



REAL ESTATE LAW & INDUSTRY



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REPORT

SEPTEMBER 21, 2010

HIGHLIGHTS**'Grey Space' Masks True Dimensions of Current Office Space Oversupply**

The CoStar Group's **Mark Hickey** and **Aaron Jodka** write that as U.S. businesses steadily work through the worst of the recent economic downturn, evidence suggests vacancy rates could stabilize soon. But they also note that many common methodologies for calculating "grey space" understate the amount of underutilized office space that must be absorbed before the market truly turns around. **Page 663**

Legislation in Advance of Elections to Feature Narrow Slate of CRE Issues

As Congress returns to wrap up unfinished business before the midterm elections, the agenda for real estate interests has narrowed down to a few items, including key tax policy matters, that they believe could be addressed in the final six weeks. **Page 668**

ANALYSIS: Foreign Investors Hesitant About U.S. Commercial Real Estate

Randy Drummer of the CoStar Group writes that although investment activity is up sharply over last year's historic lows, sovereign wealth funds and other international investors find few buying opportunities for high-quality U.S. commercial real estate. **Page 678**

Proposed FASB Rule Changes for Leases to Alter Tenant Balance Sheets

The Financial Accounting Standards Board issues an exposure draft of proposed changes for how commercial leases will be accounted for on company balance sheets. Industry experts say the new rules would essentially move leases from company profit and loss statements to their balance sheets. **Page 675**

INDUSTRY SPOTLIGHT: Wasteful Water Uses Call for Shifts in Development

Robert Glennon, author and professor at the Rogers College of Law at the University of Arizona, says water is finite and new ways to overuse it are being discovered daily. He calls for more intelligent approaches to water consumption by U.S. real estate developers. **Page 671**

FDIC Official Warns Senators of Complications in Covered Bonds Bill

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PROPERTY VALUES: Moody's Investors Service reports that commercial property prices in July post a second consecutive big decline—this time 3.1 percent—all but wiping out gains posted since values began to reverse a two-year slide last November. **Page 667**

DEAL OF THE WEEK

LEASING: With tenant concessions winding down, New Jersey leasing velocity up a reported 60 percent over last year, and construction costs moderating, a Matewan, N.J.-based real estate investment and development company completes 77 office lease transactions in the third quarter, according to Denholtz Associates. **Page 657**

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CENTRAL ASIA: Despite recent economic reverses, Astana, Kazakhstan, a city that barely existed 10 years ago, opens a \$400 million entertainment mall, another oversized project fueled by Kazakhstan's oil and gas economy. **Page 679**

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Finance

Covered Bonds

FDIC's Krimminger Warns Senators Of Complications in Covered Bonds Bill

Pending legislation to bolster the covered bonds market met with resistance for the first time Sept. 15, as federal regulators highlighted potential conflicts with the current legal framework, including the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act.

At a hearing, Michael Krimminger, deputy to the chairman of the Federal Deposit Insurance Corporation, told the Senate Banking Committee that the United States Covered Bonds Act (H.R. 5823) would constrain his agency's current flexibility to maximize the value of a failed bank's covered bonds.

Also testifying, Julie Williams, chief counsel at the Office of the Comptroller of the Currency, took issue with the bill's provision for a new covered bonds regulator within the Treasury Department. Putting one new regulator in charge "has the advantage of inherent uniformity," but also the "disadvantage of not utilizing existing supervisory knowledge and expertise of current federal financial regulators." Williams recommended, instead, that federal financial regulators collaborate to implement a single, uniform set of standards applicable to all covered bond issuers.

Broad Approach. The officials' criticisms were the first against a measure that has so far sailed through the legislative process with bipartisan support. Reps. Scott Garrett (R-N.J.) and Paul Kanjorski (D-Pa.), senior members of the House Financial Services Committee, introduced H.R. 5823 July 22. Days later, the committee unanimously approved the measure. With looming midterm elections, however, the bill's chances of reaching the House floor are uncertain.

At the Senate hearing, Garrett reiterated his view that covered bonds can oil wheels of credit that are still stiff from the financial crisis. Like asset-backed securities—which lay at the heart of the crisis—covered bonds are funded by mortgages and public sector loans. However, unlike ABS, they carry a relatively low risk of default, because covered bond issuers directly own the underlying debt instruments.

When Sen. Bob Corker (R-Tenn.) questioned whether the bill could be further improved, Garrett responded that the measure currently limits the type of assets that could fund covered bonds. He expressed hope for a broader approach to accommodate "a whole slew of different asset classes."

However, Sen. Jeff Merkley (D-Ore.) asked whether a broader approach could cause simple covered bonds to become multilayered, highly complicated, excessively risky structured finance products. Scott Stengel, a partner in the Washington office of Orrick, Herrington & Sutcliffe who testified on behalf of the Secu-

rities Industry and Financial Markets Association, assured Merkley that the industry's interest is in a "benchmark" covered bond market. At the same time, however, he acknowledged the potential for innovation of a "structured covered bond."

European Phenomenon. Stengel unequivocally endorsed Garrett's proposal. Only legislation, he said, not regulatory guidance alone, can create a "deep and liquid" covered bonds market. Stengel was referring to the FDIC's 2008 policy statement on covered bonds, which addresses how covered bonds should be treated in the receivership of the issuing bank.

Contradicting Stengel's view, Krimminger expressed doubt that legislation is necessary to create a vibrant covered bonds market. If Congress chooses to move ahead, however, it should use the FDIC's 2008 policy statement as a framework, he told the senators.

Committee members, however, have been less eager on this subject than their House colleagues. Prior to introducing his bill, Garrett tried to incorporate his idea into the Dodd-Frank law. However, during the joint congressional conference that led to the law's final version, senators objected to Garrett's bid and called first for a hearing.

The senators' hesitation reflected U.S. unfamiliarity with covered bonds. A handful of U.S. institutions have issued the instruments, but the market has not enjoyed the same success as in Europe. At the Senate hearing, Kenneth Snowden, an economics professor at the University of North Carolina, Greensboro, said that "bad timing, poor implementation, and ineffective regulation" likely stunted U.S. interest in the instruments.

Garrett, however, has consistently characterized covered bonds as a missed U.S. opportunity. At the Senate hearing, Garrett conceded that covered bonds are not a "magic bullet" to ongoing credit woes, but insisted that a robust market for these products would "solve some of our funding needs."

Shifting Losses. Although Krimminger supported the development of a vibrant covered bonds market, his concern was that Garrett's proposal to accomplish this goal would "create a new class of investments that appears 'risk-free' by providing investors with protections unavailable for any other investment."

Under the bill, Krimminger explained, the FDIC would have only two options for handling failed bank issuers of covered bonds: continue to perform the bond's obligations for a temporary period or shift the underlying collateral to a separate trustee for the bond's estate. For all other asset classes, Krimminger said, the FDIC has the third option of repudiating the bond, paying damages, and taking control of the collateral. As such, Krimminger forecast that H.R. 5823 would ultimately make the Deposit Insurance Fund—and the more than 8,000 FDIC-insured banks that sponsor it—bear covered bond losses.

The “unprecedented protection” for covered bond investors over other secured creditors, Krimminger added, “runs counter” to the policy embodied in Section 215 of the Dodd-Frank law. The provision mandates a study to evaluate whether a potential haircut on secured creditors could improve market discipline and reduce costs to taxpayers. According to Krimminger, Congress required the study in recognition of the role that the “run on secured credit and the insatiable demand for more collateral” played in the financial crisis.

Williams said that the advantages of covered bonds as an alternative to traditional financing mechanisms would depend on upcoming changes in capital rules as well as the risk-retention, or “skin-in-the-game,” provisions of the Dodd-Frank law.

BY MALINI MANICKAVASAGAM

The witnesses' complete testimony is available on the Senate Banking Committee's website at <http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Home>.

HOUSING REGULATION

New York statutes designed to protect tenants from the actions of unscrupulous landlords can have unintended consequences by forcing owners who are already financially strapped to abandon their commitments. Here the authors analyze the real-world experience of building owners and tenants who become victims of the warranty of habitability at a time when the recession is putting stress on the housing sector. They argue that the law itself needs to be revisited in light of its impact on residents and owners.

The Warranty of Habitability: An Unexpected Hazard in Home Mortgage Foreclosure



BY ADAM LEITMAN BAILEY AND DOV TREIMAN

Most attorneys and nearly all educated tenants in the state of New York are aware of the existence of the warranty of habitability. Few know that it is statutory in basis; fewer care that it contradicts the common law, but most would be surprised by the types of occupancy to which it applies. Even more surprising to most is the effect it has on the mortgage foreclosure process.

While none of these doctrines are exactly new, they are enjoying a new prominence in the popular and legal press because tenant advocacy groups are finding that the epidemic of foreclosure has brought with it a re-

newed pandemic of neglected housing. Where a landlord has lost the ability to pay its mortgage, it predictably stops making repairs to the building. If the tenants seek to have the building maintained, as through court proceedings, finding a funding source for the repairs can be challenging.

Understanding the Cycle. In order to put the entire process in perspective, one must realize that neglect of repairs and inability to pay the mortgage is, in most buildings, a self-feeding cycle that virtually guarantees the tenants will live in ever-increasing squalor until the building itself is, of public necessity, torn down. While on the surface a great benefit to tenants, the warranty of habitability found in Real Property Law § 235-b, winds up working against tenants and for nobody once this cycle initiates.

This is how it goes: The landlord, for whatever reason, neglects repairs. This can be for any number of reasons. These can include, for example, that the landlord is simply unscrupulous and seeking to yank as much money out of the building as possible while spending as little of it as possible back on the building. This was a fairly common model in the late 1970s and early 1980s and led to the devastation of square miles of the South Bronx. The Bronx was particularly vulnerable to such practices due to a number of factors, notably including the construction of the Cross-Bronx Expressway in the 1960s, which destroyed huge swaths of middle class neighborhoods, rendering previously desirable housing undesirable.² Similar but less severe results obtained in swaths of Brooklyn disturbed by the

Adam Leitman Bailey is the founding partner and Dov Treiman is a partner of Adam Leitman Bailey, PC.

² Rooney, *Organizing the South Bronx*, (Albany, NY 1995).

earlier construction of the Brooklyn-Queens Expressway.³

However, eventually the scars on neighborhoods caused by these mega-highways healed and these neighborhoods, especially those well served by the subway system, became once again desirable places to live and therefore desirable places to invest. That, however, was the set-up for the current wave of neglect. The desirability of these locations drove the prices of the buildings very high, especially as it appeared increasingly easy to build either a cooperative, a condominium, or even a rent-regulated building with the tax breaks associated with the J51 program.

However, when the financial systems melted down in 2008, there suddenly appeared on the market a glut of overpriced, over-mortgaged buildings, all with negative equity. Even unregulated buildings became unable to carry their own mortgages because the tenants themselves lacked the funds to pay the higher rents. And in regulated buildings, so-called “preferential rents” where a landlord charges significantly less than the law allows, came very much into vogue.

So the landlords found themselves simply unable to pay for repairs to the building, particularly because the building was carrying a mortgage inflated far beyond the building’s recession-adjusted equity. Once landlords started neglecting repairs, tenants, correctly so, started claiming entitlement to an abatement in rent for breach of the warranty of habitability. Since they were right, this meant the landlords got still less rent and still less ability to make repairs. They certainly could not fund the repairs by borrowing more on buildings that were already over-mortgaged. So the neglect of repair became more severe, leading to still lower rents, and so on.

Foreclosure became inevitable.

Dangers From Receivers. With income-producing property, one of the most common early steps in the foreclosure is the appointment of a receiver to take in the income of the property and to disburse it to preserve the property’s value so it will bring as high a price as possible at the auction that lies near the end of the foreclosure process. Yet one decision, *Fourth Federal Savings Bank v. 32-22 Owners Corp.*⁴, lies like an alligator under the surface waiting to snap at any passing prey. Under *Fourth Federal*, if a receiver seeks to collect rent where there has been a violation of the warranty of habitability, not only is the receiver’s claim for rent defeated, but the tenant can procure an order from the receiver’s appointing court that the foreclosing party pour more money into the building to make repairs required by the warranty and, of course, also required by the various municipal codes. So long as the foreclosing party does not move for such a receiver, there is no case imposing that kind of wash-back liability. While this could theoretically discourage the bringing of foreclosure actions in the first place, it should certainly make foreclosure counsel think twice about moving for appointment of a receiver.

³ <http://www.nycroads.com/roads/brooklyn-queens> (Last visited 8/10/2010).

⁴ 236 A.D.2d 300, 653 NYS.2d 588 (1st Dept 1997).

Limits of the Warranty. While this outcome is supposed to be tenant-friendly, consider how tenant-hostile it is in practice. If there is a receiver, the receiver is as liable on the warranty of habitability as anyone.⁵ If, on the other hand, the tenants start a rent strike under Article 7A of the Real Property Actions and Proceedings Law, the administrator appointed by the Civil Court is also equally subject to the warranty of habitability.⁶ Even if the building is sold for taxes and the building comes under New York City ownership, the city is still bound to the same rigors of the warranty of habitability.⁷ Even if after the building is sold for taxes, the city sponsors a cooperative apartment corporation and returns the building to private ownership, it does not help the tenants. Cooperative apartment corporations are also bound by the warranty of habitability,⁸ even as to the common areas.⁹ While condominium units are not directly subject to the warranty of habitability,¹⁰ when the city re-privatizes a building, it is always in the form of a cooperative, never a condominium.

Unconventional Wash-Back Liability. In all the scenarios we have discussed, there is no question that the tenant is a tenant; rather it is the “landlord” who may be somewhat difficult to recognize as such. The sole exception to this is a condominium owner who is no species of tenant at all, but rather the owner of a dwelling in fee simple absolute, the vertical equivalent of owning a one-family home. Yet even for these owners, the warranty of habitability can become an issue—not one favoring the unit owner, but rather one that cuts against the owner. That is to say that when a unit owner rents out the unit to what we would normally be inclined to call a “subtenant” but who is in fact a tenant, the unit owner takes on the landlord side of the warranty of habitability and is the warrantor, rather than the warrantee.¹¹ The situation is somewhat different in a coop, however. There the unit owner normally is a tenant. If, however, that tenant rents the place out to a subtenant, the unit owner, being out of possession, has no claim to the warranty of habitability,¹² but rather is responsible

⁵ *Bankers Federal Savings, FSB v. 247 W. 11th St. Owners Corp.*, 19 HCR 345A, NYLJ 6/5/91, 22:6 (Sup NY Evans).

⁶ *HPD v. Sartor*, 109 AD2d 665, 487 NYS2d 1 (AD1 1985); *Westway Plaza Assocs. v. Doe*, 179 AD2d 408, 578 NYS2d 166 (AD1 1992).

⁷ *HPD v. Sartor, supra*; *City of NY v. Jones*, 20 HCR 319A, NYLJ 5/28/92, 24:5 (AT 2 & 11); *City of NY v. Lewis*, 20 HCR 319B, NYLJ 5/28/92, 24:6 (AT 2 & 11); *City of NY v. Rodriguez*, 117 Misc2d 986, 461 NYS2d 149 (AT1 1983).

⁸ *31171 Owners Corp. v. Thach*, 21 HCR 169B, NYLJ 4/21/93, 21:2 (AT1); *Granirer v. Bakery, Inc.*, 54 AD3d 269, 863 NYS2d 396 (AD1 2008).

⁹ *2121 Shore Condo [Bd. of Mgrs.] v. Pennachio*, 19 HCR 605A, NYLJ 10/4/91, 25:3 (AT 2 & 11).

¹⁰ *Abbady, et al. v. Abbady*, 216 AD2d 115, 629 NYS2d 6 (AD1 1995); *Frisch v. Bellmarc Mgt., Inc.*, 190 AD2d 383, 597 NYS2d 962 (AD1 1993); *Parkchester North Condo [Bd. of Mgrs.] v. Quiles*, 234 AD2d 130, 651 NYS2d 36 (AD1 1996); *Strathmore Homeowners Assoc. v. Colon*, 28 HCR 356A, NYLJ 5/30/00, 27:1 (AT 9 & 10).

¹¹ *Itskov v. Rosenblum*, 7 Misc3d 135(A), 801 NYS2d 235 (AT1 2005).

