REAL ESTATE ISSUES

THE COUNSELORS OF REAL ESTATE™
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WINTER 2001/2002
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REAL ESTATE ISSUES

1976 - 2002

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(deadline for manuscript submission - February 11, 2002)

Summer 2002
Articles on general real estate-related topics
(deadline for manuscript submission - May 13, 2002)

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

Winter 2002/2003
Articles on general real estate-related topics
(deadline for manuscript submission - December 2, 2002)

*Visit **www.cre.org** for information on submitting a manuscript for publication consideration or contact Faye Porter at fporter@cre.org; 615.498.5858.*

SUBSCRIPTION INFORMATION

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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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Networking continues as the hallmark of The Counselor organization. Throughout the year, programs provide cutting-edge educational opportunities for CREs including seminars, workshops, technology sessions, and business issues forums that keep members abreast of leading industry trends. Meetings on both the local and national levels also promote interaction between CREs and members from key user groups including those specializing in financial, legal, corporate, and government issues.

CRE members benefit from a wealth of information published in The Counselors' quarterly award-winning journal *Real Estate Issues* which offers decisive reporting on today's changing real estate industry. Recognized leaders contribute critical analyses not otherwise available on important topics such as institutional investment, sports and the community, real estate ethics, tenant representation, break-even analysis, the environment, cap rates/yields, REITs, and capital formation. Members also benefit from the bi-monthly member newsletter, *The Counselor*, and a wide range of books and monographs published by The Counselor organization. A major player in the technological revolution, the CRE regularly accesses the most advanced methodologies, techniques and computer-generated evaluation procedures available.

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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.

The client relies on the counselor for skilled and objective advice in assessing the client's real estate needs, implying both trust on the part of the client and trustworthiness on the part of the counselor.

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.

The extensive CRE network stays a step ahead of the ever-changing real estate industry by reflecting the diversity of all providers of counseling services. The membership includes industry experts from the corporate, legal, financial, institutional, appraisal, academic, government, Wall Street, management, and brokerage sectors. Once invited into membership, CREs must adhere to a strict Code of Ethics and Standards of Professional Practice.

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The demand continues to increase for expert counseling services in real estate matters worldwide. Institutions, estates, individuals, corporations and federal, state and local governments have recognized the necessity and value of a CRE's objectivity in providing advice.

CREs service both domestic and foreign clients. Assignments have been accepted in Africa, Asia, the United Kingdom, the Caribbean, Central and South America, Europe and the Middle East. CREs have been instrumental in assisting the Eastern European Real Property Foundation create and develop private sector, market-oriented real estate institutions in Central and Eastern Europe and the Newly Independent States. As a member of The Counselor organization, CREs have the opportunity to travel and share their expertise with real estate practitioners from several developing countries including Poland, Hungary, Bulgaria, Ukraine, Czech Republic, Slovak Republic, and Russia as they build their real estate businesses and develop standards of professional practice.

Only 1,100 practitioners throughout the world carry the CRE Designation, denoting the highest recognition in the real estate industry. With CRE members averaging 20 years of experience in the real estate industry, individuals, institutions, corporations, or government entities should consider consulting with a CRE to define and solve their complex real estate problems or matters.REI

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REAL ESTATE ISSUES®

EDITOR'S STATEMENT - by Richard Marchitelli, CRE

The Editorial Board of *Real Estate Issues* has made a special effort to reflect the diversity of interests of CRE members and REI subscribers by encouraging both authorship and publication of manuscripts on a wide variety of topics from authors with varying specialties. This edition of REI is a continuation of our efforts in such direction.

"Insider's Perspectives" in this edition, by Kelly, Riggs, Corgel, and Howe, will shed some light on the current state of the economy, investment conditions, legal issues, and the hospitality industry as we attempt to understand the aftermath of September 11. Full-length articles will explore some of those same topics in more detail—specifically, M. Chase Burritt on the lodging industry and Jim Butler "and company" on the new rules of engagement for workouts and dealing with troubled loans for special purpose properties (like hotels which have been especially traumatized in the economic aftermath). The advice of Alan Barnes, Jr., in protecting a building from bio-terrorism couldn't be more timely, as building owners are forced to examine their plans (or lack of) to deal with such calamity in the wake of the anthrax contaminations of last fall. REI is also pleased to be the venue for authors Tom Stanley, John Lajaunie, and Craig Roger to debut the findings of their extensive research on the effects of the bank merger environment on the commercial and industrial real estate markets.

In winter 2001/2002, "consolidation" continues to be the operative word in mall ownership. With the sale of Rodamco's interests in its North American mall portfolio to Simon, Rouse, and Westfield, the number of mall owners continues to shrink. This transaction illustrates how concentrated the ownership of such properties has become.

The apparent benefits of size and critical mass are easy to understand. Nevertheless, there is a paradoxical undertone to the consolidation phenomenon given the volatility of the retail industry, an industry characterized by high leverage, market saturation, erosion of profitability, mixed financial performance, and increasing bankruptcies. These factors often translate into greater challenges and risk to mall owners in terms of devising and maintaining viable leasing strategies, repositioning some shopping centers within their trade areas, and shedding poorly performing malls that are likely to become adaptive re-use candidates.

As of this writing, another topic that is dominating the headlines (and is likely to do so for some time to come) is the crisis of confidence in American business which has reached epic proportions as a result of the Enron experience. Government is expected to conduct a long, far-reaching investigation into business practices that will include a fundamental re-examination of the role of corporations and their representatives, consultants, law and accounting firms, regulators, and the investment community. Morality, trust, conflicts of interest, and reform will be at the center of public debate. Given the consulting and advisory roles played by many CREs, the discourse related to the Enron debacle is likely to be followed closely by our members and readers.

Richard Marchitelli, CRE
Editor in chief

Albert Pappalardo, Sr., CRE
2002 National CRE President

New Rules of Engagement for Workouts: REMICs & Distressed Real Estate Loans

by James R. Butler, Jr. & Jeffrey E. Steiner

ABOUT THE AUTHORS

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THE CMBS MARKET IS HUGE . . . AND LARGELY A MYSTERY

The CMBS (Collateralized Mortgage Backed Securities) market has fundamentally changed the landscape in the United States for commercial real estate finance—the legal structure, ownership, management, and rules of the game. Securitization[1] has also forever altered the behavior of the participants and consequences that follow in the mortgage default dance.[2]

By 2000, the Federal Reserve estimated that 19 percent, or almost one-fifth, of all outstanding commercial mortgage debt in the United States was securitized. This amounts to almost $281 billion in mortgage loans. The amount has been growing at more than $50 billion per year and is expected to continue growing at this rate for a decade or more.

Since the early 1990s, CMBS-financed loans may have been the most attractive and available loans for many borrowers, such as hotel owners and operators. They almost certainly have provided better execution than competing portfolio lenders, but the servicing and other restrictions on handling troubled loans will present many problems for borrowers in the next downturn as their loans get into trouble.

Given the pervasive "success" of CMBS financing, it is nothing short of amazing that so many borrowers and their advisors appear to have little

understanding of the process, structure, and practical implications of their securitized debt or how to deal with it when times get tough. This article looks at a number of these issues and offers some explanations.

Given the strong sudden downdraft in the hospitality industry, this background may be particularly valuable for owners of hospitality properties financed with securitized debt.

HOW CMBS BECAME SO DOMINANT

Although securitization of residential real estate is both well-defined and mature, securitization of commercial real estate is a relatively new phenomenon and virtually untested by recession or other economic distress.

For years, commercial real estate was primarily financed by banks, thrifts, life insurance companies, and pension funds. But all this changed in the late 1980s, when the nation faced protracted economic downturn and a banking and S&L crisis of historic proportions. A virtual collapse in commercial real estate finance ensued in the early 1990s.

Taking a page from an earlier test balloon,[3] and faced with billions of dollars of troubled commercial real estate loans, the RTC helped launch the secondary market for this product. By 1993, the RTC's commercial real estate loan pools aggregated almost $14 billion. The rest is history.

Take note! This market has never been tested by the very economic stress that gave it birth. We expect many business and legal developments to evolve when it is. And the time may be close at hand. According to a recent PKF study, 36 percent of the hotels in the United States are expected to default in meeting debt service in 2002. Many of these loans have been financed from CMBS-driven sources.

NEW PARADIGMS REPLACE OLD ONES—THE FUNDAMENTALS

In contrast to traditional, non-securitized commercial real estate loans, the structure for CMBS loans is far more complex. A bank, mortgage banker, or other loan originator makes a loan secured by a mortgage on commercial real estate. The originator holds the loan until it accumulates a sufficient number of loans for securitization.[4] Then the originator sells the mortgages to a depositor.[5] The depositor transfers the loans to an entity that will pay no federal income taxes. Normally, to assure this tax transparency, the entity will be a Real Estate Mortgage Investment Conduit (REMIC).[6]

This market has never been tested by the very economic stress that gave it birth. We expect many business and legal developments to evolve when it is. And the time may be close at hand. According to a recent PKF study, 36 percent of the hotels in the United States are expected to default in meeting debt service in 2002. Many of these loans have been financed from CMBS-driven sources.

The sellers and underwriter, working with the rating agencies,[7] decide the makeup of the ideal pool—what loans, how many, and other such factors. The rating agencies determine how the pool will be tranched or divided into classes for requested ratings. The underwriters, working within the rating levels, design multiple classes of securities (bonds) to be sold at various interest rates, expected maturities, yield, payment characteristics, and other factors to satisfy market conditions—determining how many securities will be offered at each rating and maturity. There may be both fixed and variable yield tranches.

Typically a Pooling and Servicing Agreement or PSA establishes the management structure of the CMBS pool. This complex document provides extensive detail governing the duties of the servicers in handling the loans and allocation of cash flows to different classes of investors. It is designed to protect the REMIC status and resulting tax treatment of the trust, and to balance the sometimes-conflicting interests of the various classes of bondholders, as well as those of the issuer, servicers, and others. The parties to this agreement usually include the Trustee and the Custodian for the trust holding the mortgages, a Master Servicer, and a Special Servicer.

The Master Servicer is responsible for collecting and monitoring all mortgage payments and ensuring that all payments are made to the security holders. In most cases, the Master Servicer must also advance payments to the bondholders unless it can show that the advance will not likely be recoverable, in which case servicing is transferred from the Master Servicer to the Special Servicer.

The Special Servicer is usually the holder of the lowest rated or unrated tranche of the offering—the first loss or "B-piece."[8] The Special Servicer is the

party who handles the workouts, and is otherwise charged with servicing the loans when they default. The other two parties to the pooling and servicing agreement are the Trustee and the Custodian.[9] The Trustee acts on behalf of the bondholders in relaying information between the bondholders and the Master Servicer. The Custodian is the party with the actual possession of the underlying mortgage loan documents that comprise the pool.

The entire securitized transaction relies on the income stream produced by the mortgages in the pool. The overwhelming importance of the income stream reduces the real estate to a fungible commodity. It is not the real estate that is securitized, it is the cash flow. And the CMBS market depends upon the rating agencies' assessment of the likelihood of default within the income stream drives the sizing of the tranches and the subordination levels of the offering.[10]

SOME PRACTICAL IMPLICATIONS OF REMICS FOR TROUBLED LOANS

The practical implications of securitization can be profound. Compared to traditional pre-CMBS models, securitized loans invoke different players, documentation, structures, and inflexible tax rules. These differences affect the incentive, ability, and willingness to workout or liquidate troubled loans.

Structurally speaking, on the borrower side, the collateral assets securitizing the loan will be transferred to an SPE (Special Purpose Entity). In the case of larger loans, this entity will also be a so-called bankruptcy remote vehicle—designed to prevent the borrower from filing bankruptcy, or at least to make it more difficult for the borrower to file bankruptcy. And, conversely it is intended to make the bankruptcy process faster and simpler for the lender.

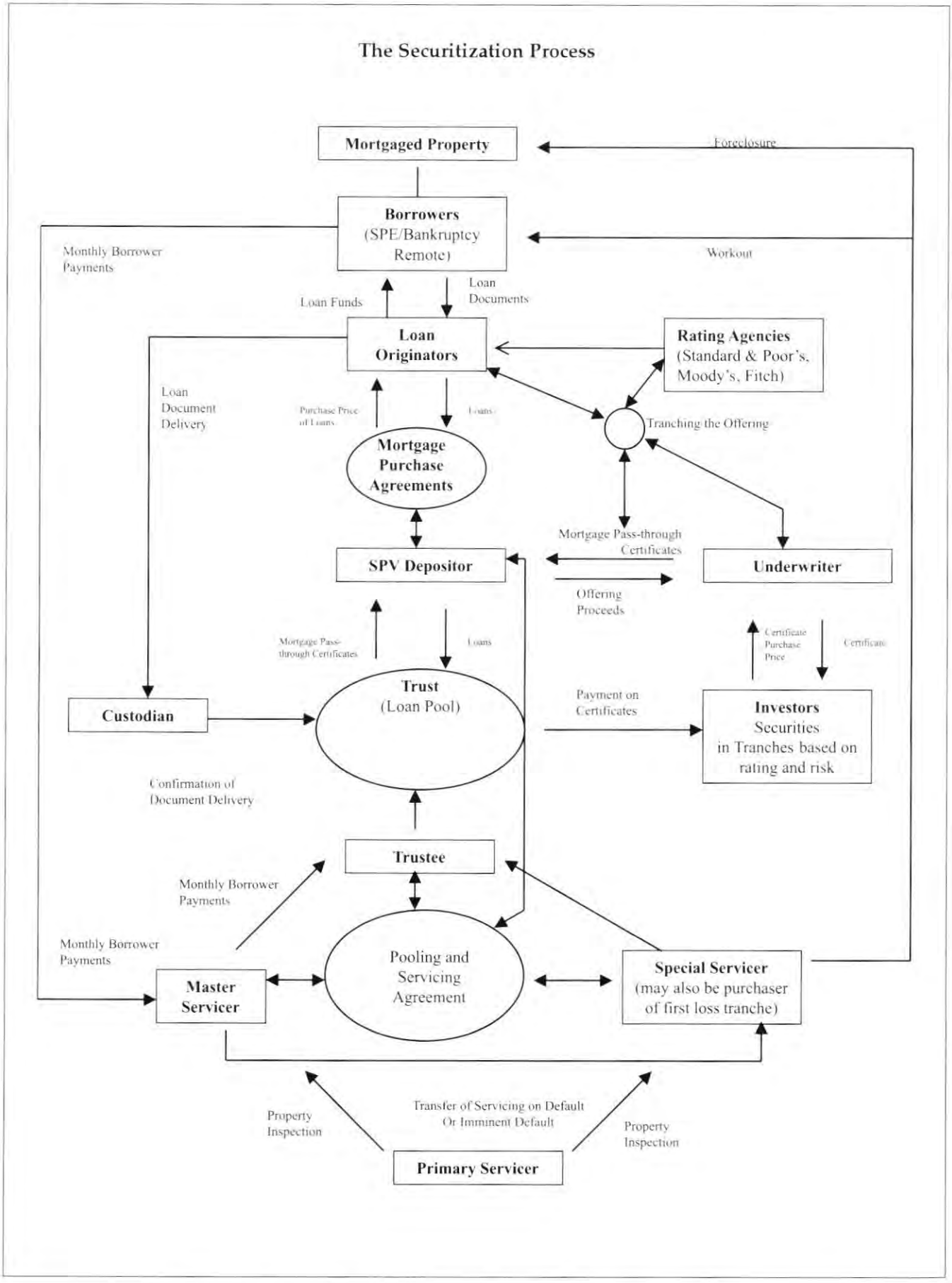
On the lender side, as noted above, most CMBS vehicles are REMICs. "REMIC" status is crucial to the securitization market, because it assures bondholders that the trust will be a pass through entity for tax purposes, avoiding a devastating double tax if the loan pool or trust were to be taxed as well. REMIC status is gained by compliance with complex and rigid rules that prohibit prepayments (unless executed in accordance with defeasance procedures) and sales or exchanges of mortgages in the trust, including modifications to the mortgages, (unless in compliance with very strict guidelines). These tax-driven mandates severely limit when and what a Special Servicer can do when a loan gets into trouble.

The REMIC rules, pooling and servicing agreement and loans documents (rating agency guidelines and accounting standards such as FASB 140)[11] together provide a strict regimen for securitized troubled debt. The REMIC rules require that REMIC pools be static—subject to very limited exceptions, they cannot be expanded, or significantly altered once formed. Failure to strictly observe these rules is the tax equivalent of Armageddon for REMIC investors, servicers and other participants, because the loss of REMIC status is a cataclysmic event in terms of double taxation, and even penalty taxes, on pool income. The REMIC rules thus limit substitution of collateral and significant modifications of existing loans prior to default. Even after default, the pooling and servicing agreement severely restricts the servicer's authority to make modifications.

Where a traditional whole loan lender would have attempted to preserve the value of the asset, REMIC regulations attempt to preserve the integrity of the trust. And borrowers find themselves dealing with multiple parties representing diverse interests that in non-CMBS loans are all typically held by the whole loan lender. Unlike more flexible, traditional portfolio lenders, borrowers will find that Servicers and Special Servicers will follow the loan documents, pooling and servicing agreement, and REMIC rules to the letter in order to comply with contractual and fiduciary duties to the trustee and ultimately the bondholders.

1. The loan will be serviced by several companies with whom the borrower probably has no relationship. The friendly, local banker or mortgage banker looking to future business with the borrower will have little or nothing to do with the securitized loan.
2. Servicers will follow and enforce precisely the strict letter of the loan documents. Servicers will also administer the loan in strict conformance with other agreements or standards that the borrower may never have seen such as the pooling and servicing agreement, REMIC rules, and accounting standards (FASB 140).
3. Multiple servicers confuse many borrowers who often have trouble finding out who to talk to, what authority the Master Servicer and Special Servicer may have, and when to talk to each. In addition to the Master Servicer and Special Servicer, there may be sub-servicers.
4. Releasing any collateral is problematic once the loan is securitized.[12]
5. Additional advances are impossible unless specifically provided for in the original loan documents

Exhibit 1


The Securitization Process
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Mortgage
Purchase
Agreements
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Certificates
SPV Depositor
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Offering
Proceeds
Mortgage Pass-
through Certificates
Loans
Certificate
Purchase
Price
Certificate
Trust
(Loan Pool)
Custodian
Payment on
Certificates
Investors
Securities
in Tranches based on
rating and risk
Confirmation of
Document Delivery
Trustee
Monthly Borrower
Payments
Monthly Borrower
Payments
Pooling and
Servicing
Agreement
Master
Servicer
Special Servicer
(may also be purchaser
of first loss tranche)
Property
Inspection
Transfer of Servicing on Default
Or Imminent Default
Property
Inspection
Primary Servicer

(and by an objective standard or schedule). A cornerstone of REMICs is that the pool is fixed and cannot be expanded after formation.

6. Once put in the pool, loans cannot be materially modified before default.[13] A Special Servicer may be able to approve a loan modification that a Master Servicer cannot approve for its most reliable and creditworthy borrower—only after a default or imminent default.
7. Servicers will enforce financial, data, and other seemingly technical requirements of the loan documents. They may impose a fee for failure to deliver data on time and ultimately may declare a default. When the data is required to be in electronic form, and on the lender's form, the borrower better comply.
8. Generally speaking, a lender will not have the discretion to permit a borrower to substitute alternate mortgage or real estate collateral.[14]
9. If permitted by the loan documents, transfers of the underlying property and assumption of the mortgage may be permitted, but usually only on one occasion and pursuant to a clearly defined process and set of conditions.[15]
10. Further encumbrance is usually prohibited in securitized loans without the consent of the lender, and is likely to be prohibited altogether. And where prohibited, the REMIC will have virtually no flexibility to accommodate the further encumbrance of the property.[16]
11. Unless specifically authorized in the loan documents, prepayments on debt held by REMICs are generally prohibited, and when permitted will be conditioned on defeasance.[17] This limits release of collateral, and complicates workouts. Defeasance is expensive and time-consuming.
12. REMICs are likely to favor foreclosure over workouts. Foreclosure will be the relatively safe alternative for servicers charged under the pooling and servicing agreement with a standard of care, preservation of the REMIC status, and choosing the alternative that will maximize net present value (without using subjective judgments and input). With the REMIC's loan documentation, lock box, SPV structure, limitations on transfer, and yield maintenance, it may be difficult to establish clearly that a workout would produce a larger net present value than a foreclosure.

CONCLUSION

REMICs have changed the landscape of commercial real estate finance forever. We are now about to see how they will change the processing of troubled loans as we experience the next real estate downturn. The complexities of the structure make it imperative for all parties to the loan to know what they are doing. If borrowers are to succeed in workouts or bankruptcies, they will need to solve the maze to find the right party to talk to at the right time, and know how to present options that are within the power and prerogatives of the servicer. Servicers will face interesting challenges in dealing with practical issues of hotels and other operating assets, protecting value, and avoiding unnecessary taxes and costs.[REI]

NOTES

1. Securitization is the process of pooling assets such as mortgage loans, enhancing the credit rating, and issuing new securities to investors based upon the underlying assets in this pool.
2. Using the rating agencies' historic default rate (18 percent) and severity of loss factor (28 percent), applied to $1.3 trillion of outstanding commercial mortgage debt, experts predict that during the next economic downturn, the holders of U.S. commercial real estate debt may lose up to $65.5 billion.
3. In one of the earliest commercial real estate securitizations, Olympia & York obtained a $970 million loan in 1984 secured by 3 Manhattan office buildings. The loan was securitized in a private placement to 40 institutional investors. But the technique did not become popular at the time, because, among other things, there were abundant alternate financing sources.
4. Securitized pools usually range from a minimum of $300 or $400 million up to $4 billion.
5. The depositor is a special purpose vehicle ("SPV") formed to minimize the possibility of a voluntary bankruptcy. Rating agencies insist that the transfer of the mortgages by the depositor must quality as a "true sale" for bankruptcy purposes and isolate the mortgage from a bankruptcy of the originator. As noted later in this article, under financial accounting standards, satisfying this test also imposes limits on the discretion that the Special Servicer will have in disposing of the loans. See the discussion regarding FASB 140, *infra*.
6. The Tax Reform Act of 1986 authorized the creation of real estate mortgage investment conduits or REMICs as the exclusive vehicle for holding fixed pools of mortgages and issuing multiple classes of interests to investors. Entities meeting the six statutory requirements for a REMIC will not be treated as a separate taxable entity. Rather, the income of a REMIC will be allocated to, and taken into account by, the holders of the residual interests.
7. The rating agencies are independent private parties that are paid to analyze the creditworthiness of the pool. The major rating agencies are Standard & Poor's, Moody's, and Fitch.
8. The "B-piece" refers to all certificates below investment grade (rated BBB and below), but in mortgage securitizations, it is the usual practice for one investor to buy the entire B-piece.
9. Sometimes, the Master Servicer or Special Servicer will engage a party known as a Primary Servicer or sub-servicer. Although such entities are not signatories to the pooling and servicing agreement, they enter into contracts with the Master Servicer or Special Servicer to assist with various functions such as property inspection, working with the borrowers on requests for assignments, assumptions, defeasance, and similar matters.

10. The rating agencies are essential in evaluating the creditworthiness of the securitized income stream from the issuer. A credit rating is an assessment of the likelihood of ultimate receipt of principal and the timely receipt of interest. This is an evaluation of default risk and does not reflect other risks, such as interest rate risks, event risks, or other informational risks. Without participation from the rating agencies, there would be no CMBS market.
11. FASB 140 restricts the role of the Special Servicer in workouts by limiting discretion. As noted earlier, it is critical to the rating agencies that the transfer of mortgages by the depositor to the trust be viewed as a "true sale" to insulate the trust from bankruptcy issues that might affect the depositor. FASB 140 provides, in essence, that for transfers after April 1, 2001, a transfer to a trust will not quality as a sale if the trust or its agents (such as the Special Servicer) can decide when and how to dispose of assets. In other words, if the Special Servicer is given substantial discretion in disposition of assets, then the transfer to the trust might be rendered a "financing" instead of a "sale." This results in severe restriction of the flexibility that the Special Servicer has in working out the loan. It is particularly noteworthy that the FASB rejected certain arguments from the financial community that the Special Servicer should be permitted to exercise "a commercially reasonable and customary amount of discretion."
12. It may be possible to release unimproved land with a value of less than 10 percent of the value of the entire parcel, but even this will take time, require a REMIC opinion, and cost money.
13. Prior to default, any material modification may be deemed a sale or exchange of a mortgage that jeopardizes the REMIC status, but minor modifications may be permissible as an "insignificant change." For example, modifications that are not significant include: (1) extensions of the loan term that are the lesser of five years or one half of the original loan term; (2) adjustments in interest rate that are less than the greater of 25 basis points or 5 percent of the annual yield of the original loan; (3) waiver of customary accounting or financial covenants; or (4) assumption permitted by the original loan documents or due-on-sale clause.

    However, even minor modifications are likely to be complex and require considerable analysis by the servicer. Undoubtedly, REMIC opinions will be required to confirm that a change is not a "significant modification" within the meaning of the REMIC rules. Such opinions can be time-consuming and involve an additional expense.
14. While there may be many reasons that a borrower would prefer to substitute one collateral property for another, it will not be possible even if everyone were to agree that the substitute collateral is more valuable, because it would violate the REMIC's requirement to avoid sales or exchanges of its mortgage pool. It would be possible if the specific exchange or substitution was provided in the loan documents (and without discretionary lender consent), but that is usually quite problematic.
15. As with most conduit loan terms, if the loan documents do not specifically authorize the transfer and assumption, it will not be permitted.
16. A violation of this restriction is probably a material default under the loan, and is likely to trigger personal liability of the borrower and its guarantors under the carve-out provisions that create personal liability for the otherwise nonrecourse debt in certain specified situations.
17. Defeasance avoids termination of the debt by substituting, after a lock out period, an over-collateralized package of U.S. government securities that are not callable or prepayable. Defeasance is somewhat cumbersome and expensive because the borrower will normally have to purchase securities for the defeasance with a face value in excess of the mortgage amount in order to match each of the payment obligations of the original mortgage. In addition, the borrower will also be burdened with the inevitable transaction costs for legal fees, REMIC opinions, and the like for itself, as well as the rating agencies, brokers, accountants, trustees, servicers, and others who are involved in or must execute the substitution of collateral.

Legal Considerations for Those Holding or Assembling a Portfolio of Commercial Real Estate

by David Warren Peters

Conventional financial wisdom suggests that a portfolio of investments can diversify, and thereby reduce, overall risk. Attractive financing arrangements, increased leverage, and other economies of scale can make assembling a portfolio of commercial real estate holdings an appealing option. If not managed properly, though, the process of diversifying a real estate portfolio could actually create an overall level of risk greater than the sum of its component parts. From the author's perspective as both a lawyer and real property broker, the purpose of this article is to highlight general considerations for assembling such a portfolio as well as specific strategies to reduce such aggregation risk.

ABOUT THE AUTHOR

David Warren Peters, APLC, *is a partner in the law firm of Higgs, Fletcher & Mack, LLP, with offices in San Diego and Beverly Hills. He assists clients with business and real estate matters, as well as litigation relating to them, in both the United States and abroad. (E-mail: dpeters@higgslaw.com)*

ACQUISITION PHASE CONSIDERATIONS

The urgency to consummate transactions often overshadows good common sense and matters which could have been resolved with little time and expense at an early phase can create significant and unnecessary problems later. If unchecked, such risk will only be magnified by the number of properties in the portfolio.

The Brokerage Relationship

Knowing that the law tolerates a buyer's lack of due diligence less in the commercial context than a residential one, and because many buyers of commercial property have considerable real estate industry experience, less importance is often placed on the assistance an experienced,

qualified commercial real estate brokerage firm can provide. Like lawyers who represent themselves, however, buyers who rely only on their own real estate industry experience may have a myopic perspective of the transaction that an objective, independent professional might have been able to counteract.

Beware dual agency

Surprisingly, the very dangerous "dual agency" representation arrangement—where the same real estate broker(age) represents both the buyer and seller in the same transaction—occurs commonly in both residential and commercial transactions. Even more surprisingly, while many "buyers only" residential brokerages have developed over the past few years (because many lawyers think it can be virtually impossible for the same broker to properly discharge all duties owed to both buyer and seller in a transaction), this author is not aware of any such "buyers only" brokerages in the commercial area. This is believed to be the result of a false sense of security among both brokers and clients in the commercial real estate arena that, perhaps because of the perception that a higher level of expertise and objectivity prevails in the commercial context, there is less likelihood of a breach of duty in a dual agency arrangement, or that the typically more savvy commercial buyers are more able to protect themselves from it. The author would politely suggest that: (1) the risk in the commercial context is the same or greater; (2) because the principals negotiating the transaction will often not personally occupy the premises, it is greater still; and (3) such risk will most likely be magnified in a portfolio context.

Particularly in a situation where the representatives negotiating the transaction are using "other people's money" (*i.e.*, investment proceeds) to acquire the property in question, which is more likely in the portfolio context, the importance of a zealous, independent advocate representing the buyer exclusively cannot be understated. Although the commercial broker should not be viewed as the ensurer of objectivity in a transaction, a reputable brokerage firm with appropriate professional liability insurance coverage will most likely have implemented safeguards to reduce the risk of claims under such policies. Although the coverage (if available) under such policies would most likely still apply in a dual agency situation, the point is that the buyers don't want an insurance claim—they want the certainty of a sound transaction. The dual agency arrangement creates the greatest possible incentive that the limited judgment and due diligence of a broker will be unavailable. Of course, because the brokerage commission is based upon the full and proper discharge of the broker's fiduciary duty to the client, this author would submit (again politely) that a client would most likely receive less in a dual agency situation.

