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TIERRA GRANDE

JOURNAL OF THE REAL ESTATE CENTER AT TEXAS A&M UNIVERSITY



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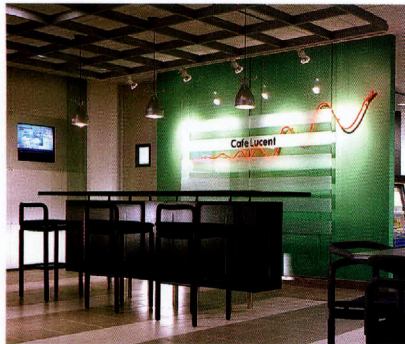
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page 5



page 8



page 14



page 20

On the Cover

The bright white of a sandstone outcropping in Palo Duro Canyon State Park, south of Amarillo, stands in stark contrast to the softer colors of the 300-foot mudstone and sandstone Lighthouse formation. **Photographer Laurence Parent**

- 1 Enron's Downfall Good for Real Estate?** *by Charles E. Gilliland*
The uncertainty of today's investing environment makes real estate look like a better bargain than ever.
- 2 Going Once, Going Twice, Sold!** *by Harold D. Hunt*
Long popular in other parts of the country, selling commercial and residential properties by auction is just beginning to earn acceptance here.
- 5 Missionaries for Affordable Housing: Housing Counseling Agencies** *by Jack C. Harris*
How can you possibly remember every detail of the many affordable housing programs available for low-income and first-time homebuyers? You can't. And you don't have to. That's what housing counseling agencies do.
- 8 1031 Tax-Deferred Exchanges: Evolving Rules, Greater Opportunities** *by Greg Lehrmann*
New tax code rules have made tax-deferred exchanges easier. That's good news for investors.
- 10 Service With a Style** *by Ellissa Bravenec*
Treating commercial tenants as prized customers can mean the difference between vacant office space and lease income in the bank.
- 12 Green Building** *by Harold D. Hunt*
Conserving natural landscapes, water and energy isn't just about saving the earth anymore. Some green building techniques and materials are also about efficiency and cost savings.
- 14 Excellence by Redesign** *by Ellissa Bravenec*
Office design can play a key role in an organization. Done well, it can improve productivity, enhance communication and promote a firm's values.
- 16 Tracking Affordability** *by Jack C. Harris*
Real estate market watchers, we've put the Texas Housing Affordability Index under the microscope to reveal the factors used to determine affordability and how the index can alert you to changing trends.
- 19 Property Tax Increases Hit Home** *by Charles E. Gilliland*
It's a given that property owners are not fond of property taxes. But school funding demands could negatively impact real estate owners in more ways than one.
- 20 Not Your Grandfather's Farm Credit System** *by Charles E. Gilliland and Michael Mays*
Farmers and ranchers aren't the only ones who can borrow through the Farm Credit System. A change in management philosophy has broadened eligibility and simplified the application process.
- 23 Letter of the Law** *by Judon Fambrough*
Blowin' in the wind . . . No description, no contract . . . The way out: contract rescission under the DTPA

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benchmarks

Enron's Downfall Good for Real Estate?



By Charles E. Gilliland

Energy giant Enron's implosion pointedly illustrates the rationale for diversifying investments into real estate. The daily din of reports on misreported income, distorted profits, hidden losses and warnings of further revelations focuses attention on the crucial issue of who controls the destiny of invested funds.

The Enron debacle is a classic example of what strategic management specialists call the *agency problem*, which occurs when a corporation's investors and management are separate, and managers make decisions inconsistent with the investors' objective of maximizing stock price. Ultimately, Enron managers, stewards of investors' funds, put personal enrichment above all other considerations. After creating an illusion of profitability, many executives are alleged to have cashed out of Enron shares before the precipitous price drop rendered the stock virtually worthless.

At the same time, policies blocked employees from disposing of the Enron stock in their retirement portfolios.

These headline-grabbing stories point out the danger of investing in an enterprise controlled by others whose activities take place beyond the view of investors.

Downside of Separate Management

Management owes a fiduciary responsibility to shareholders, and most corporate officers remain faithful to those obligations. In the worst-case scenario, however, managers seek to maximize their personal wealth and ignore the best interests of shareholders and employees. This flaw in corporate structure separates management decisions from responsibility for the consequences of those decisions.

Despite this flaw, investors flock to the corporate structure to maximize returns on investments through the benefits of specialization and economies of scale gained from pooled resources. They entrust their funds to a management team presumed to possess skills that allow them to wisely use those funds. Although they are the nominal owners of the corporation,

each shareholder in the multitude of shareholders has little individual influence on corporate decisions.

To help protect investors, modern economies have devised legal structures that create a web of obligations for corporate leaders. Those legal restrictions give investors a reasonable level of assurance that corporate management will act in investors' best interests.

Corporate managers are required to report on business activities so investors can make informed decisions about whether to hold or dispose of their shares. Battered by daily concerns, investors increasingly focus on corporate earnings as an indicator of management's competence. Quarterly earnings reports are the primary measure of success or failure. Annual reports provide a more detailed accounting to those who own shares in the corporation.

Winning and Losing Trust

But as the Enron story illustrates, the system is driven by trust. Investors looked past the confusing accounting to the persons they trusted at the helm. At Enron, those managers had done well and were considered upstanding individuals possessing high levels of energy and intelligence. They had won big in the past. It seemed a sure bet they would do so in the future.

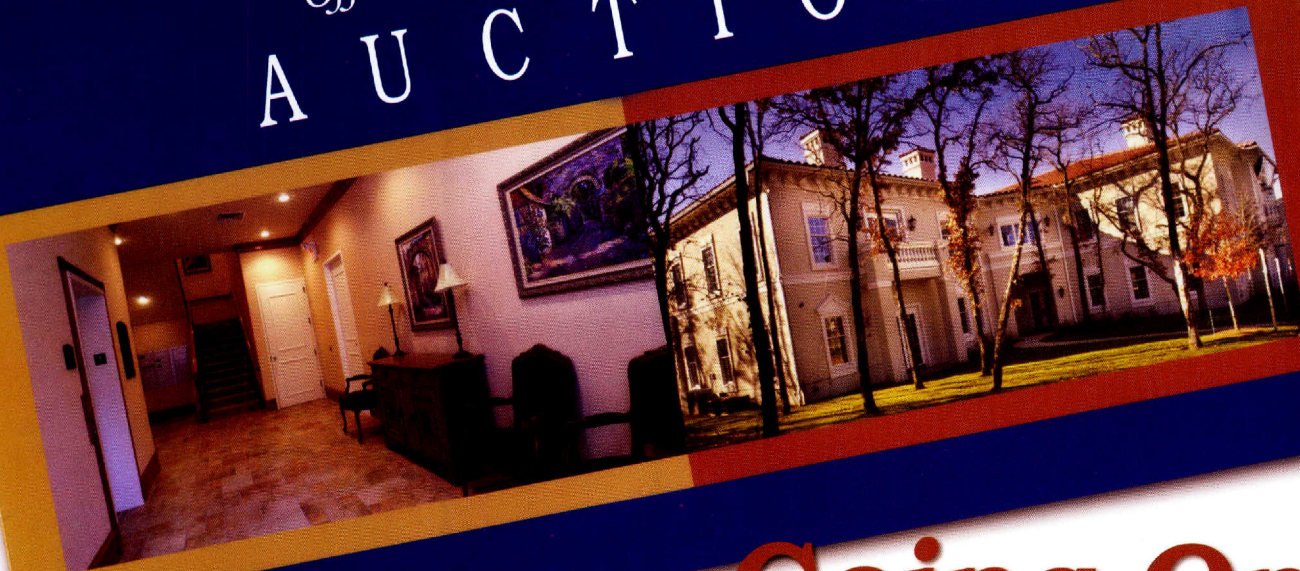
The Enron situation is not the only example of corporate management allowing socially irresponsible impulses to gain the upper hand. Each time a corporation becomes a takeover target, managers invariably devise so-called golden parachutes. The entire enterprise may not collapse in an ignominious eruption of scandals, but often top executives at the acquired firm arrange a gold-plated exit for themselves, leaving behind disappointing returns.

The temptation to use resources entrusted to them for personal gain occasionally proves overpowering. Those corrupting tendencies lurk in virtually every large business enterprise using other

(Benchmarks continued on page 27)



Office, Retail and Residential
A U C T I O N



Going Once, Going Twice, Sold!

By Harold D. Hunt

Texas culture equates auctions with “losing the ranch,” but in most other areas of the country, auctions are viewed as winning propositions.

Auctions are an increasingly popular way to sell real estate. In 1980, \$10 billion worth of real estate was sold by auction in the United States. By 1999, that figure had increased to more than \$49.5 billion.

A study conducted for the National Association of Realtors (NAR) projects that 30 percent of all real estate sold will be through auctions within eight years. NAR now provides links to more than 100 auction companies via their auction information site, www.narauctionsource.com. Not a bad idea, considering that all 50 states require real estate licensees to handle real estate transactions. Auctioneers must either have a real estate license themselves or hire a real estate licensee to handle sales.

Types of Auctions

The two most common types of auction are the *reserve auction* and the *absolute auction*. A third type is the *minimum bid auction*. All three types of auctions typically require bidders to place a buyer’s deposit in the form of a certified check for a specified amount. This allows only serious potential buyers to bid.

In a reserve auction, there is no minimum bid. The seller reserves the right to accept or reject the highest bid within the time period specified in the terms and conditions of the auction.

The main disadvantage of a reserve auction is that prospective buyers may not be willing to invest the time and expense necessary to thoroughly examine the property when there is no guarantee the seller will sell. The main advantage is that sellers are not obligated to accept any offer. Auctions are assumed to be reserve auctions unless explicitly advertised as another type.

At an absolute auction, the property is sold to the highest bidder, regardless of price. The sale is guaranteed to occur. The seller is not allowed to bid either personally or through an agent.

At a minimum bid auction, the auctioneer only accepts bids at or above a minimum price announced at the auction and in auction advertisements and brochures. Most auctioneers believe that, of the three auction types, absolute auctions bring the highest price for a property.

“Absolute auctions typically attract the most bidders because of the lure of the bargain,” says William Bone, President of the Gadsden, Alabama-based National Auction Group, Inc. These auctions produce the greatest number of motivated buyers and the most competitive bidding environment because of the guarantee that the property will be sold.

Preparing for Auction

Before entering into a contract for sale by auction, sellers must have realistic expectations about what constitutes a fair sales price. They should then choose a reputable real estate auction company to ensure that the auction is conducted

professionally. Sellers sign a listing contract with the auction company authorizing the auctioneer to conduct the auction and establishing the terms and conditions of the agreement and the rights and responsibilities of each party.

Occasionally, a property about to be sold at auction spurs a buyer to negotiate a traditional sale before the auction takes place. If sellers have signed a listing agreement with the auction company before the negotiated sale occurs, they may be obligated to pay a fee to the auction firm even if the auction is not held.

A well-planned, aggressive marketing campaign targeted to the most likely buyers of a specific property is a must. Most properties require roughly six weeks of advertising prior to the auction. Two to four weeks are usually required to prepare marketing materials, which may include advertising for newspapers, radio, direct mail or television. Many auction houses keep a database of prospective buyers and their specific property preferences.

Auction sales are typically on an "as is, where is" basis without representation of the working condition of the property or warranty of any kind. Therefore, buyers must rely heavily on property inspections and their own judgment. They must also carefully study any information provided by the auction company regarding the property's actual condition. This due diligence information must be provided to prospective buyers well in advance of the sale.

Information may include photos and maps of the property, a current survey, independent property inspection reports, current environmental reports, tax assessment information, zoning status, maintenance records, availability of financing

and a title commitment. For commercial properties, detailed information about existing tenant leases and a history of the property's net operating income should be included.

Announcements made by the auctioneer at the time of sale take precedence over any previously printed or oral statements made. Generally, any material defects known to the auctioneer prior to the auction will be disclosed at the time of the sale.

At the Auction

Licensed real estate staff are present at auctions to answer questions, receive mandatory buyer deposits and execute contracts. The top bidders must sign the real estate sales contract without changes, additions or modifications. If a buyer does not close for any reason on or before the designated closing date, the initial deposit is forfeited.

Immediate back-up bidders often are required to execute a real estate sales contract and escrow their bid deposits in case the highest bidder does not close. Most auctions have some form of financing available to qualified buyers. Closings generally occur within 30 to 45 days of an auction.

Sellers are typically required to provide a clear title at closing. Cost of the title policy, advertising and marketing costs and other expenses are negotiated between the auction company and the seller when the listing contract is executed. Terms vary greatly and depend on the seller's financial position, the salability of the property and the auction company itself.

Because of technology advances, real-time Internet bidding has become more common at auctions. While some bidders in attendance may question whether all Internet bids are legitimate bids, allowing Internet bidding can increase the pool of



Properties Suitable for Auction

Mike Jones, president of the Dallas-based Mike Jones Auction Group, states that while "not all properties are good candidates for the auction method, when a suitable property is offered by a reputable auctioneer, the seller's objectives are usually met."

What properties are best suited for auction?

Highly sought after properties. Bidding can ensure the highest sales price for hot properties.

Properties in overbuilt markets. Specific properties in overbuilt markets can be showcased through an auction sale.

Properties that are difficult to appraise. Lack of comparable sales in the market may prompt the seller to ask too much or too little, resulting in either an extended listing period or seller's remorse for letting the property go too cheaply.

Properties with high carrying costs. A quick sale at auction may be better for the seller than continuing to pay mortgage payments, maintenance expenses, taxes and insurance. Time can be critical for sellers driven by tax or financing timetables.

Unique or extremely expensive properties. The more expensive or unique a property is, the longer it typically takes to sell. Even the highest-priced properties sell relatively quickly at auction.

potential buyers. Internet bidding companies often work in tandem with auction companies, lending credibility to the process by acting as an independent third-party reporting electronic bids during the auction.

At many auctions, fees and commissions for all parties involved in the auction are paid by the buyer through a *buyer's premium*, either a flat fee or a percentage of the highest successful bid. This helps offset the cost of the event and the cost to the seller.

Although buyer's premiums are common in the industry, they are not used universally. The terms and conditions governing a sale state whether a buyer's premium will be charged. If commissions and fees are paid through a buyer's premium, they are generally calculated based on the amount of the high bid only. The high bid is then combined with the buyer's premium to determine the final purchase price paid by the buyer.

Seller Benefits

A sale by auction achieves the seller's goal — selling the property — and frees the seller from dealing with buyers who are not serious about purchasing the property. Prequalified buyers come to auction prepared to buy on the seller's timetable. In a traditional sale, buyers are usually not under any pressure to buy, often leading to lengthy marketing periods. Increased market exposure resulting from an aggressive marketing campaign can generate a larger pool of potential buyers than a traditional sale.

Quick disposal of property by auction reduces the seller's carrying costs, benefiting the seller and the buyer as well through a reduced purchase price. If an auction property has been marketed correctly and generates sufficient competition between buyers, it should sell at its true market value. The sales price may even exceed what would have been received in a negotiated sale because there is no upper limit on bids. In a traditional sale, the asking price limits upside potential.