¹² *Park South Tenants Corp. v. Chapman*, 19 HCR 522A, NYLJ 8/26/91, 24:2 (AT1); *Clinton Hill Apt. Owners v. Gooden*, 20 HCR 393B, NYLJ 6/26/92, 24:6, HCR Serial #00003086 (AT 2 & 11); *142 E. 16 Coop Owners, Inc. v. Jacobson*, 26 HCR 345A, NYLJ 6/5/98, 29:3 (AT1).

for the warranty to the subtenant.¹³ The unit owner bears the liability to the subletting occupant; the coop itself has no such liability.¹⁴

When we look at all of this through the lens of wash-back liability under *Fourth Federal*, we see that in conventional landlord-tenant buildings, the foreclosing bank may want to think twice before appointing a receiver. In a foreclosure on a cooperative apartment house, the same holds. In foreclosing on an individual cooperative unit, the procedure does not call for a receiver, so there is no issue. In foreclosing on a condominium, the only wash-back liability issues could come from persons to whom the individual unit owners have rented their units.

Other Sources of Liability. Of course, when looking at the questions of repairs to a building, the warranty of habitability only speaks to contract liability. One therefore should not ignore the questions of tort liability, specifically what happens if someone gets hurt by the shoddy condition of the building. The answer to this question has always lain not purely in terms of who owns the building, but also in terms of who controls the building.¹⁵ So, when a mortgagee brings a foreclosure proceeding against the mortgagor, if there is no appointment of a receiver, tort liability remains that of the mortgagor alone up until the very moment the title to the building passes by the execution of the deed as a result of the foreclosure auction.¹⁶ Further, there is no responsibility on the part of an out of possession mortgagee (foreclosure plaintiff) to comply with state and local building or housing codes or to make any other repairs.¹⁷ However, any receiver would have such liability both with respect to complying with building and housing codes and in tort if someone is injured.¹⁸

Mortgagees in Possession. Many older mortgages and some new ones allow for the mortgagee to short-circuit the receiver process and step directly into possession. However, this gives the mortgagee the worst of both worlds. First, it makes the mortgagee totally personally liable to its last penny for anything in the building—warranty of habitability, building codes, injuries, anything. Secondly, it places the building in a legal position where nobody has the statutory authority to bring a summary proceeding for unpaid rent.¹⁹

¹³ *Pickman Realty Corp. v. Hess*, 21 HCR 328B, NYLJ 6/22/93, 27:4, HCR Serial #00000640 (AT 2 & 11).

¹⁴ *Wright v. Catcendix Corp.*, 248 AD2d 186, 670 NYS2d 15 (AD1 1998); *McCarthy v. Bromley Condo [Bd. of Mgrs.]*, 271 AD2d 247, 706 NYS2d 104 (AD1 2000).

¹⁵ *Mortimer v. East Side Savings Bank*, 251 A.D. 97, 295 N.Y.S. 695 (4th Dept. 1937).

¹⁶ *Forbes v. Aaron*, 27 Misc.3d 719, 897 N.Y.S.2d 849 (Sup Kings 2010).

¹⁷ *Greenpoint Bank v. John*, 256 A.D.2d 548, 682 N.Y.S.2d 438 (2d Dept. 1998); and see *207 Realty Assocs., LLC v. DHCR*, 45 AD3d 364, 845 NYS2d 285 (AD1 2007).

¹⁸ Multiple Dwelling Law § 4 (44) casts liability for effecting repairs and as a consequence tort liability on "owner or owners of the freehold of the premises or lesser estate therein, a mortgagee or vendee in possession, assignee of rents, receiver, executor, trustee, lessee, agent, or any other person, firm or corporation, directly or indirectly in control of a dwelling."

¹⁹ *Singer v. Bermudez*, 117 Misc2d 708, 458 NYS2d 1018, TLC Mortgagee In Possession 1, TLC Serial #0041 (Civ NY Lehner 1983).

Conclusion. It is easy in all the situations we have discussed to look for villains. Yet there is nothing villainous about an honest tenant wanting decent housing; nothing villainous about a bank wanting its mortgage repaid; nothing villainous about an honest businessperson simply not being able to make a go of it. So without anyone to blame, there is nobody to point to as a logical one to have to pay for the damage. Several decisions have hinted that the only possible solution lies in legislation, but since there is no government feeling particularly flush at the moment, whatever the legislative solution would be it can only reallocate the pain.

Bank Failures

Regulator Sells Equity Interest in Assets To Mariner From Failed Kansas Institutions

The Federal Deposit Insurance Corporation (FDIC) Sept. 8 closed on the sale of a 40 percent equity interest in a limited liability company created to hold assets with an unpaid principal balance of approximately \$762 million from 20 failed bank receiverships.

Leawood, Kan.-based Mariner Real Estate Partners, LLC submitted the winning bid, offering a price of 30.93 percent of the unpaid principal balance.

As an equity participant, FDIC said it would retain a 60 percent stake in the LLC and share in the returns on the assets. Whatever FDIC earns will likely be returned to the deposit insurance fund.

FDIC offered 1:1 leverage financing, and said it would issue purchase money notes through the LLC in the original principal amount of \$109 million.

FDIC received eight bids from five bidders in the offering, conducted on a competitive basis. Bidders could opt for either a 40 percent leveraged ownership interest or a 20 percent unleveraged ownership interest in the newly-formed LLC.

FDIC, as receiver for the failed banks, said it would convey to the LLC a portfolio of approximately 1,062 distressed residential, commercial acquisition, and development loans, of which more than 80 percent are delinquent. Collectively, the loans have an unpaid principal balance of \$762 million. Fifty-nine percent of the collateral in the portfolio is located in Colorado, Utah, California, Idaho, Nevada, and Washington. All loans were from banks that failed in the past 25 months, FDIC said.

As the LLC's managing equity owner, Mariner will manage, service, and ultimately dispose of the LLC's assets.

BY THECLA FABIAN

FDIC has posted a short statement on the sale at <http://www.fdic.gov/news/news/press/2010/pr10204.html>.

Structured Transactions

FDIC Smaller Dollar Structured Transactions Aimed at Broadening Investor Participation

The Federal Deposit Insurance Corporation (FDIC) plans to start offering smaller-sized, more geographically focused loan pools in structured transactions formed in its capacity as receiver for failed banks to dispose of loans and related assets.

In a notice issued Sept. 13, FDIC said it expected to conduct multiple auctions of equity interest in structured transactions, generally offering up to 40 percent of a limited liability corporation (LLC), over the next few months, and that asset pools in those LLCs might include commercial real estate loans, commercial acquisition, development and construction loans, residential acquisition, development and construction loans, commercial loans secured by assets other than real estate, or single-family residential loans, and related assets such as real property.

In order to attempt to increase the number of participants in the FDIC's structured transactions, the offered asset pools held in the LLCs might be \$200 million or less and be geographically focused, FDIC's notice said, adding that the agency believed that, by offering geographically focused and smaller dollar pools, it would also support FDIC's activities to provide opportunities to increase the diversity of bidders or bidder consortia.

FDIC might issue up to five structured transactions with bid dates in the fourth quarter of 2010, and each of these may include one or more small pools, Dave McDermott, assistant director of FDIC Acquisition Services in the Division of Resolutions and Receiverships, told BNA. Geographical areas, he said could be as broad as a major region such as the Midwest, or, in areas where the number of bank failures has been high, such as the southeastern United States, could include only a couple of states.

Investors Asked for Smaller Pools. McDermott said FDIC has done a number of outreach events on asset marketing, and found many investors asking for smaller asset pools. The feedback that FDIC was getting was that due diligence on pools of around \$1 billion can be very expensive for smaller investors, and pulling together a funding package on these large pools also can be difficult. They made a good business case that smaller, more regional pools, would increase the number of bidders and lead a lot of mid-tier investors to pre-qualify as bidders, he said.

Smaller investment firms and regionally focused investment firms have expressed interest in such pools, either as individual bidders, or leaders of a bidder consortium, he added.

BY THECLA FABIAN

FDIC's notice of the new smaller structured transactions is available at <http://www.fdic.gov/buying/financial/smallerpools.html>.

Securitization

Bank Holding Companies Could Have Role In Proposed Plan for Narrow Funding Banks

A proposed new framework for the asset-backed securities (ABS) market might be tweaked to include a role for bank holding companies and financial holding companies, Federal Reserve Board Governor Daniel K. Tarullo said Sept. 17.

The proposal, presented by two Yale University finance professors during a Brookings Institution seminar, would establish Narrow Funding Banks—a new kind of bank charter with exclusive authority to buy securities backed by credit card receivables, auto loans, student loans, and other assets. They could also buy other high-quality assets such as Treasury securities.

Under the proposal, Narrow Funding Banks (NFBs)—the creation of which would require congressional action and a new regulatory framework—would stand between securitizations and investors.

Investors, instead of buying asset-backed securities as they do now, would buy debt or other obligations issued by the Narrow Funding Banks.

Tarullo, who participated in a discussion of the proposal, critiqued it without endorsing or rejecting it.

But he offered several suggestions. As structured, the proposal generally envisions private ownership of NFBs, but would ban commercial banks from taking stakes.

HBCs Might Own NFBs. However, Tarullo said NFB ownership might be broadened “to include bank holding companies.”

“It is possible that a number of large, diversified financial holding companies would find an NFB a viable part of their operations,” Tarullo said. He said partial ownership by bank firms might make the NFB business model more viable and quell potential concerns about the proposal's competitive effects.

Bank holding companies are firms that control one or more commercial banks. Financial holding companies are bank holding companies with expanded powers. Both BHCs and FHCs are regulated by the Fed.

Tarullo also suggested that NFBs might be explicitly chartered as public utilities, while acknowledging that the track record of government-chartered mortgage firms Fannie Mae and Freddie Mac raises questions about the wisdom of that approach.

The history of Fannie Mae and Freddie Mac, he said, “is a cautionary tale of the potential for a government monopoly with a conservative mandate to expand its operation into much riskier activities.”

BY R. CHRISTIAN BRUCE

*The proposal was set out in a paper, *Regulating the Shadow Banking System*, authored by Gary Gorton and Andrew Metrick, professors of finance at Yale University and research associates at the National Bureau of Economic Research.*

The text of Tarullo's prepared remarks may be found on the web at: <http://www.federalreserve.gov/newsevents/speech/tarullo20100917a.htm>

Office

DEAL OF THE WEEK

New Jersey Firm Inks 77 Leases in 3Q, Riding Wave of Improved Market Conditions

With tenant concessions winding down, New Jersey leasing velocity up a reported 60 percent over last year, and construction costs moderating, a Matewan, N.J.-based real estate investment and development company has completed 77 office lease transactions in the third quarter, according to a Sept. 7 statement by Denholtz Associates.

The transactions break down into 17 new lease agreements, five expansions, and 55 lease renewals, totalling approximately 311,876 square feet, according to the statement. Stephen Olefson, Denholtz Associates' director of leasing told BNA Sept. 15, "We have been very lucky."

All of the Denholtz transactions filled up space in office buildings, Olefson said, in line with very recent statistics indicating that the New Jersey office market is on an upswing. The Aug. 16 CB Richard Ellis (CBRE) Second Quarter 2010 New Jersey Office MarketView stated that although the overall availability rate remains high, second quarter and first half leasing velocity in the New Jersey office market outperformed the second quarter 2009. The CBRE report said that the 1.38 million sq. ft. of leasing velocity during the second quarter "dramatically outpaced . . . Q2 2009's 865,068 sq. ft., which was a record low." The report said that this represented a leasing activity increase of 48.7 percent for the first half of 2010—938,693 sq. ft.—compared to the first half of 2009.

The second quarter, however, was not as impressive as the first, with transactions dropping 96,174 sq. ft. Overall average asking rents declined to 21.7 percent, or 34.1 million sq. ft., despite a dip in the availability rate. Year-to-date net absorption, however, remains at negative 141,822 sq. ft., according to the report.

Olefson, in a Sept. 28 e-mail to BNA, said "Potential federal tax changes have business owners waiting until [the] midterm elections before making any decisions."

Incentives Windows Closing. The number of deals offering recession-style breaks and incentives are "way down," Olefson said, and "much less popular than they were a year ago," as both tenants and landlords are finding them ephemeral. He compared them to needs and wants, with something like two months free rent falling into the "wants" category. "You had a lot of concessions going on last year," he said, . . . "[but] the biggest concession is, what is your lease rate? Incentives are short term . . . [tenants] need to know what [their] monthly amount is going to be, from month one to month 50." A lower lease rate, a "nice quality buildout"—which he said is not a concession but a land-

lord's responsibility—and a building with a high occupancy rate are far more attractive to prospective tenants.

Construction and renovation prices have "settled out," he said, and he hasn't seen a lot of landlords asking for additional savings from the trades. "You know what you are getting into now," he said. Price point breaks, he said, are "all over the place. We have offices in the 20s [\$20 per sq. ft.] and we have warehouse space that is \$6 or \$7 [per sq. ft.]."

The Incredible Shrinking Law Office. Olefson said one aspect of leasing that "a lot of people don't talk about" is the extent to which technology is shrinking some workspaces. This is especially noticeable in the professional buildings, he said. A law firm's library, he said, demanded perhaps 20 percent of the available space. "Now," he said, "everything is online. So now you talk about . . . 8,000 square feet."

The requirements of tenants have shifted, he said, toward spaces that are both smaller and more open. "The requirements of the partners and the associates might not be what they once were. They might have wanted a 14 x 14 [foot] office and so forth, but you see an averaging out of everything, everybody has the same size office." Firms are trending, he said, to hand out smaller offices and "pack more people in . . . more productivity out of less spending and less space. Firms are sensitive to costs and wasted space and they are going to put money into the business, not into the square feet," he said.

A Hotbed of Ice Hockey. Of the 77 transactions, Olefson said the most interesting was a retail deal for the first southward expansion of the Massachusetts-based Pure Hockey chain, a company that specializes in lacrosse and hockey gear, sports that Olefson said are natural for New Jersey, a region he described as "a real hotbed for ice hockey and lacrosse." Denholtz got them 15,500 sq. ft. in a building in Fairfield Business Center, an area not zoned for retail use, causing Denholtz to apply for a use variance from Fairfield, N.J., township. They were successful. "Given the ratables (how much income an occupied space can bring to the municipality) that would be created for the township by us, there was a willingness for the township to . . . consider it." The township approved, he said, and the Pure Hockey outlet end up as "the biggest contributor to the township . . . [providing] a tremendous amount of help to the town's recreational facilities."

By KEVIN LAMBERT

Retail

Damages

Contractor Cannot Get Rise in Rental Value As Damages for Space Improved for Tenant

A Florida District Court of Appeal ruled Sept. 7 that the proper measure of damages for a contractor's claim of unjust enrichment stemming from improvements made to a landlord's property was the contractor's expected compensation for its work, not the increase in rent the landlord was able to obtain for the property after the work was completed (*14th & Heinberg LLC v. Terhaar and Cronley General Contractors Inc.*, Fla. Dist. App., No. 1D09-0169, 9/7/10).

In a unanimous decision authored by Judge William A. Van Nortwick Jr., the appeals court rejected plaintiff contractor Terhaar and Cronley General Contractors Inc.'s claim that it was entitled to the increase in rental rate defendant landlord 14th & Heinberg LLC received after Terhaar performed work on a retail space Heinberg owned. Van Nortwick said that to award Terhaar the windfall of the increased rental rate would violate the equitable principles on which a claim for unjust enrichment was based.

Bankrupt Tenant Led to Claim. Former department store retailer Montgomery Ward hired Terhaar in 2000 to perform improvements to its retail mall space leased from landlord Heinberg. In December 2000, after Terhaar completed the improvements but before payment was made in full, Montgomery Ward filed for bankruptcy protection.

When Montgomery Ward filed for Chapter 11 bankruptcy, it still owed over \$180,000 to Terhaar under the contract between the two. Terhaar eventually obtained a bankruptcy judgment of \$67,000 for the money Montgomery Ward owed Terhaar. Meanwhile, Heinberg terminated its lease with Montgomery Ward and relet the space to another company for significantly more than Montgomery Ward had been paying.

To obtain the balance of the amount Terhaar was owed for the work it performed, Terhaar sued Heinberg for unjust enrichment, claiming Heinberg received the benefit of an improved space to lease without properly compensating Terhaar. After a bench trial, Terhaar was awarded damages of over \$116,000, plus interest of almost \$99,000 for its unjust enrichment claim against Heinberg.