Structuring the Purchase Agreement

Many potentially significant problems can be eliminated through proper initial structuring of the acquisition agreement. Once again, the pressure to complete the transaction can often compromise the better judgment of those negotiating it.

Avoid taking title in principal's name(s), even briefly

A common and problematic practice in the commercial real estate arena is to make an offer, or sign the acquisition agreement, in any name other than that of the business entity which will eventually hold the property. Frequently, principals make the offer, or acquire the property, in their own personal names, or in the name of a parent company, with the view to transferring all rights under the agreement to a business entity to be formed some time before the close of escrow. But what about the (1) lawsuit risk relating to the acquisition transaction; or (2) a later lawsuit in which all parties on title will be named? In each case this practice only affords the plaintiff another individual or entity to pursue. Also, given the considerable risk for every name in the "chain of title" in environmental matters, how could it possibly be prudent for principals to take title in their own names, even for a "moment?"

Even if just a single property is purchased, the practice of taking initial title in a principal's name can contribute to a plaintiff's ability to assert that the company to which the principal(s) transferred the property was their mere *alter ego*, and should therefore be disregarded by a court. In the portfolio context this practice can be even more damaging—if a claimant can show that the principals or parent companies have customarily acquired property directly and then transferred it to have entities formed to hold it, it could be even more difficult to refute such an allegation.

Another common misconception is that principals must hold interests in their own names for purposes of IRC §1031 exchanges. Even if a limited liability company (LLC) selling property has some members who want to trade and others who don't, those who want to trade can form a new LLC and those who don't can form another. The property can then be transferred to the two LLCs jointly and sold.

The LLC with the members who want to do the 1031 exchange can then apply the sale proceeds to an exchange, while the other LLC can simply distribute profit to its members.

Advantages of environmental insurance

Long thought to be a tool best suited to close deals involving known environmental uncertainty, environmental insurance should now be considered by every investor who cannot afford to lose both (1) the full amount of their investment in the acquired property; and (2) all other assets in their name which were not properly asset-protected prior to any notice of claims. Though costly, the increasing availability of environmental insurance could provide considerable comfort to both buyer and seller, possibly justifying a sharing of the expense. Remember, a Phase I (or follow-up) Environmental Site Assessment can fail to reveal major problems, and liability can extend for an indefinite amount of time under certain circumstances.

A relatively new product available from several insurers is a portfolio policy, which can provide limited "blanket" coverage for all properties owned. In addition to the traditional benefit that environmental coverage can allow transactions to occur which otherwise wouldn't, portfolio coverage can insure properties which might not have been cost-effective to insure separately.

Structure of the Property Owning Entity

Choice of entity

LLCs and limited partnerships (LPs) have become a predominate choice of entity to hold commercial real property in many states. Although the considerations involved in the choice of entity alone far exceed the scope of this article, a common trade-off in many states is that the limited partnership may be available at a lower overall tax rate than the limited liability company, but has the requirement of at least one general partner (with absolute liability for the venture) be involved and the risk that limited partners may, through their mere involvement in the operations of the company, be deemed general partners (and therefore subject to general partner liability).

Often, in the portfolio context, a corporation or limited liability company is used as a general partner in one or more limited partnerships to approximate the liability protection of a limited liability company. Usually this is done for reasons of tax savings alone. The perceived tax savings should be

The urgency to consummate transactions often overshadows good common sense and matters which could have been resolved with little time and expense at an early phase can create significant and unnecessary problems later. If unchecked, such risk will only be magnified by the number of properties in the portfolio.

weighed against the risk that, sooner or later, one or more limited partners could become involved in the operations of the company and thereby subject to general partner (*i.e.*, absolute) liability. Because this may occur on a gradual basis and without knowledge of counsel, limited partners may be highly troubled to learn that their newfound (and perhaps considerable) personal liability could have been avoided through the initial selection of the LLC form of entity.

Caveats re: single-member LLCs

An increasing number of states are now offering single-member LLCs, and many lenders require such entities to be formed to hold real property on which they will lend. The popularity of such entities for this purpose should not infer their suitability for all purposes. For example, because (1) the laws of many states limit the recourse of creditors of a partner in a partnership to a charging order (*i.e.*, a court order directed to the partnership to pay all distributions to which the debtor partner would otherwise be entitled instead to the judgment creditor); and (2) because such protections have been applied to LLC interests in many states (most of which, until recently, required LLCs to have more than one member), it would be a mistake to conclude that the same partnership-type protections would apply to a single-member LLC. After all, a single-member LLC can hardly be claimed to be a partnership. The author believes that precedent also exists in certain international jurisdictions which makes the "piercing of the veil" of liability protection in a single-member LLC easier than with a multi-member LLC, because the distinction between the LLC and its sole member is less meaningful than would be the case for an entity with multiple independent members.

Special purpose entities

Lenders increasingly require "special purpose" business entities to hold title to the commercial real property on which they lend. This term generally

refers to provisions in the Articles of Organization and/or Operating Agreement of the property owning company that restrict its activities to those reasonably related to the ownership and management of the property. Additional "special purpose" provisions this author has seen added to organizational documents have included terms whereby even for as much as a "year and a day" after all obligations to the lender have been fully and indefeasibly satisfied, the borrower may still not take certain actions without the lender's express approval, which can often be withheld in the lender's "sole, absolute, and unfettered" discretion. Borrowers eager to secure attractive financing terms may overlook such provisions, but should carefully consider whether an institution will have sufficient incentive to act reasonably in granting or withholding such approval in all cases.

Avoid "funds": one building per company

Many holders of commercial real estate portfolios group smaller properties into "funds" of a number of properties. Although this strategy makes sense from an economic perspective, it can be problematic from a legal one—a lawsuit against any property in the "fund" can reach equity in the other properties. Particularly given the significant risk an environmental hazard could present, the perceived savings from such practices might eventually seem very small. If a property is worth acquiring, it is worth acquiring in a "dedicated" entity, and such entities can, in turn, be grouped into "funds." If this is not done, have investors in the "fund" been apprized of the risk of the aggregation of properties?

No prior transaction record for property owning entity

Some portfolio owners "recycle" business entities after a property has been sold or when used in making an unsuccessful offer. A business entity used to acquire real property should not have been used for other matters previously. Claims associated with such prior activity could reach the equity/profits in the new venture. As stated in Section III, below, such business entities should be dissolved as soon as possible after their use has been completed, so as to start the applicable statute of limitations running.

Use landlord/tenant structure if owner occupied

Often, a firm will seek to own the building it occupies. Conventional tax wisdom and asset protection considerations may both require that such buildings be held by a separate company created to hold the property exclusively (thus establishing a "landlord-tenant" relationship). A company engaging in business which owns the property it occupies unnecessarily subjects the equity in the property to all of the business risks otherwise associated with its operations. Thus, a lawsuit related to any of its products or services could needlessly reach the property equity.

Raising Capital

Holders of commercial property portfolios commonly raise capital through the public or private issuance of securities. Considerable care should always be taken in the offering and issuance of securities (qualified counsel should always be consulted), but especially when made in connection with a real estate portfolio.

Avoid consolidation of issuances

Many real property portfolios are properly comprised of a number of business entities each holding a separate piece of property, and the funds to acquire each property are properly raised in the name of the respective property owning entity (rather than in the name of a parent company). The problem with this arrangement is that, while each of these affiliates may raise the maximum amount it can under applicable securities laws, if the offerings were aggregated and attributed to the parent company, registration would be unavoidable. Because most such acquisitions and offerings are not structured to consider the possibility of aggregation, savvy issuers should re-evaluate this risk with each new issuance.

General securities guidelines

Although the need to take particular care and consult qualified counsel in connection with even the mere offering of securities cannot be understated, it is especially critical in the portfolio context because of the tendency of parent companies holding commercial real estate portfolios to raise capital on a project-by-project basis. If the techniques and procedures used to offer and sell such securities are not absolutely consistent with applicable law, they are likely to be repeated for each entity in the portfolio. Then, in the event of a securities lawsuit, information about these practices may be solicited from subscribers of other affiliated issuances. Thus, bad practices relating to one issuance could be used to support allegations relating to another, or aggregation of all projects together.

Financing

Avoid cross-collateralization

Those acquiring a portfolio of commercial real

property often use the same lender for the acquisition of more than one property. Although this is not necessarily an unwise practice, lenders may offer more attractive terms if loans are "cross-collateralized" (*i.e.*, the borrower pledges equity in more than one property for the repayment of a particular loan). The problem with cross-collateralization, however, is that a negative development with one property can adversely impact the operations of others. For example, an environmental claim relating to even one "cross-collateralized" property (indemnity of the lender, for example) could reach the equity in all other profitable properties.

Ensure an "exit strategy" for "special purpose" provisions

As stated above, many lenders require "special purpose" provisions in the Articles of Organization and/or Operating Agreements of borrower firms. Often these terms can be creative and onerous. Thus, it is important that a company considering a loan that would require such "special purpose" provisions ensure an appropriate "exit strategy" whereby all foreseeable needs to refinance, market, and eventually sell the property are carefully anticipated.

HOLDING/MANAGEMENT PHASE CONSIDERATIONS

When a number of properties are held in a portfolio, factors which might be more easily monitored and identifiable in a situation where only a single large property was held require special attention. Additionally, because authority for matters may be spread across a number of different individuals and locations, the need for consistent implementation of appropriate firmwide policy is critical.

Equity Reduction Arrangements

In a single large property, increases in equity can be easily tracked. In a portfolio, comparable sales near one property or another can increase equity in those properties while other factors can decrease value in others. Consequently, it can be more difficult to monitor overall and building-specific equity when a number of properties are held in a portfolio, rather than a single, large property. Nevertheless, because the equity in a building or in a portfolio, may be available to prospective claimants, the property owner should periodically review and consider reducing available equity. Subject to the limitations of investor and lender preference, this can be done by establishing an affiliated firm to make junior, equity-reducing loans on the properties in the portfolio. Fundamental asset protection considerations suggest that such a firm should (1) not engage in business other than the making of the contemplated loans (*i.e.*, if it engages in other forms of business, claims relating to such business could reach the assets of the firm); and (2) be substantially differentiated from the parent company to reduce appearance of a partnership or affiliation in the event of a lawsuit.

When a number of properties are held in a portfolio, factors which might be more easily monitored and identifiable in a situation where only a single large property was held require special attention. Additionally, because authority for matters may be spread across a number of different individuals and locations, the need for consistent implementation of appropriate firmwide policy is critical.

Operating Expense Reduction Arrangements

Property owners often attempt to achieve economies of operation and reflect those savings in their operating profit. A classic example of this is when a firm owns the building it occupies, rather than setting up a separate company to serve as the lessor. In a portfolio context, the failure to set up and properly allocate expenses for an independent management company could lead to the appearance of excess profitability for any particular property. Of course, the problem with such arrangements is that the false appearance of profitability can be both attractive to claimants and available for judgment collections. If services or benefits which would otherwise be characterized as deductible expenses are not charged to the company, in the event a judgment is obtained against the firm, it may be more difficult to persuade a judge that the true profitability of the firm is actually less than is reported on its financial statements. A lack of profitability can also serve to discourage nuisance claims in their inception. Nothing in this article should be construed to advocate the false assertion of expenses or the failure to comply with applicable tax law—only the reconsideration of any failure to knowingly assert any lawful deduction from operating income.

Avoiding Liability for Parent or Management Companies

Particularly because a single firm managing a number of smaller properties may have less control over the operations of any of the particular properties than if it managed only a single larger building, additional care should be taken to limit the risk of liability from the operations of such affiliated firms. This should include periodic spot-checking to ensure the proper implementation of overall company policy.

Personal Asset Protection Considerations for Principals

The strong liability limitations of LLCs, and to a lesser extent LPs, can create a false sense of security for those involved in the highly litigious real property arena. While there is no substitute for holding each piece of property in a separate LLC, allegations of personal liability can always surface, and appropriate personal asset protection planning will always be most effective if completed in the absence of notice of any claims. One can always be sued for one's personal involvement in a matter, and nearly all of one's personal assets can be at risk in such proceedings.

Once thought to be practical for only the very wealthy and available only through complex arrangements in remote jurisdictions, considerable personal asset protection can be afforded through the proper formation of a family limited partnership, irrevocable trust or other domestic alternatives, without the need for any offshore arrangements. Those seeking an increased level of security (using a "portfolio" theory of asset protection) may prefer to diversify by holding a portion of their wealth in an offshore arrangement and the remainder in domestic asset-protected entities. Diversifying either way, this has never been easier or less expensive to do.

RESALE PHASE CONSIDERATIONS

Because the focus of the commercial property acquisition decision is often on operating revenue, the thought of resale can often be given limited consideration when properties are expected to be held for some time. Some property owners make the mistake of thinking that decades of deferred maintenance and disregard of important operating procedures can be cured by hasty corrective action shortly before a property is sold. Because it should be assumed that every property will eventually need to be sold, however, appropriate policies and procedures should be implemented at as early a point as possible, because the eventual buyer will want to examine documents relating to the entire period of ownership.

Property Should be Transferred to LLC at the Earliest Possible Point

Given that the vast majority of real estate lawsuits are by buyers of property against sellers, often involving claims of failure to disclose, savvy sellers will transfer the property to an LLC as far in advance of the sale as possible (preferably taking initial title to the property in the name of the entity, rather than their own). Under this arrangement, the LLC is the party making the disclosures to the buyer, rather than any of the particular principals, even if one or more principals actually signs the disclosures as manager of the company. Provided the company complies with all legal formalities, and the manager acts in good faith, there is generally no automatic liability for the principal acting as a manager of the LLC for the obligations of the company. If the principal had signed the same disclosure as an owner of the property, all of his or her personal and family assets would be at risk in the event of a lawsuit relating to it. Given the increasing risk of environmental and landlord/tenant litigation, buyers and lenders are also becoming more reluctant to have principals' personal names included at any point in the "chain of title," even temporarily, as had been accepted practice for years.

"Custom Sale" Agreement Terms

A growing trend in larger transactions is to depart from the standardized purchase and sale agreements, many of which are produced by organizations of brokers in an attempt to balance the interests of buyers and sellers. Although reducing the likelihood of lawsuits is often a primary goal of the parties drafting these agreements, an increasing trend among savvy sellers is to have a "custom" agreement already prepared, ready to be signed by both parties when acceptable terms are reached, rather than using the standardized agreements which may have been designed to achieve goals which are not shared by the parties to the particular transaction.

An even more important advantage of these custom contracts is their ability to proactively reduce lawsuit risk. For example, a potentially beneficial provision for sellers (and, arguably, for buyers as well, to the extent it discourages litigation), is to create arrangements whereby the buyer is given broad access to the property during an extended pre-closing inspection period, but then after closing

occurs, the buyer's recourse is particularly limited against the seller (absent fraud, concealment, etc.). The rationale behind this trend is to give buyers a very strong incentive to actively and diligently inspect the property before closing by using contract language which makes initiating claims after closing particularly difficult. The mere "as is" language in many standardized agreements will rarely be sufficient to accomplish this goal.

Another important benefit of such "custom" purchase and sale agreements is the opportunity to insert enhanced dispute resolution provisions. For example, by requiring any party alleging harm to give the responsible party written notice and an opportunity to cure the problem before initiating litigation, many small matters which shouldn't lead to lawsuits can be resolved informally. A provision whereby the parties each agree to restrict the time period in which either can bring a claim of any sort can also provide considerable comfort, at least for sellers. More detailed arbitration provisions can also afford the parties greater certainty—because arbitrators are generally not required to follow the law in their decisions, and there may often be no meaningful judicial review (*i.e.*, appeal) of certain arbitral decisions, many believe that greater specificity in drafting arbitration provisions is the only way to reduce the risk of an unpredictable result.

A particularly troubling California case for sellers, *Jue v. Smiser* (1994) 23 Cal App 4th 312, supports the proposition that, under certain circumstances, a buyer learning of a misrepresentation of sellers prior to closing can nevertheless proceed to close escrow and then sue for damages later. Based on the holding in the *Jue* case, prudent sellers will want to restructure some of the more standardized agreements (or preferably rewrite them altogether because the pre-*Jue* transaction structure usually has a pervasive effect throughout these documents) to: (1) cause all disclosures to be made ***before*** the time the contract is signed; and (2) specifically address the *Jue* case to set an operative date, ideally after all due diligence of the buyer is complete, on which the buyer affirmatively waives rights under the *Jue* case, ideally in exchange for reasonable independent consideration, and affirms in writing the desire to complete the transaction notwithstanding any newly discovered information.

Documentation of All Disclosures to Buyer

Comprehensive, early disclosure is also essential—sellers need to evaluate each document in their possession by considering whether any argument can be made that it could influence either a buyer's decision to purchase or the price to be paid. No matter how insignificant, a lawsuit will invariably allege that it would have. Accordingly, the decision not to provide any arguably relevant document to the buyer as early in the transaction as possible should be scrutinized ***very*** carefully. Careful records should be kept to prove exactly which documents had been disclosed and when.

Considerable economies of scale can result from the aggregation of properties, or at least business entities holding individual properties, into a portfolio. Considerable care should be taken in such arrangements, however, because, in the same way the goal of portfolio management is to multiply and maximize small profits from individual holdings, comparatively small liabilities can also be multiplied if unchecked.

Environmental Reports for the Benefit of Sellers

Increasingly, sellers are obtaining environmental reports and inspections before listing property for sale, and providing copies of such reports to prospective purchasers, rather than relying on the buyer to obtain these, as had been accepted practice for decades. This serves to document the seller's notice of possible problems with the property, or the absence of the same. The fact is that the buyer may simply not obtain these reports, or the ones they do obtain may not be reliable. Particularly in light of the *Jue* case, above, such reports and findings should be disclosed to the prospective purchaser ***before*** the contract is signed.

Reiterate Environmental Insurance

As stated previously, the objective of a seller of real property is not just to receive a high sales price but also to permanently retain it. Because the laws of many states require repayment to a business entity of distributions to LLC members under certain circumstances, arrangements that can limit the likelihood of such repayment will be most attractive to investors. The protracted risk of environmental claims makes environmental insurance particularly attractive in this regard.

Beware Seller Financing

The risk of claims by buyers against sellers can

be increased in situations where sellers provide significant financing for the acquisition. While certain market circumstances may require seller financing for transactions to occur, sellers should consider strong contract language to limit a buyer's assertion of "self help" remedies such as an offset to payment. If financing is to be significant, sellers might consider setting up an independent entity to make market-rate loans against the property, rather than "carrying back paper" themselves.

Dissolve As Soon As Possible After Sale

A business entity that sells a property should properly dissolve as soon as reasonably possible after the sale thereof to activate the appropriate statute of limitations. Dissolution is normally a four step process—(1) appropriate organizational authority for dissolution must usually be obtained or independently exist; (2) appropriate notice to creditors of the firm must be provided; (3) tax clearance from the appropriate taxing authorities must be obtained; and (4) Articles of Dissolution or another similar document are normally filed with the appropriate office(s) of the Secretary of State for each state in which the company is qualified to do business. A common mistake among dissolving firms is to disregard or improperly address the first step. Often, liquidating distributions are paid in their entirety before any consideration is given to proper organizational dissolution procedures. Frequently, funds which should have been withheld as reserves are instead paid out to members and the cost of recovering those funds in the event of claims may be prohibitive.

Members will never have a greater incentive to execute the documents to properly dissolve the company than before receiving any liquidation or other distribution. This also represents a perfect opportunity to ascertain whether members have knowledge of any claims against the company. Because the laws of most states require that appropriate reserves be retained for known liabilities of the company, members should be required to confirm in writing any claims they have or know of against the company at the time distributions are to be made. Ordinarily, this will provide members the greatest incentive to downplay or underestimate any claims they might perceive against the company so as to maximize the size and speed of the distribution they will receive. In the event they later bring a claim, such written confirmation could be very effective in estopping the member's assertion of claims which should reasonably have been identifiable at the time of the distribution, provided the company relied upon the member's representations.

CONCLUSION

Considerable economies of scale can result from the aggregation of properties, or at least business entities holding individual properties, into a portfolio. Considerable care should be taken in such arrangements, however, because, in the same way the goal of portfolio management is to multiply and maximize small profits from individual holdings, comparatively small liabilities can also be multiplied if unchecked.[REI]

THE ROAD TO RECOVERY: A LOOK AT THE LODGING INDUSTRY, POST-SEPTEMBER 11

by M. Chase Burritt

The hospitality industry's ability to reclaim some semblance of normalcy after the events of September 2001 is compounded by the travel industry suffering through the worst short-term prospects since the Persian Gulf War.

The U.S. lodging industry could lose as much as $2 billon as a result of the attacks on New York and Washington, D.C., and their detrimental impact on consumer confidence, the economy, and U.S. air travel. The attacks' direct disruption of economic production reduced third-quarter U.S. gross domestic product alone by approximately $24 billion. Consumer confidence in the economy decreased to 82.2 in November 2001, the lowest since February 1994.

More than one-third of the 260,000 hotel and restaurant workers represented by the Hotel Employees and Restaurant Employees International Union have lost their jobs. The economic slowdown prior to 9/11 already prompted Walt Disney World to furlough approximately 1,400 employees, with the majority of layoffs in the management ranks. In response to the immediate and anticipated continued decline in attendance, Disney has avoided additional layoffs by reducing the hours and wages of part- and full-time employees, while Universal Studios recently announced layoffs of 100 full-time office workers.

The three major demand segments—leisure, business, and conference and group activity—will experience both short- and long-term effects.

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Leisure travel will see heavy cancellations due to air-travel restrictions, plummeting consumer confidence, and a fear of flying. However, leisure demand should rebound in the coming months as consumers regain confidence in travel and the state of the economy. Domestic demand will recover more quickly than international leisure travel.

Business travel also will see heavy cancellations as corporations implement travel restrictions in addition to already-restricted travel budgets. In the future, business travel should resume but at more moderate levels than pre-September 11. However, business travel correlates highly with the state of the U.S. economy, which has been shaken even further.

Lastly, conference and group activity experienced extensive cancellations and postponements, which resulted in loss of room nights nationwide. Attrition will become a factor as convention turnout weakens and the rebooking of events extends over a longer time period.

THE NUMBERS

Occupancy Stabilizes

An economy first weakened by the economic slowdown and then further by the shock of the events of September 11 and the ongoing United States war in Afghanistan will continue to cloud the industry's prospects for recovery in 2002. Supply growth has slowed to 2.4 percent in 2001, while room demand has observed negative growth of 3.5 percent, significantly weakening fundamentals. U.S. occupancy declined significantly from 63.7 percent in 2000 to an estimated 60.1 percent at year-end 2001, lower than 1991 levels of 61.8 percent, the year of the Persian Gulf War.

In 2002, supply growth is anticipated to moderate as the development pipeline had already thinned last year in response to a tighter lending environment. There are less hotel rooms under construction today than at any other time during the past three years. Furthermore, markets on the verge of oversaturation prior to September 2001 are anticipated to experience more modest supply growth as additional challenging market fundamentals weed out those with weaker deal structures.

In terms of demand, reductions in air-travel, corporate belt-tightening, and a fear of flying, and continued layoffs are anticipated to contribute to an elongated recovery timetable. The following factors are anticipated to be the primary drivers of recovery:

- The general state of the U.S. economy;
- The scope and length of U.S. military action; and
- Air capacity in light of recent airline cutbacks.

The second half of 2002 through early 2003 should bring improved performance to the lodging industry as supply growth slows significantly to 1.5 percent and demand exhibits growth of 1.2 percent, resulting in soft but stable occupancy expectations of 59.9 percent for 2002.

ADR (Average Daily Rate) Slightly Increases

In 2000, the national ADR reached $86.12. Rates declined during 2001, as a slow rebooking pace subsequent to 9/11 forced hoteliers to offer more attractive room rates for both transient leisure and commercial segments, resulting in an estimated ADR of $85.11 in 2001— a 1.2 percent decline from the prior year.

Significant declines in ADR will continue throughout the first and second quarters of 2002 as operators have already renegotiated group and contract rates for this period. As demand slowly recovers, we expect hoteliers to be able to maintain their rate integrity in the second half of the year, resulting in little or no overall rate growth for 2002 (approximately 0.3 percent). Luxury and first-class lodging properties will continue to feel the impact of corporate belt-tightening, while economy and limited-service properties will remain more resilient to travel cutbacks.

RevPAR (Revenue Per Available Room) Stagnates

Revenue per available room in the industry reached a high of $54.88 in 2000, a 6.0 percent increase over the prior year. In the aftermath of recent events, RevPAR declined considerably to $51.15 in 2001, an estimated decline of 6.8 percent compared with 2000.

During the first and second quarters of 2002, RevPAR should decline and then recover slightly, resulting in little overall change for the year. Airport, urban, and resort markets such as Miami and Hawaii—typically more dependent on air transportation—continue to be most susceptible, while hotels situated in regional "drive in" markets may be able to rebound better into 2002.

Industry Profits: Good-bye Glory Days

After nearly a decade-long streak of increasing revenues and profits, the lodging industry's watchword is caution. Profits for 2001 are estimated to be

approximately $18.4 billion, down significantly from $22.5 billion in 2000, while 2002 profits are anticipated to be $19.9 billion. Profit growth will increasingly become a function of efficient expense management, as well as extremely limited new development in select areas.

CRITICAL ISSUES

Insurance Recovery

The total estimated insurance costs from the events of 9/11 are $75 billion, according to insurance-industry sources. Owners affected by recent events will have to contend with many difficult business issues, including relocations, lost profits, extra costs to maintain operations, disrupted operations, damaged facilities, lost records, lack of access to premises, and even liability issues in some cases. Insurance premiums for hotel operators are expected to jump 50 percent – 70 percent in 2002.

Erosion of Hotel Values

Given the increasing volatility of cash flows, we expect substantial erosion in hotel values, particularly for the upper-upscale sector, in the near-term. This should allow owners to seek reductions in assessed values and provide substantial real estate tax savings. Hotel values will recover in the mid-term, but trade at discounts to construction costs. Transactions, however, will not be as deeply discounted as in the early 1990s (1991 values were down 28 percent) due to more responsible underwriting criteria in recent years. We would expect a 15 percent to 20 percent reduction in hotel values in the near future.

Defaults are Likely

Declines in U.S. lodging industry RevPAR have squeezed cash flow available for debt service obligations. Lending standards today are 50 percent to 60 percent of value (compared to 70 percent to 80 percent a few years ago). Hotel chains without broad distribution in multiple segments are at an increased risk for loan defaults. We would expect loan defaults to more than double in 2002.

Upper-upscale properties are at greater risk as they strive to maintain rate integrity and service levels. Cost-cutting measures are occurring, but at a slower pace relative to the limited-service/economy sector.

Deal-Making Heats Up Slowly

Transaction activity has already come to a halt, and many lenders remain skeptical of our industry,

After nearly a decade-long streak of increasing revenues and profits, the lodging industry's watchword is caution. Profits for 2001 are estimated to be approximately $18.4 billion, down significantly from $22.5 billion in 2000, while 2002 profits are anticipated to be $19.9 billion. Profit growth will increasingly become a function of efficient expense management, as well as extremely limited new development in select areas.

as evidenced by a reduction of LTV ratios and an increase in capitalization and discount rates. While there will be many opportunistic buyers, we do not expect to see willing sellers immediately. Transaction activity is expected to be very limited in the near-term as owners and investors are waiting to see how quickly the industry will recover.

Wall Street Fizzles

According to Ernst & Young's Lodging Stock Index, lodging stocks (small cap, large/mid-cap, and REITs) outperformed the S&P 500 through August 2001. Following the events of September 11, stocks plunged to all-time lows for the year. Small-cap stocks have continued to outperform the S&P 500. Large and mid-cap stocks and lodging REIT performance have fallen below the S&P 500 with REITs exhibiting the weakest performance. Despite improvements in lodging stocks as of early November 2001, mid-term performance is expected to remain below pre-September 11 levels due to an exacerbated decline in the economy and continued reluctance to travel.

As with any long-term investment you buy when the market is down, there should be good "buy" opportunities among the major hotel flags.

SOLUTIONS/STRATEGIES

Operational Enhancement

Operational enhancement initiatives and cost containment strategies are critical. These efforts may include short-term measures, such as staff furloughing or schedule reductions, or long-term solutions such as revenue and yield management, inventory control, and improved service standards.

This is also a good time for operators to consider innovative ideas such as e-procurement.

Human Resources Strategies

Payroll has been the primary focus of cost containment. Hotels have already cut staffing levels by furloughing, (temporarily laying off), employees. Reducing schedules of hourly employees, requiring mandatory vacations, and cutting overtime have proven to be effective and inexpensive solutions.

Clustering employees is another effective solution to reduce costly overhead. Examples include sharing employees among area hotels—one Area General Manager who oversees three properties and three Assistant General Managers, or pooling banquet servers, housekeepers, etc.—all through one centralized scheduling department.

Given the presence of highly unionized activity in hotels, there is very little flexibility and significant savings from altering benefits packages. In addition, contracting or outsourcing labor may appear to be a viable alternative in the short-term, but does not generate significant savings in the long haul.

