

# Real Estate Monitor

**Construction:**  
Going Green .....1

**Investments:**  
Timberland .....2

**Options:**  
Minimizing Cash Outlays .....3

**Lease Audits:**  
Benefits of Outsourcing.....4

**Patenting a Business or Legal Strategy.....5**

**Condominiums:**  
Suing Accountants and Other Professionals.....6

## Construction: Going Green

By Dan DiTieri

The growing movement known as “green building” is having an increasing impact on construction in the United States. Defined as increasing the efficiency by which buildings use energy, water and materials to reduce building impacts on human health and the environment, a green building has features that improve its ability to collect, maintain or transfer energy, provide an effective and efficient use of water resources and improve health conditions by the use of natural lighting and ventilation to eliminate a significant amount of mold and bacteria.

Achieving these objectives can be very significant, given that buildings account for 36 percent of total energy use in the United States. Buildings also account for almost two-thirds of our electric consumption as well as one-third of all greenhouse emissions and about one-eighth of all potable water consumption. A McGraw-Hill report predicts that green non-residential construction will comprise as much as 10 percent of all non-residential U.S. construction by 2010.

### What is LEED?

The acronym LEED stands for Leadership in Energy and Design Guidelines. These guidelines were first issued in 1999 by the U.S. Green Leadership in Energy and Design Guidelines Building Council (USGBC). The current version of LEED was issued in 2004 and the next one (version 3.0) is due to be released late this year or early in 2008. While no state or federal government has adopted LEED, it appears to be the most widely recognized benchmark for green design

and construction. LEED guidelines cover five topical areas, and a building is awarded points depending on how closely it follows the guideline standards. The ranking system is as follows:

- Certified: 26-32 points
- Silver: 33-38 points
- Gold: 39-51 points
- Platinum: 52-69 points

In 2005, only nine buildings had been platinum certified, six of which were in the United States. In 2006, the global number reached 14 buildings.

### Sustainable Site Issues

(14 possible points)

The first topic addresses the selection of the project site and deals with such issues as an erosion and sedimentation control plan, storm water management plans, development density, alternative transportation access and heat and light reduction.

### Water Savings Issues

(5 possible points)

This topic deals with the use of water in the building and management of its wastewater. Points are awarded for the use of innovative wastewater technologies. The object is to conserve water resources.

### Energy Efficiency Issues

(17 possible points)

This category rewards the overall energy performance of the building and efforts to improve the electrical and mechanical systems in order to conserve energy, primarily those from non-renewable resources.

### Material Selection Issues

(13 possible points)

Credits are given for the reuse of existing structural elements and the

maintenance of non-structural elements. Points are given when 50 percent of construction and demolition debris is recycled.

### Indoor Environmental Quality

(15 possible points)

This topic deals with occupant health and safety with respect to air circulation, with points also awarded based on the percentage of access to daylight. The object is to reduce indoor air quality (IAQ) issues, particularly in buildings with poor ventilation or filtration.

Five additional points can be awarded for "catch-all" provisions, i.e., whether a design innovation goes beyond LEED standards.

### Voluntary Program

LEED standards are not mandatory. However, various municipal and state incentive programs have been created and state and federal tax benefits can be obtained.

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## Investments: Timberland

*By Anthony La Malfa*

Timberland is defined as land that can be used to grow timber of merchantable quality and quantity and where timber production is not barred by legal or regulatory rules. About two-thirds of the nation's forest lands—505 million acres—is considered timberland. Relative proximity to timber consumers—most often pulp and lumber mills—is a key consideration affecting the value of timberland due to the reduced transportation costs of the cut timber. Another factor affecting value is the location of the timber-

land; areas with more rain will experience faster growth.

Federal, state and local governments own approximately 30 percent of U.S. timberland, or about 154 million acres. The remaining 70 percent, owned by private entities and individuals, include timber REITs as well as other timber investment management organizations. However, the large owners still represent less than 10 percent of privately held timberland. (Plum Creek, which owns approximately 8.2 million acres, is the largest private landowner in the United States.)