Despite its victory, Terhaar appealed the trial court's judgment, arguing that damages should have been calculated from the increase in rental rate that Heinberg was able to obtain after Terhaar performed work on the space. Using this method of damage calculations, Ter-

haar claimed the proper amount of damages should be in excess of \$2 million.

No Possessory Interest in Property. As justification for its damage calculation, Terhaar cited *Levine v. Fieni McFarlane Inc.*, 690 So. 2d 712 (Fla. 4th DCA 1997), in which a party expecting to lease a property performed certain improvements to it, and was ultimately awarded on an unjust enrichment claim the increase in rental rate the landlord obtained after denying the party the lease. The *Levine* court held that the enhanced value a landlord obtained from tenant improvements was the correct measure of damages for an unjust enrichment claim, and Terhaar relied on this holding in making its claim for increased damages.

Van Nortwick, though, said *Levine* was distinguishable from Terhaar's situation because Terhaar never claimed a possessory interest in the property, as the prospective improving tenant in *Levine* did. The court noted that the trial court found that "it would be inequitable for Terhaar to recover such a windfall when it had no expectation of such a recovery when it entered into its contract with Montgomery Ward."

According to the court, a claim for unjust enrichment "is an equitable claim based on a legal fiction" of an implied contract between parties. In such a situation, the court said, "liability is determined by principles of equity and justice and the intent of the parties is immaterial."

Expected Compensation Damages Appropriate. The appeals court agreed with the trial court's determination that Terhaar's expected compensation under its contract with Montgomery Ward was an appropriate measure of damages for its unjust enrichment claim. "Terhaar expected to be compensated pursuant to its contract with Montgomery Ward when it made the leasehold improvement," said Van Nortwick, and reiterated that, "Unlike the parties in *Levine* and *Arey* [*v. Williams*, 81 So. 2d 525 (Fla. 1955)], it did not have an expectation that it would benefit from any increase in value to the improved property."

In affirming the trial court's formulation of damages, Van Nortwick said "competent substantial evidence supports the trial court's finding that it would be inequitable to award Terhaar the value of the increase in rental value when it would not have received such value had the contract been performed by Montgomery Ward."

By ERIC TOPOR

For the full text of *14th & Heinberg LLC v. Terhaar and Cronley General Contractors Inc.*, go to <http://op.bna.com/rel.nsf/r?Open=etor-89eqrt>.

Housing

Multi-Family Housing

Laundry Room Signage Was Possible Notice Of Unrecorded Lease to Apartment Purchaser

The Court of Appeals of Indiana ruled Sept. 10 that signs in an apartment building's laundry rooms indicating the rooms were leased to a laundry service company could have provided actual notice of the lease to the property's new owner (*Commercial Coin Laundry Systems, et al. v. Park P LLC*, Ind. App., No. 34A02-1002-PL-185, 9/10/10).

Plaintiff apartment building owner Park P LLC filed suit to quiet title and declare Commercial Coin Laundry Systems' lease void because it was not recorded as Indiana state law required. The trial court granted summary judgment to Park P, finding that it was a bona fide purchaser and was not bound by the lease for which it did not have constructive notice of before purchasing the property.

On appeal however, Commercial Coin argued that Park P had actual notice of the lease, as there were signs to that effect posted in the property's laundry rooms. The appeals court agreed, and reversed the trial court's summary judgment order. Appeals court Judge Terry A. Crone's opinion said that the signs created a genuine issue of fact as to whether Park P had actual notice of the lease.

Ownership Transition. Commercial Coin originally signed a 10-year lease in 2000 with Home Apartment Development, the owner of the 254-unit apartment building at that time. The lease allowed Commercial Coin to install and operate laundry machines in the building's two laundry rooms.

Commercial Coin installed its laundry equipment in March 2000, and also put up signs in both laundry rooms and labels on the laundry machines indicating that Commercial Coin owned and operated the machines, "Pursuant to a written lease for these premises . . ."

Park P purchased the building from Home Apartment Development on April 25, 2005, and on May 4, Commercial Coin sent Park P a letter requesting that a "New Lessor/Agent Verification and Tax Identification" form be executed so Commercial Coin could direct its lease payments to Park P. A new agreement was executed, but the following month, Park P notified Commercial Coin that the condition and operation of the two laundry rooms was unsatisfactory and presented potential safety hazards.

Park P said it would continue to honor Commercial Coin's lease, but only if Commercial Coin agreed to assume liability for any accident that occurred in the laundry rooms. Commercial Coin did not agree to assume liability, and Park P filed suit to quiet title, and for a declaratory judgment that Commercial Coin's lease was void.

Lease Not Recorded. Both parties filed competing motions for summary judgment at trial. However, the trial court granted summary judgment to Park P on the grounds that Commercial Coin failed to properly record its lease in accordance with Indiana Code 32-31-2-1, which requires any lease for real property in excess of three years to be recorded. Commercial Coin did not record its 10-year lease, and the trial court held that the lease was void as a matter of law.

After Commercial Coin appealed, Park P argued once again that the lease was void and unenforceable because it was not recorded as Indiana law requires. Specifically, the law states that leases longer than three years and not recorded within 45 days of execution are "void against any subsequent purchaser, lessee, or mortgagee who acquires the real estate in good faith and for valuable consideration."

The appeals court seized on the statute's "good faith" purchaser language, stating, "in other words, an unrecorded lease in excess of three years is void as a matter of law against a bona fide purchaser." The court went on to say that to be a bona fide purchaser, the buyer must not have "notice of the outstanding rights of others."

Signs May Have Been 'Actual Notice.' Crone said that for the lease to be declared unenforceable against Park P, it would have to prove its bona fide purchaser status. To do so, Park P must show that it had neither constructive or actual notice of Commercial Coin's lease.

The court said that Park P certainly did not have constructive notice, as Commercial Coin failed to properly record its lease after execution. However, the court said there was evidence of actual notice, in the form of Commercial Coin's signs in the laundry room.

Crone noted that Commercial Coin's laundry room signs indicated that Commercial Coin held a lease for the two laundry rooms, and that the signs and laundry equipment remained in the building when Park P purchased the apartment building. Crone cited state law precedent from *Thomas v. Thomas*, 923 N.E.2d 465 (Ind. Ct. App. 2010) stating that "one who fails to examine land which he is about to purchase, and to inquire as to the rights of one in possession, is not acting in good faith and will not be treated as a bona fide purchaser."

Because the laundry room signs indicated Commercial Coin held a lease for the laundry rooms when Park P could have inspected the property as a potential purchaser, Crone said there was a genuine issue of fact as to whether Park P had implied actual notice of the lease. Therefore, the court reversed the summary judgment order, and remanded to the trial court for further proceedings on the issue of whether Park P had actual notice of the lease.

By ERIC TOPOR

For the full text of *Commercial Coin Laundry Systems, et al. v. Park P LLC*, go to <http://op.bna.com/>

[rel.nsf/r?Open=etor-89bshn.](#)

Multi-Family Housing

Administration's Housing Finance Conference Told Rental Units Needed 'More Than Ever'

The Aug. 17 White House Conference on the Future of Housing Finance brought increased attention to the renters, according to National Multi Housing Council President Doug Bibby, who said afterward that the most heartening aspect of the event was that the rental sector was "clearly not an afterthought."

More attention was paid to multi-family than at previous meetings, according to the NMHC statement, which added that, "Reform of the housing finance system must address the specific needs of the multifamily industry and must be done in the context of rebalancing our national housing policy."

The meeting, co-hosted by Treasury Secretary Timothy Geithner and Department of Housing and Urban Development (HUD) Secretary Shaun Donovan, presented three views of what housing finance should look like going forward. Some participants argued for complete government financing, for reducing the government's footprint in the housing market, and for no government financing at all, according to published reports. The meeting was designed "to provide a forum for public input as the administration continues its work developing a comprehensive housing finance reform proposal for delivery to Congress by January 2011," according to an Aug. 12 U.S. Treasury statement. The House Financial Services Committee is planning hearings on the subject this fall, according to a late August NMHC statement.

The Nature of Home Ownership. Bibby told BNA Sept. 9 that the changes in demographics and household formation necessitate the need for housing to reflect them. The typical nuclear family, a married couple with children, "is very much in the minority now," he said. He also addressed America's long-standing policy of raising home ownership and said that the meltdown in the single-family sector showed that "you can't push people into home ownership if they are ultimately going to be unsuccessful as owners." A house is a dwelling or a shelter, Bibby said, not an ATM or an investment vehicle, functions that he said are more properly performed by the stock and the bond markets. He added that "we need to understand that difference. If you go back to from the end of World War II to the present day... the average annual appreciation in housing prices is a little over 1 percent per annum. If you look at the

average annual return of equities, for example, in the stock market, over that same period, it is a little over 5 percent."

Bibby blamed one aspect of the single-family meltdown on day traders from the dot.com era, who, after losing their digital cash cow, "went over and started flipping houses. People were seeing 20 percent increases in their housing valuation each year when they weren't putting a dime into it. There was no economic reality going on during that time." He said that countless NMHC members told him they would turn down a person as a renter due to bad credit, "and the person would go around the corner and buy a house."

Multi-family underwriting, however, was "gold plated during the first decade of the 21st century," Bibby said. The serious delinquency rates for Fannie Mae and Freddie Mac are still under 1 percent, he said, while commercial mortgage-backed securities (CMBS) delinquencies "are over 7 percent. The single-family [delinquency rate] is about 11 percent, so the proof is right there before our eyes."

In regard to multi-family housing, Bibby said, the NMHC is looking to sources of capital that prevailed in the mid-20th century, when 70 to 75 percent of lenders were purely private sector participants: banks, savings and loan associations, and pension funds. "The CMBS market was thriving, and—[during] 2005-2007—Fannie Mae and Freddie Mac [handled] roughly 25—at most 30 percent—of the market. They were shareholder-owned and they were not on the federal budget. Over the long haul, we would like to see a return of a robust private sector role in financing multifamily housing, and by that we mean the dominant [role]."

The NMHC sees a more limited role for federal credit, and "one that [borrowers] pay for, to protect the taxpayer."

Asked what the sources of capital would be, Bibby said that it will be a combination: banks, the savings and loans... and "it is hoped that there will be some sort of return of the CMBS market." He also mentioned covered bonds, a market he said has totalled approximately \$2 trillion in business in Europe and parts of Asia up until now. "We don't think it's going to be a silver bullet, but it may be a small but important source of capital for housing."

"America needs rental housing now more than ever," the statement said. Bibby cited a study by the University of Utah, *Resetting the Demand for Multifamily Housing: Demographic & Economic Drivers to 2020*. The report projected that half the housing built going forward would be rental, which would bring that sector's share to 36 percent of all rental units nationwide just to meet the demand.

By KEVIN LAMBERT

Industrial

Land Use

'Market Choice' Alone Cannot Support City's Oversupply of Industrial Zoned Land

The Court of Appeals of Oregon held Sept. 8 that providing potential industrial employers with "market choice" was not an adequate reason for a municipality to set aside more land for industrial growth than was projected as needed for future development (*1000 Friends of Oregon, et al. v. Land Conservation and Development Commission*, Or. App., No. A135375, 9/8/10).

The defendant city of Woodburn set aside more land than it projected was needed to attract industrial businesses for the next 20 years, reasoning that it was necessary to provide potential developers with a choice in development sites. Several conservation groups filed suit to block the plan as not conforming with state land use planning codes because of the excessive industrial land set aside in the city's plan.

Judge Rick T. Haselton criticized the city's plan, and defendant Land Conservation and Development Commission's (LCDC) order affirming the plan as providing virtually no justification for the over-designation of industrial land except stating it was necessary to provide "market choice." In his decision reversing the LCDC's decision, Haselton said simply appealing to the need for market choice in development was not adequate to satisfy state codes mandating that future industrial land set-asides be justified.

Future Industrial Need Estimated. The city of Woodburn outlined its plan to amend its urban growth boundary (UGB) and designate certain land for industrial development as part of its 20-year future land use planning period. An Oregon municipality's future land use plans must conform to certain state guideline "Goals," which regulate a municipality's growth and development.

One of the guidelines, Goal 9, mandates that a city pursue development to enhance the economic opportunities, and general health and welfare of its citizens. In addition, one of Goal 9's implementing rules, OAR 660-009-0025, requires any new industrial land designations to be identified as needed for future development and employment during the 20-year planning cycle. Another guideline, Goal 14, states that changes in land use from rural to more urban designations must take into account actual projected need for urban development from population and economic growth.

During the latest 20-year planning cycle, Woodburn expanded its UGB by over 900 acres, and designated 409 acres of the new land for future industrial development in an effort to draw high-wage business to the city. Importantly, the city's analysis of how much industrial land would be needed to meet future goals indicated that only about 370 acres of new industrial land

would be needed to accommodate the expected development, on an employee-per-acre basis.

However, the city's estimate report said that not all development site would work for all potential developers, and industrial developers frequently desired to purchase empty land adjacent to their project to accommodate future expansion. Consequently, the city determined that 409 acres of industrial land would be necessary to provide adequate market choice to industrial developers and ultimately meet the city's economic goals.

Conservation Groups Move to Block Plan. Several environmental and conservation groups, among them plaintiffs 1000 Friends of Oregon and Friends of Marion County, lodged complaints with the LCDC over Woodburn's future land use plan. Specifically, the groups said that the city's industrial land designations violated Goals 9 and 14 because they were far too aggressive and included more industrial land than was projected as needed during the 20-year planning period.

However, after reviewing the plaintiffs' complaint, the LCDC's decision sided with the city. It defended the city's choice to designate more acres for future industrial use than projections estimated would be needed to give developers market choice in development sites, and concluded that the city's plan did not violate Goals 9 or 14 for that reason. Following the LCDC's decision, the conservation groups appealed.

Plan Not Supported by Evidence. The main issue on appeal was whether the alleged oversupply of industrial land violated state land use planning Goals 9 and 14. The appeals court concluded that LCDC's was not adequate for review because it was almost entirely unsupported by any substantive evidence that the oversupply was necessary to promote adequate industrial growth.

Haselton noted that neither the city nor the LCDC provided much in the way of supporting evidence to justify their allotment of industrial land in excess of projected future need, other than stating it was done to provide adequate market choice. The court criticized this lack of evidence, noting that "'market choice' is an infinitely pliable and elastic term," that could be used to justify any allotment of industrial land without regard to the limits prescribed in Goals 9 and 14.

According to the court, the city and the LCDC provided almost no explanation, other than simply referencing market choice, to justify why more industrial land than needed was designated for future development. Consequently, the court reversed the LCDC decision, and remanded to the LCDC for further expansion of the evidentiary record.

By ERIC TOPOR

For the full text of *1000 Friends of Oregon, et al. v. Land Conservation and Development Commission*, go to <http://op.bna.com/rel.nsf/r?Open=etor-89glpj>.

The Economy

OFFICE VACANCY RATES

As U.S. businesses steadily work through the worst of the recent economic downturn, evidence may suggest vacancy rates could stabilize soon and begin to return to more normal levels. However, the CoStar Group's methodology for calculating underutilized, or "grey space," suggests a turnaround in this area could be further away than many believe. Here the authors explain CoStar's approach to estimating true levels of office space availability and project a realistic time frame for reaching normal market conditions.

'Grey Space' Masks the True Dimensions of the Current Oversupply of Office Space



BY MARK HICKEY AND AARON JODKA

I. Introduction.

As the economy strengthens, the prospect of an office recovery draws tantalizingly nearer. Yet patience is in order: the market remains saddled with a significant quantity of "grey space" that will weigh on future demand.

In fact, we estimate a total of about 442 million square feet of grey space for the 54 major office markets in the United States at the end of the second quarter—more than the size of the entire Los Angeles office market and just a hair less than all of the office space in Chicago!

This space comes at the hands of companies large and small. But to illustrate the point, consider the 100-employee company that let 20 workers go in the recession from their 20,000 sq. ft. office. Since it likely occupies just a single floor that is not easily dividable, the

Mark Hickey is a real estate economist and Aaron Jodka is a senior real estate economist, both at the CoStar Group.

company decides not to sublet its unused space. Instead, it sits on empty cubicles, meaning, as business improves, the firm will have plenty of room to expand without taking additional space. Because this grey space is never placed back on the market, it is not counted in vacancy statistics and is difficult to track. But, with a little math, we can estimate its potential impact on the market.

