REAL ESTATE FINANCE

VOLUME 31, NUMBER 3 WINTER 2015

Real Estate Finance: Call for Articles

Real Estate Finance invites you to submit an article for publication. *Real Estate Finance* is geared toward industry professionals in the field of real estate. We seek to help real estate professionals add to their knowledge base, do their jobs more efficiently and effectively, introduce new datasets and methodologies, and inform professionals of relevant and timely developments in the field. In addition to full length studies, *Real Estate Finance* is open to publishing shorter editorial comments on past articles, current events, and so forth.

We have formed a new board and changed publication frequency from bi-monthly to quarterly. Please send your best industry relevant articles for immediate publication consideration. I promise quick review turnaround times.

Please email manuscripts to michael.seiler@mason.wm.edu.

Sincerely,

Michael J. Seiler

Dr. Michael J. Seiler
Professor of Real Estate and Finance
The College of William & Mary
Mason School of Business

Cross-Border Capital Flows into Real Estate

By Franz Fuerst, Stanimira Milcheva, and Andrew Baum

Franz Fuerst *is with the University of Cambridge, Department of Land Economy, Cambridge, UK. He may be reached at* ff274@cam.ac.uk.
Stanimira Milcheva *is with the University of Reading, Henley Business School.*
Andrew Baum *is with the University of Oxford, Said Business School.*

The authors wish to thank DTZ for providing a large database of property investment flows and other market data. We also are indebted to IPD for providing academic access to their international property return data and to RCA for providing us data for cross-border real estate capital flows. Jones Lang LaSalle also deserves credit for making the global real estate transparency data available to researchers. Franz Fuerst also wishes to acknowledge the generous support of the Cambridge University Land Society (CULS) in enabling this research.

Cross-border capital flows into property are marked by sharp differences among countries. Absent any distorting factors and cyclical swings, each country should receive capital flows commensurate with the size of its respective economy or, more accurately, the total size of its investible real estate market. This distribution of international flows is sometimes referred to as the "neutral" or "naïve" allocation. Observed capital flows deviate from this naïve equilibrium considerably, not only in the short run but tending to persist for a very long time. According to the institutional economics theory, the attractiveness of a country as an investment destination depends on its socio-economic environment and institutional framework.[1] Therefore, one possible explanation for the long-term aberration from expected values are market entry barriers encompassing a broad range of institutional, legal, and real estate specific risks.

La Porta and others[2] show that the size of the capital market and foreign financing of domestic companies strongly depends on the legal environment. Glaeser,[3] Djankov[4] and others suggest that countries that have similar law structure can more easily enforce their commercial contract rights. Institutional barriers such as property rights[5] and taxation[6] are shown to be important drivers of investment. Cross-border capital flows are shown to be restrained by regulatory limitations, exchange and ownership controls, and the repatriation of capital.[7] Daude and Stein[8] find that institutional barriers such as unpredictable laws, regulations and policies, excessive regulatory burden and government instability play a major role in deterring foreign direct investment (FDI). Crime and corruption within a country also can be a major barrier to foreign capital flows.[9]

Yet, there has been limited empirical examination of the effects of institutional differences across international real estate, primarily due to the lack of appropriate data series. Empirical studies have observed that global institutional real estate investments are focused on a relatively small set of countries, particularly developed countries such as the United States, the United Kingdom, and Japan, and within these countries on large cities such as New York, London, and Tokyo.[10] This remarkable geographic concentration of investments is puzzling and seems at odds with the diversification benefits postulated by modern portfolio theory and the core tenets of neoclassical economics. An early study by Han[11] identifies that real estate investment opportunities, demographic characteristics, and market structure are the most important drivers of international real estate investment. Chin[12] and Lim[13] show that some aspects of the legal framework, regulation, and political stability are important for real estate investors' market perceptions, which may be explained by some real estate specific properties, such as the immobility of real estate and the complexity of real estate transactions. Other institutional barriers such as fiscal regimes, differences in valuation standards, different property market conventions also can hinder foreign investment because it may impede active management of the properties.[14] More recently, Lieser and Groh[15] use panel real estate investment data by Cushman & Wakefield to examine the determinants of

international commercial real estate investment looking at socio-economic, demographic and institutional characteristics. They find that besides economic growth, urbanization, and demographics a lack of transparency within the legal framework, administrative burdens of doing real estate business, socio-cultural challenges, and political instabilities deter international real estate investors.

Our study builds on the framework of Lieser and Groh to analyze the institutional and real estate specific drivers of cross-border real estate capital. We, however, use a different methodology and account for important barriers such as real estate market liquidity and transparency. Moreover, our study includes direct property returns to account for tactical pricing in different countries. This research sets out to empirically test for the existence and significance of such barriers using a unique dataset that combines two international databases of real estate flows held by the property service providers DTZ and Real Capital Analytics (RCA) together with a large number of institutional, legal, and property market indicators from a variety of sources. The assembled panel dataset of 24 countries in Europe and Asia allows us to examine the dynamics of flows in greater detail by disaggregating them into domestic and foreign inflows and outflows for each country in order to find out to what extent flows are driven by institutional and socio-economic and real estate specific barriers. We also control for the effects from property returns as drivers of capital flows.

It has been shown recently that institutional and regulatory barriers drive cross-border bank flows,[16] supporting the concept of cross-border regulatory arbitrage. Our results do not support the idea of cross-border institutional or regulatory arbitrage in the global real estate market. Our results differ from those in Lieser and Groh in the way that hardly any institutional or legal barriers impact significantly on the level of real estate inflows. Domestic inflows, however, are significantly driven by property returns and the macroeconomic environment. While inflows in general are less affected, the presence of institutional and legal barriers has, similarly as in Lieser and Groh (2013), a strong impact on real estate capital outflows. Indeed, real estate exports increase with an easy access to the financial market, a good macroeconomic environment, and transparent real estate markets. In turn, the main driver of domestic and foreign real estate inflows is real estate market liquidity, having a significantly positive impact in countries that have high levels of liquidity. Above findings imply that investors are global players who are well informed about the local real estate markets, so that they would be affected less by institutional and legal barriers but more by the prospects of a timely market entry and exit.

DETERMINANTS OF CROSS-BORDER REAL ESTATE FLOWS

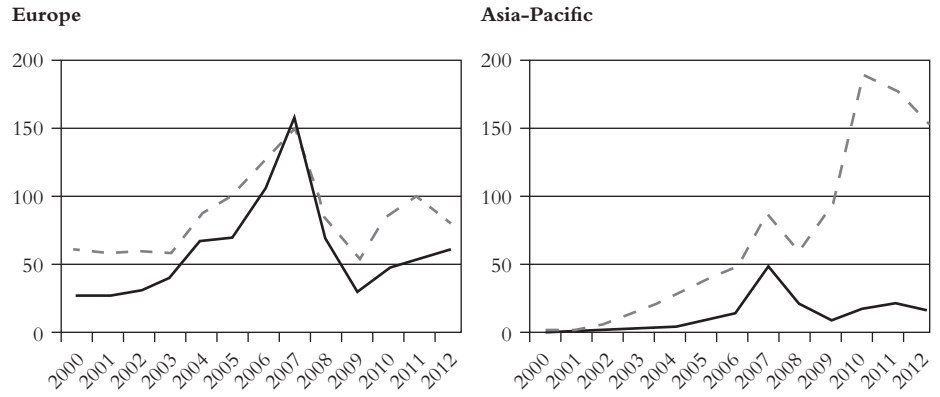
International or cross-border property investment has experienced a remarkable surge over the last decade. While this trend is not a singular phenomenon and is in fact mirrored by other asset classes such as equities and bonds as well as international trade patterns and foreign direct investments (FDI), it is notable that direct property as an inherently localized and immobile asset class should be affected by this development to the same degree as the more liquid economic activities. In this section, we discuss some stylized facts regarding the property market specific conditions that helped bring about the observed flow into real estate on a global scale.

Why Are Cross-Border Flows into Property a Relatively Recent Phenomenon?

Exhibit 1 reveals that domestic and foreign investment has grown strongly in Europe and Asia-Pacific prior to the global financial crisis, with foreign inflows exhibiting a more cyclical pattern in both regions. While foreign inflows in Europe closely track domestic flows both before and during the crisis, in Asia, domestic capital continues to grow even after the crisis while foreign capital decline making domestic capital by far the predominant source of real estate investment.

The strong increase in cross-border capital can have different drivers: (1) the availability of suitable investment vehicles; (2) technological advances; (3) internationalization of the real estate industry; and (4) increasing advantages for large investors of capital. A possible explanation for the general trend towards an internationalization of real estate investments is the concomitant expansion of indirect property investment. In particular, the investment strategies of "core" non-listed real estate funds entail domestic or foreign investment into developed economies, whereas the less risk-averse "opportunity" funds also allocate some capital to developing and emerging markets in search of higher returns.[17] Thus, the emergence of new investment vehicles arguably has helped catalyze international property investment because it has managed to overcome some of the problems that are characteristic of this asset class such as

Exhibit 1—Capital Flows into Direct Real Estate Investments from 2000 to 2012



Domestic (dashed line) and foreign (continuous line) in billion USD.
Source: DTZ

low liquidity, strong heterogeneity of individual assets, and lumpiness of the asset.

Currency hedging, however, is expensive and difficult to achieve which means that real estate investment vehicles are rarely fully hedged.[18] In practice, this problem leaves investors exposed to considerable currency risk. Other perceived difficulties, including the dangers of operating from a distance with no local representation, increases the attraction of investing internationally through liquid securitized vehicles and non-listed funds, but nevertheless remain as barriers to international exposure by asset managers.

Advances in transportation and communication technology are other factors that have enabled greater mobility of capital flows, although spatial proximity still matters for portfolio choice, savings and investment, and can have a great influence on investors' decisions and returns.[19]

It is a key characteristic of the real estate asset type that it requires large-scale equity and debt capital as well as extensive financial and technical expertise to finance and produce institutional-grade buildings. These scale and know-how requirements are the main bottleneck for emerging and developing markets. Entrepreneurship and specialized education are required along with access to foreign (and at a later stage domestic) debt and equity capital. If actual and perceived barriers to investment influence investor behavior, then large and more advanced economies will dominate cross-border capital flows into real estate and slow down economic convergence between developed and less developed economies. It is in the context of this broader debate on global economic development that we should be concerned to understand the barriers to cross-border real estate investment for the benefit of investors seeking diversification and return, and for the benefit of governments seeking to promote domestic economic development.

Finally, some barriers to investment affect not only foreign investors but also domestic investors. For example, a lack of transparency or uncertainty regarding financing opportunities tends to impede domestic investment. We therefore expect lower capital flows, both from domestic and foreign sources, in countries that score poorly on measures of transparency and other institutional factors.

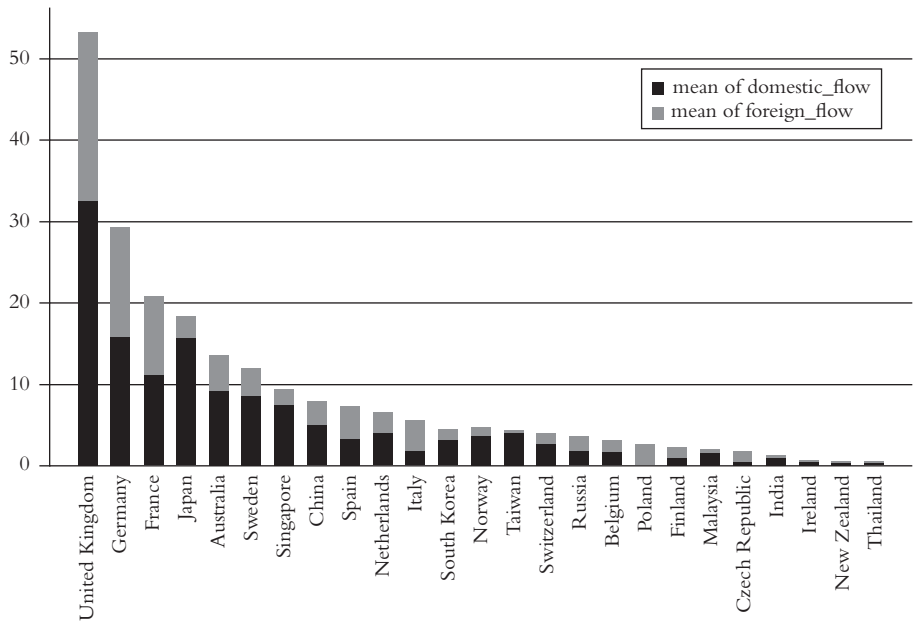
DATA

Flows

Our dataset consists of a panel of annual series for 24 countries from 2007 to 2012. As dependent variables, we use domestic and foreign real estate capital inflows provided by DTZ. In addition to analyzing inflows, we also assess the impact of institutional, legal and real estate specific barriers on capital outflows, data for which has been provided by RCA.[20]

Exhibit 2 shows the average annual domestic and foreign inflows to each country between 2007 and 2012. The United Kingdom attracts by far the bulk of cross-border investment with an average total value of domestic and foreign inflows amounting for more than 50 billion US dollars. Other major investment destinations are Germany,

Exhibit 2—Domestic and Foreign Real Estate Investment Inflows, Average Values from 2007 to 2012



In billion USD
Source: DTZ

France, and Japan. In the majority of the countries studied, domestic investment represents a higher share of total real estate investment than foreign investment.

Exhibit 3 shows that among the 21 countries for which RCA data is available the highest real estate capital outflows have been observed in Australia, amounting annually to about 5.5 billion US dollars on average between 2007 and 2012. Germany, United Kingdom, and Singapore follow with outflows ranging between 2.5 and 3.5 billion US dollars annually. Other important real estate capital exporters are Malaysia, China, the Netherlands, and Switzerland.