### Returns and Risks

Timberland is an attractive investment for long-term holders such as pension funds because the "timber crop" is renewable, as cut trees are replaced by new growth. So-called "biological growth" is fairly predictable, although it varies by species and region. For example, timber in the western United States grows an average 2.4 percent a year, while northern timber grows at 3.4 percent and southern timber at 6 percent. By one estimate, biological growth is the most important factor in generating returns on investment, accounting for between 50 and 70 percent of total return.

The major physical risk to timberland is destruction from fire, pests and disease. Overall, the risk is minimal, accounting by one estimate for losses of less than one-half percent per year. The primary economic risk in timberland investment is that prices are highly volatile. If prices are at a low point when timber is harvested, anticipated profits may not be realized. Offsetting this is the option to hold off timber sale until prices improve; in effect, timber can be "stored" on the stump.

## Timber REITs

In recent years, the traditional forest and paper product corporations have become vertically integrated, owning everything from the raw timber to the manufactured assets—wood, pulp, and paper mills. However, says Moody's Investors Service, while vertical integration is advantageous from the perspective of controlling the entire process, the ownership of the raw timber can result in uncertain cash flows that will affect a public company's stock price. As a result, many companies have sought to decouple timber ownership from the manufacturing business—a key factor in the evolution of pure timberland companies, including REITs. In addition, when timberlands are the sole asset of a company, investors are likely to benefit from a sharper focus on the land itself with no management concerns regarding the manufacturing process.

Moody's says that timberlands have the following attractions from an investment perspective:

- they are fungible (essentially similar) assets and are increasingly liquid
- they have a low return correlation to fixed-income investments and real estate
- they offer capital preservation against inflation
- they tend to grow in value rather than depreciate

Another factor favoring timberland REITs is the possibility of higher dividends, especially when compared to integrated forest product companies.

## Tax Benefits

As with traditional real estate, standing timber and timberland is a capital asset. Thus the usual rules relating to capital gain and loss

apply to sales and exchange of timber. In addition, a timber owner's opportunity for capital gain treatment is significantly expanded by Code Section 631 to include the sale or exchange of cut timber. Thus the owner of timber or the holder of a contract to cut timber can elect to treat the cutting of the timber as a sale or exchange, whether the timber is held for sale or use in a trade or business, provided the timber or the contract has been owned for more than one year.

Furthermore, the disposition of timber pursuant to a contract under which the taxpayer retains an economic interest in the timber is treated as a sale or exchange if the timber was held for more than one year. In effect, Section 631 permits the portion of a taxpayer's gain attributable to the natural growth of the timber to qualify for capital gain treatment even if the taxpayer cuts the timber and holds it for sale in the ordinary course of business.

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## Options: Minimizing Cash Outlays

*By Brian Bader*

A real estate purchase option gives its holder the right to buy a parcel of real estate at a specified price and on specified terms within a fixed period. Purchase options can be a valuable technique for investors and developers because they are the ultimate form of leverage, permitting the option holder to control property for a relatively small cash outlay. In most cases, the optionee makes a cash payment to the optionor when the option is nego-

tiated. However, an optionee may be able to negotiate a "pay as you go" plan that spreads the cost over the life of the option. The optionee thus is in a position to apply an initial cash outlay to several options over different properties, so increasing the likelihood that one of the options may prove profitable. Several of these approaches are described below.

## Interest Option

When negotiating an interest option, the parties first must agree on the present value of the optioned property. The optionee then agrees to pay to the optionor at designated times during the life of the option (say, every six months) "interest" at an agreed-rate or based on a designated standard such as the 10-year Treasury. If the option is not exercised, the optionor keeps the payments; if the option is exercised, normally the payments are applied to the agreed-upon purchase price.

## Letter of Credit Option

A letter of credit is an agreement by a bank or other lender (the issuer), at the request of a customer (the account party), that the lender will honor a draft for payment by a third party (the beneficiary) in accordance with conditions set forth in the letter. Thus, the credit of the lender is substituted for that of the customer, eliminating the risk that payment will not be made when due (e.g., when the option is exercised or the option period ends.). If no exercise occurs, the optionor receives the agreed-upon option fee. If the option is exercised, the optionor receives the agreed price. Until then, the only cost to the optionee is the interest charged by the bank for issuing the letter.

