REAL ESTATE ISSUES®

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FALL 2001
Volume 26, Number Three

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(deadline for manuscript submission - December 3, 2001)

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Articles on general real estate-related topics
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Articles on general real estate-related topics
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The Counselors of Real Estate dedicates
this edition of REAL ESTATE ISSUES to

the victims of the September 11 tragedy,
many of whom were colleagues, co-workers, friends

★ ★ ★

We are saddened by the enormous loss of human life & potential
as well as the devastation to our national landscape.

Our thoughts are with the families &
associates of those deceased or missing.

Members of The Counselors of Real Estate Consulting Corps are available to assist in the real estate needs of those displaced by the September 11 tragedy. For more information on this pro bono service, contact Executive Vice President Mary Fleischmann at 312.329.8428; mwf@interaccess.com.

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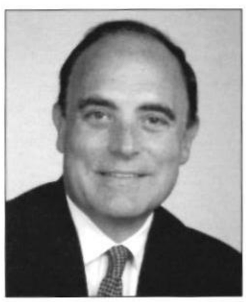
EDITOR'S STATEMENT - by Richard Marchitelli, CRE

On September 11 a cowardly yet barbaric and savage attack was launched against civilization. It was an assault on a value system that cherishes democracy, personal freedoms, tolerance of diversity, and the opportunity to participate in economic prosperity. This issue of REI is dedicated to those who perished that day—the wives and husbands, mothers and fathers, sons and daughters, friends and colleagues—innocent all. Their loss will always be remembered.

As we attempt to deal with grief and horror in deeply personal ways, we also recognize the need to return to normalcy. For those of us in the real estate industry, the first step in "getting back to business" is to assess the effects of the attack on the national psyche, the economy, the property markets, attitudes concerning building use and design, and where people choose to live and work. In recognition of the importance of these issues, the format of this edition of REI has been changed. The *Insider's Perspectives* department has been moved to the front because of the timeliness of those columns. The lead article is one that was recently published by Insignia/ESG, Inc., "Special Report: Focus on the NYC Office Markets, The Impact of the September 11th Tragedy."

Our daily lives have been altered profoundly since that sunny morning. Grief, anxiety, and concern for personal safety have replaced the generally good feelings of the past decade. We have also developed a better appreciation of those things that are truly important. While it is not for REI to interpret motivations of senseless acts of savagery, we hope to develop a better understanding of how such barbarism will influence real estate use at the beginning of the 21st century and how our lives have changed, perhaps forever.



Richard Marchitelli, CRE
Editor in chief

David Kirk, CRE
2001 National CRE President

FOCUS ON NYC OFFICE MARKETS

THE IMPACT OF THE SEPTEMBER 11TH TRAGEDY

by Insignia/ESG, Inc.

KEY TOPICS

- The entire World Trade Center complex—13.4 million square feet—was destroyed. Devastating as it was, it constituted less than 4 percent of Manhattan's office inventory.
- Nearly 1,300 Downtown businesses were directly affected by the terrorist attack.
- Although 28.7 million sq. ft. of office space incurred at least some damage, 70 percent of Downtown survived intact.
- Thirty-one tenants occupying 100,000 sq. ft. or more were displaced by the disaster. Four of them occupied 1 million sq. ft. or more.
- The real estate community has rallied together in the sharing of available listings, and most landlords have been holding their rental rates at pre-disaster levels.

September 11, 2001, will go down as one of the darkest days in our nation's history. The authors join the rest of our nation in mourning the horror of that day and the profound loss of so many lives.

As the terrible events of September 11 were unfolding, we were issuing our regular monthly reports on the status of Manhattan's Midtown, Midtown South, and Downtown office leasing markets. The destruction to Downtown has made the September reports meaningless.

Instead, this is a special report to assist in understanding the impact on the office markets—to measure not only the destruction that took place, but also the activity that has been unleashed. The healing process has begun. Companies realize that they must rebuild infrastructure so their employees can return to work and they can get back to the business of business.

In the days since the World Trade Center disaster, a team of Insignia/ESG brokers, consultants, and research professionals has conducted extensive research to determine what buildings have been affected; the extent of the damage; the tenants that have been displaced; the amount of replacement space they're seeking; and the space available to them.

This firm has honored the request issued on September 18 by the Real Estate Board of New York, calling on commercial landlords to make deals at the market conditions prevailing before September 11 and urging brokers to waive their usual commissions when helping tenants find temporary six- to 12-month leases.

We, like many other leading members of the New York real estate community, are proud to be part of the united response to this great tragedy. And we remain committed to doing our part to help heal and rebuild the Downtown Manhattan business community, and to restore the spirit of our great city and great nation.

Market Conditions Before The Attack

On September 1, 2001—10 days before the terrorist attack on the World Trade Center—the New York City office markets were healthy, although experiencing a slowdown following the collapse of the dot.com phenomenon and the flattening of the national economy. Office leasing in the greater New York area had, for the most part, returned to the more "normal" levels of the late 1990s. Availability had been rising from its extreme lows of the previous year. The optimism of late 1999 and 2000 met the reality of the slowing economy. The result was seven million square feet of sublease space added to the market.

With a total office inventory of 353.7 million square feet, Manhattan's unrivaled size, importance and diversity is the envy of most U.S. markets.

Nearly three times the size of the second-largest U.S. central business district—and larger than downtown Chicago, Washington, Houston, Los Angeles and Boston combined—New York is a leading international capital of finance, trade, publishing, education, fashion, and entertainment. With more famous landmarks than any other city in the world, it is the destination of choice for visitors from every corner of the world.

At the beginning of September, despite indications that the office market was cooling, Manhattan's overall availability rate was just above 7 percent—a rate considered to be below an equilibrium level. Of the 25.8 million sq. ft. of available space, 16.3 million sq. ft. was direct space and 9.5 million sq. ft. was sublease space.

Midtown, Manhattan's largest office market with a total inventory of 184.9 million sq. ft., had available 8.7 million sq. ft. of direct space and 4.3 million sq. ft. of sublease space, for an availability rate of 7 percent. Midtown South, Manhattan's smallest market with a total inventory of 71.7 million sq. ft., had available 4.1 million sq. ft. of direct space and 2.7 million sq. ft. of sublease space, for an availability rate of 9.5 percent.

Downtown Manhattan—a market that had been all but written off in the early 1990s—had been staging a remarkable comeback in the past few years. With a total office inventory of 97.1 million sq. ft., its availability rate was just 6.2 percent. This is the first time in more than five years that the Downtown availability rate was lower than Midtown. Available supply included 3.5 million sq. ft. of direct space and 2.5 million sq. ft. of sublease space.

Large contiguous blocks of office space were in short supply throughout Manhattan. All told, there were a

MANHATTAN — As of 9/1/01

Submarket	Total Inventory	Availability Rate	Direct Space Available	Sublease Space Available	Total Space Available
Midtown	184.9 mil. sq. ft.	7.0%	8.7 mil. sq. ft.	4.3 mil. sq. ft.	13.0 mil. sq. ft.
Midtown South	71.7 mil. sq. ft.	9.5%	4.1 mil. sq. ft.	2.7 mil. sq. ft.	6.8 mil. sq. ft.
Downtown	97.1 mil. sq. ft.	6.2%	3.5 mil. sq. ft.	2.5 mil. sq. ft.	6.0 mil. sq. ft.

SUBURBAN MARKETS — As of 9/1/01

Submarket	Total Inventory	Availability Rate	Direct Space Available	Sublease Space Available	Total Space Available
No./Central NJ	154.1 mil. sq. ft.	14.7%	18.8 mil. sq. ft.	3.4 mil. sq. ft.	22.2 mil. sq. ft.
Westchester	33.2 mil. sq. ft.	14.2%	3.9 mil. sq. ft.	871,600 sq. ft.	4.7 mil. sq. ft.
Fairfield County	44.1 mil. sq. ft.	12.7%	4.1 mil. sq. ft.	1.47 mil. sq. ft.	5.6 mil. sq. ft.
Long Island	36.0 mil.sq. ft.	11.0%	3.2 mil. sq. ft.	732,000 sq. ft.	4.0 mil. sq. ft.

BUILDINGS IMPACTED BY THE WORLD TRADE CENTER ATTACK

Address	Square Footage	Year Built	Anticipated Time Until Occupancy
DESTROYED BUILDINGS			
1 World Trade Center	4,761,416 sq. ft.	1970	N/A
2 World Trade Center	4,761,416 sq. ft.	1972	N/A
4 World Trade Center	583,684 sq. ft.	1977	N/A
5 World Trade Center	783,520 sq. ft.	1972	N/A
6 World Trade Center	537,694 sq. ft.	1975	N/A
7 World Trade Center	2,000,000 sq. ft.	1987	N/A
Subtotal	13,427,730 sq. ft.		
SEVERELY DAMAGED -- LIKELY DEMOLITION			
90 West Street	335,000 sq. ft.	1905	N/A
Subtotal	335,000 sq. ft.		
STRUCTURALLY DAMAGED -- TO BE REPAIRED			
3 World Financial Center	2,300,000 sq. ft.	1984	6 months
140 West Street	1,171,540 sq. ft.	1927	6 months
130 Liberty Plaza (Bankers Trust Plaza)	1,415,086 sq. ft.	1974	9 months
Subtotal	4,886,626 sq. ft.		
WINDOW & FACADE DAMAGE -- TO BE REPAIRED			
1 Liberty Plaza	2,124,447 sq. ft.	1973	2 months
2 World Financial Center	2,591,244 sq. ft.	1987	2 months
1 World Financial Center	1,461,365 sq. ft.	1986	2 months
101 Barclay (BONY)	1,226,000 sq. ft.	1984	3 months
90 Church Street	950,000 sq. ft.	1935	2 months
100 Church Street	1,032,539 sq. ft.	1958	2 months
22 Cortlandt Street	668,110 sq. ft.	1971	2 months
Subtotal	10,053,705 sq. ft.		
TOTAL	**28,703,061 sq. ft.**		

Major Tenants in World Trade Center Complex

Permanently Displaced Tenant	Affected Building	Total Square Footage
Salomon Smith Barney	7 World Trade Center	1,420,780 sq. ft.
Morgan Stanley Dean Witter & Company	2 World Trade Center	1,334,051 sq. ft.
	5 World Trade Center	
Port Authority of New York & New Jersey	1 World Trade Center	775,577 sq. ft.
Marsh & McLennan Companies, Inc./	1 World Trade Center	601,043 sq. ft.
Guy Carpenter & Company, Inc. (Marsh)	2 World Trade Center	
U.S. Customs	6 World Trade Center	537,694 sq. ft.
Empire Blue Cross Blue Shield	1 World Trade Center	450,820 sq. ft.
AON Risk Services Companies, Inc.	2 World Trade Center	391,645 sq. ft.
Deutsche Bank	4 World Trade Center	260,991 sq. ft.
Commodities Exchange Center	4 World Trade Center	250,120 sq. ft.
Brown & Wood/Sidley & Austin	1 World Trade Center	220,000 sq. ft.
Cantor Fitzgerald Securities Corporation	1 World Trade Center	215,278 sq. ft.
Fiduciary Trust Company International	2 World Trade Center	207,146 sq. ft.
Insurance Services Office, Inc.	7 World Trade Center	207,029 sq. ft.
Credit Suisse First Boston	5 World Trade Center	202,134 sq. ft.
Verizon Communications	2 World Trade Center	200,000 sq. ft.
Lehman Brothers Holdings Inc.	1 World Trade Center	183,738 sq. ft.

Major Tenants in Structurally Damaged Buildings

Temporarily Displaced Tenant	Affected Building	Total Square Footage
Verizon	140 West Street	1,171,000 sq. ft.
American Express Company	3 World Financial Center	1,120,500 sq. ft.
Lehman Brothers Holdings Inc.	3 World Financial Center	1,030,860 sq. ft.
Deutsche Bank	130 Liberty Street	910,000 sq. ft.
Morgan Stanley Dean Witter & Company	130 Liberty Street	67,000 sq. ft.

Deals Consummated -- Tenants with 100,000+ Requirement

Tenant	Square Footage	Location
American Express Company	311,000 sq. ft.	5 Woodhollow Road (Lucent), Parsippany, NJ
American Express Company	195,000 sq. ft.	101 JFK Parkway, Shorthills, NJ
American Express Company	175,000 sq. ft.	400 Atlantic Street, Stamford, CT
Lehman Brothers Holdings Inc.	175,000 sq. ft.	70 Hudson (Datek), Jersey City, NJ
Bank of New York	150,000 sq. ft.	330 West 34th Street, New York
Hartford Fire Insurance Co.	145,000 sq. ft.	2 Park Avenue, New York, NJ
U.S. Customs	118,000 sq. ft.	1 Penn Plaza, New York, NY
Thacher, Profitt & Wood	100,000 sq. ft.	11 West 42nd Street, New York, NY
Zurich-American Insurance Group	95,000 sq. ft.	601 West 26th Street, New York, NY
Bank of New York	79,000 sq. ft.	111 Eighth Avenue, New York

total of 28 available units (units which could be delivered to tenants within one year) with 100,000 to 250,000 sq. ft. of space, and only four available units in excess of 250,000 sq. ft. Downtown had three available units between 100,000 and 250,000 sq. ft. and only one larger than 250,000 sq. ft.

In New York's suburban markets, an additional 36.5 million sq. ft. was available—30 million sq. ft. of direct space and 6.5 million sq. ft. of sublease space. The large majority, 22.2 million sq. ft. or 61 percent of available suburban space, was in Northern and Central New Jersey. Fairfield County, CT, had 5.6 million sq. ft. available, followed by 4.7 million sq. ft. in Westchester County and 4.0 million sq. ft. in Long Island. Availability rates in the suburban markets ranged from 11 percent in Long Island to 15 percent in Northern and Central New Jersey. Fairfield County had an availability rate of 12.7 percent and Westchester County an availability rate of 14.2 percent.

Market Conditions After The Attack

As of Friday, September 21, it had been determined that only 4 percent (13.4 million sq. ft.) of the Manhattan inventory was destroyed. All of the rest of the Downtown buildings affected have some damage and can be repaired.

Three buildings comprising 4.8 million sq. ft. have suffered structural damage, but can be repaired. These buildings are 3 World Financial Center, 140 West Street, and 130 Liberty Plaza (Bankers Trust Plaza). Repair time has been estimated at nine months. An additional seven buildings comprising 10.1 million sq. ft. have some damage, and it is estimated that it will take two to three months before they are habitable. These include 1 and 2 World Financial Center; 1 Liberty Plaza; 101 Barclay Street; 90 and 100 Church Street; and 22 Cortlandt Street. Another building, 4 World Financial Center, is habitable but inaccessible at present because of debris and the collapse of the north pedestrian bridge.

Almost 1,300 businesses in the area were affected by the attack. Thirty-one tenants occupying 100,000 sq. ft. or more were displaced to varying degrees by the disaster. The largest displacements included American Express (1.2 million sq. ft.); Merrill Lynch (3.1 million sq. ft.); Morgan Stanley Dean Witter (1.4 million sq. ft.); Salomon Smith Barney (1.4 million sq. ft.); and Bank of New York (800,000 sq. ft.).

While only a portion of Manhattan's 25.8 million sq. ft. of available space was built out, and much was not scheduled to come on line until later in the year, displaced tenants have still been able to find space to meet their immediate needs. Only a handful have gone outside of Manhattan, with the Jersey City/Hoboken waterfront, Northern and Central New Jersey, and Stamford, CT, garnering the most interest. Large blocks of built-out space are also available in markets as far afield as Poughkeepsie and Albany, NY, and Wilmington, DE, however few tenants are expected to take space this far from Manhattan.

As of the end of September, 10 World Trade Center area tenants have consummated leases totaling in excess of 1.5 million sq. ft. Our sources indicate an additional 3.5 million sq. ft. of leases are pending. Most of the major landlords and property agents in New York have held their rental rates at levels that were quoted prior to September 11.

Looking Ahead

Images of the attack on the World Trade Center have been seared indelibly into the mind of every New Yorker as well as into the minds of people worldwide watching the devastation on television. Truly, a major void has been created in the world's most recognizable skyline. The healing and re-building process, however, can be expected to move forward with dispatch. Before January 1, 2002, we believe that dispossessed tenants will have returned to the buildings that sustained window and facade damage, and significant progress will have been made in repairing the three most severely damaged buildings—3 World Financial Center, 140 West Street, and 130 Liberty Plaza. Downtown Manhattan will be a smaller office district, albeit one of the largest in the country, with aggregate office space in excess of 80 million sq. ft., at least 75 million of which will be occupied by long-term tenants.

Downtown Manhattan will continue to hold strong appeal as a place to do business, particularly for companies that want proximity to such bedrock's of the nation's financial system as the New York Stock Exchange and the Federal Reserve Bank. What's more, the lower Manhattan corridor will continue to be a low-cost alternative for tenants from a wide range of industries that are seeking relief from the pricey rents in Midtown. The market's performance in 2002, however, will hinge on a restoration of investor confidence in U.S. equity markets as well as a resumption of material growth in the national economy. REI

For more information regarding this report, contact Elyse Listick, managing director Insignia/ESG, Inc.
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FOCUS ON THE ECONOMY

THE POST-ATTACK ECONOMY: AN OUTLOOK ACROSS AMERICA

by Hugh F. Kelly, CRE

Literally, before the dust settled following the collapse of the World Trade Center from the terrorist attack of September 11, 2001, and throughout the month thereafter as the fires still burned at Ground Zero, economists have been attempting to analyze the immediate effects of the catastrophe and to estimate its implications for the future. By September 14, Bank of America's Chief Economist Mickey Levy had completed an economic brief, preparing clients for a mild recession with unemployment peaking at 5.5 percent near the end of this year. Economy.com prepared a preliminary analysis by September 17, and its CEO, Mark Zandi, offered some refinements at a Property and Portfolio Research client conference in Boston on September 20—21. Updates to the forecast were issued, for a while almost on a daily basis. On September 21, Bank One issued its economic interpretation, as did Morgan Stanley three days later. Their senior economists, Diane Swonk and Richard Berner, helped lead a September 28 conference call for members of the National Association of Business Economists. The initial consensus seems to center on a recessionary episode lasting perhaps into the spring of 2002, with Federal fiscal and monetary stimulus jump-starting a recovery that could see real GDP growth in the 3.5 percent to 5.5 percent range by the final quarter of 2002.

Macroeconomic trends such as the national growth rate, the movement of interest rates, patterns of job change measured by employment and unemployment, income, and consumer spending, all are important factors considered by real estate professionals. But since real estate quintessentially remains a local commodity, it is the array of economic impacts across the geographic reach of the U.S. that most significantly affects choices and decision-making in our industry. Over the years, analytical tools to assess such impacts have been developing and may help us to unpack the likely exposure of metropolitan areas to shifts on the demand side of the real estate equation.

More than a decade ago, researchers at Prudential Real Estate Investors, led by Charles Wurtzebach, proposed what they termed "the portfolio construction process." Their work offered a model they called "the Economic Location Matrix," which arrayed cities by two characteristics: the structure of the local economy, and its long-term growth trend. Over the past 10 or 12 years, I have extended and modified that research for institutional equity and debt investors, and for developer clients. This extended work has taken the initial concept and analyzed the local economic structure in finer levels of detail, and has shifted the focus from long-term trend lines toward the exposure of the MSAs to economic cycles. This is especially pertinent now, as the economy suddenly downshifts into a post-9/11/01 recession.

Exhibit 1 shows where 58 of the country's more than 300 MSAs are situated in these basic economic terms. The 58 selected urban areas include

Exhibit 1

Economic Location Matrix

	Boom/ Bust	Moderately Volatile	Avg. Cycle – High Growth	Avg. Cycle – Low Growth	Stable
Diversified		Los Angeles	Kansas City Indianapolis Middlesex Minneapolis	Chicago	Columbus Philadelphia St. Louis
Capital Goods Production	Seattle Detroit	Toledo	Ft. Worth	Cleveland Milwaukee Stamford Newark	Pittsburgh
Consumer Goods Production	Tacoma	Riverside	Cincinnati	Long Island Bergen, NJ	
Transportation & Trade	Laredo TX		Jacksonville		Oakland
Tourism & Entertainment	Las Vegas	Orlando	Reno		
Finance & Business Services	Tampa	Dallas Atlanta Boston Charlotte Denver Miami	Salt Lake	New York	S. Francisco
Government Administration & Education	Charlotteville,VA	Washington	Sacramento	Baltimore	Madison, WI
Military & Defense			Killeen, TX	New London	San Antonio
High Technology	Phoenix Austin Orange Co. San Jose	San Diego Portland	Albuquerque		
Energy	Houston	Baton Rouge	Bakersfield	New Orleans	

all 40 of the nation's largest MSAs, plus several (such as Las Vegas, New Orleans, Jacksonville, and Orlando) with claims on real estate industry attention beyond their relative city sizes. Finally, a number of smaller areas (*e.g.*, Bakersfield, Killeen, Tacoma, and Reno) are displayed to illustrate cells in the matrix not populated by the larger metro areas. Where cells (the boxes in the *Exhibit*) are empty, that means that *none* of the MSAs in the country fall into the statistical groupings defining the matrix. This illustrates some important relationships. For instance, there are no diversified or military/defense-based economies in the boom/bust category. Neither are there any stable economies with a high-technology or energy-based economic structure.

Understanding the structure of the local economic base and the historical propensity to swing to

Exhibit 2

RECESSION PROFILE	REPRESENTATIVE CITIES
Standard (S)	Chicago, Seattle, Ft. Lauderdale, San Antonio, Cleveland
Minimal (M)	Atlanta, Suburban New York area, Los Angeles, Dallas, Denver, Washington, DC
V-Recession (V)	Boston, Charlotte, Houston, Las Vegas, Oakland, Orlando, Phoenix, San Diego, San Francisco, San Jose
U-Recession (U)	New York City, Miami, Detroit, Kansas City, Philadelphia, St. Louis
Lagging Recovery (L)	Hartford, New Orleans, Oklahoma City

a greater or lesser degree in response to macroeconomic cycles is an important aid in assessing demand risk in the present circumstances. Still, every recession has its own fingerprints, and therefore, the *Economic Location Matrix* is not a mechanical tool to be blindly applied. Thus, in looking at the outlook for the 2002 – 2004 period, I have overlaid factors of particular immediate concern in evaluating the forecasts. Such factors include the relative exposure of each MSA to the global economic slowdown that began in 1998; the already existing trends in place as a result of the bursting of the NASDAQ bubble; and truly local effects, such as the dispersal of downtown Manhattan tenants into neighboring markets such as Long Island, New Jersey, and Connecticut.

It appears to me that the "shape" of the local outlooks can be described as following one of five basic patterns. Those scenarios are termed "Recessionary Profiles," and are coded by letter: **S** for a standard MSA that is expected to mirror national trends; **M** for an MSA that is expected to have a "minimal" response to the recession, outperforming the U.S. trends; **V** for a local economy expected to have an immediate and steep contraction into 2002, with a sharp rebound in 2003 and good growth prospects in 2004 (a so-called "V-shaped recession"); **U** indicating a more lasting contraction, where the local economy does not recover to its 2001 level of employment until 2004 (which the economists are terming a "U-shaped cyclical contraction"); and **L** representing a sharp dip in employment in 2002, and a failure to return to 2001 employment levels in the three-year forecast horizon. Salt Lake City is the only exception to these scenarios, as the 2002 Olympic Games introduce unique local influences into this MSA's forecast. *Exhibit 2* lists some representative cities for each outlook.

As might be expected, many of the boom/bust and moderately volatile local economies are anticipated to have ***V-shaped*** cycles, with a steep drop and sharp rebounds. These include travel and tourism cities like Las Vegas and Orlando and high-tech localities including Austin, San Jose, San Diego, and Portland. Boston, which appears to be holding up fairly well so far, has some short-term exposure because of its financial industry cluster, as do Charlotte and Tampa. But even a few economies that have had less-than-average exposure to U.S. cycles in the past 20 years are at risk in 2002. San Francisco and the Oakland-East Bay areas, the beneficiaries of the 1990's boom, now face contractions beyond the bounds for which immediate historical experience has prepared them.

New York City faces a ***U-shaped*** recession, and will suffer the loss of more than 100,000 office jobs and perhaps as many jobs lost in the retail, hotel, air transportation, and certain blue collar sectors. This will, however, be balanced somewhat by full employment in the construction trades as infrastructure repair goes forward and damaged buildings in the vicinity of the World Trade Center are prepared to go back into service. MSAs with significant import/export exposure or ties to manufacturing industries will also see ***U-shaped*** cycles, cities including Detroit, St. Louis, Kansas City, and Miami.

Suburban areas surrounding New York, however, have minimal exposure to the national recession, though they must be wary of a downdraft if corporate decisions prompt an exodus of companies from the larger metropolitan region to other parts of the country. That does not appear probable at this juncture. More likely, New Jersey, Long Island, and southwestern Connecticut will benefit from large firms such as Merrill Lynch and American Express moving operations into available office space where rents are substantially below Manhattan standards. Some of those moves will prove permanent additions to the economic base structure of Newark, Middlesex, Nassau-Suffolk, and Stamford. Likewise, I expect Orange County, CA, sunbelt markets like Dallas and Atlanta, and government-based economies like Washington, DC, and Sacramento, to have minimal effects (or ***M-recessions***).

One might think that the default scenario would be the ***S-recession***, in which the local area is expected to follow the pattern of the nation in its slowdown and eventual recovery. But actually the "national average" is just that, and reflects the range of local economic experiences. Local economies "summing up" produce the national profile much more than U.S. trends "trickling down." Nevertheless several MSAs, especially in the Midwest, are anticipated to mirror nationwide trends: these include Chicago, Indianapolis, Cleveland, and Pittsburgh. Seattle works out to an ***S-recession*** outlook as well, because the Boeing manufacturing effect (a negative) is offset by Microsoft and related technology companies rebounding within the forecast horizon.

The most dire outlooks are the ***L-shaped*** outlooks for Hartford, New Orleans, and Oklahoma City. These were in fragile shape prior to September 11, and will find it difficult to re-establish their momentum before mid-decade. Hartford's insurance exposure has yet to be fully quantified, but the news for the property-casualty end of that business can't be considered good at the present time. New Orleans, with a combination of energy, trade, and tourism in its economic base, faces a triple-whammy in this recession. And Oklahoma City, still struggling with the aftereffects of its own terrorism experience (of the domestic variety, let us remember), has no growth trigger that I can identify that would haul it into recovery until a real robust national economic expansion comes along.

Real estate professionals will naturally be keeping up with the basic economic data flowing on a near daily basis from the federal government and from key industry groups. But we need to filter this information through the screens of our local markets. From the demand side, I have found analytical tools like the *Economic Location Matrix* extremely helpful in measuring distributed effects and in sorting the range of probable consequences. At minimum, it helps me and my clients think through the circumstances and sharpens our sense of the probabilities and the choices available in the real estate decision-making process.REI

ABOUT OUR FEATURED COLUMNIST

Hugh F. Kelly, CRE, *is the principal of an independent counseling practice, specializing in applied real estate economics for clients with domestic and international commercial property interests. Kelly is based in Brooklyn, NY, and is well-known as a writer and public speaker. Formerly, he was chief economist for Landauer Realty Group and author of the Landauer* Forecast *from 1986 to 2000. Kelly was a 2000 national vice president of The Counselors of Real Estate, chair of its New York Metropolitan Chapter in 1999 and 2000, and editor in chief of "The Counselor" newsletter from 1997-1999. (E-mail: hughkelly@hotmail.com)*

FOCUS ON INVESTMENT CONDITIONS

PRINCIPLES OF RATIONAL INVESTING STILL APPLY

by Kenneth P. Riggs, Jr., CRE

As America regroups after the September 11 attack on the World Trade Center and the Pentagon, investors are watching how terrorism and its aftereffects will play out in an economy that was already stagnant. As we go to press, we're seeing reports of huge layoffs in the airline industry, in the auto industry, in durable goods manufacturing, and in hotels and restaurants. Gross domestic product growth, which had declined last quarter, seems likely to decline further. A recession, which was only speculative previously, now seems certain.

Given such an economic situation, many investment opportunities appear grim. The stock market continues its roller coaster ride with insurance companies, the airline industry, hotels, and other travel/tourism industry holdings now joining tech stocks at the bottom of the hill. Mutual funds, 401k and 403b funds, IRAs, and other favored investment vehicles, which had finally begun to stabilize earlier this year, are expected to lose ground. Even bond funds, considered less risky than stocks or other funds, are troubled.

This is the backdrop in which commercial real estate competes for investors. The spatial (supply/demand) fundamentals will be negatively impacted by recent economic events; however, commercial real estate capital players should view this as a long-run opportunity to seek a stable environment by investing in well-leased, well-positioned commercial properties. Regrettably, the commercial property types that will feel the full impact of recent events will be hotel and retail properties.

Temporarily, there was some doubt about the riskiness of commercial real estate investment in such an environment, too. Immediately after the September 11 attacks, some of the bigger real estate investment deals were being delayed, although many of these are now going forward. In fact, reports from federal bank regulators now say that few such loan requests are being turned down, and that money is available to investors with a rational business plan, appropriate collateral, and a good track record.

This is good news for investors because it seems that "rational property-level analysis," which we have always recommended over the "bounded rationality" influenced by emotional factors (like fear), is still the key to sound investment. By focusing on the empirical data associated with a property and objectively evaluating a region's economic condition and outlook (due diligence), investors are more likely to be able to reduce emotional influences (such as fear) in their decision-making.

Comparing the economy leading up to the Persian Gulf War 11 years ago with the one we are experiencing now, can also provide insight into the climate for real estate investment in the months ahead. For example, the consumer confidence index in January 1991 dropped to half of what it was in August 1990.

Likewise, in September 2001, consumer confidence and spending, which comprises two-thirds of the American economy, fell to 97.6 from 114.0 in August 2001, the largest single monthly drop since the Persian Gulf War. Given the likelihood that economic growth will continue to decline, we believe that consumer confidence and spending will drop further as long as unemployment or fear of unemployment exists, thus negatively affecting retail throughout the holiday season.

As reported in the second quarter 2001 *RERC Real Estate Report*, the consequence of slower growth in an economy results in unemployment, and as people lose jobs or fear losing jobs, growth for commercial properties slows as well. An increase in unemployment, spurred on by the events of September 11, indicates that demand for commercial properties may decline quicker, especially in regions with a high concentration of unemployment. Even apartments are not immune. Looking back to 1990, apartments were in equilibrium with both vacancy and absorption rates around 6 percent. Apartment absorption fell to 4 percent in 1991, however, after the U.S. became more heavily involved in the Persian Gulf War. If history repeats itself, apartment absorption and return on investment will decline during the current downturn as well (except for apartment developers in regions with a high employment in growth industries such as energy or defense).

The willingness of the federal government to take a proactive stance in strengthening our economy is also expected to help alleviate the fear investors are feeling. Appropriating billions of dollars to help bail out the airlines and rebuild Manhattan; floating money to the banking system immediately after the tragedy; relaxing laws so companies can buy back their own stock; and taking on the responsibility for airline safety are just a few of the measures already underway. The Federal Reserve is doing its part to lift the economy as well, by reducing interest rates nine times already this year, including a 0.5 percent drop promptly after the September 11 tragedy and a second 0.5 percent drop in early October. Federal Reserve Chairman Alan Greenspan, reminding Americans that while they struggle to make sense of the attack and its immediate consequences for the economy, they should not lose sight of America's longer-run prospects, which have not been significantly diminished. Greenspan has expressed his willingness to further reduce rates this year, if needed.

Despite the tragedy of September 11, there is much room for optimism in the U.S. economy and in real estate in particular. For now, commercial real estate located in employment centers that are directly impacted by recent layouts and property sectors that depend on travel are being negatively affected. However, investors interviewed indicated that properties outside this envelope that are well occupied and are situated in markets with solid demand fundamentals have yet to be negatively impacted.

Regardless of whether or not there is a recession, the U.S. economic structure is sound and the real estate market, with a few exceptions, is resilient and in a state of near-equilibrium. Unemployment, while increasing, still remains near historical lows; interest rates are the lowest in 30 years; the banking industry is generally strong, liquid, and responsive; and there are few, if any, signs of massive oversupplies in business inventories or commercial property. Although the economic and financial environment is evolving each day and investors are faced with a tremendous amount of uncertainty, we believe investment decisions based on rational analysis of properties and their markets will continue to serve well. REI

ABOUT OUR FEATURED COLUMNIST

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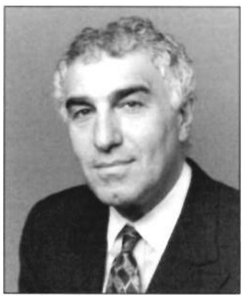
FOCUS ON THE ECONOMY & REAL ESTATE

AMERICA ATTACKED: IMPLICATIONS FOR THE ECONOMY & REAL ESTATE

by Raymond G. Torto, CRE



This perspective focuses on what the events of September 11 imply for the economy and property markets. It addresses questions such as how long to expect the recession and how deep the short-term effects will be. It also considers which property types will be most impacted.

We are in mourning for the many victims and their families. The appalling attacks are unconscionable and our country is offering our condolences, our services, and our money to help in every way.

Tragically the world has changed. Fortunately, our country has found resolve and unity. The much-needed struggle against terrorism is worldwide, fought in historically small battles with espionage and security being the predominant weapons, and where success is defined in unconventional terms. President Bush and Defense Secretary Rumsfeld have stated it will be a long and difficult struggle. We are optimistic about the outcome and we firmly believe our economy will see only temporary, albeit significant, damage.