II. How Grey Space Is Calculated.

A. Methodology. In order to estimate the amount of grey space in the market, a few calculations need to be made, the first of which is determining the usage factor, or how many square feet of office space the average employee uses. This is calculated by the equation: Total Occupied Office Sq. Ft./Total Office-Using Employment = Usage Factor (Sq. Ft./employee)

The next step is to calculate the imputed demand that would exist if firms were able to immediately adjust their space for every new employee hired or let go. In other words:

Office Using Employment * Usage Factor = Imputed Demand

For this analysis we took the slope of the usage factor (upwardly sloping in recent years—more on that later) when calculating imputed demand. The final step of the equation is to compare imputed demand to actual demand in the market:

Imputed Demand – Actual Demand = Grey Space

Of course, any changes in demand, whether imputed or actual, give us net absorption. For this analysis, imputed net absorption turned negative in the second quarter of 2008, and continued to be negative until the fourth quarter of 2009, coinciding with observed job losses. Observed actual net absorption didn't turn negative until three quarters later, and has remained sluggish in the first half of 2010. Comparing these two data sets allows us to get the most current reading on the amount of grey space haunting the office market.

B. CoStar Data, Geographies, and Office-Using Employment. For this article, we rolled up CoStar's building database to match the metro definitions, which aligns with the Bureau of Labor Statistics definition for Metropolitan Statistical Areas (MSA) and Metropolitan Divisions (MD).

Moody's Economy.com defines office-using employment as an aggregate of three super sectors; information, financial activities, and professional and business services, plus the federal government sub-sector. However, while appealing in its simplicity, this methodology leads to some inaccuracies.¹ Therefore, we have employed PPR's long developed method to calculate office-using employment. With this method, employment of each major sector of the economy is multiplied by an office-intensity factor of this particular sector, i.e., the percentage of jobs that utilize office space. For example, the financial activities sector has an office-using intensity factor of one, meaning that 100 percent of jobs in this sector are office-using jobs. On the other end of the spectrum, natural resources and mining only has 1 percent being housed in office space. At the metro level, however, we scale the office-intensity factor based on each metro's concentration in that sector as measured by the location quotient². So in a market like Boston, with a low concentration of natural resources and mining, hardly any of its 4,240 employees are office users. However, in energy-centric Houston, the location quotient for natural resources and mining is 6.4, which helped to scale up the office-intensity factor in Houston for natural resources and mining and resulted in an estimate of 5,600 office jobs.³

This captures the fact that a metro that has a high concentration of jobs in a given sector (like natural resources and mining in Houston) is likely a center for that industry and, as a result, a disproportionate number of those jobs are estimated to be office-using. Ultimately, this improves the office-using employment estimate at the metro level, allowing for a more accurate usage factor and demand forecast.

III. Findings.

A. Industry Standard of 250 Sq. Ft. Per Employee (or Less) is a Myth. When most people do a back-of-the-envelope calculation to determine the space needs of a company they use somewhere in the neighborhood of 200-250 sq. ft. per employee, but this is far from reality. Over the last 10 years, our data show an average of 344 sq. ft. per employee for the 54 markets as a whole.

This basis of the 200-250 sq. ft. per employee myth can only originate from one of two mistakes: either ana-

¹ For example, it excludes the office-using component of sectors such as construction, manufacturing, and retail trade. While the office-using component of these sectors are small, these sectors employ a great deal of the workforce and a small percentage can add up to a large number of jobs. In addition, to undercounting jobs, this methodology also includes some non-office using jobs in its total, such as motion picture and sound recording in the information sector.

² The location quotient is the percentage of jobs in a given sector at the metro level divided by the percentage of jobs in that sector nationally.

³ In addition to the 20,000 employees classified as Management of Companies, which has an office-using intensity factor of 1.

lysts are undercounting total office inventory, or they are overestimating total office-using employment. In practice, it appears that the former is the more likely culprit, as brokerage firms, constrained by their own financial limitations and interest, tend to substantially undercount a metro's inventory. For instance, most brokers don't include owner-occupied or single-tenant space in their inventory data, and also utilize minimum size thresholds, choosing to ignore an important component of the market because they either want to focus their efforts on larger, more profitable deals, or they don't have the capacity to track the entire market. In addition, most brokers don't cover the entire MSA. Thus, the 10,000 sq. ft. suburban office building full of local office-using tenants (attorneys, accountants, real estate professionals et. al.) on the outskirts of a metro are often excluded from the inventory total.

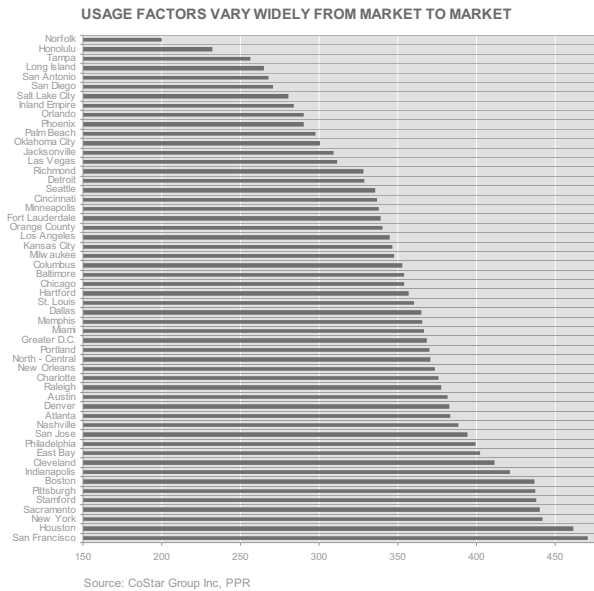
With over 800 hundred researchers across the United State, Costar doesn't have that problem and truly tracks the entire market (or very, very close to it!) To put this into context, here is a breakdown of broker inventories in "Boston;" Jones Lang LaSalle counts 156 million sq. ft., Grubb and Ellis pegs it at 169 million sq. ft., Cushman and Wakefield captures 170 million sq. ft., and Colliers Meredith and Grew says the total is 193 million sq. ft. Meanwhile, CoStar tracks 350 million sq. ft. of office space in the Boston MSA,⁴ or nearly double every broker. So, using an average estimate of 172 million sq. ft. of occupied space across these brokerage sources and any estimate of office-using employment utilizing Bureau of Labor Statistics data for the Boston MSA (we estimate it at 721,000, Moody's Economy.com pegs it at roughly 648,000) would result in a mistakenly low usage factor in the 203-265 sq. ft. per employee range. But CoStar's more complete inventory number with a tally of occupied square footage that encapsulates all of the office buildings in Boston results in a usage factor of a little over 430 sq. ft. per employee.

B. Usage Factors Vary Widely by Market. Exhibit 1 below shows the usage factor by metro, and the great degree of variation from metro to metro.⁵

There are several possible causes for this variance, but it likely comes down to the type of tenants in a market. Simply put, metros that have more front office jobs use the most space per employee. Looking at some of the top metros for usage factors bears this out. Houston and New York are headquarters metros whose tenants oftentimes require more corner offices and conferences rooms. Boston and San Francisco have less headquarters but are high-cost markets full of small innovative companies that may only have 10 employees but rent out 5,000 sq. ft. so that they have room to grow. And Stamford is a metro known for its concentration in

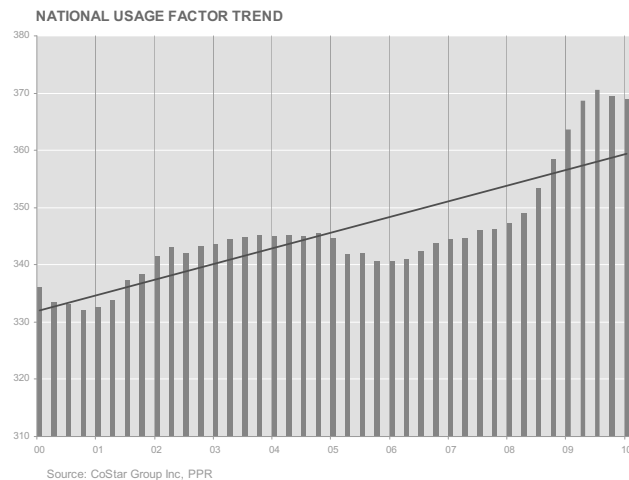
⁴ The Boston MSA is defined as Essex, Middlesex, Norfolk, Plymouth, Suffolk, and Worcester counties in Massachusetts, along with Hillsborough, Rockingham, and Strafford counties in southern New Hampshire.

⁵ In order to more accurately depict the usage factor in Washington, D.C., we have added 37.4 million sq. ft. of GSA owned and occupied space, along with an additional estimate of 56.2 million sq. ft. of additional government space not on that list, such as The Pentagon, the Department of Energy's headquarters, as well as other defense and security agency buildings in the Washington - NoVA - MD MSA. Usage factors in other markets with heavy federal government employment may be artificially depressed.



hedge funds, where the cost of rent is a small consideration in relation to potential profits and the cost of the employees. On the opposite end of the spectrum are low-cost metros, such as Tampa, San Antonio and Phoenix, home to many back-office and call center jobs. These types of firms are very cost-conscious and cram as many people into a building as they possibly can, which lowers the usage factor for these metros. In addition, new suburban construction in these suburban-dominated markets is more efficient in that there are fewer columns and wasted space, allowing tenants to minimize their space per employee.

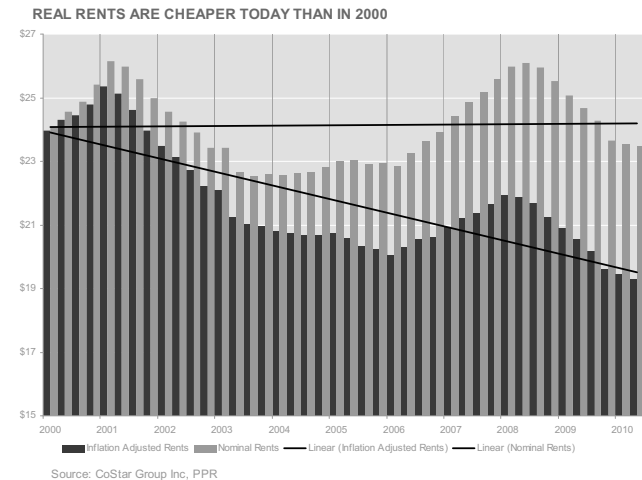
C. The Usage Factor Is Cyclical but Has Generally Been Trending Up. *Exhibit 2* shows the national usage factor over the past 10 years, with the blue line representing the linear trend over that period. While this series is volatile and changes based upon economic conditions (the current usage factor is over 360 sq. ft. per employee as of the second quarter), the usage factor has been trending up over the last decade, a contradiction of conventional wisdom.



This of course raises the question: Why? Timing plays a key part in this. In 2000, at the height of the dot-

com bubble and in an environment of record-low vacancy rates, the usage factor dropped below 320 sq. ft. per employee as offices were doubled or tripled-up with employees. After the implosion of the tech markets, the usage factor rose as layoffs outpaced space givebacks (narrowly). Once the economic recovery took hold, employers bulked up their staffs faster than they took down new space, causing the usage factor to fall once again. Then the Great Recession hit and the usage factor went through the roof as 7 percent of office-using employees were let go but total “occupied” office space only fell by 1 percent. It is unlikely that the usage factor will continue to rise in the near term. Indeed, based on historical trends, we would expect the usage factor to decrease in the next couple of years as employers ramp up their staffing levels and fill in empty desks.

Cyclical volatility aside, why is the usage factor trending up over time when conventional wisdom suggests it is decreasing due to technological innovations, namely telecommuting? There are several factors likely contributing to why companies have increased their space per employee. First, tenant demand is driven primarily by office-using employment growth but also by expectations of growth in relation to the cost of space. And it’s cheaper to rent office space now than it was 10 years ago, particularly on an inflation-adjusted basis. *Exhibit 3* shows nominal rent levels versus inflation-adjusted rent levels. While the trend for nominal rents shows a slight up-tick since 2000, inflation-adjusted rents have been decreasing over time.

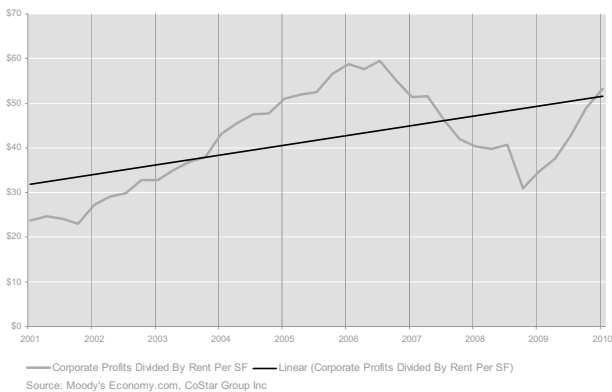


At the same time that real rents have been decreasing, corporate profits have been increasing. *Exhibit 4* shows total nominal corporate profits (financial and non-financial) compared to nominal asking rents.

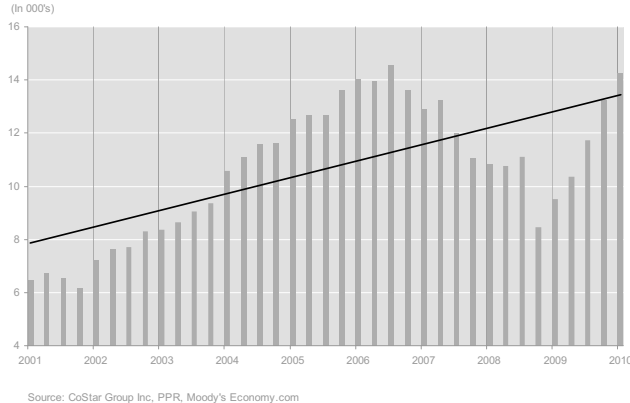
In addition, profits per employee (thank you, productivity!) have trended up over the past 10 years as well (see *Exhibit 5*). Therefore, employers are more willing and able to rent more space, or build out more common space—meeting rooms, kitchens, etc. In addition, high-value industries use office space as a form of extra compensation to retain or attract talent. And given the trends of profitability and declining rent expense, these added perks are not overly costly from a business perspective, supporting a rising usage factor over time.

There are other secular trends at play as well. Think back several decades (or visualize an episode of *Mad Men*) when pretty much everyone in an office had a sec-

IN RELATION TO CORPORATE PROFITS, RENTS ARE EVEN CHEAPER
(In Billions)



PROFITS PER EMPLOYEE SOARED IN THE 2000'S
(In 000's)



retary or administrative assistant. That doesn't happen anymore. Today, many small offices have just one or two administrative assistants or office managers for the entire company. All else being equal, the usage factor rises.

The increase in the usage factor follows the American trend in consumption for other goods. Over the past three-and-a-half decades, the average square footage of a single-family home, divided by the average household size has increased from about 550 sq. ft. to nearly 1,000 sq. ft. at the peak of the housing boom. Following a similar trend, the number of cars per household has increased from 1.4 in 1973 to 1.9 in 2009.

III. National Picture for Grey Space.

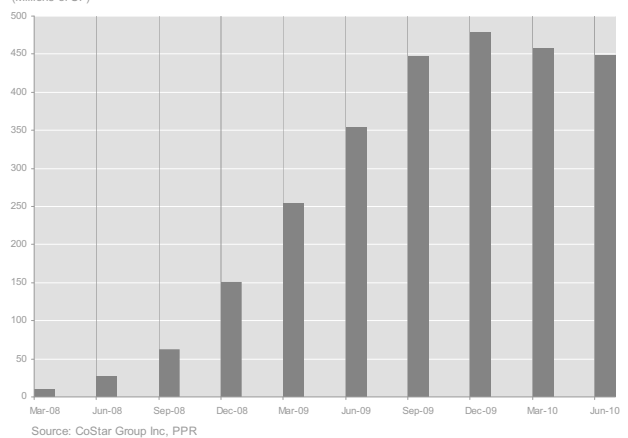
We've now laid out our framework for estimating grey space. Now for the fun part—analyzing it! During the past two downturns, we have seen that imputed net absorption based on changes in office-using jobs has been more negative than actual observed net absorption, and the difference has been far more noticeable in this recent cycle compared to the dot-com bust. In fact, the highest correlation (0.66) is found without any quarterly lags. Given the breadth of job losses across industries in the past 30 months, we estimate a staggering 441.6 million sq. ft. of grey space currently in the market. Of course, a certain amount of grey space is to be expected at any stage of the cycle, but it does ebb and flow due to the flexibility of labor markets relative to lease terms. That said, it was nearly non-existent at the beginning of 2008, but as job losses soared in the second half of that year and through 2009, grey space bal-

looned dramatically. CoStar's overall office vacancy rate for the United States (including direct and sublease space) was 13.4 percent, at the end of the second quarter. If grey space were added to the overall vacancy rate, it would add another 6.2 percentage points, resulting in a total vacancy rate of 19.6 percent.