Auction sales eliminate the often stressful negotiation process between buyer and seller. Properties are typically sold without contingencies, which are clauses in contracts that allow for specified future events to dictate whether the sale actually closes or not. If contingencies are allowed, they are offered to all bidders.

Furthermore, in an auction sale, the seller dictates what the contingencies are, not the buyer.

Buyer Benefits

The competitive bidding process of an auction means that all buyers compete fairly and openly on the same terms, usually resulting in a purchase at true market value. Buyers generally

have much more information about the property than in a traditional negotiated sale. Long negotiation periods are eliminated and the successful buyer knows with certainty how long it will take to close on the property.

Absolute auctions guarantee that the property will be sold at the scheduled auction time and that the purchase price will be determined by the buyer.

Real Estate Licensee Benefits

Bill Vaughan, president and CEO of the newly formed Coldwell Banker Commercial Special Property & Auction Group based in Southlake, says, "There has been a vast chasm in the past between the brokerage community and the auction community; they almost view themselves as competitors."

Vaughan explains that auction firms encourage broker participation and provide real estate professionals a whole new set of selling and purchasing options. Furthermore, a successful auction can result in referrals and return business for real estate licensees.

Auctions can assist listing agents and brokers by exposing the property to a broad group of ready, qualified buyers. They also let listing agents or brokers off the hook if a seller is mandating an unrealistic asking price. Through a quicker sale, the listing agent's advertising costs may be reduced as well.

Listing agents can represent sellers during the sale and at closing, receiving a commission based on level of involve-

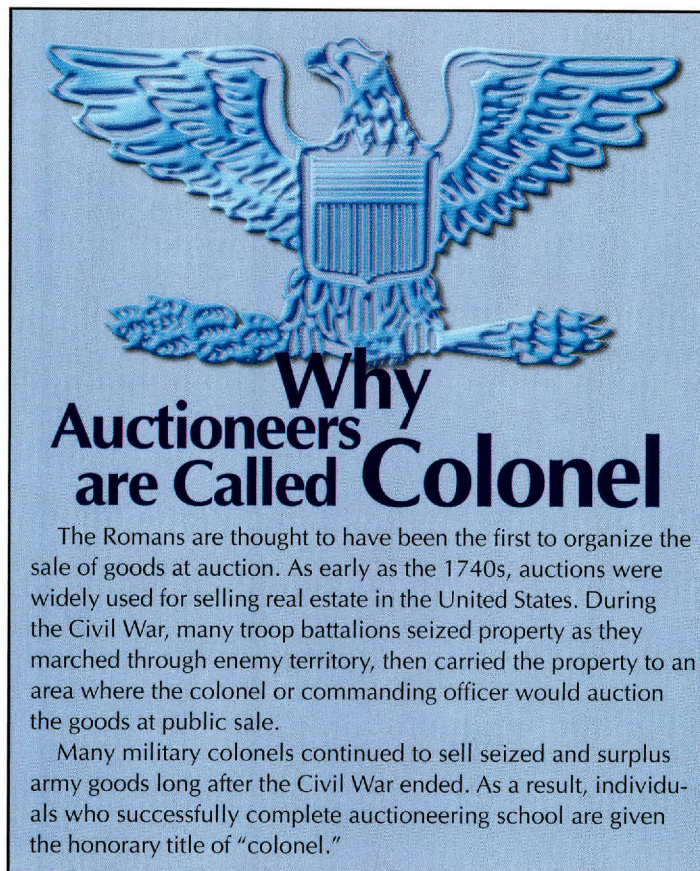
ment and the relationship defined by the parties involved. However, they must cooperate with the auction company by allowing the auction agreement to supersede their listing agreement.

Buyer agents and brokers can earn a commission established by the auction firm if they register with the firm prior to the auction, request property information and review all available information with their clients. A commission is paid only if their clients are the high bidders and successfully close on the property. Auction companies may also require buyer agents and brokers to preview the property and accompany their clients to the auction.

While auctions are not as widely accepted in Texas as they are in the southeastern United States, local auction companies are beginning to see more activity. According to

Tom Hanley, regional president of Tranzon Hanley Auction Company in Fort Worth, "Even though sellers are not beating our doors down, they are much more willing to consider our services as a sales alternative." ♣

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**Why
Auctioneers
are Called Colonel**

The Romans are thought to have been the first to organize the sale of goods at auction. As early as the 1740s, auctions were widely used for selling real estate in the United States. During the Civil War, many troop battalions seized property as they marched through enemy territory, then carried the property to an area where the colonel or commanding officer would auction the goods at public sale.

Many military colonels continued to sell seized and surplus army goods long after the Civil War ended. As a result, individuals who successfully complete auctioneering school are given the honorary title of "colonel."



Housing Counseling Agencies

Missionaries for Affordable Housing

By Jack C. Harris

The young couple sitting in your office is determined to buy a home. They are frustrated with renting because they know they can buy a house for less per month than they pay in rent. You have a few listings that would be perfect for them. Unfortunately, they do not have an ample income or a great deal of cash, so the conventional home loan is beyond their reach.

You know there are programs available to people in this situation. You remember organizations promoting programs for low-income and first-time homebuyers at real estate conventions. But you don't know how to access these programs, and even if you did, which program would be right for this couple?

Your predicament can be resolved by contacting a local housing counseling agency. These organizations, which consist of nonprofit entities, local government agencies and consumer credit counseling companies, serve as clearinghouses for affordable housing programs in the area. Housing counseling agencies are in every metropolitan area in the state and many smaller cities as well.

What Housing Counselors Do

Housing counseling agencies are an excellent resource for prospective homebuyers with limited income and knowledge. The agencies locate local home-financing programs, provide educational programs on personal finance and homebuying and counsel those who have encountered financial or legal problems when trying to buy a home or after purchasing a home.

Although real estate professionals are generally current on market activities, they may not have the opportunity to keep up with the many special programs for low-income and first-time buyers, such as:

- low-down payment, conventional loan programs offered by Fannie Mae and Freddie Mac;
- community development programs that offer monetary and educational assistance and guidance to low-income homebuyers;
- down payment assistance loans and grants provided by state and local governments;

- below-market interest rate loans funded through municipal bonds and run by local housing finance agencies and the state Department of Housing and Community Affairs; and
- affordable housing programs provided by nonprofit and for-profit companies.

These programs sometimes overlap and sometimes result in eligibility gaps. Staying current on what programs are available and who is eligible is a full-time job. Housing counseling agencies fulfill this role, and dispense pertinent information to those who can benefit from the programs.

Government's Role in Housing Counseling

The federal government has been the major player in the campaign to increase homeownership since the Housing Act of 1949 established the goal of a decent home for every American. Most federal money is funneled through the states and localities. In addition, some private and semiprivate entities (such as the Federal Home Loan Bank of Dallas) offer special financing programs.

Housing counseling agencies are not usually governmental units though some cities have housing departments that perform some counseling functions. Most are nonprofit organizations that support themselves through grants and fees from government agencies, foundations and private lenders. Some are consumer credit agencies that offer general financial counseling along with more specialized housing programs. Some legal aid offices offer housing counseling.

The Housing Act of 1968, the same law that created the Department of Housing and Urban Development (HUD), created the program through which the federal government supports counseling programs. Early on, HUD attempted housing counseling as part of its effort to work out delinquent loans through the 1972 Home Mortgage Assignment Program. The Housing Act of 1974 authorized funding for local agencies to perform these services. These early efforts were aimed at preventing foreclosures and centered on counseling people who were in danger of losing their homes because of financial difficulties.

Passage of the Community Reinvestment Act (CRA) in 1977 and amendments to that act passed in 1989 changed that role. The legislation mandated that, to maintain their charters, lending institutions must make loans throughout the communities in which they are located.

The Home Mortgage Disclosure Act (1977) requires that lenders make public information on where they make loans. As

a result, advocacy groups have had access to information needed to pressure lenders to make more loans in minority neighborhoods. Housing counseling agencies help lenders comply with the mandates of CRA by providing a link to low- to moderate-income homebuyers and helping them become financially responsible homeowners.

The 1992 Federal Housing Enterprise Financial Safety and Soundness Act set a goal of ensuring that a substantial portion of loans purchased by Fannie Mae and Freddie Mac, the major purchasers of home loans on the secondary market, be for low- and moderate-income households with further allocations for "underserved markets." Homebuyers who apply for these loans must complete educational programs offered by an approved housing counseling organization.

Agencies certified by HUD can receive training and technical assistance and can compete for government grants for specific programs. Certification is based on evaluation of the agency's ability to fulfill its stated objectives, the extent of the problems the agency seeks to address, the agency's plan and availability of funding sources other than HUD.

The government's effort to broaden access to mortgage credit relies on counseling to create reliable borrowers in areas where CRA administrators want to increase lending activity and to reduce the probability of default once the loans are made. HUD's commitment to counseling is reflected in its fiscal year 2003 budget, which calls for doubling the amount appropriated for counseling programs.

A recent study supports the department's confidence in this approach. Freddie Mac tracked a large sample of low down payment loans made in the 1990s and found that delinquencies were 19 percent lower on loans for which pre-purchase counseling was provided.

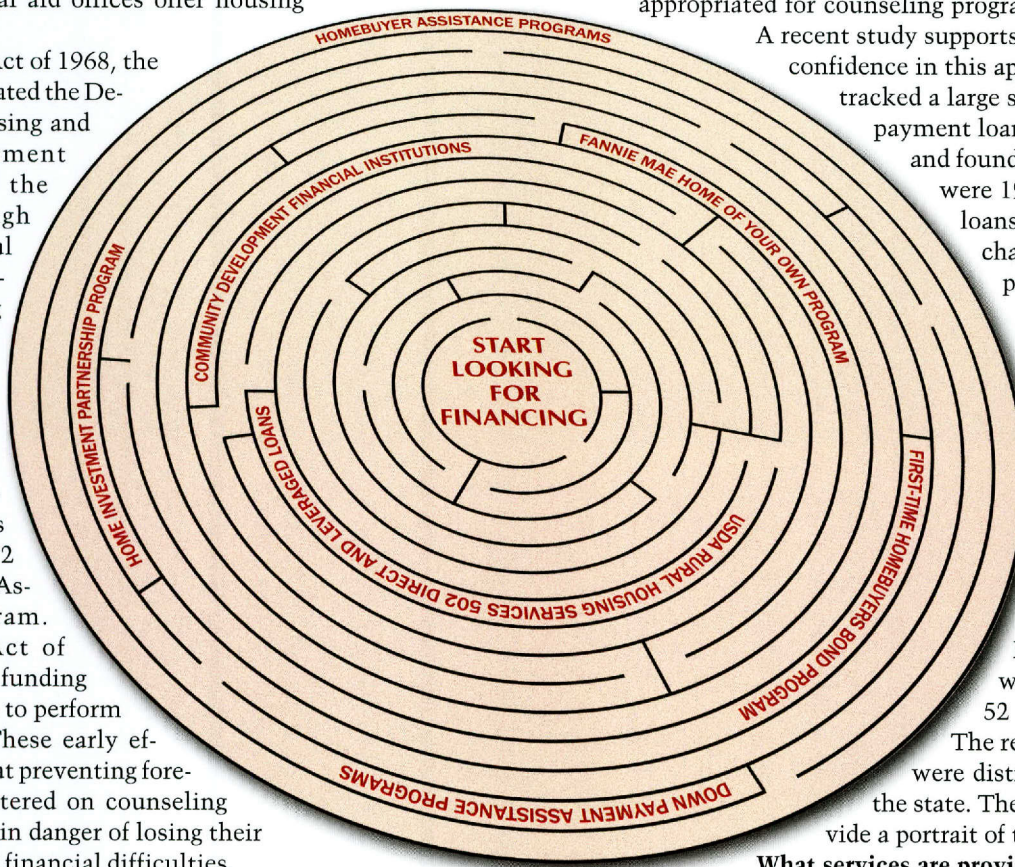
Approved Texas Agencies

Late in 2001, the Real Estate Center at Texas A&M University surveyed HUD-approved housing agencies in Texas.

Eleven responses were received out of 52 agencies contacted.

The responding agencies were distributed throughout the state. The survey results provide a portrait of the typical agency.

What services are provided? All but one of the respondents provide classes on homebuying and various aspects of personal finance designed to prepare the attendees to buy a home. Several standard curriculums are available for these classes, and most of the responding agencies use one of those curriculums. None of the responding agencies offers online or home study classes. However, most have reference material available to clients.





AGENCIES LIKE the Brazos Valley Affordable Housing Corporation help low-income and first-time homebuyers find financing from among the dozens of local, state and federal programs aimed at increasing homeownership. Eligibility requirements vary from program to program; counseling agencies stay current on exactly who is eligible for what.

All respondents provide one-on-one counseling, allowing clients to get help with problems they encounter during the homebuying experience. Most can provide this counseling over the telephone.

Almost all respondents refer clients to the appropriate government agency or nonprofit group offering affordable housing programs. Only half of the respondents make similar referrals to lenders or real estate agents. Some agencies maintain lists of lenders who offer affordable housing programs. However, HUD forbids agencies from steering clients to specific real estate agents and other service providers.

Who can access the services? Because some housing programs are sponsored by local governmental agencies, it would seem that agency services would be restricted to local residents. However, most respondents reported no such restriction. Restrictions reported related to specific housing programs rather than agency services. For example, most mortgage-bond, below-market interest rate loan programs are for local residents only. Many assistance programs put income caps on eligible recipients. However, counseling services offered by the agencies are not income restricted.

What do services cost? Most agencies survive on grants from government and private sources and fees paid by lenders when the agency provides the counseling requirement for affordable housing loan programs. Many of the counseling programs are provided free or at little cost to the public. Prepurchase classes often require a nominal fee. Some agencies provide credit reports at cost.

How do agencies find clients? Most agencies rely on referrals for clients. Few advertise or otherwise search out clients. This suggests that agencies should be receptive to referrals from real estate agents seeking to help first-time buyers.

When asked what they found to be the biggest obstacle for homebuyers, almost all respondents cited credit problems. Lack of sufficient down payment was a close second. Several reported the dearth of available affordable homes. Surprisingly, few mentioned lack of knowledge about the homebuying process.

Housing Opportunities of Houston

Housing Opportunities of Houston, Inc. (HOH), which operates throughout the Houston area, exemplifies a typical housing counseling agency. Prospective homebuyers referred to the agency receive access to information and educational programs that increase their chances of buying a home.

HOH's Homebuyer Class consists of five hours of instruction in finances and credit, the responsibilities of homeownership and how to work with real estate agents. Those who take this class are eligible for affordable housing loan programs and can be prequalified, find a lender through HOH's list of affordable lending partners and get preapproved for a loan. The course costs \$40 and is taught in English, Spanish, Chinese and Vietnamese. Each year, almost 5,000 families take the class.

In January 2002, the agency instituted Internet delivery of the homebuyer course. HOH also provides courses in personal finance, budgeting and credit in conjunction with Consumer Credit Counseling of Houston.

