richard Marchitelli, CRE
Editor in chief

David Kirk, CRE
2001 National CRE President

* Submission of "letters to the editor" implies the right to edit (for clarity or space) and/or to publish all or in part. Please include your name, address, daytime phone number, and e-mail address.
+ Deadline for submissions for publication consideration in the fall issue is August 20th. Submissions and/or questions should be e-mailed to: fporter@interaccess.com

DEFEASANCE VS. YIELD MAINTENANCE: WHAT'S THE DIFFERENCE?

by Michael Schonberger & Donald M. Moliver, CRE

Defeasance is an attractive alternative to a yield maintenance formula that may provide a benefit to the borrower. While there is some administrative cost, including a possible additional prepayment fee, on balance, the potential gain far outweighs these costs.

Now that the commercial mortgages backed securities (CMBS) market is beyond the infancy stage, many in the industry have become familiar with the uniqueness of the loan origination process. For example, owners have come to recognize that to borrow from a Wall Street lender they must form a single purpose entity and agree to a capital improvement escrow account. Borrowers have also come to recognize that Wall Street regards prepayment fees as essential. One industry expert, in reflecting upon the reasons behind the growth in the CMBS market, continually identifies, "limited prepayment risk" as a leading cause.[1] To the borrower, limited prepayment risk means enduring a lockout period, wherein it cannot prepay, followed by a period that prepayment is permitted subject to a significant fee.

Traditionally prepayment fees have been structured as either a declining balance or a yield maintenance formula. Wall Street lending offers a third option; call defeasance, which is rarely used by traditional lenders. This article will explain what defeasance is and how it works, and then compare it to a yield-maintenance formula in terms of cost. More specifically, this article will include:

- An overview of the practical and legal difference between a yield maintenance prepayment and a defeasance transaction;
- A hypothetical comparative example of the cost to prepay using a

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yield maintenance formula versus the cost to execute a defeasance; and
- The procedural steps necessary to complete a defeasance.

OVERVIEW

In the commercial mortgage market the prepayment fees are structured in a fashion whereby the lender receives nearly all of the benefits that are available as a result of declining interest rates. The borrower, however, may still be willing to prepay in order to take advantage of a market opportunity that will, or is perceived to, provide a benefit in excess of the prepayment fee. For example: sell the underlying property, a cash-out refinance, or a simply rollover refinance at a moment when rates are perceived to be at an unusually low point.[2] In each of these cases, the prepayment fee becomes one of many transaction cost/benefit factors to consider. For purposes of this article, the benefit of a refinancing is assumed positive and, therefore, the analysis focuses on a comparison between the commonly used prepayment methods.

The earliest version of a prepayment fee is the declining balance formula. This formula is structured as a fixed percentage of the outstanding loan amount. For example, 5 percent in loan years one and two, 4 percent in loan years three and four, and so on until 1 percent in loan years nine and 10. As both the percentage reduction and a decreasing outstanding loan amount decline, so does the resulting fee. The concept behind this formula is that as a loan matures, prepayment will have a decreasingly smaller impact on the lender's profit. Declining formulas often included windows of 30-180 days prior to termination, wherein, the borrower could prepay with no penalty.

Later, the yield maintenance formula was introduced. Yield maintenance is a bit more creative in that the fee is based on interest rate movement. Therefore, a borrower seeking to take advantage of an interest rate decline would pay a higher fee than the borrower who prepays when rates have remained constant or have risen. The standard yield maintenance formula is defined as the present value of the remaining payments multiplied by the difference between the note rate and the treasury securities yield with the same term as the remaining term.[3] The effect of this is to provide the lender, (or trustee in the case of a securitization), the ability to reinvest this lump-sum amount in treasury securities that will yield the same return as if the loan were in place to full maturity.

Defeasance is a process whereby the borrower offers the lender replacement collateral in order to gain a release of the original collateral. In a securitized transaction, this replacement collateral must be treasury securities. Therefore, from a practical standpoint, yield maintenance and defeasance provisions are quite similar.

Later still, defeasance was introduced as an alternative to yield maintenance.[4] Defeasance is a process whereby the borrower offers the lender replacement collateral in order to gain a release of the original collateral. In a securitized transaction, this replacement collateral must be treasury securities. Therefore, from a practical standpoint, yield maintenance and defeasance provisions are quite similar. Under the yield maintenance formula, the lender receives a lump-sum payment (based on treasury yields) that it can reinvest at will. In effect, a defeasement obligates the borrower to reinvest, on behalf of the lender, the prepayment proceeds in treasury securities.

From a legal standpoint, yield maintenance and defeasance are fundamentally different. Prepayment is the up-front payment of the outstanding loan balance, plus a prepayment fee in return for early note termination and collateral release. Since the note is terminated, the prepayment fee is considered to be a liquidated damage and therefore, when challenged, scrutinized under the "reasonableness" test. Defeasance, on the other hand is a collateral substitution. In a defeasance, the lender releases the lien on the original collateral and perfects a new security interest in some agreed replacement collateral (i.e. treasury securities). Throughout this process, the original note stays in effect with minimal or no modification. Since the note survives a defeasance transaction, there is no termination or liquidated damage issues. Courts will interpret defeasance as a prenegotiated contract option, which in general, is more likely to withstand a judicial challenge.[5]

HYPOTHETICAL EXAMPLE

As shown in *Table 1*, a $10 million 10-year 7.5 percent loan on a 30-year amortization schedule requires 120 monthly payments of $69,921, followed by a balloon payment of $8,679,499.[6] If this

Table 1

Yield Maintenance Calculation

	Initial Loan Terms		Payment Differential	
Initial Terms:	Note Rate	7.50%	7.500%	Note Rate
	Original Amount	10,000,000	4.659%	Reinvestment Rate (semi-annually)
	Amortization Term	30	4.614%	Reinvestment Rate (monthly)
	Payment	69,921	2.886%	Payment Differential (annually)
			0.240%	Payment Differential (monthly)

	(1) #	(2) Interest	(3) Amortization	(4) Principal	(5) Payment Differential	(6) Payment Stream
				10,000,000		
	1	62,500	7,421	9,992,579		
Past Period:	2	62,454	7,468	9,985,111		
	3	62,407	7,515	9,977,596		
	4	62,360	7,561	9,970,035		
	5	62,313	7,609	9,962,426		
	•	•	•	•		
	•	•	•	•		
	•	•	•	•		
	82	57,628	12,293	9,208,221		
Prepayment Date:	83	57,551	12,370	9,195,851		
	84	57,474	12,447	9,183,404		
	85	57,396	12,525	9,170,879	July 1, 2001	
	86	57,318	12,603	9,158,275	0.240%	22,022
	87	57,239	12,682	9,145,593	0.240%	21,992
Remaining Term:	88	57,160	12,761	9,132,832	0.240%	21,961
	89	57,080	12,841	9,119,990	0.240%	21,930
	90	57,000	12,922	9,107,069	0.240%	21,899
	91	56,919	13,002	9,094,066	0.240%	21,868
	92	56,838	13,084	9,080,983	0.240%	21,837
	93	56,756	13,165	9,067,818	0.240%	21,805
	•	•	•	•	•	•
	•	•	•	•	•	•
	•	•	•	•	•	•
	118	54,537	15,384	8,710,556	0.240%	20,946
	119	54,441	15,480	8,695,076	0.240%	20,909
	120	54,344	15,577	8,679,499	0.240%	20,871

Outcome:	Balloon	9,170,879	702,135	PV of Payment Stream
	Prepayment Fee	702,135	4.614%	Discount Rate
	Total Release Price	9,873,014		

loan were to be prepaid on July 1, 2001, after 85 payments, the borrower would have to pay the outstanding balance of $9,170,879 plus a treasury-based prepayment fee of $702,135. This fee is equal to the present value of a payment stream created by multiplying the difference between the note rate of 7.5 percent and adjusted yield of the three-year (the "remaining term" of the note) treasury security of 4.659 percent.[7] This difference is then divided by 12 and multiplied by the outstanding loan balance for each month of the remaining term (column 4). The outcome of this application is a payment stream (column 6), which when discounted to present value using the reinvestment rate equals $702,135. The bottom of *Table 1* reflects that the total amount necessary to obtain a collateral release is equal to the balloon amount of $9,170,879 plus the prepayment fee of $702,135, which is equal to $9,873,014. If on July 1, 2001, the lender were to reinvest this amount in a June 1, 2004, treasury security yielding 4.659 percent, they would earn the same amount as if investing $9,170,879 in a 7.5 percent mortgage maturing on June 1, 2004, thus the lender has "maintained" their yield.[8]

Given the exact same terms above, the cost to execute a defeasement is $9,905,119. This cost is the summation of the price needed to buy a series of treasury securities that will produce a cash flow exactly equal to what remained on the original loan. So for the present example, the stream to be mirrored is 35 sequential monthly payments of $69,921 followed by a maturity payment of $8,679,499. Perhaps the easiest way to understand the mechanics involved is to visualize an account. Funds are entered into this account in two ways: 1). when issues mature; and 2). when semi-annual interest payments are paid. Funds are drawn from this account to provide the lender with the remaining term cash flow. *Table 2* provides a list of 17 treasury securities that will source the "account" in a manner that will minimize the time and dollar amount where funds sit idle. As shown in *Table 2*, an investor would pay $9,831,715 (column 7) for 17 separate treasury issues

Table 2

Replacement Collateral Portfolio

(1) Maturity	(2) Type	(3) Coupon	(4) Yield	(5) $ Price	(6) Par Amount	(7) Principal Cost	(8) +Accrued Interest	(9) = Total Cost
7/12/2001	T-BILL	3.410%	3.461%	$99.90	70,000	69,927.06	-	69,927.06
8/15/2001	STRIPS-I	-	3.748%	$99.54	50,000	49,768.12	-	49,768.12
9/13/2001	T-BILL	3.510%	3.585%	$99.28	64,000	63,538.24	-	63,538.24
10/11/2001	T-BILL	3.490%	3.574%	$99.01	64,000	63,367.15	-	63,367.15
2/28/2002	T-NOTE	6.250%	3.701%	$101.66	50,000	50,828.13	1,044.50	51,872.63
3/31/2002	T-NOTE	6.625%	3.764%	$102.08	64,000	65,330.00	1,065.79	66,395.79
4/30/2002	T-NOTE	6.625%	3.810%	$102.28	64,000	65,460.00	714.35	66,174.35
8/31/2002	T-NOTE	6.250%	3.994%	$102.53	53,000	54,341.56	1,107.17	55,448.73
9/30/2002	T-NOTE	6.000%	4.006%	$102.39	64,000	65,530.00	965.25	66,495.25
10/31/2002	T-NOTE	5.750%	4.045%	$102.19	66,000	67,443.75	639.38	68,083.13
2/28/2003	T-NOTE	4.625%	4.224%	$100.64	53,000	53,339.53	819.30	54,158.83
3/31/2003	T-NOTE	5.500%	4.243%	$102.09	68,000	69,423.75	940.11	70,363.86
4/30/2003	T-NOTE	5.750%	4.253%	$102.61	68,000	69,774.38	658.75	70,433.13
8/15/2003	T-BOND	11.125%	4.405%	$113.47	194,000	220,129.38	8,108.34	228,237.72
2/15/2004	T-NOTE	4.750%	4.542%	$100.50	205,000	206,025.00	3,658.29	209,683.29
5/15/2004	STRIPS-P	-	4.652%	$87.63	5,147,000	4,510,128.90	-	4,510,128.90
5/15/2004	T-BOND	12.375%	4.659%	$120.50	3,392,000	4,087,360.00	53,610.65	4,140,970.65
					9,736,000	9,831,714.95	73,331.88	9,905,046.83

Settlement Date: 7/1/2001

COMPOSITION OF INITIAL DEPOSIT

Cash Deposit.. 72.18
Cost of Investments Purchased with Bond Proceeds.......................... 9,905,046.83

Total Cost of Investments.. $9,905,119.01

Provided by: Commercial Defeasance, LLC; CMBS Finance Group, Washington, DC

with a par amount of $9,736,000 (column 6), plus $73,332 of accrued interest (column 8) and $72 in cash.[9] The cash amount is added to the account to handle differences that cannot be mirrored by bonds offered in $1,000 increments.

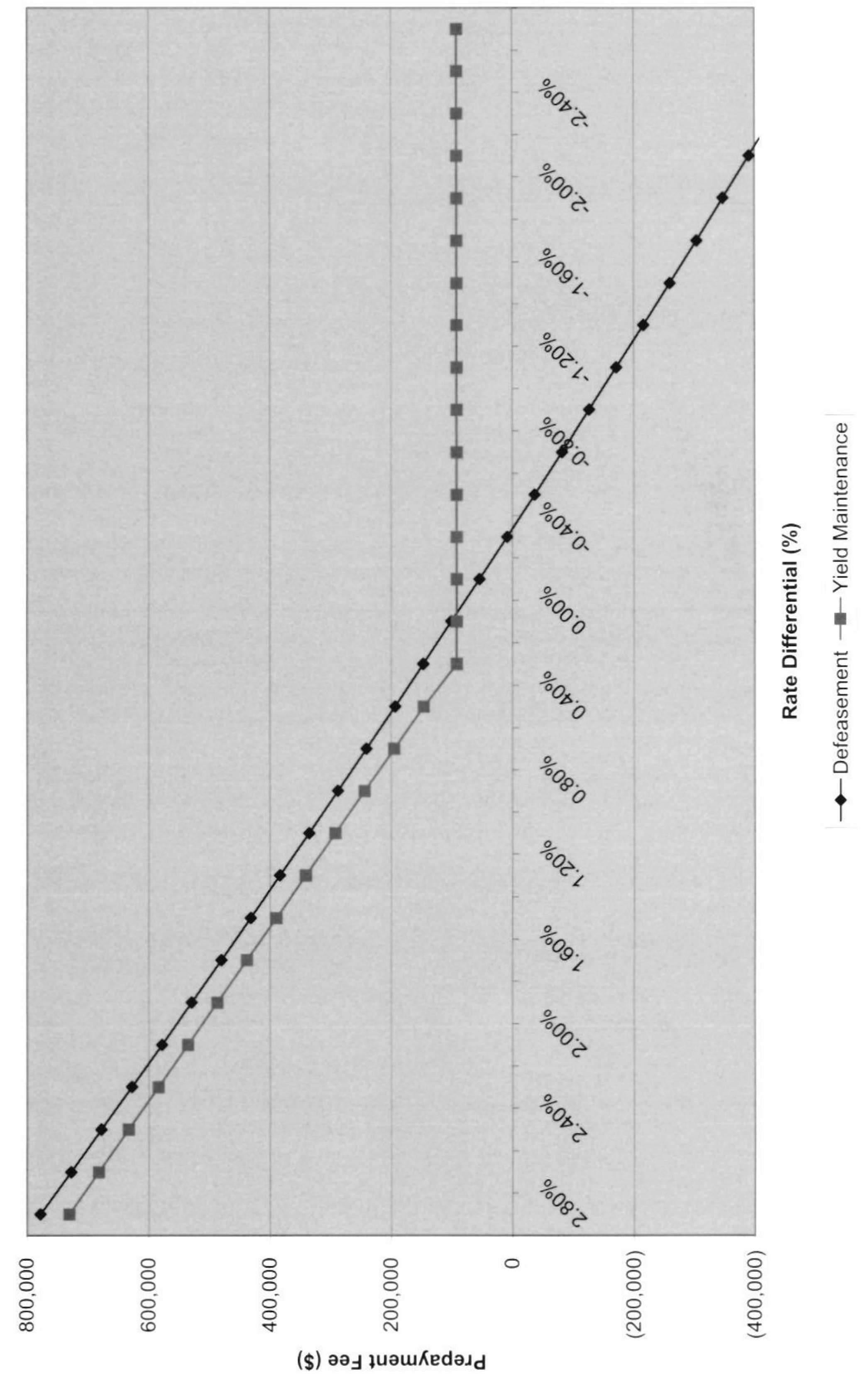
In terms of comparison, the difference between the two methods is $32,105. The best way to explain the difference is to first explain the reason for the proximity. For nearly the entire principal amount at issue, the treatment is exactly the same. The reinvestment yield of 4.614 percent used to calculate the prepayment fee is the same factor used to calculate the price of the May 2004 treasury security. The May 2004 issue accounts for the lion's share of the total replacement collateral. The difference is attributable to the price paid for the issues other than the May 2004. These shorter-term interim issues are at yields below that of the reinvestment yield that must be made-up for with additional price.[10]

The difference, called the "yield curve effect," is a function of the slope of the yield curve and the duration of the remaining term. For example, given a flat yield curve this amount will be zero; given a steeper curve it would be greater than the $32,105; and given a negative sloping curve this amount would be negative. This amount will also be influenced by the duration of the remaining term. Generally, the longer the term, the greater the yield-curve effect because in practice the yield curve is rarely flat or inverted, especially at the short end of the curve where this effect is at issue.

Exhibit 1 provides an illustration that summarizes the yield maintenance vs. defeasement relationship. The methodology used to compile this data is explained in the appendix herein. The yield maintenance curve starts high and decreases in a linear fashion as the payment differential approaches zero. At some point, the yield maintenance formula reaches the contractual minimum point, which is

Exhibit 1

Yield Maintenance vs. Defeasance



equal to 1 percent of the outstanding loan amount ($91,709). At this point, the curve remains in a horizontal position because the prepayment fee equals 1 percent regardless of how low the payment differential reaches. Depending on the length of the remaining term, this 1 percent minimum becomes active when the payment differential is between 25 and 60 basis points.

The defeasance curve will remain linear throughout its entire length. Defeasement language does not include any payment minimum. All that the lender seeks is the replacement securities that are not influenced by cost. As such, at the left of *Exhibit 1* where the payment differential is high, the fee is near $800,000. As the payment differential approaches zero (*i.e.* the reinvestment rate equals the note rate) the fee becomes very small. Once the payment differential is slightly negative the curve intersects with the x-axis; thus the prepayment fee is zero. The slight negative differential is needed to compensate for the yield-curve effect. Beyond this point the payment differential and the prepayment fee are negative. For example, if rate differential is a negative 2.0 percent, meaning the adjusted reinvestment rate is 9.5 percent and the note rate is 7.5 percent, the cost for the replacement securities would be $8,780,313, which is $390,566 less then the outstanding loan amount of $9,170,879. In effect the borrower could payoff the loan at a discount.

The small area between the two curves represents the above mentioned yield-curve effect. This effect will vary with the payment differential but to a very slight degree. As you can see from *Exhibit 1*, the area between the curves remains nearly constant despite changes to the reinvestment rate. In practice, this difference can be reduced. The defeasance scenario can be adjusted to account for the opportunity to earn interest when balances accumulate in the account. For example, on a semi-annul basis the May 2004 issue pays $209,880 into the account, which is significantly more than the $69,921 monthly amount being drawn from the account. As a result there is a 60-day period where $140,000 is left idle and a 30-day period where $70,000 is left idle. At a 4 percent investment rate the borrower could earn $5,851 in interest, which if so would narrow the yield-curve effect. [11]

PROCEDURAL STEPS

The following is a partial list of procedural steps that must be performed to execute a defeaseance in accordance with typical securitized mortgage documents.

1. *Notice* – At least 30 days prior to the intended defeasement date the borrower must deliver a defeasance request to the service.
2. *Preparation of the Defeasance Security Agreement* – The payee's attorney must prepare and review the Defeasance Security Agreement. Upon completion, these documents must be delivered to servicer.
3. *Certificate from borrower's public accountant* – An accountant, acceptable to the servicer, must certify as to the adequacy of the defeasance collateral. In essence, adequacy means that the collateral will generate monthly payments equal to the cash stream required under the original note.
4. *Opinion of counsel* – Counsel must opine that the payee has a perfected first priority interest in the defeasance collateral, the defeasance security agreement is valid and enforceable, and the proposed substitution is in accordance with Treasury Regulation 1.860(g)-2(a)(8) and will not be treated as an exchange pursuant to Section 1001. The priority, validity, and enforceability are common issues that attorneys frequently opine to for a fee. The treasury regulation lists specific ways of handling a defeasance as to stay within the boundaries of a non-tax paying entity.
5. *Written confirmation from the rating agency* – The rating agency that provided the REMIC with the original rating must provide a "no downgrade letter."[12] This letter provides that the substitution of the defeasance collateral for the mortgaged property will not result in a downgrade, withdrawal, or qualification of the rating assigned to the REMIC. This process also serves as a means for the rating agency to conduct a final review to ensure that all of the documentation related to the above items is in proper order. There is no apparent credit issue when a mortgage secured by commercial real estate is being replaced by United States Treasury obligations. There is a possible issue with the integrity of the REMIC. If one particular REMIC were to substitute many of its loans or substitute one loan improperly, the IRS could claim it as a seller of real estate assets, thus placing its non-tax paying status in jeopardy. For now this possibility seems quite remote because the number of defeasance transactions is still rather low. The agencies typically do not charge borrowers a fee for a confirmation letter.
6. *Mortgage recording tax* - In some jurisdictions, for example New York, a tax is assessed for the recordation of a mortgage. The tax is calculated on a sliding scale based on the amount of the new mortgage debt. What many borrowers do

in a refinancing is ask the new lender to take assignment of the existing mortgage and note and then record a modification reflecting the terms of the new loan. This way the tax is charged only the "new money." For example, a $10 million loan is made to refinance an $8 million existing loan. If the $8 million loan is terminated, the mortgagee must record a new $10 million mortgage and pay the recording tax based on that amount. If however, the mortgagee takes the existing note and mortgage by assignment and records a modification agreement the tax is charged on only the $2 million amount. For quite some time, many attorneys in New York were unsure of the proper recording tax given a defeasement transaction. The confusion surrounded the treatment of the original mortgage, which for defeasement purposes is terminated and for recording tax purposes is assigned. Recently, the State of New York Commissioner of Taxation issued an advisory opinion that, in effect, limits the applicability of the recordation tax to new indebtedness only regardless of whether the mortgage release is associated with a note termination or assignment.[13]

CONCLUSION

Defeasance is a unique financial concept in that it provides benefits to both sides of a transaction. To the borrower, the trade-off is a clear gain. If rates fall, except for the yield-curve effect, the yield maintenance and defeasance result in the same prepayment fee. If rates rise, the borrower can save substantially. The only downside to the borrower is the unfamiliar administrative aspects to complete a defeasement transaction compared to a straight forward pay-off given a yield maintenance fee. But even this issue is reduced to dollars, as newly formed consulting firms are available to demystify the defeasance process. The lender, or more importantly the CMBS investor, is concerned only with yield maintenance and not yield enhancement, and thus will not insist on a 1 percent minimum prepayment fee.[14] Bond investors are used to dealing with call provisions in corporate issues which can only erode yield. The idea that they can actually profit from prepayment is an anomaly. Moreover, the legal justification for a 1 percent fee in a defeasance is cloudy. Courts may likely frown upon a contract option that compensates one party in excess of its loss.REI

APPENDIX

Below are the variables added to the "replacement collateral portfolio" *(Table 2)* in order to determine the effects that rate differential changes will have on the portfolio price. The first five variables are as provided in the baseline case listed in *Table 2*. The rate adjustment (strip) was entered at a constant difference of 7/10 of a basis point regardless of rate differential movements. Likewise, the slope of .0765 percent (the actual slope of the baseline case) is applied to every rate differential calculation.

