TIERRA GRANDE

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

ON THE COVER
Mother nature's autumn quilt blankets the shore of Sam Rayburn Reservoir, near Jasper.
PHOTOGRAPHER DORIS DAY

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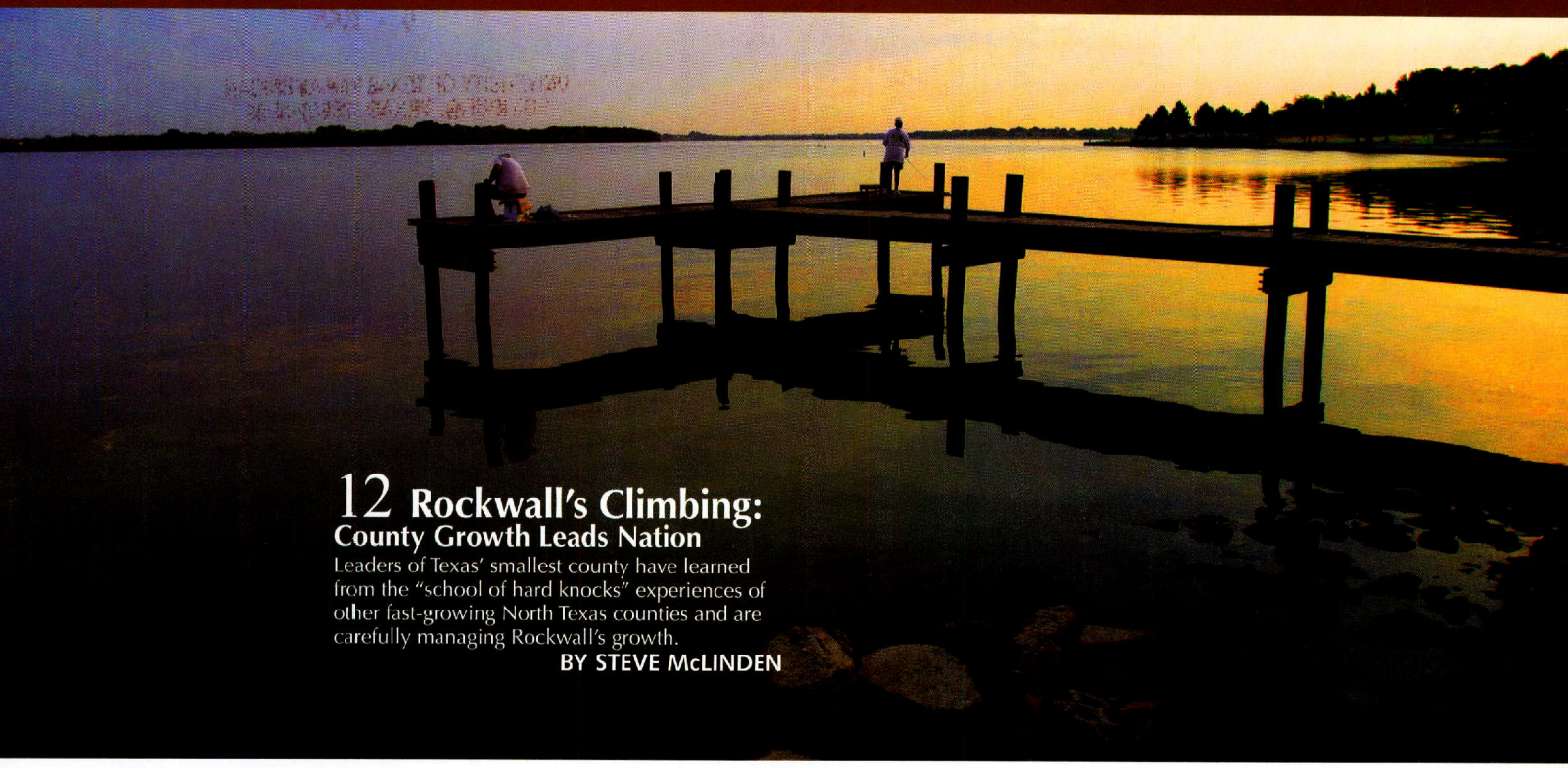

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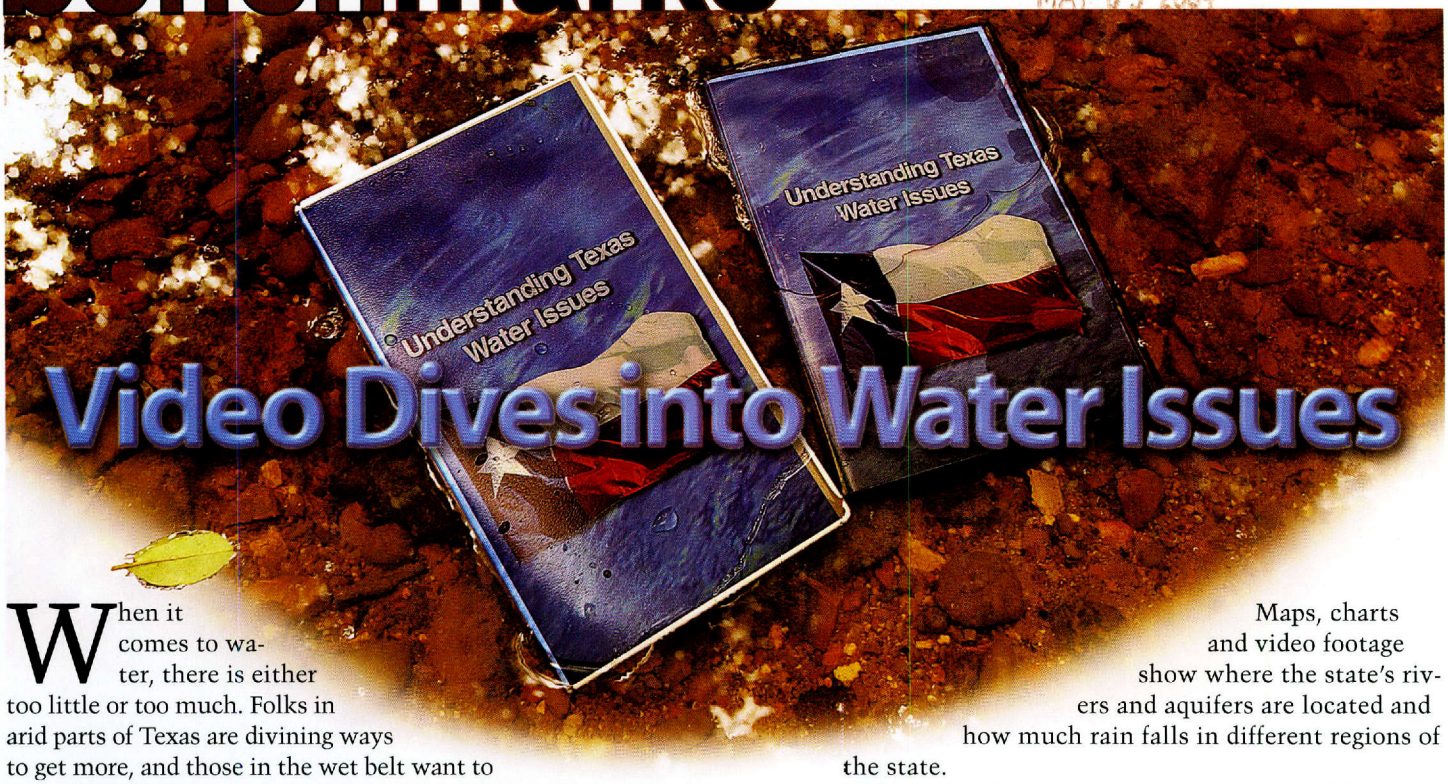


Video Dives into Water Issues

When it comes to water, there is either too little or too much. Folks in arid parts of Texas are divining ways to get more, and those in the wet belt want to keep what they have — or at least make others pay for it.

How to get water from areas of abundance to areas of scarcity is one of the challenges Texans increasingly face as the state's population multiplies.

"Understanding Texas Water Issues" helps makes sense of the problems. Additionally, this 50-minute video informs real estate professionals about how water issues can affect their business.

It explains the difference between surface water and groundwater and which agencies and laws govern the use of each.

Dr. Charles E. Gilliland, research economist at the Real Estate Center, discusses the rule of capture and how it applies to groundwater. He also clarifies the differences between leasing and selling water.

Judon Fambrough, the Center's legal expert on groundwater leasing, goes into the "do's and don'ts" of leasing. Viewers learn the importance of negotiating specific items in a groundwater lease to protect landowner interests.

Maps, charts and video footage show where the state's rivers and aquifers are located and how much rain falls in different regions of the state.

Experts who are working on solutions to water problems explain how their projects are making a difference. On-location footage shows several programs in action.

Water issues are especially relevant to the real estate industry because the value of properties and the feasibility of economic growth are affected by present and future water supplies. This video is one tool real estate agents and brokers can use to become better informed, helping them to better serve their clients.

While the primary audience is real estate professionals, the video offers valuable information for all Texans. It was produced by the Real Estate Center in association with Texas Cooperative Extension and the Texas Water Resources Institute. To order a VHS tape or DVD by credit card, call 800-244-2144. They are $19.95 each. Checks should be sent to: Real Estate Center, Texas A&M University, 2115 TAMU, College Station, TX 77843-2115.

Sam Zell to Deliver Commercial Outlook

What does real estate mogul Sam Zell think about commercial real estate markets? Find out Dec. 2, 2003, when he delivers the keynote speech at the Texas Commercial Real Estate Outlook Conference. The Real Estate Center is sponsoring the event, which will be held at Texas A&M University.

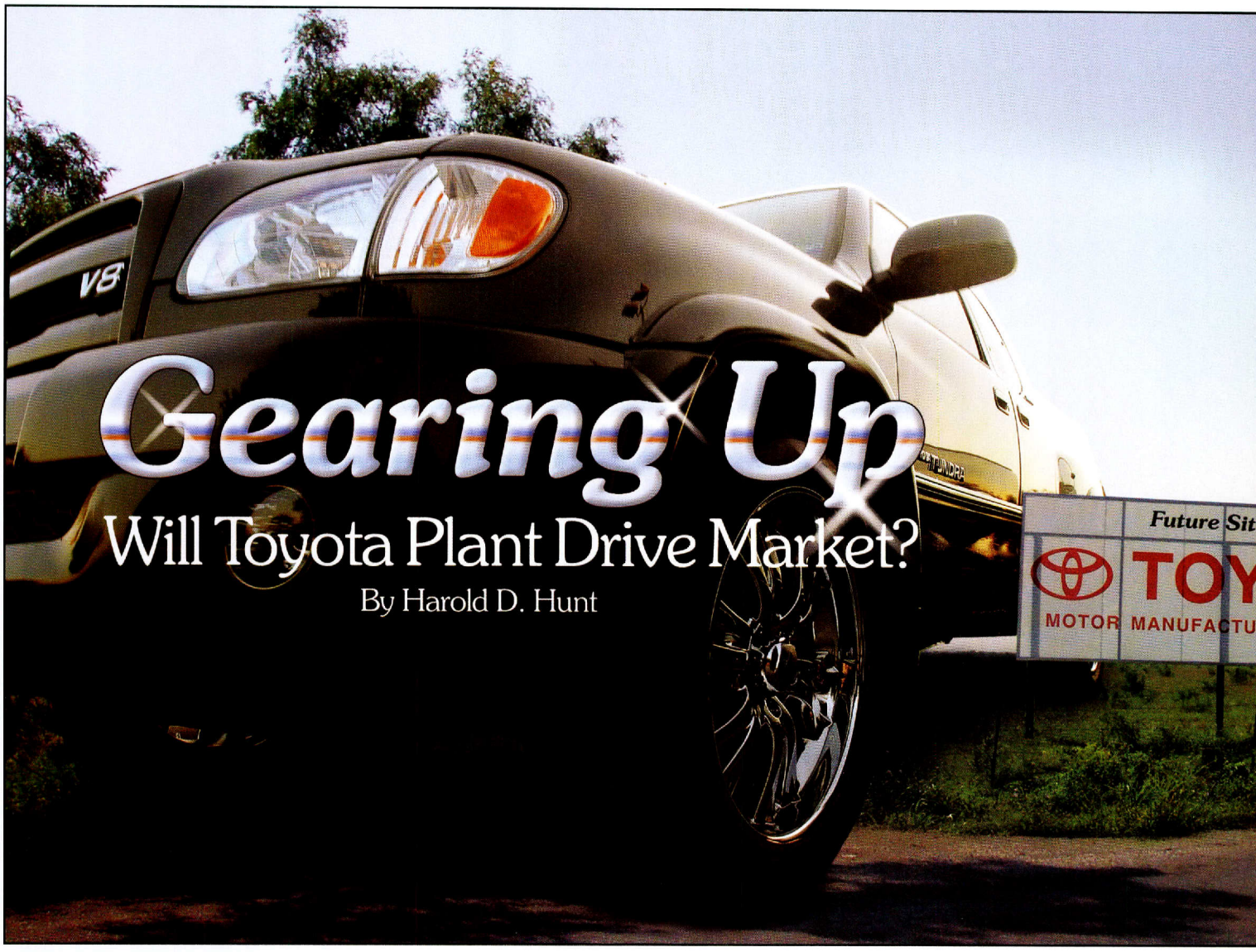
Zell, a self-made billionaire, got his start managing apartments when he was an undergraduate in Michigan. Later, he founded Equity Group Investments, an investment firm based in Chicago.

He continues to serve this group as chairman of the board. In fact, Zell is chairman of many companies, including Equity Office Properties Trust, the largest office owner in the country; Equity Residential Properties Trust, the nation's largest apartment real estate investment trust; Capital Trust, a specialized real estate finance company; and Manufactured Home Communities, Inc., a real estate investment trust that owns and operates manufactured home communities.

The December conference also will feature Dr. Mark Dotzour, the Center's chief economist, speaking on "The Texas Economy Today."

Conference sessions will focus on industrial, retail, office and investment markets. Panelists will come from across Texas.

Cost for the conference is $245. Look for registration information on the Center's website (www.recenter.tamu.edu) soon.



Gearing Up

Will Toyota Plant Drive Market?

By Harold D. Hunt

Pickups are about to pick up the pace of San Antonio's economy.

The city scored big when Toyota announced it was building a plant on the south side to assemble Tundra pickup trucks. Toyota will invest $800 million in the project, which will generate 2,100 construction jobs and 2,000 permanent jobs. The plant is expected to produce 150,000 trucks per year beginning in 2006.

The Texas economy will likely reap significant benefits from Toyota's presence, but how will Texas commercial real estate markets be affected? What areas will benefit most and why? Although past trends are not always predictors of future events, an examination of existing auto assembly plant locations provides some interesting insights.

Auto Corridor Suppliers

Auto assembly plants built in the past 15 years are designed for the just-in-time (JIT) production system, which requires suppliers to deliver components within hours, or even minutes, of when they are needed in the assembly process. This enables auto manufacturers to store a minimum inventory; suppliers instead bear the storage cost.

Toyota currently depends on about 450 "tier one" suppliers, both foreign and domestic, to feed its four North American assembly plants. Tier one suppliers manufacture or assemble components and deliver them directly to the assembly plants. Tier two suppliers provide components to tier one suppliers.

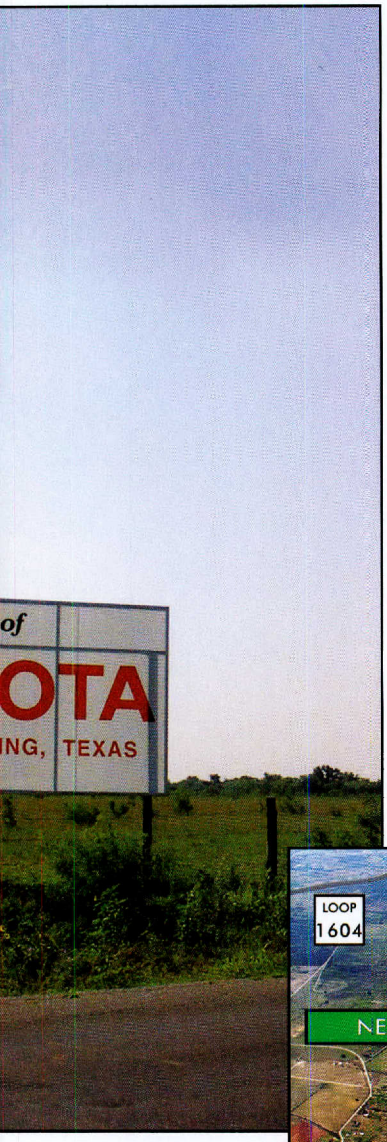
The bulk of these suppliers are located within the "auto corridor," which runs roughly between I-65 and I-75 from Michigan south through Indiana, Ohio, Kentucky and Tennessee. The U.S. auto industry was born in this region, and more than half of U.S. auto suppliers are located in these five states.

Where Suppliers Locate

JIT production has prompted changes in the criteria used to select cost-effective locations for auto suppliers. Dr. Thomas Klier, a senior economist at the Federal Reserve Bank of Chicago, has carried out extensive research on this topic.

