REAL ESTATE ISSUES

THE COUNSELORS OF REAL ESTATE™
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SUMMER 2000
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1976 - 2000
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EDITORIAL CALENDAR

Fall 2000
(deadline for manuscript submission - September 6)

Winter 2000/2001
(deadline for manuscript submission - November 27)

Spring 2001
(deadline for manuscript submission - February 12)

Summer 2001
(deadline for manuscript submission - May 14)

See "Contributor Information" on page 62 for information on submitting a manuscript or call Faye Porter at 615.498.5858

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EDITOR'S STATEMENT - by Richard Marchitelli, CRE

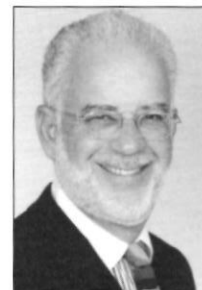
The state of real estate counseling in Summer 2000 can be characterized as busy. A variety of factors have created a frenetic business environment. Paradoxically, however, there are signs of a lack of creativity in problem-solving and a growing criticism by the users of counselors' services. To understand these phenomena, one has to step back and examine the fundamental nature of real estate counseling and the forces shaping its evolution.

As articulated many times before, counseling is not a *discipline* itself, but rather a *process* that involves a number of different disciplines. Solution to a specific real estate-related problem normally requires the interaction of several disciplines such as finance, research, property and portfolio management, valuation, law, accounting, etc. While a counselor must necessarily be an expert in one or more such disciplines, engagements require a multi-disciplinary approach that is often beyond the expertise of an individual or even a single company.

Challenges to contemporary real estate counseling are two-fold. First, there is the trend towards specialization, which is a singularly positive development. As the body of knowledge of each discipline has grown, counselors have been forced into specialization within their own area(s) of expertise. This trend is necessary and irreversible. It has occurred in medicine, law, and accounting. It is inevitable that other disciplines should follow. Because of his/her unique role in the process of counseling, a real estate consultant must also be exceptionally diligent about keeping abreast of changes in other disciplines. This will become increasingly difficult as bodies of knowledge continue to expand, and specialization further fragments existing disciplines. It also underscores the importance of continuing education in professional development because, without such micro and macro levels of understanding, individuals will become ineffective in their roles as counselors.

The second challenge is represented by the paradigmatic thinking that is so prevalent within each discipline in its approach to problem-solving. In short, many specialists, consciously or unconsciously, have become unable (unwilling) to think "out of the box." Proposed solutions are often stale and lacking in imagination. Almost 40 years ago, Thomas S. Kuhn observed in *The Structure of Scientific Revolutions,* that practitioners will take universal procedures established by others (*i.e.,* paradigms) and use them as models to solve new problems. He warned that, while such models may be useful, they tend to become institutionalized. More important, they inhibit practitioners from breaking new ground. Whether the result of being too busy or for expediency, real estate experts are demonstrating a tendency to think solely within the established paradigms of their discipline. This has led clients to question whether such experts are effective in satisfying their needs or whether they bring anything new (*i.e.,* "add value") to the process.

Richard Marchitelli, CRE
Editor in chief



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Real estate owners and investors have long searched for ways to increase their tax benefits. Now, as the result of an asset reclassification strategy known as a *Cost Segregation Study* (CSS), that opportunity may exist for those individuals and companies who purchased, constructed, or expanded their real estate holdings after 1986. As practiced by a relative handful of real estate tax planning specialists, a CSS can increase current cash flow anywhere from $100,000 to more than a million dollars. If learning how to reduce taxes is of interest, this manuscript offers some very important information.

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REAL ESTATE ISSUES

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RECOGNIZING FORMER EDITORS IN CHIEF

Probably the most surprising thing about *Real Estate Issues* is that it has survived — and more than that, prospered — despite an extremely worrisome beginning. Almost voted out of existence by an anxious Board of Governors after the first number appeared, the newborn infant, though dizzy at first from having circled the drain so vigorously, has grown into a well-balanced and mature adult, fully capable of begetting, incubating, and nurturing important new ideas. We don't have to keep worrying about its future, and are free to take satisfaction in its impressive present.

For this there are many people to thank, starting with CREs **Jean Felts** and **Jim McMullin**, who together produced that fragile first number, and the remarkable succession of editors in chief who followed them (and me) over an eventful quarter century. Every bit as meaningful have been the excellent staff and the generous contributions of more than four hundred unpaid authors. With such resources, the success of *Issues* is perhaps not such a miracle.

It may be appropriate, though largely unnecessary, to remind readers that their own personal interests, as well as those of real estate counselors in general, are served in many ways by this limited-circulation journal. Prestige, certainly, and pride in what *Issues* represents as a demonstration of our dedication to the high standards of The Counselor organization, but also information, interpretation, and guidance to help us negotiate our individual voyages through the tidal rips, sinkholes, and minefields of a fast-changing economy and an even faster-changing industry. Indeed, we have much to be thankful for — and much to be proud of. *Real Estate Issues* is after all, not just our serious, grown-up journal; even now, after 25 years of ripening and growth, it is still our amazing baby.

Jared Shlaes, CRE Emeritus
Editor in chief, 1977 - 1986

How Cost Segregation Offers Substantial Tax Benefits to Real Estate Owners & Investors in Real Estate

by David Grant

With the advent of the Internal Revenue Code of 1986, real estate owners and investors have been searching for ways to increase the tax benefits from owning or investing in real estate. A Cost Segregation Study will accelerate tax depreciation, yielding a current tax benefit. In general, the more elaborate and costly the property, the greater the tax benefit. Both commercial and residential property can reap the benefits of a Cost Segregation Study. If learning how to reduce taxes is of interest to you, this may be the most important article you have read in a long time.

FOUR FUNDAMENTAL QUESTIONS

- Can you or someone you know benefit from accelerating tax depreciation on their real estate holdings? (*i.e.* will additional depreciation shelter current tax liabilities?)
- Have you or someone you know purchased, constructed, or expanded their real estate holdings any time after 1986?
- Is the cost of the building at least $1,000,000?
- Do you, your company, or your client expect to retain their real estate holding(s) for at least the next three or four years?

If you answered yes to these fundamental questions, then you, your company, or your client's company qualify for a unique asset reclassification strategy known as a Cost Segregation Study (CSS).

ABOUT THE AUTHOR

David Grant CPA, CVA, *is a member in the Real Estate Industry Group at Mintz Rosenfeld & Company LLC, Fairfield, NJ. He previously worked as a CFO at a commercial real estate firm in New York City. He is also a frequent writer and lecturer on real estate taxation. (Email: dgrant@mintzrosenfeld.com)*

Over the last few years, we have found that many individuals and companies that owned real estate were missing out on current income tax savings by underdepreciating their real estate assets. A CSS will accelerate tax depreciation deductions, enabling individuals and companies that own real estate to lower their current income tax liability, thereby increasing current cash flow.

HOW MUCH CAN BE SAVED?

CSSs have generated millions of dollars in current federal and state income tax savings to owners of real estate. However, given the complicated nature of the study, it requires a tax expert with an intimate knowledge of the IRS code, the relevant tax cases, and a network of resources to maximize the benefits. To date, only a relatively small number of CPA firms provide this service to their real estate clients.

The amount of the benefits from performing a CSS will vary depending on a). the type of property; b). the cost of the property; and c). the year it was placed in service.

While certain properties get a bigger bang for the buck than others, we have found that almost every type of real estate can benefit to some degree from a CSS. This is due to the long-lived property categories of most real estate holdings, which contain at least some amount of shorter-lived personal property. By segregating the shorter-lived personal property from the long-lived property category, we can greatly accelerate depreciation deductions. The greater the depreciation deductions today, the greater the present tax savings. The greater the present tax savings the greater the present cash flow, which in turn can be used to underwrite current or future acquisitions.

Our experience in performing cost segregation studies for the real estate industry indicates that the savings can be as high as five percent of the asset cost. On a $5 million property, for example, a five percent benefit would generate $250,000 in tax savings. Savings of anywhere from $50,000 to $1 million, or more (depending on the type and size of facility) are routine.

WHAT TYPE OF PROPERTY BENEFITS THE MOST?

While almost every type of real estate can benefit from a CSS, our experience indicates that certain types of property yield the highest tax saving benefits from a CSS. Those properties include specialty-use buildings, such as medical facilities,

Over the last few years, we have found that many individuals and companies that owned real estate were missing out on current income tax savings by underdepreciating their real estate assets. A CSS will accelerate tax depreciation deductions, enabling individuals and companies that own real estate to lower their current income tax liability, thereby increasing current cash flow.

manufacturing facilities, and high-end office buildings, to name a few. Warehouses and industrial properties tend to yield lower benefits, while residential garden apartments fall somewhere in the middle. We have found that even large tenant fit-outs can qualify for substantial benefits as well.

WHAT IS A COST SEGREGATION STUDY?

Almost anyone can identify and properly depreciate items such as office furniture and equipment over seven years for federal tax purposes. However, a high percentage of construction-related costs, sometimes as high as 40 percent, are too commonly lumped into the building component of the property and depreciated on a straight-line basis over 39 years. A CSS is the process of reviewing and identifying the costs a company incurs to acquire, construct, or expand its real estate holdings. It identifies the specific types of assets being placed in service and often leads to a cost allocation that assigns part of the cost to 15-year real property and seven- or five-year personal property. An analysis of costs can be conducted from either the detailed construction records - in the case where such records are available - or by using qualified appraisers, architects, or engineers to perform the cost allocation analysis. In both instances, a tax expert is also needed to identify the specific types of property that will qualify as shorter-lived assets.

HOW COST SEGREGATION WORKS

While personal property is usually depreciated over a five- to seven-year life, real property is typically depreciated over 39 years (commercial property) or 27.5 years (residential property). With a cost segregation study, owners of real estate can shelter large

sums of income now rather than later, by shifting certain property costs from a 39-year life to 15-year, seven-year and even a five-year life.

Construction-related soft costs have historically been lumped together as part of real property. However, by performing a cost segregation study, these soft costs can be allocated to various components of the property, many of which have shorter depreciable lives than the real property component. The result is a faster write-off of costs previously included as real property.

Cost segregation studies can be performed on purchased facilities as well as newly constructed facilities, not to mention major renovation of existing facilities. Studies can be performed for real estate holdings placed in service as far back as 1987, even if the year is "closed" for tax purposes. Recently issued IRS revenue procedures *(see IRS Revenue Procedure 99-49 described below)* permit companies that have claimed less than the allowable depreciation to claim the omitted amount over a four-year period on a going-forward basis. In addition, the segregated components continue to be depreciated over shorter lives going forward.

Savings derived from these studies flow directly to the bottom line in tax savings and cash flow.

IS THERE EXPOSURE TO A TAX AUDIT?

This is a question that we are asked quite frequently by individuals and other practitioners. Our experience indicates that a properly performed CSS does not create additional exposure to a tax audit. Depreciation is not a high priority area with the IRS. The benefits of a CSS come from the acceleration of tax deductions, not taking a tax deduction for something the taxpayer is not already entitled to. If the property is held for its entire depreciable life, the IRS will get all that it is entitled to. The benefit from a CSS comes from the time value of money generated by current tax savings that may eventually be paid back, albeit, 20 or so years later.

CSS AS AN ESTATE PLANNING TOOL

When property changes hands through an estate, the tax basis of the property will generally step-up (usually increase) to fair market value. This stepped-up basis begins a new depreciable life for the property. The property could have been 50 years old and fully depreciated prior to the death, however, the stepped-up basis now can be depreciated based on its fair market value. This is an ideal time for a cost segregation study.

HCA CASE LIGHTS THE WAY

The *Hospital Corporation of America* (HCA) case, concluded in 1997, constituted a major win for tax payers and owners of real estate. In this case, the court concluded that property qualifying as tangible personal property under former investment tax credit (ITC) rules would also qualify in the same manner for purposes of tax depreciation. Thus, we can look to the guidance under the former ITC rules when determining whether property is depreciated as real property (*i.e.*, 39-year recovery period) or personal property (*i.e.*, generally a five-year or seven-year recovery period).

In the HCA case, the taxpayer argued that several disputed items associated with facilities it built in the 1980s constituted tangible personal property (see definition below) that should be depreciated over a five-year recovery period (based on the applicable business asset guideline class appropriate for the taxpayer's business). The IRS countered that allowing these items to be depreciated over a different recovery period than the buildings to which they related, amounted to component depreciation (which was outlawed in 1986). The IRS also argued that the items in question were structural components of the buildings in which they were housed *(see definitions below)*. Furthermore, the IRS suggested to the court that the old ITC cases that predate the adoption of current depreciation methods in the 1980s, were of limited usefulness in determining what constitutes a structural component.

The court concluded that items such as kitchen hoods and exhaust systems and wiring for telephone and communications systems, to name a few, were tangible personal property rather than structural components of the building because the items were related to furnishing medical services rather than providing building services. We would expect that similar logic should apply to other industries and activities, particularly where a part of a building's features are for the specific use of the company's business operations.

DEFINITIONS

Tangible Personal Property — Under § 1.48-1(c), is defined as, "any tangible property *except* land and improvements thereto, such as buildings and other *inherently permanent* structures (including items which are *structural components* of such buildings or structures)."

Inherently Permanent — In *Whiteco Indus., Inc. vs. Commissioner*, T.C. (1975), the following factors

were considered in resolving whether property is inherently permanent and, thus, not tangible personal property:

1. Is the property capable of being moved, and has it in fact been moved?
2. Is the property designed or constructed to remain permanently in place?
3. Are there circumstances that tend to show the expected or intended length of affixation; *i.e.*, are there circumstances that show that the property may or will have to be moved?
4. How substantial a job is removal of the property and how time-consuming is it? Is it "readily removable?"
5. How much damage will the property sustain upon its removal?
6. What is the manner of affixation of the property to the land?

Additional Factors to be Considered:

Movability itself is not the controlling factor in deciding whether the property lacks permanence.

The fact that an item is not readily reusable in another location is evidence supporting the conclusion that it is to be treated as permanent in its present location.

Structural Components — § 1.48-1(e)(2), Income Tax Regs., explains the meaning of "structural components" by way of example, rather than by definition, as follows:

> The term "structural components" includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings thereof such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of a building. However, the term "structural components" does not include machinery, the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs.

The opportunity for individuals and companies that own or have investments in sizable real estate portfolios to realize significant financial benefits through cost segregation is substantial, as are the savings. With tax laws and interpretations continually changing, the time to act is now.

Accordingly, an item constitutes a structural component of a building if the item relates to the operation and maintenance of the building. Sec. 1.48-1(e)(2), Income Tax Regs. The "sole justification" test set forth in section 1.48-1(e) (1), Income Tax Regs., excludes from the term "structural component" only machinery that is required to meet the temperature and humidity requirements of other machinery.

IRS Revenue Procedure (Rev. Proc.) 99-49 — Rev. Proc. 99-49 describes the requirements and procedures for a taxpayer to obtain an automatic consent to change methods of accounting. This Rev. Proc. allows taxpayers to retroactively change their method of accounting for depreciation and catch up the difference over a four-year period.

The Rev. Proc. describes the change as follows:

> "(a) This change applies to a taxpayer that wants to change from an impermissible method of accounting for depreciation or amortization under which the taxpayer did not claim the depreciation allowable, to a permissible method of accounting for depreciation under which the taxpayer will claim the depreciation allowable.
>
> (b) A change from a taxpayer's impermissible method of accounting for depreciation under which the taxpayer did not claim the depreciation allowable to a permissible method of accounting for depreciation under which the taxpayer will claim the depreciation allowable is a change in method of accounting for which the consent of the Commissioner is required."

The Rev. Proc. also describes in detail the requirements and conditions needed to take advantage of this provision in the law. A competent tax accountant will need to follow the strict IRS requirements to effectuate the change in accounting.

EXAMPLES OF COST SEGREGATION

These case studies further illustrate the tax savings benefits of cost segregation:

- A company constructed a $11 million office building in 1988. During the first 10 years of operations, depreciation expense was originally calculated as $3,300,000. As a result of a cost segregation study performed in 1998, the company was able to increase its depreciation expense by over $1,600,000 during the next four years. This resulted in discounted present value tax savings and additional cash flow of more than $340,000 to the company.

- A $6,000,000 warehouse facility was put into service in 1997. As originally calculated, depreciation expense during the first four years of operations was approximately $650,000. After a cost segregation study was performed in 1999, the company was able to increase its depreciation expense during the same four-year period by $225,000. This resulted in tax savings and additional cash flow of over $100,000.

- A $8,500,000 nursing home was constructed in 1987. As originally calculated, depreciation expense during the first 11 years of operations was approximately $2,600,000. After a cost segregation study was performed in 1998, the company was able to deduct an additional $1,600,000 of depreciation spread over the next four years. This resulted in tax savings and additional cash flow of over $500,000 during the four-year period.

- An office building complex costing $48,000,000 was acquired in 1995. The owner made tenant improvements of $2 million to the facility over the ensuing two years. As originally calculated, the depreciation expense from 1998 through 2001 was $5,050,000. A cost segregation study that identified improvements such as millwork, wall coverings, kitchen plumbing, telecommunications wiring, and supplemental air conditioning, to name a few, increased depreciation expense during that four-year period by $2,300,000. This led to tax savings and additional cash flow of over $700,000 to the owner.

CONCLUSION

The opportunity for individuals and companies that own or have investments in sizable real estate portfolios to realize significant financial benefits through cost segregation is substantial, as are the savings. With tax laws and interpretations continually changing, the time to act is now.REI

Quality Priority in Housing

by Stephen E. Roulac & Bruce R. Christy

Quality is important in every aspect of society and especially housing. The perceived quality of property influences its pricing, marketability, and value. Confirming and communicating quality are crucial to real estate transactions. Subsequent shortfalls of actual quality relative to representations of quality in such communications can impose significant liability for both those who build and sell properties and also for those who provide professional services to transactions.

Understanding consumers' expectations of housing quality can both increase the prospects of positive property performance and also aid a developer in building a brand name and strong market identity. Concurrently, understanding the role of quality in property transactions is crucial to mitigating litigation risk. This manuscript explores the role of quality in the context of housing decisions.

ABOUT THE AUTHORS

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QUALITY CONTEXT

Over the last two decades quality has been thoroughly ingrained in every aspect of society. Fundamental to Japan emerging as a major economic power was its national commitment to quality, transforming *Made in Japan* from representing something of shoddy workmanship and unreliable functionality to high standards of precision assembly of materials and reliability. Central to the resurgence of the United States' economy during the second half of the 1980s through the 1990s has been a pervasive, intensive commitment to quality. The much-publicized Malcolm Baldridge Award raised consciousness of quality concerns throughout the business community and motivated many companies to commit significant resources to enhancing the quality of every aspect of their operations. The proselytizing of quality gurus such as Edward Demming, Joseph Juran, and Philip Crosby, through their books, speaking, quality training and consulting, has

had a significant impact upon raising quality consciousness broadly.

The explosion of the media coverage of business has furthered the awareness of quality. Suddenly, the attention to best practices has caused those purchasing for business and consumers to raise their expectations of the quality of every good and service they buy. Specifically, the best product and service experience encountered in one setting is transferred by expectation to all settings. The quality of products and services has improved dramatically in recent years, which has therefore stimulated even higher expectations in every purchase decision, product experience, and service encounter.

The shingle theory holds that any individual or business representing to the public that it provides goods and services – by the very act of *hanging out its shingle* – communicates that the consuming public can reasonably rely upon that professional and company to possess appropriate levels of competence so that the work such professionals and organizations do is characterized by appropriate levels of quality. Thus, every individual and organization associated with housing goods and services are expected to be competent in their roles generally, and to deliver goods and services that meet society's quality expectations specifically.

The property markets have not been immune to the higher standards of consumer expectations concerning the quality of property goods and services. The implementation of quality expectations through real estate occurs in several ways, including: 1). professionals' and private enterprises' own standards; 2). behavior guidelines of professional associations; 3). regulations administered by government agencies charged with protecting the public interest; 4). the legal principles of fiduciary responsibility; and 5). the shingle theory. Among the means by which quality in housing is implemented are the following:

- Professionals and enterprises with property involvements employ their own quality standards concerning what is to be done, how it is to be done, and what internal quality control mechanisms are employed to confirm that the desired quality objectives are realized.
- Professional associations promulgate codes of ethics and behavior, specifying the standards of service that consumers of professional services should expect.
- Government regulations address the public's reasonable expectations of professional competence, diligence, and disclosure.
- Fiduciary law imposes explicit responsibilities for professionals representing their clients in terms of the standard of care that should be employed in such representation.
- Purchasers of property employ professionals to provide due diligence services to confirm construction quality, property value, mechanical systems functionality, fire and safety standards compliance, and related concerns.

Shortfalls in quality expectations can be accompanied by legal liability, which can lead to litigation and substantial awards for damages.

HOUSING QUALITY CONTEXT

Quality expectations are especially significant in housing. Housing is both a household's largest expenditure and also, in many instances, a primary component of the household's wealth portfolio. People expect to receive value consistent with what they pay. The higher the price of a particular expenditure, the higher the expectations of the value and quality of what is bought with that expenditure. Especially for a significant capital expenditure, for a product in which functionality and durability are crucial consumer expectations, consumers perceive a close correlation between the amount of what they spend with the quality of what they get. Simply stated, when a consumer spends more, that consumer expects to get more – in multiple realms of the product's attributes, and especially its quality.

