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What impact will housing have on commercial?

As the fallout from subprime concerns continues to make headlines, the question on the minds of many commercial practitioners is, "Will the subprime financial crisis affect the pricing and demand for commercial real estate?" The short answer is, "Yes." But perhaps, the question is wrong. "The issue is much broader and more systemic than commercial real estate. 'The question is, 'How will subprime affect capital markets and what impact will capital market shakeups have on the economy?'" says Dr. Raymond Torto, principal and chief strategist of CBRE/Torto Wheaton Research.

Surface shakeups

"There's definitely been an impact on capital availability because of subprime. It's rippling back to

CMBS and affecting the cost of capital," says Zanda Lynn, managing director of the CMBS Group at Fitch Ratings. Investors have less appetite for CMBS bonds, despite widening spreads, she says. Another factor is that with current market volatility, it's difficult for CMBS issuers or investors to decide on the actual risk premium for bonds backed by commercial mortgages, says Lynn. As of the end of July, even traditional buyers of CMBS such as insurance companies had pulled back, says Alan Todd, executive director and head of CMBS research at JP Morgan.

And unfortunately, when lenders can't securitize their loans, they may just not make them at all. "It's like the capital markets just turned off the money spigot," says Tony Solomon, who heads the Solomon

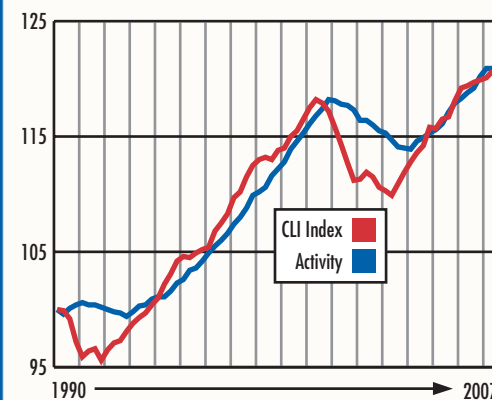
Team at RE/MAX Commercial in Los Angeles. Particularly hard hit are larger deals that need conduit financing and depend on Wall Street for funding, he notes. In fact, even before Labor Day, Bob Bach, senior vice president of Grubb & Ellis in Chicago, noted that while "deals are getting done, it's requiring more of a scramble."

More conservative value estimates by appraisers are also taking their toll on deals, since buyers are finding they have to come up with extra equity to cover differences between appraisals and contract prices, notes Ian Grusd, CCIM, RE/MAX Commercial in Cranford, N.J. "A few months ago, appraisals weren't a problem," he notes.

"Long-term financing for commercial property is dead unless

See **Housing impact** on back page

COMMERCIAL LEADING INDICATOR



The CLI, in red, is a leading indicator. The Activity line, in blue, represents actual commercial activity. Decreases in the CLI Index imply upcoming decreases in commercial net absorption and commercial construction.

Record ninth gain for CLI

NAR's Commercial Leading Indicator for Brokerage Activity rose 0.5 percent in the second quarter of 2007. This ninth consecutive jump brings the index to its highest level since its inception in 2005.

"Despite some signs of slower overall economic expansion, the rise in the index means that net absorption of space in the office and industrial sectors is likely to expand over the next six to nine months," says NAR Senior Economist Lawrence Yun. "In addition, an improvement in returns on investment implies healthy rent increases for commercial property owners."

Positive movements in industrial production, income growth, jobs requiring office space, and wholesale trade during the quarter more than offset the fall in the National Association of Real Estate Investment Trusts' index, notes Yun.



Cindy S. Chandler,
CCIM, CRE
2007 RCA Chair

Who we are?

New Commercial Member survey provides a snapshot.

When you've been active with the REALTORS® Commercial Alliance for a while, as I have, you get the idea you know who your fellow members are. So when Scott MacIntosh of NAR's Research Department shared some of the preliminary results with me, I wasn't surprised to find that 80 percent of responding members worked full time as commercial practitioners. (Too hard a job to do part-time, don't you agree?) I also expected that many RCA members would work for smaller local or regional firms, just as I do. The research found that only 21 percent of members work for larger national and international companies. The largest number of respondents in this group (7 percent) worked for Coldwell Banker Commercial. In fact, we learned that 61 percent work at companies with four or fewer commercial practitioners, and more than half work in companies that include both residential and commercial real estate professionals—including offices of such major residential franchises as RE/MAX (6 percent), Prudential (3 percent), and Century 21 (3 percent).