7/1/01	Settlement Date
7.50%	Note Rate
4.659%	Reinvestment Rate (semi-annual)
4.614%	Reinvestment Rate (monthly)
2.841%	Rate Differential
0.007%	Rate adjustment (Strip)
0.0765%	Slope

NOTES

1. Gichon, Galia, "The CMBS Market: Past, Present, and Future," *Commercial Mortgage Backed Securities*, 1999.
2. A "cash-out" is when a borrower refinances in an amount in excess of the existing loan amount. The return available from an alternative investment that can be earned with the cash-out proceeds often justifies incurring the prepayment fee. A "roll-over" is when a borrower refinances in an amount equal to the existing loan. In this case a borrower might be willing to make the prepayment fee in order to lock-in a currently available perceived advantageous interest rate rather than taking a risk of accepting whatever market rate may be at loan maturity.
3. For issues on drafting, see Galowitz, Sam, W., "The Myth of the Yield Maintenance Formula," *The Real Estate Finance Journal*, 1999.
4. In fact, defeasance was in existence for years prior to the advent of the CMBS market but used only in limited situations where a borrower would replace real estate collateral with other real estate collateral.
5. Murray, C., John, (2001). "Enforceability of Prepayment-Premium Provisions in Mortgage Loan Documents," First American Title Insurance Company.
6. Assumes payments are based on a 30/360 schedule.
7. This yield must be adjusted to account for the difference between semi-annual yield (SAY) and monthly yield (MY). The formula is MY = 12[-1+1(1+SAY/2)^1/6]. "^" represents an exponential function.
8. Actually the available issue is May 15, 2004, not June 1, 2004. As such, the funds will sit in the defeasance account for 15 days before being released to the lender.
9. Accrued interest is the amount of interest the bond has earned as of the settlement date but will not be realized until the semi-annual payment date. When bonds are traded between payment dates the buyers are typically required to pay the sellers the amount of this accrual.
10. Bond yields and price have an inverse relationship. The higher the yield the greater the attractiveness of the bond, thus the price is bid down. The same holds true for the reverse scenario where yields are down, forcing price to rise to stimulate demand.
11. There are several other occasions where smaller balances are left idle in the account. The entire effect of this is estimated at an additional $5,000.
12. A REMIC is a Real Estate Mortgage Investment Conduit created by The Reform Act of 1986. The REMIC is a pass-through entity designed to hold real estate assets without incurring entity level tax.
13. New York State Commissions Advisory Opinion, Petition No. M991230A, February 25, 2000.
14. A further benefit to a CMBS investor is that the IRS is less likely to consider a defeasance an asset sale than if the prepayment is handled as a payoff. The retention of non-tax paying status is of utmost importance to the REMIC owners.

PROPERTY-LEVEL ANALYSIS: THE KEY TO SUCCESSFUL INVESTING IN TODAY'S CHANGING LANDSCAPE

by Kenneth P. Riggs, Jr., CRE, Jules H. Marling, Jr., CRE, & Ryan W. Harms

INTRODUCTION

Today, investors are looking at a much hazier economic environment for the future than a year ago. There is excessive uncertainty about future profits of both new and old economy businesses. Market expectations govern investment activity in all financial investments (capital chases risk-adjusted returns). Further, expectation levels can reach unbelievable highs (irrational exuberance) before predictably crashing, as witnessed by the dot-coms recently and real estate in the early1990s.

A close look at the psychology of risk, however, may allow real estate investors to use such doubt to their advantage. In general terms, risk is the uncertainty that an investment will not earn its expected rate of return. The larger the range of possible expected returns, the riskier the investment. Although risk is usually viewed from its volatility around its mean, behavioral finance confirms that investors do not mind upside volatility (but they despise downside movements). When discussing classic decision-making, economist Herbert Simon differentiates between investors displaying completely rational behavior and investors displaying "bounded rationality." According to Simon, bounded rationality is characterized by many factors, including emotional influences and the failure to understand all information (which creates an inefficient market). Exploiting the psychology of the market offers investment opportunities that have the highest return given a specific risk level.

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(Continued on page 15)

The three types of risk that a real estate investor faces are:

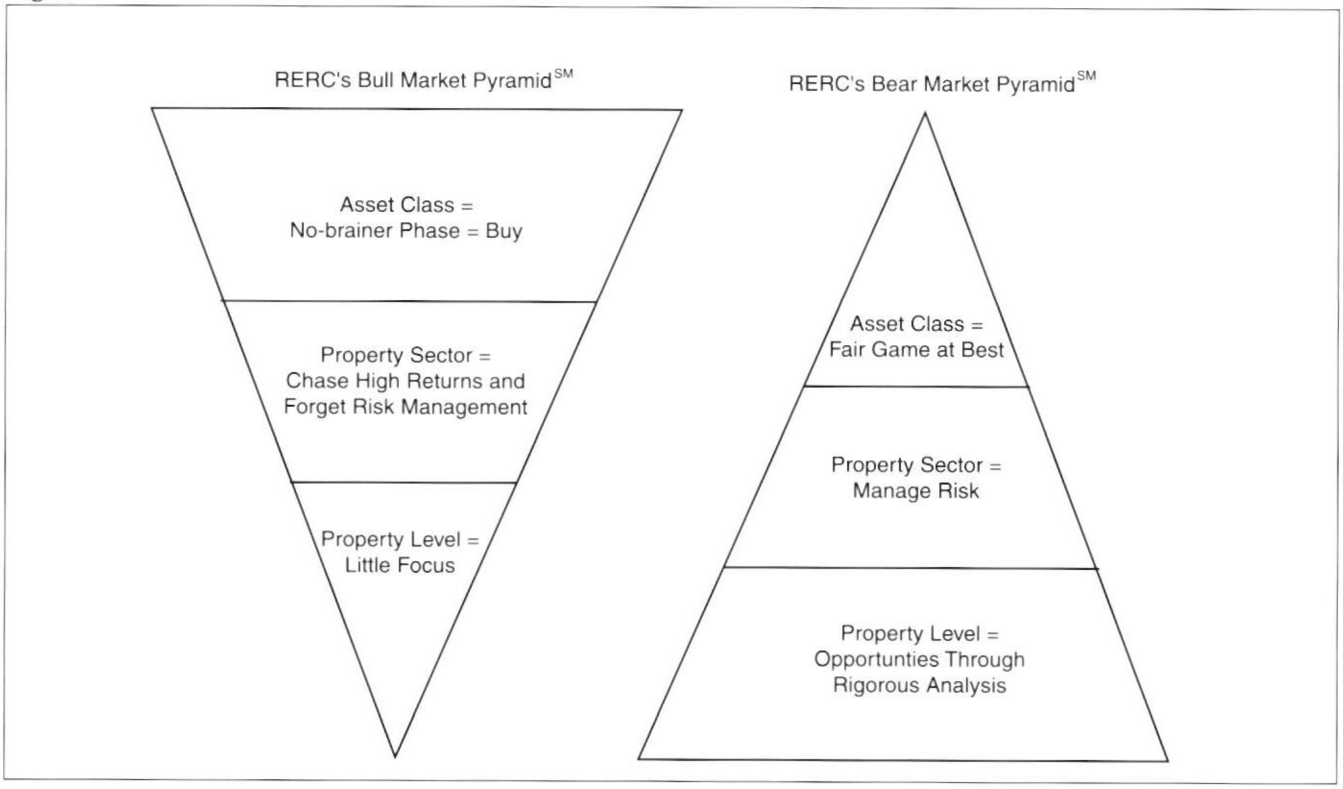
1. Overall market risk (i.e., national market risk of inflation, interest rates, capital flows), which is considered unavoidable;
2. Property sector risk (i.e., inherent risk differences among office, retail, industrial), which is theoretically avoidable and can be minimized; and
3. Individual property risk (i.e., physical characteristics, location, leases in place), which is avoidable.

In efficient markets, investors are not rewarded for the latter two forms of risk because theoretically they can be eliminated by diversifying your portfolio. However, real estate markets are not nearly as efficient as the stock and bond market. For example, managing risk (as opposed to managing the return on investment) in real estate markets is crucial for expected performance. In today's economic environment, and given the inefficiencies in the real estate market, an investor can identify opportunities at the individual property risk level, and thereby outperform the market by doing superior research.

The market's ability to seize on real estate opportunities has clearly shifted from the no-brainer investment phase of the late 1980s to a very selective property level opportunity base *(Figure 1)*. To be successful, investors have to shift their focus to meticulous property cash flow and price analyses, as demonstrated in *Figure 1*.

Identifying opportunities today, (either selling or buying commercial real estate assets), demands that investors be rigorously grounded in understanding property sector risk analysis—that is, they must be able to develop a credible cash flow forecast and to complete an unbundling analysis of the components of value to measure the relative risk of the asset. Investors also need to apply both fundamental and technical analysis to the property sector risk. By understanding the expected and required returns of a specific property, opportunities can be predicted. For example, a positive factor, such as a 12 percent future return minus 11 percent required return equals 1 percent positive satisfaction, indicates a buying opportunity; conversely, a negative factor indicates a selling situation. A critical piece of this analysis is developing insights into the market regarding investment criteria of available capital, discount and overall capitalization rates, property sector risk levels, and so on. Historically, such information has been limited to large institutional lenders, appraisers, consultants, developers, and advisors. Today, however, research firms offer this data to large and small investors and lenders in

Figure 1



such a way that opportunities with the appropriate risk level can be sought.

OVERALL MARKET RISK

Early in 2001, many investors believed that the real estate market had done such a good job of keeping supply in check that it would escape the same turmoil that the stock market experienced. However, this turned out not to be the case given that overall market risk is unavoidable. Real estate demand for space is driven by businesses' need for space in office and industrial properties. Also, hotels, along with the airlines and all other travel-related businesses, continue to depend on business travelers for an important part of their revenues. Finally, consumers, who represent some two-thirds of our economy, remain critical to the residential housing sectors of single-family and multifamily properties.

Through its surveys, Real Estate Research Corporation (RERC), determines perceived investment risk levels on metropolitan, regional, and national levels. Tracking the performance of property types in specific markets in terms of their price cycle is key to successful lending and investing. As shown in *Figure 2*, investors continue to be skittish and highly selective on an overall market risk level. A strong hold recommendation has continued to be the rule of thumb as prices in the last year have skyrocketed and investors have ridden the ship to the top.

There is a new capital order of discipline in the real estate markets—capital is rationally priced and allocated along the risk spectrum ranging from debt/mezzanine-preferred equity, to pure equity. Information gathered indicates that capital will be more restricted and lenders will become more particular in the coming months. What is more interesting is the perceived discipline of capital in the industry, as depicted in *Figure 3*.

The commercial real estate market is maturing and in turn, so is the discipline of capital. Investors must have a clear understanding of the relative discipline of capital flows to the market. A determination has to be made if capital is being rationally allocated (capital is chasing risk-adjusted returns) or if it is being thrown at the investment (capital is chasing product). As we saw in the late 1980s for real estate, and in the late 1990s for the tech sector, if capital is chasing product, then the market is doomed for large corrections later on. But for real estate today, capital is chasing risk-adjusted returns, which means that investors should look at real estate as a solid investment opportunity compared to alternative investments.

Yields have decreased in the past year, mainly due to the drop in interest rates. Required total returns usually follow the trend of interest rates, as investors and lenders are accepting a lower rate of return as deals become more positively leveraged. However, as risk has increased from economic conditions, going-in capitalization rates have edged up slightly and terminal rates have remained steady. As the gap between going-in and terminal capitalization rates narrows, investors' long-term perception of the market becomes cautious. Investors expect nothing above inflationary increases in property values as the market struggles to be in equilibrium.

Figure 4 reflects a positive message for real estate on a risk-adjusted basis. Discount and overall capitalization rates are properly aligned to provide an appropriate return to the asset class. Further analysis of this data indicates that the current spread of real estate's expected yield over 10-year treasuries is 600 basis points (bps). This is the largest spread that has been recorded since 1993 when the real estate market was at the bottom of its last cycle. In fact, it is at record levels since we have been tracking this data in 1979. This confirms the earlier observation of capital being disciplined—real estate is offering a solid risk-adjusted return in today's financial and economic environment.

As the economy stagnates, we can expect that those investors who have been sitting on the sidelines to "get out while the getting is good." This is another positive market signal, demonstrating that we have gotten rid of real estate's old mentality of "buy and hold forever." Large institutional players are "tapped out" of capital and sellers should prevail. As many prices have peaked, investors who have waited too long have asking prices above market value and are not about to attract potential buyers. This creates a sort of a stalemate until the future direction of real estate becomes clearer. Patient and astute investors can take advantage of this market factor by being on the buy-side of the equation.

PROPERTY SECTOR RISK

Office

Commercial real estate, and specifically office properties, has benefited greatly from the economy's recent bull run. NCREIF-realized returns for 2000 for all commercial property types were around

Figures 2, 3, 4

Figure 2

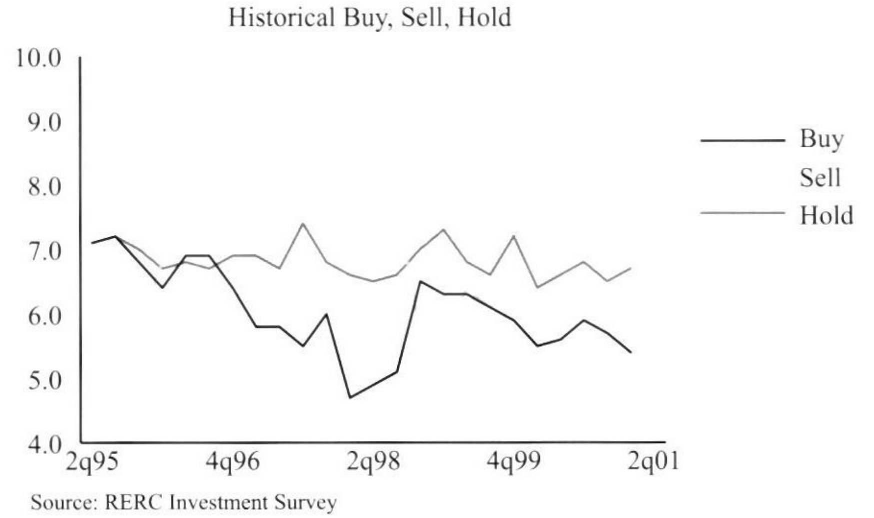


Figure 3

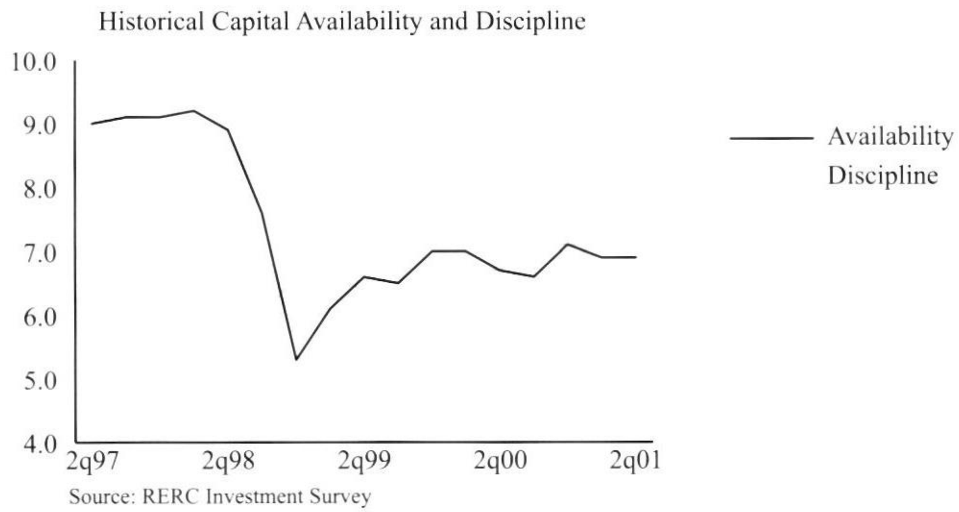


Figure 4

12.00 percent, while office properties turned in an overall return of 13.75 percent. The strength of the office sector was buoyed by CBD properties, especially those located in 24-hour market environments—Boston, Chicago, New York, Washington, D.C., and San Francisco.

Although office development capital continues to be very disciplined, the large corporate layoffs, dot-com closures, lost venture capital, company consolidations, and falling stock prices in the first half of 2001 are casting a shadow over future office demand. Investors evaluating the risk of CBD and suburban office properties are faced with very different market dynamics: supply-constrained markets (generally CBD properties) versus growth-driven markets (generally suburban properties). In today's market, supply-constrained environments are preferred. The authors expect that suburban markets will under-perform and that CBDs will be a fair market bet.

Industrial

Industrials are attempting to adhere to the solid fundamentals that have made them a property of choice for investors, but when opportunities are available, they have ventured into the new economy telecommunications/Internet business of high-risk, high-return deals. However, as is happening throughout the tech industry, telecom companies are being weeded out through mergers and closures. As a result, industrial space will generally become more abundant.

Distribution properties centered near major transportation hubs—especially airports—will continue to be market performers, while research and development properties and those built-to-suit dot-com companies will show the greatest industrial risk. Small, traditional properties located in major industrial hubs are expected to hold their own.

Apartment

From all vantage points—realized returns, expected returns, growth, and supply and demand—apartment investments are the least risky among the nine commercial property types. This continued high ranking has caused some investors to express concern about over-inflated prices and too much optimism, but apartments are delivering what the market needs—safety and stability. Certainly there are exceptions, but all in all, the multifamily sector continues to be strong and stable, and looks to top the real estate pyramid of property investments for 2001.

This low risk/high return forecast for apartment investors is supported by the age-old story of supply and demand. The population aged 18 to 34 years (typical apartment dwellers) is projected to increase by over 5 million people between 2000 and 2010. In addition, the immigrant population, which also typically rents, continues to increase. Further, census data for the last three years indicate that the fastest growing segment of apartment renters has been households earning $50,000 or more (this sector posted a more than 8 percent increase in the number of renters as compared to 1999), which suggests that people who in the past tended to steer away from renting are now choosing to rent. Even if the economy should slip into a full-blown recession, apartment demand is so strong that a recession can only help to ease record high rents and low vacancies. The return on risk for apartments is good, with low volatility.

Retail

The most publicized aspect of the retail sector in 2001 thus far has been the loss or decline among major retailers such as Montgomery Wards, J.C. Penney, Bradlees, Home Depot, and among major movie theater chains such as General Cinemas, United Artists Theatre Co., Loews Cineplex Corp., and Regal Cinemas. Malls have been traumatized from the loss of such anchors—the space is difficult to absorb, and often other inline tenants are lost.

The bright spots in retail properties are the large-scale players, especially the retail REITs and community centers, which are expected to outperform the rest of the industry. Still, the real estate retail industry, in general, takes on too much of the retail merchandising risk, and retail in general, will under perform other property types.

Property Sector Risk Summary

With the various property types, come different property cycles. Economic dynamics directly affect each of the property types differently. As would be expected, real estate is relatively slower to respond to changes in the economy as compared to many other businesses. Tenants that occupy commercial real estate are generally tied to long-term leases and do not quickly make major changes in a real estate occupancy in the face of a short-lived economic adjustment. The most important element to the relative health of the commercial real estate markets is the fact that new supply additions did not outpace demand, and in many cases, new supply significantly lagged behind demand. This is especially true for apartments in several regions of the country.

Knowing the background of a market and property type within a market can help to determine the risks and cycle length of a market. *Figure 5* and *Figure 6* review the expected performance of particular property types in the major markets around the country. As illustrated, each market and property

Figures 5 & 6

Figure 5

Metro Rankings

First Tier Markets	2001	2000	1999	1998	1997	1996	1995	1994	1993	1992	1991	1990
San Francisco	7.4	7.4	7.4	7.2	6.9	6.9	6.2	5.9	5.5	5.3	6.2	7.0
New York	7.3	7.3	6.8	6.6	5.7	5.7	5.0	3.8	3.0	3.5	3.8	6.2
Boston	7.1	7.0	6.8	6.8	6.6	6.9	5.8	4.7	3.6	3.0	3.5	6.1
Los Angeles	6.6	6.8	6.4	6.4	6.0	4.9	4.4	3.4	3.8	4.8	6.0	7.6
Washington, D.C.	6.6	6.8	6.4	6.4	5.8	6.5	6.9	7.0	6.0	4.9	5.6	7.3
Seattle	6.6	6.5	6.9	7.0	6.6	6.7	6.1	5.3	5.7	5.5	6.4	6.4
San Diego	6.4	6.5	6.3	6.4	6.1	5.9	5.1	4.5	4.6	5.2	5.4	NA
Chicago	6.3	6.6	6.6	6.6	6.2	5.8	5.3	4.7	4.2	4.4	5.6	6.7
Denver	5.7	5.4	5.5	5.7	6.1	6.6	6.3	6.1	5.1	4.1	3.1	3.4
Miami	5.5	5.7	5.6	6.1	5.5	5.5	5.5	5.0	4.3	4.2	3.7	4.7
Minneapolis	5.5	6.1	6.0	6.2	5.8	NA	NA	NA	NA	NA	NA	NA
Atlanta	5.0	4.9	4.7	5.1	6.0	7.1	6.7	6.6	5.7	4.9	4.4	5.1
Phoenix	4.9	5.3	5.4	5.2	5.5	6.2	6.1	5.6	4.9	4.2	3.3	3.4
Philadelphia	4.7	4.9	5.0	4.8	4.4	4.7	4.5	3.8	3.6	3.7	4.4	5.5
Dallas	4.5	4.6	5.3	5.6	5.9	6.0	6.1	5.5	5.2	5.4	5.4	4.8
Detroit	4.4	4.8	4.5	4.3	4.0	NA	NA	NA	NA	NA	NA	NA
Houston	4.4	4.8	5.5	5.4	4.9	4.8	5.4	5.1	5.0	4.9	5.2	4.9
St. Louis	4.4	4.5	4.6	4.5	4.7	5.1	4.7	4.1	3.7	3.6	3.8	5.0

Source: Emerging Trends in Real Estate

Figure 6

Property Markets Investment Potential

		1993	1994	1995	1996	1997	1998	1999	2000	2001
Apartments										
	Investment Potential	6.2	5.9	5.5	6.0	5.5	5.3	5.5	6.3	6.5
	Developmental Potential			5.3	5.9	4.9	4.9	5.3	5.6	6.1
** Industrial										
	Investment Potential	5.8	5.9	5.8	6.3	6.0	6.1	6.1	6.3	6.1
	Developmental Potential			5.2	6.0	5.8	5.9	5.9	5.7	5.8
Downtown Office										
	Investment Potential	2.7	3.6	4.0	4.7	5.3	6.2	6.6	6.6	6.1
	Developmental Potential			1.6	1.8	2.2	3.5	5.5	5.9	5.6
Research & Development										
	Investment Potential		3.9	4.7	5.0	5.4	5.9	6.1	6.2	5.9
	Developmental Potential			3.4	3.8	4.3	5.3	5.8	5.7	5.5
* Community Shopping Centers										
	Investment Potential	3.6	5.5	4.9	5.4	5.3	5.4	5.2	5.6	5.2
	Developmental Potential			3.8	4.5	4.3	4.7	4.9	5.4	5.0
Suburban Office										
	Investment Potential	2.2	4.4	5.5	6.0	6.2	6.1	5.6	5.5	5.0
	Developmental Potential			2.9	3.8	4.5	5.8	5.6	5.4	4.6
Hotels										
	Investment Potential	2.0	3.5	5.1	5.8	5.9	6.0			
	Developmental Potential			2.4	3.6	4.2	5.2			
Full-Service Hotels										
	Investment Potential							5.5	5.7	4.8
	Developmental Potential							5.1	5.1	4.5
Regional Malls										
	Investment Potential	5.0	5.5	5.4	4.9	4.9	4.6	4.7	4.7	4.4
	Developmental Potential			3.8	3.3	2.1	2.5	3.3	4.3	3.8
Power Centers										
	Investment Potential			5.3	5.3	4.1	3.9	3.8	3.7	3.3
	Developmental Potential			4.6	4.7	2.9	2.9	3.3	4.3	3.2
Limited-Service Hotels										
	Investment Potential							3.7	3.4	2.9
	Developmental Potential							3.4	3.3	2.7

*Before 1996, considered Retail - Other; in 1994, Power Centers were also added to Other Retail

**Before 1994, Industrial included both Warehouse and R&D

Source: Emerging Trends in Real Estate: 1993-2001 type has seen its peaks and valleys, but each has its particular time frame in which these cycles occur. For example, New York, which in the early 1990s was considered the worst city in the country in terms of investment potential, is now considered one of the best, ranking only behind San Francisco (which may suffer as the tech-centered cities will decelerate at a much quicker rate than the diverse old economy cities). The suburban office sector is another example of a property type with a historically short investment cycle. In 1993, suburban office was considered the worst property type in terms of investment potential, while in 1997 it was considered one of the best.