THE ECONOMY

Torto Wheaton Research's (TWR) current outlook on the economy is dramatically different than the outlook we had in June 2001, even though that analysis forecasted significant slowing in the U.S. economy. We are forecasting a recession for the next six quarters, which will be deeper than most other analysts are expecting and a bit longer. We believe that the first sign of positive growth will be in the third quarter of 2002 indicating an end to the recession.

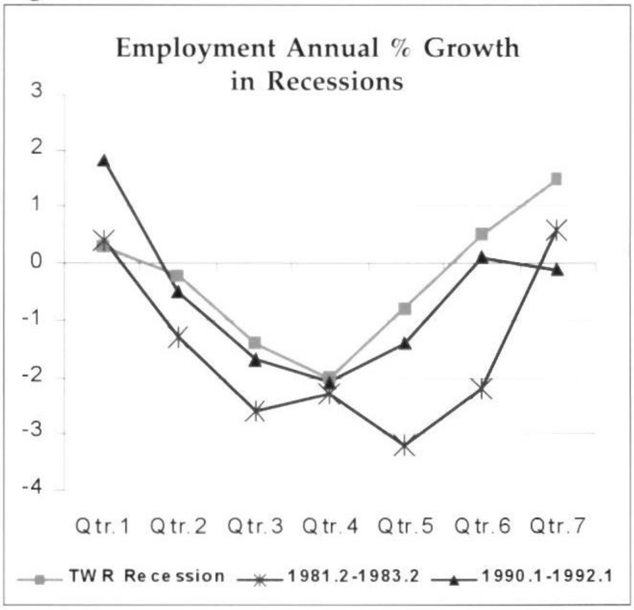
It is our expectation that September's layoff announcements will be reflected in the fourth quarter 2001 counts, which started October 1. The unemployment effects will ripple through the economy into 2002, before the pace of this recession starts to moderate. The weekly unemployment claims release of September 27, 2001, is supportive of this view. Weekly claims are up for the week of September 24, but not significantly, compared to earlier periods. We do expect these numbers to rise considerably over the next several months.

Figure 1 plots our recession outlook in contrast to the historical recessions of 1982 and 1990. The first data point in the graph is the quarter prior to the beginning of each recession. For our current forecast, the first period is the second quarter of 2001. Our forecast expects declining employment to be a –1.4 percent in the fourth quarter of 2001 and a –2 percent in the first quarter of 2002. Comparing our forecast to the previous downturns, we are expecting this recession to be less severe than that of 1982.

TWO COMMENTS ON THIS OUTLOOK

First, in the short run, we strongly advise against panic reactions and quick

Figure 1



judgments. The nation is in mourning. The magnitude is unbelievable and time is needed for all of us to return to economic activity as normally as we can. The terrorist attack of September 11 is unprecedented, but the economic effects have historical patterns that can help us analyze current markets and outlooks.

Second, we expect both an ongoing military reaction to September 11 by the United States and ongoing concern of a response by the terrorists. Further, we are expecting a fiscal stimulus package (Keynes is back!) by year-end, however, as of press time, the details have not yet been defined.

It should be noted that historically, the U.S. economy entered a recession due to the confluence of two forces. Our last recession in 1990 occurred as the Federal Reserve was tightening interest rates due to inflation fears and financial institutions were suffering a credit crunch due to real estate failures. As the economy was weakening, Iraq invaded Kuwait, consumer confidence plummeted, and the recession began in July 1990.

The 1990 recession, although traumatic for real estate professionals, was short-lived—eight months—and was not as deep as the 1982 recession. While the 1990 recession heavily impacted real estate property markets, this was not the case in 1982. The difference between the two recessions was the void of any building boom in 1982 versus a construction boom of unprecedented size in the late 1980s. Fortunately, the 2001-02 recession will affect real estate in ways similar to the 1982 recession (and not the 1990 one). That said, some property types will suffer more than others due to a mini building boom currently underway in some sectors.

PROPERTY MARKETS

The recession will impact the property markets, but real estate in general is in a better position today than in 1990. Fortunately, real estate has not created the over capacity found in many other industries. For every sector except hotels and maybe industrial, the income streams of most existing property investors have held up well compared to the alternatives.

Real estate has shown its diversification benefit over the last year and recent events have strongly endorsed its diversification role for a portfolio. The properties of many investors have occupancies above 90 percent with strong rents. These investors are in enviable positions if their tenants are credit worthy, with leases in place longer than two years. While the leasing markets for all property types will loosen significantly over the next 15 months, the 2001 recession will not be as severe to real estate as was the 1990 recession. REI

ABOUT OUR FEATURED COLUMNIST

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FOCUS ON COMMERCIAL REAL ESTATE

Real Estate Sector Faces Tough Challenges Ahead

by Dale Anne Reiss

In the aftermath of the terrible tragedies that took place in this country on September 11, 2001, the issues surrounding the commercial real estate industry seem exceedingly small. However, real estate is a key driver of the U.S. and global economies and the economic challenge to this country, in particular, has been intensified as a result of the terrorist attacks. One way we can lessen the economic impact of terrorism is to build and maintain a strong economy. In this, real estate—as the house for business—has a critical role to play.

Prior to September 11, it was evident that the commercial real estate sector was coming to the end of an unprecedented run-up in values. The cyclical nature of this industry was apparent across almost all sectors from downtown office buildings to hotels and shopping malls.

Business and leisure travel was already on the wane before September 11, and hotel operators were girding themselves for a tough year ahead. September 11 compounded that trend.

The demise of the dot.com sector brought huge amounts of sublease space onto office markets across the country. Some estimates have the amount of available sublease space now at 87 million square feet nationwide. Those numbers resonated throughout the sector, putting further pressure on rents and the events of September 11 have, for the time being, compounded that trend.

Some months before the attack on the World Trade Center, there was a whiff of restructure in the air. While we don't think the depth of restructuring will be anything like the last cycle, we are already seeing some owners having to reposition assets to reflect market changes. Beyond that, market conditions indicate that the potential for some restructuring exists: money is tight and over the last 10 years, more and more real estate loans have been securitized and sold to investment groups rather than held by friendly local lenders. With most of these securitized loans having specific collection procedures written into their documentation, it won't take much to trigger action by the lenders.

IT'S THE PACE OF THE DOWNTURN THAT CAUSES WORRY

The failure of the New Economy to live up to expectations and a slowing Old Economy has forced dramatic slowdowns in many commercial real estate markets. The one bright spot in the numbers is that sublease space isn't as bad as overbuilding, purely by virtue of the fact that most tenants keep paying rent. Vast amounts of sublease space continue to come onto the market and rents are in decline. So far, the real estate impact has largely been restricted to so-called "cool space"—older industrial and warehouse space often on the fringes of downtown converted to open-plan office space by start-up technology ventures. Market reports are now showing an impact on more traditional downtown office space as Old Economy companies feel the pinch of a slowing economy and cut jobs and their need for space. In recent months, companies like retailer The Gap and entertainment giant Viacom have announced plans to shed headquarters' jobs resulting in more space coming to market in downtown San Francisco and Manhattan.

REAL ESTATE STILL HAS VALUE

However, there continues to be real value in bricks and mortar. Many businesses are sitting on substantial long-term space commitments negotiated when the economy only looked like it was getting hotter. Companies facing the economic downturn should move quickly to wring as much value as possible from one of the most valuable assets on their books: real estate. Outright sales aren't always the best strategy. Innovative off balance sheet financing techniques such as synthetic leases, sale/leasebacks, and other capital strategies can allow companies to access equity in property assets while still maintaining some control over the real estate. Capital obtained in these ways can then be redeployed in the company's business plan to fuel future growth or to cover necessary cost reductions in a down market.

A good example of this trend toward capital redeployment is evident in the health care sector. At a time when many health care systems are seeking new competitive strategies, capital is often the constraining factor. Health care systems, particularly not-for-profit systems, have limited access to capital, primarily debt and earnings. Many systems, having invested heavily over recent years, cannot exceed their current debt levels without the risk of being downgraded by the rating agencies. In addition, with current pressure on earnings, systems are not able to generate the amount of capital from operations necessary for reinvestment in their core operations.

One strategy that a number of health care systems have used successfully to address their capital needs is to look toward their medical office buildings and other non-core real estate assets as a source of capital. Refinancing, off-balance sheet treatment or outright sale of non-essential assets has allowed some health systems to unlock funds for reinvestment in core operations, strengthened financial statements, improved financial flexibility, and uncovered hidden asset value. Look for more corporations in health care and other sectors of the economy to adopt similar strategies as access to capital becomes even more crucial in the months ahead.

As a result of the natural real estate market cycle, real estate owners, brokers, and leasing specialists have to get back to basics. Making deals happen will be just as hard in the next few months as it was in the first six months of this year. Look for smaller deals, more innovative transactions involving sublease space, and a heavier emphasis on warehouse/industrial and flex space suitable for biotech and other "growth" industries. Owners will focus hard on the bottom line, analyzing their costs and cutting back where appropriate. Construction projects may be put on short-term hold as the direction of the economy plays out. Companies that have committed to new capital projects will pay far closer attention to project cost management. In a down market, keeping the costs to a minimum and bringing projects in under budget can be vital. Companies are already outsourcing more and more of their project management and construction oversight work to outside advisors. The trend will deepen as these "project managers plus" bring tax and accounting skills to bear in an effort to pare down costs and make new construction projects even more efficient.

Finally, we expect a return to innovation in the real estate sector over the coming months. When times get tough, the tough get going, but they are also more creative, thinking in non-conventional ways. One example: there has been a steady growth over the last 12 months in mezzanine financing—lenders providing hybrid debt and/or equity to developers or buyers to cover the gap between traditional first mortgage financing and the actual equity in a deal. This financial technique, which has been accepted by an enthusiastic real estate market, is more than just a financing tool; it is also a way for capital-rich real estate owners to further develop their acquisition or development pipelines. Don't be surprised to see more major institutional owners using this technique in the future. REI

ABOUT OUR FEATURED COLUMNIST

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FOCUS ON THE FUTURE

A Region's Rising: Triumph in Transformation

by Newmark & Company Real Estate, Inc.

New York, July 4, 2006: in a ceremony forged of three equal parts—solemn remembrance, hard-won solidarity, and confident vision—New Yorkers gathered today to lay the cornerstone of the first of the new towers rising on the site of the former World Trade Center. Fittingly, the head of the Regional Reconstruction and Economic Recovery Authority (RRERA), Rudy Giuliani, wielded the symbolic trowel cementing the stone in place. The governors of three states—New York, New Jersey, and Connecticut—were in attendance, testimony to the regional collaboration credited with sustaining the long, arduous work of the Authority during the protracted local recession that followed the terrorist attack of September 11, 2001. As the Tall Ships paraded past the Battery, on the 30th anniversary of the original Op-Sail event, representatives from both the public and the private sectors spoke of the actions that propelled the city from the first dark and gripping days five years ago to this moment of pride and hope.

Perhaps the greatest catalyst in those final months of 2001 was the stunning decision on the part of New York's Real Estate Board to convene a tristate executive conference to explore a potential regional strategy. Including top elected officials from a 75-mile radius emanating at Ground Zero, the real estate leaders reached out to heads of banks and insurance companies, corporate executives, the media, top universities, religious and civic groups, and representatives of the blue-collar community: police, fire fighters, transit workers, and the construction trades. The Group of 35, convened in the year 2000 by Sen. Charles Schumer to prepare a commercial development strategy for New York City, was invited to be part of the core of the executive conference, but its reach was deliberately expanded. The World Trade Center had been the symbolic center of a wide region. The victims had lived throughout the tristate area. The direct economic effects of the disaster ranged indiscriminately across state lines. The Real Estate Board of New York signaled a courageous commitment to transcending conventional constituencies in announcing the conference, calling for a united effort in a time of crisis.

As one veteran of New York economic cycles put it, "This was not the first time New York had been hammered. In a way, we did ourselves even worse back in the early '70s when we brought New York to bankruptcy, burned down whole neighborhoods, lost jobs by the hundreds of thousands, and generally gave ourselves a big black eye. The feeling around the country and around the area this time was totally different: people were ready to rally around New York. But there were still some lessons from the Fiscal Crisis that were worth remembering. One was that we don't need to go it alone. Another is that the whole region prospers when we flourish, but gets sucked down when New

York struggles. And the third was that seemingly unlikely partners can actually make a powerful team. All of us are smarter than each of us. Fragmented efforts were going to be inefficient. We all understood that pretty quickly. So it was in everyone's interest to pull in the same direction."

FINANCING THE RECOVERY

The organizational roots of RRERA, in fact, can be traced to a fiscal crisis agency, the Municipal Assistance Corporation (MAC). Like MAC, RRERA was established to provide an off-budget source of bonded debt capital, with a sterling credit rating and low borrowing costs. With a $4 billion to $6 billion fiscal deficit looming in the year after the Trade Center Attacks, New York City could not itself foot the bill for all the work that needed to be done. With RRERA, the city's own credit rating could be protected and a long-range capital plan developed to rebuild the region's physical infrastructure and support its economic redevelopment as well. RRERA was able to issue tax-free bonds, supported by federal guarantees but primarily funded from two sources of recurrent revenues. The first was the cash flow coming from a re-instituted commuter tax for non-resident employees in New York City that was matched by an equal tax on non-resident income imposed by New Jersey and Connecticut to level the playing field and recognize the effects of job dispersal in the region after the WTC calamity. The second was a series of Payment in Lieu of Taxes (PILOT) agreements negotiated with property owners affected by the terrorist attack, that provided predictability for both the landlords and RRERA in the uncertain fiscal and economic climate of 2002 and ensuing years.

RRERA bonds were primarily sold into the institutional market, but benefited both symbolically and actually by a special issue of low-denomination bonds marketed to the general public in the manner of War Bonds or U.S. Savings Bonds. Besides being of practical benefit in the short term, the sales of the popular bonds helped focus attention on households' need to bolster their savings rate by setting aside periodic payroll deductions to purchase the bonds. The program was enhanced by allowing repaid bond principal to be rolled, dollar for dollar and tax-free, into IRA accounts. With economic recovery now accelerating in the nation and the New York region, the bonds are being repaid ahead of schedule, without having had to call on the federal guarantees.

STARTING WITH THE BASICS

Most of the RRERA funding was devoted to infrastructure projects, making up for shortfalls in Federal Emergency Management Agency (FEMA) capital and in insurance coverage for damages. Segregating the reconstruction projects from the region's normal capital needs for infrastructure allowed New York to skirt the mistakes made in the 1970s, when on-going capital maintenance was strapped to close budget gaps. This time, subways, bridges, tunnels, highways and streets, water and sewer systems, and the other elements of the municipal central nervous system were kept in good repair with orderly budgets, while the emergency funds from FEMA and RRERA were focused on the specific WTC-related rebuilding effort.

Some of the projects were fairly simple and comparatively low-cost. For instance, the decision to integrate the New Jersey Transit and Long Island Rail Road systems operations, allowing for easier regional commutation access to Long Island City, Jamaica, and Secaucus was largely a scheduling exercise, as the tracks were already linked in the Penn Station rail yards. But the integration has already created a powerful axis of new employment centers running through Queens, West Midtown, and the Meadowlands.

Other projects were more costly, but integral to the effort to make the New York region a more efficient location. Work is already underway on the much-debated extension of the Number 7 train to the Far West Side of Manhattan. The rebuilding of the downtown PATH line and the damaged 1/9, N and R subways allowed for a second regional link, providing uninterrupted access from Newark through Lower Manhattan into downtown Brooklyn. New York's central business districts have effectively been buttressed by improved access, while businesses have a wide choice of lower-cost locations for their back-office functions. Furthermore, the greater locational flexibility meets corporate strategic needs for greater redundancy, de-centralization, and crisis management alternatives, subjects that were on the top of boardroom agendas in the fall of 2001.

We now take for granted one of the least expensive and most pervasive changes of the early 21st

century. New York's water transportation network is more active now than at any time since the Second World War. Ferries and high speed water taxi service grew exponentially over the past five years, as alternatives to bridge, tunnel, and highway congestion exacerbated by security measures as well as the plethora of orange "under construction—expect long delays" signs that sprouted throughout the region.

It will be another 10 years before we see the completion of the largest of the infrastructure projects: Big Dig II, in Brooklyn—the replacement of the Gowanus Expressway by a new tunnel connecting the Brooklyn-Battery Tunnel to the Verrazzano Bridge approach road. But this project is already opening up waterfront development opportunities, both commercial and residential, in neighborhoods from Red Hook to Sunset Park, and pouring massive amounts of money into the city economy through the thousands of construction workers employed in this effort.

OFFICE MARKET STUMBLED, BUT NEVER FELL

The deployment of blue-collar workers into the infrastructure effort surely carried an important segment of the economy during a period when new office construction was slack. Although Manhattan's office inventory was reduced by millions of square feet in September 2001, the following years also saw the loss of more than 100,000 office jobs from the city economy. Part of this was due to relocations into suburban submarkets, but the greater number represented layoffs in the steep national recession of 2001–2002, and its aftereffects in New York, which saw local job declines all the way into early 2004.

Wall Street's cutbacks were particularly severe, unsurprising in response to the bear market of 1998 to 2001. It took the investment banks and brokerages time to retool but as 2002 brought a 20 percent rise in the Dow Jones Industrial Average and economic recovery took stronger hold in 2003, the conditions were established to rebuild these powerful financial empires. With the Dow now at 14,000, staffing, salaries, and bonuses on Wall Street are expected to set new records this year.

That has meant that, for the first time since the Trade Center attacks, new office construction is economically feasible on an unsubsidized basis. Wisely, incentive programs to encourage development in the post-attack years were kept modest, oriented to long-range market economics, predictable, and sustainable. Of course, the tight fiscal situation at both the municipal and state levels virtually mandated this approach, but it proved very healthy, whatever the reason. Zoning revisions upped the development densities in several targeted areas, yet the slack land market was slow in re-pricing sites. The extension of ICIP (Industrial and Commercial Incentives Program) benefits to Far West Side and WTC-impact area sites helped bring project costs to more affordable levels. Streamlining the Uniform Land Use Process (ULURP) helped by reducing time and bureaucratic requirements. The political climate for this was vastly improved when RRERA enabling legislation was promulgated, outlining its extraordinary redevelopment mission. The city's decision to tax new construction improvements upon issuance of the certificate of occupancy further reduced office costs and brought down Manhattan rents in new offices to more affordable levels, improving the New York's business retention efforts.

Nevertheless, it is market forces, not governmental subsidies that sustain the vast regional office market, which is more than 600 million square feet in size. Two-thirds of that inventory is in Manhattan. In early 2001, vacancy stood at just 5 percent in the urban core. Pre-September 11, largely in response to the technology and stock market slump, vacancy was up to about 8 percent. The destruction of the Trade Center and damage to surrounding buildings pushed occupancy in late 2001 to approximately 95 percent. But that quickly eroded in the ensuing recession, and vacancies were nearing 9 percent in 2004, when the market began to tighten again. The wisdom of a conservative policy that did not push for supply-side development incentives in the face of a battered market is now readily seen. However, it is in the attention to the demand side of the equation that perhaps the most far-sighted decisions were made soon after the catastrophe of 9/11/01 struck.

DEFINING NEW YORK AS A "CITY OF TOMORROW"

Solidifying Our Position as a Global Capital

New York has stood atop the U.S. urban hierarchy ever since the opening of the Erie Canal. The civic, business, and labor leaders convened by REBNY made this the linchpin of the revitalization strategy, and immediately launched a four-pronged effort to bolster the region's position in the global economy.

First, in cooperation with the New York Federal Reserve Bank, a coordinated campaign to secure and then to enhance the city's position as a hub for cross-border financial flows was put in place. The New York Stock Exchange, which represents more than a 40 percent share of the total capitalization of the world's markets, committed itself to an expansion program that included a five-year program to increase the number of seats on the exchange by 10 percent, jump-starting a new generation of financial firms.

Second, corporate leaders made team visits to every major U.S.-based transnational corporation to market the New York region as a business location. Especially where economies of proximity would increase business speed and coordination, corporate leaders pushed suppliers and customers to consider a tristate location. But every U.S.-based transnational was asked to make at least a representative agency commitment to the area. Taking a page from such aggressive cities as Nashville, Tampa, and Raleigh, the New York business community first understood and then sold the concept that promoting regional growth was the strongest long-term strategy for protecting their own investments in the metropolitan area.

Third, the region planned, targeted, financed, and executed a world trade strategy that sought a 10 percent annual increase in the number of foreign firms with operations in the region. These trade missions visited over 1,000 firms abroad during the last five years, beginning in 2002, listening to the companies' objectives and issues concerning a New York-area location. They reported back directly to the REBNY-convened Executive Steering Committee and to RRERA, both of whom made global competitiveness a high priority for regional policy.

Fourth, led by the Port Authority of New York and New Jersey, programs to improve operations at the region's airports and seaports were accelerated. The agency worked with the Army Corps of Engineers to assure deep-water access for 50-foot draft container shipping by the year 2010. Capital programs already underway at JFK and Newark were fast-tracked to completion by 2004. Negotiations with Metro-North were begun to create a rail link from Stewart Airport in Newburgh directly to Grand Central, and the state of Connecticut committed to a site search for an international airport near Stamford, with a direct Acela connection to Penn Station. These projects are expected to provide adequate international transportation capacity through 2025.

Reaffirming the City as a Population Magnet

In a worldwide extension of the "I Love NY" campaign, featuring symbols such as the Statue of Liberty and Ellis Island, the RRERA enunciated the unmistakable message that the region regards an open-door policy as imperative for its future vitality. The nation and the world now understand, perhaps as never before, the dynamic role in the region's economy played by the Asian community in Flushing and Brooklyn's Borough Park, the Russian immigrants in Brighton Beach, the South American enclaves in Jackson Heights, the Arab neighborhoods along Atlantic Avenue, the Indian restaurants near Gramercy Park, the Caribbean swath in Crown Heights and East Flatbush, Washington Heights and the Hub in the Bronx. This story was reinforced by "next generation" success stories from the city's outstanding public high schools: Stuyvesant, Bronx Science, Brooklyn Tech, Midwood, LaGuardia, Townsend Harris, Benjamin Cardozo, Hunter College HS, and Susan Wagner.

The area's exemplary cluster of colleges and universities were tabbed to step up their nationwide recruiting efforts, targeting a 15 percent increase in incoming freshmen from beyond a 200-mile distance from New York. The continuing replenishment of the New York talent pool was identified as a major contributor to future economic vitality and competitiveness. Students with career aspirations in key sectors including emerging technologies, business and finance, communications, international studies, and elementary/secondary education were targeted. Corporate sponsorship of scholarships in these areas helped in the recruiting efforts.

Emerging Technologies Targeted/Incentivized

Building upon the *2001 Group of 35 Report*, the region targeted four key industry clusters as "emerging technology" opportunities and pulled together resources from the entire tristate area to encourage their growth. Those industry clusters were medical/health (bio-tech), computers/data processing (info-tech), communications and advanced media, and environmental science. The emerging technology industries were identified for their potential to grow more rapidly than the local and national economy generally, to take advantage of existing intellectual capital resident in the region, to exploit the interface between the expansion needs of these industries and the financing expertise available locally, and to position the region on the cutting edge of innovative technology for the 21st century.

Challenge grant programs were set up in conjunction with the National Science Foundation, the Federal Office of Technology Assessment, the National Institutes of Health, the Homeland Defense Agency, the Federal Communications Commission, and the Environmental Protection Administration. Seed money was designated in modest amounts by each of the states to establish a revolving loan fund dedicated to emerging technologies, which then found its primary funding from venture capitalists and ultimately was able to access the public markets.

Flexible zoning and site assembly efforts were critical to developing the first incubator sites, which tended to be in low-cost, low-density locations in the outer boroughs and suburban areas. The region's teaching hospitals and research universities joined forces with corporate sponsors, agreeing to strike a balanced approach between the necessary basic science and the economic requirement for the development of marketable products.

The key concept, stressed again and again by RRERA, was the need to diversify the region's economic base while building on its strengths. The near-term objective, beyond simply stimulating growth, was to reduce the region's dependence upon the highly cyclical financial services industry, which had become increasingly dominant as a percentage of total employment in the last 30 years of the 20th century. The long-term goal was to create a matrix of complementary industries throughout the region, matching lower-density functions to opportunities outside Manhattan while keeping high value-added functions appropriately and efficiently at the city center.

Reinforce the 24-Hour City Attributes of New York

Arts, culture, and recreation are multi-billion dollar industries in New York. More importantly, they help define the best in the New York lifestyle. Therefore, efforts to shore up the 24-hour activities in the region were more than just public relations. They were key to sustaining the spirit and the vibrancy that attract the brightest and best to the region and persuade businesses that the substantial benefits of a New York location outweigh its undeniably higher costs.

Furthermore, the travel and tourism industry lives in a symbiotic relationship with the arts, recreational and cultural world, as well as with the flow of business travel in the area. Thus, high profile events assumed great importance, especially in the first years after the 9/11/01 events. For a time, it appeared that the 2002 Superbowl might be attracted to Giants Stadium when scheduling conflicts arose in New Orleans. Although that fizzled, the region immediately set its sights on getting the NCAA Final Four tournament for 2003 or 2004, with Madison Square Garden as the arena. One of the political parties brilliantly made an unsolicited offer to bring its national nominating convention to New York in 2004, tapping into an immense reservoir of good will and favorable publicity for its contribution to recovery. The city went all out to secure key industry shows and events, from Market Week for the fashion industry, to the Emmy and Grammy award shows. Op-Sail 2006 was quickly put on the calendar. Throughout the effort, a thematic linking of national pride to the feistiness of New York was consistently articulated.

HOW DID IT EVER SUCCEED?

From the perspective of 2006, the train of events seems to have had a kind of inexorable momentum of inevitability behind it. Nothing could be further from the truth. In fact, from the perspective of late 2001, the progress of the past five years would have appeared wildly improbable. What then made it work? A few basic principles best describe the formula.

- In a crisis, unlikely allies will pull together. Such alliances can be sustained as long as the common interest creates conditions whereby mutual effort produces results more favorable than the uncoordinated pursuit of individual self-interests.
- It is better to confront the crisis early than to retreat into denial. The region was well served to recognize early the probable depth and duration of its economic recession.
- Leadership is required. Organizational strengths are important, and the management challenges

of the effort daunting. But even more critical is the vision of what constitutes an optimal solution, and the communication skills to frame that vision and make it credible.

- The lessons of the past have immense value. The experience of past crises, from the fiscal emergency of the 1970s, to the stock market crash of 1987, the World Trade Center bombing of 1993, and even the natural catastrophes of hurricanes and earthquakes in other cities offer a template for recovery. Equally important, they highlight mistakes that can be avoided in dealing with current problems.
- Faith in the future of cities is eminently reasonable. One of the great lessons of history is that it is very hard to kill big cities. New York itself has been pronounced "terminal" on more than one occasion, but always fights back. The great demographic story of the 1990s was the revitalization of the urban centers of America. In the early 2000s, history is on the side of New York.
- Bad guys almost always lose in time. Edmund Burke is often quoted as saying, "The only thing necessary for the triumph of evil is for good men to do nothing." Our corollary, though, is a hopeful one, for neither Americans nor especially New Yorkers are inclined to be passive in the face of challenges. We are more likely to respond with action and, once stirred, few can resist the combination of imagination and resources we can bring to bear on our difficulties.

Thus, the laying of a new cornerstone on Independence Day 2006, on the corner of West and Liberty Streets, marks not just the erection of a new tower for the Manhattan skyline—more significantly, it epitomizes a rising region—probably the true beginning of the commercial era of the 21^{st} century.

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Is New Urbanism the Cure? A Look at Central Florida's Response

by Ted R. Brown & Cecelia Bonifay

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No theory of community design and urban form is currently more debated by architects, developers, community planners, land use attorneys, and local government officials than New Urbanism. New Urbanism, also commonly referred to as neotraditional town planning (TND), is a movement which advocates a return to pre-World War II neighborhood design patterns as a means of counteracting the perceived failures of post-World War II suburban development, now referred to by most as "sprawl." Essentially, New Urbanists envision compact neighborhoods comprised of a mix of residential housing and commercial uses, pedestrian-friendly streets, large tracts of open space, and convenient access to mass transit. By contrast, conventionally designed subdivisions refer to residential developments where all the land is divided into house lots and streets into what is essentially a monoculture of housing. All the land has been paved over, built upon, or converted into lawns or backyards.

These problems are not new. Suburbanization of the kind we call sprawl is the flip side of the deterioration of our cities and the issues implicit in both are closely related. As Steven Fader notes in his book, *Density by Design*, "these twin poles of our urban condition rise and fall on macroeconomics and politics: the cost of land, the hidden subsidies for highway development, exclusionary zoning, and the like." Until recently, the system for allocating capital for development, as well as the political context, favored suburban development over compact development, urban disintegration over reinvestment.

For any of us growing up in the 1950s, the emergence of the automobile was a key ingredient of the notion that one could leave the crowding of the inner city and escape to the suburbs. It provided a means that allowed us to move freely between work and home, and for a time "livability" was perceived to be much improved.

In the last several years a new ethos has emerged. It is couched in terms of "livability" but is more often articulated in the context of "community." In attempting to define our lives in a matrix that focuses on a communal realm, we have come to see that, with some exceptions, suburbia has become what we were running from.

There is a new search for meaning in our physical environment. Community is a paradigm that seeks to facilitate social interaction and TND suggests that one can engineer community through the design not only of the street grids, but through the use of architecture, open space, neighborhoods and even the placement of public buildings. Open space and its integration into the design are critical and land preservation for public open space are givens in the new paradigm.

TND has challenged the symbol of suburbia—the cul-de-sac. We now argue that a more uniform street network, with narrower street profiles create a safer, more intimate community. It contributes to land conservation and reduced development costs, but government is often wary and fire marshals, in particular, frequently argue (with success) that the old way is preferred in order to accommodate fire equipment.

TND also challenges the single-use planning and zoning that has characterized our historic building patterns. TND seeks to incorporate a mix of uses at both the macro and micro levels. The idea of a mixed-use neighborhood/town center with housing and retail/office mixed in is an old idea re-emerging as new in the 21st century.

Neotraditional town planning has been employed throughout the United States, and its impact in Florida continues to expand. The city of Seaside, located in Walton County on Florida's panhandle, is considered by most architects and developers to be the first New Urbanistic development in the United States.[1] Disney's Celebration, located just south of Orlando, is probably the most famous (and infamous) neotraditional development in the country,[2] although some question whether it truly

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qualifies as neotraditional. Current examples that have followed the precepts of the New Urbanism movement and that have introduced elements of TND are Avalon, being developed in southeast Orange County by Beat Kahli, and Victoria Park, being developed by the Arvida division of the St. Joe Company, which is located in both the cities of DeLand and Lake Helen.

Avalon Park can be viewed as a true TND. It is located on approximately 1,800 acres and consists of a minimum of eight and a maximum of 12 villages, three of which are under construction. Two villages are complete. In summer 2001, Avalon started its second commercial building in the town center. At build-out, it will include 4,000 single-family and multi-family units, a high school, an elementary school, 500,000 square feet of commercial/retail space in its town center and 250,000 square feet of office/industrial space. According to Ross Halle, town architect and planner, it is the combination of all the mixed uses and the planning of those uses which embody the concepts of New Urbanism. Avalon is a real neighborhood where its residents can truly live, work, send their children to school, shop and participate in community activities.

The St. Joe/Arvida project has employed many of the principles of the New Urbanist movement in its development in Volusia County. The site of approximately 1900 acres had numerous physical challenges which the developer and consultant team turned into positive aspects of the development. Because of the existing transportation infrastructure, and the desire to integrate into DeLand's retail development, the Town Center was reduced in scope. However, the anticipated effect is a service element adequate to serve the development, but not so large so as to inappropriately compete with downtown DeLand. The plan includes a mix of residential types and neighborhoods, and a unique commitment to the environment. Approximately 45 percent of Victoria Park is open space, with significant portions of that set aside for permanent conservation and subject to a site mitigation and management plan. Arvida will do most of the building in the community, but even where it doesn't, the company will control the product to ensure its vision as the project matures. Buyers can expect to see houses on lots as small as 40 feet with alleys in selected areas. Some of the houses will evoke the Victorian era, but a variety of styles is contemplated. Victorian touches such as gardens, porch swings, street lights, and gazebos will be sprinkled throughout. A workplace also allows for almost 1 million square feet of office space, together with support services, such as a hotel.

A project located farther to the north is the Springhills DRI owned by the Haufler family who had farmed the once rural area for over 60 years. Located at the intersection of I-75 and SR 222 (39th Avenue) in Alachua County, the introduction of TND concepts was a challenge as the project was divided into four distinct quadrants. The largest quadrant was designed with TND concepts in mind, including a main street, a town center, and a mixed-use development consisting of single- and multi-family housing, commercial property, and office space. Specific design regulations were developed for the project to give it a sense of place, to promote aesthetic standards, and to allow the implementation of TND concepts.

Coupled with the New Urbanism or TND movement, is the "Smart Growth" movement. As one commentator noted, "growth is the process of a community becoming bigger. If the community becomes better as it becomes bigger, that growth can be said to be 'smart.' "[3] Just as the original idea of growth management emerged as a response to the problems of urban flight, in migration and suburban development, Smart Growth has come about in response to the perceived problems inherent in our current growth management schemes.[4] The goals of Smart Growth tend to incorporate the design principles of neotraditional planning. New Urbanism is seen as a fundamental tool to successfully implement Smart Growth, therefore suggesting, that absent a TND approach to development, one, by definition, cannot meet the test of Smart Growth.

