Real Estate 1 s s u e s

THE COUNSELORS OF REAL ESTATE

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1976 - 2000

CELEBRATING 25 YEARS OF PUBLISHING EXCELLENCE

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Realized vs. Required Rates of Return & What it Means to the Real Estate Industry Kenneth P. Riggs, Jr., CRE, & Ryan W. Harms

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Winter 2000/2001

(deadline for manuscript submission - November 27)

Spring 2001

(deadline for manuscript submission - February 12)

Summer 2001

(deadline for manuscript submission - May 14)

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EDITOR'S STATEMENT - by Richard Marchitelli, CRE

The bravado of the dot.com world is aptly captured by the advertising slogan of *deal.com*: "Industries collide. Billions change hands. New world orders emerge." At the same time, a discernible loss of swagger is illustrated by the television commercial of SAP Corporation that aired during the recent Major League playoffs. The commercial depicts a maintenance man, razor blade in hand, scratching off the name of a dot.com company painted on the glass entrance door to a suite of empty offices. That message, and more importantly, the recent message of the stock market are unmistakably clear: the world has rediscovered Economics 101 as the New Old Economy meets the Old New Economy. Once again, companies are expected to make money and dysfunctional, unprofitable corporations are expected to wither and die.

The October 16, 2000, edition of *The Wall Street Journal* expanded on this theme in a front-page article titled, "Reality Check; Here Are Six Myths That Drive the Boom In Technology Stocks." This article carefully and thoughtfully dissected the arguments of the techno-bulls. The irony is that the speciousness of those arguments is so blatantly apparent like "prospects are more important than earnings" or "tech companies aren't subject to ordinary economic forces, such as a slower economy or rising interest rates." My personal favorite is "this time, things are different."

I am not forecasting the imminent collapse of the dot.com world or demise of the current bull market. However, recent events do suggest that real estate counselors need to be in a special state of readiness. Changes in the channels of distribution of B2B and B2C business models and their influence on real estate use as well as the increasing number of business failures portend that we may be entering a new phase.

If there is a shake out of dot.com companies, will there be a significant increase of available space in select office markets? As Amazon.com and similar companies continue to erect storage and distribution facilities, are such entities of the virtual world becoming more like real world corporations? It is easy to be seduced by the simplicity of cyberspace, but the reality is that the path of goods and services must pass through some form(s) of real estate. If this is the beginning of a contraction of dot.com industries, what are the strategic implications for real estate portfolio managers, property owners, and financiers? What are the business implications for vulture funds, disposition specialists, bankruptcy experts, and similar service providers? Are recent developments a false alarm, an aberration (i.e., "technical correction") that once again postpones the inevitable day of reckoning? Real estate industry participants are likely to ponder those and a myriad of related questions in the months to come as they attempt to stay ahead of the curve.



Richard Marchitelli, CRE Editor in chief



Ivan Faggen, CRE 2000 National CRE President

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Pension plans have discovered the value of the independent fiduciary in evaluating non-traditional real estate investment opportunities such as joint-ventures, opportunity funds, development programs and the like, which are often sponsored by firms that are not registered investment advisors. Seeking to provide assurance that these investments meet minimum fiduciary standards, pension plans are turning to independent fiduciaries to render overall advice on these investments. This manuscript reviews the evolution of the independent fiduciary, presents procedures designed to evaluate investments under standards of fiduciary care, and provides a simple case study to see how value is added to the investment decision process.

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The industry is roughly 10 long years past that brain damage period of the late 1980s. All industry players are trying to assess the next phase of the real estate cycle. We tend to study the physical and capital markets, and complete rigorous economic analyses to find clues about the state of the market. However, the ultimate issue is predicting performance—realized versus expected total returns. The purpose of this manuscript is to uncover if a historical return analysis can provide any clues as to what is in store for the future of the industry.

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Woodley Road represents a dramatic change for the hospitality industry. In addition to exposing almost every operator to paying big damages to hotel owners, the case could also give owners a free termination right for long-term management agreements or powerful currency to renegotiate existing agreements. Indeed, the case has provided a wake-up call for owners and operators to understand the fiduciary duties that almost every operator owes to the hotel owner, as well as sent a similar signal to all asset managers, pension advisors, and other third-party fiduciaries charged with overseeing the effectiveness of hotel operators on behalf of their investors.

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By virtue of physics and uniqueness, real estate inherently involves elements of monopoly in the property markets. The Microsoft antitrust litigation has both strategic implications for and direct applications to real estate. Monopoly, simply stated, involves dominance of a market, which dominance can take many forms, for market share is by no means the only criterion. Other criteria of monopoly include business processes, technologies, intellectual property, relationships, talents of specific individuals, brands, customer relationships, and more. Fighting the *battle for property control* without adequately considering the lessons from Microsoft's travails, as well as the implications of answers to crucial questions concerning global property involvements, can lead to very disappointing outcomes. A strategy that wins a particular battle may contribute to losing the larger war.

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PHYSICAL VS. NON-PHYSICAL DEFECTS by Richard L. Clark, Jr.

Most jurisdictions have adopted an implied warranty of habitability in residential real property leases. However, only a handful of jurisdictions have extended similar protections to the commercial tenant. Texas has been at the forefront of the evolution of implied warranties of suitability for a particular commercial purpose in the commercial real estate lease. This manuscript details the evolution of implied warranties in commercial real estate leases, focusing on Texas law, and contends that the implied warranty of suitability for a particular commercial purpose, as determined by the Texas Supreme Court, applies to non-physical defects as well as to physical defects.

- FACTORS INFLUENCING CBD LAND PRICES by Bill Mundy, CRE, & John A. Kilpatrick
 In rapidly moving but thinly-traded real estate markets, attempts at valuation using traditional, or 'first generation' approaches can be problematic. Fortunately, other valuation models are available. This manuscript demonstrates the use of an economic model, including unemployment rates and vacancy rates, to value downtown land over time.
- RECOGNIZING THE FUTURE: REAL ESTATE & THE NETWORKED ECONOMY by Woodward S. Hanson, CRE
 As far back as 1969, futurists and corporate consultants have observed "knowledge workers" as the precept of the
 "Information Age." Now, with the number of Internet connections and Web-based alliances growing exponentially,
 society and the economy are experiencing the initial stages of the "network effect," where the value of the network is
 an exponential function of the number or combination of users. As if this weren't significant enough, real estate or shall
 we say "spatial economics" is experiencing its period of critical transformation and is being redefined by technology,
 securitization, consolidation and convergence, globalization, and the longevity revolution. In this manuscript, the
 author provides an "enviro-scan" of the impact associated with these dynamic forces and identifies a marketplace where
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RECOGNIZING FORMER EDITORS IN CHIEF

Nearly 25 years ago today, I read my first edition of *Real Estate Issues* (REI). As a young professor and journal article author at the University of Southern California, I was looking for publication opportunities for articles whose content has long since been forgotten. Little did I know that less than a decade later, I would become the editor in chief; nor that I would be so privileged as to contribute these remarks during the 25th anniversary year. It is fair to say that *Real Estate Issues* has been a part of my life for most of my professional career. As a young journal author, a regular reader, an editor in chief, and a long-term member of The Counselors of Real Estate, I have watched REI grow, evolve, and prosper.

I am proud of what REI has become, and the small role I have played in helping to shape its path. I am especially thankful to former Editor, Jared Shlaes, for encouraging me to follow in his footsteps; former Managing Editor, Linda Magad, without whom I would have been unable to meet the demands of editor in chief; and the many authors whose creative thinking contributed to the quality and content of the journal.

I know that the members of The Counselors of Real Estate are proud of REI and its place in the world of professional real estate publications. On behalf of myself and all former editors, the quality and integrity of the membership served as the foundation for our effort to put out the best possible publication. May I simply say that it has been a privilege and an honor to be editor in chief, to work closely with my fellow Counselors, and to exchange ideas with so many talented authors.

Happy Birthday REI! May you have many more . . .



Rocky A. Tarantello, CRE Editor in chief, 1987 - 1993

THE EMERGING ROLE OF THE INDEPENDENT FIDUCIARY FOR NON-TRADITIONAL REAL ESTATE INVESTMENTS

by Tom Hester & John McMahan, CRE

recently published survey of pension plan sponsors¹ attempted to make big news of the fact that a number of the plans intended to reduce their respective allocations to real estate investments in the future. What is surprising about the survey to the authors, was the fact that only some 13 percent of those responding indicated that they would reduce their allocations. The authors do not consider the results to be particularly significant, especially when a number of pension plans, including CalPERS, CalSTRS, and New York State Teachers, have recently announced substantial allocation increases to the asset class.

These increases can be rationalized, in part, by pension plans' redefinition of the role of real estate in a multi-asset portfolio. Real estate investments may now include technology-related investments and higher return/higher risk vehicles such as opportunity funds, joint-ventures, development programs, foreign investment, and the like. Pension plan sponsors have recently discovered the value of an independent fiduciary in evaluating these non-traditional real estate investment opportunities.

In most cases, investments of this type are sponsored by firms that are not registered investment advisors. Seeking to provide some assurance that these investments meet minimum fiduciary standards, pension funds are turning to independent fiduciaries to perform due diligence,

ABOUT THE AUTHORS

Tom Hester is managing principal of The McMahan Group, where he is responsible for financial and investment engagements and leads the firm's independent fiduciary efforts. He is also involved in the firm's strategic management consulting services. Hester joined the firm in 1999 after 12 years with the E&Y Kenneth Leventhal Real Estate Group, where he was a management consulting senior manager. (Email: hester@mcmahan-group.com)

John McMahan, CRE, is senior principal of The McMahan (Continued on page 5)

identify risks, suggest mitigation as necessary, and render overall advice on the desirability of the investment. The independent fiduciary performs the front-end analytical functions that would be undertaken by an investment advisor in a more traditional core real estate investment, and also gives the pension plan sponsor an investment recommendation based on its analysis. The recommendation is possible, and depended upon, because by law the independent fiduciary must be a registered advisor.

EVOLUTION OF THE FIDUCIARY STANDARD OF CARE

The role of the pension fund investment fiduciary was first described in the Employee Retirement Income Security Act (ERISA) of 1974. Under ERISA, a person or firm is deemed to be an investment fiduciary if they make recommendations as to the advisability of investing in, purchasing, or selling securities or other property, pursuant to a mutual agreement between the parties.

This fiduciary standard of care was subsequently refined to establish who would be considered an investment advisor and the level of prudence under which they were expected to act. Initially, investment advisors were required to be commercial banks, insurance companies, or Registered Investment Advisors under the Security and Exchange Commission. This was subsequently modified to allow smaller firms to register with state regulatory authorities. For pension funds desiring additional protection, the Qualified Plan Asset Manager (QPAM) designation was established by the Department of Labor (DOL), requiring certain levels of financial size and assets under management.

TRADITIONAL ROLE OF THE INDEPENDENT FIDUCIARY

ERISA contemplated that the occasion might arise when the DOL, acting through the courts, would be faced with the necessity of replacing the fiduciaries responsible for a pension plan's assets. Since this might take some time, the role of the independent fiduciary was established by the DOL to be responsible for the assets of the plan and its operation until such time as new fiduciaries could be secured.

In recent years, several plans have utilized independent fiduciaries to evaluate situations in which a significant modification was being proposed in the structure of existing investment vehicles. Examples include the sale of plan assets, the rollup of portfolios to create a public company, asset transactions

The role of the pension fund investment fiduciary was first described in the Employee Retirement Income Security Act (ERISA) of 1974. Under ERISA, a person or firm is deemed to be an investment fiduciary if they make recommendations as to the advisability of investing in, purchasing, or selling securities or other property, pursuant to a mutual agreement between the parties.

between related plans, and other situations where an independent opinion was required. Investment advisors also have proposed the use of independent fiduciaries in situations where a conflict of interest existed or was perceived to be a possibility.

USE OF THE INDEPENDENT FIDUCIARY TO EVALUATE NEW INVESTMENTS

Earlier this year, The McMahan Group was awarded a contract to provide independent fiduciary investment services to a major public pension plan. The purpose was to assist its Board in evaluating certain new investment opportunities that had been previously determined by staff as meeting the plan's overall strategy and investment criteria.

In this capacity, we performed due diligence on each proposed investment in terms of its strategy, structure, pricing, congruency of investor/sponsor interests, and, if specified, the quality of assets in the portfolio. In addition, we evaluated the track record and investment performance of the sponsor in prior investment activity and the relevancy of this activity to the proposed investment program. The ability of the sponsor to successfully implement the proposed investment plan in the future was also evaluated in terms of overall firm strategy, management capabilities, staffing levels, reporting systems, and financial resources.

Since many of these proposed investment strategies utilized joint-venture arrangements or "platforms" with local real estate firms, it was often necessary to evaluate these firms as well in terms of the organizational criteria outlined above. It also was critical to establish the reputation and local market knowledge of the joint-venture partner and its ability to find and manage investment opportunities.

At the conclusion of the due diligence analysis, a recommendation based on the overall merits of each investment opportunity was provided. A conclusion to invest was always subject to a number of risk mitigation recommendations involving firm policy issues, organizational changes, and pricing and investment term renegotiations. A conclusion not to invest was based on the totality of the remaining risk in the investment opportunity that could not be mitigated away.

The major steps in the due diligence process are outlined below:

STEP 1 - TRANSACTION ANALYSIS

A "top-down" analysis to determine if the proposed investment fits into the pension plan's investment strategy:

- Consistencies of the proposed investment with the pension plan's return objectives.
- Proposed sharing of investment risks and rewards and whether the sharing is consistent with the individual interests of the parties.
- Strength of the market for similar investment vehicles.
- Reasonableness of the acquisition strategy (including property type and location).
- Soundness of the proposed exit strategy.
- Risk components inherent in the transaction and the probability of the realization of projected returns.

STEP 2 - TRANSACTION STRUCTURE

A detailed analysis of the investment structure, terms, and pricing in the form of a "bottom-up" review and benchmarking to alternative investments and market pricing:

- The use and impact of leverage, including a comparison against favorable terms currently available in the capital markets.
- Existing or potential conflicts of interest, including those that may be related to portfolio joint-ventures, platform investments, and services including brokerage, property management, etc.
- The financial terms and pricing of the transaction.
- The investment return structure, with a particular focus on the incentive and management fees paid to the investment sponsor and under what conditions they are earned.
- The funding commitments of the sponsor and possible risk factors, if any.

STEP 3 - FINANCIAL PROJECTIONS

A testing and verification of the sponsor's financial calculations and projections:

- Recalculation of proposed investment returns utilizing proprietary financial models in order to provide an independent verification of the sponsor's projections.
- If required, portfolio analyses including risk and return measurements as well as indexing to the plan's benchmark (NCREIF, nominal, real, or risk-adjusted return).
- Testing of sponsor's projection assumptions against a market-supported range of reasonable assumptions. If current appraisals or other valuations are relied upon, they should be tested for scope and reasonableness.
- Secondary research focused on specified portfolios including economic and demographic trends; property market conditions; rental rates and concessions; occupancy levels and absorption; expense data; competitive supply; development activity and approved projects; ordinances and legislation; and other relevant statistics.
- Primary research (utilized for both specified property portfolios and blind pools) including interviews with participants in the transaction (e.g. sponsor management, lenders, platform partners, etc.) as well as third-party sources (e.g. appraisers, investment brokers, leasing brokers, property managers, financial institutions, etc.).
- Sample tenant lease evaluation comparing contractual terms to market terms, duration risk, flexibility, and tenant credit.
- For specified portfolios, site inspections for selected properties focusing on building quality, amenities, general condition, location advantages and disadvantages, infrastructure, egress, visibility, and competitive position. Comparable properties should be researched in order to obtain rental rates, occupancy, and other performance data.

STEP 4 - INVESTMENT SPONSOR EVALUATION

An evaluation of the investment sponsor's organization, focusing on management capability and organizational capacity (if applicable, these procedures can be performed in full or limited-scope on platform partners as well):

 Determination of whether the principals have developed a well-thought out firm strategy, and possess the required competencies, procedures, and systems to execute it successfully.

- Sponsor investment track record, recalculating and verifying realized returns and return projections on unrealized investments.
- Evaluation of the core competencies of the firm to assess whether the requisite experience, skills, and leadership qualities exist within the firm to implement the strategic objectives.
- Review of operating policies, procedures, financial reporting, and technology systems for completeness and adherence to current industry standards and trends.
- Review of firm organization, focusing on structure, reputation and relevant company risk factors, key management personnel and dedicated time, as well as the operations of various firm committees (e.g., investment, strategy, policy, property management, etc.). Evaluate with regard to known industry best practices and successful policies. Review employee recruitment and attrition, management succession, compensation, financial operations, capital-raising, takeover or acquisition likelihood, expansion, etc.
- Obtain and check professional and financial references, evaluate potential conflicts, and research possible legal problems identified for resolution. In particular, any possible investment or fiduciary conflicts that might affect the proposed investment program. Make independent queries into the marketplace in order to assess reputation, business acumen, and integrity. Legal due diligence of current or pending litigation should be referred to plan approved counsel for review.
- Make an overall comparison of the strengths and weaknesses of the sponsor with the proposed investment program.

STEP 5 - RISK ANALYSIS AND MITIGATION

The final step in the due diligence process is to evaluate the risks of proceeding with the proposed investment against the probability of securing projected investment returns. Each risk is identified and ranked in terms of its potential impact on the success of the investment. Sponsor mitigation measures are identified and evaluated in terms of their effectiveness in reducing potential risk. If warranted, additional mitigation measures are recommended to better align risk and return. These measures may include limitations on certain types of investments, revision of the pricing terms, organizational restructuring, dedicated personnel, inclusion of additional investors, etc.

CASE STUDY

A hypothetical case study can serve as a prime

Use of the independent fiduciary will most likely increase as more plans utilize non-traditional vehicles such as joint-ventures and partnerships in their moderate and higher-risk real estate investment programs. For these plans, securing independent investment advice will be critical to the underwriting process and, ultimately, the investment decision itself.

example of how the independent fiduciary performs a valuable service.

Workers' Pension Plan (Workers) has been solicited directly by an investment sponsor seeking a large equity investment commitment for the development of commercial urban infill projects. ABC Development (ABC) is a fast growing regional developer that has never before solicited pension capital and has not developed much of an institutional reputation among the major pension plans. However, for some time now, ABC has been structuring successful single-asset joint-ventures and developing institutional quality projects utilizing equity capital from investment banks and the private capital units of several large commercial banks. Other institutional capital-backed developers are now competing directly with ABC for projects and consider the firm to be a major competitor.

ABC is looking to establish a relationship with Workers for these major reasons:

- To reduce the overall cost of its equity capital;
- To structure a separate account relationship with a future commitment large enough to allow it to move more quickly on, and increase the size of, the projects it pursues;
- To improve its market position and grow into an institutional quality firm.

Workers' real estate staff is interested in ABC. The proposed opportunity, as described in ABC's solicitation materials, meets all the plan's strategic and investment criteria for higher-risk real estate investments. The investment board of Workers is also interested but needs assurance that the investment opportunity is suitable for a pension plan and that ABC's strategy, track record, competencies, policies

and organization, with respect to the investment, support the approval of a commitment. The board has asked for the appointment of an independent fiduciary to perform due diligence services and provide a recommendation on the investment opportunity.

During the course of its procedures, the independent fiduciary (IF) discovers several significant operating strengths of ABC including sound, strategic vision, and capability. IF also verifies an outstanding track record on realized investments. However, IF also discloses many relevant findings and conclusions that give rise to serious concerns regarding any possible investment by Workers. Among these are the following:

- ABC has not developed the internal reporting systems required for a pension investor;
- The firm has not structured its development/ asset manager incentive compensation model to be tied to the performance of the specific pension plan-financed projects; instead, bonuses are tied directly to the overall performance of ABC as a firm;
- ABC's key personnel work on many projects at once and no "key man" clauses are offered to Workers;
- The proposed preferred return on Workers capital is low compared to others currently offered in the marketplace; and
- ABC's proposed acquisition and asset management fees are higher than those currently offered in the marketplace.

Based on these findings alone, IF cannot recommend that Workers proceeds with its plan to invest in ABC. However, if during the course of the procedures satisfactory mitigation is achieved, a recommendation to proceed is possible. Therefore, as part of its procedures, IF recommends mitigation measures that ABC agrees to:

- Hire an experienced director of internal reporting and accounting. The hired is familiar with industry-accepted reporting standards and previously held a similar position with a large public pension plan;
- Change incentive compensation policy so that a significant portion of development and asset manager bonuses are tied directly to the overall performance of the specific projects, rather than the overall performance of the firm;
- Draft a "key man" clause into the joint-venture agreement stating that no less than 75 percent of

- key personnel's professional time is dedicated to the venture;
- Increase the preferred return on Workers' capital
 to a level slightly above market; this compensates Workers for risk based on the fact that ABC
 is commencing a business model slightly different than its experience; and
- Reduce acquisition and asset management fees to a level currently supported by the marketplace.

Based on the above, IF issues its complete report and recommendation to invest to the investment board of Workers, which then votes on final approval.

A VIEW TO THE FUTURE

Use of the independent fiduciary will most likely increase as more plans utilize non-traditional vehicles such as joint-ventures and partnerships in their moderate and higher-risk real estate investment programs. For these plans, securing independent investment advice will be critical to the underwriting process and, ultimately, the investment decision itself. In this context, the independent fiduciary provides a valuable professional service that allows pension boards to consider a much wider spectrum of real estate investment opportunities, consistent with their fiduciary obligations.

NOTES

1. Pensions & Investments, "Sponsors Plan to Reduce Real Estate, Value Stocks," July 10, 2000.

ABOUT THE AUTHORS

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Group, a San Francisco-based real estate management consulting firm, and executive director of the Center for Real Estate Enterprise Management. McMahan developed the initial strategic plan for the restructuring of BRE Properties and currently serves as its chairman. He also is an adjunct professor at the University of California, Berkeley. (Email: john@mcmahan-group.com)

REALIZED VS. REQUIRED RATES OF RETURN & WHAT IT MEANS TO THE REAL ESTATE INDUSTRY

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

NTRODUCTION

Today's institutional real estate environment is dynamic. One only has to take a brief look at its storied past to see the roller coaster ride it has taken over the past 20 years. Fortunately, institutional real estate has begun the maturation process, or so it seems. Today's investors are exerting more control and are paying closer attention to the tell-tale signs of an impending market slowdown, with most of this control generated from an increase of information available in the commercial real estate market and the influence of the public market real estate vehicles. The importance of technology and "real-time" information has turned the archaic real estate ways of old, obsolete.

The profile of today's successful investor is one that includes descriptives such as informed, tenacious, technologically affluent, and well-read. As summed up by Andrew Carnegie, the steel magnate and multi-millionaire, "There is scarcely a man who has made a fortune by speculation and kept it." In today's instant access environment, the informed investor, more times than not, gets the cash cow.

With this in mind, the authors take you through a historical return analysis of institutional real estate investment and show how information can enable investors to predict future trends in commercial real estate.

HISTORY

The history of the commercial real estate as an institutional investment can be traced by examining pension fund investment as an asset class.

ABOUT THE AUTHORS

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As reported in "Risks and Rewards in Real Estate: A Historical Perspective," prepared by Real Estate Research Corporation (RERC) in April 1983, unlike their European counterparts, U.S. pension funds had just begun in the late 1970s and earlier 1980s to exhibit a true commitment toward commercial real estate investment.1 This is contrasted to the large Dutch and German pension funds that began investing in real property in their own countries in the 1950s. First Chicago's Real Estate Fund F, established in 1973, was one of the first real estate funds for pension investors; and as of 1983 had approximately 100 participants with a core investment portfolio of 77 properties. The age of the industry is also documented by the industry's first standardized real estate performance report being published in the first quarter of 1978. In this context, even a casual observer would recognize that the institutional real estate industry is young-20 years or so-compared to the stock and bond markets. In retrospect, is it shocking that the young industry hit the wall in the late 1980s and experienced the most significant depression ever witnessed for any commercial real estate market—the proverbial 100-year flood? The infancy of the real estate market and lack of consistent and readily available information were some of the main drivers in the late 1980's real estate fallout.

The need for concise real estate information on required and realized returns spawned the inception of the National Council of Real Estate Investment Fiduciaries' (NCREIF) Index in 1978, and the introduction of surveyed investment criteria like the Real Estate Research Corporation's (RERC) Real Estate Investment Criteria in 1979. Investors have long demanded bellwether indicators of changes in the U.S. private equity commercial real estate market. This has led us, as analysts in investment activity, to combine sources and reliable data to provide a barometer for investment activity and to predict future trends in commercial real estate.