Not surprisingly, since you need at least a certain population density to build a commercial practice, members tended to locate in larger metropolitan areas, with only 25 percent in cities with fewer than 500,000 people. Given that statistic, I was a little surprised to see that land sales was the largest category of business for members (19 percent). Second place was pretty much a three-way tie among office leasing, multifamily building sales, and retail building sales.

One statistic that did surprise me was that 57 percent of responding members weren't members of an NAR affiliate such as the CCIM Institute, the Institute of Real Estate Management, the Society of Industrial and Office REALTORS®, the Counselors of Real Estate, or the REALTORS® Land Institute. RCA members are active in other commercial real estate groups such as the International Council of Shopping Centers (31 percent) and the National Association of Industrial and Office Parks (10 percent).

One final thing that didn't surprise me—but that I hope will be different when we do the survey again two years from now—is that only 26 percent of commercial members of NAR are women. Commercial real estate has always been sort of an old boys' network. Now don't get me wrong, a lot of those old boys are my best friends and favorite co-workers. Still, I wouldn't mind seeing women more equally represented in the world of commercial real estate—just as they are in the residential area. All I can say is: "Look out, guys, we're comin'."

Thanks, RCA Members

The tremendous response to NAR's Call for Action was instrumental in the recent passage of the Terrorism Risk Insurance Revision Extension Act (see page 4). More than 10 percent of you took time to send an electronic letter to Congress and urge a yes vote for this critical legislation. The positive result clearly demonstrates the power of NAR's grassroots legislative efforts. We still need you help to get the Senate to approve TRIREA, so watch for another Call for Action soon.



To contact NAR Commercial Real Estate staff: 888/648-8321. To find an online version of this newsletter go to REALTOR.org/RCA. For a complete listing of NAR legislative and regulatory initiatives, go to REALTOR.org.

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Counselors of Real Estate (CRE)
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Institute of Real Estate Management (CPM)
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REALTORS® Land Institute (ALC)
312/329-8440; www.riland.com



Society of Industrial and Office REALTORS® (SIOR)
202/449-8200; www.sior.com

No limits to commercial options at NAR

Think there's nothing you can learn from the upcoming NATIONAL ASSOCIATION of REALTORS® Conference & Expo in Las Vegas, Nov. 13-16? Think again. Here's just a sample.

Tues. Nov. 14

Economic Issues & Commercial Real Estate Business Trends Forum: Find out how the subprime fallout, global demand for commodities, and other economic factors will affect commercial demand and construction pricing.

2007 CoNex Dinner: Build relationships and catch up with old friends at the Commercial Network-

ing Exchange party, beginning at 6:30 p.m. Cost: \$135 for RCA members, \$145, for others. E-mail Rebecca Vesconte at rvesconte@realtors.org to reserve a spot.

Wed. Nov. 15

COMMERCIAL DAY

Demystifying Due Diligence: Get insider insights on the problems that delay or derail land and property purchases.

Demystifying Appraisal: Get tips on how to evaluate an appraiser and on the types of property data needed for each type of appraisal.

Demystifying Commercial Com-

ensation: Maximize your piece of the pie on all types of real estate transactions. You will learn the steps to getting paid, maximizing your earned fees, and assessing consulting fees.

Thurs. Nov. 16

Property Management Forum: Focus on market segments that offer opportunities in the year ahead.

Commercial Field Trips: Get the lowdown on commercial opportunities in Las Vegas as local commercial brokers show you the latest industrial and mixed-use communities. (Ticketed event)

Hear Zell, Linneman at CommercialSource

What do some of real estate's most insightful thinkers believe is in store for commercial real estate? Find out Dec. 4-6, 2007, when RCA's free online convention, CommercialSource, presents real estate legend Sam Zell and Dr. Peter Linneman, Albert Sussman Professor of Real Estate at the Wharton School. Free registration to these and all other virtual education sessions is open now at www.commercial-source.com. Plus visit a virtual trade show and learn about RCA services and products.