We take exception to that interpretation and see TND as a subset of the Smart Growth initiative, but not the sole provider of design criteria necessary to satisfy the test. Instead, Smart Growth rests more on a concept that might be characterized as "conservation subdivision design." As such, it draws upon an ethic that requires adherence to a checklist of ideas and incorporation of a majority of them into the planning.

In order for Smart Growth to be successful, it must start at the roots by building neighborhoods and communities that are capable of sustaining an ever-increasing population. In order for a community to become sustainable, its population capacity must increase and/or become more efficient. Since there is growing apprehension in most states, including Florida, to destroying more and more natural open space in order to build more subdivisions, the only realistic and acceptable option left is to increase the density and efficiency of our current communities and to supplement them with new developments which are designed with efficiency in mind. New development must get away from the current trend of building at low-density which, according to one researcher, is the most unsustainable form of development ever created.[5] Making communities more livable will require "making the cities more urban and making the countryside more rural."[6] This is where New Urbanism comes in. As noted by Peter Katz, "the New Urbanism couldn't have come at a better time. There is a growing sense that the suburban paradigm, which has dominated since the 1940s and 1950s, cannot sustain another generation of growth."[7]

Having said that however, market research still suggests a significant gap on the level of acceptance for this new TND paradigm. The notion of high density living, (whether internal to the city or in the outer edge), still meets with market resistance in the absence of perceived value through the addition of significant public amenities within the development. Further, infill projects have not found ways to effectively address the question of "affordability" which is directly tied to land cost. An emerging conflict suggests that as one restricts land availability in order to preserve rural lands, lack of supply for development drives up costs. This factor was an original impetus for what we now refer to as sprawl, and its tentacles are still with us. The challenge of affordability remains in the new TND paradigm, perhaps even more so.

Further, significant portions of the home-buying public still perceive "density" as a negative, but in fairness, as more and more of the TND elements emerge in newer communities, the social contract that TND promotes is increasingly perceived as beneficial, (and sufficiently so), in overcoming the problems associated with physical proximity.

CENTRAL FLORIDA'S RESPONSE TO MANAGING GROWTH

Florida has been one of the nation's leaders in growth management for the past 30 years. Florida's population has grown to 15,982,000, up from 12,938,000 just 10 years earlier.[8] Only California and Texas had larger population growths than Florida during this time.[9] Given this rapid increase, growth management was seen as the mechanism to not only control growth, but also to sustain it. It has had success to a point, but current legislative interest in adjusting the system suggests some dissatisfaction. Suffice it to say, the dissatisfaction seems equally split between those who seek more control and those who would like controls relaxed.

The city of Orlando has been among the most active local governments in Florida pursuing a growth control and enhancement program. A prime example is the city's Southeast Orlando Development Plan for a 12,000-acre site east of Orlando International Airport. The plan incorporates many New Urbanism ideas such as high densities, services within walking distance, and a village center component that mixes housing and retail. Likewise, the city is pursuing redevelopment along similar lines of the recently closed Orlando Naval Training Center. A high priority for Orlando is redevelopment and infill projects to provide quality housing and new life for the Parramore neighborhood adjoining the west end of the downtown area.

Orlando was singled out for a special mention at the annual Conference for New Urbanism (CNU). According to the CNU, the City Beautiful has made great strides in its growth plan by incorporating New Urbanist developments, such as Celebration, Lake Nona, Avalon Park, and the Naval Training Center. "New Urbanism is based on what the old neighborhoods originally were built upon," notes Orlando Mayor Glenda Hood. "The saying is, 'what's old is new again' . . ."

By far the largest of the new mega projects is Horizons West in southwest Orange County, that is comprised of 38,000 acres that had been in the hands of hundreds of property owners. The land is bordered by State Road 50 to the north; the Butler Chain Lakes to the east; U.S. Highway 27 to the west; and U.S. Highway 192 to the south. The vast area was divided into 11 villages and master plans were to be developed for each village. Within the village, individual neighborhoods were designed.

Zoning laws were originally designed to protect encroachment of industry on residential neighborhoods. This justification is now outdated as the fears of such encroachment have greatly decreased in our post-industrial society. What is currently a much greater concern is finding ways to deal with an ever-growing population. A balance must now be struck between community and sustainable growth. Such a balance is what the proponents of New Urbanism believe that neotraditional development will achieve.

The concept was to balance housing, schools, and services in a New Urbanism motif. For instance, some neighborhoods may have houses that resemble those found in other newer central Florida communities, while others will have a more traditional feel. Houses will be only one component of the architectural mix, mingling with apartments, stores, and shops.

In addition to having its own schools, each neighborhood is supposed to have areas for shops and some offices. Each neighborhood will have about 2,500 houses, and clusters of two to four of those school-based neighborhoods will combine into villages, which will be anchored by a grocery store and possibly a middle school. Schools were seen as a critical building block to the neighborhoods based on the belief that if schools constitute the core of the neighborhood, they will have more parental involvement.

Houses will be closer together than they are in more customary suburbs, with densities of three to five houses on each acre compared with three houses on an acre in most outlying developments.

The big-picture plan calls for a number of villages supporting one Horizon town center, where regional stores could sell their wares. Streets will be shorter than they typically are in central Florida developments. And builders will duplicate the same model less frequently so that streets have more variety.

Lot sizes will vary, but if the yards are less than 50 feet wide, the garages must be in the rear of the house so that they don't overwhelm the streetscape and front of the house. Overall, the community is expected to be more pedestrian-friendly than most subdivisions being built, providing its residents the opportunity to be less dependent on their automobiles.

THE CONFLICT BETWEEN NEW URBANISM & CURRENT ZONING POLICY

Regardless of one's stance on the promise that New Urbanism holds for achieving manageable growth, an emerging consensus suggests that it is a step in the right direction toward building communities which can support large population influxes. The primary hurdle that needs to be overcome, however, is the current state of local zoning ordinances and land development regulations in most cities and counties. The vast majority of local governments have implemented single-use zoning plans, which when coupled with their land development regulations simply don't allow the TND outcome. These policies prohibit the mixing of uses within a given zoning district and require a series of design controls that are antithetical to the TND paradigm. For example, commercial zones must be kept separate from residential zones. They also set other barriers to neotraditional development with mandatory setback requirements and minimum lot sizes for residences; all throw-backs to an earlier time.[10]

Our present zoning laws were justified from their inception as a way to protect family life and property values.[11]

While the maintenance of property values and family life unarguably remain important matters, we now understand that those goals are not distinct from TND elements, but are a part of them. Our rapidly-increasing population makes it infeasible to continue with current zoning laws which facilitate, and even encourage, the suburban development of the 1950s and 1960s. Zoning laws were originally designed to protect encroachment of industry on residential neighborhoods. This justification is now outdated as the fears of such encroachment have greatly decreased in our post-industrial society. What is currently a much greater concern is finding ways to deal with an ever-growing population. A balance must now be struck between community and sustainable growth. Such a balance is what the proponents of New Urbanism believe that neotraditional development will achieve. "Our [current] planning tools—notably our zoning ordinances—facilitate segmented, decentralized suburban growth while making it impossible to incorporate qualities" of older communities which is the goal of neotraditional development."[12] "Few ordinances tolerate (much less encourage) the concentration of uses, the multiplicity of scales . . . and the hierarchical fabric of public spaces which characterize the towns of our memory." [13] They present a serious obstacle to the development of more compact urban and suburban development patterns.[14]

While few are suggesting that ordinances governing land use simply be abolished, a shift in what is being regulated is necessary.[15] Rather than restricting the type of use that is allowed in a given district, as current zoning laws do, New Urbanism "envisions broad zoning classifications allowing developers flexibility in the types of uses permitted within a proposed development."[16] For example, the ordinances should allow mixed-uses within a zoning district but still regulate things like the physical size of buildings to ensure that neighborhoods do not become an inappropriate jumble of various buildings side by side.[17]

While local governments in Florida have tried to build in the concept of multi-use districts through the use of Planned Unit Developments (PUDs), many PUDs are used simply to build single-use conventional subdivisions at densities greater than what would be allowed in a straight rezoning. Something more is needed to truly allow the development envisioned by the principles of New Urbanism.

That something more is the Traditional Neighborhood Development ordinance or "TND."[18] TNDs specifically emphasize employing neotraditional design principles. They are broader in scale than PUDs and may be enacted to either replace existing zoning ordinances or they may be implemented as an overlay zone. Orlando has already enacted a TND ordinance that applies to a rapidly-growing section of the city. Orlando's Southeast Sector Plan was enacted in 1999 to cover development surrounding the Orlando International Airport.[19] This southeast sector was designated by the city as a "Future Growth Center" in which the city believes economic growth and employment opportunities will develop substantially in the near future.[20] The stated purpose of the ordinances is to:

> ... create a sustainable and balanced community in the Southeast Orlando Sector Plan area with the characteristics of traditional "Orlando": where streets are convenient and comfortable for walking, where parks are a focus for public activity, and where the life and vitality of a mid-sized town can be enjoyed by its residents and visitors. . . In order to build and sustain a viable community, development shall feature a mixture of land uses which allow for increased accessibility, diversity, and opportunities for social interaction within the context of an integrated amenity framework. Utilizing the neighborhood as the basic community building unit, the City has developed a community framework based on Traditional Design principles. A hierarchy of places has been proposed, ranging from a Town Center that will serve as the primary destination and job center within the community, to Village and Neighborhood Centers that provide local shopping and civic spaces for residential area[s], to airport-related employment districts that include a variety of industrial and office uses. In the Southeast Plan area, centers will be compact and walkable, and residential neighborhoods shall be defined by public space and activated by locally-oriented civic and commercial facilities.[21]

In the final analysis, TND, New Urbanism, and Sustainable Development are all labels traveling on the same track, seeking to go to the same place. Peter Rummel, the CEO of the St. Joe Company, recently speaking at an Urban Land Institute conference, referred to it as the desire to have a sense of "place"; a sense of how we, as humans, fit into the larger context of life and therefore how we live in both the natural and built environment. He identified five core values to "place making" that sum up the essence of these building paradigms.

They are:

1. clear limits to the community; a willingness to define the boundary;
2. authenticity; the community must be a real place that draws on
3. its history and its environment;
4. it must incorporate and recognize local traditions in the arts and crafts and, in doing so, create a social overlay that is recognizable and accepted; and
5. it must provide a human infrastructure that supports all of the community.

We submit, if these goals are met, the issues of density, road widths, zoning, mixed use, open space, etc., are no longer relevant and the creating of spaces for human habitation will work seamlessly for a better place, no matter what the label.REI

NOTES

1. *See, e.g.*, Peter Katz, *Preface to* The New Urbanism at ix (1994).
2. The question or whether or not Celebration is truly a neotraditional community is much debated.
3. James C. Nicholas & Ruth L. Steiner, *Grown Management and Smart Growth in Florida*, 35 Wake Forest L. Rev. 645, 646 (2000).
4. *See* James A. Kushner, *Smart Growth: Urban Growth Management and Land-Use Regulation Law in America*, 32 Urb. Law. 211, 228-29 (2000).
5. *See* Peter Newman, Social Organization for Ecological Sustainability: Toward a More Sustainable Development Pattern (1990) (cited in Mark Roseland, Toward Sustainable Communities: Resources for Citizens & Their Governments 18 (1998)).
6. *Ibid.*
7. Katz, *supra* note 2, at ix.
8. *See* United States Census Bureau, *Resident Population of the 50 States, the District of Columbia, and Puerto Rico: April 1, 2000 (Census 2000) and April 1, 1990 (1990 Census)*, available at http://www.census.gov/population/cen2000/tab0r.pdf (visited Mar. 24, 2001).
9. *Ibid.*
10. *See, e.g.*, Lloyd W. Bookout, *Neotraditional Town Planning: Bucking Conventional Codes and Standards*, Urban Land Apr. 1992 at 18 (discussing the problems that traditional zoning codes pose for neotraditional development).
11. 272 U.S. at 394 (quoted in Lee Epstein, *Where Yards are Wide: Have Land Use Planning and Law Gone Astray?* 21 Wm. & Mary Envtl. L. & Pol'y Rev. 345 (1997)).
12. Alex Krieger, *Since (and Before) Seaside, in* Towns & Town-Making Principles 9 (1991).
13. *Ibid.*
14. *See* Bookout, *supra* note 64, at 19.
15. Note that one of the leading advocates of neotraditional development, James Kunstler does in fact advocate abolishing current zoning ordinances. He contends that communities built before World War II were successful without the aid of zoning laws and that these laws are merely a hindrance to building communities based on changing needs and popular consensus. Kunstler believes, therefore, that these laws serve no useful purpose. He does, however, concede that these zoning laws should be replaced by "new traditional town-planning" ordinances which are, in essence, a new type of zoning law. *See* James Kunstler, Home from Nowhere 110 (1996).
16. Eric M. Braun, *Growth Management and New Urbanism: Legal Implications*, 31 Urb. Law. 817, 818 (1999).
17. *See* Duany et al, *supra* note 15, at 16-17
18. *See generally* William Lennertz, *The Codes, in* Towns and Town-Making Principles 96, 102-03 (1991) (providing a model TND ordinance which was drafted for Palm Beach County).
19. *See* Orlando, Fla., City Code ch. 68 (2000).
20. *Ibid.* At § 68.102.

21. *Ibid.* The plan goes on to specifically lay out most of the principles of neotraditional town planning including:

> . . . development in the form of coherent and compact interconnected districts and neighborhoods with clearly defined centers and edges . . . mixed and multiple use integrated districts providing residential and employment opportunities . . . diverse, compact (typically no more than one-quarter (1/4) mile from center to edge) neighborhoods which encourage pedestrian activity . . . neighborhoods with a wide spectrum of housing options which enable people of a broad range of incomes, ages, and family types to live within a single neighborhood or district . . . a balanced transportation system providing equal access to transit, pedestrian, and bicycle mobility to reduce the reliance on automobiles . . . the celebration of public space . . . cohesive urban design which builds civic pride, enhances community identity and reinforces the culture of democracy. ORLANDO, FLA. CITY CODE § 68.104 (a)-(g).

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ENVIRONMENTAL RISK IN TODAY'S MARKET

by Donald C. Nanney

"Courage is: Being scared to death – and saddling up anyway."
- John Wayne

On the heels of environmental law and regulation came fear. Fear of environmental liability led to fallow properties called "brownfields." The redevelopment of such properties is complicated by the real or perceived presence of hazardous substances, pollutants, or contaminants and the risk of unlimited liability under stringent regulatory standards. These properties tend to be in urban areas where the opportunity and the need to recycle them to productive use is greatest. What techniques are available so that, even scared, we can "saddle up anyway" with a realistic hope of surviving, even profiting and surely benefitting the economy by turning around a brownfield property?

ECONOMIC & POLITICAL TRENDS

Available techniques are shaped by economic and political trends. The advent of the fear of environmental liability was followed by the real estate recession of the early to mid-1990s. Brownfield properties languished as potential buyers, redevelopers, and lenders (lacking John Wayne's courage) generally took a risk-averse, hands-off attitude. However, later in the 1990s, brownfields again became targets for acquisition and redevelopment due to the stronger real estate market coupled with scarce available land for development in urban areas. Environmental risks that were previously avoided have become a hot topic for assessment, negotiation, and allocation between transaction parties.

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The trend toward a stronger market in contaminated property was complemented, and in part impelled, by political developments. Recognizing the connection between the strength of the economy and longevity in public office, politicians pressured environmental regulators to ameliorate the impact of potential environmental liability in order to encourage the recycling of brownfields to productive use and to expand the employment and tax base of affected communities. Governmental initiatives were undertaken at both federal and state levels in response to these economic and political pressures, as highlighted in *Exhibit 1*. Regulators—who previously caused the fear by unreasonable, absolutist application of environmental regulations leading to uncontrolled costs and liability—had a change in attitude and adopted more reasonable policies. Relationships with regulators are still not completely without distress for landowners and developers, and attitudes vary depending upon the circumstances. But in general it is much more possible now to deal with environmental problems with all parties, including the regulators, working toward the common objective of resolving the environmental problem on a cost-effective basis and restoring the property to productive use.

If you wish to deal with environmentally impacted properties, it helps to have an appreciation for the economic and political background of current market trends, and how those trends are reflected in your area, including applicable regulations, policies, and attitudes, in order to know what is possible in a particular situation.

CONTRACTUAL ALLOCATION OF ENVIRONMENTAL RISK

Site Assessment. The first step in dealing with environmental risk is to learn as much as reasonably possible about the condition of a property through environmental site assessment by qualified professionals. Also, the seller must disclose known contamination as required by applicable environmental laws and to avoid common law fraud claims for nondisclosure of "material" facts. Sellers may fear the prospect of triggering reporting duties and regulatory oversight as a result of the discovery of contamination during site assessment. But the alternative is not to market the property, so the seller must overcome that fear. Except in the worst of cases, problems that are already known or are discovered through due diligence can usually be quantified and allocated between the parties in some mutually acceptable fashion. The handling of known problems has been made more feasible by improvements in remedial technologies and greater experience in developing accurate cost estimates. It is the unknown, unquantified risk that usually poses the most difficulty in deal negotiations. Site assessment can narrow down but cannot completely eliminate the unknown. There are a number of ways of handling unknown risk.

Deal Structure. The risk of inheriting unexpected environmental liability can be minimized by structuring the deal as an asset acquisition rather than a stock acquisition. The general rule is that an asset purchaser acquires the asset, not the liabilities of the seller. A purchaser of stock becomes the owner of the company, including its liabilities. The surviving entity in a corporate merger has both the assets and the liabilities of the previous entities. Many corporate transactions have been done without regard to environmental liability, and many new owners have experienced the unwelcome surprise of liability for past disposal of hazardous waste at dump sites that are now the subject of cleanup. Liability for previous off-site disposal can be avoided by structuring the deal as an asset acquisition.

Deal structure can also make a difference when it comes to liability for on-site conditions. If the site proves to be contaminated, a purchaser of the site may be able to establish the "innocent purchaser" defense to avoid or minimize liability. That defense will not be available to a purchaser of stock or the survivor of a corporate merger. Also the risk of future discovery of presently unknown contamination can be allocated between the parties contractually.

Allocation Strategies. Using the devices of contractual representations, warranties, indemnities and releases, environmental risk can be allocated in numerous ways between transaction parties. A range of possible strategies is highlighted in *Exhibit 2*. Entrepreneurs targeting brownfields properties typically assume some or all of the environmental risk associated with a property. However, they usually require thorough site assessment to identify the scope of the risk. Also, they usually require a sufficient price discount so that the remedial cost can be recovered, together with a profit margin, through an increase in market value as a result of the cleanup. Such entrepreneurs often use environmental insurance to limit their risk by shifting a portion of it to an insurance company. New environmental insurance products are available to close the risk gap between transaction parties and make a deal possible.

Contract Forms. It is necessary with each transaction to consider carefully how the risk should be allocated and to make sure that the contract accurately reflects that allocation. While there are many "right" ways to allocate risk (whatever is mutually acceptable), it would be "wrong" not to tailor the allocation to the situation. Allocation can be affected by prevailing market conditions (sellers' vs. buyers' markets) as well as the respective business motivations of the parties. How the risk can and should be allocated can vary with those external and internal influences. It is a common mistake to treat the environmental clauses of a "standard" form purchase and sale contract as boilerplate to be used without further thought. While that may save transaction costs at the moment, such clauses were likely developed under different economic conditions and circumstances, and you (or the other side) might be able to do significantly better under current conditions. You should not miss that opportunity.

NEW ENVIRONMENTAL INSURANCE PRODUCTS

The following environmental insurance products may be of most relevance at the time of a real estate transaction:

- *Property Transfer* or *Environmental Review* coverage insures the results of environmental site assessment against the risk of future discovery of unknown conditions not identified during the assessment.
- *Remediation Warranty* or *Cost Cap/Stop Loss* coverage insures against cost overruns during implementation of an approved remedial action plan, up to policy limits after exhaustion of the initially estimated cost of the remediation plus a self-insured retention. That margin of retained risk over estimated cost is much narrower than it used to be, due to more experience and confidence in cost estimating for remedial action.
- *Post-Remediation Warranty* or *Reopener* coverage insures against the risk that regulatory standards may change or that additional contamination may be discovered leading to further remedial action requirements notwithstanding a previous "no further action" determination.

There are other relevant coverages, such as for underground storage tanks, asbestos in buildings, pollution legal liability, first party cleanup coverage, remediation consultants, and contractors. Environmental insurance can be an important element of managing environmental risk and possibly making a deal happen that would not otherwise be feasible.

The growing importance of environmental insurance is illustrated by pending litigation in Los Angeles where one of the oldest and most prestigious law firms (O'Melveny & Myers) has been accused by its former client, the Los Angeles Unified School District, of having failed to advise the school district about the availability of environmental insurance. The school district acquired a 35-acre site in the shadow of downtown Los Angeles for the construction of the Belmont Learning Center, a much-needed new high school facility. The school district assumed full environmental risk for the site without the benefit of environmental insurance. After expending nearly $200 million, the school district abandoned the project due to the risk of methane gas and hydrogen sulfide from the old oil field at the site. The acquisition was completed allegedly without adequate site assessment, and the construction proceeded without utilizing available systems for controlling soil gasses. An enormous cost would be associated with retrofitting a huge complex of buildings with gas control systems. An insurance company likely would have declined to issue a policy without more assessment, or might have excluded coverage for the known risk of gasses from the oil field unless adequate controls were installed. That could have served as a danger signal to the school district before the acquisition or before the commencement of construction.

FORECAST

Given the influence of economic and political factors, there is a risk that regulatory attitudes may stiffen again. Some people believe that in good economic times the public becomes more concerned about the quality of the environment, with politicians and regulators following suit, and that in lean economic times, jobs and the economy become the primary concern with the environment suffering. If so, one can expect the attitude of environmental regulators to swing back and forth like a pendulum in sync with the ebb and flow of the economy.

However, this was not borne out during the recent period of economic good times. Cooperative attitudes still seemed to prevail where possible. Perhaps the last recession was too fresh to be forgotten. Also, the Federal Reserve Board exercised its monetary policy powers to raise interest rates to control the economic expansion in hopes of avoiding more boom and the inevitable bust. At time of writing in

(Continued on page 34)

Exhibit 1

GOVERNMENTAL INITIATIVES

Federal Initiatives

Brownfield initiatives at the federal level include the following:

- ***Lender liability policy***. The U.S. Environmental Protection Agency (EPA) adopted a safe harbor rule for lenders to ameliorate their concern about potential liability under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA). See the Final Rule on Lender Liability Under CERCLA, published at 57 Fed. Reg. 18344, April 29, 1992, and codified at 40 CFR §§ 300.1100 and 300.1105. But that rule was voided as beyond the EPA's authority (Kelley v. EPA, 15 F.3d 1100 (D.C.Cir. 1994)). The EPA and Department of Justice (DOJ) later issued the "Policy on CERCLA Enforcement Against Lenders and Government Entities that Acquire Property Involuntarily" reaffirming the EPA's and DOJ's "intentions to follow the provisions of the Lender Liability Rule as enforcement policy" notwithstanding the Kelley case. See 60 Fed. Reg. 63517 (Dec. 11, 1995). Congress subsequently adopted key elements of the safe harbor as a matter of law. See the Lender Liability and Deposit Insurance Protection Act of 1996, Title V of the Omnibus Consolidated Appropriations Act of 1997, amending 42 U.S.C. §§ 9601 and 9607.
- ***Innocent landowners***. The EPA adopted the "Policy Towards Owners of Property Containing Contaminated Aquifers," which provides that no enforcement action will be taken against innocent landowners whose property is contaminated solely due to subsurface migration from offsite sources. 60 Fed.Reg. 34790 (July 3, 1995). This policy is easy for the EPA to adopt in light of the third-party defense under CERCLA. But there may be some comfort in hoping that the EPA will live up to its "policy" and not initiate enforcement action, rather than having to prove the defense.
- ***Residential property***. The "Policy Towards Owners of Residential Property at Superfund Sites," OSWER Directive No. 9834.6 (July 3, 1991), is like the preceding item, but applies to residential property.
- ***Comfort letters***. The EPA adopted a policy making available status/comfort letters for individual properties and transactions. Such letters set forth EPA's view of current site status and enforcement intentions and approaches. Such letters are nonbinding, but still may be comforting. Although the policy exists, resources remain limited and it might be difficult to get the EPA's attention to issue such a letter for a site with respect to which the EPA otherwise has no interest.
- ***Prospective purchaser agreements***. These are formal, binding agreements that can define and limit the scope of the environmental risk to be assumed by a purchaser of contaminated property. Such agreements are limited regarding the kind of site and still may have qualifications and reopener provisions. The criteria (set forth in 60 Fed.Reg. 34792, July 3, 1994, replacing the original 1989 guidance) are as follows:
  - There is federal interest in the site, in that EPA action is being taken, is ongoing or is anticipated as to the site.
  - EPA and the community will receive some substantial benefit (*e.g.*, cleanup by purchaser, new employment opportunities).
  - Continued operations or new development at the site will not, with exercise of due care, aggravate or contribute to contamination or interfere with ongoing or future EPA response action, and will not pose health risk to the community or persons at the site.
  - The prospective purchaser is financially viable.

  The key elements of a prospective purchaser agreement are: consideration from the purchaser (monetary payment and/or defined cleanup obligation); EPA covenant not to sue the purchaser; protection for the purchaser against contribution actions by other responsible parties; and transferability to subsequent purchasers or tenants.
- ***Database purging***. The EPA has purged the CERCLIS database of almost 25,000 of the 38,000 sites listed that are No Further Remedial Action Planned (NFRAP) properties. The intention was to destigmatize those properties. Nevertheless, secondary databases maintained by environmental information companies were apparently not purged, and Phase I Environmental Site Assessment reports often continue to show both the CERCLIS and NFRAP listings.
- ***Risk-based corrective action***. Land Use OSWER Directive No. 9355.7-04 (May 24, 1995), requires the government to consider future land use when assessing risks, developing cleanup plans and choosing the most appropriate remedy for Superfund site cleanup.

Exhibit 1, *continued*

- ***Tax treatment of cleanup expenses.*** On March 11, 1996, President Clinton announced a $2 billion, seven-year tax incentive program to encourage brownfield redevelopment by allowing brownfield investors to deduct their cleanup expenses in the year incurred and reduce the net cost of such investment, when much of such costs might otherwise be treated as capital items not deductible in full in the year incurred.

- ***Pilot projects.*** In December 1999, the EPA announced the RCRA Brownfields Prevention Initiative under which the EPA is expediting cleanup at pilot project sites using innovative approaches. The objective is to show how the reform of corrective action approaches under the Resource Conservation and Recovery Act of 1976 (RCRA) (42 U.S.C. §§6901 et. seq.) can encourage redevelopment of brownfields.

- ***Legislative reform.*** Many of the policy initiatives can be viewed as efforts by the regulators to respond to the economic and political pressures while preserving the environmental statutes against reversal. Still, legislative reform of CERCLA is a perennial subject on Capitol Hill, lately with an emphasis on seeking a variety of ways to stimulate and encourage redevelopment of brownfields. For instance, the following bills are pending in the 107th session of Congress:

S. 1079	Brownfield Site Redevelopment Assistance Act of 2001
S. 1078	Brownfields Economic Development Act of 2001
S. 350	Brownfields Revitalization and Environmental Restoration Act of 2001
H.R. 2064	Brownfields Redevelopment Incentives Act
H.R. 1831	Small Business Liability Protection Act
H.R. 1439	Brownfields Clean-Up Act

It remains to be seen which, if any, of these bills will survive the legislative process and be enacted into law, and what liability relief and encouragement they will bring. The text and current status of these bills can be found on a Library of Congress Web site called Thomas Legislative Information on the Internet (at http://thomas.loc.gov).

State Initiatives

Brownfield initiatives at the state level include the following ***(using California for illustration):***

- ***Lender liability relief.*** California has adopted lender liability relief analogous to the federal CERCLA amendments noted above. See Health and Safety Code §§ 25548 et seq.
- ***Redevelopment agencies.*** Under certain conditions, redevelopment agencies are immune from liability under state and local environmental laws, and the immunity extends to certain persons entering into development agreements for a brownfields site, their successors in title, and persons financing the project in a redevelopment area. Health and Safety Code §§ 33459-33459.8.
- ***Special legislation.*** Special legislation was adopted for the Kaiser Steel Corporation Site in Fontana, California, to facilitate redevelopment by establishing procedures whereby certain parties could be released from liability. Health and Safety Code § 25364.1 (1992). The release, effective January 1, 1995, extended to cost recovery liability to the State under CERCLA, the State Hazardous Substance Account Act (Cal/Superfund) and the Hazardous Waste Control Act.
- ***Unified agency review.*** Under AB 2061 (Health and Safety Code § 25260-25268), a responsible party may obtain designation of a single state or local "administering agency" to oversee a project. Upon completion, the agency must issue a certificate of completion that operates like a statutory release from any further liability subject to specified reopeners. The statutory release does not apply to federal claims, only claims under state law. This law was enacted to deal with the problem of multi-agency jurisdiction and inconsistent or conflicting requirements.
- ***Pilot program.*** A pilot program was adopted for the streamlined cleanup of up to 30 sites under SB 923, the California Expedited Remedial Action Reform Act of 1994 (Health and Safety Code §§ 25396-25399.2). That law provides incentives designed to speed cleanups, such as: set time frames for agency reviews of submissions; more flexibility in remedy selection consistent with site-specific goals and "planned use" of the property (no preference for treatment except for "hot spots"); rights to dispute agency technical decisions; provision for liability allocation and state funding of "orphan shares"; mutual covenants not to sue; and future liability protection under a certificate of completion under AB 2061. Depending on the success of this pilot program, its features may become adopted more generally.

- ***Environmental use restrictions***. Under AB 1120 (Civil Code § 1471, effective January 1, 1996), owners of land are authorized to impose restrictions limiting the use of contaminated property, with the restriction running with the land and binding future owners and occupants, for protection of human health and safety.

- ***CLEAN Program***. In 2000, California enacted the Cleanup Loans and Environmental Assistance to Neighborhoods (CLEAN) Program to provide up to $85 million in low interest loans to help with the cleanup and redevelopment of abandoned or underutilized urban sites. The program is administered by the state Department of Toxic Substances Control (DTSC).

- ***The California Land Reuse Accord***. Senate Resolution No. 29–The California Land Reuse Accord, adopted July 14, 1995, encourages cooperative and expeditious solutions by all interested parties in order to remediate properties contaminated with hazardous waste and return them to productive use.

- ***Voluntary Cleanup Program (VCP)***. In order to facilitate brownfield redevelopment, this program departs from the "worst first" policy for allocation of Cal/EPA Department of Toxic Substances Control (DTSC) resources and allows a remediation project proponent to obtain DTSC oversight and cooperation. The VCP also contemplates shorter time frames for site investigation and remediation, which may accommodate development schedules and financing arrangements. Cleanups under the VCP are deemed "consistent" with the National Contingency Plan (40 CFR Part 300), facilitating cost recovery from other responsible parties. The VCP emphasizes use of presumptive remedies and innovative technologies to expedite remediation. But site-specific cleanup goals are utilized. Agreements under the VCP can clarify many of the issues that have posed difficulty. Upon completion, DTSC issues a "no further action letter" or a certificate of completion (short of a release or covenant not to sue).

- ***Prospective purchaser agreements***. DTSC (and other state agencies) may enter into prospective purchase agreements including covenants not to sue. The criteria are similar to those with the EPA's policy, but the state criteria are more flexible and of broader potential applicability. DTSC may also issue "comfort" letters. But, like the EPA, it may be difficult to get the attention of the DTSC to issue such a letter for a "pure" real estate transaction involving property that is not of concern to the regulators.

- ***CalSites Validation Program***. DTSC has deleted more than 21,000 sites from more than 26,000 potential sites on the CalSites list.

- ***Innocent landowners***. Like the federal policy, it is the policy of the state not to take enforcement action against innocent owners of property under which a plume of contaminated groundwater has migrated. Management Memo No. 90-11 (Dec. 7, 1990).

- ***Legislative reform***. Much like the Congress as noted above, the California legislature is actively considering ways to encourage redevelopment of brownfields. For instance, currently pending is S.B. 32, the California Land Environmental Restoration and Reuse Act. Another pending bill is A.B. 254, which would liberalize the CLEAN Program in certain ways to stimulate its use (such as by allowing some relief regarding the payment of DTSC oversight costs, designating the regional water quality control board as the oversight agency in some circumstances, permitting use of loan funds to pay a premium for environmental insurance, loosening the eligible property criteria, lengthening the loan repayment period, delaying the start of the loan repayment period, and allowing for other forms of security or for DTSC to have lower than first lien priority for the loan when the property being cleaned up is the security). S.B. 232 is also pending, which would establish the Financial Assurance and Insurance for Redevelopment (FAIR) Program seeking to make environmental insurance for brownfield redevelopment more available and more affordable. If enacted, a FAIR Account would establish and fund, with continuous appropriations, up to $37.5 million in order to subsidize premiums and to cover a portion of self-insured retention under certain kinds of environmental insurance products. The text and status of these bills can be found at the state Web site for Official California Legislative Information (at http://www.leginfo.ca.gov/).