In a 2000 study, Klier concluded that access to excellent transportation routes outweighs the need for a location adjacent to an assembly plant. Rather than having many suppliers extremely close to the plants, Klier discovered that it is more important to have a large number of suppliers within one day's shipping distance. Four hundred miles is considered the maximum distance for a one-day delivery.

Klier used a database of more than 3,000 North American auto suppliers compiled by ELM International, Inc., of Lansing, Mich., to determine distances between suppliers and assembly plants. He found that 5 to 29 percent of tier one suppliers are within a 100-mile radius of the plants they serve.

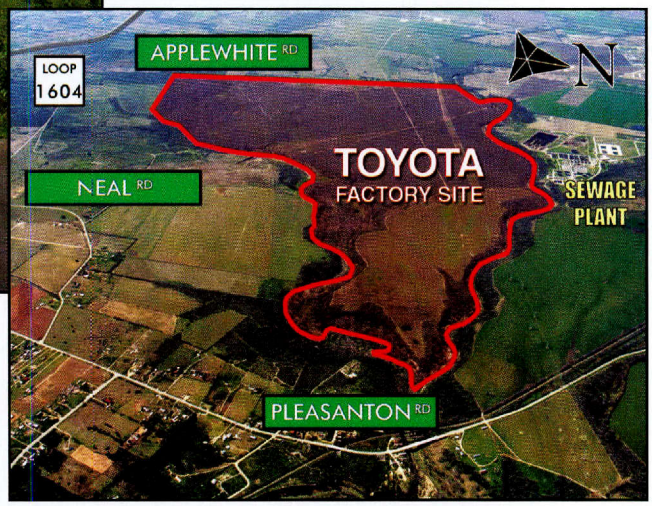


Examination of Toyota's tier one suppliers revealed that only 10 percent are within 100 miles of Toyota's three wholly-owned North American assembly operations. However, 76 percent are within a 400-mile radius.

Klier also looked at tier one suppliers providing components to a fourth assembly plant jointly owned by Toyota and General Motors. The New United Motor Manufacturing, Inc. (NUMMI) plant has been operating in Freemont, California, since 1984. Klier discovered that only 6 percent of its suppliers were within a 100-mile radius. Only 11 percent were within a 400-mile radius. The rest were located back East in the auto corridor.

The Texas Connection

Klier's research has major implications for Texas real estate markets. It shows that many Texas cities in addition to San Antonio are viable candidates for supplier sites. As long as suppliers can consistently deliver products within the time frames mandated by the assembly plants, they are not forced to locate facilities adjacent to the plants. Instead, they can choose sites where the sum of production and transportation costs is lowest.



The relative isolation of the NUMMI plant in California has produced a different supplier paradigm. Klier discovered that, rather than construct new manufacturing facilities near NUMMI, the bulk of suppliers ship parts from their existing facilities in the Northeast to warehouse-distribution centers in El Paso, Memphis, Chicago and Detroit. Various components are consolidated at these points and transported to NUMMI by rail.

"One hundred and fifty thousand vehicles per year is not a lot of production," Klier says, referencing the San Antonio plant's expected output. "In all likelihood, a supplier plant of the most efficient size would need to manufacture much more product than the amount required by San Antonio alone. So suppliers considering the construction of an additional manufacturing facility near San Antonio must ask themselves what they would do with the extra capacity."

Although Texas may one day have a number of auto assembly plants, for all practical purposes San Antonio may be an auto assembly "island," similar to NUMMI, for the foreseeable future. Suppliers may find it more cost effective to ship parts into San Antonio from existing locations rather than build additional manufacturing facilities in Texas.

Lessons from Other Sites

While the need for supplier manufacturing sites in Texas may be limited, the NUMMI scenario points out the importance of warehouse-distribution space. Suppliers will need locations to receive and possibly assemble components before they are delivered to the assembly plant for installation.

Study of foreign-owned assembly plants in Mississippi, Alabama and Kentucky confirms Klier's conclusion that only a small core of suppliers locate within minutes of the assembly plant. These suppliers often locate nearby because they must provide critical technical expertise along with components.

Local government officials report that suppliers are generally quite cost conscious. According to John Conner, executive director of the Georgetown–Scott County Kentucky Chamber of Commerce, "We missed capturing some of Toyota's suppliers when the assembly plant opened because our industrial land just wasn't competitively priced." Georgetown, Ky., is home to a 7,800-employee Toyota assembly plant that began operation in 1988.

In retrospect, Conner believes that suppliers had a hierarchy of priorities when they chose where to locate. Generally, they preferred to locate in areas that had affordable land in an industrial park with modern speculative space already constructed. This facilitated quick move-in and kept negotiations with utility companies, developers and city governments to a minimum. In other words, the "heavy lifting" had already been done.

In the absence of the ideal property, suppliers usually look for affordable sites in modern industrial parks where all necessary infrastructure is in place and they can construct their own build-to-suit space. Areas chosen least frequently by suppliers are relatively expensive tracts not in industrial parks. This is true even if the land is in proximity to the assembly plant. A number of government officials and local brokers report that it takes several years after assembly plants begin operations before land speculation around the plants subsides and reality sets in.

Local governments have increased their involvement because they want to be able to offer potential suppliers land at affordable prices. Georgetown and Scott County, Ky., are working together to develop a modern industrial park near the Toyota plant. Several other U.S. cities with relatively new assembly plants either provide or intend to provide an industrial park near the plant that is at least partially owned by local government entities.

Unlike U.S. automotive firms, Toyota has a track record of extreme loyalty to its existing supplier base. This is both good news and bad news. Those areas where Toyota suppliers locate stand to benefit indefinitely, for odds are those suppliers will be providing components to Toyota for a long time. However,

cities not chosen as sites for the original round of Toyota's suppliers should not expect a large pool of different suppliers to be shopping for sites in the near future.

Mexican Connection

Mexico is a formidable source of existing suppliers outside the auto corridor. The Texas Center for Border Economic & Enterprise Development at Texas A&M International University in Laredo reports border trade data between Texas and Mexico.

The Center's data show that billions of dollars of auto-related components are imported from Mexico into the United States each year through Texas. Among the top 25 products imported from Mexico over Texas bridge crossings in 2002,

Studies of other auto assembly sites suggest that plant suppliers will look for affordable land in industrial parks with already constructed, modern spec space.

auto-related components totaled more than $16 billion. Almost three-fourths of these components came through two Texas cities — Laredo and El Paso.

Obviously, auto-related components already are being delivered from Mexico to other U.S. assembly plants more distant than San Antonio. Almost all Texas border crossings are within a 400-mile radius of San Antonio, making them viable supplier locations. Warehouse-distribution facilities in Texas border cities could become important staging grounds for Mexican auto parts suppliers supplying Toyota's San Antonio site.

Other Real Estate Sectors

Visits to cities with existing assembly plants revealed that, in the commercial real estate sector, industrial real estate markets are the most affected by the plants. Surprisingly, the arrival of assembly plants and auto suppliers has little effect on the regions' office markets and hotel-lodging sectors. Local government officials and real estate brokers report almost no change in these markets.

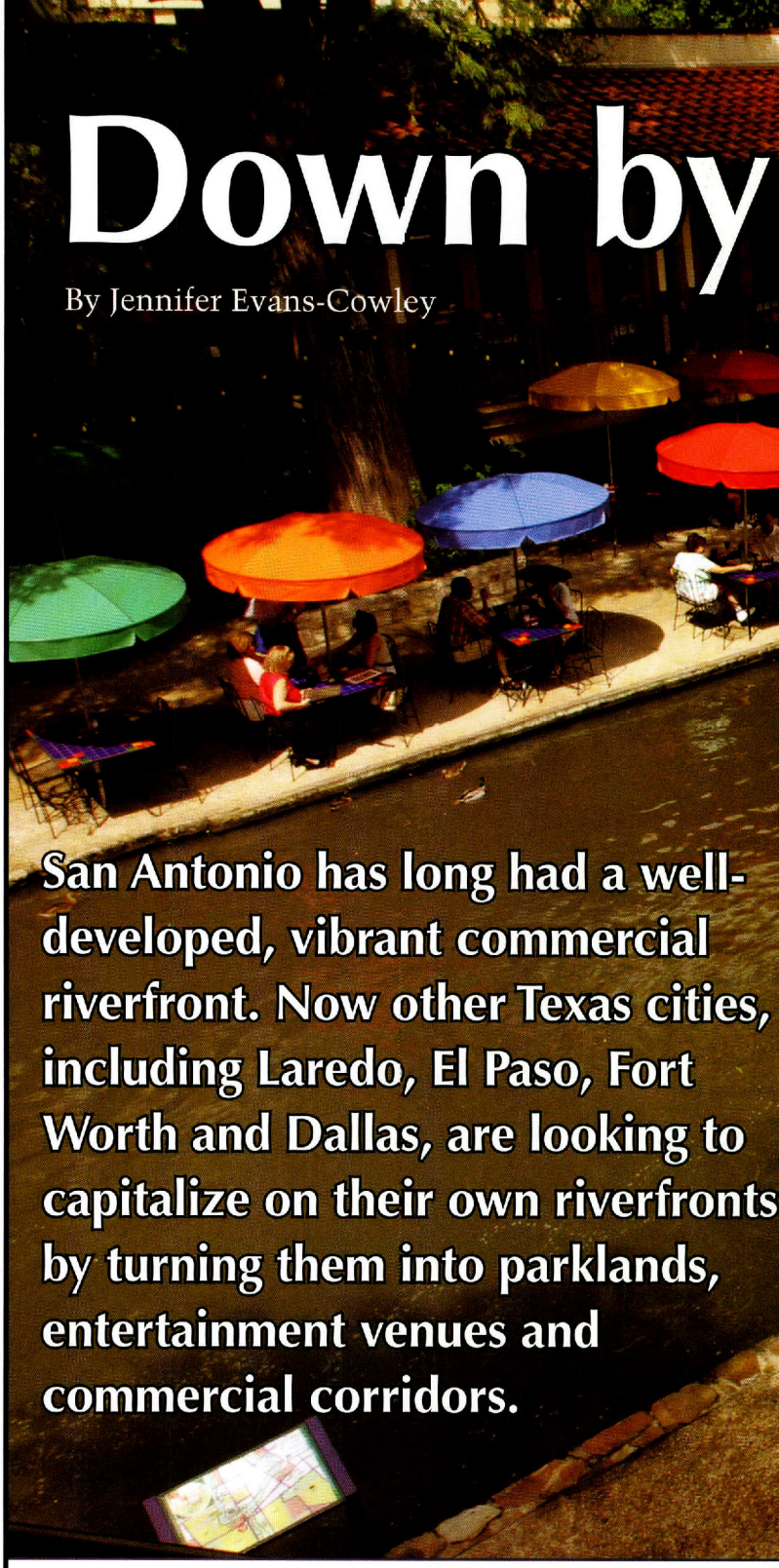
Assembly plants do affect retail markets to some degree. However, zones immediately surrounding existing auto assembly plants in the southeastern United States experienced little new retail activity. This may be explained by the high percentage of plant employees who commute from other towns.

Toyota is a great addition to the state's manufacturing base, and many areas should benefit greatly from its arrival. Cities that can offer reasonably priced land with a minimum of development headaches within a 400-mile radius of San Antonio will join the intense competition to attract suppliers into the Texas market.

Dr. Hunt (hhunt@recenter.tamu.edu) is an associate research scientist with the Real Estate Center at Texas A&M University.

Down by

By Jennifer Evans-Cowley



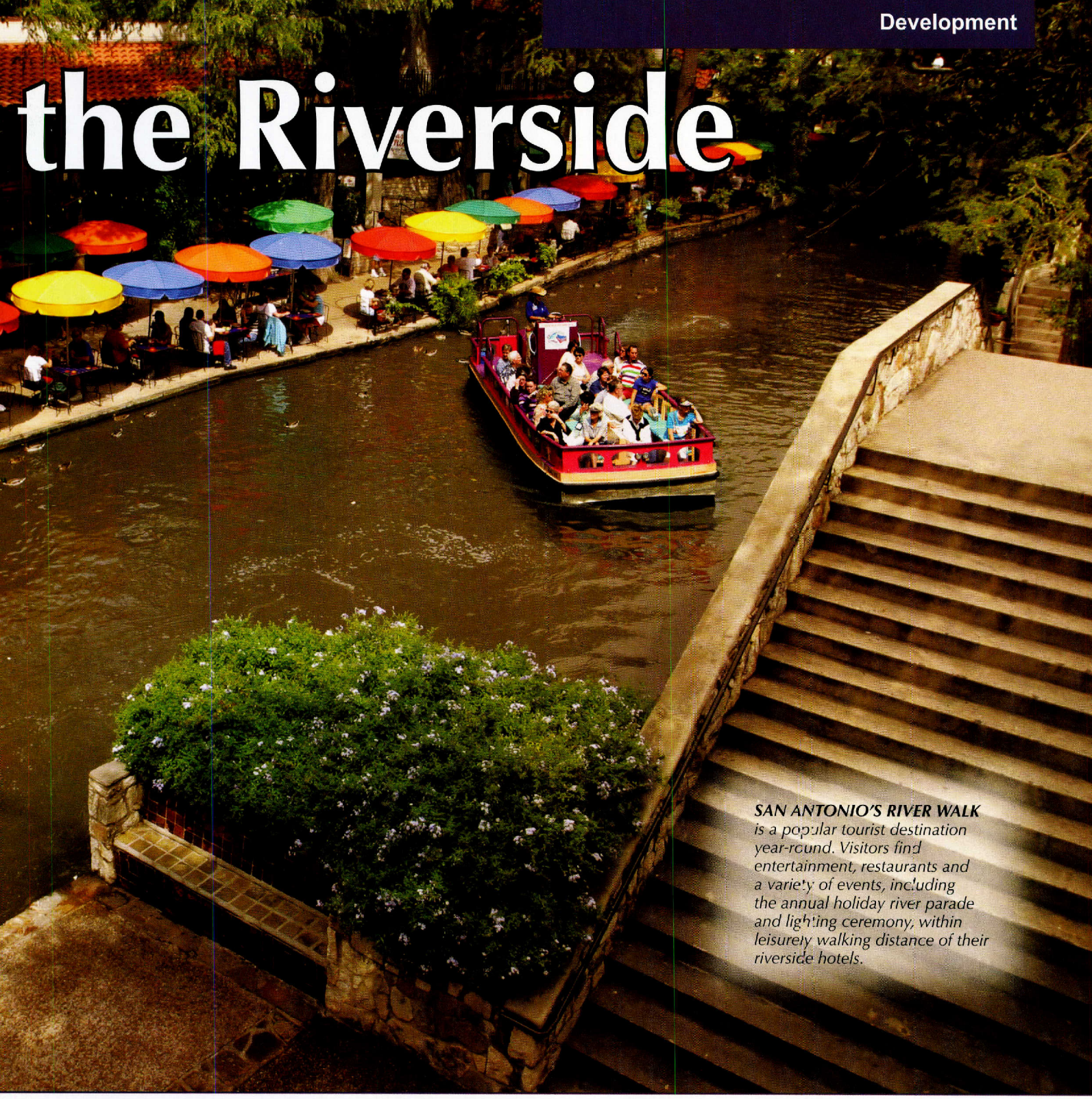
San Antonio has long had a well-developed, vibrant commercial riverfront. Now other Texas cities, including Laredo, El Paso, Fort Worth and Dallas, are looking to capitalize on their own riverfronts by turning them into parklands, entertainment venues and commercial corridors.

Laredo

Located along the Rio Grande River, Laredo already is a major hub for international freight movement between Mexico and the United States. City officials now see the riverfront's potential to serve a dual purpose: to function as an attractive gateway to the United States and to boost economic development in the historic downtown district. With these goals in mind, the city developed the El Portal riverfront project.

The project calls for the city's riverfront to be used for commercial development and public facilities. A key component of the project is a road that will open the riverfront to commercial

the Riverside



SAN ANTONIO'S RIVER WALK *is a popular tourist destination year-round. Visitors find entertainment, restaurants and a variety of events, including the annual holiday river parade and lighting ceremony, within leisurely walking distance of their riverside hotels.*

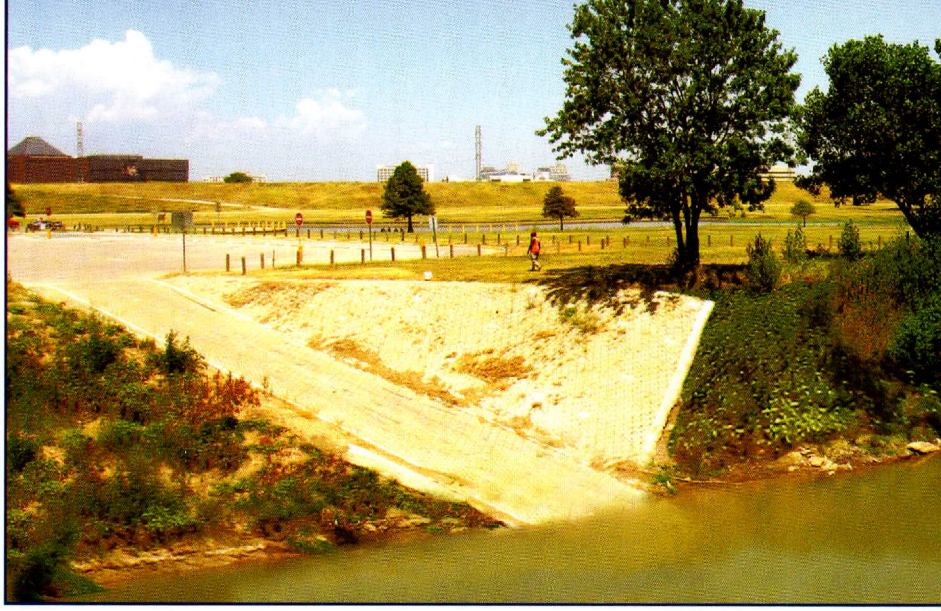
development and tourism. The nearly 26-mile road will run along the Rio Grande from Zacate Creek to Laredo Community College and will connect to I-35.