AFFILIATE SPOTLIGHT

How does your property measure up?

The new 2007 Income/Expense Analysis® reports from the Institute of Real Estate Management provide an easy, authoritative way for you to benchmark your property's performance on many key operating metrics. The reports are designed to help property owners, managers, appraisers, and other commercial real estate professionals compare their buildings' performance to industry norms. The publications are also invaluable for preparing budget and revenue projections, and feasibility studies.

Individual reports for office buildings, conventional apartments, federally assisted multifamily properties, condominiums, and shopping centers are available in book form, downloadable PDFs, and in customizable Excel file formats. Each format contains national data as well as selected regional and city breakouts. Here

are a few key trends from the 2007 reports, which use 2006 data.

Office

Net operating costs for suburban office buildings increased 2.9 percent to \$6.02 square foot for 2006, while costs for downtown properties decreased 1.0 percent to \$6.64 per square foot.

Vacancy levels for both suburban (5 percent) and downtown (7 percent) office properties remained unchanged from 2005.

Apartments

Net operating income for elevator buildings rose 3.3 percent to \$6.62 per square foot; NOI for low-rise buildings with 25-plus units increased 4.1 percent to \$4.81 per square foot; and NOI for garden apartments increased 7.6 percent to \$5.10 per square foot.

Operating ratios for all build-

ing types rose to 62 percent of annual collections in 2006, compared to 53 percent of income in 2005.

Condominiums

Annual operating expenses for all condominium property types as a group increased 5.5 percent in 2006 to \$2,045.88 per unit.

Replacement reserves for all condominium types combined rose to \$359.13 per unit, representing 17.6 percent of total operating expenses.

Shopping Centers

Median income for open shop-

ping centers across the country, based on average actual occupancy (AAO), increased to \$13.96 per square foot in 2006 from \$12.62 the prior year.

Operating costs rose to \$4.27 per square foot from \$3.73 in 2005.

The IREM® Income/Expense Analysis® studies range from \$173.95 to \$195.95 for IREM members and \$346.95 to \$391.95 for nonmembers (plus \$13.25 shipping and applicable state sales tax.). For additional information and to order, visit the "Publications" section at www.irem.org.

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®, ACM), 312/329-6000; www.irem.org; REALTORS® Land Institute (ALC), 312/329-8440; www.riland.com; Society of Industrial and Office REALTORS® (SIOR), 202/449-8200; www.sior.com

LEGISLATIVE Update



INSURANCE

Terrorism insurance renewal passes House

Just days following the sixth anniversary of the 9/11 attacks, the U.S. House of Representatives approved reauthorization of the federal government's terrorism risk insurance program. NAR believes that the passage of the Terrorism Risk Insurance Revision Extension Act (H.R. 2761) will strengthen the economic security of the commercial real estate market by reducing the uncertainty of terrorism coverage availability. The bill also expands protections by covering most conceivable forms of terrorist activity. It will prevent the devastating impact on many commercial financial agreements that require such insurance coverage as well as on commercial property owners' ability to obtain new financing, which often requires terrorism coverage.

H.R. 2761 extends the terrorism insurance backstop program, which was scheduled to expire at the end of 2007, for 15 years. It also phases in a make-available requirement for coverage of nuclear, biological, chemical, or radiological (NBCR) attacks and eliminates the distinction between domestic and foreign acts of terrorism. It further requires the Treasury Department to analyze how terrorism insurance pricing affects commercial real estate and report its findings to Congress every two years. The bill also

calls for the establishment of a blue-ribbon commission, which will include a commercial real estate professional, to research and recommend a long-term solution to the challenge of affordable terrorism insurance.

The bill, which passed the House by a vote of 312-110, continues a federal backstop program that caps losses to insurers at \$100 billion in the case of a terrorist attack. The backstop was enacted after the destruction of the World Trade Center to help incentivize property and casualty insurance underwriters to remain in the market.