In a perfect world, investors would favor actual property transaction data that involves similar types of property that are used to develop the indexes. However, the problem is that real estate, by its nature, does not lend itself to continuous, efficient trading mechanisms like the stock and bond markets, although more recently the public markets provide more real-time investment information. Real estate trades are infrequent, their terms are highly property-specific, and the number of trades germane to a particular analysis is limited. Moreover, details on transactions are seldom publicly

available. Although institutional real estate advisors and investors usually compile performance reports internally, and many also participate in public databases, these databases are typically retrospective and involve realized returns that are not readily available to the investment community.²

SOURCES OF DATA

The most widely utilized database of historic, realized institutional real estate all-equity returns is the NCREIF Property Index (NPI), published by the National Council of Real Estate Investment Fiduciaries. Other sources for these data are the National Association of Real Estate Investment Trusts (NAREIT) and Evaluation Associates, Inc. Although the NAREIT Index is market-based, we cannot use its return data for 100 percent equity real estate realized returns because the NAREIT data reflects leveraged returns and the returns are influenced by being a public company. The NPI is the most relevant, despite some limitations, for the purposes described in this manuscript. The index is widely available, and the time series covers a lengthy real estate cycle, although it may yet suffice to filter out extreme cycles. NCREIF returns will be used as a basis for realized returns (ex post). We recognize the appraisal-bias issue involved with the NCREIF data, but ultimately, it is the most credible and readily available source of realized return data.3

The Real Estate Research Corporation (RERC) has conducted and published required (expected) returns from investment surveys since 1979. RERC's quarterly survey augments the expected yield rate responses with personal interviews and monitors change in market fundamentals, such as capital availability, supply and demand in each asset class, and overall investment strategies. The investment criteria detailed in the survey include current property-type preferences, income and expense growth rates, and the expected (ex ante) yield rates used by real estate investors in discounted cash flow analyses. Required rates of returns in this manuscript will be based on investment surveys.4 As further illustrated herein, surveys of pension funds, pension fund advisors, lending institutions, and corporate and other investors provide timely insights into current investment criteria and can be a good prediction model of future trends for realized returns.

The commingling of RERC's Real Estate Investment Criteria and NCREIF's Index appears to become the benchmark for tracking realized and required returns in the dynamic real estate market. As investors know, no investment market is perfect—

there has and always will be business and investment cycles with their inevitable peaks and valleys. The world in which we live is extremely complex and unpredictable, and this instability is even more pronounced with the addition of technology. We have entered into a technological age that has garnered the echoed term, New Economy. Granted, we will experience life and business as we never have before at levels never dreamed of; but be assured, economic and investment cycles will endure in this new market order. To verify investment cycles and irrational exuberance, we need only turn our attention to the volatile technology and dot.com sectors of today's stock market where we see these characteristic unstable market fundamentals played out in real-time.

REALIZED & REQUIRED RETURNS

The industry is roughly 10 long years past that brain damage period of the late 1980s. With that lesson behind us, all industry players are trying to assess what the next phase of the real estate cycle will look like, feel like, and how it will affect them professionally. We tend to study the physical and capital markets, and complete rigorous economic analyses to find clues about state of the market. However, the ultimate issue is predicting performance—realized versus expected total returns (promise made... promise delivered...promise broken). In an effort to uncover if the past can provide any clues as to what is in store for the future of the industry, it is important to analyze the relationship of realized and required rates of return for real estate over the past 20 years. Realized returns are defined as those returns that an investment actually generates through a total return comprised of cash flow and appreciation in value. Required returns, on the other hand, are those returns (total return comprised of cash flow and appreciation in value) that investors are currently seeking in order to make new investments. This spread (realized minus required returns) analysis is done on a total return basis, which is the most crucial to investors; however, we also consider income returns, only to uncover potential trends about pricing risk in real estate.

To the authors, this relationship (realized minus required total returns) is what ultimately drives any investor's decision to place a bet or not, regardless of the type of investment—stocks, bonds, venture capital, etc. Generally, investors analyze the variance of returns to measure risk that allows them to address complex decisions about allocating money to various asset types—stocks, bonds, real estate, etc. Equally important to this process is measuring

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downside risk. Risk is defined as the exposure to a chance of loss or the degree of probability of loss. Behavioral decision research has cast serious doubt on the descriptive validity on classical decisionmaking theory. The latter assumes that investors are rational, risk averse, and integrate asset decisions or make decisions on a portfolio basis. Whereas, behavioral finance theorists do not believe that the market is necessarily rational, that investment decisions are made in isolation, and that the market may be a risk seeker in certain situations. For purposes of this manuscript, the most important aspect of behavioral finance is the notion that investors are more loss-averse than riskaverse. Investors feel more pain from losses than they feel good about the same level of gains.

Our spread analysis allows for a downside risk view. If recent realized returns are above current required returns, investment capital views the opportunity as a good bet, or a no-brainer. Investors will keep funding new investments that result in new construction, ultimately forcing realized returns down toward required levels and most likely below required returns—the market is not perfect and will oversell investment opportunities. The real issue is how far does the market overshoot its target—if overzealous, it might even kill its investment appeal. The net result over time is that realized returns should equal required returns, which

simply means that you have positive spread (realized minus required returns) periods that will equal negative spread periods. Implicitly, the ability of the market to even-out its negative spread periods with positive spread periods assumes that the market has readily and easily available sources of information and market prices that are reflective of this market.

In analyzing the historical differences between realized and required rates of returns we can also assess spread levels during different investment cycles. As the industry matures, there is consensus that the amplitudes of the cycle have changed, and if this is the case, what does this mean for real estate investors?

ALL PROPERTY TYPES

Figure 1 (on page 10), charts total (income & appreciation) realized versus required returns for all property types as reported for the NCREIF Property Index (NPI) and RERC's Quarterly Investment Survey. The attraction of institutional capital to real estate can be seen by the positive spreads (calculated by subtracting total - income & appreciation realized returns from required returns) for 1979 and 1980 of approximately 6.0 percent and 2.0 percent. It is interesting to note that in its first 10 years, starting from its inception in 1973, Fund F had produced attractive returns that outdistanced inflation and had been more attractive returns than the stock and bond markets. It is not surprising that these high risk-adjusted returns attracted capital to the industry. In addition, there was a confluence of other factors—a favorable real estate tax code, financial deregulation, and ERISA diversification requirements—that contributed to what was in store for the industry. The spread quickly turned to a negative 7.0 percent in 1983 and recovered in 1984 but stayed in negative territory, 2.0 percent to 4.0 percent up until 1990. During the first 10 years of the industry's institutional existence, the real estate market was experiencing the biggest development boom witnessed since the 1950s. The bloom quickly came off the rose. The following period is etched in most investors' minds as a real estate depression spreads between realized and required total returns went negative by 10.0 percent to 18.0 percent between 1990 and 1993. The term did not exist then, but real estate was the 'dot.com' of its day. Investors strongly subscribed to the belief that real estate rents and values always went up. Perhaps there is a lesson that today's technology investor will recognize cycles and a regression toward the mean, wishful thinking. There will always be cycles

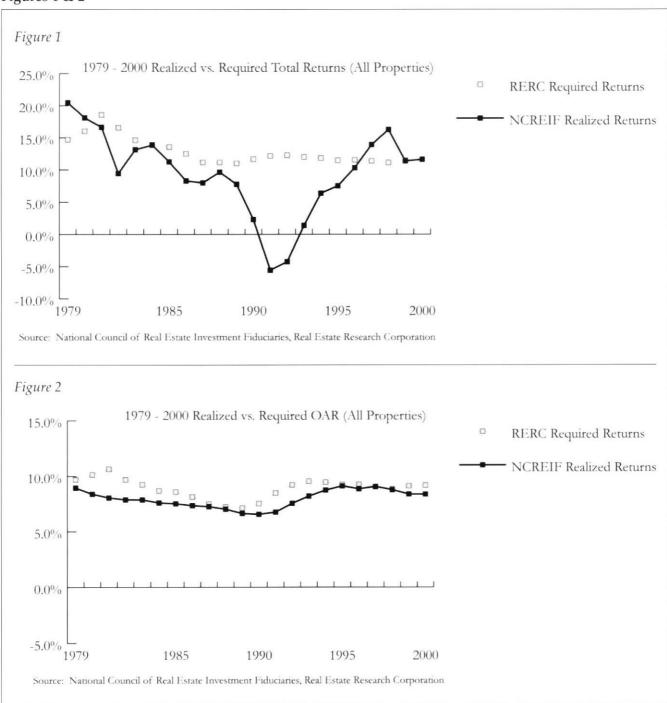
and an industry that is considered the dot.com of the day where the hot money flows. After the real estate trough, the negative spreads dissipated and only turned positive for 1997 and 1998 with a positive total return spread of roughly 3.0 percent to 5.0 percent. The recent total spreads for 1999 and 2000 are essentially zero.

The above historical analysis for total (income & appreciation) realized versus required returns demonstrates that the market has been a poor judge of pricing risk in real estate. The approximate 20-year average total realized and required returns are 9.5 percent and 12.9 percent, respectively, for a negative spread of 3.4 percent. The gap widens if we consider only actual properties sold in the NPI. According to Jeffrey D. Fisher, Dunn professor of real estate at Indiana University and NCREIF's consulting director of research and technology, the average for the NPI for properties that have sold (removing the appraisal bias) is approximately 8.0 percent. This suggests a negative total return spread of 4.9 percent over the past 20 years from the required return average.

This significant negative spread is one of the reasons that pension real estate investments represent, on average, less than 3 percent of their total portfolio and for those pension plans that have a real estate allocation, real estate represents 7 percent of the total portfolio. Before drawing conclusions and implications on the negative spread analysis for total returns presented above, the authors will analyze the spread for the income component only and then analyze the total return spread for individual property categories.

Figure 2 (on page 10), reflects the spread between realized and required overall capitalization rates (income component) for the period of 1978 to 2000. The overall capitalization rate (OAR) is defined as net operating income before capital expenditures (tenant improvements, leasing commissions, and reserves) divided by the property value and/or sale price. As mentioned beforehand, an appraisal bias exists in the NCREIF total return data and this bias has also been found to extend to the income component used to develop the overall capitalization rate.⁵ There are other more subtle issues influencing the derivation of OARs from both sources; however, for purposes of our historical spread analysis, the data sets are the most reliable and readily available. It can quickly be observed that the spread was at its highest level in 1981 at roughly minus 3.0 percent, meaning that realized OARs were below required

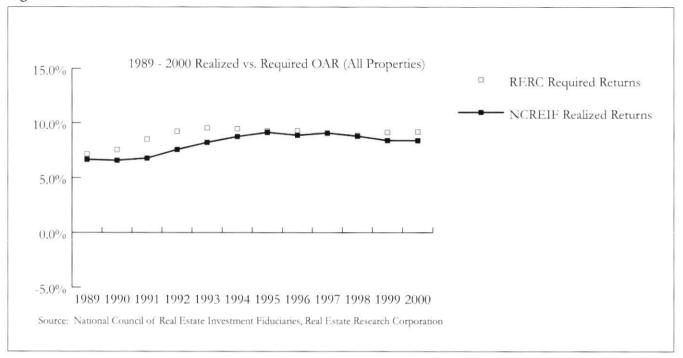
Figures 1 & 2



OARs. This observation is most likely explained by recognizing that 1981 was the height of the inflation period and it was the beginning of the institutional real estate period. From that point on, the spread is much more stable at around minus 1.0 percent to 2.0 percent, and that includes the period between 1990 and 1993, which reflects a general average spread of minus 1.5 percent. The informed investor (survey respondent) can now recognize the path of real estate returns in the future and price the risk of the income component with greater confidence.

Figure 3 more clearly depicts the relative tightness of the OAR realized versus required spreads compared to the total return spreads presented earlier in the manuscript. The difference between the net operating income used to develop the OAR and cash flow is capital expenditures and appreciation/depreciation component. Generally speaking, the formula reflects income plus appreciation or less depreciation (which incorporates value changes adjusted for capital expenditures) equals total returns. The volatility and therefore the risk lies in

Figure 3



these components — predicting capital gains / losses which incorporates capital expenditures. These conclusions tell us that a substantial risk rests in predicting total return rates versus income rate or OAR. Regretfully, the predictability of the income component relationship is not extensively explored in this manuscript, however, future research will show how it can be a tool in developing a total required rate of return. Remember the tenets of the dividend discount model, dividends plus growth equals total return. In making adjustments (be sure to make apples-to-apples comparisons) to the income component for growth may yield a very reliable way to price risk in the real estate market. Again, the relevance here is that it tells us that the ability to predict the direction of the spread between total realized versus required returns rests with understanding capital expenditures and appreciation/depreciation. These may have a very high correlation; as a property loses its competitive position and/or is faced with more competition, it has to spend more money on capital items to maintain its value or else it may see a loss in value. Therefore, the authors will address the capital gain/loss component as the capital expenditure observation.

CAPITAL INTENSIVE VS. NON-CAPITAL INTENSIVE

To further examine this capital expenditure (CapX) observation, we analyzed properties that are less capital intensive (industrials and apartments) versus more capital intensive (office and retail). Figures

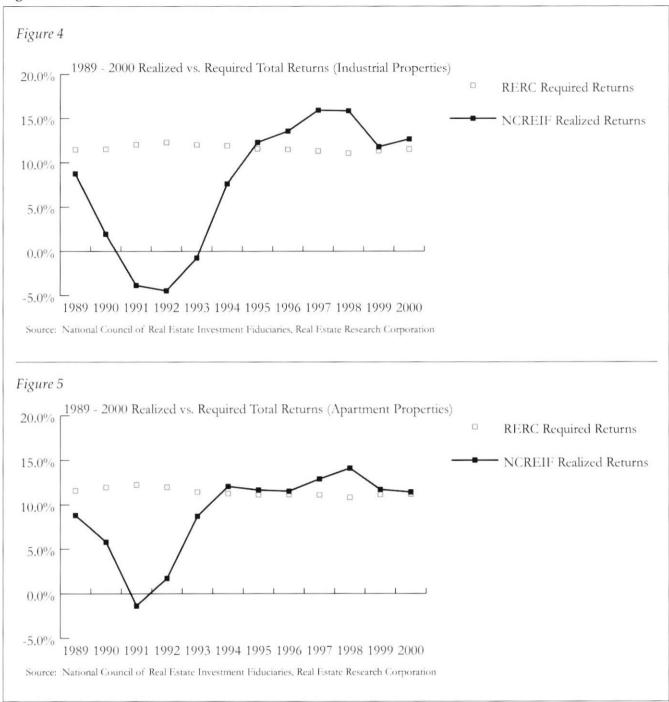
4 through 7 (see pages 12 & 13) present historical spreads of realized versus required returns for 1989 through 2000 for these property types.

As reflected in Figures 4 through 7, industrial and apartment properties continue to maintain a positive spread where total realized returns exceed required returns. Investors have recognized the predictable, stable attribute of these properties and in RERC's survey of the market, investors have consistently placed them as their favorite property types. Turning to the capital intensive property types of office and retail, we see office total realized returns still holding up in positive spread territory, but retail has been negative for the past couple of years. The performance of retail has not met investor expectations, due mainly to the industry being over-built and resulting in significant amounts of capital being spent to maintain competitive market positions. On the other end, office markets have generally stayed in balance and delivered solid performance between 1995 - 2000. Overall, realized and required returns have remained relatively proximal to each other from 1990 through the present.

CONCLUSION

The cliche "time will tell" still rings true for our maturing real estate market. The commercial real estate market for institutional investors is relatively young and its investors have learned some hard lessons about placing bets on the asset class. The

Figures 4 & 5



real estate depression in the late 1980s/early 1990s brought the asset class to its knees and over time converted the industry to a performance-driven environment. Real estate originally was sold based on which developer had the best glossy photos, with the deals being done behind closed doors — no more. Information and performance catch the attention of the analysts and investors; they drive investment decisions to allocate capital to the industry. One thing is for sure when digesting this data: timely and plentiful information has and will

continue to be key to successfully predicting the real estate trends.

The real estate asset class evolution is no different than that experienced by the stock market when it began as a widely accepted institutional investment. Prior to the 1960s, institutional investors focused primarily on the bond market and the stock market was 90 percent controlled by individual investors. It was not until Wall Street recognized the need for credible historical data in the 1960s and

Figures 6 & 7



funded a research center did stocks become a mainstream investment. The result of the hunt for credible historical investment performance information then was the formation and funding of the Center for Research in Security Prices (CRSP), a financial research center at the Graduate School of Business at the University of Chicago. CRSP files now cover common stocks listed on all major exchanges. The unparalleled accuracy of their data files has made them a staple of academic and commercial research since 1960, and is credited with

priming stock investments in becoming the heaviest weighted asset class in a pension portfolio.

Real estate is entering into the earlier phases of what the stock market experienced some 40 years ago. As reported in this manuscript, NCREIF Property Index (NPI) is now 20 years old. It is available to its members online and is continuing to develop new reports for the industry. Real Estate Research Corporation (RERC) has been monitoring investor expectations for over 20 years. The industry is finally

at a point where it is possible (through an analysis of both RERC's investment criteria from survey respondents and the realized returns from NCREIF) to more confidently predict risk and return characteristics for commercial real estate.

The analysis of these sources of industry information allows an investor to compare realized versus required rates of return. The authors have used this analysis to demonstrate that on average the industry has historically done a relatively poor job of pricing total risk or uncertainty of real estate returns. The income component analysis through overall capitalization rates (OAR) showed that the spreads between realized and required OARs have and continue to be narrow. This finding suggests that a dividend discount model style of analysis may serve as a good basis for developing a total discount rate. Finally, the uncertainty in pricing real estate risk rests with assessing the impact of the appreciation/depreciation component of the total return, which incorporates capital expenditures.

The industry will continue to develop in its ability to price risk for the real estate markets through better sources of return data. The acceleration necessary to accomplish this effort will be extremely quick due the availability of technology. Perhaps the future will bring us the stability to watch real estate tickers scroll across the bottom of computer screens with investors trading index futures for real estate around the world.

NOTES

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ABOUT THE AUTHORS

(continued from page 6)

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HOTEL OPERATORS OPEN PANDORA'S BOX: FROM "AGENT" TO "FIDUCIARY" & BEYOND

none of the risks and capital costs.

by Jim Butler & Jeff Riffer

NCE UPON A TIME ... MANAGEMENT AGREEMENTS WERE INVENTED

Once upon a time hotel operators owned the hotels they operated. Then, needing to lessen the intense capital requirements of ownership, hotel companies began to experiment with franchising and sale-leasebacks. But "paradise" was not reached until hotel management agreements were invented in the 1970s and 1980s. With this device hotel operators had almost all the benefits of ownership and almost

What could be better? Operators could build national and international chains of hotels bearing their brand names. Operators no longer needed capital to buy, operate and maintain the hotels. These burdens of ownership were transferred to owners under the management agreements. But operators could earn fees for managing the hotels and exercise almost complete control over the hotel. Owners assumed most (if not all) obligations to provide working capital, make up operating deficits, and supply cash to maintain the standards established or aspired to by operators.

To effectuate the ideal relationship, operators drafted the management contracts with owners granting powerful agency authority to the operators to maximize the operator's ability to control the hotel asset and to minimize the need to go to the owner for approvals or action of any kind. While these long-term, "no cut" contracts were largely successful in banishing many owners from any active involvement with the hotel, they created another problem that most operators never fully appreciated until recently.

ABOUT THE AUTHORS

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TROUBLE IN PARADISE: AGENCY PRINCIPLES RULE HOTEL OPERATORS

Just when things were going so nicely, Robert E. Woolley became involved in a lawsuit with Embassy Suites over termination of Embassy's longterm management agreement on nine of the 17 hotel properties his partnerships owned. Woolley claimed that the management agreement created an "agency relationship" and that certain common law rules therefore applied to the owner-operator relationship. He claimed that these rules trumped the express language of the contract and enabled Woolley to terminate the management agreement. The Court of Appeals agreed with Woolley! It held that the hotel operator is an agent and governed by agency principles that overruled any provisions of the management agreement itself to empower Woolley to terminate the management agreements.1

Woolley was the first in a steady line of relatively new cases to apply centuries-old principles of English agency common law to hotel management agreements.² Nothing was novel about the agency principles applied. Hotel owners and operators were just not used to thinking about the full implications of an operator being an agent. Under the legal tests, virtually every operator will be an agent of the owner for the hotel managed. And almost every agency (including the management contract) can be terminated by the principal (owner) at any time, however, the owner will be liable for damages to the operator if the termination is not justified.

Suddenly, operators began to worry about the agency implications of the long-term management agreements that had proliferated in the industry since the 1970s and 1980s. And when a \$51.8 million jury verdict against ITT Sheraton was rendered in 2660 Woodley Road vs. ITT Sheraton in December 1999, operators awoke with a start to find that the fairy tale had become a nightmare.

It should not have been a surprise once *Woolley* announced that hotel operators are agents, but many operators failed to appreciate all the implications of that decision. In summary, *Woolley* and its offspring establish the following principles for hotel operators:

- Virtually all hotel operators are agents.³
- Agents can be terminated by their principals (or owners) except in rare cases.⁴
- Agents are fiduciaries.⁵
- Fiduciaries owe special duties to owners and are not free to deal with them at arms length.

Under the legal tests, virtually every operator will be an agent of the owner for the hotel managed. And almost every agency (including the management contract) can be terminated by the principal (owner) at any time, however, the owner will be liable for damages to the operator if the termination is not justified.

 Remedies for breach of fiduciary duties include actual damages, punitive damages, and justifiable (free) termination of the management contract, despite provisions in the agreement to the contrary.

WHAT HAPPENED IN WOODLEY ROAD?

In 1979, the venture owned by John Hancock Mutual Life and Sumitomo Life Realty entered into a management agreement with ITT Sheraton that, with Sheraton's options to renew, ran through the year 2030. By the late 1990s the relationship between owner and operator had soured.

John Hancock and Sumitomo: 1). sued Sheraton for breach of contract and fiduciary duties; 2). terminated Sheraton as the operator and won a court order removing Sheraton from the hotel (under the *Woolley* line of cases⁶); and then 3). won \$51.8 million dollars in damages, and a verdict that it had no liability to Sheraton for terminating the management agreement that ran until 2030.

The damage award and free termination of the management agreement resulted from Sheraton's conduct, which many experts believe reflects common industry-wide practices among hotel operators. The law says that every agent is a fiduciary. Sheraton's conduct did not measure up to this high standard.

The Woodley Road jury found that Sheraton received various discounts, rebates, and other consideration from vendors and that these constituted "kickbacks" and "commercial bribes," which were a breach of contract and of Sheraton's fiduciary duty. The jury also awarded damages for breach of the Robinson-Patman claim (receiving a fee or commission in connection with a transaction for which no services were rendered) and workers compensation insurance.

Other practices challenged (though not successful with this jury) included aspects of the frequent traveler program, the reservation system, "usable denials" practices, complimentary rooms practices, and other such issues. These areas may prove problematic for operators in future litigation.

A broad spectrum of common management company practices will undoubtedly become the focus of future cases.

NEW INCENTIVE TO LEARN THE BASICS OF AGENCY PRINCIPLES

The \$51.8 million jury verdict against Sheraton in Woodley Road has provided a wake up call for owners and operators alike to better understand the fiduciary duties that almost every operator owes to the hotel owner. Woodley Road has sent a similar urgent signal to all asset managers, pension advisors and other third party fiduciaries charged with overseeing effectiveness of hotel operators for their owners.

Basic Agency Principles

As noted above, virtually all hotel operators are agents and all agents are fiduciaries. As a result, the following basic rules of agency will apply to virtually every hotel operator:

- 1. In general, an agent has a duty to act solely for its principal.⁷
- 2. Agency contracts are special fiduciary duties modify the contract.⁸
- 3. Agents owe a duty of special care and skill.9
- 4. Agents owe a duty of loyalty to act *solely* for the benefit of the owner.¹⁰
- 5. Agents owe a duty to account for profits.¹¹
- 6. Agents must not use information acquired during the agency for their own account.¹²
- 7. Agents can modify those general duties only by making full disclosure.¹³
- 8. It is no excuse that the principal is not harmed. 14

Remedies for an Agent's Breach of Duty

As demonstrated in *Woodley Road*, an operator's breach of its agency or fiduciary duties will justify a free termination of the management agreement by the owner.¹⁵ Because the breach of duty is a breach of contract¹⁶ it can give rise to all the normal contract damage remedies, but it may also constitute a tort¹⁷ and therefore expose the defendant to punitive damages.

Furthermore, if the operator has profited from the breach of duty, the principal is entitled to all the profits, and the operator must account and disgorge them. ¹⁸ And even where the operator has not breached a duty to the owner, it may be liable for any unjust enrichment. ¹⁹

HOTEL OPERATORS GENERALLY CANNOT DEAL AT ARMS LENGTH

Many hotel operators have thought of their business relationship with owners as a traditional business relationship where the parties are free to deal with one another at arms length. But that is not true for an agent. An agent cannot deal with his principal at arms length because he is a fiduciary.

These legal principles are not novel. Everyone expects that a bank trustee will act as a fiduciary. The trustee may not divert funds from the trust, invest them for his own benefit or make a secret profit. The trustee may not make secret and undisclosed charges to the trust through affiliated entities or other self-dealing. The trustee may not charge personal or undisclosed expenses to the trust.

Anybody would be outraged if the trustee of a family trust engaged in these violations of fiduciary duty. The only novel aspect of the *Woodley Road* case is applying these fiduciary principles to the agency relationship created between a hotel operator and a hotel owner. Once it is clear that an agency relationship exists, then the law attaches all of the fiduciary duties that any agent or trustee owes to its principal. This prevents the agent from operating at arms length and making undisclosed profits, self-dealing, preferring its interests over the principal, competing with the principal, using property of the owner and other such conduct.

LONG-ACCEPTED HOTEL INDUSTRY PRACTICES PUT OPERATORS AT RISK

For years, hotel operators have received rebate checks from telephone companies, vendors of food and beverage, insurance carriers, and other parties they deal with. Maybe at year-end an appliance vendor sends 10 free television sets to corporate headquarters, the property and casualty insurer gives a dividend, or home office E&O is provided on a complimentary or lower-than-market basis. Some operators may have kept the entire benefit of all of these kinds of rebates, discounts, and other considerations. Others may have refunded substantial sums where they were clearly related to a property, such as telephone company rebates or beverage vendor rebates for a specific hotel, but may not have given credit for the television sets to each hotel property under management, or may not

have reported the discount in home office insurance rates. A fiduciary cannot ignore any such benefits it receives. A fiduciary must account punctiliously to the principal for these benefits. There is no excuse because an accounting is difficult or the amounts involved are small.

