

# REAL ESTATE ISSUES<sup>®</sup>

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Devaluation and Real Estate Values: The Argentine Case  
Arq. José R. Rozados, Arq. Germán Gómez Picasso, and Ricardo Ulivi, Ph.D.

The Residential Real Estate Market in Bishkek, Kyrgyzstan: Current Conditions and Prospects  
Gary Roseman

The Quantification of Corporate Real Estate Risk  
Forrest Huffman, Ph.D.

Who's Responsible for ADA Compliance—Landlords or Tenants?  
David Warren Peters

## INSIDERS' PERSPECTIVES

FOCUS ON INVESTMENT CONDITIONS  
Kenneth Riggs, CRE

FOCUS ON GLOBAL ISSUES  
Nicholas Brooke, FRICS

FOCUS ON THE ECONOMY  
Dr. Mark Lee Levine, CRE and Dr. Libbi Rose Levine Segev

FOCUS ON CONSTRUCTION  
Thomas Cox, AIA

## RESOURCE REVIEW

The Myth of Moral Justice:  
Why Our Legal System Fails to Do What's Right  
by Thane Rosenbaum  
Reviewed by Bowen H. "Buzz" McCoy, CRE

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# REAL ESTATE ISSUES

Summer 2004 Volume 29, Number 2

## CONTENTS

**i**

About The Counselors of Real Estate

**iv**

Editor's Statement

**1**

Devaluation and Real Estate Values: The Argentine Case

**BY ARQ. JOSÉ R. ROZADOS, ARQ. GERMÁN GÓMEZ PICASSO, AND RICARDO ULIVI, PH.D.**

In early 2002, Argentina devaluated its currency, the peso, which had been pegged to the dollar. As a result, the peso lost nearly 66% of its value in a few months. What impact did this major currency depreciation have on the values of residential real estate assets in Argentina?

What can investors learn from the Argentine experience to protect their real estate investments from currency devaluations? The evidence reported in this paper shows that location is they key factor in retaining value in dollars. The better the location, the higher the retention value, and the less desirable the location, the greater loss was suffered in real dollar terms.

**5**

The Residential Real Estate Market in Bishkek, Kyrgyzstan: Current Conditions and Prospects

**BY GARY ROSEMAN**

This paper includes an overview of the residential real estate market in Bishkek, Kyrgyzstan and a discussion of the features of the market that are traceable to the problems of the post-Soviet experience. Because of the development of legal and financial institutions in Kyrgyzstan, real estate markets have developed slowly. The analysis uses specific examples and some numerical information.

**10**

The Quantification of Corporate Real Estate Risk

**BY FORREST HUFFMAN, PH.D.**

The unique nature of corporate real estate decision making is a now a well recognized aspect of real estate analysis. The examination and quantification of corporate real estate risk is a fairly recent development in the literature in corporate real estate analysis. This paper extends the current state of the discussion of corporate property risk analysis by developing a basic paradigm for the quantification of real estate risk. We first lay the groundwork for the discussion on risk by beginning with a brief discussion of overall corporate risk considerations. We then extend the discussion to a consideration of corporate real estate risk. We develop the quantification of risk by proposing a scoring or index methodology and offer a few basic examples of how a very simplified index could be constructed. Following these general guidelines can allow consultants in this area to evaluate and quantify the risks of corporate real estate and to adjust those risks in a manner consistent with the overall corporate mission.

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## 16

Who's Responsible for ADA Compliance—Landlords or Tenants?

**BY DAVID WARREN PETERS**

Considerable misunderstanding has arisen between commercial landlords and tenants as to the responsibility of each for compliance with laws—as well as the defense and settlement of lawsuits—relating to access for the disabled, under common terms of commercial leases. Misconceptions about the obligations of commercial tenants under many standard commercial “triple net” and other leases, have caused many firms to close, dismiss employees and/or file bankruptcy—in many cases unnecessarily.

This article concludes that (1) in most cases, neither landlords nor tenants will be able to state, as a matter of law, that they are relieved from their responsibility to provide access for the disabled, and (2) the standardized terms of most common commercial leases most likely will not, in themselves, be sufficient to transfer this obligation from one to the other. For these reasons, commercial landlords, tenants and others may well be indispensable parties in ADA /access lawsuits, and leases should be immediately revised to clearly confirm responsibility for compliance with access laws.

## INSIDERS' PERSPECTIVES

### 25

Focus on Investment Conditions

**BY KENNETH RIGGS, JR., CRE**

### 27

Focus on Global Issues

**BY NICHOLAS BROOKE, FRICS**

### 29

Focus on the Economy

**BY DR. MARK LEE LEVINE, CRE AND DR. LIBBI ROSE SEGEV**

### 34

Focus on Construction

**BY THOMAS COX, AIA**

## RESOURCE REVIEW

### 36

The Myth of Moral Justice:

Why Our Legal System Fails to Do What's Right

**BY THANE ROSENBAUM**

**REVIEWED BY BOWEN H. “BUZZ” MCCOY, CRE**

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# CRE

## About THE COUNSELORS OF REAL ESTATE

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

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

CREs achieve results, acting in key roles in annual transactions and/or real estate decisions worth billions of dollars annually. 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.

### **ENRICHMENT THROUGH PEER ASSOCIATION, COLLABORATION, EDUCATION & PUBLICATIONS**

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

CRE members benefit from a wealth of information published in The Counselors' quarterly award-winning journal *Real Estate Issues* which offers decisive reporting on today's changing real estate industry. Recognized leaders contribute critical analyses not otherwise available on important

topics such as institutional investment, sports and the community, real estate ethics, tenant representation, break-even analysis, the environment, cap rates/yields, REITs, and capital formation. Members also benefit from the bi-monthly member newsletter, *The Counselor*, and a wide range of books and monographs published by The Counselor organization. A major player in the technological revolution, the CRE regularly accesses the most advanced methodologies, techniques and computer-generated evaluation procedures available.

### **WHAT IS A COUNSELOR OF REAL ESTATE (CRE)?**

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

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

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

responsibility of the client-counselor relationship.

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

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

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

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

# Editor's Statement

BY HUGH F. KELLY, CRE



THE FACE OF REAL ESTATE ISSUES HAS CHANGED, and that's a good thing because it reflects the understanding that the world of real estate itself is changing constantly. Staying abreast, much less ahead, of our industry's trends is an ever-present challenge. In keeping up, though, it is crucial to be able to separate flavor-of-the-month pseudo-issues from the very fundamental concerns that will shape the future. Looking back over the past decade or so, we can recall the business press and industry magazines being caught up with topics like these: "Will telecommuting herald the demise of the office building as we know it?" "Will the growth in Internet shopping turn malls into a dinosaur property type?" and, most recently, "How global outsourcing of white collar jobs will reduce the demand for U.S. office space by 600 million square feet." Relevance is an important selection criteria for *Real Estate Issues*, but is not an excuse for getting caught up in fads or what Charles Mackay termed "extraordinary popular delusions and the madness of crowds" in his classic treatise 160 years ago.

What would qualify as an issue of fundamental relevance? Well, of course, there is the "Potter Stewart Test" (We'll know it when we see it.), but few critically-minded professionals would be satisfied with that as the basic rule. We look for articles that impact real estate at its core, and have published enthusiastically articles having to do with the evolution of property rights around the world, and the responses of local markets to the advent of property rights in the sphere of influence of the former Soviet Union. The article by Gary Roseman treating the lessons emerging from Bishkek, Kyrgyzstan meets that criterion.

Within the U.S., we are interested in some legal issues affecting the property industry, but not all. For instance, David W. Peters' discussion of ADA compliance responsibility has widespread application, both for landlords and tenants, and raises thoughtful questions of how to identify problems and then what to do in structuring leases to constructively resolve those compliance responsibility issues. The scope of the subject and the likelihood that this issue will continue to call for attention for some time to come qualifies this as a fit subject, as much as its "timeliness" does. Articles on narrow legal issues, pieces whose subject is very location-specific without wider principles adduced, or merely tactical essays treating ways to exploit the inevitable loopholes arising from changes in the law have far less interest to us.

Essays that examine market adaptations to recurrent problems are relevant because they teach us lessons that can be migrated from one place to another, or from one cycle to another. In a world of floating currencies, changes in monetary unit value—whether through formal devaluation, large fluctuations in the exchange value of a currency, or the corrosive effects of inflation or deflation—clearly have an impact on real estate assets. And since currency volatility cannot be expected to go away, articles such as the excellent piece submitted by Rozados, Gomez Picasso, and Ulivi for this edition of *Real Estate Issues* merit our attention and qualify for publication.

Methodology articles are tricky. "Pure" methodology pieces, typically those relying on advanced statistical presentation to describe technique and whose "proof" comes in the form

of mathematical analysis alone, are generally not acceptable to us. That doesn't mean that they aren't correct, or even valuable in building the knowledge base. It is just that we are publishing a journal about real estate, not mathematics. Quantitative discussions can find a home here if they are directly concerned with the elucidation (not obscuring by overly fancy numerical footwork) of an identifiable and important real estate problem. We especially like it if the methodology proposes a viable solution to the problem discussed. Forrest Huffman's article on the quantification of corporate real estate risks is methodological in nature, but usefully lays out what the risks are, who bears the risks, and how they can be arrayed and stratified. The reader can dispute the selection of variable and their weightings, if there is reason for disagreement, but the article offers all of us a broadly applicable framework for thinking about an important ownership consideration.

Over the years, we have targeted quite a few "big issues" for treatment, publishing numerous articles under the subject headings of Globalization, Technology, Securitization, and other topics that are both timely and enduring. In the past year or so, we have been adding a direct focus on real estate education, believing that the pace and pervasiveness of change mean that all real estate professional need to attend to their own education, and that the industry needs to focus on preparing the next generation of executives to meet the demands of the

future. Certainly, we will be looking for good articles on elements of public policy, the impact of demographics and economics on real estate, and the needs of the industry in terms of leadership, enterprise development, and corporate governance.

Pragmatism has long been identified as America's one most significant contribution to the history of thought. Philosophers such as Charles Sander Pierce, John Dewey, and William James made a distinct contribution by insisting that the theoretical be linked to the practical, and specifying that concepts that are not verifiable in the world of action are, to a large degree, suspect concepts. In this sense, we intend *Real Estate Issues* to be a pragmatic publication, while adhering to a high intellectual standard in both form and content. We seek contributions that aim at this intended target. And we very much welcome (and will structure ways to incorporate) reader insights into topics we present or that you feel we ought to cover.

A new look is an outward sign of an attitude that embraces change, and we look forward to further, positive changes in what you will find between our covers in the *Real Estate Issues* to come. ■

**HUGH F. KELLY, CRE  
EDITOR IN CHIEF**

# Devaluation and Real Estate Values: The Argentine Case

BY ARQ. JOSÉ R. ROZADOS, ARQ. GERMÁN GÓMEZ PICASSO, AND RICARDO ULIVI, PH.D.

ON JANUARY 7, 2002, ARGENTINA ABANDONED THEIR EXCHANGE BOARD, a law known as the Convertibility Act, that pegged the national currency on a par value with the U.S. dollar. This left the peso's value to be determined by supply and demand of the dollar on the free market. As a result, the peso lost nearly 66% of its value in a few months compared to the dollar.

What impact did this major currency depreciation have on the values of real estate assets in Argentina? What is the past and present relationship that such a tremendous devaluation has had and is still having on the value of real estate assets? In what manner did it influence the quotations and transaction prices of residential units? Were these values evenly adjusted to the new financial situation? What was the influence of the law, passed in December 2001, prohibiting the withdrawal of bank deposits to avoid capital flight from banks and a programmed permission for the later withdrawal of these funds?

This paper will describe the changes in the value of residential properties and the significance of their geographical situation in this period of post-convertibility.

## BACKGROUND

From the year 1991 to December 2001, that is, for a full decade, Argentina was governed by a law that ensured the conversion of the peso at par value of one to one to the American dollar, known as the Convertibility Act.

Nevertheless, the price of home units, especially those located in Buenos Aires, the capital city of Argentina, was typically quoted in U.S. dollars. Common market practice held that real estate values were quoted in U.S. currency

or pegged to the dollar exchange quotation on the date of valuation.

Memories of hyperinflation and previous devaluation experiences caused Argentine savers to seek protection under the American currency umbrella as a means of taking care of their capital in face of possible economic upheavals.

During the second half of the decade of the '90s an average of 1,000 USD per square meter for apartment units in Buenos Aires was the usual price. There were, of course, various quotations for the different areas of the city which were related to the quality of the environment, means of transport, availability of commercial supplies, homogeneity of architectural styles and socio-cultural level of the neighborhood.

The northern part of the urban area was the one with the highest values. The other end of the city, the southern area, had the lowest valuation figures. The existing gap between prevailing values in either location quoted for units of similar building quality was rarely higher than 33%.

## About the Author

Architects Rozados and Gomez Picasso specialize in valuing properties in Buenos Aires, whether residential, commercial or industrial. Dr. Ulivi is a professor of finance at the California State University, Dominguez Hills where he teaches real estate and finance classes. (E-mail: professor@ulivi.com)

## Devaluation and Real Estate Values

Figure 1—Demand, Buenos Aires 1998 - 2003

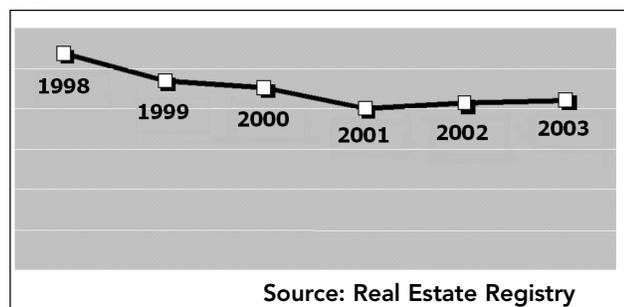
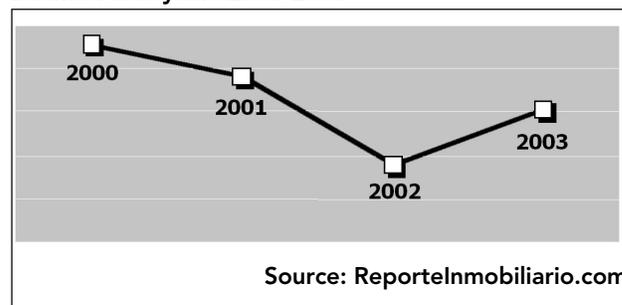


Figure 2—Supply, Apartments advertised in Buenos Aires years 2000-2003



### POST-DEVALUATION PANORAMA

The process that resulted in the currency devaluation in the first days of January 2002, started during the last semester of the preceding year. Previous to this situation, a financial crisis that resulted in an official restricting of cash withdrawals from bank deposits and savings (known as “*corralito*”) which would also effect the real estate market’s performance.

One of the first consequences of the financial crisis was a credit restriction that drained liquidity from the market-place.

Added to the restrictions on cash circulation, resulting from the “*corralito*,” there was a general uncertainty about the magnitude of the depreciation of the peso value with respect to the U.S. dollar. Strategically, pesos were quickly traded directly for dollars if at all possible.

As from the repeal of the legal exchange “*corset*,” the value of the American currency at the free exchange market went quickly from par up to double the value of the Argentine peso, reaching different levels that even quadrupled and later stabilized at 2.85 / 2.95 pesos per dollar unit by the first quarter of 2003.

