Get real with your real estate dealings

By James L. McCormick III

Fourth quarter 2008 39 LiabiLity and Litigation E nron and its progeny caused a dra- matic shift in the regulatory paradigm for American business. The excesses of off-balance-sheet financing, blatant conflicts of interest, and director ial inaction on which Enron helped focus global at- tention prompted Congress to pass the Sarbanes- Oxley Act (SOX), with its tough transparency and stricter internal corporate control standards. Given the relatively recent proximity of those events to today's business environment — SOX is still in its infancy — it is critical for American companies to focus on avoiding costly conflicts of interest that can permeate their organizations or taint their transactions. At the heart of every scandalous story of cor- porate misfeasance emanating from the Enron era has been an inability to detect and avoid question- able practices. Yet at many corporations, conflicts of interest still routinely infect many transactions, including the seemingly routine business of leasing new office, commercial, or manufacturing space. Leasing is a huge, but little-known, area of doing business. Office and industrial rents total $288 bil- lion a year in the U.S. (see accompanying chart), and current leasehold liabilities total a whopping $1.4 trillion. But many companies and boards pay little attention. Boards typically don't raise ques- tions about a company's leasing arrangements and may be unaware of expenditures and questionable practices. In ty pical corporate real estate transactions, companies retain real estate brokerage firms to represent them in lease negotiations. But the same firms that are retained to assist corporate clients often simultaneously represent the landlords sitting on the other side of the bargaining table. Indeed, as a pragmatic matter, there often is no other side of the table, because these brokerage firms usually owe far more financial loyalty to landlords than they do to their corporate tenant clients. In the crosshairs That is a blunder that can put directors and C-suite executives directly in SOX's crosshairs. Directors and managers who continue to turn a blind eye toward real estate conflicts within their organiza- tions are, therefore, taking a grave — and potentially very expensive — risk. Even before the advent of Sarbanes- Oxley, wasting corporate assets in this manner in the real estate arena was intol- erable and a potential breach of fiducia- ry duty. Since the passage of SOX, board Get real with your real estate dealings As federal regulators continue to expand the reach of Sarbanes-Oxley, directors and CEOs who sign off on conflict-ridden real estate leases may find themselves facing enforcement actions. by James L. McCormick iii and Harvey Pitt James L. McCormick III (left) is president of The McCormick Company, a corporate real estate advisory firm

based in Annapolis, Md. Harvey Pitt is former chairman of the Securities and Exchange Commission (2001-2003) and is the chief executive officer of the global strategic consulting firm Kalorama Partners LLC, in Washington D.C. He is also a member of The McCormick Company's advisory board. 40 directors & boards LiabiLity and Litigation members and senior managers face an increased likelihood of federal regulatory exposure (not to mention adverse media attention) if they allow such conflicts to persist. Sarbanes-Oxley has had the effect of federalizing many corporate fiduciary obligations, and it explicitly prohibits conduct that can lead to inaccurate corporate financial statements. These conflicts of interest can ar ise e ven in cor por a- tions with in-house real es- tate departments. While the existence of knowledgeable in-house staff is an important way to ensure that a compa- ny's interests are protected in lease negotiations, by itself it does not do the trick. When corporate real estate manag- ers lease space in cities and towns across the nation or in foreign locales, they frequently must retain firms familiar with local conditions — such as compa- rable costs and availability of space — to enable them to bargain effectively. A mistaken assumption Because they frequently work within a "status quo" system that makes it difficult to manage the inher- ent problems, in-house corporate real estate man- agers frequently overlook the conflicts that can arise from retaining firms that also represent land- lords, thus virtually guaranteeing that their com- panies will wind up with less than optimal leases. Moreover, internal real estate staffs may operate under the common but mistaken assumption that they are not encumbered by the extensive internal control requirements and federalized fiduciar y obligations imposed by SOX. Additionally, these mid-level managers often face heavy pressure from their superiors to obtain space quickly. Expedience thus becomes more important than ensuring more favorable lease terms. The problem sometimes runs deeper. Many in- ternal real estate managers are career corporate employees, working below the C-suite's r adar screens. In the worst cases, they may have de- veloped familiar (some might say "cozy") rela- tionships with brokerage firms that can involve anything from being wined and dined to taking under-the-table gifts. The result is that, with shocking frequency, cor- porate officers are presented with leases for their signatures that may run 20 or 30 percent above otherwise obtainable levels. Many directors and se- nior executives fail to take note of this because they know little or nothing about local real estate costs and conditions; from their viewpoint, rent is only one of many business expenses they must consider and often not one of the major expenses, at that. There is nothing new about this. Over the last 20 years, aggressive consolidations through mergers and acquisitions have fueled dual representations in the real estate industry. And neither landlords nor landlord-oriented brokerage companies have any incentive to eliminate a structure riddled with conflicts of interest, since it gives them a great mu- tual advantage in