It goes without saying that passing on inappropriate corporate charges from the home office, whether parties, jets, minks, and escorts or corporate G&A expense are also inappropriate unless there is express authorization and the charges are appropriate.

WHAT DO YOU DO NOW?

The real importance of *Woodley Road* is that it dramatically shows what can happen if owners challenge common industry practices applying longestablished legal principles. This case has implications for virtually every management agreement in existence between owners and operators. It builds upon the prior body of law in the *Woolley, Pacific Landmark*, and *Shopbank* cases but represents or focuses on "the next step."

If you are an operator, you need to make sure that you understand the consequences of "agency" and "fiduciary" duties. You should hire counsel knowledgeable in this area to help you understand the critical issues. Counsel should also hire or coordinate your experts to perform a self-audit on all your third party management situations, so that the attorney-client privilege may apply to important communications with staff and experts. Obviously, your team will need to address past practices and issues of liability. Your new management agreements need to fully respond to these issues, including any waivers of fiduciary obligations. Make sure your waivers are based upon sufficiently detailed disclosures to be enforceable. In the future, we will find out how much detail in disclosure is "enough" for a knowing and intelligent waiver that will meet the legal test for validity.

If you are an owner, you should first hire counsel knowledgeable in hotel management practices and agreements as well as fiduciary duties. Just as operators want to be able to claim the attorney-client privilege for the broadest range of communications with their employees and experts, you want your counsel to hire and coordinate your staff and experts for an operational or forensic audit. You should evaluate the findings of your management audit²⁰ with counsel to determine whether there have been any breaches of contract or fiduciary duty, and

What is important here is whether those currently housed in office space will choose to communicate information electronically or continue to do so on a face-to-face basis. Their choice will be influenced by the kind of information they wish to communicate, insights into which flow out of a recognition of some important distinctions that can be made with respect to information.

what course of action may be appropriate – staying the course, seeking payment of damages, termination of the management agreement, or renegotiation of the management agreement. Remember, although an owner will almost always have the power to terminate an operator under the *Woolley* case, wrongful termination can be devastatingly expensive and dangerous.

NOTES

- Woolley v. Embassy Suites, Inc., 227 Cal. App. 3d 1520, 278 Cal. Rptr. 719 (1991) ("Woolley"). Note that the "power" to terminate an agency is not the same as the "right" to terminate the agency, and a principal can be liable for substantial damages to the agent if the termination was not justified.
- See Woolley, supra. and also Pacific Landmark Hotel, Ltd. v. Marriott Hotels, Inc., 19 Cal. App.4th 615, 23 Cal.Rptr.2d 555, modified, 19 Cal.App.4th 1552i (1993) ("Pacific Landmark"); Government Guar. Fund of the Republic of Finland v. Hyatt Corp., 95 F.3d 291 (3d Cir. 1996) ("Shopbank"), and 2660 Woodley Road Joint Venture v. ITT Sheraton Corporation (USDC Del., Civil Action No. 97-450) ("Woodley Road").
- See Woolley, Pacific Landmark, Shopbank and Woodley Road, supra.
- 4. Ibid.
- "An agent is a fiduciary with respect to matters within the scope of his agency." Restatement (Second) of Agency § 13 (1958) (hereinafter "Restatement Agency").
- 6. Woolley, Pacific Landmark, and Shopbank, supra.
- "Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency." Restatement Agency § 387.

The extensive citations to the Restatement (Second) of Agency (the "Restatement of Agency") are important to those who need to understand the critical nature of fiduciary duties. The Restatement is one of the most respected authorities and oft-cited distillations of generally accepted principles of agency law in the United States.

8. "[A]Ithough the agency relation normally involves a contract between the parties, it is a special kind of contract, since an agent is not merely a promisor or a promisee but is also a fiduciary... Even specific agreements, however, must be interpreted in the light of the principles which are applicable to the relation of principal and agent. The existence of the fiduciary relation between the parties, and the duty of the agent not to act for the principal contrary to orders, modify all agency agreements and create rules which are sui generis and which do not apply to contracts in which one party is not an agent for the other. Further, unlike most other contracting parties, the agent may be subject to tort liability to the principal for failing to perform his duties." Restatement Agency, Chapter 13, Introductory Note.

 "Unless otherwise agreed, a paid agent is subject to a duty to the principal to act with standard care and with the skill which is standard in the locality for the kind of work which he is employed to perform and, in addition, to exercise any special skill that he has." Restatement Agency § 379(1).

10. "Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency." Restatement Agency § 387

"The agent's duty is not only to act solely for the benefit of the principal in matters entrusted to him ..., but also to take no unfair advantage of his position in the use of information or things acquired by him because of his position as agent or because of the opportunities which his position affords." Restatement Agency § 387, comment b.

11. "Unless otherwise agreed, an agent who makes a profit in connection with transactions conducted by him on behalf of the principal is under a duty to give such profit to the principal." Restatement Agency § 388.

"Ordinarily, the agent's primary function is to make profits for the principal, and his duty to account includes accounting for any unexpected and incidental accretions whether or not received in violation of duty. Thus, an agent who, without the knowledge of the principal, receives something in connection with, or because of, a transaction conducted for the principal, has a duty to pay this to the principal even though otherwise he has acted with perfect fairness to the principal and violates no duty of loyalty." Restatement Agency § 388, comment a

"An agent can properly retain gratuities received on account of his principal's business if, because of custom or otherwise, an agreement to this effect is found. Except in such a case, the receipt and retention of a gratuity by an agent from a party with interests adverse to those of the principal is evidence that the agent is committing a breach of duty to the principal by not acting in his interests." Restatement Agency § 388, comment b.

12. "An agent who acquires confidential information in the course of his employment or in violation of his duties has a duty not to use it to the disadvantage of the principal... He also has a duty to account for any profits made by the use of such information, although this does not harm the principal... He is also liable for profits made by selling confidential information to third persons, even though the principal is not adversely affected." Restatement Agency § 388, comment c.

"Unless otherwise agreed, an agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency or in violation of his duties as agent, in competition with or to the injury of the principal, on his own account or on behalf of another, although such information does not relate to the transaction in which he is then employed, unless the information is a matter of general knowledge." Restatement Agency § 395; see also Restatement Agency § 404, comment b ("The agent is subject to liability not only for the use of tangible things but also for the use of trade secrets, good-will, credit and other intangible assets of the principal.").

"The rule stated in this Section applies not only to those communications which are stated to be confidential, but also to information which the agent should know his principal would not care to have revealed to others or used in competition with him. It applies to unique business methods of the employer, trade secrets, list of names, and all other matters which are peculiarly known in the employer's business. It does not apply to matters of common knowledge...." Restatement Agency § 395, comment b.

Further, an agent is even restricted from using information obtained independently to compete with its principal. "The agent is entitled to use knowledge which he acquires independently for all purposes except that of competition with the principal in matters entrusted to him." Restatement Agency § 393, comment c.

13. "One employed as agent violates no duty to the principal by acting for his own benefit if he makes a full disclosure of the facts to an acquiescent principal and takes no unfair advantage of him. Before dealing with the principal on his own account, however, an agent has a duty, not only to make no misstatements of fact, but also to disclose to the principal all relevant facts fully and completely. A fact is relevant if it is one which the agent should realize would be likely to affect the judgment of the principal in giving his consent to the agent to enter into the particular transaction on the specified terms. Hence, the disclosure must include not only the fact that the agent is acting on his own account (see § 389), but also all other facts which he should realize have or are likely to have a bearing upon the desirability of the transaction from the viewpoint of the principal." Restatement Agency § 390, comment b.

Thus, an agreement by the principal to allow the agent to modify its general duties is valid only if the agent made a prior full disclosure of all the relevant facts. "Unless the terms of such an agreement provide otherwise, an agent acting as an adverse party, even though with the knowledge of the principal that he is so doing, is subject to the duty stated in Section 390 to reveal to the principal all the material facts which he knows or which he should know, and to deal fairly with the principal." Restatement Agency § 389, comment b. "The burden of proof is upon the agent to show that he has satisfied the duties required by the rules stated in this Section." Restatement Agency § 389, comment e.

14. "Where no violation of duty or loss to the principal. Even though the agent properly acquires and uses confidential information concerning his principal's activities in the course of employment, he has a duty to account to the principal for any profits thereby made." Restatement Agency § 395, comment e; see also Restatement Agency § 388, comment c ("An agent who acquires confidential information in the course of his employment ... has a duty to account for any profits made by the use of such information, although this does not harm the principal.").

"A failure of the agent to perform his duties which results in no loss to the principal may subject the agent to liability for ... any profits he has thereby made (see § 403), to discharge (see § 409)..." Restatement Agency § 401, comment b.

"[A]n agent who, without the knowledge of the principal, receives something in connection with, or because of, a transaction conducted for the principal, has a duty to pay this to the principal even though otherwise he has acted with perfect fairness to the principal and violates no duty of loyalty in receiving the amount." Restatement Agency § 388, comment a.

"The rule stated in this Section is not based upon the existence of harm to the principal in the particular case.... The rule applies, therefore, even though the transaction between the principal and the agent is beneficial to the principal." Restatement Agency § 389, comment c.

 "A principal is privileged to discharge before the time fixed by the contract of employment an agent who has committed

- such a violation of duty that his conduct constitutes a material breach of contract ..." Restatement Agency § 409.
- "[A] serious violation of the duty of loyalty ... constitutes an entire breach of contract" Restatement Agency § 409, comment b.
- 17. See note 9 supra, Restatement Agency, Chapter 13, Introductory Note.
- 18. "Unless otherwise agreed, an agent who makes a profit in connection with transactions conducted by him on behalf of the principal is under a duty to give such profits to the principal." Restatement Agency § 388.

"If an agent receives anything as a result of his violation of a duty of loyalty to the principal, he is subject to a liability to deliver it, its value, or its proceeds, to the principal." Restatement Agency § 402.

- 19. "Although the agent has committed no breach of duty to the principal, he is liable in an action for restitution for any enrichment which it is unjust for him to retain." Restatement Agency § 404A.
- 20. For a thorough discussion of the Management Agreement Audit, see "The Marriott Decision: Increasing a Hotel's Value with a Management Agreement Audit," James R. Butler Jr. and P. Peter Benudiz, Real Estate Finance Journal (Spring 1994).

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Property Markets, Monopolies & Microsoft

by Stephen E. Roulac

The Court's judgement that Microsoft violated antitrust laws has profound consequences that extend beyond the computer industry. This renewed spotlight on the issues of market dominance raises questions for the advocates of consolidation in any and every industry.

Consolidation initiatives target both new and established industries. The market that Microsoft was convicted of monopolizing did not exist until very recently. Indeed, 20 years ago none of the customers who were found to have been denied market choice had even heard of multifunctional software and Internet access, let alone made the determination that they wanted to have such products. The story of rapid product development, introduction, expansion, and deep penetration, combined with Microsoft's ascension to market dominance and the status of the country's most valuable enterprise, is a telling commentary on change and innovation in the post-industrial era.

A monopoly may be illegal if the means by which the monopoly was established, and/or the power of the monopoly position, are deemed to be anti-competitive, because competitors and/or customers are injured as a consequence of the monopolist's wrongful conduct. On the other hand, some monopolies are legal. Among companies that enjoy dominant market share, but which have yet to be attacked by the Justice Department, are Western Union controlling 81 percent of money transfers; DeBeers controlling 72 percent of the diamond market; and Rawlings Sporting Goods controlling 100 percent of the major league baseball equipment market. In the residential real estate brokerage market, the National Association of Realtors effectively enjoys a monopoly position

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of market dominance. The professional sports leagues for football, baseball, and basketball are all monopolies. While their monopoly positions are a source of challenge to some, those monopolies have not been determined by the Justice Department to be illegal per se.

As noted above, the issue of market dominance monopoly will be of increasing concern to those with property involvements. Certain consolidator strategies applied to the property sector have the objective of dramatically reducing consumer choice. Large property businesses may trigger concerns that their scale represents disproportionate market power. Many business models of the new real estate technology dot.coms aim to achieve market share dominance.

Monopoly may be defined many ways, for market share is by no means the only criterion. Other criteria include business processes, technologies, intellectual property, relationships, talents of specific individuals, brands, customer relationships, and more. While monopolies seldom last for an extended period of time, during the period that the monopoly is dominant, extraordinary profits may be extracted and massive economic distortion may be imposed. How does a company consistently outperform competitors over an extended period of time, as reflected by sustaining profits exceeding what others can accomplish? Sustained extraordinary profits are frequently achieved by monopoly positions.

Monopoly involves dominance of a market, which dominance can take many forms. Regulated industries, such as communications, utilities, and transportation, long enjoyed government-sanctioned dominance of geographic markets. The deregulation of such government-protected markets has been accompanied by a redefinition of markets, whereby the tangibles of geography and distance are de-emphasized, just as the intangibles of connectivity and exclusivity are championed.

Market consolidation leading to dominance is not a new phenomenon. Evidence of consolidation leading to oligopoly — dominance of a market by a small number of firms — if not overt monopoly is pervasive in the American business sector. Within the transportation sector, there has been an inexorable move to consolidation and domination by larger companies. In the automobile sector over the twentieth century, there was a persistent consolidation within an industry that initially consisted of

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scores of competitive independents in the North American market, into a few major global players that dominate the American, European, and Asian car makers. Similarly, both the air travel and railroad industries have been consolidated into a small number of dominant large companies. The announced intention of UAL Corp to take over U.S. Airways Group could trigger the six major airlines consolidating into a business dominated by only three major airlines.

Today, the changing market structures and competitive conditions of the communications and information sectors are especially dynamic. About the time that the personal computer emerged, the telecommunications monopoly of AT&T was splintered. As the Bell system was broken into seven regional independents, two competitive long distance services, Sprint and MCI, emerged. The delivery monopoly of the U.S. Post Office was challenged by Federal Express, UPS, Airborne Express, DHL, and other delivery services, as well as fax communications and the Internet. These enterprise reorganizations exemplify the outcome of market forces and government initiative combining to convert a former monopoly to an oligopoly.

BATTLE FOR THE DESKTOP

Commencing in the early 1980s, considerable attention was devoted to the *battle for the desktop* to determine which computer brand would occupy the desktops of businesses across the land and therefore dominate the computing market. While the consequence of this *battle for the desktop* has been

much attrition of and some consolidation of the group of companies involved in making personal computers, today no single computer brand is dominant. The battle for the desktop was a battle primarily between "proprietary" systems (Apple being the best known) and "open" systems (WinTel). While Microsoft and Intel licensed their technology to all comers, Apple refused, taking on the whole panoply of vendors who offered WinTel computers—including IBM, HJP, Compaq, and almost all other PC vendors. Because the WinTel vendors were all using the same operating systems and chip, none of them could become particularly dominant over the others.

When the *battle for the desktop* commenced, the computer was far from ubiquitous, but the general perception was that computing would move from centralized, mainframe systems to decentralized, individual computers. While there were some computers on desktops, the perception was that the leadership position for computing and communication for corporate America was to be won by placing machines on desktops in spaces which to that point in time were mostly unoccupied by computers. Thus, the *battle for the desktop* more involved winning the right to put a branded system in space that had yet to be occupied by computers than convincing a user to choose a different computer than the one already being utilized.

The battle for the desktop was a dominant theme for much of the decade for the 1980s. Of course, this battle for the desktop followed the earlier battle for the chip and battle for the operating system, which involved the technologies that would power and guide the computer itself. Intel prevailed in the battle for the chip, and Microsoft prevailed in the battle for the operating system, to the point that the majority of personal computers are Wintel dependent—which description reflects Microsoft's Windows operating system and Intel's chip.

The battle for the desktop was resolved, at least to some extent, by computers morphing into laptops and moving off the desktop. All of the WinTel system vendors — IBM, Dell, Gateway, HP — plus the Windows-based software industry won as part of WinTel excelling. This separation of computing, communicating, and related productivity functions from the office is related to the migration of work primarily from 9 to 5, five days a week, in the office, to anytime—effectively 24 hours a day, seven days a week, and any place—office, home, hotel, coffee shop, train, air plane, park, etc.

More recently, crucial technology battlegrounds have moved beyond computer chips that drive computing/communicating machines, the operating systems that run them, and space for the computers on the desktop. Now, the battleground has shifted to the Internet, which is increasingly influential in commerce generally, and in communications specifically. Initially, it was the *battle for the browser*—the means by which one viewed web content. But now the browser is less crucial.

The emerging pre-eminent concern about content was a central motivation for the AOL–Time/Warner combination. In virtual commerce, companies seek to dominate market space, by capturing more attention, involvement, loyalty, and ultimately spending than the competition. The challenge is to attract and retain people's attention, described in the vernacular of having a site that draws *eyeballs* (people), and is *sticky* in motivating them to spend time at the site, which presumably will result in them being exposed to advertising and thereby more likely to click through the advertiser's site and/or to spend money on what is offered.

Significantly, while Microsoft was slow to adapt its business to the Internet, once it decided to do so, it quickly gained a market dominant position, to the point that the Justice Department pressed antitrust litigation for illegally monopolizing a market that Microsoft earlier had largely ignored.

In assessing the lessons of the Microsoft antitrust prosecution, it is important to consider that it is not "illegal" to achieve a monopoly position in a market by virtue of one's own success resulting from initiative, applied acumen, and concerted investment in brand, technology, systems, capital equipment, and people. It is an antitrust violation to achieve monopoly position through illegal means. Then, once that monopoly position is achieved, it is an antitrust violation to employ illegal means to restrict customers' choices and defeat would-be competitors.

MICROSOFT MONOPOLY?

While the evidence of the market suggests that Microsoft indeed does possess a monopoly, how the "market" is defined may be less than clear. Just as the meaning of "market" can present interpretative challenges, so, too, can assessment of whether behavior is "illegal." Such an assessment turns on the subtle distinctions between exerting one's power legitimately and responsibly, or engaging in heavy-handed and bullying behavior, or "illegal" conduct that amounts to violation of the law.

Some who favor a libertarian political philosophy might conclude that the Department of Justice employed bullying tactics in bringing the litigation against Microsoft.

Some observers suggest that Microsoft has been less-than-effective in its litigation strategy, especially its insistence that it does not have a monopoly. Were Microsoft, or any other enterprise dominating a market, to admit that it did in fact possess a monopoly, then the focus of attention is whether illegal means were employed to create that monopoly. Just as chance plays a role in the marketplace as well as the courtroom, so, too, does chance play a role in how the events are perceived. In this regard, Microsoft in its antitrust litigation during 1998 was the fortuitous beneficiary of the presidential impeachment hearings. What would otherwise have been frequent front page, headline-dominating news, was relegated to occasional coverage or mention in the back pages, when it was mentioned at all.

One bit of telling evidence of Microsoft's monopoly position is its ability to generate extraordinary financial performance relative to the competitors that it claims it does not monopolize. For example, despite the significant distraction of management attention on the antitrust litigation in which it has been ensnared for several years, Microsoft has continued to report record financial results. Notably, Microsoft's record 1998 earnings were after paying all of the costs of defending itself in the antitrust litigation. Intriguingly, the Microsoft legal bill of some \$43 million for just one-quarter was just short of the \$46.8 million in 1998 revenues reported for all of 1998 by AtHome Corp., a once highly visible Internet company that attracted considerable stock market interest.

More fascinating than what Microsoft reported, however, is what it may not have reported. Knowing the company was under intense scrutiny during its high-stakes antitrust litigation, management's objectives would hardly seem to be inclined towards blow-out numbers. Certainly, to keep the Wall Street investment community happy, Microsoft management is motivated to meet projections. But why, rationally, would they be motivated to exceed projections so dramatically? What benefit is there to reporting nearly a billion dollars more in profit than Wall Street anticipated?

One possible answer as to why Microsoft reported the outstanding numbers that it did, is that what "M" stands not just for Microsoft but for Monopoly. The recent financial results reported by Microsoft and certain of its competitors serve as the most telling indicator of the degree of Microsoft's market monopolization. If Microsoft can do as well in its markets as it has done with the ongoing distraction of antitrust litigation, imagine what its performance might be if it were not distracted and free to pursue its aspirations without interference.

was reported is *after* substantial deferrals and the most conservative possible income realization accounting treatments. Expressed another way, if Microsoft were not putting on the financial reporting brakes, its profits could well have been dramatically greater than what were actually reported. At a time when Microsoft would rationally be motivated to minimize its market dominance and superiority, as reflected by the ultimate measure—profitability, it reported business results dramatically greater than the competition.

When a company such as Microsoft consistently outperforms its competitors, sustaining substantially above average profits that far exceed the profitability of other enterprises over an extended period of time, the inescapable conclusion is that such superior profits are achieved by virtue of its monopoly position. Microsoft's profits are telling.

These circumstances suggest that 'M' stands not just for Microsoft but for Monopoly. The recent financial results reported by Microsoft and certain of its competitors serve as the most telling indicator of the degree of Microsoft's market monopolization. If Microsoft can do as well in its markets as it has done with the ongoing distraction of antitrust litigation, imagine what its performance might be if it were not distracted and free to pursue its aspirations without interference.

IMPLICATIONS FOR REAL ESTATE

The essence of real estate rests on monopoly. A central tenet of real estate — more applicable to

commercial than residential properties — is that every location and every property are unique, there are no others like it. The entrepreneurs and/or investors who can control that property, then possess a monopoly on that unique asset. Property owners seek to create demand for the property interests they control, that is greater than the supply of those property interests. While such dominant control outcomes can be realized through many strategies and circumstances, the essential question is whether the conduct that leads to market dominance is legal or illegal.

The Microsoft antitrust litigation has both strategic implications for and direct applications to real estate. The Microsoft story offers possible lessons for real estate companies. Real estate consolidators who seek market dominance might consider whether their desired outcome is characterized only by the perception of positive upside or whether there might also be some downside. One risk is to be so successful that the Justice Department determines that the consolidated enterprise must be broken up into two or more separate companies. While this risk might perhaps be perceived to be more theoretical than real, when Microsoft was in its early years, few if any perceived the eventual scale and dominance Microsoft would ultimately achieve.

With the proliferation of innovative technology-based business models and real estate dot.com enterprises, many people are betting their careers and venture investors their dollars on their ability to create a virtual monopoly on a specific application. Indeed, many of the business models have viability, only after a substantial if not virtual monopoly share of their market is achieved. There is no question that there will be many casualties in the quest to dominate the new property goods and services markets. But will the winners also be casualties, forced by the Justice Department to give up their hard-earned share of market dominance?

BATTLE FOR PROPERTY CONTROL

Those who advocate the consolidation of real estate market ownership assert that a very small number of major national and international enterprises will own and control the spaces in which businesses work and people live. This battle for property control is very different than the battle for the desktop, since many companies own their space rather than rent. Other than demand to be generated by companies that have yet to be formed, the battle for property control involves companies that already use office space in one form or another. Thus, the battle to

dominate the office space market involves *substitution and replacement* more than it does convincing someone to adopt a new product offering.

Already, in certain geographic regions, major property enterprises are dominant landlords—to the point that a tenant seeking space in that particular region has very few options other than the dominant property owner. As a case in point, the San Jose Airport office sub-market is dominated by Spieker Properties, which controls the vast majority of the inventory of business space.

With increasing sensitivity to monopoly, this does not necessarily mean that a real estate owner cannot insist that his offering is unique. Antitrust exposure may exist, however, if that owner links access to that property to some other contractual arrangement. This linking of getting access to one thing by having to buy another, in antitrust terminology is called *tying*, which is central to the Microsoft litigation. The Justice Department lawyers argued successfully that Microsoft tied access to certain critical computer and Internet capabilities to its product.

Two real estate examples illustrate *tying* in application. A mobile home park owner who limits access to renting the park space only to those persons who buy a mobile home from him is engaging in *tying*. The office building landlord who makes the lease available only to those who agree to utilize his controlled telecommunications and Internet providers may be engaging in illegal tying.

Real estate is an especially prominent segment of an economy that has witnessed explosive growth of public control and ownership. Those who advocate consolidation of property control, achieved via securitization, suggest that a very small number of enterprises may control each major property category. If the consolidators achieve their stated objectives, such centralized control could transform the real estate markets from a lack of economic concentration to a market structure characterized by oligopoly if not monopoly.

Real estate demand is closely linked to the technologies of transportation, information, and communications—which are simultaneously *demand stimulants* and *demand substitutes*. Therefore, considering the evolution of market structure and market concentration within these sectors of economic activity can be instructive in comprehending prospective future directions and structures of the real estate markets.

MONOPOLY LESSONS FOR REAL ESTATE

By virtue of physics and uniqueness, real estate inherently involves elements of monopoly in the property markets. Because each property is unique, only one party can occupy or own it. An owner who controls a particular property that another covets, has — for purposes of that transaction — a monopoly on that tangible opportunity. Until and unless the prospective purchaser shifts her attention elsewhere, the property owner possesses a monopoly. This theory has application beyond a particular property.

Though economic theory holds and history teaches that monopolies will not persist forever, over the periods they do persist, extraordinary economic dislocation can occur. If power corrupts, and absolute power corrupts absolutely, then the monopolist who dominates a market can distort absolutely what would otherwise have transpired — in both the public and private sectors. Amongst those whose interests are damaged are 1). customers of products of present, former, and would-be competition; 2). prospects and opportunities of those who worked, aspired to work, and formerly worked in such competing and would-be competing firms; and 3). those who invested or would invest capital in those companies.