A major part of the income that people realize from their employment is devoted to housing expenditures. Housing is the largest expenditure for most households, generally taking 25 percent to 33 percent of income, or even more. Consequently, most people spend more time working to pay for their housing than they do for any other good or service that they consume. The expectations of consumers and businesses as to a product's quality is directly influenced by the purchase price. A high price generally, and especially a price that requires a substantial portion of an individual's or household's earnings, signals high expectations as to quality.

When people work harder for something, they reasonably have higher expectations associated with what they worked so hard for, than for other expenditures to which they make a lesser commitment of time and effort. Today, every person is challenged in work to be more productive and to deliver more

quantity at higher quality in less time and cost. Inevitably, the market's expectations of an individual's productivity influences that individual's own expectations in their personal consumption decisions. Housing quality that might have been tolerated or accepted in the past is no longer tolerated or accepted today.

The pressures on housing quality today are exacerbated by the higher price of housing. Housing costs in the U.S. have increased dramatically, as evidenced in *Exhibit 1*, showing how the cost of a single-family home has gone from $25,700 in 1970 to $72,800 in 1980 to $168,300 in 1999, a 555 percent increase since 1970. While average household earnings have also grown dramatically, as seen in *Exhibit 1*, the ratio of housing price to earnings continues to expand. Although part of this expansion reflects the consequences of innovations in mortgage finance as well as changing costs of capital, the daunting price of housing for virtually every segment of society motivates higher quality expectations.

SURVEY OF REAL ESTATE AGENTS

Insights into factors influencing housing expectations are provided by the results of survey research of agents representing prospective homebuyers in

Exhibit 1

Housing Affordability Decreased
Changing House Price and Household Income Relationships

- United States -

Year	Average House Price	Average Household Income	Price/Income Ratio
1970	$25,700	$12,636	2.03
1980	$72,800	$27,626	2.64
1990	$115,300	$50,634	2.28
1999	$168,300	$70,253	2.40

Source: Woods & Poole Economics, CEEDS 1998; Bay Area Real Estate Information Service; National Association of Realtors; Roulac Group, Inc.

Exhibit 2

Housing Affordability Decreased
Changing House Price and Household Income Relationships

- Marin County -

Year	Average House Price	Average Household Income	Price/Income Ratio
1970	$37,845	$17,791	2.13
1980	$168,508	$42,347	3.98
1990	$379,581	$84,018	4.52
1999	$590,821	$124,204	4.76

Source: Woods & Poole Economics, CEEDS 1998; Bay Area Real Estate Information Service; National Association of Realtors; Roulac Group, Inc.

an upscale Northern California market. Surveys were conducted in the spring of 1999 of residential real estate agents who were top performers, with long-time involvement in the Marin County housing market. Marin County is an especially significant market to study housing quality because of its distinctive attributes of housing prices and household income, as reflected in *Exhibit 2*.

The housing in Marin is not only highly coveted but amongst the least affordable anywhere. Although average 1999 Marin County household income of $124,204 is 1.7 times the national average of $70,253, the average 1999 Marin County house price of $590,821 is 3.5 times the 1999 national average of $168,300. The average housing price in Marin has increased dramatically, from $37,845 in 1970 to $590,821 in 1999, a nearly 15-fold increase since 1970. While the pricing of housing in Marin in terms of income was slightly higher than the national average in 1970, with a price-income ratio of 2.13 for Marin comparing to the national average of 2.03, by 1980 this relationship had changed dramatically from a ratio of 2.64 for the country overall to 3.98 in Marin.

As of 1999, the price premium for Marin housing was even more distorted, with the average house price in Marin being 4.76 times the average household income, which compares to 2.40 for the country overall. The high household incomes of Marin mean that home purchasers tend to be both more discerning and more financially sophisticated than average. Further, because purchasers of Marin housing are paying more than $400,000 above the average house price that applies to other parts of the country, those Marin households who do purchase a house make a more major commitment to housing than applies in other parts of the country. Such households pay more in aggregate and also devote a greater amount of their income and household wealth to housing. Consequently, issues of housing quality loom especially large in Marin.

The survey of the significance of quality in housing was conducted through phone interviews with some 15 agents, who average approximately a quarter century of experience selling real estate in Marin County. The agents had sold an average of some 20 to 26 residential units annually, with 16 percent of their sales being condominium units. Agents were surveyed for their assessments of market conditions in 1985-1987, as contrasted to 1999.

Data is unavailable on the duration of market involvement by licensed real estate sales agents in Marin. Interviews with real estate agents and residents of Marin lead to the conclusion that agents with a quarter-century of experience selling real estate in Marin County represent perhaps 5 percent to 7 percent of the total real estate sales agents active in the Marin housing market. As of January 2000 there were approximately 1,050 licensed real estate sales agents who were members of the Marin Association of Realtors, some of whom had been licensed since 1976. Consequently, the survey respondents are drawn from approximately 50 to 75 real estate sales agents, with survey respondents representing some 20 percent to 30 percent of those with approximately a quarter century of experience selling real estate in Marin County.

HOUSING DECISION PREFERENCE

Housing decision preferences reflected more quality-based reasons than financial considerations. Among the reasons agents identified that a condominium was preferred to detached home ownership were the social benefits, specifically the opportunity to interact with neighbors; the ability to rely on professional construction quality; and the ability to rely on professional management. The inability to afford a detached home was cited in only one of the 15 responses. As seen in *Exhibit 3*, the housing decision preferences were not meaningfully different in 1999 from what housing decision preferences were in the 1985–1987 time period. Overall, quality factors were meaningful influences in housing decision preferences for detached home ownership.

MEANING OF QUALITY

Given the importance of quality of society, the agents were asked to address what *premiere quality* meant as compared to *average quality*. Quality factors considered include the incidence of repairs, problems, and maintenance, which collectively can be considered outputs. Among the inputs considered were design, materials, attention to detail, and the skill and experience of those involved in the construction process itself. The responses summarized in *Exhibit 4* reflect that two factors emerge as being perceived by the real estate agents surveyed to be influential: high quality materials and more attention to detail. One conclusion from these survey responses is that quality embraces multiple output measures and is achieved by a collection of many inputs.

HOUSING QUALITY

The results of the survey indicate that in the Northern California community of Marin County,

Exhibit 3 - **Housing Decision Factors**

Survey of 15 Marin County Real Estate Sales Agents

Reason to Prefer Condo to Detached Home Ownership	1985-1987	1999
Cannot afford detached home	1	1
Ability to rely on professional management	6	5
Reduced maintenance of grounds and exterior	3	3
Reduced interior & exterior repairs required by owner	3	4
No time to take care of a detached house	2	2
Ability to rely on professional construction quality	7	7
Amenities (Pool, tennis, clubhouse, etc.)	4	4
Social benefits (Opportunity to interact with neighbors)	8	8

Source: Roulac Group, Inc.

Exhibit 4 - **Meaning of *"Premiere Quality"* Compared to *"Average Quality"***

Survey of 15 Marin County Real Estate Sales Agents

Premiere Quality	*Response*
High quality materials	12
More attention to detail	8
Low repair incidence	5
No major problems in first several years	5
Efficient and attractive design	5
Use of highly skilled and experienced trades people in construction	4
Low Maintenance	3

Source: Roulac Group, Inc.

housing quality varies significantly between detached housing and townhouse/condominium housing. The finding of inferior quality of attached housing relative to detached housing is by no means unique to Marin County, for severe quality issues are not limited by geography. The issue of housing quality is of broad concern to all with property involvements.

The overall housing quality has meaningfully improved since the mid-1980s, the agents reported that the incidence of detached houses being of poor quality with significant defects, has dramatically reduced over the last 15 years. Detached housing that is regarded excellent or above average in quality has not meaningfully changed, being 25 percent and 36 percent, respectively, over the 1985–87 to 1999 periods, as reflected in *Exhibit 5.*

Improvements in housing quality have been most pronounced for condominium and townhouse complexes, as reflected in the data shown in *Exhibit 6.* Whereas in 1985–1987 periods, agents rated the quality of all condominium and townhouse complexes as poor with significant defects; by 1999 some 60 percent of condominium and townhouse inventory, including new and existing, was rated as average or above average.

Exhibit 5 - Quality Assessment of Detached Housing

Survey of 15 Marin County Real Estate Sales Agents

	Percent Distribution		
	1985-1987	1999	Variance
Excellent	8%	12%	4%
Above Average	17%	24%	7%
Average	34%	48%	14%
Poor - significant defects	42%	18%	(24%)

Source: Roulac Group, Inc. Note: *Rounding was employed, thus items may add up to more than 100%.*

Exhibit 6 - Quality Comparison of Condominium/Townhouse

Survey of 15 Marin County Real Estate Sales Agents

	Percent Distribution		
	1985-1987	1999	Variance
Excellent	0%	0%	0%
Above Average	0%	20%	20%
Average	0%	40%	40%
Poor - significant defects	100%	20%	80%

Source: Roulac Group, Inc.

Exhibit 7 - Quality Comparison of Detached Housing to Condominium/Townhouse

Survey of 15 Marin County Real Estate Sales Agents

	Percent Distribution			
	1985-1987		1999	
	Detached Housing	Condo-minium	Detached Housing	Condo-minium
Excellent	8%	0%	12%	0%
Above Average	17%	0%	24%	20%
Average	34%	0%	48%	40%
Poor - significant defects	42%	100%	18%	20%

Source: Roulac Group, Inc.

Marin agents responding to the survey perceived the quality of detached housing to be significantly better than condominium/townhouses, as seen in *Exhibit 7*, which compares perception of housing quality in the 1985-1987 period, for housing and condominiums, to housing quality in 1999. Although the differences in 1999 are not nearly as pronounced as 1985–1987, the differences are still significant, for a buyer of a single-family home has a much greater prospect of living in a residence that has above average to excellent quality than for a condominium/townhouse.

CONDOMINIUM ASSOCIATION

A singular difference in the housing experience of single-family residences versus condominiums and townhouses is that the latter has a formal board of directors to act collectively on behalf of and to represent the interests of residents. Most single-family homeowners, except for those who live in a subdevelopment with homeowners' associations, operate autonomously and independently without collective representation. The Marin real estate sales agents were mixed in their assessment of the degree to which the presence of a condominium board of directors served as an effective professional representative of home buyers' interests, with six respondents asserting that the board did provide representation and seven asserting that it did not. Of those agents who perceived that the condominium board of directors provided professional representation to homebuyer's interests, somewhat fewer than half reported that the presence of a condominium board influenced home buyers' motivation to buy. The majority of Marin sales agents did not report that the presence of a condominium association provided assurance to homebuyers regarding overall construction quality in the assessment of a particular housing unit that was being considered for purchase. Only three Marin sales agents felt that a condominium association provided assurance of construction quality.

REPRESENTATIONS AND KNOWLEDGE

Real estate agents perceive that they have more knowledge and expertise than the average buyer most of the time, if not always. The survey responses in *Exhibit 8* reinforce that real estate sales agents perceive they contribute knowledge and expertise to servicing their buyers.

Fundamental to the real estate transaction process are representations made by builders and sellers, the reliance placed upon those representations, and the relative general knowledge of agents and buyers. There is no consensus as to how much real estate agents rely upon representations by builders and sellers, but builders and sellers are definitely relied upon, as reported in *Exhibit 9*. Real estate agents generally rely upon builders and sellers some or most of the time. The primary reason agents would rely upon the representations of builders and sellers is because they have access to information not otherwise available. Selectively, agents consider that builders and sellers have specialized knowledge that merits reliance upon their representations.

PREFERENCE FOR NEW

All agents responding reported that buyers preferred new units over existing units. Reasons buyers prefer new units over existing units are reported in *Exhibit 10*. When a purchaser has opted for a condominium, they prefer a newer unit to benefit from *modern styling* and *fixtures*. These two categories were chosen by 12 of the 15 respondents (80 percent), whereas the next highest response rate was "5" for *high quality materials* and *no major problems in the first several years*.

CONCLUSION

The concept of quality has become integral to business and society. With higher property prices, especially in housing, people reasonably expect that the standards of quality that apply and their other expenditures will apply to housing. Yet housing quality often lags meaningfully behind consumers' expectations. Survey research of real estate agents active in Marin County, Northern California, indicated that quality embraces multiple output measures and is achieved by a collection of many inputs. Although housing quality has improved, since the mid-1980s, it still lags meaningfully behind consumers' expectations.

Household incomes and housing prices are very different in Marin than in many other parts of the country. Although whether these differences alter consumer expectations as to quality was not examined in this research, no research has been encountered that would suggest that households making substantial financial commitments do not expect the houses they buy to reflect quality commensurate with the magnitude of their financial commitment. Consequently, lacking any explicit evidence that prospective homeowners do not place an emphasis on quality, the findings of the research concerning Marin County buyer behavior and expectations are generalizable and applicable to all homebuyers, irrespective of geography.

Exhibit 8 - Comparison of Average Real Estate Agent to Average Buyer

Survey of 15 Marin County Real Estate Sales Agents

Does the Agent Have More Knowledge?	Response	Cumulative Percent*
Always	3	25%
Most of the time	9	100%
Some of the time	0	--
Rarely	0	--
Blank	3	--
	15	

** Of those responding*

Source: Roulac Group, Inc.

Exhibit 9 - Reliance Upon Representations by Builders & Sellers

Survey of 15 Marin County Real Estate Sales Agents

Real Estate Agents Rely Upon Representations by Builders & Sellers	Response	Cumulative Percent*
Always	1	8%
Most of the time	6	62%
Some of the time	5	92%
Rarely	1	100%
Blank	2	--
	13	

** Of those responding*

Source: Roulac Group, Inc.

Exhibit 10 - Reasons for New Unit Versus Existing Unit Preferences

Survey of 15 Marin County Real Estate Sales Agents

	Response
Modern styling	12
Modern fixtures	12
No major problems in first several years	5
High quality materials	5
Low repair incidence	4
Low maintenance	4

Source: Roulac Group, Inc.

If purchasers know that the units are marketed as having premier construction quality or that the units are relatively new, then they expect high quality materials with modern styling and fixtures. Furthermore, during the transaction process, the real estate agent is almost always considered to be more knowledgeable, and buyer's inspection reports are important.

After the social benefits of condominium living, the ability to rely on construction quality was the most important factor in motivating the purchase of a common interest development over a single-family residence. This conclusion is especially striking, because it is readily known that the construction quality of condominiums is considered to be very low, as reflected by considerable publicity in local Marin papers about problems resulting from deficit construction quality. The quality of detached housing was perceived to be meaningfully superior to that of condominiums and townhouses. The quality of condominiums, today, is perceived to be sufficiently superior to that of what it was in the mid-1980s.

The shortfall in consumers' experience of housing quality relative to their expectations is an important issue that should concern all with involvement in the housing sector of the property markets. Divergence between consumers' experiences of housing quality relative to representations of housing quality inevitably lead to dissatisfaction. Dissatisfaction can lead to litigation, which can result in significant liability. Those with property involvements need to confirm that housing units possess the requisite quality, that appropriate professional work is done to confirm the actual quality of housing, and that communications of housing quality are accurate and not misleading.

When you hang out your shingle, increasingly knowledgeable consumers demand more of your services and representations. All involved in real estate are expected to be competent in what they represent they do. Those who sell property goods and services are accountable for the representations they make. Property professionals are expected to possess fundamental competence and to be responsible in their representations. REI

ABOUT THE AUTHORS

(continued from page 6)

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Whither Away Office Space as we Know it Today?

by Alan R. Winger

The movement of more and more business activity into the Internet economy raises concerns about the long-term future of the office building market as we know it today. While these concerns have been pushed under the rug by a booming economy and relatively low interest costs, they will arise again. The business cycle is not dead and the movement of more and more economic activity into the virtual world is inevitable. If so, doesn't it imply a very bleak future for real estate that houses office activity today?

This manuscript will address the preceding question. The author will focus on certain elements in the demand for office space as he sees as relevant to any evaluation of the impact of the digital/information revolution on office markets. He believes the arguments offered, provide the basis for some reasonable speculations about the long-term future of the office space market. To preview these, the prospects over the several decades are by no means bleak. Beyond that time, radical change becomes a real possibility. While office space will never whither away, what we consider to be such space and where we will find it is likely to be changing substantially as we move into the second half of the 21st century.

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SOME HISTORICAL PERSPECTIVE

The activity housed in office buildings is for the most part head-using activity.[1] A basic ingredient in that activity is information. The folks involved are concerned with many matters (*e.g.*, planning, monitoring, researching, controlling, marketing, purchasing, and finding human resources) that are essential to the success of the enterprise. What they do usually involves using information in ways that help them deal with the many practical problems that arise in running most businesses.

That we have so much head-using activity in the economy today has roots in our technologies. Much of what is out there today is an

outgrowth of the industrial revolution. What that revolution did was to increase the scale of operation in many businesses. It was a reflection of an emerging technology that fostered a high degree of specialization, which to take advantage of required a large-scale operation. Firms had to be big to be a part of the party and "big" meant they had to have operations and markets that often times spanned great geographic distances.

All this came about because there were significant productivity benefits to be realized by breaking tasks down into many highly specialized parts. But doing so gave rise to the need for a great deal of coordination. Much effort had to be aimed at making sure everything fit together and worked smoothly. This meant massive controlling and monitoring. And the emerging technologies made this all the more difficult by the complexities they introduced into the process. To do what had to be done to carry out a successful operation required much information and increasing amounts of head-using activity to use that information. Add to this the fact that most markets began to evolve in ways that fostered product competition. This led to a setting in which research and development along with extensive marketing activity flourished, adding further to the need for head-using activities.

That these activities became concentrated at particular sites in particular buildings was no accident. It was the result of economic decisions aimed at minimizing the cost of assembling and organizing information and maximizing the benefits from its use. Given the information transfer or communication technologies of the time, being close to one's co-worker was the cheapest and most effective way of getting and using much of the needed information in many business activities.

That a good deal of this activity was housed in the "skyscraper" structures built in the center of many of our cities in the early and middle part of the 20th century was no accident either. Given the patterns of residential living and the transportation systems of the times, being in the center of a city made economic sense. Sites in the center were convenient to where office workers lived. They also had good access to an assortment of other inputs that had bearing on the bottom line.[2]

The suburbanization of the American city, of course, changed all this, making it and central business district locations less accessible to the office worker. As a result, many office activities followed residents

That we have so much head-using activity in the economy today has roots in our technologies. Much of what is out there today is an outgrowth of the industrial revolution. What that revolution did was to increase the scale of operation in many businesses. It was a reflection of an emerging technology that fostered a high degree of specialization, which to take advantage of required a large-scale operation. Firms had to be big to be a part of the party and "big" meant they had to have operations and markets that often times spanned great geographic distances.

to the suburbs, forming the core of most of the edge cities that emerged in the second half of the 20th century. There was geographic dispersion with a lot of the activity being placed in a less dense setting. Much of this was activity that had close links to suburban residents—finance, real estate, and professional activities like medicine and law. What remained in a number of central cities was head-using activity not closely allied to the consumer; rather it was activity that was usually part of a bigger more complicated operation that required a good deal of interaction among the many folks who were a part of it, *e.g.*, headquarter operations. Even so, not all of this kind of activity remained in the central city. Some of it moved to the suburbs to be close to transportation hubs, *e.g.*, a major airport, or to find a more spacious site with good environmental features. The key in all such moves was to find a location that had access to something of importance to the mover.

This is how it was before the new economy began to unfold in the early part of the 1990s.

THE NEW ECONOMY: WHAT IS IT?

The new economy is, in the eyes of some, something that has come into being as a consequence of revolutionary changes in the information industry, changes that are being diffused throughout the entire economy. Many who talk about the new economy characterize it as the digital economy.[3] They see it as an economy in which information is digitized and communicated through digital

networks. The result is large amounts of information compressed into very small spaces and transmitted over great distances at incredible speeds and minimal costs. What this has done, among other things, is to greatly enhance the role of knowledge in the economy. With instant access to relevant information, so much more can be done and what we do increasingly puts knowledge content into what we produce and how we produce it.

Discussion of how all this works itself out in the way markets organize economic activity emphasize its impact on market competition. Markets are said to be much more competitive, filled with pressures that increasingly take the form of quality rather than price competition. The underpinning of these pressures is innovation. Firms are much more innovative than in previous years. The aim is to bring new and/or better products to market more quickly than competitors. But doing this often means doing things in ways that complicate the production process and gives rise to the need for smarter inputs. Knowledge thus becomes critical to a successful operation in today's hyper-competitive markets.[4]

These descriptions, of course, characterize activity that is on the cutting edge of the technological revolution, especially the digital revolution. While change is everywhere, a great deal of the economy remains relatively the same; it is simply a matter of degree. What makes this all so relevant to the consideration of office space is its implication with respect to how businesses operate. Apparently, significant changes in how we do business are on the way. Indeed, some of the expected changes have already happened in firms that are in the center of the technological storm.

THE NEW ECONOMY, HEAD-USING ACTIVITY & THE OFFICE BUILDING MARKET

With knowledge growing rapidly in importance as an input in production, we seem to be moving into an economic world dominated by head-using activity. If so, aren't we headed into a world in which office space demands will mushroom or maybe even explode upwards?

Certainly, there are some recent signs of improvement in the office building market that seem linked to the information revolution. In eyes of the new economy guru, we have become a nation of knowledge-oriented entrepreneurs dedicated to building the electronic infrastructure needed to take us into a digital economy. Right now it is the small firms making all the noise, firms that are searching out "cool" space often found in or around the center of the city. The current revival of the core areas in more than a few cities is a reflection of this economic trend.