One or more of these initiatives, as applicable, can be utilized to provide a measure of protection, or at least comfort, allowing a transaction to proceed. Still, brownfield redevelopment remains hampered by agency funding constraints, multi-agency coordination issues, policy uncertainty, and timeliness problems. Some regulators would rather require more site assessment and more remedial work than make a decision that enough is enough. Much remains to be done to solve the gridlock and paralysis associated with brownfield development, but we are much better off than we were before these initiatives were adopted.

Exhibit 2

Environmental Risk Allocation Strategies

- No express allocation (let chips fall where they may under applicable law, on some or all environmental aspects).
- Seller retains all risk.
- Buyer assumes all risk ("as is" sale plus release and indemnity to seller).
- Seller retains risk of all or certain "known" problems, buyer assumes "unknown" risks.
- Responsibility divided as of date of sale, preexisting vs. future conditions (requires good "base-line" site assessment).
- Sliding scale mutual indemnity (seller retains share of responsibility, reducing over agreed period after which buyer assumes all risk).
- Cleanup and "no further action" determination as condition of closing, or as post-closing covenant.
- Prospective purchaser agreements with applicable federal and state agencies (consideration paid by seller, buyer, or shared).
- Monetary holdback in escrow for remedial cost of known conditions.
- Deductibles (buyer's costs must exceed an agreed sum before seller's indemnity kicks in).
- Monetary caps (seller's indemnity has a limit after which the buyer assumes the risk).
- Scope of environmental indemnity (cleanup costs vs. economic losses vs. personal injury or toxic tort liabilities; onsite vs. offsite conditions).
- Duration of contractual protection: indefinite vs. termination provision (*e.g.*, completion of agreed cleanup, agreed time period).
- Use restrictions to limit risk of exposure to future occupants (*e.g.*, no drinking water well, no excavation below a given depth).
- Environmental insurance for unknown risks, in lieu of or in addition to contractual indemnities (premium paid by seller, buyer, or shared).
- Purchase price adjustments based on allocation of risk.
- Any combination of the foregoing.

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fall 2001, the economic expansion has foundered. The stock market has reversed course after a period of years of growth. While still active, the glow is off the hot real estate market of the last few years, with mixed results. For instance, the sudden collapse of many high-flying "dot.com" companies has had a downward impact on the real estate market in certain locations where rents were soaring one year ago. The Federal Reserve Board has cut interest rates in hopes of a "soft landing" and rebound. The effect is that the boom time mentality is in check and we remain cognizant of the prospects for recession. This should be the case even more if the U.S. economy slips fully into recession in the aftermath of the September 11 tragedy and subsequent hostilities. The scope, extent, and duration of the hostilities and the economic impact remain to be seen.

Governmental attitudes should remain cooperative, balancing environmental concerns and economic needs, as politicians seek ways to stimulate the economy. We can expect the government at all levels to be supportive of brownfield redevelopment, especially in blighted and environmentally impacted urban areas where the need to recycle properties is the greatest. Cooperative attitudes should continue even as economic conditions improve and notwithstanding fluctuations in the economic cycle, as long as there is demand for redevelopment of such areas.

The main threat at this point is not governmental attitudes; it is the availability of financing for projects involving environmentally impaired property if there is a period of deep recession. Assuming that financing is available, the climate should be favorable for the redevelopment of brownfield properties. Thus, the lesson is clear, now is the time to consider the recycling of brownfield properties before economic and political forces change sufficiently to work against such projects. Have courage and saddle up!$_{\text{REI}}$

NOTE

The author is expressing views of general academic interest, without any reflection as to how he or his firm would view any particular property, situation, or case. The views expressed are the author's and not necessarily those of his firm.

How to Structure a Lease to Protect Against the Risk of a Bankruptcy of the Tenant

by Susan Fowler McNally, Carter H. Klein & Michael S. Abrams

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The recent downturn in the economy has resulted in greater volatility in the financial status of many tenants, thus compelling landlords entering into office leases with these tenants to accept far greater risks than they are accustomed to. Due to the unconventional nature of the tenant improvements that many of these tenants require (*i.e.*, dot.com and high-tech tenants), their premises may not be readily re-leasable if they default. This article will explore how landlords can reduce the risks involved in leasing space to such tenants.

Landlords generally prefer to enter into leases with creditworthy tenants (*i.e.*, tenants with high and demonstrable net worth, substantial tangible assets, and a long track record of successful operation). Start-up companies generally do not have significant net worth, but they usually do have a significant burn rate (*i.e.*, the rate at which they burn though other people's money, whether angel financing, venture capital, or money raised through a public offering). When the financial status of a tenant is extremely volatile, the risk of a lease default increases. Dot.com tenants usually have no tangible assets and their operating histories cover a span of months (if not weeks) rather than years. The tenant improvements preferred by most high-tech tenants are unconventional and many (especially Internet and telecom-related companies) require significantly greater electrical and air conditioning capacity than traditional office tenants. Landlords attempting to re-lease high-tech premises after an early termination due to a tenant default may find themselves spending substantial sums of money to alter the premises for a more traditional tenant's use.

To induce landlords to accept the risks associated with renting to tenants whose long-term financial stability is questionable, many such tenants offer various credit enhancements, the most widely accepted of which are cash security deposits, personal guaranties, and letters of credit. Historically, the most typical forms of security accepted by landlords have been cash security deposits and prepaid rent. Both have certain limitations under bankruptcy and state laws. To understand these limitations, and to appreciate the advantages of letters of credit, it is necessary to understand how a landlord's claims against a tenant in bankruptcy are treated by the bankruptcy court.

§ 362(a) of the Bankruptcy Code provides for an automatic stay or injunction against creditors taking various types of actions affecting the debtor or its property. The stay issues automatically from the moment the petition for bankruptcy is filed by or against the debtor. The automatic stay prohibits creditors from taking possession or otherwise obtaining any property of the debtor, enforcing a lien against the debtor's property, or continuing any litigation against the debtor, after the debtor has filed for or become the subject of bankruptcy proceedings and until the bankruptcy court grants relief from the automatic stay. A landlord's claims against a tenant in bankruptcy are treated differently based on whether the tenant assumes or rejects the lease. If the tenant assumes the lease, the lease is reinstated and the landlord is paid all arrearages. If the tenant rejects the lease, the landlord's claims are subject to a statutory cap.

During the period commencing on the bankruptcy filing date and continuing until the debtor's assumption or rejection of the lease (the "**Post Petition Period**"), the debtor is required to perform all of its obligations, including paying the rent, in a timely manner.

Under § 365 of the Bankruptcy Code, the trustee or tenant/debtor in possession ("**debtor**") must either assume or reject the lease within 60 days of the bankruptcy filing date; however, the court may grant one or more extensions of the 60-day period and routinely does so. A landlord may oppose an

A landlord's claims against a tenant in bankruptcy are treated differently based on whether the tenant assumes or rejects the lease. If the tenant assumes the lease, the lease is reinstated and the landlord is paid all arrearages. If the tenant rejects the lease, the landlord's claims are subject to a statutory cap.

extension of the time period, or move to compel the debtor to assume or reject the lease; however, unless the debtor is in default with respect to its Post Petition Period lease obligations, the landlord is unlikely to prevail.

The landlord is entitled to an administrative claim (*i.e.*, a claim that gets paid before the claims of other unsecured creditors) for any default by the debtor during the Post Petition Period. The landlord may also obtain a bankruptcy court order compelling the debtor to immediately pay all defaulted amounts incurred during the Post Petition Period. This is the case even if the debtor has insufficient funds to pay all other administrative claims in full, such as those of the debtor's attorneys and other professionals.

In order to either assume the lease, or to assume and assign the lease to a third party, the debtor must cure all existing defaults and provide adequate assurance of future performance under the lease. The two principal issues between debtors and landlords over the assumption and assignment of leases are (1) what defaults exist and the amount of money or other actions necessary to cure the default and (2) whether the debtor's or its assignee's financial condition is sufficient to demonstrate adequate assurance of future performance. Generally, with respect to adequate assurance, the court will permit an assignment of the lease if the assignee's financial position is substantially comparable to that of the debtor's at the time the debtor entered into the lease.

If the debtor assumes a lease and subsequently defaults under the lease or rejects it, the landlord is entitled to treat the landlord's entire damage claim as an administrative claim in the bankruptcy case. If the debtor rejects the lease, or the lease is deemed rejected because the debtor failed to assume the lease within the 60-day period, it will constitute a breach of the lease immediately before the date of the filing of the bankruptcy case and the landlord will be entitled to assert a pre-petition claim for damages resulting from the breach. The landlord's lease rejection claim is first calculated under the lease and state law. The allowed amount of the claim is, however, subject to the cap set forth in § 502(b)(6) of the Bankruptcy Code.

Bankruptcy Code § 502(b)(6) provides that the maximum allowable claim of a landlord for damages resulting from the termination of a lease of real property may not exceed:

> A). the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of the lease, following the earlier of—
>
> (i) the date of the filing of the petition; and
>
> (ii) the date on which such lessor repossessed, or the lessee surrendered, the lease property, plus,
>
> B). any unpaid rent due under the lease, without acceleration, on the earlier of such dates;

Although the cap on its face appears to be a straightforward calculation, the maximum allowed by the bankruptcy courts is uncertain and varies by jurisdiction. The issues open to interpretation include (a) which of the landlord's claims are subject to the cap; (b) what is the rent reserved which is included in the calculation of the cap; and (c) how is the 15 percent limitation calculated.

Bankruptcy Code § 502(b)(6) splits the landlord's claims into two parts, unpaid pre-petition rent and the balance of the landlord's claims under the lease. The landlord's entire claim for unpaid rent due on the earlier of (1) the date of filing of the petition, or (2) the date the landlord repossessed (or the debtor surrendered) the property, is not capped. The determination of the date of repossession or surrender, if earlier than the filing date, is made under state law. It is important to note that landlord is entitled only to the unaccelerated amount owed on the applicable date. Thus, even if the landlord has obtained a state court judgment against the tenant for the entire amount owed under the lease prior to the filing of the bankruptcy case, the landlord's allowed claim in the bankruptcy case will be reduced to the capped amount.

Courts are divided as to whether the cap applies to all damage claims of the landlord other than unpaid pre-petition rent. Almost every court will apply the cap to items designated in the lease as rent or additional rent and to the tenant's obligations to restore the premises at termination of the lease. The majority of courts have found that the cap applies to all damages resulting from the rejection of the lease and the tenant's breach or nonperformance of any covenants or conditions under the lease. Under the majority view, in addition to unpaid rent, damages subject to the cap include pre-petition claims for repair and maintenance costs. Conversely, the minority view holds that the cap only applies to damages directly resulting from the termination of the lease and, therefore, repair and damage claims are not capped.

Interesting questions arise as to whether the landlord's claim against the debtor's bankruptcy estate arising in connection with the lease are for rent reserved under the lease and therefore are subject to the §502(b)(6) cap. Are real estate taxes, insurance premiums, and tenant's maintenance obligations part of the "rent?" How about attorneys' fees? What about build-out costs paid by the landlord, but amortized over the life of the lease? The answer to these and related questions is not found in §502(b)(6) itself, and will turn on the facts of each case, the language of the lease, and whether the claimed damages arise from the tenant's failure to pay for charges which are by their nature regular, fixed, and periodic.

Pursuant to Bankruptcy Code § 502(b)(6), a landlord's damages are calculated by using a formula that references the lease itself, specifically the "rent reserved by such lease." The meaning of the phrase "rent reserved by such lease" has given rise to a large amount of litigation, with courts applying three different tests. In the first test, a charge in a lease is included as rent reserved if it is expressly labeled as rent in the lease and is payable in fixed, regular, or periodic amounts. The second test expands the first test by including as a third factor whether the questionable charge relates directly to, or increases the value of, the property. The third test is set forth by the Bankruptcy Appellant Panel for the Ninth Circuit in *In re McSheridan,* 184 B.R. 91 (9th Cir. B.A.P. 1995). The McSheridan test provides that in order to be "rent reserved" a charge must be:

1. either (a) designated as "rent" or "additional rent" in the lease; or (b) provided as the tenant's obligation in the lease;
2. related to the value of the property or the lease thereon; and
3. properly classified as rent because it is a fixed, regular, or periodic charge.

The first and third prongs of the *McSheridan* test are relatively straightforward. If the charge is not designated as rent or specifically stated to be the tenant's obligation or is not fixed, regular or periodic, then it is not "rent reserved." Most of the litigation involves whether the charge relates to the value of the property. Courts have not been uniform in their application of this prong of the test. However, most courts include payments for insurance, common area charges, and taxes within "rent reserved." Utilities and repair and maintenance obligations generally are not included within the "rent reserved."

Courts are split over how to calculate the amount under the 15 percent limitation. Under the majority rule, the limitation is calculated by taking 15 percent of the total rent payments due under the remainder of the lease term. The minority view calculates the 15 percent limitation to the amount of time remaining under the lease. The difference between the two becomes significant when the lease provides for substantial rent increases over time.

Under common law, a landlord had the option of terminating the lease and seeking to obtain possession of the premises or keeping the lease in effect and suing for damages for each periodic default under lease. The common law has been modified in virtually every state. Under state law, landlords typically may recover an amount equal to the net present value of future rents due under the lease, plus any rent not yet paid at the time of termination of the lease.

One significant difference in state law is that certain states, such as California, impose an obligation on the landlord to mitigate its damages. Thus, under California law, the landlord's damages would be reduced by the net amount the landlord could recover by releasing the property to a third party after taking into account the costs incurred in releasing the property. Other states, such as New York, do not impose any duty on the landlord to mitigate its damages. Since a landlord's allowable damages in bankruptcy are calculated in the first instance by state law, a California landlord's damages would be reduced by any amount the debtor shows could have been reasonably mitigated by the landlord while the New York landlord's claim will not be so reduced.

In bankruptcy, a tenant's cash security deposit is an asset of the debtor's bankruptcy estate. To the extent that the cash security deposit exceeds the allowed

It is not uncommon for landlords to require guaranties from the principals of the tenant. However, in many, if not most instances, the guaranty is either not available or is of limited value if the tenant fails.

claim of the landlord, the excess will be payable to the bankruptcy estate. Additionally, the landlord is required to obtain relief from the automatic stay in order to set off the security deposit against the landlord's damages.

Several states also place limitations on the use of security deposits. Often, a landlord may only apply the security deposit to the payment of rent, the costs to repair damage to the premises caused by the tenant, and the costs to clean the premises upon termination. The landlord may further be required to return any unapplied portion of the security deposit to the tenant within a short period of time (*e.g.*, 30 days after termination). Thus, under state law, the security deposit may not be available to offset all of the landlord's actual damages.

Prepaid rent generally is treated like a security deposit under both state and bankruptcy laws. However, at least one bankruptcy court has held that the prepaid amount of future rent may not be set off against the landlord's damages and such amount must be turned over to the bankruptcy estate.

It is not uncommon for landlords to require guaranties from the principals of the tenant. However, in many, if not most instances, the guaranty is either not available or is of limited value if the tenant fails. When leasing to start-up companies, there is rarely a credit-worthy party willing to provide a guaranty. The founders of the tenant often have little net worth separate and apart from their interest in the tenant and the venture capitalists and other financial backers of the company will not provide their credit to the landlord.

A guaranty is worth pursuing if there is a credit-worthy party (ideally one whose assets are located in the state in which the premises are located) willing to sign one because the limitations of Bankruptcy Code § 502(b)(6) do not limit a landlord's claim against a non-debtor guarantor unless the guarantor is himself in bankruptcy. The purpose of Bankruptcy Code § 502(b)(6) is to limit the amount of damages a commercial landlord is allowed to recover from a debtor's estate so other creditors' claims will not be inordinately diluted by landlord's claim for breach of a long-term commercial lease. That being the case, the purpose of the statute is not served by applying its limitations to guarantors whose assets are not property of the debtor's estate. Courts that take this position, however, have not addressed the guarantor's subrogation rights and indemnity claims. Nevertheless, the cases that have addressed the issue have all held that the non-debtor guarantor liability to the landlord is not capped by §502(b)(6).

Remember too that a guaranty is subject to all of the surety defenses unless a landlord has obtained appropriate waivers of those defenses. One such defense is that any modification of the primary obligation exonerates the surety. Thus, if the landlord has entered into any extension agreement, lease modification, or workout with the tenant without the guarantor's written consent, the guarantor may be released from liability. Since most guarantors will not be willing to consent to any lease modification that will increase the likelihood that the guarantor will be called upon to pay the rent and perform the tenant's other obligations under a lease, a prudent landlord should require a guarantor to authorize the landlord to enter into agreements with the tenant to amend, modify, or supplement the lease, from time to time, without being obligated to give the guarantor notice of such modification.

For a relatively small fee (generally 1 percent per annum), a tenant may be able to apply for and have its bank issue to its landlord a letter of credit ("**LOC**") to secure the tenant's obligations under a long-term lease.

From the tenant's perspective, a LOC may be preferable to a large security deposit. A LOC will not necessarily tie up large amounts of the tenant's cash or other liquid collateral as would a security deposit. Instead, the cash can be deployed as working capital in the tenant's business.

From the landlord's perspective, a LOC may be preferable to a security deposit because a LOC is an independent obligation of the issuer. As long as conforming documents specified by the terms of the LOC are presented to the issuer before the expiration date and no fraud is involved, the issuer must honor the draw. When a LOC is utilized, the credit of the issuer stands behind the obligation of the tenant. Even if the tenant is insolvent and/or bankrupt, the issuer still must honor the beneficiary's conforming draws. Moreover, even if the tenant disputes the landlord's claim that the tenant has defaulted in its lease obligations or disagrees with landlord's determination of the amount of damages owed, the landlord can still draw on the LOC. The parties must argue about or litigate the tenant's claims outside of the draw and without involvement of the LOC issuing bank.

The strongly worded rule in Revised Article 5 of the Uniform Commercial Code ("**UCC**"), which deals with letters of credit, is that a draw under a LOC cannot be enjoined unless the applicant can show egregious fraud and all the conditions entitling the applicant to equitable relief have been fulfilled. Those conditions may include showing probable success in proving fraud, irreparable harm, no adequate remedy at law, balance of the equities, and the public interest will be served. In appropriate cases, a bond must be posted by the applicant to preserve the rights the landlord will lose if the LOC draw is enjoined and the credit expires. Appellate case law follows the statute; thus it is very difficult to enjoin a draw on a LOC.

The type of LOC used to secure lease obligations is usually a standby LOC, as opposed to a documentary or commercial LOC used to pay for goods purchased in international trade. A standby LOC is meant to be drawn upon only if a default occurs and is certified by the landlord in a document which is called for by the LOC and presented to the issuer. Besides Article 5 of the UCC, there are two principal regimes which govern letters of credit in this country: the Uniform Customs and Practice for Documentary Credits promulgated by the International Chamber of Commerce effective January 1, 1994, and found in ICC Publication No. 500 (the "**UCP**"), and the International Standby Practices 1998, promulgated jointly by the Institute for International Banking Law and Practice and the International Chamber of Commerce, effective January 1, 1999, and found in ICC Publication No. 590 (the "**ISP**").

From the landlord's perspective, as beneficiary, the preferred governing regime for a LOC should be the ISP. It is specifically designed for standby letters of credit, has clearer rules on questions involved in standbys, including assignment of proceeds and transfers of the LOC itself, and avoids several traps for the unwary found in the UCP. Those traps include (i) if the issuer is closed while the LOC expires due to a force majeure event, the beneficiary cannot effect a draw; (ii) if installment drawings are contemplated and one is not made, the beneficiary cannot make subsequent drawings; (iii) if transport documents are to be presented, they must not be stale; and (iv) documents cannot be inconsistent with one another. Under the ISP, each of these troublesome pitfalls is eliminated. For example, if the issuer is closed when the LOC expires due to a force majeure event, the beneficiary under an ISP governed LOC has an additional 30 days to make a presentment from the day the issuer reopens. By incorporating the ISP into a LOC, there is no need to worry about drafting additional terms in the LOC to avoid the pitfalls contained in the UCP. If you request them, most banks will issue standbys governed by the ISP.

A landlord is better able to make an error-free draw if the LOC it receives from the tenant's bank (1) calls for few documents; (2) minimizes the verbiage in the documents to be presented; and (3) does not require the wording of the draw documents specified in the LOC to be verbatim or exact language.

The simplest form of presentment is a draft or demand without any other documents, statements or certificates accompanying it. It is also the most difficult presentment to enjoin and is the easiest presentment to comply with without making a mistake. For avoiding the applicability of the automatic stay in bankruptcy, as discussed below, presentment of only a draft or demand is desirable from the landlord's point of view because it does not require declaration of a default or certification that notice of default or demand for payment has been given to the now-bankrupt tenant.

Other drafting tips include: (a) avoiding, as a draw condition, presentment of any document that must be signed by the tenant, a court, or an arbitrator or any third party over which the landlord has no control; (b) permitting the landlord to make partial draws on the LOC; and (c) avoiding any requirement that the landlord be required to specify the use or deployment of the funds drawn. Optimally, the LOC should have an outside or final expiration date beyond the expiration of the lease to allow the landlord to calculate and recover damages to the premises, holdover rent, and avoid or protect against a bankruptcy of the tenant within 90 days of the last payment received under the lease, if received late. The latter concern would dictate (i) requiring expiration of the LOC be more than 90 days beyond the last anticipated payment date, and (ii) using a claw-back provision in the LOC or lease (*i.e.*, a provision

The landlord should check the creditworthiness and acceptability of the issuing bank. Bank rating services are available to determine the strength and acceptability of the issuer. ...If the credit strength of the issuing bank is questionable, consideration should be given to obtaining a confirmation from a reputable money center bank.

which permits the beneficiary to draw on the LOC and hold the proceeds in escrow for as long as is necessary to protect against any preference claim if the tenant files for bankruptcy within 90 days after the expiration of the lease term).

Under the UCC, the UCP, and the ISP, if the LOC specifies no time period in which the issuer has to examine and honor, the issuer has a reasonable time, up to seven business days, to do so. Consider revising the LOC to shorten the time period for the issuer to honor to three business days.

Unless the LOC otherwise specifies, originals of each document called for by the LOC must be presented; consequently, copies or fax-signed documents will not comply. To facilitate draws (especially if the issuer is located out-of-state), have the LOC specifically permit draw documents to be presented by telecopy. The LOC should specify the issuing bank's telecopier number to be used for presentment of draw documents by fax.

Presentment letters of credit require the original LOC, including all amendments, to be presented with the documents required to be presented by the terms of the LOC to effect a draw. Although requiring presentment of the original may provide the issuer with some assurance that it is dealing with the true beneficiary, and for multiple draws, allow it to make a notation of the amount drawn on the LOC to help it prevent overdrafts, from the beneficiary's standpoint there is no reason to make presentment of the original LOC a requirement for a draw, except to assist the landlord's lender in obtaining an assignment of proceeds of the tenant's LOC. If the original LOC is lost or destroyed, then the landlord may be unable to effect a draw. Copies are not permitted as substitutes for the lost original and the issuer is under no obligation to issue a duplicate original. Neither the UCC nor the UCP even have a rule dealing with lost originals.

Although the ISP has such a rule, the issuer is not required to replace the original, but may do so in its discretion and on terms protective of it.

Under Revised Article 5 of the UCC, a beneficiary can require an issuer's consent to an assignment of proceeds if the original LOC is exhibited and the LOC is a presentment credit. If the LOC is not a presentment credit, then neither the landlord nor its lender can insist on the issuer's acknowledgment to an assignment of proceeds if the issuer refuses.

Avoid certificates which must be signed by specific individuals. In one case, an individual landlord had died and his personally-signed certificate was required to effect a draw on a LOC securing a tenant's lease obligations, which of course could not be supplied. The court upheld the issuer's right to dishonor. However, note that both the UCC and the ISP permit transfers by operation of law, so a bankruptcy trustee, receiver, decedent's estate, or successor by merger or name change is permitted to make a draw on a LOC of its predecessor even though the LOC is not transferable. Such rule does not extend to asset sales or other consensual or contractual transfers of the LOC unless the LOC is expressly made transferable and the terms of transfer are followed.

Except for transfers by operation of law, a LOC is not transferable unless it expressly so states. If the landlord sells the leased premises, its transferee will want all letters of credit, as well as any cash security deposits, transferred to it. The landlord's lender may also insist on a transfer of the landlord's letters of credit. Accordingly, each LOC should be designated as transferable. To facilitate transfer, the LOC should refer to and contain as exhibits the form of transfer notice and acknowledgment, and specify the transfer fee and who is obligated to pay any transfer fees.

Most letters of credit are issued for a term of one year or less. Banks have regulatory, prudent lending, and capital adequacy concerns about issuing longer term letters of credit. Leases frequently have terms in excess of one year. To bridge the gap between the need of the issuer to keep the expiration date of its LOC limited to a one-year period, and the landlord's need to keep the LOC in place for the duration of the lease, an automatic renewal provision should be included in the LOC. Such a provision will state that the LOC is deemed to be automatically renewed for additional one-year periods unless the issuer notifies the landlord/beneficiary a certain number of days prior to the expiration date (say 60 days) that the LOC will not be renewed. Unless timely notice of nonrenewal is given by the issuer, the LOC will automatically extend for one-year periods until an ultimate outside expiration date, if one is stated, or a cancellation and surrender of the LOC is agreed to by the beneficiary.

If notice of nonrenewal is given by the issuer before the lease terminates, the LOC should also provide that the landlord can draw on the LOC by submitting a document that states that the issuer failed to renew the LOC in a timely manner. For automatic stay considerations, the renew or draw provision should be drafted as an independent ground for the draw, apart from any other default under the lease. If the lease makes the failure to renew the LOC a set number of days prior to expiration of a default under the lease, then the landlord must decide whether it wants to terminate the lease and exercise its remedies or simply hold the draw proceeds as it would a cash security deposit and continue with the lease.

The agreement dealing with what a landlord will do with early expiration draw proceeds will usually be contained in the lease. Typically, some kind of escrow or security deposit arrangement will be negotiated, although some leases merely provide that such funds become the landlord's property and thus, are arguably treated as liquidated damages for the default; however, if the draw proceeds are excessive compared to the landlord's actual damages, it is likely that such "liquidated damages" will instead be treated as a penalty. More often, the parties agree on the landlord's escrowing proceeds of a draw on the LOC for failure to renew or they agree that the landlord will hold them in a segregated account under its sole control, but subject to the contractual obligation to apply them to the lease obligations in the event of a default.

The landlord should check the creditworthiness and acceptability of the issuing bank. Bank rating services such as Thompson's Financial BankWatch are available to determine the strength and acceptability of the issuer. While many foreign banks are as strong, or stronger than U.S. banks, convenience for presentment and enforceability and jurisdiction concerns in the event of a dispute dictate that at least a U.S. branch of a foreign bank be used. If the credit strength of the issuing bank is questionable, consideration should be given to obtaining a confirmation from a reputable money center bank.

If presentment of documents is allowed to be made by telecopier, the location of the issuing bank is important, more as a matter of convenience and logistics, although it can be important if suit must be threatened or brought against the issuing bank for wrongful dishonor. Obviously, the landlord would prefer to litigate in its own jurisdiction rather than in a distant city, state, or country. If original documents must be presented, then time and convenience favor use of a bank located in the vicinity of the landlord.

Under §362 of the Bankruptcy Code it may make a difference how the draw conditions are worded. If one of the draw requirements is that the landlord declare a default under the lease and make a demand on the tenant for payment of unpaid rent or other amounts due under the lease, the landlord may be violating the automatic stay by sending the tenant a notice of default while the tenant is in bankruptcy. Consequently, it is important to draft the draw trigger in a LOC so that the landlord need only state that a default has occurred under the lease (and not require a statement that notice of the default was delivered to tenant). Additionally, the lease should be drafted to make it clear that landlord is not required to deliver notice of default to tenant where landlord is barred by applicable law from sending tenant a notice of default.

If, as a precondition of a right to draw, the landlord must make demand on the tenant for payment of amounts in default, the landlord may or may not be held in contempt for violating the automatic stay. This depends upon whether or not the court determines the notice was merely informational for purposes of alerting the tenant and permitting a draw and was not really meant to be a coercive demand for payment. The astute landlord's attorney will avoid drafting into the lease or the LOC, the requirement for a landlord's demand of any type of payment as a precondition, directly or indirectly, for any draw on the LOC, at least at a time when the tenant is in bankruptcy.

No cases have decided the issue of whether the proceeds of a LOC securing a tenant's lease obligations which is drawn upon after the tenant's bankruptcy can be applied against those obligations in amounts in excess of the §502(b)(6) cap. Should the §502(b)(6) cap be applicable to prevent draws from a LOC to be applied against lease obligations in amounts in excess of the cap?

Because there is no case precedent, a bankruptcy court could take the position that once the draw has been effected, the cash proceeds can be applied by the landlord against the tenant's obligations only to the extent of the cap. The debtor could argue that the excess is in the nature of a penalty or unreasonable amount and it is against public policy, as embodied in §502(b)(6), for the landlord to keep the excess. The debtor would argue any such excess should be disgorged and returned to the debtor's estate. Additionally, if it is the tenant which is the applicant for the LOC, then the tenant will have to reimburse the issuer for the full amount of the draw. If the draw by the landlord is in excess of the cap amount, the issuer will have a claim against the debtor's estate or collateral for the full amount of the draw, thus depleting the estate by amounts in excess of the §502(b)(6) cap. Debtors would argue that avoidance of such depletion is the purpose for which §502(b)(6) was enacted; thus, the purpose of §502(b)(6) is frustrated if the cap is not applied to recoup the excess draw proceeds.

A landlord's secured lender should take a keen interest in the landlord's rights in and to security deposits pledged by the landlord's tenants to secure their lease obligations.

The better answer, however, is that the cap does not apply to preclude the landlord from using LOC proceeds to satisfy its state-law damages, even if they are in excess of the §502(b)(6) cap. A standby LOC is an independent obligation of the issuing bank, a non-debtor. If a guarantor cannot avail itself of the cap of §502(b)(6), a fortiori, neither should an issuing bank. Because of the strong independence principal embodied in the law of letters of credit, draws on letters of credit have typically been immune from various bankruptcy protections which benefit the debtor or its unsecured creditors. The cap on damages under §502(b)(6) should be treated no differently.

A landlord's secured lender should take a keen interest in the landlord's rights in and to security deposits pledged by the landlord's tenants to secure their lease obligations. If the lease security is in the form of a LOC, the secured lender to the landlord will want to (i) perfect its security interest in the LOC; (ii) be able to obtain control of the LOC in the event of a landlord default; and (iii) establish a protocol for when the LOC may be drawn upon and how the proceeds of the draw will be used.

Under Articles 5 and 9 of the UCC, (before the enactment of Revised Article 9), the procedure for obtaining a security interest and control over LOC collateral consisted of either having the LOC transferred into the name of the secured creditor if it were transferable, or if it were not transferable, taking possession of the original LOC, obtaining an acknowledgment of assignment of proceeds from the issuer and obtaining pre-executed undated draw documents from the landlord and holding them until an event occurs which entitles both the landlord and the secured lender to draw upon the LOC. In the latter case, the landlord's lender should have been granted authority in the security documents to complete the draw documents, date them, and present them. By having an assignment of proceeds acknowledged by the issuer, the landlord's lender could be assured, assuming the draw documents were compliant, that the issuer would pay them to the landlord's account designated in the assignment.

Lenders and landlords should be aware of the differences between an assignment of proceeds of a LOC and a transfer of the LOC. The former is accomplished by an acknowledgment of the issuer, on a standard form of the issuer, that the assignee is entitled to be paid a designated portion, or all of the proceeds of a draw on the LOC. A transfer of a LOC actually transfers the right to draw on the LOC, sign draw documents, consent to amendments, and make assignments of proceeds. As noted above, a LOC is not transferable unless it is so designated or the issuer otherwise consents to the transfer with the authorization of the applicant. An assignment of proceeds gives the assignee no right to draw on the LOC, and is subject to the rights of prior assignees, transferee beneficiaries, paying and negotiating bank rights, and the set-off rights of the issuing bank.

Under old Article 9 of the UCC, if the LOC were not transferred into the secured lender's name, the landlord's lender could only obtain a security interest in it by taking possession of it. This was true even if the LOC was not a presentment credit. Holding possession of the LOC might beat the bankruptcy trustee in the event of the landlord/borrower's bankruptcy, but such holding alone gave the landlord's lender very little control over when and if a draw would be made, where the proceeds would be deposited, or even to whom the proceeds would be payable if the landlord chose to assign the proceeds elsewhere.

Under Revised Article 9 of the UCC, the landlord's lender can perfect a security interest in LOC rights, *i.e.*, the right to receive proceeds of a draw on a LOC, by obtaining from the issuer an acknowledgment of assignment of the LOC proceeds under UCC §5-114(c). To do so, the landlord's lender must obtain a consent to or acknowledgment of assignment of LOC proceeds from the tenant's issuer. The tenant's issuer need not consent to or acknowledge an assignment of proceeds to the landlord's lender unless the LOC is a presentment credit and the mortgage lender consents to the issuer's reasonable conditions of assignment. Although such an assignment will beat the bankruptcy trustee and the tenant's rights to the proceeds, as noted above, the landlord's lender with an assignment of proceeds but not a transfer of the LOC will be subject to the landlord's decision and ability to make a timely and conforming draw on the LOC and to prior assignees transferee beneficiary rights, rights of confirming, negotiating, and other paying banks, and the right of set-off of the issuer for claims it may have against the landlord.