The Senate is in the process of considering similar legislation, and NAR is working diligently to ensure passage.

Some commercial property owners may also find insurance protection from natural disasters easier to secure if Congress passes the Homeowners' Defense Act of 2007 (H.R. 3555). This bill, which is supported by NAR and was passed by the House in late September, would strengthen the nation's insurance markets by creating a nonprofit natural catastrophe bond program. Funds from the program would provide a reinsurance backstop for state Fair Access to Insurance Requirements programs. Not all states cover commercial properties in the FAIR programs, however.

ENERGY EFFICIENCY

Zero-net could hurt property bottom line

In August, the House passed the Renewable Energy and Energy Conservation Tax Act of 2007 (H.R. 3221). The legislation is intended to find ways to make U.S. commercial buildings, which accounted for 18 percent of all U.S. energy use in 2003 (the last

year data was available), zero-net users of energy by 2050. The bill, which has no companion legislation in the Senate, would require that all buildings constructed before 2025 reduce energy consumption 50 percent by 2035 and that all buildings constructed after 2025 be zero-net-energy compliant. It also authorizes a study to determine the feasibility of these proposals. IREM, CCIM, and NAR,

along with other real estate industry groups, have formed a coalition to help ensure that energy-saving measures are not unrealistic.

TAXES

Leasehold recovery at risk

The 15-year cost recovery period for leasehold improvements is now set to expire at the end of 2007 unless it is extended once again by

Congress. The depreciable life of improvements on nonresidential properties would then jump to 39 years. Since most retail and office spaces are upgraded much more frequently, the tax burden could be significant. An appropriations bill that extended the leasehold improvement (H.R. 1591) was vetoed by President Bush last spring, and no further legislation has been introduced this year.

3-6%

Estimated increase in base compensation for top real estate executives in 2007-2008, down from 7 percent in the preceding year.

FPL Associates Survey (as cited in Institutional Investor, June 2007)

LEGAL

Slip/falls still greatest risk

Identity theft may grab the headlines, but when you look at the numbers, it's still those pesky slip and falls on the property that are most likely to get you into legal trouble. According to the 2007 Legal Scan survey sponsored by the National Association of REALTORS® and the Institute of Real Estate Management, real estate management professionals were much more likely to end up facing a suit than those engaged in other real estate activities, and premises liability issues were the single biggest cause of lawsuits against managers during the two years (2005 and 2006) covered by the Scan.

Real estate managers also have the dubious distinction of much higher damage awards than other real estate specialties, with 23 percent of damage awards reported in the management section of the Scan reaching at least \$500,000. This compares to only 7 percent of awards above that figure in other real estate-related cases. Three of the five top damage awards—totaling \$18.9 million—resulted from cases addressing dangerous conditions on a tenant's property that the management company failed to correct. In part, the emphasis on premises liability may reflect the fact that some 39 new laws and regulations on the issue have been adopted by states in the last two years. The laws range from smoke detector ordinances to disclosure requirements relating to meth labs and airport noise.

The largest single management award reported in the Scan was \$9 million to a tenant who was raped in her apartment (Anonymous Female v. EPT Management Co., 2005). The case focused on the fact that, although numerous crimes had occurred at the property, the management company failed to take steps to improve security.

Premises liability (with 57 percent) also topped the list of future legal issues among the IREM members surveyed. Debt collection was also a big concern for 53 percent of respondents. Legal disputes involving age discrimination and wrongful termination were also on the radar.

Fair housing complaints, especially those focused on race and disability, saw the biggest increases—28 percent and 31 percent respectively—in court cases in 2005 and 2006, according to the Scan. Racial discrimination cases, as well as discrimination cases based on national origin, may also rise in the future, according to survey respondents, perhaps reflecting the expansion in multiculturalism in the United States. Respondents also expect discrimination cases based on sexual orientation to rise over the next two years.

Again, the present may predict the future since fair housing received significant legislative and regulatory attention in the last two years, with 44 new laws or regulations reported in the Scan.