The majority of property types in most markets today are fairly priced, and in the best of cases, will perform in a manner that is consistent with market expectations. In other words, the market is pretty much in equilibrium. Opportunities at this vantage point are limited, and as a result, the authors maintain that one thing that investors hoping to find true opportunities in today's mature real estate market may do is look to the second-tier cities that have been ignored. Once an opportunity has been identified, an individual property risk analysis should be completed to confirm its volatility.

INDIVIDUAL PROPERTY RISK ANALYSIS

Property selection (tactical) decisions take precedence over strategic decisions (asset allocation and property sector) in today's slowing market. Further, the authors believe that property selection or underwriting is the key to successful investing in any type of real estate investment environment (if property performance fails, the capital structure will not save your returns). For real estate, the focus on strategic issues, which incorporates modern portfolio theory (MPT), is spurred by studies on investment performance for stocks and bonds. These studies have concluded that 85 percent to 95 percent of overall investment returns arise from the asset class selected and the weight assigned to the asset class regarding long-term asset allocation decisions. The belief is that good stock or bond pickers may add some value over time, but the major source of investment return and risk over time is the asset allocation decision. This may be true, and to a lesser extent, to real estate as an asset class. But regardless of the quality and thoroughness of the asset allocation decision, if an investor has pooled marginal properties, the performance will suffer.

The authors subscribe to Warren Buffet's statement on investing courses: "What you really want an investing course to do is to teach you how to value a business—as that's how you evaluate a stock. You determine the value and compare the price." To the authors, this is the bottom line—investing in real estate assets or properties that will generate solid earnings that create value and can be held and/or sold to produce a profit.

This supposition is evident in the pricing of real estate through the selection of discount and overall capitalization rates applied to various property types. The market generally uses a very tight band of rates to value properties throughout the U.S., although there are clearly different risk factors for an office in Washington D.C., versus San Francisco, for example. Risk management through property level cash forecasting suffers because of linear forecasting (i.e., the belief that the market goes in the same direction as it did in the recent past). Additionally, the market fails to complete honest downside scenarios. Investors need to complete scenario analyses of best, worst, and most likely cash flow forecasts. Understanding this market characteristic and exploiting the resulting price inefficiencies allow investors to make better investment choices in a decelerating market environment.

An improved understanding of markets and property economics can be obtained through research, market analysis, and property-specific due diligence. While obtaining information on individual properties (income and expenses, conditions, environmental problems, etc.) requires work, it can be accomplished through a fairly simple and straightforward process. The understanding obtained through this process substantially reduces risk.

CONCLUSION

The information age has provided the real estate market with more advanced methods to research and identify opportunity markets and property opportunities within a market. Properties can now be analyzed on a microscopic level as compared to yesteryear when only national information was readily available. Physical market data, sub-market, or property-specific information can be downloaded from the comfort of your own home. For the first time in history, both institutional and non-institutional investors have about the same access to information.

Employment reductions, dissolving companies, and fading consumer confidence are all current issues. However, institutional investors and lenders have learned many lessons from the past, and despite the current weariness, opportunities still exist. Identifying these opportunities, however, will take more time and effort as decelerating markets, the tech sector fallout, and other events like the energy crisis place greater emphasis on research and property selection. In this market, just putting a chip on the table does not guarantee a profit.

Imperfections in the real estate market do not correct themselves as quickly as they do in other financial assets that are traded in a continuous auction market place (such as stocks, bonds, and other marketable securities). Because real estate is illiquid, imperfections in the market can exist for considerable periods of time. Opportunities exist for investors who are capable of spotting these imperfections and quickly accessing capital to take advantage of them before the opportunity is gone. Real estate also lends itself to research and market analysis that can greatly increase an investor's understanding of the economic fundamentals affecting a potential investment in a specific property. Research and analysis, properly done, substantially reduce risk. In today's market environment, this is essential to success.

While it is difficult to predict precise market timing, it is not difficult to spot a trend and profit from it by relying on fundamental economics and market analysis, coupled with a rigorous property level analysis. To choose a real estate investment, it is necessary to analyze both the market and the specific property. Focusing in on property-level factors in today's shifting economic and real estate environs is the key to successful investing on a risk-adjusted basis. REI

NOTE

The **RERC Real Estate Report** summarizes the expected rates of return, property selection criteria, and investment outlook of a representative sample of large institutional investors and regional firms in the United States. The survey data is used as a tool by investors, developers, and financial institutions to monitor changing market conditions and to forecast financial performance. The RERC survey acts as a barometer of current market perceptions and confidence among the nation's top real estate professionals. Return data shows a normal range of expected returns for categories of investment-grade properties in 21 markets and nine property types.

ABOUT THE AUTHORS *(continued from page 8)*

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THE MYTH OF THREE INDEPENDENT APPROACHES TO VALUE

by D. Richard Wincott, CRE

Despite the fact that the Appraisal Institute now teaches that the three traditional approaches to value—the Cost Approach, the Income Capitalization Approach, and the Sales Comparison Approach—are interrelated, there are still a large number of appraisers who adhere to the premise that they are completely independent methods of estimating value.[1] This is evident in numerous appraisals that the author has reviewed, and in actual court testimony witnessed by the author. The focus of this article is to further the notion that the three approaches are not only interrelated, but the results of each approach are an integral part of achieving a reliable estimate of value. In other words, the three traditional approaches, when dealing with income producing real estate, are components of an overall Market Approach, and in fact should be renamed the Cost Analysis, the Income Capitalization Analysis, and the Sales Comparison Analysis.

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Income producing properties are purchased based on their future income generating capabilities. Each of the three traditional approaches to value may come at the issue of value from a different direction, but in the end it all boils down to the economics of the property. The Appraisal Institute teaches that the appraiser is supposed to "model and mirror" the market. As a result, the analysis must attempt to reflect the normal buyer calculus used in the purchase decision. This does not imply that the appraiser should not use sophisticated techniques to analyze that process, but it does mean that the appraiser should not be using outdated appraisal techniques that do not remotely resemble the thought process of the market. The most notable of those out-dated techniques is the adjustment grid in the Sales Comparison Approach for improved properties based on physical units of comparison.

Investors have a consistent thought pattern when addressing what price they are willing to pay for a property. First, and foremost, it is the income producing potential of the property that drives the decision. As a result, they have an optimum operating scenario in mind; they have an opinion as to how long it will take to achieve that level of operation, as well as how much it is going to cost to get there; they will make a comparison of the price they are paying with the cost to reproduce the property; and without exception, this author has never talked to investors who didn't think they could operate a property better than the owner they bought it from. Considering these factors, all of the information generated from the three approaches to value have relevant input into the value decision, but no matter what the methodology, the final answer is a function of the income estimate.

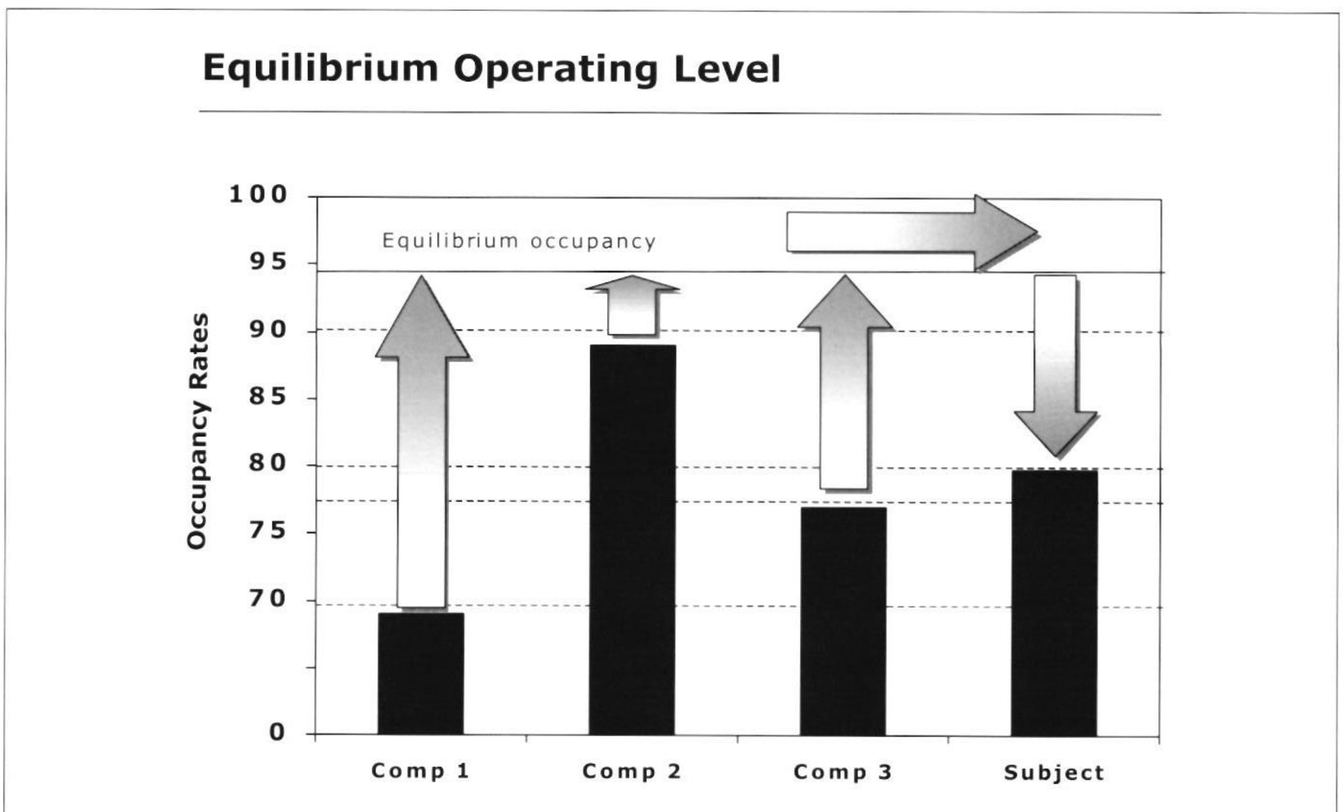
OVERALL PREMISE OF VALUE

With the underlying theory that an investor's goal is to maximize investment, the most important first step is to establish a common point of reference. Traditional appraisal theory states that comparables are to be adjusted to the property being appraised. This premise is correct, but achieving that result has quite often been reached by using flawed analysis, especially in the Sales Comparison Approach. An example would be where the subject property has an 80 percent occupancy rate, and the comparable sales range in occupancy from 70 percent to 90 percent. While one could quantify the adjustments to the sales having lower occupancy rates by adjusting for the time and economic loss associated with achieving the 80 percent occupancy level, adjusting the sales with occupancies in excess of 80 percent down to that level presents a myriad of analytic problems. The appropriate method is to model the process used by the potential buyers. That is to establish the equilibrium, or stabilized, operating level as the common point of reference.

Simplistically, this involves adjusting the comparable data to a stabilized value level, appraising the subject property based on that stabilized operating scenario, then adjusting the stabilized subject value either up or down to reflect the current operating condition of the property. Graphically, this process is demonstrated in *Exhibit 1*.

This process is consistent with how most purchasers view the investment process. The various issues

Exhibit 1



to be considered relative to achieving stabilized operating status include:

- the time that will be required to lease excess vacant space to achieve a stabilized occupancy level;
- the present value of the loss in rental revenue during that time period;
- the dollar magnitude of leasing costs, such as commissions, tenant improvements, legal fees, etc., that accompany the leasing activity;
- the dollar magnitude of capital expenditures that are immediately required to maintain competitive market position;
- the present value of remaining lease contracts that are significantly above or below current market rent levels.

Of course, where the properties are at a stabilized operating level at the time of sale, consideration of some of these items may not be required.

Income Capitalization Approach

For investment grade real estate, the Income Capitalization approach has evolved into two separate forms of analysis, the direct capitalization analysis and the discounted cash flow analysis (DCF). While they represent two distinct approaches, assumptions that are explicit in the DCF are implicit in the direct capitalization analysis. If completed appropriately, the resulting value estimates should approximate each other. In the direct capitalization analysis, a stabilized net operating income (NOI) is estimated, and this income estimate is capitalized into a value indication through the use of a stabilized overall capitalization rate derived from market data obtained from the Sales Comparison Approach. This process indicates a stabilized property value that is then adjusted for any of the factors that exist within the subject property that cause it to vary from that stabilized operating assumption to arrive at an "as is" estimate of value.

Inherent in this analysis is the estimation of the market rental rate and the normalized expense level for the property. The process of estimating market rent and expense levels for the subject property effectively makes most of the adjustments necessary to reflect differentials between the subject property and competing properties—for quality, location, age, condition, and functionality. Traditionally, appraisers have attempted to quantify each item through the use of an adjustment grid, applying a relative percentage or dollar amount to each factor. Reality is that tenants in the various properties have already voted on the cumulative impact of these items with their check books. If a particular property has an advantage over other properties with respect to location, quality, etc., it is reflected in the contract leases that that building has obtained. The same type of comparison can be made with respect to functionality through NOI estimates. For example, if a particular property has an inefficient HVAC system, the extent of the inefficiency would manifest itself in a higher than typical utility expense. This would cause the property to have a lower net operating income relative to competing properties. If these factors are correctly addressed in the NOI estimates, the use of stabilized overall capitalization rates becomes a much more consistent process, requiring only consideration of the relative risk involved in achieving those estimates.

While there are innumerable theoretical nuances to the various issues raised in this discussion, the fact remains that the ultimate estimate of value is based upon an inseparable interrelation of the three traditional approaches to value. These interrelationships are critical in arriving at a reliable estimate of value. Assumptions derived from one approach form the basis for the analysis in another.

In the DCF analysis, a cash flow model is constructed to reflect the specific timing of economic events. In essence, the DCF is a cash-based financial model, while the direct capitalization analysis is an accrual-based financial model. If the subject property is currently not operating at a stabilized level, the initial years of the cash flow model reflect the market's perception of the events that will occur between the valuation date and the estimated date of achieving stabilized operation. Following that point, cash flow models generally reflect continued operations at a stabilized level, subject to contract lease expirations. An additional element of the DCF analysis is to estimate the value of the property at the end of the investment holding period. This is generally based on the use of a direct capitalization analysis assuming stabilized operations at that point in time. Since both the DCF and the direct capitalization analyses have the same underlying investment assumptions, the results should approximate each other, and there are methods of testing the compatibility of the various assumptions used in each approach.[2]

Considering this view of the investment process, the value of a particular property is theoretically equal to the present value of the current lease portfolio, and the right to get the building back empty. The issue of getting the building back is not literally gaining possession of an empty structure, but having the ability to roll all leases to a stabilized occupancy rate at market rent levels. Therefore, the issue of an estimated holding period should be a function of remaining contract lease terms and the current market position in the real estate cycle, not strictly a given 10-year holding period.

Sales Comparison Approach

The primary purpose of the Sales Comparison Approach is to derive units of comparison from market data that give inference to current pricing levels. This factor results in numerous conclusions coming out of this analysis in addition to the traditional estimate of value. While it is typical to find references in appraisals to various sources of capitalization rate and discount rate data in the Income Capitalization Approach, reconciliation of those data sources is ultimately dependent upon the capitalization and discount rates derived from comparable sales data. This factor alone underscores the interdependency of these two approaches.

The traditional sales comparison approach methodology involves establishing a common unit of comparison, such as price per square foot, price per unit, price per room, etc., and adjusting that unit of comparison for the comparable properties to arrive at an indication of value for the subject property. What needs to be understood is that these "price per" units of comparison are market artifacts, and not the sole basis for the comparison. These units of comparison are useless without accompanying economic points of reference. Market participants anecdotally talk about the price per square foot, but the ultimate question is "compared to what?"

To simplify the remainder of this discussion, the author will focus on the analysis of an office building. Research has indicated that on a stabilized basis the most influential factor affecting the sales price per square foot is the net operating income (NOI). After adjusting comparable sales data to a stabilized price equivalent, linear regression analysis indicates a strong positive correlation between the sales price per square foot and the NOI per square foot. As the NOI increases, the price per square foot will tend to increase. In fact, our experience has been that in the large majority of cases, the R^2 resulting from this analysis is in excess of .90. That means that generally 90 percent, or more, of the variations in the sales price per square foot between properties can be explained by the corresponding NOI per square foot.

A second common unit of comparison for office buildings is the effective gross revenue multiplier (EGRM). This is the relationship between the stabilized effective gross revenue and the sale price. Here again, any differences between properties with respect to location, quality, condition, etc., have been resolved by the market through the actual rent achieved by that property. Considering this factor, the primary remaining point of comparison becomes the operating efficiency of the various properties as exhibited by the differentials in expense levels. This analysis can be accomplished by plotting the relationship of the EGRMs relative to the expense ratios for the various comparable sales. It generally reflects an indirect relationship between these two factors. As the expense ratio increases, the profitability of the property decreases, thereby causing the EGRM to decrease.

In both of these instances, once the comparable sale price has been adjusted to the corresponding stabilized price level based on information obtained by the deal participants, the requirement of a subjective adjustment process is basically eliminated. The use of this methodology is a direct reflection of market thought and behavior. All too often appraisers will attempt to go through an adjustment process using dollar amount, or percentage adjustments for location, condition, quality, etc., largely based on subjective assumptions. First, the author has never talked to a buyer or seller who prices property on that basis. Secondly, the use of that methodology is primarily a result of the appraiser not completing sufficient research to obtain the required income data on the comparable sale. The notion that the Sales Comparison Approach is an independent approach actually stems from this second issue. It seems to be an excuse for not completing the analysis adequately, rather than a theoretical reality.

Cost Approach

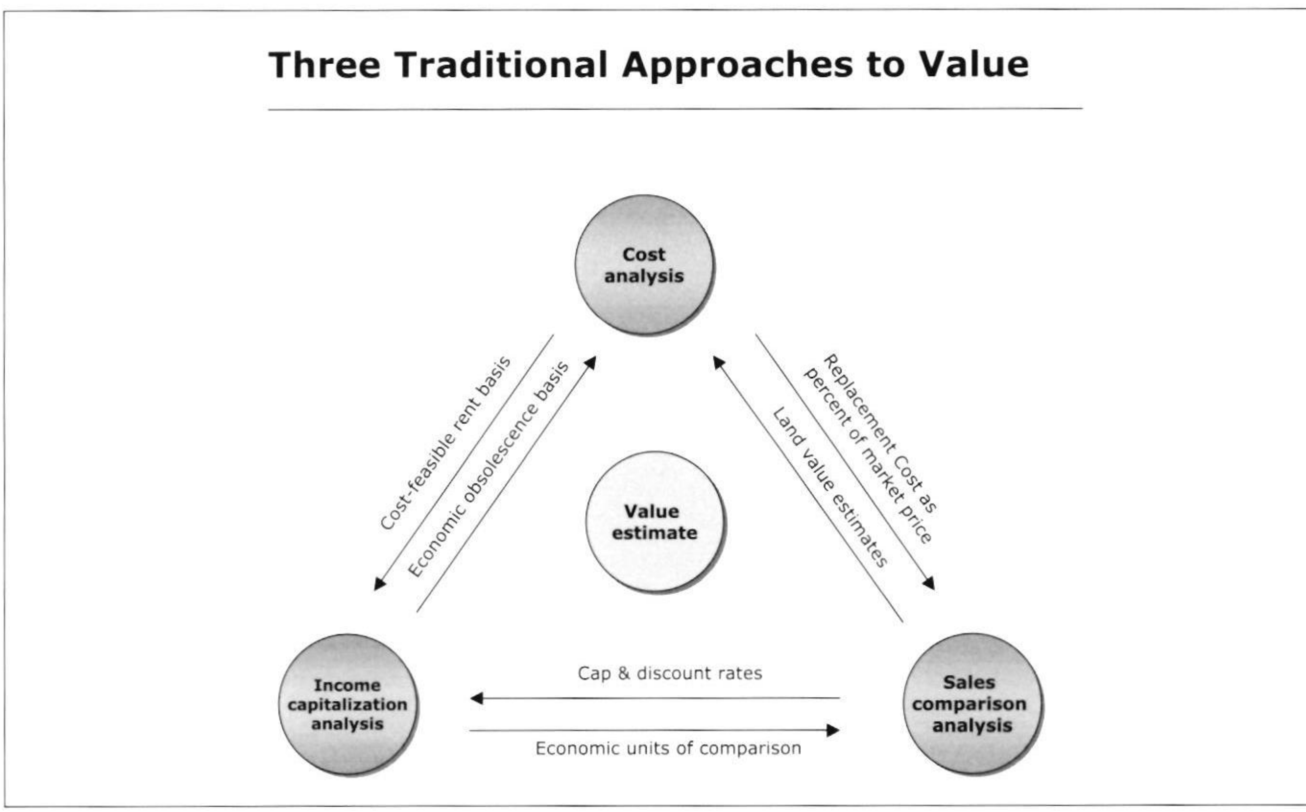
The Cost Approach is the most misunderstood and maligned points of analysis in the appraisal process. Over the past decade, because of downward pressure on appraisal fees and a disconnect in real estate development economics during the latter part of the 1980s, it has often become the practice to delete the Cost Approach from most appraisals. The reasoning typically stated for this departure from standard appraisal practices has been that it is not a relevant indicator of value, or it was omitted at the client's request (primarily to keep the fee down). Keep in mind that there are situations where the Cost Approach is a primary consideration, such as special purpose properties.

The issue of whether or not the Cost Approach is a relevant indicator of value provides further evidence of the interrelationship of the three approaches. The basic concept of the Cost Approach is that the replacement cost of the improvements, less accrued depreciation, plus land value "assumed vacant" equals an estimate of the property value. The accrued depreciation estimate is where the relationship between the Cost Approach and the Income Capitalization Approach is inescapable. While one can estimate physical deterioration on an independent basis, the estimates of functional and economic obsolescence are based on the current economics of the property relative to the market. As a result, the calculation of the obsolescence resulting from functional and economic abnormalities is circular, and therefore the value estimate by the Cost Approach would always approximate the Income Approach value estimate unless the market was perfectly in balance.

Despite this fact, a Cost Analysis is an integral part of the valuation process, particularly as it relates to office buildings, industrial properties, apartments, hotels, and some retail properties. The term "Cost Analysis" was used because the relevant point of reference is the replacement cost of the property. Particularly in recent years, the replacement cost of a property relative to the price is a decision point in a majority of the purchaser's analysis. From an analytical perspective, it is one of the critical inputs when estimating future movement in rental rates. Analysis of future rent estimates revolves around market equilibrium, and therefore the issue of cost-feasible rent levels.