Families are privately counseled on clearing up credit problems and preparing to apply for a loan. The agency also works with homeowners after they buy to prevent foreclosure when they encounter temporary financial difficulties.

HOH administers the City of Houston's Homebuyer Assistance Program, which helps homebuyers with the down payment and other closing costs if they buy a home within a designated price range within the city limits. Buyers must be willing to stay in the home for five years. Each year, more than 1,000 families meet income eligibility requirements and receive this assistance.

How can you find housing counseling agencies in your area? Check with the local branch office of the Department of Housing and Urban Development. HUD maintains a list of agencies approved to participate in federal housing programs. The list is available on the Internet at <http://www.hudhcc.org/agencies/texas.txt> and includes the types of services provided. ♦

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Real estate investing is similar to playing Monopoly. Winning at either takes savvy and the skill to negotiate the exchange of less desirable properties for more valuable ones.

Texas property owners intent on winning should understand the many benefits of Internal Revenue Code section 1031 tax-deferred exchanges.

By Greg Lehmann

Tax-deferred exchanges have been in the tax code since 1921 and are among the significant tax advantages for real estate investors. The key advantage of a 1031 exchange is that it allows an investor to dispose of a property without incurring a capital gain tax liability. This allows the earning power of the deferred taxes to work for the benefit of the investor instead of the government.

Creative Exchange Strategies

As tax code rules and cases have evolved overwhelmingly in favor of taxpayers — especially with regard to real estate — exchanges have become easier. A seller hires a 1031 qualified intermediary (QI) to document the sale of a property as an exchange. The QI holds the proceeds to prevent the seller from being in a taxable situation. Potential replacement property is identified within 45 days after closing, and some or all of those properties are acquired within 180 total days after the sale. For real estate exchanges, the properties just need to be used in the exchanger's business or held as an investment. This format is called the *delayed exchange*.

Although the delayed exchange variation is the most common, many exchangers employ more creative strategies, such as *reverse exchanges*. A 1031 reverse exchange is called for when the replacement property must be acquired before closing on the relinquished property (if for example, a prime property is listed in a hot market, investors would have to write a contract quickly to compete with other prospective buyers).

Previously, reverse exchanges were used infrequently because the IRS offered no guidance on the topic. Reverse exchanges were considered a gray area, and taxpayers either proceeded with caution or chose to avoid them.

'Parking' Properties

In the past, there were three basic approaches to reverse exchanges: the *"pure" reverse* approach, the *exchange-first* (relinquished property parked) approach and the *exchange-last* (replacement property parked) approach. The first was dismissed by most QIs because the exchanger cannot own the relinquished property and the replacement property at the same time.

The goal was to create an arms-length transaction in which the QI (or an entity created by the QI) acquired either the relinquished

1031 Tax-Deferred Exchanges

Evolving Rules, Greater Opportunities



property or the replacement property for the taxpayer and created an exchange, which should otherwise fall within the rules and regulations relating to deferred exchanges. The exchange-first and exchange-last approaches became known as parking arrangements because the QI "parks" one of the properties in the QI's name to prevent the exchanger from owning both properties simultaneously.

The problem of constructive ownership arose in these transactions. Although the QI held title to the property, all the benefits and burdens of ownership were transferred to the exchanger.

Questions regarding management of the parked property, loan arrangements, taxpayer advances to fund the acquisition, exit strategy, fixed price versus fair market value and who was to receive the tax benefits of ownership while the property was parked were common. If the taxpayer retained all the burdens and benefits of ownership while mere legal title was parked, it was feared the taxpayer would be treated as actually owning both the relinquished and the replacement properties at the same time.

New Rules for Reverse, Improvement Exchanges

After years of deliberation, the IRS has validated the parking arrangements described previously, as long as the exchange is

completed within 180 days. Revenue Procedure 2000-37, enacted Sept. 15, 2000, creates a "safe harbor" for exchanges in which a third party called the "exchange accommodation titleholder" (EAT) enters into a parking arrangement and acquires title to either the relinquished or replacement property. This applies to reverse and improvement exchanges. More on improvement exchanges follows.

The EAT is the entity that parks the property. The EAT and QI can be the same, but preferably the EAT is a separate entity formed by the QI specifically for an exchange. Strategically applied, the new rules offer investors enhanced investment alternatives.

Seize a Buying Opportunity. Investors can now immediately acquire a desirable replacement property before selling the relinquished property. Many commercial investors are using this strategy, particularly in markets where inventory of properties is low or turns over quickly. Investors can purchase their next investment property as soon as a good buy is available.

Guarantee Exchange's Buying End. The new rules can reduce the pressure associated with finding a replacement property within the 45-day identification period. Thousands of commercial transactions fail to close each year because investors are unable to locate suitable investments within the 45-day identification period constraints. A replacement property can now be purchased before selling the relinquished property. This transfers the time crunch from the purchasing phase to the selling phase.

Create an Investment. Investors can build their investment properties from the ground up or improve an existing property (as long as the property is in the EAT's name) to create an investment that

Under the primary residence tax rules, anyone living in a property as their primary residence for 24 months out of a 60-month period can exclude from taxable income \$250,000 (if filing single) or \$500,000 (if married filing jointly) of the gain from the sale of their home. This exclusion is available once every two years.

Vacation Homes and Tenants-in-Common

Real estate located in resort or vacation areas may qualify for an exchange if owners can establish that their intent was to hold the property for investment. Property owners in many resort destinations nationwide are deferring 100 percent of their capital gain taxes and exchanging for more desirable properties.

IRS rules have long allowed an owner to sell a whole property and purchase an undivided interest in another property, becoming a "tenant in common" (TIC) with other owners of the real estate.

Increasingly, owners of shopping centers anchored by national tenants like supermarkets are selling fractional ownership interests in such centers. These are called TIC/NNN programs because tenant-in-common interests are sold in centers managed largely by the tenants through triple-net leases.

Investors participate in the benefits of larger commercial projects that often result in a relatively passive investment generating a predictable monthly cash flow. However, each such investment must be closely examined for economic and legal viability.

Real estate cannot be exchanged for personal property, such as a partnership interest or REIT stock. Therefore, a taxpayer must be satisfied that the **substance** of the transaction, and not just the **form**, is still a real estate purchase. On March 19, 2002, the IRS issued Revenue Procedure 2002-22, specifying the conditions under which the IRS will consider a request for a ruling that an undivided interest in rental real estate will be considered an interest in real estate and not an interest in a partnership or "business entity." While this procedure does not constitute a safe-harbor

that automatically validates any program, the advance-ruling requirements are likely to become a litmus test for many sponsors of TIC programs.

Unlike Monopoly players, real estate investors do not have to depend on a roll of the dice to pass go and collect more money. Savvy Texas property owners are using tax-deferred exchanges to acquire desirable Boardwalk and Park Place properties and win the investment game.

This information is not intended to replace qualified legal or tax advisors. Taxpayers should review their specific transactions with their own legal or tax counsel. ♣

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meets their exact needs. Many Texas investors are using tax-deferred dollars to build new warehouses or office buildings that meet their particular requirements rather than being limited to properties available on the market. This type of exchange provides tremendous flexibility because a certificate of occupancy is not required within the 180-day exchange period to meet the requirements for full tax deferral. The taxpayer can count improvements built and paid for during the 180-day exchange period, whether the project is complete or not.

More investors are combining a reverse exchange with an improvement exchange by purchasing a new property and making improvements to the property before the relinquished property is sold.

Converting Rental to Residence

Investors can combine the tax deferral benefits of an exchange with the tax exclusion advantages available under the primary residence tax rules (Internal Revenue Code 121). Exchanging into a replacement property that is initially held for investment and later converted from rental property into a primary residence enables a property owner to obtain tax-free funds.

Service With a Style

Commercial Tenants are Customers Too

By Ellissa Bravenec

It certainly wasn't a "business as usual" year. By the end of 2001, the effects of a national recession, the decline in the telecommunications and dot-com industries and repercussions from the terrorist attacks of Sept. 11 were stifling most of Texas' commercial real estate markets.

In Dallas, the office vacancy rate including sublet space was 18.4 percent with 3.5 million square feet under construction or renovation. The Houston market was relatively stable, but Austin had the sharpest increase in vacancy rates and the widest gap between growth in supply and growth in demand of 50 major U.S. markets.

"The year 2001 was challenging. Tenants were in a wait-and-see mode, especially after the terrorist attacks," said Jane Page, an asset manager with Crescent Real Estate Equities, a real

estate investment trust (REIT) based in Fort Worth. As one of Crescent's two senior vice presidents in charge of asset management and leasing, she tracks the profitability of a 12-million-square-foot portfolio in Houston and Austin.

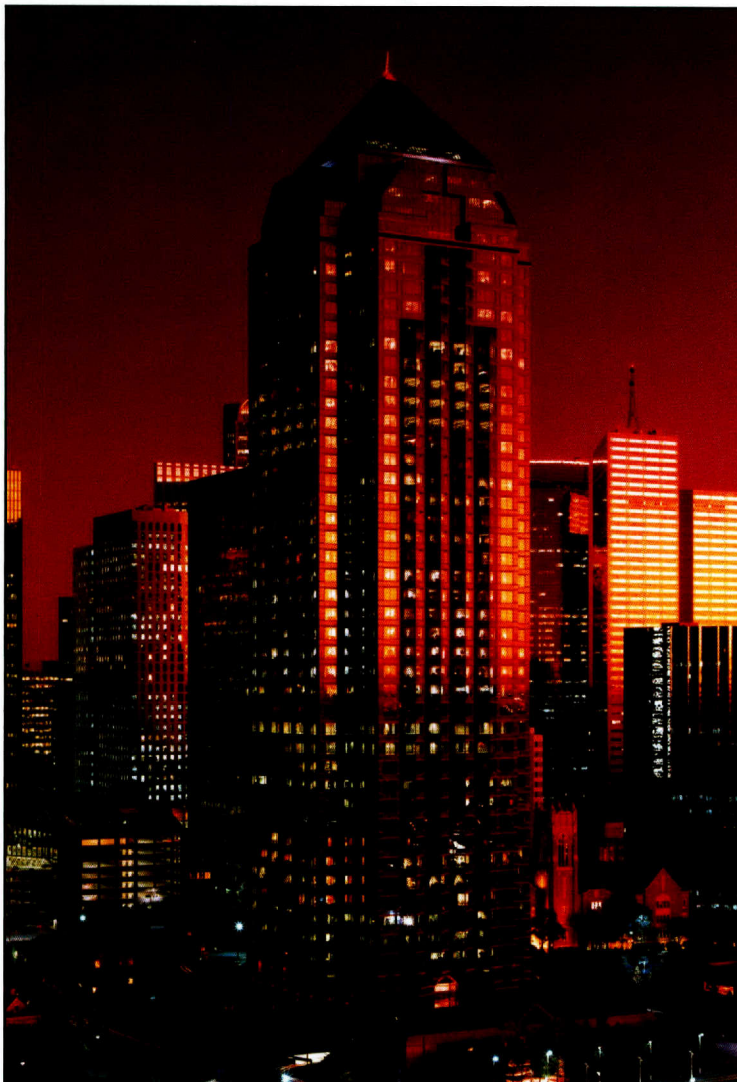
At a General Services Administration (GSA) conference at The Woodlands in February, Page said, "[In 2001,] our economists told us, 'lease space as fast as you can to any credit-worthy customer you can find.'"

Little Things Mean a Lot

Page's presentation focused on leasing real estate in challenging market conditions, with particular emphasis on retaining existing customers and attracting new ones. Crescent's strategy includes a strong customer service component, Page explained. At Crescent, tenants are called "customers," property managers are "customer service representatives," and the leasing office is the "customer service office." Instead of just managing electricity bills and elevator repairs, managers place a greater emphasis on managing relationships with tenants.

"Thinking of tenants as customers is new in the real estate industry," Page said.

When working on budgets, asset managers must weigh the benefits and costs involved in giving tenants what they want. REITs, which report earnings to Wall Street, are under constant



CRESCENT'S
50-story Trammell
Crow Center
in Dallas
encompasses
1.1 million of a
28-million-square-
foot office portfolio.

pressure to show growth. When the marketplace is highly competitive, as it was last year, cutting expenses is more practical than raising rents. Yet sometimes money must be spent even if it cannot be passed on to tenants in the form of increased rent.

Finding out what customers want is the first step. Because of this, maintaining open communications with customers is critical. Signage, for example, may be a necessary expense if tenants want it. According to Page, even little things like sending the chief executive officer and tenant contact donuts can yield intangible benefits in the form of satisfied customers.

Listen in Lease Negotiations

Listening carefully to customers' wants and needs during negotiations and responding appropriately builds the foundation for good customer service. Sometimes having specialists at negotiations can help determine needs. For example, if the customer wants an unusually large number of kilowatts, an engineer can explain what is feasible and what alternatives are available.

Having up-to-date technology available also helps. Crescent leasing managers are implementing a system that will enable them to pull up diagrams of available space from the company's intranet and negotiate documents online.

Page indicated that Crescent worked to maintain its rental rates in 2001 but made concessions in some lease contracts, such as free parking or free rent, which it called "early commencement." Such concessions are necessarily kept confidential whenever possible because if word were to get out the marketplace might change. Prospective tenants might expect something that was intended to be a perk.

During negotiations, leasing agents and property managers must work together to achieve the common goal of finding and keeping tenants, Page said. Without a commitment to cooperation, these two parties can find themselves at odds. For example, the leasing agent may make promises to the customer to get them to sign the lease, leaving the property manager in the awkward position of being unable to deliver on those promises. Page stressed that leasing agents should keep in mind that any special rights they promise must be doable and communicated to property managers.

Page recommends hiring a deal-oriented lawyer to facilitate the lease closing. All parties involved should understand the terms of the contract, and the landlord should understand what the tenant's expectations are. Having a lawyer who can effectively communicate the details of the lease to the tenant is a plus.

Security Concerns Elevated

After the events of Sept. 11, security became a top priority for many businesses. Crescent customers were interviewed to

find out how much extra protection they wanted. Security expenses doubled.

Crescent worked with local governments and other property owners to research solutions to security issues. Loading dock hours were made more stringent, and packages could no longer be left on the dock. Building managers reissued evacuation procedures and had evacuation drills. Concrete blocks were installed at ground level to prevent someone from driving into

buildings. Even so, Page said that there was really nothing a landlord could have done that would have prevented the tragedy at the World Trade Center in New York.

Repairs, Maintenance Are Key

Prompt repairs and maintenance are a cornerstone of customer satisfaction. Page reported that Crescent is adopting a new online maintenance tracking system, Rapid On Site Solutions. Tenants use this web-based program to register maintenance or repair requests. Each request is logged, and the tenant receives verification that the problem

was noted. The only person in the building who can access the system is the customer coordinator, who receives printouts every day of what needs to be done.