Survey respondents also focused in on what training should be put in place to reduce future legal liabilities. Unsurprisingly, concerns for training closely tracked the hot issue list. Events at a property (54 percent), national origin discrimination (52 percent), and property condition and common areas (each 50 percent) were top topics for future staff meeting agendas, said respondents. Training in wrongful termination of employees also ranked high (48 percent).

While legal issues remain a source of concern and a financial burden to the real estate community, perhaps the best news is that approximately two-thirds of all cases against brokers and agents were decided in their favor.

View the entire 2007 Legal Scan under the Law and Policy section of REALTOR.org.

SCORECARD

HUD FUNDING BILL

Provides annual support for such vital multifamily programs as Section 8 housing vouchers and FHA-insured mortgages.

Last action: The House passed H.R. 3074, which includes appropriation for HUD (for fiscal year ending Sept. 2008) as well as for transportation. Total funding for HUD was \$38.75 billion, including \$14.745 billion for Section 8 tenant-based renewal assistance and \$6.239 billion for Section 8 project-based renewal assistance. It also includes 4,000 new vouchers for nonelderly disabled and homeless veterans and \$100 million for HOPE IV projects. The Senate Appropriations Committee approved a similar bill. The bill passed in the Senate also provides \$38.75 billion for HUD, an increase of 5.4 percent over 2007 allocations.

Status: The two bills should be reconciled this fall, but President Bush has stated that he will veto the measure.

ENERGY TAX CREDIT

Provides tax credits to commercial property owners for expenditures that will save energy in building operations.

Last action: In August, the House passed H.R. 2776, which would extend the current tax deduction for energy-efficient commercial expenditures through 2013. The current deductions, which were due to expire at the end of 2008, provide deductions of up to \$1.80 per square foot, depending up on the amount of energy saved. Unfortunately, the companion energy bill in the Senate did not include an extension of the deduction.

Status: A conference committee is expected this fall. The President does not support either bill.

CARRIED INTEREST TAXATION

Would tax carried interest realized by general partners in real estate developments as ordinary income instead of capital gains.

Last actions: H.R. 2834 would eliminate the currently favorable tax treatment for all carried interest received by any partner or fund manager who provides "investment management services" to a partnership or fund. A companion Senate bill, S. 1624, would focus only on private equity and hedge funds and would apply exclusively to publicly traded partnerships.

Status: High-profile profits among private equity companies are likely to keep this topic hot in Congress.

INDUSTRY Update



Protecting your commission

Don't let fairy tales or faulty practices put your commission in jeopardy during arbitration

By David Reinauer, CCIM, CPM® , CRB, SIOR

Commercial real estate practitioners who rely on half-truths and half-baked recommendations from other practitioners or attorneys unfamiliar with established industry policies run the very real risk of losing their compensation when a disagreement arises. Protect yourself by following these common-sense guidelines.

Sign a legally enforceable contract that spells out the terms of compensation. Under NAR's arbitration guidelines, which must be used by all commercial members to resolve commission disputes, the right to receive a commission is based first upon a contract that clearly delineates the terms and conditions of the compensation to which you are claiming entitlement. Be sure that your contract with the other parties in the transaction spells out the specific terms that define your compensation and what you must do to earn it. If there is no contractual chain that connects the dots between your claim and the compensation you are seeking, you are not going to fare well in an arbitration proceeding. Setting forth terms of compensation in an RFP or RFQ is generally an acceptable approach, but the terms you outline should harmonize with the terms outlined in your representation agreement with your client, the tenant, or buyer.

Establish contractual privity. If you have a contract with a tenant or buyer that denominates you as that party's agent but refers to compensation due from and paid by a third party, you must be able to demonstrate (with a written agreement) that the third party is aware of that obligation or you will not have an enforceable claim for compensation. Likewise, don't make the mistake of citing a listing contract as the basis for your entitlement to compensation if you are not a party to that contract. Get a separate agreement in writing.