In markets where current rent levels are depressed because of over-supply situations, the extent of upward movement in rental rates will be a function of cost-feasible rent levels. The current market recovery has demonstrated that "rent spikes" are a market reality. The extent of those increases will be affected by that cost-feasible rent number, since once cost feasible rent levels are achieved in

Exhibit 2



the marketplace new construction will typically become a reality. The point is that understanding the dynamics of that market process is contingent upon having an estimate of the replacement cost of the property as a basis.

CONCLUSION

While there are innumerable theoretical nuances to the various issues raised in this discussion, the fact remains that the ultimate estimate of value is based upon an inseparable interrelation of the three traditional approaches to value. *Exhibit 2* illustrates some of the primary connection points.

These interrelationships are critical in arriving at a reliable estimate of value. Assumptions derived from one approach form the basis for the analysis in another. In fact, since assumptions that are explicit in one approach are implicit in another approach, wide variations in value estimates from the three approaches for a particular property would tend to indicate that the analysis in one of the approaches is flawed. The use of various tests of reasonableness in an appraisal can be a very powerful tool to demonstrate the reliability of the value estimate. Therefore, a thorough Market Approach encompassing the Cost Analysis, Income Capitalization Analysis, and Sales Comparison Analysis is critical to the appraisal process.$_{\text{REI}}$

NOTE

This is an adaptation of an article that first appeared in the September/October 1997 issue of Valuation Strategies (RIA); *it has been reprinted with permission. This rendition is the first in a series of three articles by this author; two additional articles, written specifically for of* Real Estate Issues, *will follow in upcoming editions of this journal.*

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The Future of the Residential Real Estate Brokerage Industry

by G. Donald Jud & Stephen Roulac

The real estate brokerage business is on the cusp of a radical transformation brought about by the revolution of cyberspace technology and the globalization of business. This new technology is crushing established institutions and opening up new venues of change. In this manuscript, the authors examine how the new cyberspace technology is altering the residential brokerage business, how it will change institutional structures, and how it will shape the ways in which brokerage business will be conducted in the future.

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Stephen Roulac, JD, Ph.D., AICP, CPA, CMC, *is CEO of The*

(Continued on page 30)

THE TRADITIONAL BROKERAGE BUSINESS

In 1997, there were 129,333 establishments operating in the real estate brokerage business, employing 783,518 persons with a total payroll of $21.9 billion.[1] The average brokerage firm was small, with a staff of 6.1 persons and a total payroll of $169,451. Ninety-five percent of all brokerage firms employed 19 or fewer persons. Less than 1 percent of all firms employed 100 or more persons.

The small size of most brokerage firms indicates that scale economies have been absent in the industry. Traditionally, individual agents have been more important than real estate firms were to home sellers selecting a listing agent. Likewise, most homebuyers have searched for and found their homes using real estate brokers. The National Association of Realtors (NAR) reports that when home buyers are asked where they first learned about the home they bought, 80 percent of buyers report that they learned about the property from a real estate agent; 43 percent respond that they saw a newspaper ad; and 37 percent learned about the property by searching the Internet (Roth, 2000).

FORTHCOMING CHANGES IN THE BROKERAGE BUSINESS

Historically, the brokerage business has existed because of the lack of market information. Buyers and sellers needed brokers to assemble market information that was too costly and time-consuming for them to amass on their own. Up through the mid-1800s, lawyers, bankers, and other business persons were the most common intermediaries in a real estate transaction (FTC, 1983). As the size and complexity of the real estate market increased, real estate brokerage developed as a business specialty. The brokerage firm operated with an independent contractor model, paying sales agents out of commissions and charging customers only commissions for closed transactions. Although brokerage fees are nominally negotiable, most customers accept the so-called standard commission without much discussion. And, because of industry business practices, few firms made meaningful investments in technology and training.

The National Association of Realtors (NAR) was formed in 1908. Early on, NAR began to encourage local boards to create multiple listing services (MLSs) to reduce search costs and to lobby state legislatures to enact legislation that institutionalized the agency relationship between the real estate broker and the client. These institutional relationships, which have been in place across the country since the 1920s, are now being challenged because of sweeping technological and legal changes.

The Challenge of the Internet

The new technology of cyberspace has wrought a sea of change that is making the search for housing much cheaper and easier (Tessler, 1999). Real estate Web sites like *Realtor.com*, sponsored by NAR, *Home-Advisor.com*, sponsored by Microsoft, and others allow potential buyers to search available properties by location or zip code and narrow the search by adding information on desired amenities and price range. Many sites also provide virtual tours of home interiors, allowing buyers a 360-degree look at each room. When Web searchers find something that meets their specifications, they can e-mail their interest to the seller or the listing broker.

Web sites also provide buyers and sellers with basic information about the home-buying process, loan qualification, and the other basics of a real estate transaction. They offer information about communities such as tax rates, school test scores, crime rates, etc. And they provide links to service providers: mortgage bankers, moving companies, utility providers, etc. Some also offer tools like mortgage loan calculators and links to online appraisal services.

These online services are provided free to consumers. The online service providers make money by selling advertisements and links to other Web sites. Thus, there is competition among sites to offer the most services to capture the highest traffic volume. Real estate Web sites represent substantial resource commitments by their sponsors and there is continued pressure to expand and consolidate to capture an ever-larger market share. This dynamic augers for substantial change in the brokerage industry and the way services are provided.

For years, brokerage firms have worked together to increase the efficiency of housing search through local multiple listing services. By cooperating and sharing information through their MLS, brokers reduced the cost and raised the efficiency of search. Because access to the MLS was available to market participants only through member brokers, the MLS gave members an informational monopoly. Now, however, with the availability of free market information online, the power of the MLS monopoly is greatly reduced. Almost everyone now has access to market information through the Web, and the real estate broker is no longer the gatekeeper to the housing market. The result is that search costs for buyers and sellers are greatly reduced.

The Internet makes real estate markets more efficient because it increases the quality and quantity of information available to buyers and sellers. It allows market participants to make better-informed decisions at lower costs. From an industry perspective, however, the demand for brokerage services is a function of the cost of search. Falling search costs reduce the demand for brokerage services. Because the Internet makes real estate market search easier and provides more information at a lower cost, it reduces the demand for real estate brokerage services.

The falling demand for brokerage services is illustrated in *Figure 1* by a shift in demand from D to D′. Falling demand brought about by lower search costs puts downward pressure on prices, or commissions and fees. This is illustrated in *Figure 1* by a fall in price from P to P′. Total revenue in the brokerage industry also falls from PAQO to P′BQ′O, as the quantity of brokerage services produced declines from Q to Q′.

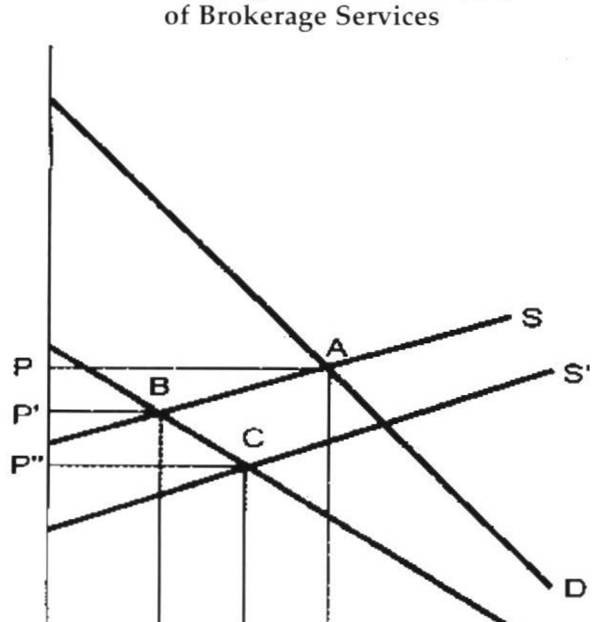
In addition to lowering demand for brokerage services, the Internet also makes demand more elastic because consumers (home sellers and buyers) have the easily available substitute of searching the real estate market using the Internet. Home sellers can list their properties on for sale by owner (FSBO) sites and buyers have expanded search opportunities.

The Internet, e-mail, and other electronic innovations also make possible greater efficiency in the delivery of brokerage service.[2] In *Figure 1*, this is illustrated by a shift in the industry supply curve from S to S′. Competition for survival will force brokers and firms to become more productive by mastering the new technology. And enhanced productivity will put still further downward pressure on prices. In *Figure 1*, this is shown by a drop in price from P′ to P″. Because the demand for brokerage services has become more elastic, the reduction in price from P′ to P″ raises total revenue from P′BQ′O to P″CQ″O and increases the quantity of service provided from Q′ to Q.″

Those individuals and firms that remain will need more education and technology to survive.

Figure 1

The Changing Demand & Supply of Brokerage Services



The Internet makes real estate markets more efficient because it increases the quality and quantity of information available to buyers and sellers. It allows market participants to make better-informed decisions at lower costs.

Only by increasing the level of investment in information technology can brokers raise their operating efficiency to levels that will allow them to remain competitive. And this dynamic will necessitate that firms become larger and more capital intensive, which are contrary to the traditions of the industry. Many small firms will exit the industry, while others will seek to survive through merger and consolidation.

Legal Changes

In the absence of institutional frictions retarding the movement of human and physical capital, we might expect that the brokerage industry—faced with declining demand and increasing needs for investment capital to meet competitive pressures to rise producer productivity—might be absorbed by larger service-sector industries. However, the process of industrial consolidation is more difficult in the brokerage sector because of the legal morass that has engulfed the industry over the past two decades. Beginning in 1983 with a report by the Federal Trade Commission (FTC, 1983), the industry has been charged with failing to disclose whom the broker really represents, and the industry has appeared deceitful and untrustworthy to many consumers. In addition, an increasing number of product liability lawsuits have been directed at brokers owing to their agency status in real estate transactions.

These legal problems have stimulated NAR and others to push to reduce the broker's legal liability by creating a form of non-agency client representation that has become known as "transactional brokerage." Transactional brokerage is a means of providing neutral third-party real estate brokerage services to buyers and sellers and at the same time reducing the liability of the broker (Evans, 1999b). By replacing the common law of agency with state statutes that clearly define broker and agency relationships, the movement to transactional brokerage hopes to make brokers no longer subject to court cases in which the common law of agency either has set or will set a precedent of broker liability. The new statutes will clearly define the duties and responsibilities of brokers, thus eliminating the basis of many liability lawsuits. A number of states, including Colorado, Florida, Georgia, Kansas, Pennsylvania, and Texas, have moved or are moving in this direction.[3]

The elimination of the liability problems that threaten the industry will have two effects. First, it will put further downward pressure on commission rates and fees. When brokers come to be seen not as agents but only as transactional middlemen, it will become harder for the industry to uphold traditional commission rates. The clear precedent here is what has happened in the securities industry, since the time commission rates were deregulated. This change in legal status will thus heighten the downward pressure on rates. Second, with the removal of the impediments of potential legal liability, entry into the industry will become easier and less threatening to service firms and others, furthering the movement toward merger and consolidation.

THE FUNCTIONS OF THE BROKER

In thinking about the future of the brokerage industry, it is useful to emphasize that brokerage services for the most part are an information commodity. The Internet makes it possible for information products to be produced dynamically based on the needs and wants of the consumer. Information technology also makes possible the personalization of information at little or no additional cost (Smith *et al.*, 1999). In this section, we consider the functions that the broker performs and how these functions are likely to change with the Internet.

Brokerage Services Offered to the Seller

According to Blanche Evans (1999a) the broker performs the following eight services for the *seller:*

1. Advice on fix-up prior to showing;
2. Advice on calculating the listing price;
3. Listing the property in the MLS and on the Internet;
4. Assistance with marketing, including signs, brochures, tours, open house parties, and other advertising;
5. Providing potential buyers with information on various financing alternatives;
6. Negotiating the offer;
7. Arranging the closing;
8. Troubleshooting the gap between offer and closing.

Looking over the list, it is clear that the Internet alters the method of efficient delivery for all of these eight services. All of the services that entail the broker relaying information to the home seller—advice on fix-up, marketing assistance, listing the property, negotiating the offer, arranging the closing—can be done faster and easier by utilizing the Internet rather than relying only on personal communication between the broker and the seller. Web sites can easily provide check lists for sellers to follow when planning fix-up activities, listing the property, developing their marketing plans, negotiating offers, and arranging the closing. Some sellers may still need or want personal contact with a broker to answer questions and provide advice, but many will not, and the savings will translate into increases in broker efficiency.

Other services like calculating the listing price and offering financing advice to potential buyers are areas where traditionally the broker has had specialized knowledge that made his/her services essential to sellers. With the Internet, however, such knowledge is widely and easily accessible to all. Sellers can easily check listing services on the Web or purchase a Web-based appraisal of their property when determining a listing price. Likewise, the Internet offers a wide array of mortgage sites, which will pre-qualify a buyer and provide information on loan terms.

The last service on the list, troubleshooting the gap between offer and closing, entails checking on loan applications, keeping track of inspection reports, arranging utility hook-ups, etc. Here the broker coordinates and manages all of the activities from acceptance of the offer to final closing. The Internet makes this coordination process easier and the broker more efficient Evans (1999a, p. 200) suggests that soon every real estate transaction will be posted online. Every service provider—loan officers, inspectors, attorneys—will deliver reports to the transaction site, allowing the broker to monitor the progress to final closing.

Brokerage Services Offered to the Buyer

Considering services provided by the broker to the *buyer*, Evans offers the following list of activities:

1. Pre-qualifying the buyer;
2. Matching the buyer's needs and wants against his/her ability to pay;
3. Help with search;
4. Showing the property;
5. Help with the offer;
6. Assistance with inspections;
7. Help with financing;
8. Help with the closing.

Scanning the list, it is again clear that the Internet makes the broker's job easier and more efficient.

Web-based services provide information to the buyer that make it easier for buyers to obtain information on their own, without broker assistance. Once again, while some buyers may still need or want personal contact with a broker to answer questions and provide advice, many will not, and the savings will translate into increases in broker efficiency. Only item four on the list (physically showing the property) remains an area where the traditional role of the broker is unchanged. However, even here, there is no reason that this service cannot be purchased from vendors over the Internet.

DIRECTIONS FOR FUTURE CHANGE

In this section, we outline five scenarios for change in the brokerage industry. The five scenarios are: 1). the FSBO Model; 2). the Unbundled Services Model; 3). the Alternate Delivery Model; 4). the Product Extension Model; and 5). the Financial Supermarket Model. The scenarios are outlined in *Figure 2*, which shows how the basic services now provided by real estate brokers will be offered under each of the five scenarios.

The FSBO Model

In the FSBO (for sale by owner) model, the Internet becomes the medium through which buyers and sellers are able to interact directly, unaided by brokers or other middlemen. Here there is complete disintermediation of the real estate market.

Figure 2

Scenarios for Change in the Brokerage Industry (where brokerage service will be offered)

	FSBO Model	Unbundled Services	Alternate Delivery	Product Extension	Financial Supermarket
Services Offered to Seller:					
1. Advice on fix-up prior to showing.	Internet	Broker/Other	Broker/Internet	Broker	Bank/Other
2. Advice on calculating listing price.	Internet	Broker/Other	Broker/Internet	Broker	Bank/Other
3. Listing property in MLS & on Internet.	Internet	Broker/Other	Broker/Internet	Broker	Bank/Other
4. Assistance with marketing.	Internet	Broker/Other	Broker/Internet	Broker	Bank/Other
5. Information on financing alternatives.	Internet	Broker/Other	Broker/Internet	Broker	Bank/Other
6. Negotiating offer.	Internet	Broker/Other	Broker/Internet	Broker	Bank/Other
7. Arranging closing.	Internet	Broker/Other	Broker/Internet	Broker	Bank/Other
8. Troubleshooting between offer & closing.	Internet	Broker/Other	Broker/Internet	Broker	Bank/Other
Services Offered to Buyer:					
1. Pre-qualifying buyer.	Internet	Broker/Other	Broker/Internet	Broker	Bank/Other
2. Matching buyer's needs & wants.	Internet	Broker/Other	Broker/Internet	Broker	Bank/Other
3. Help with search.	Internet	Broker/Other	Broker/Internet	Broker	Bank/Other
4. Showing property.	Internet	Broker/Other	Broker/Internet	Broker	Bank/Other
5. Help with offer.	Internet	Broker/Other	Broker/Internet	Broker	Bank/Other
6. Assistance with inspections.	Internet	Broker/Other	Broker/Internet	Broker	Bank/Other
7. Help with financing.	Internet	Broker/Other	Broker/Internet	Broker	Bank/Other
8. Help with closing.	Internet	Broker/Other	Broker/Internet	Broker	Bank/Other

Sellers list their properties on Internet listing services, much like they do now with electronic auction services like *eBay.com* and others. A current example of this model is *fibonetwork.com*, which is an online link to for-sale-by-owner sites across the county. The site not only allows buyers to search for homes in their area, it also offers advice on home selling and buying and links to online mortgage brokers and appraisers. So far, the site does not permit online auctions. Another example is *homebid.com*, which offers homes listed by brokers for sale online at auction.

In the FSBO model, competition among Internet service providers for online traffic ensures that new information and services will continually be provided on the Web. Buyers and sellers are able to select the services they want to best assist their particular transactions. Service providers advertise on the Internet to buyers and sellers who may need or want their services. All services are unbundled, so that a home seller who may need help, for example, on negotiating an offer, arranging a closing, or troubleshooting between acceptance and closing, can contact potential vendors and purchase these services over the Internet. Likewise, home buyers who may want help, for example, with viewing a property, inspections, financing, or closing will be able to purchase these services on the Internet. Real estate brokers may choose to offer these services, but they will be in competition with attorneys, paralegals, and other service vendors who may enter this market.

Unbundled Services Model

In the unbundled services model, in contrast to the FSBO model, real estate agents survive as a profession, but service offerings are unbundled. Agents offer consumers a menu of services from which the consumers are able to choose. Such services may include pricing the property for sale, negotiating the contract, managing the contract through closing, etc. An example of unbundled services in the area of appraisal is available on the *Wall Street Journal* Web site (www.homes.wsj.com), which allows potential home buyers and sellers to easily look up the recent selling prices of particular homes in specific neighborhoods all across the country. The site also provides neighborhood information on such factors as school quality, climate, income levels, etc.

The Internet revolution puts more control in the hands of buyers and sellers because they can obtain information more easily. Consumers can pick and choose the brokerage services they desire. In the past, consumers have had to consult brokers to obtain information. Now, information is provided free on the Internet. The rational for the local MLS no longer exists. MLS services are provided directly to consumers by Internet service providers, who are engaged in a fierce competitive struggle to maximize service offerings to attract traffic. Brokers are forced to offer services on a fee for service basis and competitive forces put downward pressure on fees.

Arguably, information advances, rather than eliminating the role of intermediaries can create multiple new niche markets for specialized, intermediary functions (PikeNet 2000). Those who provide the information, whose widespread availability challenges the traditional brokerage model, will necessarily be compensated for providing that information. If the information intermediary does not receive a commission for the transaction, then that intermediary will receive revenue through advertising, sale of allied information products, or some other economic benefit for business opportunities derivative of the function of providing that information. Interestingly, some individuals now working for salary and other forms of compensation for the Internet enterprises that provide information and services that threaten the traditional brokerage model, previously worked as sales agents in traditional brokerages.

Alternate Delivery Model

In the alternate delivery model, the full-service broker model continues to co-exist with the unbundled service model. Kim and Mauborgne (1999) remind us that competition in some industries centers around price and function, while other industries compete on feelings, using an emotional appeal. In the brokerage industry, the traditional appeal has been emotional. Consumers have been encouraged to trust their agent (broker). This appeal has been very effective for many people for whom the purchase or sale of a home is one of the largest financial transactions that they will ever undertake. Because real estate transactions involve extraordinary stress, the broker role appeals to the emotional need for a trusted adviser. Many consumers will still want advice and guidance from someone they can trust. Here the traditional, established brokerage firm with a reputation for competence and trust will be able to offer consumers help and advice as part of a total, full-service package.

For other, more independent consumers, the brokerage industry traditionally has offered many extra services that add cost without enhancing functionality. By stripping these extras away, some firms may begin to offer a fundamentally simpler, lower-cost model of service. In this kind of model, the discount brokerage firm would offer a fee-for-service price structure for services like pricing and listing the property, showing the home, negotiating the contract, etc. In this model, agents would be specialists providing services that the consumer would be free to select and add to their shopping carts as they moved through a transaction. And by moving from an emotional appeal to a more functional orientation, brokerage firms adopting this model may find a competitive advantage that may now be lacking.

Because of the revolution in information technology and the changing legal environment, the authors foresee a residential brokerage industry characterized by the crumbling of the MLS informational monopoly; the abandonment of agency law; the unbundling of services; anD the rise of fee-for-service pricing. The days of the small local firm protected by a close-knit trade association are passing fast, as widespread change engulfs the brokerage industry.

The Product Extension Model

Creating new market space often can be the key to prosperity for brokerage firms caught in a very competitive environment. Kim and Mauborgne (1999) assert that creating new market space "requires a different pattern of strategic thinking" and they point out that a common way to create new market space is by finding product and service offerings that are complementary to the firms' basic product or service. In the product extension model, brokerage firms create new market space by offering consumers such complementary products or services.

Most products and services are not used in a vacuum. Usually, the availability of other products and services affects their value. Kim and Mauborgne emphasize that untapped value is often hidden in complementary products and services, but the key to unleashing this value is to define the total solution buyers seek when choosing a product or service.

When selling a home, for example, households often need a variety of services besides traditional real estate brokerage. Many may need help finding a new home, help with financial planning, assistance with moving, tax advice, help with managing utility service cut-offs, etc. Similarly, when buying a new home, consumers may need assistance with such things as moving, utility connections, and the entire range of needs and wants related to becoming settled in a new residence and a new community, such as home improvements and interior decoration. Brokerage firms that make it easy for their customers to obtain these additional services may be able to substantially enhance the value of their overall service package. Smaller brokerage firms may lack the human and financial capital to effectively extend their service offerings. In such cases, strategic partnerships and alliances with larger service firms may allow them to offer the extra services some consumers demand.

The Financial Supermarket Model

In the financial supermarket model, large financial service firms recognize that they possess two elements required in the brokerage industry. First, they have the human and financial capital necessary to allow brokerage firms to cope with the demands of the information technology revolution. Second, they can offer the complementary products and services that real estate buyers and sellers may want as part of a real estate transaction.

In this scenario, real estate companies look for assistance from financial service firms for financial capital and technological experience, and firms in the financial service industry look toward real estate brokerage as a way to bring additional customers into their services networks.[4] A real estate transaction generates a great deal of data about the buyer and the seller that when captured by an information network becomes valuable in target marketing additional products. The transactional information can offer financial service firms a way to create new market space, thus providing them with a competitive advantage in what has become a very competitive economic environment.[5]

Looking only at the sales of existing, single-family homes suggests that the potential market is quite large. In 1997, for example, there were some 4.2 million homes sold at an average price of

$124,000, generating a transaction volume of some $520.8 billion. If this volume of transactions were to generate only 5 percent in additional fees and profits from the sales of other products (for example, brokerage commissions, mortgage origination fees, etc.), it would potentially add some $26 billion to the bottom lines of those services companies that capture it.[6]

Because the cost of housing represents a household's largest expenditure, companies offering financial supermarket services as well as related services are attracted by the opportunities that are derivative of relationships with homeowners. Specifically, the opportunities to cross-market other services to households is extraordinary (Roulac, 2000). Consequently, major companies can be expected to seek a closer alliance with the real estate brokerage transaction as a means to expand relationships and pursue cross-marketing objectives.