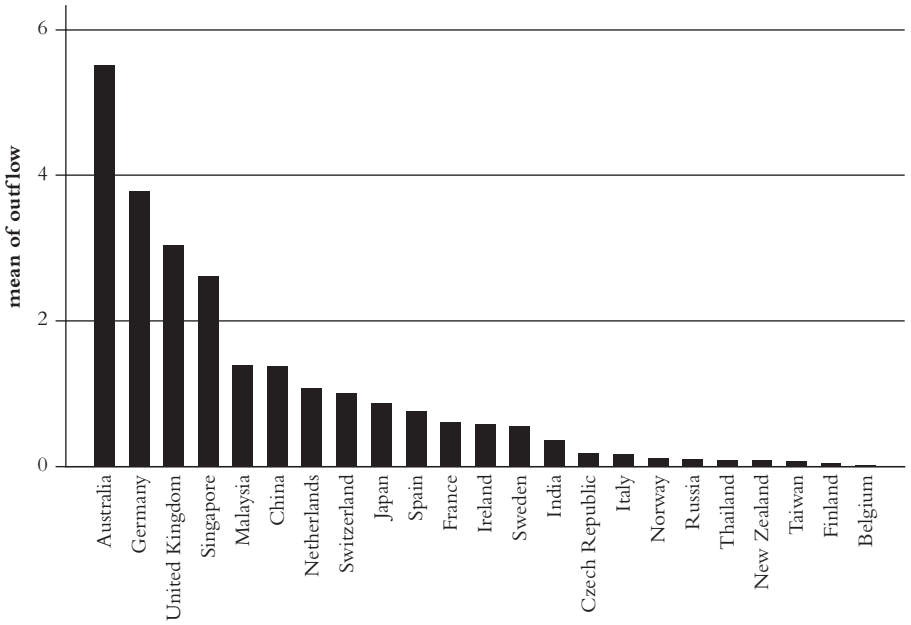
For the majority of the countries, foreign investment has not yet recovered after the global financial crisis (*see* Exhibits 4 through 7). However, in some markets such as Germany, Sweden, Poland, and China foreign investment has been trending upwards for the last few years. In about the half of the countries, domestic investment also has been increasing after the crisis. A jump in domestic investment has been observed in Germany, Sweden, Norway, Singapore, United Kingdom, Australia, and China.

Outflows show less variation than inflows in the aftermath of the crisis. However, in Singapore and Malaysia, outflows drastically increased after 2007-2008.

Institutional, Legal, and Real Estate Specific Barriers

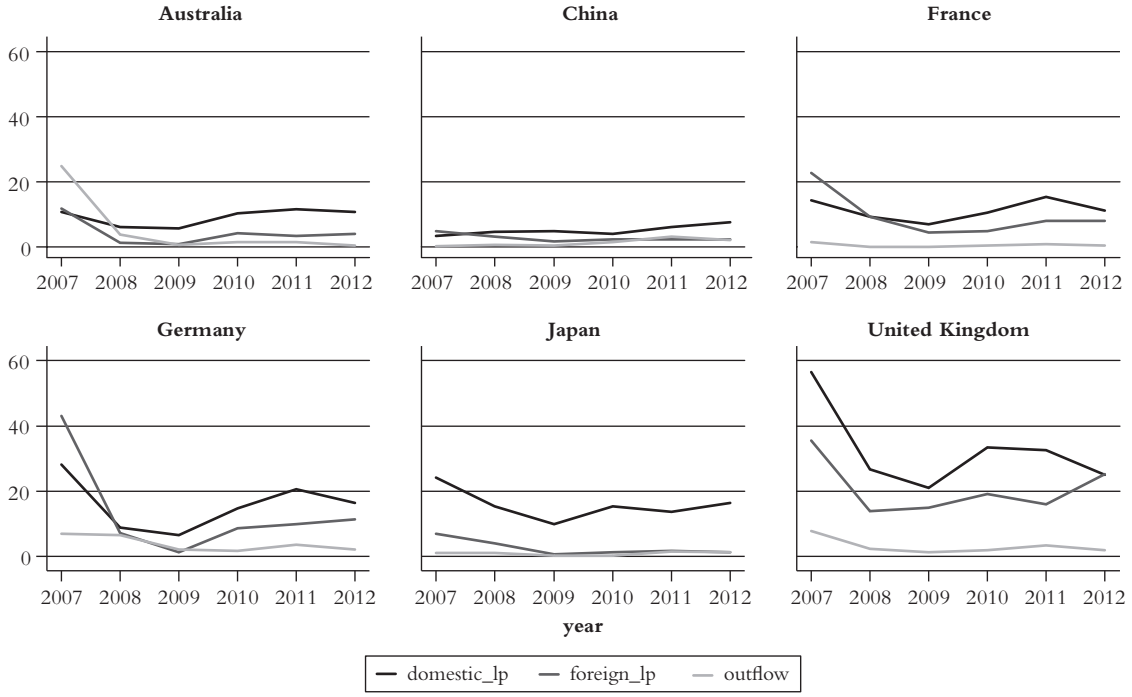
To assess the impact of different investment barriers on cross-border real estate flows, we first collected a wide range of indicators characterizing the institutional, legal, socio-economic, and real estate specific realms using data from three different sources: (1) the World Heritage Foundation (WHF), (2) the World Bank (WB), and (3) the World Economic Forum (WEF). Our database is composed of the following variables: property rights, freedom from corruption, fiscal freedom, government spending, business freedom, labor freedom, monetary freedom, trade freedom, investment freedom, financial freedom, voice and accountability, political stability, government effectiveness, regulatory quality, rule of law, institutions' quality, infrastructure, macroeconomic environment, health and primary education, higher education and training, goods market efficiency, labor market efficiency, financial market development, technological readiness, market size, business sophistication, innovation, the number of listed companies, credit depth of information, current account-to-GDP ratio, savings-to-GDP ratio, credit-to-GDP ratio, population, and GDP.

EXHIBIT 3—REAL ESTATE INVESTMENT OUTFLOWS, AVERAGE VALUES FROM 2007 TO 2012



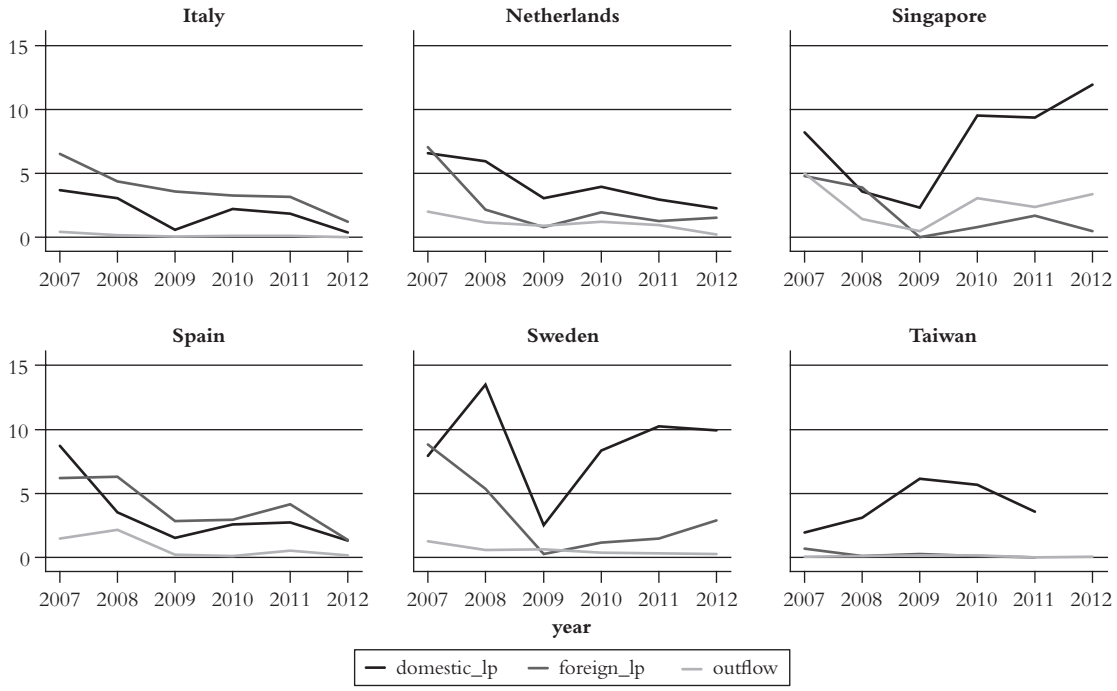
In billion USD
Source: RCA

EXHIBIT 4—DOMESTIC AND FOREIGN REAL ESTATE CAPITAL INFLOWS, AND CAPITAL OUTFLOWS



In billion USD
Source: DTZ (inflows) & RCA (outflows)

Exhibit 5—Domestic and Foreign Real Estate Capital Inflows, and Capital Outflows



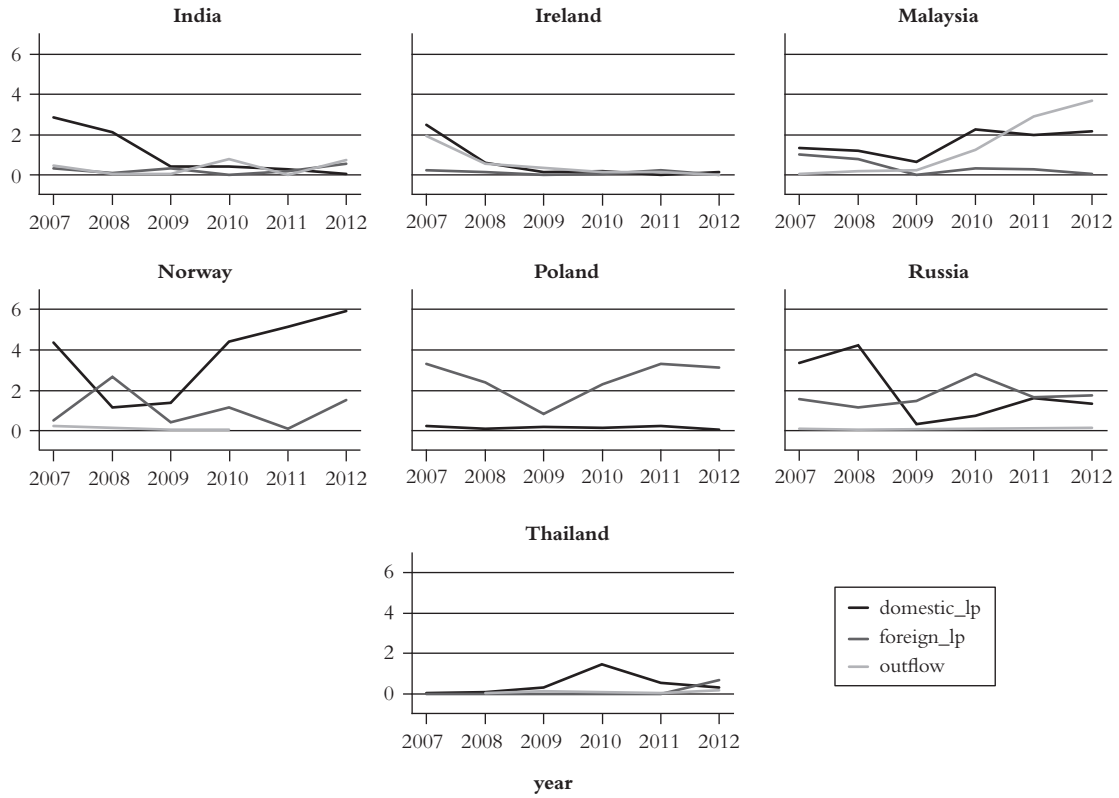
In billion USD
Source: DTZ (inflows) & RCA (outflows)

The majority of these variables present components of composed indices, such as the Index of Economic Freedom from the WHF and the Global Competitiveness Index from the WEF. However, due to the high correlation among the majority of the barriers and the multicollinearity issues arising, we are not able to include all these variables in a using a fixed-effect regression methodology. While Lieser and Groh[21] overcome this issue by applying a different methodology by conducting augmented random-effect estimation, Hausman tests indicate that we should continue with a fixed-effect regression. Therefore, one solution would be the use of a principal component analysis and factors as explanatory variables instead of the individual indicators. Because factors derived from principle component analysis are difficult to interpret, another solution would be to select those indicators that have the lowest cross-correlation as our explanatory variables.

We prioritize the second option and drop all variables that show a correlation of more than 50 percent. The set of barriers selected is based on two criteria. First, we select those barriers that are not directly related to each other by choosing those with the lowest correlations. Second, we include those variables which best describe real estate flows. The selected indicators are summarized in Exhibit 8. The set of explanatory variables includes (among others) sub-indices of the Index of Economic Freedom such as property rights, fiscal freedom, government spending, labor freedom, and investment freedom.