But is this something that will last? There is reason to believe that it might not. There is one impending element in the digital/information revolution—the expected dramatic reduction in communication costs—that could "upset this apple cart." When the infrastructure now being built around the Internet—or whatever else develops—is fully put in place, we should have an electronic mechanism that will allow us to communicate or transfer information quickly anywhere at almost a zero cost.[5] If what we need to communicate in our monitoring, planning, purchasing, or marketing activities can be done electronically, it should happen if markets remain as competitive as they are now. In fact, it has begun to happen.

How will this affect the existing office building market? If the personnel currently in these buildings are there to minimize communication costs, substantial cost reductions in ways of communicating that do not require physical co-location will remove some of the incentive to remain where they are. But can we then expect office activities to "fly their current coop?"

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

SOME IMPORTANT INFORMATION DISTINCTIONS

In considering the question of the choice of a communications medium, the first thing to note is that what is communicated — information — is far from homogenous. This lack of sameness has roots in the very nature of information itself. Consider several important distinctions that can be made about it.

First there is the distinction between information and knowledge. Knowledge is the part of information that is interpreted. It is something that can be related to meaningful behavior and experience. It really tells us something. The second is between codified and tacit knowledge. Codified knowledge is the stuff that can be written down; it is the basic

raw material of an electronic transaction. Tacit knowledge, on the other hand, is that which is in our heads; it is intuitive; it cannot be written down. Finally, there is a distinction between transmissions. One is the simple transmission with information flowing from sender to receiver. The other is a transmission that involves interaction between sender and receiver.

Obviously, the information we communicate in business is not homogeneous. Some of it is pure data; more of it is knowledge, some of which is codified. But a good deal of it comes out of the head of the sender with a lot of interaction between the sender and receiver. What we communicate comes in different shapes and sizes, not all of which is suitable for transmission through electronic means. Indeed, the means we have today is best suited for transactions involving simple transmissions of data that can be written down. While interaction is possible and we can transmit more than simple data sets, most business-to-business e-commerce today consists of relatively simple transactions. When there is complexity and the need for a lot of interaction, the communication is likely to be through a face-to-face meeting.[6]

Given today's information technologies, being face-to-face remains the richest means of information exchange, encompassing all of the senses, logical discourse, and a feedback mechanism that is both immediate and intimate. With face-to-face communication, we can bring to bear more knowledge critical to the solution of complicated business problems compared with any other means including electronic communication.[7] That is why much business communication is still carried out on a face-to-face basis. But this may not always remain so.

DECLINE IN FACE-TO-FACE COMMUNICATION TO COME

Given what we know today, no one can doubt the coming diminution of face-to-face communication in business. The process has already begun and will accelerate with oncoming technical developments that will reduce the richness advantage face-to-face meetings now have over electronic get-togethers. Much more sophisticated kinds of electronic interaction lie ahead of us. While we may never be able to duplicate in cyberspace all that we can do when we are face-to-face, we are going to be able to do a lot more.[8]

When this sophistication materializes, the cost benefits it provides will surely be incentive enough for moving much more of the communication in our head-using activities into the electronic world, especially given the hyper-competitive markets in which most firms are expected to operate. The opportunities will be there and, equally important, we should be in a good position to take advantage of them. We are, after-all, rapidly acquiring a population that is skilled in the art of navigating in this electronic world. The use of the computer and other electronic devices are fast becoming a part of what we learn even at the elementary grades of our education. Combine this with the progress that is being made in the efforts to make the entry-way mechanisms user-friendly and you have almost an explosive increase in the proportion of the population capable of functioning in cyberspace. Moreover, this seems to be a population that is increasingly disposed to communicate in this world.[9]

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

Combined, this suggests a world in which electronically-mediated information will grow substantially in importance, leading to a significant diminution in face-to-face communication in the conduct of business. This does not bode well for the office space market as we know it today. But it is also something that won't happen over night.

WHY FACE-TO-FACE BUSINESS COMMUNICATION WON'T DISAPPEAR QUICKLY

Face-to-face communication won't disappear quickly, in part, for a reason to be found in the revolution leading to its diminution. Through its impact on how we do business, the information revolution is leading to markets that are more global and increasingly dominated by innovation. The outcome for many firms is a lot of uncertainty and fuzziness not only about how to get where they want to go, but where they want to go in the first

place.[10] The business world is a much more complicated place in which to operate than it was just a short time ago.

Complexity is, of course, nothing new and is no reason, in and of itself, for excluding the communication involved in a complex business operation from the world of cyberspace. To the extent that we have codified knowledge of a complicated process, we can communicate that knowledge to others electronically. We have been doing it for years in defense-related and aerospace activities. But having such knowledge is not something that just happens. It has to be acquired and we do this through systematic thinking (analysis) and/or experimentation as well as through computer simulation. Further, codified knowledge is something we usually don't have when dealing with the complexity that comes out of innovation. In the early stages of the development of the idea, we deal with problems that don't have simple answers or certain outcomes. Indeed, we often deal with something that has problems in the beginning we do not even recognize.

How do we handle all of this? We apparently found out some time ago that it helps to assemble teams of knowledgeable people to work collectively on getting a good start. We have also found that it helps to have these people working in close physical proximity interacting on a face-to-face basis.

In time, we gain the knowledge and understanding necessary to articulate what is involved in the development of an idea. In other words, we acquire codified knowledge, meaning knowledge that *can* be transmitted electronically in today's world. What we are working with then becomes a commodity that *can* be involved in e-commerce and, therefore, its ties to the office building market are loosened.

While all this is happening now, the dominant element in the information revolution as it has developed thus far is the work of innovators who are currently adding substantially to the trailblazing kind of activity that fosters face-to-face communication. We can look at what is going on in the current technological maelstrom as the generation of complexities in business operations that offset some of the push the information revolution is giving us into cyberspace. Most of the problems this complexity gives us are being dealt with in a time-honored way—collaboration with collaborators working in close physical proximity to one another. While we see this all around us, it is especially pronounced in the growth of cutting-edge high-tech communities such as the Silicon Valley, the Golden Triangle, parts of Boston, and Austin, Texas.

Over time, we will come to solve these problems in a way that gives us codified knowledge of what is involved. This, in turn, will lead to more and more electronic encounters, particularly when the electronic channels come closer to simulating what we can do when face-to-face. But the current pace of innovation suggests that problem-solving that fosters face-to-face communication is not about to diminish. While innovation continues at its present pace, it is hard to see a massive shift of business communication into cyberspace occurring. My best guess is that what is going on now should take us out over the next several decades.

Then there is the matter of the social nature of people. Being close to one another physically has social effects that can enhance productivity. The absence of day-to-day encounters is apparently one of the reasons why telecommuting has yet to live up to its earlier promise.[11] While by no means do all the relationships we have in a traditional work situation make us happy — indeed there is misery in many of them — the overall effect seems to be positive for most. Simply working in close physical quarters with others apparently generates productivity benefits that will be hard to reproduce in a virtual world. There is undoubtedly an irreversible minimum of face-to-face communication that will decorate the business landscape as far into the future as the eye can see.

INFERENCES AND SPECULATIONS

It is not difficult to find prognostications of the upcoming demise of the office space market as we know it today.[12] In my view, such speculation is unwarranted if the concern is with the next several decades. The information revolution is exerting a good deal of influence on how we do business in most areas of the economy, but the changes thus far, with exception of a relatively small segment of the economy, can hardly be considered as radical.

Everyone agrees this revolution is providing businesses with the means of dealing with their information problems in creative and cost-effective ways. But by no means do all information problems have solutions that can be found with what that revolution has given us so far. That we still communicate with one another on a face-to-face basis when dealing with a great many knotty business problems

(even in cutting-edge areas of the technology) is not the result of some people continuing to live in the dark ages. It is a consequence of having a technical infrastructure that cannot do what face-to-face encounters are able to do when dealing with certain kinds of problems. It is also a consequence of the technology itself, creating activities that can be best carried out when the participants are physically close to one another. All this bodes well for the existing office building market.

But—and this is a big "but"—as technology improves, it will (over time) provide us with something that comes close to mirroring what we can do now face-to-face. As this happens, the basic structure of the office building market will change, just as it did when the automobile came to dominate the journey to work. This time, however, the ultimate result could be much more dramatic. The specifics of such change are, at this time, anybody's guess. But what we can say is that significant changes are on the way both in what the market looks like and in the way we will have to look at it to make sense of it.

As noted earlier, traditional models of the office building market have emphasized the accessibility of the site of the building to workers, customers, and suppliers of certain kinds of services as the key to its value. To the extent that our head-using personnel no longer need to be close to one another and those they serve and are served by, accessibility in the classic sense loses its importance.

This is going to happen, but not overnight. Nor will it be an abrupt change.[13] The answer to the question of when will depend, in part, on how we are able to deal with the complex problems being given to us by our unfolding technologies. Right now, dealing with those problems is strengthening the demand for office space. The race to build our cyberspace infrastructure is, in fact, helping to revitalize parts of some of our cities.

Suppose the pace of innovation slows. The impetus it is currently providing to office space demand would ebb and could substantially be reduced, which would not bode well for this market.

Of course, there are those peddling the idea that we are now living in a world in which there will forever be innovations that change what it is that we do and how we do it in the business world.[14] If so, there will not be a quick retreat from the need to huddle close to one's co-worker in order to deal effectively with the complexities and uncertainties continuous innovation brings about.

AUTHOR'S CONCLUDING THOUGHTS

Personally, I am less sanguine about such things. Historically, innovations have come in spurts and there seems to be no compelling reason to expect this to change in the future. Thus, in my view, as technology gives us electronic means that mimic more of what we can do face-to-face and the current spurt of innovation begins to wind down, virtual head-using activity as a proportion of the total will begin to increase substantially. If you accept these two hypotheses, there will come a time when the decisions made about where to conduct such activity will be based on considerations much different from those of today. This could very well mean dramatic changes in the office building market as we now know it.

Just how much change and what kind of change will, in my view, depend both on technical and social elements in the equation. The technical elements are those that will determine just how closely we will be able to mimic the strengths of face-to-face communication and whether any currently unrecognized strengths in electronic communication emerge as we develop the technology. In the minds of those enamored with the subject, this is a no-brainer. The technology will deliver the means of radically transforming how we communicate and hence how we organize our businesses. But it is well to remember that the same thing was said about the telegraph, the telephone, and even television.

More important, as I see it, are the social elements as they come to bear on the question of the future organization and operation of business. There can be little doubt about the prospect of more physical isolation of the individual in how we organize our business activities in the future. But how much more is going to depend, in part, on how we view that prospect. Just how much of a social animal are we? How important is interaction on a face-to-face basis over the course of a workday?

What all this says to me is that if we want real insights into what is going to happen to the office building market over the long term, we are going to have to focus more on subject matter that has traditionally fallen outside the analyses we have been making of this market — social relationships that reflect such things as feelings and trust. As I have found out, what we know about these things is not

easily gleaned from the disciplines in which they are currently being studied, especially if we want to fit what they tell us into some kind of market framework. To get what we want to know will require a mind that is open to interdisciplinary work.

My broad-brushed view of what is likely to happen is that there will be more geographic dispersion of the head-using activities that now fill up our current office space. This movement, however, need not be to far away places; nor must it dramatically reduce the density of the population in most places. What it will be is movement that is closely co-located to activities that are now outside present-day office buildings, including what happens in the home. We are, in my view, social animals who will resist moves that isolate us from one another. Yet we are also economic animals who will be more than willing to take advantage of technologies that will be giving us the means to avoid some of the problems that arise when we concentrate our activities in geographic space, *e.g.*, congestion, pollution.

In my view, we are probably headed into a world populated with urban villages — places where people work at sites of their own choosing but choose to live near one another in well-thought-out and well-planned communities. What this implies with respect to "office space" is a matter that, in time, will become a major preoccupation of those who analyze the office space market.REI

NOTES

1. Office activity is not easily defined because it is work that cuts across both occupation and industry classifications. We can say in a general way that it involves mental activity as opposed to physical activity. And it is mental activity only as opposed to mental activity that is combined with physical activity. There also gradations in the level of thinking required, going from the low-level requirements of clerical work to the high-powered requirements of the executive staff. Clerical work, however, is diminishing so that office work is increasingly becoming head-using activity in the sense of dealing with complicated problems.
2. For a detailed discussion of the economics of these location decisions, a discussion that emphasizes the importance of access, see DiPasquale, E. and W. C. Wheaton. *Urban Economics and Real Estate Markets.* Prentice Hall: Englewood Cliffs, New Jersey, 1996, Chapters 5, 6 and 11. Also see Clapp, J. M. *Dynamics of Office Markets.* Washington D.C.: The Urban Institute Press, 1993, Chapter 4.
3. One of the more celebrated promoters of this view of the new economy is Don Tapscott. See *The Digital Economy.* New York: McGraw-Hill Publishing, 1996. See also Kevin Kelly, *New Rules for the New Economy.* New York: Viking Press, 1998 and Department of Commerce, *The Emerging Digital Economy.* Washington D.C.: Department of Commerce, 1998.
4. For an insightful discussion of the nature of knowledge as an input into business activity in our new economic world see Teece, D. J. "Capturing Value from Knowledge Assets: The New Economy, Know-how and Intangible Assets." *California Management Review*, 40 (3), 1998, 55-79.
5. See *The Economist*. "The Death of Distance: A Survey of Telecommunications, (Special Supplement)." September 30, 1995, 1-28.
6. This is not to say that there is no interactive communication currently being carried out in cyberspace as indeed there is. It is to say that the kind of electronic interaction currently possible does not measure up to many of the communication needs in today's business world. For a discussion of what is going on in the virtual world today see Duarte, D. L and N. T. Snyder. *Mastering Virtual Teams.* San Francisco: Jossey-Bass Publishers, 1999.
7. See for example L. Trevino, R. Duft and R. Lengel. "Understanding Media Choices: A Symbolic Interactionist Perspective," in Falk and Steinfields (ed.), *Organizations and Communication Technology.* Newbury Park, California: Sage Publications, 1992.
8. For one discussion of some of the possibilities see M. Dertouzos. *What Will Be: How the New World of Information Will Change Our Lives.* San Francisco: HarpersEdge, 1997, Chapters 3, 4 and 9.
9. See R. D. Putnam. "The Strange Disappearance of Civic America." *American Prospect*, Winter 1996, 34-48.
10. See B. Arthur. " Increasing Returns and the New World of Business." *Harvard Business Review*, July / August, 1996, 100-109.
11. See N. Pliskin. "Explaining the Paradox of Telecommuting." *Business Horizons*, March / April, 1998, 73-78.
12. See for example Roberts, S. *Harness the Future*. Toronto: John Wiley and Sons Inc., 1998, Chapter 4.
13. One recent survey of the location decisions of "information-age" companies is suggestive of the kind of changes that will be a part of this process of change. See O'Mara, M. A. "Strategic Drivers of Location Decisions for Information-Age Companies," *Journal of Real Estate Research*, Vol. 17 (3), 1999, 365-388.
14. See for example Schwartz, P., P. Leyden and J. Hyatt. *The Long Boom*. Reading, Ma.: Perseus Books, 1999.

Mitigating Factors in Appraisal & Valuation of Contaminated Real Property

by Allan E. Gluck, Donald C. Nanney, & Wayne C. Lusvardi

Environmental issues have become a key concern in real property transactions. One particularly difficult issue is the question of how contaminated or formerly contaminated properties should be valued for sale, lease, or financing transactions, as well as to determine loss or damage in litigation cases. The following seemingly simple equation has emerged for valuation of contaminated properties:

$$I = U - C - S$$

Where:
"I" = impaired value
"U" = unimpaired value
"C" = remediation cost
"S" = stigma

This equation has been refined in the literature to break down the cost ("C") factor into three sub-factors, including: 1). the cost to implement an applicable remediation plan; 2). the cost of any applicable use restrictions; and 3). impaired financing costs. Thus, the equation can include more elements, but only as a variation on a theme.

Stigma ("S") can be defined as the incremental loss in value beyond the cost factor due to market perceptions arising from uncertainty and fear associated with the actual or potential presence of contamination.

Unimpaired value ("U") is determined as if there were no contamination, utilizing any of the customary valuation methods: 1). the comparable sales approach (based on recent sales of like properties, with adjustments relevant to the property being appraised); 2). income

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approach (based on capitalization of income or discounted cash flow); or 3). replacement or reproduction cost.

This equation only refers to the negative or aggravating factors to be deducted from unimpaired value. As a result, mitigating factors that may offset the negatives are often overlooked. Mitigating factors should be considered when using the basic or refined formulas mentioned above, to derive net values.

Both aggravating and mitigating factors generally concern technical and legal aspects of environmental risks and solutions, which likely fall beyond the expertise of an appraiser alone. Thus, it may be necessary to assemble a multi-disciplinary team of environmental consultants, legal counsel, and other relevant professionals to generate the information and analysis necessary to assist an appraiser in placing a value on various aggravating and mitigating factors. The Appraisal Standards Board has approved the use of multi-disciplinary teams for the valuation of contaminated real property, expressly recognizing that appraisers may rely on the professional work of others, as long as each professional acts within the scope of his or her expertise and acknowledges the contributions of the others.[1]

LIMITING COSTS TO FUTURE OWNERS

A basic premise of value is that it represents the value to a future owner. Contamination affects market value primarily due to environmental liability and costs that may be incurred by future owners. If a future owner may incur little or no cost or loss, there may be little or no reduction in market value.

Cleanup prior to sale.

In many cases, owners clean up sites before sale, as is the general policy of the major oil companies in selling service station sites. This reduces the uncertainty of cleanup costs, hence mitigating or eliminating possible discounts.

Cost recovery from responsible parties.

The market value impact of contamination may be limited by the identification of liable parties, especially those with deep pockets, who may bear remediation costs so that future owners will not be affected or may recover such costs. To illustrate, there may be little or no impact on the value of a property due to contamination from formerly leaking underground storage tanks at a gasoline service station where the responsible parties include a major oil company, but there may be greater impact where the responsible parties are defunct or have limited financial resources.

Environmental laws impose liability on a number of parties. For example, the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA), 42 U.S.C. §§ 9601 *et seq.*, generally imposes strict liability on present and past owners and operators of contaminated property, as well as on the generators and transporters responsible for the disposal of hazardous waste, subject to limited defenses. It is therefore appropriate to consider the potential for cost recovery from responsible parties.

According to some commentators, "[g]enerally, anticipated recoveries are not considered in the property value estimate."[2] This may be the case when an appraiser acts alone, without the expertise necessary to estimate cost recoveries, or where estimation would be purely speculative, in which case the appraisal opinion is subject to an important limitation and may *not* reflect economic reality. If possible, cost recovery should be considered in order to enhance the validity of the appraisal.

The cost recovery factor may be considered by a multi-disciplinary team including environmental consultants and counsel who can identify potentially responsible parties and advise as to the extent of their potential liability under applicable legal remedies. The availability of such responsible parties and their ability to bear their liability should also be considered.

Insurance recovery.

The costs of remediation may be covered by liability or property damage insurance. While current forms of commercial general liability insurance policies may contain "absolute" pollution exclusions, coverage may be available under older policies that were in effect when contamination occurred. Furthermore, at some cost, it is possible to purchase insurance specifically addressing environmental risk (*e.g.*, pollution liability coverage, first party property damage insurance without a pollution exclusion, and coverage for costs associated with contamination not discovered during a site assessment by qualified environmental consultants). Stop loss/cost cap insurance may mitigate the risk associated with cost overruns in a remediation program. Costs associated with a leaking petroleum underground storage tank may be covered from a state fund for the cleanup of such sites. Thus, the availability of past or present

insurance coverage or similar funding sources should be considered as a mitigating factor, and the advice of qualified insurance professionals and legal counsel may be helpful.

Cleanup by the government without recovery.

Due to a perceived threat to public health, a governmental agency may clean up a site at the cost of the public even though there may be no viable responsible parties. For example, remediation of the Ralph Gray Trucking Site in Westminster, California, was undertaken by the U.S. Environmental Protection Agency at a cost of millions of dollars with apparently little prospect for significant cost recovery. The site was used for the disposal of petroleum waste, with the parties known to be responsible for the contamination either no longer in existence or with little resources. The site is occupied largely by a residential tract with the residents benefited by the homeowner's exemption. Thus, the cost of remediation should not be a charge against the value of the homes in that area. To the contrary, not only was the Ralph Gray Trucking Site remediated at no cost to the residents, many homes and yards were renovated at taxpayer cost, a probable windfall to the residents enhancing the appeal and value of the neighborhood as a whole.

Environmental liens.

A governmental agency may seek to recover cleanup costs by imposing a lien against the real property. However, such a lien is a regular priority lien under both CERCLA and the California analogue. Thus, the environmental lien may be wiped out through foreclosure by a senior lienholder, with only partial or no net proceeds remaining for junior lienholders. Several other states, including Connecticut, Louisiana, Maine, Massachusetts, Michigan, New Hampshire, New Jersey, and Wisconsin, have adopted various "superlien" laws pursuant to which an environmental lien may be given priority as of a time earlier than its actual recordation, with the potential for "priming" otherwise earlier recorded liens. This may alter the valuation analysis in such a state.

Thus, property may be cleaned up entirely at taxpayers' expense without a viable responsible party or lienable equity in the property. Where governmental cost recovery is frustrated, the value of the cleaned up property could be restored without discount for cleanup cost. In any case, the imposition of an environmental lien would affect the amount of the landowner's equity, not necessarily the value of the cleaned up property itself.

Both aggravating and mitigating factors generally concern technical and legal aspects of environmental risks and solutions, which likely fall beyond the expertise of an appraiser alone. Thus, it may be necessary to assemble a multi-disciplinary team of environmental consultants, legal counsel, and other relevant professionals to generate the information and analysis necessary to assist an appraiser in placing a value on various aggravating and mitigating factors.