The traditional real estate broker in this scenario evolves into a real estate marketing specialist, providing sellers advice on pricing, showing, negotiating, etc. and buyers help with inspecting various properties, obtaining financing, making an offer, negotiating, and moving. And brokers increasingly are employees of larger service firms who have the resources necessary to finance the continuing investments in needed information technology. Real estate buyers and sellers are able to purchase a wide array services such as appraisal, marketing advice, financial assistance, etc., under the umbrella of the large financial services firm.[7]

SUMMARY

Because of the revolution in information technology and the changing legal environment, the authors foresee a residential brokerage industry characterized by 1). the crumbling of the MLS informational monopoly; 2). the abandonment of agency law; 3). the unbundling of services; and 4). the rise of fee-for-service pricing. The days of the small local firm protected by a close-knit trade association are passing fast, as widespread change engulfs the brokerage industry.

In the foregoing discussion, the authors outlined five scenarios for future change. At the current juncture, it is not possible to say which of the scenarios will come to dominate, and the final reality may well comprise elements of all five. The authors are certain, however, that the big winners in the new reality will be the consumers: the home buyers and sellers who will be provided with better, more timely information at lower costs.$_{\text{REI}}$

NOTES

1. U.S. Bureau of the Census, *County Business Pattern,1997 United States)*, CBP/97-1.
2. Jud, Winkler, and Sirmans (2001) examine the impact of information technology on real estate licensee income. The authors use 292 completed surveys (out of 983 surveys sent for a 29.7% response rate) of real estate licensees who are members of the Greensboro Regional Realtors® Association (in North Carolina). Their combination of factor analysis and regression modeling shows that use of information technology has a positive impact on the earnings of real estate licensees.
3. See, Miedema (1998) and Merin (1999).
4. The recently passed financial restructuring act (the Gramm-Leach-Billey Act of 1999, Public Law 106-102) maintains the traditional separation between banking and commerce which prohibits financial service companies from directly engaging in real estate brokerage, but it does not bar financial service companies from owning real estate subsidiaries. The Gramm-Leach-Billey Act permits a bank holding company that qualifies as a financial holding company (FHC) to engage in any activity that has been determined by the Board of Governors of the Federal Reserve to be "financial in nature." In December 2000, the American Bankers Association has asked the Fed to determine that real estate brokerage and management activities are financial in nature. The National Association of Realtors has urged the Fed not to permit FHCs to engage in real estate brokerage activities and has mounted a strong lobbying effort to oppose the change.
5. Recently consumer advocates have expressed concern that large financial conglomerates many share confidential information among subsidiaries.
6. A recent report by Banc of America Securities estimates that residential real estate brokerage commissions presently total some $18.8 billion annually (Rich, 2000).
7. The purchase of Better Homes and Gardens Real Estate Network by GMAC; the formation of HomeAdvisor Technologies as a partnership of Microsoft, Freddie Mac, Chase Manhattan, GMAC, Norwest Mortgage, and Bank America; and the entry of Goldman Sachs into commercial real estate brokerage are all instances of the movement of financial service firms into the real estate arena.

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The Fat Old Bird that Forgot How to Soar

by Douglas C. Kaplan

PREFACE

Real estate agency is little more than a marketing ploy. It doesn't exist and never has existed. It is the industry's way of playing "Let's Pretend."

Simply put, "agency is a *consensual, fiduciary relation* between two persons, created by law by which one, the principal, has *a right to control the conduct of the agent*, and the agent has *a power to affect the legal relations of the principal.*" [1]

But the *real estate agent* doesn't operate under the control and direction of the principal and is powerless to legally bind him. As one interested in the transaction (no deal, no fee), the *real estate agent* cannot render fiduciary services. Without each of the foregoing ingredients, agency does not and cannot exist.

Like the fruit of the poisoned tree, *real estate agency* has sprouted: *buyer's agency, seller's agency, dual agency, limited agency,* and *designated agency* — all adding tension to the pretension. Export of this quagmire to the Internet (the new real estate marketplace) results in unimaginable confusion and exposure.

Daily, buyers in 50 states deal with sellers and brokers from all over the country, indeed, the world. Listing brokers are acting under every conceivable Agency relationship. Cooperating brokers, buyers, and sellers may live in states that do not recognize the listing broker's Agency relationship. Or, by statute, they define it differently. Or they

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make it illegal. Confusion abounds, disappointment is assured, and liability is inevitable. A simple solution, however, can resolve it all.

EVEN THE MIGHTY

A president of the United States was humbled when he deluded himself into believing that his high office would protect him from disclosing embarrassing personal misconduct.

A company, whose very name conjured the image of the automotive tire industry, faced untold litigation and economic travail when the general public discovered that the company had failed to disclose a known peril generated from the manufacture of its tires.

Tobacco, an industry with major economic and political clout on state and federal levels, was traumatized to the tune of billions of dollars in judgments when the public discovered that corporate executives withheld disclosure of the addictive nature of a harmful substance.

Yet mere ***disclosure*** is not a solution—whether it be of illicit sex in the White House, defective tires that kill, or commonly used harmful, addictive substances. Why? Because disclosure alone solves nothing. It simply exposes the problems.

Conjure the image of a banner in front of the White House depicting the activity in the Oval Office, or a sign on a tire company stating, "y'all take care," or an inscription on cigarette packs suggesting that they may be dangerous to your health. In the following paragraphs, you will see a real estate brokerage industry beset by serious problems that will *not* be resolved by disclosure.

THE REAL ESTATE BROKERAGE INDUSTRY FACES TWO MAJOR CRISES THAT WILL, IF LEFT UNATTENDED, BRING IT TO ITS KNEES:

BROKER (LICENSEE)-CLIENT RELATIONSHIP: THE FIRST CRISIS

AGENCY (SMOKE AND MIRRORS)

It does not take a rocket scientist to understand that an agent who must bring you to the closing table in order to earn a fee cannot be your fiduciary and cannot prefer your interests to his own.[2] Such a proposal is childish and flies in the face of human nature. The agent gets nothing for his efforts unless he walks his principal through a contract to the closing table. The agent is an *interested party* in the transaction.

The industry has been so married to the fiction of agency and fiduciary duty that the fear exists that a divorce will leave the industry in wrack and ruin. In truth, unless the industry levels with the American public, its future is grim.

What is stunning is that enterprising lawyers throughout the country are not already defending sellers in lawsuits simply by asking the agent:

> "As you are an interested party in the transaction, how can you provide fiduciary agency services to the principal?"

Perhaps, real estate agency has sustained itself like the legendary cartoon character, Wile E. Coyote, who runs off the crest of a mountain and lingers comfortably in midair—*that is, until he looks down*! The industry has been so married to the fiction of agency and fiduciary duty that the fear exists that a divorce will leave the industry in wrack and ruin. In truth, unless the industry levels with the American public, its future is grim. Indeed, even this bold caption on the masthead of the real estate contract will do nothing to correct the problem:

> "Beware! Your agent is not your fiduciary and cannot represent you, as your agent has an independent self-interest in this transaction."

EXAMPLES

Recurring examples of real estate agent's conflicts of interest are endless:

A. Within a few days of the expiration of an exclusive listing, the seller's agent produces a buyer for 15 percent under market. Will seller's agent recommend the sale in order to avoid the loss of the commission that inevitably would occur at the termination of his listing? How would that dilemma impact fiduciary obligations?

B. Seller's agent presents seller with two offers. One is from his own customer and one from another agent. Which is he likely to recommend and what effect would that have on his fiduciary obligation?

C. Seller's agent provides seller with a proposed listing price. The lower the listing price, the more likely the sale will result during the listing period. Does this put seller at a disadvantage? What effect does this have on seller's agent's fiduciary obligations?

D. Seller's real estate agent has several similar properties listed. He shows one property. The buyer appears interested and, thus, the agent does not show the other properties. Has the agent breached his fiduciary relationship with the other sellers listing similar properties?

E. Buyers rarely, if ever, pay a commission to a buyer's agent. A buyer's agent usually is paid by sharing seller's listing commission with seller's broker. Incredibly, the more a buyer has to pay for the property, the more a buyer's agent profits for himself. What effect does this have on the buyer's fiduciary obligations?

F. An accepted practice for sellers is to offer a bonus to a buyer's agent who effectuates the sale. Often this bonus is tied to a condition that the buyer purchase the property at listing price by a given time. How can buyer's agent perform a fiduciary obligation to buyer while taking advantage of so tempting a seller's inducement?

Well, what solutions exist? The simplest answer is to have agents compensated for time and services and not compensated based upon whether they produce the deal. Then, the agent has no interest in the transaction because the agent gets paid whether or not a deal generates. Sadly, fee for time and services has never been a reality for real estate brokers. And it never will be. It is time to stop bowing down to idols of complexity, confusion and misdirection, and to earnestly start worshiping at the church of simplicity.[3]

TRANSACTION BROKERAGE (BLOWING AWAY THE SMOKE)

What does work—even over the violent protests of those who look to agency as their "security blanket"—is *transaction brokerage.* This relationship is in the nature of an independent contractor. A transaction broker crafts a transaction between buyer and seller, assists in the details, but does not pretend to represent either party.

In its simplest form, transaction brokerage is a relationship similar to that of the contractor who builds a home for a lot owner. The lot owner agrees with the building contractor, for a stipulated price, to perform a service, to build a house. The contractor is to use its best professional skill and experience in rendering that service. When the job is completed, the contractor is paid for its efforts. Under no circumstances, however, is the building contractor an agent of the lot owner. The contractor simply renders a professional service for a fee and does not pretend to be a fiduciary.

The transaction broker functions in the same way. He/she agrees to render a service—to sell your property or to find you a property—for a stipulated fee. The transaction broker does not pretend to subordinate itself and its interests to those of its client.

Transaction brokers are governed by the ethical requirements of the state licensing statutes and industry standards of ethics. But they don't dangle the unnatural and spurious notion that the licensee is the client's fiduciary and will put the client's interests above their own.

A significant number of states, recognizing the inherent problems of agency and legal exposures for licensees, have adopted transaction brokerage as one of its available brokerage relationships. Indeed, responsible sources in many states, including Florida and Colorado, (both states being at the cutting-edge of transaction brokerage), acknowledge that most of the licensees in their states have found honesty, comfort, and safety without diminution of earnings in the transaction broker relationship.

Transaction brokerage is not a panacea. It will not cure all ills created within the real estate brokerage industry. What it will do is make buyers and sellers more self-reliant and self-vigilant, peeling away the specious, misleading veneer, suggesting that an agent will promote the client's interests over the agent's own interests.[4]

FACING FRUITLESS FICTIONS

Until recently, the real estate brokerage industry has been in the awkward situation of trying to find and identify itself. Structures like *sub-agency* (an imaginative, but severely-flawed fiction) tried to impose an agency relationship between the seller and the broker who found the buyer. The vestiges of sub-agency, where it still exists, are museum pieces.

The industry replaced sub-agency with yet another fiction—cooperation between seller's agent and buyer's agent. Presumptively, this arrangement was created to justify the buyer's agent's sharing in a seller's agent's commission because, historically, buyers don't pay commissions. (How would a bar association view a successful plaintiff's attorney's sharing his fee with the lawyer for his adversary?)

DUPLICITOUS DUAL AGENCY

Of greater significance is the "**eyes wide shut**" industry attitude *concerning dual agency*. Dual agency occurs when one broker attempts to represent *both* buyer and seller, notwithstanding conflicting fiduciary relationships to each. Rocket scientists aside, integrity compels the conclusion that it is impossible to represent two commercial adversaries at the same time.

The traditional inquiry is, "How can one get the highest price and best terms for the seller, while at the same time getting the lowest price and best terms for the buyer?" That dual agency even exists in many states is testimony to overreaching, and insult to the dignity of honest commerce.

Even more insidious are the structures that seek to hide dual agency under such clone names as designated agency or the hybrid of transaction brokerage that tacks on "limited representation" of parties. Some states have sought to destroy the efficacy and simplicity of transaction brokerage by grafting on repugnant, contradictory powers. This is especially true in Florida where the legislature has granted to the transaction broker the power to offer "limited representation." The word "representation" is a code word for agency. The effect of such action in Florida is to contaminate transaction brokerage by tacking on an agency component, disguising it as a veritable wolf in sheep's clothing.

CONCEAL THE PROBLEM UNDER A MOUNTAIN OF DISCLOSURES

The core of the industry's problem lies in its abuse of the agency relationship, distorted to serve the industry's own uses. Ever wonder why brokerage disclosures are longer and more complex than the contract of sale and purchase? These disclosures describe the multiple kinds of relationships (often multiple forms of agency) effected by legislative changes in definition, e.g., buyer's agency, seller's agency, limited agency, dual agency, and designated agency. The disclosures do nothing but accentuate the confusion. Frequently, licensees cannot explain the disclosures that change after every statutory or regulatory session.

The core of the industry's problem lies in its abuse of the agency relationship, distorted to serve the industry's own uses.

The public is adrift in a sea of misdirection, a vessel without a rudder, without a chart, without a compass—piloted by a helmsman with a special interest in heading to his own home port.

LEGISLATIVE LETHARGY

Critics have opined that the real estate brokerage industry is incapable of saving itself. State legislatures often are the unwitting puppets of the industry and its lobbyists: They make token, ineffective, and confused efforts at corrections. But they end up with legislation that further confounds the problem—Band-Aid legislation. The public now finds itself with 50 different definitions of agency-dominated relationships that promise (in 50 different ways) *something that never can be*. Many states have *approved double-dealing dual agency*, promising to both sides that which it can deliver to neither side. Some states have enacted dual agency clones, such as designated agency or the hybrid of transaction brokerage that tacks on "limited representation" to clients.

REMOVE THE HEART

While still calling the relationship, *agency*, other states have actually attempted (by statute) to remove fiduciary obligations from the definition of real estate agency, a change that renders *agency* an amoral, mindless, soulless zombie. What ever happened to professionalism?

THE NEW ELECTRONIC ERA: THE SECOND CRISIS

The coming of the new electronic era has made a bad situation insufferable. Much of the property marketed today is offered through Web sites on the Internet. Significant industry plans require the sharing of listings by the year 2002.[5] The industry already has embarked across cyberspace on a voyage lacking a flight plan or destination.

THE AGE OF THE "INTERFRET"

What does a buyer in New Jersey know about the legal relationship he/she is undertaking with a broker in another state when that buyer simply opens a Web site to review the listings? Indeed, this may be the listing of a Web site broker, or of imported and adopted listings of another broker (functioning on a different contractual basis) or of listings from a broker in a neighboring state (operating under other laws).

A. Does the unsuspecting buyer know in what capacity (i.e. buyer's or seller's agent, dual agent, or transaction broker) the Web site broker is serving and how that affects the buyer?

B. Does the unsuspecting buyer know his/her new legal relationship under the statutory definitions of the Web site state?

C. Does the unsuspecting buyer know what is confidential and what the broker in the other state must disclose?

D. Does the unsuspecting buyer know to whom the Web site broker's pretended fiduciary obligations flow?

Moreover, can a dual agent in a Web site state that authorizes dual agency conduct business with a buyer in another state (such as Florida) where dual agency is unlawful?

More significantly, what are the exposures to the licensees trapped in the conflicts of laws between the states? And how do the state courts sort these conflicts out?

Doubtless, the Internet has dragged the real estate brokerage industry, kicking and screaming, into interstate commerce under the United States Constitution. Therein lies the intensification of its problems and a unique possibility of solution.

TEMPLATE FOR A SOLUTION: THE ELECTRONIC RECORDS & SIGNATURES IN COMMERCE ACT

In January of 2000, the president of the United States signed into federal law an enactment passed by both Houses of Congress providing that a document would not be deemed ineffectual simply because the signature was signed electronically.[6] No one yelled "federal preemption" or "state's rights" because the federal enactment made sense. The new law did not preempt jurisdiction over the substantive contents of the documents. Presumptively, that remains within the province of the several states. It dealt only with the legality of the manner by which the documents and signatures were communicated. That new law was the only way to assure freedom of commerce in a nation impacted by the electronic age.

Earlier, ineffectual efforts had been made to approve electronic signatures by offering, in each state legislature, a uniform act to accomplish this goal. Each legislature has been tempted to modify the act to suit itself. The modifications, if enacted, would have resulted in, after a decade of wrangling, 50 different acts—hardly a solution. The federal government *could and did* resolve the confusion existing throughout the several states with a single uniform act.

THE SIMPLE SOLUTION

The way is clear to slay the many-headed Medusa of agency, together with all of its venomous offspring. The real estate industry can purge itself of the toxins of agency by looking to the Commerce Clause of the United State Constitution and **by creating and supporting a single federal statute making non-fiduciary (transaction brokerage) the uniform default standard for all real estate broker licensee relationships throughout the country.**

The right to license real estate brokers and salespersons, and the enforcement of those privileges, would remain (as it does now) in the state of origin. The state in which an action is venued would continue to enforce the law, with due consideration for conflicts of laws, very much as it does today. The confusion generated by a multiplicity of broker relationships or diversity of their definitions, however, would be eliminated.

With one stroke of the pen of the president of the United States, a vital, honorable, professional real estate brokerage industry can emerge to conquer the business challenges of the 21st century—one pen-stroke that makes volumes of confounding disclosures disappear, and one that will dance across the Internet bringing honesty and candor back to the real estate profession. No other viable alternative exists.

The status quo is no alternative. It is merely an invitation to the muckrakers, to the Federal and State Trade Commissions, and to a legion of trial lawyers to pick on the bones of a **fat old bird that forgot how to soar.** REI

NOTES

1. Professor Warren A. Seavey in *Restatement of Agency, Law of Agency*. The legal requirements of agency are: (1) The relationship must be consensual. That is, both parties must agree to its existence. (2) A fiduciary relationship must exist between the principal and the agent. (3) The agent must function under the control and direction of the principal within the

scope of the agency. (4) The agent must have the ability to affect the legal rights of his principal.

2. Douglas C. Kaplan, Esq., "When It Comes To Agency The Industry Needs To End 'Let's Pretend'" The Real Estate Professional (November/December 1996).
3. Ironically, most industries that profess similar agency brokerage services (e.g., boat brokers, insurance brokers, business brokers) appear to be governed by the cases and state laws of the real estate brokerage industry.
4. In a September 2000, report, the Florida House of Representatives Committee on Real Property & Probate Committee on Business Regulation & Consumer Affairs reported in its conclusion that "the committee members supported an initial presumption of a transaction broker relationship, with the right of the real estate licensee to act as a single agent pursuant to the written authorization of the buyer or seller, as appropriate."
5. The following Statement of Multiple Listing Policy became effective upon approval by the National Association of Realtors Board of Directors on May 22, 2000: "Associations of Realtors and their Multiple Listing Services are encouraged to immediately, and must by January 1, 2002, enable MLS Participants to display on Participants' public Web sites aggregated MLS active listing information through, at Participants' option, either downloading and placing the data on Participants' public access Web sites or by framing such information on the MLS or association public access Web site (if such a site is available) subject to the requirements of state law and regulation."
6. The "Electronic Signatures in Global and National Commerce Act," January 24, 2000.

By Repealing the Basis Step-up on Death, Did Congress Bury the Estate Tax or the Taxpayer?

by Mark Lee Levine, CRE

Introduction

The following article was prepared after the execution, by President Bush, on June 7, 2001, of what has been labeled as the "Economic Growth and Tax Relief Reconciliation Act of 2001," herein sometimes referred to as the EGTRR Act, or the "Act."

Under the Act, Congress repealed the position that existed in §1014 of the Internal Revenue Code, which allowed, in most instances, the basis to a beneficiary of property received from the estate of a decedent to be deemed to be, in most settings, the fair market value of the property, on the date of death of the decedent.

This simply meant – notice the past tense – as an example, that if "D" died owning a property worth $1 million, with an adjusted basis to the decedent of $100,000, the beneficiary, receiving the property from "D" on "D's" death, would generally have received a basis of $1 million, thereby eliminating the potential income tax on $900,000 in the example given.

Under the 2001 Act, the beneficiary, with several exceptions noted below, would now receive a basis of $100,000 for the asset(s) in question.

What needs to be understood by real estate practitioners (and "potential decedents") is the simple, above-noted example, in which such change could result in additional income tax to beneficiaries, where no such

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income tax would have existed under the law immediately prior to this new Act.

Shortly before penning the final comments and portions of this article, I raised the question with one of the top real estate lobbyists in Washington, D.C., as to the reason for the exchange or payment by the real estate industry in "trading" or giving up the step-up in basis. That is, one would certainly be delighted with benefits under the new Act, but the question is raised as to whether one might surrender or give up the benefit of the increase in basis that existed prior to the new Act. Were the benefits so valuable as to substantially outweigh the costs or loss of the increase in basis that existed prior to the new Act?

The lobbyist noted that the surrender of the benefit of the increase in basis, as a payment for some of the other benefits under the Act, has been questioned by this lobbyist and many others. The saving grace, noted by the lobbyist, which is indicated further along in this article, is the potential that some of the detrimental issues under the Act that impact real estate, such as loss of the increase in basis, may never come into play as this new provision may be repealed prior to its application date. (Details on this point are discussed below.)

Such response is only partially acceptable as an "answer" to the query. Why was anything required to be paid for the benefit if, in fact, the purpose of the new Act was to return money to taxpayers, not to require some *quid pro quo* payment for such benefits under the Act? This portion of the query was never answered by the lobbyist, aside from a candid response that the lobbyist and others remain in doubt as to why the legislation had moved along some of the lines that it did, "necessitating" the *quid pro quo* of giving up basis for some of the benefits.

There were many positions that could be asserted for repealing basis in exchange for other benefits, assuming the basis benefit was of limited value, *vis-a-vis* the other benefits that were received under the Act.

It is also true that taxpayers in the United States have paid a large mix of many taxes over their lifetime. These taxes include many that continue to exist today, such as income taxes, sales taxes, use taxes, excise taxes, property taxes, employment and unemployment taxes, special industry taxes, and much more. The common taxes that are faced by taxpayers in all walks of life, such as sales taxes, are certainly regressive and apply to the millionaire who purchases a piece of clothing as well as to the $8.00 per hour laborer. Advocates for the repeal of estate tax argued that this Act at least rids us of one more tax.

Most taxpayers would not challenge or argue that the repeal of the estate tax is acceptable and is to be encouraged. As is true with most of us, when we are offered a "free ticket," we gladly accept it. However, when informed that the "ticket" is not free, but has some charge to it, we hesitate reaching out for the "free ticket," until we are aware of the cost of those tickets.

Because of this mountain of taxes and the huge surplus that "apparently" existed when this legislation was discussed, Congress, with leadership from the president, approved a "giving back" Tax Act that was designed to benefit taxpayers in refunding some of "their" taxes, gleaned by the federal, state, and local governments through many of the taxes indicated.

The question was also raised, specifically regarding estate tax, as to why such tax should exist in the first place. Arguably the taxes that are obtained through an estate tax are simply a tax on earnings that in many instances were already taxed through salaries that were paid. Thus, when Taxpayer "X" receives a salary for the year of $80,000 and pays various taxes from that $80,000, whether that be income taxes, employment taxes, or others, the taxpayer then seeks to take part of that gross earnings amount and provides for an estate-building opportunity. This estate-building opportunity may be the purchase of tangible or intangible assets.

On the death of "X," the estate tax potential would come into play, allowing the federal government (without regard to an issue on inheritance or state taxes), to assess an additional tax. It is this additional tax on the earnings of the decedent, whose earnings had been placed into property (which could face an estate tax on the death of Mr. "X") that engendered at least part of the move to repeal such estate tax.