The above situation was expected to cause a remarkable drop in real estate transactions but, in fact, that did not happen. The market had suffered a lot in the course of 2001; values had started a gradual decrease owing to the effects of consecutive years of economic recession, the political crisis resulting from the collapse of the financial system, and the local currency devaluation.

It was obvious that the devaluation was a point of inflection for assets but the number of transactions was kept relatively constant, experiencing a very positive peak when people were allowed to acquire properties with the money withheld in the banks. This was a result of fear and mistrust on the part of savers who felt that they would only in

the very long term, or perhaps never, recover their capital (April and May 2002; Figure 1).

During the first months following the devaluation and prohibition to withdraw money from bank deposits, the real estate market was in a state of chaos. Many local real estate operators as well as potential customers were completely mystified.

Prices of residential units went down about 30 to 40%. Initially, values were very unpredictable. Publications were quoting very contradictory prices and consequently, nobody knew the actual price of a property at the moment of valuation.

In fact, transactions were taking place for similar properties at prices differing about 50%; in addition, property offers dropped very quickly due to the discrepancy in values (Figure 2).

The price drop was larger in Greater Buenos Aires than in the rest of the provinces. In some places, properties practically maintained their peso value with the resulting huge U.S. dollar loss for the owners.

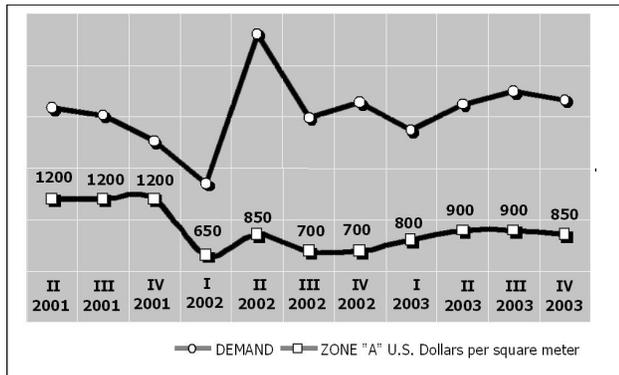
In Greater Buenos Aires (or areas in its periphery) and in the rest of the country, the number of purchase and sale transactions decreased: this was clearly noticeable from offer values. This market suffered a lot more than that of the Federal Capital. Values were adjusted more naturally to a domestic consumption economy.

*The best locations in the country maintained their previous U.S. dollar value.*

It is rather difficult to find a logical explanation for the above events but, basically, there were some significant factors. From the onset, it was widely held that foreign investors attracted by the drop in prices would come and buy property. In fact, that only took place on a minor scale. This leads us to think that this statement of “*expec-*

## Devaluation and Real Estate Values

Figure 3—Value, US dollars per square meter in Zone "A" - Demand



Source: ReporteInmobiliario.com, - Real Estate Property Registry

tations” was a ploy to induce uninformed customers to pay values that were unsustainable.

By November 2002, the relaxation of the freeze on bank deposits resulted in an increase in property demand and a rise in building activity levels, as a part of the 25 billion pesos freed from financial restrictions were channeled to the purchase of properties in better locations or private developments. Also, due to the rise in value of the dollar, construction costs were lower and the number of square meters that could be built with the same investment increased.

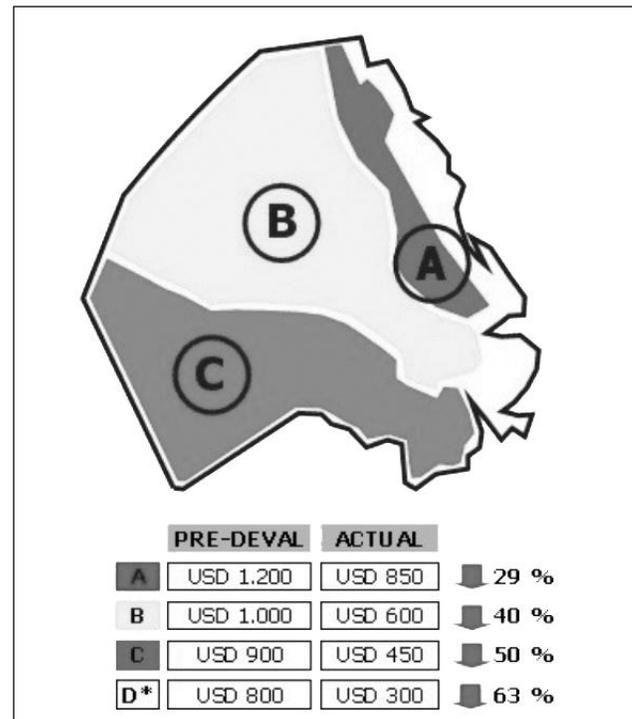
As a result of the lack of confidence in the financial system, a sum of approximately US\$7.5 billion was employed in the acquisition of well located properties in central areas, properties that were recognized by buyers for their high liquidity and unproblematic letting capability.

The flow of funds into real estate was increased by information and articles that, through the press, confirmed the advantages of “buying bricks” as a strategy for conserving values. This, combined with a total lack of faith in the financial system and a complete disappearance of low-risk investment options, kept values relatively stable (or depreciating at a very slow pace) in certain areas for a period of 28 months (December 2001 - March 2003; Figure 3).

*These conditions, which encouraged demand, caused an important value polarization and the price of well-located residential units decreased less than those of inferior location.*

In this manner, the gap in prices per square meter widened between the southern areas and those in the northern districts of Buenos Aires corridor, rising to 65%,

Figure 4



\*Peripheral Areas; Greater Buenos Aires area

Source: ReporteInmobiliario.com, - Real Estate Property Registry

doubling the difference in quotations existing in 2001. The map of values changed showing a general drop, with higher prices being maintained in better locations (Figure 4).

*At present, prices in the best-located areas are quoted at 80% of their dollar value previous to the devaluation, notwithstanding the fact that the peso lost approximately two-thirds of its value in respect of the American currency.*

Even today, values keep at levels that are higher than would be expected by any theoretical standards, if one bears in mind the fact that a property can only be sold on the local market.

### CONCLUSION

■ Real estate in superior locations maintained its value to a reasonable extent in the first two years following devaluation, enabling operators to reconsider and adapt their sales strategies.

■ The location of a property became the fundamental issue when purchasing decisions were made.

## Devaluation and Real Estate Values

- The scarcity of financing did not hinder the market as much as anticipated.
- A substantial change in the profile of buyers occurred, from homeowners to non-resident investors.
- Clients with no knowledge of the market too readily accepted as definitive values what was published in the press.
- Values in the market became polarized more than ever.
- If one measured the market in pesos (the Argentine currency) it generally went up and devaluation benefited the real estate market—if measured in foreign currency (assets in euros or dollars)—depreciated, but not in proportion to the Argentine currency devaluation.

The Argentine experience of devaluation, in respect of situations such as the one underwent and its impact on the real estate sector, is quite rich in lessons. The varied responses exposed the weakness of simplistic analysis that does not consider the multiple factors at work in a crisis. Many issues are not related to the area of economics, but

are more closely linked to cultural, sociological and subjective behavior. Perhaps operators in certain other world markets will be able to recognize patterns similar to those observed during the Argentine devaluation when reviewing the events that took place in our country. ■

### SOURCES

Reporte Inmobiliario, a weekly publication of real estate trends in Argentina. Can be found at [www.reporteimobiliario.com.ar](http://www.reporteimobiliario.com.ar)

# The Residential Real Estate Market in Bishkek, Kyrgyzstan: Current Conditions and Prospects

BY GARY ROSEMAN

THIS ARTICLE REVIEWS THE CURRENT STATE of the housing situation in Bishkek, Kyrgyzstan and examines the factors that influence price and availability, particularly the development of supporting institutions. The topic is relevant because security in and alienability of this asset, which is one of the few widely held tradable major assets in developing countries, is important in the development of vehicles for the accumulation and storage of wealth.

Over the last two years, price increases in residential real estate in Bishkek have generated much attention and analysis among residents of this capital city of Kyrgyzstan. Prices have risen by more than 100% over the months since the summer of 2002. Along with this growth in prices has come development in agency matters and mortgage lending. This article provides an overview of the market in Bishkek and a review of the ancillary changes that will affect the housing market.

## **BISHKEK**

The city of Bishkek, with population of 600,000, is the capital of the Kyrgyz Republic, a mountainous country in Central Asia along China's western border with over 5 million people. Over 90% of Kyrgyzstan, as it is commonly called, is 3,000 feet above sea level or higher. Named Frunze, after a Red Army general who operated in Central Asia, the city was the capital of the Kyrgyz Soviet Social Republic and changed its name to the Bishkek at the time of independence. Before its Soviet status, the city was called Pishpek and served as an outpost for the Russian Army in the 19th century expansion of the Tsarist empire into this region.

In the 1990s, after independence, the city became the base for organizations operating in the newly independent country. The Kyrgyz government made an effort to attract multilateral and aid organizations to the city, where the impact on the population, which was relatively small for a capital city, would be palpable. Organizations like the UN, TACIS, the Organization for Security and Cooperation in Europe, and even Helvetas, which brings Swiss expertise to the country's dairy industry, set up offices in the city. The country's proximity to Afghanistan made it attractive to the U.S. government after September 11, 2001 and the U.S. Air Force soon established a base next to the Bishkek's Manas International Airport, which is less than 25 miles from a Russian air base.

Most households in the capital live in apartments, with single houses becoming more popular. Single-family dwellings are usually located on the outskirts of the city, where residents must have transportation means to reach the city center, given the slowness of the municipal system.

## About the Author

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# The Residential Real Estate Market in Bishkek, Kyrgyzstan

## THE MACROECONOMIC SETTING

The Kyrgyz economy has stabilized over the last several years, with annual rates of inflation consistently averaging in the single digits and evidence of long-term economic growth emerging. These factors have in turn promoted stability of the currency against the dollar and euro and gains in the purchasing power of wages and salaries since the end of the 1990s.<sup>1</sup> With the new wealth of many Kyrgyz and few attractive investment alternatives, real estate has become a desirable asset for households with incomes above their spending needs.<sup>2</sup> The poor state and crowded conditions of much of the Soviet-era housing stock have also stimulated spending on renovation of existing structures, often on an individual basis.

Before independence, Bishkek was a russified city, with the majority of its population ethnic Russians. Currently, that ethnic group is about 20% of the city's population, reflecting a large emigration in the years following independence. With fears primarily of economic uncertainty, rather than ethnic unrest, many Russians with familial or professional connections to other post-Soviet republics emigrated from Kyrgyzstan. This migration resulted in a large quantity of housing for sale on the city's market, with a corresponding slump in real estate prices. At the current time, most Russian would-be emigrants with prospects in other countries have already left, and those who remain face more favorable economic prospects. The days of large out-migration have ended, thus removing large supply shocks that come from excess property caused by the outflow. However, migration to the capital, as is common in developing countries where business opportunities are less available in the smaller cities, adds to a steadily growing demand for housing in Bishkek.

With the beginnings of economic growth and an emerging number of households with incomes to devote to housing of better quality than Soviet-era stock, the process of "euroremont" is more common. This process covers fitting apartments with Western or South Korean appliances and fixtures, in-house hot water heaters, plastic-framed windows that seal better than the wooden Soviet-era frames, and flooring that is more even than the traditional parquet or the heavily coated plank floors. Often these renovated and improved apartments exist in Soviet-era apartment buildings alongside unimproved units. The process of euroremont covers the interior of a unit only and may exist in a building with poor lighting, littered

entrances, unpainted stairwells, and overgrown courtyard areas outside the buildings.

## CONSTRUCTION

As stated, increases in available supply are no longer subject to the shocks produced by emigrating residents. Increases in the overall volume of housing in the country have been slow, with little new construction. For example, the amount of new residential space reported by the National Statistics Committee increased by 0.7% in 2002.<sup>3</sup> Explanations for this creeping pace in construction have been insufficient financing and deficiencies in the legal framework.<sup>4</sup>

The lack of financing is evident in the bias toward short-term credit in the country. In 2003, nearly 60% of credit issued by the banking sector was short-term, defined as being less than a year in duration.<sup>5</sup> Consistent with this the lack of long-term credit, mortgage lending is rare and the terms are not as favorable as in the West, with one major participant in the mortgage business offering terms of 50-60% of purchase price financed for a maximum of five years with an annual interest rate of 20%, for a dollar-denominated loan.<sup>6</sup> Such terms are similar to those on offer from other lenders in Bishkek. Mortgage lending is a new concept in former Soviet republics. To increase the familiarity with the principles and opportunities, Western organizations arrange training seminars with participants from the major Kyrgyz banks. But the practice has not sufficiently increased to address adequately the financing needs of the housing construction sector.<sup>7</sup> Even the estimate that 10% of current real estate transactions involve mortgage credit<sup>8</sup> means that new construction must generally be financed by prepaying buyers. These first pay and then wait for a year or more for the building of their housing units, followed by some term in fitting out the units with fixtures and flooring.

Tenancy rights also hinder the development of mortgage lending. The land code prohibits seizure of a residence to satisfy debts. This legal restriction limits the value of a real estate asset as a means of securing credit. However, with the low percentage of the value of an apartment purchase financed, lenders can recover a great portion of the value of a loan by seizing personal assets. Also, some lenders will base their credit decisions on the ability to seize income from a debtor in the event of a default, so that mortgage borrowers are often in some way connected professionally or personally with a mortgage lender.<sup>9</sup>

# The Residential Real Estate Market in Bishkek, Kyrgyzstan

Table 1—Average Prices of Apartments in Bishkek, by Type\* (Standard Deviations in Parentheses)

Apartment Type	June 8, 2004	Observations	June 15, 2004	Observations
1 Room	7.81 (2.62)	91	8.30 (3.14)	80
2 Rooms	13.06 (4.96)	193	14.08 (4.46)	115
3 Rooms	18.61 (7.07)	137	19.77 (7.51)	130

\*The observations for June 8 are from Vechernii Bishkek , pp. 3-7, 10 and the June 15 observations are from Nedvizhimost, pp. 10-12. The differences between the average prices for a given type (1-room 2-room, 3-room) on the two difference dates are not statistically significant.