Environmental risk allocation by private agreement.

The potential costs of remediation may be tempered by private agreements, such as through indemnification by the seller or other responsible parties, or by new insurance products as mentioned above. Contaminated properties that may be seemingly unmarketable for sale or lease, or which would otherwise incur a significant discount, can be made viable by such private agreements. Some entrepreneurs have developed alliances with insurance companies and developers to assume environmental risks associated with the acquisition and redevelopment of contaminated property. The value of the property should be restored to the extent that environmental risk has been shifted to such parties, particularly insurers or other creditworthy parties, and away from the property itself.

Environmental cleanup not required or unlikely.

In *SDC/Pullman Partners v. Tolo Inc.* (1997) 60 Cal. App. 4th 37, a landlord sought to require a tenant to remediate toxic materials that were present in the soil at trace levels, not high enough to pose a real increased risk of heath problems or to trigger any cleanup order by regulators. The court ruled that the tenant was not obligated to clean up trace or *de minimis* amounts of toxic materials to avoid purely speculative rather than real environmental liability.

The nature and extent of the contamination, the applicable regulatory standards, and the extent of any cleanup obligation should be considered in the valuation process. Where contaminant levels are low or *de minimis*, such that remedial action is not

required or is not likely to be required, there should be no remedial cost to present or future owners, and therefore no charge to property value under the cost ("C") factor. Without cost, the remaining factor is market stigma (discussed below).

Time value of money.

To the extent that remediation costs ("C") will be incurred over a long period of time into the future, it would be inappropriate to deduct the full amount up front in an appraisal. The projected costs should be discounted to present value.

THE UNCERTAINTY AND LIFE CYCLE OF REMEDIATION COSTS AND STIGMA

The costs of remediation are often uncertain. Significant variables include the scope of contamination, the alternative remedial strategies, and the degree of regulatory enforcement. These variables, and associated stigma, may have different impact over time.

Valuation model v. life cycle.

The valuation model summarized above operates at only one point in time, whereas the impact of contamination actually changes over time, as to both remedial action cost and stigma factors. Typically, the life cycle of environmental risks, and its costs and discounts, begins with a phase where there is significant fear—possibly irrational— arising from uncertain knowledge of the scope of the problem. When little is known, speculation is rampant, and the emotional impact (stigma) may be greatest at this point in time.

The level of uncertainty frequently changes over time, however, as studies proceed, the contamination is better characterized, the history of the property is ascertained, potentially liable parties are identified, and remedial strategies are developed and effectuated. The unknown becomes known, costs are better defined and fear subsides or becomes contained and focused. (Of course, if it is found that the contamination is more extensive than anticipated, the impact may continue.) The parties often come together to find solutions, including appropriate remedial action, which can allay concerns and reduce the emotional component associated with the impact of the contamination.

Accordingly, the effect of the presence of contamination on value may be reduced over time simply due to changing perceptions as the facts and costs associated with the property are clarified. The outcome may be the redevelopment of the site, in which case the past presence of the contamination may no longer be a factor. For example, when a shopping center is built over a contaminated or formerly contaminated site, the presence of any residual contamination encased beneath the structures might not influence the rents being paid by the tenants, and hence the value of the property may no longer be affected by the presence of the contamination (*i.e.*, if unimpaired value of such an income producing property is based on the income approach, and if the net income stream is not affected by present or former contamination at the site, the calculation of value could be unaffected).

Remediation technology.

There may be alternative environmental engineering solutions to a given contamination problem, with widely divergent costs. New and more cost-effective cleanup techniques are being developed continually, and as the technology improves, remedial costs could be reduced. The timing requirements for remedial action may also have a significant impact on costs, whether the timing is transaction-driven or imposed by regulators. In general, expedited remedial action usually increases costs greatly. Unless immediate action is required for business reasons or to abate an imminent health hazard, it is usually possible to design more cost-effective remedial measures, spreading out and marginalizing the cost over time. Thus, a wise choice among available remediation options may significantly reduce costs and, concomitantly, mitigate the impact on property value. Of course, the technical advice of qualified environmental consultants is critical to this mitigating factor.

Enforcement and cleanup standards.

Regulatory standards vary between governmental agencies. Where more than one agency has jurisdiction, remedial action methods and costs may depend on which agency becomes the "lead agency." Moreover, applicable standards may differ based upon the circumstances. Of particular significance is the potential impact of the contamination on groundwater, especially groundwater that is a source of drinking water. The risks and costs of two otherwise identical sites may be vastly different if the contamination of one affects sources of drinking water but the other does not. Similarly, concern may vary depending upon the natural background level of the contaminant. Accurate estimation of remedial cost should involve the assistance of qualified professionals to assess the risk of exposure to human health or the environment and the remedial standards to be applied by the lead

regulatory agency as a result. Remedial costs can be controlled, and hence the impact on property value mitigated by the application of reasonable risk assessment and cleanup standards.

Political backlash.

As indicated by almost daily coverage in the news media during the 1990s, environmental programs have been under attack at federal and state levels, impelled by the perceived adverse impact of environmental regulation on the nation's economic malaise in the early to mid-1990s. The cost of compliance bites harder during recessionary times, especially when the regulations and their enforcement are seen as unfair by the regulated community. Along with other social programs, agencies charged with enforcing environmental laws and regulations have been affected by budget cuts at all levels of government. This political backlash has reduced the real and perceived power of those agencies. Thus, the impact of contamination on property value may be affected by prevailing political forces and the extent to which the applicable agencies are exercising their enforcement powers rigidly or reasonably.

Judicial backlash.

Similarly, after many years of largely unquestioning deference to environmental regulators, the courts in the 1990s began to make decisions curtailing what some judges perceived as excessive application of regulatory authority.

Response of regulators to the backlash.

Regulators are not insensitive to the backlash, and policies have been modified to make the enforcement of environmental laws more reasonable and consistent among agencies. Many "brownfield" initiatives have been adopted to facilitate the cost-effective resolution of environmental problems and to return contaminated sites to productive use. For instance, California's State Water Resources Control Board has adopted an number of initiatives including, significantly, a December 1995 guidance letter to the Regional Boards supporting cessation of remedial action in some cases and, in general, an enhanced consideration of risk assessment-based closure of low-risk sites contaminated by leaking fuel tanks. This represented a major departure from previous views of the threat of leaking USTs, and was based on the Lawrence Livermore National Laboratory report of October 1995 finding that the environmental impact of leaking USTs is not as severe as previously thought, and that natural bioremediation should be a primary remediation tool

The costs of remediation are often uncertain. Significant variables include the scope of contamination, the alternative remedial strategies, and the degree of regulatory enforcement. These variables, and associated stigma, may have different impact over time.

in most cases once a fuel leak source has been removed. Although this attitude shift has been controversial in some quarters, it has dramatically reduced remedial costs at UST sites around the state as literally hundreds of sites have been closed. Such initiatives may reflect an attempt by regulators to blunt the general political backlash in hopes of avoiding wholesale legislative reversal of environmental laws.

In the face of political and judicial backlash, it is no wonder that the attitude of the regulators has changed. A stronger economy has apparently not reversed that change in attitude. Many regulators realize that cooperative efforts can return idle properties to productive use providing jobs and improving the tax base while still preserving public health. The interested parties, including regulators, tend to work in concert for the efficient remediation of a property, reducing costs where possible and serving both public and private objectives. More reasonable enforcement of environmental laws should have a significant effect on the extent and cost of remedial measures, mitigating the charge to property value.

STIGMA

Trend toward risk-assessment.

Part of the political backlash has been against the arbitrary application of stringent cleanup standards developed in the abstract seeking zero risk regardless of cost and utilizing unrealistic assumptions such as lifetime exposure to minute levels of pollutants. Now, the trend is toward risk assessment-based decisions focusing on the actual risk posed by a given situation. This significant change in approach can be expected to have a mitigating impact on perceptions, in many cases ameliorating the uncertainty and fear of health risk and potential regulatory requirements, and, hence, reducing the stigma associated with contaminated or formerly contaminated property.

Stigma diminishes over time or may be noncompensable.

As noted above, customary valuation methods "take a picture" of value as of a given time, whereas the impact of contamination on value actually varies over time. Studies have shown that stigma dissipates, and value eventually returns to, or nearly to, unimpaired value.

Post-cleanup stigma claims appear to be based on the fear that there may be some unknown or residual contamination, or that cleanup standards may become more stringent in the future, leading to additional liability even after sign-off by regulators. Some courts have allowed claims for post-cleanup stigma damages, but other courts have denied or limited such claims. Other cases have considered stigma associated with proximity to contaminated sites or fear of toxic impact from nearby operations. Again, some courts have allowed such claims and other courts have rejected them. Accordingly, it remains controversial whether and under what circumstances post-cleanup or proximity stigma damages are recoverable, and, if recoverable, the extent of the residual damage. Thus, the analysis should include consideration of the law in the applicable jurisdiction. If stigma damages have been rejected as a matter of law, or only narrowly permitted, the application of that factor may be eliminated or mitigated at the time of a property appraisal.

A mechanical application of a stigma discount may be inappropriate. It should be considered in each case whether stigma is a proper factor under the circumstances, and if it is, further consideration should be given to mitigating factors and approaches, and the manner in which the risk and profit opportunity posed by the stigma element has been or is being allocated between the transaction parties.

MARKET FACTORS

Highest and best use.

The impact of the presence of contamination may also depend on the current or changing "highest and best use" of the property.

In circumstances where the contamination is located in a building, and there is already limited utility to the building, the costs to mitigate the contamination may exceed the contributory value of the improvements, in which case a sound economic alternative may be to remove the improvements, which may cost less than other forms of remedial action, mitigating net remediation costs.

In cases where the land is contaminated, the regulatory stance and market response may be affected by the long-term outlook for the use of the property, so that if the contamination is commonly associated with the anticipated use, its impact on value may be nominal.

If the market perceives that a property can be reused without exacerbating or exposing the contamination, or the anticipated use is consistent with past uses, then liability or stigma may be largely a moot issue. In contrast, if a change in use is anticipated, a change where there is less tolerance for the presence of the contamination than the tolerance existing for the current use, then the presence of the contamination may trigger a significant impact on the value of the property.

Sellers' vs. Buyers' Market.

Prevailing economic and market conditions can have a significant impact on the marketability and value of contaminated properties. The 1990s have seen a dramatic swing of the pendulum from the real estate recession to a relatively "hot" economy and real estate market. Many environmentally impacted properties that languished during the recession are now moving in the marketplace. Governmental brownfield initiatives, along with better economic conditions, have helped to stimulate this. In a hot sellers' market, value and price tend to firm up, and buyers tend to be willing to assume more risk with less discount than during gloomy economic times. Thus, the place and time of a transaction in the economic and market cycle is an important factor that may mitigate (or aggravate) the impact of contamination on value and price.

No uniform market price discount.

It is a common misconception that there is a uniform market price discount for contaminated properties. In fact, there are usually few, if any, comparable transactions, as each may represent a unique condition and may reflect a wide geographic range. It may not be possible to draw valid market conclusions from the small sample size. Even if transactions involving comparable property types and environmental conditions are available, the pricing may have been affected by business considerations, such as the need for a particular location, the need to close the second leg of a tax deferred exchange, or private agreements between parties for mitigation of contamination costs. It is

therefore necessary in each case to undertake a careful analysis of the applicable method of determining unimpaired value and the various aggravating and mitigating factors that are relevant to a determination of the impairment to value, with the assistance of qualified professionals, as needed.

LEGAL AND REGULATORY EXEMPTIONS OR DEFENSES

The impact of the presence of contamination may depend, in some circumstances, on limited requirements for investigation or on certain legal limitations and exemptions.

No duty to investigate.

While certain disclosure duties apply under applicable law, there is no general requirement for a seller to undertake an environmental site assessment prior to sale in order to obtain new knowledge. Nevertheless, environmental site assessments by buyers have become a common feature of real property transactions, particularly when required by lenders, and in some contexts, *e.g.*, for a leased property, existing legal principles may impose on a property owner the duty to inspect and be aware of, and to repair or warn of, dangerous conditions. Also, real estate brokers may have a duty to undertake some investigation. In any case, if the transaction parties are not aware of existing contamination, there would be no impact on market value and price at the time of the transaction. Similarly, in many instances there is no requirement for remediation even when contamination is known to be present, again resulting in little or no potential impact on value.

Condemnation.

Some courts have not allowed the presence of contamination to be taken into consideration when determining the value of property that is being condemned, but other courts have ruled that remediation costs or stigma are admissible with respect to determining value in condemnation proceedings. This may also be affected by applicable statutes. For instance, California law expressly excludes consideration of the presence of hazardous substances in determining the appraised value of property being taken by a school district under the power of eminent domain. Instead of a price discount, Calif. Code of Civil Procedure § 1263.740 contemplates that the property will be cleaned up under the procedure set forth in Section 1263.720, using the full fair market value purchase monies, with any excess costs recoverable under Section 1263.730.

The valuation of contaminated or formerly contaminated property is a complex undertaking, with a variety of aggravating and mitigating factors. Accurate appraisal requires careful investigation and assessment of such factors, with the assistance of qualified environmental consultants and counsel as to technical and legal aspects. Without a multi-disciplinary team, an appraiser acting alone probably will lack the necessary expertise to render anything but an unimpaired value opinion assuming the absence of contamination.

Thus, the extent to which loss of value due to contamination may be considered in condemnation proceedings will depend upon the statutes or case law of the applicable jurisdiction.

Homeowner's exemption.

The U.S. EPA has adopted a policy statement establishing a qualified homeowner's exemption declaring that the average homeowner will not be required to conduct or pay for cleanup when residential property is part of a federal Superfund site. This seemingly discretionary policy is, of course, based on the fact that most homeowners would have the benefit of the third-party defense under CERCLA in any event, and it would be decidedly unpopular were the U.S. EPA to begin pursuing homeowners who happen to reside on top of a contaminated region. Similar homeowners' exemptions have been adopted under the laws of some states.

Defenses to liability.

Current and future owners may have defenses to liability under CERCLA and other environmental laws. Thus, the government may have to pursue other responsible parties, if any, for cost recovery (such as former owners or operators, or those who actually disposed of hazardous waste on someone else's property). Even though contamination may nevertheless have to be dealt with by the owner (*e.g.*, to obtain financing), the availability of defenses to liability will enhance the potential for obtaining recovery from other responsible parties.

Thus, to the extent that defenses are available and remedial costs are not legally recoverable from current or future owners, the potential charge to the real property should be mitigated.

CONCLUSION

It is not enough to deduct mechanically the costs of remediation or regulatory compliance, and any presumed "stigma," in calculating the impact of contamination on the value of real property. The usual valuation model is, at best, simplistic in making short-shrift of relevant mitigating factors (such as those discussed in this manuscript) and may be misleading to the extent that it does not reflect the market devices and legal factors that are frequently present. The valuation of contaminated or formerly contaminated property is a complex undertaking, with a variety of aggravating and mitigating factors. Accurate appraisal requires careful investigation and assessment of such factors, with the assistance of qualified environmental consultants and counsel as to technical and legal aspects. Without a multi-disciplinary team, an appraiser acting alone probably will lack the necessary expertise to render anything but an unimpaired value opinion assuming the absence of contamination. Such an opinion may be of some use, but would not reflect the actual, impaired value of the property, a serious limitation that the appraiser would be obligated to disclose under applicable ethical standards. REI

NOTES

The authors are expressing views and concerns of general academic interest, without any reflection as to how they would view any particular property, situation or case. The views and concerns are those of the authors, not necessarily of their companies or firms.

1. See Appraisal Standards Board Advisory Opinion G-9 "Responsibility of Appraisers Concerning Toxic or Hazardous Substance Contamination," dated December 8, 1992; see also, Appraisal Institute Guide Note 8, "The Consideration of Hazardous Substances in the Appraisal Process," as amended January 28, 1994.
2. Colangelo and Miller, *Environmental Site Assessments and Their Impact on Property Value: The Appraiser's Role.* The Appraisal Institute (1995), at p.50.

ABOUT THE AUTHORS

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The Art of Real Estate: Understanding the Visual Artists Rights Act

by Susan Taylor & John Mackel

Given the sheer volume of law created in this country since its inception, one would expect that the relative rights between artists and purchasers of art would be well established, and generally understood. But try answering the following question with any sense of confidence: If money were no object, and you were to buy a painting, perhaps a Rembrandt, do you have the legal right to bring it home and draw a mustache across the face, or even burn it, if that is what you were so moved to do? Does it make a difference if the work was created by a living painter? Does an artist retain any rights in his or her work? What about artwork purchased for, or created for, a building you or your company owns? Does your ownership of the art permit you to destroy it, or even to alter it? Does it matter if the work is moveable, such as a sculpture, or if it has become a part of the real estate, such as a mural?

The Visual Artists Rights Act of 1990 ("VARA") is an attempt by Congress to answer some, but not nearly all, of these kinds of questions. VARA grants artists substantial rights to protect their works of visual art, and to some extent, their honor and reputation as reflected through that art. These rights sometimes exist in stark contrast to traditional notions of property ownership as understood by most real estate owners, purchasers, and lenders, and can lead to significant costs and inconvenience.

Traditional American notions of property ownership and copyright protection generally allow for unrestricted transfer of art as between artist and purchaser. The rights afforded artists under VARA, by contrast, have their roots in European intellectual property law and recognize distinct "moral rights" of artists with respect to works of visual art, rights that cannot be bought and sold.

ABOUT THE AUTHORS

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In theory, Congress, in enacting VARA, sought to balance society's interest in promoting a flourishing artistic community with this country's long-held and deep-seated belief in property rights and free transferability of property. The cynics among us would hasten to point out that, in reality, the enactment of VARA probably had more to do with the fact that it was appended to a very popular piece of legislation than with any conscious, much less noble, design by Congress to promote society's interest in the welfare of artists.

THE ORIGINS OF THE VISUAL ARTISTS RIGHTS ACT

In *Carter v. Helmsley-Spear, Inc.*, the leading case considering VARA, Circuit Judge Cardamone explains the societal policy behind VARA this way:

> One of America's most insightful thinkers observed that a country is not truly civilized "where the arts, such as they have, are all imported, having no indigenous life." *7 Works of Ralph Waldo Emmerson, Society and Solitude, Chapt. II Civilization 34* (AMS ed. 1968). From such reflection it follows that American artists are to be encouraged by laws that protect their works.

Encouraging artists by creating laws that protect their works may in fact be a laudable goal, but because few real estate owners, purchasers, and lenders (those most likely to bear the economic burden of VARA) are aware of VARA, the statute as a practical matter can be a trapdoor for the unwary.

DEFINING A WORK OF VISUAL ART

VARA's protections are afforded only to a "work of visual art" which is defined by federal statute, at §101 of Title 17 of the United States Code. In brief, a "work of visual art" must be a painting, drawing, print, sculpture, or still photographic image produced for exhibition purposes only. But to understand the definition, one really needs to know the various exceptions and limitations that limit the application of VARA. Some of the more important exceptions and limitations are as follows:

- VARA only applies to a work of visual art created on or after June 1, 1990.

- A work of visual art does not include "work for hire" (works created by an artist who is an employee acting within the scope of his or her employment).

- A work of visual art does not include "applied art" (which means applications of decoration or ornamentation to objects that are otherwise utilitarian in nature).

- A work of visual art does not include any poster, map, globe, chart, technical drawing, diagram, model, motion picture, or other audiovisual work, book, magazine, newspaper, periodical, data base, electronic information service, electronic publication or similar publication, merchandising item, or any advertising, promotional, descriptive, covering, or packaging material or container.

- A work of visual art must exist as a single copy or in a limited edition of 200 copies or fewer, each signed by the artist and consecutively numbered.

- The work of visual art must be capable of copyright protection (which, among other things, usually requires that the work be an original work of authorship).

ATTRIBUTION AND INTEGRITY RIGHTS

Assuming the work in question is in fact a work of visual art, what rights does the artist receive? The artist is entitled under VARA to two basic kinds of moral rights: (i) rights of attribution; and (ii) rights of integrity.

An artist's rights of attribution take into account the intangible quality of the artist's good name, and include: (i) the right to claim authorship of a particular work; and (ii) the right to prevent the use of his or her name with respect to a work that has been distorted, mutilated, or otherwise modified, if such use would be prejudicial to his or her honor or reputation. In considering whether an act is prejudicial to the honor or reputation of the artist, the artist does not need to be well-known or have pre-existing standing in the artistic community; the courts will instead focus on the artist's honor or reputation as embodied within the work in question.

An artist's rights of integrity encompass the physical integrity of the piece of art, and include: (i) the right to prevent any intentional distortion, mutilation, or other modification which would be prejudicial to the artist's honor or reputation; and (ii) the right to prevent any intentional or grossly negligent destruction of a work of recognized stature. "Recognized stature" is not defined in VARA, creating

what is probably the single largest invitation to litigation within the statutory scheme. The trial court in *Carter v. Helmsley-Spear, Inc.*, determined that for a work to be of recognized stature it must have "stature" (*i.e.* is viewed as meritorious) and this stature must be recognized by art experts, other members of the artistic community, or by some cross-section of society. The idea seems to be that the work need not necessarily be of the stature of "Picasso, Chagall, or Giacometti" but, by the same token, nuisance claims should not be encouraged.

CARTER v. HELMSLEY-SPEAR, INC.