Congress did repeal, subject to some of the rules noted below, the estate tax. However, in repealing the estate tax, Congress exacted a price. Subject to some exceptions, Congress provided that the beneficiaries from the decedent, Mr. "X" in the example, would *not* receive a basis for the property at the fair market value of the property at the date of death of Mr. "X", but would rather receive the basis held by Mr. "X" at the time of death.

As indicated in the earlier example, this could mean that the beneficiaries would be paying, upon their disposition of the inherited property, a greater income tax than would have otherwise existed had the new Act not come into play that repealed the estate tax, but created the burden of, potentially, a lower basis to the beneficiaries.

One could argue whether an estate tax is or is not a justifiable tax in today's world. However, Congress has already concluded under this new Act that such tax is not acceptable (subject to many variations and exceptions that are indicated below).

Most taxpayers would not challenge or argue that the repeal of the estate tax is acceptable and is to be encouraged. As is true with most of us, when we are offered a "free ticket," we gladly accept it. However, when informed that the "ticket" is not free, but has some charge to it, we hesitate reaching out for the "free ticket," until we are aware of the cost of those tickets.

If the cost of the tickets is $0.10 on the dollar, and we choose to have the opportunity to utilize the free tickets, it may still be attractive; it certainly is not as attractive as receiving the tickets without any charge. However, what is indicated in more detail in this article is that the "free tickets" may bring with them a charge that *exceeds* the benefit from having received the "free tickets." Such could be the result when the loss of the increased basis proves to be more costly than the potential of the estate tax that would have existed, had the new Act not come into place.

The focus of this article is not to argue that the estate and gift tax laws on a federal level should not be repealed; to the contrary, the author is a strong advocate of repealing such laws. However, such repeal is not supported when the repeal requires some offsetting payment by the taxpayer to receive this benefit—notwithstanding that the new Act was engendered in large part by representations made to the public that the purpose of the act was to pay back "their" monies, and was not a revenue-raising measure.

The repeal of the estate and gift tax positions, leaving in tact and in the law (as it existed prior to the new Act) the basic rules that provided for an increase in basis of property flowing from a decedent to the beneficiaries on the death of the decedent, would have been ideal.

HISTORY OF THE REPEAL OF THE ESTATE TAX

The elimination of the transfer taxes generated in death, *i.e.*, an "estate tax," or the elimination of a transfer tax for transfers during life, *i.e.*, a "gift tax," are not new concepts. There have been prior attempts to repeal these laws. In fact, the estate tax repeal discussion has occurred over many years.

It is not a new argument to repeal the step-up in basis rules. The "step-up of basis" was repealed some years ago in legislation. However, the burdens and complexities, without regard to inequities, were so overwhelming that Congress, in the year subsequent to the repeal, retroactively retracted its position and repealed the prior repeal of the loss of the step-up in basis rules.

That is, Congress had changed the law to eliminate the increase in basis on property passing from a decedent to a beneficiary, much like the $1 million example indicated earlier, with the basis of $100,000.

Congress was forewarned of the complexities and problems with such repeal, but it chose *not* to properly address those issues. As a result, as mentioned, Congress had to repeal the rule.

Is it possible that Congress will, in turn, once again recognize that such action under the current Act is fraught with problems, and, therefore, should be repealed? It is this author's opinion that Congress has not properly weighed, (as was true with the prior repeal position), the implications of the repeal of the increase in basis rules. Therefore, it is entirely possible and likely that Congress will make additional adjustments to the laws recently passed under the Act, or Congress will (as took place in the prior legislation) repeal the loss of the step-up in basis rules, as noted.

WHY REPEAL THE ESTATE TAX/GIFT TAX IN THE FIRST PLACE?

One of the more fundamental questions that should be asked is: Why was there a move to repeal the estate and gift tax positions, *ab initio?*

One argument was simply the fairness position, asserting that to tax the assets in the decedent's estate for an estate tax, after the income, employment, and other taxes were already paid, would result in at least a double, if not a greater taxation position. Therefore, from a fairness standpoint, the argument was that there should be no additional tax on the death of the decedent.

The same argument has been made with regard to gift taxes. As an example, if Mr. "X" received $50,000 of income, paid tax on it, and received a net position of $35,000, and then transferred that $35,000 to a beneficiary during life (gift), why should it be taxed, again, even with a different type of tax?

The same argument could be made as to taxing the $35,000, or an asset worth $35,000, that passes from the decedent, Mr. "X," to a beneficiary.

Thus, the stage was set for the potential repeal of what was an unfair and repetitive-type tax. However, some argued that such tax should remain in place, as it only affected the wealthy, a group, they argued, that should pay a disproportionate part of the tax burden, given their wealth. (Of course, many would challenge these assumptions.)

The proponents of this position have support, given that recent studies show that only approximately 2 percent of all estates, prior to the new Act, faced an estate tax. The reciprocal, therefore, is that 98 percent of people would *not* be paying an estate tax on the transfer of property from a decedent to the decedent's beneficiaries. Therefore, the argument is that we should *not* strain to undertake the elimination of estate and/or gift tax when so few people are impacted by it.

The counter position is that if so few people are affected, why should we place this extra burden on them? Further, the argument is that if the intent of the 2001 Act was to refund or reduce the surplus, some of that surplus was, arguably, created because of the estate and gift tax burden; therefore, we should allow for an elimination of this problem, henceforth, by eliminating such tax.

There is the further argument that the net benefit, after administrative costs, to the federal government when administering the estate and gift tax, does not warrant keeping the tax. (There certainly have been other arguments made for the repeal of the estate and gift tax.)

There have been a number of articles in newspapers indicating that some of the more wealthy individuals, such as Warren Buffet, George Saros and others, advocated the retention of the estate tax obligation. These are particularly noteworthy individuals, given that one would normally assume that the very wealthy would support the repeal of the estate and gift tax rules, and not their retention.

As most readers know, the new Act that was ultimately passed *did* repeal the estate tax, to a degree (discussed below), but it did *not* repeal the gift tax. It also provided for a number of exemptions and exceptions as to **when** the basis rules, noted earlier, will be impacted by the change as to the elimination of the step-up in basis. (This was noted earlier and is examined in more detail, below.)

As a parting comment, relative to whether estate tax should or should not be repealed, there have been a number of articles in newspapers indicating that some of the more wealthy individuals, such as Warren Buffet, George Saros and others, advocated the retention of the estate tax obligation. These are particularly noteworthy individuals, given that one would normally assume that the very wealthy would support the repeal of the estate and gift tax rules, and not their retention.

WHAT IS THE NEW LAW?

Under the Act for Year 2001, the essence is that the estate tax would be repealed, but the gift tax would be retained. However, this general rule is subject to many qualifications that have given rise to much criticism as to why Congress even went forth with these changes in the Act.

A. However, first it is worthwhile to state the general rules under the new Act relative to the estate tax and the basis rules:

   Although the new Act was to eliminate the estate tax, while retaining the gift tax rules, compromises were necessary between the House and the Senate, as well as with the president on these issues. Some favored an outright repeal. Others favored no repeal.

There were also a number of issues as to the cost of such repeal, relative to the federal budget and the projected financial position of the federal government.

To compromise and to coordinate a workout of such positions through the Joint Committee of the House Ways and Means and the Senate Finance, with the concurrent consent, ultimately, of members of the House and the Senate, along with the president, compromise was necessary.

Part of this compromise was that the estate and gift tax rates would be decreased *over several years*. The actual repeal of the estate tax would not take place until Year 2010.

Congress agreed that the repeal of the estate tax (not gift tax) that would take place in Year 2010 would in fact only apply *to that year*. To meet existing financial restrictions, such changes would be erased. For Year 2011, the estate and gift tax rules that existed, with certain qualifications, in Year 2001, would come back into play!

In other words, this is referred to as the "sunset provision" that would only repeal the estate tax for Year 2010, but would be reinstated in Year 2011. (Some have argued that this leads to the magnanimous estate planning position of instructing clients to be sure to die in Year 2010, the year in which there is *no estate tax!)*

B. **Basis:** As to basis, the compromise was that in place of eliminating the step-up in basis rules, as discussed earlier, Congress should allow the step-up in basis as it existed before this Act, for "smaller" estates involving decedents who should not be adversely impacted by the loss of the increase in basis.

To compromise this position, Congress arbitrarily agreed to a rule to allow a step-up, or increase, in basis up to a total of $1.3 million in chosen assets from the estate of the decedent.

As an example, if Mr. "X" died with assets of $1.3 million or less, all of these assets would have the increase in basis to the fair market value, similar to the rule that existed before the current 2001 Act. Thus, the "small" estates were not impacted by this. (Note that the estate may be much larger than $1.3 million. The increase can be to a maximum of $1.3 million in basis. Therefore, as an example, if the decedent died with appreciated assets representing $1.3 million of appreciation, and also $2 million in cash, all of the assets would step up to fair market value, since there was no need to "increase" the cash amount as to basis.)

Further, to be equitable, Congress provided under the new Act that if assets are passed to the surviving spouse of the decedent, there can be an additional, potential, $3 million increase in basis on assets passing from the decedent to the spouse, beyond the $1.3 million amount, as indicated earlier. Therefore, as an example, if the decedent died with $4.3 million of assets, or less, all going to the spouse, there would be no concern at this point as to basis.

There are many exceptions to the rules noted, and certain assets will not qualify for the increase in basis. However, one can see the general structure that Congress passed. It was designed to eliminate the estate tax, by reducing rates over a number of years, and then simply taking the estate tax off all together in the year 2010.

To offset the damage of the loss of basis, the $1.3 million and $3 million provisions, noted earlier, were placed into the law.

Many other changes were made under the 2001 Act. However, this article attempts to focus on the two issues of: elimination of estate tax and the basis issue. (As noted, the gift tax was not eliminated under the new Act; however, rates were reduced on the gift tax. A discussion of this is outside the scope of this article.)

DO THE CHANGES MAKE SENSE? WHO PAYS FOR THE CHANGES?

Each reader must determine whether the changes are beneficial to their position, given that the estate tax rates decrease at a very slow pace, with the ultimate position in Year 2010 of the total repeal of the estate tax.

Many would argue that the "repeal" of estate tax has simply added more complexity. This seems to be true and seems to create additional planning concerns for taxpayers as to whether the estate tax will or will not be present in the year in which they die; this also adds confusion as to basis, as indicated.

Although the change in basis rules for smaller estates will not be important in almost all instances, given the rules discussed, there is already confusion within the minds of many taxpayers on this issue. They have read in some newspapers that the basis increase has been *eliminated.* They are not aware of the partial step-up in basis rules, nor the timing rules noted.

Other concerns will arise as to whether a given basis is or is not increased. This depends on the decision that must be made by a personal representative as to which assets will increase in basis, and which will not increase in basis.

For example, assume Mr. "X" died without a spouse, and with an estate of $2 million, with a basis of $200,000, and, thus, $1.8 million of appreciation. Since only $1.3 million of the assets can increase in basis, this means $500,000 of assets will not be increased in basis. This may be an important issue and concern for and between beneficiaries who do and do not receive the increase in basis. Additional language within the wills and trusts of testators/settlors must be considered to not only give the personal representative flexibility in making the basis allocation, but to also allow for proper planning and insulation of the personal representative when some assets are increased in basis, and other assets are not.

CONCLUSION

Although one would generally favor the repeal of taxes, whether estate taxes, gift taxes, or others, where there is a cost exacted for such repeal, one must carefully weigh such costs and the *quid pro quo* for the repeal.

Although the National Association of REALTORS® (NAR) and others might have more vehemently opposed repealing the estate tax *in exchange for* the surrender for part of the increase in basis of assets, possibly much of this will be moot, because the change as to the repeal of the estate tax *and* the elimination of the potential increase in basis for assets received from the decedent do not come into play until the Year 2010. This certainly is a lifetime—and more—in many instances when addressing changes in the tax law and changes in Congress.

Possibly at this stage there will be additional moves to encourage Congress to review some of the changes under the Act, supporting a position of the continued repeal, after Year 2010, of the estate tax, as well as reduction or elimination of the gift tax, and the total increase in basis of qualified assets received by a decedent by a beneficiary, which was the law, for the most part, prior to the 2001 Act, as noted.

If simplification was part of the goal by the 2001 Act, it was a dismal failure. If the 2001 Act was a first step toward repeal of the estate tax, then it is important to keep Congress on this path and to reach not only the repeal of the estate tax for the Year 2010, but also for years thereafter. And, it is important to allow, as noted, the full increase in basis of assets flowing from a decedent to a beneficiary. REI

E-Signatures in the Real Estate World:

There's more to it than the technology enables and the law allows

by Bill Brice

With the passage of the U.S. federal E-SIGN bill, which took effect October 1, 2000, much attention has been paid to the fact that electronic signatures are now possible and hold great promise for completing business and government transactions electronically. According to the National Association of REALTORS®, at least 55 percent of homebuyers now use the Internet to shop for their home.

Electronic signatures will allow real estate transactions, traditionally slowed down by endless paper trails, to take place online. With just a few clicks of the mouse, property searches and inquiries, bids, mortgage and loan applications, contract approvals and negotiations, closings, secure account inquiries, client relationship forms, and more can be completed and approved in real time. The potential cost savings amount to hundreds of billions of dollars when electronic signatures are fully deployed, not to mention saving a forest or two. But the legislation, and the new products it is generating, actually raise more questions for business deployment than they resolve.

Confusion is growing. What does the law cover, and what important gaps remain? What is an electronic signature, and what are the remaining barriers to widespread adoption? What is really possible now in the real world? Under the E-SIGN Act, and similar state legislation (the Uniform Electronic Transactions Act, or UETA): 1). A signature, contract, or other record relating to such transaction may not be denied legal effect, validity, or enforceability solely because it is in electronic form;

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and 2). A contract relating to such transaction may not be denied legal effect, validity, or enforceability solely because an electronic signature or electronic record was used in its formation.

For political reasons, the legislators made the E-SIGN Act technology-neutral. An electronic signature is defined as: an electronic sound, symbol, or process, attached to or logically associated with a contract or other record and executed or adopted by a person with the intent to sign the record. This means that an electronic signature may be made by pressing a touchtone keypad, clicking I AGREE on a Web page, or typing your name at the bottom of an e-mail. Clearly, these simple methods may be appropriate for small value transactions made by consumers, but most professionals agree that they are unsuitable for business transactions.

As the drivers of e-commerce activity shift, the demand for fully electronic transactions increases. But standing squarely in the path is the business requirement for a trusted document – a permanent business record. Over the past five years, a large quantity of business documentation has moved from manual methods (postal, overnight, and inter-office mail) to e-mail and Web delivery. However, the final record has not made the electronic transformation. For those final records that require an enforceable signature or tamper-evident original, the completion of a transaction has reverted back to paper. People still print, sign in ink, and file their permanent records. However, this is changing quickly.

If properly deployed, electronic signatures can be used in place of traditional pen and paper signatures where a legally enforceable signature is required. Electronic signatures are used to "sign" a document electronically and can be attached or embedded in the document to provide for the official "signing ceremony" which binds people or organizations to an agreement.

Electronic signatures may also be used to create a tamper-evident, permanent electronic business record, even where a legal signature is not required. Using a digital certificate or ID issued from a service provider, users have the ability to electronically sign documents and e-mails, ensuring that the message has come from only the intended party, has not been altered by anyone else, and can only be read by its intended recipient. An electronic signature can be a secure, user-friendly, and cost-effective method for validating an individual's identity as well as

An electronic signature not only guarantees that documents and e-mail are secure, but also offers companies speed and convenience. This type of technology and business solution is of significant benefit to the real estate and financial industries. Brokers and their clients can replace intensive paper processes with rapid and secure online transactions.

ensuring that electronic documents are not tampered with prior to reaching their final destination.

An electronic signature not only guarantees that documents and e-mail are secure, but also offers companies speed and convenience. This type of technology and business solution is of significant benefit to the real estate and financial industries. Brokers and their clients can replace intensive paper processes with rapid and secure online transactions. For example: printing a mortgage application, signing it in ink, faxing or sending it through overnight mail can be inconvenient, time-consuming, and expensive. Electronically signing a mortgage application or any other type of form saves money and allows for real-time transactions. Successful loan officers, agents, lenders, etc. are integrating these technologies in ways that will fundamentally change their relationships with clients, vendors, investors, and insurers.

There are three questions that must be considered and answered when deploying any electronic solution for an enforceable and/or permanent electronic business record:

1. Is your solution technically secure? Can you prove the document has not been altered since being completed?

2. Will your transactions be enforceable? Have you met the necessary conditions to create a legally valid electronic signature?

3. How will you manage risk? Have you addressed authentication, authorization, and/or risk assumption?

Technical Security

The best technical solution for electronic signatures *is to use digital signature technology* — Digital signatures are a type of electronic signature that uses complex cryptography to bind a person's identity to a specific document or transaction record. Typically, when using digital signature technology (also known as PKI technology, or Public Key Infrastructure), each person is issued a digital credential, known as a Digital ID or digital certificate. These credentials are issued by a third party that is known and trusted by all parties. The credentials are issued in such a way that they can't be altered without detection, so the information contained within them is safe from tampering. In some of the newest applications, the PKI technology is buried, so that the issuance of individual digital IDs is not required.

In addition to the ability to bind an identity to a specific record, electronically signed documents also have the property of a permanent business record. The signed documents can be safely stored and any tampering after signing will be detected. Thus an electronic document becomes permanent. It can be used to prove at a later date that a specific person signed a specific document at a specific time. Other technological solutions cannot provide such permanence.

PKI technology has been criticized as being difficult to deploy and use. Fortunately, this has changed dramatically over the past two years. It is true that setting up your own PKI system is daunting and suited only for large, technically adept organizations, but most organizations can take advantage of the technology by subscribing to an outsourced global trust provider that handles all the issues required, and delivers easy-to-use solutions to the desktop.

Enforceability

There is no point in concluding a business transaction electronically unless it can be enforced — upheld in court or arbitration. This, even more than technological complexity, has been the barrier to the widespread adoption of electronic signatures. Unfortunately, legislation has created a confusing picture. The E-SIGN law, in the jurisdictions where it applies, requires you to jump through many hoops in order to take advantage of it because it includes considerable consumer-notice provisions and opt-in requirements. Additionally, there are many states where UETA applies, not E-SIGN. Some states have other digital signature laws; some states have no laws covering electronic signatures. E-SIGN and UETA do not apply to many transactions, such as Uniform Commercial Code Transactions under articles 3 through 9, and judicial documents. When evaluating the legislative landscape, there are at least 16 possible outcomes to the enforceability question, depending on jurisdiction, status of the parties, etc. So, the legislative changes, while promising in their encouragement of the use of e-signatures, do not on their own create the kind of reliable business solutions that companies need.

Risk Management

What happens if a signer is not who he or she claims to be? What happens if a digital certificate is fraudulently issued or fraudulently used? — If you use your own solution, or a technology-only solution, you must address the issue of identity authentication or face potentially large, open-ended liabilities. An outsourced global trust provider may offer warranty insurance against financial loss due to fraud up to pre-defined dollar limits. This is coverage well worth having, and it will encourage your business partners to do business with you electronically.

Considerations

There are many considerations that should be evaluated when selecting an electronic signature/ electronic document business solution to help transform paper-based real estate transactions. Listed below are a few issues worth thinking about.

1. **You need more than technology**. Public key infrastructure (PKI) technology has been available for more than two decades and is the technology most commonly used to create electronic signature and encryption software. However, should a digital ID be used under false pretenses or to commit fraud, PKI technology alone can't protect you. While technology can provide technical security for electronic signatures, it can't provide commercial trust, enforceability and risk management. Make sure your electronic signature vendor acts as a trusted third party which creates an environment for companies to conduct secure business transactions, like a credit card company that stands behind merchants and cardholders by offering a contractual legal framework and warranty protection.

2. **E-SIGN is a law, but not the final word.** While E-SIGN makes electronic signatures valid and legal, it does not clearly provide an implementation plan or cover intrastate and international

transactions. When properly deployed, electronic signature vendors can provide technology solutions that are E-SIGN compliant. However, many vendors don't address the opt-in and notification provisions of the E-SIGN law or cover jurisdictional gaps created by legislation. Ask electronic signature vendors two questions: 1) Are you E-SIGN compliant?; and 2) How do you address and resolve enforceability issues for your customers?

3. **Using electronic signatures should save your company time and money.** While processing a mortgage application may not seem costly, getting the paper contract to the final step can end up costing hundreds or thousands of dollars in fax, courier, and overnight shipping costs, not to mention the indirect costs such as lost time, delayed capital deployment, and customer dissatisfaction. Electronic signatures can significantly reduce time and paper costs by allowing parties to securely conduct business electronically. Electronic signature providers charge either a flat rate, a per user or per transaction fee. Carefully evaluate which pricing model works best for your company.

4. **Know how your electronic signature works.** The use of digital certificates or IDs and their functionality continues to cause significant confusion. Make sure you understand the functionality your electronic signature solution offers. Ask if your digital certificate is authenticated and can be used to sign more than just e-mail. Few companies offer digital IDs that allow users to electronically sign enforceable transactions or to embed digital signatures in Microsoft® Word, Excel, or Adobe® documents, as well as attach signatures to documents created in other applications, including HTML, PDF, JPEG, and more.

5. **Do your homework.** There are so many enabling technologies available. In fact, it can become very confusing and overwhelming when evaluating all the possible options. And the more you research you do, the more you can get confused. Many technology solutions seem to meet real estate requirements by stating they can transform paper processes to electronic processes. However the solutions stop short of providing necessary business requirements and don't address legal enforceability, tamper-evident permanent business records, or document storage. Significant progress has been made with the development of enabling technologies that provide for comprehensive and integrated electronic workflow processes; however you need to do your homework to find out what best meets your business requirements.

6. **Determine whether to build or outsource.** Some large companies choose to develop their own PKI, rather than purchase commercially viable products and services from vendors. Then, once the infrastructure is in place, the needed tools and applications must be developed. Most businesses find it is easier and more cost-effective to purchase outsourced electronic signature products versus developing their own PKI solution, which can cost millions of dollars and has limited functionality.

7. **Select a solution that is flexible and adaptable.** To remain competitive, select a solution that provides for flexibility and adaptability as your business requirements change. There are a limited number of companies that have integrated business requirements and are able to provide reliable, simple, and easy-to-use point and click operations to complete complex business documentation. Some companies have even streamlined deployment to include Web-based applications, eliminating the need for users to install hardware or software, with the only requirement for use being a standard Web browser. In this case, removing cumbersome IT plumbing from the deployment process facilitates hassle-free and happy end-user adoption. Keep in mind that whatever your real estate technology requirements may be, solutions exist that are designed to be flexible and adaptable to security technology as it evolves, without creating a dependency on any one product or technology.

CONCLUSION

In summary, transactions secured with electronic signatures are key to enabling expanded e-business. Your client's electronic signature, as well as your own, will soon become an important business tool—as important as e-mail or Web access. But before leaping in, recognize that technology and legislation are not enough.REI

CRE PERSPECTIVE

Living Beyond the Boundaries

by Bowen H. "Buzz" McCoy, CRE

INTRODUCTION

There appears to be a growing interest in the field of religion, spirituality and business, as evidenced by recent stories in major magazines and several books. A *Business Week* story, "Religion in the Workplace," indicated that there are some 10,000 Bible study and prayer groups in workplaces, that meet regularly. The article further stated that 95 percent of Americans say they believe in God or a universal spirit, and 60 percent of those polled stated that they believe in the beneficial effect of spirituality in the workplace. A survey published by the *New York Times* Sunday magazine indicated that 81 percent of Americans surveyed believe in an afterlife; 72 percent absolutely believe in the religious practices they follow; but 75 percent believe their behavior at home is more indicative of who they really are than is their behavior at work. There is a perceived dichotomy between the "real" person and the person at work.