Definitions for each variable used in the analysis are presented in the Appendix and taken from the respective sources. An increase in the property rights index is relevant for domestic and foreign investors to the extent that it increases their confidence to undertake entrepreneurial activity, knowing that their wealth is safe from unfair expropriation.[22] Fiscal freedom measures the tax burden imposed by government, accounting for direct taxes and overall taxes, and may also affect investment decisions. Government spending presents the share of government expenditures as a percentage of GDP. Countries with high spending would probably crowd out private investment activity. Labor freedom accounts for aspects of the legal and regulatory framework of a country's labor market. In general, the greater the degree of labor freedom, the lower is the rate of unemployment in

Exhibit 6—Domestic and Foreign Real Estate Capital Inflows, and Capital Outflows



In billion USD
Source: DTZ (inflows) & RCA (outflows)

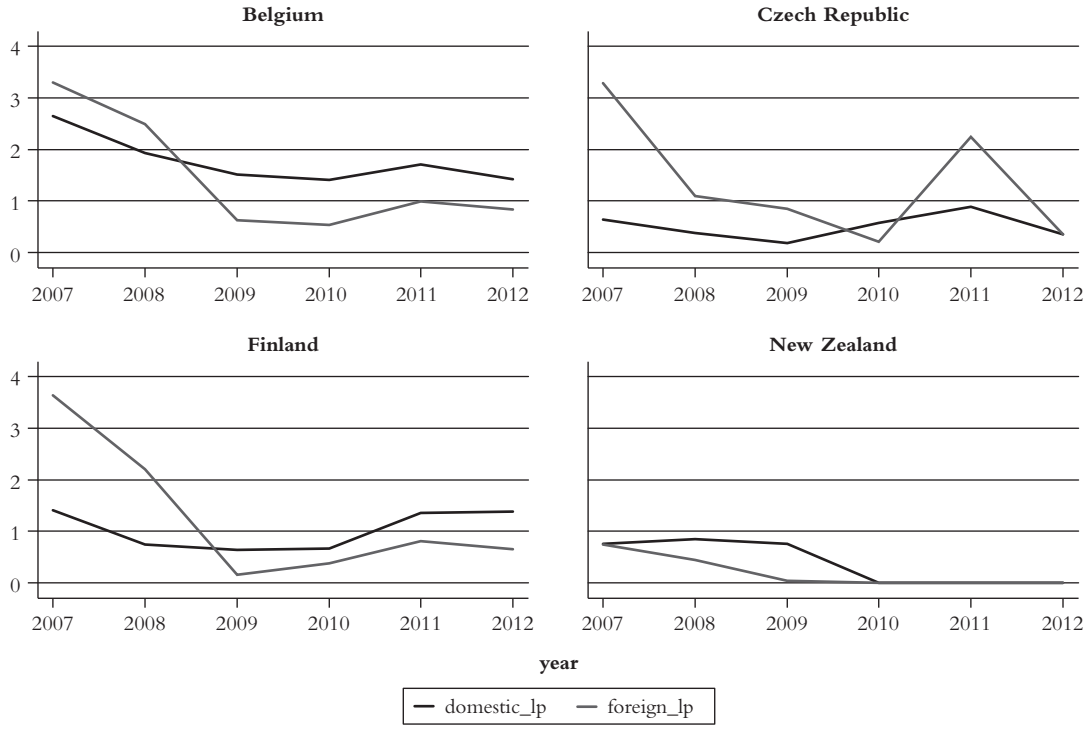
an economy[23] and the higher the incentive for investors to run a business in this country. Investment freedom accounts for restrictions of foreign investment, restrictions on land ownership, capital controls, foreign exchange controls, etc. and can directly affect investment flows.

Other barriers included in the analysis are associated with the state of the financial market and include indices of financial market development, credit depth of information, and macroeconomic environment from the WEF's Global Competitiveness Indicators. The index for financial market development measures the degree of development of the financial market by accounting for the availability and affordability of financial services, financing through the local equity market, ease of access to loans, venture capital availability, trustworthiness and confidence, soundness of banks, regulation of securities exchanges and legal rights.[24]

The index for the credit depth of information measures rules affecting the scope, accessibility and quality of credit information available through public or private credit registries. Due to its highly capital-intensive character, real estate investment could be affected by this index since it can serve as a proxy for the availability of credit. The index of macroeconomic environment includes the following macroeconomic indicators: government budget balance, gross national savings, inflation, government debt, and the country credit rating.[25] We prefer to include this index instead of GDP or other macroeconomic variables because the latter are highly correlated with the other indicators while the index shows a much lower correlation. In order to control for the size of the economy, we include an index of market size consisting of 75 percent of the size of the domestic economy measured by GDP and net exports and 25 percent of the size of the foreign economies.

The indices reported in Exhibit 8 measure the institutional, regulatory, and real estate specific barriers that may be relevant for investors. It is important to note that the

EXHIBIT 7—DOMESTIC AND FOREIGN REAL ESTATE CAPITAL INFLOWS



In billion USD
Source: DTZ

EXHIBIT 8—SOURCES FOR THE INSTITUTIONAL, REGULATORY, AND REAL ESTATE SPECIFIC BARRIERS

Barriers	Index	Source
Property rights	Index of Economic Freedom	World Heritage Foundation
Fiscal freedom	Index of Economic Freedom	World Heritage Foundation
Government spending	Index of Economic Freedom	World Heritage Foundation
Labour freedom	Index of Economic Freedom	World Heritage Foundation
Investment freedom	Index of Economic Freedom	World Heritage Foundation
Credit depth of information	World Development Indicators	World Bank
Macroeconomic environment	Global Competitiveness Index	World Economic Forum
Financial market development	Global Competitiveness Index	World Economic Forum
Market size	Global Competitiveness Index	World Economic Forum
Global competitiveness index	Global Competitiveness Index	World Economic Forum
Real estate transparency	Global Real Estate Transparency Index	Jones Lang LaSalle
Real estate liquidity	Real estate liquidity	DTZ

only variables that are specific to the real estate market are the Jones Lang LaSalle Transparency Index and the liquidity measure. While Lieser and Groh use some of above variables in their regressions as well, they do not include direct measures of real estate market transparency and liquidity. However, the latter address unique factors affecting real estate markets across the globe, such as real estate performance, availability of listed vehicles, the regulatory

and legal environment for real estate businesses, market fundamentals affecting the real estate market, and real estate transaction costs. The transparency index is compiled from a survey of the global business network of Jones Lang LaSalle and LaSalle Investment Management. The survey has been conducted since 1999, and is updated every two years. The higher is the value of the index, the lower is the transparency of the respective real estate market.

The real estate liquidity measure provided by DTZ is expressed as transaction volumes in relation to total real estate stock. It can be seen as a proxy indicator for the time needed to enter or exit the real estate market. The index shows a low correlation with the remaining variables. The inclusion of a liquidity measure is important, as direct real estate is regarded as being less liquid than other asset classes.[26] This applies particularly to smaller and less dynamic markets. It means that illiquidity presents an additional investment barrier especially when investors are concerned about their entry-exit options in times of distressed markets and systematic liquidity crises.

Finally, in addition to the above barriers, we include annual all-property total returns taken from IPD. The IPD database covers the majority of countries in our sample.[27] However, there is a range of countries for which we infer total returns based mainly on GDP growth data to estimate capital growth plus some simplifying assumptions about income returns that we derive from known values for similar countries in the IPD database.[28] This analysis does not consider currency effects and therefore all returns are based on local currencies.

Exhibit 9 shows the summary statistics of all variables including the mean, standard deviation from the mean and minimum and maximum values. On average across the 24 countries from 2007 to 2012, total real estate capital inflows were around 9.5 billion US dollars with almost two-thirds of the capital coming from domestic investors. Domestic

EXHIBIT 9—SUMMARY STATISTICS

Variable	Obs	Mean	Std. Dev.	Min	Max
Foreign inflows (billion USD)	138	3.5	6	0	43
Domestic inflows (billion USD)	138	6	8	0	56
Outflows (billion USD)*	109	1	3	0	25
Outflows (billion USD)**	186	2	8	0	89
Property returns (%)	144	5	9	−34	30
Credit depth of information (index)	138	5	1	3	6
Real estate market transparency (index)	144	2	1	1	4
Property rights (index)	144	72	21	20	95
Fiscal freedom (index)	144	65	13	33	91
Government spending (index)	144	53	25	4	95
Labour freedom (index)	144	67	16	40	99
Investment freedom (index)	144	66	20	20	95
Global competitiveness (index)	144	5	0	4	6
Macroeconomic environment (index)	144	5	1	4	7
Financial market development (index)	144	5	1	3	6
Market size (index)	144	5	1	4	7
Real estate liquidity ratio (%)	144	4	3	0	17

* Data is from RCA including all the countries in the sample determined by the DTZ data except Belgium, Czech Republic, Finland, and New Zealand.

**Data for outflows comes from RCA. The full dataset comprises 50 countries. However, it contains a lot of missing observations that explains the relatively low number of observations. For the sake of comparison across inflows and outflows, we report two summary statistics for the same sample of countries as the inflows. As robustness checks we also account for the whole sample of countries available from RCA.

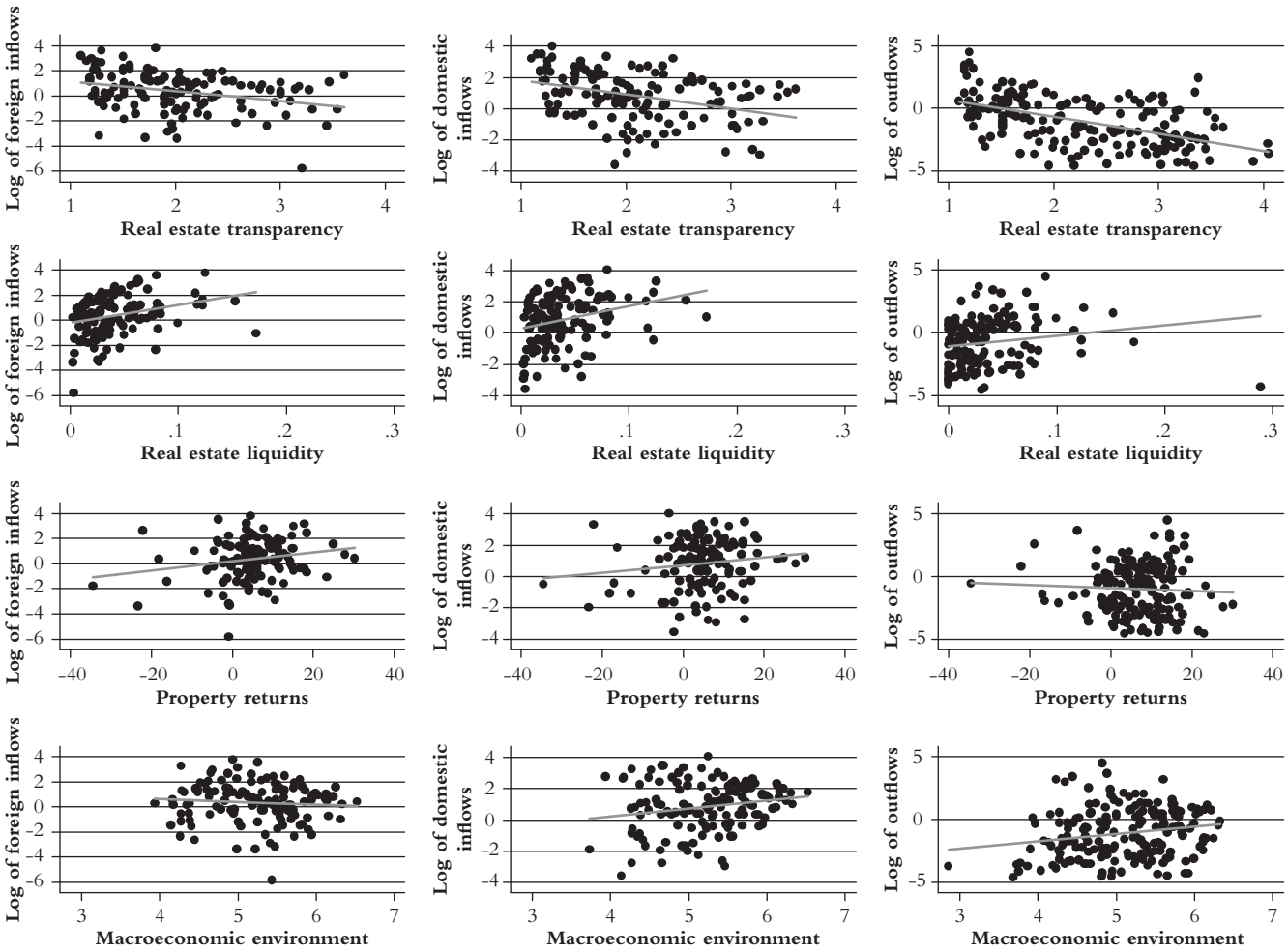
inflows reached a maximum value of 56 billion US dollars in comparison to 43 billion US dollars for foreign inflows. The variation in domestic flows is similar to that of foreign flows indicating that both foreign and domestic investors may base their decisions on investing in these markets on similar indicators.

With respect to the outflows, we observe an average value based on a sample of 21 countries amounting to 1 billion US dollars per year. Compared to domestic inflows, the share of outflows is lower, meaning that for the estimated sample period domestic investors in the above countries have invested more in domestic rather than in foreign real estate.

Property returns vary strongly across the countries ranging from a minimum value of -34 percent to a maximum value of 30 percent, with an average return across the 24 countries from 2007 to 2012 of 5 percent and a standard deviation of 9 percent. Regarding legal, institutional, and real estate specific barriers, the indices of fiscal freedom, labor market freedom, and global competitiveness show the lowest volatilities across the 24 countries throughout the estimation period. In turn, the highest variability has been observed for government spending. For this institutional barrier we also observe the lowest mean in comparison to the other barriers. Countries seem to have relatively high government spending but score well in other institutional and legal barriers with little variation.

Exhibit 10 plots foreign inflows, domestic inflows and outflows against the index of real estate market transparency, real estate market liquidity, property returns, and an index

Exhibit 10—Scatter Plots of Real Estate Flows and Different Explanatory Variables



Note: Each dot represents a value in a particular year for a particular country. Property returns are given in percentages.

of macroeconomic environment. For both inflows and outflows, the fitted values of the observations show a negative relationship with transparency of the real estate market (the higher the index value, the less transparent the market is).

We observe a positive relationship between liquidity and the three types of capital flows, with inflows being more strongly correlated with liquidity than outflows. The observation that outflows do not decrease when domestic liquidity and real estate transparency are high means that these characteristic of the real estate market are not associated with arbitrage opportunities for international investors. Such investors would not necessarily re-direct capital across countries but will increase their overall investment. In turn, we observe arbitrage behavior regarding the returns, with an increase in investment inflows and a decrease in outflows for countries offering high property returns. Good macroeconomic environment drives investors to increase both, investment in and out of their country but does not necessarily attract more foreign capital into the country.