Grey space peaked at the end of 2009 with nearly 470 million sq. ft. of unutilized office space sitting in existing leases, but the hiring of hundreds of thousands of office-using workers since the end of 2009—mostly temps, which isn't unusual at this point in the cycle—has bolstered office-using employment to date in 2010, causing those empty cubicles to slowly begin filling up.

That said, the market is improving somewhat. Grey space peaked at the end of 2009 with nearly 470 million sq. ft. of unutilized office space sitting in existing leases, but the hiring of hundreds of thousands of office-using workers since the end of 2009—mostly temps, which isn't unusual at this point in the cycle—has bolstered office-using employment to date in 2010, causing those empty cubicles to slowly begin filling up. Exhibit 6, shows the trend in grey space beginning in 2008, through the second quarter of 2010. This downward trend will continue over the next several years, curtailing absorption totals even as office-using employment continues to recover.

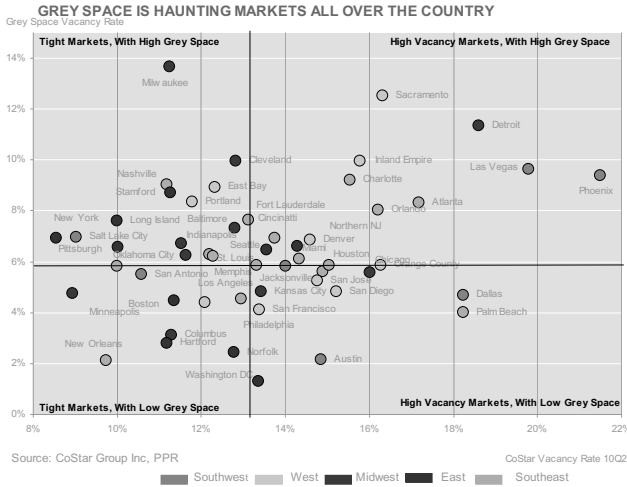
GREY SPACE PEAKED IN 09Q4 - BUT REMAIN DAUNTING
(Millions of SF)



IV. Grey Space at the Metro Level.

The impact and prevalence of grey space varies widely by market—largely because the effect of the recession has been vastly different metro to metro. Major economies such as New York, Chicago, Los Angeles, and Atlanta have lost the most jobs cumulatively—while housing bust markets such as Las Vegas, the Inland

Empire, and Phoenix have led the nation in terms of percentage of jobs lost. On the other end of the spectrum are markets like Austin and Washington, D.C., where the recession dealt a relatively minimal blow. Exhibit 7, compares actual vacancies as of the second quarter and the implied grey space vacancy rate. Markets in the upper right hand quadrant are saddled with above-average vacancies, and also have an above-average share of grey space. These are markets like Atlanta, Detroit, Las Vegas, Sacramento, and Phoenix. On the opposite end are markets with relatively tight vacancies and less grey space. Those markets include Hartford, Columbus, Washington, D.C., Boston, and Minneapolis.



lion sq. ft. If that space were added to the market, the metrowide vacancy rate would nearly double to 15.5 percent. While several financial firms famously imploded during the financial crisis, others have yet to consolidate all their space, creating large pockets of unutilized space—despite the fact that many of these firms have put a significant amount of space on the sublease market. Atlanta is in worse shape, as its vacancy rate could be 8.3 percentage points higher—a staggering increase for a market with perpetually high vacancy rates to begin with. Conversely, only 1.3 percent of occupied office space in the nation’s capital is currently underutilized, and Dallas and Los Angeles also fare better in this analysis

Exhibit 9 highlights the markets with the largest grey space issues. These are markets where observed net absorption losses and imputed losses have been the furthest apart, meaning tenants in these markets likely have the largest amount of under-utilized space. Landlords with holdings here should be the most proactive in making sure they understand their tenant’s space utilization and likelihood of maintaining their current footprint upon their lease expiration.

Metros With Greatest Risk of Grey Space	Imputed Net Absorption	Actual Net Absorption	Grey Space Inventory	Implied Grey Space Vacancy Rate	Current Vacancy Rate	Total Possible Vacancy Rate	# of New Jobs Needed to Fill Grey Space	% of New Jobs of Current Workforce	
Milwaukee	(8,653,771)	345,344	(8,999,115)	65,854,999	13.7%	11.2%	24.9%	27,420	16.3%
Sacramento	(10,633,794)	1,269,837	(11,843,621)	94,304,111	12.6%	16.9%	28.9%	27,278	15.2%
Detroit	(23,381,655)	(2,978,680)	(20,402,975)	179,456,331	11.4%	18.6%	30.0%	65,311	14.7%
Cleveland	(10,102,991)	-	(10,102,991)	101,318,699	10.0%	12.8%	22.8%	32,486	15.1%
Inland Empire	(4,979,262)	1,802,042	(6,781,304)	67,921,617	10.0%	15.8%	25.8%	28,938	14.4%
Las Vegas	(4,887,109)	714,615	(5,601,724)	58,115,210	9.6%	19.8%	29.4%	17,611	11.8%
Phoenix	(16,814,134)	(2,228,370)	(14,585,764)	155,114,953	9.4%	21.5%	30.9%	50,110	11.9%
Charlotte	(7,543,377)	856,336	(8,399,713)	90,851,854	9.2%	15.5%	24.8%	22,419	11.0%

Source: CoStar Group Inc. PPR

V Conclusion.

The amount of grey space on the market is staggering, and it will take time to work through it all. While the usage factor may be on a long-term upward trend as the economy continues its move towards higher-value, higher-paying jobs, it has likely overshoot, as has been the case in past recessions, and will therefore decrease over the next several years. Even using the currently elevated usage level, however, suggests a minimum need of roughly 1.35 million office-using jobs just to soak up currently leased, yet underutilized, office space. Based on the current forecast, it will take until the first quarter of 2013 for office-using employment growth to reach those levels. Now that is not to say that there won’t be net absorption for the next 11 quarters. There will be, but it won’t be as strong as office-using job growth would suggest (i.e., imputed net absorption will outpace actual absorption), as grey space stunts the recovery.

Property Values

CPPI Slips Again in July, All but Erasing Gains Since CRE Prices Bottomed in October

Commercial property prices in July recorded a second consecutive big decline, this time 3.1 percent, all but wiping out gains posted since values began last November to reverse a two-year slide, Moody’s Investors Service reported Sept. 20.

The latest dip in the Moody’s/REAL Commercial Property Price Indices (CPPI) comes after an even larger decline in June of 4.0 percent; the index has

One would assume that markets with a larger share of single-tenant or owner-occupied space would have a harder time accessing the sublease market (it is difficult for such tenants to rearrange and consolidate their operations to make floors available for lease, while some single-tenant properties lack the infrastructure to easily convert space to multi-tenant—think elevator banks), and thus have higher grey space issues. Sacramento is a great example. The metro has the lowest percentage of multi-tenant space among the top 54 office markets, but has one of the highest grey space issues in the country. The metro has been hit with a collapsed housing market along with epic state budget issues, which in this case makes its reliance on government a hindrance, not a stabilizer. However, there is no correlation or causality between grey space and multi-tenant or single-tenant oriented markets. In fact, New York, Cleveland, Nashville, Las Vegas, and Stamford, which have some of the highest proportions of multi-tenant space to total inventory, also have some of the highest grey space concerns.

Exhibit 8, shows the relative risk of grey space in the six largest office markets in the United States:

Major Metros	Imputed Net Absorption	Actual Net Absorption	Grey Space Inventory	Implied Grey Space Vacancy Rate	Current Vacancy Rate	Total Possible Vacancy Rate	# of New Jobs Needed to Fill Grey Space	% of New Jobs of Current Workforce	
Atlanta	(26,101,993)	(2,546,769)	(23,454,824)	281,543,822	8.3%	17.2%	25.5%	89,199	11.4%
Chicago	(27,368,653)	(2,437,517)	(24,931,136)	447,046,271	5.6%	18.0%	21.6%	85,112	6.3%
Dallas	(8,861,556)	6,992,581	(15,454,137)	328,216,097	4.7%	18.2%	22.9%	39,310	5.3%
Los Angeles	(31,485,112)	(12,940,273)	(18,544,839)	420,856,650	4.4%	12.1%	16.5%	54,827	5.1%
New York	(97,254,008)	(5,825,925)	(51,428,083)	740,291,108	6.9%	8.5%	15.5%	122,863	8.0%
Washington DC	(1,761,559)	4,423,245	(6,184,804)	466,461,953	1.3%	13.3%	14.7%	14,712	1.1%

Source: CoStar Group Inc. PPR

New York is the largest market in the country, and not surprisingly, it has the most grey space, at 51.4 mil-

fallen by 7.3 percent over the past year and by 35.9 percent over the past two years. Moreover, CRE prices remain 43.2 percent under their October 2007 peak, and the recent downturn has erased all but 0.9 percent of the gains recorded since the CPPI hit bottom in October 2009.

Nick Levidy, Moody's managing director, said in a statement accompanying the CPPI that, "Commercial real estate markets were caught in a downdraft as the economy appeared to further weaken in the early part of 2010, resulting in relatively large declines in the index in the early summer. The recent performance, while perhaps somewhat discouraging, should not come as a complete surprise. We have noted for several months that markets are likely to remain choppy for some time as property values slowly form a bottom in conjunction with a gradual recovery of the broader economy."

A closer inspection of the data highlights relevant variations in specific regions and CRE sectors. For example, Moody's noted that in the Eastern United States only industrial properties, which fell in price during July by 7.6 percent, were still in decline. All three of the other major categories, including apartments, retail space, and office facilities gained ground in July.

Retail Prices Up in the East. Retail sites in the East have climbed by 12.9 percent so far in 2010, according to Moody's. The South, on the other hand, has seen a 31.5 percent drop in retail space prices through July of this year.

Apartment prices in the South have plummeted by 48.0 percent since peaking three years ago, Moody's said, but noted that over the past 12 months apartment prices in Florida rose by 10.8 percent, reversing a downturn that began four years ago.

Other regional texture in the CPPI data can be found in Southern California, which Moody's said turned in a "mixed performance" over the past year. Whereas apartment and office properties advanced in price over that time, industrial and retail prices continued to slump.

Moody's also focused on three major office markets, noting that Washington, D.C., showed the most strength by gaining 6.4 percent in value over the past year, although prices have fallen by 17.3 percent over the past two years. San Francisco also posted office price increases of 6.1 percent during the past four quarters. New York, by contrast, showed a 7.6 percent dip in office prices during the past year, underperforming the East region, which saw an overall rise of 7.3 percent in office prices. New York's 28.7 percent drop in office space prices over the past two years is on par with the 26.4 percent decline for the region itself, according to Moody's.

Muted Transaction Volume. Another indicator of the overall lackluster performance of the commercial property market is the decline in repeat sales transactions. Moody's reported only 119 repeat sales in July, compared with 153 repeat transactions in June. Transaction value also slid from \$2.1 billion in June to \$1.35 billion in July, according to Moody's.

"Transaction volumes retreated from last month's modest spike owing to the effects of a slow economy and the summer doldrums," Moody's said in its CPPI report. "Signs of a sustainable uptick in investment ac-

tivity cannot be found in recent data as the market continues to drift along with no clear long-term direction."

Legislation

Capitol Hill Activity in Advance of Elections Likely to Feature Narrow Slate of CRE Issues

As Congress returns to wrap up unfinished business before the midterm elections, the agenda for real estate interests has come down to a few items, including key tax policy matters, that they believe could be addressed in the final six weeks.

Industry sources indicated that lawmakers are likely to work toward completing action on a handful of non-controversial issues that can come to a vote.

"That obviously will narrow down the real action," Jeffrey DeBoer, president and chief executive officer of the Real Estate Roundtable, told BNA Sept. 10, "But what I really expect to be happening in these last few days of the session is more of a setting up of issues for either consideration during a lame duck session or for a longer-term debate next year."

That suggests Congress will debate the 2001 and 2003 Bush tax cuts, which are set to expire at the end of this year. How Capitol Hill acts, or decides not to act, on these matters will have a significant impact on those who are concerned not only about overall marginal tax rates, but about taxes on inheritance, capital gains, and dividends.

"We are looking for any sort of policy that might encourage job creation and not discourage job creation . . ." DeBoer said. "So in that vein, we have continued to try to explain to members of the policymaking world what the carried interest issue would mean for commercial real estate activities and what it means to job creation . . . It's certainly not the time to be enacting that type of provision right now."

Ad Campaign on Carried Interest. The Roundtable, along with other pro-business groups have funded an advertising campaign aimed at persuading Congress not to push through a measure that would end a benefit for certain fund managers, including real estate firms, that would effectively shift a greater portion of their compensation from being taxed at the lower capital gains rate to the higher personal income tax rate.

The conflict for the Roundtable in regard to carried interest is that the proposal is intended as a revenue-raising measure that would help support a series of expiring tax incentives, also called "extenders," some of which real estate interests support. Among those provisions is a brownfield benefit that helps promote restoration of contaminated properties for commercial purposes and a leasehold improvement tax benefit (3 REAL 310, 5/4/10).

The extenders package also includes a pro-real estate tax benefit for energy-efficient buildouts of commercial structures. Although real estate groups are generally supportive of this feature, DeBoer noted that it "is a very difficult and complicated benefit for anyone to qualify for." He went on to explain that the Roundtable has been more interested in a House green building bill, the Energy Efficiency Act of 2010 (H.R. 5476), introduced by Rep. Peter Welch (D-Vt.), and its Senate coun-

terpart (S. 3079), introduced by Sen. Jeff Merkley (D-Ore.).

That bill, the so-called Building Star proposal, “would provide a much more powerful rebate incentive to building owners to put in more energy-efficient equipment or materials . . .” DeBoer said. “If structured the right way, we think this could be very positive for reducing energy consumption and also for helping the manufacturing” sector that produces the equipment, as well as construction operations. Regardless of that legislation’s prospects over the remaining days before the election, DeBoer said the Roundtable hopes to see more debate on this and related issues.

Small Business Incentives Package. The most immediate legislative action in advance of the midterm elections is likely to be an administration-backed set of initiatives aimed at fostering small business investment in job-creating activities.

The House will consider the recently passed Senate version of a small business tax bill during the Sept. 20 week. House Speaker Nancy Pelosi (D-Calif.) said Sept. 17 that the House will debate the Senate-passed Small Business Lending Fund Act (H.R. 5297) during the week.

The bill would create a \$30 billion lending pool for small community banks and offer tax incentives for small businesses. The Senate’s version of the bill, which passed Sept. 16 on a vote of 61-38, differs significantly from the House version, which passed in June on a vote of 241-182. The Senate-passed version contains \$12 billion in tax incentives, compared to \$3.6 billion in the House version. The Senate-approved bill would allow small business owners to deduct the cost of their own family health insurance when calculating 2010 self employment taxes. Other Senate changes to the small business bill include a modification of the new Form 1099 information reporting requirements and language to increase the maximum amount that small businesses can write off in capital expenditures in 2010 and 2011. The House could begin consideration of the Senate amendment to the small business legislation as early as Sept. 22.

The Roundtable is on record favoring the small business initiative. It includes the proposed permanent extension of the research and development tax incentive. That benefit has long been one of the more popular tax extenders.

FIRPTA Under Consideration. Another proposal that has been high on the Roundtable’s agenda and that may yet be part of the political conversation this fall is Real Estate Jobs and Investment Act (H.R.5901). The bill, introduced by Rep. Joseph Crowley (D-N.Y.), would amend the Foreign Investment in Real Property Tax Act (FIRPTA) to boost from 5 percent to 10 percent the permissible level of foreign ownership in publicly traded real estate investment trusts (REITs).