Legal issues also limit construction. In Soviet times, the state-owned apartment buildings and the land underneath the buildings. With privatization in the 1990s, the housing units passed to individual owners and the land underneath, along with the buildings' common spaces, passed to a partnership in which the residents of the building all owned shares. However, ownership boundaries of the land around the buildings were not clearly defined and disputes have arisen over who owns the right to use the land. The municipal government has in some cases granted or sold permission for construction on land assumed to be owned by the nearby apartment building, but the legal status of these permits has not been decided on the national level. Also, the pipes and power lines leading to an apartment building remain the property of the utility suppliers, but often these entities are poorly funded state entities with limited means for repairing or even maintaining these assets, so damaged pipes or power lines often remain that way for uncomfortably long periods. Land ownership issues prevent the commencement of some construction projects and banks are reluctant to issue credit on properties with tenuous ownership rights to some of the features that affect its value, like bordering space and infrastructure.<sup>10</sup>

## PRICES

Because of the growing prosperity among a significant number of people, the reduction in emigration, and the lack of new construction, housing prices have risen significantly. Estimates are that prices have doubled in the last 18 months.<sup>11</sup> Property in the center is the most desirable. Ground floor units are highly valued. Extras like the quality of refurbishment add significantly to an apartment's

value, as in other former Soviet Republics. Apartments are advertised by the number of rooms, with a one-room apartment corresponding to a studio apartment in the United States, a two-room apartment to a one-bedroom apartment, and so on. Most apartments have three or fewer rooms. Prices (expressed in U.S. dollars per square meter) range from \$200 to \$300 per square meter for local-standard property, with sizes averaging about 27 square meters (290 square feet) for a one-room apartment, 47 square meters (505 square feet) for a two-room apartment, and 72 square meters (775 square feet) for a three-room apartment.<sup>12</sup> As illustrated in the table below, recent data indicate that apartments in Bishkek range in price from about \$7,000 - 8,000 to close to \$20,000. The averages mask a great deal of variety in the location and other amenities of a given property. The data for the table come from two publications in which local-standard properties are usually advertised, thus minimizing the effects of euroremont, or Western-standard property, on the prices below.

Because sale prices are often underreported for tax considerations, advertised asking prices are often the source for construction of price data in a post-Soviet market.<sup>13</sup> The advertised prices in Bishkek are expressed in dollar terms in denominations of \$1,000, with one place to the right of the decimal, so that an example is \$9,5, which Americans would write as \$9.5, for the price of \$9,500. The two columns of prices are from two weekly real estate periodicals available in Bishkek, *Kvartira* (in English, "Apartment") and *Nedvizhimost* ("Real Estate" in English) from one issue each in the month of June. Both periodicals are primarily advertising and informational vehicles

# The Residential Real Estate Market in Bishkek, Kyrgyzstan

for individuals and agents in the city's real estate market (Table 1).

## **AGENTS**

Partly because of the novelty of the profession in Kyrgyzstan, agents have received attention and some blame with the increase in real estate prices. However, as in all economies, agency arose because of the position's role in producing and disseminating information about the market and the provision of specialized procedural information. In an economy where the buying and selling of real estate was a heretofore rare occurrence for the vast majority of individuals, agents provide a valuable service. For example, the time between conclusion of a sale which, for residential sales is often in cash, and the recording of the transfer by the state can be several months.<sup>14</sup> The rights of ownership are not recognized by the state until this recording so, in the meantime, agents are needed to protect the integrity of the sale from unforeseen changes in this interim period. These procedural and paralegal functions of agents induce market participants' willingness to pay agents' commissions.

The need for agents in the Bishkek real estate market arose recently, as in Soviet times the function did not exist. Agents generally work for sellers and charge 3-5% of sales price as a commission. Renters, and particularly short-term foreign visitors, engage the services of agents for finding apartments with euroremont features. In this case, agencies typically charge the lessor one-half of one month's rent for the services, which include bringing together the two parties, providing advice on terms of a lease, and providing information to each party about the reputation and risk of dealing with the other party. Most

agencies will combine commercial and residential real estate operations in the same firm. Because of the sudden appearance of the functions of agents, the Association of Realtors of Kyrgyzstan was founded in June 2002, with sponsorship from USAID and Chemonics, as an umbrella group designed to promote professionalism and training in areas such as appraisal and valuation, codes of ethics, and, because of the novelty of the practice in Bishkek, the use of mortgages. Currently, 11 agencies in Bishkek belong to the Association with 15 or more agents employed by each firm.<sup>15</sup>

## **PROSPECTS**

The residential real estate market in Bishkek is in the process of development. For a more vigorously growing housing sector, legal and financial institutions must stabilize. With sound economic growth and low inflation for the past several years, long-term credit will expand if sanctioned by a reliable legal system, and with this expansion, mortgages will continue to develop. This will provide the means for households to own property and for construction companies to have access to funds.

Some institutions conducive to a well-functioning real estate market are developing. Agencies are known and advertised, and the professionalization of the role is proceeding. Awareness of the utility of agents in property transactions is becoming more understood. Privatization has occurred and rights to apartment units are undisputed. With a stable currency and continued economic growth, the advent of a consistently growing demand for housing should, in turn, be met with a continued growth from the supply side.

# The Residential Real Estate Market in Bishkek, Kyrgyzstan

## ENDNOTES

1. National Statistics Committee, Sotsialno-ekonomicheskoe Razvitie Kyrgyzskoi Respubliki, 2004, p. 116 and National Statistics Committee, Kyrgyzstan in Figures, 1999, p. 227.
2. Vechernii Bishkek, March 26, 2004, p. 8.
3. National Statistics Committee, Sotsialno-ekonomicheskoe Razvitie Kyrgyzskoi Respubliki, 2004, p. 135.
4. While treated separately, the two issues are related. Property rights must be mortgagable (see Olga Kaganova, "Urban Real Estate Markets in Russia: The Current State," Real Estate Issues 18 [1998], pp. 30-35).
5. National Statistics Committee, Sotsialno-ekonomicheskoe Razvitie Kyrgyzskoi Respubliki, 2004, p. 101.
6. Advertisement, Bishkek, June 2004.
7. A. Decker, Conversation, Bishkek, June 8, 2004.
8. Vecherniy Bishkek, March 26, 2004, p. 8.
9. Kaganova (1998) also reports that mortgage loans were difficult to obtain in Russia in the early 1990s unless the borrower had close relations with a bank (p. 33).
10. S. Gradwal, Conversation, Bishkek, June 15, 2004.
11. Vechernii Bishkek, March 12, 2004, p. 6
12. These averages are taken from the apartments in Kwartira, June 8, 2004 that listed sizes. Most of the apartments listed did not indicate area.
13. see Kaganova (1998), pp. 32-34.
14. Discussions of agencies and the public perception are in Verchenii Bishkek, March 12, 2004, p. 6 and March 26, 2004, p. 8.
15. T. Semenchenko, Conversation, Bishkek, June 15, 2004.

# The Quantification of Corporate Real Estate Risk

BY FORREST HUFFMAN, PH.D.

THE ANALYSIS OF THE DECISION-MAKING FRAMEWORK for the efficient usage of corporate real estate assets is a growing aspect of the analysis of real estate assets in general. For example, the major academic literature has devoted significant space to corporate real estate issues.<sup>1</sup> One of the more recent developments in corporate decision making is the consideration of real property risk (Huffman, 2002). The rather recent, and to some extent belated, attention to real estate risk analysis is not surprising since the consideration of corporate risk analysis in general is one of the more recent developments in corporate finance and corporate strategic management. This paper offers some insight to consultants and analysts by attempting to quantify the risk inherent in property usage and summarize these measurements into a score or index that can be used to represent the real estate risk exposure of an individual firm. To that end, this paper first considers the analysis and measurement of corporate risk. We then extend the discussion down to the property level. We develop the concept of a risk score and offer a basic example of how such an index could be constructed. We begin with a discussion of the risk concept.

## RISK DEFINITION

Risk in general can be defined and measured in several ways. An early definition of risk was that risk is associated with the probability of an event (Baird and Thomas, 1985). Given that corporate decision makers rarely know every possible outcome, the precise determination of probabilities (and thus overall probability distributions) is difficult. Today, risk, especially in corporate finance, is most often measured in terms of the variance (or its square root, the standard deviation) of expected returns. Unlike the determination of probabilities, which is to some degree subjective, the variance of returns can be estimated so long as sufficient data on past returns are available.<sup>2</sup> The variance in

returns, in effect, sets the boundaries of uncertainty or the “riskiness” of a particular venture.

One difficulty in the use of variance of returns lies in the need for sufficient return data from which to calculate variability. Investment real estate suffers from this shortcoming. Each piece of real estate is, to some extent, unique. Although rental income can be estimated, the lack of sales prices makes determining capital values cumbersome. Corporate real estate assets would also suffer from the lack of information on returns.

A more fundamental problem for the corporation exists in the need to be able to translate specific risk exposures, such as from the use of debt or the impact of poor human resource decisions, into a suitable estimate of the impact on returns. That is, a major weakness of the use of returns and return variability as a measure of risk is that generally the underlying causes of that variability and their specific impacts on variability are often unknown.

## CORPORATE RISK MANAGEMENT

The relevant aspects of corporate risk management really began in the 1980s with the development of models of corporate risk taking. Baird and Thomas (1985) was one of the first attempts at development of a model that would encompass the various components of corporate risk exposure and the development of corresponding corporate risk policies. Much of the early discussion centered on the true

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# The Quantification of Corporate Real Estate Risk

relationship between corporate risk and corporate returns. The discussion was crucial since one early study, Bowman (1980), found that, contrary to general accepted theory, risk and return were negatively related.

Subsequent studies amplified and extended the relationship between risk and return such that it became clear that while there might be some circumstances where firms might accept higher risk for lower returns, the expected positive relationship generally held true.<sup>3</sup>

Current corporate risk assessment models entail an analysis of specific risk exposure and a consideration of their impact on returns as discussed next.

## **CORPORATE RISK MEASUREMENT AND REPORTING**

Corporate risk management is rapidly being integrated into the corporate culture. Barton, et al (2002) propose an “enterprise-wide” risk management strategy that manages all corporate risks together. They specify a three stage model for corporate risk assessment that consists of risk identification, ranking and measurement. Other techniques are the plotting of functions to assess the effect of corporate risk exposure on revenues, earnings and shareholder values; and the development of scenarios to identify key risks and their impacts.

The key element to all of these strategies is the identification and impact assessment of corporate risks. Assuming major risks can be identified and quantified in some way, the next step might be the development of an overall risk index for the firm; in effect, an enterprise-wide numerical representation of the risk exposure of the firm.

A major shortcoming in the assessment of specific corporate risks is that there is very little detailed reporting of specific risk exposure for any corporation. Annual reports of U.S. corporations are required to enumerate various risk possibilities. Along other filings with regulators, these reports give some idea of the financial health of the firm and its vulnerabilities. But recent events such as the collapse of Enron, World-Com and others illustrate that current GAAP financial disclosure requirements are far from perfect.

One of the difficulties in the reporting of risks is often that the corporation is unaware of its vulnerabilities. As Thornton (2002) notes, firms report very little on how they assess, monitor and mitigate specific corporate risks and the firm may have little understanding of its risk exposure or be unable to predict what may happen.

Thornton describes the impact of a purchase by Halliburton Company of Dresser Industries in 1998. Although Dresser Industries’ exposure to asbestos liability was known and accounted for, Halliburton subsequently discovered that its losses were not indemnified as expected.

Barton et al, (2002) discusses some corporate characteristics that could be used to develop an index of corporate financial prospects. Relevant items range from the existence of off-balance-sheet liabilities, the presence of management experience and the size of the corporate audit staff. Other third-party assessments of corporate risk exposure are available.<sup>4</sup> Bond ratings by Moody’s and Standard and Poor can give indications of the financial health of the firm, particularly its default risk on corporate debt. Also, the reporting of betas, which measure the volatility of the firm relative to a market benchmark, is available. However, these estimates of the firm’s well being do not reveal the specifics that the rating agency used.

At least one risk index of corporate risk has been developed. CCN Business Information, an English commercial credit information company, has developed an index that estimates the likelihood of company failure. The firm uses information on over one million UK companies to create the index (CNN, 1994).

## **CORPORATE REAL ESTATE RISKS**

Executives face a number of risks in managing corporate real estate assets. Most important are varied risks associated with property development. The risks incurred in development activities run the gamut from financing risk to physical risks to regulatory risk (Huffman, 2002).

Bajai (2001) examines the risks associated with construction and bidding (or cost estimation) specifically. A number of factors enter into the decision to bid. Most relevant to corporate decision makers in estimating the construction costs of corporate facilities would be such variables as the size of the project, duration, and the state of the market.

Real estate development also entails significant interest rate risk associated with construction loans, the effect of interest rates on the demand for rental space, and the effect of interest rates changes at any future sale or refinancing. Cameron, et al (1990) illustrates various meth-

# The Quantification of Corporate Real Estate Risk

ods of offsetting interest rate risk including the use of interest rate caps, collars and swaps. However, given the multitude of activities comprising real estate development, no single risk management strategy can suffice.

Risks that can be incurred outside the development sphere include the financial risks incurred in leasing, purchasing and the potential reversion of the asset; and various physical risks such as design weaknesses and site and location risks. Corporate real estate will also be burdened by the risks associated with the regulation of such assets by a host of local, state and national agencies (Huffman, 2002).

As noted above, one of the more difficult risks is assigning accurate values to corporate real property. According to Brueggeman, et al, (1990), one of management's greatest challenges is to capture "hidden value." The underestimation of corporate property assets artificially depresses share values and can provide the incentive for hostile takeovers.

## **REAL ESTATE RISK IDENTIFICATION**

Despite the difficulty of quantifying corporate risks and more particularly, real property asset risks, any legitimate attempt in risk assessment must eventually arrive at an overall determination of the corporate real estate risk exposure of the firm. Such a risk index would require an identification of specific real property risks affecting the firm and attempt to measure or rank these risks. An overall risk index could then be developed based on the identification and assessment stages.

Following the developments in general corporate risk assessment, the first step in creating a real estate risk index would be to identify the appropriate factors inherent in the control and use of property. The next step is to attempt to measure or rank these risks. Using a standard index or scoring methodology, an index could then be constructed.

A discussion of specific risk identification can be found at Huffman (2002). Specific risks would include, at a minimum: development risks, financial risks, physical risks and regulatory risks. To recognize the risks associated with potential hidden values, one could also include a risk factor to account for other risks such as under-valued (over-valued) real estate assets. These risk measurements could then be compared, or added to, other corporate risks and risk measurements to integrate real property risks with the overall corporate risk profile.

Looking at development risks first, corporate real estate development is perhaps the single most important real estate risk exposure to the firm since it encompasses many other related risks and thus significantly increases the risk exposure of the firm. This exposure would require a significant risk premium or ranking.

Financial risks would be a function, to some extent, of the firm's preference for owning over leasing. Ownership would require the consideration of potential mortgage default risk, property management risk, and perhaps most importantly, reversion risk. Leasing, on the other hand, would require the measurement of the risk exposure associated with lease terms, particularly their length. It would also consider the risks associated with escalations, increased expenses under a net lease and the amount of space leased.

A measurement of physical risks would require a determination of the amount of functional obsolescence in various buildings and improvements such as parking lots, etc., as well as an assessment of site and locational strengths. Regulatory risks involve the consideration of environmental and, other land regulations and restrictions.