Yet, most people do not wish to compartmentalize their lives. Research performed by University of Southern California Marshall Graduate School of Business Professor Ira Mitroff indicates that organizations which identify themselves with spirituality have employees who: 1). are less fearful of their organizations and 2). less likely to compromise their basic beliefs and values in the workplace; 3). perceive their organizations as being significantly more profitable; and 4). report that they can bring significantly more of their complete selves to work, especially their creativity and intelligence. Many studies have indicated that what gives individuals the most meaning and purpose in their job is the ability to realize their full potential as a person.

In medieval society, (a.k.a., the Age of Faith), there was a strong connection between church and state, between faith and work. There was an order to society which was comforting in a world filled with superstition and mystery. In the post modern age, reason dominates all. We are suspicious of mystery, even of faith. While we may be willing to discuss spirituality at work with a stranger, we find it difficult to discuss our religious faith outside the boundaries of the church or synagogue. Ironically, in an age where 95 percent of Americans are said to believe in God or a universal spirit, the subject is taboo at work or in the classroom, even though research is showing that such faith brings great comfort to individuals in the workplace.

The dilemma, it seems, is how to break down the walls between the fields of religion, business, and ethics to the mutual benefit of all. They are formidable walls, reinforced by constitutional interpretation, political correctness, over specialization, and the like. If we cannot break the walls down, then we must learn how to straddle them and to become boundary people, attempting to deftly navigate our way through a life while staying true to our beliefs and to our vocation to be our best professionally. I know it is not always easy. In a successful career as an investment banker, I have tried to live out my faith in all the aspects of my life. I was Dr. Faust to some. To others I was perceived chiefly as a church elder, a seminary trustee and a teacher.

I have written several published articles on the field of business ethics. Comments come back to me from many sources. A philosopher said my articles were not scholarly enough. A business ethicist said I was too critical of the way business ethics is taught. A theologian said I was too worldly. A business person said I was too religious. A Christian said I was too universal. Being a boundary person is not easy; but how else can one respond to the dual calls to be authentic in work and in faith? In this paper I propose that we can live rich lives of faith, while being engaged in the world as successful business people. We can live with one foot in the spirit and one foot in the world. I believe most of us are designed to be boundary people, and we thus have instilled in us the hope that we can realize our full potential as people created in God's image. Let me explain this further by discussing the four levels of reality.

FOUR LEVELS OF REALITY

As a teacher of business and organizational ethics, I ask my students to spend some time considering four-level living, a concept embraced by many of history's great thinkers—from Dante to Peter Drucker. We can be said to be operating on these four levels, consciously or unconsciously, more or less simultaneously: 1). the superficial **surface** story level; 2). the **allegorical** level, which we allow to shape our own stories—our heroes who we can copy and mimic, mentors and the like; 3). the **moral** level where society sets appropriate behavior by social custom or laws and regulations; and 4). the deep transcendental **spiritual** level, where one is in touch with what it is God truly intends us to do.

The **first level** is easily described. It is about socialization. How do I look? Am I late? Do you mind if I smoke? Are you using this chair? This is not where we make our deepest connections. The **allegorical level** can help us to soar, or to fall flat, depending upon whom we set as models. These choices are obviously influenced by pre-conditioned values that we have bought into.

The **third level** looks easy, but cultural norms that began as positives fall victim to neglect and can inculcate bad practices. When we live right up to the edge of what society may tolerate from time to time, without a deeper grounding for our behavior, we may find ourselves living dangerously. Society has an uncomfortable and unpredictable disposition to change its mind over time about everything—appropriate dress, sexual behavior, insider trading, anti-competitive behavior, the payment of employment taxes for part time household labor, just to name a few.

I believe that ethical living is a product of the **fourth level**, grounded deeper than cultural norms, a by-product of faith. It can inform us about when we decide to stop trading off. We trade off, always, compromising our deep beliefs for expediency. When and where do we stop and take a stand? Which ditch do we die in? Ethics is not about always winning. Ethics is about what we are willing to fight and lose for. Morals are human response to humans. Ethics is human response to God. Therefore it is difficult to talk openly about ethics in a business, because we have made it difficult to talk about God in a business. This is certainly our densest wall to straddle.

In this current age of globalization, such activities as global money, capital markets, and the Internet are driven by the culture of the United States. Within this culture are imbedded the canons of Jewish-Christian experience. My Christian faith informs me that one must come into a relationship with the creator God through Jesus. To be successful in the global arena, it seems to me that we must expand our cultural consciousness beyond that of our own. World culture is shaped by religion, or those deepest feelings about who we are and who we want to become. If we are to have impact in other cultures, we must bring with us an awareness of the others' deep cultural perceptions. At some point, as we become ever closer together, we must begin to evolve a true global ethic. If such an ethic is to motivate us at our deepest level, it must be pluralistically faith-based.

The polling data in the *New York Times* article indicated that 42 percent of the respondents believe the best religion would be the one that borrowed from all religions. A number of individuals and institutions have worked on a global ethic, including Hans Kung, the Dali Lama, the Parliament of the World's Religions, various U.N. agencies, and various business groups. For many, this is a unique moment in history, with the end of the Cold War and an increasing perception of the needs of humanity and the earth.

The One Great Commandment to love the Lord our God with all of our strength and heart and mind and spirit, together with the great corollary: "love your neighbor as you love yourself," are explicit parts of the three great Abrahamic religions and are implicit in every form of religion. So is the beatitude: "do unto others as you would have them do unto you." One may discern these concepts in the literature of the management field as well, including such individuals as Peter Drucker and John Gardner. In his recent book on the leader of the future, Drucker states such a leader must be in touch with himself, love people and have a passion for the enterprise. I see the Great Commandment in those statements.

Ethics is deeper than morality or custom. It comes out of our deepest desire to make meaning out of our lives, and hence resides in the areas of spirituality and religion. The deepest and most meaningful relationships develop out of this level of interaction. To have integrity, one must be able to bring deep meaning to bear in all aspects of one's life. To deal effectively in the global arena, one must have some notion of the deep cultural meanings imbedded in counter-party cultures.

How then can we bring these deeper levels to play in our business world?

HOW DO WE LIVE OUR FAITH OUT AT WORK?

If one has chosen a worldly profession such as investment banking, litigation, brokerage and the like, one should be authentically **worldly**. Don't be afraid to be who it is you say you are. Be an aggressive investment banker. Don't confuse the issue. Don't burden your work too much with church or outward signs of religion. Do not wear your heart on your sleeve. Be authentic. The German theologian, Dietrich Bonhoeffer, articulated the useful concept of hidden, or "religionless" religion. Participate in the polyphony of life, but attempt to practice the presence of God in all that you do. A leader helps to create a context; helps to shape a corporate culture.

Encourage an atmosphere of **openness** and **honesty** where questioning is tolerated. Keep your door open, and spend considerable time in the work areas of other folks. They will often be amazed at how much you know about what is going on. It is because they tell you. Young people often wish to query the ethics of what you are doing. Most times you will have a good explanation, based upon your experience. Once in a while you will not, and then it is time to change behavior.

Trust, even intimacy, is important in an organization. It is important to have in-depth annual reviews of up to several hours each for key people, coaching them on how to get ahead, goal-setting for the next year. They invariably set higher goals for themselves than those that might have been mandated without discussion. Try to take some of the mystery out of the promotion process by sharing the evaluation forms with key employees and telling them what they have to do to get promoted. If they attain your mutual objectives, then, of course, you must deliver the goods when promotion time comes around.

Fairness is a keystone of a successful organization. How does one allocate "good" assignments? Who is promoted; who is rewarded; who is punished? Are there consistent standards. In my experience, it was difficult to get the bonus systems right; we were always tinkering; they were never complete, never perfect. If we rewarded production, we would get hit with trading losses when we tried to move the merchandise out. We tried linking various groups together. A bonus payment system based solely on production will never work. It gives control to the inmates. There is no leeway for rewarding character and leadership. There is no way to manage greed. We evolved bonus pools for groups of individuals, tied to production; but the allocation of the pool allowed management to override production and bring other leadership characteristics into play.

The best organizations are broken down into small groups or **teams** that can then be empowered to solve certain tasks. A major investment banking firm's trading floor can appear as a disorganized sea of cacophony. Yet, the best managed firms have broken the floor down into turret teams of four or six individuals, each with a leader to provide training, supervision, and coherence to the operation. These trading operations can become a classic example of Peters and Waterman's "tight/loose" organizational structure.

Organizations are **covenental**. Many of the covenants have been explicitly agreed to, such as a written code of conduct; others may be implicit. A leader must understand these covenants, as they shape the culture of the organization; but they may not be written down. It may become necessary for a leader to develop the will to manage and change the covenants, if the company is to survive. Changing covenants, managing the anxiety and stress of change, is perhaps the most difficult thing a leader has to do.

Sanctions are important also. Some believe a virtuous organization can exist solely on positive reinforcement. Rewards are great, but organizations tend to be more virtuous when there are sanctions as well as rewards. The law of the Old Testament has its place alongside the love of the New Testament. There is a therapeutic benefit, as well as an essential fairness, in firing low relative performers. Distinctions must always be made among the awards.

There is room in such a discussion for such concepts as servant leadership and **discipleship**. **Stewardship** includes the appropriate nurturing and development of people resources. Mission and vocation include the "little" people, not just the "big" people. This is true in churches as well.

Taking time for **others** is very important, if one is to live out a balanced life. Encourage young people to make time for family, church, charities, exercise, and fun. I advised them if they were working 105 percent of their time, with no balancing activities, they would fail, as they were competing with others who could successfully do the work at 85 percent capacity and have time for other activities that would keep them healthy.

Quiet, personal **prayer**, contemplation, and meditation is appropriate in any workday and anywhere, in a way that is not offensive to others. It is useful to find a place or a time where such practice can be maintained. In my case, it was often on the commuter train as it passed through the long tunnel from 96th street to Grand Central Station. Prayer can sustain calmness, a transcendent hope, a sense of detachment. When such detachment is maintained, one becomes more centered, less anxious about taking risk, less stressed about losing. One can become tolerant of more ambiguity and paradox. Peter Drucker has written that the leader of the future must have the emotional strength to manage anxiety and change. He adds that leaders must have the ability to develop comfort with risk while building trust.

One might argue that you do not need to be a person of faith to observe these practices. This is undoubtedly correct, but as Mitroff points out, individuals at work are seeking meaning and purpose in their lives and a deep feeling of interconnectedness. A faith-based and centered core culture can provide orientation for best practices. I would be very interested in seeing anecdotal evidence of the role of faith in shaping corporate culture.

THE ROLE OF THE CHURCH

What is the role of the church in breaking down the walls that divide faith from work? Back in the early eighties the response of my east coast Protestant church to one of its members who was incarcerated for alleged price-fixing was a benign silence. Of course the stigma attached to many transgressions seems to be receding, while the modern church appears to be making some movement from accuser to mentor, nurturer, and bridge builder.

A frequent theme from the pulpit of my local church is how I can take my faith into the world as I experience it. A favorite benediction of mine is when my minister asks us to look carefully at the week ahead—the travels, the business dealings in progress, the people we will be dealing with—and know that God will be present in all those events. It is the reminder of Bonhoeffer's words: "Religion is part-time; faith is full-time." Business people respected for their faith-infused leadership are often held up as models: Bill Hewlett, former CEO of Hewlett Packard and Jim Burke, former CEO of Johnson and Johnson.

The adult study curriculum at contemporary churches has broadened from Bible study to other subjects that nurture us as people in the world. I have enjoyed good attendance and response in my classes on Tillich, Bonhoeffer, T.S. Eliot, Dante, and others. I sometimes comment that I am called to teach Christian ethics in the business school and business ethics in the church.

Individual churches are becoming more responsible organizations. Pastors, who were once anti-business and intimidated by business persons, are now hiring MBAs as administrators, and are requiring church boards to follow fair employee practices, and provide competitive pay and other compensation benefits.

We need the church to reinforce our sense of values and to help us have the courage to bring our deepest values into the workplace. At times, the church has focused more on "the eye of the needle" story than on the "go into the world" admonition. The best churches can be critical of business and pursue social justice for all, while continuing to support the needs of business people and to celebrate those who try to live out their faith in their daily lives.

CONCLUSION

Boundary living is not new. There is a lot of theology in Peters and Waterman and in Peter Drucker, as there is a lot of good management in the Rule of the Order of St. Benedict. There is an interconnectiveness, a polyphony, among all aspects of life. We are all people of faith, searching for ways to be good. With globalization, we may come closer together, but we still will not know one another. We can start up a new business—fast. However, growing wise in the way of life takes time. It is never complete, never right, and never perfect. We must utilize our collective faiths to draw us closer together, not drive us further apart.

Boundary living is endangered if we stay too long in one world or the other. We are people of faith who were not all created to live in monasteries. We are called to be in the world, but not to be consumed by the world. The physical needs of our world will be met only through the inspired work of creative workers, managers, and entrepreneurs—business people. As the creations of a faithful God, we are people of faith, which has many forms. We must live out the polyphony, embrace our differences, fortify our personal beliefs, and move forward. We may trip, stumble, and even fall along the way, but we will be a presence in the world. REI

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FOCUS ON THE ECONOMY

Ain't No Cure for the Summertime Blues

by Hugh F. Kelly, CRE

Back in 1958 (in dinosaur times, my kids tell me), Eddie Cochran complained, "I'm gonna raise a fuss/I'm gonna raise a holler/About workin' all summer/Just tryin' to earn a dollar."[1] (I'll admit to being out of touch these days. Do they still write songs about working?) Readers who have been following my adventures in economics columny[2] know by now that the Federal Reserve, last spring, took the aggressive path outlined in my previous essay, a path which I predicted would see rebounding consumer confidence, the Dow Jones Industrial Average in a trading range of 10,000 – 11,000; business fixed investment for 2001 in the 8 percent - 10 percent range; and year-end GDP growth at 2.5 percent to 3 percent.

As I write this in July, such targets probably invite skepticism. Indeed, there are those claiming that Alan Greenspan and his confreres still don't "get it" and those who call for still further interest rate cuts through the dog days of August. That's not a good idea, in my opinion. I'd like to look at a few of the charts published in each edition of *The Counselor* newsletter to explain why.

Figure 1, "Non-Farm Employment and GDP," presents two of the broadest and most familiar measures of the economy, albeit in a somewhat non-traditional format. Most often, these statistics are presented in terms of "quarterly change at a seasonally adjusted annual rate." *Figure 1*, however, simply shows the data based upon their year-over-year percentage change, *i.e.*, the actual difference from (say) the first quarter 1999 to the first quarter 2000. I think this perspective reveals very clearly what the Fed's sense of the economic "speed limit" is. When year-over-year GDP spikes up toward 6 percent, the Open Market Committee looks for the brakes. On the other hand, if Gross Domestic Product falls under 2 percent growth, the Greenspan Fed has systematically primed the pump for greater liquidity and subsequent spending-induced expansion.

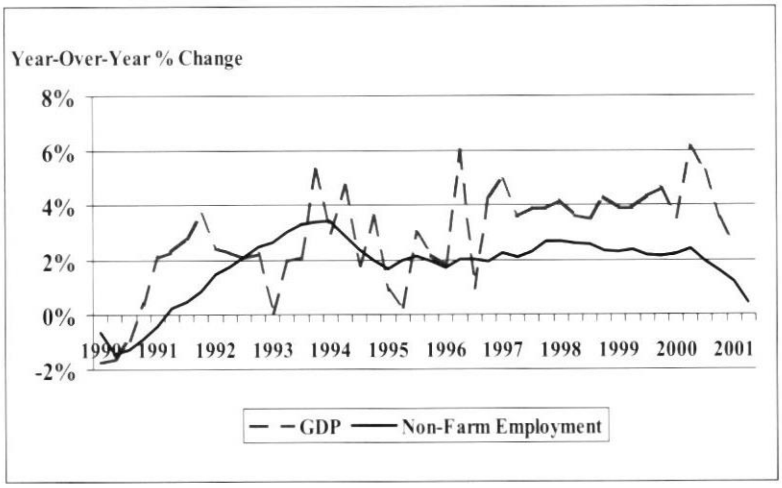
GDP, as normally reported, grew at a seasonally adjusted 1.0 percent in the final quarter of 2000, and at 1.2 percent in the first quarter of 2001. On a year-over-year basis, its growth rate from first quarter 2000 to first quarter 2001 was 2.5 percent. As the robust expansion of early 2000 is replaced by the tepid results in the spring and summer of 2001, the GDP curve will dip lower, as it did in 1993, 1995, and in 1996. The Fed's critics see this, and want further stimulus.

A contraction in employment, the most severe job slowdown since the last recession, is adding urgency to the situation. Indeed, though the year-over-year job figures were still marginally positive in June, it is likely that net job losses will be accruing as the summer wears on. That, of course, is when the bite becomes most painful and calls for further Fed action come from the politicians, the editorialists, and the armchair economists, all a-fussin' and a-hollerin'.

Figures 1, 2, 3

Figure 1

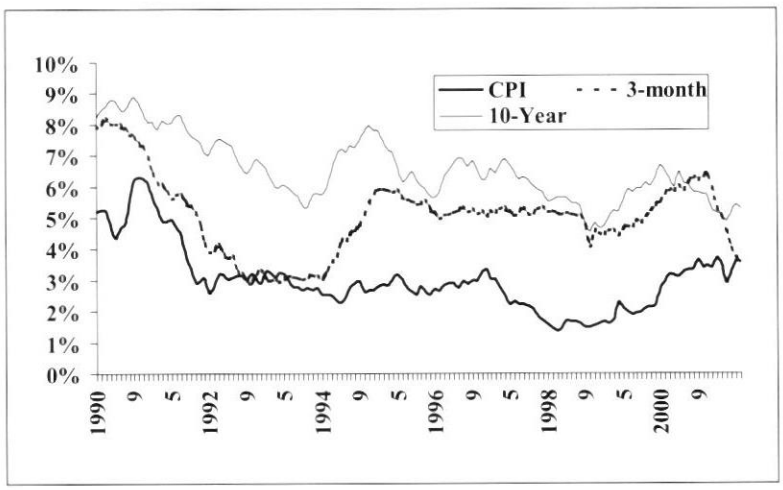
Non-Farm Employment & GDP



Sources: U.S. Bureau of Economic Analyses; U.S. Dept. of Labor

Figure 2

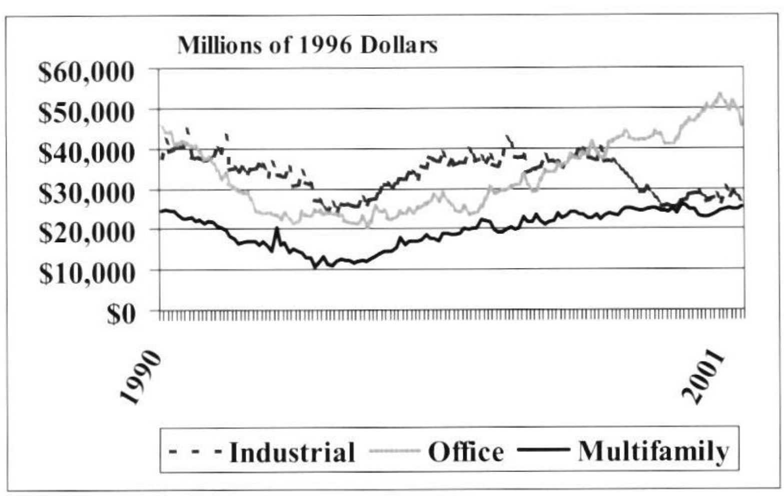
Interest Rates & Inflation



Sources: U.S. Dept. of the Treasury; U.S. Census Bureau

Figure 3

Value of New Construction Put in Place



Sources: U.S. Dept. of Commerce; U.S. Census Bureau

Patience may be required, but I would say that the Fed has already done its job and should refrain from an overdose of monetary medicine. *Figure 2*, "Interest Rates and Inflation," shows that the three-month Treasury Bill has already descended to approximately the same level as the Consumer Price Index. The last time this happened was in 1992 – 1993, and the Fed held its discipline even as pundits were sounding the alarm about a potential "double-dip" recession (as in the early Eighties). That discipline paid off with the strong growth – low inflation expansion of the Nineties.

Without being callous about the difficulty of unemployment, it is worth noting that the U.S. is in a period of general labor shortage. The jobless rate, though rising, is still just at 4.5 percent and not long ago sustained unemployment under 5 percent was considered unachievable without dire inflationary consequences. Productivity gains have allayed some of those fears, and I believe that the Fed is correctly betting on continued productivity advances to turn the corner on corporate profits, triggering a resumption of growth.

That does take time, though. Economists usually expect a six- to nine-month lag in the effects of interest rate policy changes, meaning that we will see the effects of lower rates gradually taking hold through the late summer and becoming more apparent during the fall. My column in the Spring 2001 (Vol. 26, No.1) edition of *Real Estate Issues* noted that real estate risk had shifted from the supply side to the demand side. That's what the employment figures are now confirming. Ray Torto's column in that edition, by the way, underscored the continuing cyclical risk from the development cycle, so readers of *Real Estate Issues* had a full alert to the rising vacancy rates we are seeing in the commercial property markets as 2001 wears on.

Nevertheless, I remain fairly sanguine about the outlook for the economy and the real estate industry looking ahead. The demand side cycle is typically much shorter and shallower on its downward leg than the risks of a construction boom. And, as *Figure 3* ("Value of New Construction Put in Place") illustrates, office and industrial development has already begun the process of pulling back from their peaks. Liquidity for real estate investment remains ample, and the pullback of prices and rents from the speculative levels seen in the dot-com euphoria should be regarded as a healthy correction.

Some may look at the present U.S. economic dilemma with the fear that we will follow Japan's sad lead, where a bursting of an economic bubble led to a prolonged slump. And, naturally, there is enough residual pain from the last real estate depression here in the states to provoke nervousness in our own industry. Frankly, though, the numbers don't support such worries, much less any threat of panic. Absent any external shocks, the year-over-year numbers in the summer of 2002 should be showing acceleration in both the fundamental economy and in the property markets across the United States. For now, though, Eddie Cochran had it right, "There ain't no cure for the summertime blues." REI

NOTES

1. "Summertime Blues", words and music by Eddie Cochran and Jerry Capehart. © Warner-Tamerlane Publishing, 1958 (renewed).
2. My spellcheck says this is an illegal word, but if William Safire, the language maven, can use it, so can I!

ABOUT OUR FEATURED COLUMNIST

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FOCUS ON REITs

IRS Ruling Permits REIT Spin-Offs

by David M. Einhorn, Adam O. Emmerich, & Robin Panovka

In a significant and long-anticipated ruling, the IRS has reversed a long-standing position and ruled that REITs may be sufficiently "active" to permit them to engage in tax-free spin-off transactions. As a result, many REITs will be able to spin-off parts of their businesses in order to create more focused companies and to carry out other strategic goals, including mergers and acquisitions.

While the ruling is most likely to stimulate transactions by REITs, it has also sparked a wave of discussion with regard to non-REIT public companies restructuring their real estate holdings by transferring their real estate to a newly-formed REIT, leasing back the real estate and distributing the REIT stock to their shareholders in a tax-free spin-off transaction. But while the IRS ruling has largely eliminated one of the impediments to such tax-free restructurings, there are still unanswered questions with regard to whether REIT spin-offs will satisfy other requirements for qualification as tax-free and whether such spin-offs will ultimately prove attractive and workable for many companies.