### Effort Option

Developers frequently use options to tie up land that may not be ready for development for several years. An "effort option" from the landowner requires the developer to obtain preliminary development plans and all necessary approvals within the option period at the developer's expense. If the developer decides not to exercise the option at any time during the option period, all the plans and studies as well as any lease commitments from third parties become the property of the landowner. On the other hand, if the option is exercised, the developer will pay the agreed-upon price.

### Real Estate as Consideration

An alternative for a developer holding long-term land is to pay for an option on land ready for development with a portion of the longer term property, perhaps transferring a parcel each year that the option continues.

### Land Cost Option

Yet another approach tying up vacant land at minimum cost is for the optionee to agree to pay all of the costs of the vacant land until a specified date (unless terminated earlier by the optionee). If the option is exercised, the optionee will pay the agreed-upon price. The landowner then knows all expenses will be covered during the option term, including property taxes that may rise over time, as well as special assessments for roads or utilities.

### Contract With Liquidated Damages

An option with another name is a contract with a liquidated damages clause. A developer signs a contract with the seller, making small down

payment. The contract contains a liquidated damage clause limiting the seller's remedy to the down payment in the event the developer fails to close. Since the developer can walk away without liability during the contract period, he in effect holds an option.

Another approach is for the developer to buy property for a small cash payment with the balance of the price in the form of a purchase money mortgage. The mortgage has an exculpatory clause that limiting the seller's remedy to repossession of the land in the event of default. Here again, the buyer in effect holds an option. If the mortgage permits release of individual lots as they are sold off by the developer, the transaction is the equivalent of a rolling option.

Contracts with limited liability, as describe above, have an advantage over options resulting from the fact that the holder of an option has no legal or equitable interest in the property as does a contract vendee. For example, an optionee has no standing to seek a zoning change, but must act through the optionor, whereas a contract vendee can act directly.

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## Lease Audits: Benefits of Outsourcing

*By David Tevlin*

Tight market conditions are permitting commercial landlords to raise rental rates to record levels. From tenants' point of view, it is vital that they utilize all opportunities to keep overall facility costs as reasonable as possible. The best hope for ten-

ants in this regard is to periodically audit their leases to assure that lease provisions are being correctly adhered to and billings are free from overcharges or errors. Lease audits, by which qualified experts verify the accuracy of operating expense pass-throughs, real estate tax contributions, and any other charges other than basic rent, have become a service increasingly performed by outside vendors rather than in-house.

Within the past decade, lease audits have grown from a very small niche market with few participants nationwide into a segmented industry with several large national participants and dozens of small local firms specializing in their particular market region. The rapid growth of lease audits has been due both to the cost-cutting measures of many corporations in the face of difficult market conditions as well as by the realization by many office tenants that expenses and pass-throughs were not being properly billed. And every audit that produced savings for the tenant brought new business to the lease audit specialist.

When lease audits first began to be performed by outside professionals, the exercise often proved to be not much more than a standard due diligence procedure. Professionals who functioned as general auditors lacked the specific knowledge of real estate and familiarity with tenant/landlord case law to successfully realize savings from audits. Still, this represented an important step forward from the practice of performing lease audits by staff members of a firm who usually lacked the training, resources and time to adequately address the challenge of analyzing complex lease provisions and oblique billing practices of landlords.

### Advantages of Outsourcing

The advantages of outsourcing lease audits rather than doing them in-house are easily recognized when certain considerations are made clear with respect to the audit process. First of all, most lease audit firms perform their services on a contingency basis, thereby absorbing all of the financial and time-related risks involved in an audit. By one estimate, the average field audit encompassing the initial review through the final report submitted to the tenant after an inspection of the landlord's books and records can take between 50 and 60 hours. The estimate does not include additional time spent negotiating with the landlord to actually realize the savings—this often being the most time-consuming part of the process.

Lease audit professionals, with their extensive knowledge of lease clauses and market practices, are in a position to identify lease audit candidates that have a high probability of a substantial recovery. This permits them to avoid spending their resources in auditing properties with a low probability of recovery. As a result, even when a lease audit professional declines to take on a particular tenant, the tenant has learned that it may not be worthwhile spending its own resources in seeking errors in the lease.