Many of the emerging real estate technology dot.com business models aspire to — and in some instances depend upon — achieving a scale and market dominance that, in relative terms, might rival what Microsoft has achieved in its markets. Indeed, these business models mandate capital investments and market coverage that can only be justified and maintained by a volume of business that would dwarf, if not render insignificant, the offers of competing enterprises. If these real estate technology dot.com companies are to meet their objectives, they must necessarily achieve market dominance that could raise questions of oligopoly and perhaps even monopoly.

The battle for control of the market for property goods and services represents both a threat and an opportunity for all professionals and companies with property involvements. As important as new offers, new concepts, and new approaches may be, those who overlook fundamental strategic issues shall do so at their peril. Specifically, for global property involvements, seven crucial questions in formulating effective strategies need to be addressed:

- 1. Where will demand be?
- 2. How does a local-oriented business service a

- global market?
- 3. What is the location of work and sales?
- 4. What are the implications of the information economy for property demand?
- 5. How will governance forms evolve?
- 6. What are the opportunities and implications of new forms of real estate ownership?
- 7. Which theory of town development planning will dominate?

Thoughtful answers to these questions extend thinking well beyond the *battle for property control*.

Consideration of the issues concerning markets, monopolies, and Microsoft leads to several direct applications to significant real estate decisions:

- The transition from a business traditionally dominated by direct involvement to a securitized dominant form of equity and debt financing can involve no small amount of peril. Indeed, the rules of the game for direct real estate are very different than those for securitized real estate. As a case in point, while the use of inside information is not illegal concerning direct real estate transactions, when real estate is in the securitized form, different rules, specifically the rules of corporate securities, apply.
- 2. The premise of *fair dealing* is the foundation for transactions that do not give rise to legal problems. Although acquiring a dominant position in a particular market is not in itself illegal; what is illegal is the use of inappropriate means to acquire that position, or to exercise the power of that dominant position. Indeed, the extensive litigation concerning wrongful conduct involving environmental contamination and pollution; inappropriate activity by lenders; self-dealing by general partners and control parties of real estate entities; and inappropriate practices in violation of fiduciary responsibilities, carry significant liability damages.
- 3. Merely buying properties in a pattern resulting in an enterprise being the dominant owner in a market is neither wrong nor illegal. What may lead to a violation of competitive practices is the finding that those acquisitions were made via transactions that precluded fair consideration of other owners' interests and objectives.
- Comprehension of market performance and definition is crucial to assessing questions of market

dominance and performance causation. Multiple factors influence the definition of markets for property-related services. As those forces that influence the definition of property markets are subject to dynamic realignment, appreciation of subtlety and complexity are required.

5. Changing spatial patterns of how and where people live, work, learn, and play are realigning business strategies. These new business strategies lead to enterprises electing different strategies for the places and spaces in which they do business, which in turn leads to new approaches to the corporate real estate function.

Fighting the *battle for property control*—as interesting as it may be—without adequately considering these five lessons as well as the implications of the answers to the seven crucial questions listed above, can lead to very disappointing outcomes. Specifically, a strategy that wins a particular battle may contribute to losing the larger war.

Just as the *battle for the desktop* is impacted by the transformation of the form and portability of computing and communicating, so also is the *battle for property control* largely impacted by the transformation in how and where people live, work, and play. Worrying about desktops proved to be not the only crucial question for the computer industry. Perhaps there is a similar lesson for those with real estate involvements who aspire to dominate their markets.

ABOUT THE AUTHOR

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IMPLIED WARRANTIES OF SUITABILITY IN COMMERCIAL REAL PROPERTY LEASES: PHYSICAL VS. NON-PHYSICAL DEFECTS

by Richard L. Clark, Jr.

NTRODUCTION

Although not readily apparent, the subject of implied warranties in commercial real estate lease agreements is important to everyone in society and substantially impacts the national economy. It is a waste of a commercial tenant's financial resources to lease commercial property for a specific commercial purpose only to discover after commencement of the lease that the subject property is not suited for its intended commercial purpose due to a latent defect in the property that the landlord knew or should have known about. Such waste may have the effect of driving smaller commercial tenants out of business, including many start up companies and family-owned businesses, thus suppressing economic entrepreneurship, which has an adverse effect on the nation's economy as a whole. Money spent on unusable lease space could have been used to expand business or to donate to charity. The businesses that are not forced to shut down may have to increase prices to cover for their losses due to wasted lease space. Such price increases will of course have an adverse effect on all consumers and their pocketbook. However, all of this economic waste could be avoided if only the landlord had a duty to inform the prospective tenant of any latent defect in the leased premises which would restrict the tenant's stated intended use of the premises.

In 1988, the Texas Supreme Court in *Davidow v. Inwood North Professional Group— Phase I*¹ recognized for the first time the existence of a landlord's implied warranty of suitability for a particular commercial purpose,² making Texas one of only two states to recognize an implied

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warranty of suitability for a particular commercial purpose.³ The Texas Supreme Court's ruling was broad, and did not limit such implied warranties to apply only to non-physical defects in the leased premises. Such non-physical defects may include: inappropriate zoning, parking ordinances and regulations; restrictions on the sale of liquor; and other miscellaneous factors which hinder or restrict the intended use of lease space.

However, in the wake of *Davidow*, the Dallas Court of Appeals, in *Coleman v. Rotana*, *Inc.*,⁸ interpreted *Davidow* to rule that an implied warranty of suitability for a particular purpose applies only to physical latent defects in the premises and does not cover non-physical latent defects in the premises.⁹

This manuscript contends that in Texas, under the Texas Supreme Court's ruling in *Davidow*, the implied warranty of suitability for a particular purpose covers *all* latent defects in the property that the landlord knows about or should know about, including non-physical defects as well as physical defects. In other words, without an agreement to the contrary by the contracting parties, a commercial landlord implicitly warrants that the premises are suitable for their intended commercial purpose.

Parts I and II of this manuscript will trace the history of implied warranties in real property leases, from its origins up to the current status of the law, including changes in the law and reasoning for the changes. Part III analyzes the Dallas Court of Appeals' holding in *Coleman v. Rotana, Inc.*, that implied warranties of suitability for intended commercial purposes cover only latent physical defects in leased premises and do not cover latent non-physical defects.¹⁰ Lastly, Part IV advances policy reasons why implied warranties of suitability should cover non-physical latent defects in the premises as well as physical latent defects.

I. IMPLIED WARRANTIES IN REAL PROPERTY LEASES

A. Implied Warranties in Residential Leases

The common law has assumed that a lease of real property primarily conveys to the tenant an interest in land.¹¹ The law has historically seen the landlord-tenant relationship as governed by the tenets of property law.¹² The value of the lease was the land itself,¹³ and the structures of the land were not the focus of the lease.¹⁴ The lease was seen as a conveyance of an estate in land for a limited term, and was based upon the parties' mutual promises.¹⁵

Possession of the land was key to the common law concept of a leasehold, ¹⁶ and the tenant's promise to pay rent was exchanged only for the bare right of possession. ¹⁷ Thus, the landlord was under no duty to deliver the premises in any particular condition, ¹⁸ and the rule of caveat emptor, or "let the buyer beware," governed all real property lease transactions. ¹⁹

This concept of the landlord-tenant relationship may have been reasonable in a rural society, but is not as applicable in today's urban society.²⁰ The agrarian concept of landlord-tenant law has become outdated, and is no longer representative of the relationship existing between the modern lessor and lessee.21 Today's tenant is more concerned with suitable facilities and tenant services than the possibility of the landlord's interference with his possession.²² The primary importance of the lease today is not to create a tenurial relationship between the parties, but to arrange the leasing of space appropriate for its intended use.²³ Furthermore, the landlord, and not the prospective tenant, usually has superior knowledge of the existence of defects in the leased premises which may render the property uninhabitable.24 In light of these changes in the landlord-tenant relationship, many jurisdictions, including Texas,25 have recognized this transformation of the landlord-tenant relationship and have either judicially or statutorily adopted an implied warranty of habitability in residential leases.26

In 1978, the Texas Supreme Court, in Kamarath v. Bennett,27 recognized, for the first time, the existence of an implied warranty of habitability by the landlord that the leased premises are habitable and fit for living in a residential apartment lease.²⁸ In this case, Kamarath leased an apartment from Bennett pursuant to an oral, month-to-month lease agreement.29 Kamarath examined the leased premises before moving in.30 However, shortly after commencement of the lease, Kamarath became aware of defects in the premises, including broken pipes, faulty electrical wiring, and physical defects, rendering the premises uninhabitable and unfit for living.31 City building inspectors supported Kamarath's testimony that the defects were undiscoverable at the time Kamarath moved in to the apartment,32 and Kamarath subsequently ceased rental payments.33

The trial court found that Bennett did not breach the lease contract with Kamarath, or violate any duty owed to Kamarath concerning the state of repair of the premises.³⁴ On appeal, the Waco Court of Civil Appeals affirmed and applied the common law rule that absent fraud, there is no implied warranty on the part of the landlord that the leased premises are habitable and fit for living.³⁵

However, the Texas Supreme Court reversed the appeals court, holding that in the rental of residential real property, there is an implied warranty of habitability by the landlord that the leased premises are habitable and fit for living.³⁶ In other words, at the commencement of the lease, the landlord warrants that there are no latent defects in the facilities that are crucial to the use of the premises for residential purposes and that the facilities will remain in a condition which makes the premises habitable.³⁷

B. Implied Warranties of Suitability for a Particular Purpose in Commercial Leases

In contrast to the widespread recognition of implied warranties in residential real property leases, most jurisdictions, including Texas, have been slow to adopt an implied warranty of suitability in a commercial real property lease context. The old common law rule of caveat emptor remains prevalent in most jurisdictions for the commercial tenant.38 However, in 1988, the Texas Supreme Court in Davidow recognized the similarities between residential and commercial tenants and determined that residential lease warranties should apply to commercial lease property.³⁹ Specifically, the court held that there is an implied warranty of suitability by a commercial landlord that the premises are suitable for their intended commercial purpose.40 The particular commercial purpose must either be known by the landlord or specified in the lease itself.41 Such a warranty guarantees to the tenant that at the inception of the lease, there are no latent defects in the facilities that are vital to the use of the premises for their intended commercial purpose.42

In *Davidow*, a doctor, Dr. Joseph Davidow, was sued by his landlord, Inwood North Professional Group—Phase I, for unpaid rent.⁴³ Shortly after moving into the medical office space, Davidow began having problems with the facilities.⁴⁴ The roof leaked when it rained, causing the carpet to rot and to mildew.⁴⁵ Rodents and other pests infested the office,⁴⁶ and the air conditioning in the building was out of order, often causing the temperature inside the office to rise above 85 degrees.⁴⁷ The landlord neglected to replace burned out hallway lights, resulting in hallways remaining dark for several months at a time.⁴⁸ Contrary to the lease agreement, cleaning, hot water, and maintenance

It is a waste of a commercial tenant's financial resources to lease commercial property for a specific commercial purpose only to discover after commencement of the lease that the subject property is not suited for its intended commercial purpose due to a latent defect in the property that the landlord knew or should have known about. Such waste may have the effect of driving smaller commercial tenants out of business, which has an adverse effect on the nation's economy as a whole.

were not provided,⁴⁹ and the parking lot was constantly filled with trash.⁵⁰ On one occasion, Davidow went without electricity for several days after the landlord failed to pay the electric bill.⁵¹ Davidow finally moved out of the office space and ceased rent payments over a year before the lease expiration date.⁵²

After the landlord initiated suit for unpaid rent against Davidow, Davidow counter-sued for breach of an implied warranty that the premises were suitable for use as medical offices.⁵³ The jury found that the landlord knew of Davidow's intended use of the premises as medical offices, that the landlord warranted to Davidow that the office lease space was suitable as a medical office, and that the office lease space was not suitable as a medical office.⁵⁴ The trial court subsequently rendered judgment that Davidow recover \$9,300 in damages and that the landlord take nothing in its suit.⁵⁵

On appeal, the court of appeals refused to extend the implied warranty of habitability to commercial leases. ⁵⁶ Holding that there is no implied warranty of suitability in commercial real property leases, the court of appeals reversed the judgment of the trial court and rendered judgment in favor of the landlord for Davidow's unpaid rent. ⁵⁷

However, the Supreme Court of Texas reversed the judgment of the court of appeals, holding that there is an implied warranty of suitability by a commercial landlord that the premises are suitable for their intended commercial purpose.⁵⁸ In other words, at the inception of a commercial lease, a landlord impliedly warrants that the premises are

suitable for their intended commercial purpose and that there are no latent defects that would prevent the use of the premises for its known intended commercial purpose.⁵⁹ The court recognized the similarities between commercial and residential tenants, and therefore expanded residential warranties to cover commercial leases as well.60 "It cannot be assumed that a commercial tenant is more knowledgeable about the quality of the structure than a residential tenant."61 A businessman should not be expected to have the requisite expertise to assure the suitability of the premises, and many commercial tenants do not have the financial ability to hire professionals to assess the suitability of the premises for their intended commercial purpose.⁶² Therefore, commercial tenants must rely on the landlord's greater ability to discover any latent defects that would hinder the tenant's intended use of the property.

The court goes on to state that the existence of a breach of the implied warranty of suitability in commercial real property leases is a fact question to be determined from the circumstances of each case. Among the factors to be considered when determining whether a breach of such a warranty has occurred are: the nature of the defect; the length of time the defect persisted; the rental amount; the age of the premise's structure; the effect of the defect on the tenant's use of the premises; the area in which the premises are located; whether the defect was a result of any abnormal or unusual use by the tenant; and whether the tenant waived the defects. 64

Only one other state court of last resort besides the Texas Supreme Court has expressly recognized an implied warranty of suitability in commercial real property leases: the New Jersey Supreme Court in Reste Realty Corp. v. Cooper. 65 Both courts' rulings are broad in that at the inception of a commercial lease, a landlord impliedly warrants that the premises are suitable for their intended commercial purpose and that there are no latent defects that would prevent the use of the premises for their intended commercial purpose. 66 There is nothing in either case to suggest that the implied warranty of suitability for a particular purpose does not apply in cases where the latent defect is non-physical in nature, such a particular use being forbidden by a zoning ordinance, restrictive covenant, or other municipal ordinance.⁶⁷ Furthermore, neither court listed the requirement that the defect be physical in nature among the factors to be considered in determining the existence of a breach of the implied warranty of suitability in commercial leases.68

II. COLEMAN V. ROTANA, INC.69

In the wake of the Texas Supreme Court's landmark decision in *Davidow*, the Dallas Court of Appeals heard the case of *Coleman v. Rotana, Inc.,*⁷⁰ only one year after the *Davidow* decision was handed down. In the *Coleman* case, a group of investors, J. Hamilton Coleman, Dean Flowers, John Ward, and Curtis Whitehead, leased commercial retail property from Rotana, Inc., the owner of the a retail strip center on Greenville Avenue in Dallas for the specified use as a restaurant and bar to be operated under the trade name of Catalina Cafe.⁷¹ Included in the lease was a provision for the non-exclusive use of the parking area for patrons and employees of the restaurant.⁷²

The City of Dallas parking ordinances required 23 spaces for use by a restaurant the size of the Catalina Cafe, and the strip center in total only had 29 spaces. Before the lease was signed, Rotana's agent had represented to Coleman and the other restaurant owners that the Catalina Cafe would have access to 23 of the 29 parking spaces available for the exclusive use of the restaurant. However, the two other tenants in the center required and used more than three spaces each. Thus, any restaurant in the space was going to be in violation of the city's parking ordinances.

After opening, the Catalina Cafe experienced constant parking problems. ⁷⁶ Coleman testified that on weekend nights, the Catalina Cafe never had more than 50 percent of the 29 spaces in the strip center available to its customers. ⁷⁷ The Catalina Cafe tried numerous tactics in an attempt to solve the parking issue, including hiring a valet service, but nothing solved the problem. ⁷⁸ Subsequently, the restaurant received numerous warnings from the City of Dallas for parking violations. ⁷⁹

Business at the Catalina Cafe began to falter and the restaurant eventually closed its doors. 80 Coleman and the rest of the restaurant's owners subsequently sold their interest in the restaurant to Robert Miller and Thomas Fleeger, and the restaurant re-opened as a Mexican food restaurant under the new ownership. 81 However, the original owners of the Catalina Cafe remained obligated to Rotana for the restaurant's lease, due to the personal guarantees each individual owner had signed at the commencement of the lease. 82

The Mexican restaurant closed after only a few months.⁸³ After the restaurant closed the second time, Coleman and the other original owners

attempted to secure the landlord's permission to sublease to other investors. Hotana rejected the restaurant owners' proposal, and Rotana sued Coleman and other the original owners of the restaurant for unpaid rent individually on their personal guaranties of the payment and performance of the obligations and liabilities of the tenant under a commercial lease. Coleman and the original restaurant owners counterclaimed for constructive eviction, fraudulent inducement, and breach of an implied warranty of suitability for a particular commercial purpose, all arising from Rotana's failure to provide adequate parking to the tenants for their restaurant.

The suit was originally filed in the 101st District Court in Dallas County. The trial court refused to submit Coleman's and the other defendants' counterclaims to the jury, except for the fraud claim, for which the jury answered in favor of the landlord, Rotana. The trial court subsequently entered judgment on a jury verdict in favor of Rotana, and Coleman and the original restaurant owners appealed. The Dallas Court of Appeals affirmed the trial court's judgment, and writ of error to the Texas Supreme Court was denied.

In affirming the holding of the trial court, the Dallas Court of Appeals held that an implied warranty of suitability for a particular commercial purpose covers only latent defects in the nature of a "physical or structural defect" which the landlord has a duty to repair. The court of appeals claimed that this holding was based on the Texas Supreme Court's holding in *Davidow*. The court reasoned that inadequate parking which violates city parking ordinances is not a physical defect vital to the use of the premises for their intended commercial purpose of the type specified by the *Davidow* court. The court of the specified by the *Davidow* court.

In support of its holding, the court quoted the *Davidow* opinion:

It cannot be assumed that a commercial tenant is more knowledgeable about the quality of a *structure* than a residential tenant. A businessman cannot be expected to possess the expertise necessary to adequately inspect and repair the premises, and many commercial tenants lack the financial resources to hire inspectors and repairmen to assure the suitability of the premises.⁹⁴

From this quote, the court ascertained that the *Davidow* court intended the implied warranty of

Money spent on unusable lease space could have been used to expand business or to donate to charity. The businesses that are not forced to shut down may have to increase prices to cover for their losses due to wasted lease space. Such price increases will of course have an adverse effect on all consumers and their pocketbook. However, all of this economic waste could be avoided if only the landlord had a duty to inform the prospective tenant of any latent defect in the leased premises which would restrict the tenant's stated intended use of the premises.

suitability to encompass only physical or structural defects in the premises and not non-structural or non-physical defects such as inadequate parking facilities. Therefore, the court concluded that although Coleman could not utilize the leased premises for their specified purpose as a restaurant due to inadequate parking facilities, the landlord was not to be held accountable, for inadequate parking facilities is not a physical or structural defect in the leased premises. 96

III. MISAPPLICATION OF DAVIDOW

A. The Texas Supreme Court's Ruling in Davidow

The Supreme Court of Texas ruled in *Davidow* that there is an implied warranty of suitability by the landlord in a commercial lease that the premises are suitable for their intended commercial purpose. 97 This means that at the inception of the lease, there are no latent defects in the facilities that are vital to the use of the premises for its intended commercial purpose.98 However, the Davidow ruling is broad, and as stated previously, at no point in that opinion does the court impliedly or expressly rule that an implied warranty of suitability for a particular commercial purpose does not cover nonphysical defects in the leased premises.99 Such a requirement was not listed by the Texas Supreme Court in Davidow among the factors to be considered when determining the existence of a breach of an implied warranty of suitability in commercial real property leases. 100

Nevertheless, the Dallas Court of Appeals in Coleman read the Davidow decision too narrowly and ruled that parking facilities that violate city parking requirements are not the type of defects that are covered by the implied warranty of suitability for a particular commercial purpose as defined by the Supreme Court in Davidow. 101 The court in Davidow stated, "This warranty means that at the inception of the lease there are no latent defects in the facilities that are vital to the use of the premises for their intended commercial purpose and that these essential facilities will remain in a suitable condition."102 The word "facilities" in no way can be seen as limiting implied warranties of suitability for a particular commercial purpose to those defects of a physical or structural nature. Yet, the word "facilities" may have misled the Dallas Court of Appeals into reading that such warranties are limited to structural or physical defects in the facilities.

In addition, the statement in Davidow that the essential facilities "remain in suitable condition"103 on its face could imply that the implied warranty of suitability covers physical or structural defects only, thus misleading the Dallas Court of Appeals to hold that adequate parking is not a defect covered by the implied warranty of suitability. However, in Coleman, at the inception of the lease, there were an adequate number of parking spaces in the shopping center for use by the restaurant due to the fact that only one of the other two lease spaces in the center were occupied. 104 Only after the lease began did the restaurant fail to have an adequate number of parking spaces available to it in order to satisfy city parking ordinances.¹⁰⁵ Thus, the parking facilities did not "remain in suitable condition" throughout the term of the lease. Therefore, the Davidow court's use of the term "remains in suitable condition" does not necessarily intimate that the implied warranty of suitability applies only to structural or physical defects, and the Coleman court should not have been led astray by the phrase.

Furthermore, the Texas Supreme Court in *Davidow* did not expressly limit implied warranties of suitability to cover only latent defects in the structure of the premises. ¹⁰⁶ As stated earlier, the court said that the nature of the defect was only one of several factors to be considered when determining whether there has been a breach of such a warranty. ¹⁰⁷ In addition to the nature of the defect, a court should also consider: the defect's effect on the tenant's use of the premises; the length of time the defect persisted; the structure's age; the area in which the premises are located; the amount of rent;

whether the tenant waived the defects; and whether the defect resulted from any unusual or abnormal use by the tenant.¹⁰⁸ However, the court gave little guidance on how much weight to give each factor.

Thus, according to the Texas Supreme Court's wording in *Davidow*, the *effect* of the defect on the tenant's use of the premises carries equal weight to the *nature* of the defect. This is due to the fact that the *Davidow* court did not indicate which factor should receive the greater weight. Therefore, affording one factor more weight than the other is reading more into *Davidow* than the court expressly or implicitly said. Accordingly, determining whether a breach of an implied warranty of suitability in commercial real estate leases hinges on more than whether the defect was physical or non-physical in nature.

Therefore, the Dallas Court of Appeals in Coleman misinterpreted the Davidow opinion, and the court should not have hinged its entire decision on the physical or non-physical nature of the defect without consideration of the other factors outlined in Davidow. By basing its entire decision on the nature of the defect without consideration of the other factors, the court of appeals has inappropriately limited implied warranties of suitability for a particular commercial purpose as defined by the Texas Supreme Court in Davidow. Furthermore, the court of appeals ignored the majority of factors to be considered when determining the existence of a breach of an implied warranty of suitability for a particular commercial purpose that the Texas Supreme Court spelled out in Davidow. 109 While the factor of the age of the structure applies only to physical defects, the remainder of the factors can apply to both physical and non-physical defects in the facilities of leased premises. Although the Dallas Court of Appeals in Coleman did consider the nature of the defect, the other Davidow factors were ignored altogether, and the resultant decision was error.

B. The Results of the Misapplication of Davidow

If based on physical defects only, many tenants will be stuck with lease payments for property which is useless for the lease's intended commercial purpose. For instance, in *Coleman*, the tenants to a retail restaurant lease were held to be responsible for lease payments for a lease which was essentially not usable for its intended commercial purpose. The tenants leased the space for the purpose of operating a restaurant. However, the strip mall in which the space was located had inadequate parking to satisfy city parking ordinances. Thus, the

space was in effect not usable for the purpose of operating a restaurant.

As a result of Davidow, Coleman and other owners of the restaurant should not be held responsible for the unpaid rent. The landlord, Rotana, implicitly warranted to Coleman and the other owners that the leased premises were suitable for use as a restaurant and bar under the rule set forth in Davidow, which states that at the inception of the lease, the landlord implicitly warrants that the premises are suitable for their intended commercial purpose.113 It was known by Rotana that Coleman and the other owners were leasing the premises for use as a restaurant and bar.114 Thus, just as Dr. Davidow was not liable for unpaid rent to his landlord, Inwood North, after Inwood North breached its implied warranty of suitability to Dr. Davidow, Coleman and the other original owners of the Catalina Cafe should not have been liable to Rotana, its landlord, after Rotana breached its implied warranty of suitability to Coleman and the other original owners of the restaurant.

