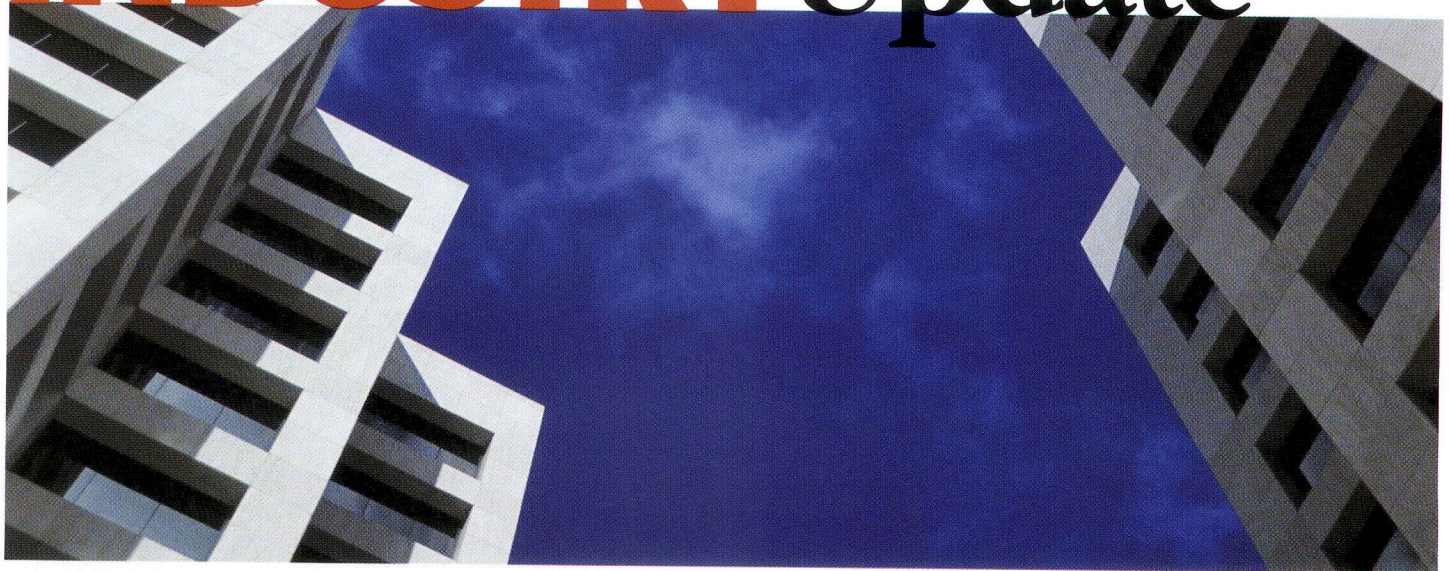


INDUSTRY Update



Are you overlooking traps in your deals?

As commercial investors scramble to make deals in hot markets, the careful analysis of tenant leases, zoning laws, and other factors that affect property use and value are often given short shrift. Yet buried down in the pages and pages of minutia that constitutes the leases of most major tenants may be hidden traps that can undermine a property's value, says Joshua Stein, a partner in the Finance and Real Estate Department at Latham & Watkins LLP in New York and the author of four books and over 100 articles on commercial real estate.

It's easy to miss these time bombs, says Stein, if you just look at the basic financial terms in your lease review. Here are a few lease clauses and issues that you or your client shouldn't overlook when analyzing your next commercial deal.

Options and other off-premises pitfalls

Anyone buying a building should pay special attention to any com-

mitments that the landlord has made outside the leased premises. "Whenever you give a tenant any rights over space they don't actually lease, you're looking for trouble," Stein says. Expansion options and rights of first refusal on space are the most prevalent outside-of-premises commitments at most properties. Beyond their obvious impact on future flexibility, options and similar rights can sometimes overlap or clash. This can create recordkeeping headaches, or worse, litigation. The more leases that contain options, the greater the chance of creating a conflict between the rights of two tenants or overlooking a tenant's rights.

While it's unrealistic to think you can eliminate options, "keep the options simple and few," Stein recommends. Instead of a general right of first refusal over any available space, for example, he suggests that anyone negotiating a lease should try to give rights for specific space at specified dates. If

multiple leases have options, try to have all options on the same time schedule, if possible. Offering options only on whole floors is another way to prevent space from being carved up.

Rights to parking spaces or to control any changes in parking, for example, are also often outside-of-leased-premises restrictions tenants commonly request during negotiations. Other tenants might demand "no-build" areas, restrictions on competition through exclusive-use clauses, rules about signs, traffic controls, or other restrictions.