The proposal also includes a complete redesign of the area around International Bridge No. 1. The development will include a series of plazas, a riverfront promenade, a Water Street pavilion, an outdoor market, retail development and reconstruction of city and federal offices. More pedestrians will be able to cross the bridge after the redesign.

Laredo's officials plan to develop a greenbelt with walking and biking trails, picnic areas, a bird sanctuary and a nature preserve. The northern edge of the park will connect to the Lamar Bruni Vergara Environmental Science Center's Paseo del Indio Nature Trail at Fort McIntosh.

In addition to the city-initiated improvements, the U.S. Army Corps of Engineers conducted a feasibility study to restore wetlands along the river. Currently, the Corps is designing the wetlands restoration project.

The Environmental Protection Agency granted Laredo $200,000 as part of the Brownfields Economic Redevelopment Initiative to clean up contaminated sites along the river. The grant allowed the city to inventory properties along the river and work with current owners, real estate licensees, lending institutions and buyers to educate these groups about the city's brownfields efforts.



The total cost of the El Portal project is estimated at $18 million. The city has been purchasing land along the river from the Laredo Community College to Zacate Creek, south of downtown, to allow for development of parkland and commercial development. The design for phase one of the El Portal project has been approved by the city council.

During the first phase of the project, 140 acres of riverfront property near the bend in the Rio Grande will be developed as nature trails. The border crossing administration building will be demolished and a new building constructed, along with a new parking lot, which will be connected to the bridge via escalators and elevators.

Phase one will also include the introduction of pedestrian smartcards. These allow pedestrians to purchase multiple bridge crossings. Pedestrians insert the card into a machine to open the turnstiles. Currently, 95 percent of pedestrians using the bridge are commuters who go back and forth across the border. This system is expected to help the flow of pedestrian traffic.

El Paso

In El Paso, construction has begun on a 32-mile park along the Rio Grande. The Rio Grande Riverpark will connect existing and proposed significant sites along the historic river corridor through a series of trails, cultural destinations, community parks and historical markers.

Projects to be undertaken include construction of bicycle and pedestrian trails along the river's edge, design of a riverfront municipal park, adaptive reuse of industrial and agricultural buildings along the banks, renovation of abandoned facilities into visitor areas with shops and restaurants and wetland restoration.

Commercial development will be adjacent to the Riverpark's trailheads. Historical and cultural activities are expected to encourage businesses to locate close to the trails. El Paso's designated empowerment zone abuts the river, allowing economic development projects to be linked to other Riverpark amenities, further enhancing the value of zone investments.

A $1 million grant from the Texas Parks and Wildlife Department was matched with $500,000 in local money to fund the trail system in El Paso's Upper Valley. The city also received a $3.5 million grant from the Texas Department of Transportation to fund projects in the Lower Valley from Ascarate Park to the Rio Bosque wetlands project.

The first phase of the five-phase project includes the construction of a ten-kilometer walking and bicycling trail. Construction between the Country Club area and Canutillo began in June 2003 and is scheduled for completion in November 2003.

The second phase will run between Canutillo and the New Mexico state line near Vinton. The area from Ascarate to Rio Bosque in Socorro will be constructed in the third phase and Socorro to Tornillo in the fourth. The first four phases of the project are expected to be finished by 2007. The fifth phase includes the downtown area from Hart's Mill to Ascarate.

Fort Worth

Fort Worth has plans to encourage development along its riverfront. The Trinity River Vision, developed by the Tarrant Regional Water District, calls for the removal of a system of levees installed by the U.S. Army Corps of Engineers in the 1960s.

A FORMER POWER PLANT *site may become a community college campus. The project would be one of many included in the Trinity River Vision developed by the Tarrant Regional Water District.*

A BOAT LAUNCH *at Sylvan Avenue was constructed under the parks portion of the $1 billion Trinity River Corridor Project in Dallas. More than 6,000 acres along 20 miles of the river will be included in the project.*

The result will be a lake along an 850-acre area from Seventh Street to the stockyards. The new waterfront will include commercial, entertainment, retail and high-end residential development. The project is expected to generate 9.6 million square feet of new property for development.

Phase one will create a mile of urban waterfront between Main and Seventh streets and could be finished in five years, according to James Oliver, general manager of the Tarrant Regional Water District. A number of different projects have been proposed. Pier 1 Imports and Radio Shack plan to build new corporate campuses along the river. A 1,500-unit residential development is proposed in the Samuels Avenue neighborhood. Tarrant County College is considering purchasing the TXU power plant on the bank of the river at North Main Street for a new downtown campus.

Recreational uses are also planned. A canoe run will be opened in Trinity Park in late 2003 to test interest in water enhancements.

The Corps of Engineers is conducting a feasibility study and environmental impact review that is expected to be completed in spring 2005.

The Trinity River Vision project could total $285 million. According to Oliver, this total would include $250 million for construction of a 50-acre lake, including demolishing current levees and building a bypass channel to carry floodwaters. Riverfront development would cost about $15 million and dam improvements to raise the river's water level would add an additional $20 million to the project's total cost.

There has been substantial public support for the development of the lake and riverfront areas. The result is expected to be an active office, retail and entertainment corridor between downtown and the stockyards.

Dallas

Dallas has had plans to redevelop the Trinity River area for more than 30 years. The Trinity River Corridor Project is a $1 billion project that will encompass more than 6,000 acres along 20 miles of the Trinity River. The six-year plan calls for improvements to the city's floodway, along with retail, entertainment and residential areas. In 1998, Dallas voters approved a bond program that allocated $246 million to the Trinity River Corridor Project.

Flood prevention is the primary goal of the project, with commercial revitalization running second. The Dallas floodway extension will be a system of wetlands and protective levees to reduce the risk of flooding. This part of the project will convert previously flood-prone areas into properties suitable for development. Once the floodway extension is completed, the area along the river will be made available for commercial development.

The $92 million parks portion of the project is moving forward. A boat launch giving recreational access to the river at Sylvan Avenue was completed in January 2002. Construction on a second boat launch and two nature trails began during the summer of 2003.

Laredo, El Paso, Fort Worth and Dallas hope to lure visitors to riverfront areas with parklands, office, retail and entertainment development.

Other parts of the project — a downtown lake, equestrian center and an interpretive center — are being designed. The city is working to acquire 2,700 acres along the river to expand the Great Trinity Forest. Construction on the equestrian center, which will be located in the Great Trinity Forest, is expected to begin in 2006. Construction of a northern gateway to the forest, planned for the vicinity of Moore Park, is expected to begin in late 2003.

In addition to the recreational aspects of the development, a new Woodall Rodgers Bridge has been designed. The new bridge will extend the Woodall Rodgers Freeway over the Trinity River, connecting downtown Dallas with Oak Cliff. The bridge is expected to ease traffic congestion into and out of the downtown area.

In Laredo, Fort Worth and Dallas, the Corps of Engineers has been heavily involved in evaluating the feasibility of riverfront development. The cooperation of the Corps, along with significant public investment by the cities, may well result in revitalized commercial corridors along riverfronts across the state.

Dr. Cowley (cowley.11@osu.edu) is an assistant professor with the Austin E. Knowlton School of Architecture at Ohio State University.

Biotechnicalities

Challenges of Developing Life Science Space

By Harold D. Hunt

The biotechnology industry, like most U.S. industries, is feeling the pinch of hard economic times. Biotech investment capital remains tight. Venture funding in 2003 is down compared to the boom times of three to four years ago. Institutional investors have been hesitant to invest in the life sciences as well, although the sector is perceived more positively this year.

Most new biotech investment has focused on opposite ends of the drug discovery process: promising new ideas and drugs with a proven record of clinical trial successes in the late stages of development.

An Ernst & Young study reported that the market capitalization of all U.S. biotech companies fell from $353 million at year-end 2000 to $226 million by year-end 2002 as a result of restricted capital flows. Only 24 biotech drugs made it through the regulatory approval process in 2002.

Both biotech landlords and tenants are increasingly looking to cities to help facilitate the development process. For example, cities can streamline their building code process and revamp building codes to recognize the unique characteristics of biotech space. Some cities have been offering extraordinary financial incentives to biotech companies to attract more tenants.

The low end of the range for tenant improvement (TI) allowances in biotech space is currently about $100 per square foot. This is high compared with other commercial real estate sectors such as office property. To retain existing biotech tenants and attract creditworthy new ones, some landlords have begun to offer even larger TI allowances.

Understanding what biotech companies actually do is extremely difficult for many property owners. Malcolm O'Donnell, CarrAmerica Realty's managing director for Southern California, believes landlords should focus on the quality of a company's management and "burn rate" — how fast the company spends its venture capital — rather than concentrating too much on understanding the science.

"Balance sheet strength continues to be an extremely important factor in evaluating biotech firms," says O'Donnell.

More than 40 biotech industry specialists addressed the 2003 annual meeting of the Building Owners' and Tenants' Summit on Biotech, Medical & Pharmaceutical Lab Facilities in San Francisco. Sponsored by New York-based Information Management Network, the program covered a wide range of biotech facility issues. Those of interest to real estate professionals are summarized here.

Developing Start-Up, Incubation Space

Landlords of start-up biotech properties must be ready to assume significant risk. The biggest challenge in developing start-up or incubation space is providing the most flexible space at the lowest cost. Increasing a property's flexibility for future expansion or retrofit usually increases development costs.

Landlords typically front most start-up space costs. If a life science start-up firm succeeds, landlords can recoup the initial outlay as the tenant requires more and better space in the future.

Purchasing existing labs that require a minimum amount of retrofitting is one way to develop affordable incubator space. Another promising initiative is development of "condo" incubator spaces within a building, each of which can be purchased by investors.

Other options being considered by landlords include public-private partnerships designed to share the financial risk. Assessing a flat fee for each scientist occupying incubator space ($3,000 per person per month, for example) is another possibility.

Managing tenant relationships requires a great deal of skill on the part of landlords, according to Geoffrey Sears, a partner with California-based Wareham Development. Developing small incubator spaces for short-term lessees that often have little or no credit can require a host of complex tenant agreements.

Activity Outside Major Markets

The bulk of biotech activity remains clustered around the metro areas of San Francisco, San Diego, Boston and Raleigh-Durham. The cream of the scientific crop often chooses to locate in these high-cost areas because they can afford to do so

(continued on page 11)

RESEARCH SPACE *configured and finished out for one client may require extensive, costly retrofitting for the next life science tenant.*

Accommodating Research

The Torrey Pines section of San Diego is the country's fourth largest region for biomedical research and technology. The presence of institutions like the Scripps Clinic and Research Foundation, the Salk Institute and the University of California–San Diego makes the area an ideal location for office and research space users.

"About ten million square feet in metropolitan San Diego is classified as biotech space," says Malcolm O'Donnell, CarrAmerica Realty's managing director for Southern California. CarrAmerica is a real estate investment trust with 24 million square feet of net rentable space in 12 U.S. markets.

Biotech space makes up only about 3 percent of CarrAmerica's portfolio, but the returns are generally superior to other commercial property types. The expected unleveraged internal rate of return for biotech developments is about 2 percent higher than ordinary office projects, according to O'Donnell.

Among its 500,000 square feet of research space holdings in the San Diego area is the La Jolla Spectrum Technology Park in La Jolla, Calif. The property consists of nearly 157,000 square feet of office and lab space in two buildings.

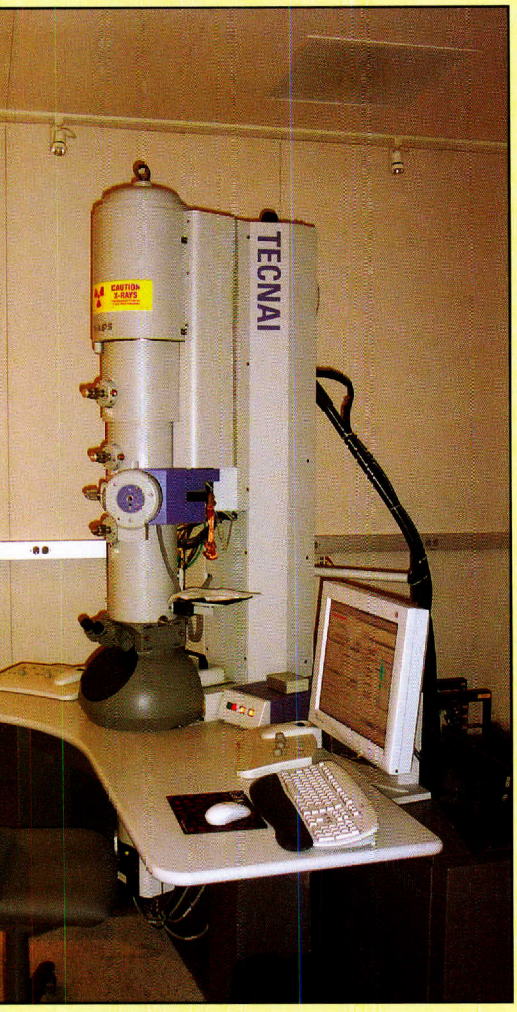
Tenants include Novartis Agricultural Discovery Institute, with 45,000 square feet of biology-chemistry lab space, specialized growth chamber facilities and 5,000 square feet of research greenhouse. Scripps Research Institute occupies 77,000 square feet, including biology-chemistry and microscopy lab facilities. The largest electron microscope lab in the United States, currently being used to conduct advanced cancer research, is housed here.

Although these are extremely specialized properties, they were created with future flexibility in mind. If Novartis or Scripps should choose to leave after their leases expire, a new tenant's scientific needs would probably require some modification of the space configuration and finish-out.

"What are the odds that the next tenant will need a research greenhouse or an electron microscope lab?" asks Patrick Russell, vice-president of CarrAmerica Development, Inc., in San Diego. "Even in more generic biotech space, when landlords invest $100 per square foot in tenant improvements in a building, they are really gambling on the company staying in business," states Russell.

Specialized finish-out required by the La Jolla development's tenants include rooms that must be kept below 18 percent humidity, static-dissipating

CARRAMERICA'S LA JOLLA SPECTRUM TECHNOLOGY PARK *(left) is home to high-profile tenants including Scripps Research Institute. Scripps projects include cancer research conducted in the largest electron microscope lab in the United States (below).*



flooring and "duct-socks" used to diffuse airflow. The building had to be tested for electromagnetic currents that could be detrimental to operation of electron microscopes.

Scripps also requested that exposed ceilings be included in all research lab areas. Constructing the ceiling above the utilities was a big up-front cost; however, it makes maintenance or utilities changes easier.

The same desire for flexibility carried through to the lab furniture. C-frame lab casework attached to rails rather than mounted permanently is initially more expensive but easier to reconfigure than fixed casework.

Heating, ventilation and air conditioning (HVAC) is a major concern. Most biotech labs require 100 percent outside-air HVAC systems that allow no recirculation of conditioned air. Positive HVAC pressure is used in office spaces to ensure that potentially dangerous gases from lab space are controlled.

If tenant space will not be fully occupied at completion, the phasing of improvement construction must be well thought out. "You need to think about exactly what should be phased," Russell states. "Coordination with the tenant's planned configuration is extremely important to save both time and cost. If you install the sprinkler system during initial construction without regard for tenant space needs, it has to be removed and reconfigured when the tenant comes in."

Ken Kristofek, vice-president and director of development of CarrAmerica Development, Inc., in Dallas, offers another recommendation. "Planning a generous service yard is extremely important," he says. "The amount of mechanical equipment needed in a biotech building can be overwhelming."

Utility capacity must be considered during initial development. "Unusual utility requirements — sufficient steam capacity to sterilize glassware, for example — must be carefully considered. Adding this type of capacity later can be very costly," says Kevin Thompson, project manager for DPR Construction. Electrical power is another important consideration.

"The rule-of-thumb for electrical capacity in biotech space is roughly twice what standard office space requires," Kristofek says.

Development costs for biotech space are typically two to three times higher than for standard office space. According to Kristofek, "Typical development costs for an 80,000-square-foot life science chemistry-biology lab would include $120 per gross square foot cold shell cost, $100 per square foot tenant improvement allowance and an additional tenant contribution of $120 per square foot. Rent term is typically ten years with two five-year options."

(continued from page 9)

and are willing to pay for a high quality of life. If external factors such as increased traffic congestion or a rapidly rising cost of living begin to erode quality of life, lower-tier markets may become the beneficiaries, assuming the technical workforce is available.