Carter v. Helmsley-Spear, Inc., a 1995 decision of the United States Court of Appeals (Second Circuit), is the leading judicial decision considering VARA. Three New York artists contracted with the long-term tenant of a mixed-use commercial building located in Queens, New York, to install and create artwork in the lobby of the building. The Second Circuit described the artwork as follows:

> ...a very large "walk-through sculpture" occupying most, but not all, of the building's lobby. The artwork consists of a variety of sculptural elements constructed from recycled materials, much of it metal, affixed to the walls and ceiling, and a vast mosaic made from pieces of recycled glass embedded in the floors and walls. Elements of the work include a giant hand fashioned from an old school bus, a face made of automobile parts, and a number of interactive components. These assorted elements make up a theme relating to environmental concerns and the significance of recycling.

Needless to say, not artwork for all tastes.

The tenant's lease was terminated and the landlord/owner of the building subsequently demanded that the artists cease installing new additions to the lobby artwork and indicated that it intended to remove the artwork already in place.

The artists were initially successful at the trial court level in obtaining a permanent injunction prohibiting the owner of the building from distorting, mutilating, modifying, destroying, and removing the artists' artwork. In accordance with VARA, the injunction was to remain in effect for the lifetime of the last surviving artist. The owner of the building successfully appealed to the United States Court of Appeals (Second Circuit) on the basis that the artwork was "work for hire" (see above) such that it was exempted from VARA protections. The United States Supreme Court declined to hear the case.

The Visual Artists Rights Act of 1990 ("VARA") is an attempt by Congress to answer some, but not nearly all, of these kinds of questions. VARA grants artists substantial rights to protect their works of visual art, and to some extent, their honor and reputation as reflected through that art. These rights sometimes exist in stark contrast to traditional notions of property ownership as understood by most real estate owners, purchasers, and lenders, and can lead to significant costs and inconvenience.

CONTRACTING WITH ARTISTS

An artist's rights of attribution and integrity cannot be transferred (unlike ownership and copyrights), but can be waived in a written instrument signed by the artist and the owner. The writing must specifically identify the work, and the uses of the work. In the case of a work prepared by two or more artists, a waiver by one artist waives the rights of all artists.

Accordingly, when contracting with an artist over work that could fall within the scope of VARA, whether the artist is an independent contractor or an employee (to be conservative), a provision similar to the following should be considered, at least as a starting point:

> Pursuant to the waiver provisions of the Visual Artists Rights Act of 1990 and applicable state legislation, if any, [Artist] hereby waives all rights of attribution, integrity and such other similar rights as may exist and which may restrict [Owner]'s right to subsequently modify, alter, destroy, replace, or otherwise deal with the [describe the work of art and its use – *e.g.* bronze sculpture used for lobby ornamentation]. [Artist] expressly acknowledges that he/she will not exercise any rights with respect to the aforementioned work of art which would prevent [Owner] from modifying, altering, destroying, replacing or, otherwise dealing with [Owner]'s property.

Note that a transfer of a copyright in a work does not act to waive the protections of VARA and that, accordingly, the foregoing waiver should be used in conjunction with the usual provisions regarding ownership of copyrights.

BUILDING REMOVAL PROCEDURE

VARA provides a mechanism for owners that may allow removal of a work of visual art from their buildings. If the removal can be accomplished without destruction, distortion, mutilation, or other modification of the work, the owner may remove the work if it has made a diligent, good faith attempt, without success, to notify the artist of the owner's intended action (or the owner provides notice to the artist and the artist does not remove the work or pay for its removal within 90 days of notice).

A diligent, good faith attempt to send notice, for the purposes of VARA, means notice to the artist by registered mail to the artist's most recent address as recorded with the Register of Copyrights. The onus is thus clearly on the artist to provide his or her address to the Register of Copyrights, and to keep that address current.

This notice procedure has its limitations. Chief among them is that it is available only if the work can be removed from the building without destruction, distortion, mutilation, or other modification. There are also some significant unknowns: What obligations does the owner have with regard to a work once it has been removed? Who is responsible for damage to the building incurred during removal of the work of visual art?

This last question is of particular importance for property owners because, aside from costs attributable to development prohibitions, these are likely to be the most significant costs associated with VARA. Unfortunately, VARA is silent with respect to this issue although, arguably, an artist's obligation to pay for removal could include incidental costs.

IMPACT OF STATE LAW ON VARA

Anyone performing due diligence with regard to artwork-related issues must also consider the possible effect of state legislation. For example, New York and California have enacted legislation addressing some of the same issues. The California legislature created the California Art Preservation Act ("CAPA"), which was in fact a model for VARA, and which provides somewhat similar moral rights to artists and also provides a waiver mechanism. To a great extent, VARA will likely preempt state legislation, but there is always a possibility that some provisions of the state legislation will remain applicable. For example, CAPA grants post-mortem rights to the artist's estate, whereas VARA's protections are limited to the lifetime of the artist. In addition to any due diligence and contracting considerations arising as a result of VARA, owners, purchasers, and lenders will need to make a state-by-state analysis of applicable law.

OWNER, PURCHASER AND LENDER CONSIDERATIONS

Given the foregoing, what should prudent owners, purchasers, and lenders do?

- Owners should avail themselves where possible of the waiver provisions of VARA, and contract accordingly with artists.

- Purchasers and lenders will want to perform proper due diligence to uncover whether the real properties they are considering include any works of visual art protected by VARA. Due diligence would include:

    - Site inspections;
    - Review of contracts with artists; and
    - Searches of the Register of Copyrights to determine if an artist has registered.

- Purchasers and lenders should obtain express warranties from sellers and borrowers stating that no VARA claims exist, and these warranties should survive completion of the transaction.

- Purchasers and lenders may also wish to consider whether their title insurance will protect against damage caused by VARA. There is at least an argument that title insurance would cover a claim if a VARA-imposed limitation on a building's use can be construed as a defect in marketability of title. That said, the prudent course when dealing with title insurers is to raise the issue directly with the insurer.

- Landlords should require receipt of appropriate VARA waivers before a tenant can install a work of visual art.

CONCLUDING THOUGHTS

In conclusion, artistic work such as a sculpture, painting, or interactive mural can often positively impact the value of property. However, real estate professionals must also be aware of the rights

accorded to the creators of the artistic work and understand how laws such as VARA effect how that artistic work is used and to whom it belongs.REI

ABOUT THE AUTHORS

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Elusive Sources of Capital Forcing Corporations to Re-Focus on Benefits of Sale-Leaseback Financing

by Jonathan S. Horn

Uneasy stock market also propels investors toward sale-leaseback investments with triple-net (NNN) leases.

For nearly four decades, "Turn concrete into cash," has been the heraldic cry of America's leading lessors of net-leased corporate property. Now, more than ever, the declaration seems *en vogue* across the land.

Of course, few observers would argue with the authoritative statement by the *National Real Estate Investor*: "The sale-leaseback industry has restructured the ownership of trillions of dollars worth of the nation's corporate real estate assets." Even fewer critics would dispute *The CPA Journal* comment that, the "National franchise and chain businesses have led the way in using sale-leaseback to benefit business owners, but the system can work for any business — small or large."

Fact is, funds from sale-leaseback transactions have fueled leveraged buy-outs, mergers and acquisitions; underwritten the cost of maintenance and technology to remain competitive; and erased obligations from countless corporate balance sheets nationwide.

Recent developments in the corridors of capital, up and down Wall Street and inside the Internet scene, however, seem to have conspired to further restrict access to traditional cash resources by mainstream companies. Subsequently, firms finding it increasingly difficult to

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attract cash for bricks-and-mortar growth, geographical expansion or competitive marketing campaigns appear to be seriously revisiting the concept of sale-leaseback transactions and the benefits they afford.

An interesting recent example is Carmike Cinemas, Inc., (NYSE-CKE) of Columbus, GA. As of December 31, 1999, this 18-year-old firm, had 458 theaters (2,848 screens) in 36 states. In mid-April 2000, Carmike completed the sale and leaseback of $23.5 million in three properties – 41 screens in three states – to an undisclosed investor. The Carmike complexes included a 10-screen operation in Missoula, MT; a 15-screen facility in Raleigh, NC; and a 16-screen unit in Johnston, IA.

Carmike Cinemas dedicated to maintaining its position as one of the strongest theatre circuits in the industry, had to change its growth strategy in recent years. It moved from the selective acquisition of theatres and circuits located in small to mid-sized communities to constructing new theatres and expanding its existing complexes. That includes retrofitting some of its older properties with stadium seating and digital stereo surround-sound.

Obviously, cash is the key to completing the competitive retrofits and to opening five additional theatres (88 screens) in Alabama, Florida, Minnesota, North Carolina, and Tennessee by mid-2000. A comment by Martin A. Durant, SVP and Chief Financial Officer of Carmike Cinemas, to the Dow Jones Newswire, reflects the importance of sale-leaseback as a capital resource:

"The ability to turn high-performing assets into cash when so much investment capital is flowing into other industries offers us fresh resources to maintain our steady pattern of growth and to improve existing properties."

There is no question that the theater industry, with its specialized, single-tenant facilities is ideal for triple-net (NNN) deals. It is also one of the last frontiers to be discovered by investors seeking conservative types of passive investments. But Durant's point is applicable to many industries and numerous corporations challenged to turn non-performing as well as high-performing assets into available capital for additional growth.

A more traditional example is Wild Oats Markets, Inc., a natural foods supermarket chain in North America, which turned to sale-leaseback financing

There is no question that the theater industry, with its specialized, single-tenant facilities is ideal for triple-net (NNN) deals. It is also one of the last frontiers to be discovered by investors seeking conservative types of passive investments. But Durant's point is applicable to many industries and numerous corporations challenged to turn non-performing as well as high-performing assets into available capital for additional growth.

as an effective technique for recovering capital in fueling its growth. Specialty retailers, such as Wild Oats, realize their primary profit potential is in their core business operations, not in the hassles of management and property ownership. Otherwise, they would alter corporate mission and make-up and instead, simply become real estate investors.

THE CURRENT MONEY CHASE

Some of the reasons many traditional corporations, are finding it increasingly more expensive to borrow money in 2000:

- Telecom, wireless, biotech, and dot-com (Internet and e-commerce) operations — both ongoing entities and aspiring initial public offerings — have literally sucked billions of dollars into perhaps the longest sustained bull market in Wall Street history. Until last spring, technology issues were the darlings of investment bankers and hungry investors, venture capital firms and "angels" couldn't wait to crown the next dot-com entrepreneur with a garland of greenbacks— primarily, large denominations. The Nasdaq or "new economy" looked glandular, unstoppable.

- The surge in 401k and other savings plans across the employer-employee landscape are pushing more funds into mutual funds, stocks and bonds and away from low-paying savings accounts and dull certificates of deposit.

- Then, in mid-May, the Federal Reserve Board raised the key short-term interest rate a half percent – its sixth increase since June 1999 – and set off a chain reaction as banks ratcheted upward their own interest charges to reflect their new costs. The lingering uncertainty of

additional rate increases, possibly before the November 2000 elections, is expected to further slow consumer spending and economic growth, as well as trigger some heart-stopping corrections in the market.

Not only have traditional borrowing sources been displaced as funds feverishly pursued new, promising opportunities proffered by the Information Age, but some nervous investors are now moving their money to the conservative sidelines . . . or saying goodbye to it all together as dot-com ventures consolidate, retrench, and evaporate entirely.

BASIC TENETS OF SALE-LEASEBACK & NNN

Sale-leaseback financing most commonly involves a company selling one or more single-tenant properties to an investor (individual, company, pension fund, or group), usually for *fair market value*. The investor/landlord provides the seller with a triple-net lease for a negotiated period of 10 to 25 years. The seller/tenant usually pays the investor a negotiated annual rent equal to 8 percent to 15 percent of the contracted sale price. Most often, the lease rate is credit-driven and constant. If agreed to, there may be scheduled rent increases.

Net-net-net (NNN) refers to the payment of property taxes, maintenance, and insurance. In a NNN lease, the single tenant agrees to pay all of the expenses associated with the property use and occupancy, including the cost of insurance, real estate taxes, improvements, on-site property management, and maintenance, in exchange for control of the property and a favorable long-term lease. There are derivatives of NNN called "bond-lease," "absolute NNN," and "double-net lease." These names invariably change across the United States and with different investors.

NNN investments are available for all types of existing or build-to-suit real estate, including service centers, fast food establishments, industrial and health care facilities, office and educational buildings, distribution warehouses, and retail stores.

Corporation/Tenant Viewpoint

Most companies require real estate to conduct their businesses, however few firms profit from owning those properties. The cash and credit they have tied-up in facilities and land represent assets that could be employed much more productively in the corporation's core business operations. Directors and officers are constantly faced with the question of how the company will pay for or finance the cost of the properties without tying up operating dollars, without severely impacting its credit facility and loading up their balance sheet with debt.

The question is fraught with a variety of uncertain variables, including the present and future costs of money, projected tax benefits, maintenance and rental costs, and the accounting treatment. Then there is the guessing game on the expected future value of the real estate in 10, 20, or 30 years.

A triple-net leasehold obligation that qualifies as an operating lease under the criteria set by the Financial Accounting Standards Board, however, will not appear on the tenant's balance sheet as either debt or long-term obligation. The corporation pays off the mortgage obligations and receives the unlocked cash from the sale of its depreciated real estate.

The improved debt-to-equity ratio and current ratio can make a seller/tenant much more attractive to banks and other traditional lenders, as well as to shareholders, prospective investors, and potential acquisition partners. Short-term borrowing can be avoided and a need for credit lines possibly eliminated.

In addition to expense reduction and the conversion of the seller/tenant's illiquid real estate assets to capital, a sale –leaseback with a properly structured operating lease can provide the seller/tenant company with the following business advantages:

- 100 percent financing based on the assessed value of the property, in contrast to the 50 percent to 85 percent usually provided by mortgage financing;
- Full operating control of the real estate under the tenant's lease provisions;
- Operating leases that do not appear on the corporate balance sheet as debt or as a long-term lease obligation;
- Tax deductible lease payments, that is a lower after-tax cost;
- Effective land depreciation; (*NOTE:* Since the value of the land acquired is factored into the rent, the tenant can effectively depreciate the

land by deducting the rent under the lease attributable to the land.)

- A fixed rent structure or "flat lease" with no inflation adjustments provides inflation protection. It is dependent on the type of lease-term structured.

- Cash realized from the sale-leaseback transactions that can be used to expand operations, enhance liquidity, acquire other businesses, reduce debt, or utilize a 1031 exchange, etc.

In the area of acquisitions and leveraged buyouts (LBOs), a sale-leaseback can be utilized as part of the overall transaction. A corporation planning to acquire another firm – or even their own companies through an LBO – can use the assets of the acquired company to reduce total acquisition cost. The need for higher-cost debt and lengthening the maturities of the overall financing is reduced.

Taking a long view, many executives express concern about their tenant options when the lease expires. Three choices emerge: a). the tenant can renew the lease at a new negotiated rate, or b). if the tenant had a renewal clause in its initial lease, it could exercise its option and re-lease the property from the landlord at the rate specified in the clause. And c). the tenant can also move to a new location.

Investor/Landlord Viewpoint

Commercial property ownership under a NNN lease agreement has emerged as a highly popular and effective strategy in real estate investing in the past decade. *Business Week* has called triple-net lease real estate "a smart idea...for risk-averse investors seeking a steady source of income."

Banks, trusts, pension funds, REITs, and other conservative investors are probably the best candidates for these types of investments. They share homogeneous objectives: safe, passive real estate investments designed to provide predictable, advantageous annual cash income, tax reduction benefits, and the opportunity for significant long-term gain.

A sale-leaseback investment with a triple-net lease (NNN) provides that unique investment opportunity to individuals or institutions interested in owning real estate without the hassles of management and leasing typically found in conventional real estate investments. Such transactions generally require a long-term investment of $1 million to $100 million or more.

A sale-leaseback investment with a triple-net lease (NNN) provides that unique investment opportunity to individuals or institutions interested in owning real estate without the hassles of management and leasing typically found in conventional real estate investments. Such transactions generally require a long-term investment of $1 million to $100 million or more.

As noted previously, the cash-on-cash rate of return varies, depending on the tenant's financial strength. For example, a new franchisee might be considered the highest risk. A multi-billion-dollar, profitable corporation with good management, one that has always fulfilled its lease obligations, would be the lowest risk and earn the lowest rate for the investor.

A NNN lease is considered a *passive* investment, since minimal or no landlord responsibility is required. The single tenant agrees to pay all costs associated with the property use and occupancy, including real estate taxes, insurance, improvements, on-site property management and maintenance. As a result, the investor has the ability to invest in geographic markets beyond his own immediate location, without day-to-day involvement required of a multi-tenant lease.

From another view, commercial tenants can be equated to "positive renters." Unlike apartment renters, for example, they are less likely to abuse the property and then relocate, saddling the owner to refurbish and to find a new renter. Commercial tenants have a vested business interest in seeing that a location is well maintained and attractive to customers.

A NNN property is effectively a long-term bond of a corporation in the form of a lease document encompassed by real estate. The investment appears to be a bond-type investment due to the "coupon-clipper" type of returns; however, they also provide the added benefits of tax deductions and appreciation found in conventional real estate. Strictly defined, NNN transactions of 15 to 25 years are more credit-oriented, whereas a lease-term of 10 years or less is typically more real estate-oriented.

The property types of net-leased investment are usually categorized in one of three ways:

1. **Retail** refers to *big-box* users (*e.g.*, discount variety stores, department stores, theaters, and/or home improvement stores) as well as *small-box* users (*e.g.*, restaurants, convenience stores, and/or drug stores).

2. **Industrial** includes facilities used for distribution, manufacturing, or research and development.

3. **Office** refers to any single user such as an oil company or pharmaceutical company occupying a facility as the sole tenant.

Surprisingly, the focus in recent years has been on the retail box category, perhaps to the detriment of the office and industrial categories. Owners of office/industrial real estate certainly should be more aggressive in exploring sale-leaseback opportunities and benefits with knowledgeable realty consultants with deep sale-leaseback experience."

Pricing on net-leased projects is based *primarily* on the tenant's a). credit; b). the lease; and c). the location. Although each of these variables has an important role in the pricing of net-leased projects, it is the culmination of all *three* that determine a true purchase price.

A). Tenant's Credit

- Many net-leased projects are based solely on tenant's credit. Therefore, it is important that investors evaluate the financial strength of a prospective tenant on its own merit and as a competitor in its industry. Consider the long-term stability of the tenant and that industry during good economic times as well as recessionary periods. Industries that provide basic products and services are usually recession-proof.

- Tenants considered "investment grade" by a recognized rating agency usually command a premium (*e.g.*, Wal-Mart, Walgreen's, General Motors).

- Tenants with *junk bond* (non-investment grade) ratings or minimal net worth typically provide a higher return (*e.g.*, Regal Cinema, Ameriserve, Dairy Mart).

B). Lease

- *Length* of a lease is a primary factor in determining the selling price. Primary terms of 15+ years are preferred, but 10 years are sufficient in 1031 tax-deferred exchanges and similar cases.

- "Absolute" triple-net leases — tenant responsible for roof, structure, and parking — trade at a premium.

- "Double-net (NN)" leases—landlord responsible for roof and structure — produce a higher yield and usually include a reserve taken for any potential repairs.

- Leases with built-in "bumps," or rental rate increases, are valued higher, with the exception of flat leases with investment grade credit.

C). Location

- NNN leases are credit-driven, causing location to be a secondary factor.

- Investors often are willing to pay an added premium for the residual benefit of well-located properties.

The combination of credit, lease, and location can lead to paying a higher premium with a lower yield for investment grade credit (*i.e.*, Wal-Mart: 20-year absolute NNN, flat) or receiving a higher yield for a non-investment-grade credit (*i.e.*, CSK Auto: 15-year NN, with rate bumps).

Yield on a triple-net lease property is composed of three components beginning with the capitalization rate, or cap rate, which is the total annual lease payment as a percentage of the purchase price of the property. *(Annual rent divided by purchase price)*

The second component is the dollars sheltered from federal income taxes. A portion of the cost of the property is allocated to the building and the balance is allocated to the land. For tax purposes, the owner may depreciate the cost of the building over a designated period of time. Thus, the portion of the annual cash-on-cash return, which is no greater than the annual depreciation, is sheltered from the long arm of Uncle Sam.

The final component is the compounded annual appreciation rate as a percentage of property cost, since well-maintained real estate traditionally

will appreciate substantially in value during a long period of time.

On the positive side, a lease also can be written to provide the opportunity for rent increases as a hedge against inflation. Another hedge may be in establishing a minimum lease payment plus a reasonable percentage of the tenant's gross sales above an established annual base.

INVESTOR PRUDENCE AND RISKS

An over-riding concern of most investors new to sale-leaseback deals is the amount of management required. Although the tenant maintains and manages the property, insures the real estate, pays property maintenance expenses, and remits taxes directly to taxing entities, the prudent landlord will take some protective steps.

Investors should always review a lease agreement with competent legal and tax advisors to avoid unexpected expenses. For example, unless specified as a tenant's obligation, intermittent, additional tax assessments during the term of the lease may be determined to be the owner's responsibility. Unless properly detailed as a tenant responsibility in the lease document, all types of structural repairs (roof leaks, foundation problems) may become the owner's responsibility.

To further reduce risk, the investor/landlord will periodically check with the taxing authorities to verify timely receipt and payment of all tax obligations. The investor also should periodically search the title to the property to make sure no liens or other encumbrances have been negligently filed against the property. The lease agreement also should require the tenant to pay any *property taxes under protest* to avoid the (investor's) loss of the property through nonpayment, or the investor having to pay the property taxes.