A further advantage in having outside professionals perform a lease audit is that a second and independent set of eyes review the lease and billing invoices of the landlord. Too often, in-house lease administrators are so familiar with the files they deal with daily that they pass over indications of possible errors. It is for this same reason that many lease audit firms have a second

auditor review a file for overlooked or unidentified opportunities for savings. In addition, most lease auditors specialize in certain areas such as accounting, law, electrical and other utility services, and architectural and engineering subjects. A lease audit firm is able to draw upon various individuals who have the necessary knowledge in each subject.

### Landlord/Tenant Relationships

A consideration to be borne in mind by a tenant when deciding whether to use in-house auditors or engage outside professionals relates to the relationship the tenant wishes to have with its landlord. Some tenants are concerned that engaging an outside firm to conduct an audit will result in a confrontational relationship with the landlord. Although this can occur, most landlords accept the right of a tenant to examine the landlord's records relating to rent and other charges. It is more likely that the landlord would prefer to deal with an outside auditor who will conduct a review efficiently and in a minimum of time. Even in situations when the magnitude of the claim creates a level of acrimony between the auditor and the landlord, prudent tenants that have utilized outside professionals are able to insulate themselves from any unpleasantness, and indeed may be in a position to step in and help to negotiate a satisfactory settlement.

A final consideration with respect to maintaining a relationship with the landlord arises when the tenant and the landlord have a contractual or other relationship separate and apart from the landlord/tenant relationship. While this can be a very sensitive concern to the tenant, he

should bear in mind that rent and lease escalations are second only to payroll for most corporate tenants and should be reviewed just as is any other invoice sent by a vendor.

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### Patenting a Business or Legal Strategy

*By Marshall Tracht, Esq.*

Real estate, tax, accounting and legal professionals know that creativity is a critical element of long-term success in any business, but also that they rely on following the paths others have blazed. Imagine, then, that you structure a deal in a creative way for tax purposes and find yourself the defendant in a patent infringement lawsuit. Ridiculous? At first it might seem so, but increasingly, information professionals are filing patents on their ideas.

The "business method patent" seems to have caught on most broadly with Internet companies, such as Amazon.com patenting its "1-click" purchasing method and PriceLine.com patenting its reverse auction system. These followed a critical 1998 court decision that held patent laws could protect any business method that produced a "useful, concrete and tangible result." (*State Street Bank & Trust Co. v. Signal Financial Group, Inc.* 149 F.3d 1368 (Fed. Cir.1998)). Following the State Street decision, the U.S. Patent and Trademark Office (PTO) created a new classification for patents: "Data processing; financial, business practice, management or cost/price determination."

### Other Examples

Patent applications are now exploding in areas that once might have been considered absurd. For example, Robert Slane, a financial adviser, has recently filed what appears to be the first patent infringement suit based on alleged infringement of a patented tax strategy. Slane's patent, granted in 2003, covers the use of unqualified stock options in grantor-retained-annuity-trusts (GRATs). Slane has sued the former chairman and CEO of Aetna Insurance for using such stock options in GRATs as part of his estate planning.

While this appears to be the first enforcement action premised on a tax patent, Slane is not alone in seeking to protect his professional advice. The PTO has granted at least 52 tax patents and at least 84 published applications for tax strategy patents are pending. What may be the first real estate strategy patent application is that by Freehold Development, of Austin Texas. It is seeking to patent a restrictive covenant entitled "Springing Interests Flowing From Benefits that Run With the Land." The idea sought to be protected is a servitude that entitles the current owner to receive income every time the property is sold in the future.

### Implications for the Future

The implications of such patents are immense. There are obviously opportunities here; for example, a company with an innovative business or tax strategy can put potential competitors at a significant disadvantage and create a potential source of income lasting for decades. And consider the other side. Imagine if each time an accountant or lawyer suggests a strategy, a patent search must be done to see

if it is "owned" by someone else so that royalties must be paid. In fact, many tax professionals today are finding they must do just that.

### Some Limitations

Not every business method can be patented, of course. To be patentable, an idea must be useful and not obvious. Business-method patents also are subject to a "first inventor" defense. Under this doctrine, created in response to the uproar raised by the first business-method patents, a patent cannot be enforced against anyone who (1) had independently developed the method at least one year before the patent application was filed and (2) had commercially used the method before the patent application was filed.