Doug Kornich, managing director of Bioscience Capital Consulting, believes that about one million square feet of life science space will be built in secondary and tertiary U.S. markets during the next two years. Kornich notes that three states — North Carolina, Maryland and Texas — have become especially aggressive in creating technical training programs in the life science field.

Acquisitions, Dispositions

Parties considering the purchase of life science properties often encounter serious barriers. Biotech property buyers tend to be either local professionals who know the market well or national investors that have the time and resources to seek out choice properties.

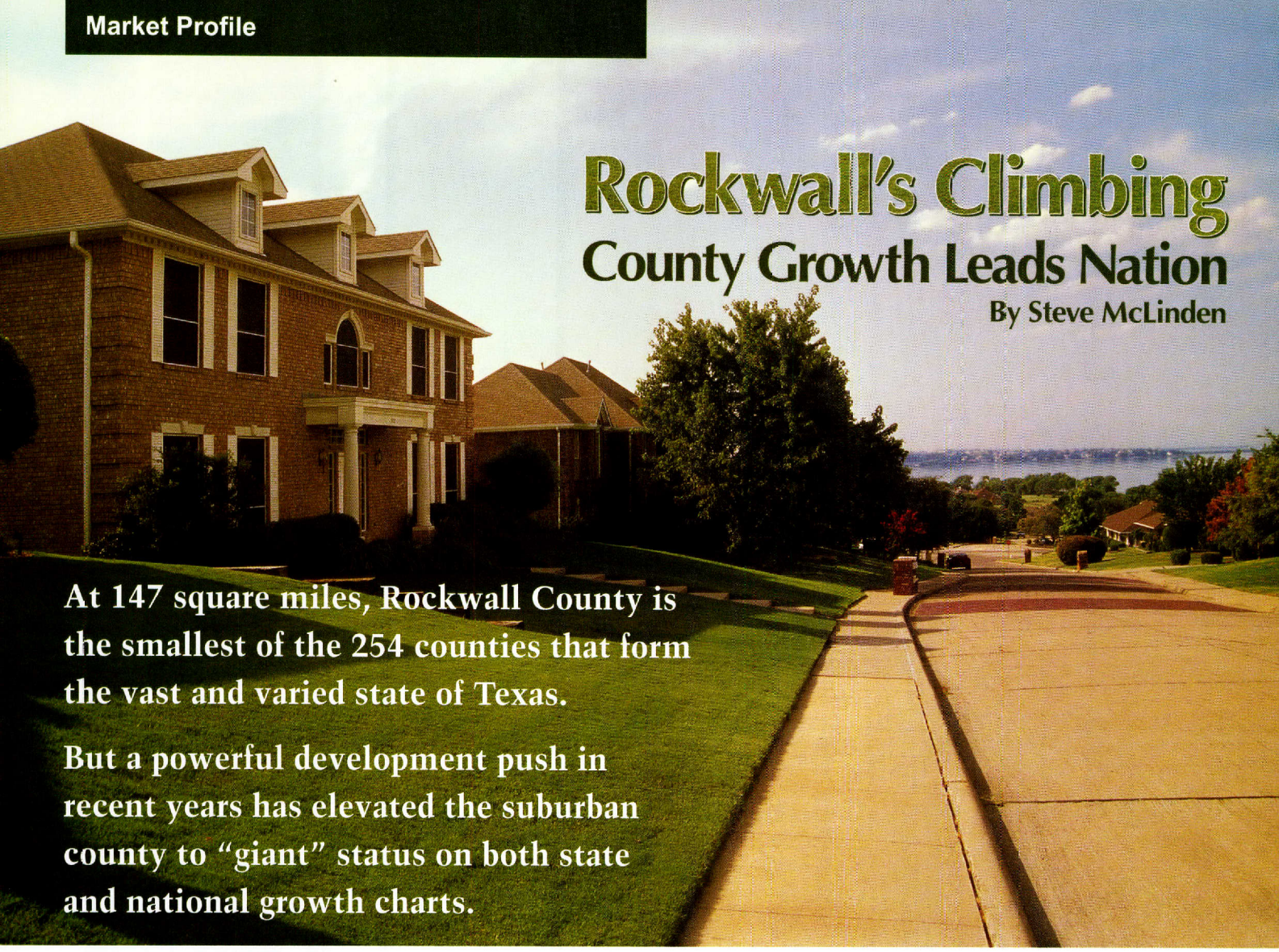
Capital investment in biotech space has begun to focus on either well-located, quality properties or bargains. Few investors are willing to move up the risk scale just to attract higher yields, according to Gary Willard, managing partner for the West Coast brokerage firm BT Commercial.

Only the highest quality biotech properties are trading at capitalization rates similar to the rest of the commercial real estate market. Historically, biotech cap rates have been averaging 10 to 15 percent to offset the attendant risks of biotech investment. John Bergschneider of Slough Estates USA, Inc., believes that biotech properties with high-credit tenants and long leases could trade at cap rates as low as 8.5 to 9 percent.

Bergschneider stresses that biotech deals are often much more complicated than typical commercial property transactions, requiring more than just a cap rate calculation. Life science property buyers often make investment decisions more on internal rates of return than capitalization rates.

Richard Robbins, president of Wareham Development, sums up the general consensus from the biotech summit. "Although life sciences won't be an economic savior," he says, "it will become an important sector for many cities."

Dr. Hunt (hhunt@recenter.tamu.edu) is an associate research scientist with the Real Estate Center at Texas A&M University.



Rockwall's Climbing
County Growth Leads Nation

By Steve McLinden

At 147 square miles, Rockwall County is the smallest of the 254 counties that form the vast and varied state of Texas.

But a powerful development push in recent years has elevated the suburban county to "giant" status on both state and national growth charts.

In a one-year span ending July 1, 2002, Rockwall County led all U.S. counties with a 7.9 percent population growth rate, more than seven times the national average of 1.1 percent, according to the Census Bureau. The county ranked fourth in the United States in the same category the previous year.

County by the Lake

Rockwall County has flourished in grand fashion, decades after many neighboring population centers in North Texas were racked by acute growing pains. Its growth is buoyed by the popular Lake Ray Hubbard and by the relatively painless commute residents take down I-30 to nearby Dallas.

Two large mixed-use "power" centers, replete with trees and other flora, manicured green spaces and tasteful facades, have taken root in recent years in the City of Rockwall, 22 miles east of Dallas. Their offerings range from Lowe's Home Improvement Center to Pier 1 Imports, to OfficeMax, Starbucks and Petco.

Large grocery chains, a host of new service businesses and a mix of national chain restaurants including On the Border, Saltgrass and Chili's have sprung up, as have many independents, several of which offer live music and lakeside dining.

"A lot of people who live in areas east of the City of Rockwall are now stocking up here and dining here, instead of driving to Dallas," says Bob Wieneke, president of Rockwall County's Chamber of Commerce.

The spate of new development is serving the needs of a county population that has grown from about 29,200 in 1992 to nearly 50,860 in 2002, according to U.S. Census data.

The fast-filling Rockwall Technology Park, home to a Pilgrim's Pride data center, GE Digital Energy and others, is getting several new tenants this year. These add to an older industrial component and help diversify the city's swelling tax base.

Wieneke sees parallels between construction in the Rockwall area and that in the San Jose area of California. Rockwall is starting to attract similar clean, higher-tech industries. The city's well-groomed appearance and broad selection of housing, including enough high-end homes to attract corporate executives, make it appealing to such industries.

By any measure, area demographics are tough to beat. The 2002 median family household income in the City of Rockwall was almost $70,000, while the median owner-occupied home was valued at $134,300, according to the city.

Rock-Solid Foundation

Rockwall County got its name following a water well dig in 1851, when settlers unearthed an underground rock-wall system they thought was man made. Geologists thought otherwise, believing the wall was the result of sand dikes that formed along the Balcones Fault line. Today, parts of the wall can be seen jutting above ground at some points.

The county had no large, navigable body of water until the East Fork of the Trinity River, which runs north to south on the western fringe of the county, was dammed to form Lake Ray Hubbard in the 1960s. The lake covers more than 13 percent of Rockwall County. It supplies water for Dallas and sparkling vistas for residents of Rockwall and neighboring Heath. According to Rockwall city officials, the lake once formed a natural barrier that kept growth and traffic at bay. This helped the county evolve at its own pace.

In 1960, there were actually fewer residents (5,870) living in Rockwall County than 70 years earlier in 1890 (5,970). Area historians attribute this to wars and shifting labor forces.

"In the not-too-distant past, the county was all cotton and cattle," Wieneke says. "As recently as 15 years ago, if you wanted anything other than bread and milk, you had to drive across the lake for it."

That has changed. From 2001 through 2002, the county added 7,800 residents, according to the Census Bureau. Meanwhile, the City of Rockwall has grown to about 20,000 and is expected to reach 53,000 by 2030.

Royce City, which grew 34 percent in that span, has just over 3,000 residents in 2003, while Fate recently topped the 1,000 mark. Mobile City and McLendon-Chisolm have fewer than 1,000 residents each.

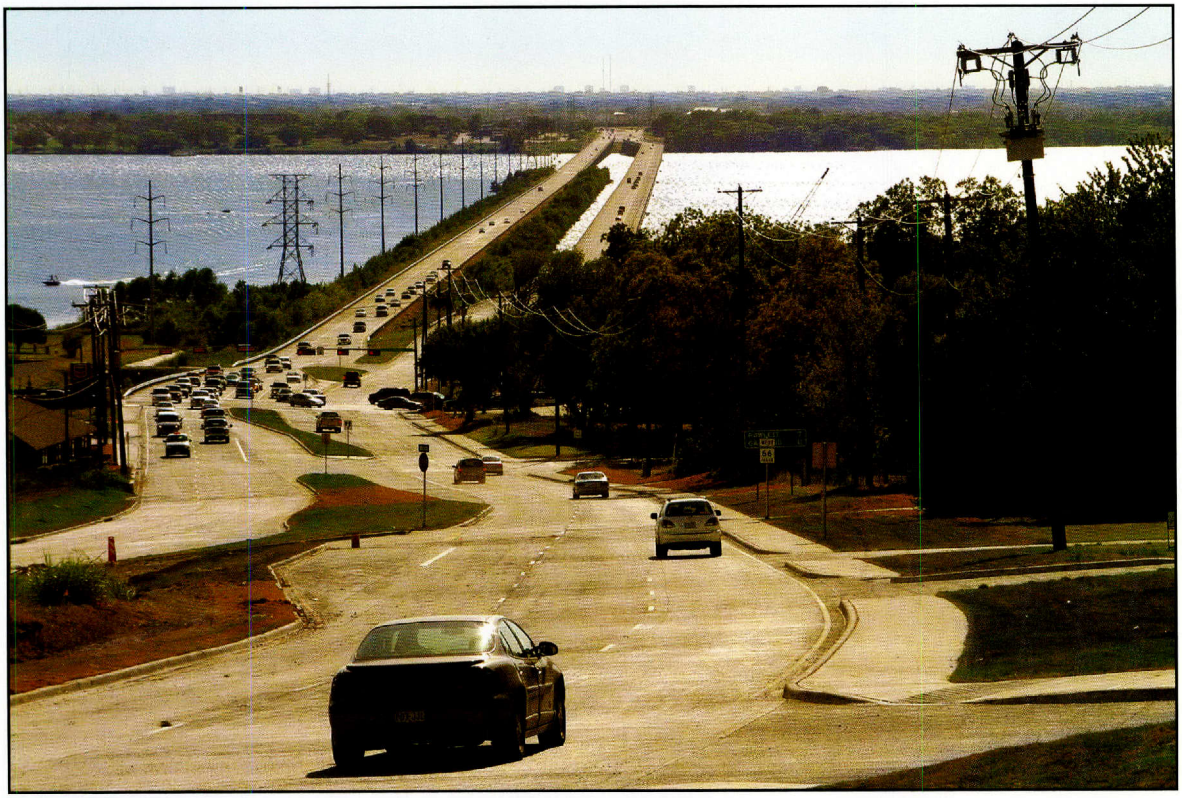
New County Economy

Although best known in residential circles for its sprawling lake homes, Rockwall County offers a selection of other housing and lifestyle choices, according to Lance Holland, owner of Regal Realtors. "Properties range from gated communities to waterfront lots to zero lot-line homes to horse farms," he says.

Most newer homes in Rockwall County range from $170,000 to $200,000, although a scattered few hover around $1 million.

"But if you're looking in the $200,000 to $300,000 range, you're going to have about 40 choices at any given time," says Holland.

Fate, in north central Rockwall County, rapidly grew from 500 residents in 2000 to about 1,100 currently, according to Gary Boren, city administrator. The town is in the process of kicking off a Texas-sized residential project. Woodcreek will be one of the largest planned developments in the state, with 1,445 acres being rezoned from agricultural to residential use.



UPPER-END HOUSING *in view of Lake Ray Hubbard (facing page) is plentiful in Rockwall County, but castles for those with more moderate incomes can be found as well. Widening of the Hwy. 66 bridge over the lake (left) is just one testament to the county's tremendous growth.*

Because Rockwall County was largely insulated from the frenetic North Texas growth binges of the 1970s and 1980s, officials had the luxury of learning from other area cities. Some suffer from an imbalance of small homes that do not produce enough tax revenue to support the city services and streets their owners need.

"We had the great benefit of seeing what worked well and what didn't," says Gary Martin, vice president of the Rockwall Economic Development Corp.'s board of directors.

Rockwall County, which is sandwiched between Hunt, Collin and Dallas counties, is also home to the smaller burgs of Fate, McLendon-Chisolm, Mobile City and Royce City.

Heath, which abuts the lake, grew 96 percent from 1990 to 2000, from 2,100 to 4,100 residents, according to the North Central Texas Council of Governments (NCTCOG).

Noted Texas investor Lamar Hunt bought most of the property in the 1970s and has parceled it off in recent years, Boren says. ERD/Fate Development Corp. and Provident Realty are spearheading the development. Fate, in which many new homes sell for around $180,000, is platting 1,218 homes in Woodcreek.

"The real growth is yet to come," remarks Boren. "It's going to be wild out here."

In Heath, lake frontage "is pretty well developed out, except for a few strips," says George Costan, the city's public works supervisor. "With the exception of some sites around Buffalo Creek Golf Course, all we have left is acreage through the middle of town that is zoned for agriculture."

Growing Smartly

Rockwall County has garnered national attention since its high-growth honor was announced in the spring. Recently, the City of Rockwall enacted a few "smart-growth" measures to keep development in check. In June, the Rockwall City Council amended the city's noise ordinance to prohibit construction on Sunday and to limit it on weekdays and Saturday. And at press time, a moratorium on rezoning agricultural land in Rockwall for other uses remained in effect.

At build-out, Rockwall County could total about 200,000 residents, county officials say. NCTCOG estimates the county population will grow to about 145,000 by 2030. The cities are trying to stay a step ahead to prevent strain on basic services such as schools and roads.

Officials are working hard to stay a step ahead of growth to prevent strain on basic services such as schools and roads. The county's population is predicted to grow to 145,000 by 2030.

Heath, which Costan says is a whopping 99 percent residential, plans a $40 million high school that will be shared with the City of Rockwall. The Rockwall Independent School District has acquired land on the north side of town for a third local high school. Two more will eventually be needed in the district, which includes most of Rockwall County, Wieneke says.

Two major road projects that will help carry traffic more efficiently through the county's population centers were recently completed. The Highway 66 bridge, the only alternative to the I-30 bridge across Lake Ray Hubbard to Rockwall County, has been expanded from one to three lanes each way. Just north of I-30, the bridge serves as a crucial detour route in the event that the interstate bridge is closed. Ridge Road, a major north-south artery through the county, has been improved and widened also.

Local voters opted out of extending the George Bush Turnpike through Rockwall County from the northern part of the Metroplex. It will run through neighboring Rowlett instead, providing a more streamlined connection with North Dallas, says Wieneke.

The city's high-tech, 223-acre Rockwall Technology Park, at Hwy. 276 and FM 549, has ample room for expansion. Lots range from three to 60 acres and are priced at 75 cents to $1.75 per square foot, according to the Rockwall Economic Development Corp. EZ-FLO International and Col Met, Inc., will open there later this year.

Walton Gilpin, president of one of the center's current tenants, GE Digital Energy, calls the Rockwall area "a good place to do business, with a lot of positive, evolving growth." Gilpin cites "good incentives," a lack of traffic problems and the park's well-maintained roads as drawing points.

Coming Down the Pike

Rockwall County officials are turning cartwheels over The Harbor, a planned lakefront entertainment venue that is expected to feature a 160-room hotel, 12-screen theater, a light-

THE OLD TOWN SQUARE *in the City of Rockwall with its shops and galleries (left) is key to a community culture that attracts clean, high-tech industries. The Rockwall Technology Park (below) is home to systems engineering firm ComCept., Inc. (bottom).*

house, a kids' "spray park" with numerous fountains and an area for outdoor concerts. Ground is expected to be broken on the 33-acre complex south of I-30 next year, with completion expected in early 2006.

Area residents place a high priority on recreational and cultural pursuits. The City of Rockwall has three golf courses, four marinas, three public boat ramps, two yacht clubs and cohosts Dallas Raceweek, a nationally known regatta, each summer.