However, the Dallas Court of Appeals misapplied the Davidow rule and held the tenants responsible for lease payments throughout the term of the lease.115 The Coleman court held that an implied warranty of suitability for a particular commercial purpose covers only latent defects in the nature of a physical or structural defect.¹¹⁶ Therefore, the court of appeals allowed Rotana to lease space to tenants for the expressed purpose of operating a restaurant in the leased premises, even though the premises were not usable as restaurant space due to Dallas city parking requirements.117 Such a result is clearly contrary to the spirit of Davidow and the reasoning behind the supreme court's decision to recognize the existence of implied warranties of suitability for a particular commercial purpose in commercial real property leases.118

Moveover, holding that implied warranties of suitability for a particular commercial purpose are not applicable to commercial leases that have non-physical defects in the premises would have inequitable results far beyond the mere waste of tenants' resources. For instance, consider a situation where a landlord leases commercial property to a psychiatrist that the landlord knows specializes in treating known pedophiles, and later leases space immediately next door to the psychiatrist's office to a day care center, whose owner was unaware of the nature of the psychiatrist's practice when he signed the lease agreement. The landlord would thus have

Over the last few years, there has been a gradual trend towards expanding the protection the law affords to both residential and commercial tenants. Most jurisdictions have adopted an implied warranty of habitability in residential real property leases. However, Texas is one of the first jurisdictions to recognize the similarities between the residential tenant and the commercial tenant and apply the implied warranty of habitability in the commercial context, in the form of the implied warranty of suitability for the property's intended commercial use.

superior knowledge of a defect in the premises which would hinder the tenant's intended use as a day care center, yet failing to disclose such information to the prospective tenant. At worst, children who attend such a day care center would be put at risk of molestation due to the proximity of pedophiles to the day care center, and at best, parents would take their children out of the day care center, leaving the center with no customers and thus no means of paying rent. Therefore, it would be outrageous to suggest that the day care's lease space would remain "fit" for use as a day care center in such a situation where the landlord has superior knowledge of a defect that would endanger the lives of numerous preschool children. The day care center would be well-advised to move out upon such an occurrence in order to protect the health and safety of the children. The law should not force day care businesses to choose between protecting innocent children and remaining in business. Certainly the Dallas Court of Appeals did not intend to condone such an unjust result in its ruling in Coleman.

However, according to the court of appeals' interpretation of *Davidow*, the day care center would remain responsible for all unpaid rental payments from the time the day care center moved out of the lease space until the termination of their lease. The landlord would be absolved of any wrongdoing, despite the fact that the landlord had knowledge of the nature of the psychiatrist's practice at the time the landlord leased the space to the day care center. Therefore, because the defect in this example is not

physical or structural in nature, the implied warranty of suitability for a particular commercial purpose would not apply to the day care center's landlord. The landlord would be allowed to collect rent for unusable lease space at the expense of the day care center, which would have little means of paying such rent due to a lack of children attending the center. Such an inequitable result would have the effect of forcing most day care centers in a similar situation to remain in such a lease despite the presence of those who are a danger to the children who attend day care at the center; for most day care center operators would not have the financial ability to move if forced to pay rent both at the former lease space and at a new lease space. Surely the Dallas Court of Appeals had not taken such a possibility into consideration at the time that it decided Coleman.

As both Davidow and Kamarath tell us, modern landlords are not at liberty to lease real property to a tenant when the landlord has knowledge that the premises are not suitable for the tenant's intended use of the premises.¹¹⁹ Moreover, it is generally recognized that a landlord has a duty to inform prospective tenants of any qualities of the premises which might reasonably be undesirable from the tenant's perspective. 120 The landlord must sufficiently inform the prospective tenant on the prospective lease space to the extent that the tenant has enough information to properly assess the premise's suitability for its intended purpose.121 Thus, the landlord in the day care center situation has a duty to inform the day care center of any qualities of the lease space that might hinder the tenant's intended use of the premises. Surely an office full of pedophiles next door to a day care center could reasonably be found to hinder the use of the day care center's space as a day care center! The days of the caveat lessee are over. 122 As the day care center example demonstrates, such a change in the law, where an implied warranty of suitability is imposed on the lessor of commercial real estate should be welcomed due to the likelihood of such unjust and potentially dangerous repercussions.

Furthermore, the court of appeals' decision in *Coleman* may have the unfortunate effect of misleading other courts in their interpretation of *Davidow* to hold that implied warranties of suitability for a particular commercial purpose cover only latent defects of a physical nature. As a result, numerous other tenants may be forced to remain in unsuitable lease space or be held liable for rental

payments for commercial lease space that is unfit for its intended use if they decide to move.

IV. POLICY REASONS WHY THE DAVIDOW TEST SHOULD BE READ TO APPLY TO NON-PHYSICAL DEFECTS AS WELL AS DEFECTS THAT ARE PHYSICAL IN NATURE

A. The Economic Ability of Tenants to Assess the Suitability of Premises for Their Intended Commercial Purpose

As stated in Davidow, a typical businessperson cannot be expected to possess the necessary expertise to adequately assess the suitability of the premises for their intended commercial purpose, and "many commercial tenants lack the financial resources" to hire professionals who are able to assess the suitability of the premises for a particular purpose. 123 Furthermore, the landlord, as permanent owner of the property, usually has superior knowledge of any defects in the premises that may render them unsuitable for a known purpose. 124 As a consequence, commercial tenants, with the exception of large corporations with substantial financial resources, usually rely on their prospective landlord's greater ability to assess the suitability of the premises for their intended commercial purpose.¹²⁵

Therefore, no fundamental difference exists between a physical or structural defect in a leased commercial property which precludes the use of the property for its intended commercial purpose and a non-physical defect which has a similar preclusive effect on the use of the property for its intended commercial purpose. It takes a comparable amount of financial resources, if not greater resources, to determine the existence of a latent non-physical defect in a property which would limit a tenant's use of the property as it would to determine the existence of a latent physical defect which also would limit a tenant's use of the property.

Moreover, there is little essential difference between the tenant in *Davidow*, Dr. Davidow, who could not use the space he leased for use as a medical office due to numerous problems with the premises, ¹²⁶ and the tenant in *Coleman*, the owners of the Catalina Cafe, who could not use the space they leased for use as a restaurant due to inadequate parking facilities which violate city parking ordinances. ¹²⁷ Both tenants leased space which is unfit for use as its intended commercial purpose. Therefore, just as the landlord in *Davidow* was not allowed to collect unpaid rent from the doctor who

had leased space that was unfit for its intended commercial purpose for use as a medical office, the landlord in *Coleman* should not have been allowed to collect unpaid rent from the restaurant space tenants who had leased space that was unfit for use as a restaurant.

However, the results of *Davidow* and *Coleman* are diametrically opposed from one another. The consequences of the defects to the leased premises in both *Davidow* and *Coleman* have a similar prohibitive effect on the tenants in each case, yet the court of appeals in *Coleman* allowed the landlord to collect unpaid rent from the affected tenants, ¹²⁸ due to a perceived difference on the part of the court between physical and non-physical defects. As previously stated, such a difference was never recognized by the Texas Supreme Court in *Davidow*, ¹²⁹ and should not have been recognized in *Coleman*. ¹³⁰

B. The Landlord's Knowledge of the Premises

Because of his familiarity with the property, the landlord should have superior knowledge of any defects in the premises that will render them unsuitable for a specified use. 131 Additionally, the landlord, as owner of the property, should bear the cost of curing any defect in the premises.¹³² Furthermore, "[a] tenant, even one who inspects the premises prior to leasing them, is under no obligation to discover each latent defect that would render the premises unsuitable for his purposes "133 Therefore, due to the fact that most commercial tenants lack the capacity to accurately assess the existence of any possible latent defect in a property that will render it unsuitable for a particular commercial purpose;134 the fact that most property owners should have knowledge of any defects in the premises which will render the property unsuitable for its intended commercial purpose;135 and the fact that tenants do not have a duty to uncover latent defects that would render the property unsuitable,136 it would be highly inequitable to hold a tenant responsible for lease payments when the property is not suited for its intended commercial purpose. The landlord has the responsibility and the duty to inform the tenant of any possible defects that would interfere with the tenant's specified use for the premises.137

As stated earlier, there is little difference between the effect a physical defect has on the tenant's use of the premises and the effect a non-physical defect has on the tenant's use of the premises. ¹³⁸ Furthermore, as stated in *Davidow*, a landlord should have knowledge of *any* defects which will render

In light of the Texas Supreme Court's opinion in Davidow, such an implied warranty of suitability clearly covers all latent defects in leased commercial real property in Texas. Furthermore, considering the inequitable results of restricting implied warranties of suitability to situations where the defect is physical and not applying implied warranties of suitability where the defect in the premises is not physical, the Texas Supreme Court surely did not mean what the Coleman court said it meant.

the premises unfit for a particular use. 139 In Davidow, the landlord was held to have knowledge that the space leased to Dr. Davidow was unfit for use as medical offices, due to numerous physical and nonphysical defects in the premises. 140 Following such logic, the landlord in Coleman should have had knowledge that the space leased by the owners of the Catalina Cafe was defective in that the space was unfit for use as a restaurant due to an inadequate number of available parking spaces according to city parking requirements and the use of such space as a restaurant would be in violation of such parking requirements. Therefore, the landlord in Coleman should have been charged with knowledge of the latent defect in the premises it leased to the owners of the restaurant, thus establishing a breach of the implied warranty of suitability.

However, the court of appeals disregarded the guidance given by the *Davidow* court, holding that regardless of the landlord's knowledge of any defects in the premises which would make the premises unfit for their intended commercial purpose, the landlord does not impliedly warrant to the tenant that the premises are fit for their intended commercial purpose if the defect is non-physical in nature.¹⁴¹

If the court of appeals read the *Davidow* opinion correctly, the court would have realized that the landlord is usually in a better position to have knowledge of a defect which would affect a tenant's commercial use of a property. It makes no difference that the defect in *Coleman* was non-physical in nature. The landlord, as owner of the property, has superior knowledge of the property and *any* defects it may have as to a particular use. Therefore, the

landlord has the duty to notify the tenant of any latent defects which might limit the tenant's intended use of the premises. If the landlord fails to notify the tenant of such a defect, the landlord impliedly warrants to the tenant that the premises are suitable for the tenant's known intended use of the premises.

CONCLUSION

Over the last few years, there has been a gradual trend towards expanding the protection the law affords to both residential and commercial tenants. Most jurisdictions have adopted an implied warranty of habitability in residential real property leases. However, Texas is one of the first jurisdictions to recognize the similarities between the residential tenant and the commercial tenant and apply the implied warranty of habitability in the commercial context, in the form of the implied warranty of suitability for the property's intended commercial use.

As previously stated, the Texas Supreme Court's ruling in Davidow v. Inwood North Professional Group—Phase I was broad. The court held that in a commercial lease, there is an implied warranty of suitability by the landlord that the premises are suitable for their intended purpose and that at the inception of the lease, there are no latent defects in the facilities that are vital to the intended use of the premises. Under the Texas Supreme Court's ruling in Davidow, the implied warranty of suitability for a particular commercial purpose covers all latent defects in the property that the landlord knows about or should know about. Furthermore, in Davidow, the court listed numerous factors to be considered when determining whether there has been a breach of such a warranty. The court did not include among the factors to be considered a requirement that such defects be physical in nature to be covered by the newly-recognized implied warranty of suitability for a particular commercial purpose.

However, the Dallas Court of Appeals in Coleman v. Rotana, Inc. misapplied Davidow and held that such an implied warranty of suitability as defined by the Texas Supreme Court in Davidow covers only latent physical defects in the premises that the landlord knows about or should know about and not latent defects which are not physical in nature, even though there was no requirement in Davidow that the defect be physical in nature. Moreover, such non-physical defects may have the same prohibitive effect on the tenant's use of the premises, but according to Coleman, no implied warranty of suitability would be applied in such a situation.

In addition, the result in Coleman that the tenant was held responsible for all unpaid lease payments until the termination date of the lease for lease space that was unsuitable for its intended commercial purpose was clearly inequitable and may lead to further unjust results if other courts rely on Coleman in interpreting the Davidow opinion as it relates to implied warranties of suitability for a particular commercial purpose. In light of the Texas Supreme Court's opinion in Davidow, such an implied warranty of suitability clearly covers all latent defects in leased commercial real property in Texas. Furthermore, considering the inequitable results of restricting implied warranties of suitability to situations where the defect is physical and not applying implied warranties of suitability where the defect in the premises is not physical, the Texas Supreme Court surely did not mean what the Coleman court said it meant.

NOTES

- 1. 747 S.W.2d 373 (Tex. 1988).
- 2. See id.
- 3. The New Jersey Supreme Court in Reste Realty Corp. v. Cooper, 251 A.2d 268 (N.J. 1969), recognized for the first time the existence of an implied warranty of suitability for a particular purpose in a commercial lease.
- 4. See, e.g., Service Oil Co., Inc. v. John T. Arnold Associates, Inc., 542 P.2d 652 (Kan. 1975).
- 5. See, e.g., Coleman v. Rotana, Inc., 778 S.W. 2d 867 (Tex. App.— Dallas, 1989, writ denied).
- 6. See, e.g., Truetried Serv. Co. v. Hager, No. 70163, 1997 WL 25517 (Ohio Ct. App. 1997).
- 7. See, e.g., Vermes v. American Dist. Tel. Co., 251 N.W.2d 101 (Minn. 1977).
- 8. 778 S.W.2d 867 (Tex. App.—Dallas, 1989, writ denied).
- 9. See id. at 871.
- 10. See id.
- 11. See Kamarath v. Bennett, 568 S.W.2d 658, 660 (Tex. 1970). See also Javins v. First Nat. Realty Corp., 428 F.2d 1071, 1074 (D.C. Cir. 1970), cert. denied, 400 U.S. 925 (1970).
- 12. See Kamarath, 568 S.W.2d at 659-60.
- 13. See id. at 660.
- 14. See id. See also Paula Murray, The Evolution of Implied Warranties in Commercial Real Estate Leases, 28 U. Rich. L. Rev. 145,
- 15. See id.
- 16. See Kamarath, 568 S.W.2d at 660.
- 17. See id.
- 19. See Anthony J. Vlatas, An Economic Analysis of Implied Warranties of Fitness In Commercial Leases, 94 Colum. L. Rev. 658, 661
- 20. See Kamarath, 568 S.W.2d at 660. See also Javins, 428 F.2d at
- 21. See Kamarath, 568 S.W.2d at 660.
- 22. See id.
- 23. See id.
- 24. See Davidow v. Inwood N. Prof'l Group—Phase I, 747 S.W.2d 373, 375-76 (Tex. 1988).
- 25. See Kamarath, 568 S.W.2d at 661.
- 26. See, e.g., Green v. Superior Court, 517 P.2d 1168 (Cal. 1974); Boston Hous. Auth. v. Hemingway, 293 N.E.2d 831 (Mass.

- 1973); *Javins*, 428 F.2d at 370-71; Kline v. Burns, 265 A.2d 526 (N.H. 1970). Only Alabama, Arkansas, Colorado, Mississippi, South Carolina, Utah and Wyoming have declined to recognize an implied warranty of habitability in residential leases.
- 27. 568 S.W.2d 658 (Tex. 1978).
- 28. See id. at 661.
- 29. See id. at 659.
- 30. See id.
- 31. See id.
- 32. See id.
- 33. See id.
- 34. See id.
- 35. See id.
- 36. See id. at 660-61.
- 37. See id. at 661.
- 38. See Vlatas, supra note 17, at 664.
- See Davidow v. Inwood N. Prof'l Group—Phase I,747 S.W.2d 373, 375-76 (Tex. 1988).
- 40. See id. at 377.
- 41. See id.
- 42. See id. at 377.
- 43. See id. at 374.
- 44. See id.
- 45. See id.
- 46. See id. at 375.
- 47. See id. at 374.
- 48. See id. at 375.
- 49. See id.
- 50. See id.
- 51. See id.
- 52. See id.
- 53. See id.
- 54. See id. at 377.
- 55. See id. at 375.
- 56. See id.
- 57. See id.
- 58. See id. at 377.
- 59. See id.
- 60. See id. at 376.
- 61. Id.
- 62. See id.
- 63. See id. at 377.
- 64. See id.
- 65. 251 A.2d 268 (N.J. 1969).
- See Davidow, 747 S.W.2d at 377; Reste Realty Corp., 251 A.2d at 272-73.
- See Davidow, 747 S.W.2d at 377; Reste Realty Corp., 251 A.2d at 272-73.
- See Davidow, 747 S.W.2d at 377; Reste Realty Corp., 251 A.2d at 272-73.
- 69. 778 S.W.2d 867 (Tex. App.—Dallas, 1989, writ denied).
- 70. See id.
- 71. See id. at 869.
- 72. See id.
- 73. See id.
- 74. See id.
- 75. See id. 76. See id.
- 77. See id.
- 78. See id.
- 79. See id. at 870.
- 80. See id.
- 81. See id.
- 82. See id. at 868.
- 83. See id. at 870.
- 84. See id.
- 85. See id. at 868.

- 86. See id.
- 87. See id.
- 88. See id.
- 89. See id.
- 90. See id. at 874.
- 91. See id. at 871.
- 92. See id.
- 93. See id.
- 94. *Id.* (quoting Davidow v. Inwood North Professional Group— Phase I, 747 S.W.2d 373, 376 (Tex. 1988)) (emphasis added).
- 95. See id.
- 96 See id
- 97. See Davidow, 747 S.W.2d at 377.
- 98. See id.
- 99. See Davidow, 747 S.W.2d 373.
- 100. See supra Part II.B. See also Davidow, 747 S.W.2d at 377.
- 101. See Coleman v. Rotana, Inc., 778 S.W.2d 867 (Tex. App.— Dallas, 1989, writ denied).
- 102.Id. at 377.
- 103.Id.
- 104. See Coleman, 778 S.W.2d at 869.
- 105 See id
- 106. See id.
- 107. See supra Part II.B..
- 108. See id.
- 109. See id.
- 110. See Coleman, 778 S.W.2d at 868.
- 111. See id.
- 112. See id. at 869.
- 113. See Davidow, 747 S.W.2d at 377.
- 114. See id.
- 115. See id. at 868.
- 116. See id. at 871.
- 117. See id. at 869.
- 118. See supra Part III.A.
- 119. See Davidow v. Inwood N. Prof'l Group—Phase I, 747 S.W.2d 373, 375-76 (Tex. 1988); Kamarath v. Bennett, 568 S.W.2d 658, 660-61 (Tex. 1978).
- 120. See Vermes v. American Dist. Tele. Co., 251 N.W.2d 101, 105 (Minn. 1975).
- 121. See id.
- 122. See Davidow, 747 S.W.2d at 375-76.
- 123. See id. at 376. See also Kerrville HRH, Inc. v. City of Kerrville, 803 S.W.2d 377, 385 (Tex. App.—San Antonio, 1990, writ denied).
- 124. See id. See also Vermes, 251 N.W.2d at 105.
- 125. See id. See also Kerrville HRH, Inc., 803 S.W.2d at 385.
- 126. See id. at 375.
- 127. See Coleman, 778 S.W.2d at 869.
- 128. See id.
- 129. See supra Part II.B.
- 130. See Coleman, 778 S.W.2d at 871.
- 131. See Davidow, 747 S.W.2d at 376; Kamarath v. Bennett, 568 S.W.2d 658, 660 (Tex. 1978); Kerrville HRH, Inc., 803 S.W.2d at 385; Reste Realty Corp. v. Cooper, 251 A.2d 268 (N.J. 1969).
- 132. See Davidow, 747 S.W.2d at 376.
- 133. Kerrville HRH, Inc., 803 S.W.2d at 386.
- 134. See supra Part IV.A.
- 135. See Davidow, 747 S.W.2d at 376; Kamarath v. Bennett, 568 S.W.2d 658, 660 (Tex. 1978); Kerrville HRH, Inc., 803 S.W.2d at 385; Reste Realty Corp. v. Cooper, 251 A.2d 268 (N.J. 1969).
- 136. See Kerrville HRH, Inc., 803 S.W.2d at 386.
- 137. See Vermes v. American Dist. Tele. Co., 251 N.W.2d 101, 105 (Minn. 1975).
- 138. See supra Part IV.A.
- 139. See Davidow, 747 S.W.2d at 376.
- 140. See id. at 377.
- 141. See Coleman, 778 S.W.2d at 871.

FACTORS INFLUENCING CBD LAND PRICES

by Bill Mundy, CRE, & John A. Kilpatrick

ricing land in central business districts (CBD) offers a challenging paradox. During economic "boom" times, the conventional wisdom is that land values should soar with increasing demand and decreasing vacancies. Conversely, accurate forecasting of these values exercise.

is problematic since comparable transactions are relatively infrequent and thus time factors are often erratic. As developable CBD land becomes increasingly short in supply, developing useful supply, demand, and pricing models for Counselors is more than an academic

Generally accepted appraisal methodology (i.e.—"First Generation" approaches)1 leave much to be desired in this context. A straightforward sales comparison approach is deficient, since aggregate adjustments to sales – particularly for market conditions – can often exceed 100 percent of the unadjusted sales price due to rapidly changing markets. A land extraction method (extracting the depreciated value of the building from the sales price to arrive at land values) can be fraught with errors due to judgmental issues in determining depreciation and verifying data.² Other first-generation techniques (cost, income) are not even applicable.

As such, second generation techniques (e.g.-regression modeling, survey techniques) are increasingly appropriate for valuing CBD building sites. This manuscript reviews one application of time-series regression modeling and presents a recent case study from Seattle which illustrates when such modeling can be useful.

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REGRESSION ANALYSIS - AN OVERVIEW

Regression analysis has been a fixture of economic analysis for over a hundred years. Bruce and Sundell (1977) shows that regression analysis has apparently been used in real estate valuation since 19243 and more recently Colwell and Dilmore (1999) show that a 1922 monograph by G.C. Haas of the University of Minnesota's Division of Agricultural Economics utilized this methodology in the analysis of rural land prices. 4 The modern regression models to estimate land prices (often referred to as "hedonic models" when used to value real estate) owe their roots to the work of Colwell and Sirmans (1980),5 Chicoine (1981),6 Kowalski and Colwell (1986),7 and others. Isakson (1997) recently extended these models to value urban land using sale date, distance from an interstate corridor, zoning, and buyer and seller characteristics as explanatory variables. His model was statistically significant and explained about 43 percent of the variance in prices on a set of 363 land sales in Denver between 1985 and 1992.

These regression models can be viewed as a variation of the sales adjustment grid, a long-standing mainstay of first-generation appraisal methodology. While appraisers would traditionally use two or more "paired sales" to estimate adjustments which then would be applied in an adjustment grid, the hedonic model collapses these two steps into one, and uses a richer data set coupled with a more advanced set of statistical tools.

Indeed, in this context, the rich set of analytical tools implicit in hedonic modeling may make it a preferred variant on the sales adjustment grid, when properly applied. Wolverton (1998) shows that normative paired-sales has an implicit linear relationship, and thus fails to account for diminishing marginal price effects.^{8,9} Pace (1998a¹⁰ and 1998b¹¹) and Ramsland and Markham (1998)12 show that using the hedonic model improves on the sales adjustment grid solution. Colwell, Cannady, and Wu (1983), in their review of the sales comparison approach, suggest that coefficients estimated from a regression equation should be used as factors in the adjustment grid.13 Isakson (1998)14 further applies the hedonic model to the appraisal review process.

REGRESSION MODELING USING ECONOMIC VARIABLES

Appraisal methodology derives from the general theory that, at equilibrium, ¹⁵ the value of real estate is a function of utility, scarcity, desire, and effective purchasing power. ¹⁶ Real estate pricing models are

To the extent that appropriate data is available, the first-generation approaches to value may suffice. However, when data is unavailable or when the Counselor wants to use multiple approaches, other general equilibrium models which rely on more readily available data may be useful. Critics would suggest that there is one and only one set of traditional methods that can be used to explain market prices and hence estimate or forecast market values. However, the realities of economic analysis are just the opposite.

equilibrium models because they estimate market value as the interaction of supply and demand at equilibrium. Over the years, appraisal methodology has evolved as an explanatory model which uses the prices of similarly situated properties ("comps") to estimate the value of the property in question. However, it is clear that appraisal theory would accommodate other equilibrium pricing models, and indeed it appears that the currently popular first-generation approaches are simply special cases of a more generalized pricing model.

To the extent that appropriate data is available, the first-generation approaches to value may suffice. However, when data is unavailable or when the Counselor wants to use multiple approaches, other general equilibrium models which rely on more readily available data may be useful. Critics would suggest that there is one and only one set of traditional methods that can be used to explain market prices and hence estimate or forecast market values. However, the realities of economic analysis are just the opposite. Kennedy (1985) states it most emphatically, "In reality, no such 'true' model could ever be found; an investigator is really searching for an 'adequate' (and parsimonious) approximation." ¹⁷

Hence, a model which uses, for example, general economic variables and which explains price variation would appear to be at least as good as one which uses comparable market prices to explain subject property prices. If the generalized economic model has a stronger fundamental basis in economic reality, then it may be preferred even if it only does "as good" a job of explaining prices.

The use of general economic factors to explain asset prices is well steeped in economic literature. One economic model which was developed to explain stock prices was the Capital Asset Pricing Model (CAPM). It is analogous to first-generation appraisal methods (specifically the sales adjustment grid) in that the CAPM uses the prices of similar assets (in this case, the Markowitz¹⁸ - type diversified market portfolio and a risk-free asset) to develop an explanatory model for any other asset within that market portfolio.19 If real estate is included in a market portfolio (as increasingly it is due to the proliferation of REITs), then CAPM is a perfectly good general equilibrium model for pricing real estate, albeit one not frequently used for pricing non-securitized assets.²⁰ Ross (1976) developed the Arbitrage Pricing Theory (APT), a more generalized model which allows for numerous factors to be applied to explain the price of an asset.21 While the extension of an APT-like model to real estate pricing at equilibrium seems intuitively obvious, it is even more so driven when one considers the arbitrage motivations of the classical real estate investor.

TIME-SERIES ECONOMIC DATA

If the sales adjustment grid can be viewed as a special case of a multiple regression methodology, then it is one which uses *cross sectional* data (sales that have occurred within a confined time span, *i.e.*—the last one or two years) versus *time-series* (also called *longitudinal*) data. The use of time-series data carries with it two important implications:

- 1. What are the factors which cause real estate prices to vary over a longer time-frame?
- 2. What sort of statistical implications are there in using time-series data?