Crowley’s bill easily cleared the House in late July and is awaiting action in the Senate (see related story in the International section). The Roundtable and other real estate organizations have advocated a more thoroughgoing approach to liberalizing the terms of FIRPTA than the provisions contained in H.R. 5901, and DeBoer said he hopes Congress will at least address the matter before the November elections.

“It’s our hope that, whether it’s before the election or in the lame duck or early next year that that important

bill that came over from the House can be reviewed and made a little more robust because it’s very critical that the United States’ commercial real estate marketplace not discourage foreign capital investment, but in fact encourage foreign capital investment,” DeBoer said. He noted that high levels of mortgage debt on commercial real estate will mature in the coming years. At the same time property values have eroded, hampering the ability of owners to refinance.

“What FIRPTA reform would do would be to encourage equity to flow into the United States’ commercial real estate market,” DeBoer said.

BY RICHARD COWDEN AND PATRICK AMBROSIO

Construction

Construction Management Techniques Reduce Costs, Time, Provide Better Control

Construction management (CM), a professional discipline that offers more efficient project development techniques, can add significant value to the entire construction process and will be a necessary discipline in getting America through the “trillions of dollars” worth of infrastructure repairs that are coming due, according to industry experts.

John McKeon, executive vice president of the Construction Management Association of America (CMAA), told BNA Aug. 31, “We define CM as a professional service that applies effective management techniques to the planning, design, and construction of a project from inception to completion for the purpose of controlling time, cost, and quality.” It is not a project delivery method, he said, which CMAA interprets to be more of a contractual structure, like design-bid-build or design-build. “CM [practitioners] are not constructors, we are not general contractors . . . the professional service is compatible with all of them; it really is neutral in terms of the contractual method of delivering the product, e said.

According to a May 24 statement from Skanska USA Building Inc., a firm that uses and promotes CM, utilizing construction management can:

- Reduce the cost of the project;
- Decrease the overall time required for planning and design;
- Accelerate the physical construction;
- Provide continuity and improve project coordination throughout both the design and construction phases, and
- Provide more continuous control of the project.

Considering the cost and complexity of today’s capital projects, the importance of time, and the need to deal with unanticipated events, it is becoming more and more apparent that an integrated and managed approach to planning, design, and construction of the built environment will be needed, according to CMAA. “Quality-focused, cost-effective, dispute-and injury-free project delivery does not occur without a deliberate commitment and effort to manage the project delivery process,” according to the CMAA website.

One of the tasks of CM professionals is to match the needs of the owner with costs and benefits, at each stage of the project. This has become a full-time opera-

tion, and coordination from the CM professional will soon be unavoidable.

Whip Inflation. Construction management, McKeon said, has been around since the 1970s, a decade remembered for “an intense period of inflation,” which had a severe impact on the construction industry. “Owners were reluctant to begin jobs because they had no confidence in what their costs were going to be by the time the job was going to be finished,” he said, “and a tightening of processes became vital.” It was at that point that people realized that construction management was a separate discipline, he said, adding, “You could do it if you were an architect or an engineer, but it wasn’t automatic.”

Public Sector. CM, McKeon said, is “skewed toward the public sector, at least for the moment, and in fact agencies like GSA [General Services Administration] will give contractors a preferred consideration if staff trained in CM are part of the offering.” The CM process will be found in large-scale infrastructure projects, like highways, airports, ports, and transit, he said, and the GSA uses CM on nearly all of its projects, as does the Army Corps of Engineers. “There’s a lot of CM being done in the private sector as well . . .” he said. “We’re working on that.”

Experience Required. Professional construction management services are selected on the basis of qualifications and experience, matched to the needs of the owner and the project, according to CMAA. McKeon said that potential construction managers have to have a minimum of four years of running projects, in which they were “the main person whose decisions affected the outcome of the project,” before they can even send

in an application. References are required, as is a five-hour exam. “There are about 1,500 construction [managers] in the country right now, and that’s growing pretty quickly,” he said.

Trillions Needed for Infrastructure. Asked about the future of CM in the construction industry, McKeon said that his organization is “very, very optimistic about it. We think it is going to continue to gain market share as people understand that the era of tight budgets is not going to change.” Owners, he said, are under a lot more pressure, and they have to be able to get things done on time, and they are looking for a more comprehensive approach to the process.

When construction begins, McKeon said, “[owners] will want to know what the building is going to cost to operate over the life of the building.” This touches on sustainability, he said, “not only to build in a sustainable and environmentally responsible way, but also to build a building that can be operated in a sustainable way over a long period of time.” McKeon described this area as confusing and difficult, and builders and planners will “need somebody to guide them on that. We feel that a construction manager is an ideal person to figure out what they can do, how expensive and difficult it will be to do it, and what the benefits will be.”

CM, he said, will be a pivotal factor in the refitting and upgrading of America’s infrastructure, such as highways, water, wastewater, and most likely power generation. The undertaking will run into the “trillions of dollars,” he said. Since so much is needed, money will be in very short supply, and “these pressures on the market are going to make our professional servicers have to figure it out.”

By KEVIN LAMBERT

Industry Spotlight

WATER MANAGEMENT

Global Warming, Wasteful Water Uses Call for Shifts in Development Patterns

Water, our first necessity is finite, and new ways to overuse it are being discovered daily. It takes, for example, 13.5 million gallons a day to run chillers on an AT&T server farm. But water availability is rarely factored in when Americans decide where to live and work, which has shifted from areas where the water is to places where the water isn't. This is straining our overall supply and causing water disputes in states as wet and humid as Florida. Robert Glennon, author and Morris K. Udall Professor of Law and Public Policy in the Rogers College of Law at the University of Arizona, spoke with BNA's Kevin Lambert about America's "self-inflicted" water crisis—how it is already affecting real estate decisions, how it will shape the demographics of the future, and how Americans are building homes and businesses in areas most notable for sunshine and drought.

BNA: In your book *Unquenchable*, you talked about low water flows. What are the economic consequences for the United States?



Glennon

Glennon: If we have lower water flows in the Colorado River due to climate change or drought—or anything—we get less hydropower out of that system. That means we have to find replacement energy, and that is an expensive proposition, because that is buying spot market energy—which is the most expensive. Then you have other problems. If you have low flows, the whole commercial transportation system is upset, a lot of stuff moves by barge and not just on the Mississippi River. The Snake and Columbia systems move a lot of traffic. [Then] you start talking about impeding navigation and driving up shipping costs. The third thing is that low flows [spell] habitat change for the species around it. You're going to have warmer temperatures in the river, and a change, possibly, of algae blooms, and that has implications for commercial fisherman in the Gulf of Mexico, for example. It has implications for recreational anglers who like to go out and throw a line into their local river and all of a sudden the fish are stomach-up dead. It has implications for wastewater treatment systems, because warm waters and low flows mean changes in what they have to do to the water to provide it to various municipalities.

BNA: You have said that Americans are moving to the wrong places when it comes to water use.

Glennon: One of the drivers behind the water crisis in the United States is population growth. We just

nudged over 300 million in the U.S. two or three years ago, and yet, the Census Bureau [projects that for] 2050—only 40 years from now—the population will reach a staggering 420 million people. So that's an additional 120 million fellow citizens that we have to find water for. Where is it going to come from? And that is compounded by internal migration, because what's happening in the United States is that people are moving from where the water is, like Michigan, to where the water isn't, like Florida, Georgia, Arizona, New Mexico, and California. It's a remarkable but true fact that [the population in] the state of California over the last several years has gone up by one person per minute.

Here's another demographic fact: the state of North Carolina has replaced New Jersey as the 10th most populous state in the country.

Jobs Moving to Drier Areas. **BNA:** And all these moves are economically based—people going to where the jobs are from where the jobs aren't?

Glennon: Absolutely. When you look at a state like North Carolina or a state like Georgia you would say, 'How on earth can those Southeast cities—the very epitome of humid-region states—be having water problems?' But they both are. The state of North Carolina is involved in litigation against South Carolina, which is currently pending in the United States Supreme Court. The state of Georgia is fighting with Alabama and Florida over the Apalachicola-Chattahoochee system. We think of water wars and we think of the American West but here are two pieces of litigation that are going on in the Southeast.

BNA: Would California's Inland Empire be an example of people moving to where the water isn't?

Glennon: Well, there's no water there, so that's right. But there's no water in Tucson, where I live. So what we have been doing is borrowing from the future, by excessive groundwater pumping, which is lowering the water tables, hammering our rivers and riparian areas, and causing a decline in the groundwater, because the deeper you pump from an aquifer, the saltier it gets and there are even some natural contaminants that may be leached into the water at deeper depths because of the water's internal temperature being higher down lower.

BNA: Do you think that this sort of groundwater grab could affect the structural integrity of the planet itself?

Glennon: That's a surprisingly interesting question. You might think it's science fiction, but there was a study about a year ago that said so much water had been pumped from aquifers in California that there was actually a shift in the earth. I don't know. I'm not a sci-

entist and I wouldn't pretend to know whether that's true or not. It seemed a little bit like a modeler got carried away, but it certainly is food for thought.

BNA: If people are going where they shouldn't, water-wise, where should they go? Should they go to Michigan? Should the federal government prop up water-rich states?

Glennon: Some communities are trying to do exactly that. The city of Milwaukee [thinks] that they can offer kind of a water hub for companies and researchers to go [there]. People are going to go where they want to go. We have a right—a liberty—to travel protected by the Constitution. People are going to go to where the jobs and opportunities are and that's going to continue. I'm not saying that we should close the doors to people moving to water-short places. What I am saying is that that poses enormous challenges to water managers and requires all of us to think about how we use water. In *Unquenchable* I document very clearly that there is a water crisis. When you have commercial and residential projects being cancelled in California, power plants not being built in four different states, a paper company in South Carolina closing its doors and furloughing hundreds of workers, commercial fishing seasons off of California and Oregon being cancelled for the third year in a row, you are talking about jobs. We may fret about running out of oil but water lubricates the American economy just as oil does. So there is a crisis. We should have no illusions about that, but a crisis is a time of opportunity and what I do in *Unquenchable* is to show a variety of options . . . solutions to dealing with the water problem.

BNA: Looking at some of the uses of water, one could get the impression that even though every industry and person needs water to survive, industry still seems to give the bottom line precedence in their water decisions. Is that your impression?

Businesses Discount Personal, Farming Uses. **Glennon:** I don't think most commercial businesses, whatever business they are in, think too much about water use by the citizens or the farmers or other people. I think they are concerned about water, in their particular business. Water is an input not just for the obvious industries like farmers or cereal producers like Kellogg's or even drink producers like Coca Cola. Water is also an important input for companies like Intel and Google. That's quite remarkable, because if you think about how these high-tech companies—and they use a lot of water—Google uses it for cooling but Intel actually has an ultra-pure water that they produce at their fabrication facilities. They use it for making the silicon chips that are the heart of the semiconductors. So it is absolutely integral to the success of Intel.

BNA: You wrote about Rockland, N.Y., as a community where there are just enough people for the water that is there, which implies that nobody else should move there. Could this lead to some sort of zoning restrictions, and eventually lead to zoning that prevents more than a certain number of people living in a certain area?

Glennon: The short answer is no, those sorts of things are of dubious constitutionality. But what could happen and what is happening in some communities is that [they] are saying not that it is no-growth but they are saying that growth needs to pay its own way. 'You want to do a deal, you have to bring water with you.' In

Santa Fe there is a wonderful example of that in action. Santa Fe is a beautiful place, very upscale, very popular, but they are starting to run out of room and they have long run out of water. So what the Santa Fe city council did was to say, 'We don't want to stop growth, we don't want to stop construction, but we want to have construction that is sustainable.' So they took a look and they said the average new home needs x gallons of water per year. If we were to take an old home in Santa Fe and replace the old high-flow toilet with a new high efficiency low-flow toilet, that would save x number of gallons. If we did that in eight houses, that would be the equal amount of water as the new home would require. And so what they said to developers was that if you want to put in a new home in Santa Fe, then you need to retrofit eight existing homes with low flow toilets. So it was the cost of doing business. It wasn't no-growth. They told the developers exactly how to do it. Then the local plumbers realized that this was an opportunity for them. They started going around knocking on doors and saying to people, 'Would you like a new high-efficiency toilet?' And they would swap out the old wasteful toilet with a new [efficient] one, document that with the city, and then sell those credits to developers.

It's a wonderful story, and what I like most about it is that it is not the word no, not 'Nellie, bar the door' kind of a Boulder, Colorado, no more growth prohibition system. It was saying to developers, 'We need you to pay your own way. We need you to ensure that you don't make our water situation worse.'

Water Marketing a Solution. What's really happening in the American West in a big way [is] that we are going to solve this problem through water marketing. You are seeing that communities simply can't grow when you don't have water for new growth, and yet in lots of communities you have agricultural users who have been using water in very inefficient ways for decades or even for generations. And what I argue . . . and what in fact is happening is that farmers are selling out to developers a portion of [their] water rights, and . . . the farmers are improving their irrigation systems, making on-farm improvements. They are adjusting their crop mix to go from low-value crops like alfalfa to higher value food products like broccoli or cauliflower, and they are continuing to farm the same land and yet using less water.

BNA: You also mentioned that Minnesota, the land of 10,000 lakes, is having a water problem.

Glennon: I have [also] written about Minnesota in my book *Water Follies*, about a farmer that was trying to produce perfectly uniform potatoes for McDonald's. . . and they are using a lot more groundwater trying to produce perfectly formed French fries. I used Minnesota to illustrate the problems created trying to make ethanol. Ethanol is controversial for lots of reasons, but I don't have a dog in that fight. What I think is interesting is that we have essentially ignored the water implications of our energy policy. And in the case of ethanol there are immense water implications. It takes on average four gallons of water to refine one gallon of ethanol. So a typical 50 million gallon ethanol plant is going to need 200 million gallons of water just to produce the ethanol. I talk about communities in Minnesota saying to the ethanol manufacturer, 'Sorry, we can't provide you with that much water; we don't have it in our system.' And that turns out to be just a drop in the bucket,

because first you have to grow the corn. It's not too bad if you are in the Midwest, say Illinois, and you have plenty of precipitation from Mother Nature, but the moment you move west, into the western part of Nebraska and beyond past the hundredth meridian, every agricultural field is irrigated. You have to irrigate and when you talk about irrigating for corn you can look at numbers that are simply staggering. It can take as much as 2,500 gallons of water to grow enough corn to refine one gallon of ethanol.

BNA: On the basis of numbers like that, would you say that ethanol is going to be a dead duck? Another dot-com boom and bust?

Glennon: Oh, no, it's just the opposite. You cannot be elected president of the United States without going to Iowa and worshipping at the shrine of ethanol. That's just a political reality. That's not going to change, unless Iowa's caucuses change.

BNA: In the future, how much will water be driving American demographics?

Glennon: Quite a bit, because there are a couple of things going on. One is what the scientific community seems to be coming to believe in a very clear way . . . that the earth is warming. We have certainly seen that this summer, with record heat, also more extreme events, nastier storms, more prolonged droughts. And that is exactly what the climate scientists have been predicting would happen. Now the paradox of this is there won't be more or less water on earth. The hydrological cycle is a closed cycle and the water that we are drinking is the same water the dinosaurs drank. But the global climate change issue is likely to mean that there will be more water in some places and less water than there is now in other places. That's going to be particularly difficult for the Southwestern U.S. because the climate people think that the Colorado River basin and the Sierras and the Cascade ranges are going to be very, very affected by global climate change.

Ingenuity at a Premium. BNA: Do you think that we can utilize American ingenuity and engineering skills to work ourselves out of this crisis, or is it just too big for that?