EMPIRICAL RESULTS

In this section, we assess the empirical effect of legal, institutional, and real estate specific barriers on real estate capital flows. We look at the factors influencing capital flows into the recipient countries, and we then separately examine the factors that influence the level of outflows from the same set of countries. To examine the relationship between capital flows to real estate and barriers, we conduct panel regressions using both time- and country-fixed effects.

The regression equation is given as:

$$REflow_{i,t} = \alpha + \beta_1 Barriers_{i,t} + \beta_2 Return_{i,t} + \beta_3 Msize_{i,t} + \beta_4 Econ_{i,t} + \beta_5 Liq_{i,t} + \varphi_i + \mu_t + \varepsilon_{i,t}, \quad (5)$$

where i and t indicate, respectively, the country and time (year), with $i = 1,\ldots,24$ and $t = 2007,\ldots,2012$. The dependent variable, *REflow*, is defined as the log-value of domestic real estate capital inflows to country i, foreign real estate capital inflows to country i or real estate capital outflows from country i in year t.

The explanatory variables include several institutional and legal barriers collected in the vector *Barriers*, as well as returns (*Return*), market size (*Msize*) and real estate liquidity (*Liq*). Instead of using the standard controls, such as GDP and population, we include an index of economic environment (*Econ*) which accounts for the government budget balance, gross national savings, inflation, government debt, and the country credit rating. The reason is that the traditional controls show a high correlation with our institutional variables but the index does not.

The inclusion of a liquidity measure is particularly important because we are dealing with real estate capital flows. One of the major concerns in investing into direct real estate is that it is less liquid compared to other asset classes. It means that illiquidity presents an important investment barrier especially when investors are concerned about the exit options out of a real estate market. Because the other barriers do not account for the liquidity of the real estate market we also account for that barrier. In addition, we include country-fixed effects φ_i and time-fixed effects μ_t as indicated by coefficient F-tests. We use heteroskedasticity-robust standard errors in computing p-values.

We expect that the tighter the barriers the more negative the impact on the volume of real estate flows into direct real estate markets will be. Barriers can have, in turn, either a positive or a negative impact on the volume of outflows from the country. A positive impact of barriers can be associated with crowding out of domestic investment abroad and a substitution effect. Domestic investors will tend to substitute domestic investment with foreign investment. A negative impact meaning that well-developed institutions and markets contribute to an increase in foreign investment, in turn, may result from more financial market flexibility and fewer capital controls so that capital can flow easily abroad in a search for higher profits even in the presence of higher barriers in the foreign countries.

The results are presented in Exhibits 11, 12, and 13, respectively. Each exhibit contains four different model specifications varying the set of institutional and legal barriers in the regressions due to the multicollinearity that would arise if these barriers were jointly included in the regression equation. However, we keep a few variables the same throughout all specifications in order to control for the macroeconomic environment, return impact, liquidity of real estate, credit constraints and loan accessibility, and market size.

The first specification includes the majority of the barriers but does not account for property rights, the real estate transparency index and the competitiveness index, as these variables show a high correlation with the other factors. In the second specification property rights are added but as this variable has a high correlation of over 50 percent with financial market development and investment freedom the latter two have been dropped from the regression. The third

Exhibit 11—Institutional, Legal and Economic Barriers and Real Estate Foreign Capital Inflows

	(1) foreign inflows	(2) foreign inflows	(3) foreign inflows	(4) foreign inflows
Credit depth of information	0.583 (0.479)	0.566 (0.455)	0.594 (0.444)	0.600 (0.396)
Property returns	0.00450 (0.0142)	0.00403 (0.0111)	0.00901 (0.0143)	0.000411 (0.0120)
Market size	−1.875 (2.229)	−1.979 (2.320)	−0.859 (1.724)	
Macroeconomic environment	0.0164 (0.304)	−0.0794 (0.265)	0.0705 (0.259)	
Fiscal freedom	−0.0175 (0.0503)	−0.0149 (0.0371)		
Government freedom	0.0209 (0.0217)	0.0274 (0.0235)		
Labor freedom	0.0274 (0.0246)	0.0262 (0.0241)		
Investment freedom	0.000440 (0.0197)			
Financial development	0.0127 (0.273)			
Real estate liquidity	14.98* (7.360)	15.83* (7.856)	13.66 (8.552)	13.74 (8.559)
Property rights		−0.0621 (0.0368)		
Real estate transparency			−1.499 (1.469)	
Global competitiveness				−1.914 (1.311)
Constant	5.084 (11.08)	10.27 (11.74)	4.715 (9.392)	7.123 (6.721)
Observations	125	125	125	125
R-squared	0.470	0.492	0.470	0.469
Number of countries	24	24	24	24

Note: The dependent variable is the natural logarithm of foreign real estate capital inflows. The estimations are based on fixed effects (FE) panel OLS regressions including both time-fixed and country-fixed effects. The time-fixed effects and country-specific effects are included in the regressions but not reported. p-values are computed using heteroskedasticity-robust standard errors clustered for recipient countries and are presented in brackets. *, **, and *** represent statistical significance at the 10 percent, 5 percent, and 1 percent level, respectively.

specification replaces all institutional barriers from the second specification by the index of real estate market transparency which is a composite index and already accounts for institutional and legal barriers related to real estate. The fourth specification is the same as the third, but instead of transparency we use a composite index of global competitiveness which accounts for institutional barriers. In this model, the variables for market size and macroeconomic environment have also been excluded as they are already contained in this index.

Foreign Inflows

Exhibit 11 shows the four different model specifications for the effect of institutional, regulatory, and real

Exhibit 12—Institutional, Legal and Economic Barriers and Real Estate Domestic Capital Inflows

	(1) domestic inflows	(2) domestic inflows	(3) domestic inflows	(4) domestic inflows
Credit depth of information	−0.00255 (0.162)	−0.0338 (0.171)	0.00168 (0.177)	−0.0404 (0.313)
Property returns	0.0170* (0.00929)	0.0127 (0.00824)	0.0143* (0.00805)	0.00974 (0.00959)
Market size	−1.621 (1.018)	−1.583 (1.145)	−1.146 (1.280)	
Macroeconomic environment	1.143*** (0.250)	1.329*** (0.302)	1.259*** (0.239)	
Fiscal freedom	−0.00951 (0.0238)	0.00906 (0.0227)		
Government freedom	−0.00864 (0.0150)	−0.00407 (0.0139)		
Labour freedom	0.0217 (0.0233)	0.0215 (0.0223)		
Investment freedom	0.0143 (0.0105)			
Financial development	0.389 (0.243)			
Real estate liquidity	17.21*** (3.530)	18.17*** (3.676)	17.64*** (3.720)	16.69*** (4.216)
Property rights		−0.00136 (0.0162)		
Real estate transparency			-0.0909 (0.501)	
Global competitiveness				0.930 (1.283)
Constant	−1.324 (4.948)	−0.787 (6.162)	−0.889 (5.951)	−4.541 (6.205)
Observations	133	133	133	133
R-squared	0.598	0.576	0.560	0.398
Number of countries	24	24	24	24

Note: The dependent variable is the natural logarithm of domestic real estate capital inflows. The estimations are based on fixed effects (FE) panel OLS regressions including both time-fixed and country-fixed effects. The time-fixed effects and country-specific effects are included in the regressions but not reported. p-values are computed using heteroskedasticity-robust standard errors clustered for recipient countries and are presented in brackets. *, **, and *** represent statistical significance at the 10 percent, 5 percent, and 1 percent level, respectively.

estate specific barriers on foreign capital inflows. As we have pointed out above, our sample is composed of only 24 countries that attract the largest chunk of real estate investment in Europe and Asia. Explaining the determinants of real estate capital flows by looking at such a small sample of countries means that we are not immune from sample selection bias and this may lead to insignificance of the barriers. Indeed, Exhibit 11 shows that the selected institutional and legal indicators do not affect foreign real estate capital inflows significantly. The only variable that has a significantly positive effect on foreign flows in two out of the four specifications is real estate liquidity. A more liquid property market will enable investors to more quickly sell the property and leave the country, thereby

EXHIBIT 13—INSTITUTIONAL, LEGAL AND ECONOMIC BARRIERS AND REAL ESTATE CAPITAL OUTFLOWS

	(1) outflows⋆	(2) outflows⋆	(3) outflows⋆	(4) outflows⋆
Credit depth of information	−0.0614 (0.707)	0.0328 (0.791)	1.055⋆⋆ (0.447)	0.755⋆ (0.432)
Property returns	0.00348 (0.0108)	−0.00913 (0.0112)	−0.00138 (0.0122)	−0.0111 (0.0136)
Market size	0.653 (2.365)	−0.126 (2.547)	2.099 (2.750)	
Macroeconomic environment	0.203 (0.519)	1.634⋆⋆ (0.658)	0.822⋆⋆ (0.357)	
Fiscal freedom	−0.0512 (0.0368)	−0.0480 (0.0498)		
Government freedom	−0.00130 (0.0325)	−0.0330 (0.0328)		
Labour freedom	0.0537⋆⋆ (0.0228)	0.0496⋆⋆ (0.0220)		
Investment freedom	−0.0825⋆⋆⋆ (0.0185)			
Financial development	1.301⋆⋆⋆ (0.244)			
Real estate liquidity	8.281⋆ (4.466)	4.509 (4.318)	3.653 (2.785)	1.333 (4.452)
Property rights		0.0589 (0.0346)		
Real estate transparency			−4.303⋆⋆⋆ (0.956)	
Global competitiveness				1.879 (2.397)
Constant	−6.578 (12.35)	−11.27 (13.40)	−11.39 (12.26)	−13.09 (11.78)
Observations	104	104	104	104
R-squared	0.530	0.376	0.438	0.250
Number of countries	22	22	22	22

Note: The dependent variable is the natural logarithm of real estate capital outflows. (⋆) As the data source for the outflows differs from those of inflows, we restrict the sample to include only those countries for which inflow data is available. The estimations are based on fixed effects (FE) panel OLS regressions including both time-fixed and country-fixed effects. The time-fixed effects and country-specific effects are included in the regressions but not reported. p-values are computed using heteroskedasticity-robust standard errors clustered for recipient countries and are presented in brackets. ⋆, ⋆⋆, and ⋆⋆⋆ represent statistical significance at the 10 percent, 5 percent, and 1 percent level, respectively.

decreasing the risk of losing money and attracting more foreign capital.

Indeed, other barriers such as property rights or financial market development do not seem to be a deterrent to foreign investment between 2007 and 2012. Even the degree of legal restrictions on foreign investment seems not be important for the level of foreign investment flows. The insignificance of these barriers may be explained by the economies of scale available to the large global investors, as we mentioned at the beginning of this article.

This means, given that institutional real estate investments typically require large amounts of equity and/or debt

capital, large global players may be able to raise capital at a lower cost compared to small and predominantly local investors, giving them a competitive advantage even in the presence of barriers. Moreover, we observe that foreign investors are not driven by past returns. If time-fixed effects were not included in the regressions, returns would become significant. However, as F-tests suggest, time-fixed effects should be included and we see that they capture the variations in the foreign inflows better than returns.

The third specification shows the effect of real estate market transparency on investment flows. We can see that even high real estate market transparency does not attract significantly more foreign real estate capital. Overall, foreign investors seem to be only concerned with the liquidity of the real estate market but not with past property returns or the macroeconomic environment. In other words, a more liquid real estate market appears to have a stronger positive impact on cross-border flows than any other barrier.

Domestic Inflows

Exhibit 12 shows the results for domestic real estate capital inflows. We can see that institutional and legal barriers do not have a significant impact on domestic investment either. Similarly to foreign inflows, domestic inflows seem not to be affected by the transparency of the real estate market. This finding may be explained by domestic investors being well informed about the local market so that, even in the presence of barriers, the anticipated risks can be better priced. However, unlike foreign investors, domestic investors seem to be significantly driven by past returns. Like foreign investors, domestic investors are concerned with the liquidity of the real estate market. However, this time the variable is highly significant in all four specifications. Countries with more liquid real estate markets will retain significantly more domestic investment than countries that offer less liquidity. Domestic flows in real estate would increase if the country has a more preferable macroeconomic environment. Economic indicators such as balanced government budget, high savings ratios, low inflation, low government debt and a high country credit rating enhance domestic investment into real estate but do not contribute to more foreign investment.

Overall, we find similarities between foreign and domestic investors into direct real estate to the extent that their decisions are not significantly affected by institutional and legal barriers but rather by the liquidity of the real estate market. The latter seems to represent a much higher risk for investors than barriers such as property rights, government, or investment freedom. This may be due to the fact that most investors are either large global players or are well-informed about the market, so that they can anticipate risks from institutional and legal barriers but are concerned about the exit strategy in less liquid markets. In addition, these findings are likely to be heavily influenced by the global liquidity shortage experienced during the recent financial crisis. The finding that not just domestic but also foreign investors respond significantly to liquidity suggests that shocks to real estate markets have far more outreaching effects that go beyond the national borders. Interestingly, the size of the market does not appear to matter for attracting real estate investment as is often argued in the literature.[29]

Outflows

Exhibit 13 shows the results for the real estate capital outflows. These results could be compared with the results for the domestic inflows, as we have the same domestic countries, but one should do this with caution because the source for the outflows is different from that of the inflows. By looking at the drivers of outflows, we want to assess whether the above institutional and legal barriers, although insignificant for inflows, can still drive investment outside of the country. The underlying hypothesis is that domestic investors constrain their decisions on whether to invest abroad based on the situation of the domestic market.

The results show that if the domestic market has a more favorable macroeconomic environment investors are not only likely to invest in their home countries but also in the rest of the world. Outflows also seem to be more affected by institutional barriers than inflows. Outflows increase significantly if the country is characterized by high financial market development, good credit and real estate market transparency, and labor market freedom. The significant response to financial market development and credit depth of information may be associated with a strong dependence of domestic investors on the domestic credit market when they want to invest abroad. While real estate market transparency does not significantly increase real estate inflows, it affects positively real estate capital outflows. However, there is the risk of a reverse causality meaning that countries that export more capital are in general more transparent. Instead, we see that more investment freedom and hence less restrictions on foreign and domestic flows will lead to less outflow from the domestic country. It means that abolishing capital controls

and foreign exchange controls will not necessarily cause investment to flow abroad. The liquidity of the domestic real estate market seems not to be an important driver of outflows in the majority of the specifications.