Closing food and beverage outlets for certain meal periods and reducing hours of operation for businesses such as health clubs, gift shops, or eliminating 24-hour room service—all which require significant operating expense and often minimal revenue—are additional cost reduction measures to implement. Another example is removing turndown services, a labor-intensive and non-revenue generating activity.

Energy Savings

A successful energy strategy (supply sourcing, conservation, implementation, capital financing) can also result in substantial savings for the bottom line in the long term. These measures can reduce operating costs, increase efficiency, and improve the indoor environment without compromising business objectives. Cost savings ranging from 15 percent and 20 percent can be achieved depending on the systems and facilities.

Management Company Selection

The selection of a management company is critical. Management service contracts are the most important relationship an owner can forge. Today, many owners look at this relationship and wonder if more value can be created through a change in management company or contract terms. Owners and developers need to drive business into the property, manage the facility, staff efficiently, and brand the property for long-term success. Selecting the correct management contract is the key to each of these goals, and deserves the highest level of sophistication and advice. Choosing the right management company and structuring a sound contract can turn a lagging market leader, and launch a new property with great success.

Asset Management

In the face of increasingly complex industry challenges, many individual and portfolio hotel owners are recognizing the value of independent professional asset managers that serve as a vital intelligence link between ownership and management. In addition to providing strong, innovative and profit-driven property management, professional asset management provides the potential for increased profit from operations, the convenience of a central, unbiased point of communication, and the creation of an independent strategic plan.

FINAL THOUGHTS

The lodging industry has not experienced zero RevPAR growth in more than a decade; however, the unforeseen circumstance in which the industry finds itself is one of the greatest demand challenges it has ever faced. Before the economy and world events settle to the point where the American public is willing to resume business and leisure travel in force, lodging managers will be left focusing on the expense side of the operation to squeeze additional value from their operations, continuing a decade-long focus on operational re-engineering, financial restructuring, and a highly disciplined adoption of appropriate new technologies.[REI]

THE BANK MERGER ENVIRONMENT & ITS EFFECT ON COMMERCIAL & INDUSTRIAL REAL ESTATE MARKETS

by Thomas O. Stanley, John P. Lajaunie & Craig Roger

The advent of a substantial number of intrastate and interstate bank mergers and acquisitions has led to a large volume of research that has questioned the potential economic and political implications of these events [1,3,7,8,9,10,11,13,19,24]. The vast majority of this research has focused on two issues: (1) the potential anti-competitive effects; or (2) the potential cost differentials that are likely to exist in a post-event environment [12,15,16,17,18,20,21,25,26,27]. Most of this research has tested for the likelihood of significant differences in the level of interest rates paid on bank deposits, or the availability of total loanable funds in a banking market before and after a merger or acquisition event. In general, this research has suggested that the likelihood of differentials in interest rates on loans or deposits would indicate a competitive advantage for a merger partner relative to its local counterparts. Any sustained differential would therefore suggest that bank mergers or acquisitions affect the competitiveness of the local post-event bank environment.

All of the studies have concluded that no "local effects" are evident in the data and therefore mergers and acquisitions do not create any anti-competitive elements.[1] Furthermore, it is argued that because banking products are generally homogenous and substitute sources of funding are readily available, future mergers or acquisitions are unlikely to create an anti-competitive environment [4].

However, when the focus of the research is shifted from the deposit-side of the balance sheet to the asset-side of the balance sheet, and the

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post-event effects in the discrete lending environment are tested, *i.e.* the commercial and industrial real estate markets, the agricultural production lending market, etc., rather than the availability of total loanable funds, the findings of "no local effects" may no longer be valid. Furthermore, the assumptions of homogeneity and substitutability do not appear to be supported since, for example, the risk, earnings, and maturities, etc., of a residential real estate loan are not comparable to a loan to a small business for an expansion.

The data and analysis in this study demonstrate that "local effects" do exist when the discrete lending categories are analyzed. The results of the analysis demonstrate many instances where significant concentrations and market dominance in post-acquisition environments exist [5,14,22,23].

In addition, Besanko points out that the lack of monopoly pricing elements, (in this case higher interest rates charged), is not necessarily indicative of the level of competition in the market. Instead, the existence of a lack of inter-firm competition may be evident in the operational characteristics of the market [4]. In the market for commercial and industrial real estate lending, the lack of competition can lead to a situation where very few banks are setting virtually all of the policies and standards for a very large group of borrowers. For example, the parent organization's loan committee would likely set credit analysis procedures, credit scoring requirements, collateral requirements, repayment schedules, etc., for all operating units. Since extensive intrastate merger activity could result in a situation where a substantial number of previously independent banks are now governed by a single, more standardized lending policy, the potential is increased for commercial and industrial real estate borrowers to be penalized or even excluded.

PURPOSE OF THE STUDY

The purpose of the study was to demonstrate the extent to which a discrete category of lending; *i.e.*, commercial and industrial real estate lending, can become very concentrated in a very few banks in local banking markets as a result of inter- and intrastate bank mergers and acquisitions. The study results show that in some states these concentrations are so significant in the post-event environment, that there is virtually no competition among banks in the market for commercial and industrial real estate lending.

FRAMEWORK OF THE STUDY

The study period 1982 to 1999 was chosen because

The data and analysis in this study demonstrate that "local effects" do exist when the discrete lending categories are analyzed. The results of the analysis demonstrate many instances where significant concentrations and market dominance in post-acquisition environments exist.

it encompassed a vast number of bank mergers and acquisitions and is consistent with the 1982 Justice Department Merger Guidelines. These revised guidelines provided for a more lenient regulatory environment with respect to approval of merger and acquisition activity. In addition, this time period allows the use of the most complete FDIC and Federal Reserve Bank data relative to bank merger and acquisition activity including the year-end FDIC *Call and Income Reports* and the *Federal Reserve Bank Holding Company Acquisition and Merger Data Report*.

Specifically, the Department of Justice has for many years published formal guidelines that identify structural changes resulting from mergers that are likely to cause the department to challenge a merger. Since 1982, the department has based its merger guidelines on the Herfindahl-Hirschman Index of Concentration (HHI). This measure, which is also used by the bank regulatory agencies, is calculated by squaring the market share of each firm competing in a defined geographic banking market and then summing the squares. The HHI can range from zero in a market having an infinite number of firms to 10,000 in a market having just one firm (with 100 percent market share).

The HHI is a particularly useful tool for bank merger analysis because it accounts for the presence of every competitor in a market and provides a measure of the structural effect of a merger of any firms in a market. In addition, the squaring of the market shares gives greater weight to firms that have large market shares. This weighting of the largest competitors in a market is consistent with the economic theories that predict weak competition in markets in which a few competitors hold a large combined market share [14].

This study used all commercial banks in the 50 United States over the period 1982 to 1999. Each bank's total assets, total loans, total deposits, and total commercial and industrial real estate loans

were obtained from the FDIC year-end Call and Income Report data [8]. A Herfindahl-Hirschman Index number was calculated for each of these balance sheet variables on a state-by-state basis for each study year [14,22,23]. The HHI therefore provides a summary measure of market concentration that reflects the proportion of the total assets, deposits, or loans, etc., accounted for by each firm serving the market [25]. The HHI is calculated in the following manner:

$$C = \sum_{i=1}^{N} A_i^2$$

Where A_i^2 represents the percentage of the market-area deposits or assets controlled by the i'th bank in the market. For presentation purposes, C is divided by 10,000 in order to demonstrate the percentage of the market controlled by the largest banks. The number of equivalent firms is then calculated by dividing one by the percentage of the market controlled by the largest banks.[2] The Justice Department defines bank markets where C exceeds 1800 as a highly concentrated market [14,22]. This translates to a decimal of .1800 as a highly concentrated market with a numbers-equivalent threshold of 5.556 banking units [23].

DATA & ANALYSIS

Table 1 presents the total number of dollars of bank loans classified as commercial and industrial real estate loans by year for selected states and U.S. totals. *Tables 2 through 7* present the HHI and the numbers-equivalent calculations for six representative states.[3] Each table, by state, contains the variables: year, the number of banks as of year-end, the HHI for total assets, the HHI for total loans, the HHI for total deposits, the HHI for commercial and industrial real estate, and the numbers-equivalent for the number of banking units based on the HHI for commercial and industrial real estate loans.

In order to assess the degree of concentration in a post-merger market environment for commercial and industrial real estate lending, an analysis of the HHI for commercial and industrial real estate loans and the numbers-equivalent of units on a state-by-state basis provided the most insight. For example, *Tables 2 and 3* depict the post-merger commercial and industrial real estate lending environment of two states, Pennsylvania and Texas, with very large commercial and industrial bases. Note that in Pennsylvania, the number of banks declined from 349 to 193 and in Texas from 1601 to 753 over the study period. In both of these states as the number of operating banking units has fallen, the numbers-equivalent columns, column 8, in both *Tables 2 and 3*, indicate that the number of active bank lending participants in the commercial and industrial real estate market has also fallen, indicating an increased pattern of concentration in both of these markets. Yet the HHI figures and the numbers-equivalent figures indicate the commercial and industrial real estate environment remained relatively broad-based, and dispersed across a large number of banks with no Pennsylvania bank controlling more than 9 percent and no Texas bank controlling more than 5 percent of the commercial and industrial real estate market within the state.

However, *Tables 4 and 5* present the data and analysis for Arizona and Rhode Island over the same study period and depict a substantially different environment for commercial and industrial real estate lending. For example, Arizona is one of only five states over the study period that maintained a relatively stable number of operating banking units with the number of banks ranging from a high of 54 in 1986 to a low of 34 in 1994 and 1995. Yet even with a minimum of 34 operating units in the state, the results in *Table 4* indicate substantial market dominance in every study category in virtually every year where the index number exceeds 0.1800. Of special significance to this study is the fact that the concentration index for commercial and industrial real estate lending and the resulting numbers-equivalent of active market participants, columns 7 and 8 of *Table 4*, indicate that the concentration ratios exceeded the Justice Department guidelines in every year of the study.

In *Table 5*, representing the commercial and industrial real estate lending market in Rhode Island, the pattern of a very highly concentrated market is also depicted with columns 7 and 8 indicating figures exceeding the Justice Department Guidelines in 17 of the 18 years. What is also significant is that while the commercial and industrial real estate lending markets are highly concentrated in both states throughout the study period, the high level of market dominance in total lending, (column 5), and total deposits, (column 6), does not occur except for the year 1998.

Furthermore, *Tables 4 and 5* indicate that significant concentrations existed in the commercial and industrial real estate lending markets prior to the start of the extensive merger and acquisition activity in both Arizona and Rhode Island. More importantly, nine states plus the District of Columbia demonstrated

Table 1

Total U.S. and Select States
Commercial Industrial Real Estate Loans (000's)

YR	U.S. Total CIRE	Pennsylvania	Texas	Arizona	Rhode Island	Alabama	Minnesota
82	161,032,989	7,177,926	14,524,405	1,371,864	1,604,061	1,224,349	1,942,114
83	181,118,288	7,149,654	21,563,028	1,674,492	1,762,950	1,374,502	2,255,716
84	204,125,548	7,674,400	28,900,032	2,552,032	1,094,271	1,672,023	2,558,200
85	239,005,705	8,496,803	31,927,231	3,894,096	1,511,362	2,020,844	2,823,289
86	292,526,751	11,921,934	33,139,871	4,854,203	1,870,212	2,582,640	3,217,335
87	344,943,896	14,775,218	30,509,439	5,196,848	2,410,385	3,297,911	3,439,478
88	382,224,001	16,945,233	21,510,419	5,110,277	3,060,963	3,897,545	3,701,496
89	419,389,105	19,163,270	17,660,170	4,288,423	2,933,831	4,374,428	3,976,741
90	429,769,828	20,463,331	14,160,968	3,258,902	2,508,146	4,708,617	4,062,235
91	413,974,954	19,849,752	13,545,420	2,612,837	2,328,415	5,151,777	4,099,029
92	394,297,052	19,140,263	14,039,712	2,370,129	1,968,210	5,752,188	4,155,823
93	392,868,109	19,334,006	15,016,674	2,599,520	2,083,029	6,414,167	4,298,600
94	408,912,887	18,048,008	17,333,647	3,086,039	2,117,908	7,328,256	4,949,062
95	432,572,226	18,315,130	20,557,379	3,844,313	2,095,988	8,427,774	5,698,826
96	460,043,067	26,017,435	21,215,870	4,440,130	971,364	10,258,710	6,418,664
97	499,714,408	27,834,216	23,685,718	4,146,140	6,406,833	19,446,126	15,946,282
98	551,155,986	20,837,189	23,036,909	4,796,424	5,906,462	28,977,550	17,166,979
99	640,547,638	22,457,675	27,318,926	5,629,508	6,252,672	39,051,011	21,064,278

concentration measures exceeding the Department of Justice guidelines prior to the adoption and implementation of the 1982 merger and acquisition concentration guidelines. Similar data for all 50 states shows that 17 demonstrated significant concentrations in the market for commercial and industrial real estate lending at some point during the study period. Of these states, eight states had at least one year where there were approximately three or less competitors effectively lending in the commercial and industrial real estate markets.

Tables 6 and 7 provide the results for the lending environment for commercial and industrial real estate in the states of Alabama and Minnesota during the study period. These results show a shift from a highly diverse, broad-based lending environment to one that is highly concentrated within the state during the study period.

Both states demonstrated the relationship between intrastate bank mergers and increased concentrations in the commercial and industrial real estate lending markets. For example, *Table 6*, column 3 shows the decline in the number of operating banks in the state of Alabama which parallels the decline in the numbers-equivalent of active commercial real estate market participants, *Table 6*, column 8. This pattern of increased intrastate concentrations is also evident in *Table 7* for the state of Minnesota.

An additional aspect of the data is the ability to evaluate the HHI and numbers-equivalent with respect to the Federal Reserve Merger and Acquisition report. For example, *Table 6*, column 3, shows a decline of three operating units from year-end 1986 to year-end 1987. Yet the actual number of intrastate mergers in Alabama during this period was 11. Likewise from year-end 1987 to year-end 1988, the

Tables 2 & 3

Table 2

Pennsylvania
Commercial Industrial Real Estate Loans

STATE	YR	n	HHI_2170	HHI_2122	HHI_2200	HHI_CIRE	num_equiv
PA	82	349	0.0353	0.0376	0.0234	0.0172	58.26
PA	83	341	0.0324	0.0372	0.0207	0.0228	43.83
PA	84	326	0.0379	0.0452	0.0247	0.0340	29.43
PA	85	312	0.0386	0.0435	0.0236	0.0380	26.29
PA	86	300	0.0356	0.0428	0.0266	0.0378	26.44
PA	87	295	0.0324	0.0341	0.0259	0.0319	31.35
PA	88	293	0.0323	0.0332	0.0254	0.0280	35.78
PA	89	299	0.0351	0.0349	0.0269	0.0273	36.57
PA	90	301	0.0369	0.0362	0.0308	0.0280	35.67
PA	91	290	0.0488	0.0482	0.0427	0.0309	32.31
PA	92	281	0.0512	0.0490	0.0458	0.0315	31.70
PA	93	261	0.0750	0.0726	0.0585	0.0398	25.12
PA	94	245	0.0933	0.0898	0.0682	0.0480	20.82
PA	95	224	0.0928	0.0958	0.0751	0.0484	20.65
PA	96	218	0.1082	0.1121	0.0977	0.0841	11.89
PA	97	212	0.1155	0.1301	0.1005	0.0806	12.41
PA	98	197	0.1521	**0.1831**	0.1260	0.0794	12.60
PA	99	193	0.1412	0.1618	0.1168	0.0634	15.78

Table 3

Texas
Commercial Industrial Real Estate Loans

STATE	YR	n	HHI_2170	HHI_2122	HHI_2200	HHI_CIRE	num_equiv
TX	82	1601	0.0161	0.0192	0.0109	0.0237	42.11
TX	83	1733	0.0151	0.0185	0.0087	0.0233	42.94
TX	84	1853	0.0142	0.0180	0.0080	0.0224	44.58
TX	85	1936	0.0135	0.0166	0.0075	0.0196	51.02
TX	86	1971	0.0117	0.0159	0.0060	0.0210	47.59
TX	87	1766	0.0166	0.0230	0.0077	0.0306	32.73
TX	88	1492	0.0308	0.0278	0.0263	0.0259	38.60
TX	89	1313	0.0475	0.0395	0.0394	0.0308	32.48
TX	90	1183	0.0477	0.0446	0.0447	0.0218	45.91
TX	91	1121	0.0465	0.0471	0.0452	0.0237	42.23
TX	92	1089	0.0525	0.0706	0.0468	0.0305	32.75
TX	93	1011	0.0627	0.0855	0.0530	0.0427	23.44
TX	94	980	0.0591	0.0857	0.0471	0.0343	29.17
TX	95	935	0.0670	0.0973	0.0444	0.0419	23.86
TX	96	878	0.0536	0.0587	0.0497	0.0254	39.33
TX	97	838	0.0786	0.0733	0.0695	0.0244	40.95
TX	98	797	0.0393	0.0507	0.0386	0.0212	47.10
TX	99	753	0.0462	0.0554	0.0404	0.0265	37.72

number of operating units declined from 225 to 221. However, the actual number of bank mergers in this period was 12. The resolution of these apparent discrepancies is embodied in the FDIC Call and Income Reports where new bank formations in the state account for the year-to-year differences.

Furthermore, the FDIC data indicates whether a bank is engaging in a specific lending market, in this case, the commercial and industrial real estate market. The results of these comparisons are also directly consistent with the variation displayed in the numbers-equivalent in column 8 of the tables.

Tables 4 & 5

Table 4

Arizona
Commercial Industrial Real Estate Loans

STATE	YR	n	HHI_2170	HHI_2122	HHI_2200	HHI_CIRE	num_equiv
AZ	82	39	**0.2829**	**0.2766**	**0.2708**	0.1913	**5.23**
AZ	83	47	**0.2741**	**0.2634**	**0.2670**	0.1944	**5.14**
AZ	84	46	**0.2585**	**0.2550**	**0.2575**	0.2102	**4.76**
AZ	85	52	**0.2505**	**0.2473**	**0.2469**	0.2425	**4.12**
AZ	86	54	**0.2338**	**0.2323**	**0.2419**	0.2318	**4.31**
AZ	87	49	**0.2253**	**0.2200**	**0.2394**	0.2194	**4.56**
AZ	88	47	**0.2333**	**0.2229**	**0.2394**	0.2270	**4.41**
AZ	89	43	**0.2303**	**0.2347**	**0.2367**	0.2320	**4.31**
AZ	90	38	**0.1802**	0.1777	**0.1932**	0.2173	**4.60**
AZ	91	39	0.1703	0.1668	**0.1894**	0.2258	**4.43**
AZ	92	38	**0.1943**	**0.2055**	**0.2179**	0.2132	**4.69**
AZ	93	37	**0.1942**	**0.2081**	**0.2171**	0.2367	**4.23**
AZ	94	34	0.1777	**0.1901**	**0.2246**	0.2396	**4.17**
AZ	95	34	0.1586	0.1638	**0.2070**	0.2695	**3.71**
AZ	96	36	**0.1815**	**0.1906**	**0.2622**	0.3608	**2.77**
AZ	97	41	**0.2116**	**0.2233**	**0.3266**	0.3438	**2.91**
AZ	98	43	**0.2862**	**0.3122**	**0.3371**	0.3389	**2.95**
AZ	99	45	**0.3092**	**0.3089**	**0.3396**	0.3194	**3.13**

Table 5

Rhode Island
Commercial Industrial Real Estate Loans

STATE	YR	n	HHI_2170	HHI_2122	HHI_2200	HHI_CIRE	num_equiv
RI	80	17	0.0289	0.0296	0.0219	**0.1914**	**5.23**
RI	81	18	0.0334	0.0341	0.0232	**0.2062**	**4.85**
RI	82	18	0.0353	0.0376	0.0234	**0.2201**	**4.54**
RI	83	18	0.0324	0.0372	0.0207	**0.1968**	**5.08**
RI	84	13	0.0379	0.0452	0.0247	**0.2743**	**3.65**
RI	85	16	0.0386	0.0435	0.0236	**0.2271**	**4.40**
RI	86	15	0.0356	0.0428	0.0266	**0.2586**	**3.87**
RI	87	12	0.0324	0.0341	0.0259	**0.2621**	**3.82**
RI	88	12	0.0323	0.0332	0.0254	**0.2061**	**4.85**
RI	89	13	0.0351	0.0349	0.0269	**0.2082**	**4.80**
RI	90	11	0.0369	0.0362	0.0308	**0.2214**	**4.52**
RI	91	13	0.0488	0.0482	0.0427	**0.2096**	**4.77**
RI	92	12	0.0512	0.0490	0.0458	**0.3173**	**3.15**
RI	93	10	0.0750	0.0726	0.0585	**0.3280**	**3.05**
RI	94	9	0.0933	0.0898	0.0682	**0.2855**	**3.50**
RI	95	8	0.0928	0.0958	0.0751	**0.3070**	**3.26**
RI	96	8	0.1082	0.1121	0.0977	0.0588	16.99
RI	97	9	0.1155	0.1301	0.1005	**0.7181**	**1.39**
RI	98	7	0.1521	**0.1831**	0.1260	**0.7226**	**1.38**
RI	99	6	0.1412	0.1618	0.1168	**0.7153**	**1.40**

In Minnesota, *Table 7*, column 3, shows the number of banks declining over the study period from 762 in 1982 to 497 in 1999. As is the case in Alabama, the decline in the numbers-equivalent of active market participants, column 8, parallels the decline in the number of banks with the year-to-year variations resulting from new banks being created and entering the lucrative commercial and

Tables 6 & 7

Table 6

Alabama
Commercial Industrial Real Estate Loans

STATE	YR	n	HHI_2170	HHI_2122	HHI_2200	HHI_CIRE	num_equiv
AL	82	294	0.0382	0.0346	0.0318	0.0395	25.33
AL	83	273	0.0533	0.0575	0.0442	0.0521	19.19
AL	84	269	0.0561	0.0694	0.0465	0.0680	14.71
AL	85	240	0.0743	0.0912	0.0628	0.0890	11.24
AL	86	228	0.0863	0.1035	0.0776	0.0966	10.35
AL	87	225	0.0858	0.0993	0.0770	0.1057	9.46
AL	88	221	0.0945	0.1059	0.0876	0.1077	9.29
AL	89	221	0.0917	0.1055	0.0844	0.1072	9.33
AL	90	220	0.0901	0.1027	0.0847	0.1026	9.75
AL	91	219	0.0913	0.1006	0.0840	0.0949	10.54
AL	92	217	0.0901	0.1042	0.0825	0.0961	10.40
AL	93	214	0.0885	0.1035	0.0817	0.0908	11.02
AL	94	208	0.0932	0.1058	0.0852	0.0936	10.68
AL	95	186	0.1196	0.1318	0.1045	0.1644	6.08
AL	96	183	0.1219	0.1323	0.1026	**0.1815**	**5.51**
AL	97	175	0.1701	**0.1806**	0.1513	**0.2484**	**4.03**
AL	98	160	**0.1818**	**0.1904**	0.1739	**0.2273**	**4.40**
AL	99	156	**0.1890**	**0.1927**	0.1735	**0.2121**	**4.71**

Table 7

Minnesota
Commercial Industrial Real Estate Loans

STATE	YR	n	HHI_2170	HHI_2122	HHI_2200	HHI_CIRE	num_equiv
MN	82	762	0.0387	0.0357	0.0228	0.0344	29.04
MN	83	754	0.0415	0.0398	0.0238	0.0362	27.64
MN	84	739	0.0474	0.0470	0.0275	0.0320	31.21
MN	85	736	0.0507	0.0530	0.0296	0.0440	22.70
MN	86	733	0.0564	0.0582	0.0291	0.0418	23.93
MN	87	704	0.1016	0.1076	0.0643	0.0736	13.58
MN	88	653	0.1006	0.1278	0.0751	0.0727	13.76
MN	89	637	0.0892	0.1166	0.0680	0.0691	14.46
MN	90	626	0.0866	0.1089	0.0687	0.0661	15.13
MN	91	608	0.0795	0.1070	0.0639	0.0600	16.67
MN	92	593	0.0974	0.1297	0.0656	0.0445	22.47
MN	93	573	0.1254	0.1555	0.0972	0.0520	19.22
MN	94	563	0.1189	0.1304	0.0780	0.0538	18.60
MN	95	525	0.1242	0.1323	0.0780	0.0636	15.73
MN	96	520	0.1137	0.1228	0.0790	0.0681	14.68
MN	97	520	**0.2890**	**0.3330**	**0.2757**	**0.4012**	**2.49**
MN	98	514	**0.2688**	**0.3147**	**0.2585**	**0.3893**	**2.57**
MN	99	497	**0.2841**	**0.3257**	**0.2729**	**0.4223**	**2.37**

industrial real estate market [2]. Invariably, these banks become attractive acquisition targets and create a situation where the commercial and industrial real estate lending market becomes further consolidated.

However, there is an additional aspect to the 1997 through 1999 data for both Alabama and Minnesota. In 1994, the Interstate Banking Efficiency Act was passed allowing bank holding companies to engage in interstate banking acquisitions starting

June 1, 1997. In 1997, Alabama banks acquired 38 billion dollars in assets through 25 interstate bank mergers and acquisitions. Of this, $20 billion were in commercial and industrial real estate loans. Twenty-three of the 25 mergers and acquisitions were carried out by only three banks. Since these dollars are reported in the chartering state for the flagship bank, this means that a block of approximately $20 billion in commercial and industrial real estate loans has been further consolidated and is administered by only four Alabama banks by the end of 1997.

In 1998, 62 interstate mergers and acquisitions were completed by four banks. Of this, 51 were carried out by only two banks. This moved $39 billion of bank assets and $10 billion of commercial and industrial real estate loans under the control of four Alabama banks. In 1999, four major interstate acquisitions resulted in the addition of $37 billion in total banking assets and $11 billion of commercial and industrial real estate loans controlled by approximately four Alabama banks.

In Minnesota, although the acquisition strategy was somewhat different, the results are very similar to the Alabama experience. For example, in Alabama in 1997, 25 interstate acquisitions occurred resulting in an addition of $38 billion in total bank assets coming under the administrative control of the Alabama parent bank. In Minnesota, only 12 interstate acquisitions occurred in 1997. However, these 12 acquisitions brought over $60 billion in total bank assets under the administrative control of several Minnesota banks including $9.5 billion of commercial and industrial real estate loans. The 1998 and 1999 data shows only four more interstate acquisitions with $26 billion being added in total assets and $5 billion in commercial and industrial real estate loans.

In addition, both states continued a consolidation of in-state banking assets: in Alabama, nine intrastate mergers in 1997 and eight intrastate mergers in 1998; in Minnesota, 26 intrastate mergers in 1997 through 1999. Furthermore, the FDIC Call and Income reports support the conclusion that both the intrastate and interstate acquisitions tended to target banks with very similar loan portfolio compositions [6]. This is directly consistent with the decline in the numbers-equivalent of active market participants in commercial and industrial real estate lending in both Alabama and Minnesota.

SUMMARY AND CONCLUSIONS

If the focus of the research proposition: "it is likely that intrastate bank mergers and acquisitions have the potential to create an anticompetitive lending market" is shifted to the asset-side of the bank's balance sheet and the post-event effects in discrete lending sectors are analyzed in specific geographic banking markets, (*i.e.*, commercial and industrial real estate lending), the findings of "no local effects" does not appear to hold. Furthermore, the assumptions of homogeneity and substitutability are no longer plausible. With regard to the assumption of substitutability among or between bank loans, this does not appear realistic given the different risk-return profiles. The differences in collateral requirements and the difference in the multitude of economic factors would suggest that no other type of loan could be a viable substitute for commercial and industrial real estate loans. Second, while the assumption of substitutability from different sources of capital in the commercial and industrial real estate lending market is reasonable for large investors, it is likely that commercial banks are still the major suppliers of funds for land sales for medium and small investors.

While prior research has focused primarily on deposit effects and loan pricing, analysis of the empirical results over the 18-year study period in this article support the conclusion that significant concentration effects either have been in existence prior to or have resulted from the intrastate and interstate merger and acquisition activity. The effect of this extensive consolidation and subsequent concentration of capital sources within the sector is that relatively few entities will now be in a position to set policies and standards for loan terms and conditions, approval criteria, and other economic factors irrespective of the loan pricing which is likely to be a function of the general economic environment and the individual customer relationship [27]. The effects of this consolidation and the resulting standardization of the lending criteria have the potential for excluding some previously acceptable commercial and industrial real estate borrowers and may have the tendency to exacerbate problems in the local business environment when other economic difficulties arise.