Under Revised Article 9 of the UCC, mortgage lenders to landlords are at a disadvantage compared to personal property lenders when it comes to perfecting a security interest in LOC rights. A personal property secured lender can obtain automatic perfection in LOC rights without having to go to the trouble of obtaining an acknowledgment of assignment of proceeds from the issuer. The personal property secured lender will have a perfected security interest in LOC rights if it has a perfected security interest in underlying personal property collateral secured or "supported" by the LOC, such as an account, an instrument, a payment intangible, or another general intangible. Revised Article 9 of the UCC provides that a personal property secured lender that has perfected its security interest in the underlying personal property collateral needs do nothing further to obtain a perfected security interest in the LOC rights supporting or securing payment of the underlying obligation, *i.e.*, perfection is automatic. A mortgage lender to the landlord has a mortgage lien on and assignment of rents in the mortgaged premises and the tenant leases. That collateral is not personal property of a type in which a supporting obligation arises under Revised Article 9 of the UCC. Therefore, to obtain a perfected security interest in LOC rights, the landlord's mortgage lender will have to obtain from the issuer an acknowledgment of assignment of the proceeds of the LOC.

If the landlord's lender can obtain neither a transfer of the LOC nor an assignment of the proceeds, in both cases consented to by the issuer, it may still try to obtain control over the LOC proceeds by the use of pre-signed documents and a payment direction. This method, however, may not always work if the issuer finds out about it and refuses to recognize it or the landlord files for bankruptcy before the draw is made or within the preference period thereafter. The safest procedure for the landlord's lender is still to obtain a transfer of the LOC, which will enable the lender to effect draws, and will put the lender's claim prior to that of other assignees and set-off rights of the issuing bank.

The secured lender to the landlord should realize that it has one year from the effective date of Revised Article 9, which in most states was July 1, 2001, to reperfect its security interest in letters of credit which it perfected by holding possession under old Article 9, of the UCC. If the lender's security interest is perfected prior to Revised Article 9, by holding possession of the original of the LOC, that will no longer be sufficient under Revised Article 9. Instead the lender must obtain an acknowledgment of assignment of proceeds from the issuer within the one-year period, or better yet, obtain a transfer of the LOC into its name. Otherwise, after the one-year period the lender's interest will be unperfected.

Tenants who are unable to pay their rent in a timely fashion frequently threaten to file for bankruptcy if the landlord refuses to restructure their lease obligations. (Generally speaking, tenants want to reduce the size of their premises and/or their rental rate when they are in financial difficulty.) A landlord may be willing to work with the tenant, but should nevertheless be concerned about the risk of the tenant filing for bankruptcy within 90 days after making any payments to the landlord pursuant to any such workout agreement, because such payments may be treated as preferences which are subject to being recovered by the bankruptcy trustee. Thus it is helpful to define tenant defaults broadly to include several precursors to the tenant filing for bankruptcy. Examples of such precursor defaults include:

a. failing to maintain a Web page;
b. tenant making any public announcement that the tenant intends to either (i) cease operations; (ii) dissolve; or (iii) make a distribution of all liquid assets to its shareholders;
c. failing to complete its tenant improvements by a specified date;
d. failing to occupy the premises and commence conducting business from the premises by a specified date;
e. vacating the premises; and
f. failing to obtain the next round of private or public financing prior to a specified date.

Because a LOC is an independent obligation of the issuer and thus a draw upon a LOC is not barred by the automatic stay that prevents landlords from taking various actions affecting a tenant/debtor in bankruptcy, and because a draw upon a LOC is (arguably) not subject to the cap on damages under Bankruptcy Code §502(b)(6), LOCs will remain the security of choice for landlords leasing to tenants whose credit is deemed risky.

Typically landlords pay for the cost of tenant improvements and brokerage commissions and capitalize them into the rent stream. The problem, as discussed above, is that by including these costs in the "rent reserved" they become subject to the cap imposed by Bankruptcy Code § 502(b)(6). To avoid the risk of such sums remaining unpaid if the tenant becomes bankrupt, landlords like to get cash-flush tenants to pay for all of those items the landlord typically goes out-of-pocket for, such as tenant improvements and broker commissions. Consequently, leases with such tenants are frequently drafted to clarify that it is the tenant's responsibility to pay for all of the tenant improvements, as well as the brokerage commissions.

If the tenant is unwilling or unable to pay for such costs upfront, the landlord can lend the tenant a sum of money equivalent to the sum of the tenant improvement costs and brokerage commissions, but the landlord should not amortize the repayment of such loan into the rent stream. Although this will affect the cap rates on the building, most sophisticated buyers are capable of understanding the value of treating the loan for tenant improvements and brokerage commissions as a separate transaction from the lease. This minimizes the risk of non-payment if the tenant files for bankruptcy and can make the appropriate adjustment in determining the fair market value of the building.

The landlord should be careful to document such a loan outside of the lease and treat it as a completely separate transaction. Such a loan structure should be carefully documented as a secured creditor/debtor relationship to avoid any implication that the sums due under the loan are really rent payments due under the lease and thus are subject to the cap on landlord's claims for damages under the lease. Some landlords go so far as to have one of their affiliates make the loan to the tenant to maximize the likelihood that such a transaction will be treated as being an obligation, independent from the tenant's lease obligations.

In order to properly document the loan as an obligation separate and apart from the lease, the tenant should be required to sign a promissory note and a security agreement. Ideally, the lease should not make any reference to such loan and the lease definitely should not be cross-defaulted with the note and security agreement.

Any loan to a tenant should be collateralized. Since many start-up companies do not own real property or other tangible assets which could serve as collateral for their debts, the security of choice is a LOC. Because the issuing bank's obligation to pay out on a LOC is independent from the tenant's obligation to repay the loan, and is one step further removed from the tenant's obligations under its lease, the transaction should not be subject to bankruptcy or state law limitations on the damages a landlord can recover from a tenant/debtor. However, as is true with most bankruptcy matters, it remains possible that a bankruptcy court could collapse even the most carefully documented loan into the lease under the theory that the loan repayments really reflect costs associated with tenant's use and occupancy of the leased property and thus qualify as "rent reserved." To date, no bankruptcy courts have decide this issue, so transactional lawyers can only hope that documents which clearly reflect the intent that the obligations to repay the loan be treated as separate and distinct from the obligations to pay rent under the lease will be honored.

CONCLUSION

Because a LOC is an independent obligation of the issuer and thus a draw upon a LOC is not barred by the automatic stay that prevents landlords from taking various actions affecting a tenant/debtor in bankruptcy, and because a draw upon a LOC is (arguably) not subject to the cap on damages under Bankruptcy Code §502(b)(6), LOCs will remain the security of choice for landlords leasing to tenants whose credit is deemed risky.REI

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LIGHTS OUT FOR CALIFORNIA REAL ESTATE?

by Andy Warren

California can not guarantee that it will have enough electricity to meet future demand. Since the state began experiencing rolling blackouts in January 2001, the media has extensively covered every possible cause for the power crisis and scenario as to how the solution will be paid for. Yet no one has addressed the ultimate economic impact the problem will have on California's economy—the world's seventh largest economy, larger than the entire country of Italy. Given the uncertainty surrounding the situation, determining the impact is a daunting task but one that needs to be addressed.

By comparing our third-quarter 2001 real estate forecast to a forecast showing the potential impacts of the energy emergency, we concluded that California's commercial real estate markets will be negatively impacted by the current power crisis. The forecast impounded decreasing economic activity in 2001, slower-than-expected growth in 2002, and normal growth in years 2003 to 2005. The impacts on employment, population, and income were then incorporated into our real estate models to come up with the new forecast. Eight metro areas, which represent over 90 percent of California employment, were included in this analysis. Four of the metro areas are in Northern California (San Francisco, San Jose, Oakland, and Sacramento) and four are in Southern California (Los Angeles, Orange County, Riverside, and San Diego).

The results of our analysis clearly indicate that the current energy emergency will impact the commercial real estate markets in California. The impact will be painful, but not terminal.

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The pain will come from decreased activity leading to slower rent growth. Decreased economic activity will lead to lower levels of absorption and this factor, combined with new space coming online, will lead to vacancy rates that are substantially higher than earlier projections. With rising vacancy rates, rent growth is likely to be slowed by two factors: 1). higher vacancy rates will give tenants more choices; and 2). landlords may have difficulty passing on rent increases to tenants who are feeling pinched by higher utility costs and who have other options available.

There are two factors at work that should help the commercial real estate markets avoid catastrophe. Primarily, most of the markets entered this situation in historically strong condition. Vacancy rates at the beginning of 2001 were at or near historical low levels and supply and demand were nearly perfectly balanced. The frenzied activity of the past two years did lead to an increase in new supply started in 2000, and the slowing economy in 2001 is leading to higher vacancy rates. Whether the addition of this new space will have severe consequences on the market will depend on how quickly the energy emergency is solved. If a solution can be found and implemented by 2002, economic activity should increase and be ready for the new space without an appreciable lag. The other factor in California's favor is that it isn't alone. It is becoming increasingly obvious that energy problems are likely to spread throughout the West and to other areas of the country. This makes a mass migration of California companies to out-of-state locations unlikely.

DEFINITION OF THE PROBLEM

A wide variety of factors have contributed to the current energy emergency in California. There has been much debate about inept deregulation, corporate greed, unrestrained consumption, extremist environmental policy, as well as many others that have been blamed for the situation.

In a nutshell, **the state of California could again have problems providing enough electricity in the right places at the right time to meet its future demands.** So, how will the current and potential energy emergencies impact commercial real estate markets in California?

Lease structures and who gets charged for electricity

While no one is likely to be left unscathed by rising energy prices, the type of lease in place helps identify who is directly responsible for the increased costs. The lease structures currently being utilized in California are:

- *Gross Lease* — Under the gross lease, the landlord pays all expenses for a year up to a predetermined level, or base year stop. Any expenses above this level are the responsibility of the tenant. In this instance, the landlord is only responsible for rising energy costs up to the base year stop. The amount above this will be the responsibility of the tenant. Leases that are previously in place protect the landlord from the rising expenses. New leases going forward are going to be a little trickier. Estimating how much to expect in energy expenses over the next several years will be a dangerous business.

- *Gross + Utilities Lease* — The gross + utilities lease helps protect the landlord during times of uncertainty about utilities costs. This lease operates like the gross lease described above except that the tenant pays all utility costs. The use of this lease expanded in San Diego when it began to feel the effects of deregulated electricity costs.

- *Triple-Net Lease* — The triple-net lease, as the name implies, requires the tenant to pay taxes, utilities, and maintenance. Thus the tenant is responsible for any increases in electricity costs.

What seems to be the common theme in each of these lease types? It would seem that the tenant is most likely to bear the increased electricity prices. The landlord, however, does have some exposure to rising electricity costs. The primary risk to the landlord is if market conditions deteriorate to the point where it is difficult to obtain rents that will cover the increased expenses. If appropriate rent levels are not achieved, then net operating income and the value of the building are likely to suffer.

THE OFFICE MARKET

A slowdown in office demand brought about by the California energy emergency will negatively impact office markets in the state. The impact will likely be reflected in higher vacancy rates and slower rent growth. While all markets could experience these symptoms, Northern California metro areas will see the greatest disruption. A total catastrophe in the office market is avoided due to the strong position of most office markets at the end of 2000. *See Exhibit 1.*

The intensity of electricity use makes office users susceptible to the current emergency. Office building tenants typically use 23.4 kWh per square foot of electricity. Advancements in technology have greatly increased office building electricity use. Tenants in office buildings now have an average of 949 computers for every 1,000 workers. This, combined with basic power uses such as lighting and heating and cooling, is the reason that office buildings have the third highest intensity of electricity use.

While the office sector is an intense user of electricity, the overall cost as a percentage of the cost of doing business remains relatively low. Current general estimates put electricity costs at between three and five percent of total costs. This is after the average cost of electricity spiked by 50 percent over the past year. Electricity costs are a larger percentage of occupancy costs, but a 40 percent increase in the cost of electricity only raises the percentage (of total costs) from seven to nine percent.

The risk of an office user losing power is relatively low compared to other commercial uses. An interruption in the power supply to an office building certainly results in lost productivity and in some cases may result in lost revenue. While these losses are certainly problematic, in a general sense they are relatively minor compared to a manufacturing operation that may lose an entire production run due to a power interruption.

In California, the office tenant is most likely to bear the burden of increased electricity costs. As previously mentioned, the typical office lease is usually a gross lease, a triple-net lease, or a gross + utilities lease. Each of these lease types passes on most if not all of the utilities cost through to the tenant. The primary risk to the landlord or owner is if market conditions make it difficult to negotiate lease rates that cover rising expenses. If increases in utility costs can not be passed through to the tenant, then the net operating income of the property will be negatively affected. *See Exhibit 2.*

A decrease in office employment growth due to the energy emergency will have a significant impact on office markets in the major California metro areas. Under a possible scenario, the eight largest metro areas could create 47 percent fewer office jobs through 2005. This translates to 83,000 fewer office employees over the next five years. Northern California, with its higher concentration of office employment, is projected to experience the worst of the downturn. The four Northern California metro areas could see 43,000 fewer jobs created over the forecast period.

A wide variety of factors have contributed to the current energy emergency in California. There has been much debate about inept deregulation, corporate greed, unrestrained consumption, extremist environmental policy, as well as many others that have been blamed for the situation.

If the energy emergency impacts the California economy as projected in our scenario, the office real estate sector will suffer. Before the energy crisis, the forecast for the eight metro areas called for a combined vacancy rate of a very healthy 7.2 percent by 2005. The forecast impounding the energy emergency boosts the aggregate vacancy rate by 40 percent to 10.1 percent. Historically, a 10 percent vacancy rate is not catastrophic. This is a testament to the very tight conditions that existed in most of these markets at the end of 2000. The boost in vacancy rates will be accompanied by a slowdown in rent growth. Rent growth in the metro areas is projected to slow in a range from 3 percent to 17 percent through 2005. The greatest impacts are expected to occur in markets with low vacancy rates at the beginning of the emergency, that, as a result, were expecting greater rent growth over the forecast period.

THE INDUSTRIAL MARKET

The energy emergency will have a varied impact on the industrial sector depending on the use of the property. Basic warehouse and storage facilities are not heavy users of electricity, but if any type of manufacturing is added to the operation the electricity requirements can dramatically increase. The type of activity in the industrial building also dictates how dependent the facility is on the supply of power. In some cases, interruption of power can cause a significant loss to the tenant in terms of lost time and product. Industrial facilities are also at risk to decreased industrial production in the state. These factors indicate that the industrial real estate sector will experience an increase in projected vacancy rates and slower than expected rent growth. *See Exhibit 3.*

Basic warehouse and storage facilities are the least intense users of electricity among commercial buildings. On average, a warehouse facility in the western region uses only 6.0 kWh per square foot. The majority of this electricity is used for lighting, Exhibits 1 & 2

Exhibit 1

Office Real Estate Energy Sensitivity

Electricity Use Intensity	Electricity Uses	Relative Service Interruption Risk	Sensitivity to Utility Costs	Lease Types
Medium to High *23.4 kWh per sq. ft.*	Lighting Heating & Cooling Office Machines	Low to Medium	Low	Gross Lease *(So. Cal.)* Gross + Utilities *(So. Cal.)* Triple-Net *(No. Cal.)*

Exhibit 2

Potential Energy Emergency Impact on Office Real Estate

Metro Area	Decrease in Competitive Office Employment Growth through 2005	Decrease in Absorption through 2005 (sq. ft.)	Potential Basis Point Change in 2005 Vacancy Rate	Potential Decrease in Rental Growth through 2005
Los Angeles	20,341	5,695,540	290	9.0%
Orange County	8,895	2,001,275	220	8.9%
Riverside	3,777	661,000	220	3.3%
San Diego	6,925	1,558,224	120	4.6%
Southern California	**39,938**	**9,916,038**	**240**	**6.5%**
San Francisco	12,859	3,021,966	370	11.5%
San Jose	11,320	2,264,075	380	14.7%
Oakland	12,517	3,672,059	410	16.4%
Sacramento	6,233	1,800,768	110	8.8%
Northern California	**42,929**	**10,758,867**	**340**	**12.9%**
Eight Metro Total	**82,868**	**20,674,905**	**290**	**9.7%**

heating and cooling, and refrigeration. While basic electricity use is low, other activities can greatly increase the use of electricity in these facilities. Any type of manufacturing activity will greatly increase electric power use, and in many cases require the installation of onsite generation capacity. For this reason, it is difficult to generalize the electric use by manufacturing activity.

The intensity of electricity use usually correlates very closely with how vulnerable an industrial tenant is to power interruptions. A good example is a manufacturer of plastic components that schedules production runs on a daily basis. Once a run is started, this manufacturer is very vulnerable to a power interruption. If the power goes out during the production run it may result in the loss of all the

Exhibits 3 & 4

Exhibit 3

Industrial Real Estate Energy Sensitivity

Electricity Use Intensity	Electricity Uses	Relative Service Interruption Risk	Sensitivity to Utility Costs	Lease Types
Variable *6.0 kWh per sq. ft. for Warehouse*	Lighting Heating & Cooling Refrigeration Stacking Equipment Assembly	Low – Storage High – Assembly & Manufacturing	Low – Storage Uses High – Assembly & Manufacturing	Triple-Net

Exhibit 4

Potential Energy Emergency Impact on Industrial Real Estate

Metro Area	Decrease in Industrial Employment Growth through 2005	Decrease in Absorption through 2005 (sq. ft.)	Potential Basis Point Change in 2005 Vacancy Rate	Potential Decrease in Rental Growth through 2005
Los Angeles	19,705	23,880,442	50	6.1%
Orange County	8,315	7,483,725	220	11.4%
Riverside	5,014	11,533,207	40	7.2%
San Diego	5,078	5,078,408	50	6.0%
Southern California	**38,113**	**47,975,782**	**80**	**7.7%**
San Francisco	4,319	1,662,443	370	21.5%
San Jose	1,652	912,504	260	7.8%
Oakland	5,087	7,122,002	380	18.6%
Sacramento	4,704	7,173,348	420	27.5%
Northern California	**15,762**	**16,870,297**	**380**	**18.8%**
Eight Metro Total	**53,875**	**64,846,079**	**140**	**13.3%**

material that is currently in the molds. In addition, time and wages are lost cleaning equipment from the aborted run. A tenant like this is likely to require the availability of a backup power source.

The tenant bears the risk of an increase in utility costs in an industrial building. The typical industrial lease in California is the triple-net variety, which makes the tenant responsible for all expenses. Risk to the landlord is tied to current market conditions. Will higher energy costs depress demand for the space to such a level that the landlord will be forced to accept a lower rent or won't be able to lease the space at all? *See Exhibit 4.*

The largest potential impact to the industrial real estate sector is a significant slowdown in the California economy. If the energy emergency leads to decreased production, it is reasonable to assume that this will have a negative impact on industrial real estate demand. Because the California economy actually dipped into a moderate recession in the fourth quarter of 2001, it is very possible that employment growth for the year could be 0 percent or actually decline at a negative .8 percent rate. This blip in the economy, along with slower growth in 2002, could cost the eight metro areas the creation of over 50,000 industrial jobs between now and 2005. In real estate terms, this translates into lost absorption of 64 million square feet. Nearly 80 percent of this would come from the more industrialized Southern California metro areas.

The energy emergency is likely to depress industrial real estate activity, but several factors should prevent the impact from being devastating. The first mitigating factor is that nearly all of the eight metro areas included in this analysis are at or below current equilibrium vacancy levels. The markets are going into the slowdown in a very strong position. The level of expected new supply is the second factor that will help lessen the impact of the energy emergency. While the industrial market could see 50 million square feet less absorption over the next five years, the amount of expected new supply should also slow to manageable levels. The result is that the aggregate vacancy rate for the eight metro areas will rise to 8.2 percent, only 140 basis points above the expected 6.8 percent without the energy emergency. The overall slowdown in activity is more likely to manifest itself in terms of slower rent growth. Through 2005 rent growth could on average be 7 percent to 19 percent lower than the level of growth projected before the energy emergency.

THE RETAIL MARKET

The energy emergency will put a fairly high strain on the overall retail market. While the sum of the impact will be negative, there will be some differentiation among retail segments. The retail market is going to get hit by the energy emergency both coming and going. First, the retail market will have to deal with a rising cost of doing business. This is especially problematic to a real estate sector that often operates on very thin margins and is very conscious of any variable that impacts occupancy costs. Next, sales are likely to decline as consumers have less disposable income due to their own rising energy costs. Lower sales will prevent retailers from fully passing on increased operating costs to consumers, forcing them to absorb some of the increased energy costs. The result of the pressure on the retail sector will be lower than expected absorption, leading to higher vacancy rates and smaller rent increases. *See Exhibit 5.*

All the evidence points to the fact that the current energy situation will impact California's commercial real estate markets. While we can theorize on the extent of this impact, the bottom line is that a tremendous amount of uncertainty remains.

The intensity of electricity use in the retail sector is very dependent on what is being sold at the location. General mercantile and service buildings are moderate users at 13.9 kWh per square foot. Food sales locations, such as grocery stores, are very high intensity users at 39.7 kWh per square foot. Typical uses of electricity include lighting, heating and cooling, refrigeration, cooking, and dishwashing.

The use of triple-net leases in California serves to make the tenant responsible for rising energy expenses. The tenant is then faced with the difficulty of trying to pass through the increased costs to their consumers, or deal with lower profits. The landlord in this case is not directly impacted by the increased energy costs. However, slowing absorption that will hinder their ability to raise the rents of stressed tenants will have an effect.

Lower retail sales will be the result of slower population growth and decreased disposable income. Projected population growth could result in just over 1.0 million fewer residents by 2005. Slower economic growth will create less opportunity leading to slower net-in migration. This is especially true in the Bay Area where the cost of living is exorbitantly high. The increase in energy prices will effectively reduce the amount of disposable income in the state. Fewer people with less money to spend will result in approximately $11.0 billion in lost retail sales between now and 2005. This reduction in demand could make it more difficult for retailers to pass on higher energy costs to their customers. *See Exhibit 6.*

Retailers dealing with rising costs and reduced sales will put negative pressure on the retail real estate sector. Absorption could slip by as much as 16.5 million square feet over the next five years.

Exhibits 5 & 6

Exhibit 5

Retail Real Estate Energy Sensitivity

Electricity Use Intensity	Electricity Uses	Relative Service Interruption Risk	Sensitivity to Utility Costs	Lease Types
Moderate to Very High *13.9 kWh per sq. ft. for Mercantile* *39.7 kWh per sq. ft. for Food Sales*	Lighting Heating & Cooling Refrigeration Specific Requirements	Low to High	Very High	Triple-Net

Exhibit 6

Potential Energy Emergency Impact on Retail Real Estate

Metro Area	Decrease in Population Growth through 2005	Decrease in Absorption through 2005 (sq. ft.)	Potential Basis Point Change in 2005 Vacancy Rate	Potential Decrease in Rental Growth through 2005
Los Angeles	379,670	3,995,010	110	7.8%
Orange County	106,816	2,089,848	80	13.6%
Riverside	156,918	2,307,260	170	14.3%
San Diego	114,109	2,083,359	150	5.9%
Southern California	**757,513**	**10,475,478**	**120**	**10.4%**
San Francisco	71,206	1,641,891	230	14.6%
San Jose	69,914	1,441,182	370	2.4%
Oakland	102,097	1,667,453	80	4.5%
Sacramento	72,444	1,287,317	370	7.1%
Northern California	**315,659**	**6,037,843**	**250**	**7.2%**
Eight Metro Total	**1,073,172**	**16,513,320**	**170**	**8.8%**

Dropping from a baseline projection of 40.6 million square feet to the energy impacted forecast of 24.1msf. The four Northern California metro areas could see absorption reduced by as much as 46 percent. Southern California is impacted to a lesser extent. The decrease in absorption is projected at 36 percent. Less demand and financially strapped tenants mean that rent increases are also likely to decrease. Through 2005, the average retail rent was expected to increase by just over 19 percent. With the stress applied by the energy emergency, this forecast has been lowered to just over 10 percent.

RISKS & OPPORTUNITIES

All the evidence points to the fact that the current energy situation will impact California's commercial real estate markets. While we can theorize on

Exhibit 7

Steps to mitigate risks...	*Potential opportunities...*
Identify who will ultimately bear the higher cost of electricity and the potential impact on their occupancy decision	*Not all industries will be impacted equally. Softening property markets may present opportunities for some tenants*
Identify how higher electricity costs could influence occupancy of a sub-market	*By virtue of controlling their own generating capacity, some metro areas are immune to shortages and rising costs. These areas may well attract new potential tenants*
Determine how sensitive the tenant base is to power interruptions	*A location may benefit by being near a power grid, or being suitable for an auxiliary power supply*
Incorporate higher energy costs into the financial evaluation of a property (impact on expenses and future rent increases)	*There is always the possibility that a "herd mentality" may improperly asses the financial impact on a property*

the extent of this impact, the bottom line is that a tremendous amount of uncertainty remains. What will be the proposed solution? Will the timing of the solution be sufficient? What we do know is that ultimately everyone in California is going to have to pay more for electricity. This includes consumers and businesses alike. All major property types will feel the economic consequence of higher energy prices.

Another thing we know about uncertainty is that therein lie risks and opportunities. This situation is no different. It is quite possible that you can mitigate some of the risk in this situation by monitoring certain basic variables. Conversely, this situation may provide opportunities that may not have arisen otherwise. As shown in *Exhibit 7*, there are several steps that can be taken to mitigate risk, while also being cognizant of potential opportunities.$_{\text{REI}}$

How Relevant are Appraisals/ Valuation Reports to International Real Estate Transactions?

by Mark Lee Levine, CRE & Jeffrey L. Engelstad

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Introduction & Research Statement of Purpose

On what basis do international buyers, sellers, and those involved in leases, value realty for disposition, acquisition, and/or leasing property, whether within or outside of the United States, and, in doing so, undertake such actions and/or strong support for their decisions by reliance on a formal appraisal or other similar valuation tool for such decision-making process?

This analysis looks to survey work by the authors and a review of literature within the field relative to international valuation issues and the relevant literature in place as to the reliance on appraisals and/or other valuation techniques when making these decisions for acquisitions, dispositions, and/or leasing.

Through a brief survey, *(see Exhibit 1)*, of investors, advisors and consultants, governmental officials, academicians, real estate brokers, valuers, appraisers, and others, the research and analysis examined whether they and/or their clients conclude that their decisions are reliant on the appraisals and/or valuation tools which one might traditionally use in (commercial) real estate transactions.

This study, in part, questions the almost gospel, dogmatic position by many in the United States of their reliance on formal appraisals, at least in part, when there are larger commercial real estate transactions being undertaken by a buyer, seller, or those involved in leases.

In part, the use of appraisals in the United States may be reliant on data and analyses that are not relevant in some other countries. A portion of this manuscript examines such position, including the availability of relevant market sales data. Such data may exist in the United States but may not be available in many other countries.

Part of this research, relevant to the question of reliance or non-reliance on appraisals or other valuation techniques, was tested through the responses from the formal survey, as well as an examination of literature in the field that denoted availability of information necessary to produce what might be labeled as a "traditional appraisal" of commercial real estate.

REVIEW OF LITERATURE: INTERNATIONAL STANDARDS OF VALUATION & USE OF VALUATION TECHNIQUES

Valuation Techniques: Fundamental Approach

Although use of the term "appraisal" is employed differently in varied settings throughout the world, the use of this term in this manuscript relies on the broad, generic definition of an appraisal as ". . . the act or process of estimating value." [1a]

The use of the term "appraisal" may be more common in the United States than much of the rest of the world, where the reference to one who is undertaking an appraisal, an "appraiser," might be referred to as a "valuer." [2] However, for purposes of this manuscript, the reference to the term "appraiser" will equate to the term "valuer" and the use of the term "appraisal" will equate to a valuation report, or similar document.

The United States appraisal profession has generally followed the Uniform Standards of Professional Appraisal Practice (USPAP),[3] promulgated by The Appraisal Foundation.

After an examination of many other studies and papers on the topic of appraisal and valuation, it is clear that there are many standards or differences throughout the world when undertaking valuation reports. For an excellent overview of this area, see the article prepared by Dorchester and Vella.[4] In their article,[5] these authors undertook an impressive review of the topic of valuation standards as they exist throughout the world on a broad scope, and more specifically as to the European Union and their valuation standards.[6]

Because valuation standards are important for one to determine the nature of the report, the authors, emphasized the need for consistency in valuation standards throughout the world. The authors noted the development of such valuation standards in the European Union.[7]

Reliability is the key factor for appraisals and valuation reports. The authors made the point that standards attempt to improve reliability and consistency of the process and the parties involved: "As valuation standards are fully implemented internationally, foreign investors are more likely to seek and rely on U.S. appraisers for professional assistance."[8]

The need for international valuation standards, for valuation of U.S. properties, valuation of foreign properties, liaison with capital markets, liaison with accounting standards, and public sector financial reporting were key issues mentioned in the article, which examined how appraisers can work well with their international clients.[9]

Thomas Friedman said in his *Lexus and the Olive Tree* work that globalization issues face everyone.[10] There is certainly no exception to this conclusion. It is only a question of the degree.

One of the concerns with valuation in general is the Standards which are employed, if any. This was highlighted in the United States and supported under the concept of The Appraisal Foundation and development of the Uniform Standards of Professional Appraisal Practice (USPAP).

Other countries have also focused on the need for valuation standards. Only very recently, and very apropos to this research, has been the release in July, 2000 by the International Valuation Standards Committee (IVSC) of the *International Valuation Standards 2000* (IVS). This *International Valuation Standards* document emphasized the importance, as seen by all of the sponsors, for the need of a position that is consistently followed throughout the world, and certainly relative to European standards in particular. IVS 2000 is the first publication to emerge from the IVSC Standards Project launched on January 1, 2000. This three-year project aims to produce a comprehensive and robust set of international valuation standards and guidance by 2002.

The IVS 2000 publication stated, on page 3, that the objectives of the IVSC have been two major concerns:

- The formulation and publication of valuation standards and the promotion of their worldwide acceptance; and
- To harmonize standards among the world's states and identify and make disclosure of differences in statements and/or applications of standards as they occur.

These goals or objectives by the IVSC also relate to the research undertaken in this manuscript in that they emphasized the concern with valuation reports, the need for consistent standards, and the need to properly apply those standards in various settings. The IVSC continues to be concerned with a lack of standards, especially those involving the appraisal standards of emerging countries that are only now gaining in some degree of sophistication as to real estate valuation issues.

For an interesting discussion of many of the broader issues noted in this section of this manuscript, see the authorities cited in the footnotes. These authorities discuss the issues of international valuation standards,[11] (European, in particular),[12] international real estate appraisal organizations, adaptability and applicability of standards at different times and locations throughout the world, as well as differences in techniques, cultures, and application when undertaking appraisals or valuations in any country.

EXPLANATION OF METHODOLOGY

The approach to examining the issue of the applicability of an appraisal or valuation report when acquiring, disposing of or leasing real estate on an international basis is examined through the use of the brief survey (*Exhibit 1*).

In the survey, there were six questions that attempted to pointedly direct the participant.

Question 1 focused on the current position of the respondent in terms of occupation, profession, or primary job function. As to real estate issues, the respondent was asked to note his/her general background as to the current area of practice, the country of domicile, and investments in a given country or countries.

Question 2 addressed the capacity in which the respondent was acting, viz., personally or as a representative of another party or entity, on an international basis. This included representation of a seller, buyer, or one under a lease position. Question 2 also noted that if the answer to the above questions indicated that the respondent was not involved in those activities, then the respondent would end the survey and go no further, but would transmit the survey back to the sender.

Question 3 asked for varying positions of agreement or non-agreement, numerically, from 1 to 5. The least agreement would be Level 5; the strongest agreement would be Level 1.

Question 3 covered:

- The use of appraisals as important in the decision-making process for the sale, purchase, and/or lease of real estate;
- Issues of bias and independence;
- Use of the term "appraisal";
- The importance of a formal appraisal as a valuation tool.

Question 4 focused on the majority of transactions that the respondent had undertaken in international, commercial real estate. As to the representation of a buyer, seller, or lessor/lessee, or for one's own interest, the question then asked whether such party relied on an independent, third-party appraisal/valuation on the subject property for the acquisition, disposition, or leasing.

Question 5 inquired as to what primary valuation tool was used by the buyer, seller, or lessor/lessee. This question attempted to determine what valuation instrument was most favored when making the decision as to what a property was allegedly worth for the acquisition, disposition, or leasing. The choices ranged from individual approaches to value to "personal reaction" to the formal appraisal document.

Question 6, the final question, asked the respondent to note whether his/her main area of focus in real estate, whether personally or with clients, involved residential or commercial real estate.

As can be seen, the attempt was to keep the survey short, thereby encouraging a greater response rate.

The responses to these survey questions are illustrated below.

DATA ANALYSES

Question 1: Background Information: The background information on the respondents illustrated

Exhibit 1

SURVEY ON VALUATION ISSUES

Note: Limitations and Qualifications on this Study: The study was undertaken by the use of surveys sent by e-mails, mail, and handouts. (Not all questions were answered by all respondents.)