A 10,000-square-foot lakeside Larry North Fitness Club opened in Rockwall Harbor Phase II in June. Exercise and diet guru North says the club is the most attractive he has built, with "great views of the lake and decor that blends New York hip and Miami chic."

Corey Duhon, leasing agent for a new speculative strip center under construction on I-30 next to Rockwall's water tower, says the area "has good population density and good income." His firm, Shafer Property Co., leased all the outparcels to the successful Wal-Mart Supercenter on I-30 to businesses such as Car Toys and Mattress Giant. Shafer's planned 16,000-square-foot center, which will be inhabited by Bank One and several service businesses, was almost fully leased before ground was broken, he said.

"It's a great community," Duhon says. "And the interstate itself is like having a billboard for your business."

Area arts offerings include the Rockwall Community Playhouse, the Hubbard Chamber Music Series, a movie complex and arts festivals. Quaint antique shops and galleries can be found near the old town square in central Rockwall, where a $2.5 million refurbishment of the town's historic courthouse now serves as a centerpiece. A new city hall sits a few blocks away on Goliad Street.

"We are trying to preserve our culture and our old downtown, plus we are trying to create other urban-style environments that are more like villages, with more walkability," said Robert Lacroix, director of community development for the City of Rockwall.

"Rockwall does not want to be labeled a bedroom community," Lacroix states. "It wants to be distinctive, self-sufficient and independent."

McLinden (skmscribe@yahoo.com) is a freelance journalist specializing in Metroplex business.

Rockwall County by the Numbers

Single-Family Building Permits

Year	Dwelling Units	Average Value per Unit
1992	167	$129,300
1993	206	141,600
1994	251	150,200
1995	247	172,800
1996	410	158,800
1997	391	154,600
1998	495	169,200
1999	761	165,900
2000	955	194,400
2001	1,267	171,000
2002	1,224	171,000

Sources: U.S. Bureau of Census and Real Estate Center at Texas A&M University

Employment

Year	Employment Total	Employment Percent Change From One Year Ago	Unemployment Rate
1992	15,329	5.7	5.0
1993	16,010	4.4	4.0
1994	17,121	6.9	3.3
1995	17,930	4.7	3.2
1996	18,768	4.7	2.8
1997	19,766	5.3	2.7
1998	20,826	5.4	2.1
1999	22,181	6.5	2.1
2000	23,548	6.2	2.0
2001	25,147	6.8	3.4
2002	24,700	-1.8	5.4

Sources: U.S. Bureau of Census and Real Estate Center at Texas A&M University

Valuing Business Intangibles

By Charles E. Gilliland

When Texans voted to exempt intangible personal property from ad valorem taxes, they were no doubt thinking of stocks, bonds and bank accounts.

That exemption has resulted in controversy and legal confrontations for some businesses as appraisers have begun to place a value on entrepreneurial expertise, innovation and strong leadership in successful business operations. Appraisers must now discern how much of a firm's operating success originates from its tangible assets, such as real property and personal property, and how much stems from intangible assets.

Determining a firm's value by capitalizing the entire income generated at a particular site captures both the contribution of the physical assets and the intangible influence of the unique business model that generated the income. The total of these two is the *going-concern value* and includes business enterprise value of both identifiable and nonidentifiable intangible assets.

Without a strong business model, a firm's tangible property could not achieve a superior profit. Determining the value of properties owned by large, complex businesses with multiple sites is particularly complicated as it requires differentiation between the physical and nonphysical assets contributing to value.

Business enterprise value expresses a judgment of the worth of the business model of an operating firm. That judgment includes the benefits from current and foreseen employment of the assets bound up in that business. Because the organization's revenue stream is produced from operation of the model, an appraisal focused on income-generating capacity ensures that the resulting valuation includes both tangible and intangible asset values. In essence, such an analysis renders an evaluation of the organization — the physical assets, identifiable intangible assets and the business model — and not the value of its physical and identifiable intangible assets on the open market.

Business Model Contributes to Value

When the business model that creates the business enterprise value becomes the focus of an appraisal analysis, the results provide a measure of the tangible assets' unique worth to a particular configuration only, known as *value-in-use*. Only when a large number of competitors with similar competing business models vie for the same set of tangible assets — buildings, equipment and machinery, for example — does the business enterprise value converge to a *value-in-exchange* that corresponds to market value in appraisal.

When that level of competition is present, an appraiser can safely argue that the so-called intangible elements of the business have enhanced the value of the tangible items and, therefore, have become part of the tangible asset value. In these circumstances appraisers should find sufficient numbers of arms-length transactions to avoid total reliance on the income approach to value.

Consider the case of a firm operating two chains of oil terminals — one stretching from the Gulf Coast to Memphis and

the other from Ohio to the Atlantic. Suppose the firm acquires a number of take-or-pay contracts along with its acquisitions in assembling these chains. The firm then buys three terminals linking the Atlantic chain with the Gulf coast chain. This enables it to move oil from the Gulf coast into the international market in New York, reducing costs and increasing profit.

Prices paid for the three terminals exceeded established market norms. Why? Because those terminals completed a structure envisioned by the business model and gave the firm a stronger position in the petroleum market. The firm paid more than market value to acquire the last pieces of their network. The excessive price reflects the value of those last terminals to that particular business enterprise, not their value on the open market.

If a superior business plan produces an enlarged income stream and creates value above costs, an inferior plan does the opposite. A deficient business plan can cause the value of the organization to fall short of the aggregate value of its assets on the open market. In these cases, gains follow from dissolution of the business and subsequent sale of the assets to more efficient producers. The wave of takeovers in the 1980s that saw corporate raiders plunder vulnerable companies signaled a paucity of business enterprise value in the targeted firms.

Challenge of Estimating Enterprise Value

Companies spend significant energy every year debating tax appraisers over the value of real estate and tangible personal property owned. The Appraisal Standards Board developed Standard 9 of the Uniform Standards of Professional Appraisal Practice (USPAP) to address assignments involving business enterprise value. At the same time, practitioners struggled to develop a methodology for producing credible estimates.

Because there is no ultimate market test of estimated business enterprise value, appraisals of intangible elements of operating businesses remain fraught with controversy. Market developments can erase business enterprise value, and, therefore, many question its presence for specific firms. Questions remain regarding both the existence of identifiable intangibles and acceptable methods of appraising them.

Toward an Appraisal Theory

In the January 2002 issue of *The Appraisal Journal*, Wolverton et al. offer a lexicon (see "Appraisal Lexicon") designed to guide appraisal applications in segregating the value of intangibles from tangible assets. The model to establish the separate value of each business component requires estimating the following (real property value is determined as a residual in this model):

value of total assets of the business
- furnishings, fixtures and equipment value (FF&E)
- cash and equivalents value
- skilled workforce value
- name, reputation, affiliation value
- residual intangible assets value

= real property value as a residual

Economic profit consists of the excess of revenues above opportunity costs of inputs used to produce those revenues. Economic profit continues each year as long as a firm has this economic advantage over potential competitors. When others replicate the production process, the advantage disappears as output prices drop and input costs rise.

Because of the ephemeral nature of business, economic profit unavoidably expands or contracts. Capitalized economic profit is the discounted present value of a firm's economic advantage. Therefore, capitalized economic profit (CEP) may exist at one date only to vanish as market conditions create new realities that extinguish economic advantage. The fleeting character of economic profit makes it the most contentious component of business enterprise valuations.

Current Appraisal Institute Thinking

Before reaching the final estimate of business enterprise value embodied in the residual intangible assets, an appraiser must deal with the issue of values accruing to the list of identifiable intangible assets (see figure p. 18). The Appraisal Institute holds

Appraisal Lexicon

Going concern — an established and operating business having an indefinite future life.*

The going concern concept recognizes the contribution of the business and the systems developed to implement it. It acknowledges the transitory nature of the advantages garnered by that business by specifying an indefinite future period of operation.

Market value of the total assets of the business — value of all tangible and intangible assets of a business as if sold in aggregate as a going concern.*

This concept embodies an estimate of the value of the temporary advantage accruing to the business because it possesses a unique set of assets organized by a superior business model.

Total intangible assets — all of the intangible assets owned by a business (going concern).*

These assets represent the value the business model creates beyond the market value of the assembled tangible assets.

Identified intangible assets — Those intangible assets of a business (going concern) that have been separately identified and valued in an appraisal.*

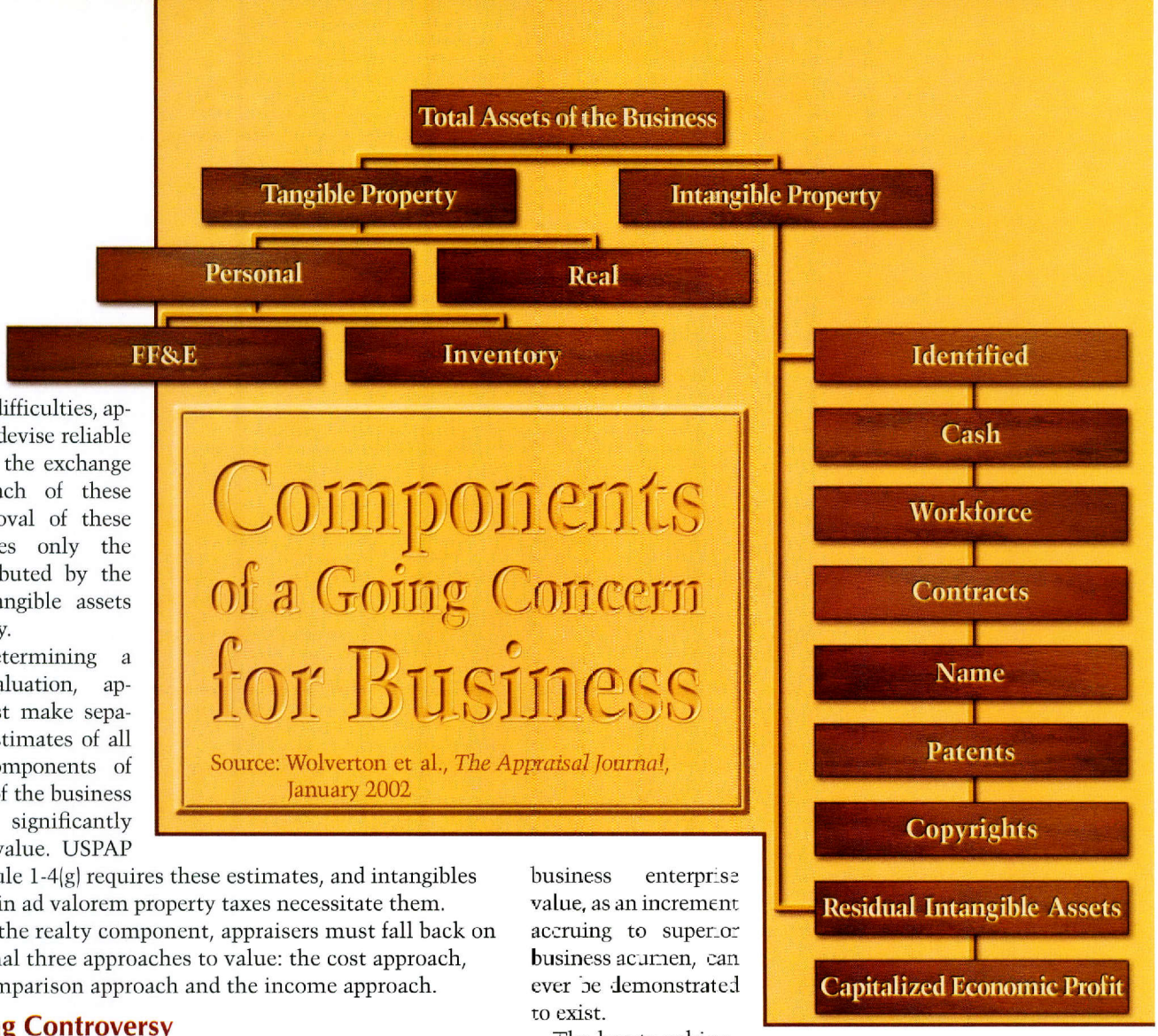
These assets represent advantages enjoyed by the firm with respect to potential competitors. An assembled, skilled workforce that enables a business to respond more quickly and expertly in the product market than its potential competitors is an example of this kind of asset.

Residual intangible assets — those intangible assets of a business (going concern) that have not been separately identified and valued in an appraisal. The value of residual intangible assets equals the value of total intangible assets minus the value of identified intangible assets.*

This residual represents the value of the contribution of the business plan after compensating for all other assets including identifiable intangible assets. This residual exists because the business has gained an advantage over potential competitors that allows the business to retain the economic profit. In accounting, these influences are frequently labeled goodwill.

Capitalized economic profit — the present worth of an entrepreneur's economic (pure) profit expectation from being engaged in the activity of acquiring an asset, or collection of assets, at a known price and then selling, or being able to sell, the same asset or collection of assets at a future uncertain price.*

*Source: Wolverton et al., *The Appraisal Journal*, Jan. 2002



that despite difficulties, appraisers can devise reliable estimates of the exchange value of each of these items. Removal of these values leaves only the value contributed by the residual intangible assets and the realty.

When determining a business valuation, appraisers must make separate value estimates of all of these components of total assets of the business when they significantly affect that value. USPAP Standards Rule 1-4(g) requires these estimates, and intangibles exemptions in ad valorem property taxes necessitate them.

To derive the realty component, appraisers must fall back on the traditional three approaches to value: the cost approach, the sales comparison approach and the income approach.

Continuing Controversy

Notwithstanding the Appraisal Institute's pronouncements, appraisers continue to argue against the existence of separable intangible values. They particularly criticize the idea of residual intangible value.

Noting the influence of intangible elements on residential property — superior views and neighborhood cachet, for example — some argue that the intangible elements enhance the values of the tangible commercial assets. The residual intangible value that one appraiser sees appears to another as a locational premium accruing to the real estate. One appraiser may estimate a substantial business enterprise value addition to a specific hotel building because it is affiliated with a nationally prominent chain. Another may argue that the hotel's location creates its highly profitable revenue stream.

Recall the source of intangible value: that increment to income that exists because of the superior aspects of the business model guiding property management. The brains behind the operation count for more than the bricks and mortar. If competition from competing enterprises emerges in sufficient quantities that the surplus above cost has vanished in a cost squeeze, the intangible value has vanished. To sustain the residual intangible value, the operator must continue to enjoy advantages that competitors cannot duplicate.

Opponents of the CEP concept frequently assert that the residual intangible value cannot exist as property until it can be separated from the business enterprise and sold or transferred to another location. This objection rejects the idea that business enterprise value, as an increment accruing to superior business acumen, can ever be demonstrated to exist.

The key to achieving a business value as an economic surplus remains the ability to operate in an atmosphere of limited competition. Competition inexorably erodes economic profit. Barriers to entry, specialized knowledge or processes and all other features of a product market that conspire to limit competition create and sustain economic profit.

The crucial element of a business model that confers residual intangible value is its ability to produce superior results that others cannot copy. If a business enterprise can credibly demonstrate that it enjoys such an advantage, business enterprise value must exist.

Although the Appraisal Institute has begun to weigh in on the topic of intangibles in appraisals, the matter is far from settled. The controversy is increasingly ending in courtroom confrontations. Judging from industry reports, courts remain confused about the sources and nature of business enterprise value. Careful analysis and documentation of value estimates may fail to persuade unless combined with a lucid defense of the methods and data used.

In the end, those who present the most compelling explanation of business enterprise value likely will carry the day. From an economist's viewpoint, the winning argument should explain why the enterprise enjoys or does not enjoy a unique advantage and how long that advantage will persist. ♦

Dr. Gilliland (c-gilliland@tamu.edu) is a research economist with the Real Estate Center at Texas A&M University.

Banks in Real Estate

By Jack C. Harris

A few years ago, mortgage bankers were up in arms over the threat posed by real estate agents who were getting involved in the loan origination process. Using computerized loan origination systems, agents were beginning, and in some cases completing, loan origination. Some were creating Controlled Business Arrangements, which allow real estate brokers to own and operate mortgage banking operations.

Mortgage brokers feared that real estate agents were so influential that homebuyers would give all their mortgage business to lenders affiliated with the broker. As it turned out, the threat was overblown. Mortgage companies learned how to work with the innovation by improving the way they did business.

Now the situation is reversed, and the real estate industry is battling to keep lenders — specifically commercial banks — from encroaching on their business. Longstanding restrictions on the activities of federally chartered banks were largely wiped out in 1999, allowing banks to engage in a wider array of financial and complementary services. Thus far, this change has allowed banks to underwrite securities and sell insurance. Now banks are looking to expand into real estate brokerage to funnel more business to their mortgage loan operations.

The National Association of Realtors (NAR) has sponsored bills to declare real estate brokerage and property management off-limits to banks. How much of a threat would banks entering the brokerage business pose for real estate professionals?

Segregation of Financial Functions

The Banking Act of 1933 included the Glass-Stegall provision, which was designed to rein in the power of big banks by prohibiting them from entering the investment banking business and other financial services businesses such as insurance. This, it was believed, would put the nation's financial system on a smooth, regulated path. By the 1990s, however, many of the Glass-Stegall restrictions had been weakened. Banks were offering insurance services even before the restrictions were officially repealed with the 1999 passage of the Gramm-Leach-Bliley Act (GLBA).