While not within the scope of the research question addressed in this study, in those commercial and industrial lending markets where only one or two banks have been the major acquisition leader(s), an additional problem may arise as the result of the magnitude of the market share inequality between the leader(s) and the remaining lenders [16,23,25]. This inequality of market share further magnifies

the ability of larger entities to demonstrate a position of market dominance in setting policies, lending standards, and approval criteria. This assumption of increased market dominance is testable and appears to be supported by the data and analysis where numerous intrastate and interstate mergers and acquisitions were reported in the study as the result of the expansion activity of only one or two banks.[REI]

FOOTNOTES

1. For a detailed argument that disputes the research that suggests that no anticompetitive cost effects will evolve in a post-merger environment, see Dymski, Gary A., *The Bank Merger Wave: The Economic Causes and Social Consequences of Financial Consolidation*, published by M.E. Sharp Inc., June 1999.
2. The numbers-equivalent of firms is an important measure of bank concentration because it allows the reader to compare the percent of the market controlled by the largest banks relative to the number of banks in the state.
3. Tables for all 50 states are available, upon request, by e-mailing: ECFI-TOS@Nicholls.edu

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HEALTHY WALKWAYS: A GUIDE FOR PREMISES LIABILITY

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THE ONCE AND FUTURE SIDEWALK

For years, Americans have been walking less and less. Pedestrian journeys have gotten fewer and shorter. A recent report on pedestrian safety says Americans take 42 percent fewer trips by foot than they did just 20 years ago. One author said 600 feet is the maximum distance an American will walk before turning to the car. It would be difficult to walk less than we do now. To go out for a stroll sounds both quaint and anachronistic. However, there is good news: Americans are beginning to walk more...gradually.

We often look to and envy European cities for models of good pedestrian environments. This is partly due to their density, which is a function of the period in which they were built. We think of European cities evolving in a period that supported pedestrian life. Keep in mind, though, that great walking cities like Paris were terrible places for most pedestrians before the 19th century. Sidewalks were few and pedestrians moving about had to avoid horses, carriages, and carts second by second. Not only that, but muddy streets were also storm sewers and often a dumping ground for garbage, debris, and sewage. The potential for robbery was sometimes more certain than flickering nighttime illumination.

Today, there are a few things we notice quickly about European city life: (1) the high level of pedestrian amenity; (2) the rule-abiding character of European pedestrian culture: few Europeans jaywalk; and (3) the absence of parking meters and street signs on stanchions near the curb. Part of this is because European city walkways are more crowded, allowing less chance to avoid moving cars, motorcycles,

scooters, bicycles, and trams. Also, due to the history of European city development, pedestrian ways were established as functional entities that would be more than spatial appendages to streets. It is said that Parisian sidewalk culture is not what it used to be with so many sidewalk cafes having closed over the past two decades. Even so, the streets in Paris, as well as those in London, Berlin, and Rome reverberate with pedestrian life.

A sidewalk in original British-English usage was referred to a secondary walkway near a primary or central walkway, not as a walk aligned alongside a street. In British-English usage, pavement refers to what we Americans call a 'sidewalk' and is distinguished from a 'roadway.' In Britain, you *walk* on the pavement, but *drive* on the roadway. The phrase, "pounding the pavement," makes more sense in this context.

What brought better sidewalks to European cities and made them the great places they are for pedestrians today was the development of modern retailing in 19th century Paris after the fall of the *ancien regime*. Retailing and entertainment literally "paved the way" for the public ways that are so familiar now.

First were the dozens of *passages couverts* (covered arcades with shops and cafes), developed by entrepreneurs and developers to exploit the new large plate glass developed by the St. Gobain glassworks and the new possibilities of access after the break up of the great church and aristocratic urban estates. These were the first covered malls, some 180 years ago—the places where the *flaneur*, (the new middle-class social animal), could engage his counterparts in these new public places. Many were developed to counter the outward migration of shoppers. As suitable sidewalks became more common in the city, especially with Baron Houssmann's overhaul of Paris's medieval street system, many *passages couvert* failed or were converted to other uses later in the 19th century. The still-enchanting Galerie Vivienne remains as one of the best examples.

In many American cities, the specific results will be different but the same process is now underway. The development of American shopping centers over the past six decades was partly about making good places to walk and shop. As urban areas mature, the need for many early shopping centers is predictably waning as human movement patterns change. Consider that an airport concourse often functions very much like a walkway along a retail street with displays, vendors, shops, and restaurants. Walking habits are beginning to change for two reasons: to improve health and to relieve traffic congestion. They work together.

The accelerating movement to create more walking places is one of the most widespread and important developments in the United States. In the coming years, it will result in increased pedestrian activity. No one doubts that frequent, vigorous walks are one of the easiest ways to combat weight gain and physical and mental decline coming from aging. Furthermore, the New Urbanism, pre-WWII town planning and design approaches, a revival of interest in core city living, and new transit systems are beginning to result in less reliance on cars and more places where trips can and must be taken by foot. The development of new multi-use retail-cultural-entertainment-sport centers and clusters in so-called 24-hour zones of cities puts more people on their feet. In the coming years, we can expect that increased numbers of Americans will take more trips by foot and that these trips will be longer. They should also be safe and enjoyable.

WALKING & FALLING

Surprisingly, a large number of accidents, mostly slips and falls, happen on ordinary pedestrian ways—both private and public. In 1993-1994, there were eight million emergency room visits for falls. Approximately eight percent of all deaths from injuries, (over 11,000), are *known* to come from falls. While less than 10 percent of fall deaths result from falling on level ground, many such falls result in disabling injuries—sprains and fractures to legs, arms, hips, wrists, ankles, or the skull. As the American population ages, injuries resulting from falls could become a more serious and widespread problem.

In most communities, property owners are responsible for the sidewalks adjacent to their property and are liable for damages or injuries resulting from defective conditions. Responsibility usually includes construction; maintenance and repair of the sidewalk; and ensuring that debris and projections like signs, tree limbs, and bushes do not obstruct movement. Commercial property owners and business improvement districts are usually under a much greater obligation than residential owners to fulfill these responsibilities. Furthermore, local governments are no longer as immune as they once were.

Property owners will need to address the condition of the walkways on their property and in the public

space abutting it. One unforeseen impact will be a change in the relationship between public space and private space, especially in the interface or the transition zone between the two, at entries and exits where there are changes in level, materials, illumination, weather, and visual cues. Business property owners will need to attend to the configuration of this interface because the transition zone is one of the principal areas in which pedestrian accidents occur.

Although the design, construction, and maintenance of walkways would seem to be a matter of common sense, there are many instances where common sense appears to have failed. Not only is there more to the effective functioning of walkways than might first appear, but surprisingly, there is little explicit knowledge of what makes a good sidewalk.

Because of the systematic way in which we analyze how design affects way-finding in problem properties, our consulting over the past several years has taken us into personal injury suits involving the places we walk. Most of these have involved transitional spaces such as private property thresholds, and each could have been prevented if walkways were not carelessly maintained, defectively built, and/or poorly designed.

In one instance, a couple in their 60s had an early dinner at a popular chain restaurant. At about 5 p.m. on sunny day in mid-May, they walked out heading to their car in the parking lot. As she walked, she didn't see the edge of the two or three stair steps in her path and tumbled down. Her multiple fractures left her with a six-figure health care bill. The actual site conditions conformed to the design drawings, which showed a condition of merging treads and risers as the site's slope gradually increased. In this particular instance, the two to three steps looked like a ramp because in the bright afternoon lighting conditions of that season, it was difficult to identify the edge of the stair tread. This was an example of poor design.

In another, a young woman exited her friend's townhouse on a late, early winter afternoon, walked down two steps and turned to head to her car. As she took a step on the sidewalk, her foot slid out from under her and she fractured her wrist in several places as she thrust her hand out to cushion her fall. In this case, part of one sidewalk slab was about five inches lower than the slab adjacent to the steps. Instead of rebuilding and raising the lower sidewalk, the sidewalk builder beveled the edge where the two slabs connected so there was a short but steeply angled slope connecting them. With the snow, it was slippery. In the poor light at that time, it was difficult to see. This was an example of defective construction.

In most communities, property owners are responsible for the sidewalks adjacent to their property and are liable for damages or injuries resulting from defective conditions. Responsibility usually includes construction; maintenance and repair of the sidewalk; and ensuring that debris and projections do not obstruct movement. Commercial property owners and business improvement districts are usually under a much greater obligation than residential owners to fulfill these responsibilities.

A third injury occurred at the entrance to a major performing arts building. A husband was pushing his wheelchair-bound wife across the plaza to go into the building. The double-door entries were all open. As he wheeled her through a doorway, the wheels hit something on the surface and the chair bounced ejecting the woman and breaking again her already fractured leg. It later required amputation. The threshold plate was set at a level that was too high and functioned like a speed bump. This was an example of defective construction and careless maintenance.

The list could go on. The individual physical cost of falls, the discomfort, pain, temporary or permanent loss of mobility and the use of one or both hands, and society's financial cost are all equally beyond measure. What is *not* beyond measure is the financial cost—to individuals and to property owners.

FACTORS AFFECTING SIDEWALK USE

Three principal factors affect how walks are used: human, environmental, and configuration. While many environmental and human factors involve patterns that can be predicted on a statistical basis, they are not controllable. Configuration factors, on the other hand, which are designed responses to environmental and human factors, are largely controllable. Although there is anecdotal evidence that each of the factors weighs differently in contributing

to falls, from our research, there appear to be no scientific studies that assess or assign weights to the various configuration factors.

Environmental factors

The natural and the human built environment each affect how a walkway can be used. The natural environment involves variations in terrain, subsoil, vegetation, and weather. Terrain variations will obviously affect walkway configuration and could require steps, ramps, cuts, and fills. Other environmental factors vary, but in ways that are usually predictable. Walking outdoors is affected by seasonality, weather, and time of day, all of which can alter light, shading and shadows, precipitation, and temperature. Temperature, wind, light, and the form and amount of precipitation vary with the season.

Geographic region has an impact. In New Orleans, you can count on 50 to 60 inches of rain a year. In some seasons, there are regular, heavy rains that end before late afternoon. In semi-arid, mountainous Colorado, microclimatic variations are more frequent than in other regions. In winter, the sidewalk on the north side of the street, the sunny side, is more likely to be dry and free of snow and ice, as opposed to the shady south side. Diurnal variations, (*i.e.*, day-night), can easily be 30 degrees Fahrenheit. In the winter, with low light and long shadows for most of the day, collected moisture will freeze quickly when surfaces cool even if there have been relatively mild (above freezing) temperatures during the day.

The human built environment served by walkways affects their use. Walkway width in areas of commercial land use needs to be wider than in residential areas. Walkways at the entrances and exits of performance, entertainment, and sports facilities need to accommodate large crowds of persons with varying physical capabilities. Walkways in parks may curve and meander. Walkways interfacing with parking areas for automobiles and bicycles require special consideration. Walkways immediately adjacent to rapidly moving traffic need to be wider and protected from out-of-control vehicles.

Human factors

The human population's ability to use walkways varies. Human factor variables involve demographic factors like age, sex, and marital status. Human perception, cognition, and coordination are factors that vary with a person's age, sex, physical condition, attention, stress, fatigue, alcohol consumption, infirmity, and short-term and long-term memory. These affect how persons map the environment, choose, and use routes.

Age is a significant factor in falls. Persons 65 or over fall and are injured more frequently and severely than younger persons. Sex difference is another significant factor. Females fall on stairs more than males. However, males up to age 14 (*i.e.*, boys) fall more than females in the home. Combining age and sex factors indicates that elderly women fall more. Vision and type of correction in glasses can affect what is seen. Persons who are wheelchair-bound and vision-impaired usually give special attention to movement requirements. Places that serve persons who are less physically able, like senior housing and health care institutions, and places that serve alcohol, should be especially cognizant of the condition of their walkways.

Human physiological factors are influential, but in unexpected ways. An important aspect is the nature of the human gait, which varies considerably according to both individual characteristics and environmental and configurational characteristics. In a normal gait characteristic of walking on a level surface, a pedestrian's heel touches the surface at about a 30-degree angle of incidence. In wet or slippery conditions, most people consciously shorten their stride length and thus reduce the angle of incidence. The gait used in ascending steps differs from the gait used in descending them. The human cone of vision normally does not include the area immediately in front of the feet.

Cognitive factors affect how pedestrians retrieve information from their environment. A pedestrian's attention to conditions can vary depending on distractions and behavior. A variety of things can distract a walker's attention from the sidewalk but a common one is packages (like grocery sacks) that obscure vision of the surface immediately underfoot. Like drivers, pedestrians engaged in conversations, (on mobile phones for example), do not fully attend to the route they are traversing.

Depending on the cues embedded in the configuration, pedestrians choose channels of movement sometimes consciously, but usually not. Route choice and navigation are strongly influenced by the spatial and material conditions that allow perception of a channel through which one can walk. For example, perceived continuity in one direction may not be similar to what is perceived in the opposite direction. Thus, in emergencies, people will often try to exit a building using the route they

used to enter it rather than by the designated emergency exit. Sidewalks clearly define a channel of movement. Where no channel is defined, route choice will be influenced by how conditions like openings, signs, and barriers around the destination are perceived.

To a large extent, walking is governed by spatial cognition, which may be determined by handedness (left versus right hand dominance) and by social convention, which relates to right dominance in most of the population. Consequently, most people walk on the right side of a walkway. We have observed this in studies of shopping behavior in indoor and outdoor shopping areas, on city sidewalks, in museums and galleries, and in a wide variety of settings. Templer observed similar movement patterns in relation to ascending and descending stairs.

Configuration factors

Configuration includes those factors that constitute the walkway corridor to accommodate variations in human and environmental factors. These are largely controllable factors. Collectively, configuration factors afford both material and information conditions for pedestrian movement. They are:

- continuity
- width
- running grade
- cross slope
- surface profile
- surface material
- surface pattern
- encroachments
- lighting
- overhead protection
- transitions

See pages 33 - 35 for an illustration and explanation of 11 configuration factors.

Each configuration factor should be considered both individually and as it interacts with other factors of configuration. For example, width and continuity patterns interact in commercial areas. Objects like streetlights and trees and tree grates create flow 'shadows' outside of normal pedestrian paths. These shadows create potential spots for sidewalk vendors, peddlers, and buskers, and for interfaces between sidewalks and streets where auto passengers can be picked up and discharged without interfering with pedestrian flow. Supports for permanent overhead protection present opportunities for displays. Surface patterns obviously interact with surface materials and can be linked to changes in continuity.

WHY WE FALL

Why do people fall? The short answer is when they cannot *recover* their balance, not just because they lose their balance. Loss of balance does not inevitably lead to a fall. Pedestrians slip, trip, stumble, and lose balance momentarily but don't fall, especially if they are non-elderly. Walking is dynamic balance and some people typically have more trouble walking, particularly those with a disability or the elderly.

For a human, the angle of incidence of the heel to the surface in normal walking is about 30 degrees. Older people and those being careful will reduce their stride length so the angle of incidence is less—about 25 degrees. In addition to sprains, there are generally two kinds of falls on level surfaces and both result in what emergency room personnel call a *foosh* (fall on out-stretched hands):

- those resulting from a trip or stumble that usually involves a fall forward;
- those resulting from a slip which usually involves falling backward.

The kinetic sequence of a the fall leading to injury starts with a loss of balance; an attempt to recover from loss of balance; recognition that recovery is not likely; an attempt to dampen impact by extending an arm in the direction of the oncoming surface; hitting the surface with a force and at an angle that could cause injury. If the arm is not extended rapidly enough, a different part of the body, like the hip, will hit the surface and be exposed to injury. All of this happens in an instant.

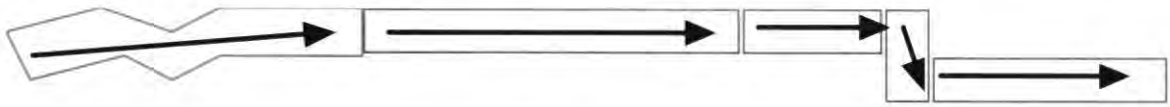
A fall happens so suddenly and unexpectedly that people sometimes cannot explain how it happened. Loss of balance can not be recovered because of a combination of gravitational force; the three-dimensional geometry of the walkway and surface condition under the feet; the kinetic patterns of leg and feet movement (gait); and the physical (neurological/muscular/skeletal) constraints on perceiving the loss of balance and, once perceiving the loss of balance, moving quickly enough to reposition the feet, the arms, and torso or manually reaching a device, like a handrail, that could slow the process and restore balance.

But, in many cases, there is a preceding cognitive sequence, or absence of one. Walkways—sidewalks,

CONFIGURATION FACTORS

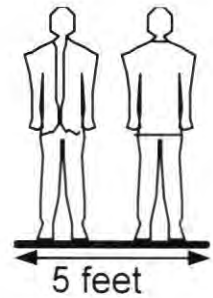
1. Continuity

Most sidewalks in improved or built residential or commercial areas are usually orientated with reference to the adjacent street and are continuous axially. Minor acute-angle discontinuities occasionally occur requiring slight reorientation of movement. Sudden or unexpected discontinuities requiring a right-angle change in direction are disorientating and, at street crossings, can be a safety hazard. Three sidewalk layouts are illustrated below. The middle indicates the preferred form of continuity.



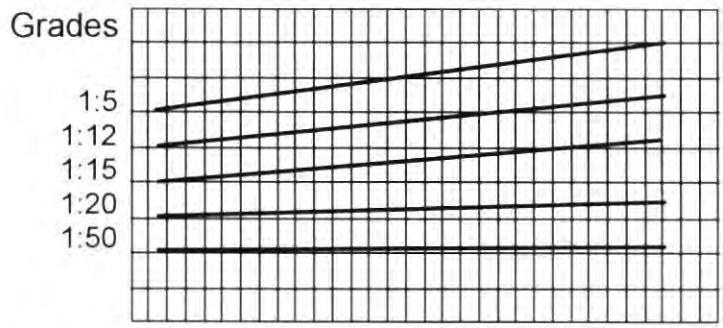
2. Width

Walkways need to be wide enough to accommodate expected pedestrian traffic volumes. In heavily used commercial areas, sidewalks may be 12 to 16 feet or more wide. Ample width is important in commercial areas because of the flow in and out of buildings and the tendency of people to slow down or stop for orientation as they leave a place. Sidewalk width in traditional residential areas is typically five feet—enough to allow two adults to pass in opposite directions. Anything less should not be considered for normal pedestrian use.



3. Running grade

Running grade is the slope of walk coincident with the designed direction of pedestrian movement. It affects effort made in walking. A sidewalk's recommended grade is no more than 1:20. For ramps it is 1:12. Grade changes should be gradual and consistent. Normally, a sidewalk should be at the same running grade as the street it abuts. A very steep grade will require the sidewalk to be stepped (as it is on many San Francisco streets). The relation of the running grade of the sidewalk to the profile a commercial building, particularly one with retail uses, is important because the shop or building entry should be at the same level as the sidewalk. When the running grade varies, it is a judgment call as to where cuts and fills are appropriate.



4. Cross slope

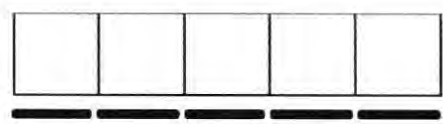
Cross slope is the slope of the walkway for water drainage, usually perpendicular to the direction of pedestrian movement and in the direction of the adjacent street. The recommended normal cross slope to allow water drainage is very slight: 1:50—with 1:25 in exceptional situations.

5. Surface profile

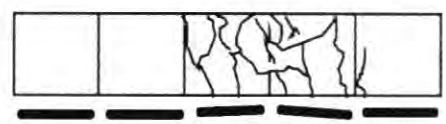
A typical American sidewalk is usually made of Portland cement concrete. When it is new, it looks like the first illustration with the concrete units intact as shown in plan on the top and in profile beneath the plan.

With weather, soil and below-grade changes over the years, the sidewalk may crack and heave. Below grade changes are often caused by growing tree roots, which can crack and raise the sidewalk. The second illustration shows typical changes.

When these changes are minor, gradual, and perceptible, they cause few problems to pedestrians. Eventually, though, they need to be repaired and the sidewalk replaced. A sidewalk should have an even surface and the edges between paving units and adjacent materials at the same level to ensure the surface under the sole of the approaching foot is flat.



Normal surface plan and profile.



Normal surface plan and profile after subsurface vegetation changes.

(continued on next page)

CONFIGURATION FACTORS, *continued*

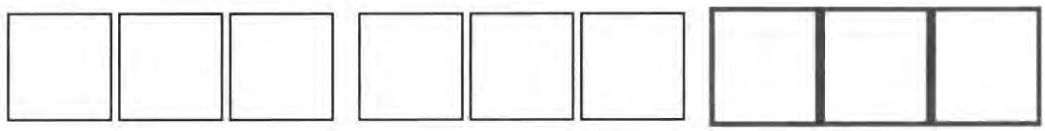
6. Surface materials

Sidewalk surfaces vary depending on expected use patterns; environmental conditions; subsurface conditions; maintenance expectations; and the need for durability, tactility, and attractiveness. Concrete is the typical material but others include pavers, stones, bricks, and asphalt,. Slip resistance with concrete is achieved by the grain of the surface, by 'brooming' concrete or by cross-hatching or scoring the surface.

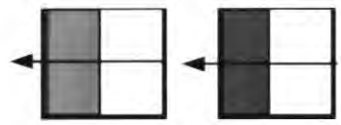
Materials for indoor walking areas, like malls and airport terminals, are far more diverse but still should be selected on the basis of durability, tactility and attractiveness along with ease of maintenance.

7. Surface patterns

A wide variety of patterns are possible depending on materials and design intent. Surface patterns should be even, consistent, have adequate friction and not be confusing. Most outdoor sidewalks have a simple pattern like that shown on the left of the figure below. Some are tiled or bordered.



Sidewalk surface patterns.



Sloped surface patterns
(arrow indicates down slope).

Distinctive patterns are not simply for decorative purposes but to provide cues for users—for store entrances, street crossings, or changes in grade. The blind, for example, use surface patterns to detect their position relative to street crossings. A pattern of cross-hatching, dimpling, or scoring is usually applied at sloped or potentially slippery areas like curb ramps.

8. Encroachments

Encroachments include bushes, tree limbs, and projections from buildings, signs, vending boxes, and trash receptacles. They should be controlled in residential areas. Encroachments like limbs and bushes force people to couch and stoop, take detours into grass, mud, or the street and can cause people to stumble or be hit by limbs causing injuries to the face and eyes. Tree limbs and bushes protruding into streets block the visibility of stop signs and oncoming traffic and cause accidents. In commercial areas, sidewalk trees and planters should be minimized and tree types carefully selected for two principal reasons. Trees can obstruct the pedestrian's and the driver's view of the business and the containers for trees and planters easily become unintended waste receptacles. Awnings over storefront windows should have ample clearance height. Stanchions clutter the sidewalks of many American cities. Signs on stanchions, lights on stanchions, traffic signals on stanchions, and parking meters on stanchions can easily fragment the sidewalk space and make it less intelligible to pedestrians and to drivers.

9. Lighting

Sidewalks are lit by daylight that varies by season, by weather conditions, by time of day, and by artificial illumination. The relationship between the light source and other objects can cause shadows, reflection, and glare.

10. Overhead Protection

Sidewalk channels receive overhead protection for two typical reasons: weather extremes and adjacent construction. In rainy climates like that of New Orleans, sidewalks in commercial pedestrian areas are often covered by second story balconies. In hot, sunny climates, sidewalks are often under sheltering arcades. In cold climates like in Minneapolis or Montreal, there is a secondary system of covered walkways—above ground or below ground.

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CONFIGURATION FACTORS, *continued*

11. Transitions

Transitions in the sidewalk corridor are part of the configuration of the pedestrian way and can be the most problematic of all configurational elements. They also interact with the other configuration factors and with the larger context of the built environment. The principal transitions are up/down (steps and ramps); in/out (doorways); turns (right/left and their reverse); and crossings. Inattention to transitional factors, especially those occurring in combination, can cause serious problems. What might be easy to see going up, going in, or turning right may be impossible to see going down, going out, or turning left. Until the past couple of decades, scientific knowledge about these transitional factors was poorly developed. Steps and doorways should be given more attention.

a. Steps

We make a distinction between stairs, which typically link one level of a building with another, and a short run of steps that does not necessarily require handrails. While Templer has thoroughly researched stairs in order to improve the functional, safety, and aesthetic characteristics of their design, his work does not appear to be widely known among designers. The configuration and design of a short run of several steps needs to accommodate the rhythm of movement in the context where they are located. Tread and riser shape are critical in the way they enhance or modify movement and make pedestrians aware of forthcoming or imminent elements of interest. The terminus of an escalator run, especially going up, can be a point of congestion.

b. Doorways

We also make a distinction between doorways and entrances. An entrance can consist of a simple door or can be a grand sequence that includes doors, steps, spaces, and visual elements that signify arrival. Height, width, and (as previously mentioned), threshold condition affect a doorway's functionality. In the past, doorways to the private sleeping quarters of rulers were sometimes built with higher thresholds and lower headers to thwart the intentions of unauthorized persons who might enter the chamber at night. Although this is not necessary now, similar conditions nevertheless exist. There are doors with barely visible push-bars and pull-handles that say "push." There are automatic doors that close too quickly on elderly shoppers. We know of package shipping stores with unwieldy doors that force customers into odd contortions as they bring in the object they wish to have packed and shipped. We know of doors that suddenly stop halfway open and others with weak closers that hit and injure users when the wind gusts. We know of large glazed areas that look like so much like doorways or openings that persons have run through them and been seriously injured.

It is not that transitions should be routinely minimized. Transitions can be extremely effective design elements that affect perception, way-finding, and meaning. The monumental stairways entering or inside of important buildings like capitols convey meaning. One of the most effective transitional areas is the covered front porch of the traditional American house. Good transitions allow a person to gather information and make decisions quickly without obstructing other pedestrians.

paths, stairs, ramps, plazas—are artifacts of human ingenuity and effort, and affordances, to use Donald Norman's term. Put simply, they afford walking—pedestrian movement. It is very difficult to find pedestrians (or just about anybody else) in places where some form of walkway doesn't exist. As artifacts, they do two things:

1. afford our actual physical movement;
2. afford *information* about our possible or planned physical movement.

In the second way, the configuration of a sidewalk is a cognitive or decision tool. It gives a pedestrian information about what to expect. Walkways can be hazardous when they *do not* afford adequate conditions for actual movement. When they *do not* afford sufficient information, or afford the wrong information, about our possible or planned movement, walkways can also be hazardous. Signs are not necessarily the whole answer. Norman says a high incidence of signs signifies a more fundamental problem.

Over the past couple of decades, a new discipline called cognitive science has emerged. Within its domain of knowledge is the relationship between the physical form of things designed for human use and the way humans actually use these things. It overlaps with human factors and ergonomics and addresses the way information is intentionally or unintentionally encoded or not encoded in the configuration of things, including everyday environments. It is used in modeling human error.

Much of the original research in this field focused on the relationship or the interface between computerized control systems and human operators. But, as research results emerged, two things became clear. First, they applied to a much wider range of phenomena beyond control systems. Second, many of the principles were not necessarily

new but were simply a part of a large body of socially applied but unsystematic forms of knowledge used in design, manufacture, and building.

Many examples of the problem can be found in the design of audio-visual equipment like receivers and VCRs. On retailer's shelves are a few pieces of equipment with knobs and buttons arranged in distinctive, asymmetric arrays that contrast with the front panel. Most, however, have their knobs and buttons arranged in patterns that require very close visual inspection to distinguish their functions. Similar problems, with more serious consequences, can be found where people walk.

Configuration factors can directly affect the *foreseeability* of the conditions that contribute to falls through their levels of coherence. On one hand, among those responsible for the walkways, they can contribute to habituation practices that limit the foreseeability of problems. On the other, among those using the walkways, they can lead to false interpretations of actual conditions.

Most falls can be traced back to the most controllable factors, the surface condition and the three-dimensional configuration of the walkway. The configuration or design of sidewalks is the most controllable of the three factors (human, environmental, configurational) affecting their use and should accommodate varying environmental conditions and use by persons of varying conditions and abilities.

CONCLUSION

Not only will more Americans be walking in the next 10 to 25 years, but there will simply be more people and more of them moving—by auto, transit, motor scooters/cycles, bicycles, (and skateboards, push scooters, skates, Segway HTs, and that which is yet to be invented). All elements of configuration will need to be addressed and the interfaces and transitions between movement modes will need more attention if they are not to become more complex, confusing, and dangerous.[1]

There is a commonsense expectation that walkways for general use in an improved area will be regular and consistent, especially on private property. The built environment is created to create continuity so that people do not have to think and analyze every movement they are about to make. In the natural environment, people don't have this expectation. That is why people go hiking—for the difference. Sidewalks are not new technology and knowledge of the proper way to build a sidewalk is not an esoteric form of knowledge. Nevertheless, surprisingly few design and building professionals, architects, landscape architects, planners, traffic engineers and contractors, are fully aware of the ways in which sidewalks can be unhealthy places.

More research on walkways will no doubt be useful and its dissemination can certainly result in improvements. But perfection is not the aim and there's no need to wait. Simple audits of the walkways by which a premises is used are easy to conduct if they are done with fresh and dispassionate eyes. Property owners and managers should include such reviews in their loss prevention programs. Otherwise, and all too often, the obvious is overlooked.REI

NOTES

1. For example, in 1997, 5,483 pedestrians died as a result of collisions with motor vehicles; over two-thirds were men. Sidewalk design, especially in commercial areas, will have a lot to accommodate. For the present, it's enough to get the fundamentals right.

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Protecting Buildings from Bio-Terrorism

by Alan Barnes, Jr.

BIOLOGICAL ATTACKS ON BUILDINGS

Unlike an explosion or a tornado, a terrorist attack using biological weapons could be invisible and silent, and thus would be difficult to detect at first. As we learned with the recent postal anthrax attacks, the release of a biological agent might not have an immediate and visible impact because of the delay between exposure and onset of illness, or incubation period.

Spreading bio-terror through the mail caught most of us off-guard in October, and many of the existing precautions for biological attacks simply could not protect those exposed to germ warfare through a letter sent via the U.S. mail.