1. Background information:

a. My current position can best be described as an (check all that apply):
  1. Investor_____
  2. Advisor/consultant_____
  3. Government official_____
  4. Academician_______
  5. Broker (real estate)_____
  6. Appraiser or valuer_____
  7. Other (please specify)_____.

b. My country of domicile is_________________________________.

c. Directly, or with clients, I am involved in investments in real estate in (check all that apply):
  1. USA_____
  2. Central or South America_____
  3. Canada_____
  4. Europe_____
  5. Australia/New Zealand_____
  6. Asia_____
  7. Africa_____
  8. Other locations than noted above_____
  9. None of the above_____.

2. Do you represent, or act personally, on an international basis (check all that apply):

Yes__ No__ a. Sellers of real estate, where the real estate is located outside or within the United States of America?

Yes__ No__ b. Buyers of real estate, where the commercial real estate is located outside or within the United States of America?

Yes__ No__ c. Lessors or lessees of real estate located outside or within the United States of America?

NOTE: d. If a, b, or c were answered "Yes," go to Question #3. If the answer to a, b, and c, above, were "No," stop the survey and please transmit the survey back to the sender. Thank you for your cooperation.

3. In your order of agreement or disagreement, please respond to the following (circle 1 for the strongest agreement, and circle 5 for the least agreement with the following statements):

STRONG LEAST

1 2 3 4 5 a. The use of appraisals is important in our and my clients' decision-making process for the sale, purchase, and/or lease of real estate.

1 2 3 4 5 b. I and my clients put very little weight on an appraisal, unless we know it is undertaken by an unbiased person, unrelated (to the transaction).

1 2 3 4 5 c. An appraisal (when we/I use this term) covers the broad range of valuation, opinion of value, comparative market analysis, and the like, undertaken by a reasonably informed, independent, third-party.

1 2 3 4 5 d. One of the most important valuation tools used by me and/or my clients when valuing property is an appraisal, although we certainly also use other tools.

1 2 3 4 5 e. I and my clients would rarely undertake the purchase, lease and/or disposition of realty without an independent appraisal (valuation) being undertaken prior to such act.

1 2 3 4 5 f. Appraisers in my country of domicile generally act independently and are held to standards prescribed by government(laws) and/or professional organizations that regulate such appraisers/valuers.

(Continued on next page)

Exhibit 1, *continued*

4. In answering the following Questions, assume that your answer represents the majority of transactions that you have undertaken in commercial real estate on an international basis. In representing a buyer or a seller, or for your own interests, as noted in Question #2, did you, the buyer, seller, or lessor/lessee rely on an independent, third-party appraisal/valuation on the subject property for the acquisition or disposition of the property?
CHECK ONE:

__ a. Heavily relied on the appraisal for the decision to buy, sell and/or lease;
__ b. Relied on the independent appraisal, but only moderately;
__ c. Did not rely on the independent appraisal that was undertaken;
__ d. There was no independent appraisal used in this transactions; or
__ e. I do not know if there was any reliance on an independent appraisal relative to the transaction(s).

5. The primary valuation tool used by you and/or a buyer, seller or lessor/lessee you represented to value the subject property in question, which was being sold or purchased outside of the United States of America, by an international non-citizen/non-domiciliary of the U.S.A., was:
CHECK ONE:

__ a. An independent appraisal/valuation;
__ b. The Income Approach employed by a party to the transaction;
__ c. A "personal reaction" to the property by the buyer or seller;
__ d. The cost of the property;
__ e. Market comparisons undertaken by a party or representative of a party; or
__ f. Other means.

6. My main dealings in real estate, personally or with clients, is with:

a. Residential real estate____
b. Commercial real estate_____.

that their strongest interests seemed to be from what could be considered "traditional appraisers" within the United States.

As indicated in Question 1(a), the respondent groups tended to be in seven general categories, including investors, advisors/consultants, governmental officials, academicians, real estate brokers, appraisers, and others, as indicated in the following material. Appraisers dominated, being approximately 40 percent of the entire populace responding. This is reasonable, as they would naturally be more likely than non-appraisers to answer a survey involving appraisal-related issues. The bulk of the non-appraiser respondents were from real estate brokers, advisors, and investors.

The job positions, excluding the 40 percent group of appraisers, showed a balance in many areas of real estate, *e.g.*, investors at 24 percent; advisors/consultants at 27 percent; and brokers in real estate at 42 percent. Thus, once appraisers were removed from the mix of declared, primary professions, there were three large groups—brokers, investors, and consultants.

Under Question 1(c), the dominant country of domicile of respondents was the United States at 77 percent. The U.S. was also the geographic area of greatest concentration for those respondents with international dealings. (It is important to note that the data may be interpreted to mean that the majority of responses contained in this survey were related to dealings with an inbound foreign investor or company.)

The respondents were fairly balanced with respect to their representations of clients in international transactions. Of those responding, 39 percent indicated that they primarily represented purchasers of real estate; 34 percent primarily sellers; and 27 percent lessors or lessees. Given the fact that this ties most respondents to the geographic area of the United States, we can again surmise that the majority of respondents were dealing with U.S. and foreign investors or users of commercial real estate.

Questions 3 through 5 were more substantive questions on specific issues relative to the importance or lack thereof, of an appraisal/valuation report in the real estate decision-making process.

Question 3(a) addressed the issue as to whether the respondents agreed or disagreed with the importance of an appraisal being used in the (international) real estate decision-making process.

The survey instrument was based on a five-point scale of agreement with the stated questions. A response of 1 related to the strongest agreement and a response of 5 related to the weakest agreement: the authors interpreted a response of 1 or 2 as "strong agreement"; a response of 3 as "neutral"; and a response of 4 or 5 as "weak agreement."

Figures 1, 2, & 3 illustrate the responses as to how important the respondents considered the appraisal to be in the decision-making process. *Figures 1-3* also reveal an important distinction between appraisers and non-appraisers when considering the importance of a formal appraisal document in the investment decision-making process. Of all respondents to the survey, 78 percent were in strong agreement that an appraisal weighs heavily in the decision-making process; however, among non-appraisers, the percentage, was only 55 percent. (Among those respondents that are exclusively engaged in the appraisal profession, the "strong agreement" percentage was 92 percent.)

Question 3(b) addressed the issue of the importance of the appraisal relative to whether the clients put much weight on the appraisal or valuation report if they were not assured it was undertaken by an "unbiased" individual. In some countries the level of bias is not raised to the same degree and does not carry the same level of concern as is true in the United States under the Uniform Standards of Professional Appraisal Practice.

Question 3(b) concluded that 58 percent of the appraiser respondents answered that it was a very important element. Contrasted with this, 12 percent of all respondents indicated that the issue of bias was not one of focus relative to the use of the appraisal report.

The data also indicates that appraisers and non-appraisers alike feel somewhat strongly that an appraisal is most valued when it is performed by an unbiased third-party that is disconnected from the transaction. One distinction worth noting is that while only 18 percent of non-appraisers felt a weak agreement with the statement, 36 percent of those exclusively engaged in the appraisal profession had a weak agreement.

Question 3(c) raised the issue of how one might consider using the term "appraisal" or "valuation opinion," given that the term is bantered about in various settings, not always in a technical or formal sense, as one might associate the term with USPAP. The general response from individuals as to the meaning of the term "appraisal" might mean an unbiased opinion of value. Or, the term "appraisal" might mean "what their broker undertook." It might be a Comparative Market Analysis (CMA), which is phraseology that is often utilized in the brokerage community. That is, the concept of an "appraisal" might be equated to a Comparative Market Analysis in some settings.

Results from the respondents to Question 3(c) indicated that the term "appraisal" covers a broad range. About 75 percent of the respondents indicated that the term is in fact used very broadly. Only a small percentage of respondents indicated that an "appraisal" was more strictly defined.

Question 3(d) attempted to focus on whether the appraisal was considered "one of the most important valuation tools" utilized. The survey results indicated that other tools might also be used. Approximately 65 percent of all respondents considered the appraisal a very important valuation tool; however, among non-appraisers less than 50 percent considered an appraisal as the most important tool.

Question 3(e) raised the issue as to whether the respondent and his/her clients would act in the purchase, lease, or disposition of real estate without an independent appraisal first being undertaken. Approximately 66 percent of all respondents indicated they would tend not to act without such an appraisal.

Question 3(f) focused on if the appraisers or valuers would act independently and whether they would be held to standards prescribed by government and/or professional organizations which regulate such appraisers or valuers. A strong response for regulation consisted of 82 percent in the first category, and only 9 percent in the least important category—category 5. (Obviously these results are influenced by the mix of the respondents, clearly dominated in this survey by U.S. appraisers/valuers.)

Question 4 was designed to tie with some of the issues in Question 3, but Question 4 looked to the majority of the respondent's transactions undertaken, either personally or by representing others, and if they relied on an independent appraisal. Of all respondents, 81 percent indicated that there was moderate to heavy reliance on a formal appraisal document; however, 12 percent of non-appraiser

Figures 1 - 3

Figure 1

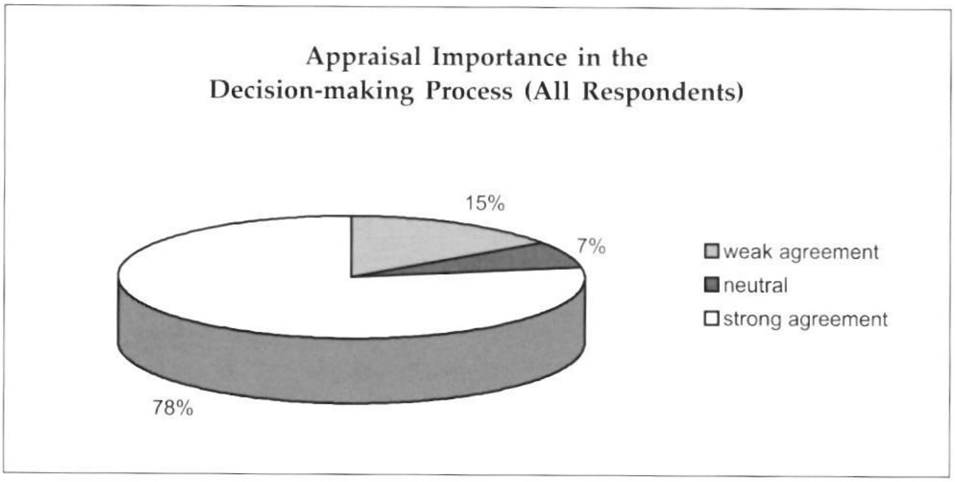


Figure 2

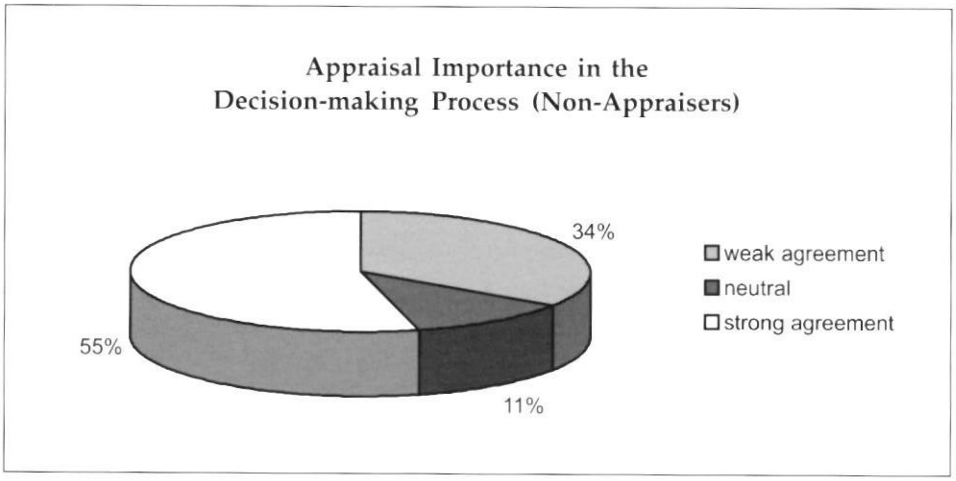
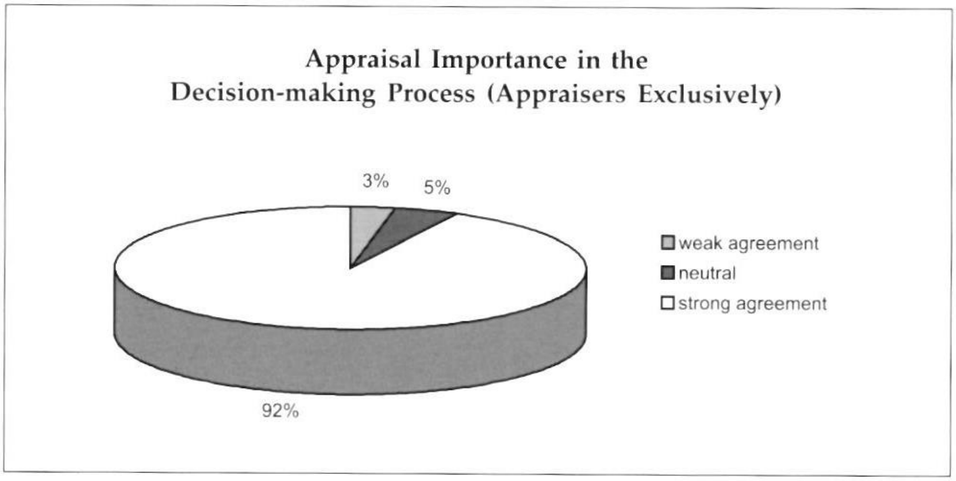


Figure 3



respondents indicated that there was no reliance on a formal appraisal.

Question 5 sought to reconfirm some of the earlier answers and to look for inconsistencies, as well as which tools were used to value the subject property—whether using an independent appraisal; the Income Approach; a "personal reaction"; cost basis for the property; market comparison; and/or other means.

The primary valuation tool indicated by 58 percent was the independent appraisal. This ties reasonably well with the prior responses; however, an exact tie was not possible, since there were different numbers of responses with the different questions.

Of the non-appraiser respondents, 35 percent indicated that an Income Approach or a Discounted Cash Flow model was the primary valuation tool, while only 31 percent of that same group considered an appraisal the primary valuation tool.

Figures 4 & 5 portray the primary valuation tool used by the various categories of survey respondents and the importance of the appraisal document.

Figure 4 reveals that among non-appraisal professionals there is somewhat of a balance between the valuation tools of the traditional appraisal, an Income Approach and Market Comparisons.

Figure 5 indicates that while the majority of respondents in each category deem the appraisal document important, there is a relatively large gap between appraisers and non-appraisers.

CONCLUSIONS

The practical conclusions that one might derive from this research certainly should commence with an acknowledgment that this research is not all inclusive, nor is it completely clear as to the conclusions that are noted and the summaries that were provided earlier. However, it is clear that there are a number of directions or inferences that seem to be present from the survey work undertaken on the responses relative to international real estate transactions, whether involving sellers, buyers, and/or lease interests by lessees or lessors. Specifically focusing on the utilization of and importance of appraisals or valuation reports, it seems that one could reasonably conclude with at least the following summary positions:

1. Appraisers in particular, but all potential users of valuation or appraisal reports, should recognize that not all users of reports (sellers, buyers, lessors, lessees, lenders, brokers, governmental officials, and so forth) are necessarily willing to accept (especially relative to international transactions) the appraisal or valuation report. It is often viewed as one of many tools that might be considered or utilized in many real estate transactions.

   The degree of uniform standards that are applicable, enforcement of those standards (whether by governmental bodies or other professional organizations) and the "added value" that is present by the report, will determine the weight and importance of such valuation/appraisal reports.

2. Appraisers should also recognize that adhering to strong ethical standards, uniform standard requirements by governmental positions, and professional organizations, and consistency with unbiased positions, are crucial to the continued viable use of appraisals and those who perform them.

3. If appraisers cannot show an added value or benefit that they provide through their efforts, and the analysis that they provide through the (valuation) report, they will, very soon, not be in demand.

4. Without proper analysis and support, mere conclusions of value are unacceptable. Such "mere conclusions" further demean the potential worth of valuation reports and the profession of valuers/appraisers.

5. Those involved in international transactions, especially as to investors that are inbound in the United States, with citizenship or residency outside of the United States, tend to place less value on the appraisals because of the lack of uniform standards and/or the oftentimes biased positions that are found in reports from countries outside of the U.S., western Europe, and a few others.

6. Many appraisals and valuation reports are undertaken as a result of, and requirement by, federal and/or state laws, whether under the Financial Institutions Reform Recovery and Enforcement Act of 1989 (FIRREA); the federal income tax laws (*e.g.*, Internal Revenue Code of 1986, as amended, Code Section 170, for

Figures 4 - 5

Figure 4

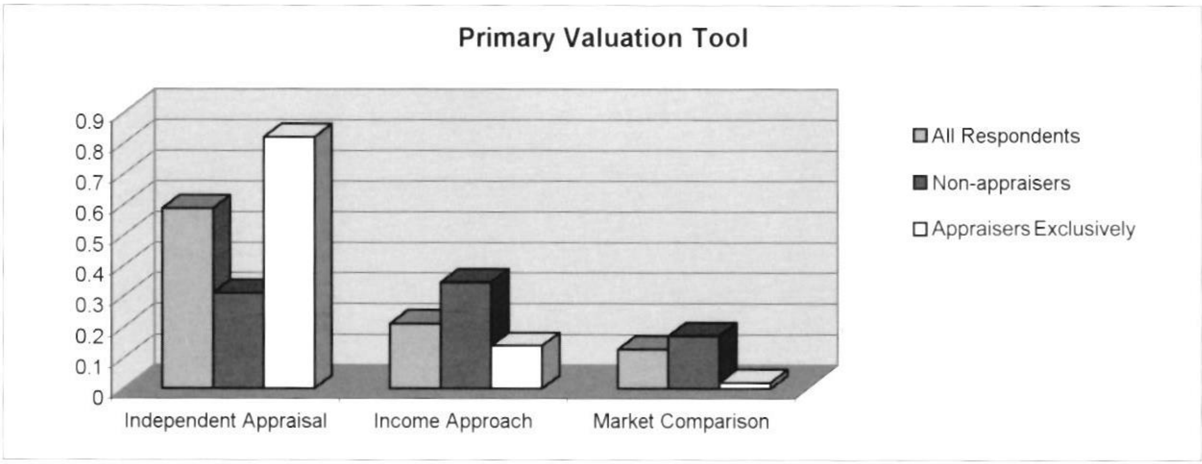
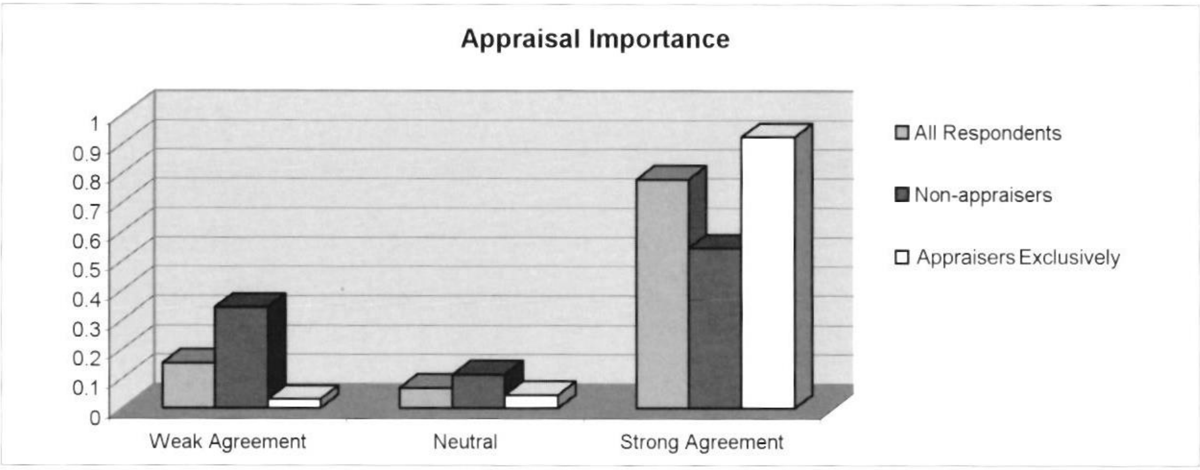


Figure 5



contributions to charities); or for other controls that are imposed on the appraisal. In many instances, an appraisal is the document that is placed in the file. In such settings, often the appraisers are sought by the users of the report, because of what is imposed on them to meet governmental standards, not for the value-added or benefit that the appraiser/valuer might provide. If such report is acquired for the reason noted, *i.e.*, to comply with the law, appraisers can expect to find a substantial diminution in requests for appraisal services when and if those laws are eliminated and/or reduced.

There is a clear tendency for those in any field to more readily value and place importance on their own work than is true with others who come in contact with such individuals and/or fields, but who are not in the same field. Such position was certainly present in the survey, as indicated earlier, wherein appraisers consistently tended to value their positions and reports at a much higher worth than was true with the positions held by the entire populace of respondents.REI

NOTES & REFERENCES

The authors acknowledge the support and input of students at the UNIVERSITY OF DENVER, *Daniels College of Business*, Burns School of Real Estate and Construction Management. Jose Ramirez and many other students have been involved with the Global Real Estate classes and Web site (http://burns.dcb.du.edu/). This data and our Survey work were crucial factors for this manuscript.

1. Ring, Alfred and Boykin, James, *The Valuation of Real Estate*, 3rd Edition, Englewood Cliffs, New Jersey; Prentice-Hall, Page 1 (1986). The authors addressed the need for appropriate valuation standards by stating: "... valuation is the heart of all economic activity. Everything we do as individuals or as groups of individuals in business or as members of society is influenced by the concept of value."

1a. See the Appraisal Foundation, Uniform Standards of Professional Appraisal Practice (USPAP), the "Definitions" Section. See also *The Appraisal of Real Estate*, p.11, Appraisal Institute, 11th Edition, 875 North Michigan Ave., Chicago, Illinois.
2. *Ibid.*
3. See The Appraisal Foundation, Uniform Standards of Professional Appraisal Practice (USPAP), which Standards are constantly being revised.
4. Dorchester, John, Jr., and Vella, Joseph, "Valuation and the Appraisal Institute In A Global Economy: The European Initiative," *The Appraisal Journal*, Vol.72, January 2000.
5. *Ibid.*
6. See supra, Footnote 3, p.75.

See *Valuation 2000, Papers and Proceedings*, published in July 2000, at the Program in Las Vegas, Nevada. See also the publication by John A. Edge, "The Globalization of Real Estate Appraisal: A European Perspective," *Papers and Proceedings, Valuation 2000*, p.167, July 2000.

See also Edge, John A., "The Time Is Right For Global Standards," *Valuation Insights & Perspectives*, p.5, 2nd Quarter 2000. This article provides an excellent overview of what standards arguably exist now relative to valuation. It traced the history and development of the Uniform Standards of Professional Appraisal Practice (USPAP), including development by the Royal Institution of Chartered Surveyors (RICS), which initiated development of its Standards in 1974 and furthered the development through what became known as the *Red Book*. As explained by Mr. Edge in his article, there was also development of other standards, such as the *Blue Book*, which was "originally based almost word-for-word on the *RICS Red Book*; the *Blue Book* is now truly an amalgam of trans-European influences designed to comply with the EC Rules and Regulations."

Mr. Edge also indicated in his article the history of the International Valuation Standards Committee, founded in 1981 as a non-governmental organization. It is beyond the scope of this manuscript to examine this in detail. However, readers are encouraged to review the article by Mr. Edge, which is very informative as to the history of development of standards within the appraisal industry. Also included by Mr. Edge is a summary of the history of RICS.

EUROPEAN GROUP OF VALUERS: The European Group of Valuers of Fixed Assets is another group of international valuers looking to international standards for valuation reports. This group was established about 23 years ago and evolved from a merger with EUROVAL. The combined group is now labeled TEGoVA. For an examination of this area, and the application of these standards in many instances with much of Eastern Europe, see the site: http://www.ara.net.md/tegova/standart/

VALUATION STANDARDS: IVSC: This group examined international valuation standards under IVSC. See the IVSC site at: http://www.ivsc.org
7. See supra, Footnote 3, p.76.
8. See supra, Footnote 3, p.78.
9. *Ibid.* See also Ling, Hin, Li, "The Official Land Value Appraisal System Under the Land-Use Rights Reforms In China," *Appraisal Journal*, Vol.63, p.102 (January 1995). In the former state-owned property setting under China, the author indicated the reforms and concerns necessary there to attempt some valuation of realty. As noted in the article, part of the approach has been to have benchmark pricing to attempt to have a starting point for a country such as China, that previously had only state-owned realty. The author indicated a three-level approach in which a benchmark price would be established. Subsequently, there would be adjustments according to micro factors for the property, such as its location, etc. Finally, the parties involved as buyer and seller would further negotiate, allegedly under the market conditions that then applied.

Additionally, see Wong, Kin Chee, "The Evolution of Land Valuation In China," *Appraisal Journal*, Vol.66, No.1, p.1. As Mr. Wong noted in this article, the problem in China is that the land was owned by the state; therefore, there was no basis for valuation on a market comparison for transactions. The author also noted the use of Residual Method for valuing property, a Comparative Method in major cities (comparing sales data), an Investment Method, a Cost Method, and a combination of techniques. The problems in China continue to focus on the availability and reliability of data to make the decisions.

MALAYSIAN VALUATION STANDARDS: An examination of this topic and the need for restructuring Malaysian standards under world valuation practices is indicated in their site: http://www4.jaring.my/lppeh/standards.htm

The new Malaysian Valuation Standards has 11 Standards and 2 introductory chapters; it addresses international valuation issues.

Pornchokchai, Sopon, "How to Standardize Real Estate Valuation Practices In Thailand," found at http://www.area.co.th. The author emphasized the need for valuation education and standardization relative to appraisal or valuation reports. The author also emphasized the need for standards for international practice when undertaking valuations. Standards of practice include what is to be part of the report, proper supervision and training, and information management.

Ryska, Jaromir, Drozen, Frantisek, and Ryska, Petr, "The Real Estate Valuation Profession and the Czech Republic," *Appraisal Journal*, Vol.67, No.4, p.345. In this article, the authors considered valuation issues in the Czech Republic, as well as valuation requirements for the party undertaking the valuation in the Czech Republic.
10. Friedman, Thomas, *Lexus and the Olive Tree*, published by Favras, Straus, Giroux, New York, New York (1999).

See also Zuckerman, Howard, "Global Real Estate Standards Will Dictate Future Access to Capital," *Capital Sources For Real Estate*, Warren, Gorham & Lamont (1996). This article emphasized the need for investors to have reliable data to make investment decisions.
11. When addressing the question as to international standards, John Ross of The Appraisal Institute responded that there were four significant sets of standards that were applied on an international basis, including the Uniform Standards of Professional Appraisal Practice (USPAP), the TEGoVA *Blue Book* European Standards, the Royal Institution of Chartered Surveyors *Red Book*, and the *International Valuation Standards Committee's IVSC Appraisal Standards and Appraisal Practice Guide*. Mr. Ross noted that these latter guides are coordinated somewhat with the International Accounting Standards Committee's International Accounting Standards.

Mr. Ross said: "We believe (and the capital markets appear to concur) that a critical need exists for standards that can be consistently applied globally, but which also recognize jurisdictional, cultural, legal, and data issues. To that end, we are working with IVSC, RICS, and others to further develop the IVSC Standards for international application."
12. Champness, Peter, *Approved European Property Valuation Standards*, (April, 1997), published by TEGoVA.

See also Graeme, Newell, "The Quality of Appraisal Reports In Australia," *Appraisal Journal*, Vol.LXV, No. 1, pp.92-95. In this article, the author examined the standards that exist in appraisal reports in Australia.

How do U.S. Residential Brokerage Trends & Fees Compare to the Rest of the World?

by Natalya V. Delcoure & Norm G. Miller

Introduction: Pressures from the Internet

There are many sweeping changes in the way business is conducted in all industries as a result of the Internet. The real estate industry is no exception. According to the *2000 National Association of REALTORS® Profile of Home Buyers and Sellers*, in 1999, 37 percent of homebuyers used the Internet as a key source of information in their home purchase process, a 19 percent increase from 1998. It appears that in 1999 the U.S. real estate industry has become more Web-based despite the fact that four out of five customers used real estate agents in their home purchase process. If this trend continues, and more consumers use the Internet as the primary source in their real estate information search and purchase, real estate professionals may face a decrease in commission fees and a reduced demand for their services.

Technological innovation (voice mail, e-mail, cell phones, pagers, Web presence, etc.), has empowered consumers in their real estate information search and purchase decisions, and prompted the development of virtual real estate brokerages offering "ala carte" services to their customers. Cyber brokers, (*i.e.*, www.4Sale-ByOwners.com, www.FSBOFreedom.com, www.FISBODepot.com), provide customer services such as:

- free 24-hour-a-day access to property listings;
- different property listing fee alternatives, including promotional packages;
- a FSBO site index;

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- blank pre-formatted real estate contracts and forms;
- virtual sale negotiations including instant contract formulation; and
- many other resources for homeowners.

For a traditional real estate firm to compete with cyber brokers, it has to perceive that the Internet expands capabilities and is a vital tool for achieving greater service, cost efficiency, and profitability, thus turning the technology into a source of new empowerment rather than threat to its existence. One tactic often exercised by traditional real estate firms to defend against the cyber brokers is to buy the more successful private MLS style networks. The consolidation process among traditional and newer real estate companies with a Web-presence can be already observed. For example, the www.cyberhomes.com Web site links to www. homeadvisor.com, which is owned by Microsoft Corporation. Also, Cendant Corporation owns www.homebytes.com, and www.cold wellbanker. com, and they recently acquired www.owners.com.

Successful real estate companies may gain several advantages if they efficiently use automated communication and information technology to attract and serve customers. Web-based programs like www.valueyourhome.com can estimate prices or market price trends and provide neighborhood information. Other online programs can set up appointments, transmit contract offers and counteroffers, provide mortgage assistance, and much more. Ancillary and complementary services including relocation, title insurance, landscaping, property insurance, and more can produce referral fees or new profit centers that many large traditional brokerage firms already attempt to capture, but the Web makes it easier to track the flow of information requested and to instantly offer potential services. Traditional firms that will survive have no choice but to embrace all the possibilities for new services and efficiency gains in order to compete in the future.

Investment in technological innovations requires cash outlays. There are economies of scale to such investments and small firms with no affiliations may have to look for assistance to support this investment. Thus, there is a potential for further consolidation trends in the real estate brokerage industry as smaller real estate companies look for a potential acquirer that will allow them to stay in business.

Another possibility for traditional real estate companies to survive the increasing competitive pressure from "lean and mean" cyber brokers is to mix traditional and non-traditional listings. For years U.S. real estate brokerage companies successfully operated through strong local, state, and national trade association representation (the National Association of REALTORS) and provided the core of the Multiple Listing Service (MLS) system. Most real estate agents belong to more than one MLS. Over the years, the access to MLS and strong interdependency among industry participants ensured high real estate commission fees in the U.S. compared to other countries and promoted a stable rise in the U.S. real estate agents' compensation.[1] However, open listing MLS services and the development of cyber brokerages challenge the market information monopoly once held by traditional real estate companies and encourage commission price competition within the industry.

Until recently the majority of traditional real estate firms with a Web presence prohibited For Sale By Owner (FSBO) listings. However, there are exceptions. For example, www.owners.com, which was acquired by www.homebytes.com in October 2000, is the biggest FSBO database in the U.S. Also, open MLS vendors are starting to encourage commission price competition in residential real estate. Several Internet-based real estate companies charge fees of 3 percent to 5 percent instead of the 6 percent or 7 percent traditionally charged by real estate firms. Some cyber brokers charge a home seller 4.5 percent, the homebuyer agent receives 3 percent, and the company keeps 1.5 percent. Technological innovations allow real estate brokers to speed up Comparative Market Analysis (CMA) report generation, the contract negotiation process, thus making the real estate professional more efficient and productive.