The first question has been fairly well treated in the salient real estate literature. Rice (1992) developed and supported the long-term economic model which demonstrated that real estate prices were cyclically depressed by economic forces in the late 1980s and early 1990s, and that the trend back to long-term economic equilibrium would require a long-term transition. As of the time of his writing, the nation had approximately 5.7 billion square feet of office space, of which about one billion square feet were vacant. At an average factor of 250 square feet per worker, the nation's economy in 1992 – still in recession – needed to expand by four million

workers to fill the then-existing vacant space. Thus, Rice foresaw the long-term stagnation of developable land prices in the downtowns of the U.S., and the price recovery the real estate economy is just now experiencing. In the same vein, Dolde and Tirtiroglu (1997) use data over a 13-year period (1982-1994 inclusive) to measure property value changes in Connecticut and San Francisco. Also, Meese and Wallace (1994) use data over 19 years (1970-1988) to model San Francisco real estate values.

Second, the empirical questions associated with using time-series models and data to estimate real estate prices have been addressed thoroughly by Clapp (1990),²⁵ Isakson (1997),²⁶ and others.

SEATTLE DOWNTOWN LAND PRICES – A CASE STUDY

The link between employment and the health of the economy is widely known and generally appreciated by the lay person. However, the specific mechanism by which employment drives other sectors of the economy is not fully appreciated. Specifically, the channels by which employment drives land prices is not widely understood.

First, land prices are driven by the demand for raw land to build buildings. In Downtown Seattle, for example, the buildings are most often offices, which house workers. Simple logic suggests that as the number of workers increases then the demand for office space increases, and so does the demand and hence the price of land. However, the linkage is not so simple -- why does the number of office workers increase in the first place? How does the number of workers at, say, a Boeing plant in the suburban city of Everett influence the number of workers at a bank in Seattle?

People work and pay taxes. The income left after paying taxes (plus or minus a few adjustments) is disposable income. Spending patterns may or may not equal current disposable income. For example, if a household thinks that its job prospects are pretty good for the near future, and that income is expected to rise, then they may be willing to go into debt to purchase additional things, such as cars, homes, and appliances. Conversely, if a household is worried about employment in the near future, then they will tend to save or invest more, and defer purchases of big-ticket items.

Hence, the economy is not just a function of employment, but of the expectation of employment

and income in the near term. Low unemployment rates, coupled with increasing salaries, generally translates into a booming economy where people buy well beyond their current income dictates.

Office space demand (and hence, office land price) is a direct result of this economic reality. Robust employment and income causes households to spend money, and this money is multiplied several times in the economy.²⁷ Bankers, attorneys, accountants, and investment houses – among other office functions – are all secondary recipients of the increased spending which results from these positive expectations. The following sections briefly outline some of the linkages by which the economy in Seattle, as an example, is manifested in increased land prices.

Unemployment Impacts on Land Prices

The principal driving force behind raw land prices in downtown Seattle is the record low unemployment rate presently felt throughout the Puget Sound region. The robust employment picture generates four principal secondary effects that are linked to downtown land prices:

Retail — The healthy economy – particularly the stability of employment and the relative shortage of skilled workers – has driven up wages in the area, resulting in record levels of per-capita and aggregate disposable income. This, coupled with the stability of employment – signified by the persistence of low unemployment – stimulates record levels of retail spending. This, in turn, stimulates increases in retail space absorption in Downtown Seattle, at record per-square-foot prices (both rents as well as space prices).

Professional Offices — A significant portion of the employment base is white-collar office employment. Recent economic analyses of the Puget Sound economy indicate that transportation manufacturing (e.g. – Boeing) plays a much less significant role in the local economy than at any time in second half of the 20th century. The basic (exportive) economy of the Puget Sound region today stands on three legs: transportation, high-technology, and agriculture (including forest products). Much of the downtown Seattle demand for office space is to house the increasing numbers of individuals employed in the rapidly growing sectors which directly support this basic economy (e.g. - accountants, bankers, attorneys, and the investment sector) as well as headquarters for businesses directly involved in the exportive field.

Office space demand is a direct result of this economic reality.

Robust employment and income cause households to spend money, and this money is multiplied several times in the economy. Bankers, attorneys, accountants, and investment houses – among other office functions – are all secondary recipients of the increased spending which results from these positive expectations.

Tourism – In simple terms, conventions = hotels. As businesses profit, they are increasingly able to participate in conventions, trade shows, training sessions, and other hotel uses. Hotels have proliferated in downtown Seattle in the past few years, with healthy occupancy rates and increasing room rates. Tourism and hotel occupancy generate substantial secondary effects, including bars and restaurants, entertainment, and taxis and limousine services. All of these require real estate.

Government – Government growth has a component which is sensitive to the economy as well. As citizens' confidence grows, new bonding is allowed. As taxpayers' incomes grow, increased taxes are paid. This provides money for government to expand, and downtown Seattle has seen a new Federal building, new transit facilities, and new city buildings.

In summary, the unemployment rate is a proxy for a healthy and robust economy, and is a direct measure of the stimulation in downtown land prices currently being felt. *Table 1* shows the recent end-of-year unemployment statistics, as well as consensus projections for end-of-year unemployment for the coming years. *Table 1* (Puget Sound Unemployment Rate) illustrates the collapse in the unemployment rate since 1996.

Office Space Impacts on Land Prices

Demand for office space is directly measured in terms of office absorption. It is important to note that, as with any demand function, it is also necessary to measure contemporaneous supply (generally measured in terms of the vacancy rate).

Tables 1 - 4

Puget Sound Unemployment Rate		Table 2 Downtown Seattle			
		Office Absorption			
Year	Unemployment Rate	Year	Square Feet Absorbed		
1991	5.3	1991	208,254		
1992	6.7	1992	-617,791		
1993	6.7	1993	350,392		
1994	5.8	1994	846,221		
1995	5.6	1995	1,550,616		
1996	5.3	1996	850,672		
1997	3.7	1997	1,237,363		
1998	3.1				
1999	3.0				
le 3		Table 4			
Downtown Seattle Office Vacancy Rates		Puget Sound Annual % Change in Household Income			
Year	Office Vacancy Rate	Year	Annual % Change		
Year 1991	Office Vacancy Rate 13.7%	Year 1990	Annual % Change 8.05%		
1991 1992	13.7% 15.3%	1990 1991	8.05% 4.32%		
1991 1992 1993	13.7% 15.3% 13.0%	1990 1991 1992	8.05% 4.32% 5.11%		
1991 1992 1993 1994	13.7% 15.3% 13.0% 10.9%	1990 1991 1992 1993	8.05% 4.32% 5.11% 1.43%		
1991 1992 1993 1994 1995	13.7% 15.3% 13.0% 10.9% 7.6%	1990 1991 1992 1993 1994	8.05% 4.32% 5.11% 1.43% 2.90%		
1991 1992 1993 1994 1995 1996	13.7% 15.3% 13.0% 10.9% 7.6% 6.3%	1990 1991 1992 1993 1994 1995	8.05% 4.32% 5.11% 1.43% 2.90% 4.57%		
1991 1992 1993 1994 1995 1996	13.7% 15.3% 13.0% 10.9% 7.6% 6.3% 5.0%	1990 1991 1992 1993 1994 1995 1996	8.05% 4.32% 5.11% 1.43% 2.90% 4.57% 7.19%		
1991 1992 1993 1994 1995 1996	13.7% 15.3% 13.0% 10.9% 7.6% 6.3%	1990 1991 1992 1993 1994 1995	8.05% 4.32% 5.11% 1.43% 2.90% 4.57%		

In the case of the Seattle market, absorption statistics indicate a substantial increase in demand during the most recent years, as indicated in Table 2.28 Note that annual absorption was well under 1,000,000 square feet in each year from 1991 through 1994, and was even negative (indicating loss in tenants) in 1992. Overall, the average absorption (demand) for office space during the four-year period 1991-1994 was 196,769 square feet annually. However, in 1995, this jumped to over 1.5 million, and the average annual absorption in the three-year period 1995-1997 was 1.2 million square feet – about six times the earlier average. If coupled with decreasing supply, this would indicate impending upward price pressure on both office space and the principal factor of production for new office spacethe raw land.

Again, the other important factor – the supply measure — is the office vacancy rate for Downtown Seattle. While unemployment is a more powerful predictor (statistically), its effects are secondary and tertiary. Decreased unemployment means people will spend more of their income on products and services which will have an indirect yet powerful impact on the demand for downtown space.. Vacancy, on the other hand, has a more direct and fairly obvious bearing on land prices. While the relationship between vacancy rates and land prices is not necessarily linear, it is clearly causal. For example, a relatively high (greater than 10 percent) vacancy rate would have little predictive power for land prices, nor would a change from, say, 15 percent to 10 percent. However, below 10 percent or thereabouts, vacancy rates have powerful predictive power, since vacancy rates at very low levels trigger office construction and anticipatory land speculation. Table 3 (Downtown Seattle Office Vacancy Rates) illustrates the recent trends in vacancy rates.

A simple visual inspection of the data suggests that office vacancy rates may have a lagged predictive element to land prices. In other words, the sharp decline of vacancy rates, from 10.9 percent in 1994 to 7.6 percent in 1995 did not begin to be felt until 1996 transactions were negotiated. This is reasonable and logical, since land prices tend to be set after data such as this is known in the market-place. Sellers who find out about declines in vacancy rates (often six to 18 months after the fact) will then offer land for sale at prices influenced by those vacancy rates. Similarly, buyers will react to announcements of vacancy rates (again, six to 18 months after the fact) and will enter the market with bids on those parcels.

Household Income

As mentioned earlier, household income is a driving force in the economy, both directly (more income translates into more spending) as well as indirectly (anticipated stability and increase in income has a multiplicative impact). In the Puget Sound market, annual percentage increases in household income were on a decidedly downward trend from 1989 through 1993, suggesting a destimulus in spending and reductions in the multiplicative impact through the economy. *Table 4* (Puget Sound Annual percent Change in Household Income) illustrates these trends.

The average annual increase in household earnings fell to a low of 1.43 percent by 1993, and the average from 1991 through 1995 was only 3.7 percent. However, after the bottoming in 1993, the trend turned decidedly upward, and in 1996 and 1997 rose above 7 percent and 6 percent respectively. These annual increases – and the acceleration in annual increases – translates into a powerful force for increased consumer spending, consumer borrowing, and multiplicative impacts throughout the Seattle economy.

Retail Sector Impacts

Ultimately, increases in household earnings, low and decreasing unemployment, and other economic factors translate into increased retail spending. The retail linkage is important in Downtown Seattle for two reasons. First, retail headquarters operations are directly impacted, resulting in increased demand for office space. More significantly, however, is the substitution price impacts in the Downtown Seattle market. The area can roughly be divided into three sectors – government, financial (office), and retail. Statistical analysis of land prices in the three sectors indicates that the government market is separate unto itself, and has no direct impact on financial sector prices.

However, that same statistical analysis shows a high degree of correlation between retail sector land prices and office sector land prices. In other words, over time the two sectors tend to be price substitutes for one another, and the price trends are statistically identical. Thus, factors that cause retail sales (and hence demand for retail space) in Downtown Seattle also positively impact office sector land prices.

While retail sales have been on a general upward trend throughout the 1990s, the trend actually slowed during the early years of the decade,

Tables 5 - 8

ible 5			Tab	le 6			
Downtown Seattle Retail Spending Patterns		Downtown Seattle Traffic Counts					
Year 1991 1992	Sales (\$ millions) \$ 35,604.93 \$ 36,209.36	% change from previous 2.57% 1.70%	1	991 43	# of rs Daily 1,412 2,786	% cho from pr 2.09	evious 9%
1993 1994 1995 1996 1997	\$ 37,422.02 \$ 38,418.33 \$ 39,364.96 \$ 41,590.58 \$ 43,987.00	3.35% 2.66% 2.46% 5.65% 5.76%	1 1 1	994 44 995 44 996 46	6,682 4,779 9,592 0,435 6,421	0.90% 1.85% 1.08% 2.41% 1.30%	
ible 7	Parking Reve Representative		Tab	Table 8 Downtown Seattle Land Prices			
Year 1991 1992 1993 1994 1995 1996 1997	Average Daily Revenue ²⁹ 921.38 954.76 1072.96 1083.68 1143.09 1358.69 1495.79	% change from previous 3.15% 3.62% 12.38% 1.00% 5.48% 18.86% 10.09%	Year 1985 1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996	Unemploy Rate (contempore 6.80% 6.79% 6.38% 5.12% 4.93% 3.77% 5.29% 6.66% 6.74% 5.85% 5.57% 5.31%	aneous)	Vacancy Rate (lagged) 14.50% 14.97% 15.23% 11.60% 14.20% 14.00% 13.50% 13.70% 15.30% 10.90% 7.60%	Land Prices 238.14 363.76 265.49 226.70 255.19 298.30 197.14 140.97 125.45 176.46 175.95 179.45

reaching an annualized increase bottom of 1.7 percent in 1992. However, after several years of sluggishness, annual increases jumped from 2.46 percent in 1995 to well above 5 percent in both 1996 and 1997. This change in retail sales patterns (contemporaneous with other predictive variables) predict sharp increases in demand for retail space, as well as sharp increases in retail and office sector land prices. *Table 5* illustrates the specifics (Downtown Seattle Retail Spending Patterns) showing both the early 1990's stagnation and the later-years jump in spending.

Downtown Traffic Patterns

A collateral predictor of downtown retail demand, and hence downtown office space demand and land prices, is downtown traffic. While traffic counts downtown have increased each year in the 1990s, closer examination shows the same stagnation in the early part of the decade, followed by accelerated upward trends in the latter part of the decade. *Table 6* (Downtown Seattle Traffic Counts) illustrates the details.

Downtown Parking Revenues

Additional evidence of downtown economic trends can be examined from parking revenues. Since these are difficult to aggregate, we chose to analyze a representative parking facility over time. *Table 7* shows the results.

The average annual increase for the period 1991-1995 was 5.1 percent, principally skewed upward by changes from 1992 to 1993. As shown, in three out of the five years, annual revenue increases were below 4 percent. However, in 1996 and 1997, annual increase percentages were substantially higher, averaging 14.5 percent those two years.

Land Prices

From 1970 through 1977, downtown Seattle land prices were sluggish, rising less than 4.5 percent per year. However, from 1977 through 1983, land prices rose dramatically, with average annual land price increases of nearly 43 percent over that period. Land prices rose in response to a rapidly expanding Seattle economy, with the two key factors being relatively low unemployment (6.4 percent in 1980) and low office vacancy rates (reaching a trough of 2.3 percent in 1979).

However, land prices soon began to fall, and from 1983 to 1993 dropped an average of 10.5 percent annually. Two factors coincided to stimulate this long-term systemic drop in prices – a sluggish

In thin but rapidly moving markets, traditional appraisal methods may fail to provide adequate accurate value estimates or forecasts. Given the magnitude of the potential errors, these are not trivial issues, and are matters of significant importance in the real estate profession.

economy in the early 1980s coupled with overbuilding of office space. For example, unemployment in the Puget Sound area reached peaks of 10.3 percent in 1982 and 9.9 percent in 1983, coincidental with the cyclical "top" of the land price market. Additionally, office vacancies soared at the beginning of the 1980s, with the vacancy rate increasing from 2.3 percent to 15 percent in just six years (1979-1985).

Land prices again reached a bottom in 1993, but the principal indicators which signaled the regime shift in 1983, again signaled a change in direction for land prices. Unemployment in the region, which held above 5 percent since 1991, fell precipitously in 1996 and dropped to 3.3 percent by 1997. Year-end unemployment for 1999 reached approximately 3 percent, and was projected to hold at or below these levels for several years into the future. Additionally, the double-digit office vacancies of the 1980s and early 1990s were fully absorbed by 1998, with the year-end vacancy rate below 5 percent — one-third the level experienced in the overbuild 1980s. Vacancy rates, unemployment, and land prices for the period 1985 through 1998 are shown in Table 8.

MODEL DEVELOPMENT

A basic hedonic pricing model, in the absence of a supply constraint, would take the form:

Land Value =
$$f(x_1, x_2, ..., x_n)$$

where x_1 through x_n are various characteristics, and $f(\cdot)$ describes a pricing function, usually estimated from a linear regression model. Parsimony dictates the use of the most simple model which will accommodate known and expected characteristics of the data.

Data and Analytical Methodology

To estimate the functional form of the model, it was first necessary to gather a broad sample of

downtown land sales and cross-sectional pricing variables. Eighty-two separate transactions were analyzed, spanning 14 years (1985-1998), and these parcels were described by 26 separate characteristics.

Transaction prices in three different forms (raw price, price per square foot, and price per square foot of FAR) were regressed on individual and groups of variables. In all, over 100 separate regression analyses were performed. Additionally, variables were regressed in linear form, in semilog form, and log-log form (commonly known as a "Box-Cox" transformation). This last form was chosen due to the expected non-linearity in the data.

The decision rule was to maximize both the adjusted R² of the regression model as well as the statistical F-test. In short, these two measures, which tend to move in tandem, measure the ability of the statistical model to account for variation in the data.

It is also important to carefully analyze models for other specification errors. It is possible to have a model with a very high R², but very fragile in terms of predictive power due to poor specification. Parsimony in selection of explanatory variables is key, and thus it is typically considered appropriate to "optimize" R² while at the same time minimizing the number of variables used in the model. In the final analysis of this model, only two explanatory variables were needed to adequately explain land values. Earlier models tested included as many as 16 variables simultaneously.

Additional tests were performed both before and after construction of the models to determine the quality of the data. For example, statistical ttests of price means were conducted on logical groups of data (*i.e.* – government area transactions versus financial area transactions) to determine if all of the data came from uniform underlying populations. Time series tests were performed to determine if there were temporal characteristics which were otherwise unexplained by the other variables. Corner lots were tested against non-corner lots, and zoning characteristics and FAR assignments were tested.

Findings

The final functional form determined by the regression analyses was:

ln(prices) = a + bln(unemployment + cln(vacancy rates) + e

where *a*, *b*, and *c* are standard regression output coefficients, and *e* is an error term, assumed (after the Box-Cox transformation) to be normally distributed with a mean of zero and a standard deviation of one. These are the typical constraints of a best, linear, unbiased estimator of land prices.

The analysis revealed six key findings in addition to the model:

- Land prices in the financial district were statistically equal to those in the retail district, but not equal to those in the government district.
- 2. Corner lots and non-corner lots do not have statistically different prices.
- 3. Zoning characteristics (for commercially zoned parcels) were not statistically significant.
- 4. Selling price per square foot was not a function of parcel size.
- The impact of unemployment appears to be contemporaneous, consistent with a hypothesis that developers (buyers of land) react to leading economic variables.
- The impact of vacancy rates appears to be lagged by one year, consistent with a hypothesis that developers rationally react after key supply variables are revealed.

The regression model yielded the following coefficients:

a = 7.7425

b = -1.4681

c = 0.1057

It was additionally necessary to deal with the issue of a supply constraint. Model adjustments were found useful to proxy for the pricing problems associated with this supply constraint. Specifically, land prices were adjusted to the third quartile rather than the means. This was accomplished by analyzing the distributions around the means in sample data to determine the approximate average relationship between the third quartile and the mean. It was found that the third quartile is approximately 1.24 times the mean, on average.

Mid-1999 land values, on a per-square-foot basis, are thus estimated as follows:

 $Land\ Value = 1.24 \big[e^{7.4725-1.46811n(unemployment)+0.1057\ln(vacancy\ rate)}\big]$

Final regression results included an adjusted R² of 83.38 percent, and an F-test statistic of 21.0728, which indicates that the model has a statistical reliability of approximately 99.8 percent.

Predictive Results

Using this model, downtown Seattle land prices would be predicted at \$513 at mid-year 1999. At the same time, appraisers in Seattle were forecasting 1998 and 1999 land prices no greater than \$425 per square foot.³⁰

While there were a limited number of actual transactions consummated in Seattle during this period, the transactions which were consummated were well predicted by the model. Indeed, traditional appraisal methods failed to account for transactions above \$500 per square foot. However, the lowest price we recorded for a developmental commercial parcel in the downtown Seattle study area during the months following the conclusion of this study was \$543 per square foot.

SUMMARY & CONCLUSIONS

In thin but rapidly moving markets, traditional appraisal methods may fail to provide adequate accurate value estimates or forecasts. Given the magnitude of the potential errors, these are not trivial issues, and are matters of significant importance in the real estate profession. This study shows the usefulness of a time-series regression model which uses economic data to provide more accurate forecasts of prices in rapidly moving markets.

Clearly, the model developed herein should not be viewed as static, either in coefficient value or in functional form. Rather, this study demonstrates the usefulness of time series regression methodology._{REI25}

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- 28. Table 2 and several subsequent tables were developed two years ago for an early version of this model, and hence does not include data after 1997.
- 29. This is an index number designed to shield the parking operator's identity but accurately reflect the revenue changes.
- 30. Indeed, appraisers engaged by the State of Washington in a major downtown land condemnation case during the Spring of 1998 forecasted prices much lower than these.

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RECOGNIZING THE FUTURE: REAL ESTATE & THE NETWORKED ECONOMY

by Woodward S. Hanson, CRE

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ACKGROUND

Alvin Toffler, author of the 1970 forward looking Future Shock, prefers to describe phases in human history as a "series of waves." The first-wave transformation was human development of "agriculture." The second was the Industrial Revolution, and the third is the current "knowledge age," driven by information technology and demands for freedom. Peter Drucker, the pre-eminent business philosopher of the 20th century, as far back as 1969 noticed the advent of an emerging new economy with the arrival of 'knowledge workers.' This new economy was referred to as the Information Economy, because of information's superior role (rather than material resources or capital) in creating wealth.

Kevin Kelly, executive editor of *Wired* and author of *New Rules for the New Economy*, prefers the term "Network Economy" because information isn't enough to explain the discontinuities he sees. Kelly states that this 'new economy' has three distinguishing attributes: 1). It is *global*; 2). It favors *intangibles* – ideas, information, and relationships; and 3). It is *intensely interconnected*. And, that these attributes will lead to a society and marketplace characterized by 'electronic ubiquitous networks."

REAL ESTATE AND THE NETWORKED ECONOMY

Against the backdrop of Toffler's *third wave*; Drucker's *information economy*; and Kelly's *ubiquitous networks*, the fragmented, commercial real estate industry is experiencing *forces of change*. Hopefully, all leading to a more efficient, stable financial system. In this manuscript,

the author has identified several of these forces and their pronounced effect on the real property marketplace and property profession. These agents of change include, but are not limited to:

- Consolidation and Convergence: The genetics of a new world.
- Technology: A consumer-centric, techno-savvy world.
- Securitization: Real estate becomes a commodity.
- Globalization: It's a small, small world.
- Demographics: The Longevity Revolution.

Already, strategic initiatives, business plans, and alliances have been formed in order to harness the opportunities of a global, connected economy.

CONSOLIDATION AND CONVERGENCE

Peter D. Linneman, Ph.D., CRE, Albert Sussman professor of real estate, professor of finance and public policy and management at The Wharton School, University of Pennsylvania, published a paper in 1997 titled, "The Forces Changing the Real Estate Industry Forever." I first read the paper following a September 1999 office conference with Joe Forte, Past President of CSSA (now the CMSA – www.cssacmbs.org), as a member of the Appraisal Institute's (www.appraisalinstitute.org) Wall Street Initiative. The article emphasized the similarity between today's commercial real estate industry and the automobile industry of the 1940s, a "fragmented, cottage industry."

Dr. Linneman described the commercial real estate industry as capital intensive, inefficient, and in the 7th year of a 25-30 year "critical transformation period." The catalysts for this transformation were the industry's collapse in the early 1990s; the need for liquidity; changing regulations in the banking and finance industries; and the emergence of the commercial real estate public capital markets. Linneman reported that three to five more downturns in the commercial real estate cycle would likely occur before the "critical transformation period" would be complete and that all capital intensive industries have experienced similar periods of transformation.

As the transformation or consolidation process continues, watch for an emergence of all sorts of new partnerships and strategic alliances intent on optimizing human capital, knowledge, or the supply chain. As of September 11, 2000, the financial news was crowded with reports of such events:

- Hewlett-Packard Co., the second largest computer maker, was reportedly paying \$18 billion in cash and stock for the 30,000 personnel strong, consulting arm of PricewaterhouseCoopers, the world's largest professional service firm. The convergence of information and technology.
- Morgan Stanley, Goldman Sachs, Saloman Smith Barney, Merrill Lynch, UBS, CSFB, and Deutsche Banc launched a "new Internet portal designed to integrate their equity resources on-line."
- The U.S. Federal Trade Commission approves Covisint, an on-line B2B marketplace being developed by General Motors, Ford Motor Co., Daimler Chrysler, Renault USA and Nissan Motor Co. The project will be engineered by Oracle (an Internet software company) and Commerce One (a B2B Internet solution provider).

Each of these events are patterns of convergence in the "networked economy" and are probably the first of many more to come.

TECHNOLOGY

According to R. Stanley Williams, a senior principal laboratory scientist at Hewlett Packard labs, the primary technology that dominated the latter part of the previous century was the invention of the integrated circuit in 1959. Since that date, the number of transistors that can be fabricated onto a single chip has been doubling about every 18 months - a rate commonly know as "Moore's Law." Kevin Kelly concludes that the grand irony of our times is that the era of computers is over. All the major consequences of stand-alone computers have already taken place. In contrast, the most promising technologies making their debut now are chiefly due to communication between computers - that is, to connections rather than to computations. The technology we first invented to crunch spreadsheets has been hijacked to connect our isolated selves instead.