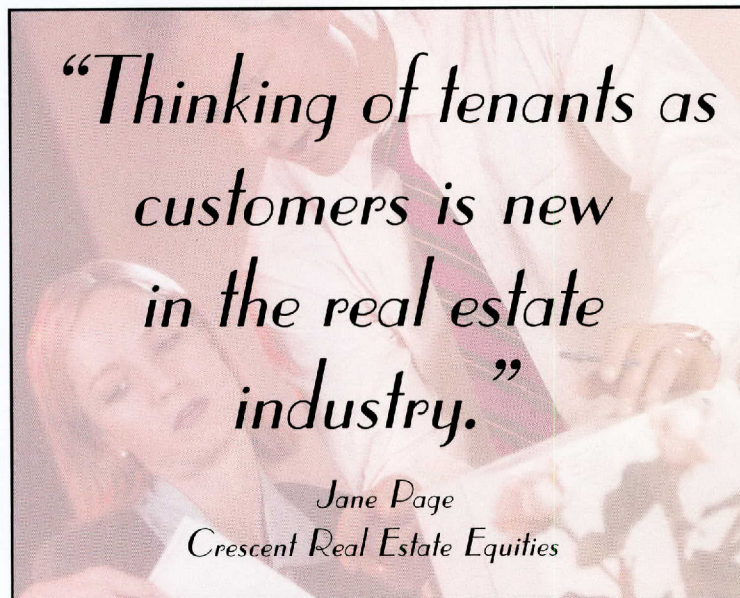
Work orders are relayed by e-mail to staff in the field through handheld devices. When the work is completed, the assigned worker enters that information on a handheld device. The system produces an accurate log of calls and when they were handled.

Measuring Customer Satisfaction

Tenant-landlord relationships were tested in 2001 when one of Crescent's largest customers expanded and, as a result, 19 tenants in a building had to be relocated based on the terms of their leases. Only one of the 19 tenants decided to leave Crescent because of the reshuffling. Page attributes this to the rapport the company maintains with its customers and the organization's high customer service standards.

Crescent contracts with CEL & Associates to survey tenants about customer satisfaction. In 2001, 86 percent of tenants surveyed responded. The survey is used partially as a motivational tool for property managers, who receive extra compensation if they achieve a rating higher than 90 percent in each category.

The emphasis on customer service seems to have paid off. In March, the company was recognized as one of the top five real estate companies nationally for customer service, an honor awarded annually by the Building Owners & Managers Association and CEL & Associates. ♦





GREEN BUILDING

BY HAROLD D. HUNT

"Green" homes are sprouting everywhere. Each day, more homeowners are convinced that implementing energy-efficient and resource-efficient design and construction techniques in residential construction is the right path to take. Nowhere in Texas is this sentiment stronger than in Austin, a city that has long been known for its pro-environment culture.

In April 2002, the Sustainable Living Alliance, Newmark Homes, the City of Austin Water Conservation and Texas Solar Energy Society produced a self-guided tour of 21 Austin area homes in conjunction with Earth Day. The tour showcased sustainable or green building and landscape techniques that are attractive, practical and affordable.

"The tour featured some of the best examples of environmentally friendly building practices in the state, if not nationwide," says Kathryn Houser of the Sustainable Living Alliance.

Green Building Defined

The National Association of Homebuilders broadly defines green building as constructing homes in a manner that conserves resources. Although green building can affect virtually every aspect of the development and construction process, as well as the physical structure of the house, it is not an all-or-nothing proposition. Green building projects typically incorporate at least one of the following:

- land planning and design techniques that preserve the natural environment and minimize disturbance of the environment;
- site development methods that reduce erosion, minimize paved surfaces and runoff and protect vegetation, especially trees;
- water conservation systems, both indoors and outdoors;
- energy-efficient heating/cooling systems, appliances, lighting and building envelope;

- material selection based on recyclability, durability and the amount of energy used to create the material; and
- waste reduction, reuse and recycling during construction and throughout the life of the home.

Green building practices vary by location because of differences in climate, availability of materials and local customs and preferences.

More than a decade ago, the City of Austin developed a green building program that provides consultation services, technical seminars, a directory of green building professionals, a resource library and presentations to interested groups. The program was recognized at the 1992 Earth Summit by the United Nations Local Government Honours Programme as one of 12 exemplary local government initiatives from around the world. It was the only U.S. program recognized.

The Austin Green Building Program rates new homes and remodeled homes of builders or architects who are program members on a scale of one to five stars. Rated categories include energy efficiency, water efficiency, materials efficiency, health and safety and community improvement. Information about green construction techniques and materials can be found at the Green Building Program's website, www.ci.austin.tx.us/greenbuilder.

Design and Location Considerations

Architects of green homes believe that energy efficiency begins with a good design and proper orientation. These are not new concepts. However, they are often a secondary consideration in the homebuilding process today. New energy-efficient technologies and materials are more effective when they are not compensating for a poorly designed, incorrectly placed home.

Popular home design features include extended overhangs or shading devices, careful window placement, covered porches



BREEZEWAYS
provide natural ventilation for this Austin home.

and the use of natural indirect light to combat hot weather, a primary concern in Austin. Ventilation often is enhanced through the use of breezeways and "thermal chimneys." Thermal chimneys use stairwells or elevated ceilings as natural cooling towers by drawing air through lower windows of the house and up through higher windows as it warms.

Many of the homes are designed without attic space. Ductwork is inside the conditioned space for greater efficiency. Build-up of overhead heat is avoided, and leaks in ductwork do not result in the loss of conditioned air.

Houses are oriented to face south when possible, thus limiting east and west sun exposure. However, orientation also is based on prevailing wind patterns, location of natural vegetation (especially trees) and minimization of overall site damage. Some homeowners choose to build on urban infill sites to promote Austin's Smart Growth initiative and simultaneously help revitalize older neighborhoods.

Use of Building Materials and Technology

Materials and technology used in green homes are generally chosen because they save energy, cut construction time, reduce waste, protect the environment or lower home maintenance costs. Some materials and technology are commonly used in home construction today while others have not been widely accepted. Only a few of the many different materials and technological innovations used in green homes are discussed here.

One of the more popular materials is **metal roofing**. Metal roofs are efficient, especially when constructed with a radiant barrier to reflect the heat and an air space between the radiant barrier and the metal roof to allow channeling of hot air away from the roof surface. Proponents of metal roofs argue that asphalt shingles tend to absorb heat during the day and continue

radiating it into the house during the night. By contrast, metal roofs begin cooling almost immediately after dark.

Structural insulated panels (SIPs) are also popular. SIPs are typically manufactured by combining a wood wafer board product or steel exterior with a nontoxic foam interior. SIPs typically range in thickness from four to 12 inches and can be as long as 24 feet. SIPs can be ordered as a packaged system that arrives at the site precut with all window and door openings installed. Electrical openings may be cut at the factory or in the field.

Manufacturers state that SIPs can be designed to withstand winds in excess of 160 mph. SIPs have excellent insulating characteristics, with some homeowners reporting energy savings as high as 50 percent.

Engineered wood products (EWPs), a popular substitute for conventional solid lumber, are used in many of the homes. Engineered beams and joists offer increased stiffness, more uniform strength and shape and less weight. The length of the finished product is not limited by tree height because EWPs are manufactured from shorter pieces of wood. EWPs can be ordered in various lengths and delivered finished to the jobsite, reducing waste and saving labor. Some of the more popular EWPs are gluelam, laminated veneer lumber, parallel strand lumber and I-joists.

Steel framing is another substitute for conventional lumber. Approximately 68 percent of all steel is recycled. Stronger, yet lighter than a wood-framed construction, steel framing has no food value for termites. Steel products are either precut for studs or used in panels to build walls, steel trusses and floors.

Insulated concrete forms, including RASTRA, Autoclaved Aerated Concrete (AAC) and Faswell, were used in the construction of several green homes on the Austin tour. RASTRA, developed in Europe more than 25 years ago, is 85 percent recycled polystyrene and 15 percent portland cement. The RASTRA system produces a monolithic reinforced concrete



STEEL FRAMING
and styrofoam eliminate much from the termite's menu in another green home.

wall with structural strength, high insulation value and extreme resistance to fire, wind, insects and mildew.

AAC was developed in Europe more than 75 years ago. AAC blocks are one-fifth the weight of conventional concrete because they are 70 to 80 percent air, which significantly improves their insulating characteristics. Blocks are glued together with a special adhesive to form a monolithic wall.

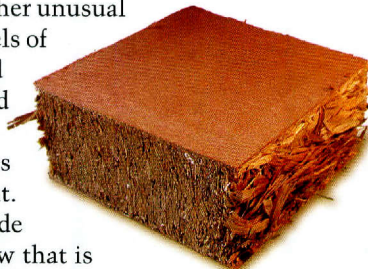
Faswell blocks, made of 85 percent treated recycled woodchips and 15 percent portland cement, were developed in Europe following World War II. Faswell structures allow a slow air exchange, preventing condensation and keeping walls dry.

Bamboo flooring is one of the more unusual products found in some green homes. Bamboo is a grass that grows extremely rapidly after harvest, as much as 24 inches in 24 hours. Proponents of bamboo flooring point out that no hardwood trees are used in its production and claim it resists scuffing, staining and moisture damage while requiring less care than conventional flooring.

Cellulose insulation, made primarily from recycled newspaper treated with a fire retardant, is used in

some green homes. One hundred pounds of cellulose insulation contains 80 to 85 pounds of recycled newsprint. Cellulose insulation is low in "embodied energy," defined as the amount of energy consumed in producing the product. Fiberglass, rock wool and plastic insulation have from 50 to 200 times more embodied energy than cellulose.

Compressed straw was another unusual product shown in Austin. Panels of compressed straw are designed to replace traditional studs and sheetrock. The product has good sound-deadening qualities and is surprisingly fire resistant. Each four-by-eight panel is made from about 125 pounds of straw that is typically grown within 50 miles of the manufacturing plant.



Age-old housing design and orientation concepts are combining with increasingly affordable and ever-improving technology to expand the popularity of green building. However, the architects who designed the environmentally friendly homes on this tour were careful not to elevate environmental factors too far above cultural, social or aesthetic concerns.

Although some homebuilders are implementing green building techniques today, many more are not yet ready to bear the risk and expense of retraining their labor force to build using the new materials and techniques. Many builders are hesitant to bid jobs using nontraditional building techniques and products because bidding incorrectly could have disastrous financial consequences. Widespread implementation of green building techniques and materials will have to be consumer-driven.

Availability of information about green building practices has improved dramatically, and consumers are becoming better informed about the monetary and social benefits of green building. Even so, building green will not become commonplace overnight. ♣

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Excellence

by

Redesign

By Ellissa Bravenec

Like a car, an office needs maintenance. And there's more to it than just keeping the carpets clean and the computers running. Business managers need to periodically assess and update workspace to keep it functional and in line with the company's needs and goals.

Workplace strategy consultant Jill Duncan, president of aha!Works Too, and office design consultant Jean Bellas, president of SPACE, shared ideas about redesigning offices with real estate professionals at a General Services Administration (GSA) educational conference in The Woodlands in February.

In the past, Duncan says, building owners would pour money into a building, market ten-year leases and then let the building degrade for ten years. Today most building owners continuously make improvements to keep buildings up-to-date.

The same is true of office design. Duncan gives her clients schedules for reviewing how office space is being used and identifying areas that need tweaking.

Many office design ideas being implemented today are not new. Elements such as mobile offices, which can be converted to an entirely new arrangement in a weekend; touchdown (also called hoteling) areas, which serve as temporary offices for workers who are out of the building most of the time; informal meeting areas; open work areas; and cubicle clusters have been around for a while.

What is changing is management's awareness of how workplace design affects recruitment and retention of employees, time management, efficiency, exchange of information and creativity. Whether deliberate or unintentional, workplace design makes a statement to employees, clients and visitors regarding the business' mission and core values.

An environment in which space and resources are shared, doors are unlocked and group accomplishments are celebrated reflects a company that values trust and integrity. A workspace in which everything is locked down or hoarded suggests the opposite.



Bellas and Duncan agree that when redesigning space, the greatest amount of time and effort should go into evaluating business problems and brainstorming solutions. Problems that can be solved with new workplace designs include those relating to noise, productivity, creativity and communications.

For example, one of Duncan's clients wanted its workers to spend more time working with clients in person. The consultants

pointed out ways the existing workplace design encouraged workers to stay in the office, where they were conducting much of their business on the phone.

Everyone who will be affected by a redesign should have a voice in the decision-making process, Bellas says. She especially takes note of what the outstanding achievers want or need. The consultants suggest tracking how



some privacy and noise control while lessening the isolation associated with traditional private offices.

Duncan says taking a fresh approach to a problem could be less costly than plugging in a standard solution that may not improve the situation. For example, open work areas fit some businesses but are not a panacea.

Although open areas are thought to be more efficient in terms of office workers per square foot, research shows no difference in efficiency between open and closed environments. Because open environments cause noise and distractions, sound-related protocols would need to be established. For example, speakerphones might need to be banned.

"The success of any new working environment depends on teaching people how to use it," Duncan says. Learning to function efficiently in a redesigned space is complex because it often involves changing employee behavior.

In today's more democratic workplace, large corner offices and luxurious upper-floor suites for senior managers are being replaced in some instances by offices centrally located to facilitate communication between management and workers.

A reduction in document storage space is influencing trends in office design. Less space per worker is needed because space-eating manuals and files can be stored electronically. To increase efficiency, many companies are putting information in databases and integrating those databases with a web-based program making them accessible to both in-house employees and those working in the field.

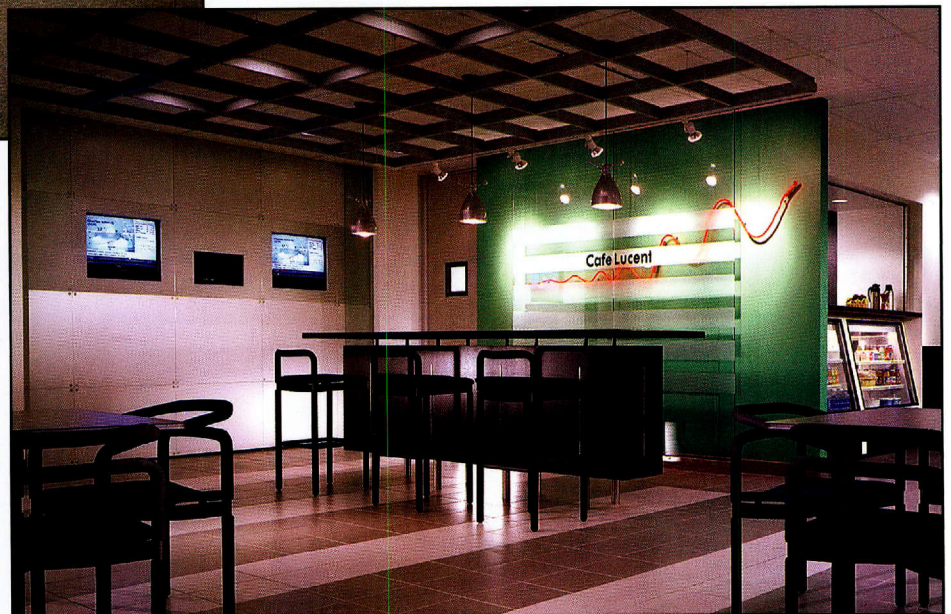
Bellas and Duncan stress that workspace design changes should not be made for the purpose of changing the culture of a business. Changing workspace alone will not change the culture, although it is one element of such a change. What matters is that the workplace fit the culture and vision of the company. ❖

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space is being used and measuring performance or revenue before and after the redesign to determine its effectiveness. Did the redesign result in an increase in sales or productivity? Redesigning should focus on improvements in productivity and an increase in revenue rather than cost savings.