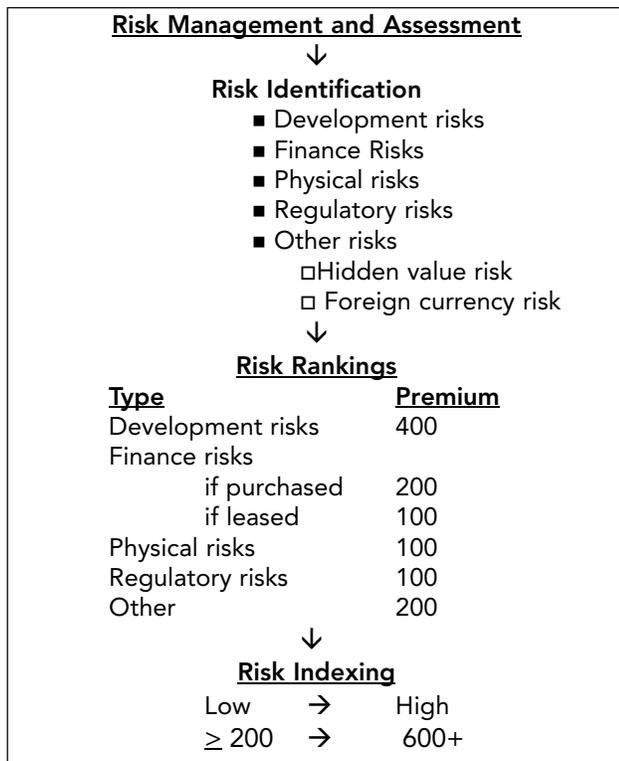
## **RISK MEASUREMENT AND RANKING FOR CORPORATE REAL PROPERTY**

A vexing problem that one must face in the quantification of any risk exposure is that risk premium assessment, magnitude and structure may not be the same for all participants. In fact, it should be expected that they would not be. Risk assessments are, to some extent, arbitrary, since risk determinations themselves, are subjective. This simple truism presents several thorny problems in the construction of any risk measurement system. For instance, is development more risky than, say, the real estate risks associated with regulation? Most might think so but what about those for those with substantial experience and the ability to minimize the risks of development through the use of options, hedging and insurance and bonding?

If we can all agree on a basic risk hierarchy, how does one determine the basic unit of measurement? Is development 100 points more risky than the risk exposure due to local regulatory restrictions? 200 points? 1,000 points? How much risk does each unit of measurement capture? Thus any numbering scheme may hide a multitude of assumptions regarding the risk averseness of the participating firm.

# The Quantification of Corporate Real Estate Risk

**Figure 1—Corporate Real Estate Risk Index Development**



Source: Huffman (2002) and text.

Once we arrive at a basic premium structure, we must decide how to levy these assessments across the firm. That is, is it likely that a multi-national firm with thousands of pieces of real estate is only 500 points, say, more risky than a small firm with a single piece of real estate? Another way might be to evaluate each real estate holding individually and aggregate into a total score for the entire firm. Sub-aggregates might also be employed such that, for instance, all holdings of land receive one score, while buildings of various types are scored as a group. Given any number of complicating factors, any risk premium construction mechanism illustrated here can only be a first approximation of any risk index. For illustration purposes we use a constant scale model in which all firms are scored on the same scale, ie, 1-1,000.

However, some rules will apply. For instance, we can assume that all firms are risk averse and will only accept higher risks by receiving an appropriate 'return' and an appropriate ranking. Secondly, some risks, specifically development risk, will be ranked higher than other, less potentially damaging risks. With these general rules in

mind, we illustrate how a corporate real property risk index might be constructed (see Figure 1).

The usual first step in constructing an index is to establish a base value. The Consumer Price Index is calibrated to a base value of 100.<sup>5</sup> For illustration purposes and keeping simplicity in mind, we decide to set a base value at 1,000 points. Our next task is to allot points across the various risk exposures.

Of the total 1,000 points, we allot 400 points to development risk exposure. In effect, development risk would then constitute 40% of the total real estate risk exposure to the firm. Since many firms will never engage in development, this development risk premium will for many firms equal zero.

Taking each of the remaining risks in turn we look next at the purchase/lease decision. The purchase/lease decision is probably the most critical financial decision for most corporations since the result is easily translated into financial statements and the firm's bottom line. Since the decision is an either/or proposition, we look at the two choices in tandem.<sup>6</sup>

Possession by purchase or lease of an existing structure could be thought of as possession without construction, where construction includes development activities such as construction financing, permit approvals, environmental issues, design requirements, location analyses, etc. Taking possession of an existing building, by purchase or lease, eliminates the volatility (or uncertainty) in these actions. Looking at the ownership alternative first, we rank ownership risk premiums at 200 points total. A portion of these points would be allocated to financing risk, including default risk.

Leasing eliminates much of the uncertainty associated with ownership, in particular the risks associated with disposition. Furthermore leasing does not expose the firm to mortgage default risk. We therefore begin our leasing premium at 100 points (essentially one-half the exposure of ownership). Risk premiums would fall to the extent the firm can negotiate significant options for renewal and avoid the pass through of various expenses.

We next assign a risk premium for physical risks of 100 points with approximately half of this premium allotted to various location risks. We allot 100 points to various regulatory risks such as zoning restrictions. Finally, in the

# The Quantification of Corporate Real Estate Risk

**Figure 2—Real Estate Space Needs**

The firm is a service corporation currently occupying 40,000 sq. ft. of Class B office space, located in central city with good proximity to clients. Firm is currently leasing on a gross rent basis with options to renew at third and fifth years. Lease includes rent escalations based on inflation adjustments with a maximum adjustment of 5% annually. Firm is responsible for cleaning and maintenance. Firm is anticipating expansion of space needs due to new hiring and will be in the market for an additional 10,000 - 20,000 sq. ft. in the near future. The firm has expressed its desire for leasing in the same general area under approximately similar conditions and terms. The firm may consider a move to Class A space if lease terms are acceptable.

**Risk Identification and Quantification:**

1.	Development Risk	0
2.	Financial Risk	
	■ Lease only	
	■ Gross with CPI adjustments (capped)	25
	■ Class A rent exposure	25
3.	Physical Risks	
	■ Parking and congestion	25
4.	Regulatory Risks	25
5.	Other	25
<b>TOTAL SCORE</b>		<b>125</b>

(Risks allotted in 25 point increments for illustration purposes)

Source: text

other category, we assign the remaining 200 points to account for miscellaneous and unique risks faced by specific situations. These might include the failure to mark real estate values to market, foreign market risks, unusual location risks and so on. Note that the failure to mark to market might affect lessees as well as fee simple owners. Lease terms may have value in a rising market or costs to the firm with fixed lease payments in a declining property market.

Figure 1 shows a potential index range with potential total values from about 200 points to 600+. A score at the low end of the scale would indicate a firm that does not develop, prefers to lease with gross leases or minimal pass

**Figure 3—Example B: Moderate Risk Firm**

**Real estate space needs:**

Firm is small firm with a national market for its products. The firm currently holds fee simple ownership of 50,000 sq. ft. of office space plus a 150,000 square foot production and distribution facility in suburban area close to interstate highway. Firm is currently looking to expand production, subject to potential development incentives in current location. Firm would consider taking an option on an appropriate site in immediate location until location decision is reached. Firm will negotiate build-to-suit facility with local developer. Additional square footage would be in the 50,000 - 60,000 range. Final decision will be dependent upon analysis of various location alternatives.

**Risk Identification and Quantification:**

	Current	Proposed
1. Development Risk	0	200
2. Financial Risk		
■ Ownership	200	200
3. Physical Risks		
■ Design and Location Risks	25	100
4. Regulatory Risks	25	50
5. Other	25	25
<b>TOTAL SCORE</b>	<b>325</b>	<b>575</b>

through of expenses and has little exposure to physical, regulatory or other risks. A high score would indicate a firm that develops its own properties, holds fee simple ownership and does not offset the remaining risks significantly.

Figures 2, 3 and 4 present three examples of firms with differing real property risk characteristics and how a risk score might be calculated for each. Firm A has minimal risks associated with leasing efficient facilities at market rents with relatively few physical, regulatory and other risks. Firm B is larger and facing the possibility of expansion and developing the proposed space. Finally, Firm C is a large international corporation with over 3,000 locations. Corresponding risks thus range from below 200 to a risk index of 900.

**CONCLUSIONS**

Although the above is certainly only a crude approximate measurement, the basic components necessary for the creation of an index are present. The essential risk exposure

# The Quantification of Corporate Real Estate Risk

**Figure 4—Example C: High Risk Firm**

**Real estate space needs:**

The firm is one of the largest retailers in the world. The firm operates over 3,000 stores in 10 countries. Stores are can be divided by size into neighborhood stores, standard, and "Supercenters." The average size of a neighborhood outlet is 44,898 square feet, standard outlet average size is 96,875 square feet and Supercenters average over 186,000 square feet. The firm aims to increase productivity, pass cost reductions to consumers and provide as complete an inventory for sale as possible. The firm expects to add 50 million square feet of new space in the 2005 fiscal year based on expected net sales growth of about 12%. The firms prefers free standing "big box" stores in rural and suburban areas but is moving into higher density areas as opportunities arise.

**Risk Identification and Quantification:**

1. Development Risk	300
2. Financial Risk	
■ Ownership	200
3. Physical Risks	100
■ Functional Obsolescence	
4. Regulatory Risks	100
5. Other	200
■ Miscellaneous foreign	

**TOTAL SCORE 900**

of the corporation's real estate assets has been identified, measured, and indexed. Certainly each corporation will have differing risk factors with differing weights allotted to each factor but the basic risk index structure is evident. Following these general guidelines can allow analysts to evaluate and quantify the risks of corporate real estate and thus be able to adjust those risks in a manner consistent with the overall corporate risk profile. The next step in the development of corporate risk index measurement would be to refine the index to more accurately reflect specific circumstances and premium structures.

It also must be noted that the values for corporate real estate risks identified and measured here are for illustration purposes only. A significant evaluation and reporting process will have to be developed before analysts use these techniques to assess the real estate risks of any specific corporation.

**ENDNOTES**

1. See, for example, the second special issue on corporate real estate by The Journal of Real Estate Research, Vol. 17, 3(1999).
2. The use of probabilities is a major component in the development of Monte Carlo simulations. Other measures of risk are the use of expected values and the adjustment of returns using certainty-equivalence. See any university level finance text for details.
3. See, for instance, Figenbaum and Thomas (1986) and (1988) and, more recently, Bromley (1991). The basic premise underlying the acceptance of higher risk is the necessity of achieving a corporate "target" rate of return which in turn requires the firm to become a higher than usual risk taker.
4. See "CNN Scores with Risk Index," 1994.
5. The base value of the Dow Jones Industrial Average Index is a price index in which the per share prices of the 30 firms was totaled in the base year and then divided by a divisor such that the base value (100) is derived. Unfortunately real estate risk premiums are much more difficult to price.
6. For a more detailed discussion of the purchase/lease decision, see Deeble (2000).

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# Who's Responsible for ADA Compliance—Landlords or Tenants?

BY DAVID WARREN PETERS

CONSIDERABLE MISUNDERSTANDING HAS ARISEN between commercial landlords and tenants about the responsibility of each for compliance with laws—as well as the defense and settlement of lawsuits—relating to access for the disabled, under terms of many common commercial leases. Misconceptions about the obligations of commercial tenants under many standard commercial “triple net” and other leases have caused many firms to close, dismiss employees, or file bankruptcy—in many cases unnecessarily.

This article concludes that (1) in most cases, neither landlords nor tenants will be able to state, as a matter of law, that they are relieved from their responsibility to provide access for the disabled, and (2) the standardized terms of many—if not all—common commercial leases most likely will not, in themselves, be sufficient to transfer this obligation from one to the other. For these reasons, commercial landlords, tenants and others may well be indispensable parties in ADA (the Americans with Disabilities Act of 1990, 42 USC §12101) and access lawsuits, and leases should be immediately revised to clearly confirm responsibility for compliance with access laws.

## 1. WHAT CAN HAPPEN IF AN ESSENTIAL PARTY IS NOT INCLUDED IN AN ACCESS LAWSUIT

Many have suggested that a major part of the current crisis of ADA/access lawsuits is the misunderstanding between landlords and tenants as to which of them is responsible for complying with access laws or defending lawsuits involving them. Many tenants have mistakenly undertaken the defense of lawsuits, and even made major structural renovations, because they incorrectly believed that their leases required it; others just started defending lawsuits because they hap-

pened to be sued. Some landlords have also taken on obligations that should have been borne by (or at least shared with) their commercial tenants.

The failure to have all necessary parties involved in an ADA/access lawsuit at the earliest possible point will most likely result in unnecessary and avoidable expense to all involved. For example, even if a tenant had an obligation to defend a lawsuit, to the extent the lawsuit seeks injunctive relief (ie, a court order, for example, requiring that structural renovations be made), the tenant might not have the legal right to make such renovations. Similarly, if a landlord is the sole defendant in a lawsuit and part of the resolution requires that the restroom not be available to the public, if the tenant is not a party to the proceedings, s/he may object to such a reduction in their leasehold rights.

Too often, the parties realize too late that an essential party has been omitted from a case, and that party will, quite appropriately, object to being brought in at the “last minute” when important decisions may have been made without them. Because a plaintiff may well be entitled to an award of attorneys fees during the entire time the defendants try to sort out responsibility, it is essential that all conceivably appropriate parties be joined in an access lawsuit at the earliest possible opportunity, even if some are later dismissed.

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## Who's Responsible for ADA Compliance?

Defendants should not assume that a plaintiff has joined all necessary parties in an access lawsuit; while there is a strong incentive to do this in non-access cases, a plaintiff is probably not required to research all possible defendants and consider documents (to which they may not have access when the suit is filed) just to gain access to commercial premises.<sup>1</sup> They may be entitled to sue just one party doing business on the property; the party they sue has the right to bring in other parties responsible for the harm, and should consider joining them at the earliest possible opportunity to avoid irreparable harm.

### **2. JOINT AND SEVERAL LIABILITY OF COMMERCIAL LANDLORDS AND TENANTS FOR ACCESS IMPEDIMENTS**

In general, landlords and tenants are jointly responsible for compliance with access laws, at least from the standpoint of third-parties (eg, disabled visitors to the property); however, they are free to shift the allocation of responsibility between them by contract.<sup>2</sup> Of course, such a re-allocation is only binding as between the landlord and tenant<sup>3</sup>—a disabled plaintiff will generally have recourse against both of them, and if just one of them is sued, or found liable, s/he may have a claim against the other for indemnity and/or contribution (ie, a legal action to recover losses that are another's responsibility). The rationale for this policy is that it would be unfair to a disabled plaintiff if a landlord tried to avoid making access renovations by leasing only to tenants with limited resources or for tenants to avoid taking responsibility for removing access barriers over which they have complete control.

### **3. DON'T ASSUME YOU HAVE FULL (OR ANY) RESPONSIBILITY FOR THE LAWSUIT**

Too often, a party is sued, assumes they are at fault, and just starts defending the lawsuit. Sometimes they are correct; often they are not. More commonly, there are a number of individuals and firms that may bear some responsibility for the problem, and the participation of multiple defendants can ease the burden of resolving any access case considerably.

It is essential to consider which parties should be included in a lawsuit at the earliest possible opportunity. For example, because some insurance companies will cover some ADA/access claims and others will not, one party or another may have insurance that will cover a claim while another may not. As facts emerge in a case through the exchange of documents and information, parties are often

surprised to discover that those originally thought to be responsible for access issues may not, in fact, be liable, while others initially overlooked should be joined.

### **4. AMBIGUITIES IN THE LEASE WILL GENERALLY BE CONSTRUED AGAINST THE PARTY WHO PREPARED IT**

Many landlords have tried to convince tenants that they have taken on the responsibility of making fundamental structural improvements to the landlord's property (which would increase the value of the property when returned to the landlord at lease-end), simply by virtue of the tenant having signed a fairly standard commercial "net" lease agreement. Because commercial tenants indeed take on many obligations of the property owner when they enter many commercial leases, they often incorrectly assume that they have undertaken all of them, or that they are responsible for "everything inside the exterior walls."