The investor/landlord also must receive current endorsement certificates from the tenant's property and liability insurance carrier indicating that the policies are in force and that the limits of the policies are sufficient to cover risk, the current market value of the property, and that the investor/owner is named as the additionally insured.

The major risk for investors in a sale-leaseback, triple-net lease investment is tenant default – bankruptcy, reorganization, etc. Before a tenant becomes a total default, it usually becomes a slow-pay or communicates problems to the landlord. The investor's options include defaulting the tenant; canceling the lease and re-leasing the property to a new, creditworthy tenant at an equal or higher rate; or, the investor might sell the property for a profit and reinvest the gain in other real estate.

Corporations facing critical crunches in credit and capital, as well as wary (and weary) investors looking for more conservative, long-term opportunities should seek the common ground of well-conceived NNN sale-leaseback transactions. Whether an individual or institution is in need of a smart depreciation vehicle or a relatively safe "coupon-clipper," net-leased properties provide great investments in both credit and real estate markets. The longtime popularity of net lease transactions appears to be in for an extended run, thanks to recent stock market gyrations and the Fed's unflagging resolve to cool the economy.

Obviously the investor/landlord wants to act quickly at any signs of financial difficulty to avoid limiting his options. If the tenant is forced into an involuntary bankruptcy, the investor could be drawn into the litigation, and the monthly income stream (rent) would be interrupted. The investor might decrease risk by including a security clause in the lease in which the tenants' equipment is pledged as additional lease collateral. A default would then allow the landlord to seize the equipment.

On the cautious side, investors should be wary of "recapture clauses," which permit the tenant to subtract increases in property taxes, maintenance expenses, and/or insurance premiums out of any percentage of rent that might otherwise be paid.

OVERVIEW OF INVESTOR BENEFITS

Any "Sale-Leaseback 101" discourse would be incomplete without a snapshot of the primary benefits of NNN investments to the Investor/Landlord. Here's our "Top-Nine" list:

1. Security of both the tenant and the real estate

2. Hassle-free transaction with minimal costs

3. Annual high interest cash return on a passive investment

4. Property depreciation tax-shelters as a portion of the annual cash return

5. The value of the real estate frequently appreciates during the lease term

6. Minimal risk occurs with investment grade tenants

7. The opportunity exists for higher cash returns from less-than-investment-grade tenants

8. The investor does not pay for property insurance, maintenance, improvements, or taxes

9. The investor can cash-out at any time, often with a profit, by selling the property, or hold the property, allow it to further appreciate in market value, and lease it again at a higher rate to the original tenant or a new tenant when the lease term expires.

The market for net-leased real estate investments is strong currently. The availability of attractive financing, coupled with minimal landlord responsibilities, creates highly-desirable commodities, especially for investors desiring a property for an IRS Section 1031 tax-deferred exchange.

In such a case, the corporate seller can also become an investor itself for a good reason – to avoid significant taxes on the income from the sale. By reinvesting the income in a timely manner into single-tenant NNN real estate, the corporate seller can defer 100 percent of its tax obligation. IRS Section 1031 permits this maneuver, which can ultimately provide its shareholders with revenue from a relatively secure investment vehicle with little or no management responsibility.

CONCLUSION

Corporations facing critical crunches in credit and capital, as well as wary (and weary) investors looking for more conservative, long-term opportunities should seek the common ground of well-conceived NNN sale-leaseback transactions. Whether an individual or institution is in need of a smart depreciation vehicle or a relatively safe "coupon-clipper," net-leased properties provide great investments in both credit and real estate markets. The longtime popularity of net lease transactions appears to be in for an extended run, thanks to recent stock market gyrations and the Fed's unflagging resolve to cool the economy. REI

Long Distance Residential Mobility & the Baby Boom

by Charles F. Longino, Jr.

The housing industry has loved the baby boom since its members entered the housing market in the mid-1970s. Born between 1946 and 1964, this large birth cohort has affected the housing marketplace until today. Developers of retirement housing are jockeying for position, anticipating the retirement of the baby boom between 2010 and 2028. The question most often asked by developers is "how will baby boomers be different from retirees who have gone before them?"

This manuscript will focus on only one segment of baby boom retirees, namely, those who may make long-distance residential moves. A strong attempt has been made to ground the speculation, therefore, in the body of knowledge accumulated in a research literature known as retirement migration *(Longino, 1995)*.

Speculation about the baby boom is certainly not new. The behavior of members of the baby boom generation has been a subject of intense speculation generally for decades, because fluctuation in the size of a population brings with it resulting fluctuations in the numbers of potential students, voters, workers, drivers, home owners, service users, and consumers of all kinds. Every institutional sector of society has had to pay attention or risk disastrous consequences *(Russell, 1993)*.

The maturing of the baby boom created a tidal wave of individuals moving through schools from kindergarten to college, into job markets, along career paths, and into first and second home markets. Now into financial markets, boomers, in their forties and early fifties, are beginning finally to invest in their future retirement lifestyles *(Dent, 1993)*. In

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about five years, as the earliest and oldest baby boomers approach very early retirement, the speculation about retirement mobility patterns in this huge birth cohort has already begun to buzz with intense conjecture.

TREATING THE BABY BOOM AS THOUGH IT IS A CONCRETE THING

It is always dangerous to assume that any marketplace is only influenced by population size. Not all voters vote, nor do all consumers consume. Projected market trends based on such oversimple assumptions are bound to disappoint in the end. For example, such projections tend to overlook the fact that baby boomers have a distinctive market profile.

Age-based marketing has created an image of baby boomers that is truly mythic in proportion. One often hears such phrases as the baby boom likes certain things or will take certain actions, as if the baby boom were a person. This tendency to reifying the baby boom is philosophical wrong-headedness. It may be too obvious to point out that the goal of marketing is to sell products and services. Marketing, therefore, is most interested in that part of the population with discretionary income. By focusing just on the college-educated portion of the population, however, demographic analysts have built psychographic images that are then applied by the lay observer to all persons born between 1946 and 1964. Such uncomplicated thinking reifies the baby boom and ignores its rich diversity.

All myths, however, are rooted in an element of truth. And the generalized images of middle-class baby boomers generated by age-based marketing cannot be dismissed out-of-hand. Overall, there is a greater value for independence, the entrepreneurial spirit, and empowerment. Also, there is a greater distrust of authority of all kinds, less company and brand loyalty, greater value for leisure over work, informality over formality, and a more relativistic understanding of ethics among middle-class baby boomers than there were among their parents *(Russell, 1993).* To the extent that retirement moves are made by the better-educated part of the middle-class, these baby boom values may have an influence on their mobility choices.

What has been described in the research literature as lifestyle-motivated migration, should apply well to baby boomers. One would expect that their appetite for leisure and new experiences would reinforce retirement migration to areas rich in amenities with pleasant climates and vistas. Therefore, for the 20 years following 2010, there should be a surge of migration of recently retired baby boomers to high amenity areas. The tide will rise rapidly for the first decade of this period, the rate of growth slowing during the second. Retirement community developers are already rubbing their hands together in eager anticipation of this surge. The problem is that they will cross a valley before they get to the population mountain, so positioning themselves too early with large-scale construction projects could be problematic. People retiring now were born during the depression when fertility rates were at a historical low.

Unfortunately, however, when projecting images of baby boom relocation more than two decades in the future, one cannot take into account surprising technological and economic changes that will occur in the interim. These factors will certainly alter population-based projections, perhaps even radically. It is much more realistic to discuss the diversity within the early baby boomers and how this diversity will expend our understanding of retirement lifestyles, including those among the mobile.

APPROACHES TO RETIREMENT MOBILITY

Are there characteristics and attributes in the baby boom population that may bear on the issue of retirement migration? Certainly there are. First, there will be an increase in the number of couples among retirees where both had careers, and who have complex packages of retirement income drawn from several sources. There will be, perhaps, a larger increase in the retirement of single parents, whose reduced opportunities and increased burdens may leave them with reduced retirement income. So, greater relative wealth *and* poverty may be simultaneously evident in the retiring baby boom. In the upper income end of the distribution, the number of those who can afford to make retirement amenity moves will increase. The simultaneous growth of the low-income elderly will have little effect on interstate migration. The near-poor have not been well represented among amenity migrants in past decades. The unprecedented growth of the U.S. economy during the middle-aging of the baby boom will no doubt enhance the wealth of couples with two professional careers.

Second, due to the elevated value of leisure in the baby boom upper income segment, those with ample financial resources in their fifties may be lured during the next decade by the development of leisure-oriented "empty nest" communities that

are beginning to appear in Arizona, Texas, and elsewhere. These communities feature golf, health spas, hiking and biking trails, club houses, and to the casual observer, they look very much like upscale retirement communities. Most of the residents, however, are not yet retired. Nor are they interstate migrants. Rather, they move from, and commute to, the adjacent metropolitan area. Of course, if the residents do not move, the residential development, over time, will become a retirement community, de facto.

Third, it is easy to speculate that, as middle-class baby boomers first enter retirement, there will be an increase in alternative retirement lifestyles. Carrying on as before, but without working, or moving to a retirement community in the Sunbelt, will not be the only lifestyles from which to choose. Some of these choices will not require the purchase of a new home, nor a permanent move. Lifestyle change characterized many college students in the late 1960s and early 1970s. The early boomers valued their generational differences. They let their hair grow long, dressed down, and rejected the view of maturity espoused by the middle-class of the 1950s. As a consequence, some will be more sensitive to experience rather than location. The idea of a permanent retirement move may not attract these particular boomers.

Rescue operations.

For boomers with a strong service orientation and the willingness to spend parts of the year away from home, the American Red Cross already provides an interesting model. The organization trains a cadre of volunteers who will fly into disaster areas and set up the infrastructure for the thousands of local volunteers who will put out the fires, search for survivors, or fill sandbags. The lodging, feeding, and health care of these volunteers requires trained volunteers who are willing to move from one natural disaster to another. And most of these trained volunteers are retired. This kind of activity is certainly more experience-based than location-based and it is a functional alternative to retirement migration. The Peace Corps was a baby boom phenomenon; it will surely find a counterpart among retirees of the same birth cohort.

Senior volunteer services.

There are organizations that help retirees to find places where they can live and work as volunteers on projects that are not as dramatic as rescue operations. The Human Service Alliance of Winston-Salem, North Carolina, for example, houses and trains hospice workers who care for the terminally ill in a home-like environment and respite workers who care for autistic children weekly in an enriched educational environment. Retired couples are among the live-in volunteers. These are service opportunities that require travel and temporary relocation, and may be viewed as an alternative to leisure-oriented seasonal migration.

The generalized images of middle-class baby boomers generated by age-based marketing cannot be dismissed out-of-hand. Overall, there is a greater value for independence, the entrepreneurial spirit, and empowerment. Also, there is a greater distrust of authority of all kinds, less company and brand loyalty, greater value for leisure over work, informality over formality, and a more relativistic understanding of ethics among middle-class baby boomers than there were among their parents. To the extent that retirement moves are made by the better-educated part of the middle-class, these baby boom values may have an influence on their mobility choices.

Elderhosteling.

Summer visits to college campuses across this country have been organized for decades by the Elderhostel organization. During the past decade, it has expanded its operation to college campuses in several other countries. Perhaps such travel should be considered as an alternative to vacations, rather than to residential moves, because the visits are for a relatively short duration. Indeed, elderhosteling in no way precludes a retirement move. Nonetheless, it is experience-based mobility and demand for these experiences that are likely to increase among early-retired baby boomers. Sensing an increased interest in service opportunities among early baby boomers, Elderhostel is setting up a branch office to expand the concept into this new area.

Mobility in cyberspace.

Baby boomers dominate the Internet. In proportion to their numbers, Generation Xers use it more, but boomers greatly outnumber them *(Smith &*

Clurman, 1997). An opulent banquet of mobility experiences will be marketed to retired baby boomers over this medium. The Internet home pages of the many Sun Cities, for example, are an integral part of their national marketing operation. At the same time, Elderhostel makes worldwide educational travel information available on its home page. National volunteer organizations, such as Senior Corps and the Environmental Alliance for Senior Involvement do the same. Communications for a Sustainable Future cut across education and service domains, offering campus-based opportunities to study ecology and the environment, heterodox economics, peace and conflict, education and service-learning, and international studies. These topics sound like baby boom agendas of the late 1960s. During the next 10 years, Internet opportunities to learn about experience-based mobility will double and double again, encouraging further the diversity of retirement activity for baby boomers.

Virtual communities.

We are at an early stage in the development of virtual reality as a viable travel experience. The popular image of the future in this regard is the holodeck on the Starship Enterprise. There is no way at this time to make reasonable projections concerning the availability and uses of such technology in the future. However, the future will be different than the present, and by 2050 when the baby boom dies off, it may be very different indeed. There will be technologies in the future that will simulate travel in ways that will satiate wanderlust without requiring physical mobility. How these technologies will influence geographic mobility in retirement is anyone's guess, but to ignore their potential would be foolish.

CONCLUSION

So, will the patterns of retirement mobility change between 2010 and 2020 as the baby boom generation enters retirement? The answer, of course, is yes and no. The general patterns of retirement migration have changed very little over the past 40 years. Between 4 percent and 5 percent of the population 60 or older will move across state lines in each five-year period. Most will be recent retirees. The popular destination states today will be popular among migrants in 20 years. Actually, even if somewhat smaller proportions pour into Florida, Arizona, Texas, North Carolina, and California, the larger population base will still make the numbers rise.

On the other hand, there are enough free agents and trailblazers among baby boomers that some new trends should be set into motion. Some candidates have been suggested here. REI

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ABOUT THE AUTHOR

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CAVEAT EXCHANGER: "DE JA VU ALL OVER AGAIN"

by Mark Lee Levine, CRE

This article focuses on the risks a taxpayer takes when undertaking an exchange, with escrow, where the escrow party (intermediary) defaults.

INTRODUCTION

The author hopes that Yogi Berra[1] will indulge the incorporation of his cryptic one liner, "De ja vu all over again," in the title to this manuscript. This sardonic phrase seems to be most apropos, given that the author has argued on prior occasions that we should change the tax-deferred exchange rules by simplifying the process to defer gain when we "sell" and reinvest the *proceeds* from the "sale." The potential pitfalls outlined in this article support that position.

Taxpayers have been forewarned on numerous occasions,[2] when undertaking tax-deferred exchanges and using intermediaries (escrow parties), that the area can be complex. Care must be exercised to comply with the requirements in the Federal tax law for exchanges. It behooves all of us to reflect on the basic requirements for a tax-deferred exchange, whether undertaking a simultaneous exchange or a non-simultaneous (deferred) exchange.[3]

Once the fundamental requirements for the use of a tax-deferred exchange under Code §1031,[4] with their rules,[5] and the use of an intermediary[6] have been reviewed, the exchange can be examined to see what happens if an escrow agent does not perform.[7] *The bottom line is that the exchange treatment may be lost.*

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HISTORICAL PERSPECTIVE OF CODE §1031 AND NONSIMULTANEOUS EXCHANGES

The historical position under Code §1031, back in 1921[8] and up until approximately 1968[9] seldom addressed an exchange that did *not* occur simultaneously, between the "buyer" and the "seller." That is, under normal circumstances, the buyer will transfer his or her monies or other payment for the property, and the seller will transfer his or her property to the buyer. However, with the advent of a few cases, followed by the *Starker* cases[10] and the changes in the 1984 Code,[11] the issue arose as to the requirements necessary to undertake an exchange where the parties do not transfer their properties at a simultaneous point. In most instances, the non-simultaneous exchange results in the taxpayer-seller transferring his or her property, often identified as "**relinquished property**,"[12] now, for the promise, and support for that promise, to receive other like-kind, qualified Code §1031 property, at a later date and on a timely basis.[13]

With the advent of the non-simultaneous flavor of exchanges, there was a need to determine many of the guidelines that would apply in such settings. Questions arose as to who might hold the property on either side, either the property relinquished by the seller or that transferred by the buyer; and, who would control the timing of these events? Does the concept of constructive receipt[14] apply? What constitutes a "sale," as opposed to an "exchange?" And, there were a myriad of other questions. Some of these queries were answered as a result of Regulations.[15]

CURRENT CONCERNS

Many issues remain that were not resolved by the Regulations. Therefore, numerous Private Letter Rulings, cases and other authorities have addressed the conundrum of tax issues that have arisen because of non-simultaneous exchanges. These concerns relate to the essence of this article, with particular emphasis on the question as to what happens when someone who is acting as a qualified intermediary,[16] within the meaning of the Regulations mentioned, defaults or fails to properly act? Does this mean that the taxpayer will be given some relief position, or is the taxpayer burdened with the failure of the intermediary to comply with the requirements to assure the tax-deferred status as an exchange? In most instances, the answer, coming from the cases, Rulings, and other authorities, is that it is the taxpayer that suffers the adverse consequences of the failure of the intermediaries to act properly.

One of the main concerns arose because of the nature of Code §1031 and the Regulations, relative to the non-simultaneous exchange, sometimes referred to as a *"deferred exchange,"* (as labeled in the Regulations). This is when a third-party acts on behalf of a party or parties, thereby hopefully preventing adverse tax results. When such third-party (intermediary) is used, a common issue that could result in a position in favor of the government and against the taxpayer is an argument that, while a taxpayer might have transferred his or her property to such intermediary, with the intent to receive like-kind qualified property in an exchange, it may be argued that the seller is deemed to have received the property (often cash) acquired by the intermediary, because the seller has "control" over the transaction. (This issue is sometimes labeled as a "constructive receipt" issue.)

To avoid this issue, the Regulations that were promulgated under Code §1031 provided that a third-party, not an agent (intermediary) of the seller, should hold the funds in question that might be paid, by a buyer, allowing the intermediary to hold those funds to avoid both the actual and constructive receipt of the monies by the taxpayer-seller, and to otherwise comply with Code §1031.

Without attempting to cover in detail these Regulations, noted under Treasury Reg. §1.1031(k), the essence is that the intermediary must act independently, and according to proper instructions, to hold the funds, as indicated previously.

The problematic issue is:

What if the intermediary fails to act properly and is in violation of the intermediary's contract with the seller? Can this lead to adverse tax implications for the buyer? A failure to properly act may be the result of the intermediary's negligence, fraud, theft, or other improper actions. However, even if the actions are improper, and this gives rise to a claim, civilly, by the taxpayer-seller against the intermediary, the tax question remains: Is the seller's potential exchange damaged by the intermediary's improper actions?

The author has addressed this issue in prior articles and presentations relative to situations where the taxpayer is damaged because the intermediary, maybe involuntarily, is facing a bankruptcy. In the articles indicated, a few cases were mentioned where the courts have shown little sympathy or empathy for the taxpayer who was damaged, through no intentional act by the taxpayer,

when such bankruptcy occurs. That is, as many familiar with exchanges know, the technical requirements of timing the investment normally dictate that the property relinquished by the seller must also result in the seller timely identifying the replacement property. A "timely" basis for identification normally means that within 45 days from the transfer of the relinquished property by the seller to the intermediary, the seller must identify the property the seller is to receive. (Further, there is generally a 180-day rule that requires the taxpayer to not only identify the property, but also to actually close and receive the replacement property within 180 days of the transfer of the relinquished property by the taxpayer-seller; there are few exceptions.)

The cases in question create a problem for the taxpayer-seller, because the taxpayer, in attempting to meet all of the requirements of Code §1031, (including the Regulations to timely replace the relinquished property), may be thwarted as a result of the taxpayer discovering that the intermediary, who was to handle the transaction, was placed into bankruptcy. This has occurred.

The conclusions by *all* of the courts in these cases have been that the taxpayers are *not* entitled to any relief from the adverse tax implications that might be present for the taxpayer-seller in failing to meet Code §1031 on a timely basis for replacement, even though the taxpayer was not the generating cause of the failure to timely meet the requirements. Although the tax law contains relief provisions in other Sections of the Code, no such provision exists in this Section; and, no court has allowed the taxpayer to simply avoid the timing requirements that are required under the Code and the Regulations indicated simply because the taxpayer's intermediary failed to properly and timely meet the requirements of the Code.

This issue has been further addressed with a more abhorrent fact situation in a setting where the intermediary absconded with the "escrowed" funds. The question that must now be addressed is whether, in this extreme case, the taxpayer would receive any relief relative to the tax issue (and without regard to the more important issue of receiving a return of funds because of the criminal actions by the intermediary).

IMPACT OF DEFAULT IN THE TIMELY MEETING OF REPLACEMENT RULES WHEN THE INTERMEDIARY COMMITS A CRIMINAL ACT

Taxpayers have been forewarned on numerous occasions, when undertaking tax-deferred exchanges and using intermediaries (escrow parties), that the area can be complex. Care must be exercised to comply with the requirements in the Federal tax law for exchanges. It behooves all of us to reflect on the basic requirements for a tax-deferred exchange, whether undertaking a simultaneous exchange or a non-simultaneous (deferred) exchange.

Thus, the focus of this Note is to deal with the question of the timely performance of exchange requirements for a non-simultaneous exchange under Code §1031. This issue was recently examined by the 1999 Court of Appeals decision out of Georgia on the issue of a non-simultaneous exchange that failed to meet timing requirements because of the intermediary's conversion of the funds that were to be held in escrow for and on behalf of the taxpayer.

The issue was addressed in the case of *Deer Creek, Inc. v. Section 1031 Services, Inc., et. al.,* 510 F.E.2d 853 (Ga. App. 1999). In the Georgia *Deer Creek* case, a number of individuals undertook Code §1031 transactions and utilized a Company entitled Section 1031 Services, Inc., to support the requirements under Code §1031 for an intermediary or facilitator to complete the exchange requirements.