The patentability of business methods and tax strategies is likely to create a significant slant in favor of larger real estate and professional organizations that have the wherewithal to file patent applications for new ideas and strategies. It now becomes important for many businesses that never considered themselves "researchers and developers" to be sure they have practices and procedures in place to ensure the fruits of their intellectual labors are protected.

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## Condominiums: Suing Accountants and Other Professionals

*By Alvin Arnold*

Do individual condominium unit owners have the right to sue the sponsor, managing agent and accountant to recover damages for

a variety of alleged wrongs? A New York appellate court held that certain claims could go to trial. (*Caprer v. Nussbaum*, 2006 WL 2963128 (N.Y.A.D. 2d Dept.))

### Background

Richard and Erica Nussbaum lived in a rental building that was converted to a condominium. The Nussbaums became members of the condominium's board of managers and also owned the corporate managing agent. An outside firm rendered accounting services. This lawsuit was brought by several unit owners who alleged wrongdoing by the board, its managing agent and accountant. The defendants moved for summary judgment. The trial court granted summary judgment in most respects, allowing to stand only a cause of action alleging breach of contract by the sponsor and a cause of action alleging breach of fiduciary duty by the Nussbaums and board members. The plaintiffs appealed.

### Three Significant Issues

The appellate court said the appeal raised significant issues of first impression with respect to the relationship between condo unit owners on the one hand and the sponsor and other parties involved in the conversion on the other. The three specific issues before the court were as follows:

- Does a unit owner have standing to sue to recover damages for a wrong to the condominium, either individually or derivatively on behalf of the condominium?
- Does the managing agent or its accountant owe a fiduciary duty to the unit owners?
- Can a unit owner bring an action against the condo accountant for professional negligence?

### Standing to Assert Claims

The court first ruled that the owner of an individual condominium unit is without standing to assert a claim for damages to the common interest. Said the court, "Since any recovery in such an action by an individual unit owner would necessarily be limited to the owner's individual fractional interest, allowing such individual suits would likely lead to duplicative, piecemeal litigation of the issues." Such suits also would engender potential conflicts with similar suits initiated by the condominium board of managers.

The court, however, ruled that a unit owner can bring a derivative action on behalf of the condominium. The court said there is "practical logic" in permitting unit owners to sue derivatively. Condominiums essentially operate in the same manner as cooperatives despite their different legal structures, and the fiduciary responsibility of board members of a condominium is governed by the same legal standard as the responsibility of a corporate director of a cooperative. Since the owner of shares in a cooperative can bring a derivative action in New York, the owners of condominium units should have the same right.

The court noted that even if derivative action is not permitted by statute (as it is in New York for cooperatives), such action also has a basis in the common law as an equitable proceeding. The court said that those jurisdictions that have considered the issue have recognized the unit owner's right to bring such action. In particular, the Florida courts have held that in the absence of statutory authority, derivative actions can be permitted in the court's discretion.

### Fiduciary Duty, Aiding and Abetting

The plaintiffs also allege the defendants breached their fiduciary duties to the unit owners. The court dismissed the claim against the sponsor because no fiduciary relationship exists between sponsor and condominium. The trial court also dismissed the action against the managing agent and accountants because neither owes a fiduciary duty to the unit owners.

As a general rule, accountants are not fiduciaries as to their clients, except where the accountants are directly involved in managing the clients' investments. Since such involvement is not alleged here, the accountants are not subject to breach of fiduciary duty claims. However, when it is alleged, as here, that the accountants had full knowledge of the misuse of funds and were indispensable to the board members in their efforts to conceal the misuse of funds, the accountants can be held liable for aiding and abetting the breach of fiduciary duty by the board members.

### Accountants' Professional Liability

The trial court dismissed the causes of action relating to the professional liability of the accountants because of the absence of privity of contract between the accountants and the unit owners. This issue is of first impression in New York. The appellate court ruled that because accountants stand in a relationship with respect to the unit owners that is sufficiently close to privity, a unit owner can bring an action individually against the accountants for negligence.

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