Don't look to procuring cause to get paid. Many practitioners believe that demonstrating they were the procuring cause for a transaction entitles them to compensation. It doesn't work that way. Procuring cause is merely a performance metric. It determines the degree to which you are involved in the series of events that leads to a successfully consummated

transaction. It, alone, does not determine whether you are entitled to compensation. Without a contractual foundation, a demonstration of procuring cause will not prevail in an arbitration proceeding.

Remember that cooperation and compensation are separate matters. If a listing broker has agreed to "cooperate" with you (or vice versa), there is no explicit or implied agreement to share a commission. None! Article 3 of the NAR Code of Ethics states that: "An offer of cooperation does not necessarily include an offer to compensate a cooperating broker. Compensation in a cooperative transaction results from either a blanket offer of subagency made through MLS or otherwise, or offers to compensate buyer agents, or other arrangements as negotiated between listing and cooperating brokers prior to the time an offer to purchase is produced." If you expect compensation when you cooperate, get the specific amount and terms of cooperative compensation in writing before you show a property to a buyer or tenant.

Never, ever rely on local customs and practices to support commission claims. Many commercial real estate brokers seem to believe there are unwritten rules recognized and subscribed to by all the practitioners in their market, entitling agents to receive a certain rate of commission. Sorry. If you find yourself involved in an arbitration, your claims must conform to NAR's official policies and rules. There is no NAR rule that says entitlement can be derived from past dealings between the parties. There is no rule that says you are entitled to anything—except the benefits that are confirmed by the dynamics of contract formation and performance.

Say what you mean in clear terms, without jargon. Lease or sale transactions are not geometric objects—they do not have "sides." If you use confusing terms like this when you negotiate the fee split in a cooperating transaction or referral and the matter winds up in arbitration, you are probably going to lose your argument.

Don't get down to he said/I said. Arbitrators do not like to be put in the position of distilling terms and intentions from a chain of events that has

Legal clout to get paid

Broker lien laws help protect compensation

By James Hochman

Taking all the necessary legal steps to spell out how and by whom you'll be compensated in a commercial transaction should be a basic part of doing business. But even if you dot all the "i's" and cross all the "t's," you might still find yourself in a dispute over a commission with a property owner, buyer, or tenant. The good news is that these days, thanks in part to lobbying efforts by the NATIONAL ASSOCIATION OF REALTORS®, almost 50 percent of states permit a licensed real estate broker with a written commission agreement to claim a lien on the property involved in the disputed transaction. (See www.REALTOR.org/RCA and click on Commercial Lien Map at the bottom of the page) While the statutes in most lien states apply to both sale and lease commissions, lien rights in a few states—Arizona, Maryland, New York, Tennessee, and Virginia—cover only commissions on leasing activities. A properly completed and recorded lien puts a commercial broker in a strong position to collect earned compensation in the event of a dispute.

Putting the lien on

The key to lien rights is a written commission agreement, with either the party responsible for paying the commission or that party's agent, such as the listing broker who signs the procuring broker's representation agreement. While it is possible that language in a lease or sale contract may satisfy the written agreement requirement in the applicable statute, a clear, enforceable commission agreement drafted by counsel familiar with local laws and practices is a much more reliable way to protect your rights to record a lien for compensation.

Likewise, a properly drafted notice of lien is also critical to a successful lien. This notice should include a proper legal description and accurate owner of record and be filed on the correct form. In addition, you must be certain that you file your right to claim a lien for compensation in a timely fashion. Usually, this filing should be done shortly before closing a sale or within a short period after lease execution. Failure to satisfy statutory requirements could be fatal to your lien claim.

When it is recorded and properly served on the property owner (and perhaps the buyer or tenant), a lien attaches to the real estate involved in the transaction and encumbers the owner's title or tenant's interest in the property. In addition, because a recorded lien is usually escrowed by the title company or closing agent, recording a lien virtually assures that the broker will collect a fee if a court or arbitrator resolves the claim in the broker's favor.

Lien rights still have a benefit even if a commission dispute is resolved by arbitration—as it would be between two REALTORS® as required by the Code of Ethics. In such a case, the broker would record notice of lien, begin to foreclose the lien, and then put the suit on hold with the approval of the court and proceed to arbitration.