Robustness Checks

We conduct several robustness checks in order to assess the stability of above results. We exclude the year 2007 when the financial crisis occurred but the results stay robust. We conduct additional regressions by excluding significant variables (*e.g.*, liquidity) to see whether the results will remain robust but could not find any major changes in the results. Overall, the selected variables in above specifications do not show high correlation and the signs of the coefficients remain robust throughout different model specifications.

CONCLUSIONS

This study investigates the drivers of cross-border capital flows into direct real estate markets. We assess whether existing legal, institutional, and real estate specific barriers are negatively associated with cross-border real estate flows in a set of 24 countries. We do not find evidence for cross-border institutional or regulatory arbitrage on the real estate market as has been recently reported for bank flows.[30] Hardly any institutional or legal barrier impacts significantly on the level of foreign real estate inflows. Real estate market liquidity has the most significant impact on inflows of real estate, both domestic and foreign, suggesting that investors are well-informed about the real estate market and could be large global players who depend less on institutional barriers but are rather interested in the market entry and exit options. Moreover, the stance of the economy, returns and liquidity are more important drivers of domestic investment rather than barriers, such as property rights, government freedom, investment freedom, etc. This may be due to the fact that domestic investors have good knowledge of the local market so that they can anticipate such risks. However, the presence of institutional and legal barriers affecting the financial markets, the macroeconomy and real estate market transparency can indeed hinder capital exports into direct real estate. Real estate liquidity is another driver of real estate outflows.

The empirical findings presented in this study are limited to a short time period (2007–2012), and a small set of countries (24 out of roughly 200 countries) and continents (Europe and Asia) due to the limited data availability. The inclusion of other countries and continents, notably North and South American countries, may alter the picture dramatically and is left for further research.

APPENDIX

Definition of Indicators

Property rights—"The index measures the likelihood that private wealth will be expropriated by looking at the independence of the judiciary, the existence of corruption within the judiciary, and the ability of individuals and businesses to enforce contracts. A high value of the index is associated with more secure property rights. An increase in property rights is relevant for domestic and foreign investors to the extent that it increases their confidence to undertake entrepreneurial activity, knowing that their wealth such as income, savings, and property is safe from unfair expropriation." (The Heritage Foundation, 2013)

Fiscal freedom—"Fiscal freedom measures the tax burden imposed by government accounting for direct taxes and overall taxes (direct and indirect taxes), such as payroll taxes, sales taxes, excise taxes, tariffs, the value-added tax (VAT). The index is composed of three quantitative factors: the top marginal tax rate on individual income, the top marginal tax rate on corporate income, and the total tax burden as a percentage of GDP. The higher the tax rates are, the lower the overall private-sector activity." (The Heritage Foundation, 2013)

Government spending—"Government spending considers the level of government expenditures, including consumption and transfers, as a percentage of GDP. "Excessive government spending runs a great risk of crowding out private economic activity. A government's insulation from market discipline often leads to bureaucracy, lower productivity, inefficiency, and mounting debt that imposes an even greater burden on future generations." Therefore, countries with low expenditures score high." (The Heritage Foundation, 2013)

Investment freedom—"Investment freedom accounts for restrictions of foreign investment, restrictions on land ownership, sectoral investment restrictions, capital controls, foreign exchange controls, etc. The higher the index is, the freer the country is economically, and there would be less constraints on the flow of investment capital, both internally and across the country's borders." (The Heritage Foundation, 2013)

TABLE A1: INSTITUTIONAL, LEGAL AND ECONOMIC BARRIERS AND REAL ESTATE FOREIGN CAPITAL INFLOWS

Au: There is no reference in text to Tables A1, A2, and A3. Please indicate where they are discussed or where they fit in.

	(1) foreign inflows	(2) foreign inflows	(3) foreign inflows	(4) foreign inflows
Credit depth of information	0.0402 (0.184)	0.0906 (0.182)	−0.0537 (0.141)	0.352** (0.173)
Property returns	0.0132 (0.0172)	0.000586 (0.0164)	0.00575 (0.0142)	0.0262 (0.0238)
Market size	1.779*** (0.197)	1.755*** (0.187)	1.548*** (0.136)	
Macroeconomic environment	1.028*** (0.243)	1.041*** (0.230)	0.342** (0.154)	
Fiscal freedom	0.0307** (0.0150)	0.0269* (0.0142)		
Government freedom	−0.0380*** (0.00950)	−0.0427*** (0.0104)		
Labor freedom	0.0179** (0.00803)	0.0230*** (0.00829)		
Investment freedom	0.0252*** (0.00872)			
Financial development	0.0560 (0.174)			
Property rights		0.0153** (0.00691)		
Real estate transparency			−1.502*** (0.212)	
Global competitiveness				0.691*** (0.250)
Constant	−17.05*** (2.409)	−16.09*** (2.256)	−5.222*** (1.383)	−4.389** (1.782)
Observations	124	124	124	124
R-squared	0.600	0.572	0.625	0.172

Note: The estimations are based on pooled OLS panel regressions including time-fixed effects. The time-fixed effects are included in the regressions but not reported. p-values are computed using heteroskedasticity-robust standard errors clustered for recipient countries and are presented in brackets. *, **, and *** represent statistical significance at the 10 percent, 5 percent, and 1 percent level, respectively.

Labor freedom—"The labor freedom accounts for aspects of the legal and regulatory framework of a country's labor market, such as the ratio of minimum wage to the average value added per worker, hindrance to hiring additional workers, rigidity of hours, difficulty of firing redundant employees, legally mandated notice period, and mandatory severance pay. Low labor market freedom is associated with rigid labor regulations result often in a mismatch of labor supply and demand. In general, the greater the degree of labor freedom, the lower is the rate of unemployment in an economy." (The Heritage Foundation, 2013)

Financial market development—"The index measures the degree of development of the financial market by accounting for the availability and affordability of financial services, financing through local equity market, ease of access to loans, venture capital availability, trustworthiness and confidence, soundness of banks, regulation of securities exchanges and legal rights." (World Economic Forum, 2013)

Macroeconomic environment—"The index includes the following macroeconomic indicators – government budget balance, gross national savings, inflation, government debt, country credit rating." (World Economic Forum, 2013)

Table A2: Institutional, Legal and Economic Barriers and Real Estate Domestic Capital Inflows

	(1) domestic inflows	(2) domestic inflows	(3) domestic inflows	(4) domestic inflows	(5) domestic inflows
Credit depth of information	−0.277**	−0.190	−0.213	0.183	−0.319***
	(0.116)	(0.140)	(0.132)	(0.159)	(0.110)
Property returns	0.0146	0.0163	0.00828	0.0647***	0.0103
	(0.0115)	(0.0126)	(0.0122)	(0.0196)	(0.00971)
Market size	2.240***	2.303***	1.870***		2.094***
	(0.147)	(0.186)	(0.138)		(0.131)
Macroeconomic environment	1.026***	1.349***	1.053***		0.717***
	(0.225)	(0.201)	(0.184)		(0.173)
Fiscal freedom	−0.00400	−0.00127			
	(0.00897)	(0.00830)			
Government freedom	−0.0102*	−0.00590			
	(0.00611)	(0.00665)			
Labour freedom	0.0271***	0.0317***			
	(0.00568)	(0.00538)			
Investment freedom	0.0141**				
	(0.00567)				
Financial development	1.161***				1.069***
	(0.182)				(0.187)
Property rights		0.0428***			
		(0.00536)			
Real estate transparency			−1.466***		−0.878***
			(0.153)		(0.187)
Global competitiveness				2.140***	
				(0.259)	
Constant	−22.67***	−22.08***	−10.01***	−11.42***	−15.62***
	(1.871)	(1.857)	(1.432)	(1.690)	(1.615)
Observations	130	130	130	130	130
R-squared	0.757	0.725	0.650	0.346	0.747

Note: The estimations are based on pooled OLS panel regressions including time-fixed effects. The time-fixed effects are included in the regressions but not reported. p-values are computed using heteroskedasticity-robust standard errors clustered for recipient countries and are presented in brackets. *, **, and *** represent statistical significance at the 10 percent, 5 percent, and 1 percent level, respectively.

Market size—"The market size is an index which consists to 75 percent of the size of the domestic economy and to 25 percent of the size of the foreign economies. The size of the domestic market is constructed by taking the natural log of the sum of the gross domestic product plus the total value of imports of goods and services, minus the total value of exports of goods and services. The size of the foreign market is estimated as the natural log of the total value of exports of goods and services. All variables are valued at purchased power parity (PPP)." (World Economic Forum, 2013)

Global competitiveness index—"The global competitiveness index measures the microeconomic and macroeconomic foundations of national competitiveness. "Competitiveness is defined as the set of institutions, policies, and factors that determine the level of productivity of a country also associated with the rates of return obtained by investments in an economy." The GCI includes 12 pillars of competitiveness: institutions, infrastructure, macroeconomic environment, health and primary education, higher education and training, goods market efficiency,

TABLE A3: INSTITUTIONAL, LEGAL AND ECONOMIC BARRIERS AND REAL ESTATE OUTFLOWS

	(1) outflows	(2) outflows	(3) outflows	(4) outflows	(5) outflows
Credit depth of information	0.274*	0.331*	0.455**	0.349*	0.339*
	(0.148)	(0.171)	(0.206)	(0.178)	(0.181)
Property returns	−0.0128	−0.0240*	−0.0250*	0.000981	−0.0201
	(0.0146)	(0.0134)	(0.0141)	(0.0139)	(0.0142)
Market size	1.495***	1.567***	0.946***		1.151***
	(0.179)	(0.206)	(0.162)		(0.177)
Macroeconomic environment	1.259***	1.516***	1.181***		0.916***
	(0.243)	(0.236)	(0.185)		(0.185)
Fiscal freedom	0.0394**	0.0410**			
	(0.0186)	(0.0189)			
Government freedom	−0.0161	−0.0149			
	(0.0106)	(0.0113)			
Labour freedom	0.0207**	0.0245***			
	(0.00932)	(0.00892)			
Investment freedom	0.0253***				
	(0.00682)				
Financial development	0.895***				0.891***
	(0.190)				(0.220)
Property rights		0.0406***			
		(0.00731)			
Real estate transparency			−1.121***		−0.731***
			(0.178)		(0.198)
Global competitiveness				1.733***	
				(0.242)	
Constant	−25.10***	−24.09***	−10.80***	−10.57***	−15.36***
	(2.274)	(2.168)	(2.001)	(1.522)	(2.171)
Observations	104	104	104	104	104
R-squared	0.651	0.624	0.507	0.355	0.592

Note: The estimations are based on pooled OLS panel regressions including time-fixed effects. The time-fixed effects are included in the regressions but not reported. p-values are computed using heteroskedasticity-robust standard errors clustered for recipient countries and are presented in brackets. *, **, and *** represent statistical significance at the 10 percent, 5 percent, and 1 percent level, respectively.

labour market efficiency, financial market development, technological readiness, market size, business sophistication and innovation." (World Economic Forum, 2013)

Credit depth of information—"The credit depth of information is an index which measures rules affecting the scope, accessibility, and quality of credit information available through public or private credit registries. The higher the index is, the better the availability of credit information which in turn will facilitate lending decisions." (World Bank, 2013)

NOTES

1. D'Arcy, E., and Keogh, G., "Property market efficiency: an institutional economics perspective," *Journal of Urban Studies*, 36(13), 2401-2414 (1999); Lee, S., "The risks of investing in the real estate markets of the Asian region," *Working Paper of Department of Land Management*, The University of Reading, no. 6 (2001); Lee, S., "Gauging the investment potential of International real estate markets," *Working Paper of Real Estate and Planning*, The University of Reading, no. 19 (2005).
2. La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R., "Legal determinants of external finance," *Journal of Finance*, 52(3), 1131-1150 (1997); La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R., "Law and finance," *Journal of Political Economy*, 106(6), 1113-1155 (1998); La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R., "Agency problems and dividend policies around the word," *Journal of Finance*, 55, 1-33 (2000); La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R., "Investor protection and corporate valuation," *Journal of Finance*, 57(3), 1147-1170 (2002).
3. Glaeser, E. L., Johnson, S. and Shleifer, A., "Coase vs. the coasians," *Quarterly Journal of Economics*, 116, 853-899 (2001).