Mr. James Gideon owned the Section 1031 Services Company. Allegedly, Gideon commingled funds in the escrow account, withdrew millions of dollars of those funds, and, as one might guess, chose to leave the country. The net result was that there were a number of individuals who attempted to try to collect "their" monies from the account. Although the case focused on the basic position of "who gets stuck" with the loss of the monies, since there were multiple parties involved and a limited amount of funds that were available, the case also, implicitly, raised the issue, for tax people, of the impact of such position on the Code §1031 transaction. (Obviously, this was the lesser issue for the taxpayers. Although the failure of the reinvestment to meet Code §1031 might have been present, the issue for the plaintiff was to seek a return of the monies, even if that meant paying taxes out of such funds.)

The Court ruled on the propriety of the claims by the various plaintiffs as to the amount of monies that were available. It was not a tax case. However, one can see the impact on the exchange position by the failure of timely completion of the Code §1031 issue.

This is not the only case in which there has been a potential loss of the deferred exchange position because of a failure to meet the requirements in a timely fashion under Code §1031 for replacing the property. It is not the only case in which funds have been lost because of an intermediary or third-party absconding or failing to account for funds that were in their control.

CONCLUSION

All of the cases in which a third-party has control of funds that are owned by another party should give each transferor of those funds cause to consider, as a paramount issue, the protection of those funds. The key issue should be the assurance that the funds will be properly directed and utilized as required by the owner of those funds. Unfortunately, there has been, and continues to be, too much focus by taxpayers on saving taxes and eliminating that burden. Taxpayers have often thrown caution to the wind in many instances in failing to use reasonable steps, whether personally, or through their representative, to protect their funds. This must be the primary concern for the taxpayer.

There has been a tendency by some to merely push the safety of funds issue aside as one that is an unusual, hybrid, and erratic mutation that will never occur. However, a series of cases on intermediaries being placed into bankruptcy, in which trustees have contended that the monies held by the intermediary are in fact those of the trustee, and not those of the seller, coupled with the recent *Deer Creek* case in which the intermediary absconded with the funds, should direct the taxpayer's attention to the need to ignore the tax implications until they, *first*, address the security implications, for the taxpayer's funds. Once the funds are properly protected, the need to meet the requirements for the tax-deferred exchange treatment of those funds can be addressed as a secondary issue. REI

NOTES

1. With thanks to Yogi Berra
2. For an examination of this issue, addressed in previous articles, see Levine, Mark Lee, *Exchanging Real Estate*, Vol. 2, Page 10-168a, published by Professional Publications and Education, Inc. (1999). See also the article by Levine, Mark Lee, "The Impact of A Tax-Deferred Exchange Under Code §1031 When An Intermediary Enters Bankruptcy," *Journal of Property Management* 20, Institute of Real Estate Management (November/December, 1998).
3. The question as to undertaking a simultaneous exchange or a non-simultaneous exchange was not a topic in most instances until the advent of the now-famous *Starker* decisions. These included: *Bruce Starker v. United States (Starker I)*, 75-1 U.S.T.C. 9443 (D.C. Ore. 1975); *Starker, T. J., v. United States (Starker II)*, 77-2 U.S.T.C. 9512, 432 F. Supp. 864 (D.C. Ore. 1977); and *Starker, T. J., v. United States (Starker II on Appeal)*, 79-2 U.S.T.C. 9541, 602 F.2d 1341 (9th Cir. 1979), aff'g and rem'g 77-2 U.S.T.C. 9512, 432 F. Supp. 864 (D.C. Ore. 1977.
4. Code §1031 is technically referred to as 26 U.S.C.A. Section 1031, but will be referred to herein by reference to the general label of "Code §1031."
5. Code §1031 generally provides that gain will not be recognized under the Internal Revenue Code for Federal income tax purposes if there is an exchange of property that meets certain requirements; *e.g.*, it was used in the trade or business or for investment. For more details and a discussion of these requirements, see Code §1031(a) and a discussion of the exchange rules in the Levine text, cited *supra*, Footnote 1.
6. Intermediaries became a topic of discussion as a result of the modifications in 1984 to Code §1031, allowing a non-simultaneous exchange and the advent of the promulgation of Regulations under Code §1031, specifically, Treasury Reg. §1.1031(k). For further details on intermediaries, see Treasury Reg. §1.1031(k)-1(g).
7. The question as to the impact of a default by an intermediary on the Code §1031 tax-deferred exchange has been discussed in cases where a default occurred. Specifically, some of these cases are enumerated in the article, cited *supra*, Footnote 1.
8. Code §1031 in 1921. See the Levine text, *supra*, Note 1, Chapter 1.
9. *Redwing Carrier v. Tomlinson*, 399 F.2d 652 (5th Cir., 1968).
10. See *supra*, Footnote 2.
11. See Footnote 8.
12. "Relinquished property" is that property transferred by the seller.
13. See Code §1031(a)(3).
14. "Constructive receipt" is a term that denotes a *deemed* receipt of the property, even if there is not an actual receipt.
15. Treasury Reg. §1.1031(k).
16. "Qualified intermediary" is defined in Treasury Reg. §1.1031(k).

FOCUS ON THE ECONOMY

From Sea to Shining Sea

by Hugh F. Kelly, CRE

If there is a canon of classic texts in our professional literature, *Principles of Real Estate* by Arthur M. Weimer and Homer Hoyt certainly has a place of honor on the bookshelf. Originally written in 1939, *Principles* was published in several editions over the course of many decades. Today, many of its teachings may appear overly obvious, but they are no less fundamentally important for all that. And because of their basic validity, they remain a healthy corrective to uncritical enthusiasm for the "trend du jour."

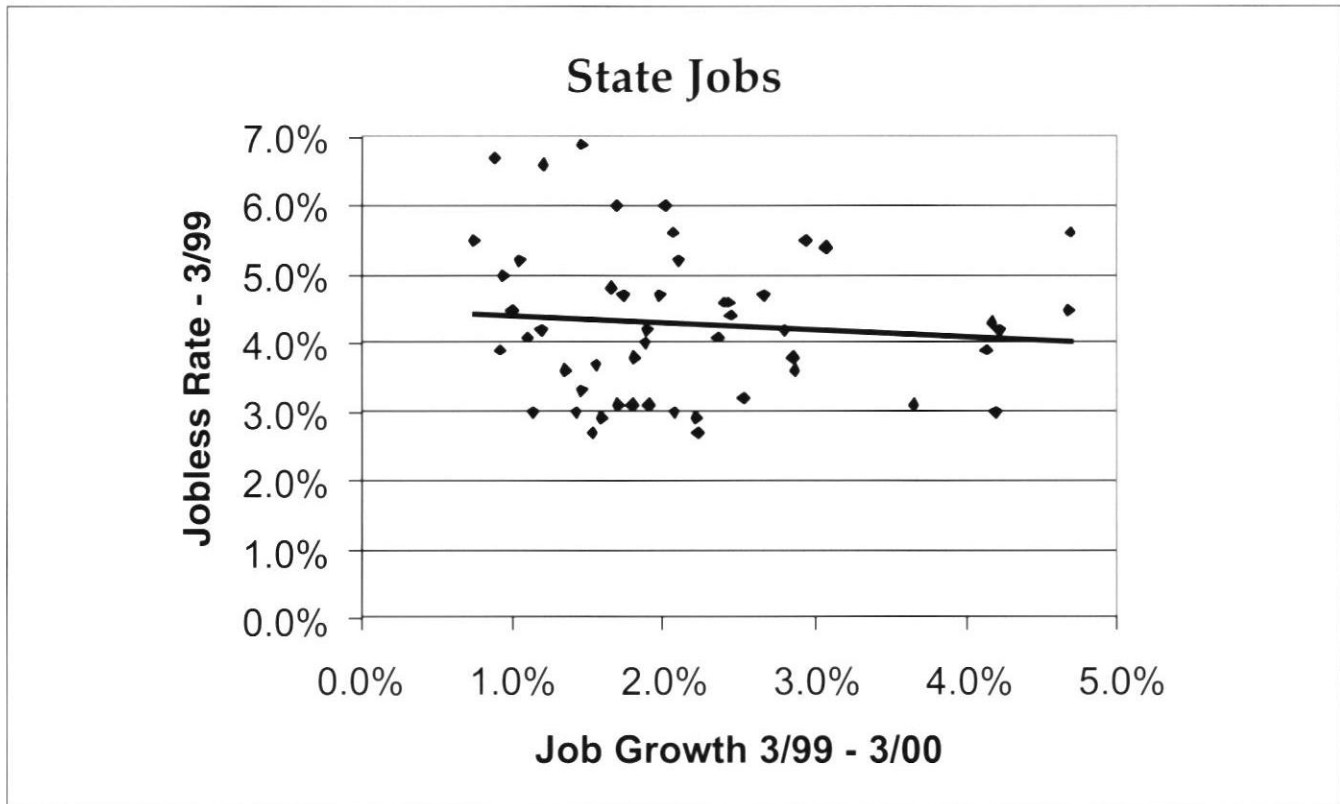
On page 414 of the Fourth Edition (1960), Weimer and Hoyt wrote: "The real estate market of a locality will be influenced by the trend in local business conditions... Of the many factors to consider..., the most important is the trend in employment and incomes." This observation is well worth pondering as the U.S. economy and real estate markets enter the new millennium.

Spectacular commercial property performance on either side of the country, especially in markets such as San Francisco, Washington, DC, New York, and Boston, has had commentators resurrecting a term popular in the '80s: "the Bi-Coastal economy." Have the states with shorelines on either the Atlantic or Pacific oceans in fact been better-off than the nation as a whole in recent days? The evidence seems to make this case nicely. Twenty states have ocean frontage, five on the Pacific and 15 on the Atlantic. Taken together, these states represent 51.4 percent of the U.S. employment base (about 65.3 million jobs out of the national total of 127.1 million). But, over the 12 months ending March 31, 2000, the bi-coastal group of states accounted for 57.7 percent of the nationwide increase of 2.8 million jobs. This means that these states are growing more rapidly than the rest of the nation. The Pacific states generated 489,800 new jobs, while the Atlantic Seaboard added 1,128,800 positions to the payroll. This goes a long way toward explaining the robust supply/demand conditions in local real estate markets, and the consequent surge of investor interest from Montauk to Santa Monica.

It is not simply growth that is supporting high real estate values in these states, though. They also boast substantial concentrations of population and economic activity, and density contributes to real estate pricing. The national norm for population density is about 75 persons per square mile. Seventeen of the 20 coastal states exceed this standard, sometime spectacularly so. New Jersey has over 1,000 person per square mile, leading the country by this measure. Only three of the coastal states have densities below the U.S. average: Maine (40.2 persons per sq. mile); Oregon (33.8 persons), and Alaska (1.1 persons). Even including these states, though, the bi-coastal cluster tallies a population density of 323 persons per square mile.

Won't the coast states soon approach some significant limits to their economic expansion? In an era of increasing labor shortage, surely localities

Figure 1

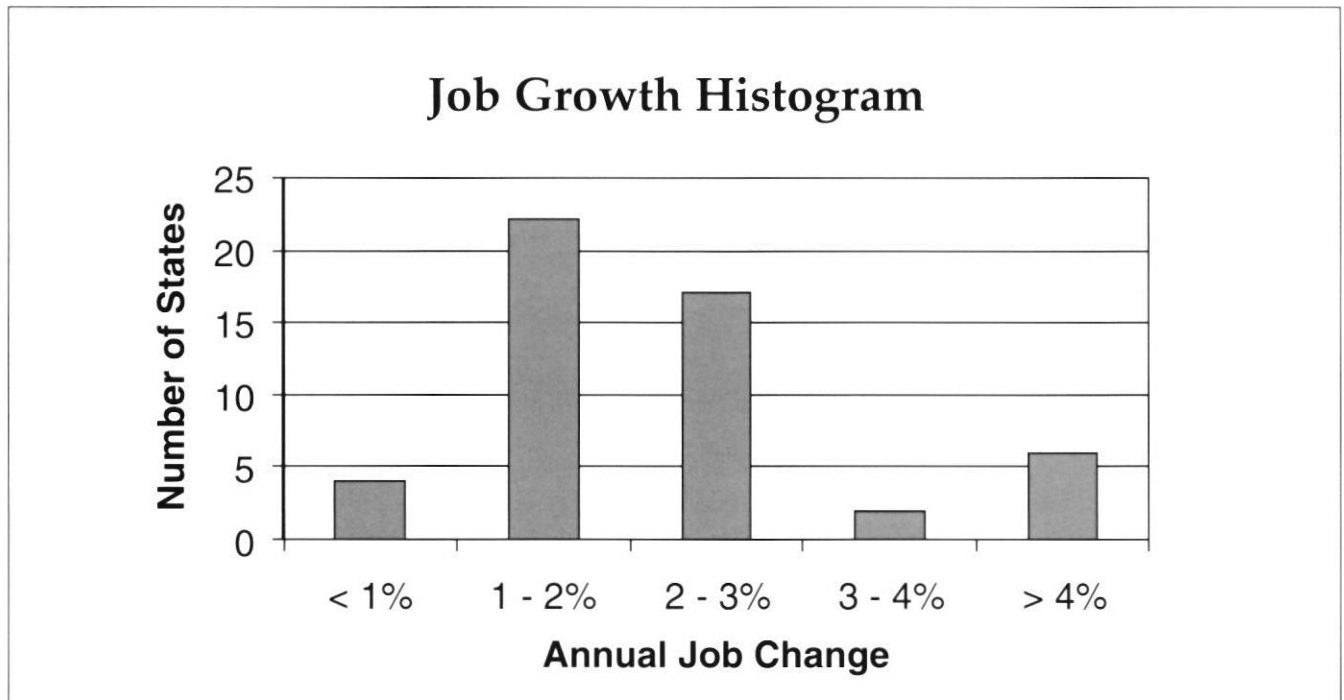


that are already so densely concentrated will be running out of available workers. Such an assumption, while sounding logical enough, has some problems when faced with the data. In the first place, there still seems to be some untapped labor resources in the coastal state. Unemployment in Alaska and Hawaii, in fact, is above 6 percent. And even in some of the more populous states, the jobless rate has greater slack than in the nation as a whole. As of the end of 2000's first quarter, California had a 4.9 percent unemployment rate, New York 4.6 percent, and the State of Washington 4.5 percent. These rates were posted after a 12-month span in which California led the nation with 406,500 new jobs; New York added 174,200 jobs; and Washington gained 43,200.

Interestingly, the argument that local labor constraints are stifling growth seems to have shaky statistical support as the calendar turned to 2000. The scatter-graph *(Figure 1)* displays for all states and the District of Columbia the March 1999 unemployment rate (on the vertical axis) and the subsequent job growth rate (on the horizontal axis). Many might expect that there would be a strong relationship between sub-4 percent joblessness at a point in time, and below-average job growth thereafter. More hopefully, in a strong economy, you might anticipate a movement of job opportunities toward states with relatively available labor.

Unfortunately for this hypothesis, at least in the past year, the expected relationships haven't emerged. If we simply divide the data into quadrants, above and below the 4 percent unemployment rate and to the left and right of the 2.3 percent job growth rate (the U.S. average), we see some interesting results. The upper left quadrant (higher unemployment; slower subsequent growth) is the most crowded, with 17 observations. In 12 cases, we do find strong job growth generated by states with comparatively slack labor markets - sometimes very strong expansions as in the cases of Arizona and Idaho, which posted 4.7 percent job gains through March 2000. But there were also a half-dozen states with sub-4 percent unemployment that nevertheless beat the mean U.S. growth rate, led by Florida (4.1 percent growth) and Colorado (4.2 percent growth). Fifteen states matched the "labor

Figure 2



constrained" prediction of low unemployment/ low growth. A regression line calculated against the data has only a modest downward slope, revealing a "weak" relationship between the variables, and the closeness-of-fit measure is ...well, it isn't close. Up to now, the presumed labor scarcity constraint has yet to prove a significant factor in U.S. economic performance at the state level.

For real estate counselors, what concepts do the statistics point us to and what should we be focusing on in the near future? First of all, the economy is already slowing in many places, even if labor scarcity is not a strong explanatory variable. As the histogram in *Figure 2* shows, 26 of the 51 employment observations showed gains of 2 percent or less in the year ended March 2000. Only six states had growth of 3 percent or more, and none were above 5 percent.

Second, there are no Berlin Walls in the United States. Labor is quite migratory, and workers are ready, willing, and able to pursue economic opportunity. That was true in hard times, and is apparently also a significant force in this era of prosperity. Even with low unemployment, the job market is very dynamic, and real estate investors should be sensitive to the mobility of workers and of corporate users in this environment. Here's a hint: it is much easier for a household to relocate than it is for a corporation.

Thirdly, density is a positive factor for real estate value over the long haul and probably should enter more consciously into our evaluative and counseling consciousness. Big cities, especially of the 24-hour variety, have demonstrated marginally superior investment performance in the last decades of the 20th century and have earned the benefit of the doubt for the future. Not the least of the reasons for this are the agglomeration features I pointed out in the Spring 2000 issue of this column. Big cities have economic critical mass, and can produce tremendous energy. This is manifestly the case at the present time.

Finally, it is no coincidence that in an era where age demographics are slowing labor force expansion, both the Atlantic and Pacific coasts are prospering. This is where we find the great gateway cities for immigration. Cities that are population magnets for new U.S. residents possess a remarkable comparative advantage in the area of human capital. From 1970 through 1995, the rate of immigration into the U.S. roughly doubled; this helped

keep our economic momentum accelerating in the Eighties and Nineties. Those looking to plot the trajectory of future economic activity will have to pay careful heed to the contributions of the newest Americans. Tip O'Neill said that all politics is local, and real estate professionals understand that the local market is key to property performance. But in politics and in real estate, the local scene is inextricably linked to the globe. By and large, this is a good thing, if only it can be understood clearly and without bias.

These attributes of valued human capital, population mobility, economic agglomeration, and open borders are really very traditional American strengths. They sustained the U.S. economy through the railroad era of the 19th century, and the industrial evolution of the early 20th century. I'm confident that classic authors like Weimer and Hoyt would see both the continuity of principle and the novelty of evolution in the fundamental trends shaping early 21st century real estate markets from sea to shining sea.REI

ABOUT OUR FEATURED COLUMNIST

Hugh Kelly, CRE, *New York City, is chief economist for Landauer Realty Group, Inc., (a Grubb & Ellis Company), who spends much of the year speaking and writing about the domestic and international marketplace. He is a 2000 national vice president of The Counselors of Real Estate, chair of its New York Metropolitan Chapter, and has served as editor in chief of "The Counselor" newsletter, 1997-1999.*

FOCUS ON U.S. LODGING

RevPAR Growth Projected to Ease in 2001 and Rebound in 2002

by Bjorn Hanson, CRE

PricewaterhouseCoopers has been providing 12-quarter econometric forecasts of the U.S. lodging industry since 1991. The four million rooms counted in the lodging industry encompass the full range of property types from full service to limited service hotels to extended stay properties. The model consists of three stochastic equations: *demand* as a function of 4-quarter polynomial distributed lag of real GDP and real ADR with an adjusted R-squared of 0.99; *room starts*, with an adjusted R-squared of 0.89; and *room rate*, with an adjusted R-squared of 0.93, all significant at ρ=0.5. Following is a summary of the lodging forecast through 2002.

The continued strong U.S. economy has supported high levels of lodging demand so far this year. Confident consumers and expanding businesses continue to keep travel activity high despite rising oil prices. In the first five months of 2000, room supply grew at 3.3 percent, but demand expanded at a much faster pace of 3.8 percent. This translates into a 0.4 percentage point rise in the occupancy rate to 61.9 percent from the comparable five-month period in 1999.

U.S. RevPAR growth will continue to rise in 2000 alongside expectations of stronger U.S. economic growth. RevPAR growth is expected to rise to 3.9 percent in 2000 from 3.1 percent the previous year. *(Table 1.)* In fact, data from Smith Travel Research (STR) indicate that RevPAR is growing at 4.8 percent for the first five months of the year, supported by strong average daily rate (ADR) growth of 4.2 percent.

MODERATING U.S. ECONOMIC GROWTH IN 2001

Following a strong first quarter with real GDP growth of 5.5 percent, the U.S. economy is expected to slow from its current exceptional pace over the next six quarters. Macroeconomic Advisers expects a moderate slowdown in real GDP from 4.4 percent in the year 2000 to 2.8 percent in 2001 and 3.1 percent in 2002.[1] Recent data show that consumer spending growth slowed in the second quarter of 2000. Moreover, housing starts have eased and survey data for the manufacturing industry indicate that activity is expanding at a slower pace than in 1999. Since June 1999, the Federal Reserve has increased the target fed funds rate by a cumulative 175 basis points, with the aim of containing inflationary pressures. Macroeconomic Advisers forecasts modest inflationary pressures of 2.6 percent in 2000; 2.5 percent in 2001; and 3.1 percent in 2002.