"Most options and restrictions sound reasonable in theory," Stein says, but to a buyer the whole area represents a minefield that sometimes doesn't get as much attention as it should. And if the various tenant rights don't all fit together perfectly—for example, if the landlord unwittingly violated one tenant's restriction by leasing some space to another tenant without realizing it infringed on the first

tenant's exclusive—a careless buyer may get a long-term headache that won't go away easily.

The solution? Carefully review existing leases with a special emphasis on these "extraterritorial" tenant rights. Stein notes that while it's possible to amend leases after the fact to try and solve conflicts, "it's never easy. Prevention is the best cure; otherwise bring your checkbook," he says.

Use impediments

Another area Stein flagged for special concern is the whole area of how a buyer might plan to reconfigure or change the use of a particular property. Issues like these can easily get overlooked in the compressed due diligence process of a hot market, says Stein.

"If you're not planning to rock the boat, chances are you'll be okay on issues like these," Stein said. But if a buyer wants to change things around, even a single tenant may have the power to block the buyer's plans until that tenant's lease expires. Major leases may limit construction, reconfiguration of parking, competition, particular uses within the property, and other elements of the buyer's grand scheme for redevelopment. And zoning laws can be barriers.

When they're thinking about zoning, buyers should also watch out for "legal nonconforming uses," Stein warns. These are buildings that conformed with zoning when built, but no longer do because the law has changed. Usually the zoning law allows continued operation of the original use, but only if the use is not suspended for more than a certain amount of time, as might happen during a renovation.

As an example of a problem in this area, Stein mentioned a property that had been used as a theater—a legal nonconforming use—but was shut down for several years because of an earlier owner's financial problems. When a new owner began renovation to reopen the theater, he discovered that because operations had been

suspended for too long, the building could no longer be used as a theater.

Stein cautions that if you plan to rely on legal nonconforming use status, try to dig into the history of the property enough to know that the property didn't lose its special protected status.

Escalation caps and bases

Setting aside special cases like buyers who want to change everything around, where has Stein seen the most problems in leases?

"Just as a practical matter, I've seen the most problems in the formulas for rent escalations—anything from inappropriately high or low base years to complex formulas that just don't work right," Stein says.

He recommends that any buyer

treat rent escalation formulas as a major potential pitfall in any lease. If a base is artificially low, for example, a buyer needs to assess the risk that a tenant will be able to force a change in the base year, thus reducing escalation rent. If a base is artificially high or not yet determined, the buyer needs to factor that problem into its financial analysis for the building. Stein also notes that many major tenants try to cap their rent escalations.

As with options, the best course is to keep it simple, says Stein. "I've seen plenty of cases where the lawyers write a very complicated formula for this kind of thing, a masterpiece of legalese, but it leaves something out or says something twice, and the formula just doesn't work right." In such cases, a buyer should try to insist on a

lease amendment or at least an estoppel certificate to confirm what the formula really means.

"Never skip over a formula and just assume it's right. Be a skeptic," recommends Stein.

Concentrate on what matters

Even with all the time in the world, Stein says, it's not practical or financially feasible to review every clause of every lease. Instead owners and their attorneys and accountants should focus on important issues and risks of the type mentioned here.

"There's a tremendous amount of detail in any lease, and you don't want to get bogged down in all of it. Try to focus on where the problems might come up," he concludes.

AFFILIATE SPOTLIGHT

CCIM brings expertise to Gulf Coast colleagues

In early November 2005, CCIM Institute launched the Gulf Coast Relief Tour to bring both expert advice and emotional support to Institute members and other commercial real estate professionals in the areas devastated by hurricanes Katrina and Rita. Experts provided insight into managing insurance claims, insurance litigation/dispute resolution, tax and accounting issues, and real estate law. Presenters also offered more personal advice on rebuilding homes destroyed by the hurricanes. The free one-day seminars were presented in New Orleans; Gulfport, Miss.; and Beaumont, Texas.

Scott DeLuise, CCIM, of Denver, who served as a public adjuster specializing in disaster claims preparation and as an engagement coordinator and manager of disaster teams under Federal Emergency Management Agency Technical Assistance contracts, offered advice on coping with disaster claims. Phoenix attorney Donald Stevens delivered a presentation entitled, "Claim Denied: Now What," which gave straightforward advice on insurance litigation issues. Area certified public accountants provided insight into the Hurricane Katrina Tax Relief Act and advice on how businesses can resume operations following a disaster. Local real estate attorneys discussed landlord/tenant covenants and leases and how they were affected by property damages and *force majeure*, or uncontrollable force. Pastor Kenneth Davis of Phoenix concluded each event with a message of hope and inspiration.

The Relief Tour was coordinated by CCIMs from across the country with tremendous assistance and support from local and state REALTOR®

organizations, commercial overlay boards, and others. Real estate visionary Jack DeBoer, who pioneered the all-suite hotel concept, dispatched his private plane to transport speakers between Mississippi and Texas.