The consultants explain that while there are no one-size-fits-all solutions, some general trends are driving workplace innovations. Today's business climate is interactive. People work in teams and often share ideas and expertise, Bellas says. Studies have found that increasing the connections and communication between workers increases profits.

The arrangement of workspace can facilitate or hinder this exchange. Informal gathering areas at work are growing in popularity, as are offices with sliding translucent doors or panels, which allow for



REDESIGNS BY SPACE (top to bottom): A tire factory was converted to a network operations center for Qwest. The redesign of the Qwest customer care center reduced real estate costs 20 percent and increased productivity through improved ergonomics, lighting and information access. The Qwest training-conference room uses modular furniture and moveable panels for flexibility. Lucent Technology's café provides workspace for casual interaction.

Tracking Affordability

By Jack C. Harris

Housing markets need two things to perform well: prosperity and affordability. When job security is strong and incomes are rising, more people have the financial confidence to purchase a first home or move up to a better home.

A strong economy means more people are moving into an area than are leaving, and the higher demand for housing supports rising property values.

When homes are affordable, more people enter the market because they can qualify for the financing needed to purchase a home. How affordable homes are depends on interest rates and the relationship between housing prices and income. All of these factors are taken into account in the Texas Housing Affordability Index (THAI) compiled by the Real Estate Center.

What the Index Means

The THAI tracks the ability of the typical Texas household (a household earning the median Texas income) to buy a house selling for the median home price. The index is not like the consumer price index, which is pegged to a specific point in time. Instead, the THAI is a ratio arrived at by dividing the median household income for a market area by the income needed to buy a home selling at the area's current median sales price.

The THAI for each market area estimates the percentage of area households that can afford the median-priced home. If household income and income needed to buy the median-priced home are the same, the index has a value of 1.00. This means the median income for the area is enough to afford the median-priced home, and half (50 percent) of all households can afford the median priced home. If household income is higher than that needed, the index is greater than 1.00, more than half the households can afford the home and the market is considered affordable. For example, a THAI of 1.34 indicates that the median area household has 34 percent more income than needed to buy the area's median-priced home. Conversely, an index less than 1.00 means that household income is insufficient to purchase the median-priced home and the market is

unaffordable. The index value indicates how much more or less household income there is compared to what is required.

Several assumptions are made to arrive at the amount of income needed to buy the median-priced home. The THAI uses a method similar to that used by lenders to qualify loan applicants. First, the mortgage amount is calculated by multiplying the median house price by the standard loan-to-value ratio of 80 percent (see "Sample THAI Calculation"). Second, the monthly payment is estimated based on the current mortgage interest rate, a 30-year term and an average increment added for the insurance and tax escrow payment. Third, the

minimum monthly income is calculated by applying the payment-to-income ratio required by most conventional lenders. Finally, the monthly income is converted into an annual figure.

Existing Debt Not Considered

Note that the THAI calculation method ignores a second income test commonly applied by lenders. That test adds the applicant's existing debt obligations to the monthly payment and then compares it to income. Timely data on existing debt per household are not available so adding this test is not practical. Also, it is assumed that the typical household has sufficient cash to make a 20 percent down payment. Again, data are not available for determining how realistic this assumption is for each area. A 20 percent down payment is used because that is the minimum down payment required to avoid paying for private mortgage insurance.

The THAI is estimated for most local areas that report home sales data to the Real Estate Center. Areas not reporting median sales price are excluded. A quarterly estimate is made for each area. These estimates are reported approximately

six weeks following the end of the quarter, the earliest that mortgage interest rate data are available. This lag time results in a more complete reporting of sales during the quarter. Values are available for most Texas metro markets on a quarterly basis on the Center's website (see <http://recenter.tamu.edu/data/dataaffd.html> for the latest figures).

Quarterly estimates are based on projected household income numbers. When better data become available later in the year, a final annual estimate is made for the preceding year. These annual estimates indicate past trends in affordability. A table of annual values for each local market is included in the THAI annual report.

Historically, increases in the THAI have corresponded with increased sales and THAI decreases with decreased sales growth. The THAI is one indicator of market vitality. At times, a market can appear strong because prices are rising and buyer motivation is strong. But such markets may actually be weakening from a lack of affordability. Sales may be thinning as prices rise until the upward price spiral collapses from a lack of qualified buyers. The THAI may provide an early warning of such developments by expressing affordability trends.

The National Association of Realtors (NAR) compiles a similar measure. In fact, the THAI originally was patterned after the NAR index. The main difference between the two is that NAR uses family income, defined as the income of two or more related persons, and the THAI is based on median household income. Household income is lower because it includes

Sample THAI Calculation

Here is a sample THAI calculation using statewide data for first quarter 2002.

Median home price = \$121,500

× 80 percent = \$ 97,200

At 6.92 percent interest, a 30-year loan has a monthly principal and interest (P&I) payment of \$641.46.

An escrow payment is added equal to 17 percent of the P&I, or:

$\$641.46 + .17 (641.46) = \$750.51 = \text{monthly payment}$

Conventional loans generally require monthly payments to be no more than 28 percent of monthly income:

Minimum monthly income = $\$750.51 / 0.28 = \$2,680.39$

This equates to an annual income of: $12 \times \$2,680.39 = \$32,164.68$

Median household income for Texas during the period is estimated to be \$42,960

Therefore, the THAI for the period is $\$42,960 / \$32,165 = 1.34$.

single-person households. Nonfamily households do buy homes, and their ability to do so should be reflected in the index.

The NAR index is compiled only for the nation. By contrast, a separate THAI value is calculated for every local Texas market for which median sales price data are available. Most of these areas cover an entire metropolitan area, but some are county or city specific. The coverage for each area is described in the THAI report. Having localized indexes allows more detailed monitoring of affordability trends and shows how a run-up in home prices can counter or compound the effects of interest rate changes. For example, rapidly rising prices in Austin during the late 1990s caused THAI values for that area to fall more drastically than they did statewide.

First-Time Buyer's Index

Affordability has special meaning for first-time buyers, particularly when high prices and high interest rates prevent them from entering the market. First-time buyers generally have lower incomes than those who already own a home, and they rarely are able to make substantial down payments.

To monitor the buying power of first-time buyers, the Center has the First-Time Homebuyer Affordability Index (FTHAI). This index is similar to the THAI, but is calculated

Brownsville to Denton to get more affordable housing would be disappointed. Denton's housing is more affordable for Denton residents, who have a median income of \$57,700 compared to Brownsville's median income of \$22,400.

Although homes are more expensive in Denton compared with Brownsville, the difference in their THAI values indicates that Denton residents have less difficulty buying a home because their income more than makes up for the higher home prices. Thus, relative THAI values express something about local housing market conditions. For example, affordability might be expected to lead to higher rates of homeownership. Yet, when THAI and homeownership rates are compared statistically, the correlation is not high.

Minority, Student Distortions

There are two reasons for this. First, homeownership rates are determined more by demographic factors — age and family makeup — than economics. People decide to become homeowners because doing so fits their situation; then they follow through if they can afford it. Affordability is only part of the equation. Second, the data used to calculate THAI may lead to distortion in some cases.

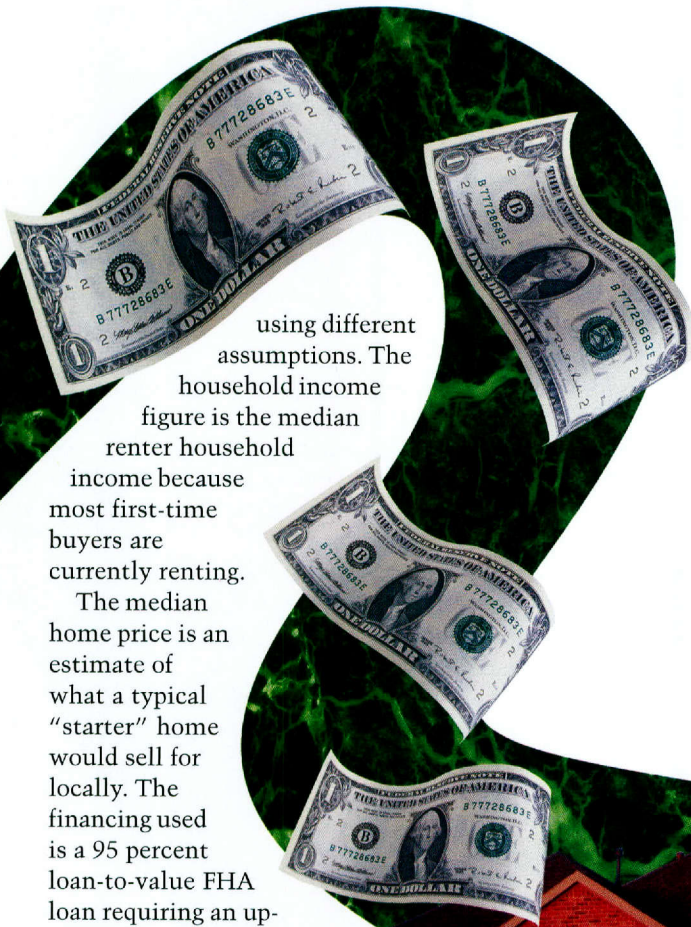
The main problem is that median household income covers the entire population of the area. If a sizable portion of the population rarely buys homes, it has little effect on home prices. For example, a large portion of the Bryan-College Station population consists of students. Students have low incomes that depress the overall median income. College students, by and large, do not buy homes. Consequently, the median sales price reflects the homes purchased by more affluent residents, and the THAI formula makes the market look much less affordable than it is (0.97 in first quarter 2002).

Such distortion may also be caused by concentrations of ethnic minorities. Hispanic and African-American families, as a group, tend to have lower incomes and homeownership rates. Thus they affect THAI much like the college students — lowering the overall median income without having much effect on prices. Consequently, a high inverse correlation exists between THAI and the percentage of Hispanic and African-American households.

Aside from these aberrations, the THAI does indicate

some things about relative affordability. For example, a high correlation exists between THAI and the percentage of middle-income households in the area. It is possible that these households insist on better value when buying a home. Also, THAI tends to be lower in areas experiencing rapid growth, as in the case of Austin. The increase in housing demand caused by growth often outstrips supply and pushes home prices up, resulting in less affordability. ♦

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using different assumptions. The household income figure is the median renter household

income because most first-time buyers are currently renting.

The median home price is an estimate of what a typical "starter" home would sell for locally. The financing used is a 95 percent loan-to-value FHA loan requiring an upfront mortgage insurance premium that is financed into the loan and a monthly insurance premium. The minimum income needed to

purchase a home is based on FHA's requirement for a 29 percent payment-to-income ratio.

Can Local THAIs be Compared?

Because each market has its own THAI value, it is tempting to use the data to compare affordability among areas. Such comparisons can be misleading. For example, Denton's THAI of 1.45 in first quarter 2002 appears to make housing in that area a bargain compared to Brownsville, with a THAI of 1.06. But the median Denton house price was \$149,700, while in Brownsville it was only \$79,600. Anyone moving from



Property Tax Increases Hit Home

By Charles E. Gilliland

The now famous, so-called Robin Hood plan sought to ensure equal access to resources for all Texas schools by requiring rich school districts to share their wealth with poor districts. The plan also significantly increased reliance on the ad valorem property tax for support of public education, placing an increasingly heavy tax burden on Texas real property.

Given that substantial burden and the impending crisis in funding public schools, many are speculating on how potential property tax increases could impact Texas real estate. Although numerous complicating factors come into play, markets work to reduce property values and reduce owners' wealth when property taxes increase.

Short-Term Effects

Assessment and collection determine the first impact of the property tax. Some owners appear to be able to avoid the negative effects of the tax by passing the cost along to the end users of the real estate. For example, landlords can raise rents and developers can boost lot prices. But a competitive economy ultimately counteracts these mechanisms and imposes the entire cost of the tax on current owners by reducing property values.

Economic theory holds that an efficient public finance system should result in individual tax burdens roughly equating to the taxpayer's benefit from public expenditures the taxes support, and that anything funded by property taxes should enhance the social and economic environment of property owners.

In the short term, imposing an added tax on property without a corresponding increase in the level of government services disrupts the efficiency of real estate markets. The additional tax drives up ownership costs, thereby reducing effective demand for the taxed property. It results in less development, higher prices to consumers and reduced revenues to developers, in part because of the economic activity that **does not** occur because of the tax.

Fewer potential homebuyers can afford a new house. Fewer retailers can afford to rent space for a shop. Every class of property owners subject to the added tax faces the same prospects. Although markets act to create these conditions, value added through enhanced public services financed by the taxes make it difficult to verify this effect with market data.

Long-Term Impact

In the long run, competitive pressures limit an owner's ability to pass the tax to end users. Suppose an owner negotiates leases requiring tenants to pay property taxes. These leases

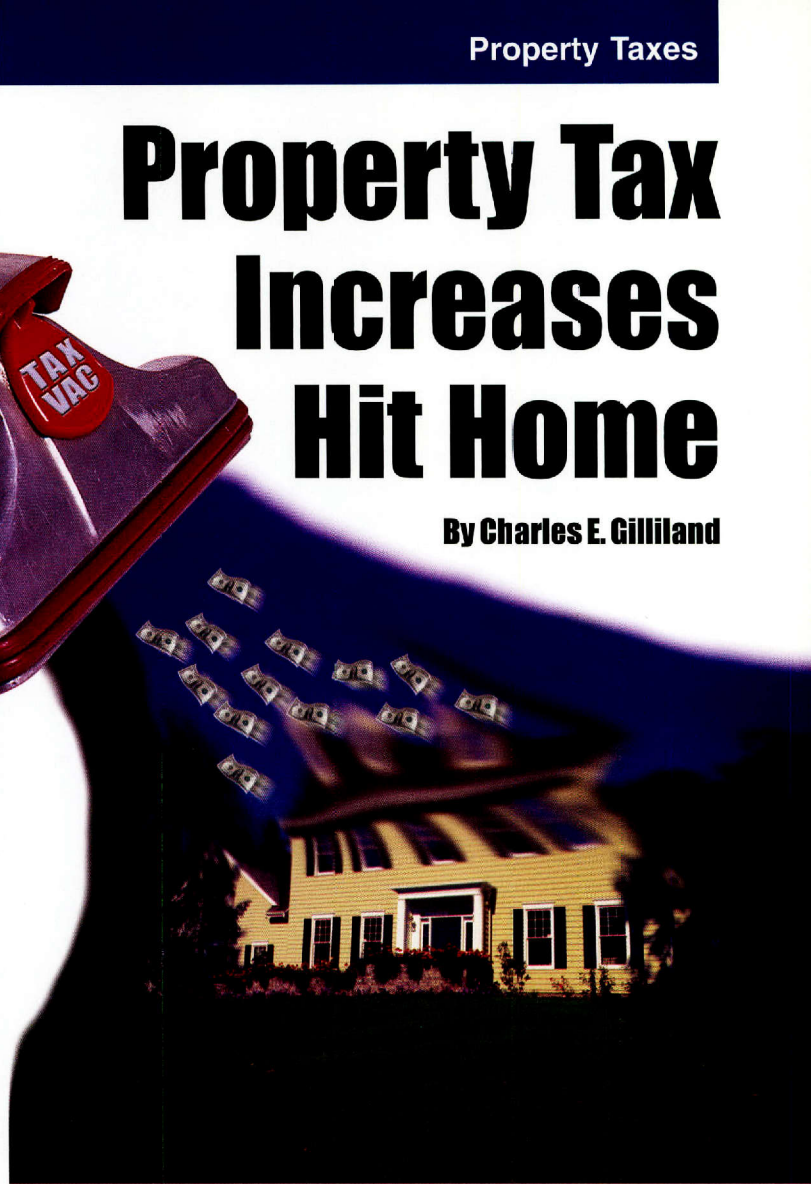
allow the owner to avoid the costs of the added tax in the intermediate run by passing on the increase to tenants.