It is a well-settled legal principle that ambiguities in a document will generally be construed against the party who drafted (ie, prepared) it. The reason for this is that the party who prepares a document is in the better position to make it as clear and unambiguous as possible; additionally, the non-drafting party may not always be in a position to meaningfully negotiate the terms.

Typically, because most commercial leases are drafted by the landlord, matters of uncertainty will often be construed in the tenant's favor because the landlord would be seen as having more time and opportunity to clarify uncertain terms, and the tenant might have less ability to bargain. Accordingly, unless the tenant expressly agreed in writing to make specific structural renovations to the property, many attorneys do not believe that relatively standardized provisions, like those found in many commercial "net" leases, transfer the landlord's obligation to make significant access improvements to the tenant.

### **5. WHAT DOES THE LAW SAY?**

As of the date of this article, many jurisdictions lack decisive case law that confirms the respective responsibility of landlords and tenants under standard commercial leases; additionally, commercial lease terms vary considerably, despite the fact that they are usually referred to as "standard." A surprising number of leases still in use do not address the responsibility for access compliance and claims, and this obligation is substantially different from other obligations the tenant may assume, as discussed below. Certainly, any landlord and tenant can agree that a

## Who's Responsible for ADA Compliance?

tenant will make specific structural modifications to the property, but the question in most access lawsuits is whether the standardized terms commonly found in commercial net leases would in fact transfer the obligation to the tenant without such an express agreement.

Because most commercial leases rarely identify specific access improvements the tenant agrees to make, many landlords have tried to claim that standard commercial lease terms require the tenant to make such improvements by implication (ie, based on cases that have interpreted certain standard lease terms to require the tenant to undertake certain renovations, which were unknown at the time the lease was executed). Of course, an important difference between the facts in these cases and most ADA/access cases is the fact that the need for access renovations is usually apparent to the unaided eye, and both landlord and tenant are equally charged with knowledge of the noncompliance of the facility; accordingly, there is no “surprise” as there is in the cases on which many landlords have tried to rely (as discussed below).

In one California case, *Botosan v. Fitzhugh*<sup>4</sup> held that one commercial lease for a chain “fast food” restaurant did not transfer responsibility for access improvements from landlord to tenant, based on the standard “compliance with laws” provisions it contained. Since *Botosan*, many landlords have attempted to claim that other provisions in standard commercial leases somehow operate collectively to shift this burden in situations where there was no clear agreement about responsibility for specific structural renovations that needed to be made. Because many of the ADA compliance disputes between landlords and tenants arise in smaller properties, they are less likely to be litigated. Unfortunately, this forces consideration of similar, but not identical cases, that may not be entirely comparable.

In California, the cases that currently come closest to providing guidance on this question differ from ADA/access cases in at least one critical respect—each of them deals with relatively concealed defects in the property that would most likely not have been identifiable to the casual observer at the time the lease agreement was signed. One case involved a structural seismic retrofit and the other involved the removal of friable asbestos, each problem was discovered some time after the lease agreement was signed. In each case, the problems in question would most likely not be ascertainable without the aid of experts. In contrast, virtually all common access impediments are

visible to the naked eye and the regulations relating to them are matters of public record. Indeed, many businesspeople make their own accessibility inspections and renovations without the use of experts, and sometimes do it properly, based solely on the diagrams and guidance in the ADA Accessibility Guidelines (“ADAAG”), state building codes and other similar sources. Of course, such “self help” can also result in costly mistakes.

The fact that the overwhelming majority of access impediments are visible to both landlord and tenant, and each are deemed to be “on notice” of the access laws means, for practical purposes, that both landlord and tenant “knew” (or should reasonably have known) that the property was noncompliant at the time it was leased (or the lease renewed) and knowingly failed to make written arrangements for any structural renovations that were required. Under these circumstances, it seems reasonable to assume that the tenant agreed to comply with all laws *within* the confines of the premises s/he leased, but not to *improve* them by making significant structural renovations, unless the parties expressly entered into a clear written agreement providing exactly for that. Many judges may be reluctant to invest valuable court time considering an issue the parties were free to address for themselves when they entered the lease—at least to the extent that the landlord wants the court to interpret a broader obligation for the tenant than the plain reading of the document they prepared might create.

### 5A. THE LEGAL FRAMEWORK

As of the date of this article, commercial landlords may still be unable to point to a case or law that allows them to transfer responsibility for access law compliance to their tenants through the standardized general terms of most commercial leases—the matter will most likely remain an arguable question of fact a judge or jury would have to decide. For this reason alone, most commercial landlords and tenants will most likely be necessary parties in many access lawsuits. Because the terms of commercial leases vary considerably and the conduct of the parties will also have considerable bearing on this question, it is unlikely that any landlord or tenant will be able to claim that, as a matter of law, they are entitled to look to the other to take responsibility for making access improvements to the property, unless they have entered into a clear, express agreement for this purpose (which is often not the case).

## Who's Responsible for ADA Compliance?

### 5B. HAS THE LANDLORD BEEN RELIEVED OF THE OBLIGATION TO PROVIDE ACCESS?

The starting point in any analysis must begin with the premise that the landlord never loses the obligation to provide access to the property—public policy requires that some party be continuously responsible for health and safety issues for any given property. In many jurisdictions including California, this obligation is presumed to rest with the landlord,<sup>5</sup> and the landlord may contract with others (including tenants) to fulfill this obligation, but will never be relieved of it with regard to the claims of third parties (such as disabled visitors). Of course, if the tenant makes fundamental changes to the leased premises, s/he may take on the obligations of the landlord with regard to those changed areas for claims of inaccessibility by disabled visitors to the premises.<sup>6</sup> While the tenant(s) would certainly have undertaken the obligation to provide barrier-free access within the areas leased to them, is there evidence that the tenant agreed to take on the *additional* obligation of making structural improvements to the property, which would return a better building to the landlord at lease-end than was received?

### 5C. GUIDANCE FROM NON-ADA CASES

ADA/access cases are a fairly recent phenomenon, while disagreements between landlords and tenants over responsibility for repairs have persisted for centuries. While cases interpreting these disputes will most likely not resolve all landlord/tenant issues in an ADA/access lawsuit, they can provide limited guidance until more applicable cases become available. An essential distinction between this line of cases and most ADA/access lawsuits is that the defects in these cases were concealed or otherwise not likely to be seen by the casual observer, as they are in ADA/access lawsuits.

In access cases, there can usually be no question that any party visiting the property would have had to look at—if not physically pass through—the same path of travel a disabled visitor would use. Thus, it would be rare for any access impediment not to have been seen by even the most casual visitor (even if not understood to be an article), and both landlord and tenant are deemed to have “constructive” (imputed) knowledge of all access laws and regulations. Accordingly, if both the landlord and tenant must be presumed to know of a problem and declined to clearly confirm the responsibility for remediating it in the agreement between them, how can we assume that the

responsibility (which is presumed to reside with the landlord) had been transferred to the tenant, in light of Sections 4 and 5b, above?

Two California cases provide guidance as to some of the issues courts consider relevant in resolving disputes over problems that were *unknown* to both landlord and tenant when the lease was signed:

- *Hadian v. Schwartz*<sup>7</sup> confirmed that a commercial tenant who had renewed a three-year lease for an additional five-year period had not assumed the obligation of paying for a seismic retrofit required by the City of Los Angeles solely by virtue of having executed a standard “fill-in-the-blanks” commercial net lease.
- *Brown v. Green*<sup>8</sup> held that commercial warehouse tenants *did* assume the responsibility for removing asbestos-laden material from a building, even though such renovation would inure to the landlord’s long-term benefit, when the tenants, who were particularly sophisticated in commercial leasing, had been advised in advance of the possibility that such contamination might exist and declined to inspect for it, nevertheless signed a long-term lease in which a majority of the risks of ownership were expressly shifted to the tenant.

The *Hadian* and *Brown* cases were decided the same day and reached different conclusions. Both cases were decided by the California Supreme Court, and the Court applied many of the same factors to each case. In each case, the specific facts and circumstances (including the conduct and experience of the parties and the specific language of the lease) determined the outcome of the case. As stated above, each of these cases involved “surprises” that were discovered during the term of the lease—quite different from the access obligations, of which landlords and tenants have had at least “constructive” notice for some time.

### 6. WHY IT IS IMPORTANT TO DETERMINE THE EXACT PROBLEMS THE DISABLED VISITOR ENCOUNTERED ON THE PROPERTY

Basically, most access lawsuits are filed because a disabled plaintiff claims they encountered difficulty entering a facility or had problems once inside. Because disabled plaintiffs are not required to attempt to enter premises that appear physically inaccessible,<sup>9</sup> they will often do a

## Who's Responsible for ADA Compliance?

“drive by” and properly determine that access impediments make entry potentially dangerous. Nevertheless, the lawsuits they file are often replete with references to the barriers inside the premises. This is because they may have a friend or a scout enter the premises to gather information about problems inside.

The significance of identifying the specific obstacles the plaintiff actually encountered can prove fairly important in apportioning liability between landlords and tenants in access lawsuits. For example, if the plaintiff revealed that s/he made a determination from the appearance of the exterior that entering business premises was unwise or potentially dangerous, it might support an inference that all, or substantially all, of the cost or liability of the access lawsuit should properly be borne by the landlord. Likewise, if all of the access impediments complained of by the plaintiff were of a structural nature (eg, matters that existed on the property the day the tenant took possession), a similar result could be reached. However, if it appeared that the building and property were not the problem, but a rolling rack or moving palette blocked access on the day in question, a majority (if not all) of the liability might be borne by the tenant. In many cases, it will be a combination of factors—some the responsibility of the landlord and some the responsibility of the tenant—which result in access claims; understanding exactly which problems led to the claims is essential to any later apportionment of liability between landlord and tenant.

### 7. COMMON LEASE PROVISIONS:

Several common lease provisions, particularly those found in commercial “triple-net” leases, contribute to the misunderstanding between landlords and tenants as to which of them is responsible for renovations and compliance with access laws:

#### 7A. “TENANT IS RESPONSIBLE FOR COMPLYING WITH ALL APPLICABLE LAWS”

A common provision of many commercial leases is a requirement that the tenant comply with “all applicable laws.” A plain reading of such provisions requires that the tenant not violate the law in the things they do *within* the areas they are leased.

Some landlords have suggested that such a provision requires the tenant to make fundamental structural renovations

which would *improve* the property the landlord will receive back at lease-end, or to defend lawsuits resulting from structural inaccessibility. This question was addressed in *Botosan*<sup>10</sup> where the relevant provision of the commercial lease stated “Tenant shall . . . keep and maintain . . . the Premises . . . in compliance with all laws and regulations . . .”. The *Botosan* court considered a number of common provisions of commercial leases, which were also found in the lease in question, including one which required the tenant to obtain the landlord’s approval for any major renovations to the leased premises; based on these, they rejected the landlord’s claim that the responsibility for access compliance had been shifted to the commercial tenant, in this case, a small Mexican restaurant that was part of a chain. The *Botosan* court went on to say “. . . even if the lease allocated all responsibility to the tenant, that would not insulate [the landlord] from liability under the ADA. Under the ADA liability attaches to landlords and tenants alike.” Based on the foregoing, if landlords want such “compliance with laws” provisions of leases to be construed to require tenants to make fundamental structural improvements to the leased premises (ie, improving them over the condition in which they were received)—and not just to obey all laws in conducting their operations—they should make this conspicuously clear in the agreements they prepare.

#### 7B. “TENANT SHALL INDEMNIFY LANDLORD FOR ALL CLAIMS ARISING OUT OF TENANT’S USE OF THE PROPERTY”

Many commercial landlords have attempted to persuade tenants that they are required to indemnify them for access claims, even if there is no evidence that the claim resulted from any act or omission by the tenant—for example, if the plaintiff just did a “drive by” and was discouraged from entering by the structural inaccessibility of the premises (and not, for example, some impediment the tenant had introduced to the property).

In many states, it is well settled that one cannot seek indemnification for one’s own negligence.<sup>11</sup> To the extent a property owner has failed to comply with applicable access laws or regulations, s/he may not be entitled to demand indemnification from a tenant, when the decision to refrain from making access renovations on an ongoing basis may be deemed to be a conscious, deliberate and/or intentional one.<sup>12</sup> Thus, the question is whether the claim

## Who's Responsible for ADA Compliance?

arises out of the tenant's use of the property or the landlord's ongoing negligence in failing to renovate it. Clearly, the analysis in Section 6, above, becomes more relevant in cases like this.

A tenant or franchisee in an access case should also consider a cross-claim for "equitable indemnity" against the landlord or franchisor, even if there are provisions in the lease or franchise agreement whereby the tenant/franchisee agrees to indemnify the lessor or franchisor. In many cases, the tenant or franchisee will read provisions whereby they have agreed to indemnify the landlord or franchisor and incorrectly conclude that they have undertaken an unqualified obligation to indemnify them for any and all claims, including the landlord's or franchisor's negligence. As discussed above, however, a landlord or franchisor may be partially or fully responsible for the harm from which the claims arise, and such indemnification provisions may well not require the tenant/franchisee to indemnify the landlord or franchisor from their own negligence. The problem, of course, is that if the tenant or franchisee does not assert these claims early in the lawsuit, they may be barred.

### 7C. THE REPAIR COVENANT

Although a tenant's covenant to repair and maintain the property, usually at the tenant's expense, is a common provision in many commercial net leases, the *Hadian* and *Brown* courts each considered this obligation in their analysis. Because a requirement to repair or maintain the property may under certain circumstances be interpreted to require the tenant to repair the item in a manner that causes it to comply with current law, some landlords have tried to argue that the tenant should be required to improve non-complying areas of the property by bringing them up to current accessibility standards (ie, that the inaccessible areas of the property are "broken" and it is the tenant's obligation to "fix" them). The analysis in *Hadian* and *Brown*, above, confirms that such arguments may be ambitious, at best. In addition, additional clauses, such as (1) the tenant's obligation to return the property to the landlord in substantially the same condition to the landlord, and (2) limitations on the tenant's right to make significant structural (or any unapproved) modifications, can provide important clarification of this question.

### 8. IS THE PROPERTY EXEMPT FROM COMPLIANCE OR "GRANDFATHERED"?

A striking number of defendants incorrectly believe that their properties are exempt from compliance with access laws (because they have been "grandfathered" in some respect) because they are of a certain age, or because no major renovation has ever been performed. While it is not the intention of this article to provide legal advice about specific renovations that are required for any particular property, the reader is reminded that:

- The ADA requires removal of such access impediments as are "readily achievable" for the defendant,<sup>13</sup> there is no "exception" or "grandfather" provision exempting older properties.
- The ADA and attendant regulations confirm that what is "readily achievable" depends on the total financial resources of both the commercial tenant and property owner,<sup>14</sup> and would presumably include equity in the property. Many defendants read this and think they will assert the defense that a particular renovation was not "readily achievable" for them because it was too expensive or complicated; once they find out they will have to produce their financial statements to support this argument, they often re-evaluate this position, but only after considerable time and legal expense. Assuming all appropriate defendants are joined in an action (see Section 10, below), and considering the vast increase in equity that has applied to commercial real estate in many parts of the country, it may be difficult to argue that almost any barrier removal was not "readily achievable" at many properties.
- Certain state laws enhance the power of the ADA, and should not be overlooked; for example, California's Unruh Act provides that a violation of the ADA (and presumably the ADA Accessibility Guidelines, or "ADAAG") constitutes actionable discrimination.<sup>15</sup>

### 9. THE NEED TO REVIEW, AND REVISE, LEASE AGREEMENTS

More than a decade after the passage of the ADA, a remarkable number of leases remain silent about the allocation of responsibility for complying with access laws and regulations, and/or the lawsuits for noncompliance. The time may be fast approaching, if it is not already here, when courts will have lost sympathy for any party who

## Who's Responsible for ADA Compliance?

doesn't make advance written arrangements clearly apportioning responsibility for access matters; the ADA is here and is not going away. If landlords want to shift this burden to tenants, they will need to do so through particularly clear and conspicuous terms.