negotiations. A sufficient incentive But it is, of course, axiomatic that the longevity of any troublesome situation can in no way justify it. Depending on the extent of a company's leasing needs, allowing these arrangements to continue can cost larger companies material amounts of money ever y quar ter. Responsible boards of directors should not tolerate its unreviewed continuation. The dollar losses alone provide sufficient incentive to reject it, especially in these challenging economic times, when a tight hand on operating costs may be the key to survival. Even more urgent, there is an increasingly criti- cal reason for senior executives and their respec- tive boards to stand up and take notice. As federal regulators continue to expand the reach of SOX, Directors should pay close attention to their companies' real estate leasing because it's a little-known and unexplored area of board oversight. Here are eight strategic questions that an engaged board should be asking: • What are our company's leasehold procurement arrangements? • How can the board review these arrangements annually in a practical way? • What percentage of the operating budget is devoted to leasing? • What is the competitive bidding process for the company's leaseholds? • Does the internal leasing department have a code of ethics that is familiar to its employees? • Are employees required to sign off annually on the code of ethics, which becomes part of their personnel file? • Are all employees restricted as to conflicts of interest and inappropriate gifts? • Does the board need to hire an independent leasing expert for guidance and establishing initial rules of oversight? — James L. McCormick III and Harvey Pitt 8 questions every director should ask about leasing With shocking frequency, leases are presented for approval that may run 20 or 30 percent above otherwise obtainable levels. Fourth quarter 2008 41 LiabiLity and Litigation directors and CEOs who sign off on conflict-rid- den real estate leases may find themselves facing enforcement actions. The alternative is for companies to retain inde- pendent firms that strategically manage real estate conflict risks. By providing best-in-class indepen- dent negotiators, these independent advisory firms build a firewall between their clients and the inces- tuous world of double-dealing real estate transac- tions. Realistically, it is impossible to completely elimi- nate the conflicts inherent in the real estate world. But by delivering professional, independent teams that conduct transparent, arms-length negotiations, these independent risk-management firms reduce such conflicts to the minimum while maximizing their clients' bargaining leverage. Three goals Independent corporate advisory firms have three principle goals: • To strategically install a firewall between their tenant-clients and the hodgepodge of dual repre- sentation brokers in local markets. • To add negotiating leverage to in-house real es- tate departments, empowering them to win leases that significantly reduce their client's costs through lower rents and long-term flexibility. • To protect boards of directors and senior execu- tives from after-the-fact charges that they tolerated conflicts of interest, lacked adequate

internal con- trols and published potentially inaccurate financial information. Of course, when senior managers review leases that have been negotiated by independent corpo- rate advisory firms, they may have difficulty in as- sessing the precise benefits actually achieved. Who knows, after all, what a reasonable rent is for space in a city on the other side of the continent or half- way around the world? But some qualities are measurable. For example, landlord-oriented brokerage firms will usually ne- gotiate long-term leases of, say, 10 years. The secu- rity that such deals bring landlords increases the value of their assets, and it's in the brokerage firm's interest to keep landlords happy. In contrast, inde- pendent real estate advisory firms frequently push for short-term leases, usually three to five years, on the sound business principle that market un- certainties make flexible leases preferable for most companies. The pros have it From the board of directors' perspective, employ- ing conflicted full-service brokerage firms to nego- tiate real estate leases is costly and potentially dan- gerous. In contrast, using independent firms that strategically manage the serious risks otherwise caused by dual representation will assure leases that are professionally negotiated on the company's be- half. These leases will deliver optimal costs and the greatest lease flexibility and will insulate the cor- poration from the inevitable second-guessing of regulators and plaintiffs' lawyers alike. The full extent of Sarbanes-Oxley is not yet fully understood in boardrooms. But its reach can ex- tend to real estate leases, and prudent corporations should anticipate its impact. ■ The authors can be contacted at jmccormick@themccor- mickcompany.com and harvey@kaloramapartners.com. Leasing is a huge, but little-known, area of doing business. Office and industrial rents total $288 billion a year in the U.S. and current leasehold liabilities total a whopping $1.4 trillion. Total U.S. office square footage . . . . .7,769,633,587 Average rate per square foot . . . .$24.50 Average annual office rent by corporations . . . .$190,356,022,881.50 Average lease term (years) . . . . .5 Estimated lease liabilities on five-year leases . . . .$951,780,114,407.50 Total U.S. industrial square footage . . . . 16,296,870,118 Average rate per square foot . . . .$6.03 Average annual industrial-space rent by corporations . . . .$98,270,126,811.54 Average lease term (years) . . . . .5 Estimated lease liabilities on five-year leases . . . . $491,350,634,057.70 Total annual rent (office + industrial) . . . .$288,626,149,693.04 Total estimated lease liabilities (office + industrial)1 . . . .$1,443,130,748,465.20 1based on an estimated average five-year lease commitment Source: The CoStar Industrial Report Under the radar: Leasehold liabilities