However, as leases expire, tenants typically explore available options. When they find comparable space not subject to the tax increase, they move to the lower-cost location. As more and more tenants exercise that option, the property owner is forced to reduce rents to keep the building occupied.

This competitive pressure drives down rent by the amount of the property tax, and the rent reduction returns the tax burden to the property owner. When the owner sells, prospective buyers regard the elevated tax burden reflected in reduced rents as an ownership cost and consider that cost in formulating their offers. Over time, then, the economic system reduces property prices to equal the increase in taxes.

Suppose now that instead of a localized increase like those initiated by the Robin Hood plan, the property owner sustains a tax increase applying to all taxable properties in Texas, again with no increase in public services. In this scenario, no real estate investments escape the increased tax, so there is no pressure to lower rents. Tenants cannot escape the tax by moving. In fact, the tenant seems to shoulder the entire tax burden.

Despite that appearance, markets for investment capital again return the tax burden to the property owner. Investors consider the return an investment will generate before they commit capital. Property owners selling real estate must lower the asking price to compensate for the added tax burden.



The property tax has evolved from a generalized tax on all wealth to one mainly concentrated on real property. Investment alternatives not subject to property tax vie with real estate for capital, and that competition tends to drive down real property prices to compensate for the tax on its value. So once again, the tax burden returns to the property owner through reduced prices for real estate.

This is true for all types of real estate because real estate cannot be moved. Capital can be transferred and labor can migrate to locations that provide superior returns, but real estate is stationary. Because capital and labor are mobile, they can earn the competitive market rate for an economic activity.

However, real estate yields only the income remaining after capital costs and labor have been paid. Property taxes reduce that residual income and thus lower a property's investment value.

Taxpayer Reactions

Although the modern real estate economy is considerably more complex than the simple system outlined here, the discussion demonstrates how real estate investors react to property tax levels. Essentially, they try to avoid a higher tax burden when they purchase a property. Investors shop around among locations, seeking one with equivalent public services but a lower property tax rate.

Corporate managers choosing a location for a facility also consider tax rates. When other factors are equal, they choose the location with the most favorable tax climate. In the end, buyers go where taxes are lowest when all other factors are equal. The proliferation of tax increment finance zones and tax abatements to recruit industry and development reflects this.

The Texas property tax system with its complicated mixture of exemptions and preferential valuation provisions unquestionably affects real property decisions. Buyers weigh the tax implications of a home or other real estate purchase.

School tax freezes on homesteads of those older than 65 provide the elderly an incentive to locate in districts with low property tax rates. Further, it encourages them to purchase low-cost homes to establish a low school tax liability, because that freeze can be transferred to another home.

The property tax affects land use patterns as well. For example, because owners no longer need livestock to qualify for advantageous "open space" taxation, livestock will vanish from much of the land purchased for recreational use. These effects cross state and local boundaries and pit one location against another in setting property tax rates and exemptions.

Texas officials have chosen to rely increasingly on local property taxes to fund public education and, as the need for funds is expected to escalate, the already high property tax burden on Texas property owners will increase. This will tend to reduce real estate values below their expected levels and encourage owners to look for methods to avoid the tax. Many will seek legal advice as they strive to structure ownership to minimize school tax liabilities.

All of this translates into increased ownership costs, which in turn translate into reduced affordability. Continued heavy reliance on the property tax to fund education could adversely impact the supply of affordable housing in the future. Texans would do well to consider this as they search for an optimal school finance system. ♣

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Anyone who has tried to get a loan for recreational land, a rural home or rural agricultural property knows that this type of financing can be hard to come by. One source of loans — the Farm Credit System (FCS) — is unknown to many buyers. Those familiar with the FCS may assume that only farmers and ranchers are eligible to apply for FCS loans. But the FCS isn't what it used to be. It's better, offering a wider range of loan products to a broader spectrum of borrowers.

For many years the FCS provided loans for farmers and ranchers through locally owned lending cooperatives. Long-term farm and ranch mortgage loans were made by Federal Land Bank Associations (FLBAs), and short- and intermediate-term agricultural production and equipment loans were offered by Production Credit Associations (PCAs). Although both organizations were involved with agricultural financing, these two lending systems operated independently with separate management.

FLBAs and PCAs both primarily served agricultural borrowers in narrowly defined geographic regions. However, FLBA lending territories differed from PCA regions, and borrowers had to locate the FLBA or PCA office nearest to the property they were financing. They had to endure an arduous application process and were required to purchase and hold stock in the local FLBA or PCA while their loans remained outstanding.

Farm Credit Comes of Age

In January 2001, the FCS adopted a new management philosophy that relaxes the geographic barriers and makes the overall loan process more accommodating to borrowers. The new system reflects changing rural markets, with loan approvals based on credit scoring for many of the smaller loan requests.

Local associations now compete to provide loans to borrowers no matter where the borrower buys land. And although the



NOT *Your Grandfather's* FARM CREDIT SYSTEM

By Charles E. Gilliland and Michael Mays

bulk of their loan volume continues to revolve around agricultural properties, FCS now will make loans to borrowers who are not full-time farmers or ranchers. Borrowers are still required to hold stock in a local association, but most associations have significantly reduced the amount of stock required.

The revitalized FCS consists of 15 primary lending entities offering a variety of loan products for land and homebuyers in rural Texas.

Changes Bring Flexibility

The changes began in 1999 when several FLBAs, which had been locally controlled agents of the Farm Credit Bank of Texas (FCB) in Austin, converted to Federal Land Credit Associations or FLCAs. Over the next two years, all FLBAs in Texas adopted the new FLCA business model, making them independent lenders with full ownership of their loan portfolios. In doing so, these associations took on the risk of underwriting the loans.

Beyond simplifying the loan application and approval process, the conversion from FLBAs to FLCAs has had little effect on customers' day-to-day dealings with their lenders. However, this shift in ownership gives FLCAs more local control and more flexibility in setting loan terms and rates and fosters more aggressive marketing and loan development activity.

Last year, a number of FCS lenders — both FLCAs and PCAs — went a step further and became Agricultural Credit Associa-

tions (ACAs) with FLCA and PCA subsidiaries. ACAs are chartered to make both mortgage loans and agricultural production loans through their respective subsidiaries. Currently, there are five FLCAs and ten ACAs in Texas.

Although local associations retain responsibility for their chartered territories, the merger and reorganization process has resulted in overlapping boundaries in many areas of Texas. The surviving entities compete directly within the same territory and may lend funds for purchases outside that area if a borrower's headquarters is located within the association's region.

For example, a rancher in Amarillo could obtain a loan from his local FLCA to purchase land in South Texas. Before the change, that rancher would have had to locate and contact the FCS lender in South Texas to apply for a South Texas loan. Now borrowers can establish and maintain a relationship with local offices even as they purchase land farther from home.

Despite the shift toward local control within FLCAs, the FCB in Austin maintains a working relationship with the individual associations. Through bond sales, FCB serves as a financial conduit, securing funds from the Federal Farm Credit System Funding Corporation to be used in the lending operations of local associations. However, the merged management and lending system should allow local FLCAs to offer more competitive interest rates and more flexible loan programs designed to better meet borrowers' needs than the

old FLBAs. Because credit decision authority is retained at the local level, the loan application process should be less daunting, with timelier loan approvals and more efficient loan servicing.

Available FCS Loans

Currently, local associations offer loans for farm and ranch properties, rural homes and home sites, timberland, recreational land and agribusinesses. The system also makes farm and ranch operating loans and loans for equipment and livestock. These loan products have a variety of terms. The associations routinely describe available loan products and terms on their websites (see chart).

Although most FCS loans support agricultural operations, a growing portion of lending activity focuses on owners of recreational properties, part-time operators, absentee landlords and rural homes. Although some regulations restrict the availability of home loans made through the system, most residences within the city limits of communities with populations of less than 2,500 may be eligible.

Most residences outside city limits on small tracts will qualify for system residential loans. The system can even grant loans to individuals building in rural subdivisions provided the subdivision is platted and deed restricted. However, rural residence loans made to nonfarmers and nonranchers set a maximum home value of \$153,583 for 2002, not including land value.

Application Process

In addition to the changes in focus and geographic coverage, the loan application process has been streamlined. Associations now offer an Ag Fast program for small loans, generally limited to a maximum of \$100,000, featuring a shortened application. Applicants may not be required to submit detailed financial statements for Ag Fast loans, which are available to simple partnerships or individuals.

Applications for loans of more than \$100,000 are more complex and call for more information from the borrower to establish a credit history. These loans require full financial disclosure covering the past two to three years.

The time required for loan approval depends on the type of loan. Some loans are approved in one day; others take longer. Most property transfers can be closed within 30 to 60 days from first contact with the local association. To help speed decisions, associations now use mathematical credit

scores as part of the process. Credit scores are principal factors for Ag Fast loans but also impact decisions on the more sizeable loans.

FCS: The Next Generation

While meeting the financing needs of today's rural land owners, FCS also is planning how best to serve the next generation of farmers and ranchers. Because this market segment usually encounters the most difficulty obtaining loans, FCS has established young, beginning and small farmer and rancher programs ranging from financial

counseling to educational scholarships to relaxed credit standards.

Today's rural land buyers have a wide spectrum of objectives. From owning a country home to creating a recreational retreat, buyer motives often extend beyond the dominant motive in granddad's day: increasing agricultural production.

The local lending arms of the FCS are refining their application processes and expanding their menu of loan products to satisfy an increasingly diverse array of customers. This shift in business practices has positioned the FCS to efficiently provide capital to fuel rural Texas land markets and support farming and ranching activities throughout the state. ♣

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*The FCS is
planning how
best to serve the
next generation
of farmers and
ranchers.*

Farm Credit System Lending Associations

Association	Location	Website
Heritage Land Bank	Tyler and McKinney	www.heritagelandbank.com
Capital Farm Credit	East and Central Texas	www.capitalfarmcredit.com
Brady Land Bank	Brady	www.bradylandbank.com
Ag Credit of South Texas	Weslaco, Hebbronville and Raymondville	www.agcreditofsouthtexas.com
Agriland Farm Credit Services	Headquartered in Tyler, services East Texas	www.agrilandfcs.com
Ag Texas Farm Credit Services	Headquartered in Lubbock, with 12 branches	www.agtexas.com
First Ag Credit	Statewide	www.agmoney.com
Federal Land Bank Association of Texas	Headquartered in Coleman with branches in Brownwood, Haskell and San Angelo	www.flbatexas.com
The Land Bank of Sulphur Springs	Sulphur Springs	www.flba.net
Lone Star	Weatherford	www.lonestarflba.com
Panhandle-Plains FLBA	Panhandle Region	www.panhandle-plainsflba.com
Southwest Texas ACA		www.southwesttexasflba.com
Texas AgFinance	South Texas	www.texasagfinance.com
Texas Land Bank	North East Central Texas	www.texaslandbank.com
Great Plains Ag Credit	Amarillo	www.greatplainsagcredit.com

Blowin' in the Wind

By Judon Fambrough

Wind rights. If the concept sounds ludicrous, go ahead and chuckle. But pay attention; harvesting the wind to generate electricity is becoming big business.

Experts assert that wind power may be able to satisfy as much as 15 percent of the country's energy demand. Leasing property for wind-powered generators in West Texas has become more commonplace than leasing for oil and gas exploration and production. Property owners should stay tuned to see how wind rights evolve in Texas law.

Technology for wind-powered generators is in its infancy, and the legal principles governing use and ownership of wind are even less developed. Terry E. Hogwood, a Houston attorney, raised some interesting questions in an article published in the State Bar of Texas' *Oil, Gas and Energy Resources Law Section Report*.

Wind is simply the movement of air. Can it be owned in the traditional sense? It has no physical manifestation equivalent to oil or gas deposits or any substance on which to stake a claim. However, Hogwood suggests that three legal theories in Texas support ownership of wind.

Unified Fee Ownership Theory

The unified fee ownership theory holds that a landowner owns from the center of the earth to the sky and all that lies between (*Broughton v. Humble Oil & Refining Co.*, 105 SW2d 480.) Texas courts have ruled in support of the theory, stating that landowners are entitled to natural rainfall coming from clouds over their property. The court ruled further that any interference by cloud seeding is subject to an injunction if not authorized by statute (*Southwest Weather Research, Inc. v. Rounsaville*, 320 SW2d 211.)

Planes have the right to fly over land as long as they do not interfere with the landowner's property rights. The theory does not apply to water or to wild animals roaming the surface. With these exceptions, landowners own all rights necessary for full and complete enjoyment of their property.

Hogwood suggests that wind must be captured for ownership to be possible. To capture wind, air movement must be concentrated on the vanes of a windmill used

to generate electricity. "Capture," in this context, refers to the right to or the actual conversion of wind to energy.

Wild Animal Theory

Assuming that wind can be captured, what laws permit private ownership? Hogwood proposes that the courts could apply either the wild animal theory, better known as the free in nature theory, or the rules regarding percolating water to reach essentially the same conclusions.

The wild animal theory, as it originated in the common law, holds that no individual owns indigenous wild animals as long as they remain wild and unconfined in a natural setting (*Jones v. State*, 45 SW2d 612). If a person legally captures a wild animal, he or she gains ownership. Otherwise, ownership remains with the state (*State v. Bartee*, 894 SW2d 34).

According to this theory, the state owns wind until it is captured. For the wind to be privately owned, a landowner must capture it legally, according to state law. Landowners lose claim to the wind by failing to capture it while it passes across their property.

Percolating Water Rules

Basically, Texas recognizes two types of underground water. First, there is water in an underground stream or lake that belongs to the state. A permit is needed to use this water. Second, there is water oozing or slowly moving through the soil not in any underground stream or lake. This water is better known as percolating groundwater. It is subject to the rule of capture with one important difference

from the wild animal theory. The water is privately owned prior to capture, not owned by the state.