Certainly, the case for transferring real estate to a spun-off REIT can be compelling for some companies. The advantages include potential tax savings from holding real estate in a REIT (which generally does not pay entity-level tax on rental and other income), streamlining the company's balance sheet, enabling the company to focus on its core business and reduce its investment in real estate, enabling the company to raise capital efficiently in a concurrent IPO of up to 20 percent of the REIT's stock. On the other hand, the path to any such transaction presents the following potential pitfalls and issues, which may prove to be insurmountable:

- In any spin-off of a REIT (or other corporation) from a regular taxable corporation (a "C corporation"), the retained earnings and profits ("E&P") of the distributing company must be divided between the distributing company and the REIT on the basis of the relative fair market value of each company. This is potentially problematic because the REIT rules generally prohibit REITs from having C corporation E&P and would require the spun-off REIT to distribute its share of the E&P to shareholders in the form a taxable dividend. Companies considering a restructuring that have substantial retained E&P (which will be the case for many profitable companies) will need to consider the cost of such a taxable dividend and to measure it against the benefits of the transaction. While such a dividend may be paid with stock, companies must consider the reaction of their shareholders to a taxable non-cash dividend.

- Any restructuring will need to carefully balance the company's need for control and flexibility with respect to its real estate against a series of competing forces, including the capital markets' requirements with respect to the structure and governance of the REIT (which typically include the requirement for some degree of independence and which will be particularly relevant if the restructuring involves capital raising through a public offering); the REIT rules' restrictive and potentially burdensome requirements with respect to the REIT's assets and activities; and tax and accounting considerations designed to ensure that the form of the transaction as a sale lease-back is respected. Depending on the real estate involved and the company's approach to its real estate, it may be that even the most thoughtful structuring will result in too great a loss of control and flexibility. These issues should, therefore, be considered early in the process.

- As noted, the recent IRS ruling spoke only to whether a REIT could satisfy the spin-off requirement that the companies involved be engaged in an active business. It remains unclear whether the other spin-off requirements can be satisfied, particularly the requirement that the spin-off must be motivated "in whole or substantial part" by a legitimate business purpose other than avoiding federal taxes and not be a "device" for the distribution of earnings and profits. Indeed, the recent ruling expressly stated that the IRS was not ruling on the question of whether a spin-off of a REIT might satisfy the business purpose requirement.

It is also important to keep in mind that, while the REIT spin-off mechanic is now a hot topic, it may not be the best way for all interested companies to restructure their real estate holdings. Depending on the specific goals of the company, many of the desired objectives may be achievable with superior results through other transaction structures, including a tax-free contribution and lease-back transaction with an UPREIT (Umbrella Partnership REIT). The best structure for any company will be the product of careful analysis and will depend on the company's goals and business plan and the particular real estate involved.REI

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FOCUS ON HOSPITALITY ISSUES

A DIFFERENT KIND OF PAIN & GAIN FOR HOTEL INVESTORS DURING THIS CYCLE

by John "Jack" B. Corgel

As a real estate professor during the 1990s, I unavoidably made occasional references back to events in the 1980s in support of lessons about commercial real estate market performance in response to macroeconomic events. Despite the power of these lessons, I never failed to notice the student sighs, rolling of eyes, and under-the-breath remarks, such as "Oh no, he isn't going to talk about the 1980s again, is he?" In 2001, it isn't only the yellow-note professors who are thinking about the 1980s. Many real estate owners, lenders, and analysts are doing serious looks back to the last business cycle for guidance in calibrating their real estate market forecasting models.

Having traded-in my teaching credentials for a stimulating life in hotel consulting, I now vicariously feel the pain of hotel market participants as they brace for the financial impact of the current general economic downturn. For those in hotel real estate, swings in the economy usually create more good fortune and, in turn, more pain than for those who concentrate on other property types.

As the possibility of a recession hovers, an initial reaction is to seek insight from studying outcomes of previous recessions.[1] Unfortunately, the 1980s mark the beginning of time for availability of reliable real estate and hotel industry data with which to perform these analyses. Therefore, over-weighted outcomes from the last recession (*i.e.*, July 1990 through March 1991) may become the only guide available for making predictions about how things will work out this year and beyond. Forecasting hotel real estate market movements based on behaviors during the last two decades, however, is a BIG mistake—the following paragraphs tell why!

HOTEL MARKET DISTORTIONS

The performance of hotel markets during the 1980s was unique and in violation of the economic principles that govern these markets. The most direct evidence of this period-specific behavior comes from the fact that hotel occupancy rates noticeably and persistently declined during the decade while the supply of hotel rooms sky rocketed.[2] *Exhibit 1* contains information on hotel market indicators from the database of thousands of hotels that my firm manages. The average hotel occupancy rate in the U.S. began the decade in 1980 at 73.5 percent and ended at 65.2 percent. In direct contradiction with how supply should have behaved in response to falling occupancy, the number of available hotel rooms increased every year of the 1980s and ended up 48 percent higher in 1990 than in 1980. In addition, real average daily room rates by 1993 ($57.69) about equaled the 1983 ($59.99) level. And by 1994, astute investors were able to pay a mere 30 to 40 cents of replacement cost dollar for quality, full-service hotel assets.[3]

While not all economists agree on causes and effects, persuasive arguments have been put forward to support the position that the market distortions of the last two decades resulted from economic agents acting rationally in response to incentives

Exhibit 1

Hotel Market Indicators, 1980-1999

Year	Rooms Occupied- % Change	Rooms Available- % Change	PERCENTAGE POINT DIFFERENCE DEMAND OVER SUPPLY	Occupancy %	ADR	Real ADR	% Change	RevPAR	Real RevPAR	% Change
1980	-2.0%	1.6%	-3.6%	73.5%	46.63	56.59		34.25	41.57	
1981	-0.5%	2.6%	-3.1%	71.3%	51.95	57.15	1.0%	37.05	40.76	-1.9%
1982	-0.9%	2.2%	-3.2%	69.1%	55.38	57.39	0.4%	38.27	39.66	-2.7%
1983	1.3%	2.7%	-1.5%	68.1%	57.76	57.99	1.1%	39.36	39.52	-0.4%
1984	6.9%	3.5%	3.3%	70.3%	59.78	57.54	-0.8%	42.00	40.42	2.3%
1985	-1.6%	4.8%	-6.4%	66.0%	64.09	59.56	3.5%	42.32	39.33	-2.7%
1986	2.0%	5.3%	-3.4%	63.9%	68.12	62.16	4.4%	43.55	39.73	1.0%
1987	11.0%	9.9%	1.0%	64.5%	71.73	63.15	1.6%	46.27	40.73	2.5%
1988	4.1%	3.5%	0.6%	64.9%	74.75	63.18	0.1%	48.50	41.00	0.7%
1989	4.3%	3.4%	1.0%	65.5%	77.44	62.45	-1.2%	50.75	40.93	-0.2%
Decade Average	2.4%	4.0%	-1.5%	67.7%	62.76	59.72	1.1%	42.23	40.37	-0.2%
1990	2.0%	2.5%	-0.5%	65.2%	80.84	61.85	-1.0%	52.72	40.34	-1.4%
1991	-0.7%	0.7%	-1.4%	64.3%	80.44	59.06	-4.5%	51.72	37.97	-5.9%
1992	2.8%	0.5%	2.3%	65.8%	82.21	58.60	-0.8%	54.13	38.58	1.6%
1993	2.8%	0.3%	2.4%	67.4%	83.36	57.69	-1.5%	56.20	38.89	0.8%
1994	4.1%	0.6%	3.4%	69.7%	86.44	58.33	1.1%	60.26	40.66	4.5%
1995	4.1%	1.6%	2.5%	71.4%	90.51	59.39	1.8%	64.61	42.40	4.3%
1996	3.0%	1.7%	1.3%	72.3%	97.48	62.13	4.6%	70.49	44.93	6.0%
1997	2.1%	1.9%	0.3%	72.5%	104.98	65.41	5.3%	76.15	47.44	5.6%
1998	1.5%	3.0%	-1.6%	71.4%	112.23	68.85	5.3%	80.10	49.14	3.6%
1999	0.9%	2.5%	-1.6%	70.3%	115.93	69.59	1.1%	81.50	48.92	-0.4%
Decade Average	2.3%	1.5%	0.7%	69.0%	93.44	62.09	1.1%	64.79	42.93	1.9%

Source: Hospitality Research Group of PKF Consulting created by bad tax law and ill-advised financial institution deregulation.[4] While the exact causes are not yet clear, Congress did not set up the current economic downturn and associated hotel market responses. Throughout most of the 1990s, ADRs, available rooms, and occupied rooms behaved in ways that make it easy for professors to explain *(Exhibit 1)*. The winners, losers, and the dimensions of gains and losses also should be predictable.

From the rubble of the hotel real estate disaster of the 1980s, huge winners and losers (principally the U.S. taxpayer) emerged. When the rubble is finally cleared from the current downturn we should find the following corpses:

1. Owners of older (*i.e.*, 25+ year old) hotels, some of which have unpopular designs (*e.g.*, exterior corridors).
2. Mezzanine lenders who extended financing late in the cycle.

Obsolescence and greed are central to identifying the losers following any normal economic downturn.

Room nights are a visible component of the household and business budgets across the U.S. When incomes change, budget allocations to hotel room nights change. Hotel owners and managers would rejoice if hotel business activity always increased by more than incomes increase and declined by lesser percentages than incomes decline. Unfortunately, these relationships tend to be symmetrical. No matter how hard industry executives pray, room nights will not economically behave like necessities, such as food, permanent shelter, and even television cable service. When budget cuts must occur, hotel room nights will appear on the floor well before items deemed essential for running households and businesses.

In now what appears to be a L-shaped or U-shaped downturn rather than a V-shaped economic event, certain hotels will suffer. The industry, however, has a large profit cushion entering this downturn; supply growth has moderated in recent quarters; and some degree of 'service creep' in the upper end of the market could be reversed. The likelihood of winners emerging from this downturn is slim. No reasonable quality hotel product will be for sale this time at 40 cents on the replacement cost dollar. REI

NOTES

1. See, for example, Morgan Stanley Dean Witter, *What Happens to RevPAR in a Recession?* Equity Research – Lodging, March 19, 2001.
2. Patrick J. Corcoran, "Explaining the Commercial real Estate Market," *Journal of Portfolio Management*, Spring 1987, pp. 15-21, presents evidence of the same perverse outcome for other property types.
3. See John B. Corgel, "Capital Flow to Lodging Real Estate," *Real Estate Finance*, Winter 1996, pp. 13-19 for estimates.
4. See Corcoran, *op. cit.* and Patrick H. Henderschott and Edward Kane, "U.S Office Market Values During the Past Decade: How Distorted Have Appraisals Been?," *Real Estate Economics* 23, No.2, 1995, pp.101-117.

ABOUT OUR FEATURED COLUMNIST

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FOCUS ON LEGAL ISSUES

Getting Ready to Sell a Property

by Edwin "Brick" Howe, Jr., CRE

Some years ago, one of the institutional real estate clients of my law firm in New York City promoted the executive who had been dealing with us for some years and put a new man in that position. One of the first things the new arrival told me was: "I am here, *inter alia*, to prove that legal services are a commodity." I responded that I considered it my responsibility to prove to him that they are not. You will sense that I eventually made my point (else I would not be starting the column with this anecdote).

Though the lawyer on the "sell" side of a real estate transaction has less occasion to exercise informed judgment and to make sound analyses and decisions than the buyer's counsel, the seller's lawyer is no more a "commodity" than his counterpart on the "buy" side. More often than not—even in that deceptively simple-appearing legal horror of horrors, the residential sale—there are problems that must be resolved, often with thoughtful, creative solutions, and the seller's lawyer is normally an important member of the team that produces the solution.

Having said the foregoing, my firm has, over the years, worked up a checklist of items to consider *before* marketing a property. With thanks to the firm's partners for authorizing me to do so, I have adapted that checklist for publication in this column. Please remember, however, that having the checklist does not entitle you to consider your lawyer a commodity—far from it. Rather, the idea is for you and your counsel to be as knowledgeable as possible about the property before you go to market and to have dealt with (or at least prepared for) any obstacles that do not emanate solely from the minds of the team on the other side.

First & Foremost

- Determine whether there are any outstanding *rights of first refusal*, option or the like. Thirty years ago or thereabouts, it was very common for a purchaser to extend a right of first refusal, first offer, etc., to *his* seller as a simple courtesy. These days, the original seller or his successors are as likely as not to use such a right against you as a weapon that has to be bought out. Even in more recent years these rights have been granted because they were part of the price you or your client had to pay to get the property. They are a serious threat to a property's marketability and price; in one recent case a client was given an estimate by his broker of a 15-30 percent discount from what would otherwise be the market price. So try to settle these matters before you go to market, unless the right is a so-called deal-in-hand right of first refusal held by a person who just says *No*, in which case you're simply stuck.

I have dealt with the first subject at some length, because it is of such vital importance (and perhaps because it has been the source of substantial damage to the author's stomach lining in recent years). The exposition of the other points will be in far more summary fashion.

Alternatives to Sale

- Don't rush into a sale without considering *other marketing or quasi-marketing strategies,* such as redevelopment, refinancing, sale of air rights, etc. In this connection, if sale is not your only alternative but things are a little tight for you and the market is soft, think carefully through what you can do to hold on to the property until market conditions improve. Of course, you need to consider rights of first refusal here, too. They may be an obstacle — or your alternative may be the way *around* the obstacle.

Brokerage Agreements

- Look for *existing brokerage agreements* that might cover the sale, and don't say a word about selling to any other broker or "intermediary" until you're certain that you are free to do so.

Tenant Matters

- *Leases*: Locate, analyze, and catalogue all leases and ancillary agreements, including tenant correspondence that may be of a contractual nature.

- Prepare *rent roll* with a summary of major lease terms. Write it in English, not code or jargon, so that the lawyers' paralegals (or secretaries) on both sides of the deal can efficiently follow and check them against the leases.

- *Security Deposits*: List them and note any interest obligations. Determine what can be done with deposits in letter-of-credit form (*e.g.*, assignable?).

- Review possibility of tenant or landlord *defaults* and of curative action underway or indicated.

- *Build-Outs*: Review and list status of same, whether undertaken by landlord or tenant, and any landlord obligations to perform or reimburse. (Some sellers prefer to include this in the rent roll.) Review and list outstanding construction contracts.

- Determine status of, and schedule, any *free rent* not burned off. (Again, some make this part of the rent roll.)

- *Estoppel Certificates*: If mortgage is not due on sale, determine form required by mortgage and check against tenants' lease obligations. (Some would put this off until seller knows buyer is not going to refinance.) In *any* event, determine what form you would want to get in the buyer's shoes and see how this matches up with tenants' obligations. Work out a preliminary strategy for dealing with any discrepancies.

Building Operations

- Review *management agreement and (if separate) the agreement with the leasing agent* for any landlord obligations regarding assignment, termination, or notice, and also any outstanding commitments regarding leasing fees on renewals or extensions.

- Review *operating agreements* (typical for shopping centers but sometimes found in multi-owner integrated office or mixed-use projects). List any obligations or problems regarding assignment or notice.

- Review *parking contracts* for assignment, termination, or notice provisions (including contracts with independent operators providing landlord with spaces for employees of landlord or tenants).

- Review *all other service agreements and equipment leases* for assignment, termination, or notice provisions.

- Determine whether *insurance policies* require any action at time of sale, such as cancellation notice.

- Inventory *personal property* and *intangible property* (*e.g.*, property name) and prepare schedule showing what is to be included in, or excluded from, sale.

- Inventory *real and personal property tax bills*; schedule same, indicating any pending tax certiorari proceedings or refunds.

- Determine *status of utilities* and note action needed to be taken at closing time (*e.g.*, notice to cancel service, proration at closing, including likelihood of reproration's being required, or perhaps some other procedure).

- Determine assignability of any *building systems or equipment warranties or guaranties*.

- Without necessarily engaging an independent engineer, *inspect the property*, putting yourself insofar as possible in the shoes of the buyer's consulting engineer. Consider taking care of some or all indicated repairs and replacements before going to market.

Existing Financing

- Review documents for any *prepayment penalties, due-on-sale or assignability provisions, notice obligations*, etc.

Title, Survey and Other Matters

- *Review existing title insurance policy, endorsements and updates* and determine whether insurer is still in business. (If not, consider trying to look up your contact at the defunct company if he is still in the business.) *Order update*, including copies of any referenced documents, *and compare to existing policy*.

- *Review latest existing survey* and determine whether surveyor is still in business.

- Determine *local customs* regarding prorations, party required to pay for title, survey and transfer taxes and any other points that should be specified in the marketing brochure and should not be allowed to become the subject of wrangling at the closing. A seller's lawyer, if located in an area other than the property's location, normally doesn't hire local counsel, but may have to do so on this point. Best bet: Ask your lawyer to call a law school classmate who practices where the property is; this is likely to result in the information you need in return for the price of lunch for two.

- Estimate *transfer taxes*, by whatever name they are called locally, and consider structuring the transaction to minimize their impact (especially on you).

- *Order violation search* and take any necessary curative action. Get your hands on the *certificate of occupancy*, review it for any wrinkles and then guard it with your life until the closing. Determine *zoning* status and compliance of property. Be sure to state the exact zoning classification and what is permitted by that classification in the marketing brochure; I've never been sure exactly why, but you know from your own experience as a buyer how much potential purchasers love this!

- Schedule and assess all pending *claims and lawsuits*. Figure out how you are going to make the investigation underlying the buyer's lawyer's virtually inevitable demand for a representation regarding threatened claims. If you can't figure out how to do this, then figure out how you're going to resist that demand.

- Review any existing *environmental reports*. If there aren't any, or even if there are and they are not fairly recent, consider ordering a Phase I Report, but (except in exceptional circumstances), only if the environmental inspector is willing to allow a buyer to rely on the Report.

- *"Corporate" Matters*: Determine entity status, good standing, and condition of the entity's organic and other official records. Check what approvals (shareholders, partners, etc.) you need and, above all, make sure that the people who have to sign will be there to sign – or, if they won't, make sure that someone who *will* be there is appointed as one or more additional signatories. Remember that some of the world's greatest real estate lawyers don't know the first thing about the law of corporations, partnerships, limited liability companies, etc., and are prone to making the most awful hash of the "corporate" work. So be sure that there is a qualified corporate lawyer on board; he/she may well also be your real estate lawyer, but be candid in inquiring about his/her "corporate" qualifications. He/she doesn't have to be The Great M&A Maven; he/she just needs to understand how corporate law and practice work and what a glorious thing it is when it's thought through in advance of marketing; implemented in a reasonable period of time before the closing; and done right the first time.

Neither my law firm nor I will claim that the foregoing checklist is complete or that all of its items are applicable in all circumstances. We do hope that it will be a helpful start for you and your lawyer. Among other things, it's probably not a bad start for deciding which tasks will be best performed by the real estate professional, the lawyer, the paralegal, the property's managing agent, and others who may be available. If anyone has any suggestions, as to additions or clarifications, I'd be delighted to hear them. You will find my e-mail address below. REI

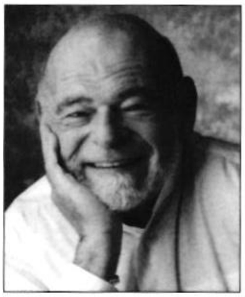
ABOUT OUR FEATURED COLUMNIST

Edwin "Brick" Howe, Jr., CRE, *is a lawyer practicing for 36 years in a range of areas, including real estate, shopping center, business, partnership and international law, taxation and litigation strategy and tactics. His law practice is currently conducted principally out of Ticonderoga, NY, which is also the base of his consulting firm, The Roseville Company LLC. In addition, he is senior counsel (by telecommunication and, when required, by airliner) to Howe & Addington LLP, the New York City law firm he founded in 1970. (E-mail: rosevilleco@aol.com)*

FOCUS ON THE ECONOMY

This Time It's Different

by Samuel Zell



There's a bumper sticker that was seen in Houston at the end of the last real estate cycle—*Please, God, just give me one more boom and this time I promise not to screw it up.*

The real estate industry may have been granted its wish. This time it really may be different.

The current economic downturn is unprecedented in the slope of its decline. But the new discipline brought about through the sea of change in real estate lending over the last decade is resulting in a properly positioned real estate market, with sufficient supply to absorb economic growth but without the excess that has characteristically been a drag on recovery as lenders struggled to cover the lack of cash flow.

It is impossible to overestimate the significance of the loss of dedicated real estate lenders to the demise of the boom and bust cycles of the real estate industry. The massive shifts in both the structure and philosophy of traditional real estate lenders will, for perhaps the first time in modern real estate history, break the correlation of a looming real estate oversupply with the early stages of economic recovery.

Historically, real estate has been segmented as an asset class with institutional allocations separate and distinct from cash, debt, or equity. Lending institutions—S&Ls, insurance companies, banks—thus began their budget year with an allocation for real estate that once committed, rarely went anywhere else, regardless of changing conditions in the marketplace. In theory, uncommitted funds in any given segment were returned to the general pot if unexpended. Needless to say, examples of return of capital were rare.

Such practices led to significant excesses. Supply and demand forces related to the supply and demand for capital for the asset class, rather than for customers and space inventory. Thus, the existing pool of capital for a cyclical industry was dangerously insensitive to changing conditions. The result was a lag of years rather than months between the time when indicators should have put the brake on new supply to the actual cessation of construction. This massive misallocation of capital produced not only an oversupply of real estate unsupported by cash flow, but resulted in a drag on emerging economic recovery that lasted well past the resumption of job growth and other positive indicators.

The evolution of the real estate capital markets in the last decade, particularly towards publicly-traded REITs, has been propelled by the increasing demand of the capital markets for liquidity. Job growth through the 1990s finally completed absorption of the oversupply of the 80s. The re-emergence of the construction crane on the skyline in 1998, however, almost immediately resulted in the stock price deterioration of REITs, reflecting the perception of "here we go again" oversupply. This snapping-shut of the capital markets, particularly for equity, acted as a governor of the industry, resulting in the deferral or cancellation of much of the anticipated oversupply. And where in years past, funds might readily have been available from the debt side, this source was no longer available, nor did it re-materialize. The ancillary effect of the increased information flow of public markets has been to act as a benchmark for pricing capital for all other sources. The discipline predicted in a newly accountable marketplace proved indeed to produce the necessary braking effect.

But this was not a one-time phenomenon. The most far-reaching effect of this realignment of the capital markets has been the virtual elimination of dedicated real estate lending, allowing capital to most appropriately seek opportunity, in any sector. In efficient markets, capital flows to the perceived best opportunities instead of following pre-ordained conclusions. While it may have seemed to be a growth engine, in reality, dedication of capital to real estate as a separate segment impaired the natural flow of capital to the best opportunities, and ultimately led to the destructive consequences of oversupply.

The REIT market in 1998 marked the first instance where capital freely fled the real estate markets to perceived better—non real estate—opportunities. While harsh in its swiftness, the market discipline so imposed headed off nascent overbuilding, and ultimately greatly enhanced the stability of the real estate sector. The current recessionary cycle is proving an even greater test of the new capital reality. Given the volatility of the equity markets as the market has finally come to terms with the concept of valuation based on earnings and assets, this is historically where the real estate lending cycle would have begun to create oversupply. However, the reality is much different.

We are already seeing a significant reduction in the delta between absorption and completion in commercial real estate as the economy recovers, compared to 1989-91, with vastly more alignment between the forces of supply and demand. Today, we increasingly see capital available to flow to the highest opportunities available to institutional lenders. And for the first time, as we emerge from recession and the market begins to improve, we will find real estate is not in a state of vast oversupply.

This time, it really *is* different. REI

ABOUT OUR FEATURED COLUMNIST

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