In the wake of the anthrax attacks, however, scores of building managers have begun to see the vulnerabilities in their own buildings, and have taken action. Simple protective measures include adding security guards, physical barriers, and video cameras to protect large ventilation intake ducts; in new buildings, air intakes are being placed high above the ground in protected areas, in an attempt to guard against a deadly agent from being dispersed directly into the ventilation system.

High-efficiency filtration has also been identified as a more expensive, longer-term solution for protecting against most biological agents. Of course, efficient filtering systems can't prevent all exposure from within a building—especially if the source of the germ is a simple letter. Still, filters can stop most powders from spreading through the rest of the building through the ventilation system.

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Dozens of specially selected buildings throughout the country have already been outfitted with elaborate ventilation and filtering systems, which provide significant protection against accidents or attacks; many experts believe this kind of protection will become more common in the future. These buildings include schools, hospitals, and jails that are located near chemical depots where accidental releases are a concern, and others are military installations that could be the target of attacks.

Many of the newer commercial and institutional buildings (less than 10 years old) already have in place a good foundation of high tech HVAC system infrastructure that can form the base of a more protective environment against bio-terrorism. These newer buildings are generally of tighter construction, allowing less outside air to infiltrate into the building. They are also, generally speaking, complying with recent ASHRAE (American Society of Heating, Refrigerating and Air-conditioning Engineers, Inc.) ventilation standards that allow for the appropriate amount of ventilation air to be introduced into the building, thereby reducing the risk of sick building syndrome. Another important piece of the high tech infrastructure that newer buildings often have in place is a direct digital control system that controls the operation of the HVAC system. Each of these newer building attributes can help complete the puzzle for providing maximum protection against bio-terrorism.

Some experts believe that the recent bio-terror attacks could push building owners who haven't met these recommended standards to retro-fit their buildings for safety, if not building code compliance.

TAKING ACTION

In the case of a biological attack to a building's ventilation system, initial responders include local, county, and city health officers, hospital staff, members of the outpatient medical community, and a wide range of response personnel in the public health system.

It is extremely important that building owners and managers have the necessary communications and information gathering infrastructure in place at their facility so that they are notified of a biological weapons release as early as possible. Once notified of a release, the building owner or manager could then implement emergency procedures developed for this situation.

The following potential safeguards can be implemented immediately. They range considerably in cost and in effectiveness. Therefore each building manager should make his or her own decision as to which measures to implement based on specific needs and circumstances.

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PROACTIVE MEASURES

Obviously, if a biological weapon were released *outside* of the building (external release), the steps taken to protect occupants would be different from those necessary due to a release inside the building (internal release). The following section addresses measures for each scenario.

Protecting Against an External Release:

With an external release, the goal is to prevent contaminated outside air from entering the building. Consider the following measures:

- If you have an emergency plan, review it. If you don't have a plan, develop one for responding to an External Release. The plan should help manage a crisis in stages: First, contain the situation; assess and understand exactly what you're dealing with; then make and execute a specific plan for this situation; recover from the emergency as quickly as possible; and then review to improve the process for the next time. In a disaster, your cellular telephones and other technology are likely to fail, and transportation could be impeded, so plan how to handle such problems. Designate an employee to contact and assist emergency personnel; make sure employees that are on medication are personally prepared with extra medicine; encourage all workers to have a comfortable pair of shoes at the work site. Ask employees if they have contingency plans for child or pet care if they can't get home.
- Implement periodic drills to practice agreed-upon emergency procedures.
- "Tighten-up" your facility's construction. If the building was built before the Carter Administration (1976), it is most likely of "loose" construction. If this is the case, the windows, doors, soffits, and other areas where outside air could

infiltrate the building should be sealed. Consult a general contractor who specializes in retrofitting buildings, and ensure that that building is still capable of delivering the appropriate amount of fresh air to its occupants in accordance with ASHRAE Standard 62-99 (go to www.ashrae.org for more information on this standard).

- Identify outside air intakes and place controls on them so that a building operator, if necessary, can close them quickly and easily from a central location. In addition to controls placed on outside air intakes, the dampers themselves should be evaluated. Consider replacing the existing dampers with new, high-efficiency, low leakage dampers.
- All exhaust fans in the building (including vent hoods) should have controls placed on them so that they can be turned off easily and quickly from a central location, by a building operator, if necessary. Shutting down vent hoods and fume hoods, however, should be carefully considered and measures should be undertaken to prevent the internal contaminants that the hoods are removing from entering into the building's air system.
- If the building has an automated control system for the HVAC systems installed, an "External Release Emergency Program" should be created so that a building operator can push a button on his/her control screen that will implement specific measures as described below.

Protecting Against an Internal Release:

The specific course of action a building owner should take with an Internal Release should be determined based on the design of the HVAC systems in the building. If the building has centralized air handling equipment (*i.e.*, several floors are served by a centralized air handler), the procedure as outlined directly below should be followed to "flush" the building with fresh (and presumably uncontaminated) air. It should be determined, however, if the air outside of the building has been contaminated before initiating these courses of action.

With an internal release, the goal is to remove the contaminated air from the building as quickly as possible. Consider the following measures:

- Develop an emergency action plan for responding to an Internal Release to distribute to all building personnel (see above).
- Periodic drills should be implemented to practice the emergency procedures.
- Maintain appropriate levels of security in and around the building to prevent access to individuals wanting to indulge in criminal behavior. Consider security guards, video monitoring and physical barriers. Consult with a security company for additional recommendations.
- Identify, secure, and camouflage the outside air intakes for the building. Again, consider video monitoring, and physical barriers that would discourage foul play.
- Secure mechanical rooms as well as all building entrances.
- Mailroom personnel should be educated on identifying and handling suspicious packages and letters. Since the anthrax attacks in October, the United States Postal Service has updated its Web site to include information from how to respond to anthrax in the mailroom to identifying suspicious packages and letters. The information should be printed out and posted in all commercial mailrooms.
- Install automatic controls on all exhaust fans and outside air intakes and dampers. If the building has an automated control system for the HVAC systems installed, an "Internal Release Emergency Program" should be created so that a building operator can push a button on his/her control screen that will implement specific measures as described below.

EMERGENCY ACTIONS

In the case of a biological attack, the following actions should be taken in relation to the HVAC system, and should be a part of every building's emergency plan. Please note that the actions taken for external release (outside the building) and internal release (inside the building) are very different.

Emergency Actions for External Release:

- Initiate Emergency Action Plan.
- Notify all occupants that a biological weapon has been released, external to the building, and that no one should leave the building until further notice.
- Have building operator press the "External Release Emergency Program" button programmed into the building automation system, if applicable. This action should automatically shut down air-side economizers, outside air intakes, exhaust fans, and give status of building entrances (closed or open and should alarm if opened).
- Have the building operator shut down all air-side economizer functions within the building manually (if building automation system is not programmed to do so).

- Have the building operator shut down all outside air intakes and exhaust fans manually (if building automation system is not programmed to do so).
- Secure all entrances to the building.
- Monitor public health information system via radio or television to determine when the area is safe again and what medical counsel may be needed.

Emergency Actions For Internal Release

- Initiate Emergency Action Plan.
- Notify occupants that they should leave the building as quickly and as orderly as possible once it is certain that no biological weapons have been released externally.
- Have building operator press the "Internal Release Emergency Program" button programmed into the building automation system, if applicable. This action should put the building into a fresh air "flush" mode that will automatically open up all outside air dampers, turn on all exhaust fans and turn on any applicable air-side economizer.
- Notify health services and the FBI.
- Monitor public health information system via radio or television to determine when the area is safe again and what medical counsel may be needed.
- If the building has separate air handling systems with minimal outside air on each floor, then an "isolation" strategy should be implemented. This strategy would entail shutting down all HVAC systems completely thereby reducing the possibility that contaminated air could travel to uncontaminated areas. If the building HVAC system design allows, only the isolated area where the release occurred should be flushed with fresh air. The occupants should be evacuated as soon as possible. Many large buildings have smoke partitions that are required to have dampers with operators at all penetrations. It would be relatively easy to include a link from these smoke dampers to a control system that would close all of them in an emergency. Some buildings also have emergency smoke evacuation systems that could also be utilized to limit exposure.

POST-CONTAMINATION PROCEDURES

In the aftermath of the postal anthrax attacks in October, it became clear that one of the biggest obstacles to re-occupying a contaminated building is psychological.

In Florida, anthrax turned American Media Inc.'s headquarters into a 70,000-square-foot white elephant. None of the employees wanted to return after a photo editor was killed by inhalation anthrax; the company decided to relocate, and put the building on the market.

As with any emergency, proper preparation and precaution will go a long way in protecting our buildings against biological attacks. Make sure your employees are knowledgeable about bio-terror, and give them ample time to feel comfortable with your emergency procedures.

However, simply selling the building because traces of anthrax were discovered inside is not an option for other anthrax-contaminated buildings. Imagine abandoning the U.S. Senate office building in Washington, D.C., or the NBC headquarters at 30 Rockefeller Plaza in New York, both treasured and historical American buildings.

In November 2001, the Centers for Disease Control posted guidelines for the decontamination of anthrax-contaminated sites, saying simple chlorine scrubs should be adequate for most buildings, especially in small areas with light contamination. The CDC added that the bleach must be in direct contact with anthrax spores for at least two minutes to kill them.

Such a bleach solution was used to clean the NBC offices; however, at ABC and on Capitol Hill, cleanup officials used a bacteria-killing agent developed by Sandia National Laboratories, which is run by Lockheed Martin Corp. (LMT) for the Department of Energy. The Sandia-developed new substance is nontoxic—it is made of materials including hydrogen peroxide—and can be used in various forms, such as foam, fog, gas, and/or spray.

In buildings where a fatal inhalation anthrax case occurred, the CDC determined that the building must be shut down and subjected to more vigorous decontamination.

SUMMARY

As with any emergency, proper preparation and precaution will go a long way in protecting our buildings against biological attacks. Make sure your employees are knowledgeable about bio-terror, and give them ample time to feel comfortable with your emergency procedures.REI

AUTHOR'S NOTE:

This document is intended to be used as a general guideline for building owners. It is not intended to include every possible solution for each and every building. Every building is unique and offers specific challenges for the building owner in regards to protecting occupants from biological weapons. Aircond assumes no liability or risk in offering these recommendations to building owners. The recommendations made in this document are based on research and information received from the FBI, CDC (Centers for Disease Control), United States Postal Service, BOMA (Building Owners and Managers Association), and from our many years of expertise in the field of commercial and industrial HVAC design, installation, maintenance, and repair. This article tries to give the building owner a practical set of recommendations geared towards protecting occupants from a biological weapons release. A chemical weapons release is not addressed here in this article. In fact, some of the recommendations made here for protections against biological weapons release would be ineffective against a chemical weapons release.

NOTES

If you would like more specific recommendations for your particular building, contact your current HVAC service provider.

If you would like more information or recommendations from other sources regarding biological and/or chemical weapons protection, explore the following Web sites:

Federal Bureau of Investigation: www.fbi.gov
Centers for Disease Control: www.cdc.gov
Building Owners and Managers Association: www.boma.org

THE EFFECT OF THE ECONOMIC GROWTH & TAX RELIEF RECONCILIATION ACT OF 2001 ON REAL ESTATE INVESTORS

by J. Russell Hardin & Jack R. Fay

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INTRODUCTION

If real estate investors are to maximize after-tax profits and maintain appropriate levels of capital investment, they must have a working knowledge of the latest legislative changes enacted by the United States Congress that pertain to real estate. On June 7, 2001, President George W. Bush signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001 (hereinafter Act). This sweeping piece of legislation contains numerous amendments to the Internal Revenue Code that will cut federal taxes by $1.35 trillion between now and 2011. Several of the provisions of the Act have implications for real estate investors.

The purpose of this article is to summarize the provisions of several of the important changes to the Internal Revenue Code, that pertain to real estate investments, that are now the law or that will soon become the law. Investors in real estate are urged to look closely at this new tax legislation to seek ways in which they can significantly diminish their future income taxes. The following discussions focus on the major provisions of the new bill that, directly or indirectly, affect real estate investments. Some suggestions for tax planning are also included in the discussions. To determine what effect, if any, each of these provisions will have on a particular investment, a reader should consult with his/her CPA, tax attorney, or other tax professional.

INCOME TAX RATE CUTS

The centerpiece of the new tax law is an across-the-board cut in individual income tax rates. The Act does not provide any major corporate tax relief, reflecting the Bush Administration's effort to limit tax relief to individuals. However, the individual rate cuts will provide relief to real estate investors who conduct business through sole proprietorships, partnerships, and S Corporations.

Prior to the new law, rates ranged from 15 percent to 39.6 percent. The Act makes three major changes to the tax-rate structure:

1. The Act creates a new 10 percent tax bracket.
2. The Act gradually lowers the highest tax rate to 35 percent.
3. The Act cuts most other tax rates by three percentage points.

The new tax law lowers the 15 percent bracket to 10 percent on the first $12,000 of taxable income on a joint return, $6,000 for singles, $10,000 for heads of household, and $6,000 for married persons filing separate returns. This new 10 percent tax bracket provides up to $600 in tax relief for married couples and up to $300 for single individuals. In addition, in 2008, the amount of income subject to the 10 percent bracket increases to $14,000 for married couples filing jointly and $7,000 for single taxpayers.

The highest tax rate (currently 39.6 percent) will be lowered by 4.6 percentage points to 35 percent while all other rates (except for the 15 percent rate) will be lowered by 3 percentage points. The first cut took effect on July 1, 2001, the second cut will take effect in 2004, and the third in 2006. The top rate will eventually drop to 35 percent, the 36 percent rate will drop to 33 percent, the 31 percent rate will drop to 28 percent, and the 28 percent rate will drop to 25 percent (see *Table 1*).

Tax Planning Tip: Individuals should consider deferring ordinary income into subsequent tax years to take advantage of the reduced rates. For example, a taxpayer could receive a year-end bonus on January 1 of next year rather than receiving it on December 31 of the current year to take advantage of the lower tax rate. On the other hand, taxpayers could reduce their tax liability by accelerating deductions to gain the maximum benefit from a tax deduction. For example, a taxpayer could make deductible state estimated tax payments in December, rather than in January. A taxpayer could also make charitable contributions sooner rather than later while still in a higher tax bracket. Finally, individuals should be able to lower their estimated tax payments to reflect the lower tax rates.

REPEAL OF ITEMIZED DEDUCTION LIMITATION

The Act eliminates the overall limitation on certain itemized deductions for high-income taxpayers. Current law subjects most taxpayers with six-figure incomes to an automatic reduction of their itemized deductions (except for medical expenses, casualty and theft losses, and investment interest expense). Specifically in 2001, taxpayers must reduce their itemized deductions by 3 percent of adjusted gross income (AGI) in excess of $132,950 for single individuals and married couples filing joint returns—$66,475 for married individuals filing separate returns. The Act eliminates this overall limitation on itemized deductions over a five-year period. The limitation will be 2 percent of AGI for the 2006 and 2007 tax years, 1 percent of AGI for the 2008 and 2009 tax years, and it will be eliminated completely for tax years beginning after 2009.

Tax Planning Tip: To maximize the benefit of itemized deductions, higher income taxpayers should consider postponing certain itemized deductions (such as employee business expenses) until a future

Table 1

Taxable Years Beginning In:	The corresponding percentages shall be substituted for the following percentages:			
	28.0%	31.0%	36.0%	39.6%
2001	27.5%	30.5%	35.5%	39.1%
2002 and 2003	27.0%	30.0%	35.0%	38.6%
2004 and 2005	26.0%	29.0%	34.0%	27.6%
2006 and thereafter	25.0%	28.0%	33.0%	35.0%

year when a larger portion of the expense will be deductible. However, taxpayers must also consider that tax rates will be lowered over the next several years and that could reduce the tax savings from postponing an itemized deduction into a future taxable year.

REPEAL OF PERSONAL EXEMPTION PHASEOUT

Under present law, deductions for personal exemptions are reduced or eliminated for higher-income taxpayers. The personal exemption deduction for 2001 is reduced by two percent for each $2,500 ($1,250 for married individuals filing separate returns), or fraction thereof, by which the taxpayer's AGI exceeds $199,450 for joint returns, $99,725 for married individuals filing separate returns, $166,250 for heads of households, and $132,950 for single taxpayers. This means that for 2001, personal exemptions and dependency deductions are completely phased out at $321,950 for joint returns and at $255,450 for single returns.

The Act eliminates the phaseout of personal and dependency exemptions by the year 2010. The Act provides that the current phaseout is reduced by one-third of the disallowance amount in taxable years beginning in 2006 and 2007. This fraction increases to two-thirds for taxable years beginning in 2008 and 2009. Finally, the overall limitation ceases entirely for taxable years beginning in 2010. *Tax Planning Tip*: The effect of the phaseout of the personal exemption limitation (and the itemized deduction limitation) is to further lower marginal tax rates for higher-income taxpayers. Therefore, taxpayers should consider paying a lesser amount of estimated tax during the years of the phaseout.

INCREASE IN THE ALTERNATIVE MINIMUM TAX EXEMPTION

The Act is a double-edged sword when it comes to the Alternative Minimum Tax (hereinafter AMT). The Act increases the individual AMT exemption amount by $4,000 for married couples filing jointly and by $2,000 for all other taxpayers. Even though this increase in the exemption is effective for 2001, the provision expires at the end of 2004. This provision is a stop-gap measure to provide some AMT relief until Congress can address the issue in detail. However, if Congress takes no action to revise (or eliminate) the AMT provisions, the number of higher-income and middle-income taxpayers subject to the AMT could rise from 1.4 million this year to 35.5 million by 2010 when the ACT is fully phased in. Part of the increase is due to the lack of an inflation adjustment to the AMT exemption and part of it is due to the new lower tax rates. As a result, millions of taxpayers will realize little or no benefit from the new lower tax rates.

Real estate investors have many opportunities created by the new tax rules to reduce their tax burdens. However, a law as complicated as this commands a great deal of study by investors who desire to maximize returns and minimize the tax burden. Real estate investors should consult with appropriate tax professionals to assure proper application and maximum benefit from this new tax Act.

ESTATE TAX AND GST TAX REPEAL

From 2001 through 2009, the estate tax and the generation-skipping transfer (GST) tax will be phased out. If Congress makes no changes to this provision in the future, the estate and GST taxes will be repealed in the year 2010. During this 10-year period the maximum estate tax rate will be reduced gradually while the unified credit will increase rather significantly. In 2001 the threshold (exclusion amount) for estate taxes is $675,000, the unified credit is $220,550, and the maximum tax rate is 55 percent. For the next 10 years the amounts are as follows:

Year	Maximum Tax Rate	Estate Tax Exclusion
2002	50 percent	$1 Million
2003	49 percent	$1 Million
2004	48 percent	$1.5 Million
2005	47 percent	$1.5 Million
2006	46 percent	$2 Million
2007	45 percent	$2 Million
2008	45 percent	$2 Million
2009	45 percent	$3.5 Million
2010	0 percent	$0
2011	55 percent	$1 Million

In the year 2011, the maximum tax rate reverts to the 2001 rate, but the exclusion amount reverts to the 2002 rate.

A strange provision in the new laws relates to the "step-up in basis" for inherited property. From 2001 to 2009 the rule will remain the same; that is, inherited property's basis will be stepped up to its fair

market value at date of death. The step-up in basis will be reduced in 2010. This automatic step-up in basis in 2010 will apply only to the first $1.3 million in the estate, plus an additional $3 million for any transfer to a surviving spouse. For any estates above these amounts, the executor will be able to choose which assets would receive the step-up in basis.

Another change affecting federal estate taxes is a change in the state death tax credit deduction. The state death tax credit that can be deducted against the federal estate tax will be reduced by 25 percent in 2002, 50 percent in 2003, 75 percent in 2004, and then the credit will be repealed for tax years beginning on January 1, 2005.

GIFT TAX CHANGES

The gift tax is not going to be repealed. There is a major change, however. Beginning in 2002, a $1 million lifetime gift tax exclusion will apply. This exclusion will pertain to taxable gifts (gifts in excess of $10,000 per year per donee or $20,000 for married donors per year per donee). Besides the lifetime gift tax exclusion, the gift tax rates will decline from the current maximum rate of 55 percent until 2010, when the maximum rate will be 35 percent.

Tax Planning Tip: Taxpayers who plan to make gifts to relatives or anyone else should take advantage of this lifetime exclusion of $1 million during the next 10 years. If they plan to donate more than $1 million, they should defer any excess until later taxable years when the gift tax rates will be significantly lower.

INSTALLMENT PAYMENTS OF ESTATE TAXES

In the past, estates and beneficiaries have often had serious liquidity problems when closely held business interests have been involved. To help eliminate some of these problems, provisions now prescribe that qualifying estates may defer an estate tax related to a closely held business on an installment basis for a period of up to 14 years at a low interest rate. This new installment relief is for certain qualified lending and finance interests (as well as for certain holding company stock). It also increases the maximum number of partners or shareholders in a qualifying closely held business from 15 to 45 to be eligible for the relief.

A lending or finance business must meet several technical requirements to qualify for the installment payment relief. For example, the stock or debt of the corporation could not have been publicly traded at any time within the three years immediately preceding the decedent's death. These changes are effective for decedents dying after 2001.

GAIN EXCLUSION ON SALE OF PRINCIPAL RESIDENCE

The gain exclusion upon the sale of a principal residence ($250,000 for single and $500,000 for married taxpayers) is extended by the Act to residences sold by a decedent's estate and by certain revocable trusts established by the decedent. Unfortunately, this provision only applies to estates of decedents who die in 2010 and thereafter.

OTHER ESTATE TAX ITEMS

The estate tax deduction for a qualified family-owned business interest (QFOBI) is repealed starting in 2004. This deduction is repealed because the estate tax exemption amounts to $1.5 million in 2004 while the QFOBI is limited to $1.3 million, less the estate tax exemption amount.

The 2001 Tax Act provides an estate tax recapture from cash rentals of specially valued property. In addition, the statute of limitations is now waived for a claim of refund or credit in relation to any estate taxes paid on certain specially valued farm property in which the tax overpayment resulted from the application of specific net cash lease arrangements with spouses and lineal descendants of the decedents which may have been considered non-qualified uses of the properties. The claim for the refund or credit must be made within one year of June 7, 2001.

NEW RULES FOR RETIREMENT PLANS

The maximum **IRA** contribution limit is increased from the current maximum of $2,000, starting in 2002. The new maximum limit will be $3,000 for the years of 2002-2004; increased to $4,000 for the years 2005-2007; and further increased to $5,000 for 2008. After 2008, the limit will be indexed annually for inflation in $500 increments.

Also, the maximum contribution limit will be increased by $500 for the years of 2002 through 2005 and $1,000 for years after 2005 (affecting only those taxpayers age 50 and older).

Tax Planning Tip: An individual taxpayer that reaches the age of 50 by the end of the taxable year may make additional catch-up IRA contributions. In addition, taxpayers who have sufficient cash flows should take advantage of these new maximum contribution limits whether or not they receive any current tax deductions from such contributions

since the earnings on the contributions are tax deferred.

Educational IRA rules have been significantly modified. These changes, beginning January 1, 2002, include: (1) the annual limit on educational IRA account contributions will be increased from $500 to $2,000; (2) the phase-out for married taxpayers filing a joint return will be increased to twice the range applicable to single filers—the new range for married taxpayers filing jointly will be from $190,000 to $220,000 of modified AGI; (3) qualified education expenses which may be paid tax-free from an educational IRA will now include elementary and secondary school expenses; (4) taxpayers will be able to claim the HOPE credit or lifetime learning credit and also exclude from gross income amounts, the educational IRA accounts for the same students in the same year—any amount of the distribution which is excluded may not, however, be the same educational expenses for which the credit is claimed; (5) educational IRA age limits will no longer apply to special needs beneficiaries; and (6) corporations and other entities (including tax-exempt organizations) will be able to make contributions to educational IRA accounts regardless of the corporate or other entity's income during the year of contribution.

Tax Planning Tip: Again, any taxpayers who have sufficient cash flows and uses for educational IRA accounts should take advantage of these new tax breaks.

Qualified retirement plans will have increased contribution and benefit limits, starting January 1, 2002. These increases include the following:

1. The current $35,000 limit on annual contributions to defined contribution plans will be raised to $40,000 in 2002 and then indexed for inflation in $1,000 increments thereafter. The current $140,000 annual benefits limit for defined benefit plans will be raised to $160,000 in 2002 and then indexed for inflation in $5,000 increments.
2. The compensation limit which may be taken into account under a qualified plan will be increased to $200,000 in 2002 and then indexed in $5,000 increments.
3. Annual contribution maximums for 401(k) plans, 403(b) annuities, and salary reduction SEPs will be increased to $11,000 in 2002. The maximums will be increased another $1,000 per year until they reach $15,000 in 2006; after 2006 the limits will be indexed in increments of $500.
4. Annual contribution maximum to a SIMPLE plan will be raised to $7,000 in 2002. The limit will be increased another $1,000 per year until it reaches $10,000 in 2005; after 2005 it will be indexed in $500 increments.
5. Annual deferral limit under section 457 will be increased to $11,000 in 2002. The limit will be increased another $1,000 per year until it reaches $15,000 in 2006; after 2006 the limit will be indexed in $500 increments.

The 2001 Tax Act also allows additional contributions to qualified retirement plans (besides the changes mentioned above) for taxpayers who are at least 50 years old. These taxpayers may make additional contributions of $1,000 to 401(k) plans, 403(b) annuities, SEP plans or 457 deferrals in 2002, $2,000 in 2003, $3,000 in 2004, $4,000 in 2005, $5,000 in 2006, and then indexed in $500 increments starting in 2007. Taxpayers who are at least 50 years of age may make additional contributions to a SIMPLE plan of $500 in 2002, $1,000 in 2003, $1,500 in 2004, $2,000 in 2005, $2,500 in 2006, and then indexed in $500 increments starting in 2007. No additional contributions may be made to any of these plans out of after-tax employee compensation, and no additional contributions may be made to any of these plans if any other deferral provisions apply.

Beginning in 2002, shareholders of S corporations, partnerships, and sole proprietors will be able to receive loans from qualified plans other than IRA accounts; such loans will no longer be considered to be prohibited transactions.

A new nonrefundable tax credit is available to certain taxpayers who contribute to qualified retirement plans (including IRAs and Roth IRAs.) The maximum annual contribution eligible for the credit is $2,000; this credit is in addition to any tax deduction. The credit rate phases down from 50 percent to 10 percent on the contribution, depending upon the taxpayer's AGI. This credit is available only to taxpayers with AGI below the beginning of the IRA deduction phaseout; the credit is completely phased out for joint filers with AGI exceeding $50,000, $37,500 for head-of-household, and $25,000 for single taxpayers. Students, taxpayers under age 18, and dependents may not receive this tax credit. This new tax credit will only be available for the years 2002-2006.

Briefly, here are some other new provisions relating to qualified retirement plans (most of which take effect at the beginning of 2002):

1. Small businesses will be entitled to a nonrefundable credit for administration expenses associated with certain qualified retirement plans.
2. Faster vesting of employer matching contributions will be permitted.
3. Hardship withdrawals will be easier to make.
4. Plan rollover rules will be liberalized.
5. Certain existing small plans and new plans will be exempted from many normal administrative rules.
6. The Tax Act directs the IRS to revise the life expectancy factors used to calculate minimum distributions from qualified retirement plans (the life expectancy factors that have been used before the revision are from the original regulations initiated in the mid-1980s.) The IRS recently revised its proposed regulations to minimum distributions and significantly simplified them. One of the new rules is that everybody is treated as having a joint life expectancy based on his/her own age and that of a beneficiary who is 10 years younger (even if the actual beneficiary is older than that or there is no beneficiary.) These revised rules must now be used by taxpayers beginning in 2001; an exception to the requirement of using the new rules is when a spouse is the sole beneficiary and is also more than 10 years younger than the owner of the retirement plan.

Tax Planning Tip: Tax planning will become more important in the near future for eligible taxpayers and small businesses as they take advantage of these new opportunities created by the liberalized retirement plan changes. Some of these new changes are rather complex and taxpayers are encouraged to obtain the services of a professional consultant.

CONCLUSION

This article has attempted to summarize some of the tax changes in the 2001 Tax Act. The focus has been on the changes that would directly or indirectly affect real estate investors and small businesses. The authors see no movement toward tax simplification by the U.S. Congress and the president, but the Economic Growth and Tax Relief Reconciliation Act of 2001, hopefully, will meet the objectives of improving the economy and providing some relief to taxpayers. Real estate investors have many opportunities created by the new tax rules to reduce their tax burdens. However, a law as complicated as this commands a great deal of study by investors who desire to maximize returns and minimize the tax burden. Real estate investors should consult with appropriate tax professionals to assure proper application and maximum benefit from this new tax Act. REI

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Beyond the Basics: How to Deal with Troubled Loans on Special Purpose Real Estate Assets with Operating Businesses

Hotels, Casinos, Entertainment Parks, Senior Living Facilities, Franchised Gasoline Stations, Convenience Stores & Restaurants

by James R. Butler, Jr., Neil C. Erickson, Robert B. Kaplan & Richard A. Rogan

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THE PIPELINE BEGINS TO FILL

After unprecedented years of economic expansion, our teetering economy was shoved rudely toward recession by the September 11, 2001, terrorist attacks. In the immediate aftermath, more than 100,000 people were laid off by the airlines and travel was down by more than a third. The travel, tourism, and lodging industries were hardest hit. One respected national firm predicted the worst performance for the hotel industry in 33 years. Most hotel stocks lost between 20 percent and 70 percent of their value in the first week of trading after the attack. Many hotels and restaurants watched their business fall by 40 percent or 50 percent. Conventions, meetings, and vacations were canceled or postponed.

