

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

ENRON AND ITS PROGENY caused a dramatic shift in the regulatory paradigm for American business. The excesses of off-balance-sheet financing, blatant conflicts of interest, and directorial inaction on which Enron helped focus global attention 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 corporate misfeasance emanating from the Enron era has been an inability to detect and avoid questionable 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 billion 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 questions about a company's leasing arrangements and may be unaware of expenditures and questionable practices.

In typical 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 organizations 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 intolerable and a potential breach of fiduciary duty. Since the passage of SOX, board



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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 arise even in corporations with in-house real estate departments. While the existence of knowledgeable in-house staff is an important way to ensure that a company's interests are protected in lease negotiations, by itself it does not do the trick. When corporate real estate managers lease space in cities and towns across the nation or in

foreign locales, they frequently must retain firms familiar with local conditions — such as comparable 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 managers frequently overlook the conflicts that can arise from retaining firms that also represent landlords, thus virtually guaranteeing that their companies 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 fiduciary 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 internal real estate managers are career corporate employees, working below the C-suite's radar screens. In the worst cases, they may have developed familiar (some might say “cozy”) relationships 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, corporate officers are presented with leases for their signatures that may run 20 or 30 percent above otherwise obtainable levels. Many directors and senior 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 mutual 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 every quarter. 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 critical reason for senior executives and their respective boards to stand up and take notice. As federal regulators continue to expand the reach of SOX,

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8 questions every director should ask about leasing

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

directors and CEOs who sign off on conflict-ridden real estate leases may find themselves facing enforcement actions.

The alternative is for companies to retain independent firms that strategically manage real estate conflict risks. By providing best-in-class independent negotiators, these independent advisory firms build a firewall between their clients and the incestuous world of double-dealing real estate transactions.

Realistically, it is impossible to completely eliminate 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 representation brokers in local markets.
- To add negotiating leverage to in-house real estate 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 executives from after-the-fact charges that they tolerated conflicts of interest, lacked adequate internal controls and published potentially inaccurate financial information.

Of course, when senior managers review leases that have been negotiated by independent corporate advisory firms, they may have difficulty in assessing 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 negotiate long-term leases of, say, 10 years. The security 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, independent real estate advisory firms frequently push for short-term leases, usually three to five years,

Under the radar: Leasehold liabilities

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

on the sound business principle that market uncertainties make flexible leases preferable for most companies.

The pros have it

From the board of directors' perspective, employing conflicted full-service brokerage firms to negotiate real estate leases is costly and potentially dangerous. 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 behalf. These leases will deliver optimal costs and the greatest lease flexibility and will insulate the corporation 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 extend to real estate leases, and prudent corporations should anticipate its impact. ■

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