### 10. RULING OUT ALL POTENTIAL CO-DEFENDANTS

Initial defendants should consider all of the following categories of potential defendants in a lawsuit before concluding that they are solely responsible for defending it (of course, this list is not all-inclusive):

- Architects and other design professionals (depending on the date of the design and the agreement of the parties);
- Coastal, district and other agencies and commissions (to the extent they prevent necessary/appropriate renovations from being made, or failed to require them during the approval process, and to the extent they are not immune from suit);
- Contractors (depending on the date of construction/renovation and whether the contractor was responsible for causing the work to comply with access requirements);
- Experts in previous access cases (to the extent they failed to identify appropriate renovations and the law has not changed with regard to the claims in the current lawsuit);
- Franchisors (to the extent they designed/built premises in question, dictate operating policy at franchisee's facilities, inspect for violation of laws/compliance with regulations, have renewed franchise agreements without requiring compliance since the accessibility laws in question were enacted, etc.);
- Historic site board(s) (to the extent they made determinations about renovations that would be required or allowed after applicable access laws were enacted, or refuse to permit a property owner to make necessary access renovations, to the extent not immune from suit);
- Landlords (to the extent the landlord is different from the property owner and/or has engaged in activity (including without limitation a decision to refrain from removing access impediments) that could be claimed to be discriminatory to the disabled);
- Lawyers (to the extent they prepared commercial leases since the access laws in question were enacted that did not address the issue of responsibility for access renovations and defense of access lawsuits);
- Lawyers in previous access lawsuits on the same property or issue (to the extent they demanded fewer renovations than were actually necessary/required in exchange for a larger payment to their clients or themselves, and sought or received fees based on an assertion that their work was responsible for a significant benefit to society under, for example, "Private Attorney General" provisions like California's Code of Civil Procedure § 1021.5);
- Municipalities (depending on when building permits were issued and whether compliance with applicable access laws was expressly disclaimed, to the extent not immune from suit);
- Plaintiffs (to the extent they engaged in intentional conduct that could create or exacerbate their harm);
- Previous occupants (to the extent they took, or refrained from taking, actions that had a material impact on the accessibility of the property or failed to comply with access laws);
- Property Owner(s), who, in most cases, would never be relieved of the obligation to the disabled community to cause their properties to comply with access laws;
- Realtors (to extent noncompliance with applicable laws was not disclosed; or appropriate inspections were not recommended);
- Sellers (to the extent notice of noncompliance with applicable laws, or prior lawsuits, were not disclosed or if they failed to comply with applicable access laws); and
- Tenants, who would never be relieved of the obligation to comply with access laws, at least within that portion of the premises they occupy.

Based on all the foregoing, it is essential that all necessary parties be involved in the resolution of an ADA/access lawsuit at the earliest possible opportunity.

### 11. SPECIAL CONSIDERATIONS FOR FRANCHISES

Many franchise chains have been especially hard-hit by ADA/access lawsuits. In some cases, this is because fran-

## Who's Responsible for ADA Compliance?

chise chains are perceived to have greater financial resources available to meet accessibility obligations, or to pay judgments.

Many franchise chains have made commendable progress in ensuring compliance standards in each of their locations while others, astoundingly, have done almost nothing. Worse still, many new locations do not meet applicable access standards and are subject to suit virtually from the day they open.

Remarkably, many of these franchisors have taken the position that the franchisee must bear the financial responsibility for access lawsuits, even though the basis for the lawsuit relates directly to the franchisor's design or policies. Many franchisors have attempted to invoke indemnification provisions to require the franchisee to, in essence, indemnify the franchisor from the franchisor's own negligence (see Section 7b, above). Such positions should be carefully scrutinized in that it is usually the franchisor who:

- (1) designed, approved and/or built the structures on the property,
- (2) regularly inspects the property for compliance with laws (surprisingly, though, access laws are often not part of these inspections), and
- (3) imposes contractual provisions prohibiting changes to the property without franchisor approval.

Often, franchisees are immediately cited for violations that could injure the non-disabled, but violations of decade-old access laws are ignored, so lawsuits often come as a complete surprise to the franchisee.

Franchisors should immediately institute chain-wide compliance requirements, certainly for the renewal of franchisees, but franchisees should not wait for franchisors to do this—a lawsuit may already be pending. Franchisees should demand that franchisors play a strategic role in chain-wide access renovations, because they can accomplish such renovations far more cost-effectively than individual franchisees. Because the renovations will make the properties more valuable, the property owners should also play a financial role in the process.

### **12. THE NEED FOR IMMEDIATE ACTION**

Anyone who has completed accessibility renovations knows it can be an overwhelming task—reconciling feder-

al, state and local standards, ensuring that construction irregularities don't form the basis for future claims, regularly inspecting for vandalism and keeping up with the constant stream of changes in standards—can be an overwhelming task for access professionals, much less those who find running their businesses to be more than a full-time job. An ADA/access lawsuit will not make things simpler. A business that has not been sued has an invaluable opportunity to save tens, if not hundreds, of thousands of dollars by taking immediate action.

The first step in preventing, or resolving, an ADA/access lawsuit is to have the property inspected by a highly qualified inspector. It is extremely important that the inspector be retained through an attorney so that the report is protected by the attorney-client and/or attorney work product privileges; without such protection, the report can be obtained in any future lawsuit, and could be deemed notice of noncompliance.

While it has always been riskier to do business or hold property in one's own name, the increase in access litigation make it even less advisable. Because the obligation to make renovations can depend upon the financial resources of the defendants, defendants with significant financial resources are particularly at risk. Accordingly, property owners should consider holding the property in a separate limited liability company ("LLC") or a limited partnership with a corporate general partner. Commercial tenants should also consider doing business as a corporation or LLC.

Business owners need to understand that there is generally no limit to the number of times they can be sued about even minor non-compliance with access laws. The number of "professional plaintiffs" seems to increase on a daily basis, and judges are becoming increasingly reluctant to shelter firms that have ignored a law passed in 1990. Businesses should evaluate access renovations in terms of the considerable cost of litigating the failure to make them. Landlords and tenants—and especially franchisors—should all work together to prevent a problem from becoming a crisis. ■

# Who's Responsible for ADA Compliance?

## ENDNOTES

1. Independent Living Resources v. Oregon Arena Corp, 982 F. Supp 698, 768 (D. Or. 1997) supplemented 1 F. Supp 2d 1159 (D. Or. 1998)
2. Botosan v. Fitzhugh 13 F. Supp 2d 1047, 1054 (S.D. Cal 1998)
3. A number of jurisdictions have laws that support this principle, as one such example, California Civil Code §3513 confirms that “. . . a law established for a public reason cannot be contravened by a private agreement.”
4. Botosan, *infra*.
5. Glenn R. Sewell Sheet Metal v. Loverde (1969) 70 C2d 666, 672 n6, 75 CR 889
6. Sewell, *infra*
7. Hadian v. Schwartz (1994) 8 Cal 4th 836; 35 Cal Rptr. 2d 589; 884 p2d 46
8. Brown v. Green (1994) 8 Cal 4th 812; 35 Cal Rptr 2d 598, 884 P2d 55
9. 42 USC §12188; also see Pickern v. Holiday Quality Foods 2002 293 F. 3d 1133
10. Botosan at 1053
11. For example, in California Rooz v. Kimmel (1997) 55 Cal App 4th 573; 64 Cal Rptr 2d 177 and it's progeny provide considerable guidance; an exception to this rule is that when a contract expressly provides that a party will be indemnified against that party's own negligence, as is the case in insurance policies. In such cases, however, the requirement that a party is being indemnified against his/her own negligence must be very clearly and expressly stated, as is rarely the case in most commercial leases. Even then, strong considerations of public policy may override such provisions, particularly when the indemnitee has foreknowledge of a problem that could trigger indemnification, as in Westlye v. Look Sports, Inc., (1993) 17 Cal App 4th 1715.
12. Modern Development Company v. Navigators Insurance Company (2004) 111CA4th 932
13. The Americans with Disabilities Act of 1990 42 USC 12101; specifically §12182(b)(2)(a)(iv), (v) and (vi)
14. 42 USC 12181(9)
15. California Civil Code § 54(c)

FOCUS ON INVESTMENT CONDITIONS

# Financial Risk Management— Understanding Returns



BY KENNETH RIGGS, JR., CRE

WHEN THE FEDERAL RESERVE REVERSED COURSE by raising the federal funds rate and signaled their intent to continue raising rates in order to keep inflation in check, investors began contemplating how much higher interest rates will go over the next couple years, and more importantly, how quickly the increases will occur. As one of the key drivers of real estate values, low interest rates are credited with allowing investors to receive, on average, record appreciation, despite poor space market fundamentals. The expectation is that as interest rates go higher, however, the interest rate environment will not continue to bail out poor space market fundamentals and real estate values. Since institutional investors generally have an abundance of investing options available to them, this column focuses on determining what returns are fair and reasonable for real estate, given the degree of risk for real estate, as compared to returns for 10-year T-bonds. As our industry moves forward in maturity, financial risk management will be the key to successful investing.

One way to derive an appropriate level of return is to examine the required overall capitalization rate (OAR) data provided each quarter in the RERC Real Estate Report. Rather than using the data straight from the investment report, a Counselor can use the reported OAR and analyze the relationship of the historical spread of the required OAR versus 10-year T-bonds. In the past, this spread generally has ranged between 200 and 400 basis points. At an OAR of 8.4 percent (this is an average for all property types with an average earning structure), RERC's average required overall capitalization rates are the lowest they have been in approximately 15 years. However, at approximately 400 basis points, the spread between

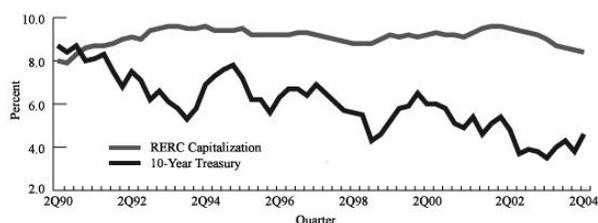
required overall capitalization rates and 10-year T-bonds remains near an all-time high.

This reflects the cyclical relationship of current returns, but secular financial trends analysis indicates this spread may be too wide and that the pricing of real estate in the form of overall capitalization rates should continue to decrease. Keeping in mind that the concern is the speed of future increases in interest rates, today's wide spreads are probably reasonable given the direction interest rates are heading. This wide spread acts as a risk premium if interest rates increase faster than what is expected.

Generally speaking, as 10-year T-bonds increase or decrease, required overall capitalization rates for real estate slowly follow the same pattern, as shown in Figure 1 (RERC Required Overall Capitalization Rates vs. 10-Year T-Bonds). Since real estate competes with other assets for capital, increases in risk-free investment rates should motivate real estate investors to require higher returns on investments with a higher degree of risk, thereby creating higher capitalization rates. Figure 2 (Spread Between Overall Capitalization Rates and 10-Year T-Bonds) illustrates the yield relationship of RERC's required overall capitalization rates and 10-year T-bonds with the spread showing a continual increase from 1990 to today. This above-average spread will tend to keep capitalization rates stable in anticipation of interest rates increasing, and allows for cyclical movements in interest rates to keep the spread normalized and prices relatively steady in the short-term.

The use of this higher spread allows investors to avoid the cyclical movements in the financial markets that real estate

**Figure 1—RERC Required Overall Capitalization Rates vs. 10-Year T-Bonds**



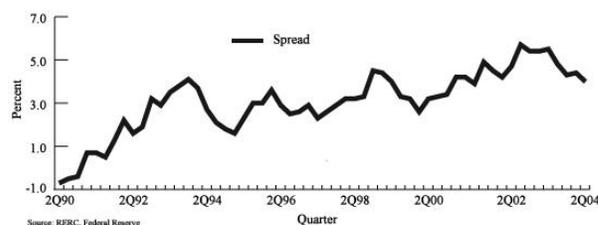
Sources: RERC, Federal Reserve

markets cannot quickly adapt to, thereby reducing the potential negative impact on values and prices if rates unexpectedly move upward. It is also important to note that the relatively high capitalization rates specified by respondents in RERC's survey, as reported in the RERC Real Estate Report, indicate that investors are starting to adjust their spread over T-bond expectations because they are concerned that the drop in 10-year T-bonds is cyclical and temporary, and do not wish to buy properties at too low a capitalization rate, given that T-bonds could rise quickly. As discussed previously, this is appropriate given the direction of interest rates.

RERC's forecast is for a normalized spread of 200 to 400 basis points over equal-term 10-year T-bonds for required overall capitalization rates to continue during this period of increasing interest rates. For example, if investors anticipate 10-year T-bonds to be 5 percent, investors should use average required overall capitalization rates around the 7- to 9-percent range (200 to 400 basis points higher than T-bonds) to compensate for the risk associated with their investment. This reflects RERC's view for average institutional core properties that have solid cash flows, various lease durations, and tenant credit quality.

Since no two properties are identical, especially when it comes to location, occupancy, tenant quality, age, and condition of the properties, investors need to evaluate all their properties in determining appropriate capitalization rates. We are quick to throw in the mix that in developing this analysis one must remember that the OAR has a growth component that influences the spread and the level of return. Further, the OAR is a one-year rate (but has imbedded level durations of longer periods) versus the obvious term for the treasury issue. In the end, this is one way to ascertain the appropriate level of return given the level of risk. The use of a spread allows you to take cues

**Figure 2—Spread Between Overall Capitalization Rates and 10-Year T-Bonds**



Sources: RERC, Federal Reserve

from the financial market about risk-free rates, imbedded inflation expectations, and overall levels of expected returns.

### FINANCIAL RISK MANAGEMENT

■ The rising interest rate environment is a reflection of the expected inflationary economic growth over the next several years.

■ Expanding business environment will put upward pressure on income for real estate, which is a result of increasing rental rates and decreasing vacancy rates.

■ The growth expectations for income will allow OAR to remain stable, even as interest rates begin to increase.

■ As the economy continues to expand, income within the real estate sector will follow suit and increase. This will allow total returns to increase, even as capitalization rates stay flat or rise slightly.