Used well and wisely, properly exercised broker lien rights can often shorten or even eliminate litigation and assist commercial real estate practitioners in the timely collection of disputed fees.

James A. Hochman is an attorney with Coman & Anderson PC in Lisle, Ill. As part of his practice, he assists the REALTORS® Commercial Alliance in working to secure broker lien rights in all states.

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no documented contractual links. Get any agreement in writing, or at the very least, write a memo to yourself after receiving oral instructions.

Don't try to leverage compensation during a negotiation. Using the terms of offers or counteroffers to establish or modify terms of compensation can lead to serious allegations of unethical conduct. Circumstances may warrant a modification of the compensation terms, but such modifications must be negotiated in good faith. They must not be used as leverage in ways that may conflict with the interests of the principal parties.

More often than not, the commission dispute cases that wind up in arbitration could have been avoided by paying more attention to basic legal and ethical precepts. By instituting sound business practices instead of relying on shaky advice from so-called experts, you can ensure that you receive the compensation you've earned for the commercial services you provide.

David Reinauer, CCIM, CPM®, CRB, SIOR, is president of Reinauer Real Estate in Lake Charles, La., and a past chairman of the Professional Standards Committees of the Society of Industrial and Office REALTORS® and the NATIONAL ASSOCIATION OF REALTORS®.

This article is adapted from "Commission Entitlements," by Stephen Blau, Victor Bruno, and David Reinauer, which was published in the Fall 2003 issue of *Professional Report*, a publication of the Society of Industrial and Office REALTORS®. "It is used with the permission of SIOR. Blau, Bruno, and Reinauer are all former chairmen of SIOR's Professional Standards Committee and were co-authors of the SIOR Code of Ethical Principles and Standards of Professional Practice.

T&I BRIEFING PREVIEW

Some highlights of your enclosed T&I Briefing CD for Fall 2007

SUZANNE GOLDSTEIN BAKER and **H. THOMAS DUNCK** are vice president and national exchange counsel and vice president and Midwest regional manager, respectively, for Investment Property Exchange Service Inc., which serves as a qualified intermediary in 1031 exchanges.

Tidbit: Good financial controls that prevent commingling of investor funds and the presence of fidelity bonds and E&O insurance are critical when choosing a qualified intermediary.

LOUIS ARMSTRONG has been CEO of the Royal Institution of Chartered Surveyors since 1998. Founded in 1868, RICS is one of the world's largest and most respected professional real estate, standards, qualification, and regulation organization.

Tidbit: Climate change is the hot button in Western Europe, with investors concerned about buying or leasing any non-green building.

MARK LESSWING, senior vice president and CTO, NATIONAL ASSOCIATION OF REALTORS®. Mark heads NAR's efforts to assist its REALTOR® members and REALTOR® associations in understanding and implementing technology solutions.

Tidbit: New OSCRE lease definition standards, which will facilitate communication of property data among commercial professionals, will probably become available in software in late 2008.

Housing impact

Continued from page 1

you have a relationship with an insurance company, and land loans are even deadlier than dead,” Dr. Peter Linneman, the Alfred Sussman Professor of Real Estate, Finance, and Public Policy at the Wharton School of Business, told a RCA-sponsored conference call in late August.

Some of this reluctance may be purely psychological. After all, notes Lynn, “You have pretty solid real estate fundamentals and minimal default rates in CMBS.” In fact, CMBS defaults actually declined by 0.28 basis point in the second quarter of '07 and quarterly fluctuations are less than 0.1 percent, points out Lee Cotton, president of the Commercial Mortgage Securities Association and vice chairman of Centerline Capital Group, a real estate investment provider.

“Commercial real estate is just caught up in the global repricing of debt brought on by the crisis in subprime,” Bach says.

Deeper concerns

But if lenders' reaction thus far has shown a tendency that Todd characterizes as “throwing the baby out with the bathwater,” that doesn't mean that there are no causes for concern about commercial loans. Todd, like several other interviewees, noted that commercial loan underwriting had become “frothy” at the end of 2006 and into 2007. In April 2007, Fitch Ratings issued a press release cautioning investors that a growth in 100-percent loans and assumptions of ever-growing cash flows in commercial properties could pave the way for the same sorts of problems now facing the housing sector. “Experience has taught us that continuously upward trending rents and real estate values are not guaranteed,” said Lynn in the release.