Absent malice or willful waste, landowners have the right to take all the percolating water they can capture from under their land. According to the Texas Supreme Court, landowners are not liable to their neighbors even if they drain their neighbors' water supply (*Sipriano v. Great Spring Waters of America, Inc.*, 1 SW3rd 75). Center publication 1377, "Who Owns Groundwater?" describes the case in detail.

The Texas Constitution declares natural resources to be a public right and permits the Texas Legislature to pass appropriate laws for their conservation and preservation. In the *Sipriano* case cited previously, the high court placed the duty to preserve Texas' natural resources on the state, not the courts. Because percolating groundwater is a natural resource, the state has the right to regulate its capture.

If wind, like water, is considered a natural resource, the legislature may eventually pass laws to regulate its capture and usage, perhaps including spacing requirements and production limits. In 1999, the legislature passed Senate Bill 1, which permits the creation of groundwater conservation districts that have the power to regulate the pumping of groundwater and the spacing of wells.

Supposing that percolating water principles are applied to wind, landowners would have the right to capture as much of the wind crossing their property as they want. There would be no liability to neighbors as long as usage is not malicious or

wasteful, even if it prevents the wind from crossing adjacent property.

So could a landowner, without liability, build a wall on his or her property and block or divert the flow of air across adjacent property? Probably so, according to Texas case law.

The Texas Supreme Court has ruled consistently that adjoining landowners have the sole and exclusive right to build on the boundaries of their land, subject to zoning and deed restrictions (*Boys Town, Inc. v. Garrett*, 283 SW2d 416). If a legal structure, such as a wall or billboard, blocks the wind or view from another's property, there is no liability. (See Center report 1092, "Property Rights: Obstruction of View, Light or Air.") By the same token, Texas landowners may block natural sunlight from reaching neighboring land without liability (*Ft. Worth & D. C. Ry. Co. v. Ayers*, 149 SW2d 1068).

Is a landowner liable if the diverted wind damages a neighbor's property? The answer is *yes* if the Texas court applies the same rules to wind as it does to water. According to Section 11.086 of the Texas Water Code, a landowner is liable for diverting the natural flow of surface water in such a way that it causes damage to neighboring property. (For more details, see Center publication 804, "Brief Shower Creates Storm").

Separate Wind Rights?

If wind can be privately owned, is this a separate and distinct property right, like water rights or mineral rights, that can be owned apart from other property interests?

According to Hogwood's research, only one case in the United States — a California case — addresses the issue. In 1997, a condemnation case established that wind rights are distinct property rights that can be severed from other interests and owned separately (*Contra Costa Water Dist. v. Vanquero Farms Inc.*, 68 Cal Rptr. 2d 272). Of course, because this is not a Texas case the ruling is not binding on Texas courts. However, Texas courts look to other jurisdictions when cases involving new issues arise. If Texas courts rule similarly, a four-tier system of property ownership could develop. One person could own the surface, a second the minerals, a third the water and a fourth the wind.

It will be interesting to see if West Texas ranchers attempt to reserve wind rights when they sell all or a part of a ranch. If all the wind rights are not reserved, sellers may try to negotiate a part of royalties from future wind-generated power.

Energy Demand vs. Property Rights

Finally, can wind-generating devices be erected on a property in violation of existing deed restrictions, zoning ordinances or conservation easements on the basis that the public need for energy outweighs private property rights? Hogwood feels the answer is "no" based on a Connecticut zoning case (*Shippee v. Zoning Bd. of Appeals of the Town of Old Lyme*, 466 A. 2d 328). However, Texas case law has long held that general principles of property rights may fail when confronted with society's need for energy.

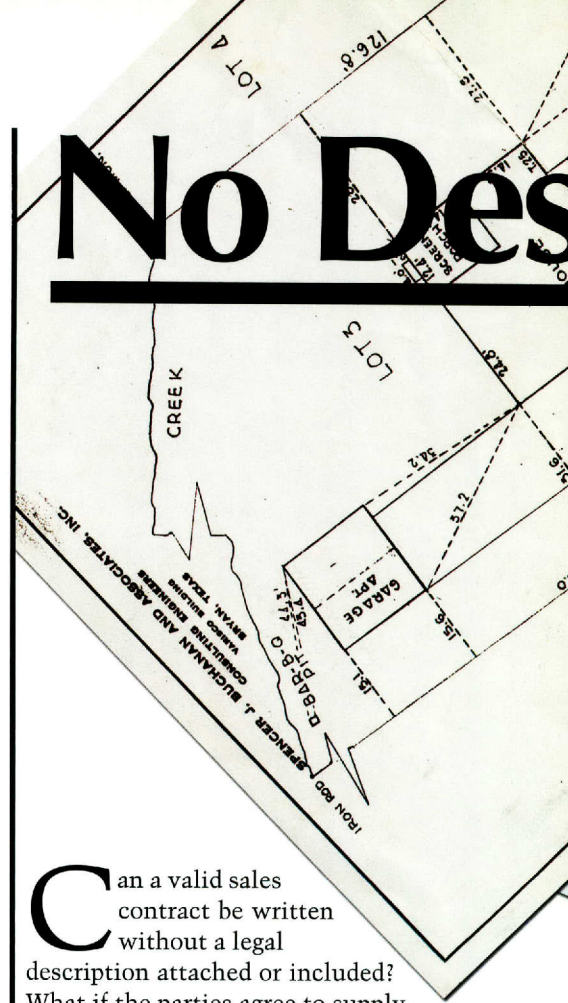
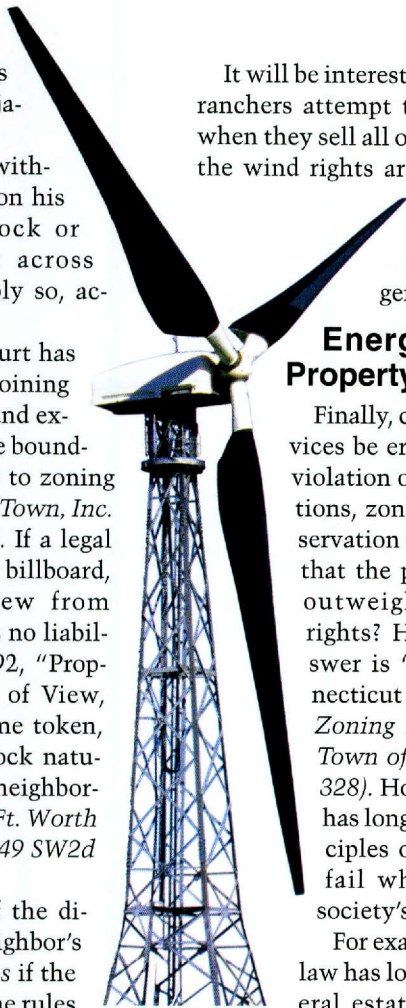
For example, Texas oil and gas law has long asserted that a mineral estate is dominant over a

surface estate. Under this general rule, the mineral lessee has a right to use as much of the premises as is reasonably necessary to produce and remove minerals without getting permission from the surface owner and without having to pay damages. This rule is based on the state's public policy for developing natural resources (*Humber Oil & Refining Co. v. West*, 508 SW2d 812.)

Legal precedents exist in Texas for finding that society's need for energy outweighs any interests served by enforcing land-use controls. According to oil and gas law litigation, the only remedy for violating land-use controls is damages, not an injunction to cease operations (*Railroad Commission v. Manziel*, 361 SW2d 560). Damages may be the only remedy in a wind-related case rather than an injunction requiring removal of the windmill.

Right now, the answers to most legal questions related to wind harvesting are indeed blowing in the wind. As this renewable natural resource becomes increasingly valuable, however, necessity will dictate case law and possibly legislation that specifically address pertinent wind-related issues. ♣

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Can a valid sales contract be written without a legal description attached or included? What if the parties agree to supply the description after the contract is executed? Is such a sales contract enforceable?

An enforceable contract for the sale of real property must be in writing and signed by the person charged with the promise (Statute of Frauds, Texas Business & Commerce Code Section 26.01). With sales contracts, both the buyer and seller must sign because the buyer promises to buy and the seller promises to sell at a stated price.

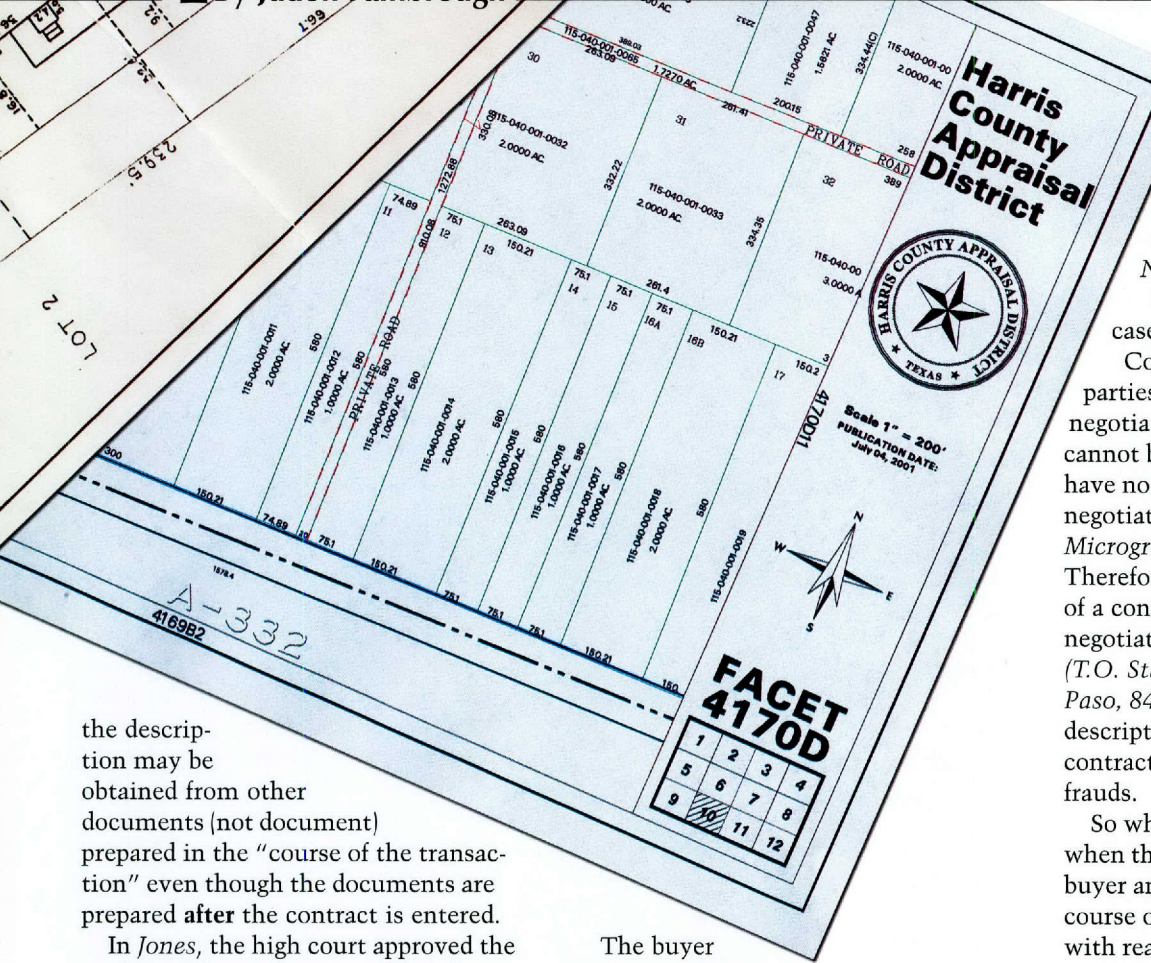
Noticeably absent from the statute is the requirement of a legal description. The Texas Supreme Court ruled, however, that the sales contract must contain or at least reference an existing document that describes the land with reasonable certainty (*Morrow v. Shotwell*, 477 S.W.2d 538 [Tex. 1942]).

Cases abound regarding what meets the "reasonable certainty" test. For example, suppose the description states "my land in Brazos County, Texas." Does this meet the test? According to the Texas Supreme Court, it does if the evidence reveals the seller owns only one tract in the county (*Kmiec v. Reagan*, 556 S.W.2d 567 [Tex. 1997]).

One case expanded on the test when referencing other documents for the legal description (*Jones v. Kelley*, 614 S.W.2d 95 [Tex. 1981]). The high court ruled that

Description, No Contract

By Judon Fambrough



the description may be obtained from other documents (not document) prepared in the "course of the transaction" even though the documents are prepared **after** the contract is entered.

In *Jones*, the high court approved the reading of four instruments together to satisfy the legal description for the statute of frauds. This was allowed because the instruments were executed at the same time, for the same purpose and "in the course of the same transaction." Texas courts have even construed different contracts and instruments as one even though they were between different parties (*Miles v. Martin*, 321 S.W.2d 62).

On April 20, 2001, the Dallas Court of Appeals faced a similar problem regarding the application of the "course of the transaction" test. The sellers agreed to sell, and the buyers agreed to purchase a single-family tract along a proposed golf course. Neither the tract nor the golf course had been surveyed or platted. The description was to be supplied later.

The seller decided not to close, and the buyer sued for specific performance. The seller defended on grounds that the sales contract lacked a legal description in violation of the statute of frauds.

The buyer countered that the subsequent description supplied by the survey and plat satisfied the statute of frauds according to the *Jones* decision. The buyer claimed the survey was permissible because it occurred in the course of the transaction even though after the sales contract was signed.

The appellate court disagreed with the buyer's interpretation of *Jones*. Despite the language in *Jones*, the documents containing the legal description in the *Jones* case were not prepared **after** the contract was entered but **contemporaneously** with the contract as part of another transaction between the parties.

The appellate court concluded by stating "These cases (cited by the buyer) did not create an exception to the long-held rule that **subsequent** documents cannot be used to aid in supplying a sufficient description. The agreement must furnish within itself or by reference to other identified writing then in

existence the means or data by which the particular land to be conveyed may be identified with reasonable certainty" (*Ford Development Corp. v. Town of County Development at Stonebriar Inc.*, No. 05-98-01561-CV).

Is this decision in line with other case law regarding contracts? Yes.

Courts cannot make contracts for parties. An agreement to enter into negotiations (an *agreement to agree*) cannot be enforced because the courts have no way to determine what the negotiations may produce (*Central Tex. Micrographics v. Leal*, 908 SW 2d 292). Therefore, if an essential term or terms of a contract are left open for future negotiations, no binding contract exists (*T.O. Stanley Boot Co. v. Bank of El Paso*, 847 SW 2d 218). Obviously, a legal description is an essential part of a sales contract according to the statute of frauds.

So what should real estate licensees do when they have a willing seller, a willing buyer and no legal description? The best course of action is to identify the tract with reasonable certainty using whatever tools are available. Street addresses will work in urban areas, and penciled boundary lines on plats should be sufficient for rural properties.