■ Overall, the risk and return profile of commercial properties compared to alternative investments will improve as the economy expands and income for commercial real estate increases. ■

### About our Featured Columnist

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FOCUS ON GLOBAL ISSUES

# Urban Regeneration: The Need for Partnership in Rejuvenating Old Neighbourhoods



BY NICHOLAS BROOKE, FRICS

URBAN RENEWAL AND REGENERATION SCHEMES are sensitive in any city but in such a densely developed area such as Hong Kong, which is my home and from where I practise as a Chartered Surveyor, they attract particular attention. Recently town planners and community leaders have expressed fears that the older areas of Hong Kong will become a series of “air conditioned glass boxes”, if the government continues to allow historic buildings to be replaced by high rise office developments.

Outside Hong Kong, the premise underlying the modern urban regeneration movement is to provide an integrated approach to the rehabilitation of sub-standard urban areas to improve social, economic and environmental conditions. There has been a widespread recognition that it is a range of issues that lead to the decline of major urban centres as desirable or acceptable places to live, including poor economic development, increasing crime, limited education and employment opportunities and a lack of recreational and leisure facilities whilst the availability and quality of work opportunities, accessibility to green space and the availability of affordable attractive housing have been found to be the key factors in attracting residents to rejuvenated urban areas.

In the 1990s there was a refocusing of urban policy in many developed markets with a shift away from emphasis on property-led regeneration towards a broader based agenda. Current thinking suggests a stronger focus should be placed on the social aspects of urban renewal and that consideration and respect should be given to the scale of the existing development, the preservation of local special-

ist employment options, and the wish of many residents to remain in an area with which they are familiar after the regeneration exercise is complete.

Urban regeneration projects are often perceived as being high risk/ low return locations, offering only weak investment opportunities and the attraction of private sector funding, usually in the form of equity, requires new and innovative measures—co-investment, market transparency, and clear exit strategies that allow for retention of investment management control.

The regeneration of areas of Hong Kong suffering urban decay and a lack of modern amenities has been a government policy objective for a number of years but progress has been slow. Whilst there has been some evaluation of initiatives and schemes, there has been no real attempt to benchmark urban regeneration activity. Weak and confused market signals in regeneration areas linked to an inappropriate regulatory framework have perpetuated misconceptions regarding potential investment returns and risk. This has led to regeneration (as against redevelopment) opportunities being ignored by many institutional investors.

## About our Featured Columnist

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Research on regeneration areas in major UK cities published by the RICS foundation, however, indicates that investment property in regeneration areas can out-perform other forms of property development and that over the long term, regeneration areas provide significant investment opportunities, particularly in the retail sector—a finding that challenges conventional wisdom. A further significant finding is that in the early stages of a property downturn there is a less marked downward trend in investment performance within supported regeneration areas as they benefit from a cushioning effect and far from being riskier investments, the risk is, in fact, lower. This research is of great relevance when promoting the need for public sector support and partnering for regeneration as it confirms the effectiveness of regeneration policy mechanisms in creating sustainable urban environments capable of meeting private sector investment goals. As governments increasingly look for greater private sector participation, success in previous schemes and confidence in current policy mechanisms are fundamental.

Regeneration incentives, such as subsidised land prices or gap funding, and old risk reduction measures can act as a

catalyst to offset adverse property market impacts or affordability concerns, but their effectiveness is highly localised. Furthermore, the time that is involved in site assembly, securing appropriate permissions and implementing urban regeneration is such that sustainable schemes require policy mechanisms that have a longer-term perspective, whilst also attracting investors who have the staying power and the vision to build on existing community drivers. The nature of the challenge also explains the interest of private investors and developers to retain management and maintenance control within regeneration areas for an extended period of time.

Whilst many cities have made significant progress, Hong Kong has a long way to go to devise a workable regeneration model that achieves the necessary balance between commercial and social priorities. Similarly there is the need to accept that the social elements in many cases have to be funded out of the public purse and cannot always be cross-subsidised by the more profitable parts of the project. ■



FOCUS ON THE ECONOMY

# "BUBE"—Is the Market A Bull Or A Bear?

BY DR. MARK LEE LEVINE, CRE AND DR. LIBBI ROSE LEVINE SEGEV

## I. THE GAME

"THE TERM "BUBE" IS A YIDDISH TERM for grandmother.\* It is pronounced "buh-bee."

A Jewish grandmother can be stern, strong and directed. But, more often, the grandmother, Bube, is often sweet, kind and understanding. The question is to know the mood of Bube.

By a metaphor, one could ask: "Is a Bube stock market a Bear or a Bull?" That is, is Bube a "bear" (stern, strong)? Or, is this the day of the Bube "Bull Market" (sweet, kind and understanding)?

The term "Bube" often gives mixed messages to grandchildren, as to grandmother's mood. There can also be "confusion" as to the mood of the market. It is not always clear which factors actually influence Bube—or the Market—and the degree of such influence.

## A. PROJECTIONS

Inconsistent signals are being given by the market. Are increasing interest rates good or bad? Is inflation good or bad? Is the interest rate (prime) moving up too quickly? What are the impacts of war, terrorism, the election, deficits, employment and other signals or signs of consumer confidence on the economy?

There is confusion as to whether the market is a bull or a bear market. What is Bube's mood—and how long will it last? Since economists cannot answer the questions—without many hedges, maybe we should ask Bube—depending on her mood!

\* It is no small coincidence that Bube may be an acronym of Bu=Bull and Be=Bear!!

We have all heard, read, and seen multiple projections and suggestions from various entities that shed "light" on the path of the U.S. economy in the next 6 to 12 months.

The general format of the chosen game seems to be "Monopoly" during the past several decades when considering "playing" in the real estate market as well as the U.S. economy. The new game is to guesstimate the behavior of many variables and how they will affect the economy. Those variables might be such factors as economic growth, including Gross Domestic Product (GDP), Gross National Product (GNP), and many other indices which, allegedly, give us "insight" as to how the economy is actually performing and, implicitly, how it will perform.

In an article addressing how the U.S. economy is performing and how it will perform, by James R. DeLisle, Ph.D., there is a continuing attempt to prognosticate. [DeLisle, James R., "Real Estate and the Economy: The Train Has Left the Station," *The Appraisal Journal* 5 (Winter, 2004)].

According to the DeLisle article, some factors to consider as key indices in the analyses include GDP, GNP, whether employment is increasing or decreasing, inflation, interest rates, the stock market, consumer confidence, real estate markets and aspects within those markets, including capital funds.

## About our Featured Columnists

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Many factors influence the U.S. economy. Despite uncertainty about where those factors may move, given the interplay of many facets of the economy, there is general reliability as to GDP, GNP, and related numbers in the U.S. economy.

However, when attempting to compare the U.S. position with foreign markets, there may be differences because of a lack of reliability in the reported data from some other countries. Such indicators as to the performance of markets, including the Gross Domestic Product (GDP), are noted in *The Economist* on a regular basis. (The concern is often focused on the issue of reliability of the data.)

When looking to the factors indicated by Dr. DeLisle (or by others who report the same type of information), recent indicators, if accurate, seem to be fairly positive. For example, the United States shows a GDP growth position for the year 2004 of somewhere in the range of 4.1% to 4.5%.

Employment growth has been improving in recent months. General concerns voiced by some economists on the current economic position is that the U.S. unemployment rate will continue to fall, reaching close to 5% in 2004.

As another example of favorable trends in the market, [reported in the Meyers Group "Housing Market Key Indicator Alert" (May 10, 2004)], existing home sales are still very strong. The amount of inventory is sufficiently low to indicate a favorable position within the residential real estate market.

However, affordability to purchase housing is dropping, which is, in part, a function of the recent increase in interest rates. The 30-year fixed long-term mortgage interest rates have been climbing back and are now near 6%. Although, on a relative basis, this is still a favorable interest rate, continued rise in the interest rate impacts the public from an economic and psychological standpoint. Most buyers recognize they "could have" received a lower interest rate, had they purchased or refinanced last year, as opposed to this year. (And, the implicit question exists: Will interest rates be higher next year?)

There is a negative economic impact of affordability as to rising interest rates, as opposed to only the psychological impact. Buyers generally recognize that they now qualify for a lesser purchase price or refinance amount toward a

home, since interest rates have risen. They also face a higher monthly mortgage payment. Therefore, the affordability, of purchasing a home, or refinancing an existing home, has decreased.

**B. OTHER FACTORS: MIXED MESSAGES**

Inflation is an additional factor with regard to the U.S. economy. On the positive side, inflation remains fairly low; therefore, the rate of inflation has generally been a positive indicator. However, if the inflation rate increased "too much," this could be a negative factor for the economy.

Because of the overall increase in employment (ie, decreasing unemployment), low interest rates, a low inflation rate and other positive signs, some economists suggest that the American economy has a very impressive likelihood to have a positive growth rate for 2004, growing at a projected 4.5%. (See this position by Jeff Thredgold, economist for Vectra Bank, in his publication, *Insight* (Winter, 2004).)

Notwithstanding some of the above-mentioned positions by DeLisle and Thredgold, there are "mixed messages." [See the article by Tom Locke, "Hearing Mixed Messages? Deciphering the Economy," *Denver Business Journal* A9 (March 12-18, 2004)]. The Locke article pointed out that these "mixed messages" include increasing defaults by consumers, a limited amount of job growth, a drop in production, reduction in available venture capital, and many other "negative" factors.

"Positive" signs, as noted, include reduced unemployment. The increase in housing prices, general growth in venture capital, positive spur in consumer confidence, as well as many other favorable factors, boost the economic outlook. The most often-cited economist is Federal Reserve Chairman, Alan Greenspan, who warned investors in 1997 that the stock market was being pushed to levels that were unreasonable. In fact, Mr. Greenspan noted that there was an "irrational exuberance" within the marketplace.

The question remains as to whether the U.S. economy is in an "irrational exuberance" stage (using the label by Mr. Greenspan), or whether it is demonstrating a very rational "exuberance." Do consumers have a rational exuberance in the marketplace? In the best-selling book by author and Pulitzer Prize winner, Thomas Friedman, *The Lexus and the Olive Tree* (1999), Mr. Friedman referred to this concept. In Chapter 17 of this Work, page 367, Mr.

Friedman referenced this “irrational exuberance” as raised by Mr. Greenspan. Mr. Friedman wrote: “Dear Mr. Greenspan, I have a terrible problem. I’m feeling irrationally exuberant about the U.S. stock market, and I just can’t shake it. I know you’ve said ‘irrational exuberance’ is bad for my health, and I’ve tried everything: Hypnosis, Valium, short selling, even reading your speeches from 1987. But nothing works. Every time I come to Europe or visit Japan, I return home itching to invest more in the U.S. market.”

This tongue-in-cheek position by Mr. Friedman focused on whether one should have “rational” or “irrational” “exuberance” as to our economy. A review of various newspapers and reporting sources leaves one confused as to whether one should or should not be confident with an “exuberance” in the U.S. economy.

## **II. READING THE TEA LEAVES**

Many factors indicated earlier could be considered either positive or negative, depending on the reporting position.

### **A. RESIDENTIAL HOMES**

Interest rates remain still relatively low; they are the lowest interest rates in the market in the last 40+ years. Even with slightly increasing long-term mortgage interest rates, overall interest rates are still very low. Does this indicate that one should be “exuberant” on the “positive” side, because interest rates are still very low? Or, does this mean that consumers should feel less “exuberant,” because interest rates are increasing? As interest rates increase, signals from various parts of the market include a general slowing of the U.S. economy, greater restrictions on consumers’ ability to acquire housing, and the “snowball” or “domino” effect of fewer prospective homebuyers. This in turn, impacts many other facets of home ownership (such as purchasing home furnishings, repairs, etc), and other parts of the market.

On the “optimistic” side of the market economy, home sales and increased home acquisitions have been very strong for several years. These strengths, in turn, generated support for other types of purchases in areas such as retail sales.

A “counter” to such “positive” position is the impact on consumer confidence and spending when the general U.S. market substantially slows. In February, 2004, Chief Economist for the National Association of Home Builders

(NAHB), Mr. David Seiders, reported that there was a decline in home sales. This might not appear to be a “negative” position, since home sales have been very strong over the last number of years. However, this is still an “actual” decrease; therefore, this might be treated in some reporting agencies as an overall “negative” position, if it portends a downward trend.

### **B. DEBT**

The issue that Mr. Greenspan raised in the debt area is another factor of concern. In early February 2004, Chairman Greenspan voiced his concern to members of the U.S. Congress that the major mortgage entities of FANNIE MAE and FREDDIE MAC were too aggressive in their activities. Because of the size of these two entities, involving trillions of dollars, a failure by either or both of them could substantially impact the financial position of the United States, warned Greenspan.

If the market is “positive,” maybe there is less concern with this issue. However, Mr. Greenspan indicated that he was concerned with the economy because of the amount of debt involved. When such position is coupled with other legislation, such as H.R. 3755, an Act to provide for a zero dollar down payment for home purchases through FHA, there is additional concern of potential financial difficulties that may be later faced by the general U.S. economy.

Increasing home prices, increased interest rates, and an increase in the debt level raises awareness of a potential “bubble” in housing markets. [Regarding this concern, see the Note, “Cracks In the Brickwork?” *The Economist*, page 51 (January 3, 2004)]. This article focused on the risk of falling home prices, following a very strong increase in pricing in such countries as Australia, Great Britain, and the United States. The article also characterizes housing prices as being dangerously overvalued in six housing markets, including the United States, Australia, Great Britain, Ireland, The Netherlands, and Spain. The question raised was whether “cracks” were starting to appear as to pricing of homes, and whether there would be an actual overall decrease in value and pricing of homes. The concluding line in this article, on page 52, stated: “But in many big cities there must be a high risk that prices will fall.” This raises broader economic consequences.

### **C. STOCKS AND BONDS**

Mr. Warren Buffett, known as the “Sage of Omaha,” and head of Berkshire Hathaway, noted the high price of many

stocks. Because of these risk concerns, the comment in the above-captioned article was that Berkshire was “holding” \$36 billion of cash. (Some might argue that there is very little interest being paid on “cash holdings.” The response by Mr. Buffett was simple enough: “. . . the pain of doing something stupid is potentially worse.”)

Diane Vazza, a manager of Standard & Poors, noted that although bond defaults are falling, the only reason was because of favorable interest rates. Her comment was: “Trouble is brewing. . . .”

#### **D. FORECLOSURES**

Foreclosures are rising in many cities. For example, in Denver, Colorado, foreclosures are already hitting very high levels. In fact, Denver has experienced its highest level of foreclosures in 13 years. Many other cities in the U.S.A are facing this same issue.

#### **E. CONSUMER DEBT**

An additional area that has been reported is the ability of consumers to gain more spending power by refinancing real estate, especially via the principal residence of the consumer. The ability to “pull cash” from the equity of the home and utilize that cash to satisfy spending needs (and desires) as well as debt requirements has directed attention to this “warning sign.” Other warning signs include substantially increased credit card debt, increasing interest rates on credit card balances, and other debts that consumers are facing.

#### **F. GOVERNMENT ISSUES**

Even beyond direct consumer issues, when looking to the United States government, and state and local governments, there is concern with debt in the economy. There is no question that growth in the U.S. economy at 4.5% is a positive sign. However, because of deficit spending caused largely by a “weak” economy over the last few years, additional spending necessitated by the war in Iraq, other U.S. commitments abroad, tax reduction, etc, there is greater strain placed on the U.S. economy. With the reduction of tax revenues for the Federal government, along with revenues for state and local governments, there has been additional concern and strain on the economy.