4. Djankov, S., La Porta, R., Lopez-de-Silanes, F., Shleifer, A., "The regulation of entry," *Quarterly Journal of Economics*, 117(1), 1-37 (2002); Djankov, S., La Porta, R., Lopez-de-Silanes, F. and Shleifer, A., "Courts," *Quarterly Journal of Economics*, 118(2), 453-517 (2003); Djankov, S., La Porta, R., Lopez-de-Silanes, F. and Shleifer, A., "The law and economics of self-dealing," *NBER working paper* 11883 (2005).
5. Knack, S., and Keefer, P., "Institutions and economic performance: cross-country tests using alternative institutional measures," *Economics and Politics*, 7(3), 207-228 (1995); Mauro, P., Corruption and growth," *Quarterly Journal of Economics*, 110, 681-712 (1995); Svensson, J., "Investment, property rights and political instability: Theory and evidence," *European Economic Review*, 42(7), 1317-1341 (1998).
6. Webb, J. R., "Real estate investment acquisition rules for life insurance companies and pension funds," *Journal of the American Real Estate and Urban Economics Association*, 12(4), 495-520 (1984); Worzala, E., and Newell, G., "International real estate: a review of strategic investment issues," *Journal of Real Estate Portfolio Management*, 3(2), 87-96 (1997); Adair, A., Berry, J., McGreal, S., Syacutekora, L., Ghanbari Parsa, A. and Redding, B., "Globalization of real estate markets in Central Europe," *European Planning Studies*, 7(3), 295-305 (1999).
7. Solnik, B., International Investments (3rd ed.). Massachusetts: Addision-Wesley (1999); McGreal, S., Parsa, A. and Keivani, R., "Perceptions of real estate markets in central Europe: a survey of European investor," *Journal of Real Estate Literature*, 9(2), 147-160 (2001).
8. Daude, C. and Stein, E., "The quality of institutions and foreign direct investment," *Economics & Politics*, 19(3), 317-344 (2007).
9. *See* Lee, *supra* n.1.
10. Lizieri, C. and Pain, K., "International office investment in global vities: The production of financial space and systemic risk," Regional Studies, forthcoming 2013.
11. Han, J., "Targeting markets is popular: a survey of pension real estate investment advisors," *Real Estate Finance*, 13(1), 66-75 (1996).
12. Chin, W., Dent, P. and Roberts, C., "An explanatory analysis of barriers to investment and market maturity in Southeast Asian cities," *Journal of Real Estate Portfolio Management*, 12(1), 49-57 (2006).
13. Lim, L. C., McGreal, S. and Webb, J. R., "Perception of real estate investment opportunities in Central/South America and Africa," *Journal of Real Estate Portfolio Management*, 12(3), 261-276 (2006).
14. *See* D'Arcy and Keogh, *supra* n.1.
15. Lieser, K. and Groh, A. P., "The determinants of international commercial real estate investment," *Journal of Real Estate Finance and Economics*, DOI 10.1007/s11146-012-9401-0 (2013).
16. Houston, J., Lin, C. and Ma, Y., "Regulatory arbitrage and international bank flows," *Journal of Finance*, 67 (5), 1845-1895 (2012).
17. Fuerst, F., and Matysiak, G., "Analysing the performance of non-listed real estate funds: A panel data analysis," *Applied Economics*, *45*(14), 1777-1788 (2013); Baum, A., Commercial Real Estate Investment: A Strategic Approach, Elsevier (2009).
18. Lizieri, C, Worzala, E. and Johnson, R., "To hedge or not to hedge?," London: RICS (1998).
19. Stulz, R. M., "The limits of financial globalization," *The Journal of Finance*, 60, 1595-1638 (2005).
20. It should be noted that the countries studied are selected based on the availability of good quality data describing cross border capital flows. This biases the study towards transparent and active markets, and the findings of the research only hold for relative differences between countries which are generally active in cross-border transactions.
21. Lieser and Groh, *supra* n.15.
22. World Heritage Foundation (2013): The Index of Economic Freedom, online: *http://www.heritage.org/index/book/methodology.*
23. *Id.*
24. World Economic Forum (2012): The Global Competitiveness Report 2012-2013.
25. *Id.*
26. Baum, A. and Hartzell, D., Global Property Investment: Strategies, Structures, Decisions, Wiley Blackwell (2012).
27. Countries in our dataset that are covered by IPD are Australia, Belgium, Czech Republic, Finland, France, Germany, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Poland, Spain, Sweden, United Kingdom.
28. These countries are IPD countries for which the series is incomplete and are China, Hungary, Hong Kong, India, Malaysia, Russia, Singapore, Taiwan, Thailand.
29. *See* Lieser and Groh, *supra* n.15.
30. *See* Houston, *supra* n.16.

The Effect of Founder CEOs on the Structure of REIT Board of Directors and REIT Performance

By Magdy Noguera

Magdy Noguera *is in the College of Business and Economics at the University of Idaho.*

Au:You did not provide a cite for this article, please provide.

Despite their explosive growth since the 1990s (as measured by both number of firms and market capitalization), approximately 38 percent of equity Real Estate Investment Trusts (REITs) are still led by their founders. This is almost four times the case of the largest public US firms[1] and truly an atypical instance for growing firms.[2] From an agency perspective such high proportion of REIT led founders could have a great impact on REITs' corporate governance, given founders' high and undiversified nature of ownership, their historical, reputational, and emotional ties to the firm and their significant control over directors and management postings.[3] Ideally, unselfish founders could reduce agency problems and governance concerns and foster firm value.[4] On the other hand, they could choose to entrench themselves, in detriment of the rest of the shareholders, for the purpose of extracting private benefits of control.[5] For REITs, whether the monitoring effect dominates the entrenchment effect may be a function of the board of directors' structure and monitoring effectiveness in the presence of Chief Executive Officer (CEO) founders, due to their corporate governance nuances derived from regulation.

REITs' corporate governance issues differ from those of non-REITs because REITs are highly regulated firms.[6] On a positive note, regulatory requirements for REITs may reduce agency conflicts, since both REIT managers' limitations on investment choices and required high dividend payouts reduce free cash flows, discouraging empire building by self-interested managers.[7] In addition, the required dividend payouts subject REITs to capital markets for needed funds, which increase monitoring and questioning by capital market participants. However, some of the REITs' regulation has weakened their corporate governance mechanisms. For example, the five or fewer rule has virtually eliminated the possibilities of hostile takeovers, thus, facilitating managerial entrenchment[8] and making internal governance mechanisms such as the board of directors crucial for REITs' effective corporate governance.

I posit that the presence of founder CEOs can affect greatly the structure and effectiveness of REIT boards and, in turn, REIT performance. Accordingly, this study contributes to the existing literature on REIT corporate governance in two ways. First, the differences in board structure depending on whether or not the CEO is the founder are examined and presented. Second, the relation between founders being CEOs and REIT performance is analyzed. In a practical sense, the results of this study provide relevant information for potential and current equity REIT investors since it has been documented that institutional investors prefer REITs with strong corporate governance.[9]

This article examines the structure of a sample of equity REIT boards for the 1999-2012

period. The analysis indicates that REIT boards in which a founder is the CEO have fewer outside directors and typically are led by them compared to boards in which the CEO is not a founder. On the relation between the CEO founder and REIT performance, the results show a negative effect of CEO founder on the REIT performance. These results suggest that founder REIT CEOs entrench themselves in these positions and adversely affect the performance of their firms.

LITERATURE REVIEW AND TESTABLE HYPOTHESES

CEO Founder and Board Structure

To the extent of the literature review conducted for this article, how founder CEOs affect their firm's board structure remains an unexplored research question for REITs.[10] Rather, the REIT and non-REIT literature are extensive on the optimal features of corporate boards and their effect on performance. In this regard, Jensen[11] posits that small boards, with a majority of outsider members and not led by the firm CEOs, are virtuous models for nearly any corporation. Small boards are preferred over large boards because, as board size increases, its efficiency declines because it becomes harder to coordinate large numbers of people. In addition, boards with a majority of outside directors and not led by their CEOs are thought to be more independent. In reality, though, empirical findings have not found a strong relation between these preferred board characteristics and corporate performance. For instance, while Yermack[12] and Ning, Davidson and Wang[13] find a negative relation between board size and performance, Dalton, Daily, Johnson, and Ellstrand[14] find a positive relation. However, Bhagat and Black[15] find no consistent correlation between the same variables. Also, as summarized by Hermalin and Weisbach,[16] the relation between the ratio of outside versus inside directors on a board and firms' profitability is not clear. By assessing the effect of changes in the board composition on the firm value, Brickley and James,[17] Rosenstein and Wyatt,[18] and Shivdasani[19] find that the presence of independent directors improve performance. However, several other studies[20] find no significant relation between performance and the proportion of outside directors sitting on the board.

These conflicting results are plausible because, although investors, practitioners, and regulators consider directors' independence a crucial measure for an effective monitoring mechanism, such effectiveness can sometimes be counterweighted by their lack of knowledge, time, and experience. In the CEO duality debate, the consensus among investors and regulators seems to be that a CEO should not serve as a board chairman. Recently though, some researchers have argued and found empirical evidence that requiring all firms to separate CEO and chairman duties may be counterproductive. For instance, Faleye[21] finds that CEO duality is a matter of organizational complexity (scale and nature of operations), CEO reputation, and CEO share ownership.[22] Dey, Engel, and Liu[23] find that board leadership choices by firms and market responses are consistent with an efficiency argument because firms that split the CEO and chairman positions have significantly lower subsequent performance. But earlier empirical evidence in the relation between CEO chair and firm performance is mixed as well. For instance, Harjoto and Hoje[24] find that CEO-chair of the board positively influences firm value and performance whereas Bhagat and Bolton[25] find that CEO-chair separation results in better contemporaneous and subsequent operating performance.

Another important board feature is whether the board is classified (staggered) or not. Some researchers argue that having declassified or annually elected boards is a preferred governance practice, given that annual elections provide shareholders with the opportunity to vote out directors due to poor performance. Moreover, annual elections open the possibility of hostile takeovers of poorly performing firms, thus, effectively subjecting the company to market discipline. In support of these claims, Bebchuck and Cohen[26] and Faleye[27] find that classified boards significantly reduce firms' value. Moreover, Faleye concludes that the reduction in value stems from managerial entrenchment as classified boards insulate top managers from market discipline and reduce director accountability to shareholders. Despite such evidence, proponents of classified boards argue that classified boards are desirable because they provide continuity for directors, allowing them to concentrate on adding value to the firm. Also, in the event of a hostile takeover, staggered directors could hold off for the best deal for the shareholders. In the case of REITs, however, the argument of classified boards as an anti-takeover defensive measure in favor or against shareholder interest seems to be irrelevant,[28] as hostile takeovers have been found non-existent among REITs.[29] Yet, 48 percent of REITs in the sample have staggered boards. Hence, the presence of classified boards in the context of governance and their effect on REIT performance remain open research questions.

As per the relation between board structure and REIT performance, the findings are somewhat more consistent with agency theory. There is little evidence that independent directors improve performance, but it has been found that CEO chairmanship and large board size deteriorate REIT performance.[30] To the extent that founder CEOs, powerful as they are, can influence the structure of boards, and given that REIT managers have been found to have more influence over board composition than do managers in non-REIT firms,[31] it is expected that

Hypothesis 1: REIT boards, in which the CEO is the founder, are smaller, have a majority of inside directors, and are typically chaired by these founders compared to REIT boards where the CEO is not the founder.

CEO Founder and Performance

The literature on the financial performance of firms led by founder CEOs is mixed.[32] For non-REITs, Vintila and Gherghina[33] find no difference in performance between firms where the CEO is the founder and the companies where the CEO is not. Adams, Almeida, and Ferreira[34] do not find evidence of firms with founders as CEOs having worse performance than non-founder led firms, but do find that financial performance is more variable for firms with founder CEOs. Anderson[35] et al. find that in less transparent firms led by entrenched CEOs there is a negative relation between founder ownership and firm performance. However, consistent with the hypothesis that the interests of founders are aligned with those of the rest of shareholders, several studies[36] find that founding family control is associated with higher valuation. Likewise, Fahlenbrach[37] finds family controlled firms to have higher valuation and performance, and show better investment decisions. Also, Cox and Shulman[38] find that for the 1997-2005 period, the stock market performance of founder CEO companies, regardless of their market capitalization size, outperform their respective benchmark.

In the case of REITs, the evidence on the impact of CEO founder in performance is limited. Cox and Shulman[39] find that equity REITs have greater variability in stock performance than non-founder equity REITs in every single year for the 1986-2006 period. More interestingly, they find that non-founder equity REITs exhibit superior stock returns with respect to founder equity REITs. Even though no formal testing on the effect of founders on performance was completed, these findings suggest that REITs led by founder CEOs are associated with inferior performance. On the other hand, Ghosh, Giambona, Harding, and Sirmans[40] find that REITs with founder CEOs have higher leverage and longer maturity debt. Based on their findings, they suggest that founders could be making choices that allow external monitoring by creditors and reduce agency costs. To the extent that founders make such choices consistent with an alignment of interests between them and the rest of the shareholders, and eventually their actions would positively reflect on performance, it is expected that:

Hypothesis 2: REITs led by founder CEOs experience better financial performance than REITs led by non-founder CEOs.

EMPIRICAL METHODS

Data

The initial sample includes 115 exchange-traded, equity REITs listed in the SNL Financial REIT Database (SNL). Only REITs with enough accounting, board, and founder related data for the period 1999-2012 are retained.[41] The financial variables of interest are collected from Bloomberg. The characteristics of the board of directors for the final sample are manually collected from proxy statements. To identify the REIT founder-CEOs, proxy statements or Web sites, such as Yahoo.com, Businessweek.com, Forbes.com, or the respective REITs Web site are searched. To qualify as a founder CEO, a CEO must be either the founder or member of the founder group. A CEO who took over the company as a result of a merge or a purchase of assets, both fairly common in the REIT sector, or a CEO who belongs to the second or older generation of a family does not qualify as a founder-CEO. Exhibit 1 presents the time-series distributions of founder CEOs included in the analysis. All summary statistics and the sample description are based on these data. As observed in Exhibit 1, there is a steady decline of the percentage of REITs led by founders across the years. This is due to the founders leaving their firms, either because of age, as the average CEO founder age rises from 55 years old in 1999 to 58 in 2012 or because their REITs are involved on a merger or on a sale of assets during the studied period and they do not remain CEOs.[42] Still, a significant number of REITs, relative to non-REITs, are led by their founders during the sample period.

Exhibit 1—Frequency of Founder CEO Observations

Year	Number of Founder CEOs	Number of REITs	Frequency (%)
1999	37	71	52.1
2000	40	75	53.3
2001	40	78	51.3
2002	34	70	48.6
2003	31	71	43.7
2004	27	68	39.7
2005	26	69	37.7
2006	21	56	37.5
2007	16	53	30.2
2008	14	46	30.4
2009	18	60	30.0
2010	18	68	26.5
2011	18	70	25.7
2012	18	69	26.1

This presents a time series distributions of founder CEOs for the sample period 1999-2012.