Another major national hotel consulting firm agreed that recent declines in the revenue per available room, a common measure of hotel profitability, showed the biggest drop in the 80 years the firm has been tracking the industry. It also analyzed the financial statements of more than 3,300 hotel financial statements in its database and in late 2001, the firm predicted that the number of hotels unable to generate sufficient cash to meet debt service would rise from 16.4 percent in 2000, to 20.9 percent in 2001, and to an astounding 36.5 percent in 2002.

Prior to the events of that fateful September, many lenders' pipelines were starting to see a flow of troubled real estate loans—particularly

those loans secured by hotels, casinos, entertainment parks, senior living facilities, franchised gasoline stations, convenience stores, restaurants, and other special purpose real estate associated with operating businesses. Now the pipelines are starting to fill with such loans gone sour.

This article will provide a brief reminder to lenders about the basics of working with troubled loans, and then it will quickly go beyond those fundamentals to discuss some of the unique issues and problems encountered in dealing with troubled loans on special purpose real estate assets with operating businesses.

QUICK REVIEW: BASIC DO's-AND-DON'Ts OF WORKING WITH TROUBLED LOANS

The 1980s and 1990s saw an explosion of troubled real estate loans and specialized lender teams to handle them. The ensuing years saw veteran workout teams clean up the mess and ultimately disband, as troubled loans all but disappeared. While each lender tended to have its own name and acronym for the troubled loan department, most lenders recognized the need for a special assets group or "SAG" to handle the problems presented by troubled loans. Savvy lenders also realized that workouts take time, and that line officers who spend time on workouts can't spend that time generating new deals.

These lenders focused on prevention, monitoring, and early detection. At the first signs of trouble, they brought the SAG into the picture or transferred responsibility to the SAG. They recognized that information is powerful and constantly updated critical information about the loan, the collateral, and the borrower. They analyzed their options in light of clearly defined goals and policies. They developed a game plan for each asset and they stuck to it. And having been burned by lender liability claims, they used pre-workout agreements and team members knowledgeable about lender liability matters. They also knew that complete documentation of any deal was essential. We have summarized these fundamentals in the "Basic Do's-and-Don'ts" set forth in *Appendix 1*.

WHAT MAKES SOME SPECIAL PURPOSE ASSETS DIFFERENT?

Special purpose real estate assets associated with operating businesses present unique problems. The pipelines of lenders and special servicers are filling with troubled loans secured by such hotels, casinos, entertainment parks, senior living facilities, franchised gasoline stations, convenience stores, restaurants, and the like. Each of these assets involves an operating business that is integrally intertwined with special purpose real estate, and that operating business comprises a large component of the asset's value.

It is the operating business that raises some thorny problems. The operating business often needs management and franchise affiliations, licenses and permits, extensive vendor relationships, marketing efforts, and a significant work force. Many of these aspects of the operating business are critical to the value and success of the asset and the recovery to be realized. They can evaporate very quickly during the handling of the troubled loan.

For example, what is the value of a Marriott, Holiday Inn, Hilton, Hyatt, or Four Seasons if it loses the brand and professional management? It becomes just a big box hotel with no name, no reservation system, and no professionally run staff. What impact does it have on the lender's collateral if breach of a management or franchise agreement exposes the owner to the expected profit of the brand or operator for a remaining 20- or 30-year term, or more? What damage is done to the public image of the asset if quality is not maintained, rumors of bankruptcy taint expectations of service, inventories fall below acceptable levels, and relations with critical vendors are damaged?

Or, to use another common example of loans secured by gasoline stations with franchised restaurants and convenience stores, it may be easy enough to renegotiate gasoline supply agreements, but what is the value of a Burger King or Del Taco restaurant that loses its franchise, jeopardizes its ground lease, and faces default under its franchise agreement and other contracts?

USING A HOTEL EXAMPLE

Many lenders and servicers are unfamiliar with the business and legal "structure" of these special assets, so we will first use a hotel example to illustrate the franchise and management overlay that complicates working with many of these assets. The typical hotel is owned by an individual, institutional investor, or investor group, and this owner is usually the borrower on the hotel loans. Complications grow geometrically when the operator also has a joint venture or other investment interest in the ownership, and such arrangements are common with many hotels. The hotel company—Marriott, Starwood, Hilton, Hyatt, or whatever—is a separate entity that will manage or franchise the owner's hotel.

When you drive by a hotel and see a big red Marriott sign on top, the chances are great that an owner has entered into a franchise or management agreement with Marriott to brand the hotel and plug into Marriott's reservation system and expertise. But it is fairly unlikely that Marriott owns the property or a significant interest in it. In many instances, the hotel is managed by the branded hotel company, but often the hotel will have a franchise from Marriott or one of the other branded hotel companies, and an independent management company—unaffiliated with the brand—will manage the hotel under a separate arrangement.

In the jargon of the hotel industry, these independent management companies are often called independents or "third party managers" because they do not own a brand and are a third party to the owner-franchisor-operator relationship. In any event, these arrangements are governed by complex and critically important franchise agreements and management agreements that can add or subtract millions to the value of the hotel.[1]

Depending upon the nature of the property, there are also likely to be a host of important agreements, licenses, and permits. Resort properties often have "use agreements" or leases that provide access to hotel guests for golf, tennis, marina, spa, or other facilities. Licenses may include cabaret and business licenses, liquor licenses, and many other permits such as FCC licenses for base-to-shuttle or ship-to-shore communications for shuttle buses, marinas, and similar operations. The ability of a foreclosing lender or buyer to continue to enjoy rights under these agreements and licenses can be critical. One can imagine the impact on value when a resort hotel loses its golf, tennis, beach club, and other amenities, or can't serve liquor at large group meetings, banquets, weddings, and events. And, of course, it is almost certain that there will be a significant work force that may be technically employed by either the owner or the operator, but for which the owner will have full legal responsibility and extensive indemnity obligations. There may even be union contracts and potential labor claims and liabilities.

The lender's choice of options in dealing with a troubled loan on a hotel is complicated by the typical hotel management or franchise agreement. It tends to give tremendous control and many exclusive rights and powers to the operator and franchisor. The owner's (and thus the lender's) access to information, the work force, and the asset itself may be greatly limited. It is also common for the lender's position on the loan to be subordinated to the hotel management and franchise agreements so that upon a foreclosure, the lender or its successor will continue to be bound by the old management or franchise agreement. Alternatively, and sometimes worse, the lender may lose the benefit of the franchise or management agreement and find itself with an unbranded and unmanaged asset.

Special purpose real estate assets associated with operating businesses present unique problems. The pipelines of lenders and special servicers are filling with troubled loans. Each of these assets involves an operating business that is integrally intertwined with special purpose real estate, and that operating business comprises a large component of the asset's value.

THE PRACTICAL IMPACT: SPECIAL PURPOSE ASSETS MEAN SPECIAL PROBLEMS

All the basics of troubled loans summarized in *Appendix 1* still apply to the special purpose assets we are focusing on. One need only add the overlay that the operating business creates. Without repeating the basic principles, we can continue using the example of a troubled hotel loan and focus on what is different, beginning with the first principle—prevention.

Prevention

Initial underwriting includes focus on brand, operator, terms of management and franchise agreements and borrower's track record. It also requires a market analysis and use of consultants and counsel experienced in hospitality matters, because the hospitality industry has its own unique standards, norms, customs, and players. Lenders should use professionals familiar with the industry who can apply a checklist approach to hospitality financing, like the Hospitality Investment Task List or HIT List® developed by the authors' firm and published by the Educational Institute.[2]

With hotel loans, there are at least four categories of issues that lenders don't usually encounter with traditional real estate loans such as those on their office buildings or apartment houses. These

Appendix 1

Basic Do's-and-Don'ts of Working with Troubled Loans

1. Prevention. Prevention is the first step in a well-planned approach to troubled loans. Proper underwriting, documentation, and provisions for access to information may help a lender facing a troubled loan. In the event the loan does get into trouble, the lender will be in a stronger position to protect its interests. Prevention includes careful underwriting of the collateral and the borrower. In underwriting the borrower, the lender should obviously look to the usual credit report and financial statements, but should often go beyond them to get a better feel for the borrower's reputation, character, fortitude, expertise, consistency and creativity. The lender should ask: Has this borrower built or managed this kind of project before? Are the market and feasibility studies realistic? Are the projections consistent with these factors and do they provide adequately for a worst case scenario?

Once the credit decision has been made, the transaction should be fully and carefully documented with prevention in mind. Use the checklist approach to be sure nothing is overlooked. Be sure all desired title and liability insurance is in place, with endorsements to cover the lender's interests. Particularly with construction loans, negotiate all necessary controls for the project — to cover both the ordinary course of building and the possibility of default. A lender will never have a better opportunity to protect its interests than the period before it has disbursed the loan proceeds.

2. Monitoring and Early Warning. Information control is paramount. A lender must carefully monitor its loans until they are paid off. Early warning systems should be established to alert the lender to problems with the borrower, the collateral, or the project's feasibility. Is the construction or marketing of the project being delayed? Is the property being wasted? Are materials disappearing from the job site? Have the demographics and economics of the market changed adversely? If signs of trouble appear, the troubled asset group should be consulted at an early stage, even if the project stays in the hands of the loan servicing department.

3. Use a Special Assets Group for Troubled Assets. Whatever the name and acronym,[1] a specialized group should be used for handling troubled assets. A specialized division for working on troubled assets (for convenience we will refer to this group as a special asset group or "SAG") brings greater objectivity in dealing with troubled loan issues, thereby minimizing the peril of an approach drawn from past dealings with the borrower that may be either too sympathetic or too harsh and raise lender liability issues.

The SAG should also bring or will develop specialized expertise in handling the unique problems of troubled assets. It should be provided with expedited access to senior management for policy decisions and allocation of resources. It should also have authority to implement crucial procedures and policies such as settling customer complaints, bringing in special counsel, hiring consultants, executing pre-workout documents and documenting negotiations to avoid liability for unsuccessful workouts. Bringing the SAG into the situation also provides notice to the borrower that the lender is serious about collecting the debt and that this is not business as usual.

4. Information Update. The SAG, with its experienced, detached personnel, should gather, analyze and summarize all relevant information on the loan, the borrower, the collateral, and relevant documentation and history. Update the borrower's financial statements, tax returns, litigation history, and credit rating. In addition to gathering all loan documents, promissory notes, guaranties, and evidences of advances, notices, a complete written history of the loan should be prepared. When the history is compiled, care should be given to protect as much as possible from discovery if you choose litigation so that any candid descriptions of problems and proposed solutions to such problems will not be a part of the evidence at trial. This can be done by engaging outside counsel or involving the bank's in-house legal department. Loan service personnel should be interviewed, and waiver and estoppel issues must be evaluated. Consider interviewing witnesses with counsel present, to protect sensitive information obtained from disclosure later on if litigation is filed. The impact of conversations, correspondence, and course of conduct must be given careful consideration. Appraisals, projections, and feasibility studies should be updated as necessary.

Two final cautions on information updates. First, the update of collateral information should include a physical inspection of the premises. Walk the project! Don't settle for "drive-by" or borrower's guided tour. The physical inspection may suggest problems to be dealt with or new approaches to the project.

Second, the information, documents and summaries gathered by the SAG should be reviewed by counsel experienced in troubled loan matters and lender liability. This review should analyze the validity of the notes, security interests, guaranties, and other important documents with an eye toward identifying defects that might be cured or curable. From this review, lenders should also be able to determine the potential of any borrower defenses

(continued on next page)

or counter claims. Counsel should find out from the lender if there are any potential tort or strict liability claims that may go along with any transfers of ownership in real property, such as an apartment owner's duty to pay for tenant injuries or a landowner's duty to pay the costs of cleaning up contaminated property.

5. Evaluate the Information and Alternatives. All the gathered information needs to be evaluated by appropriate business and legal personnel. Fully armed with this information and evaluation, the lender can then assess whether to do nothing, commence a work-out or restructure of the loan, seek a receiver, initiate foreclosure or initiate involuntary bankruptcy proceedings.

6. Develop a "Game Plan" and Stick to it! Once an alternative course of action has been selected, the lender should develop a game plan or blue print for executing its course of action. There may be valid reasons to wait until specified events have occurred or time periods have elapsed. However, in general, once the course of action has been decided, delay is ill-advised. The most successful lenders are those who stick with their game plan, except as changed circumstances may warrant.

7. Pre-Workout Agreement. Before commencing workout negotiations, a pre-workout agreement should be executed. Such an agreement offers the advantage of protecting the lender from liability for claims arising from the workout process itself.

Many institutions have been "bitten" by their good faith efforts in a workout situation. They report that desperate debtors or their unscrupulous representatives have either misunderstood statements made in workout negotiations, or intentionally misrepresented positions taken. Whatever the motivation or cause of the problems, these institutions find themselves the victim of claims that oral agreements, representations, or waivers made in the course of a workout entitle the borrower to rights or damages never contemplated by the lender upon entering workout negotiations. The pre-workout agreement is designed to minimize these risks.

The pre-workout agreement typically recites that the parties are about to commence workout negotiations and that the agreement is a material inducement for the lender to participate. Loan documents can be attached as exhibits and acknowledged to be legally binding on the parties. It is usually agreed that the loan documents continue in full force, unless modified in the specific manner permitted by the pre-workout agreement. Sometimes, egregious problems that exist in the lender's loan documentation can be corrected in a pre-workout agreement, when the borrower is usually in a very cooperative mood. The confirmation of loan document's binding effect, recital of loan history, and acknowledgment of defaults may greatly simplify collection efforts later if the negotiations fail or the workout falls apart. Consider inserting a confidentiality provision in the pre-workout agreement, to try to prevent the borrower from using the media to increase its negotiating leverage, especially if the borrower is in a business that may attract media attention.

The key provision of the pre-workout agreement recites that discussions and negotiations between the parties may be lengthy and complex, however, no discussions or oral agreement have any effect whatsoever unless all parties execute a written agreement. This critical provision helps prevent a party from claiming a binding agreement was reached on certain issues in the absence of satisfactory resolution of all disputes in the workout process.

The agreement should: 1). provide that only amendments in writing have any effect; 2). should state that the pre-workout agreement is the entire agreement of the parties on the subject matter; 3). specify the governing law; and 4). provide for attorneys' fees to the prevailing party in the event of any dispute. The agreement should also provide that no negotiations or other acts taken in the workout process constitute any waivers by the lender of its rights except to the extent specifically identified in writing. The pre-workout agreement should also confirm that the attorney's fees to be incurred by the lender in the workout would be reimbursed by the borrower.

The most controversial issues on pre-workout agreements usually involve whether to include a mandatory arbitration provision for any disputes concerning the credit (with corresponding waiver of jury trial and court process) and any release provisions. Some lenders say they would rather proceed with the "main event" if they cannot obtain an arbitration provision and release for any action up to that date. Others would rather engage in the workout process to cure defects in the loan documentation in exchange for concessions to the borrower and are less concerned with the benefits of arbitration or waivers.

8. Document the Transaction Completely. It goes without saying that once negotiations have resulted in a restructuring or workout, all aspects of the agreement should be thoroughly and fully documented promptly.

1. Specialized groups working on troubled loan assets have often had interesting names and acronyms, such as the Managed Asset Division or "MAD," the Specialized Asset Division or "SAD," and the Specialized Assets Group or "SAG."

special issues should all be addressed in the prevention stage and considered as a loan gets into trouble. They include:

1. Subordination and SNDA. Subordination agreements and SNDAs will be addressed in depth later, but many prudent lenders will require the subordination of management and franchise agreements so that in the event of a default, the lender or its successor will have the option to either reaffirm and continue the arrangement under an automatically approved assignment, or the right to terminate the arrangement if it wishes to do so. In many cases, a management agreement can add or subtract up to 25 percent of the value of a hotel.

2. "Rents vs. accounts." Hotel revenues are not the same as "rents" from other kinds of commercial real estate. As a result, a lender's security interests in the revenues of a hotel are perfected differently (requiring both a deed of trust along with a security agreement and a UCC-1 adequately describing the collateral revenue source). Hotel revenues are also subject to different treatment in bankruptcy than rents from traditional real estate, but we will talk about these issues shortly under the so-called "rents vs. accounts" topic on page 54.

3. Need for access to more information. Because hotels and other special assets have operating businesses, there is a vast amount of information that can and should be provided by the operator on a monthly or other regular basis that will greatly assist a lender in monitoring developments with the asset events that may happen months before the effect is seen on the income statement or balance sheet. The prudent lender will assure access to such vital information, and may provide that a default occurs if there is deterioration in certain operations or procedures reflected in such reports.

4. Lender liability. There is a much better balance today than 10 or 15 years ago between the lenders' needs to protect their collateral and realize its value and aggrieved borrowers to obtain redress for excesses and abuses of overzealous lenders. But lender liability should still be a significant concern or focus for the careful lender, and these concerns are likely to be aggravated by dealing with a more active operating business such as a hotel than a passive real estate asset like an office building. Binding arbitration and jury trial waivers continue to be important elements in the lender's defensive arsenal.

Early Warning Signs

For the same reason a lender needs access to information, it needs an excellent early warning system. In addition to obvious items such as a default under a franchise agreement or material contract, knowledgeable industry people are likely to know or be able to detect when a geographic area, market segment or particular hotel is getting into trouble—long before it shows up in the profit and loss statement. A decrease in inventories, failure to maintain the property, a cutback in marketing, and/or other changes in the annual, budget, or marketing plans may all be early warning signs. Many prudent lenders have consultants watch their asset portfolios for significant trends and changes that indicate problems. The SAG team should become involved early in the process. But special assets generally also require availability and advice from industry-savvy consultants and counsel.

Information Update

The concept of updating all information for special assets is the same as for any troubled assets. However, in the case of a hotel, one will typically look for items such as hotel franchise agreements and amendments, management agreements and amendments, any agreements, leases, and other arrangements with golf pros, concessionaires, and the like, recreational use agreements for golf, tennis, aquatics, equestrian, or other amenities, and tax information and returns including occupancy, sales and use, employment, personal property, and real property taxes. A checklist approach is helpful.

Comprehensive Situation Analysis and Selection of Alternatives

What is the value of the asset and how do you optimize it?—The comprehensive "situation analysis" is the cooperative effort by the lender's SAG team, experienced hospitality lawyers, and hotel consultants. It examines the business, legal and hotel-specific factors affecting the asset—the complexities captured by the following update of what many know as Baltin's Law:

> "Each hotel or other special purpose asset is a unique combination of physical plant, available market, location, brand identification, management, contractual arrangements, and capitalization. The mix of these factors is different for each asset, and therefore the value of a hotel or other special purpose asset will be optimized by implementing intelligent, property-specific plans, and management for both the asset's business and real estate."[3]

In other words, to understand the value, potential, and problems with the hotel, one has to look at all these factors affecting the hotel real estate *and* business.

In the physical plant assessment, one should look at the intrinsic value of the building, as well as how it enhances or limits operations, rebranding opportunities, and marketing alternatives. One has to look at inventories, FF&E, and a host of systems for food and beverage, labor management, reservations, marketing, and other operations. The market and the property will each affect the other and upside potential. Is this property properly positioned? Would value be optimized by taking it upscale or downscale? Are product improvement plans (PIPs) warranted to maintain a certain franchise? What capital improvements are necessary or valuable?

Is the current brand or management right for this property? Can it be changed and what will it cost to change, both in terms of exit fees or damages and in terms of rebranding or repositioning? Who is a logical and optimal buyer of the property through foreclosure, a deed-in-lieu, or bankruptcy? Can the universe of buyers be expanded and improved? In short, what is the highest and best use for this property and what are the costs and limitations on positioning the property for such use?

What are the contractual and business constraints?—If the Situation Analysis is to be more than an intellectual exercise if it is to have practical value it must consider the web of complex agreements affecting the property the franchise, management, amenity and use agreements, leases, licenses, and the like. Management or franchise agreements tend to be very long term agreements (say 10 to 50 years) and often have limited or even no termination rights. They are usually not assignable by the borrower without consent, and transfers to "competitors" are frequently prohibited, although there are usually exceptions for transfers upon foreclosure or deed-in-lieu.

The SNDA—The lender's rights are often vitally affected by the terms of a subordination agreement or a common variation called the SNDA[4] which the owner, lender, and operator may have executed. Such agreements typically provide comfort to lenders that, upon a foreclosure, deed-in-lieu, or sale in bankruptcy, the lender or its successor in interest will continue to enjoy the benefits of the management agreement.

This may be of great value in some circumstances. However, as many surprised lenders learned in the last downturn of the early 1990s, approximately 80 percent of the buyers for properties selling for $10 million or more were either other hotel companies or joint ventures of capital sources and hotel companies. In either event, these buyers would only purchase assets they could brand and manage, so the ability to terminate existing management and franchise agreements could make the asset attractive to a larger universe of buyers and could add tens of millions of dollars to the hotel's value.

But the typical SNDA contractually obligates the lender to the terms of the management agreement, by providing that if the lender or anyone succeeding to the property by foreclosure, deed-in-lieu, or otherwise ever comes into possession of the hotel, the lender or its successor shall immediately be bound by the original agreement. Alternatively, they are obligated to execute a new agreement on identical terms to the original for the remaining term of the original agreement. The lender faces liability for breach of contract if it does not fulfill its obligations and ensure that successors are similarly bound.

While this would seem to suggest that long-term, no cut management contracts and franchise agreements cannot ever be terminated, the use of a court-appointed receiver will generally not constitute a breach of an SNDA by the lender, and certain sales pursuant to a plan of bankruptcy will also likely avoid breach of a lender's obligations under even the most stringent SNDA. Long-term management agreements will generally be viewed as executory contracts that can generally be rejected in bankruptcy, and the operator then becomes an unsecured creditor in the bankruptcy to the extent of damages sustained for rejection of the contract. Thus, where the lender is properly secured and there is no equity, the rejected operator will take nothing for its damages.

"Rents vs. Accounts"—This issue here normally comes up when a hotel goes into bankruptcy. The Bankruptcy Code looks to state law for the characterization of the property and how a security interest is created and perfected. For example, you generally create and perfect an interest in real property with a mortgage or deed of trust and an assignment of rents which you record in the appropriate office, but you create and perfect an interest in personal property with a security agreement and a UCC-1 that is filed appropriately. And as lenders to

operating businesses know, the filing of a bankruptcy petition cuts off even a perfected security interest in future earnings of a bankrupt business (though leaving it in place as to pre-petition receivables and inventory), but a perfected security interest in real property survives the bankruptcy petition filing. Thus it is critical to know whether your collateral is viewed as a real property interest or a personal property interest. This characterization will affect both how you create and perfect your security interest—or whether you have a perfected interest—and it will also determine whether your security interest terminates upon the filing of bankruptcy as to post-petition revenues.

As an example, say one has an office building and a hotel. Both structures and the underlying land are real property. And the security interest in the real estate is perfected by the recording of the mortgage or deed of trust and assignment of rents. But what is the revenue that is derived by the owner from each of these pieces of real estate? Rents?

It has not always been so, at least according to the courts, and even now it is not always so. Normally the revenue derived from an office building or an apartment house under leases will be treated as "rents." But one doesn't sign a lease on checking into a hotel, and, in addition to providing a room, the hotel may provide a number of services including food and beverage, telephone, parking, laundry, in-room movies, banquet facilities, golf or tennis, spa treatments, maid service, and so on. Are payments the hotel collects for the use of the room and these services really "rents" or something else?

At least one court in a case called *Drake Hotel Associates*[5] said the payments were "rents." Realizing that it was one of the few courts to take that position, the judge said that he did not care about the overwhelming number of cases to the contrary. He felt that the common-sense meaning of "rents" should characterize revenues derived from use of a hotel and its facilities. Unfortunately, there were many more cases representing the other view generally characterized by the *Northview* case[6] that held revenues from hotel rooms and these other activities were not "rents." Instead, they were some form of intangible personal property in the nature of "accounts" or receivables.

What does that mean to a lender? If the loan is secured with a typical mortgage and assignment of rents, this would create a valid security interest in the real estate under either line of cases. But the lender also wants to control the income or cash flow from the property. That is what the cash collateral battles are all about while seeking relief from a bankruptcy stay or working on a plan for disposition of the hotel. And that is where the difference is.

Under the *Northview* approach, unless one had a security agreement with an appropriate description of the revenues from the hotel and a properly filed UCC-1, the security interest in the revenues would not be validly created and perfected. The typical assignment of rents in a mortgage would not be adequate. So when the hotel goes into bankruptcy, the security interest is not perfected in either the pre-petition or post-petition income from the hotel.

And if even if the lender did use a good security agreement and UCC-1, under the *Northview* approach, the security interest is cut off by the filing of the bankruptcy petition in post-petition revenues. Only under the *Drake Associates* approach does the security interest survive the filing of the bankruptcy petition as to post-petition revenues.

Although this appears to be a fairly grim scenario for lenders, things were improved a little when the Bankruptcy Code was amended in 1994. There was a specific provision added to treat room revenues like rents. The provision was amended to include "fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties . . . except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise."[7]

Unfortunately, in a full-service hotel or resort, revenues from other sources—banquet, food and beverage, telephones, and the like—can easily constitute more than 60 percent of the total income from the hotel. Those items of income do not come from room revenues and would appear to still be subject to the old "rents vs. accounts" or "*Drake* vs. *Northview*" dichotomy. Undoubtedly, there will be a great deal of litigation in the bankruptcy courts in the next industry downturn to determine what the amendment to the Bankruptcy Code means.

Evaluating the Options

From the lender's perspective there are several options or alternative courses of action on a troubled asset. It can do nothing of course, or it can pursue a strategy that is directed toward one or more of the following:

- Workout
- Receiver
- Deed-in-lieu of foreclosure
- Foreclosure
- Bankruptcy

The workout typically leaves the borrower in possession or physical control of the asset, and the other alternatives all seek to move that control to someone else—a receiver, the lender, a buyer of the property, or a bankruptcy trustee.

KEY TO EVALUATING ALTERNATIVES: "BUTLER'S MATRIX"

The situation analysis should have considered all the relevant factors concerning the borrower, the hotel and their related considerations. Now it is time to consider these in light of the lender's goals and the available alternatives. Given the complexities of the typical special asset, it is sometimes helpful to boil it down to a summary form that may over-simplify, but at least provides a grid or framework for analysis.

One of this article's authors, Jim Butler, developed an analytical tool in the last great real estate and hotel downturn in the late 1980s that has come to be known as "Butler's Matrix" (see *Table 1*).

In applying Butler's Matrix, no single factor or group of factors is necessarily determinative, although a single factor could be. The lack of a critical mass of motivations on one side or the other will normally suggest that the lender will want to take possession by foreclosure or deed-in-lieu of foreclosure or at least displace the borrower from possession through use of a receiver.

For example, in the absence of other controlling considerations, inadequate collateral value for the debt, defective documentation, a good borrower, a strong management company, and a weak market

Table 1

BUTLER'S MATRIX		
Issue	**Workout**	**Take Possession from Debtor** (Receiver, Deed-in-Lieu, Foreclosure or Bankruptcy Trustee)
Collateral	Limited or problematic	Full or satisfactory
Documentation	Problematic	Full or satisfactory
Borrower		
•Integrity	High	Questionable
•Financial strength	Strong	Weak
•Managerial strength	Strong	Weak
Management (operational)	Strong	Weak
Marketing	Focused	Diffuse
Franchise affiliation	Correct	Wrong image
Asset		
•Design	Good for market	Poor
•Physical condition	Well maintained	Deferred
Market	Weak	Strong

would all suggest a workout instead of the possessory alternatives. However, if the property is severely damaged by a hurricane or other disaster, that factor alone might outweigh all the others and swing the evaluation in favor of one of the other "possessory" alternatives.

SAG – PROFIT CENTER FOR THE 21ST CENTURY

How the SAG is run can make a critical difference. Utilizing the SAG as a profit center can make a difference in amounts recovered and how the bank is protected from lender liability claims. The bank can position itself to make a bigger impact on its profitability, more so than the commercial loan originations. In recognition of that, senior management should be given prompt access to decision-makers and other resources, including hotel lawyers and consultants.REI

NOTES

1. The terms of a hotel management agreement can easily add or subtract 25 percent or more to or from the value of a hotel.
2. James R. Butler, Jr., Co-Author, Chapter 14 "Special Legal Considerations for Hotel Investors," Hotel Investments Issues & Perspectives (2nd Ed. 1999), Educational Institute, American Hotel & Motel Association.
3. Baltin's Law was formulated by Bruce Baltin, Senior Vice President of PKF Consulting in Los Angeles, California. Mr. Baltin has more than 30 years of hotel experience.
4. The SNDA is the acronym for Subordination, Non-Disturbance and Attornment agreement, which is usually a three party agreement involving the owner, the operator and the lender of the hotel. Such agreements typically provide comfort to lenders that upon a foreclosure, deed-in-lieu or sale in bankruptcy that the lender or its successor in interest will continue to enjoy the benefits of the management agreement. This may be of great value in some circumstances. However, many such agreements also limit the lender's or successors' options in purporting to bind them to the terms of the agreement whether they want it or not. This poses many interesting issues where the lender or a successor want to remove or terminate a brand or operator.
5. *In re S.F. Drake Hotel Associates*, 131 B.R. 156 (Bankr. N.D.Cal. 1991) (minority view holding that hotel room revenues are "rents").
6. *In re Northview Corporation*, 130 B.R. 543 (9th Cir. BAP 1991) (majority view that room revenues are "accounts" and not "rents"). See also, *In re Ashkenazy Enterprises, Inc.*, 94 B.R. 645 (Bankr. C.D. Cal 1986) and *In re Mid-City Hotel Associates*, 114 B.R. 634 (Bankr. D.Minn. 1990).
7. Bankruptcy Code Section 552(b).