This shift to communications and connectivity is best evidenced by the Internet, although other technologies are also relevant to commercial real estate's evolution. As the number of connected PC's increases from 33.3 million in 1998 to 59.8 million in 2003, the value of the network increases by no less than "n-squared." The consumer has more information and power than ever before, leading to Kelly's "techno-savvy, consumer-centric" market-place.

Arthur Andersen and the Rosen Consulting Group in their, eReal Estate: a Virtual Certainty, focus on

how the Internet and e-business affects the commercial real estate industry in terms of future opportunities and risk. They report that the use of the Internet is increasing at an exponential rate as the world "webs up." Mega-trends expected to apply to the industry as a whole were identified as follows:

- Internet Benefits: The Internet facilitates growth in worker mobility, globalization, and securitization. Also, the Internet is increasing worker productivity to all-time highs resulting in GDP increases.
- Location: Just as important as it was a century ago, location remains central to success. While traditional location factors like highway or rail access will still be important, those projects with proximity to fiber optic and cable hubs, or proximity of logistic hubs, will generate increasingly greater value.
- Physical Structures: The Internet and eBusiness are encouraging physical changes in all product types, including automation in warehouses, flexible space configurations in offices that adapt to changing tenant improvement requirements, and the inclusion in alcoves in apartments for computers and other technology.
- Capital Requirements: Because of the costs of retro-fitting existing buildings for new technology, or the cost of installing the latest technologies in new buildings, real estate will become an even more capital intensive industry. "Internet ready" properties will be increasingly demanded by tenants in most markets and most product sectors.
- New Revenue Sources: The growth of the Internet is expected to generate for all property types (except retail) new revenue sources (e.g., the provision of telecommunications and tenant advisory services).

In the recently published eReal Estate Companies: The Impact of eBusiness and the Internet in the New Economy, by Arthur Andersen, it is noted that the industry as a whole has historically been something of a laggard in embracing new technology. And that has a lot to do with the nature of the business. "Some real estate professionals believe that the industry is too relationship-oriented to benefit from the technology-driven Internet," said Carl Berquist, worldwide managing director of Arthur Andersen's Real Estate and Hospitality group. "They don't recognize the impact of enhanced customer access and communication; the savings in business-to-business cost and time; the critical importance of changes in information access and dissemination; or the

With so much "info clutter," the Internet provides the property counselor with the opportunity to convert raw data to useful information. A value-added process intended to provide information based solutions to client projects. It has been estimated that "infomediation" will be our core competency in the 21st century, just as manufacturing was in the 20th century.

effect of improved work processes and organizational efficiency." Internet-driven real estate, however, is breathing down our necks, Andersen's research suggests. "It is only a matter of time," the report says, "before property changes hands partially or completely on-line."

According to Peter Pike (www.pikenet.com), the likely Internet trends will include branding, email connection, intranets and extranets, public access, and data access. According to *Business2.0* (www.business20.com) the Internet's future will be characterized by ubiquitous connectivity, streamed not downloaded data, flat-fee pull and a renaissance of creative expression.

With the advent of numerous web-based, real estate "portals" such as Inman News (www.inman. com); LoopNet (www.loopnet.com); PropertyFirst (www.propertyfirst.com); CoStar Group (www.co stargroup.com), etc., sophisticated real estate information has become readily available to buyers, sellers, and the markets between them. Many real estate professionals argue that the availability of this information will limit their business opportunities. Nothing could be further from the truth. With so much "info clutter," the Internet provides the property counselor with the opportunity to convert raw data to useful information. A valueadded process intended to provide information based solutions to client projects. It has been estimated that "infomediation" will be our core competency in the 21st century, just as manufacturing was in the 20th century.

SECURITIZATION

Robert Hall, a Stanford University economics professor, published an article titled, "This New Economy Won't Stop: Thank the Capital Markets," in the February 2, 2000, *Wall Street Journal*. Hall stated that, "Capital markets have developed a

much more stable financial system – based almost entirely on markets rather than banks." With increased liquidity and specialized analyst coverage, the current expansion phase of the commercial real estate market has enjoyed an extended term.

When discussing *securitization*, there are primarily two topics: 1). Real Estate Investment Trusts (REITs) -- the *equity play*; and 2). Commercial Mortgage Backed Securities (CMBS) -- the *debt investment*. Information concerning REITs is available from the National Association of Real Estate Investment Trusts (www.nareit.com); and information concerning the CMBS market is available from the Commercial Mortgage Securities Association (www.cssacmbs.org); the investment banking community; and the rating agencies.

REITs

Information obtained from the NAREIT Web site defines a REIT as "a company dedicated to owning/operating income producing real estate." REIT shares are traded on the major stock exchanges and are referred to as "dividend stocks" as opposed to "growth stocks." REITs are required to pay virtually all of their taxable income (95 percent) to its shareholders. REITs provide the commercial real estate investor with several benefits:

- Liquidity: REITs have helped turn real estate liquid. With over 200 publicly traded, diversified portfolios, investors can buy and sell interests instantaneously.
- Security: With a low level of debt, professional management, and the underlying security of the real estate asset, REITs provide the small investor with a reasonable level of security.
- Performance: Between 1979 and 1998, equity REITs had a total annual return that far outpaced that of direct property investments (14.35 percent v. 8.72 percent). Currently, most equity REITs have a net asset value which exceeds their market capitalization and are producing excellent returns.
- Access to Superior Management and Cheaper Capital: Another advantage that REITs have over the traditional direct real estate investment is the "institutional advantage" of attracting envisioned managers and access to cheaper capital.

According to an August 21,2000, NAREIT press release, funds from operations (FFO) per share rose 8.7 percent on average for all equity REITs in the second quarter of 2000, when compared with the

same period last year. In the first quarter of 2000, comparable year-over-year FFO per share growth was 8.1 percent. Earnings growth for other large publicly traded real estate operating companies (REOCs) also advanced, with year-over-year earnings per share growth of 33.1 percent in the second quarter, compared to 29.1 percent in the first quarter. Among equity REITs, the strongest 2Q2000 FFO was in the apartment, industrial, regional mall, and office segments.

CMBS

Joshua Anderson, MAI, published an article titled, "The abc's of CMBS," in the Third Quarter 1999 issue of *Valuation*, *Insights and Perspectives*, as published by the Appraisal Institute. Anderson defined commercial mortgage backed securities as "asset backed securities that are the products of financial engineering designed to convert a pool of mortgages into a series of bonds." They take the form of conduits, fusions, Re-REMICs and Credit Lease Pools. Through the use of CMBS instruments, investment bankers have a way of placing public market capital into commercial mortgages.

Four rating agencies: Fitch IBCA (www.fitch ibca.com); Moody's (www.moodys.com); Standard & Poor's (www.standardandpoors.com); and Duff & Phelps (www.duffllc.com), play significant roles in determining the price of the CMBS bonds. Each rating agency has a slightly different rating or grading scale. Investment Grade ranges from the highest rating of "AAA" indicating the capacity to pay interest and principal is extremely strong through "AA" and "A" to "BBB," which indicates adequate payment capacity. Speculative Grade ratings are "BB," "B," "CCC," "CC," and "C" indicating that there is some capacity for repayment, however, there are large uncertainties or major risks of repayment. Other grades and notations include "D" rating which indicates payment default.

A review of the April 26, 2000, "CMBS Quarterly Insights: Changing With the Times," as published by Standard & Poor's Structured Finance indicates that there is growing consensus among those involved in CMBS that the U.S. market is showing signs of "maturation." The days of heady, exponential growth in domestic issuance are, for now, over. As the first quarter drew to a close, it seemed that Standard & Poor's earlier prediction that 2000 will see domestic issuance levels of between US\$50 billion and US\$55 billion remains on target. These levels mark considerable decline from the previous two years, ranging from US\$67

billion in 1999 issuance, to US\$78.4 billion in 1998 issuance.

This decreasing level of issuance is traceable to a few sources. One main factor has been the already high level of financing that occurred from 1997 to 1999, severely limiting the universe of new financing this year. Also, the low volume of commercial mortgage origination between 1989 and 1992, means that there are fewer refinancing opportunities now. Last, but certainly not least, bond markets as a whole have been significantly impacted by rising interest and treasury rates.

GLOBALIZATION

Thomas L. Friedman, author of *The Lexus and the Olive Tree*, indicates that the driving idea behind "globalization" is free-market capitalism – the more you let market forces rule and the more you open your economy to free trade and competition, the more efficient and flourishing your economy will be. Globalization means the spread of free-market capitalism to virtually every country in the world. Globalization also has its own set of economic rules – rules that revolve around opening, de-regulating and privatizing your economy.

How have America's largest companies responded to globalization? A review of the *mission statements* and *tag lines* associated with the "Big Five" *professional service* firm's Web sites confirm several of the mega-trends discussed thus far. By example:

- KPMG Peat Marwick: KPMG is the global network of professional advisory firms whose aim is to turn knowledge into value for the benefit of its clients, its people and communities. (www.us. kpmg.com)
- PricewaterhouseCoopers: Restructuring to serve clients in the new global economy. (www.pwc global.com)
- Deloitte & Touche: Strong national presence & expansive global reach. (www.dttus.com)
- Ernst & Young: Long-distance issues. Far-reaching solutions. Global business has a new address.
 (www.ey.com)
- Arthur Andersen: Leading the new economy as one firm. One World. One Organization. (www.arthurandersen.com).

These carefully constructed *message statements* seem to confirm: 1). The "Big Five" are now "professional service providers," a branding decision reflecting a wider view of the marketplace than accounting; 2). There is a new economy; and 3). Yes, it is global. Also,

An evolution revolution is going on – a revolution so vast and extraordinary that it will affect every aspect of our lives – the professional, personal, social, economic, political, and spiritual. We are facing change as never before. An aging population will demand not only a reallocation of wealth and services, but the rethinking of the conventional wisdom that has been supporting and directing society for hundreds of years. Imagine the impact on the health-care segment of the commercial real estate industry.

one of the messages suggest that being perceived as "one firm" is competitively advantageous. I strongly suggest that you visit each of the Web sites noted above for a comprehensive view of the visions, initiatives and branding related to the top five, global consultancy firms.

A May 1, 2000 article titled "Go Global," posted on the *Business2.0* Web site, indicates that by 2003, an estimated 67 percent of Internet users will log on outside the United States; and foreign share of ecommerce will reach 56 percent - up from 28 percent in 1998. In B2B e-commerce, although the United States currently controls 60 percent of the global market, the American share will plunge less than 40 percent by 2004, when the worldwide B2B market reaches \$7.3 trillion. In Europe, B2C e-commerce is expected to grow from a mere \$5.6 billion in 1998 to \$430 billion by 2003. Japan is forecasted to experience a 20-fold increase from \$3.2 billion in 1999 to \$63.4 billion in 2004.

A contrary position is taken by Stephen Roach in his Web posting "Global: Payback Time" on the Global Economic Forum site (www.msdw.com/GEFdata/digests/latest-digest.html). Roach states that it is payback time for a worldwide economy growing at its fastest pace in 17 years. To the extent investors are disappointed by a stock-adjustment-induced-downshift in the economy, optimistic growth expectations could be dealt a tough blow. That could well be exacerbated by the impacts of higher energy prices.

DEMOGRAPHICS

And on top of everything else, the world is aging; a new "longevity based era" is dawning. This was the focus of The Counselors of Real Estate (www.cre. org) High Level Conference 2000 in Scottsdale, Arizona. According to Philip Cottone, CRE, Conference Chair:

- At the turn of the last century, the average life expectancy was 47. In our lifetime, there is a real possibility that the average life expectancy will increase to 100...or more.
- Today, people over 50 represent a 27 percent of the population, and people over 80 are the fastest growing segment of the population.
- Next year, for the first time in the history of industrial countries, people over 60 years old will outnumber children. Even Third World populations are living longer.

An evolution revolution is going on — a revolution so vast and extraordinary that it will affect every aspect of our lives—the professional, personal, social, economic, political, and spiritual. We are facing change as never before. An aging population will demand not only a reallocation of wealth and services, but the rethinking of the conventional wisdom that has been supporting and directing society for hundreds of years. Imagine the impact on the health-care segment of the commercial real estate industry.

SOME CLOSING THOUGHTS

Ray Kurzweil, author of *The Age of Spiritual Machines*, and winner of the 1999 National Medal of Technology, with his "intuitive linear" view of technological progress expects 20,000 years of technological progress in the 21st century. In order to retain our personal health through this period of exponential change, Kurzweil advocates that our profession must be our passion, and we must make a life-long commitment to learning.

According to Walid Mougayar's "Aggregation Nation" in the March 2000 edition of *Business2.0*, we must create businesses that constantly manipulate information to extract higher value from it by reselling it, re-using it, re-packaging it, or giving it away; either directly to end-users or indirectly via third parties. Electronic market power, then, will be determined by how cleverly we mediate information services.

Finally—"the cluetrain manifesto . . . the end of business as usual"—suggests that many companies

fear these changes, seeing them only as a loss of control. But control is a losing game in a global marketplace where the range of customer choice is already staggering and a suicidal game for companies that must come up with knowledge necessary to create those market choices.

CRE PERSPECTIVE

SOME PRINCIPLES OF REAL ESTATE COUNSELING

by Anthony Downs, CRE

INTRODUCTION

My career as a real estate consultant began over 50 years ago when, while still in high school, I started counting pedestrian traffic on Chicago's State Street for my father's firm, Real Estate Research Corporation. After I received my Ph.D. in economics from Stanford and served in the Navy for three years, I began working full-time for my father's firm in 1959. Since then, I have been continually engaged in consulting. (In the early 1960s, I had a part-time appointment at the University of Chicago. In the mid-1960s, for two years I spent alternate weeks at the RAND Corporation and consulting at our Los Angeles office.) During those several decades, I have formulated some basic principles concerning real estate consulting that might be useful for others now doing such work. This article presents those principles and some advice about how to use them.

UNDERSTANDING WHAT YOUR CLIENTS REALLY WANT, AND WHY THEY WANT IT

The first principle is that it is important to know why your clients want you to do whatever they initially think you ought to do for them. This may seem silly, because it should be obvious that each client wants you to answer some specific question about what he or she or their firm ought to do about something. But that may not be true at all. There are many reasons why people hire consultants besides actually wanting to discover the answers to the questions they ask the consultants. Many of these reasons are grounded in the politics of the client organization.

This raises the preliminary issue: *just who is the client?* Is it the person or group in an organization who hired you and will receive your report? Or is it the entire organization containing that person or group, since the organization will ultimately pay the bill? Government clients normally have to go through a formal competitive process to select consultants; so the client is quite clearly the whole organization. But private clients often select consultants without such

formal processes; so the principal client may be an individual or sub-group within an organization. When there are conflicts among factions and groups within an organization, it may not be easy to decide who is the "true" client. However, it is probably wise to put the welfare of the organization as a whole above that of any individual or group within it when they conflict, even if the person who hired you is that individual or in that group. Or at least you must point out the impacts, to the organization as a whole, of anything desired by that person.

The client may genuinely want to find the solution to the problem you have been asked to remedy. But that is not true in all cases. Often, the client wants you to help him or her persuade other people in the same organization or in other organizations to accept a course of action the client has already decided is the right one. You are really hired as a presumably "unbiased" source of wisdom who is expected to substantiate the client's views—and therefore makes those views more plausible, credible, or acceptable to others. In real estate, this is quite common. Borrowers want you to appraise a property at the level high enough for them to get the size loan they think they need. Lenders want to justify the huge amount they have already given to the borrower, etc.

When this is the case, the client wants you to arrive at a specific answer which the client already has in mind before you enter the equation. Therefore, the client is likely to put pressure on you to arrive at that answer, rather than some other answer he or she does not want to hear. This can create difficult situations—making it especially hard to collect your fee if your conclusion is not what the client wants to hear. I had such a client in Atlanta who wanted to build a privately-owned convention center on the site of an old steel mill. Since almost no privately-owned convention centers can make profits for their owners, I concluded that this was a bad idea. As a result, he refused to pay me. Fortunately, my firm had just been bought by the First National Bank of Chicago, and they rented a lot of space from him in an Atlanta office building. So they put the squeeze on him and he paid. He went bankrupt shortly thereafter.

Another reason to hire a consultant is to delay a decision until a lengthy study can be carried out. An example is requiring a lengthy environmental impact study before approving a project. *Research as delay* is common among politicians, who often appoint "fact-finding commissions" to postpone having to decide publicly some highly controversial issue until after the next election. By then, most

people may have forgotten about it, or it may have receded in importance.

Still another reason to hire a consultant is to create someone else to take the blame for arriving at a potentially controversial conclusion or recommendation. If an executive has decided that a whole division of his company ought to be abolished, he may want to get someone else to recommend this so he can deflect the blame to an outsider who does not need to take the heat for long. This is related to giving more credibility to such conclusions, but is fundamentally different because the motive is to deflect criticism from the client to the consultant. Obviously, this puts the consultant in a difficult position. Consultants should be sure their scope of work is broad enough to explore all the important ramifications of the issue, which may initially have been narrowly defined by the client. If the consultants' recommendations will make many enemies in the client's firm, then those recommendations probably will not be carried out anyway, and the consultants will get a reputation for giving advice that is not followed.

Another function that consultants may be asked to perform is settling hot controversies within an organization about what ought to be done about something. If the leaders in the group do not agree among themselves, they may hire a reputable outsider to help settle the issue one way or the other. It is clearly in the consultant's interest to understand this situation before he or she makes any recommendations, because whatever the consultant says, it is bound to be attacked by somebody in the firm.

UNDERSTANDING WHAT THE REAL PROBLEM IS,

REGARDLESS OF WHAT THE CLIENT SAYS IT IS

My second principle has always been that the consultant should never assume that the client actually perceives the real problem; often what the client needs is not at all what he or she thinks is needed. This leads to the corollary principle: spend a lot of time trying to discover what the real problem is, regardless of what the client says it is.

One reason these principles are important is that, in relatively rare instances, the client may be the biggest problem involved in the situation. The CEO's personality, management style, or views about the state of the markets, may be both wrong and dysfunctional. That makes it very difficult to tell the client what the problem really is and still survive! In such cases, the consultant must make allies with other influential people in the organization who will support controversial conclusions about possibly dysfunctional individuals in high positions. This means consultants should normally define the scope of their work to include interviewing and getting data from people other than their immediate client contact, so they can discover the broader situation with some independence from the hiring officials.

In all cases, I ask a number of questions about the supposed problem just to be sure it is the real problem, rather than something else. Never take for granted that the CEO or other official who hired you knows the real issue. Doing this takes tact and diplomacy, because the client almost always thinks he or she knows exactly what is the matter or what needs to be done.

ALWAYS TELL THE TRUTH, HOWEVER PAINFUL

Once the consultant has identified the problem, the first and

most vital principle about how to carry out the assignment is: always tell the truth, no matter how unpleasant it may be to the client. In the long run, the consultant's reputation rises or falls on how honest and objective he or she is. This often puts a consultant in hot water, but I strongly believe it is the right way to go. I once told the head of a city planning department orally what my conclusions were from a controversial assignment he had given me. He was so horrified by possible adverse public relations implications that he refused to look at my written report; told me not to show it to anyone else; and urged me to destroy all copies! Yet he did not claim I was wrong, and he paid me without delay.

However, if your conclusions are not what the client wants to hear, show the client a draft of those conclusions before anyone else sees them, and listen to any complaints he or she has about just how you express the truths you have found. I was usually willing to re-phrase something that the client regarded as harmful or disappointing in ways that remained true, but might be less aggravating or challenging. The client deserves a chance to coat the bitter pill with at least a little sugar, if possible, while upholding the truth.

An important corollary of telling the truth is: give the client the best advice you can today, regardless of what you said yesterday, last week, or last year. You may have to state conclusions that seem inconsistent with what you said at some earlier time. That can happen either because conditions change, or because you now see it more clearly, or because you were just wrong in the past. I believe you are morally bound to give the best advice you can right now-that is what you are ultimately being paid for.

Another corollary of telling the truth is never recommend a course of action, or acquiesce in one, that you believe is either illegal, immoral, or just plain wrong. Consultants do not usually decide what will actually be done about something; that is the function of the client's senior management responsible for their own organization's behavior. But consultants do have the obligation to make their recommendations morally correct and financially sound. This principle can get you into really hot water. It cost me plenty to tell Mayor Richard J. Daley of Chicago (the father of the present mayor) that he ought to let me double the assessed values of homes in the ward of his residence. when he did not want to do that. Yet he had hired me to reform the Cook County Assessor's Office, and he told me to do it right. Assessed values in his ward were half of those almost everywhere else. It would have been wrong to ignore that fact. Even so, he never agreed with my doing what I knew was right, and in fact retaliated forcefully by cutting off all further business to my firm-even though the City of Chicago had been our largest client.

Another principle I have always followed is don't leave it up to your client to draw out the implications of important findings you have made-draw them out yourself and put them in plain English the client can clearly understand. If a market study shows there is very little demand for a new shopping center on a given site, do not just quantify the demand there, but point out that the center should not be built there. This was a key factor in American architects' designing many huge and financially disastrous office buildings throughout Asia in the early 1990s. They often knew the structures they were designing could not work economically, but since there was no

new business in the U.S., they went ahead with those projects anyway. I asked several whether they thought they had any moral duty to tell their clients that these projects were bound to fail financially. Most said "No!" I don't agree. It is especially crucial for economic consultants to spell out fully the implications of their findings for the potential success or failure of the projects involved.

In consulting on public policies, it is tempting for consultants to state only factual conclusions and leave the policy implications unstated—especially if they are controversial. I believe that is a disservice to the taxpayers who are paying the bills. On the other hand, if there are good arguments on both sides of some issue, then set forth both sets of arguments—do not just leave that up to other people.

This is related to another principle my father often stated: be definite in your conclusions. He always said, "I may be wrong, but I sure am definite!" People are not paying you to say, "On the one hand this, on the other hand that." They need to know "Which should I do – this or that?" Of course, some situations are inescapably unclear or inherently ambiguous. But it is important for you, the consultant, to give definite advice about what to do, not just set forth the factual issues on all sides of the problem.

HOW MUCH RESEARCH SHOULD THE CONSULTANT DO?

Another principle concerns the extent to which the consultant should go to investigate and analyze a problem. As an economist, I know that gathering and interpreting information is costly in both time and resources. Therefore, I try to estimate the cost of doing each job by balancing two opposite considerations. One is to be sure to have enough resources to reach

credible conclusions. If you are responding to a Request For Proposal, and it does not provide enough resources, do not pursue the job unless you can persuade the client to spend more.

On the other hand, the consultant should not expend more effort than necessary on research and analysis. The proper amount depends upon the possible cost of the client's making a mistake in arriving at a course of action. If a mistake could cost billions, then it is worth spending a lot of money to prevent it. If a mistake is not likely to cost the client or society very much, the consultant can cut off the amount of research much sooner.

This thinking was related to my Ph.D. thesis on political parties, in which I argued that it did not pay most citizens to become very well-informed about election issues. Why? Because the cost to them of *their* voting erroneously—that is, voting for the "wrong" party compared to the one they would have voted for if they had perfect information—was very small. After all, the probability that each citizen's one vote would actually decide the outcome was tiny.

I used to say that I could appraise any property in the world in 10 minutes. From there on out, it was merely a matter of making my appraisal more precise! But it is not worth making one's results more accurate than they need to be to prevent the client from making a big mistake.

How much research a consultant should do also relates to how much the client is willing to pay for the assignment. If the client does not think it is worth spending much to solve a problem, I do not believe the consultant should either—unless the consultant discovers that a really costly mistake might arise from under-investing in research on that problem.

PRESENTING THE RESULTS AND FINDINGS

Some pragmatic principles I tried to follow concern how to present conclusions in the final report. These are as follows:

- Always include an executive summary of the major findings and implications at the beginning of the report. Spend a lot of time writing that section, because it is all that most people will ever read.
- Write in plain English with a minimum of complex or technical terms or jargon, and leave as little ambiguity as possible.
- Give explicit credit in your report to the people who actually did the work—especially concerning what they contributed to the report. Accounting firms sign only their firm names, even though particular partners are responsible for each assignment. But I always signed my own name and also had any major contributors sign theirs. I believe that helps build the reputations of associates, and strengthens their pride in their work.

SHARING YOUR KNOWLEDGE AND CONCLUSIONS WITH THE REST OF SOCIETY

The last principle I will describe is not for everyone, but it has immensely benefited me. It is: try to draw relatively broad social generalizations from the accumulation of detailed specific cases you deal with, so as to improve your own mind and the perspective of society on the field we work in. Real estate consulting exposes its practitioners to a fascinating variety of situations and conditions rich in policy implications. Even though many individual assignments are narrow in scope, considering many of them together as drawn from your own experience provides an

opportunity to see a much broader part of the social and economic landscape. From an early age, I started writing articles and eventually books about conclusions I was able to draw from my varied experiences across the country. My books have hardly been best sellers-they are like most Brookings' books. They lack the sex and violence most Americans like to find in their leisure reading. In fact, most Brookings books are the type that, once you put them down, you just can't pick them up again! My books are similar, judging from their minuscule sales.

Yet the mental exercise of reflecting on daily experiences and correlating details to draw from them some broader conclusions has been both useful and an intellectual joy over the years. It stretches your brain to look beyond the limitations of any one assignment to the possible social and economic implications of many assignments considered together. There are plenty of publications looking for material, so you can likely always get your thoughts published in a magazine, journal, or on the Internet. And forcing yourself to generalize and put it in writing for others to analyze and respond to will sharpen your thinking and broaden your horizons.