Model Specifications

Founder CEO versus Non-Founder CEOs' REIT Board Characteristics

To assess differences in the configuration of REIT boards according to the CEO status (*i.e.*, founder or not), univariate analyses on board composition are performed. Results are reported in Panel C of Exhibit 2. In addition, the effect of CEO founder on the board composition is examined after controlling for firm-specific aspects. For this purpose, the following set of fixed effects regressions is estimated:

$$BSIZE = \alpha + \beta_1 FOUNDER + \beta_2 TA + \beta_3 MKTtoBOOK + \beta_4 STAGGERED + \beta_5 CEOOWN + \beta_6 LAG(OUTSIDERS) + \beta_7 LAG(CEOCHAIR) + \varepsilon, \quad (1)$$

$$OUTSIDERS = \alpha + \beta_1 FOUNDER + \beta_2 TA + \beta_3 MKTtoBOOK + \beta_4 ROA + \beta_5 STAGGERED + \beta_6 CEOOWN + \beta_7 LAG(BSIZE) + \beta_8 LAG(CEOCHAIR) + \varepsilon, \quad (2)$$

$$CEOCHAIR = \alpha + \beta_1 FOUNDER + \beta_2 TA + \beta_3 MKTtoBOOK + \beta_4 ROA + \beta_5 STAGGERED + \beta_6 CEOAGE + \beta_7 LAG(BSIZE) + \beta_8 LAG(OUTSIDERS) + \varepsilon, \quad (3)$$

where *BSIZE* is the number of directors on a board, *OUTSIDERS* is the proportion of outside directors to the number of directors on a board, and *CEOCHAIR* is an indicator variable that equals one if the CEO chairs the board and zero otherwise. *FOUNDER* is a dummy variable that equals one if the CEO is the firm founder and zero otherwise. *STAGGERED* is an indicator variable that equals one if the board is staggered and zero otherwise. *TA* is the natural log of REITs' total assets. Return on assets (*ROA*) is the measure of performance, calculated as the ratio of funds from operations, a preferred measure of earnings for REITs, to total assets. *CEOOWN* is the percentage of shares owned by the CEO, CEOAGE is the CEO's age,[43] and *MKTtoBOOK* is the market to book ratio of equity. All variables included in the model, except *FOUNDER*, are commonly used as control variables in the financial literature.[44] The lagged values of the dependent variables are included as instrumental variables to lessen endogeneity concerns. The regression results are presented in Exhibit 3.

Founders and REIT Performance

To gain insight into the relation between the CEO founder and REIT performance, the following random effect regression models[45] are run:

$$PERFORMANCE = \alpha + \beta_1 FOUNDER + \beta_2 TA + \beta_3 DEBT/TA + \beta_4 FIRM\_AGE + \beta_5 FOUNDER\_LASTNAME + \beta_6 STAGGERED + \beta_7 FOCUS_j + \varepsilon, \quad (4)$$

where *PERFORMANCE* measures are Return on assets (*ROA*) and Tobin's Q (*Q*). *ROA* is the ratio of funds from operations to total assets, and *Q* is the ratio of market value of equity plus liabilities plus preferred equity plus minority interests to total assets. Both *ROA* and Tobin's *Q* are common measures of financial performance in the financial literature. *Founder* is a dummy variable set to one if the CEO is the founder of the firm and zero otherwise. *TA* captures REITs' size and is equal to the natural log of REITs' total assets. *DEBT/TA*, a control variable for leverage, is the quotient of debt to total assets; *FIRM_AGE* is the number of years since the REIT initial public offering date (or incorporation date if IPO date is not found).

Following Fahlenbrach,[46] *Founder_Lastname* is an instrumental variable introduced to control endogeneity problems

EXHIBIT 2—DESCRIPTIVE STATISTICS

Panel A: Full Sample (N=921)

Variable	Mean	Median	Standard Deviation	Minimum	Maximum
BOARD SIZE	8.46	8.00	1.98	4.00	15.00
OUTSIDERS (%)	71.00	71.43	11.49	37.50	93.33
CEOCHAIR	0.51	1.00	0.50	0.00	1.00
STAGGERED	0.48	1.00	0.50	0.00	1.00
ROA (%)	4.61	4.45	5.00	−58.11	45.83
TOBIN'S Q	1.36	1.28	0.53	0.61	14.00
TA (logs)	22.60	22.69	1.42	18.57	26.28
DEBT/TA (%)	43.82	46.90	21.06	0.00	104.31
MKTtoBOOK	2.24	1.70	5.07	−27.29	74.42
FirM AGE	16.81	15.00	10.69	1.00	54.00
CEOTenure	9.28	8.00	6.92	1.00	44.00
CEOAGE	56.15	55.00	9.38	38.00	85.00
CEOOWN (%)	5.66	1.75	10.02	0.00	79.13

Panel B: Non-CEO founders versus CEO founders

Variable	Non-CEO founders Mean (Median)		CEO founders Mean (Median)	
N	563		358	
BOARD SIZE	8.63	(9.00)	8.20	(8.00)
OUTSIDERS (%)	72.20	(72.72)	69.10	(66.67)
CEOCHAIR	0.32	(0.00)	0.80	(1.00)
STAGGERED	0.41	(0.00)	0.57	(1.00)
ROA (%)	4.73	(4.54)	4.43	(4.27)
TOBIN'S Q	1.37	(1.31)	1.35	(1.24)
TA (logs)	22.62	(22.63)	22.58	(22.74)
DEBT/TA (%)	41.12	(45.60)	48.05	(50.51)
MKTtoBOOK	2.48	(1.71)	1.88	(1.66)
FIRM AGE	18.14	(16.00)	14.72	(12.00)
CEOTenure	7.20	(6.00)	12.57	(11.00)
CEOAGE	52.65	(52.00)	61.68	(61.00)
CEOOWN (%)	3.19	(1.10)	9.56	(4.64)

Panel C: Difference in means of the structure of the board variables by founder status

Variable	CEO founders Mean	Non- CEO founders Mean	
N	358	564	Difference
BOARD SIZE	8.20	8.63	−0.43***
OUTSIDERS (%)	69.10	72.21	−3.11***
CEOCHAIR	0.80	0.32	0.48***

(Continued)

EXHIBIT 2— (CONTINUED)

Panel A shows descriptive statistics for the full sample during the period of 1999-2012. Panel B shows the descriptive statistics for REITs not led by founder and those led by founder CEOs, respectively. Panel C shows difference in means of the structure of the board variables by founder status. *BOARD SIZE* equals the number of directors in the board. *OUTSIDERS* is the ratio of outside directors to the total number of directors in the board. *CEOCHAIR* is an indicator variable that equals one if the CEO leads the board of directors, zero otherwise. *STAGGERED* is an indicator variable that equals one if the board is staggered, zero otherwise. *ROA* is funds from operations divided by total assets. *TOBIN'S Q* is the ratio of market value of equity plus liabilities plus preferred equity plus minority interests to total assets. *TA* is the natural log of the dollar amount of total assets. *DEBT/TA* is the ratio of total debt to total assets. *MKTtoBOOK* is the market-to-book ratio of equity and *FIRM AGE* is the firm's age calculated as the difference between the respective year and the IPO date (or incorporation date is IPO date is missing). *CEOTENURE* is the number of years the CEO has held the CEO position. *CEOAGE* is the CEO's age. *CEOOWN* is the percentage of shares held by the CEO. ***, **, and * denote statistical significance of difference in means between founder CEOs and non-founder CEOs firm-year at the 1 percent, 5 percent, and 10 percent levels, respectively.

EXHIBIT 3—MULTIVARIATE ANALYSIS ON THE IMPACT OF CEO FOUNDER ON REITS BOARD STRUCTURE

Variables	BSIZE	OUTSIDERS	CEOCHAIR
Intercept	−10.18 (−5.2)***	0.84 (4.8)***	−2.98 (−4.7)***
FOUNDER	0.32 (2.3)**	−0.03 (−2.9)***	0.23 (4.2)***
TA	0.83 (9.6)***	−0.01 (−0.8)	0.06 (1.9)*
MKTtoBOOK	−0.00 (−0.7)	0.00 (0.8)	0.00 (1.5)
ROA		−0.00 (−0.2)	−0.00 (−1.1)
STAGGERED	0.30 (2.4)**	−0.01 (−1.0)	−0.02 (−0.7)
CEOOWN	−1.75 (-3.3)***	−0.01 (-0.1)	
CEOAGE			0.03 (14.2)***
LAG_BSIZE		0.00 (1.2)	−0.03 (−3.3)***
LAG_OUTSIDERS	−0.07 (−0.17)		0.27 (2.2)**
LAG_CEOCHAIR	−0.11 (−1.2)	0.01 (1.1)	
Adjusted R-square	0.12	0.66	0.77
Observations	921	921	921

This table presents results of fixed effect regression models on the impact of CEO founder on REITs' board structure. The dependent variables are BOARD SIZE (BSIZE), OUTSIDERS, and CEOCHAIR. *BSIZE* is the number of directors in the board. *OUTSIDERS* is the ratio of outside directors to the total number of directors in the board. *CEOCHAIR* is an indicator variable that equals one if the CEO leads the board of directors, zero otherwise. *FOUNDER* is an indicator variable equaling 1 is the CEO if the REIT founder, zero otherwise. *TA* is the natural log of total assets. *MKTTOBOOK* is the market-to-book ratio of equity. *ROA* is the ratio of funds from operations to total assets. *STAGGERED* is an indicator variable that equals one if the board is staggered, zero otherwise. *CEOOWN* is the percentage of shares held by the CEO and *CEO_AGE* is the CEO's age. *LAG_BSIZE* is the number of directors on the board in the previous period. *LAG_OUTSIDERS* is the ratio outside directors to the total number of directors in the board in the previous period. *LAG_CEOCHAIR* is an indicator variable that equals one if the CEO is also the chairman of the board in the previous period. T-values are shown in parentheses. Statistical significance is displayed by the use of one (10%), two (5%), or three (1%) stars.

between performance and the variable *FOUNDER*. It is designed as an indicator variable that equals one if the firm name is related to the personal name of the founder, zero otherwise. As an instrumental variable, *Founder_Lastname* is unrelated to the dependent variable but correlated to the founder CEO status. Finally, other control variables are *STAGGERED*, an indicator variable that equals one if the board is staggered, zero otherwise; and *FOCUS,* a control variable for REIT property focus, since there may be distinction in financial performance depending on property type. REITs with similar focus are grouped to create binary variables as follows: *RETAIL* is equal to one for REITs with focus on shopping center, regional mall, or other retail, zero otherwise; *RESIDENTIAL* is equal to one if the REIT focuses on multi-family or manufactured homes, zero otherwise; *MIXED* is equal to one if the REIT focuses on specialty or diversified, zero otherwise; and *HOTEL, OFFICE, INDUSTRIAL*, and *HC* are equal to one for REITs with focus on hotels, offices, industries, and health care respectively and zero otherwise. The reference level for the indicator variable is self- storage, the best performing REIT property focus during the sample period. The random regression results are included in Exhibit 4.

RESULTS

Differences in the Structure of the Board

The descriptive statistics for the sample are included in Exhibit 2. Panel A provides descriptive statistics for the full sample; Panel B compares descriptive statistics for REITs with founder CEOs against REITs with non-founder CEOs while Panel C presents the difference in means results, by founder status, for selected board variables. A first study of the data shows, not controlling for other factors, that REITs with founder CEOs have smaller boards and a lower percentage of outsiders sitting on their boards. In addition, the percentage of boards chaired by CEO founders is significantly higher than in the case of non-founder CEOs. These differences are statistically significant, as shown in Panel C. These findings could imply that founder CEOs prefer small, less independent boards that they can control for their private benefits. Also, Exhibit 2 shows that founder CEOs are on average nine years older and entrenched in their positions as they have longer tenures and have three times the shares ownership than their non-founder counterparts. Therefore, CEO founders fit the profile of powerful CEOs as they draw their power from their years of service and stock ownership, in addition to holding the board chairmanship.

Besides, Exhibit 2 shows that CEO founders lead, compared to non-founder CEOs, newer, less profitable REITs as indicated by ROA, with lower growth prospects as indicated by lower market to book ratios but comparable in size as measured by the log of total assets. Finally, consistent with Frank and Ghosh[47] findings for REITs and Faleye[48] for non-REITs, Exhibit 2 shows that as many as 48 percent of REITs in the sample have staggered boards. For REITs, firms that are well insulated from takeovers *per se*, such a high number of staggered boards cannot be explained in the context of CEO entrenchment efforts. Therefore, this could mean additional protection for nonconforming directors from powerful CEOs.

Exhibit 5 presents Pearson correlation coefficients for selected economic and CEO characteristics variables. It can be observed that the correlation coefficients between founder and CEO tenure (0.38), between founder and CEO chairmanship (0.46), and between founder and CEO age (0.47) are large in magnitude. They also are large (with absolute correlation coefficients of more than 0.35) in the case of CEO ownership and CEO age (0.37), CEO chairmanship and CEO age (0.45), and CEO tenure and CEO age (0.49). In contrast, the correlations between the three measures of CEO power, *i.e.*, CEO chairmanship, CEO ownership, and CEO tenure, are relatively low, indicating that these measures capture different aspects of CEO power. For the remaining variables, all coefficients are small in magnitude suggesting that multi-collinearity is not a problem for most of the analysis.