"The support throughout the real estate community for our efforts was outstanding," said Tim Hatlestad, CCIM, the Institute's First Vice President and 2005 President of the Arizona Association of REALTORS®. "The local community really came together to help with logistics, even providing places to sleep for speakers. They also were invaluable in spreading the word about the seminars, which was a challenge because electricity is not restored in some areas and mail service is sporadic."

CCIM Institute is now working to coordinate a Relief Tour in Alabama and Florida, two other states hit hard by hurricanes in 2005. Preliminary plans are also underway to provide scholarships for CCIM education through the Education Foundation of the CCIM Institute to help candidate members and new students in affected areas.

"Through our education program, we hope to provide commercial practitioners in the Gulf States with the skills they'll need to rebuild their communities in the years to come," Hatlestad said.

NAR Commercial Affiliates CCIM Institute (ccim), 312/321-4460; www.ccim.com; Counselors of Real Estate (CRE®), 312/329-8427; www.cre.org; Institute of Real Estate Management (ARM®, CPM®), 312/329-6000; www.irem.org; REALTORS® Land Institute (ALI), 312/329-8440; www.rliland.com; Society of Industrial and Office REALTORS® (SIOR), 202/449-8200; www.sior.com

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T&I BRIEFING PREVIEW

Get a quick overview of what industry experts have to say in the second installment of RCA's audio update.

Cash in on conservation

Energy management isn't sexy. It's about saving a little here, a little there. How can that compete with the adrenaline rush of selling a 1 million square foot building?

Maybe it can't. But with the U. S. Energy Information Administration (www.eia.doe.gov) predicting that natural gas costs for the commercial sector will increase 39 percent in first quarter 2006 over one year ago, even those who find energy management a bore may start seeing things differently.

"Effective energy management is a great way to show value-add to both customers and owners, especially with the rising price of energy," says Dennis Thurman, vice president of engineering and construction for the west region of Transwestern Commercial Services. The company was EPA's Energy Star® Partner of the Year in 2004 and 2005. "If your building is inefficient, buyers are going to ding you when you sell."

"It's absolutely critical to demonstrate to our clients that we operate our buildings efficiently both for tenant retention and because every \$1 saved in operating expenses translates into \$3 in increased asset value," says John Rowen, senior vice president, operations and engi-

neering for PM Realty Group, also an Energy Star® Partner.

The cost of conservation

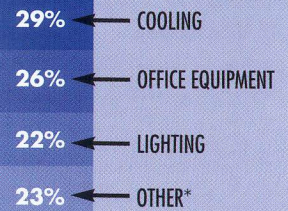
Still, if there seem to be clear financial benefits to conservation, there is also resistance from owners who don't see the payback for big capital improvements.

"There's a myth in the real estate industry that you have to spend significant money on technology to achieve greater energy efficiency, but it's just not so. Most properties can realize savings of between 10 percent and 30 percent on energy consumption with no- or low-cost initiatives," says John Klein, a principal with JDM Associates (www.jdmgmt.com) and a co-author of *A Practical Guide to Energy Management*, published by the Institute of Real Estate Management.

Since utility costs can represent an average of 22 percent of a building's operating costs, according to the *2005 Income/Expense Analysis: Office Buildings*, published by IREM, that savings can turn into a big boost to a building's profits.

In the past, part of the resistance to conservation was also about perception, says Klein. Sometimes, tenants and owners equated energy

OFFICE BUILDING ENERGY LOAD



*Includes ventilation (7%), space heating (6%) and water heating (1%) among others. Source: Environmental Protection Agency

savings with deprivation.

"You have to take time to educate tenants. It has to be a partnership," says Rich Greninger, managing director of operations at CarrAmerica, another Energy Star® Partner. Good communication with tenants may also make it possible to learn if the operating requirements within the parameters of a lease represent a tenant's current needs or could be changed to conserve energy.

Thurman found that he was able to get tenant buy-in to conservation by sharing tips on ways workers could save on their home energy costs. For example, simple devices such as the Watt Stopper that reduce plug load from computers and other office equipment can sig-

See **Conservation** on back page

DATAPoints

15.8%

Annual return on REITs over last 27 years; higher than stocks or bonds

1st

Warsaw, ranked as the top city for corporate expansion in Europe

6.94%

Average national cap rate for offices in 3Q05

115.8

Confidence level in commercial real estate market, with 100 being a stabilized market

Credits: CREB/Toronto Wheaton Research; ResearchWorld.com; CMBS Weekly Relative Value, published by RBS Greenwich Capital; Society of Industrial and Office REALTORS® Commercial Real Estate Index.