CMBS investors recognized this same “exuberance” in lending early in '07, well before the sub-

prime headlines, says Cotton. This discipline, combined with the fact that most CMBS issues are based on properties with long-term leases in place, should minimize the likelihood of growing mortgage loan defaults, he believes.

“To some degree, CMBS has been a victim of its own success,” Todd says. “After 10 years of solid performance, deal structures and underwriting standards have changed. If the economy slows, some deals have very little cushion for the tranches rated A and below.”

“Many lenders have been in a rush to loan, repackage, and securitize debt and have allowed themselves to buy into asset pricing that may be unattainable in the future,” says Solomon. “Private equity money has sold lenders on some wild IRRs based on retreating and adding value, then turning the property in a couple of years. The fallacy is that you have to find a buyer at this new higher price.”

Short-term flutters or long-term hits?

Like most of those interviewed, Torto expects to see capital repricing continue through the fall and then stabilize. Thus far, capital market issues haven't translated to lower prices or higher cap rates for commercial properties, say interviewees, but the move seems inevitable. Bach expects to see cap rates rise by 25 to 50 basis points in the next six months and deal volume to slow somewhat. Torto notes that the need for some major pension investors to place money by year-end may create activity.

But slower deals aren't the issue keeping these experts up at night. The real concern is that the financial market volatility will seriously slow the economy. If that happens, the impacts on commercial real estate could be much more severe and affect demand and rent growth as well as cap rates. “The longer

CMBS fixed-rate credit curve (AAA to BBB-)



Source: RBS Greenwich Capital

debt repricing takes, the more damage it will do to the economy,” Bach says. Recent drops in job numbers and retail sales may foreshadow this slowing. For now, the Fed's rate cut has helped.

Linneman believes that the underlying economy is sound and most sectors won't suffer ill effects. Financial firms will be exceptions, he adds. He points out that in other recent capital market crises, such as the default by Russia a decade ago, the capital markets roiled, but the general economy was unharmed.

Torto-Wheaton Research is already predicting slower absorption and sluggish rent growth in all commercial property sectors for the remainder of '07. Housing market declines are already being felt in retail as consumer confidence weakens. Areas dependent on construction employment may also suffer setbacks that could spill over into companies like lenders and title companies that support the real estate industry, says Solomon. Keep your eyes on a growth in sublease space as an early indicator of trouble, suggests Torto.

Linneman doesn't anticipate that credit problems will have a significant impact on commercial property cash flows, although pricing may suffer, he adds. “After all, if all other assets are going down 15 percent to 20 percent, it's unreasonable to think that commercial real estate prices won't go down, too.”

Multifamily may both benefit and suffer from the housing slowdown. If you can buy, you'll have to rent so many anticipate that apartment

vacancies will fall. Inventories of unsold condo properties that “come back as rentals” may reverse that trend in some cities, notes Bach.

When will it end?

How long the housing decline will last is still anyone's guess. NAR Vice President of Research Lawrence Yun anticipates that housing should see a recovery by 2008 and that the sluggish GDP growth of '07 should improve to around 3 percent next year. “Right now, the markets are just sorting things out, but once they distinguish that subprime is the principal bad player, things will settle down for commercial lending,” he predicts.

“We think that the current tightening is a technical reaction. Commercial lenders will sit on the sidelines until they understand what's happening,” says Cotton.

Credit spreads will drift downward and get back to normal over the next 12 to 18 months, says Linneman. Todd notes that even with the current unease in financial markets, “there is still plenty of capital out there,” so buyers should be able to find financing even if it is at slightly higher cap rates. Cap rates may increase moderately, he says.

“We've just taken one step in the dance, paused, and looked around,” agrees Torto. While there's a risk that capital markets will overreact and keep stepping backward, he says, a much more likely scenario is that lenders will recognize the strong fundamentals underlying commercial real estate and keep stepping forward.