BROKERAGE FEES AROUND THE WORLD

The evaluation of the commission rates in foreign countries *(Exhibit 1)* indicates that the real estate commission rates are lower when the information within the market is more efficient, open, and reliable. Less developed countries, like Russia, with costly information dissemination processes hampered by high bureaucracy and/or no MLS system, exhibit the highest commission rates (10 percent or even 15 percent). The economic efficiency is proxied by GDP per capita and compared to the median commission fees among 30 countries *(Exhibit 2)*. The graphical representation of the relationship between GDP/capita = f (Real estate commission

Exhibit 1

International Commission Rate Comparisons

Country	License	Real Estate Transaction Characteristics	Compensation	Typical Sales Per Agent	Internet Impact
Argentina**	yes	6%, where 3% paid by the buyer, and 3% paid by the seller; does not require buyer broker.	commission	n/a	**n/a**
Australia	yes	5% on the first $18,000, 2.5% -thereafter; also properties are sold through auction system; advertising is provided by real estate agent.	commission & auction	30	**no significant impact**
Belarus	n/a	6%-15% commission, averaging near 10%. Public information is scarce.	commission	n/a	**n/a**
Brazil	yes	5% commission, less on a higher priced units.	commission	n/a	**n/a**
Canada	yes	3-6% commission rate.	commission	30-50	**no significant impact**
Caribbean***	yes	5% - Jamaica, 3-5% - Trinidad & Tobago.	commission		**n/a**
China**	yes	No set regulations and standards for real estate transactions.	n/a	n/a	**n/a**
Denmark**	yes	2-4%, buyer pays 25% of sales price transfer tax; advertising is provided by real estate agent.	commission	n/a	**Large impact on MLS**
Finland	n/a	Fees run about 5% of the sale price on condos and 3%-4% - on a single family home. Higher priced houses have lower commission fees. Also, government collects value added tax (22% of the selling price).	commission	n/a	**n/a**
France**	yes	Only 50% of property listed with real estate agents; real estate transactions are kept very private; 50% of real estate is sold FSBO.	commission	n/a	**MLS is encouraged**
Indonesia**	no	5% paid by either buyer or seller, but not both; buyer broker is required for real estate transaction.	commission	n/a	**n/a**
Ireland**	yes	In cities - 1.5-2%, small towns - 2-3%; also properties can be sold through action system.	commission & auction	n/a	**n/a**
Israel	yes	4% commission rate equally split between buyer and seller agents.	commission	n/a	**growing impact**
Italy**	yes	Paid by both buyer and seller: each party pays 2-3%.	commission	n/a	**n/a**
Japan**	yes	3% commission rate.	commission	n/a	**n/a**
Malaysia**	yes	3% on the first $100,000 and then 2% of the remaining amount of the sale, commission is paid either by buyer or seller, not both.	commission	n/a	**n/a**
Mexico**	Varies	5-10% commission rate.	commission	n/a	**Large impact on MLS**
Netherlands**	yes	1.5-2%, broker represents either the buyer or the seller but not both.	commission	n/a	**n/a**
Norway**	yes	2-3%, broker represents both parties in the transaction.	commission	n/a	**n/a**
Philippines**	yes	5%, broker represents either the buyer or the seller but not both.	commission	n/a	**n/a**
Russia	yes	5% to 10% but "net listings" common; advertising is provided by real estate broker/agent; FSBO very common; buyer broker representation is not required.	fee above net	n/a	**absolutely none**
Singapore	yes	1.5-2.0%, FSBO very rare; buyer broker representation is not required.	commission	20-40	**slight - for marketing**
Spain	yes	Commission rate depends on the property location, averaging 5% of total estate price.	commission	n/a	**n/a**
Sweden**	yes	5%; commission is paid by seller, 10% commission is charged for lower priced units.	commission	n/a	**n/a**
United Kingdom	yes	1%-2%; in very competitive areas - 0.5-0.75%; in low priced areas - 3.5%; advertising is provided by real estate broker/agent; buyer broker representation is not required.	commission & auction	60-100	**no significant impact**
United States	yes	6%-7%; advertising is provided by real estate broker/agent; in 1999 – 6% of the residential real estate transactions were "FSBO" excluding builder sales but the FSBO success rate appears to be climbing rapidly in 2000 and 2001.	Most commission; Some charges flat fees or 2% to 4%	4. 3* while top agents do 20 or more.	**Rapidly increasing.**

*** This number is calculated as Total home sales in 1999 (according to NAR Profile) is 6.5 million. According to NARELLO, in 1999, there were 515,225 active real estate brokers and 980,083 active real estate agents. ** Information is obtained from http://onerealtorplace.com.**
***** Jamaica, Trinidad and Tobago**

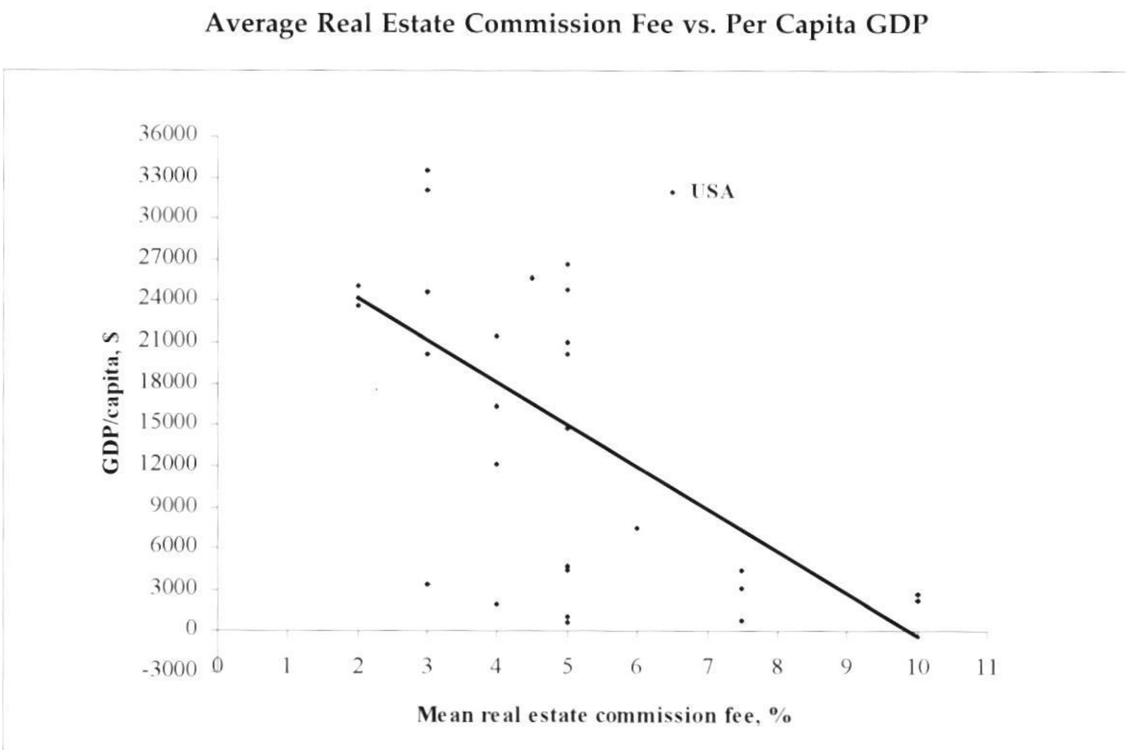
Exhibit 2

List of Countries, Average Real Estate Commission Fee, & Per Capita GDP, 1999

Country	Mode Real Estate Commission Fee, %	1999 GDP/per Capita, $
Argentina	6.00	7,550.00
Australia	5.00	20,950.00
Belarus	10.00	2,620.00
Belgium	3.00	24,650.00
Brazil	5.00	4,350.00
Canada	5.00	20,140.00
Caribbean	5.00	4,750.00
China	7.50	780.00
Denmark	3.00	32,050.00
Finland	5.00	24,730.00
Germany	4.50	25,620.00
Greece	4.00	12,110.00
Indonesia	5.00	600.00
Ireland	4.00	21,470.00
Israel	4.00	16,310.00
Italy	3.00	20,170.00
Japan	3.00	32,030.00
Malaysia	3.00	3,390.00
Mexico	7.50	4,440.00
Netherlands	2.00	25,140.00
Norway	3.00	33,470.00
Philippines	5.00	1,050.00
Russia	10.00	2,250.00
Singapore	2.00	24,150.00
South Africa	7.50	3.170.00
Spain	5.00	14,800.00
Sweden	5.00	26,750.00
Thailand	4.00	2,010.00
United Kingdom	2.00	23,590.00
United States	6.50	31,910.00

Note: The data was obtained from the World Bank Group Web site (http://www.worldbank.org)

Exhibit 3



Note: The data was obtained from the World Bank Group Web site (http://www.worldbank.org)

Statistical results:
Regression F statistic 12.918
R-squared = .316 Adjusted R-squared = .291
Beta Coefficient on Fee -.562 t = -3.594 significance = .001
Note the beta coefficient in this case is also the correlation between GDP and Fee.
K-S test 1.067 on GDP 1.269 on Fee Chi-Square test = 17.400

fee) is presented in *Exhibit 3*. The model exhibits good explanatory power (R-squared equals to approximately 32 percent). As it has been anticipated, the estimated beta coefficient is negative and statistically significant (b = -.562, P-value is .001, t= -3.544). The statistical results provide the evidence that in the foreign countries, commission rates are lower as information dissemination within the market becomes more efficient.

Also, there are other implications of price competition in the real estate industry. For example, lower price homes should see higher commission rates relative to higher priced homes. Such pricing approach is employed in Sweden, Finland, Ireland, Mexico, and Belarus. We should also see more marketable and higher priced homes listed at lower percentage commission rates, similar to those in the United Kingdom, Singapore, and other developed countries. More developed markets rely upon a regulatory environment to facilitate the accuracy of the real estate transfer price and protect both parties involved in the transactions.

An alternative to the MLS system exists in UK, Ireland, and Australia: MLS brokered sales and auction sales. In these markets, the public auction system is not viewed as a reserve for the selling of distressed properties. Rather a public auction system is viewed as a positive alternative to the MLS.

CONCLUSIONS

The real estate industry seems to be undergoing an evolution of great significance. Consumers have become a driving force behind the real estate search process when they gather preliminary information on property via the Web. More information is available than ever before and virtual touring is becoming the standard expectation, not only among cyber real estate companies, but also among traditional real estate firms as well.

As traditional brokerage firms use more automated services and expert systems to serve both consumers and agents offering a range of service packages they will become more efficient, enabling successful agents to serve more clients. The cost of the full service agent should decline to 5 percent or so within the next decade and possibly to as low as 2 percent or 3 percent within the next two decades — provided the fees in other countries are a reliable comparison. Agents in those countries where fees are lower make as much or more income than agents in the U.S., but there are certainly fewer real estate agents in those countries. A drop in the commission rates to a 3 percent range will likely drive more than half of the existing marginal producers out of the industry. This "weeding-out" process is likely to result in a more professional and experienced agent becoming the norm. For consumers, this is the greatest benefit from price competition. REI

NOTES

1. This is a result of home prices rising faster then inflation over the past 30 years.

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Home Office Deduction Can Benefit Both Real Estate Professionals & their Clients

by Bruce McClain & Abba Spero

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Real estate professionals should have a working familiarity with the current state of the law regarding tax deductions for offices in the home. One reason for this is that a number of real estate professionals have their own home offices, either as a supplemental office or even as their principal place of business. In addition, many potential homebuyers will be considering homes with an existing home office or with a space that might be converted to such, and these buyers will generally be quite concerned with obtaining all possible tax deductions they can in conjunction with their home purchase. While the real estate professional should not be in the position of being a tax advisor, he or she can point out to potential buyers that a home office deduction may be available in the proper circumstances, allowing buyers to follow up with their own tax advisors.

TAX SAVINGS POTENTIAL

The tax savings from a home office deduction can be significant. Essentially, the home office deduction allows the taxpayer to deduct expenses that would ordinarily be nondeductible—such as depreciation, utilities, and home repairs—on that portion of the home used as an office. It also may allow the taxpayer to take a portion of his/her mortgage interest and real estate taxes as "above the line" deductions, and offset them against self-employment income, rather than merely as an itemized deduction. This can create tax savings, especially for self-employed taxpayers subject to the 15.3 percent self-employment tax.

Example:

Kathy Huang is a real estate professional operating from her home. She is an independent contractor, and treated as self-employed for income tax purposes. Her gross income from real estate activities in 2000 was $80,000. She had $10,000 of business expenses other than home and home office expenses, and she files her return as single. Her home cost her $150,000, and the office portion comprises 10 percent of the total home size. Her annual applicable home expenses are: taxes, $3,000; mortgage interest, $10,000, home utilities, $3,000; home repairs and maintenance, $2,000. Her state and local income taxes total $1,000.

If Kathy does not qualify for a home office deduction, her total federal taxes for 2000 will be approximately $19,990. This consists of self-employment tax of $9,890, and income tax of approximately $10,100. If she does qualify for the home office deduction, this will both add to her deductible expenses and also transfer some itemized deductions to "above the line." Her self-employment tax will decrease to $9,582, and her income tax will decrease to $9,895. Overall, her tax savings will be $513 ($19,477 vs. $19, 990).

Thus, the tax savings from the home office deduction can be significant.

HOME OFFICES FOR ADMINISTRATIVE FUNCTIONS

The controversy regarding the home office deduction has often centered on home offices used primarily for administrative functions. For a number of years, the government disallowed a tax deduction for home offices which were used primarily for administrative functions of a business, as opposed to the income-generating functions of the business. Administrative functions include such matters as billing/bill paying; continuing education/industry publication review; and maintaining client databases or contact lists. Real estate professionals are a good example of a group that was severely harmed by this restriction. Certainly, for most real estate professionals, their primary income-generating activities occur outside their office. Any home office they have will be used primarily to perform administrative tasks, and thus real estate professionals were generally among those unable to qualify for the home office deduction under this restrictive standard.

Congress amended the tax law several years ago to loosen this rule and to make the home office deduction more obtainable for many taxpayers. Real estate professionals and other taxpayers who use their home offices for the administrative functions of their work now have a much better chance to qualify for a deduction. However, the rule changes did not go as far as some believe. There are still fairly rigorous requirements that must be understood and met in order to obtain this deduction.

LEGAL BACKGROUND

The deduction for home office expenses is provided by Section 280A of the Internal Revenue Code.[1] Section 280A allows taxpayers to deduct expenses of a home office only where the office area is used exclusively, on a regular basis, in one of the three following manners:

1. As the principal place of business for a trade or business of the taxpayer;
2. As a place of business used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of the taxpayer's trade or business; or
3. In the case of a separate structure, not attached to the home, if used in connection with the taxpayer's trade of business.

In the case of an employee, it is also required that the exclusive use of the home office is "for the convenience of his/her employer."

Most of the attention has focused on the first of these: home offices used as the principal place of business of the taxpayer's trade or business, and specifically on the determination of when the home office can be said to constitute the taxpayer's principal place of business. Following the enactment of Section 280A, a number of court cases began to thresh out judicial tests to determine when a home office will qualify as the "principal place of business."

Initially, the Tax Court, a special federal court which only hears tax cases, adopted a rather narrow test that came to be known as the "focal point test."[2] The focal point test looks to the "focal point" of the taxpayer's business, placing primary emphasis on the location where the major part of the business's income is generated and where most of the goods or services are provided to customers. Moreover, the Tax Court viewed this as conclusive in determining where the taxpayer's principal place of business was located. For instance, in one case the taxpayer operated a hot dog stand near her home. She prepared all the food in her kitchen and did the bookkeeping and other administrative work in another room used exclusively for that purpose. The Tax Court denied the deduction for either the kitchen or the office on the basis that the income-generating activity of selling hot dogs occurred away from the home, even though these rooms played an indispensable role in her business. The focal point test made it extremely difficult to claim the home office deduction if the home office was not the place where the services were performed or income generated.

However, several appellate courts were critical of the Tax Court's conclusive focal point test as being overly strict. In one case, the Federal Second Circuit Court of Appeals[3] allowed the home office expense deduction to a musician who earned his income playing at the symphony hall, but who spent the majority of his work time, approximately 32 hours per week, practicing in his home. In another case,[4] the Second Circuit went even further, and directly rejected and criticized the focal point test, as wrongly emphasizing, in many cases, the place where the work is most visible, versus the place where the dominant portion of the work is actually done. Other Circuit Courts also sided with the Second Circuit.[5] They established their own review standard, sometimes called the "comparative analysis" approach, under which the court looks to all relevant factors, including the time spent at each location, the necessity of having the home office; and the relative importance of the business functions done at each location. Based on this, taxpayers who used the home office only for administrative functions of the business could still qualify for the home office deduction.

COMMISSIONER v. SOLIMAN

In 1993, the U.S. Supreme Court issued its decision in the case of *Commissioner v. Soliman*,[6] which, as a Supreme Court decision, superceded all prior court guidelines. In *Soliman*, the Supreme Court introduced its own somewhat restrictive test for qualifying a home office as the "principal place of business." This test looked primarily at two factors: 1). the relative importance of the activities performed at each business location, and 2). the time spent at each place. Regarding the first item, the relative importance of each location; the Court stated that the place where the services are rendered or the goods delivered should be the principal consideration in most cases. Based on this, the Supreme Court rejected the allowance of the home office deduction to a doctor who performed his administrative activities in his home office, such as billing and bookkeeping, but who treated his patients outside the home at several hospitals. The *Soliman* test made it extremely difficult for taxpayers, including most real estate professionals, to deduct the expenses of home offices that are used primarily for the administrative functions of their business, but where the customer contact or other profit-making activity takes place primarily outside the home.

Real estate professionals who have an office outside their home and who merely use their home office as a second office, will likewise continue to be prohibited from taking the deduction.

CONGRESS'S RESPONSE TO SOLIMAN/ CURRENT STANDARDS

In response to widespread taxpayer criticism (including some in the real estate profession) of this restrictive test, Congress passed a provision as part of the Taxpayer Relief Act of 1997[7] that eased back from the strict *Soliman* requirements. The 1997 law provided that the term "principal place of business," as used in the tax code, *may* include a place of business which is primarily used by the taxpayer for administrative or management activities, so long as there is no other fixed location where the taxpayer conducts substantial administrative or management activities of the business. This amendment specifically overturned the more restrictive test in *Soliman* for the deduction of the expenses of home offices used primarily for administrative, as opposed to profit-generating, activities. It makes it much easier for real estate and other sales professionals to qualify for the home office deduction. This same benefit extends to other home-based professionals, such as trade representatives and home-based consultants, who use home offices for the administrative tasks of their business.

The revised rule now permits taxpayers running home-based businesses, but who primarily see customers or clients outside the home, to deduct the costs associated with a home office used for the administrative aspects of their business, such as billing/bill-paying, record keeping, and database maintenance. In addition to including many real estate professionals, this would also include, for example, many insurance salespeople, trade representatives, and consultants who operate from a home office. The key is that the taxpayer has no other place outside the home in which to do this administrative work.

The changes in the 1997 tax act were thus quite helpful in expanding the availability of the home office deduction. However, taxpayers who may view these changes as entirely overturning *Soliman* are going too far. The changes were limited to overturning the narrow restriction in *Soliman* relating to home offices used primarily for administration and management. They did not erase other import restrictions on the home office deduction. For instance, a home office deduction will still be unavailable to taxpayers who have an office outside the home and use the home office only supplementally. Teachers and college professors are good examples of persons who may use a home office extensively in conjunction with their work, but who do have an office or other work place provided to them outside the home. Real estate professionals who have an office outside their home and who merely use their home office as a second office, will likewise continue to be prohibited from taking the deduction.

Also, as always, the home office must be "exclusively" used for the business use. Obviously, so long as there is a separate room in the home, basically used for work-related tasks, it can be difficult for the government to challenge the office deduction on the exclusive-use basis. However, this requirement should not be forgotten.

Other important elements of *Soliman* also remain very much alive. *Soliman's* basic two-part test mentioned above, along with its rejection of the previous court-provided standards, were both left intact by the 1997 law. Specifically, the 1997 amendment did nothing to reincarnate the Tax Court's "focal point" test, nor did it revive the pure case-by-case approach of the Circuit Courts' comparative analysis approach. Instead, *Soliman's* two-part test, (1. examining the relative importance of the activities at each location, and 2. the time spent at each), while considering all factors but treating the place of delivery of services or product as a principal consideration, still stands as the test to be used.

The key area in which the 1997 amendment did reverse *Soliman* was, of course, *Soliman*'s virtual prohibition on allowing a home office used mainly for administrative activities to qualify as a "principal place of business." This was an important reversal. Many of the cases where the taxpayer's home office expense deduction is questioned involve offices used mainly for administrative purposes. Where the home office is used to sell products or to meet with clients, the argument for deductibility has normally been much stronger anyway. Therefore, the 1997 amendment helped many taxpayers. But there are many home office scenarios where the 1997 law revisions may not help. In these other situations, *Soliman* will continue to supply the sole guidance. The following examples will help to show where *Soliman* will continue to prohibit the home office deduction and also where the 1997 amendment has overturned *Soliman* and permits the deduction.

Example 1: A real estate sales professional, affiliated with a local or national agency, has office space at the agency's local office, which can be used for his administrative work, but finds it preferable to perform these functions in a home office. It is difficult to work at the local office due to distractions. In addition, it is simply more convenient and comfortable to do this work at home in the mornings or evenings. The real estate professional maintains a home office exclusively used for the purpose of doing the administrative work connected with his business, including maintaining client information, continuing education and review of real estate publications, bill paying, and record keeping.

In *Example 1*, the amendment to Section 280A will not allow a deduction for the home office. The home office must still meet the test of being maintained "for the convenience of the employer." The availability of office space at the agency's local office suggests that the real estate agent's use of the home for this work was for the his own convenience, not the agency's. The real estate professional *might* try to show that, while office space at the local agency was nominally provided, it was actually not feasible to use that office space due to distractions or other factors. The professional would have a substantial burden in trying to make that argument, however.

Note that whether the real estate professional is an employee or an independent contractor is really not the key issue, although generally it will be easier for independent contractors to qualify for a home office deduction. In the case of employees, it must be shown that the home office existed "for the convenience of the employer." However, in the above example, even if the real estate professional qualifies as an independent contractor rather than an employee, he will still probably not be able to claim a home office deduction if the agency's local office provides a reasonable workspace for him to perform his administrative tasks.

Example 2: A taxpayer operates a cookie business selling from a stand but cooking at home. She makes the cookies in her kitchen and uses a separate home office exclusively for the bookkeeping and other administrative functions of her business. She sells the cookies at a location outside the home. The approximate breakdown of her time is 15 percent cooking time, 15 percent administrative, and 70 percent selling her cookies outside the home.

In *Example 2*, the 1997 law and *Soliman* yield an interesting bifurcated result. The kitchen and the office would appear to receive different treatment. Under the 1997 amendment, the taxpayer could deduct the expenses of her home office used for administrative functions, as this comes under the specific language of the amendment, overturning the *Soliman* result relating to home offices used for administrative work. However, the kitchen must still stand on its own in meeting the *Soliman* test, as it is not covered by the revised language. The deduction for the kitchen would appear to fail, as both the primary earnings function and the majority of time spent in the business take place outside the home.

Example 3: An independent consultant works out of a home office. She spends 10 to 15 hours per week in the home office, taking care of the administrative side of the business, including bookkeeping, keeping up on technical issues, bill paying and marketing. She has no office anywhere else. She spends 25 to 30 hours per week on the road meeting with clients and potential clients.

Example 3 constitutes a good example of a scenario in which the 1997 amendment overruled *Soliman*. *Soliman* would no doubt have disallowed the home office deduction since both the majority of work time and the profit-making process occurred outside of the home. But the 1997 law would now permit the home office here, used for the administrative part of her job, to qualify as the principal place of business.

Example 4: An independent trade representative has a small office in an office building, where he does about 40 percent of his administrative work. The trade representative also maintains a home office used exclusively for doing administrative work at home, when it is inconvenient to do this at the office. Approximately 70 percent of the trade rep's time is spent on the road calling on customers and the balance doing administrative work.

In *Example 4*, the taxpayer would not appear to be entitled to the home office deduction. The 1997 law still disallows a deduction for a home office used for administrative functions when the taxpayer has another location where he or she "conducts substantial administrative or management activities." Given that 40 percent of the administrative work takes place at the outside location, the 1997 amendment would not appear to save the deduction in this instance. Under *Soliman*, the home office would not qualify as the principal place of business since both the majority of time spent at the business and the profit-making activity of the business occurred outside the home.

...this deduction is reasonably available to many taxpayers and there are many who are able to take advantage of it. Real estate professionals are encouraged to check with your tax advisor or accountant to see if your home office may qualify for the deduction.

Example 5: A financial consultant in Cleveland keeps both a home office and an office at the company headquarters 40 miles away in Akron. Her territory is Cleveland, but she is expected to visit the Akron office frequently to consult with senior sales management and do other administrative work. Both her home office and the Akron office are used for administrative work, to handle client work, and to supervise a staff of two junior employees who work under her. She spends approximately one-third of her time at each of these two offices, and the other third calling on clients at their locations.

In this final example, if the consultant's activities in the Akron office constitute "substantial administrative" activities, then the 1997 amendment will not help to save her home office deduction. It will need to be determined to what extent her activities at the Akron office are administrative, as opposed to consulting related, and whether these activities are "substantial." If they are so deemed, then she will not be able to use the 1997 amendment and must try to qualify the home office under the *Soliman* test. However, here she would again appear to have trouble. It appears that no single place can be said to constitute the principal place of her business. If that is the case, *Soliman* instructs that this does not make the home office the principal place of business by default. IRS Publications 587 and 334 both contain practical guidance on qualified home office expenses, and are readily available from the Internal Revenue Service, http://www.irs.gov/forms_pubs/.

SOLIMAN LIVES

The *Soliman* test for qualifying for the home office deduction remains very much alive. Outside of the specific area of home offices used for administrative functions, it remains the definitive test of whether the home office will qualify as a principal place of business. The 1997 amendment should properly be viewed as overturning only the specific result reached in *Soliman* (prohibiting deductions for any home office used primarily for administrative work) rather than as an overall repudiation of *Soliman*. Taxpayers who want to take a home office deduction should also bear in mind the other requirements, such as the requirement that the home office be an area exclusively used for the office function. At the same time however, this deduction is reasonably available to many taxpayers and there are many who are able to take advantage of it. Real estate professionals are encouraged to check with your tax advisor or accountant to see if your home office may qualify for the deduction.$_{\text{REI}}$

NOTES

1. Added by Tax Reform Act of 1976, P.L. 94-455, Act. Sec. 601(a) (October 4, 1976).
2. *e.g., Baie vs. Commissioner,* 74 TC 105 (1980).
3. *Drucker v. Commissioner,* 715 F.2d 67, 83-2 USTC &9550 (2d Cir. 1983).
4. 751 F.2d 512, 85-1 USTC &9106 (2d Cir. 1983).
5. See *Meiers v. Commissioner,* 782 F.2d 75, 86-1 USTC &918 (7th Cir. 1986); *Soliman v. Commissioner,* 935 F.2d 52 , 91-1USTC &50,291(4th Cir., 1991).
6. 506 U.S. 168, 173; 93-1 USTC &50,014, p.87,055.
7. P.L. 105-34.

WHY PEOPLE ENTER THE REAL ESTATE SALES BUSINESS

by James R. Webb & Michael J. Seiler

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INTRODUCTION

Turnover in the real estate sales business is reputed to be one of the highest in all job categories. Estimates from interviews performed with real estate brokers range from 50 percent within two years to 98 percent within five years.

While no studies have attempted to accurately estimate the turnover of real estate sales people, all agree that it is very high. The purpose of this study is to ascertain why people enter real estate sales. Since so many people exit in a relatively short period, it would seem that their expectations upon entering are not met and are, perhaps, not realistic. If this is true and expectations upon entering can be altered, then the high turnover rate can possibly be reduced.

LITERATURE REVIEW

House(1977) suggests that high turnover in real estate sales can be attributed, in part, to the non-routine, problematic, and irregular work hours involved. He argues that real estate agents must be ready to see prospective clients at almost any time. This, coupled with the commission-based pay structure, which makes income irregular and uncertain, leads to a low success rate for new agents.

Wotruba(1991) contributes high early failure rates to the "sink or swim" philosophy followed by most real estate firms. The marginal cost of providing desk space and secretarial service for a new salesperson is low and so too is the time spent screening and training new agents. If the new agent becomes successfully established, the company profits. If the agent fails, the firm can easily and inexpensively hire a new recruit to replace him/her. Moore, Eckrich, and Carlson(1986) suggest that early failure rates could be greatly decreased by implementing basic screening procedures. They studied the skills and characteristics needed to be successful in sales and produce a hierarchy of importance among 82 sales competencies.

Since failure rates are so high, why then do so many individuals seek to become real estate sales agents? Barth(1964) explains that many new real estate sales people are primarily entrepreneurs that are willing to work hard for a living, but lack formal education and financial capital, which are necessary to be successful in other careers. Other explanations for real estate sales entry include ease of entry, low screening procedures, and the independent nature of the work [House(1977)].

RESEARCH DESIGN

The research design was a questionnaire. Fourteen questions, (13 closed-ended and one open-ended) were mailed to 1,500 randomly selected people who recently entered the real estate sales business in the state of Ohio. (Entering real estate sales people were defined as those who recently received sales licenses in the state of Ohio.)

The surveys were accompanied by a self-addressed return envelop and a cover letter emphasizing the importance of the study in an attempt to raise the response rate. *Appendix A* contains a copy of the questionnaire used.

A second group, consisting of 1500 individuals who recently exited the real estate sales business, was also mailed questionnaires. The attempt was to learn, ex post, of the relationship between expectations when entering real estate sales and the realization once exiting. Unfortunately, a parsimonious response rate of only 1.1 percent (17/1500) rendered the comparisons unattainable.

RESULTS

Entering Real Estate Sales

Of the 1500 surveyed, 418 people returned useable questionnaires. This is a response rate of 27.9 percent. *Exhibits 1 - 6* show the geographical location, affiliation, gender, age, education level, and household income, respectively, of the respondents.

As would be expected, the larger response rates are from the population centers and the highest response rate is from the source of the survey (northeast Ohio). Southeast Ohio is sparsely populated, when compared to the other parts of Ohio, thus contributing to its low frequency of responses. *(See Exhibit 1.)*

Almost all of the respondents (395/418) were affiliated with the REALTOR® association (95.0 percent). The other 5 percent were Realtists and non-affiliated people. The survey was generic and sent to randomly selected real estate sales licensees, so the high response rate from REALTORS® was not expected. In Ohio only about 65 percent of the real estate sales licensees are affiliated with the REALTOR® group. Perhaps being part of the REALTOR® trade group influenced people to respond, since the cover letter used made reference to the National Association of REALTORS®. *(See Exhibit 2.)*

The study respondents entering real estate sales were almost evenly divided between male (47.1 percent) and female (52.9 percent). In addition, a third of the respondents were 26-35 years old and over 70 percent were 45 years old or younger *(Exhibits 3 & 4)*. Only two of the respondents did not have a high school diploma, while 29 (6.9 percent) had completed an advanced college degree. Nearly 40 percent of the respondents had at least a bachelor's degree. *(See Exhibit 5.)*

Exhibit 6 shows household income from all sources, not just real estate sales. Many times real estate sales people enter on a part-time basis. As expected, the frequency observed in each household income category increased up to the $30-40,000 per year range, then decreased thereafter.

Expectations

When asked "Why they entered real estate sales" *(Exhibit 7)*, almost half (45.2 percent) indicated they did so because of flexible work hours. However, the two responses which were almost tied for second were "to earn a little `extra money' " (24.1 percent) and "chance to earn lots of money" (18.1 percent). No one thought the work was easy and almost no one thought that it was easy to get a job or that little education was required.

Exhibit 8 shows a cross-tabulation of age and how long the respondents expect to be in real estate sales. Almost 19 percent expect to be in real estate sales 10 years or less while 26.8 percent expect to be in it over 30 years. Undoubtedly, age of

Exhibits 1 - 5

Exhibit 1 - **Geographic Location**

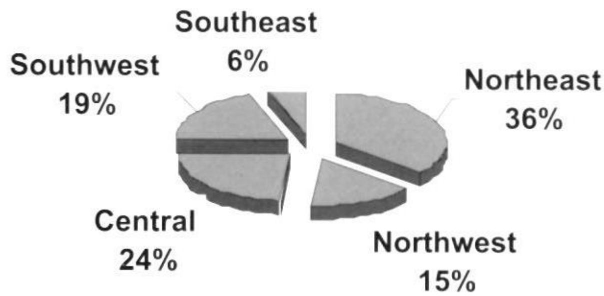


Exhibit 2 - **Affiliation**

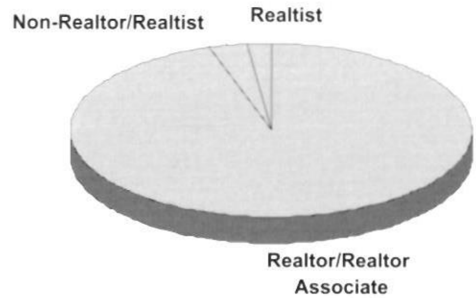


Exhibit 3 - **Gender**

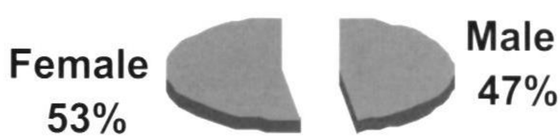


Exhibit 4 - **Age**

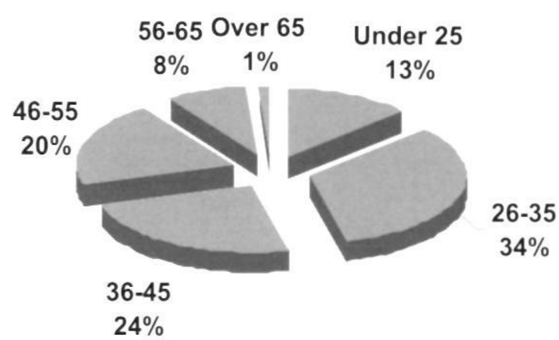


Exhibit 5 - **Education**

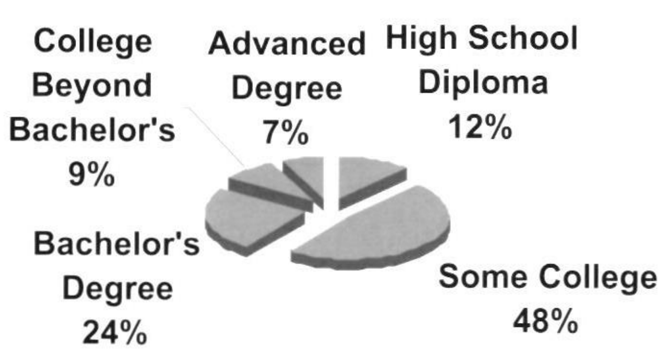


Exhibit 6

Annual Household Income from All Sources

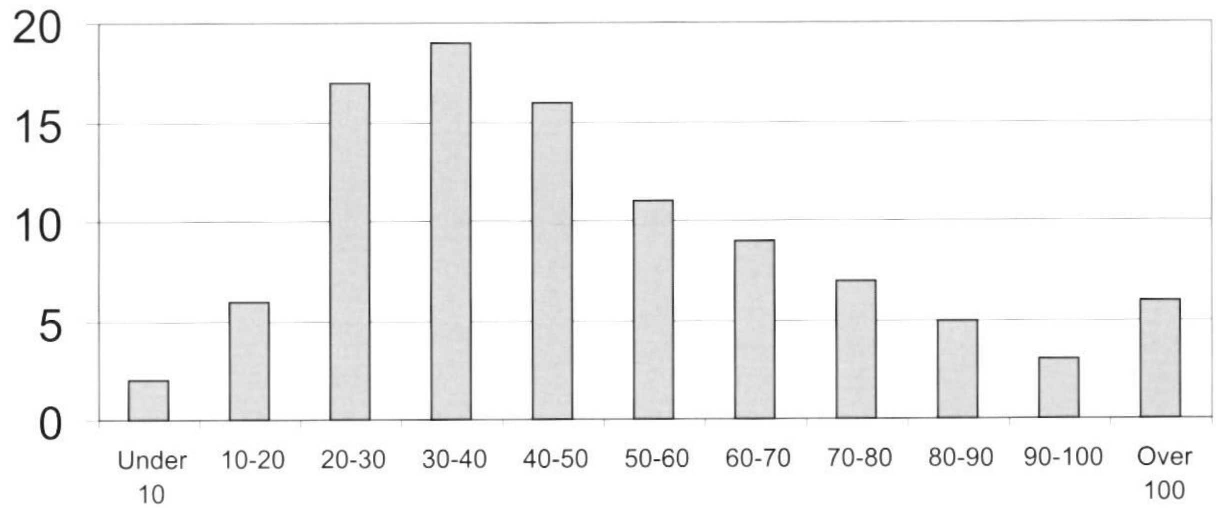


Exhibit 7

Why Did You Enter Real Estate Sales?