Under GLBA, federally chartered banks can create financial holding companies to conduct any business that is financial in nature and may provide services that are incidental or complementary to these financial services. Banks cannot engage in complementary activities directly but can create and control subsidiaries to conduct such business.

The law defines specific allowable services, and the Federal Reserve Bank and the U.S. Department of the Treasury have the authority to add other services. The act expressly prohibits real estate investment and development.

Shortly after passage of GLBA, the American Bankers Association (ABA) petitioned the Fed and Treasury for authorization to offer real estate brokerage and property management services. Strong opposition from NAR prompted officials to extend the time allowed for consideration of the proposal. A decision has yet to be rendered.

NAR is attempting a preemptive strike to prevent real estate activities from being added to the list of allowable services. At NAR's urging, Senate Bill 98 and House Bill 111 were introduced this year as the "Community Choice in Real Estate Act." The bills would amend the Bank Holding Company Act of 1956 to prevent the Fed and Treasury from finding real estate brokerage or property management to be legitimate activities for bank holding companies.

HOMEBUYERS MIGHT *not notice a difference if banks enter the brokerage business. Buyers would likely interact with personnel of bank subsidiaries operating out of local offices.*

This battle between NAR and the ABA centers around five questions:

1. Would bank-provided real estate services create conflicts of interest that would victimize home sellers and buyers?
2. Would bank involvement in real estate brokerage compromise customers' privacy?
3. If banks enter the real estate brokerage market, would there be a higher or lower level of competition among service providers?
4. Are the makeup and nature of commercial banks well suited to the real estate brokerage business?
5. What would be the effect on existing real estate brokerage firms?

Conflict of Interest

NAR contends that if brokers work for banks, they might persuade buyers to obtain loans from banks even though those loans might not be the best ones for the borrowers. The broker, NAR says, may even lead the buyer into thinking the sale is contingent on using the bank's financing.

The ABA responds to these objections by pointing out that banks are covered by the conflict of interest provisions of the Real Estate Settlement Procedures Act (RESPA) as well as specific "anti-tying" laws that apply only to commercial banks. RESPA prohibits referrals in which the agent receives a kickback for sending customers to a particular service provider.

Regardless of legal and regulatory constraints, it is difficult to police referrals, particularly if there is no direct monetary compensation to the agent. It is impossible to protect buyers who refuse to shop the market and who are unaware of their rights.

Shopping for a mortgage involves more than comparing terms. An agent's experience can be valuable in finding the lender who provides the best service. How can regulators tell whether an agent is making a referral based on the best interest of the buyer or on business relationships?

Consumer Privacy

NAR points out that a financial firm brokering real estate would have the ability to construct a database of homebuyer characteristics that they could use to market other services. This database would consist largely of confidential information the buyer shared with the agent while shopping for a home, not realizing it would be shared with other bank affiliates.

The ABA asserts that there are legal prohibitions against such practices. One of the purposes of GLBA is to strengthen privacy protections in the banking laws. This is the law that compelled financial institutions to send customers notices explaining privacy policies.

The ABA maintains that bank entry into real estate brokerage would provide consumers more choices and lead to more reasonable pricing (that is, lower commissions) and better service. Moreover, it maintains that the level of competition in the financial services field would be raised.

NAR counters that the brokerage market is already competitive and that banks entering the business actually could reduce the level of competition. Economists consider the brokerage market to be a monopolistic competitive market, in which suppliers attempt to maintain market share through nonprice competition. Instead of offering lower prices, they portray their product as being higher quality than others.

In such a market, selling homes for a lower commission rate will not necessarily attract more clients. However, demonstrating that you can sell homes faster and at higher prices certainly will.

Results of Competition

When new competitors enter the market, they spread the existing business more thinly rather than stimulate greater demand through lower prices. The result is a lower overall level of efficiency as all suppliers scale down their operations. The likely result is higher prices and lower quality service.

Banks could enter the industry by either buying up existing firms or starting new ones. Buying up small firms would simply reduce the number of competitors and could move the market from monopolistic competition to oligopoly. An oligopoly is a market dominated by a few large firms that charge what the market will bear.

If banks create new firms, the result could be much the same, as small independents could be driven out of the market trying to compete with large companies that can offer convenient financing along with the home purchase.

Such scenarios may be overestimating the potential impact of bank entry. Certainly, similar projections were made when national franchises began to move into the market in the 1980s. The market penetration by franchises reached about 30 percent quickly but has failed to advance much further. Perhaps the same would be true of bank-owned brokerage firms.

Brokerage as a Financial Service

One of the intentions of GLBA is to allow banks to offer a full array of financial services. Whether real estate brokerage and property management qualify is the major contention between NAR and the ABA.

NAR maintains that selling real property is not a financial service but a commercial business outside the purview of the law's intent.

Furthermore, NAR feels banks are poorly suited to real estate brokerage and property management. Banks, according to NAR, lack knowledge and experience of real estate markets, are not accustomed to serving customers in the role of principals in a transaction and are unfamiliar with laws governing brokerage.

The ABA counters that allowing banks to engage in real estate brokerage is not the stretch portrayed by NAR. Half of the states already allow state chartered banks to offer real estate services. Texas does not. Before GLBA, NAR promoted the concept of "one-stop shopping" through real estate firms operating mortgage bank subsidiaries or computerized loan origination systems. Now that banks want to provide similar convenience, NAR calls it a bad idea.

The double standard may have to do with the advantages banks enjoy as a result of their unique legal status and connection to the national banking system. Unlike other firms, federally chartered banks can offer investors federal deposit insurance and access to low-cost financial assistance from the Federal Reserve Bank and the Federal Home Loan Banks. While there are few barriers to setting up a real estate brokerage business, there are substantial hurdles to becoming a federally chartered bank. The simple image of knocking down walls to allow competition is complicated by the significant regulatory differences between the potential competitors.

Effect on Existing Firms

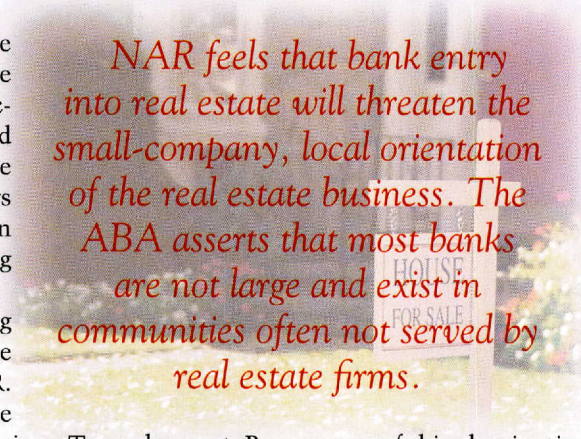
The image of large, powerful corporations invading the provinces of small business is the backdrop for another point of contention between banking and brokerage interests. NAR feels that bank entry into real estate will threaten the small-company, local orientation of the real estate business. Customer service, it is said, might be sacrificed to highly standardized services aggressively marketed to the broadest segment of customers.

The ABA asserts that most banks are not large and exist in communities often not served by real estate firms. Besides, ABA officials say, large financial firms like Prudential own real estate brokerage operations without affecting the structure of the market. The ABA contends that by allowing commercial banks to become players, everyone would benefit. Consumers would have more choices of service providers, agents would have a wider range of places to work and owners of existing firms would face a better market when they wish to sell their businesses.

Of course, this assumes that a consolidation of bank-owned brokerage firms does not take place. If it does, consumers would face more limited options, fewer agents and broker-managers would be needed and there might be no market for existing firms.

Cause for Concern?

If bank-owned realty brokerage does become a significant part of the business, how might this affect consumers? Most consumers probably would notice little change. Real estate operations likely would be handled through subsidiaries working out of offices much as brokers do now.



NAR feels that bank entry into real estate will threaten the small-company, local orientation of the real estate business. The ABA asserts that most banks are not large and exist in communities often not served by real estate firms.

There would, however, be a closer relationship with the mortgage banking and possibly with the insurance brokerage operations of the mother bank. Referrals from real estate agents to the bank's services would operate under the oversight of RESPA. The agents themselves could not be given incentives to make referrals, but there might be affinity-like discounts for applicants who use the bank's mortgage or insurance services.

The impact on agents would depend on whether bank-owned firms were successful in dominating the industry. If the brokerage-financing connection proves overwhelming and banks drive out most independent firms, there may be a difference in how brokerage firms deal with their sales agents.

Banks would want to run brokerages more like banks, meaning agents would be treated more as employees and less like independent contractors. Expect a move away from all-commission compensation and back toward the more traditional commission-salary split. The bank-owned firms would not have this effect unless they possessed a competitive advantage in the market. Otherwise, they would have to offer comparable terms to hire the best agents.

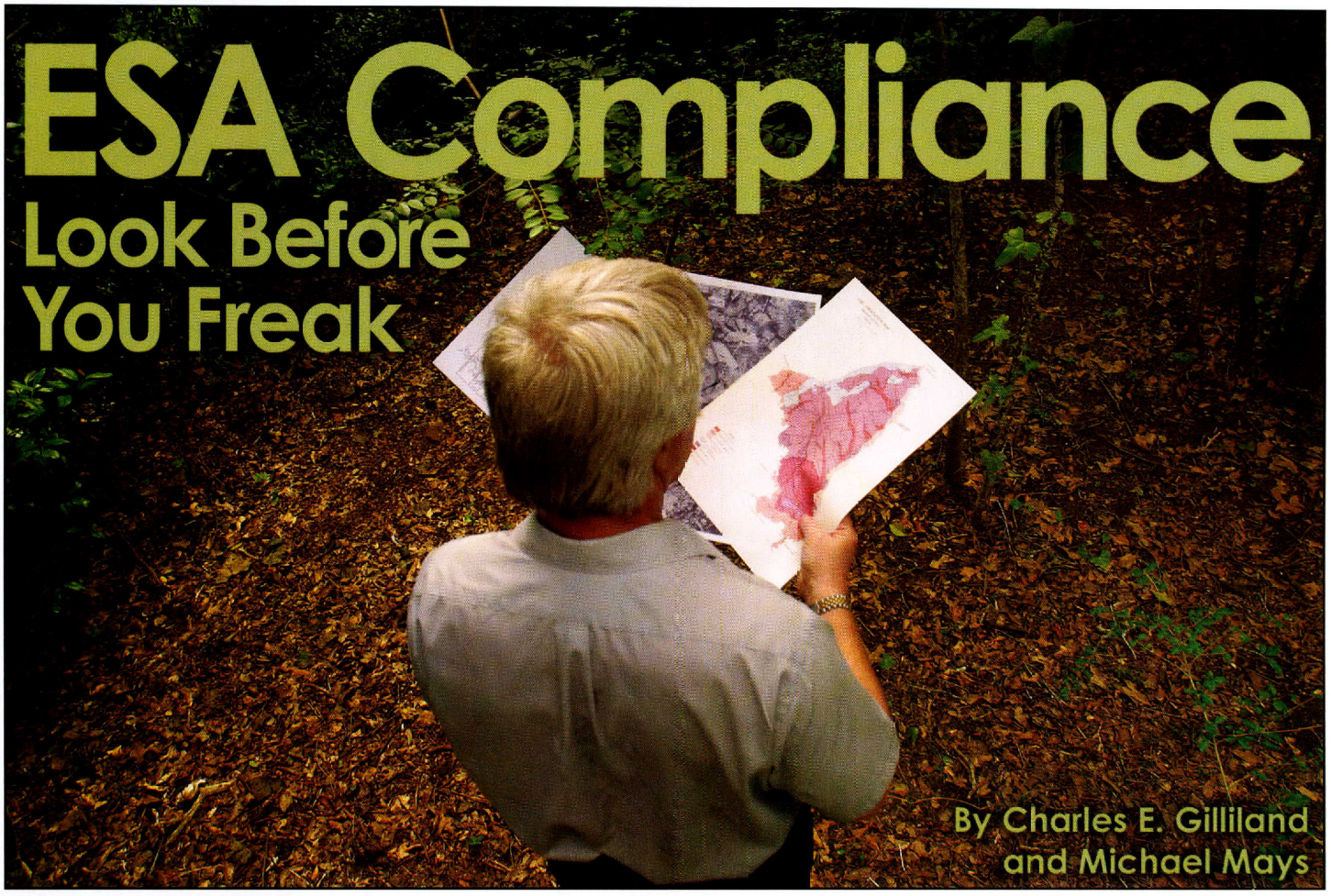
At this point, it looks like Congress will favor NAR's effort to forestall the entry of banks into the business. However, banks have found ways to sidestep regulations when the result makes economic sense. Some of the services authorized by GBLA were already being offered through exceptions in the law. So it is worthwhile to think about how this change might affect the market for brokerage services, agents and firms.

For more information, see Center technical report 1633, *Banks in Real Estate,* at http://recenter.tamu.edu/pdf/1633.pdf.

Dr. Harris (jharris@cgsb.tamu.edu) is a research economist with the Real Estate Center at Texas A&M University.

ESA Compliance

Look Before You Freak



By Charles E. Gilliland and Michael Mays

Fear of violating the Endangered Species Act (ESA) and frustration with the complicated process to secure an incidental take permit (ITP) often drive landowners in one of two directions. Some wave a white flag and invite the U.S. Fish and Wildlife Service (USFWS) to scour their land for signs of habitat. Others resort to a "shoot, shovel and shut up" strategy, hoping to escape penalties by eradicating threatened or endangered species habitat.

Before opting for either of these extremes, landowners should consider taking proactive steps to determine their level of exposure to penalties.

Perform Self-Assessment

So how do landowners know if conditions on their properties necessitate an incidental take permit and habitat conservation plan? Inviting the USFWS to inspect the land is one way to find out, but the lengthy process may be unnecessary. Instead, landowners can perform a self-assessment of conditions on the property.

Self-assessment consists of classifying areas within a property based on whether they contain habitat for a threatened or endangered species, whether the habitat is occupied and how much the proposed land use will disturb the habitat. Once the landowner has identified key aspects of the property, a reasonable ESA compliance strategy becomes clearer.

The self-assessment should answer the following questions:

- ✓ Are listed species in the area?
- ✓ What constitutes habitat for any listed species?
- ✓ Does the property contain habitat for any listed species?
- ✓ If yes, is the habitat occupied?
- ✓ Do current activities disturb the habitat?
- ✓ Are proposed activities likely to disturb the habitat?

Landowners face possible penalties under Section 9 of the ESA when property contains habitat of a listed species (for a discussion of penalties, see "Endangered Species Act: What Landowners Should Know," *Tierra Grande*, October 2002, http://recenter.tamu.edu/pdf/1587.pdf). If the habitat is occupied, disturbing it constitutes a "take" under the ESA. Land that contains no habitat suitable for ESA-listed species is not subject to penalties. Owners can safely presume that land use activities may be undertaken without risk.

If the land contains habitat, but the habitat is unoccupied, disturbance or destruction of the habitat will not incur a penalty. But the landowner must prove to the satisfaction of the USFWS that the habitat is unoccupied.

Presence of suitable, occupied habitat increases the likelihood of encountering ESA restrictions. Land uses that do not alter or disturb habitat do not result in a "take" of a listed species, and therefore represent no risk of ESA penalties.

Land uses that alter or disturb habitat — building or development activity, for example — probably call for consultation with the USFWS or the Texas Parks and Wildlife Department (TPWD). Ultimately, such land may require an ITP. However, landowners should confine the consultation to the specific areas containing habitat rather than opening the entire property to inspection.

Landowner's ESA 'Bible'

The first step in evaluating the risk of penalties involves researching threatened and endangered species to identify those that may inhabit the area. *Endangered and Threatened*

Animals of Texas (Texas Parks and Wildlife Press, 1996; ordering information is at http://www.tpwd.state.tx.us/news/press/index.htm) is widely considered the landowner's ESA "bible." The book includes all species listed in Texas along with detailed, illustrated descriptions of habitat requirements, breeding and feeding behavior and approved management practices. Using this guide, landowners can inspect the property for threatened or endangered species habitat.

For example, Bastrop County is home to the Houston toad, an endangered species. Landowners wanting to build homes or construct improvements in that area can learn from *Endangered and Threatened Animals of Texas* that the toad prefers "large areas of predominantly sandy soils greater than 40 inches deep. . . ." Landowners can then study Bastrop County soil maps to locate those soil types. Information on local soil surveys is available through the Natural Resources Conservation Service. To locate the nearest office, go to http://offices.usda.gov/scripts/ndCGI.exe/oip_public/USA_map.

If the land in question and surrounding properties do not contain the preferred soils, the property probably contains no toad habitat. Searching for particular types of vegetation and wetlands may further narrow the probability. If those soil types do exist on the property along with certain vegetation and wetlands, the risk of ESA penalties is high.

Golden-cheeked warblers prefer moist, steep hillsides like canyon walls with mature Ashe juniper mixed with hardwoods. Maintaining the canopy cover of trees is critical to preserving golden-cheeked warbler habitat. Because clearing a building site in such a location would destroy a portion of the canopy, such activity would most likely constitute a take under ESA.