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(continued from page 48)

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Real Estate Industry Consortiums– National or Local– Who Will Succeed?

by Michael Praeger

The commercial real estate market has been revamping the way it does business in the last two years, through the introduction of the Internet and Web-based applications. Increasingly more commercial real estate organizations are realizing the power of streamlining purchasing, asset management, financial management, and other business processes online. Real estate organizations can realize an even bigger benefit by joining together to create one cohesive group, or consortium. Consortiums are relatively new to the real estate industry—but if formed and operated correctly, can provide real estate organizations with a powerful buying and negotiating tool. But the real question that plagues the industry today is which will succeed—national, local, or industry-specific consortiums?

While national consortiums have the operating capital to adopt all the technology available and can guarantee financial stability to its members, the disbursement of members is too large and their scope is very wide. Local consortiums, on the other hand, operate within a smaller geographic area and members are usually focused on achieving one goal at a time. The jury is still out on which consortium type will be more successful. Reports indicate that while industry segment consortiums are providing value to their members within a national framework, local consortiums, in all practicality, have the upper hand to succeed due to the common geographic market its members operate in.

ABOUT THE AUTHOR

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CONSORTIUM BENEFITS

Two key components that provide major benefits to consortium members include the ability to implement affordable technology and collaboration. Through Web-based applications such as e-procurement, these property owners and operators are seeing a massive reduction in paperwork, time, and inventory. In fact, one real estate operator, Levine Properties, based in Charlotte, NC, saw a 15 percent decrease in controllable operating expenses once online purchasing and a bid management application was implemented in its offices.

National, regional, and local consortiums are a means for property owners to increase their competitive advantage through developing relationships with other property owners, creating one large network that can provide financial stability, additional revenue opportunities, and more leverage in negotiating contracts with suppliers. The goal of this new collaboration is the gain of additional resources and purchasing power without surrendering individual purchasing control or flexibility.

Smaller companies who join together in a consortium are able to take advantage of the economies of scale and become more competitive with larger real estate operators. In addition, these companies are realizing the revenue- and cost-focused benefits:

1. With regard to revenue, consortiums allow real estate operators to act as a united group when negotiating profit-sharing deals with third parties such as advertising or telecommunications companies—basically companies that provide services for tenants.

2. On the cost side, consortiums enable operators to act as a cohesive bargaining unit to standardize business practices and purchase software and supplies. Consortiums have more pull with suppliers than independent real estate operators, enabling negotiation for more competitive pricing and terms. The cost side can also be extended to include various costs from service contracts for landscaping or security, to purchasing janitorial supplies for restrooms.

THE DEBATE: NATIONAL VS. LOCAL

National consortiums are formed when large regional companies join together to create a virtual Fortune 500 corporation. National consortiums primarily consist of publicly traded real estate organizations, such as real estate investment trusts (REITs) or large institutional firms. Typically, publicly traded REITs are forming the national consortiums and each group has a different reason for its existence. For example, a national consortium may evolve to provide industry standards that can be used by all real estate organizations, while another may develop as a common ground for similar real estate organizations to share ideas, discuss problems, and find solutions. National consortiums are not always able to offer one product or solution to all its members due to their geographic disbursement. As a result, this may decrease the chance of success or accomplishment of goals. Examples of some successful, national consortiums include Office Technology Consortium (www.officetechconsortium.com), and Constellation Real Technologies (www.constellationrealtechnologies.com).

Local or regional consortiums, on the other hand, are banding together in a single geographic area. This offers them more negotiating and buying power with those common suppliers and contractors they all share, and also gives these small organizations a forum for solving problems, adapting new technology, and discussing business concerns with similar organizations. As we all know, real estate is overwhelmingly a locally focused market. When you are a small operator that has banded together with other small operators to form a virtual mid-sized company, you can become a dominant force in your local marketplace. An example of a local or regional consortium is Preferred Offices, headquartered in Washington, D.C.

In general, the success of national vs. local consortiums is still being decided. National consortiums are only beginning to see the fruits of their labor, and many local consortiums are still in their infancy.

NATIONAL CONSORTIUMS

National consortiums appeared on the scene in early 2000, and at that time expectations for success were high. Many industry analysts and members of the real estate industry saw these national consortiums as a way for a group of companies to dominate the market. They expected consortiums to revolutionize the way vendors conducted business with real estate operators and give independent operators more power through collaboration. Since that time, little had been heard from the national consortiums and many suspect that they have been falling apart. But there are some national consortiums that have weathered the storm and are still operating today.

In a study done by Banc of America Securities in February 2001, Lee Schalop and John Saunders found that speculation of the demise of national consortiums had been greatly exaggerated. After several discussions with multiple consortium participants, they found that consortiums were still meeting regularly and still considered them very much alive.[1] Another finding reported in this study showed that regardless of how many deals are accomplished or not accomplished, consortium members believe they are reaping positive benefits; their participation involves a sharing and flow of ideas that can be very beneficial.[2]

National Consortium Case Study: Office Technology Consortium (OTC)

One of the national consortiums examined in Banc of America Securities' study was Office Technology Consortium (OTC), a national consortium for Class-A office space owners. It formed with a specific focus on two areas—e-procurement and online leasing/listing. One of the main goals of the OTC is to review technology service providers for each of the initial two areas/categories and select a "preferred vendor" or multiple preferred vendors as a recommendation to its members. It would then be up to each member to decide which vendors they wanted to contract with. OTC members view their consortium primarily as a vehicle through which they can further their own technology initiatives, rather than as an investment vehicle (which is a primary function of Constellation, another national consortium).[3]

The Office Technology Consortium (OTC) started out on the right path. With only 13 members and a limited focus, the OTC, established in June 2000, formed an industry group that would be a model for other real estate consortiums. Founding members realized the opportunities created by the new economy for companies to work together to explore and develop efficiency-enhancing Internet enabled technologies and increase access to ideas and initiatives to improve the commercial real estate marketplace.[4] With 13 members, the OTC is the first group of its kind to focus specifically on increasing value for office property tenants. Combined, the member companies of the OTC own or manage over 400 million square feet of premier office space in North America.[5] The OTC has succeeded where other national consortiums have failed—by limiting its focus to one or two key initiatives that all members agree on and limiting the financial stake of its members in the proposed initiatives. What this does is eliminate the "looking out for myself first" mentality that plagues many of the national consortiums and other groups, whether in the real estate industry or not. Looking ahead, the OTC is firmly planted on the road for success, opening its exclusive membership to only major real estate organizations and publicly traded REITs.

National, regional, and local consortiums are a means for property owners to increase their competitive advantage through developing relationships with other property owners, creating one large network that can provide financial stability, additional revenue opportunities, and more leverage in negotiating contracts with suppliers. The goal of this new collaboration is the gain of additional resources and purchasing power without surrendering individual purchasing control or flexibility.

Local Consortium Case Study: Preferred Offices

Preferred Offices is a local consortium whose members are seeing benefits. Preferred Office's objective is to create value for every property participating in the consortium and to build a branded network of high quality office properties that capitalize on the opportunities created through an economy of scale; opportunities such as marketing, buying power, and tenant services. With larger owners and operators of quality office properties increasingly harnessing the benefits of Web-based technology resulting in more efficient operations, Preferred Offices realized the power and value that independent owners can capture by banding together to achieve the same goal.[6]

The Preferred Offices consortium provides its members with several value-added benefits, including:

- A brand name that is supported by consistent standards, both on the Web site, within their listing services, and on the property;
- Power buying through an e-procurement system, which enhances property values by providing the opportunity to improve the quality of services, such as janitorial or landscaping, while reducing expenses;

- Identify opportunities for incremental income, thus providing revenue enhancements and more value to the property owners;
- Tenant services that add an additional layer of services to the building's amenity base; and
- A Web-based listing and reservation system that provides a searchable database for tenants and is supported by focused regional advertising.[7]

Preferred Offices has successfully set up vendor alliances with major suppliers such as AgilQuest, BroadBand Office, Pepco Energy Services, Carr Capital Corporation, and Captivate. These vendors now provide services at better terms for each of the members of the Preferred Offices consortium. For some members, these services are with large, national or regional vendors that would not provide a smaller, local operation with deviated pricing or increased service levels due to their limited buying power. But by leveraging the buying power of a group of independent real estate operators, Preferred Offices has been able to make these national and regional vendors and provide the Preferred members with discounted pricing and elevated service response times.

What Preferred Offices has done and continues to do has placed them on the road to success. Preferred Offices is a prime example that there is strength in numbers, that identifying the right vendor/partner is crucial to successful negotiation and implementation, that the balancing of near-term vs. long-term value creation is important, and that a group of local real estate operators can level the playing field with larger owners.

Today, Preferred Offices has recruited over 14 million square feet of property owned by members and signed six vendor alliances. Overall, Preferred Offices has helped its members reduce operating expenses and provides a Web site with office space search capability and a tenant services menu. Preferred Offices has become a great example of how a local consortium can succeed when it limits its scope and works to achieve common goals. Preferred Offices has created immediate benefits of an average $0.15 SF for its owner-occupied office building through power buying and revenue enhancements. This equates to an approximate $120,000 to $130,000 per year for the average Preferred Office member.[8] And, as Preferred Offices' brand awareness continues to increase, it will be able to generate $75,000 to $150,000 of benefits each year for its members through increased occupancy and rates.[9]

BUILDING A LOCAL CONSORTIUM

Local consortiums will be the success of the future. And while national consortiums require significant funding, local consortiums are relatively easy to form and do not require substantial financial backing. Below are the basic steps to form a local real estate consortium in your area.

1. Find one or two strong, influential real estate companies in your geographic area to act as the founding sponsors for the consortium. This is an imperative part of making sure that your consortium begins on target, because these companies will already know about the marketplace and possess the available technology and vendor relationships. In the Preferred Offices consortium, one of its founding sponsors is CarrCapital—a very strong and influential real estate company in the Washington, DC, area. Its staff knows the industry and the local marketplace well enough to bring big benefits to the table.
2. After the founding sponsors have been located and have agreed to work on forming a consortium, the next step is to identify a slate of objectives that need to be accomplished. Again, a good example is the Preferred Offices consortium, whose goal was to combine resources in order for all members to be able to compete with national companies like CB Richard Ellis and Trammel Crow.
3. Next, the sponsors will need to decide the legal structure of the group. Preferred Offices is set up as a franchise and each of its members are franchisees. Other legal structures are a loose collaborative agreement between various member companies or the establishment of the consortium as a membership-oriented organization. A major part of the legal structure decision will lie in the goals to be accomplished. For example, Preferred Offices wanted to brand each of its member properties as a Preferred Office property to build value in their brand. However, if a consortium's main objective is to have access to consolidated resources such as different technological capabilities, then a membership-type organization is the easier and more efficient legal structure.
4. Once the founding sponsors and the legal structure have been secured, the fourth step is for the founding sponsors to actively recruit other members. Experience has shown that the ideal number of real estate organizations encompassed in one consortium is between five and 15. Less than five and you will not have the buying power to

attract vendors. With more than 15, it will be difficult to conduct meetings, allocate responsibilities, and agree on common objectives for the group—the most common problems of large groups.

5. After the consortium has selected its members, the first order of business is to decide on annual objectives and key areas of immediate focus. The list should tie in to the overall slate of objectives detailed by the founding sponsors, but will narrow down the focus to the most important objectives to be accomplished within the first year.
6. Next, allocate responsibilities among member companies. This means each member company will be assigned one objective or project to research for the group. For example, one member may sponsor an e-procurement initiative. That member company would review procurement vendors and prepare a report to present various options for a technology application that can provide the best value to all members. Another company might be responsible for doing the same process but with telecommunications services. By allocating the responsibilities, no one company has to bear the time and expense of researching and finding all the technology or services available.
7. Finally, consortium members will want to decide and agree upon the frequency of meetings, how information will be shared among members, and when project sponsors should have the reports back to the consortium.

A local real estate consortium can be easy and successful if you have the right partners. The future of real estate shows that local consortiums will succeed because of the value and benefits they provide its members. Local consortiums can be focused on technology initiatives, building a brand, or consolidating resources. Whatever the focus, just be sure that the scope is limited and the objectives are achievable.REI

NOTES

1. *Real Estate & Technology Week*, Banc of America Securities, February 20, 2001.
2. *Ibid.*
3. *Ibid.*
4. Office Technology Consortium Web site, www.officetechconsortium.com
5. *Ibid.*
6. Excerpt from Preferred Offices presentation given by Oliver Carr, III on March 13, 2001.
7. *Ibid.*
8. *Ibid.*
9. *Ibid.*

CRE PERSPECTIVE

Dante's Vision: a Guide for Modern Business Leadership

by Bowen H. "Buzz" McCoy, CRE

INTRODUCTION

Recently, I have been teaching Dante's *Divine Comedy* as an adult education class in my local church. As I have immersed myself in the thoughts of this great 13th century poet, it has occurred to me that he has a great deal to say which is relevant to modern business leadership. Dante's genius results in his poetry having fresh meaning for us seven centuries after his death.

Dante wrote his great poem while in political exile from his beloved city of Florence. Part of the time he lived in Verona under the protection of a close friend, Can Grande. Dante wrote a letter to Can Grande della Scala, describing how he felt the poem should be read. Dante described four levels of interpretation for the poem, all of which might operate simultaneously. He explained his theory with the example of Moses leading the Exodus out of Egypt. Dante's four levels, freely translated, are as follows:

1. The **literal**: Moses led the Israelites out of Egypt.
2. The **allegorical**: Christ's role in redemption and transformation.
3. The **moral**: The turning of a soul from sinful life to a state of grace.
4. The **anagogical (mystical)**: The movement of a life from a focus on the temporal world to the freedom of an eternal state of grace.

In modern parlance, the four levels can be described as follows:

1. The **surface level:** Dealing with the superficialities with which we all must cope in our daily lives; being socialized.
2. The **allegorical level:** This is the level in which we make meanings out of stories and heroes.
3. The **moral level:** This is the level of the limits of the law. It is that behavior which society as a whole is willing to condone from time to time. It sets limits as defined by those living around us.
4. The **deep:** The level from which we draw our deepest meanings of life. This is the level of the ethical, the spiritual, and the religious. This is where we define what we are willing to lose for. This is the level of the transcendent, or what many call, God.

We live on all four levels simultaneously. The bulk of our time is spent in the surface level. For most, the least amount of time is spent in the deep level. We move in and out of the different levels all the time. If one has the ability and the support to decompartmentalize one's life, and bring the fourth level into all that they do, including their work, they can be said to have a fully integrated life. They can be said to live a life of integrity. Most of us move in and out of such a state.

Dante brought his concept into his relationship with Beatrice. In his poet's mind, they shared a perfect relationship, which was at once physical, emotional, intellectual, and deeply spiritual. After Virgil departs, Beatrice leads Dante first to Christ and then to God. Dante first sees Christ reflected in the eyes of Beatrice.

The extent to which friendships and relationships are based upon a commonality coming from the respective deep levels, the greater sense of support and well-being an individual is likely to have. Writers, including Sissela Bok, have informed us, however, that most of us cannot sustain a plenitude of such deep relationships without beginning to trade off confidences and trust.

Many in today's world have experienced disillusionment, broken promises, token relationships, fragile commitments, and provisional settling for whatever gets us through until we find something that is better. In these cases, a kind of hopeless cynicism emerges and tends to create self-oriented worlds for the person who has been disappointed. Such attitudes narrow the field of choices, as we are always suspecting that others will most certainly let us down. A business leader who resonates with the deep foundational values of the enterprise and those working within it is far more likely to break down these walls of cynicism and provide inspired possibilities.

Let us explore the challenges of modern business leadership from the point of view of Dante's vision of the four levels of being.

The Surface Level

This is where we all spend the bulk of our time, worrying about to-do lists, meetings, presentations, travel arrangements, clothing, commutation, how

we are viewed by others, and the myriad of miasmic details of daily life. We can get so lost in the details that we lose our way, our sense of purpose, of who we really are. We let our in box and telephone and e-mail lists drive our day. We lose our sense of spontaneity and creativity. We are short with people and have no time for the daily acts of communion which make life worth living.

When we are living outside of community, it is easy for the dominant drivers to become ego and greed satisfaction. There is only one stakeholder in the enterprise, and it is me! I am not getting enough recognition, compensation, office space, support staff, etc., etc. I was screwed last year at bonus time. My shortcomings are always someone else's fault. The externalities of the reward and punishment systems and the allocation of perks become the primary drivers of behavior.

Group norms, which have the unsettling characteristic of changing radically over time, become the prime influence on our actions. Reliance upon prevailing norms and group-think are an insufficient foundation for sorting through the challenging issues that confront business leaders. Where do we find the courage to deal with failed leadership and to deal with the complexities of power and wealth? Perhaps we need to move a bit deeper.

The Allegorical Level

This is where one begins the search for enduring foundational duties and principles. This is where one begins to make contact with those who have gone before, (a.k.a., the community of fellow travelers), for stories of courage and of those who are willing to go against the grain and become the immovable object, the fixed point, in the flow of daily life.

Peters and Waterman's *In Search of Excellence* does an excellent job of making the point with their case studies of "management by walking around." Bill Hewlett and David Packard had an immense impact on their enterprise by their presence and force of character. Donald Siebert, former CEO of J.C. Penney, liked to tell stories about the unintentional great impact of the CEO who, as he is walking out the door, shouts back at his secretary: "Get my niece a job!" or "Don't put that in the minutes!" or "I don't care what you call it. Call it corporate overhead expense!" Siebert pointed out that such statements carry far more weight in an enterprise than do pious statements of corporate ethics or purpose.

We know that stories are a key method of conveying corporate culture. Do we wish our culture to be translated by the most loquacious denizens of the water cooler or by the actions of our senior leaders? In the best companies the stories told most often depict the courage and fundamental values of senior management.

Robert Coles, among others, has enjoyed great success conveying fundamental values to Harvard Business School students through the great literature of the ages, including Tolstoy, Dostoevsky, Walker Percy, and Flannery O'Connor. Their stories challenge the reader to probe below the surface level in order to truly confront oneself and become engaged in discovering one's value system.

The Moral Level

The moral level—what society will condone from time to time—provides an excellent opportunity to move outside of oneself into community with others. The moral level would include such societal institutions as The Business Roundtable, institutionalized religion, private philanthropy, the Supreme Court—the entire panoply of organizational structures which society has created to inform us concerning appropriate behavior.

Cultural norms, which begin 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.

How do we decide when it is appropriate to do what society, at the moment, does not condone; to take the path not traveled, to move against the grain of popular will?

The Ethical Level

I believe that ethical living is grounded deeper than cultural norms. It is a by-product of our foundational beliefs. The deep level 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 lose for. Morals are human response to humans. Ethics is human response to some greater transcendent power.

Ethics is deeper than morality or custom. It comes out of our deepest desire to make meaning out of our lives. 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.

How do we attain our foundational beliefs? They must be developed within the individual over a lifetime, starting at the earliest age. We learn them from the family, from teachers, from our peers, from our heroes, from the stories we resonate with, and the interactions of society. This is why it is often thought that it is not possible to "teach" ethics in a graduate professional school. The mission is thought of as teaching foundational beliefs, or religion, or spirituality, or something that is not felt as appropriate in a professional academic environment. Yet, much can be accomplished in such classes, if the goal is thought of as increasing the students' ethical awareness and ethical imagination. The goal might be to make ethics and basic values appropriate inputs in making business decisions.

At some point in discussing the deep level, Dante would encourage us to consider religion and spirituality as inputs. Religion is the repository of the wisdom of billions of people across thousands of years. Religion provides a language to facilitate discussion. Foundational beliefs can be found in the teachings of the great teachers, be they Christ, Buddha, Confucius, the Prophets, Mohammed, Gandhi, or any of the others. Such wisdom is not necessarily found in the group norms of specific religious institutions.

Religion can provide one answer to some universal questions: How do we find our center? How do we gain a sense of detachment in the highly competitive cacophony of current business? Where does the passion come from? For a religious person, business can become a calling, a vocation, a battleground where one can test out their faith. For many, the work place can provide their sole community. Young employees may work from 10:00 a.m. until 3:00 a.m., seven days a week. If they cannot form meaningful relationships in the business environment, they become rootless and subject to early burnout.

Most of us, including people of faith, are uncomfortable with any form of evangelicalism at work. We feel it is simply not appropriate behavior on the job. Nevertheless, one should be able to live out of one's religious conviction in the work place. This is what certain theologians have termed "stealth" religion, or "religion less" religion. We are respected by our actions, not by the symbols we wear or the attempts we make to recruit others to our faith.

The deep sense of the other which comes out of all deep religious convictions helps to take us out of pride and greed. We can become whole, complete, and more relaxed when we discover that we can live out our foundational beliefs. We can become good persons without necessarily subscribing to a particular institutional religion, or to any religion. What we are talking about are foundational beliefs, however attained.

CONCLUSION

Dante encourages us to live beyond the boundaries of everyday life. Boundary living is not new. There is a lot of theology in Peters and Waterman and in Peter Drucker. There is an interconnectiveness, a polyphony, among all aspects of life. A complete life, a life of integrity, involves a balance among family, profession, public life, philanthropy, physical well-being, and the inner spiritual life. The extent to which one is ignored forces the others out of balance. A "life of leisure" can be termed as a state of mind which occurs when all such efforts are perceived of as being voluntary.

Business should be seen as building relationships, not doing deals. A business person of integrity focuses on vision, values, and valor. There is an immense difference between a business life bound by the limits of the deal and business life bound by the limits of one's faith. We will be far more effective if our values are congruent with our professional lives. We are talking of such values as service to others, respect, and justice. Faith can help sustain moral courage. Faith provides us the staying power through adversity.

No rational decision-making system is perfect. In the true ethical dilemma, we are thrown back into our own inner resources. Faith helps us to set our priorities and to live with the consequences of our actions. We must develop the courage to balance our intuition with our rational nature. As Emerson has suggested, "We must live out of the depth of our being." REI

ABOUT THE AUTHOR

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FOCUS ON THE ECONOMY

Diagnostics Yield Prescription for Recovery

by Hugh F. Kelly, CRE

Diagnosis and prescription are distinct operations in economics as in medicine. But they had better be well related, or the patient may be in for a rough time. The economy, like the human body, has marvelous natural recuperative powers. Intervention, therefore, is indicated only when and to the degree that the course of treatment will enhance the healing process that occurs in due time. Hippocrates, after all, enjoined physicians, "First, do no harm."

Economists, in their shorthand, write the equation for national output as GDP = C+I+G+(x-i). Translated, that means Gross Domestic Product is composed of Consumption, Business Investment, Government Spending, and the Balance of Trade. Diagnosing the economic ills that threw the nation into recession involves a look at these specific components to see where the fever began, and where the symptomatic chills are worse.

During the tremendous economic boom of the '90s, two staples of my talks around the country were the comments that "we will remember these as the 'good old days,'" and "inflation in the fundamental economy is not a problem; it is only in the stock market that we see 'too much money chasing too few goods.'" Undoubtedly, the United States will be challenged to approach the combination of robust GDP growth, low inflation, low unemployment, and substantial, sustained productivity gains that characterized the past decade. It is not impossible, though it will take a combination of skilled public policy planning and execution, sustained business management for long-term profit growth, and some luck on the world scene. I will deal with these topics in the 2002 series of columns for *Real Estate Issues*. Presently, I'd like simply to do some of the diagnostic work.

Where did the recession come from? Despite the decision of the National Bureau of Economic Research that the downturn started in March 2000, the causes of the recession need to be placed both before and after that date. The economy had been placed in fragile health by the overheated stock market (see *Exhibit 1:* "Trends in Stocks and Bonds"), epitomized by the NASDAQ bubble but spread throughout all the major indexes, including the broad-based S&P 500, which doubled in price between 1995 and 2000. While U.S. corporations were arguably much stronger at the end of the decade, there was no way that they were worth twice their 1995 value. So a full year before the "official" recession date, Wall Street was reeling in financial assets, and strapping the economy's strength. It's not for nothing that the S&P 500 is included in the Index of Leading Indicators.

As 2000 progressed, businesses started to pay stricter attention to inventory volumes (see *Exhibit 2:* "Inventory Correction–With a Vengeance"). Wholesalers

Exhibits 1 - 3

Exhibit 1

Trends in Stocks and Bonds

Sources: Standard & Poors; Lehman Brothers

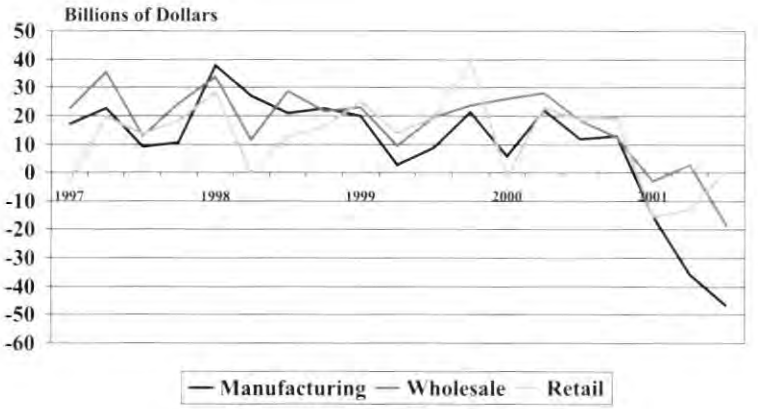
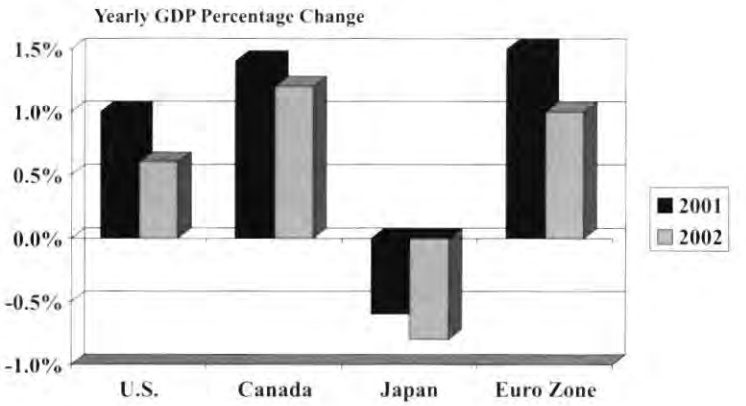


Exhibit 2

Inventory Correction–With a Vengeance

Exhibit 3

No Jump Start from Abroad



Source: *The Economist* Poll

led the trend from mid-2000 onward, and were joined by retailers and manufacturers as the year turned into 2001. What were the numbers? Immense. Inventories of all private businesses plummeted at a rate of $27.1 billion in the first quarter of 2001; $38.3 billion in the second quarter; and $61.9 billion in the third quarter.

So the "I" component of Gross Domestic Product was under considerable stress, even as the "G" component was producing "drag" in the form of federal budgetary surpluses. (When the government takes in more money than it spends, that counts as a negative in the GDP calculation.) And foreign trade (the [x-i] component) was producing disastrous figures. By 2000, our current account deficit was more than $450 billion; seven times the level of 1991 and three times as large as in 1995.

Nevertheless, through August of 2001 it was an open question whether the economy would slip into recession or if the Fed's aggressive rate reduction regime would engineer a third consecutive "soft landing" by Alan Greenspan. Consumer spending, the housing market, and continued expansion in the economy's services sector provided forward momentum for the nation. September 11 made the debate moot. With a severe contraction seen for the end of 2001, the dating committee of the National Bureau declared that the economy peaked in the previous March and we began concentrating on the depth and duration of this, the first recession of the 21st century. In this sense, the backdating of the recession to March was contingent upon unforeseeable (and previously unthinkable) events outside the parameters of forecasting models.

During economic contractions, of course, the critical concern is to locate the potential engines of recovery. For some of the indicators, hope can be discerned even in the first days of 2002. Stocks have recovered to the value levels prevailing prior to September 11, 2001, and typically perform well in the first year of an economic expansion. Inventories have been drawn down so drastically that the year 2002 will likely see this element of business investment turn positive by the spring. Fiscal policy interventions are superfluous to these trends: they are responding to their own market-oriented rhythms and to the monetary policy moves that have made the cost of capital exceptionally low.

Unfortunately, we can't expect much help from other major industrial nations, as can be seen in *Exhibit 3:* "No Jump Start from Abroad." Japan's troubles are actually expected to deepen in 2002. Mexico's GDP had contracted on a year-over-year basis by 1.6 percent as of third quarter 2001. Argentina's economy is in a shambles, with potential ripple effects elsewhere in Latin America and even in Spain. And while both Canada and Europe will outperform the U.S. in GDP growth this year, both will be slower than in 2001 and unlikely to be creating external market demand for American goods and services. This will have to be a bootstrapped recovery.