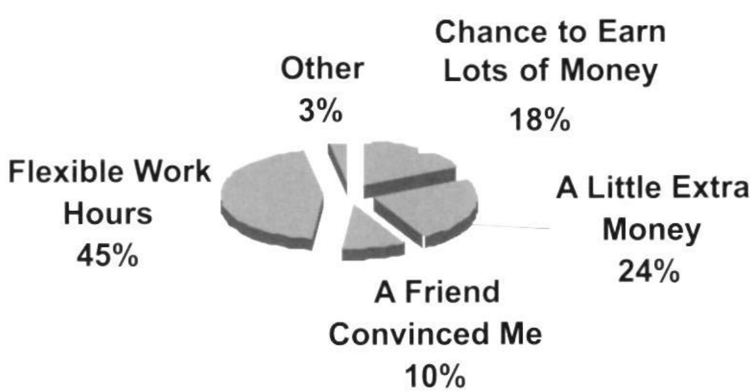


Exhibit 8

Cross-tabulations of Age by Length of Time the Respondent Expects to be in Real Estate Sales

	1-2	3-5	6-10	11-15	16-20	21-25	26-30	30+	Row Total
Under 25	1	6	3	5	2	4	8	23	52
26-35	1	4	13	12	14	18	15	55	132
36-45	2	1	5	9	17	31	13	17	95
46-55	1	0	10	29	17	7	6	12	82
56-65	1	5	17	7	2	1	0	1	34
Over 65	0	0	3	1	0	0	0	1	5
Column Total	6	16	51	63	52	61	42	109	400

* Columns represent the Length of Time Left in Real Estate Sales (in years).

Exhibits 9 - 11

Exhibit 9

How Many Hours a Week Do You Currently Work?

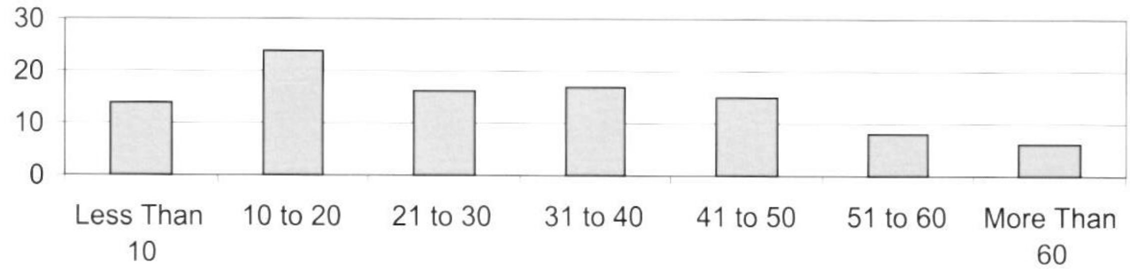


Exhibit 10

How Long To Reach Peak Earnings?

Response	Frequency	Percent
1 to 2 years	36	8.9
3 to 5 years	225	55.7
6 to 10 years	111	27.5
11 to 15 years	16	4.0
16 to 20 years	9	2.2
21 to 25 years	1	0.2
26 to 30 years	2	0.5
Over 30 years	4	1.0

Exhibit 11

How Much Do You Expect To Earn At Peak?

Response	Frequency	Percent
$10,000 or Less	9	2.2
$10,001 - $20,000	31	7.7
$20,001 - $30,000	35	8.6
$30,001 - $40,000	50	12.3
$40,001 - $50,000	44	10.9
$50,001 - $60,000	42	10.4
$60,001 - $70,000	30	7.4
$70,001 - $80,000	36	8.9
$80,001 - $90,000	15	3.7
$90,001 - $100,000	20	4.9
Over $100,000	93	23.0

Exhibits 12 & 13

Exhibit 12

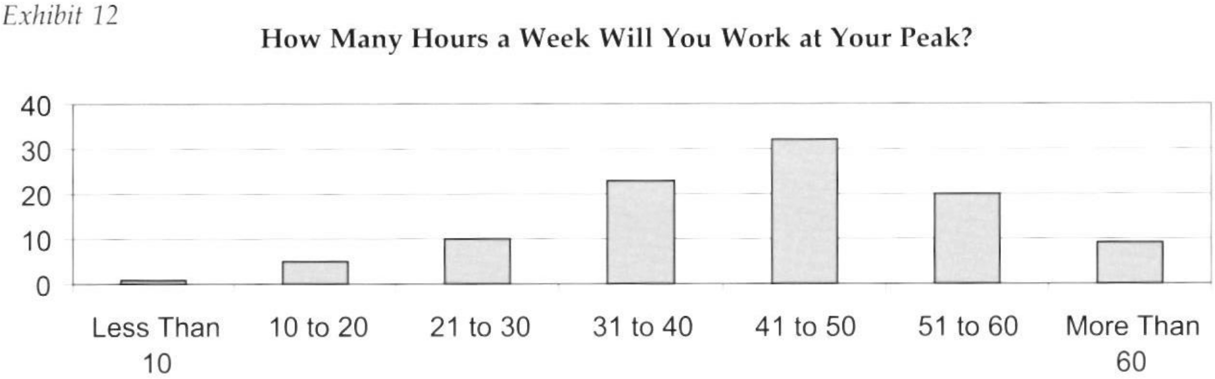
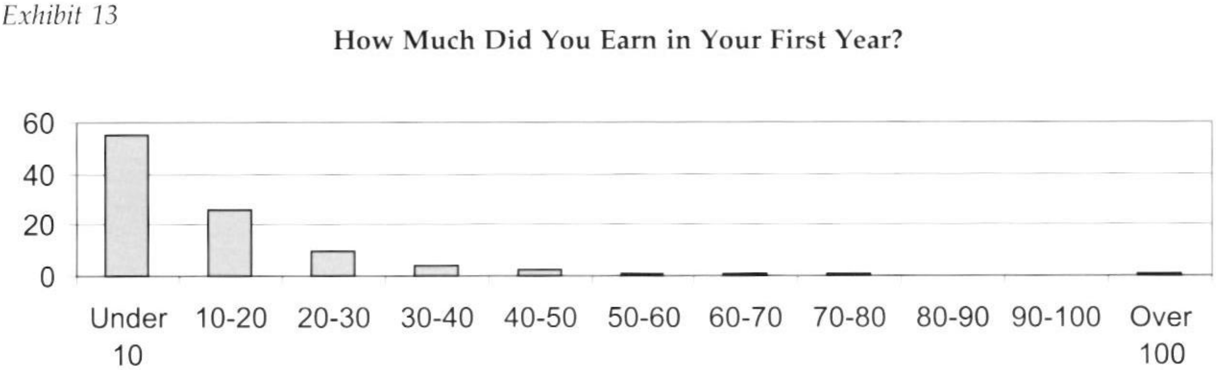


Exhibit 13



the respondent has a major influence on length of stay. The cross-tabulation reveals that, on average, new real estate agents expect to leave the real estate sales industry when they near age 65.

Exhibits 9 & 10 show how many hours a week the respondents currently work and how many years they believe it will take them to reach their peak earnings, respectively. Of respondents, 38.4 percent indicated that they work less than 20 hours per week. This high percentage of part-time employment is not nearly as common in other careers. Over two-thirds (71.3 percent) indicated that they currently work 40 hours a week or less.

Exhibit 10 shows that almost two-thirds (64.6 percent) of the respondents indicated that they would reach their peak earnings in five years or less. This is clearly an optimistic estimate when the respondent's current level of income is compared to the income they expect to earn at their peak. Only 7.9 percent of the respondents believe it will take over 10 years to reach their peak earnings.

Exhibit 11 shows how much respondents expect to earn at their peak. As expected, the frequency rates increase to the $30-60,000 range and then decline until the over $100,000 category. Of respondents, 23 percent expect to earn over $100,000 per year at their peak. This is an extremely optimistic and unrealistic expectation.

As shown in *Exhibit 12*, over a third (39.4 percent) of the respondents feel they will need to work 40 hours a week or less at peak earnings. This clearly points to a discrepancy between expectations and reality. However, about 29 percent believe they will have to work 51 or more hours per week. Unlike the disparity between current income and income at peak earnings, respondents seem to be aware that many additional work hours will be needed to substantially increase income. Still, while there is a high correlation between peak earnings and expected hours worked at peak earnings (ρ=.4971; p=.0001), the number of hours necessary to earn these levels of income seems to be substantially under-estimated by the respondents. *(See Exhibit 13.)*

Over half of the respondents (55.5 percent) earned less than $10,000 in their first year of real estate sales and almost all of them (91.4 percent) earned less than $30,000 during their first year.

Year 1 income from real estate sales is regressed against other survey questions based on the following equation:

$$Y1_i = \alpha_i + \beta_i LN_i + \beta_i CR_i + \beta_i YP_i + \beta_i IP_i + \beta_i HP_i + \beta_i RG_i + \beta_i AF_i + \beta_i GN_i + \beta_i AGE_i + \beta_i ED_i + \varepsilon_i \quad (1)$$

where,

$Y1_i$ = first-year income for respondent i
LN_i = length of time expected to stay in RE sales for respondent i,
CR_i = current number of work hours for respondent i,
YP_i = years until respondent i expects to reach peak earnings,
IP_i = expected income at peak for respondent i,
HP_i = hours worked at peak for respondent i,
RG_i = region of respondent i,
AF_i = affiliation of respondent i,
GN_i = gender of respondent i,
AGE_i = age of respondent i,
ED_i = education level of respondent i,
α_i = intercept term,
β_i = regression coefficient,
ε_i = error term

Not surprisingly, a significant relationship exists with current number of work hours and expected earnings at peak. Further, a negative and significant relationship is observed between first-year earnings and length of time necessary to reach peak earnings. All other variables are insignificant.

CONCLUSIONS

It is apparent from these surveys that people of all ages enter real estate sales and do so for a variety of reasons. However, some results do seem worthy of note. These include the following.

1. Earnings expectations upon entering seem to be much too high. Almost one-fourth (23.0 percent) of those respondents entering real estate sales expected to earn over $100,000 per year at their peak.

2. The length of time expected to reach peak earnings is too low. Over 92.1 percent of the respondents expected to reach their peak earnings in 10 years or less.

3. While many liked "flexible hours" when entering, they did not seem to realize that this meant working weekends and evenings. Many eventually left real estate sales due to schedule conflicts with their spouses and/or children.

4. Real estate agents expect to leave the real estate sales business, on average, prior to age 65 as evidenced by a cross-tabulation in *Exhibit 8*. This is consistent with the entrepreneurial concept set forth by Barth(1964).

While the accuracy of expectations concerning what life will be like as a real estate salesperson are hard to quantify, one significant observation does stand out. Although most new real estate agents have prior sales experience, over half (55.5 percent) earned less than $10,000 in their first year of real estate sales. Further, 81.5 percent earned under $20,000, and 92.0 percent earned under $30,000.

In addition to low and uncertain income, high early failure rates can be attributed to the "sink or swim" philosophy adopted by almost all real estate companies. The implied low levels of screening, ease of entry, and low educational requirements allow individuals to engage in a career that they may not be qualified to perform.

Future research should be directed towards ways in which new agent expectations can be made more realistic. Only then can the high turnover rate be reduced.REI

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See Appendix "A" on next page.

Real Estate Salesperson Questionnaire
Real Estate Research Center
Cleveland State University

Appendix A

Real Estate Salesperson Questionnaire
Real Estate Research Center, Cleveland State University

I. Expectations

1. Why did you enter the real estate sales business?
__ Easy to get a job
__ To earn a little "extra money"
__ A friend convinced me to try it
__ Flexible work hours
__ Chance to earn lots of money
__ Work appeared to be east
__ Little education required
__ Other (Please explain) ____________________

2. How long do you intend to be in the real estate sales business?
__ 1 to 2 years
__ 3 to 5 years
__ 6 to 10 years
__ 11 to 15 years
__ 16 to 20 years
__ 21 to 25 years
__ 26 to 30 years
__ over 30 years

3. How many hours a week do you work NOW in the real estate sales business?
__ less than 10 hours per week
__ 10 to 20 hours per week
__ 21 to 30 hours per week
__ 31 to 40 hours per week
__ 41 to 50 hours per week
__ 51 to 60 hours per week
__ more than 60 hours per week

4. How many years will it take you to reach your peak earnings?
__ 1 to 2 years
__ 3 to 5 years
__ 6 to 10 years
__ 11 to 15 years
__ 16 to 20 years
__ 21 to 25 years
__ 26 to 30 years
__ over 30 years

5. How much do you expect to earn **per year** at your peak?
__ less than $10,000
__ $10,000 to $20,000
__ $20,001 to $30,000
__ $30,001 to $40,000
__ $40,001 to $50,000
__ $50,001 to $60,000
__ $60,001 to $70,000
__ $70,001 to $80,000
__ $80,001 to $90,000
__ $90,001 to $100,000
__ over $100,000

6. How many hours a week (on average) do you expect to be working when you achieve your peak earnings?
__ less than 10 hours per week
__ 10 to 20 hours per week
__ 21 to 30 hours per week
__ 31 to 40 hours per week
__ 41 to 50 hours per week
__ 51 to 60 hours per week
__ more than 60 hours per week

7. How much did you earn (or expect to earn) in your first year of real estate sales?
__ less than $10,000
__ $10,000 to $20,000
__ $20,001 to $30,000
__ $30,001 to $40,000
__ $40,001 to $50,000
__ $50,001 to $60,000
__ $60,001 to $70,000
__ $70,001 to $80,000
__ $80,001 to $90,000
__ $90,001 to $100,000
__ over $100,000

II. General Information

1. What is your geographic location?
__ Northeast Ohio
__ Northwest Ohio
__ Central Ohio
__ Southwest Ohio
__ Southeast Ohio

2. What is your affiliation?
__ Realtor/Realtor Associate
__ Realtist
__ Non-Realtor/Realtist

3. What is your gender?
__ Male
__ Female

4. What is your age?
__ under 25 years old
__ 26-35 years old
__ 36-45 years old
__ 46-55 years old
__ 56-65 years old
__ over 65 years old

5. What is the highest education level you have attained?
__ Do not have a high school diploma
__ Have a high school diploma, but no college
__ Some college, but no degree
__ Bachelor's degree
__ Some college beyond the Bachelor's degree
__ Have completed an advanced college degree

6. What is you annual household income from ALL SOURCES?
__ less than $10,000
__ $10,000 to $20,000
__ $20,001 to $30,000
__ $30,001 to $40,000
__ $40,001 to $50,000
__ $50,001 to $60,000
__ $60,001 to $70,000
__ $70,001 to $80,000
__ $80,001 to $90,000
__ $90,001 to $100,000
__ over $100,000

III. Other

Please use this space to communicate any and all opinions you have about your expectations upon entering the real estate sales business that have not been adequately covered (or to make any comments you wish). ____________________________

CRE PERSPECTIVE

Free Market Environmentalism

by Bowen H. "Buzz" McCoy, CRE

DEFINITIONS

With the selection by President George W. Bush of Christine Todd Whitman as Environmental Protection Agency Administrator and Gale A. Norton as Secretary of the Interior, there was considerable interest in their libertarian, market-based policies, sometimes referred to as **free market environmentalism**. Free market environmentalism has been described as a philosophy that is grounded in property rights, voluntary exchange, common law liability protection, and the rule of law—all of which seek to integrate environmental resources into the market system.

Free market environmentalism conflicts with traditional environmentalism in its visions regarding human nature, knowledge, and processes. With respect to **human nature**, man is viewed a self-interested. This self-interest may be enlightened to the extent that people are capable of setting aside their own well being; but good intentions will not produce good results. Instead of intentions, good resource stewardship depends on how well social institutions harness self-interest through individual incentives.

Knowledge and information cannot be general and global, but must be time- and place-specific. These visions of knowledge and human nature make free market environmentalism a study of **process** rather than a prescription for solutions. If we can rise above self-interest and if knowledge can be concentrated and specific, then the possibility for solutions through political control is feasible.

Many environmental problems are caused by the **"tragedy of the commons."** If access to a valuable resource is unrestricted, people entering the commons to capture its value will ultimately destroy it. Even if each individual recognizes that open access leads to resource destruction, there is no incentive for him/her to refrain from over-grazing the common pasture or over-harvesting the fish. If he/she does not take it, someone else will, and therein lies the tragedy. There is no community in which to regulate individual self-interest. The individual, who is unconstrained and wastes a community resource, through over-grazing, pollution, or the like, is called a **free rider**. He/she does not pay for the value or cost of what he/she takes away from the community.

Transaction costs become important. It is costly to restrict entry. The costs of organizing and bargaining can be high. **Information costs** are the costs or values attributed to what is taken from the community. What is the cost of my backyard barbecue polluting your air? How much of such pollution should be allowable? What are the costs and benefits of drilling for petro-chemicals in the Arctic National Wildlife Refuge? Such costs are difficult and expensive to obtain in the absence of established markets for wildlife habitat, or hiking, or snowmobiling. In order to solve environmental problems, we must find ways of discovering and articulating this type of information. Once such values and costs are determined, rational choices can be made and rights can be marketed or traded.

Free market environmentalism identifies systematic differences in the way information about subjective values is communicated in markets and politics. In the marketplace, prices convert subjective values into objective measures. In the political process, voting is a signal that communicates the subjective values, especially of special interest groups. Special interest groups lower the cost of information to its members, allowing legislation to pass which costs each taxpayer a few pennies, but provides significant benefits to the special group.

COMMUNITY MANAGEMENT SYSTEMS

Community management systems have evolved over hundreds of years to manage issues such as the tragedy of the commons. They seem to contain six basic factors:

1. Boundaries must be clearly defined so that individuals know what they can use and others know when they are trespassing.
2. Rules are required to determine how the value of the resource is parceled out.
3. Rules must be specific as to time- and place-specific resource constraints, or there will be pressure to change them.
4. There must be effective monitoring of the rules, and a system of rewards and sanctions imposed.
5. Dispute resolution mechanisms at the local level are necessary.
6. The rules must not be subject to change by higher levels of government.

An example may be given of the destruction of the Nepalese forests. The national government chose to ignore previously successful community arrangements, and all the forests were placed under central control of the government. The act led to a chain of destruction that resulted in the removal of almost half of the trees in Nepal's forests. Nepalese villagers began free riding, systematically overexploiting their forest resources on a large scale. They had lost control of their forests.

Examples of free market environmentalism occur in areas such as grazing rights, hunting, multiple use of government lands, recreational land uses, water rights, pollution, fisheries, and the like. The argument is made that entrepreneurial pragmatists in the environmental movement have come up with incentive systems, such as trading unused rights to pollution or rewarding ranchers for protecting endangered species, which have led to more positive outcomes than either the government command and control systems or the legal process.

Market-based property rights evolved on the frontier, which was once open to all. Cooperative systems evolved for the ownership of land, livestock, and water. As the perceived values of assets changes over time, so do the incentives. With the use of global positioning systems, DNA testing, and radio and acoustical tagging of species, it is possible to imagine such solutions as tradable rights in whale harvests.

Public funding and bureaucratic controls have not solved such problems as lost salmon runs in the Pacific Northwest or the upkeep of our national parklands. The Endangered Species Act creates perverse incentives for landowners to take preemptive actions to eliminate wildlife habitat, rather than to preserve it.

Oil and gas leasing on public lands pits environmentalists, development companies, and state and local interests against one another in the political process, where the stakes are high and the winner often takes all. This fosters acrimony rather than cooperation among disparate users of natural resources. Free market environmentalism emphasizes well-defined and enforced property rights. Where environmental groups own energy resources in sensitive wildlife reserves, they become willing to make trades because they see costs in not deploying a valuable asset. By forcing price and opportunity cost discovery, free market environmentalism can assist in the determination of rational choices where all might benefit.

CONCLUSIONS

Critics of free market environmentalism include those who state that environmentalism is a moral issue and should not be decided by cost/benefit analysis. Others claim that rights to magnificent landscapes and wild animals are more important than the rights conferred to property owners. They state that environmentalists would be willing to pay more for such rights if only they, or the government, had the resources. The case is made that the distribution of wealth favors private landowners over environmental preferences.

I would agree with critics who state that environmentalism is a moral issue. Pure air and water and gorgeous sunsets have aesthetic values and cannot be evaluated solely in dollars and cents, but must be valued out of our deepest sense of who we are and who we want to be. These deep intuitive yearnings, which stem out of our foundational beliefs, cannot always be bargained away. Living out an ethic, even an environmental ethic, is not about always winning. It is about what we are willing to sacrifice for. Always equating ethics with winning diminishes the depth of ethical commitment.

Moreover, the command and control systems imposed by various government levels give some assurance that the publics' will might be done. Systems based upon virtue, free bargaining, and perfect information are commendable and should be used wherever possible. Given human nature, however, a system of rewards and punishments should also remain available.

It is my view that free market environmentalism offers a creative and positive way out of the morass of over-regulation and endless litigation. Rather than painting everyone as either for us or against us, as The Sierra Club and others are prone to do, this concept forces us to think hard about costs and benefits—to balance the rights and duties of all parties and to come up with a more balanced and effective solution.

Understanding free market environmentalism is important for any property owner who wants to gain a better understanding of the environmental movement, or wants to protect their property rights, as well as those who would like to better understand the public dialogue we can expect with Whitman and Norton, among others, over the term of the current administration.

Those wishing to learn more about the free market environmental movement are urged to contact the Political Economy Research Center (PERC) located in Bozeman, Montana (perc@perc.org). REI

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CRE PERSPECTIVE

APPRAISAL OR VALUATION: AN *ART* OR A *SCIENCE?*

by Barry G. Gilbertson, CRE

Herein, the author looks at the age-old conundrum to see whether, in today's hi-tech world and with the advent of Global Valuation Standards, there is a consensus of opinion.

Art: *thing in which skill may be exercised.*

Science: *systematic and formulated knowledge.*

- Source : *The Concise Oxford Dictionary*

There seems to be a common view among those I interviewed for this article that roughly correlates with the dictionary definitions. Another way of distinguishing between the two might be that one is *subjective* whilst the other is *objective*. Which is which? Well, I believe that whilst art is a subjective view, a scientific view should be objective. However, in terms of an appraisal, it could be argued that a client is paying the appraiser for a subjective interpretation of the objective scientific analysis and calculation. There will always be an esoteric mix of factors to interpret, such as current market sentiment, the micro-location of the asset, age, and precise specification of the building, among many others.

NEW VIEWS FOR OLD

Is this ratio of subjectivity a new view? Has this view changed in recent years? Folk have been valuing property for centuries. The Roman trader needed to assess an asset's value just as much as today's real estate bond trader. What has changed, particularly in very recent years, is the methodology by which the number is calculated. Indeed, the very word *calculated* implies a more scientific approach than when I first valued property. Gut feel had a lot to do with a value then, based on the comparables method. Yes, there was some mathematics—the application of a years purchase multiplier to the rent. Even then, the valuer needed to apply a subjective judgement to arrive at the number reported to the client.

Perhaps appraisal was, in the past, a cottage industry, as the quality of the output depended on the appraiser's ability to gather market information that used to not be so readily available. Lack of data needs more experience. More data leads to a better opinion.

Nowadays, most appraisers would not dream of undertaking an appraisal without the benefit of a computer package. It is not for me to give credit to a particular supplier—there are many on the market...some better than others. However, some packages require so many fields to be completed that the appraiser can end up making judgements on judgements, and the ensuing variables call for considerable (artistic) interpretation.

However, even when the factual data has been input, the appraiser still needs to make assumptions. Is this the art or the science at play? Assumptions as to market rent, probable yield, discount rate, and the like, all call for considerable relevant experience and subjective judgement. Is this not what scientists do when hypothesising a theory? Appraisals cannot be proved empirically. Even a genius has to make a judgement of whether a theory is proven or not. Does that make it any less scientific? I think not.

So, maybe appraisal is an imprecise science rather than an art.

DATA MINING

When an appraiser conducts market research, this can produce raw data. The client could, most likely, get that data from the Internet or another source. There is so much data available today, with increasing transparency in the marketplace. Data mining is part of the science. However, the client is willing to pay for the interpretation of the data to determine an opinion of value, which can be relied upon. The interpretation is the art.

Deals happen. There is not a perfect market. This imperfection makes an appraiser's task very difficult. The appraiser has to interpret where the market is going. A valuation is like a snapshot in time. Imagine a photograph containing a ball in flight. Is it actually going up, or going down? That's what the client wants to know. He would really like to know where that ball will be after an agreed period of time, but that is probably too difficult for all but the crystal-ball gazers.

Appraisers have to reflect, not make, the market. An appraisal could be a surrogate pricing process.

Whereas, worth is what the purchaser is prepared to pay. What is value? Does value exist? Can value really be measured, or is it ethereal?

Does an appraiser work in the property market, or measure the market in property?

UNDER THE INFLUENCE

For some time, probably since the need for independent appraisals began (whenever that might have been), appraisers have come under pressure—usually from the person wanting to borrow the money, or to buy or sell the asset—to move the number in a particular direction. Has this pressure increased or decreased lately? Well, appraisers know the answer. Is it wrong to change a number? The reader will have a view. If the number is purely the product of scientific or mathematical application then probably, yes—it is wrong. If the number is the result of objective analysis and subjective judgement, then possibly, no. What is wrong, though, must be the changing of the judgement by influence, other than by new data. Opinions can change, of course they can. It just depends what has caused them to change. The prospect of a cut-off in supply of future work is one example of undue, and wrong, influence.

A recent survey published by the Investment Property Forum, in the UK, suggests that valuations can "alter significantly" following the appointment of new valuers. Is this because of previously or currently exerted pressure, or because valuation is not scientific—there is always more than one answer? If valuation was an exact science there would be no need for independent, third-party, arbitrators to settle rent review disputes, for example.

In reference to the same report, the *Estates Gazette*, one of the leading real estate journals in the UK, in its leader column, suggests that these are moral hazards, with conflicts of interest grinding beneath the surface to distort valuations and undermine trust. The leader column also makes a link between this pressurised distortion and the year-end bonuses of investment fund managers being based on demonstrable growth, usually measured by valuations measured against, say, upper quartile performance of a recognised industry benchmark.

It could be argued that the market is made by institutions that buy, hold, and sell property. These institutions are judged by and against their peer group. The arbiter is the benchmark, such as IPD or NCREIF. But, what makes the benchmark? Why, the returns from the funds managers, of course. So, are all fund managers chasing comparison with a set of indices which could be inherently flawed? This could be so in a falling market, when fund managers will be looking for a soft landing rather than a hard crash.

GLOBAL STANDARDS

If valuation standards become more global, then does that make them more like a science than an art? Possibly so. Art is essentially individual. Standardisation is essentially scientific. It is certainly more prosaic. However, to be truly effective, international standards need to make the valuation process globally significant yet locally relevant.

Currently, valuation standards—whether local to a territory, region, theatre, continent, or global—primarily address the product and the way in which the process is undertaken. They do not usually tackle methodology. Why not? It seems illogical not to determine how a valuation should be undertaken, if the standard for the process is the same.

I believe that we will see the regulatory bodies across the world getting to grips with methodologies. The lead needs to be taken by the International Valuation Standards Council—a lead that others will follow. TEGoVA has declared, for example, at a European regional level, that methodology is important, by adding some detail on the topic in its latest edition. The RICS, at a UK level and the Appraisal Institute at a USA level and both at a global level, must also set an example, unhindered by tradition but responsive to market needs.

Clients need to understand that a valuation produced in Massachusetts, Manchester, Melbourne, Moscow, or Matabeleland is reliable in its standards and its methodologies. That must increase the value of the product.

So, will clients pay extra for a valuation that is more scientific than arty? Yes, I believe that they will, if they can be assured of common standards and methodologies across the planet. Global clients, whether actual or aspirant, need a global product. So, too, do local clients—one never knows when they might be taken over and the valuation needed in due diligence.

THE FEW

Perhaps it could be argued that most appraisers are keen to keep it an art. It has been said that good quality institutional work is done by 10 percent of the appraiser population—sometimes at a loss, to encourage the more lucrative (if speculative) brokerage instructions from the same institutional clients. So, 10 percent do 90 percent of the work. Maybe the other 90 percent want to keep it less scientific, and more judgmental, so that there can be less scrutiny. A rule of thumb guide, thought to be based on a legal precedent in the British courts, used to suggest that valuers were unlikely to be considered negligent if within 15 percent of the true valuation. Fifteen percent on either side indicates an astonishing 30 percent range! Surely, today, the courts would adjudge that to be too wide a variation.

SOME FINAL THOUGHTS

- Is it better to have an appraisal by a 25-year-old bright cookie with a computer, than an appraisal by a 45-year-old with 20 years of experience in the same marketplace? Which is [more] accurate?
- Is valuation a numbers thing or a gut feel thing—or a dynamic, but essential combination of the two?
- Is it more valuable to "know" the answer before proving it with the calculations, or to use the calculations to arrive at the answer?
- So, is it an art or a science?
- Does the answer influence how clients feel about the worth of the appraisal?
- Can appraisers earn more fees if clients better appreciate the product?

What do you think? Readers are encouraged to e-mail their thoughts to the author: *barry.g.gilbertson@uk.pwcglobal.com* REI

NOTES

This article is based on an adaptation of an article that appeared in PWC's in-house publication, Global Real Estate Now. *It has been reprinted with permission.*

Throughout this article, the terms appraisal and valuation are interchangeable and are taken to mean the work involved in appraising or valuing a physical asset, to establish its value, regardless of whether that be market value, depreciated replacement cost, or any other definite number.

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Barry G. Gilbertson, CRE, *is a vice president of the RICS and a PricewaterhouseCoopers partner, based in London, UK, where he leads the Real Estate Hospitality & Leisure practice. He also has a pan-EMEA responsibility for real estate appraisals and valuations. The author acknowledges the contribution to the debate made by various international colleagues, clients, appraisers, and valuers whose views were canvassed. (E-mail:barry.g.gilbertson@uk.pwcglobal.com)*

CONTRIBUTOR INFORMATION

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See Editorial Calendar on inside back cover for deadlines.

MANUSCRIPT/GRAPHICS PREPARATION

1). Manuscripts **must be submitted on disk** (along with hard copy) in **IBM or** <u>**PC format only**</u>**--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 two hard 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.)*

2). Graphics/illustrations are to be considered as figures, numbered consecutively and submitted in a form suitable for reproduction. Graphics must either be submitted camera-ready or computer-generated as PC compatible ONLY. DO NOT submit colorized computer files -- the graphics <u>must be created in grayscale or black and white only</u>. If possible, save in all of or at least one of the following formats: .emf; .eps; .tif.

3). Number all graphics (tables/charts/graphs) consecutively. All graphics should have titles.

4). All notes, both citations and explanatory, are to be numbered consecutively in the text and placed at the <u>end</u> of the manuscript.

5). Whenever possible, include glossy photographs to clarify and enhance the content in your article.

6). Article title should contain no more than eight to ten words including an active verb.

7). For uniformity and accuracy consistent with our editorial policy, refer to *The Associated Press Stylebook*.

THE BALLARD AWARD MANUSCRIPT SUBMISSION INFORMATION

The *REI Editorial Board* is accepting manuscripts in competition for the 2001 William S. Ballard Award. All articles published in *REI* during the 2001 calendar year will be eligible for consideration, including member and non-member authors. The $500 cash award and plaque is presented annually each spring, during The Counselors' Midyear Meetings to the author(s) whose manuscript best exemplifies the high standards of content maintained in the journal. The recipient is selected by a three-person subcommittee comprised of members of The Counselors of Real Estate. (The 2001 recipient will be honored at The Counselors 2002 Midyear Meetings.)

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