These economic strains have been further magnified by recent Federal tax refunds to taxpayers. The intent, when approving the refunds, was to have taxpayers help “stimu-

late” consumer spending, and, in turn, stimulate the economy. Whether such acts will prove to be fruitful is not the current issue. The issue at hand is that there has been a reduction in the revenue stream for Federal, state and local governments; and there has been an increase in spending by the Federal government. There have been further strains on the economy, at Federal, state and local levels, due to other factors, such as increasing terrorism alerts, unemployment, aging of the general population, medical costs and health concerns for consumers, etc. These issues, and many others, have challenged and adversely impacted the economy.

Along these lines, see the article by David Lereah, Senior Vice President and Chief Economist for the National Association of Realtors (NAR), *Realtor* magazine, page 18 (April, 2004). In this article, Mr. Lereah labeled the “trillion-dollar question” as: “What happens when the effects of the tax cut and Federal spending, which have swollen the budget deficit—and the Fed’s policy wears off?”

As noted by Mr. Lereah, the question is whether there will be an increase and expansion of corporate profits, job creation, strong consumer spending, and whether other positive signs will emerge to help the economy move in a positive, growth direction. If such favorable events occur, the budget deficit can be reduced and the economy will be postured for a positive position to continue low interest rates and, in turn, to continue a favorable housing market, along with other positive results.

The “counter” position is also of concern: If the expansion cannot be sustained, if jobs are not created, if consumer confidence is down, if the Federal Government is not able to gain economic support, these factors spell a great deal of trouble, arguably, to the Federal Government, and, in turn, to state and local governments. Most state and local governments are in a dire economic position at this time; they are attempting to find ways to cut their budgets to deal with the decreased economic positions. Unlike the U.S. government, states and municipalities have statutory requirements for balanced budgets.

#### **G. INTEREST RATES: A REFOCUS**

Although low interest rates have been extremely favorable to the economy, interest rates are rising now, and will generally continue to rise. How much those interest rates will increase, and how quickly they will rise, are key questions. A dramatic increase of interest rates over a short period of

time would be a major, negative blow to the economic posture of the United States. [For comments on these issues and related points, such as inflation, see the article by Raymond G. Torto, "Inflation Again," TWR-About Real Estate Report, in the *CBRE/Torto Wheaton Research Report*, Volume 5, No. 15 (issued April 19, 2004).]

### III. CONCLUSION

As stated at the beginning of this Note—and nothing has changed in these few pages—we are all uncertain as to exactly where the economy will move in the next few months.

There are more challenges to consider. In the article by Brian Miller, "More Challenges Ahead," [*Real Estate Forum* 30 (December, 2003)], Mr. Miller noted: "Despite signs the economy is improving, the experts say it will be some time before the property markets begin to turn around." As Mr. Miller pointed out in his discussions from many real estate experts, there are many factors to consider. The jobless recovery issue, the outsourcing of jobs to India and elsewhere, and many other factors need to be considered. Some argue that it will take many years for the U.S. economy to improve. This may mean part of the issue is longevity. As Ms. Jeanne Myerson (one of the parties involved in discussing the economy with Mr. Miller) commented: "Stay alive 'til 2008" is the key.

### PROJECTIONS FOR THE ECONOMY

Assumptions made by most prognosticators are normally "hedging" positions that assume certain factors. For example, in most projections for the economy, there is an assumption that there will not be major terrorism activities in the United States and that interest rates will rise, slowly. But, what if these "assumptions" are faulty? What about other assumptions?

In an article by Byron Wien, U.S. Senior Investment Strategist with Morgan Stanley (see the web site under [www.morganstanley.com/ourviews](http://www.morganstanley.com/ourviews)), there were a number of items noted as potential "surprises."

Many economists assume that job growth will reasonably continue, capital will be reasonably available, interest rates will remain reasonably low, and so forth. However, possible events such as additional terrorism, increasing deficits in foreign trade and domestic trade, escalating problems in Iraq, negative consumer confidence levels, financial scandals, and higher energy prices should give us pause.

The summary outlook for the economy remains: "Uncertainty." It appears that we know many factors that will influence how the economy reacts, and whether we will be in a generally "positive" or "negative" position as to the economy. The continuing problem is that we are not certain which factors will arise, which factors will move, and the degree and speed of movement of those factors. Such factors, especially changes in interest rates, war in Iraq, and terrorism issues continue to cloud the vision for projecting the economic position of the U.S.A.

The often-cited retort continues to be applicable to Bube—and all of us: "Wait and see." ■

FOCUS ON CONSTRUCTION

# High Rise Multi-family Construction

BY THOMAS COX , AIA

THANKS TO NEW TRENDS IN DESIGN, construction, and consumer demographics, the development of high-density housing in downtown areas is becoming increasingly popular. The multi-family market is hot at the moment . . . so hot that everyone is trying to get into it. The growing consumer interest in multi-family housing is drawing developers from other sectors of the industry, including single-family and commercial real estate developers.

Competition has always been fierce in the multi-family industry, and the bar of expectation continues to get higher. Today's renters and buyers are more demanding than ever when it comes to high design. They want to be surrounded by special features and amenities; they want to entertain guests, they want to be proud of where they live.

So what does this mean for the multi-family developer and what will it take to remain competitive? Sadly, the rising cost of building new for-sale and rental housing (especially in growing urban areas), will push many out of business. Those who do succeed in this increasingly competitive market will have to strive to improve and utilize new techniques, materials and design principles.

Multifamily developers -both for-sale and rental, will have to develop better, newer construction methodology such as modular construction, off-site manufacturing and pre-fabrication. Many of these techniques help save time, control quality and eliminate waste—they should be used in other types of construction as well.

Concrete and steel have to be used in order to achieve these higher densities in taller residential structures. In the urban environment, the developer of higher density housing is looking to build about 100+ units to the acre. Five stories is pushing wood to its absolute upper limits. Using Type 3 modified construction, which is a wood hybrid

technique, allows for up to 150 units to the acre. Higher densities are going to require Type 1 construction that utilizes concrete forms and steel framing.

Higher densities are not the only factor driving the shift from wood to concrete and steel. It's all about limiting liability. Water intrusion through walls, windows and roofs can create huge construction defect issues. Concrete and steel construction help to minimize some of these issues. The most important advantage to using these materials are their resistance to expansion or contraction due to moisture content, which can be a catalyst for mold. By not being vulnerable to fungi or organisms, concrete and steel help reduce the chances of mold infestation. Steel framing has the highest strength-to-weight ratio of any building material, and it doesn't rot, warp, split or crack, or serve as a banquet for termites.

Building with concrete and steel also helps with phasing and value engineering—it eliminates the guessing game associated with the fluctuating costs of lumber. We believe this will become an increasingly important factor in the future. As it is, in the last year, lumber prices have increased about 50 percent and plywood prices have increased about 100 percent. It should be noted however

## About our Featured Columnist

Thomas Cox is the senior principal with TCA (Thomas P. Cox: Architects). TCA is one of the most innovative multi-disciplined architecture, planning and urban design firms in the western United States. TCA is currently designing high-profile projects with leading developers throughout California and the Western United States.

that steel can be difficult to obtain right now because it's in such high demand, even in other countries like China.

Building with concrete and steel further eliminates waste, which is a huge advantage, especially with larger buildings. With the use of steel panelization, there is very little waste, and unused steel is recycled. In fact, approximately 60 percent of the steel used in steel panelization comes from recycled products, and for green community advocates, it's the most recycled material in the world. Another advantage . . . there's less mess on the jobsite itself, and thus cleanup time is minimized.

The use of concrete and steel does not present any major obstacles to design; in most instances, it helps because it can be more flexible. There are occasional design issues in which other materials have to be used to create the intended architectural detail, but the materials hybrid well. In many ways, steel framing creates unintended benefits by going up straight and true.

There are some architectural requirements that could only be achieved with steel framing. The panelized construction of the steel stud walls make it possible to mockup entire floors before development actually starts so design changes can be made prior to the final steel fabrication for the project. This can be an extraordinary opportunity to maximize final designs.

As far as the availability of a trained workforce is concerned, in many instances, building with concrete and steel can be more difficult. While I believe this is a better type of construction, it is more complex and difficult. There aren't a lot of people trained in this area yet, at least not in the residential construction industry, which puts those in the commercial construction industry in a good position to move into high-rise. Making the change from wood to concrete and steel construction can be difficult, but once you do, it is easier in the long-term. Builders can order panels with all studs and rough openings pre-cut for the "carpenter" to assemble. These panels can result in easier installation for workers; builders become more like assemblers rather than framers. Ultimately, this helps reduce construction time and creates a more consistent product since framing pieces are manufactured in a controlled environment and once on-site are impervious to weather and other climate conditions.

One of the challenges of designing high-rise is creating an "urban quality" design in a cost-effective manner. In many

instances, increasing the density of a project, allows for better profits. In fact, higher densities may be the only way to make these projects pencil out because of high land costs. It costs between \$250 and \$300 per square foot to build high-density projects of steel or concrete.

There are other issues as well: When you go higher, the city may require larger setbacks and more parking. Public/private partnerships are crucial to developing high-rise housing. It has to be a cooperative process in which everyone involved must work together from formulating a vision to gaining the necessary approvals. In order to get these projects off the drawing table, private companies must actively pursue partnerships with the city and it has to be done early in the game plan.

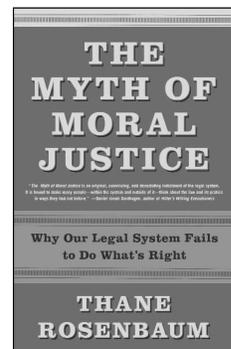
Many high-rise communities are benefiting from striking exterior designs that are made possible thanks to new creativity and thinking on the part of architects. These structures have assumed a new sense of scale and character. Many of these communities offer a mix of low- and high-rise buildings, which help create nice street scenes. New trends are emerging to satisfy the demands of today's more discriminating residents. These people demand high design and they want to live somewhere that's cool, contemporary... Today's looks are much more modern—although many draw upon elements of traditional design. Many of the newest high-rises are offering never before seen architecture, both inside and out. These unique designs feature vibrant color schemes, eclectic detailing, commercial windows, and the creative use of different materials such as industrial metal siding and concrete block.

This is definitely an emerging trend—the move towards higher-density housing in urban areas that provide a variety of first-class amenities and appointments. According to demographics experts, these communities are catering to a new breed of more sophisticated renters and buyers who are changing the face of multi-family design. It can be a challenging market to satisfy, but with the proper planning and know-how, multi-family developers are successfully appealing to this market by providing exceptional floorplan design, distinctive architecture, lifestyle conveniences, and five-star luxuries. ■

RECOMMENDED READING

# The Myth of Moral Justice: Why Our Legal System Fails to Do What's Right

by Thane Rosenbaum (2004, 354 pages)



REVIEWED BY BOWEN H. "BUZZ" MCCOY, CRE



Thane Rosenbaum, lawyer, law professor and novelist, explores the paradox that we are both fascinated and repulsed by our legal system. While we expect justice to be done, the legal system willfully ignores basic moral criteria.

As a result the justice system undermines truth, perpetuates secrets and lies, prevents victims from telling their stories, promotes adversarial enmity over community repair, and fails to equate legal duty with moral responsibility. Legal outcomes that make sense to lawyers and judges feel simply wrong to most people and enrage others. Many view the law as overly logical, technical, narrow, bureaucratic and insensitive to basic human emotions and moral principles. Rosenbaum explores our longing for moral justice using examples from literature and feature films.

Rosenbaum claims to attempt to teach his law students how to enter their chosen profession with a deeper spiritual and moral awareness of what the law lacks. As a novelist, he claims that with all its obsessive insularity and narrowness, its pretense that all that matters is what takes place under oath, the law misses the emotional back-story, the suppressed part of every lawsuit. It relies too much on logic and not enough on compassion. The institution of law defines itself as an arbiter of legal disputes, and not a dispenser of moral lessons or seeker of truths. It thrives on an adversarial process that only takes prisoners and leaves little room for peace. Legal facts override the moral

dimensions of emotional and literal truth. Procedural correctness becomes more important than establishing the truth. Legal ethics has more to do with legal correctness than moral values. Courts pick winners and losers in a zero sum game that fails to resolve emotional distress. The irreconcilable split between the legal and the moral shatters the public's faith in the law.

The novelist Rosenbaum states that the process of the law keeps one from telling their story coherently. Evidence rules truncate and rob stories of their meaning. For one who has suffered pain or loss, the telling of their story is an important aspect of healing, and the court does not provide this outlet. There is a basic incompatibility between grief and monetary damages. When the legal system shuts itself off from the story, it cannot do moral justice. In accepting plea bargaining, we have bargained away the sanctity of the truth for the certainty of jail sentences. The proliferation of settlements prior to trial have robbed the legal process of its therapeutic healing potential of bringing together the community in the search of the truth and the moral lessons that are learned from those truths. A settlement is tantamount to an entirely lawful, economically efficient bribe. Perjury is probably the most under-prosecuted crime in America.

## About our Featured Columnist

*Bowen H. "Buzz" McCoy is a retired investment banker and former President of the Counselors.*

## RESOURCE REVIEW

We are trained by lawyers never to admit guilt or apologize. In Japan, when an airplane crash occurs, the president of an airline will go to the homes of each of the families who suffered loss and virtually beg for forgiveness. In many cases this is more redemptive than monetary damages. We risk being punished if we go to someone else's aid. The law cannot compel one to become virtuous. We are all better off when virtue exists in the general population, and we are worse off when it is absent. As the Southern writer, Ala Tate, has written: "The religious unity of intellect and emotion, of reason and instinct, is the sole technique for the realization of values."

Great moralists from Dante to Kierkegaard have warned us that the law cannot be the final arbiter of the good in society. There is a level deeper than the law from which we draw our values. It is the level of the spiritual, religious, or transcendent. It is where in our innermost quiet times, we listen to what the good truly can be. It goes far beyond procedures and precedents. We must each discover our own inner strength, stability and emotional maturity. Perhaps Rosenbaum is asking us to place too much weight

on the law and not take enough responsibility for our own lives.

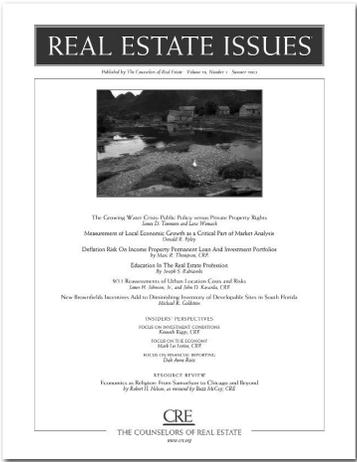
Once he has made his valid point, the book seems to continue longer than necessary, becoming preachy without resolution. The book is more visionary than practical, and lawyers will be annoyed at the author's superior tone. Provoking lawyers is clearly the book's point.

It is difficult to understand from a practical standpoint how the court system can also be expected to provide emotional healing. Should courtrooms serve as public forums for aggrieved parties cathartically to tell their stories rather than pursue monetary settlements? One can readily predict the reaction of a hardened courtroom lawyer suggesting that the client should: "Get his loving at home!"

Nevertheless, the book provides a mirror into which a middle-aged, burnt-out lawyer can examine himself and recognize once again the potential of what the law could be. ■

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