If no plat is available, outline the proposed boundary lines on a map downloaded from the web (find maps at terraserver.homeadvisor.msn.com). Marking on a downloaded map should be sufficient in light of *Pickett v. Bishop*, 223 SW 2d 222, in which the court held the contract must furnish within itself or by referencing some other extrinsic writing, the means or data to identify with reasonable certainty the land to be conveyed.

There are no guarantees of what constitutes *reasonable certainty*, short of an actual survey. However, real estate licensees should remember that a contract without reasonable identification of the property is unenforceable. Do the best you can with what resources you have available.

This article is for information only and is not a substitute for legal counsel. ♣

The Way Out

Contract Rescission Under the DTPA

By Judon Fambrough

Mention the Deceptive Trade Practices Act (DTPA) and real estate licensees immediately conjure up images of lawsuits filed by dissatisfied buyers. Most of these cases center on whether the seller or broker failed to disclose an essential fact about the property.

The DTPA is generally viewed as a way for a wronged party to recover damages, but the act also contains a less-known, less-used remedy — contract rescission. Contract rescission refers to the rescinding or canceling of the contract. It is an effective way for a buyer to get out of a real estate sales contract when guile and deceit is evident.

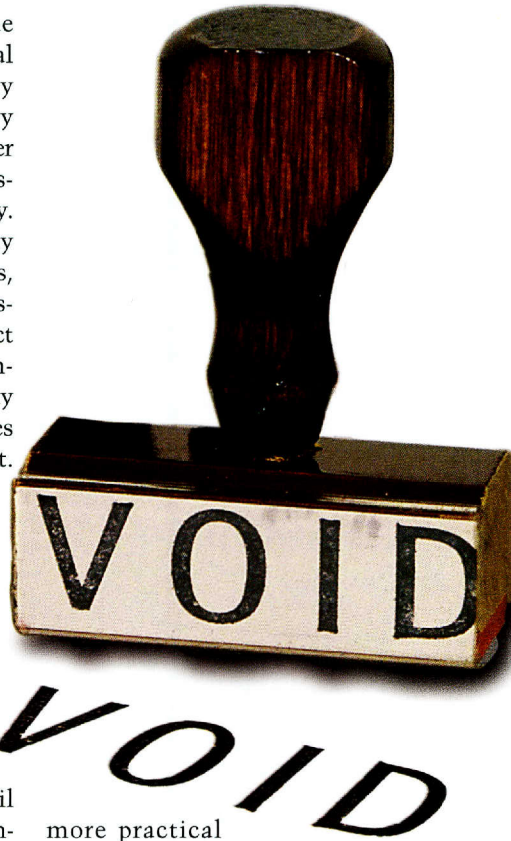
Consider the following scenario. The buyer finds an attractive property for sale. The listing broker is familiar with the property, having listed and sold it to the present owners. The buyer and seller enter a contract, and the buyer places \$5,000 in escrow. The transaction moves smoothly until the buyer attempts to purchase insurance.

As it happens, a couple of years earlier, the property suffered extensive hail damage. The current owners received monetary payment from the insurance company for a new roof. Instead of making the repairs, the owners pocketed the money and did not tell the current buyer. The failure to replace the roof rendered the property uninhabitable unless the buyer was willing to replace the roof at his own expense. The broker also remembered that the current owners experienced \$20,000 in flood damage in another incident but does not know what the owners did with the insurance proceeds.

When the buyer confronts the sellers with these nondisclosures, they do not deny the allegations. They state that the roof never leaked, so they saw no need to disclose. As to the previous flooding, they say those damages were remedied, and there was no need to disclose that the property was prone to flooding.

The buyer wants out of the contract and the escrow money returned. The sellers feel they have done nothing wrong and demand the buyers close.

This situation is a good illustration of when the DTPA can be used to rescind the contract before closing. Rescinding the contract after closing is possible, but it is



more practical to do so before closing. The buyers could also close and then sue for damages under the DTPA.

Contract rescission cancels marred contracts. The contract is cancelled, but more importantly, the plaintiffs are restored legally and financially to the position they maintained before entering the contract. Both parties must return any property received and the value of any benefits derived from the contract.

Both common law and statutory law recognize contract rescission, but there are procedural differences. Under either, the mere breach of contract is insufficient to support rescission (*Jim Walter Homes v. Samuel*, 701 SW2d 351). More must be proven.

Under common law, the plaintiff must prove something that would render the contract voidable, such as fraud, undue influence, mutual mistake of fact, illegality of the subject matter, failure of consideration or lack of mental capacity. The statute of limitations is four years. The plaintiff cannot recover damages and rescind the contract; the two remedies are mutually exclusive. Generally, the plaintiff

must offer to restore to the defendant any property received before filing the suit or offer to do so in the petition filed with the court.

The DTPA modifies the common-law rules. To sue under the DTPA, the plaintiff (the buyer in this scenario) must prove three things.

- The plaintiff is a consumer as defined by the DTPA.
- The defendant (the sellers) employed a false, misleading or deceptive act or practice; breached an express or implied warranty; or pursued an unconscionable action in the sale of the property.
- The defendants' (sellers') actions were the procuring cause of the plaintiff's (buyer's) economic damages or mental anguish. (For more information on each of these elements, see Center publication 1114, "The DTPA Protects Consumers and Defendants.")

Under the DTPA, plaintiffs face a two-year statute of limitations. Also, a strict reading of the statute allows recovery of damages along with rescission of the contract. Section 17.50 of the act lists recoveries in the following order:

- damages (triple damages in some cases),
- injunction (to keep the defendant from repeating the practice) **and** (not "or")
- contract rescission.

The DTPA apparently allows the three remedies in the same lawsuit. Thus, damages and rescission are not mutually exclusive remedies under the DTPA. However, case law limits the damages to those necessary to restore plaintiffs to the economic positions they held prior to the contract.

In two cases the court allowed limited recovery of damages for reimbursement of expenses incurred because of the contract (*Ridco Inc. v. Sexton*, 623 SW2d 792, and *LaChalet Inc. v. Nowick*, 787 SW2d 101). This was needed to fully restore the plaintiffs financially. In the present scenario, if the contract is rescinded, the plaintiff needs reimbursement for the loan application fees, inspection fees, the cost of the survey, and other costs related to the transaction to be fully restored financially.

Another case limited the circumstances in which contract rescission can be granted

even if all requirements of the DTPA are met (*Schenck v. Ebby Halliday Real Estate, Inc.*, 803 SW2d 361). In this case, the contract gave buyers 15 days after the contract was signed to investigate whether any of the property lay in the floodplain. If any did, the contract could be terminated. The buyers did not investigate the issue, and the contract closed.

Later, when the buyers attempted to resell the property, they discovered that part of the property was in the floodplain. They sued the seller and broker to rescind the contract for failing to disclose this fact.

While the court granted the buyers certain damages, rescission was denied. All parties appealed the denial. The appellate court upheld the trial court, stating that contract rescission cannot be granted if the plaintiffs have "unclean hands," meaning rescission cannot be granted when the plaintiffs are at least partly at fault. Had the plaintiffs investigated the floodplain issue

Case law limits damages to those necessary to restore plaintiffs to the economic positions they held prior to the contract.

during the 15 days allocated in the contract, the lawsuit would not have occurred.

The DTPA generally requires a 60-day notice before filing a lawsuit. This notice is required only if the lawsuit is for damages (Section 17.505 [a]). It does not apply to rescissions.

Can plaintiffs recover attorney fees under the DTPA when the court grants a contract rescission? Section 17.50(d) states, "Each consumer who prevails shall be awarded court costs and reasonable and necessary attorneys' fees." Apparently, court costs and attorney fees are recoverable when the contract is rescinded.

Contract rescission is not a popular remedy, perhaps because aggrieved buyers are more attracted to the possible triple damages the DTPA offers. Perhaps buyers are not aware of this remedy because attorneys do not promote it. Or perhaps they become aware of the remedy after closing, when it is less attractive than before closing. But contract rescission under the DTPA should not be overlooked by purchasers who were deceived or misled and want to get out of a contract before closing. ♣

peoples' money. Ultimately, managers' integrity and the legal system are the last defenses against such corruption.

The disquiet settling over the stock market in the wake of Enron hearings in Congress and ongoing revelations in the media reflect a tacit acknowledgement that managerial chicanery may have infested other firms. The shock of the September 2001 attacks and the ensuing war have further heightened the perception of risk in investing in stocks.

Renewed Interest in Real Estate

In light of these misgivings, some investors may find direct investment in individual real estate projects an attractive alternative to pouring funds into equity shares of corporations, including real estate investment trusts, or even corporate bonds. The single most defining characteristic of real estate, namely location, comes with both advantages and disadvantages. Investors in real estate projects have the opportunity to take more direct control of their investments.

Because direct real estate investors can identify and see the assets from time to time, they can personally oversee the project and its managers. This places responsibility for risk management squarely in investors' hands and frees them from depending on corporate managers known to them only through glitzy annual reports or news stories.

Investors can quickly correct problems and take steps required to maximize their returns. In addition, they can share in the vision of creating projects that will help define local communities. In short, real estate investment offers more control of funds invested much closer to home than investments in corporate financial instruments, in which the only control investors have may be whether to hold or sell the security.

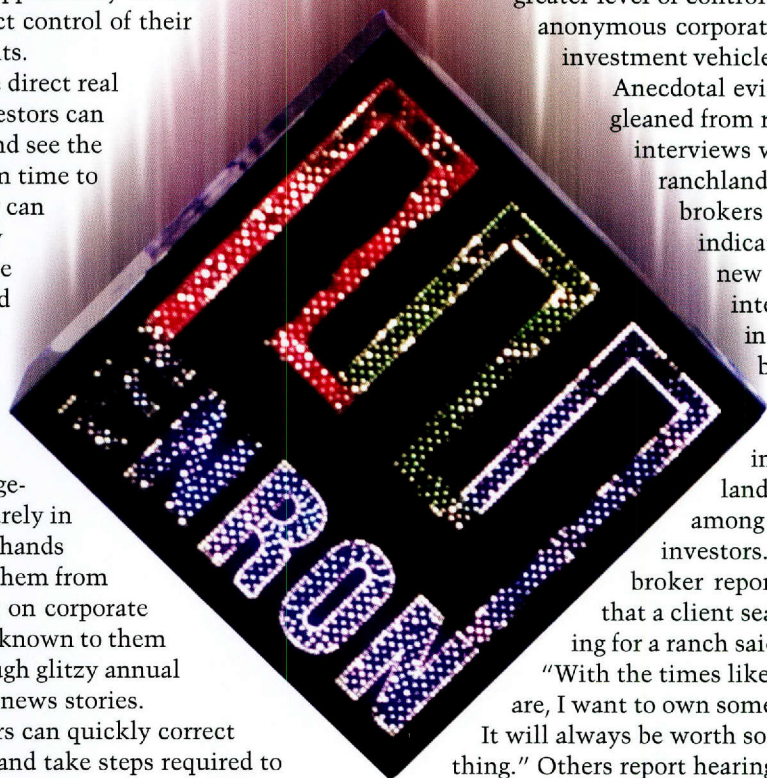
Real estate investments have potential disadvantages. First, the increased degree of control real estate investments offer requires greater vigilance from the investor. Second, prudent real estate investing requires study of real estate economics and local markets and a keen eye for future market developments.

Despite the increase in personal control, real estate investment carries the risk of loss. Finally, real estate investments are illiquid compared with corporate securities traded in large volumes daily.

For investors with limited knowledge of real estate markets, partnerships may offer an attractive option. Investors can create partnerships in which neophytes depend on more experienced partners to oversee projects. While ceding some degree of control, many partnerships involve circles of friends who have built trusting relationships.

Personally knowing and trusting your partners gives a much greater level of control than anonymous corporate investment vehicles.

Anecdotal evidence gleaned from recent interviews with ranchland brokers indicates a new interest in buying and holding land among investors. One broker reported that a client searching for a ranch said, "With the times like they are, I want to own some land. It will always be worth something." Others report hearing similar sentiments among land buyers. The uncertainty of the global political situation and the renewed focus on the risk of investment in securities appears to have enhanced real estate as a viable investment alternative. ♣



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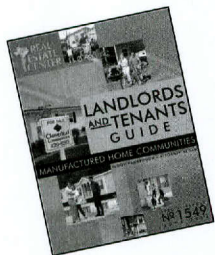


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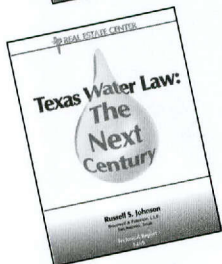
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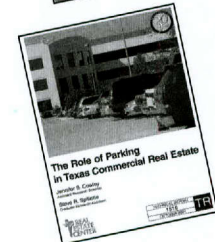
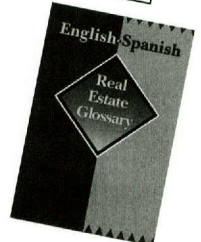
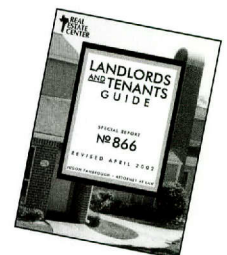
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TEXAS SHOOTIN' MATCH 2002



Combining the Real Estate Center's annual report with a wall calendar was a winning idea. Last year's annual report-calendar won a coveted Brazos Bravo award from the International Association of Business Communicators.

The calendar's prizewinning photos from the Great Texas Photo Shoot-Out, a contest we held for *Tierra Grande* readers, were a big hit. So we've decided to do it all again — the whole shootin' match.

We're asking you to again share your best Texas photos with us. And we won't fence you in with categories. Let your photographic spirit run free!

Capture whatever intrigues you about Texas — wild weather, cute (or not so cute) critters, odd-looking buildings, the beauty of oil derricks and pickup trucks, landscapes, seascapes, cityscapes — you call the shots.

Twelve winning photos will be showcased in next year's calendar. Winners will also receive an award certificate, a gift certificate for free Real Estate Center publications and ten copies of the annual report-calendar. Names of winners will be published in the October 2002 issue of *Tierra Grande*.

TO ENTER

- Fill out entry form on facing page. Electronic forms are at <http://recenter.tamu.edu/pdf/photocontest.pdf>
- Attach a label to the back of each print with your name and a brief description of the photo, including location. Do not write on photos with ballpoint pens or hard lead pencils.
- Digital photos may be sent by e-mail to ebravenec@recenter.tamu.edu but entry forms must be mailed or faxed [979.845.0460].
- Mail prints or slides to: Real Estate Center
Texas A&M University
2115 TAMU
College Station, TX 77843-2115

If shipping by courier, send photos to the Real Estate Center, 313 E.L. Wehner Building at the mailing address. Our telephone is 979.845.2031.

CONTEST RULES

- Entries must be received at the Center (not just postmarked) by August 15, 2002.
- All photos must have been taken in Texas within the last two years.
- Acceptable formats are color prints, slides and digital (minimum size: 3.2 megapixels or 2000 x 1600 ppi).
- No more than six photos per person may be entered.
- Only horizontal, color photos will be judged.
- Entries must have signed entry forms.
- Negatives must be sent with prints.
- Only entries with stamped, self-addressed envelopes will be returned.

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Green Building

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Tracking
Affordability

Property Tax
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