Thus we have our work cut out for ourselves in 2002. It would be exceptional if this recession were to persist into the summer, but the quality of the recovery and subsequent expansion should not be taken for granted. Done right, public and private economic decisions could put us back to the vigorous economic health we enjoyed during the '90s. Over-medication or inappropriate treatment could make for an extended convalescence and even have some nasty side effects that would last for years. But those are subjects for the coming editions of this journal.REI

ABOUT OUR FEATURED COLUMNIST

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FOCUS ON INVESTMENT CONDITIONS

COMMERCIAL REAL ESTATE 2002: AFTER THE FALL

by Kenneth P. Riggs, Jr., CRE

Investor psychology most certainly underwent a dramatic shift during 2001. The industry went from believing that the commercial real estate markets had exercised so much discipline that it would escape the dot-com and stock market demise, to recognizing that as the economy goes, so does the commercial real estate market. One observation we make is the fact that commercial real estate lags the economy—this makes intuitive sense, for as profits wane, stock prices decline, companies re-trench, layoffs occur, and the need for commercial space declines.

The more we analyze the wealth of financial information available to us, one truth stands out—investing is about expectations. As the aftermath of September 11 ripples throughout the real estate industry, directly affecting the hotel and retail industries but also influencing the office, industrial, and apartment markets, it is clear that performance expectations for commercial real estate were too high and not at sustainable levels, given the relative supply/demand balances in most markets. This view is supported by the special investor survey RERC conducted with institutional leaders who work on both the debt and equity side of commercial real estate, whose views were measured both before and after September 11. These results and trends were analyzed and several distinct conclusions were reached for 2002.

First, September 11 only exacerbated an ailing economy and apparent recession that were already in process. Well before the attacks on New York City and Washington, D.C., the economy and the stock market were in the midst of a downturn. The special investor survey showed that the pre-September 11 opinion rating on the economy was 4.3 on a scale of 1 to 10, but it dropped to 3.1 post-September 11. What the terrorist attacks have done is to make the downturn more sudden and more severe, bringing to light the recession that was already at hand. However, instead of an anticipated U-shaped trough and recovery that was expected for the economy before September 11, we are now more likely facing a reverse L-shaped recession and recovery, with a sudden downturn and most likely a slow recovery.

Of all the property types, hotels have seen the most damage from September 11, with an increase in the discount rate of over 50 basis points and an increase in the going-in capitalization rate of over 100 basis points. The decrease in travel has dropped occupancy rates to over 20 percent in some markets, and hotels are struggling to stay open. As a result, commercial real estate investors are assessing the risk of their hotel portfolios, and in some cases, are even suggesting that their lenders take over the properties.

Interestingly, the terrorist attacks have not moved investors' perceptions of regional malls and retail properties, as there has been almost no change in the discount rates and going-in capitalization rates from pre- to post-September 11.

Retail has been low on the radar screen for investors in the past several years anyway, and it has had bearish investment prospects imbedded into return requirements. However, this author believes this static view could be short-lived, as economic realities regarding layoffs in the airline, travel and tourism businesses, and other industries directly affected by September 11 take hold of consumer spending over the next several months. Ironically, the only advantage this sector had going for it was that investors had not put high hopes on retail investments in 2002, except in the neighborhood shopping center category, which may prove to be its savior in 2002.

Other property types, such as office and industrial, have also been affected. According to TortoWheaton Research, these sectors are now seeing persistent negative net absorption, with vacancy rates increasing over existing levels by roughly 5 percent and 2.5 percent nationwide for office and industrial properties, respectively. In tech-sensitive economies—Boston, San Jose, San Francisco, and Austin—vacancy rates for office properties have increased by 10 percent from levels seen last year. The only silver lining is the fact that these tech economies had vacancy rates well below 5 percent, which allows these markets to still report overall vacancy rates in the low teens. Although disappointing to market expectations, we will have weathered this downturn in good fashion, if this is as high as vacancy rates get.

Reported return expectations have seen increases in *required* capitalization and discount rates of approximately 50 basis points for office and industrial properties. Of greater risk to the commercial real estate is the real potential of negative net operating growth in the coming years. Rents are expected to be flat to down for most markets, but expenses—especially insurance, utilities, and security—are expected to rise at least equal to inflation, and most likely will exceed this level. Property earnings will be further dragged down by increased tenant improvement costs as landlords fight over tenants. For the office sector in particular, future income prospects do not look good as tenant leases roll.

As mentioned previously, commercial real estate is driven by the economy, and the economy has decelerated faster than anyone expected. Commercial real estate will lag the economy's recovery by one year, which most likely puts a real estate physical market recovery into mid-2003. The commercial real estate market will be in for a long winter (values, prices, and rents will be under pressure), but late 2002 should be a good time to make solid risk-adjusted deals in the commercial real estate market.

Recent events, coupled with the sagging economy, position real estate to provide the best returns among all asset types. Regarding successful investment, however, Warren Buffet stated, "Keep expectations low." Now is the time for commercial real estate investors to adjust their expectations, and the quicker the market does this, the quicker the real estate return performance will get back to acceptable levels. For now, commercial real estate is not expected to provide much beyond an 8 percent to 10 percent total return in 2002, which come to think about it, is not too shabby compared to expected stock market returns.REI

ABOUT OUR FEATURED COLUMNIST

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FOCUS ON HOSPITALITY ISSUES

When Hotel Revenues Dive, What Happens to NOIs & Property Prices?

by John "Jack" B. Corgel

Each week, the hotel industry anxiously awaits the release of the Smith Travel Research room revenue numbers for thousands of U.S. properties. Interest in these reports reached new highs during recent months as the private and public markets continually monitor industry performance during the recession and following the events of September 11. Through the fourth quarter of 2001, room revenues remain well below levels achieved during the same weeks in 2000.[1]

The availability of timely revenue information represents a large first step toward understanding how hotel property returns have held up under current economic pressures. Nevertheless, these data may be somewhat misleading about the severity of hotel market softness from a capital market perspective. While the share prices of franchise and management giants in the hotel industry (*e.g.*, Marriott International) vary directly with movements on the top of hotel property income schedules, equity and debt capital suppliers have more of a steak in the bottom-line incomes and property valuations. Unfortunately, timely information about hotel NOIs and property values is far less available to the capital markets than are the revenue numbers to franchise and management interests.

At a minimum, the shortage of information about hotel NOIs and values makes hotel capital more expensive than it would be if the risks could be analyzed more completely.[2] In the extreme case, these information problems could lead to an inefficient allocation of capital to hotel property investment.

TRANSLATING REVENUE TO NET INCOME

Hotels have known systematic risks. The income elasticity of demand for hotel rooms exceeds 1.0, meaning that hotel rooms trade as luxury goods. With firm and household budgets strained, expenditures on travel will be deferred, reduced, or eliminated. Hotels also have extremely high expense ratios. While the expense ratio of an investment grade office property is less than 50 percent, full-service hotels have 70 percent expense ratios.[3] The large and highly complicated expense schedules of hotels, especially full-service hotels, elevate the degree of difficulty in converting changes in revenues to changes in NOI.

Translating hotel revenues to net income is meaningful to capital market participants for the following reasons:

1. The key loan delinquency indicator, the debt coverage ratio, requires estimates of NOI in the numerator, not revenues.
2. Capitalization and discounted cash flow models require NOI forecasts as inputs for estimating property values.

A recession produces many opportunities for expense reduction that serve to lessen the impact of revenue declines on hotel NOIs. As heavy consumers of capital and energy, hotel properties have benefited from debt refinancing and the remarkable turnaround in energy pricing during the past 18 months. Energy cost savings effect NOI directly, while lower debt costs create more favorable debt coverage ratios and capitalization rates.

Because many hotel expenses vary with occupancy, falling occupancy reduces expenses along with lower revenues. During this recession, some hotel owners and managers have chosen to exercise their put option to close down floors, sections, and even entire properties in an all-out assault on variable expenses. Hotel NOI generally have been bolstered by lower labor costs which constitute about 40 percent of the expenses in a typical full-service hotel. The late 1990s was an era of strong revenue growth accompanied by employment growth in many hotels. Some of these employees are no longer necessary and thus have received involuntary separation notices. The wage pressures felt by hotel management in recent years have totally disappeared. Also, hotel owners are beginning to challenge property tax assessments in the shadow of the recent declines in revenues. Fixed expenses may actually increase, however, since savings in property taxes will be more than negated by increasing insurance premiums.

GO WITH THE FLOW

An important performance statistic for analyzing NOI impact from falling revenues is the 'flow-through' ratio. As defined below, flow through represent the NOI elasticity with respect to revenues.

Flow-Through Ratio = % Change in NOI / % Change in Revenue

Flow-through ratios depend on the relationship between revenue growth and expense growth. Revenue shifts create larger shifts in NOI as revenue growth rates diverge from expense growth rates. The extent of the NOI shifts is determined by the profit margin of the hotel. Full-service hotels with lower profit margins have higher flow-through ratios than limited-service hotels with higher profit margins.

Using financial statement data managed by my firm for thousands of hotels during the period 1959 to present, I calculated the median flow-through ratio for limited- and full-service hotels. The results are as follows:

Limited service = .63
Full-service = 1.47

The conventional wisdom based on barriers-to-entry arguments suggests that limited-service hotels are far riskier than full-service hotels. Historical flow-through ratios indicate that the same percentage change in revenues will produce much larger percentage change in full-service hotel NOIs than limited-service hotel NOIs.

REVENUE CHANGES AND PROPERTY PRICES

All real estate suffers from the same problem with respect to understanding the dimensions of capital loss due to sudden negative shifts in revenues. The problem stems from the non-continuous nature of asset trading. Hotel investors have struggled during recent months to understand how property prices are reacting to the one-two punch of recession and air-travel stigma. The search for answers leads in the following three directions:

1. Public market trading of pure plays on hotel real estate (*i.e.*, hotel REITs)
2. Capitalization rate evidence and forecasts
3. Transaction price evidence

Hotel REIT prices fell by approximately 20 percent to 25 percent during August and September, as did prices of management and franchise companies. Since that time, prices of management and franchise company stock have recovered somewhat, as have hotel REIT prices. There is some evidence to suggest that securitized real estate price changes lead property price changes by as much as one year. Parameters of a capitalization rate forecast model produced with Torto Wheaton Research indicate that hotel revenue changes are mostly reflected in capitalization rates in six months. Thus, hotel property price effects should begin showing up in transactions during the first two quarters of 2002. Recent hotel transactions have not reflected strong downward movements, although some of these transactions were negotiated prior to September 11.

FINAL COMMENTS

The trend for hotel revenues continues to be negative across most areas of the U.S. and all property types. Revenue declines will translate into lower NOIs and property prices, but by varying magnitudes and with some delay. Full-service hotels in major markets are experiencing the most financial pain during this recession. Revenues have fallen sharply due in part to air travel dependency. Unfortunately, the NOIs of full-service hotels are quite sensitive to revenue changes. Real estate price discounts should begin to appear by mid-2002, especially if the economy does not show signs of recovery during the first and second quarters of 2002.[REI]

NOTES

1. The RevPAR declines for all properties during December 2001 equaled about 12%.
2. For core property types (*i.e.*, office, industrial, retail, and apartment), property level risk analysis is aided by historical valuation measures available from sources such as NCREIF and the Real Estate Index.
3. The average profit margin in 2000 of full-service hotels reporting to PKF Consulting and the Hospitality Research Group equaled 30.3%. See *Trends in the Hotel Industry USA Edition – 2001*.

ABOUT OUR FEATURED COLUMNIST

John "Jack" B. Corgel, Ph.D., *joined the Hospitality Research Group (HRG) of PKF Consulting in 1999 as managing director of applied research. There, he is developing new products for the hotel industry based on property-level financial performance information. Prior to joining HRG, he was a member of the Cornell Hotel School faculty for 10 years and served as the first director of the Center for Hospitality Research from 1992-1994. He is widely published in academic and professional journals and is a fellow of the Homer Hoyt Institute. (E-mail: jc1616@pkfc.com)*

FOCUS ON LEGAL ISSUES

Preliminary Reflections Inspired by the Terrorist Attack

by Edwin "Brick" Howe, Jr., CRE

If you haven't already read the fall edition of *Real Estate Issues*, please be sure to do so as soon as you have finished the present column. The fall edition contains, among other things, a compendium of columns concerning the ramifications of the September 11 terrorist attack. It is a remarkable and timely collection of fascinating and informative essays by numerous experts, including Hugh Kelly's retrospective from the viewpoint of mid-2006 (commissioned by Newmark & Company), which gave us the best roadmap I've seen for turning tragedy into triumph.

Interestingly, at this point, there has been relatively little activity on the legal end with respect to September 11 beyond what any faithful reader of *Time* magazine would know. Clearly, an attempt today to "write the book on the law" relating to the issues arising from this ghastly tragedy in any comprehensive, even organized, fashion would be seriously premature. Yet more premature would be an effort to catalogue the potential resolutions to these issues by which humankind will govern its behavior from this point forward. On the other hand, it may be worth reflecting here on a few selected issues, both legal and non-legal, which have arisen from the attack and also on some issues that relate to the attack in the sense that I, for one, would not have taken particular notice of them but for the ruminations inspired by the attack and its aftermath.

WHAT WE KNOW FOR SURE

- Leaving aside military and diplomatic issues, what we know for sure is pretty limited. For months before September 11, we had been asking ourselves, "Are we headed for a recession? Are we already in a recession? Are we beginning to pull out of a V-shaped recession?" The terrorist attack has laid to rest any doubts on this issue—at least as I write this in early January of 2002.
- We also know for sure that many legal documents, including leases and security documents, need to be improved. As a result of our having had a taste of a calamitous series of events that could not have been anticipated by the legal profession or its clients (though some suggest that our federal government might have done a slightly better job in the anticipation sector), it is now it is necessary to turn to the task of prioritizing and taking on these defects.
- A difficulty, of course, is the (seemingly universal) client who complains, "I pay 90 percent of my legal bills for the final 10 percent of the legal protection I get." If the legal profession is going to perform adequately in this sector, the client is will determine the profile of many of the legal consequences resulting from the terrorist attack. Put another way, leaving the money factor out, it is one thing to proclaim, "It seems we have a problem with [say] casualty clauses of our [say] leases." It is quite another to negotiate (even between two parties, much less the multitudes of parties who have come to this realization since September 11) clauses that will make for more just, or simply more businesslike, results.

SOME OF THE THINGS TO THINK ABOUT AND WATCH FOR

Here are some of the key points, which I think should be on the intellectual horizons of lawyers, real estate advisors, and their clients following the terrorist attack:

- The casualty, indemnification, and exculpation clauses of leases and mortgages are, in my experience, one of the stepchildren of the legal side of the real estate industry. In fact, I have found that such clauses are more often a bone of contention in a contract of sale than in a lease, where the parties have many, many other points to cover (such as common area maintenance, escalation, cleaning schedules, you name it) or in a mortgage, where the secured party is interested primarily in the validity and priority of its lien, rather than in the details of the insurance-based portion of its security, and where the mortgagor, who often has to pay the secured party's legal bill, has an interest in minimizing that bill. Of course, many of the risk issues facing mortgagees will be applicable to an unwary ground lessor, as well.

  Factors such as these typically cause the parties to take solace in the "Oh, that'll never happen" school of risk assessment. The parties to documents covering a continuing relationship, rather than a merely transactional relationship, and their counsel really need to think such issues through in a far more mature fashion than has heretofore been the general practice. At the same time, I realize as vividly as you that even considering the advice I have just offered constitutes tinkering with the efficiency of commerce that makes everybody's world go round.

- A subset of the general issue as to casualty and related clauses is differences among such clauses from lease to lease of space within the same facility. Depending upon the relative strength of the tenant and the landlord, the parties may work off the "tenant's standard lease form" (and, having acted primarily as counsel to landlords, I have seen some dillies coming even from sophisticated tenants, including some leases which are incomprehensible in their virtual entirety) or the "landlord's standard lease form." As tenant's counsel, I have seen some bad ones coming from landlords, too, though rarely from sophisticated landlords. (Fortunately, my own lease forms—one for landlord representation and one for tenant representation—are like the Baby Bear's porridge, "just right.")

  But even more troublesome potentially than the problem of incomprehensibility, is that of variety. If a given facility housing 50 tenants is covered by even as few as 15 different lease forms, that means 15 separate disputes when a total casualty occurs, instead of just one. Ideally, the real estate industry would come together to try to control disparities like these. Is this a realistic expectation? Obviously not, as there are hundreds of thousands of leases out there that reflect precisely this shortcoming and that are not about to be renegotiated. Should landlords have this point in mind as they negotiate their leases and mortgagees have it in mind as they approve lease packages for financing? Obviously yes, though the tendency will always be to give in on such "boilerplate issues" in favor of improving the "economic terms." This means that only a few select unhappy landlords and mortgagees will have the opportunity to don sackcloth and ashes when it turns out that the boilerplate is at the heart of the economics of a relationship.

- My sense is that there will be a growing tension between:

  1. landlords and tenants,
  2. landlords and insurers, and
  3. insurers and re-insurers (and presumably between tenants and their own insurers, as well), as to the dispute-resolution process and any lease or policy language covering the same.

  Typically, there will always be at least one party that favors litigation over alternative dispute resolution (ADR). Normally the party favoring litigation will be the one who, absent a dispute, would be the one subject to laying out the cash as a result of a casualty. This is because litigation has become an embarrassingly and artificially lengthy and expensive process in this country that, in most financial cycles, tends to favor the party who has got the cash for the time being and can invest it to cover its legal costs and perhaps something more, leaving the other party without the cash but with the uncertainty as to the litigation's outcome. While ADR—typically arbitration and/or mediation—is hardly

a perfect process, my experience is that it is likely to produce a just result at least as often as litigation and a far more timely result than litigation. It is for this very reason that The Counselors have been in the process, during the last couple of years, of developing their own ADR program for real estate disputes. Perhaps this program, which is on the verge of hitting the market, will provide some opportunities for CREs in the aftermath of the terrorist attack.

- Of course, one needs to be realistic here. Pressure to adopt ADR clauses has to come from the bottom (*i.e.*, the insureds) up. It seems unlikely that such pressure will be exerted at the top or middle of the food-chain (the re-insurers and insurers), and it is they, not the ordinary consumers of insurance services, that have the organized lobbies and pressure groups. Nevertheless, there are others in this picture, as well, including The Counselors and other groups that would like to promote use of their ADR services. And there are also organizations of property owners, operators and mortgagees, such as ULI, ICSC, NCREIF, BOMA, the Real Estate Roundtable and the MBA (and many others) that ought to be interested in taking up these particular cudgels. At the end of this column you will find my e-mail address, and I sincerely invite you to contact me. I would be particularly interested in your suggestions as to how a movement like this could be formed and put into action.
- It occurs to me that a party more likely to suffer than any of the others as a result of some of the negative factors outlined above is the mortgagee whose mortgage does not give him the option to claim insurance proceeds in case of casualty. Such an option was pretty standard fare when I first practiced law in the mid-1960s. Over the years, a great many prospective mortgagors have convinced mortgagees to drop this option. In case of casualty, the absence of this option puts the lender on the sidelines, at least in regard to its practical position as a financial player, when negotiations are undertaken with the borrower's insurer. Notwithstanding the fact that I have normally argued this point on the mortgagor's behalf, the terrorist attack causes me to conclude that the mortgagee who does not insist upon this option is giving up a right far more important than I once thought.
- I think I see a new professional line developing as a result of the attack, which has focused so much attention on insurance issues—a line for which CREs who know something about the insurance business or are willing to bone up on it may be ideally equipped.

  My most frustrating experience of 1999 was representing the owner of multiple shopping centers in three-cornered dealings with the client's insurance broker and with the insurance broker of the company that was to become my client's portfolio and asset manager. I happened to be the only lawyer actively involved, as the manager was doing the legal work in-house. It was many a happy hour I spent in teleconferences with the brokers while they spoke their own private language, arguing over the insurance, exculpation, and indemnification provisions of the draft management contract and the potential insurance-policy clauses that would reflect those provisions, all the while trying to do my best to guide the negotiations in a direction that would be reasonably fair to both parties. Never forget that, if you have an insurance broker who speaks English in a manner understood by laymen, you have a real prize on your hands!

  My client would have been far better served by having on the phone, instead of me, an independent insurance consultant who could speak the lingo and work out appropriate solutions to all these issues and then read the proposed insurance policies to make sure that the issues agreed upon were accurately reflected in them. My client's ability to rely on my real estate background was, if I may say so, a definite plus, but it was *all* I could bring to the table. I believe this state of affairs shortchanged my client, and the asset manager was theoretically even more vulnerable to being shortchanged because it had *no* representative participating in the negotiations who was independent of the commissioned insurance brokerage community.
- In the case just cited, my frustration turned to something like a bad dream when the parent companies of the two brokerages involved in the negotiation merged. The client-oriented imbalance that my presence may have provided initially was, I believe, more than offset by the fact that, within the merged company, the

manager's broker out-ranked the client's. I would not for a moment suggest that the merger gave rise to a conflict of interest, but facts are facts and this particular fact increased the sensitivity of my position by at least 100 percent. It appears that this phenomenon will become ever more prevalent as the wave of consolidations in the insurance industry continues and even accelerates.

■ A final word of caution concerning the concept of an independent insurance consultant: CREs who are not already reasonably familiar with the insurance industry should not rush out to educate themselves in insurance and then hang out an "Independent Insurance Advisor" shingle. They should do some market research first to ensure that there is a market for such services in a geographical or networking community where they are well known.

Some years ago, one of the large international brokerages spent a lot of money developing an independent advisory group and then found little or no market for the service, which potential clients expected to receive from their lawyers and/or accountants. I tend to think of that as a somewhat special case. I believe a high-profile splashily-advertised advisory service performed by a gigantic, multi-product insurance firm is less likely to be regarded by clients as truly independent than such a service provided by a comparatively specialized and probably relatively small, even one-man, CRE shop or perhaps by a litigation-support group that knows its insurance onions, whether independent or part of a larger organization that does not concentrate on insurance sales.

Whatever a potential client's views on that distinction may be, please do not hesitate to show him the present column as proof-positive that lawyers (and in my view accountants), who are unable to produce credible insurance credentials, *cannot* competently provide these services. You might also mention to the prospective client that the CRE's efforts would not be doubling-up other professionals' efforts. That is to say, *you* would be at the negotiating table *instead* of the client's lawyer or accountant, and, given the several learned professions' fee schedules these days, almost certainly at a fraction of the cost of another professional.

WHAT NOW?

I hope that the above will give the reader a small taste of what we need to reflect upon now that we know that the unthinkable can happen. It will, in my view, be a long, long time before any "standard" responses to these issues can be hammered out and then achieve general acceptance.

Here is an example received from a friend who lives across Lake George from us and who recently retired from one of the large international insurance brokerages. We were discussing how to define "terrorism" in the "terrorism exclusion," a clause that nearly everyone expects to see in future insurance and re-insurance policies. I said, "This is really a tough one. It's no simple task like defining 'pollution.'" He replied, "Brick, it took the industry 30 years to work out a generally accepted definition of 'pollution.'"

I look forward to keeping readers abreast, from time to time, of salient developments on this very new frontier. I look forward equally to readers' input.REI

AUTHOR'S NOTE

The author acknowledges with gratitude the assistance of Philip W. McLaughlin in reviewing a draft of this column and offering a number of valuable suggestions. Mr. McLaughlin was a principal and senior vice president of Johnson & Higgins, both before and after its merger with Marsh & McLennan, and has been acting as an independent insurance consultant since his recent retirement from the combined organization.

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 the strategy and tactics of dispute resolution. 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 telecommutation and, when required, by airliner) to Howe & Addington LLP, the New York City law firm he founded in 1970, and is executive director of the National Real Estate Forum. (E-mail: rosevilleco@aol.com)*

A Practical Guide to Real Estate Practice

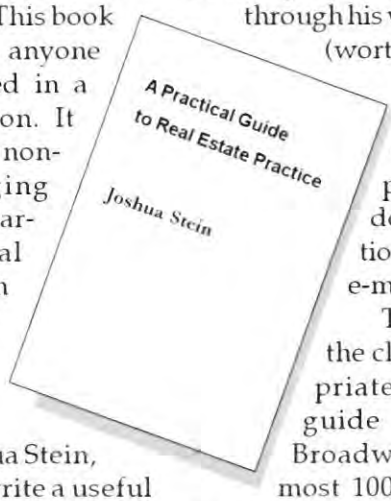
by Joshua Stein
ALI-ABA, © 2001
American Law Institute—American Bar Association Committee on Continuing Professional Education
320 pages

As Reviewed by
Dwight Merriam, CRE

You'll laugh, you'll cry. This book is "The Perfect Storm" of real estate law practice. You won't be able to put it down until you've turned back that last page and slumped deep into your seat, satisfied that you now know all about the scintillating subject of severance clauses.

Sorry. I got carried away. The editors told me to jazz up the book review a bit. I mean, think about it. Book reviews are not all that exciting, and a review of a book on how to practice real estate law...Now that I might have your attention, please read at least one more paragraph. Then, if you must, you can bail out.

The inside cover says that "*A Practical Guide to Real Estate Practice* is designed for real estate attorneys..." Not so. This book is great reading for anyone who is ever involved in a real estate transaction. It would be helpful for non-lawyers in managing their lawyers, and its targeted audience—real estate lawyers—can glean enough from this small volume of 320 pages to make it worth the time.



The author, Joshua Stein, has the pedigree to write a useful book. At age six, he says, he helped edit galley proofs of his father's book series on mathematics at the dining room table. (My six-year-old son, Alexander, pedals his John Deere tractor around, so he'll probably become a dairy farmer, I guess.) Mr. Stein's mother is a published author of poetry. And the author has every imaginable ticket punched for a real estate lawyer—U.C. Berkeley Phi Beta Kappa, Columbia Law School, partner at Latham & Watkins, American College of Real Estate Lawyers, and 20 years of practice.

Like Gaul, the book has three parts. At the beginning, Stein starts with an overview of real estate practice. It's a hodgepodge of things, nearly all of them useful and some a little too cursory.

The second part, "The Documents," is half of the book and rightly so. Stein takes us from how to prepare legal documents, through his writers' workshop (worth the price of the book), to use of defined terms, reviews by others, practical aspects of document production, and his rant on e-mail.

The last part is on the closing and appropriately reads like a guide to producing a Broadway musical. Almost 100 pages are spent on "before, during, and after" closing matters. Each chapter ends with a practice checklist summarizing the chapter and reinforcing key points.

Stein's chapter on post-closing issues is a must-read. Here, his experience yields especially cogent advice based on a scary, but all-too-realistic, hypothetical transaction that went into default 27 months after the closing.

A lender's state-of-the-art non-recourse clause and an additional checklist for model documents are included as appendices.

Stein is my kind of real estate lawyer. He likes checklists, plain language writing, active prevention of mistakes, and critical review of documents by his colleagues. His coaching on writing could be useful even to some of the "old dogs" in our business. He gives lots of good illustrations that help sensitize the reader to recognize and correct bad writing. In one chart, he offers "complicated" versus "powerful" phrases—instead of "provide the requisite information," use "tell." Instead of "provide with," use "give." (Personally, the best discipline I get is when an editor tells me to cut an article *in half*. You quickly learn to trim wasted words.)

My beloved first semester contracts professor at Yale Law School, Leon Lipson, gave a brilliant graduation address of monosyllabic words. To write simply, plainly, and concisely requires more skill than writing the verbose and confusing documentation we see too often in transactions.

The author cites the U.S. Securities and Exchange Commission's *Plain English Handbook*. The correct site is currently www.sec.gov/pdf/plaine.pdf. It's a useful resource for any writer, but Stein is careful to point out that what's good for SEC investor disclosure documents may not always work with deal documents.

Stein is right on with his suggestion that we use "defined terms" to make documents work better. "Mortgaged Property," he says, might take several pages to define, but then you have the economy and precision of using just two words. Obviously, the non-lawyer real estate professional (Can you say CRE?) is often a key player in structuring and describing the defined terms. I write countless regulations in my work, and I spend most of my time on the definitions. And sometimes an effective definition, even though it should usually have its natural meaning, can shape the deal.

I see only one area where I differ with the author. Stein doesn't like e-mail, and he gripes about all the usual abuses. In the process of venting, he misses the chance to be positive and advocate what will be commonplace in five years—the use of extranets to manage the real estate deal making, permitting, financing, and closing processes. The extranet, which the author's firm uses (See www.lw.com/news/clippings1%2Ehtm regarding its "ComplianceNet"), puts all the documentation in one place, accessible by the Internet. No faxes, no overnight or hand deliveries, no e-mail attachments. Our firm uses it with some of our biggest clients. With good planning in terms of access and who gets to edit what, it's a boon to efficient practice. It's like having the same file cabinet and work table in everyone's office.

Twenty-one percent of corporate counsel report that at least one of their outside counsel offer extranet service to them. BNA, *Corporate Counsel Weekly*, No. 41 (10-24-01) p.325. Go to the Web site of the American Corporate Counsel Association www.acca.com and use the search word "extranet" for more information.

As I said, this is a book worth buying and reading for both real estate deal makers and lawyers. Put it in your briefcase and read it while waiting for a meeting or traveling, and you'll have a quick education from a seasoned practitioner.REI

ABOUT OUR REVIEWER

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