Endangered and Threatened Animals of Texas spells out management guidelines approved by the regional director of the USFWS that allow landowners to avoid the permitting process. This approval explicitly excuses landowners who follow the prescribed management guidelines from obtaining an ITP.

For the Houston toad, these guidelines appear to preclude most if not all building activity. Any plan that fails to conform to the guidelines puts the property at high risk of encurring ESA penalties. A prudent owner should therefore consult with a professional. Even then, plans to build would likely require an ITP.

Some land-use activities may improve an endangered species' habitat. The black-capped vireo prefers a mixture of grasslands and shrubs. Studies have shown that excessive browsing by an overabundant deer population can destroy the kind of brush the birds prefer. A landowner with vireo habitat could initiate an intensive hunting operation to control deer populations without running afoul of the ESA. A well-designed game management plan that did not destroy habitat probably would enhance vireo recovery by limiting destruction of brush.

Commission Versus Omission

Activities that result in a take of a species are called acts of commission. However, another option for landowners may be doing nothing — an act of omission. Acts of commission result in USFWS punitive action; acts of omission do not.

For example, East Texas is home to the red-cockaded woodpecker. Landowners harvesting timber in this area would violate the ESA if nesting red-cockaded woodpeckers occupied the stand of timber being cut.

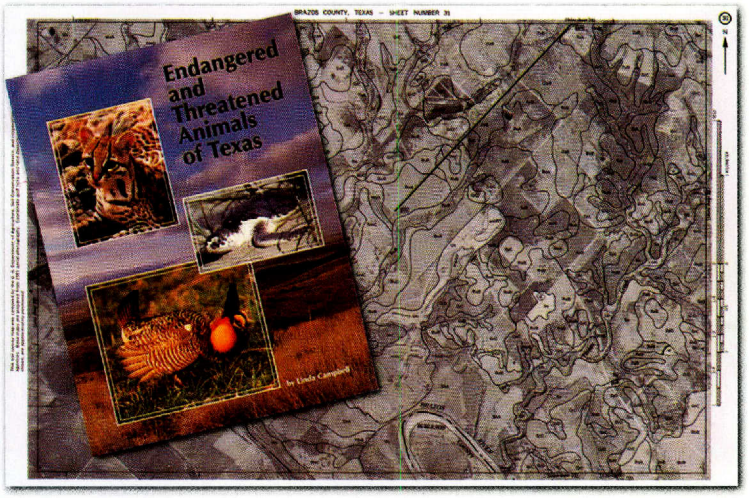
However, red-cockaded woodpeckers prefer forest with little or no understory — trees and shrubs that grow between the forest canopy and the ground cover. A landowner could allow the understory to grow (an act of omission) until the woodpeckers vacated the area, at which time the landowner could harvest timber without violating the ESA. This act of omission would not constitute a "take" under the law. By doing nothing, the landowner lets Mother Nature resolve the ESA habitat issue.

Expert Consultation

When self-assessment prompts landowners to consult an expert, choosing a qualified consultant can be difficult. TPWD biologists are an often-overlooked resource for this type of inspection. They can provide the landowner with expert assessments of the extent of potential habitat on a property. There is no fee for consultation with the TPWD and TPWD biologists are bound by law to maintain confidentiality.

The disadvantage of using TPWD biologists is that the agency does not have the manpower to serve all the landowners requesting consultations. A wait is usually necessary.

Depending on the results of the TPWD inspection, it may be necessary for the landowner to hire a professional consulting biologist, a potentially costly undertaking. Fees vary widely based on several factors. Often, only a few biologists are qualified to evaluate a particular species. Property size and the intensity of the development goals can further affect the number and type of biologists required. Factors such as these obviously affect costs.



DO SOME HOMEWORK. *Resources such as soil maps and a guide to Texas endangered and threatened species help landowners determine whether they are at risk for ESA penalties.*

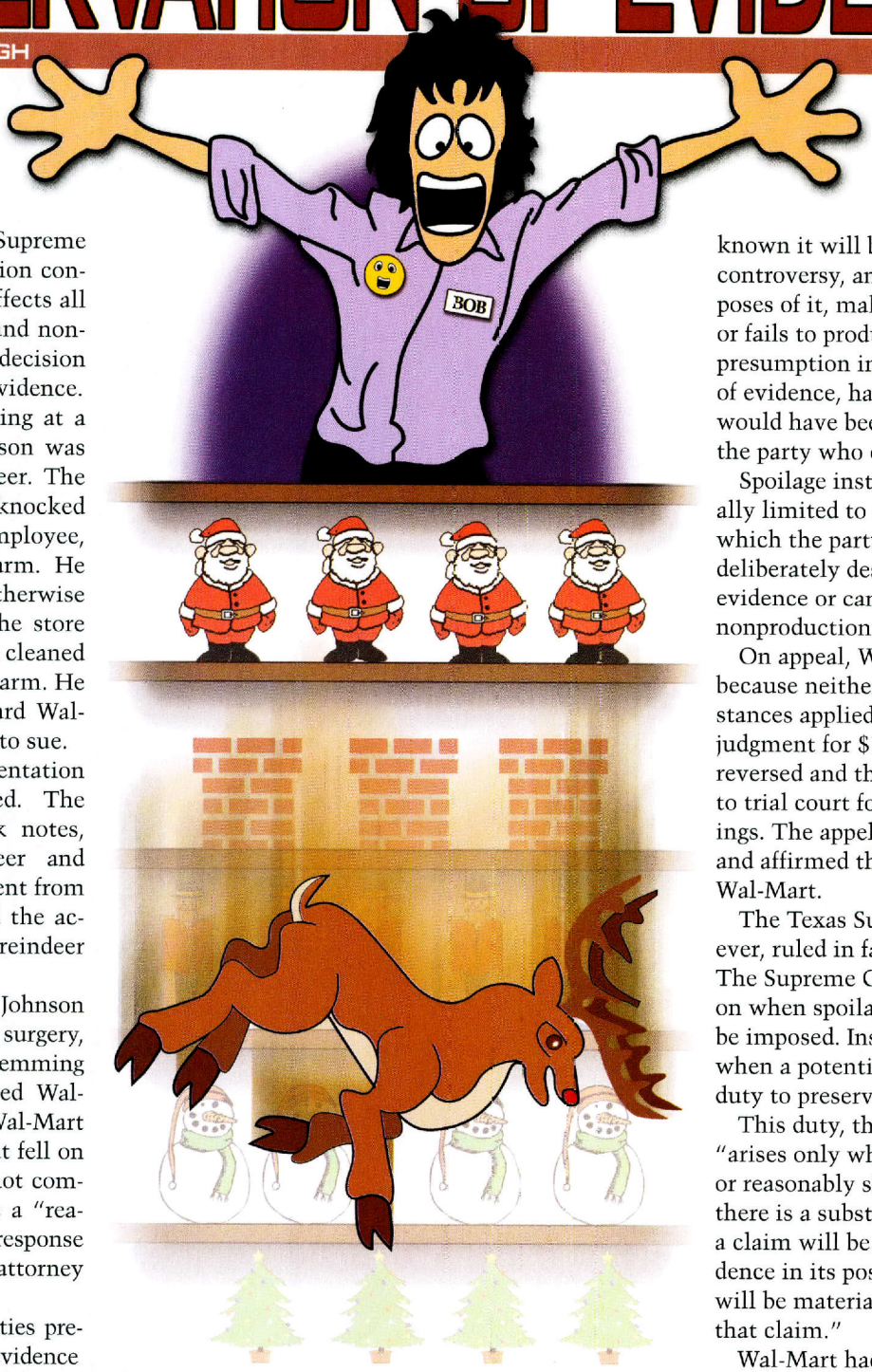
Congress authorized the ITP process to allow human activities to continue while affording protection to endangered creatures. Landowners should take care to identify habitat and endangered species on their properties to ensure compliance with ESA. A proactive stance allows landowners to comply with the ESA and conduct land-use activities with minimum interference.

For further information on landowner obligations and strategies, see "Capturing the Elusive Incidental Take Permit," *Tierra Grande*, July 2003, http://recenter.tamu.edu/pdf/1627.pdf.

Dr. Gilliland (c-gilliland@tamu.edu) is a research economist and Mays a former graduate research assistant with the Real Estate Center at Texas A&M University.

PRESERVATION OF EVIDENCE

By Judon Fambrough



In May 2003, the Texas Supreme Court rendered a decision concerning liability that affects all landowners, commercial and noncommercial alike. The decision concerns preservation of evidence.

While Christmas shopping at a Wal-Mart store, Mr. Johnson was injured by a falling reindeer. The Christmas decoration, knocked off an upper shelf by an employee, hit Johnson's head and arm. He was dazed and cut but otherwise seemed unhurt. He left the store after a Wal-Mart employee cleaned and bandaged a cut on his arm. He indicated no ill will toward Wal-Mart and did not threaten to sue.

All the store's documentation procedures were followed. The Wal-Mart supervisor took notes, photographed the reindeer and obtained a written statement from the employee who caused the accident. Subsequently, the reindeer was sold.

Seventeen months later, Johnson underwent serious neck surgery, allegedly to repair injury stemming from the incident. He sued Wal-Mart. His attorney asked Wal-Mart to produce the reindeer that fell on Johnson. Wal-Mart could not comply but offered to produce a "reasonable facsimile." This response was unacceptable to the attorney and later to the trial court.

During the trial, the parties presented sharply contrasting evidence regarding the composition and weight of the reindeer. Johnson testified it was made of wood and weighed as much as ten pounds. Wal-Mart countered that it was made of papier-mâché and weighed five to eight ounces. The photographs of the reindeer could not refute either contention because they were such poor quality.

Because Wal-Mart had disposed of the "carcass," the trial court issued a "spoilage" instruction that required the jury to presume the missing reindeer would have harmed Wal-Mart's case.

The jurors were instructed that, "when a party has possession of a piece of evidence at a time he knows or should have known it will be evidence in a controversy, and thereafter he disposes of it, makes it unavailable, or fails to produce it, there is a presumption in law that the piece of evidence, had it been produced, would have been unfavorable to the party who did not produce it."

Spoilage instructions are generally limited to circumstances in which the party in possession deliberately destroys relevant evidence or cannot explain its nonproduction.

On appeal, Wal-Mart argued that because neither of these circumstances applied in this case, the judgment for $76,000 should be reversed and the case remanded to trial court for further proceedings. The appellate court disagreed and affirmed the judgment against Wal-Mart.

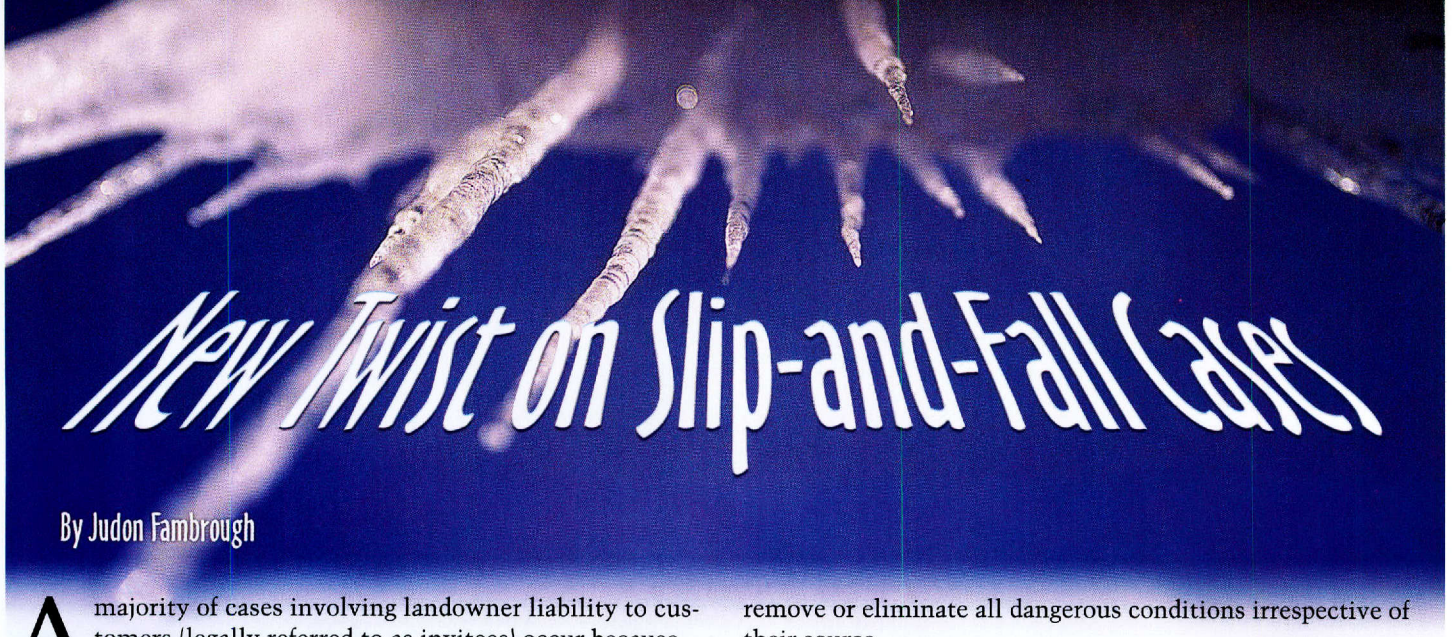
The Texas Supreme Court, however, ruled in favor of Wal-Mart. The Supreme Court did not focus on when spoilage instructions may be imposed. Instead, it examined when a potential defendant has a duty to preserve the evidence.

This duty, the court ruled, "arises only when a party knows or reasonably should have known there is a substantial chance that a claim will be filed and that evidence in its possession or control will be material and relevant to that claim."

Wal-Mart had no notice that the reindeer would be relevant to a future claim at the time of the accident. It did not learn of Johnson's claim until all the reindeer had been disposed of. Even after Johnson learned that he had injured his neck, nothing in the record suggests that he informed Wal-Mart of his claim prior to filing suit.

To avoid imposition of spoilage instructions, landowners should refrain from disposing of any property that causes an injury to a guest until after the statute of limitations expires.

Fambrough (judon@recenter.tamu.edu) is a member of the State Bar of Texas and a lawyer with the Real Estate Center at Texas A&M University.



New Twist on Slip-and-Fall Cases

By Judon Fambrough

A majority of cases involving landowner liability to customers (legally referred to as invitees) occur because of a slip and fall. An owner-operator owes a duty to customers to exercise reasonable care to protect them from known or discoverable dangerous conditions on the premises. The courts impute "constructive knowledge" of the dangerous condition to the landowner when it is discoverable. For a customer to recover damages, he or she must prove several elements.

- The owner-operator had actual or constructive knowledge of the dangerous condition. Sometimes the courts simply say the owner-operator knew or should have known of the dangerous condition.
- The condition posed an unreasonable risk or harm to the customer.
- The owner-operator did not exercise reasonable care to reduce or eliminate the risk.
- The owner-operator's failure to use such care was the proximate cause of the customer's injury.

A slip-and-fall case in Grayson County set precedents in Texas after a customer slipped and fell on Wal-Mart's ice-covered parking lot.

The incident occurred on Dec. 23, 1998, following an arctic cold front that dumped freezing rain, sleet and snow in the area. The plaintiff drove to Wal-Mart in her four-wheel drive vehicle and parked 30 feet from the entrance. She made two trips into the store. She slipped and fell on the ice while returning to her vehicle the second time.

Wal-Mart took no measures to remove the frozen precipitation or lessen the risk it posed. Wal-Mart contended, as a matter of law, the natural accumulation of frozen precipitation did not constitute a condition that posed an unreasonable risk of harm in this situation.

Wal-Mart contended that the natural accumulation of frozen precipitation did not pose an unreasonable risk of harm.

The court noted that the premises owner-operator's duty to protect customers (invitees) from the natural accumulation of frozen precipitation has been litigated extensively in colder climates. Two conflicting rules emerged. The "Massachusetts" or "natural accumulation" rule releases the premises owner-operator from any liability under such circumstances. The "Connecticut" rule requires the premises owner-operator to remove or eliminate all dangerous conditions irrespective of their source.

Four Texas appellate cases dealt with slip-and-fall injuries caused by frozen precipitation. None discussed the application of either the Massachusetts or the Connecticut rules. In this case, the court applied the Massachusetts rule removing liability for natural accumulations.

The Texas court was reluctant to require a premises owner-operator to expend a great deal of physical and financial effort to protect its invitees from a naturally occurring condition that usually dissipates in a short time. While the premises owner-operator may avoid this burden by closing the business during times of bad weather, the public is better served if businesses remain open to supply needed goods and services during harsh weather conditions.

The court limited its decision to parking lots only. "The question of the duty owed with respect to natural accumulations of frozen precipitation occurring on sidewalks, entryways, and other areas intended for pedestrian traffic is not before us."

This decision was rendered by the Eastland Court of Appeals on April 10, 2003. Two months later, the Amarillo Court of Appeals decided another case involving an ice-covered sidewalk at an apartment complex. Because of the timing of the two cases, the first case had no bearing on the second.

The Amarillo Court of Appeals did not focus on the premises' or operator's liability for the natural accumulation of frozen precipitation. Instead, the key question was whether the person injured while delivering the morning paper was an *invitee* or a *licensee*.