Glennon: It's not too big for it. I am an optimist. Absolutely. I think that there are five things [that are] really core. First, conservation. We can do a heck of a lot better. Second, re-using water, municipal effluent. We don't need to drink it, but we can sure use it for watering golf courses and highway medians and light industrial applications. Google is using reclaimed water for server farms. Third, desalination for some of coastal areas will be a part of the portfolio. The fourth is price signals, because we Americans are spoiled. We wake up in the morning, turn on the tap and out comes more water than we could possibly want or need and we pay less for it than for cell phones or cable television. The price of water in the United States is ridiculously cheap. Fifth is reallocation, and that's when water marketing comes in. And the beauty of my system is that it is not some heavy-handed set of government rules that tells farmers that you can't do this or you must install some kind of conduit or pipes with these dimensions. It's nothing like that. It says to the farmer and the developer, 'You two ought to talk to one another. The developer's got a lot of money and the farmer's got a lot of water and the two of you can do your own deal.'

Now what I'm talking about is really a regulated market, it is not a free market. Because if you think about it, there is actually no such thing as a free market. A market depends on property rights and property rights are created by the state. So every market is one that is state-sponsored and created, and here too we need to have state oversight of the regulation of the water marketing, because left to itself, the market could give a hoot about some really important but low-value uses.

The . . . unregulated free market doesn't protect the environment. And here's the problem of bottled water. Nestlé has decided that we Americans would find greater caché and therefore pay more for water that is labeled 'spring water' than water that is labeled 'artesian water' or 'groundwater' or 'filtered water.' The problem is, if you install a pump next to a small stream and you start pumping 500 or 600 gallons every minute of every day of the year, you are talking about millions and millions of gallons of water. And that water would have flowed on the surface as a spring, so every drop of water that goes into a bottle for spring water is water that will no longer flow. Well, that's a huge club across the forehead to the neighboring habitat, and often these are really beautiful streams that we are talking about. So I want a market; I'm in big favor of voluntary transactions, but we do need government oversight to protect the environment.

BNA: That brings us to the question of the future of government oversight. You wrote about a successful public/private partnership for Trout Unlimited, where they worked with the local ranchers to save fishing streams. What influence could pressure from extreme free marketers have on the 'public' side of ventures like that?

Glennon: I hope none, because that story from Montana is a great story of partnering and of working through the various levels of government. I don't see these issues as politically partisan issues and what's wonderful about the Montana story is that Laura Ziemer and Stan Bradshaw were able to work with those crusty old Montana ranchers—you can be sure that every last one of them is a dyed-in-the-wool Republican—and you've got these—sort of—whippersnappers from Trout Unlimited, but they found common ground. And there is common ground there, to protect their community, to bring back the trout stream, and some of it is just self interest.

Addressing Greed With Incentives. I'm not looking for people to be idealists in this process; I want to use the reality that we are all a little bit greedy, so you have to show someone why they should do something differently, and the color of green helps them see why that makes a lot of sense.

BNA: You talked about wealthy water wasters in your book. What is your favorite—if that's the word—example?

Glennon: The misters outside of stores and restaurants in places like Phoenix—misting systems that try to lower the temperature in outdoor seating areas by increasing the humidity. Along the roof line of these outdoor patios you have misters. It's a trivial amount of water, looking at the big picture, but it is so absurdly self-indulgent. And then there are power showers, with 10 shower heads on them. I think that's on my top 10 list. And spring water.

BNA: What will be the impact of ignoring the crisis and also trying to meet the crisis in industry? For instance, the lodging industry. Will hotels in dry areas adapt?

Glennon: I think you are seeing that already . . . Las Vegas, for instance, has changed their water use a lot, casinos or big hotels or tourist or conference places need to worry, but what you are seeing is that people are looking for LEED [Leadership in Energy and Environmental Design] certification, [which] is now a bragging right. People go for that and they use that to try to get people to come in. So I don't see the lodging industry changing too much. I think the industry that is going to be very interesting to watch is the food industry. Restaurants use a lot of water, and particularly in the dishwashing operations. There are some industrial restaurant suppliers now who have some very interesting and innovative ways to wash dishes . . . that's a pretty interesting development.

For office and retail, I think the same. I don't see big changes there. The price of water has started to move up—it's going to go up some more, and it is still such a small percentage of any business's use that I think businesses are just going to adapt. Just one more input that they are going to have to pay a little bit more for.

BNA: Do you think water usage will be much of a driver in shifting the trends to more efficient water usage communities, for instance transit-oriented development?

Glennon: I don't think so. I don't think it is a big driver. With very few exceptions, companies aren't paying a lot of attention to water. Now, that's changing and there is a company in Boston that is kind of a shareholder group that likes to monitor what companies are doing and they are encouraging the business sector to be as concerned about their water footprint as they are about their energy footprint.

Economy's Health at Stake. BNA: Would you consider that an indication that people are becoming more aware of the water usage issue?

Glennon: I hope so; this is deadly serious business. It is the health of our economy that's at stake.

BNA: You wrote about our national habit of 'fouling our own nests.' Which geographic areas might make the quickest comeback from that situation?

Glennon: It's really complicated. You've got some pockets of industrial pollution where there are some pretty focused, albeit pretty expensive solutions. But you can do it. Then you've got agricultural contamination on such a wide scale, for example in California's Central Valley or in Iowa. It's hard to know how those agricultural communities are going to change.

BNA: How much of an answer could desalination be?

Glennon: I see it as part of the portfolio—one option for communities. But the problem with desal is three-fold: First, it is very expensive, and anyone who says that [that expense] is going to change is not coming to

terms with basic principles of thermodynamics. It is darn difficult to get the salt out of water. It's just challenging. The membranes that we use are high-tech, very costly, prone to fouling, and they require frequent replacement. The second problem with desal is that it is enormously energy intensive, because all of this reverse osmosis stuff is done under high pressure, and that takes lot of energy and energy takes a lot of water. So that drives up the cost and it drives up the amount of water that we use. The third problem that desal faces is, you take 100 gallons and you desalinate it and maybe you end up with 50 or 60 or possibly even 70 gallons of pure water, but you also have 30 or [more] gallons of water that now has 100 percent of the salt that used to be in the 100 gallons.

BNA: Couldn't that be used to season French fries or something?

Glennon: Well, when I was on the *Daily Show* with Jon Stewart, one of his suggestions was brine stream flows for the kids to play in. It's a tough one because what desal companies would like to do is to just use the return outflow pipe from an existing power plant and dump it in the ocean. But that concentrated salt going in near the coast in sensitive estuaries will just hammer [them]. So you're seeing a lot of pushback from the environmental community. Now, if you had some outflow that went into a big trough—say 20 miles out 2,000 feet deep—it would have negligible effect on the environment. But that's really, really expensive. So desal is no silver bullet. We're not going to be using it to grow alfalfa. But if you've got a high value use and a few other options, desal will be part of the portfolio.

BNA: So it may not change the real estate values of coastal communities, for instance?

Role of Desalination. Glennon: I think it actually may. You're seeing in [California communities] like Monterey, Santa Barbara, Marin County—all three of those areas are flirting with desal operations. And that's a major undertaking. If you're going to put in a multi-billion dollar desal plant for your water supply, that certainly has the potential to affect real estate investment in communities.

BNA: You ended your book on an upbeat note, sort of, by writing that, 'We have abundant tools available to alter [our old patterns of water use],' and all we need is the moral courage and the political will to confront the water crisis. Does that mean, that through engineering, we can get ourselves out of this?

Glennon: Yes and no. I think some communities will do better at this than others. It will not be uniform progress across the United States. But here is the optimistic message: Those communities that do confront the crisis will prosper more than those that don't. So investment, [in] the same way that if you are looking for a place to invest in real estate, you want to know about the schools and the jobs and the infrastructure. Water should be part of your calculation.

Tax & Accounting

Leasing

Proposed FASB Rule Changes for Leases Will Radically Alter Tenant Balance Sheets

The Financial Accounting Standards Board (FASB) issued an exposure draft Aug. 17 of proposed changes for how commercial leases will be accounted for on company balance sheets. According to industry experts, the proposed changes would essentially move leases from company profit and loss statements to their balance sheets, and could make net leases and sale-leaseback arrangements a more attractive financial option.

The FASB lease proposal is designed to bring U.S. generally accepted accounting principles (GAAP) into compliance with international accounting principles. In a Sept. 16 American College of Real Estate Lawyers-sponsored webinar, Thomas F. Kaufman, a partner at Hunton & Williams LLP, explained, "There is a significant movement going on within the accounting profession of converging with international accounting standards."

Not only the FASB, but the Securities and Exchange Commission (SEC) too is pushing for the new lease accounting rules for public companies. Peter T. McElwain, senior manager at Baker Tilly, said, "In this convergence, the SEC is certainly the driver of this, and under the new legislation they have enhanced powers to force these kinds of things to happen, because of the financial controls statutes and regulations. So the SEC will be a huge driver as to how fast this happens. FASB is going to be in the driver's seat, but the SEC is going to tell them how hard to put the pedal to the metal."

International, Credit Market Standards. Kaufman explained that under current GAAP rules, lease liabilities are not usually represented on a company's balance sheet, except perhaps in a footnote. Kaufman noted that, "There's maybe \$1 trillion in leases for public companies alone that are noted only in the footnotes" of balance sheets.

However, Kaufman said that the leases are in reality obligations to these companies, sometimes decades-long obligations, and the FASB is endeavoring through these new proposed rules to enhance transparency and have the leases represented on a company's balance sheet. Stephen F. Olsen, president and chief executive officer of Global Net Lease Partners, said the proposed rules would bring lease accounting "into compliance with credit markets, where the rating agencies have historically treated all leases as more or less capital leases anyway." Olsen added, "Probably in the long run [it's] a good thing."

Olsen noted that similar accounting rules have been in place internationally, without major adverse effects. "Internationally," said Olsen, "there has been a very strong market in the U.K. and Northern Europe, and in-

creasingly in other areas in Europe, where sale-leasebacks and long-term net leases are in fact a very popular financing option for companies, increasingly so, and they already are dealing with compliance with international GAAP [standards]... Some of these changes could alter some decisions for sale-leaseback or a long-term net lease deal. We're going to have to wait and see, but I think at the end of the day, these rules will still allow them to do these transactions."

Leases Will Go on Balance Sheets. Currently, McElwain said, most companies classify their leases as "operating leases," which don't have to be accounted for on a balance sheet, as opposed to "capital leases," which do. However, McElwain said, "Under this exposure draft, under this new proposed model by the FASB, off-balance sheet lease financing will be a thing of the past. There will be no such thing as 'operating leases' going forward."

This means big changes for the accounting practices of companies with many leases, according to McElwain. He indicated that such companies would probably require new processes and financial reporting controls to comply with the proposed rule changes. This is partly because the new rules will require the use of judgment and estimates not present in existing rules and require some level of ongoing evaluation.

The new proposed lease rules would require tenants to apply a "right of use model" in accounting for their leases on balance sheets. McElwain said tenants "will be required to put some type of process in place [to estimate future cost of a lease, and] to reassess these estimates on a regular basis." McElwain also said that these new rules, as currently proposed, would apply to "every single lease," whether new or pre-existing when the rules take effect.

Effects of New Rules. Kaufman said that the new rules would inject "a lot of subjective decisions" into the accounting of leases on balance sheets, as the future costs of a lease would be loaded towards the beginning of a lease on a balance sheet, as much as a 20 percent increase or more, rather than pushing them towards the back end. This change will radically alter the balance sheets of some companies.

"So some companies will be renegotiating their debt covenants with their lenders, explaining to stock analysts why their balance sheet is radically altered," said Olsen. He added, "I can think of some retailers with these really long-term leases, obviously their financial statements are going to look radically different than they are today."

Olsen said that "[o]ne of the major impacts that we could see here... is shorter lease terms." But Olsen said this could create a conflict between what is best for tenants in their accounting of leases, and what lenders and investors are comfortable with. "There's another whole group of players out there called financial lenders who have a hard time living with a two-year lease."

And also investors trying to evaluate the likelihood of renewal on shorter leases makes the risk of the investment that much greater,” said Olsen. “Lenders will definitely be pushing for longer lease terms in terms of the quality of financing that a borrower can obtain.”

Kaufman urged tenants to impress upon their lenders how the new proposed rules could alter a borrower’s balance sheet when negotiating financial covenants. “If you’re doing borrowing covenants that are going to stretch forward into the real estate of the company, I think you’re going to want to try and specifically state in your loan agreements that any change in the FASB rules shouldn’t be taken into account in computing your financial covenants until people have a chance to sit down and mutually agree on how to apply them,” said Kaufman.

Sale-Leasebacks an Attractive Option. The proposed FASB rules could also make a sale-leaseback a more attractive financing option for some owner-occupiers of commercial real estate. McElwin said, “While the number that’s going to be recorded in these financial statements will go up—20 percent was the number we saw earlier in the presentation—I think companies will inevitably look at, especially non-proprietary real estate

like warehouses and suburban regional office, they will look at it as an opportunity, from a sale-leaseback perspective or net lease perspective, to monetize that asset is going to remain a very viable financing option going forward.”

Olsen agreed with this point, stating, “At the end of the day, there’s no doubt that this change will result in more equity being invested in single-tenant, net lease real estate transactions. The amount of leverage will be reduced, and you’ll eliminate off-balance sheet type financing, all of which, according to the general consensus, contributed in part to the financial crisis. There is this benefit that it is consistent with overall financial reform.”

Though the proposed rule changes would have big impacts on company balance sheets, McElwin said they would have no effect on the actual amount of money a tenant would pay under its lease. Nor would it affect tax treatment of leases.

The FASB is currently accepting public comment on the exposure draft through Dec. 15, 2010.

By ERIC TOPOR

The full text of the FASB exposure draft can be downloaded at <http://www.fasb.org>

Environment

PACE Bonds

Business Leaders Encourage Lawmakers To Restore Stalled PACE Bond Program

Business Leaders from all over the country sent a letter to lawmakers Sept. 15 urging them to pass legislation to fix the Property Assessed Clean Energy (PACE) program, which has been stalled due to guidance issued by the Federal Housing Finance Agency (FHFA), which supervises Fannie Mae and Freddie Mac, the largest purchasers of U.S. home mortgages.

PACE programs allow commercial and residential property owners to finance energy retrofits and then repay the cost over 20 years through an annual assessment on their property tax bill, according to a Sept. 15 statement by the United States Green Building Council (USGBC), the primary organizer of the letter. "In PACE, we have an engine for creating new retrofit jobs in every community in America," Jason Hartke, vice president of national policy at the USGBC, said in the statement.

Hartke told BNA Sept. 17 that the PACE track record has been good, giving the example of its Babylon, N.Y., program, one that has already retrofitted about 500 homes. "[PACE] is making a difference. It is creating jobs in the locality [and] saving people money. The consumers love the program because they actually see savings right away. It has been a bright spot in this otherwise gloomy recession," he said.

William D. Browning, a partner at Terrapin Bright Green, a New York City-based environmental consulting and strategic planning firm, told BNA Jan. 2, "[PACE is] one of several financial innovations in the last several years that could change the equation of how we get at deep retrofits and renewals." (3 REAL 104, 2/9/10) Browning said the greatest advantage was that the bonds would provide a chance to retrofit for property owners who "wouldn't otherwise have the money to implement these kinds of changes."

The issue, Hartke said, is that FHFA was worried about "subordination on the mortgages. They were concerned that these PACE loans would take a senior position as a priority of existing mortgages." The proposed legislation, he said, directs FHFA to rewrite their guidance for Fannie and Freddie. "Local governments have

used very similar, if not the same mechanism, for all sorts of government improvements," he said.

PACE bonds are primarily residential, at least for now, but Browning said "there's really no reason why you couldn't use it for commercial real estate (CRE) as well. [PACE bonds for commercial properties] is sort of the logical next extension," he said, although "the mechanism would have to be slightly different." Browning said that in mid-December 2009 a group of New York City CRE professionals got together to explore creating a similar mechanism for commercial properties.

Possible Application to Commercial Properties. The businesses that signed the letter, Hartke said, were "very large . . . construction firms, real estate companies like Transwestern" [and] businesses from the architectural, engineering, home improvement, contracting, and construction communities. "There are more than 1.5 million people who are out of work in the construction industry," he said, ". . . who could easily get into this retrofitting industry if . . . the right policies were put in place to help it." Hartke added that "we are not going to hit any of our climate and energy goals if we don't get this off the ground."

Hartke said that his organization is "pushing for broad bipartisan support" and that the chances of passing some legislation are "good." There are several bills pending that they might attach it to.