Equally important, your ideas may contribute to a social dialogue that can help solve some of the pressing problems our nation faces, especially in urban areas. I hope you feel an obligation to share your knowledge and wisdom with others in ways that could eventually help improve society, as well as expanding your own mental horizons.

CONCLUSION

Real estate consulting is a challenging, often exhausting, and frequently intellectually stimulating occupation. It is full of surprises! The consultant does not usually choose what he or she will work on—those wanting something done choose the consultant! That often leads a consultant into unexpected and unfamiliar arenas requiring fresh thinking and new approaches. Yet, in spite of the variety of assignments that every consultant encounters, adhering to a few basic principles can make the consultant's life easier, more productive, and more rewarding in the long run. I hope the principles set forth above will have those effects upon each reader's experience. RE125

NOTES

- The views in this article are solely those of the author, and not necessarily those of the Brookings Institution, its Trustees, or its other staff members.
- This is an edited version of a speech presented at the Spring 2000 meeting of The Counselors of Real Estate in Toronto, Canada, in June 2000.

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FOCUS ON THE ECONOMY

WATCHING THE TIDES

by Hugh F. Kelly, CRE



A pologists for the high stock market valuations that have so enthused Wall Street point to the huge worldwide capital pool that is keeping the economy buoyant. So long as we avoid a 1930s-style deflation that shrinks the real amount of wealth available for investment, they argue, the stock market has just about nowhere to go but up (little wrinkles and corrections aside). The happy talk is selling books about a possible Dow Jones Industrial Average at 30,000 points, and is the unspoken premise behind programs to set aside some Social Security withholding for personal investment accounts that would "have to" bring better yields than the present imputed returns.

No one seems to be watching either basic demographics or the advice, quite sound on its face, of virtually every fiduciary money manager. As workers by the millions have been shifted from defined benefit pension plans to defined contribution programs like 401(k)s, financial planners have laid out a simple and cogent strategy. Prior to age 55, it makes sense to have most retirement funds invested in common stocks. The objective is simple: seek aggressive capital growth. That's where we've been up to now. In years immediately preceding retirement, start shifting to a portfolio that emphasizes conservation of capital, mostly high-quality bonds. Right now, there are few if any analysts discussing what happens when the baby boomers begin to execute this strategy en masse, through the agency of mutual funds, as they surely will some time in the coming decade. It will be interesting to observe, to say the least.

Real estate is facing something of an analogous situation. As commercial property has climbed the steep slope of recovery from its collapse of a decade ago, investors have ridden a market up, based upon a strategy of capital growth. In this rising market, assets characterized by multiple leases, many of which face nearly certain upward adjustment upon expiration, have been the most sought after. Office buildings, in particular, have attracted the majority of capital. Apartments have been purchased at very aggressive prices, on the expectation that rents will rise sharply without much negative effect upon the occupancy rate of the property. Thus far, the strategy has worked brilliantly, as values have leapt from severe discounts to replacement costs to clear premiums in most markets.

Experience, and the economics of market equilibrium, suggest that this cannot go on indefinitely, though. Most professional real estate observers are still congratulating the industry on its ability to maintain development discipline. But even if construction lenders can keep building reined in over a long period of time, it is probable that the steep upward climb in rents and prices will not persist longer than another year or two. Tenants simply do not have infinitely elastic budgets, for one thing, and we are running out of the raw

material for 1990s-style absorption gains, viz., huge employment, and household increases across the entire market.

This means that shrewd real estate investors will be looking at conservation of capital strategies with increasing interest over the next few years. The quality and durability of the income stream will become of paramount importance. Investors will look less enthusiastically at tenant rolls with lots of near-term expirations, and will seek high-quality, long-term leases as the most sought-after feature in their prospective purchases. Industrial properties could see their market share growing under such as scenario, as will triple-net-leased shopping centers anchored by strong credits. Master-leased office buildings could become a more common feature, especially if lenders can get comfortable with appropriate underwriting standards and the securitized mortgage market can provide secondary liquidity for the collateral. Now that major urban areas, newly baptized as "24-hour cities," have regained credibility, we could even see the return of the long-term ground lease as a low-risk, predictable-return investment vehicle.

As we start to prepare for the year 2001, much attention is likely to be devoted to the immediate cross-currents affecting the markets: shifts in interest rates, the fate of the dot-coms, rent spikes, construction starts, and so forth. The wisest investors will be more concerned with the tidal forces that will be affecting capital for the coming five to 10 years. It won't pay to stick to "business as usual" if that means repeating the investment behaviors that paid off so handsomely during the Nineties.

While the relationship between the capital markets and the fundamental economy is often tricky to puzzle out, commercial real estate professionals need to think through the consequences of the shift from a capital growth to a capital preservation bias in the decade ahead. Absent any external trigger to higher inflation, a flood of capital into the bond markets is likely to have the effect of lowering interest rates, which move inversely to the price of bonds. As this column has noted previously, real interest rates are quite high and have been since 1995. Thinking globally, high real rates have contributed to the strong dollar (and conversely, to the weak yen and euro). If U.S. policy were to seek some reduction in the dollar, let us say to tackle our enormous trade deficit at some time, downward pressure

on rates would be one of the key monetary policy levers.

Real estate counseling is all about choices. The range of choice is influenced in turn by the condition of the property markets as well as the underlying economy that supports all real estate. If the tides of capital flow are turning, so too will the array of options for real estate. Otis Redding, sitting on the dock of the bay, might be proposed to offer our theme song for the early 2000s.

ABOUT OUR FEATURED COLUMNIST

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FOCUS ON LEGAL ISSUES

Using Private REITs for Joint Ventures with Foreign Investors

by Edwin "Brick" Howe, Jr., CRE



In recent years there has been increasing interest in structuring a joint venture between one or more U.S. investors in real estate and one or more foreign investors as a private real estate investment trust, or REIT. (The term "investor," as used below, is equally applicable to a plurality of investors.) This piece will 1). set forth an outline of this structure and its tax implications; 2). describe (as an illustration) a transaction on which I and others in my law firm worked recently that might be described as "the latest thing off the boat" in this sector; and then 3). analyze some variations that may be made on the theme, depending upon the status of the parties to the investment and their respective tax and other requirements.

A RÉIT is a corporation, or a business trust taxable as a corporation, that essentially pays no federal income tax at the REIT level. Rather, the shareholders are taxed on dividends received from the REIT – at the shareholder's ordinary-income rate on dividends corresponding to the REIT's ordinary income or at the shareholder's capital-gain rate on "capital gain dividends" corresponding to the REIT's capital gains. By way of contrast, as a general rule, a corporation is taxed at the corporate level and its dividends are taxed a second time at the shareholder level. Thus, REITs for the most part share the characteristic of "tax transparency" with partnerships and with limited partnerships and limited liability companies not electing to be taxed as corporations.

In years gone by, REITs were subject to numerous, complex, and very burdensome legal requirements, including severe restrictions on management and the rule that they must pay out as dividends at least 95 percent of their REIT taxable income. These were, and are, not applicable to the other tax-transparent entities. Partnerships and limited partnerships were therefore the preferred vehicles for many years for U.S./foreign joint investment in U.S. real estate. (The limited liability company is a form of entity that has received widespread acceptance in just the last few years.)

Since then, Congress and the IRS have lightened up considerably on REITs. The applicable legal requirements are still numerous and complex but they are now just tolerably burdensome. Among the major remaining strictures is that the REIT's gross income must consist, to at least a specified minimum percentage, of income related to real estate (informally called "good REIT income"). In addition, effective January 1, 2001, the minimum dividend payout rate will drop from 95 percent to 90 percent. At the same time, there have been major changes in the international tax field which have boosted the popularity of private REITs.

Until 1980, if a foreign investor's investment in U.S. real estate—directly or through a tax-transparent entity—was properly planned, there would never be

any federal income tax payable, including tax on capital gain realized at the time of sale. In December 1980, Congress enacted the Foreign Investment in Real Property Tax Act, or FIRPTA, making it effective retroactively for some six months. (In the last 20odd years, Congress has become very fond of retroactivity in tax legislation.) FIRPTA introduced a broad-based tax, at rates ranging from 20 percent to 35 percent, on a sale by a foreign investor of U.S. real estate or an interest in a tax-transparent entity or corporation holding U.S. real estate. Capital gain dividends paid by a REIT are also subject to FIRPTA. Section 897(h)(2) of the Internal Revenue Code provides an exemption for dispositions of shares of a domestically-controlled REIT (a "USREIT"), defined as a REIT more than 50 percent by value of the shares of which are owned by U.S. persons; the U.S. investor must, of course, be prepared to make a genuine investment equal to more than half the value of the USREIT. This exemption is *not* applicable to capital gain dividends paid by a USREIT. Section 897(h)(2) is one of the few ways to plan around FIRPTA. Indeed, it may be the only way.

Of course, the foreign investor could sell its USREIT shares to anyone and claim the benefits of section 897(h)(2). But the sale of a minority interest in a USREIT is unlikely to fetch as high a price as the sale of the foreign investor's shares in conjunction with the sale of the USREIT's real estate. In recent years, a technique to achieve the latter result has been developed. The U.S. and foreign investors set up a private USREIT (i.e., a non-publicly-traded USREIT with two or more, but very few, principal investors). In the USREIT's governing documents, the foreign investor is essentially given the right, exercisable before the sale, to put its shares to the principal U.S. investor on the basis of the anticipated sale price of the underlying real estate. The price is payable by a non-recourse note of the U.S. investor that is secured by a pledge back to the foreign investor of the shares sold. The note itself is in effect payable when the real estate closing has taken place.

In the spring of last year, a deal containing a major twist on the structure just described arrived at our office. Our client was a Dutch pension fund. The counter-party was a publicly traded USREIT (the "Investor REIT"). The parties wished to invest a specified amount in a *portfolio* of six to eight properties, to be jointly selected over the ensuing year or two. This presented some interesting new issues.

The following description of our resolution of these issues outlines the basic structure that was adopted but, for the sake of clarity and brevity, it leaves out some of the less consequential details and simplifies others.

The Income Tax Treaty between the U.S. and The Netherlands provides that dividends paid by a U.S. corporation to a Dutch pension fund are generally exempt from U.S. income tax. However, a Protocol to the Treaty withdraws the exemption in the case of capital gain dividends paid by a REIT. Since it is unlikely that the entire portfolio would be sold simultaneously, the gains on sales would result in capital gain dividends taxable to our client if all of the properties were held by a single REIT. The solution was to set up a separate USREIT (a "Venture REIT") for each property and incorporate in its governing documents the put procedure described above. The parties entered into a Framework Agreement which contained their respective capital commitments, the program's investment criteria, etc., and to which were attached forms of the other documents to be used for the investments. Because the Investor REIT has no control over the composition of its shareholdership, it was decided to add to the investor group, with an investment of about 9 percent, another U.S. financial institution in an effort to "insure" the Venture REITs' status as USREITs.

As the portfolio and asset manager of the properties, the Investor REIT was to receive compensation based on performance (called a "promote" in the industry) equal to a percentage of net operating income after all parties had received the return of their investments and a specified return on the investments. The promote was to be portfolio-wide, netting the losers, if any, against the winners. The parties determined that the most efficient way to accomplish this was to insert a Master Limited Partnership, or MLP, between the investors and the Venture REITs. The investors would hold interests in the MLP, which would in turn hold the Venture REITs' shares. The MLP Agreement was to be signed at the same time as the Framework Agreement.

Then, just before the closing of the first investment in late summer, there was introduced in Congress a bill, retroactive—of course—to the preceding July, whereunder REIT status would be denied to any entity owned more than 50 percent as to vote or value by any one person. The term "person" includes the MLP and may also include other

shared-distribution structures, which risk being classified as partnerships for tax purposes. So, as each investment has been funded, the MLP has been bypassed and the investments have been made directly in the shares of the Venture REITs. The parties also signed an additional agreement to put the MLP back into the loop if the proposed legislation dies or to negotiate in good faith the next-best alternative to the MLP if the proposed legislation becomes law.

While the proposed legislation is an unwelcome snag, it is not regarded as a critical hurdle at this time. Because of its residual nature, the promote will not begin to be payable for some years to come. Indeed, the same parties are proceeding with a second, similar investment program, notwithstanding the proposed legislation.

Now, let's look at a couple of variations. There are doubtless many others, but these examples will give you a taste of how small changes in the fact pattern can affect the outcome.

Suppose that the facts of the structure just described stand as they are but that the principal U.S. investor is not a REIT. That would do away with the snag introduced by the proposed legislation. Because of the dire consequences of the Investor REIT's failure to meet the minimum standard for "good REIT income"—loss of REIT status—the Investor REIT wants every possible dime of its receipts to be good REIT income. Income constituting a special distribution on shares of a REIT, whether received directly or through an entity like the MLP, is good REIT income. Fees are not. A U.S. investor other than a REIT, however, could receive the promote in the form of fees paid pro-rata by the Venture REITs, rendering an MLP unnecessary.

Now suppose that the foreign investor is someone other than a Dutch pension fund. It won't have the benefits as to ordinary dividends that our Dutch client has. These will be subject to U.S. income tax at the rate of 30 percent, or lower treaty rate. (The coming reduction in the minimum dividend payout rate from 95 percent to 90 percent may provide at least some relief here.) But it will have the benefit as to gains on sales of USREIT shares provided by section 897(h)(2). To me, that is the elegant part of this structure. Section 897(h)(2) is statutory, available to all who come, not a creature of a tax treaty that is available only to a select few.

NOTE

The foregoing is merely an outline of a potentially useful structure and should not be relied on as legal advice. This is definitely something you should not try at home.

ABOUT OUR FEATURED COLUMNIST

Edwin "Brick" Howe, Jr., CRE, is a lawyer practicing for 35 years in a range of areas, including real estate, business, and international law, taxation, and litigation management. He is currently senior counsel to Howe & Addington LLP, the New York City law firm he founded in 1970. He is also president of The Roseville Company LLC, a consulting firm based in Westport, CT, where he serves on the Town's Land Acquisition Committee and its Architectural Review Board. (Email: ehowe@howeaddington.com or rosevilleco@aol.com)

FOCUS ON RESEARCH

TECHNOLOGY PLAYS A HEAVY MARKET ROLE

by Raymond G. Torto, CRE



Every other word today is technology, or at least that is the way it seems. But although technology is 90 percent of the "buzz," it is a far smaller portion of key measures of economic strength. Nevertheless, the buzz is dramatically affecting markets both stock and real estate.

Some recent calculations by the Federal Reserve Bank of San Francisco show that the tech industry is not as dominant in the economy as it is in the stock market. In terms of balance sheet assets, tech companies controlled 9 percent of total assets in 2000 compared to 6 percent in 1990. In terms of sales or employment the numbers are just as weak. The tech companies account for 7 percent of total employment and 10 percent of sales based on a study of publicly-traded, nonfinancial companies.

On the other hand, when looking at the stock market, tech companies play a heavier role. The San Francisco Fed found that tech stocks made up 36 percent of the market capitalization in March 2000 as compared to only 7 percent 10 years ago. And when it comes to profits, in an independent study, an analyst at Merrill Lynch, estimated that technology companies accounted for 17 percent of the profits of all companies in the S & P's 500 stock index over the last year. Dramatically, these same companies account for 27 percent of the coming year's estimated profit growth.

Bottom line: the tech companies are a small part of the economy, but big players and a heavy influence in the stock market.

TECH AND REAL ESTATE

The same is true today in the office real market. Tech is a small part of the market but big players in today's market measures. This dichotomy is leading us to see record levels of net absorption of space that are not consistent with the underlying fundamentals of office space demand.

More precisely, net absorption in the second quarter was 45 million square feet —a record quarterly level. In fact, the previous record was first quarter 2000 and prior to that it was in fourth quarter 1999. Put another way, the pace over the last three-quarters has been blistering and accelerating! How can this pace of net absorption be explained?

One thesis is that today's office market is reflective of the current boom in venture capital in technology companies. If markets are showing strong absorption without sustainable fundamentals, the explanation is simply "phantom absorption" or maybe we should call it "VC absorption"! Newly formed companies sign leases with letters of credit with the expectation of growing into the space by hiring employees from other firms. Landlords get high rents for short leases and for taking some risk.

Surveys show that in the first quarter of 2000, a record amount of venture

capital (VC) dollars were invested into entrepreneurial endeavors. The number of companies receiving funding was up 94 percent and the average funding per company increased 105 percent. Technology based companies received 93 percent of the total funding. These companies were service companies, application companies and business to business companies, all users of office space.

These companies expect to grow into their space and we would expect that many would fail after an exciting ride. While every VC-financed company needs to rent space, the venture capitalists know that only a few will make it. A year or so from now, we will be watching the sublease market for early signs of this.

Some of the underlying statistics on this phenomenon show that both office and industrial vacancy rates declined significantly in the second quarter of 2000, reflecting an element of "phantom" or "VC" absorption.

Industrial vacancy rates fell by 40 basis points in the second quarter and office vacancy rates fell 90 basis points. The industrial market is at 6.7 percent vacancy and the office market is down to 8 percent from 8.9 percent last quarter. Downtown rates are 6.7 percent and suburban rates are 8.8 percent. Third quarter reports equal second quarter.

Vacancy Rates	2000.2	2000.1	1999.2	
Office Downtown	6.70%	7.30%	8.90%	
Office Suburban	8.80%	9.80%	10.10%	
Industrial	6.70%	7.10%	7.50%	

The office market's results are particularly strong and unexpected.

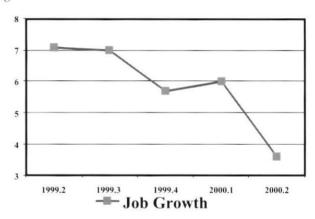
Traditional economic analysis of office real estate markets focuses on the number and growth in office related jobs as the underlying impetus to office net absorption. Historically, the analysis shows that stronger job growth leads to stronger net absorption. However, the basic economic fundamentals today show slowing job growth across the nation.

Overall job growth has been declining since 1998. In that year job growth for those occupations that occupy office space was 5.9 percent. In 1999 the growth rate fell to 5.1 percent and through 2000 to 4.4 percent. These are very healthy growth rates,

compared to total job growth in the economy, but these fundamentals do not support the recent experience with net absorption.

Torto Wheaton Research looked behind the office employment growth rates to identify the growth in dot.com jobs or technical jobs. Here again, we find very healthy growth rates, but rates that are declining over time. Technical job growth was about 7 percent in early 1999 and has declined to under 4 percent on an annualized basis for the second quarter of 2000. The numbers are plotted in *Figure 1*. Of course, it makes perfect sense that job growth is slowing; there is a labor shortage.

Figure 1



There is one other consideration when looking at the relationship between job growth and net absorption. This relationship, research shows, holds strongly except when rents are high and rising.

Generally, when space is expensive, tenants economize and try to use less space per employee. Today's market is just such a period — high and rising rents. So how does one explain a strong and accelerating pace for net absorption when renting is expensive? It is all due to the "buzz!"

Beware of the "buzz." It does not last. REIZS

ABOUT OUR FEATURED COLUMNIST

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Culture Matters: How Values Shape Human Progress

Edited by Lawrence E. Harrison & Samuel P. Huntington Basic Books, © 2000 348 pages



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

RELATED READING RECOMMENDED BY THE REVIEWER

- Dalai Lama Ethics for the New Millennium
- Hans Kung
 A Global Ethic and/or
 Global Responsibility
- United Nations Declaration on Human Rights
- Laura Nash Good Intentions Aside
- IAN MITROFF
 A Spiritual Audit of Corporate
 America
- Max Weber Protestant Ethics and the Spirit of Capitalism
- SAMUEL P. HUNTINGTON
 The Clash of Civilizations and the Remaking of the World Order
- Francis Fukuyama
 Trust: The Social Virtues and the Creation of Prosperity

ulture Matters is a collection of 22 papers concerning the role of culture in human life. The papers were submitted at a symposium, "Cultural Values and Human Progress," which took place at the American Academy of Arts and Sciences in Cambridge, MA, in April 1999. The symposium was sponsored by the Harvard Academy for International and Area Studies. The purpose was to explore the link between culture and political, economic, and social developments.

The presentations focused on five major issues: 1). The link between values and progress; 2). The universality of values and Western "cultural imperialism;" 3). Geography and culture; 4). The relationship between culture and institutions; and 5). Cultural change.

Several papers focus on the work of Max Weber and his seminal book, The Protestant Ethic and The Spirit of Capitalism. Weber's thesis was that Protestantism promoted the rise of modern capitalism because it embraced an ethic of everyday behavior tied to economic success. He further stated that opening up the Bible to the masses greatly enhanced literacy, and the Protestants' preoccupation with time further supported their adaptability to capitalism. Weber stated that religion supported the deep values of society which either hinder or enhance economic growth. Societies which provide opportunities for the rich, which

he termed "pharisaic," are more likely to promote economic growth than those which favor the poor, which he termed "publican."

Economists would argue that good policy can override cultural values. This thesis appears to be readily disproved by the current state of the Russian economy. Anthropologists reject the evaluation of another society's culture on the basis of cultural relativism. Yet others state that secularism, individualism, and science may not be as useful in the 21st century as they have in the 20th. Such institutions as religions, tribes, and cultures persist in their shaping of individual values and desires.

There is a consensus among the papers that attitudes, values, and beliefs shape culture, which in turn shapes human behavior and has a major impact on economic progress. Ethics and values can give a society motivation to forgo instant gratification for long-term goals, including economic growth. Trust and shared values are a precondition for sustained growth. Religion can determine the level of corruption in a society. A society ruled by justice and the rule of law is much more likely to produce sustained growth than one is which does not share such values.

Following Weber's thesis, there are cultures, including our own, where many sincerely believe that technology, economic wealth, and growth are deemed to produce the

best life, the most natural life, and indeed even the seeds of personal salvation. Such a virtuous cycle should indeed provide the preconditions to support economic growth, but it is also the source for Third World antagonism and provokes the obvious reaction from "publican" religions. In recent years many groups, (including those organized by the Dalai Lama, Hans Kung, the United Nations, and various business institutions), have come together to attempt to frame a positive global ethic which would provide a moral value system for economic growth.

One of the papers lists 10 values which distinguish cultures that foster economic growth. They are:

- 1. An orientation on the future as against the present or past;
- 2. A positive attitude toward work as against work as a burden;
- 3. A propensity to save and invest as against income equality;
- 4. Mass availability of education, as against education for the elite;
- Fairness in advancement as against cronyism and connections;
- Trust in a broad range of extended communities as against trust primarily in the family;
- A strong ethical code and a relative absence of corruption, without resorting to sanctions;
- Justice and fair play as against who you know and how much you pay off;
- Dispersed authority and broad empowerment as against hierarchy and command and control systems; and
- 10. Religion as essentially a private matter allowing for plurality and dissent as against orthodoxy and conformity.

Two opposing world views emerge from these papers. The first,

that of Francis Fukuyama, is that the West will come to dominate world culture, through economic power, military might, the globalization of money and capital markets, the English language, the Internet, telecommunications, and the force of Western cultural exports. The countervailing argument is that of Samuel Huntington, which is that Western economic imperialism will cause other cultures to revert to their traditional distinctiveness. The West is unique, but not universal. Other civilizations need not be like us to be modern. Such reversion to traditional values may cause increased global strife, terrorism, and the like.

A more moderate view is that cultural differences and unique and distinctive products and services should be celebrated. Economic growth is heavily influenced by values and religions; but perhaps more important are such factors as geography, history, and the development of institutions. We may end up with strong global markets and institutions heavily shaped by the Judeo-Christian, Western, Protestant ethic and a plurality of local markets and institutions, separate and diverse, retaining a unique sense of identity and a desire for enhanced wealth. Such a third way might be termed universalism without uniformity, allowing for pluralism, where culture can continue to override consumption.

In a world that is growing increasingly global and complex, peopled by those of diverse religions and cultural values, how do we come together? We can come together in our consumerism or in our desire to be entertained, but these are connections at only the superficial, surface level. To come together at our level of deepest meaning, we must have

an understanding of the deep beliefs which we share, and the deep beliefs which divide us. Perhaps the most important challenge of the 21st century is what use we make of our religious beliefs, and whether, ultimately, they bind us together or divide us in an unceasing struggle. REI

ABOUT OUR REVIEWER

Bowen H. "Buzz" McCoy, CRE, is past president of The Counselors of Real Estate. In addition to professional activities, he teaches business ethics at graduate business schools. He also teaches adult education classes in Christian theology and ethics in local churches and at the Graduate Theological Union at Berkeley, California.

NOTE: For those who find the issues raised in *Culture Matters* to be of interest, they will form a significant portion of the presentations and discussion at The Counselors' 2001 High Level Conference: *Business, Ethics, and Religion: Making the Reconnection,* February 8-11, 2001, Ventana Resort, Tucson, AZ. Visit www.cre.org for more information.



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- 1). Manuscripts must be submitted on disk (along with hard copy) in IBM or PC format only--Mac files cannot be accommodated: .txt (text) file format or Word for Windows 6.0. All submitted materials, including abstract, text and notes, are to be double-spaced. Number of manuscript pages is not to exceed 25 single-sided sheets (approx. 7,000 words). Submit five copies of the manuscript, a 50- to 100-word abstract* and a brief biographical statement. Computer-created charts/tables should be in separate files from article text. (* An abstract is a brief synopsis. If the manuscript is accepted for publication, the abstract would appear on the table of contents page.)
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