SUPPLY GROWTH WILL DECLINE FURTHER AS DEMAND GROWTH PICKS UP IN 2002

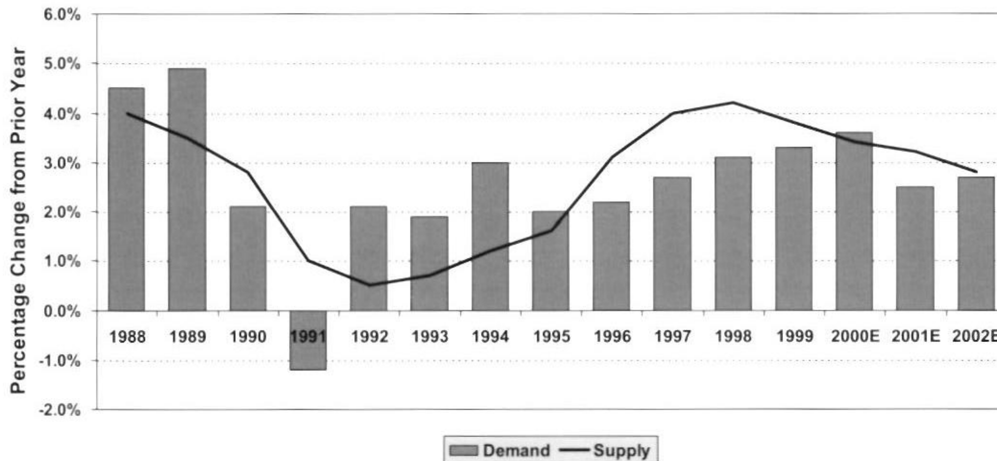
For the year 2001, lodging demand growth will slow to 2.5 percent from 3.6 percent in 2000, mirroring the tempering of overall economic growth. By 2002, demand growth will recover modestly to 2.7 percent.

Meanwhile, end-of-year room supply growth is forecast to decelerate through 2002, after posting a record pace of 4.2 percent in 1998. Supply growth is expected to taper off to 3.2 percent in 2001 and 2.8 percent by the end of 2002.

Figures 1 & 2

Figure 1

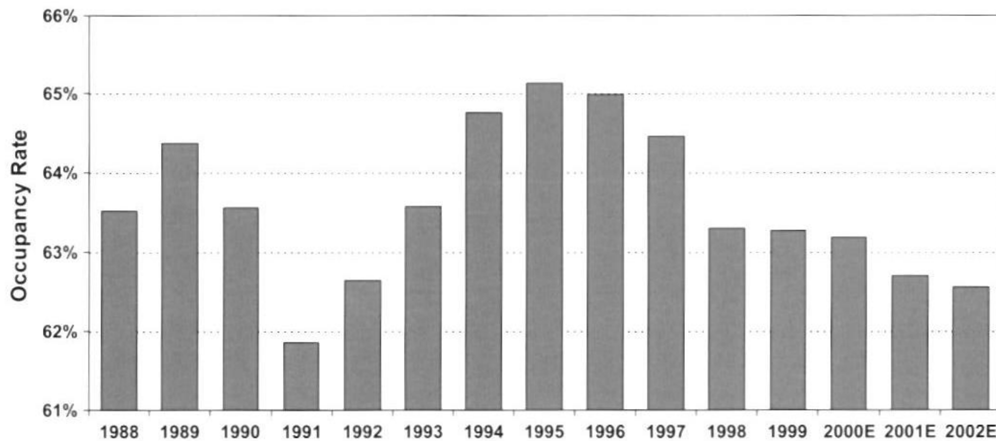
Gap Between Supply Growth & Demand Growth Expected to Narrow in 2002



Source: PricewaterhouseCoopers L.L.P. (2000 to 2002); Smith Travel Research (1988 to 1999)

Figure 2

Occupancy Rate Has Been Declining Since 1996



Source: PricewaterhouseCoopers L.L.P. (2000 to 2002); Smith Travel Research (1988 to 1999)

Therefore, in 2001, the occupancy rate is expected to decrease by 0.9 occupancy points to 62.7 percent as the gap between supply and demand growth widens. By 2002, the occupancy rate is expected to stabilize at 62.6 percent as demand growth rebounds modestly and supply growth slows further. *(Figure 1 & Figure 2.)*

ADR growth, which has been falling in line with occupancy rates, is predicted to fall to 3.6 percent in 2001 and rise slightly to 3.8 percent in 2002.

Easing demand growth and smaller ADR increases will lower RevPAR growth in 2001 to 2.8 percent. By 2002, RevPAR growth will climb to 3.5 percent as demand growth picks up and supply growth continues to decrease.

Tables 1 - 3

Table 1: PricewaterhouseCoopers U.S. Lodging Forecast, as of June 2000	Annual Figures				
	1998	1999	2000	2001	2002
Occupancy (Percent)	63.8	63.3	63.2	62.7	62.6
Average Daily Rate ($)	$78.14	$81.25	$84.51	$87.56	$90.86
Percentage Change from Prior Year	4.6	4.0	4.0	3.6	3.8
Annual RevPAR (Percentage Change from Prior Year)	3.5	3.1	3.9	2.8	3.5
Annual Inflation-Adjusted RevPAR (Percentage Change from Prior Year)	1.9	0.9	1.3	0.3	0.4
Average Daily Rooms Sold (000s)	2,358	2,436	2,523	2,586	2,657
Percentage Change from Prior Year	3.1	3.3	3.6	2.5	2.7
End-of-Year Supply (000s)	3,768	3,910	4,043	4,172	4,290
Percentage Change from Prior Year	4.2	3.8	3.4	3.2	2.8

Table 2: PricewaterhouseCoopers RevPAR Forecast for Chain Scale Segments, as of June 2000 Annual Figures Percentage Change from Prior Year				
	1999	2000	2001	2002
Upper Upscale	4.3	4.0	3.0	4.4
Upscale	0.4	1.3	1.2	3.2
Midscale with F&B	2.5	2.5	2.5	2.8
Midscale without F&B	2.3	4.0	2.1	4.5
Economy	2.8	4.4	2.7	4.2

Table 3: U.S. Lodging Industry Statistics Segments and Regions Ranked by RevPAR Growth (Year-to-date May 2000)			
	RevPAR Growth	Supply Growth	Demand Growth
Chain Scale			
Upper Upscale	6.0	3.6	4.5
Midscale with F&B	4.0	0.4	0.3
Midscale without F&B	3.6	10.9	10.0
Economy	3.4	4.9	5.7
Upscale	3.2	8.0	8.2
Region			
New England	12.8	2.2	6.9
Pacific	9.6	2.2	5.4
Middle Atlantic	7.8	2.5	4.0
West South Central	4.4	3.8	5.3
South Atlantic	3.1	3.9	3.4
West North Central	2.8	2.6	2.1
East North Central	2.6	4.1	3.0
East South Central	0.5	3.0	1.1
Mountain	-0.1	3.6	3.4
Location			
Urban	6.9	2.4	3.8
Resort	5.3	2.6	2.6
Highway	5.1	3.6	3.5
Airport	5.0	3.4	4.0
Suburban	4.6	3.6	4.8
U.S.	**4.8**	**3.3**	**3.8**

Sources:

Tables 1 & 2: PricewaterhouseCoopers L.L.P. (2000 to 2002); Smith Travel Research (1998 to 1999)

Table 3: Smith Travel Research, *Lodging Outlook,* July 2000; *Chain Scale Trends Reports,* July 2000

CHAIN SCALE SEGMENT FORECASTS

With the exception of the *Upper Upscale* segment, RevPAR growth is forecast to rise moderately in 2000 and fall in 2001 across the five chain scale segments. *(Table 2.)* The only exception is the *Upper Upscale* segment where RevPAR growth is projected to decrease by 0.3 percentage points in 2000 as ADR growth slows to 4.7 percent in 2000 from 5.5 percent in 1999. By 2002, a sharp decline in supply growth will have a sizeable positive impact on RevPAR growth across all five segments.

The *Upper Upscale* segment will continue to lead in terms of RevPAR growth. This segment also has the highest occupancy rate. In the *Upscale* segment, RevPAR growth, in inflation-adjusted terms, is expected to be negative, largely due to falling occupancy rates. The performance of the *Midscale with F&B* segment is expected to be relatively weak. Demand growth will continue to decline in this segment as newer Upscale and Midscale without F&B continue to gain market share. The outlook for the *Midscale without F&B* segment will improve substantially in 2002 as the occupancy rate is expected to increase in that year. In terms of absolute occupancy rates, the *Economy* segment remains the weakest among the five segments. However, it is the only segment in which the occupancy rate is expected to rise or remain unchanged during the period from 2000 to 2002. The *Economy* segment's RevPAR is also expected to grow at a pace close to that of the *Upper Upscale* segment.

Consistent with our forecast, the January through May 2000 data from STR show that *the Upper Upscale* segment has posted the highest RevPAR growth of 6.0 percent. This is followed by the *Midscale with F&B* and *Midscale without F&B* with 4.0 and 3.6 percent RevPAR growth, respectively. *(Table 3.)* Year-to-date supply growth is very strong in *the Midscale without F&B* at 10.9 percent, which is tracked closely by demand growth of 10 percent. This contrasts starkly with the *Midscale with F&B* segment, which continues to register close to zero supply and demand growth.

REGIONAL PERFORMANCE

On a regional basis, the New England, Pacific, and Middle Atlantic regions continued to outperform the industry with continued strength in RevPAR growth based on year-to-date STR data through May 2000. *(Table 3.)* In first five months, these regions have posted moderate supply growth in the range of 2.2 to 2.5 percent combined with robust demand growth ranging from 4.0 to 6.9 percent. The performance of the Pacific region is not surprising given the favorable trends in the Los Angeles-Long Beach and San Francisco markets which together account for 21.4 percent of room supply in the Pacific region. The worst performing regions were the East South Central and Mountain, with 0.5 and -0.1 percent RevPAR growth, respectively.

Among the top 25 markets in terms of room size, the leading performers with RevPAR growth far above the national average of 4.8 percent in the year-to-date period are San Francisco/San Mateo, Boston, New York, Los Angeles-Long Beach, and New Orleans. These trends are supported by strong growth in the ADR. Boston and New York are key lodging markets. Boston accounts for approximately 26 percent of room supply in the New England region, while New York accounts for more than one-fifth of total room supply in the Middle Atlantic region.

The underperformers with negative or less than 0.5 percent RevPAR growth are Seattle, Philadelphia, St. Louis, and Phoenix. These cities are plagued with ADR growth that is below the inflation rate. Generally, the poor RevPAR performance is due to declining occupancies and weak ADR growth as a result of strong supply growth.

By location, urban properties achieved the highest year-to-date May 2000 RevPAR growth of 6.9 percent. *(Table 3.)* This was followed by resort and highway properties. The worst performing location was the suburban properties where RevPAR growth was 4.6 percent.

In summary, 2000 will be a positive year with RevPAR growth recovering from a trough in 1999 (the actual trough was during the first quarter of 2000). RevPAR increases will slow in 2001 primarily because of room supply, creating another trough in 2001. The year 2002 will be a strong year with RevPAR growth rebounding.$_{REI}$

NOTES

1. This macroeconomic scenario is based on assumptions developed as of March 2000.

ABOUT OUR FEATURED COLUMNIST

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FOCUS ON REITs

TAKING REITs PRIVATE

by Robin Panovka

Talk of taking REITs private continues despite the recent rebound in equity REIT stocks. Many smaller REITs have been left out of the multiple expansion being enjoyed by their larger peers and continue to explore strategic alternatives. While the renewed strength of the large cap REITs increases the possibility of selling out to a large competitor (who now can more easily manage a stock-for-stock transaction or perhaps even a cash deal), the option of going private is often an attractive alternative, particularly because of the continued healthy valuations in the private real estate markets. And from the perspective of financing sources, the gap between the Wall Street valuations for REITs and the private market values of the assets held by REITs presents an obvious opportunity. These dynamics have resulted in a number of successful LBO transactions in the REIT sector, and will likely result in additional activity.

While the idea of taking a REIT private is relatively simple, execution is often complex, in that it involves weaving through a number of business and legal constraints. Recent LBO activity in the REIT market and broader experience from other sectors provide a number of useful guidelines which should be kept in mind when evaluating a potential going private transaction involving a REIT:

- **Pricing Considerations.**
  It is important to understand at the outset that procedural constraints (outlined below), competition from other bidders, the value demanded by shareholders as an inducement to approve a transaction, and transaction expenses typically will push up the cost of the deal to a number which is not too far off from real value. Bargain basement bids (measured by real value, not just current stock price) usually attract competition, litigation, and other scrutiny, and are unlikely to succeed in their initial form.

- **Inability to Control Outcome.**
  Once the LBO process is initiated, the process often takes on a life of its own and the initiators (management and its financing sources) will likely lose control and be unable to assure a particular outcome. Management-led buy-outs typically result in auctions in which third-party bidders have the opportunity to compete with the insider group on a "level playing field." Also, importantly, the ultimate decision of whether to consummate any particular transaction and with whom generally rests in the hands of the shareholders.

- **Managing Conflicts of Interest.**
  LBOs and other going private transactions which involve management or members of the board of directors necessarily raise potential conflicts of interest. In the UPREIT context, there is an additional layer of conflicts because of the potentially divergent interests of the OP Unitholders and the shareholders. Procedures must

be implemented to ensure that potential conflicts do not taint the "fairness" of the transaction and result in shareholder litigation which has the potential to derail the transaction or expose the participants to liability. As a practical matter, this usually means that it is advisable to have the transaction evaluated and negotiated by a special committee of directors who do not have a financial interest in the proposed LBO. In order to provide the desired legal protection, the special committee should have independent financial and legal advisors, be well informed, and have the ability and bargaining power to negotiate on behalf of the public shareholders.

- **Enhanced Disclosure.**
  Extensive disclosure is required by Rule 13e-3 under the Securities Exchange Act – particularly with regard to contacts and negotiations leading up to the transaction – where the acquiror group includes management or any other affiliate of the target REIT.

- **REIT Rules.**
  In any transaction involving a REIT, consideration should be given early on to the impact of the special tax rules that apply to REITs and to the target REIT's charter provisions that are designed to preserve its REIT tax status. In that regard, careful thought must be given to the decision to continue the target's status as a REIT or to operate it as a taxable real estate company. The entity's ability to service its debt after the going private transaction and still satisfy the REIT income distribution requirement and the tax consequences of the loss of REIT status must be analyzed.

Properly planned and executed going private transactions, of course, often do succeed and yield the expected benefits. It is important, however, to set realistic expectations at the outset and to exercise care in threading through the legal, regulatory, and market challenges.REI

ABOUT OUR FEATURED COLUMNIST

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LETTER TO THE EDITOR

In response to the
CRE Perspective: ***Just Thinking About it is Illegal***
by Arnold S. Tesh, CRE
Spring 2000 (Vol. 25, No. 1) issue, pgs. 55 - 57

Dear Editor:

Arnold S. Tesh, CRE, in his CRE Perspective, " Just Thinking About it is Illegal," explores two themes which he then combines in argument. I take exception to both of his analyses and to his conclusion.

In one theme Tesh relates that appraisers should be licensed in the state "wherever they domicile a practice." That is "where the (appraisal) services are provided," therefore, that is where the state has "residents to protect" from "incompetent or unscrupulous practice." That seems okay at first reading. But he does not mean that appraisers should be licensed *wherever they practice,* but only wherever they domicile a practice. He writes that through well-intentioned initial mistake by a conscientious group acting in haste "(a)ppraisal licensing laws are based on where the property is located rather than where the services are provided." What results is multi-state licensing which, in Tesh's opinion is "truly unjust and unworkable," and "make it impractical ... to run a(n appraisal) business," and "does not prevent victimization" (of clients, or are they) "in any way helped or protected by ... a matrix of ... state licensing."

What particularly offends Tesh in this matter is his view that the very purpose of licensing is thwarted by the focus on the property to be appraised which he characterizes as "an inanimate object" and "a thing which just happens to sit somewhere." His rationale for eliminating multi-state appraiser licensing is that the client, not the real estate, needs the state's protection. These are the nub of my disagreement with him. What will be appraised are property interests or rights and obligations, which must be identified, defined, and recorded in the state where the property is located. Furthermore, whereas the users of the appraisal will be identified in (and may influence the nature of) the appraisal report, the client is immaterial to the market value opinion, inasmuch as *market value* as a concept presumes unidentified parties to the transaction. Whether for an actual market transaction (*e.g.* lease, mortgage, purchase) or a simulated market transaction (*e.g.* eminent domain, ad valorem, casualty loss), the transaction will occur in the state in which the real property is located, and those professionals upon which the parties and the state rely should be subject to rules that obtain there.

The other theme that Tesh explores in the article recognizes that some CREs strive to construe the counseling designation as conferring appraisal credentials. He notes that a division is meant to exist "between appraising and consulting or counseling." But asks: "where does one draw the line?" Here is my answer. All CREs are real estate experts who are familiar with valuation theory and market prices. Some CREs are acknowledged appraisal experts, whatever their occupations. And, of course, some of them are practicing appraisers. No CRE is permitted to appraise without having either, 1). an appraisal designation from an organization that is a Sponsor of the Appraisal Foundation, or 2). an appropriate current license issued by the appraisal board of the state in which the real estate is located. The consequence of that CRE rule is that no CRE may appraise without being subject to the Uniform Standards of Professional Appraisal Practice (the USPAP) as interpreted by the state's licensing authority. Well-settled regulatory law permits these state boards to adjudicate improper conduct while denying restraint-of-trade counter actions by the accused. The boards levy money-fines and suspend the right-to-practice, among other penalties, but the most severe punishment, especially for the high-profile appraiser, is publication in the appraiser's home-town press of the determination of guilt. Multi-state practitioners, and those who want to be, are advised that states' findings of appraisers' serious misconduct are posted against the appraisers' names on the Appraisal Foundation's national Web register; real estate litigators look at the register, as do appraiser licensing boards in all the states.

My answer continues. The USPAP is clear that one acting for a party to the transaction, or perceived as so acting, is not appraising, not consulting as an appraiser, and is not subject to Standard 4 even if licensed as an appraiser. It is the certain view of the Appraisal Foundation's Appraisal Standards Board (ASB), and of all state boards of which I am aware, that their regulation reaches no further than

appraisal consulting, by which they specifically mean when the assignment is to develop a recommendation "without advocacy." The ASB correctly states that "consulting is a broad term." The distinctive *counseling* process is not synonymous with "consulting. " The CRE (Counselor of Real Estate), as defined by The Counselors of Real Estate, ". . . is an advisor who ... directs ... efforts toward the clients' best interests through (among other aspects of the process) advocacy of the client's interest... ." A hard and bright line separates impartial opinions of market value (appraising) from efforts to advocate a client's interest (counseling). One appraises real property, but counsels clients.

The argument that Tesh mounts is that inasmuch as, ". . . bureaucracy has produced"a "nightmare scenario. . . for appraisal," and inasmuch as "all CREs will be facing in coming years" an unclear "line between appraising . . . and counseling, therefore, "... (c)ounseling as a profession is . . . in danger" of licensing, and, in fact, nightmare licensing. I am unconvinced by the argument. Admittedly, there was Standard 4 confusion for a time caused by false linkage of vague language. Patience and precision of speech by CRE leaders and staff and others, together with sound thinking and persuasion by some Appraisal Standards Board (ASB) members, have eliminated the earlier concern that state appraisal boards might seek to apply to Counseling the USPAP Rules under Standard 4 or Standard 5. On the other hand, the wording of the *appraisal consulting* Standard 4 precludes its use for development of either an *appraisal* or an *appraisal review*.

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Real Estate Issues publishes four times annually (Spring, Summer, Fall, Winter). The journal reaches a lucrative segment of the real estate industry as well as a representative cross section of professionals in related industries.

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Member and non-member authors are encouraged to submit their manuscripts to:
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See Editorial Calendar on inside back cover for deadlines.

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

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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 2000 William S. Ballard Award. All articles published in *REI* during the 2000 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 2000 recipient will be honored at The Counselors 2001 Midyear Meetings.)

James MacCrate, CRE, & David Peterson Receive 1999 William S. Ballard Award

The Editorial Board of *Real Estate Issues* was honored to recently present its 1999 William S. Ballard Award to James R. MacCrate, CRE, & David L. Peterson, for their article, "Land Investment in the 21st Century." It appeared in the Summer 1999 edition of *Real Estate Issues*. The honor, given annually by The Counselors of Real Estate, recognizes the author(s) whose work best exemplifies the high standards of content maintained in the organization's 25 year-old professional journal, *Real Estate Issues*.

The award-winning article examined some of the ways which U.S. land investment in the 21st century will be different from what we know today. As a baseline from which to analyze expected changes in risk elements and strategies, the authors first described the basic elements of risk and related strategies that are always present in land investment, followed by a review of recent history to see how land investment has changed over the past 10-15 years. The authors then looked ahead five to 10 years to predict which of today's practices and patterns will have changed - and how dramatically. They also examined how such changes could affect future returns and investment strategies.

Jim MacCrate, CRE, has been an active member of The Counselors since his invitation to membership in 1983. Currently, he has an independent real estate and financial investment consulting firm in the New York metropolitan area. He was formerly a director in the Real Estate Group at PricewaterhouseCoopers LLP in New York, where he was responsible for conducting the annual *National Land Investment Survey*. Jim has supervised and performed real estate valuation and consulting assignments on all property types, real estate operating companies, family limited partnerships, allocation of shares for UPREITs, swaps, and portfolios.

Based in Canada, **David Peterson** is an independent Internet business advisor, with extensive experience in bringing technological innovation to real estate and appraisal consulting practices. He monitors and reports on new Internet and web developments affecting the real estate industry and has taught in university and professional seminar settings in North America and Asia.

Funding for the Ballard Award is provided by the generous contributions of the William S. Ballard Scholarship Fund in memory of the late Ballard, also a Counselor of Real Estate. All manuscripts published in *Real Estate Issues* during 1999 were eligible for the award. The 2000 award will be presented next spring during the CRE Midyear Meetings. REI

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

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

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