Asked what might happen if nothing is done, Hartke replied that "we have already seen what's happened. These programs have been suspended all across the country, layoffs have happened . . . we are losing jobs, retrofitting opportunities have come to a screeching halt." Without this legislative fix, he said, PACE advocates will have to "look at some other financial vehicles," he said.

Hartke stressed that the PACE program is not a taxpayer-funded, government program. "It doesn't cost the American taxpayer anything," he said. "This is going to save any consumer—[a] homeowner or business—money because the retrofit pays for itself and saves money over time. What the PACE program does is spread out the up-front costs over such a long period of time that you barely feel it, and you start to see savings in your monthly bills almost right away. This is not a federal program, the funds get generated from the bonds."

By KEVIN LAMBERT

International

FOREIGN INVESTMENT

Although investment activity is up sharply over last year's historic lows, sovereign wealth funds and other international investors find few buying opportunities for high-quality U.S. commercial real estate. The author notes that federal policy continues to discourage investment from abroad in domestic properties, but sites evidence that America may represent an improving opportunity for foreigners.

Foreign Investors Hesitant About U.S. Real Estate, but Future Prospects Brighten



BY RANDYL DRUMMER

Foreign investment in U.S. real estate has nearly doubled in the first half of 2010 over the dismal numbers from one year ago, but overall activity remains muted by the slowly recovering economy and a lack of high-quality property available in large U.S. metro markets.

According to research released this week by Jones Lang LaSalle, the United Kingdom has emerged as the most popular destination for cross-border investment in 2010 with \$7 billion invested. International transactions in the U.S. market jumped from \$2.2 billion to \$4.3 billion, a significant increase but not enough to prevent Germany from bumping the United States as the second-most popular destination for foreign real estate capital.

"The rise in cross-border transaction volume also shows a real estate return in the major markets, and an encouraging 176 percent increase year over year in the United States, which had the greatest fall in cross-border investment during the downturn," said Steve Collins, managing director, Americas, for JLL's International Capital Group.

Randy Drummer is senior news editor for the CoStar Group.

No Rush to America Yet. While investors have started to move back into the United States with major purchases in 2010, the long-predicted rush of foreign capital has yet to materialize. Some see the lack of available well-leased core and trophy assets in major U.S. metros that foreign investors covet and the bidding wars for the few Class A properties that are brought to market as being two factors dampening investor interest.

"Demand is especially robust for well-leased, core-style product in gateway markets such as New York and Washington, D.C., whereas demand remains much weaker for the non-gateway cities markets," Collins said.

Commercial property by far has the lowest foreign ownership of any U.S. asset class by percentage, just 5 percent as of the end of 2009, compared to ownership of U.S. government securities at 49 percent, corporate bonds (18 percent) and stocks, (16 percent), according to data from various government and industry sources.

"It is clear that foreign investors are under exposed to commercial real estate," said Umair Shams, economist for CB Richard Ellis. "According to recent industry surveys, however, interest in U.S. commercial real estate remains healthy among foreign investors and their exposure to U.S. commercial properties should increase significantly in the next few years."

In addition to the economy and the shortage of available product, another potential hurdle for foreign investors is a 1986 provision that heavily taxes foreign investments in U.S. real estate interests. The intent of the Foreign Investment in Real Property Tax Act (FIRPTA) was to ensure that the government can tax gains recorded when a foreign entity sells U.S. property or shares in real estate companies. But critics have long sought to amend or repeal FIRPTA, maintaining that the law effectively blocks or impedes the flow of foreign capital into the U.S. An attempt to drastically overhaul the law fell short this summer.

FIRPTA Passes in House. The Real Estate Jobs and Investment Act (H.R.5901), a bill introduced by Rep. Joseph Crowley (D-N.Y.) that would raise the allowable foreign ownership of a publicly-traded real estate in-

vestment trust (REIT) from 5 percent to 10 percent before proceeds are taxed under FIRPTA, passed the House by a vote of 406-11 on July 29. The bill must still be approved by the Senate and signed by the president before becoming law.

While the industry welcomes any change in the onerous tax law, the legislation applies only to investments in REITs. That makes it a limited victory for the CRE industry, which lobbied Congress to make all direct investment by foreign entities eligible for tax relief.

"It's certainly not what we hoped for. It's really just a start," said Jim Fetgatter, chief executive officer of Washington, D.C.-based Association of Foreign Investors in Real Estate (AFIRE). "It may encourage a little foreign investment, but it's only going to impact foreign investors who are already investing in REITs, allow them to take a bigger piece of a company. But there are a lot of countries in the Middle East and Germany that do not invest in REITs. They're direct investors and the new law won't have any impact on them."

Many foreigners used to hedge their U.S. tax costs, understanding they needed slightly higher returns on U.S. investment than in other countries, Collins said. However, "the theory now is if they make the deal and it's a nice investment and the hedge goes their way, great, otherwise, they've still made their return."

"I don't think you'll see a huge jump in foreign activity if the legislation goes through, with the exception of a few countries that have had adverse tax ramifications issues, like the Netherlands, Norway, Korea," Collins said.

While the bill might have very little impact on U.S. commercial real estate, it could bring some much needed additional liquidity to the asset class, noted Shams.

Low-Risk U.S. Assets Available. "In our view, investors can find low-risk and stable assets today in U.S. commercial real estate. Irrespective of tax and regulation effects, foreign investors will be well justified in increasing their U.S. commercial real estate exposure in the upcoming years, and domestically, the market will benefit from greater liquidity as a result," Shams said.

The good news is that global commercial real estate investment nearly doubled from \$76 billion in the first six months of 2009 to \$132 billion for the first half of 2010, according to JLL. Cross-border investment activity, which hit a low of 31 percent of total volume in the first half of 2009, increased to 43 percent in the first half of this year, a level not seen since before the recession. That reflects generally improved confidence and a resumed search for yields by investors, according to Jones Lang LaSalle.

Growing numbers of foreign investors, spooked by the European debt crisis and the weakening of the euro against the dollar, are convinced that the U.S. is the safest place to park capital, Fetgatter said. Foreign metros such as London have been inundated with foreign investment, driving down yields, and some foreign capital is beginning to look elsewhere, including the United States.

U.S. Market Highly Rated. The Fair Market Index by London-based research firm DTZ Investments, based on relative price attractiveness, gave the United States a rating of 89, considered "hot" while the Asia Pacific region also scored a "hot" with a rating of 67. Europe, meanwhile, received a 49 rating, considered "warm,"

while the United Kingdom received a "cold" rating of 38.

However, many foreign investors remain risk-averse. Finding few quality assets that meet their investment criteria, most are still opting to hover rather than swoop.

"We won't be returning to 2007 levels, but I would expect the second half of 2010 to be a bit better than the first half," said AFIRE's Fetgatter. "Had the U.S. economy not taken the pause it did during the summer, along with all the talk about a double dip recession, I think we would have seen more activity, even among U.S. domestic investors."

Central Asia

Astana, New Kazakh Capital City, Built With Oil, Gas Money, Adds Pleasure Dome

Despite recent economic reverses, Astana, Kazakhstan, a city that barely existed 10 years ago, opened in mid-July a \$400 million entertainment mall, marking another oversized project fueled by Kazakhstan's oil and gas economy. The mall is already 80 percent occupied.

Astana, named the country's new capital in 1997, hosts both international oil and gas companies and all of the government's institutes and embassies, and has been designated a special economic zone, according to an Aug. 24 e-mail to BNA from Evgeny Nadorshin, Jones Lang LaSalle's (JLL) head of research in Russia, and Anna Savenko, of JLL's retail department in Russia. Since the move, Astana has witnessed what has been described by published reports as "one of the world's greatest building projects," as state money has been spent on government buildings, a mosque, parks and monuments, and a "massive" home for Kazakhstan's president. The project is designed not just to make Astana the center of Kazakhstan, but of all Central Asia. "Kazakhstan [intends] to position itself as a transport hub . . . between Asia (in particular China) and Russia," Nadorshin wrote.

The new city, which had hardly any infrastructure or services until mid-decade, has gone from what Nadorshin called "a huge construction site [with] plenty of mud" to "the fast developing economic and business center of new Kazakhstan," an urban magnet that is threatening to de-populate the countryside.

Kazakhstan is the largest of the former Soviet republics in territory and its economy is larger than all the other ex-Soviet states combined. It abounds in fossil fuel reserves, minerals, and metals, with an industrial sector that focuses on their extraction and processing, according to data from the Central Intelligence Agency (CIA). Kazakhstan's oil and gas sector totaled 22.3 percent of the country's gross domestic product (GDP) in 2009, Nadorshin wrote.

Kazakhstan's recent political history has been stable and an encouragement to foreign investment, according to the CIA. Kazakhstan boasted double-digit growth from 2000 to 2001 and 8 percent or more per year from 2002 to 2007. It opened the Caspian Pipeline Consortium in 2001, from western Kazakhstan's Tengiz oilfield to the Black Sea, in 2009, and the Kenkiyak-Kumkol portion of an oil pipeline from the Caspian Sea to Xinjiang, China, was completed in 2009.

Bright Lights, New City. Astana, Nadorshin said, “could be compared to Dubai . . . a place of shopping centers and modern business[es].” Astana has three museums, two drama theatres, two literary magazines, and over 40 newspapers, according to published reports. Ivan Torshin, head of research and consulting with NAI Aristan Company, the Kazakh branch of Princeton, N.J.-based NAI Global, wrote in a mid-August e-mail to BNA that over the last 10 years “Astana has changed almost beyond recognition.”

Government business is the main economic driver, according to Torshin, although Nadorshin wrote that “energy is definitely the main source of power.” The government, Nadorshin said, “applies serious efforts in order to diversify [the] economy and redistribute flows, so it plays a very important role in the economic process.”

Construction Boom/Bust. Astana’s construction boom, according to Nadorshin, went active in the early 2000s, building a city infrastructure “from zero. The targets were to build as much as possible as fast as possible.” Torshin, in words that could have come from almost anywhere, wrote that the boom “was triggered by readily available credit, the rapidly growing economy, rising property prices and rising incomes of the population.” The property market was speculative, he wrote. “Too many large trade centers were built in Astana and some of them are half-empty. Rent and sales prices are [now] close to [their] bottom . . . [and] poor growth is expected in 2011.” Prices for office housing and retail have fallen roughly to half of their 2007 value, he wrote.

According to the CIA, GDP growth slowed to 3.3 percent in 2008, and to 1 percent in 2009, largely due to declines in oil and metals prices, and problems in the banking sector.

Nadorshin said that the growth rate of construction projects was positive 1.9 percent in 2008 and negative 3.2 percent in 2009, and that residential investments were negative 11.2 percent in 2008 and negative 36.9 percent in 2009.

Mall in a Tent. The 1 million square foot Khan Shatyr center is shaped like a traditional Central Asian yurt, made from a plastic called ethylene tetrafluoroethylene (ETFE), which admits sunlight but blocks extremes in weather, quite necessary in a climate that can reach 40 degrees below zero in winter and up to 90 degrees in summer. It contains 430,000 sq. ft. of retail space and a man-made beach, fitted with imported sand from the Maldives. Ainash Chengelbaeva, a journalist living in Astana, wrote in a Aug. 6 e-mail to BNA that Astana residents “who have a car” are happy with the mall. The rest, she wrote, in may “need to change 2 or so buses” to reach Khan Shatyr.

As a special economic zone, Astana features customs, corporate, land, property, and Value Added Tax (VAT) exemptions, and financial accommodations for building construction, with an accent on infrastructure, such as power networks and sewers, which are paid for by the state, Nadorshin wrote.

Down but Not Out. The last major project in Astana, before Khan Shatyr, was the Pyramid of Peace and Accord (completed in 2006), designed by the British architect Lord Norman Foster, who also designed Khan Shatyr. Torshin wrote that no new development is planned for the next two years.

While the Kazakh economy is down at the moment, Torshin wrote, “in general the city is growing faster than others in Kazakhstan . . . due to large amounts of investment in construction, especially with the support of the state. Astana is a young city with large undeveloped spaces.”

According to Torshin, Astana has a “great potential for investors,” including Americans. Kazakhstan, he wrote, is “interesting . . . for construction companies, management companies, [and] distribution networks. Already there is a shortage in high technology and modern materials.” Nadorshin agreed that there “definitely” is a potential for American investors in Astana, but cautions that there are risks involved, which would come largely in the form of official red tape.

Asked if the growth and relative opportunity in Astana will soon overload the city with people from everywhere else in the region, Chengelbaeva said that “it is already happening.” But Torshin said that this influx of newcomers “promotes the development of the city. At the moment there is a fairly stable demand for professionals in all areas of business.” There is no oversupply of cheap labor, he said, as people with lower levels of education prefer the country’s southern regions, which include the former capital of Almaty, Kazakhstan’s largest—and most polluted—city. Torshin wrote that “such a dynamic development [witnessed by Astana] will not repeat but improvements will be continuing.” Further improvements, he said, will “increase not only the growth of population, but also the social standard of living. Large international developers have greater opportunities to enter the market, as competition and dumping have fallen sharply.”

Chengelbaeva, who formerly lived in Moscow, with its notorious traffic jams, wrote that she likes life in Astana. She lives in an old Soviet-era apartment, with thin walls, but her neighbors are friendly and the nightlife is adequate, and she said that the streets are always safe. “I think there will be built more ultramodern buildings of the most incredible and different forms,” she wrote. “Then our city will be like Kubrick’s dream come true.”

By KEVIN LAMBERT

Journal

CONFERENCES

To post a notice of an event on the *Real Estate Law & Industry Report* calendar, e-mail it to rcowden@bna.com.

September

AFIRE European Conference; Sept. 19–21; Chicago; <http://www.afire.org>.

MBA Mortgage Operations Conference; Sept. 19–21; Dallas; <http://www.mbaa.org>.

ARDA-Carolinas Regional Meeting; Sept. 20–21; Myrtle Beach, S.C.; <http://www.arda.org>.

NAREIT Senior Financial Officers/Investor Relations Officers Workshop; Sept. 20–21; Washington, D.C.; <http://www.reit.com>.

CREFC German Loan Restructuring Workshop; Sept. 21; Frankfurt, Germany; <http://www.crefc.org>.

ICSC Czech Republic & Slovak Retail Real Estate Conference; Sept. 22; Bratislava, Slovakia; <http://www.icsc.org>.

MBA Quality Assurance and Residential Underwriting Conference; Sept. 22–24; Dallas; <http://www.mbaa.org>.

ICSC Western Division Conference; Sept. 22–24; San Diego; <http://www.icsc.org>.

ABA RPTE Joint Fall CLE Meeting; Sept. 23–25; Toronto, Canada; <http://www.abanet.org/rppt/>.

MBA Regulatory Compliance Conference; Sept. 26–28; Washington, D.C.; <http://www.mbaa.org>.

Real Estate Roundtable 2010 Fall Meeting; Sept. 28; Washington, D.C.; <http://www.rer.org>.

October

Expo Real 2010; Oct. 4–6; Munich, Germany; <http://www.exporeal.net>.

ISCS Canadian Convention; Oct. 4–6; Toronto, Canada; <http://www.icsc.org>.

PREA 20th Annual Plan Sponsor Real Estate Conference; Oct. 4–6; San Francisco; <http://www.prea.org>.

ACREL 2010 Annual Meeting; Oct. 7–10; Toronto, Canada; <http://www.acrel.org>.

RetailGreen Conference & Trade Exposition; Oct. 12–14; Scottsdale, Ariz.; <http://www.icsc.org>.

ULI 2010 Fall Meeting & Urban Land Expo; Oct. 13–15; Washington, D.C.; <http://www.uli.org>.

NAREIM Issue Forum Convention; Oct. 18–20; Atlanta; <http://www.nareim.org>.

ISCS Pathway To the Future Conference; Oct. 24–26; Orlando; <http://www.icsc.org>.

MBA 97th Annual Convention & Expo; Oct. 24–27; Atlanta; <http://www.mbaa.org>.

Europe Autumn Conference 2010; Oct. 25–26; London, United Kingdom; <http://www.crefc.org>.

NAIOP Development '10: The Annual Meeting for Commercial Real Estate; Oct. 26–29; Orlando; <http://www.naiop.org>.

NAHB Fall Construction Forecast Conference Webinar; Oct. 27; Webinar; <http://www.nahb.org>.

IFMA World Workplace; Oct. 27–29; Atlanta; <http://www.worldworkplace.org>.