An invitee is someone on the premises for the economic benefit of the owner-operator. A licensee is there with permission but for no economic benefit (for example, a guest at a social gathering).

The owner-operator has a duty to exercise reasonable care to protect invitees from unreasonably dangerous conditions the owner-operator knows about or should have known about. However, the duty to protect licensees extends only to unreasonably dangerous conditions of which the owner-operator has actual knowledge; constructive knowledge is not imputed.

The owner-operator of the apartment complex had no knowledge that ice was on the sidewalks when the papers were delivered. Attorneys for the apartment complex argued that without actual knowledge of the presence of ice, it owed no duty to protect the delivery person, who was a licensee.

The plaintiff countered that the delivery person was an invitee, not a licensee. As such, the apartment complex owner-operator had a duty to protect that person from the presence of ice, which the owner-operator should have known about.

The court reversed a summary judgment in favor of the apartment complex and remanded the case for trial. Sufficient evidence existed for a jury to decide whether the delivery person was an invitee or licensee. The first case ruling would have had no bearing on this case because it was restricted to natural accumulation of frozen precipitation on parking lots. Here, the injury occurred on a sidewalk.

In another slip-and-fall case, Wal-Mart persuaded the Fort Worth Court of Appeals to reverse itself regarding the standard of care owed to invitees when customers are allowed to bring food and drinks into the store. Knowledge of the unreasonably dangerous condition again played a critical role.

Lorene Rangel slipped and fell on a mixture of water and ice cubes spilled on the floor by a customer. Wal-Mart's employees did not prevent customers from carrying food and drinks throughout the store. The store had a written safety manual emphasizing that employees were to keep the floors safe.

Wal-Mart contended that, without more evidence, Rangel did not prove Wal-Mart knew or should have known that the water had spilled on the floor. Wal-Mart argued that the substance had not been on the floor sufficient time to discover and remove it.

The assistant manager testified that he knew customers carried food and drinks throughout the store and spills could occur. Thus, it was foreseeable customers might slip and fall on the spilled substances.

The trial court concluded Wal-Mart's policy, which allows customers to carry food and drink into the store, created a foreseeable danger and risk of harm and that Wal-Mart failed to prevent this danger by exercising ordinary care. The mere fact Wal-Mart allowed its customers to carry drinks posed an unreasonable risk of harm, according to the court. The customer did not have to prove that Wal-Mart had actual or constructive notice of the spill.

Five years later, an identical situation occurred. Again, Wal-Mart was sued. However, this time the Fort Worth Court of Appeals reversed the standard it set in *Rangel.* To prove Wal-Mart had actual or constructive knowledge of the conditions, the court said, the customer must show Wal-Mart:

- placed the foreign substance on the floor,
- knew it was on the floor and negligently failed to remove it or
- should have removed the substance from the floor after it had been there a sufficient length of time to be discovered.

Under the *Rangel* approach, the owner-operator became liable for allowing a foreseeable potential dangerous condition to occur. This extended the scope of responsibility too far and led to a reversal of *Rangel.*

Fambrough (judon@recenter.tamu.edu) is a member of the State Bar of Texas and a lawyer with the Real Estate Center at Texas A&M University.

FIXIN

RCLA Mandates Reco

By Judon Fambrough

Low interest rates fueled all-time record new home sales and residential remodeling expenditures over the past couple of years. Texans who purchase new homes or remodel or repair existing ones must realize that traditional laws governing recoveries, including the Deceptive Trade Practices Act, do not apply to construction defects.

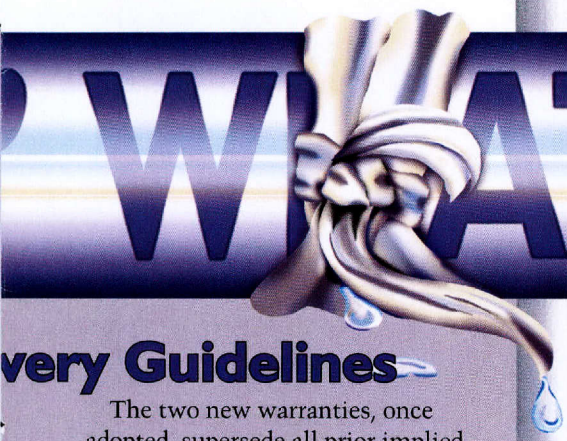
Instead, homeowners must comply strictly with pretrial guidelines mandated by the Residential Construction Liability Act (RCLA) or face dismissal of their lawsuits. The latest amendment to the act, effective Sept. 1, 2003, made sweeping changes to the pretrial requirements.

The Texas Residential Construction Commission (the commission) is the cornerstone of the new legislation. The nine-member commission appointed by the governor is charged with implementing, overseeing and administering nearly every aspect of the new law.

The commission's most challenging task is creating and adopting two warranties covering all residential construction and repair work statewide. The first warranty, known as the limited statutory warranties and building and performance standards (hereafter referred to as limited statutory warranties), sets the minimum standards for all new home construction as well as home improvements and repairs.

The limited statutory warranties cover workmanship and materials for one year; plumbing, electrical, heating and air conditioning for two years; and structural components for ten years. The second warranty, that of habitability, covers anything having a "direct, adverse effect on the habitable areas of the home. . . ." This warranty ensures the home or home improvements are safe, sanitary and fit for humans to inhabit.

WHAT'S BROKE



very Guidelines

The two new warranties, once adopted, supersede all prior implied warranties applicable to residential construction and improvements. The warranties cannot be waived, but the contract between the homeowner and builder may be more stringent.

The new statute applies to those who for compensation construct, supervise or manage the construction of a new home; those who materially improve a home (other than repairing or replacing a roof on an existing home); or those who improve the interior of an existing home at a cost exceeding $20,000.

Beginning March 1, 2004, all Texas builders must obtain a certificate of registration from the commission. Builders must register each new home with the commission after the title is transferred to the buyer. Likewise, each home repaired or improved must be registered after the contract is signed or the work begins.

If a dispute arises involving a construction defect (as defined by the statute), the owner or builder may initiate a procedure known as the state-sponsored inspection and dispute resolution process. The process begins with the homeowner submitting a request to the commission within two years after discovering the defect but not later than 30 days after the warranty expires.

The commission appoints a third-party inspector who examines the alleged defect(s) and renders a recommendation. The recommendation addresses only the alleged construction defect(s) based on the applicable limited statutory warranties adopted by the commission. It addresses only the method or manner of repair, not the monetary amount needed to remedy it.

If a structural defect creates an imminent threat to the inhabitants' health or safety, the builder must take reasonable steps to cure the defect as soon as practical. Otherwise, the owner may correct the defect and recover reasonable costs from the builder along with any attorneys' fees and associated expenses.

Either the owner or builder may appeal the third-party inspector's recommendation to a panel of three state inspectors employed by the commission. The panel may approve the third party's recommendation, reject or modify it, or return the matter for further consideration.

Once the panel's decision becomes final, dissatisfied owners may file a lawsuit against the builder or its warranty company to recover economic damages. However, a judicial presumption exists that the panel's decision is correct.

The 2003 amendment describes the use of arbitration. Although the procedure is unclear, it is apparently designed to correct past abuses of binding arbitration clauses in building contracts. The commission will maintain and update a list of certified arbitrators and make the list available to the public.

If an award concerning a residential construction defect is issued by a certified arbitrator after Jan. 1, 2004, and filed in a court of competent jurisdiction, several items regarding the award must be filed with the commission. Confidentiality is no longer an option.

Status of Former Statute

The procedure for settling disputes under the RCLA prior to Sept. 1, 2003, remains in place with modifications. The procedure, described in Chapter 27 of the Texas Property Code, must still be used to rectify construction defects occurring prior to Sept. 1, 2003, and possibly until the commission adopts the new warranties.

Under Chapter 27, the owner must send a demand letter to the builder at least 60 days prior to initiating any legal action, which includes compelling mediation or arbitration when the claim exceeds $7,500. The letter must describe the alleged construction defect in reasonable detail.

The contractor may ask the owner to provide evidence of the nature and cause of the alleged construction defect and the nature and extent of needed repairs. These help the contractor assess potential liability.

Also, the contractor may ask to inspect the property. The owner must comply or face a trial delay until the inspection is completed.

After a determination under the new statute becomes final and no longer appealable or after receiving the demand letter from the owner under the former statute, the contractor may submit a written settlement offer. The offer may be:

- an agreement to repair all or a part of the defect,
- an offer to have all or a part of the defect repaired by an independent contractor or
- a monetary payment to correct the defect.

The owner may accept the offer or advise the contractor why the offer is unacceptable. The offer is deemed rejected if not accepted within 25 days. If the

owner accepts an offer for repairs, they must be completed in a workmanlike manner within 45 days unless delayed by the owner or circumstances beyond the contractor's control.

The act penalizes owners who, in bad faith, reject a reasonable offer or who do not allow the contractor a reasonable opportunity to make repairs. Likewise, the contractor is penalized for failing to attempt reasonable repairs, to complete repairs in a good and workmanlike manner or to make a reasonable monetary settlement. The penalties impact the amount of recovery ultimately afforded the owner.

Recoveries Under RCLA

If a settlement cannot be reached under either the new statute or under Chapter 27, the statute specifies the economic damages that can be recovered.

These include the reasonable costs of the repairs needed to correct the defect, costs of repairing or replacing the damaged goods and reasonable and necessary engineering and consultant fees. Also covered are reasonable expenses for temporary housing during the repairs, reduction in current market value caused by a repaired structural failure and reasonable and necessary attorney fees.

Builders and remodelers are not liable for the percentage of damages caused by negligence of someone other than the contractor, its agent, employee or subcontractor. Likewise, they are not responsible for the failure of someone other than the contractor, its agent, employee or subcontractor to take reasonable action to mitigate damages or to maintain the residence.

Builders and remodelers cannot be held liable for normal wear and tear, normal shrinkage caused by drying or settlement of construction components within building standards tolerance and the contractor's reliance on false or inaccurate third-party written information obtained from official government records. The latter applies when the contractor did not know or could not have reasonably known the information was inaccurate.

Limits on Recovery

For construction defects occurring prior to Sept. 1, 2003, the statute limits recoverable damages, including the owner's attorney fees, to the greater of the:

- owner's purchase price for the residence or
- current market value of the residence without the construction defects.

Under these guidelines, homeowners get to keep the residence plus recoup the entire purchase price or the fair market value of the home.

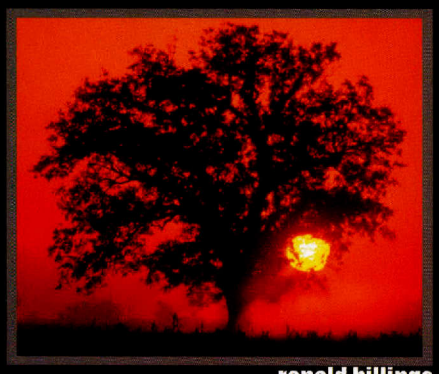
For contracts entered after Sept. 1, 2003, the owner and contractor may agree for the contractor to repurchase the residence when the costs of repairs exceed a stipulated percentage of the fair market value of the home without the construction defect. The repurchase price must include the original purchase price, closing costs and costs of transferring title to the contractor. The agreement is void when the residence is more than five years old or when the contractor elects to repurchase more than 15 days after the panel's decision becomes final and unappealable.

Even if the contractor elects to repurchase, the owner may still recover reasonable and necessary attorney and expert fees, reimbursement for permanent improvements after the date of the original purchase and reasonable moving costs.

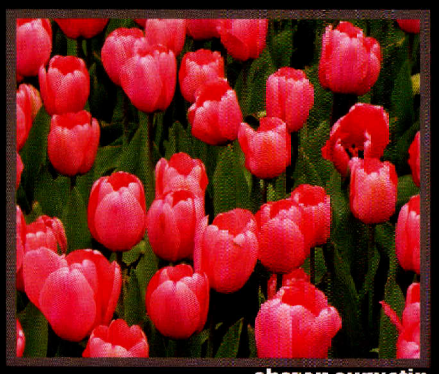
The statute requires specific language to be placed next to the signature lines in all construction, repair or remodeling contracts. The notice, printed in 10-point boldface type, briefly summarizes the procedure for rectifying any complaint arising from a construction defect under the contract. The contractor faces a $500 fine for failing to insert this notice in addition to any other remedies available under the act.

Fambrough (judon@recenter.tamu.edu) is a member of the State Bar of Texas and a lawyer with the Real Estate Center at Texas A&M University.

Want to know more? A copy of the legislation can be found at http://www.capitol.state.tx.us/cgi-bin/tlo/textframe.cmd?LEG=78&SESS=R&CHAMBER=H&BILLTYPE=B&BILLSUFFIX=00730&VERSION=5&TYPE=B.



ronald billings



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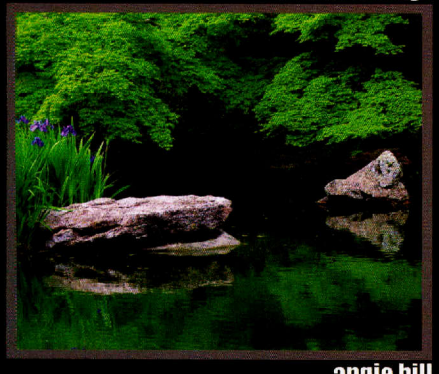

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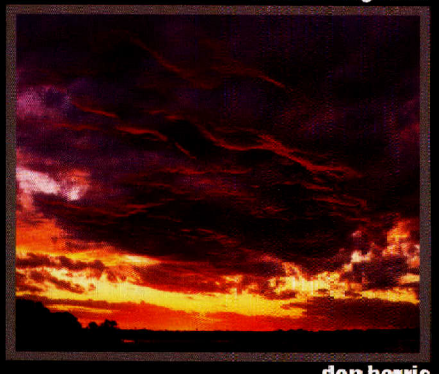
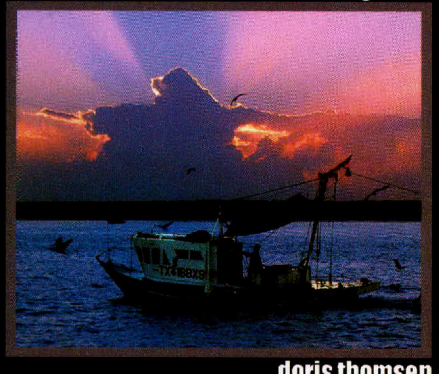
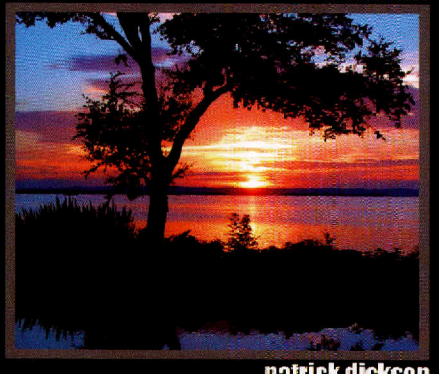


don harris

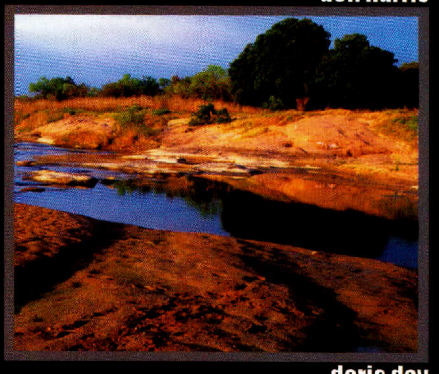
don harris



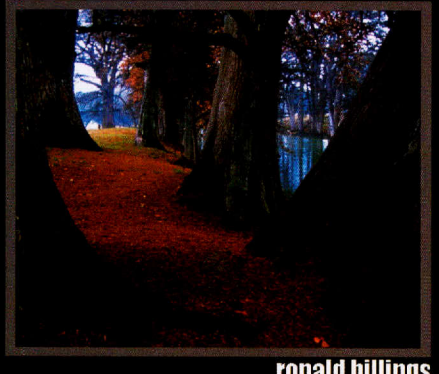
doris thomsen



patrick dickson



doris day



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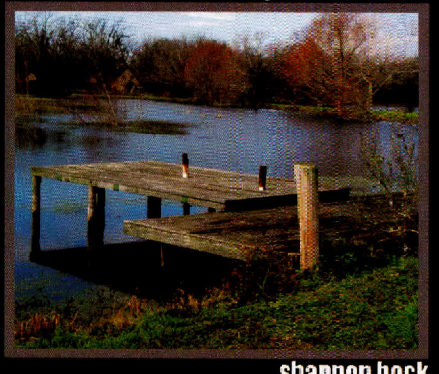

shannon bock

doris day

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www.recenter.tamu.edu

Tierra Grande editors were amazed at the variety and excellence of entries in our "Postcards from Texas" photo contest. The need to whittle a long list of finalists down to 12 winners brought out the inner politicians in us, resulting in heated debates and covert lobbying for personal favorites. In the end, we settled on these beauties, which will be featured in our 2002-2003 annual report and calendar.

Thanks to all who entered and congratulations to the winners!

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