Exhibit 3 presents the results of multivariate analysis on the effect of CEO founder on REITs board structure. Partially consistent with *hypothesis one*, the results show that REITs with founders are less independent because they have fewer outside directors and typically are led by these founders. Surprisingly, Exhibit 3 reveals a positive relation between board size and founder presence even after controlling for the size of the REIT. It also shows that staggered boards add to the board size. An explanation for both findings could be that staggered boards are very common on REITs with founder CEOs (57 percent in the sample) and typically companies strive for equal size classes in a staggered board (*e.g.*, instead of a five- member board with three classes having one director on his own in one of the classes, they may consider to increase the board size to six to accommodate two directors per class). Overall, the results

EXHIBIT 4—CEO FOUNDER AND REIT PERFORMANCE

Variables	TOBIN'S Q	ROA
Intercept	1.54 (3.3)***	18.77 (4.9)***
FOUNDER	−0.09 (−1.7)*	−0.35 (−0.7)
TA	−0.01 (−0.5)	−0.52 (−3.1)***
DEBT/TA	0.21 (1.8)*	−2.78 (−2.7)***
FIRM_AGE	0.01 (2.4)**	−0.01 (−0.2)
FOUNDER_LASTNAME	0.26 (2.3)**	0.58 (0.6)
STAGGERED	−0.06 (−1.1)	0.45 (1.0)
RETAIL	−0.13 (−0.9)	−1.15 (−1.0)
RESIDENTIAL	−0.10 (−0.6)	−1.45 (−1.2)
OFFICE	−0.22 (−1.3)	−1.53 (−1.2)
HC	0.09 (0.5)	0.60 (0.43)
INDUSTRIAL	−0.17 (−0.8)	−1.60 (−1.1)
MIXED	−0.25 (−1.45)	−1.42 (−1.1)
HOTEL	−0.3 1 (−1.7)*	−3.65 (−2.64)***
Adjusted R-square	0.03	0.05
Observations	921	921

This table presents the results of random effect regressions on the impact of CEO founder on REITs' performance. The dependent variables are Tobin's Q and return on assets (ROA). TOBIN'S Q is the ratio of market value of equity plus liabilities plus preferred equity plus minority interests to total assets and ROA is funds from operations divided by total assets. *FOUNDER* is an indicator variable equal to one if the CEO is the REIT founder, zero otherwise. *TA* is the natural log of total assets. *DEBT/TA* is the ratio of total debt to total assets. *FIRM-AGE* is the number of years since the REIT IPO, *CEOAGE* is the CEO's age. *FOUNDER_LASTNAME* is an indicator variable, added as instrumental variable to control for endogeneity effects, that equals one if the firm name is related to the personal name of the founder, zero otherwise. *STAGGERED* is an indicator variable that equals one if the board is staggered, zero otherwise. *RETAIL, RESIDENTIAL, OFFICE, HEALTH CARE (HC) INDUSTRIAL, MIXED* and *HOTEL,* are dummy variables for REITs property focus. T-values are shown in parentheses. Statistical significance is displayed by the use of one (10%), two (5%), or three (1%) stars.

provide evidence that founder CEOs do importantly affect the board structure.

Founders and REIT Performance

The central purpose of this study is to determine if REITs led by founder CEOs perform better. The results reported in Exhibit 4 show that when Tobin's Q is the measure of performance, the coefficient for founder is negative and statistically significant while the founder coefficient in the ROA equation also is negative but not statistically significant. Overall, these results provide substantial evidence that, contrary to *hypothesis two*, REITs led by founders experience worse performance. This finding is consistent with the results by Anderson[49] that founder and heir-controlled firms exhibit a negative relation to performance in all but the most transparent firms. Also, the results are consistent with Cox and Shulman[50] who find that the US REITs as industry did better than the market in the 1986-2006 period, in both bull and bear markets. They find that REITs' performance is greater for non-founder CEOs in the case of equity REITs than for equity REITs led by CEO founders. They attribute such difference to agency

EXHIBIT 5—PEARSON CORRELATION COEFFICIENTS

Variables	FOUNDER	CEOCHAIR	CEOOWN	CEOTENURE	CEO_AGE	TA	DEBT/TA
CEOCHAIR	0.46***						
CEOOWN	0.31***	0.32***					
CEOTENURE	0.38***	0.31***	0.18***				
CEOAGE	0.47***	0.45***	0.37***	0.49***			
TA	−0.02	−0.01***	−0.10***	−0.15***	−0.21***		
DEBT/TA	0.16***	−0.09***	0.24***	0.02	−0.03	0.17***	
STAGGERED	0.15***	0.12***	0.19***	0.16***	0.14***	0.01	0.24***

This table presents Pearson correlation coefficients between founder status and CEO characteristics and selected board and economic variables. *FOUNDER* is an indicator variable equaling one if the CEO is the REIT founder, zero otherwise. *CEOCHAIR* is an indicator variable that equals one if the CEO leads the board of directors, zero otherwise, *CEOOWN* is the percentage of shares held by the CEO, *CEOTENURE* the number of years the CEO has held the CEO position, and *CEO_AGE* is the CEO's age. *TA* is the natural log of total assets, *DEBT/TA* is the ratio of debt to total assets and *STAGGERED* is an indicator variable that equals one if the board is staggered, zero otherwise. ***, **, and * denote statistical significance at the 1 percent, 5 percent, and 10 percent levels, respectively.

costs of having the CEO founders viewing their firms as their private banks and favoring nepotism in personnel practices. Another interesting result from the analysis is the no relation between staggered boards and either measure of performance. This result supports Rose's[51] conclusions that for firms with low takeover probability as REITs, a staggered board should have no significant effect on firm value. This result also adds to the irrelevance of classified boards on firm value, as found by Frank and Ghosh[52] in the case of mergers across the REIT industry.

CONCLUDING REMARKS

Unlike non-REIT firms, a large percentage of equity REITs are led by founder CEOs. This work shows and compares the structure of REIT boards by founder status. In addition, the relation between founder CEOs and REIT performance is examined. With respect to the impact of CEO founder on the REIT board structure, the results show that REIT boards are less independent when the CEO is the founder. In the relation between founder CEOs and REIT performance, founders are found to negatively affect performance. This result is inconsistent with most of the findings of the non-REIT financial literature but consistent with the scarce REIT literature. Overall, the dominance of CEO founders over the structure of boards and the negative influence of CEO founder and founding family on performance are bound to be discomforting for current and potential investors in founder controlled equity REITs. Lastly, additional results in this article indicate no effect of staggered boards on performance. Reconciling these results with the effect on board size that staggered boards have in the presence of CEO founders, as well as uncovering why they even exist for the case of REITs, provides avenue for future research.

NOTES

1. Fahlenbrach, R., "Founder CEOs, investment decisions, and stock market performance," *Journal of Financial and Quantitative Analysis*, 44, 439-466 (2009).
2. Managerial research, for the most part, has found evidence that rapidly growing firms soon outpace their founders' managerial capabilities and therefore, they typically are replaced by professional managers. REIT founders do not seem to follow the same fate. Possible explanations are either that REITs' small size, relative to S&P firms, make them easier to manage and thus, more likely to remain under their founders control or that given their relatively recent creation (by law dating back to 1960 but in practice, most of them created within the past 15-20 years after the introduction of the UPREIT structure) most founders are alive and no succession have been needed.
3. (Arenas & Braga-Alves, 2013).
4. Anderson, R. & Reeb, D., "Founding-family ownership and Firm Performance: Evidence from the S&P performance," *Journal of Finance, 58*, 1301-1328 (2003).
5. Anderson, R., Duru, A. & Reeb, D., "Founders, heirs, and corporate opacity in the United States," *Journal of Financial Economics, 92*, 205-222 (2009).
6. In order to be income tax exempted at the federal level, REITs essentially must pay out as dividends at least 90 percent of their taxable income as dividends, have at least 100 shareholders while adhering to the five or fewer rule (five or fewer shareholders cannot own 50 percent or more of the shares), have at least 75 percent of their assets invested in real estate related investments, cash and/or government securities and generate at least 75 percent of their income from rent, mortgages, and the sale of property.
7. Jensen, M.C., "Agency costs of free cash flow, corporate finance, and takeovers," *American Economic Review. 76*, 2, 323-329 (1986).
8. Campbell, R., Ghosh, C. & Sirmans, C.F., "The Information Content of Method of Payment in Mergers: Evidence from Real Estate Investment Trusts (REITs)," *Real Estate Economics 29*: 361-387 (2001); Adams, R. & Mehran, H., "Is corporate governance different from bank holding companies?," *FRBNY Economic Policy Review.* 123-142 (2003); Hardin, W. & Wu, Z., "Bank mergers, REIT loan pricing, and takeover likelihood," *Journal of Real Estate Finance and Economics. 38*, 275-301 (2009).
9. Frank, L. & Ghosh, C., "Does firm governance affect institutional investors? Evidence from Real Estate Investment Trusts," *Applied Financial Economics. 22*, 1063-1078 (2012).
10. For the case of non-REITs, in the relation between non-REIT CEO founders and board structure, Yermack, D., "Higher market valuation of companies with small board

of directors," *Journal of Financial Economics 40,* 185-211 (1996), found that smaller boards are more likely to have CEOs who either founded the company or belong to the founding family. Shivdasani, A. & Yermack, D., "CEO involvement in the selection of new board members," *The Journal of Finance. 54*, 1829-1853 (1999), find a negative relation between CEO from a founding family and the likelihood of the board to have a majority of independent directors. Braun, M. & Sharma, A., "Should the CEO also be chair of the board? An empirical examination of family-controlled public firms," *Family Business Review. 20,* 111-126 (2007), conclude that having different persons occupy the CEO and board chair positions, in family-controlled public firms, is a useful governance control as the risk of family entrenchment increases.

11. Jensen, M.C., "The modern industrial revolution, exit, and the failure of internal control systems," *The Journal of Finance. 48,* 831-880 (1993).
12. Yermack (1996), *supra* n.10.
13. Ning, Y., Davidson, W. & Wang, J., "Does optimal corporate board size exist? An empirical analysis," *Journal of Applied Finance. 2*. 57-69 (2010).
14. Dalton, D. Daily, C. Johnson, J. & Ellstrand, A., "Number of directors and financial performance: A Meta-Analysis," *Academy of Management Journal. 42,*674-686 (1999).
15. Bhagat, S. & Black, B., "The non-correlation between board independence and long-term firm performance," *The Journal of Corporation Law* 231-273 (2002).
16. Hermalin, B. & Weisbach, M., "Boards of directors as an endogenously determined institution: A survey of the economic literature," *FRBNY Economic Policy Review*, 7-26 (2003).
17. Brickley, J. & James, C., "The takeover market, corporate board composition, and ownership structure: The case of banking," *Journal of Law and Economics. 30*, 161-180 (1987).
18. Rosenstein, S. & Wyatt, J., "Outside directors, board independence, and shareholder wealth," *Journal of Financial Economics. 26*, 175-191 (1990).
19. Shivdasani, A., "Board composition, ownership structure, and hostile takeovers," *Journal of Accounting and Economics. 16*, 167-198 (1993).
20. Hermalin, B. & Weisbach, M., "The effects of board composition and direct incentives on firm performance," *Financial Management*. 101-112 (1991); Klein, A., "Firm performance and board committee structure," *Journal of Law and Economics, 41*, 275-303 (1998); Bhagat and Black, *supra* n.15; Lehn, K., Patro, S. & Zhao, M., "Determinants of the size and composition of US corporate boards: 1935-2000," *Financial Management, 38*, 747-780 (2009).
21. Faleye, O., "Does one hat fit all? The case of corporate leadership structure," *Journal of Management and Governance, 11*, 239-259 (2007).
22. Faleye (2007), *supra* n.21, acknowledges that CEO ownership could either proxy as CEO alignment or CEO entrenchment, but states that it is beyond the scope of his work to explore such distinction.
23. Dey, A. Engel, E. & Liu, X., "CEO and board chair roles: To split or not to split?," *The Journal of Corporate Finance, 17,* 1595-1618 (2011).
24. Harjoto, M. & Hoje, J., "Board leadership and firm performance," *Journal of International Business and Economics, 8*, 143-154 (2008).
25. Bhagat, S. & Bolton, B., "Corporate governance and firm performance," *Journal of Corporate Finance, 14*, 257-273 (2008).
26. Bebchuck, L. & Cohen, A., "The cost of entrenched boards," *Journal of Financial Economics, 78*, 409-433 (2005).
27. Faleye, O., "Classified boards, firm value, and managerial entrenchment," *Journal of Financial Economics, 83*, 501-529 (2006).
28. Campbell, R., Ghosh, C., Petrova, M. & Sirmans, C.F., "Corporate Governance and Performance in the Market for Corporate Control: The Case of REITs," *Journal of Real Estate and Economics 42*, 451-480 (2011) studying REIT mergers and acquisitions, expected that if classified boards matter then there should be a significant relationship between classified boards and acquirer returns. Instead, they find no significant relationship between the presence of staggered boards and abnormal bidder returns, suggesting that staggered boards are redundant in the case of REITs as managers are already immune to hostile takeover attempts.
29. Campbell et al. 2001, *supra* n.8; Hardin & Wu 2009, *supra* n.8.
30. Ghosh, C. & Sirmans, C.F., "On REIT CEO Compensation: Does Board Structure Matter?," *Journal of Real Estate Finance and Economics. 30*, 397-428 (2005); Ghosh, C. & Sirmans, C.F., "Board independence, ownership structure and performance: Evidence from Real Estate Investment Trusts," *Journal of Real Estate Finance and Economics 26*, 287-318 (2003); Friday, H. & Sirmans, G., "Board of director monitoring and firm value in REITs," *Journal of Real Estate Research 16*, 411-427 (1998).
31. Ghosh & Sirmans 2003, *supra* n.30.
32. For recently publicly traded firms, founder CEOs might be resources rather than liabilities. He, L., "Do founders matter? A study of executive compensation, governance structure and firm performance," *Journal of Business Venturing 23*, 257-279 (2008) finds that founder- managed firms are associated with higher financial performance and are more likely to survive after their IPOs than professional managed firms. Gao, N. & Jain, B., "Founder CEO management and the long run performance of IPO firms," *Journal of Banking and Finance 35*, 1669-1682 (2011) find consistent evidence that founder CEO leadership is particularly beneficial to IPO firms in high technology environments.
33. Vintila, G. & Gherghina S., "An empirical investigation of the relationship between corporate governance mechanisms, CEO characteristics and listed companies' performance," *International Business Research 5*. 175-191 (2012).
34. Adams, R.B., Almeida, H. & Ferreira, D, "Powerful CEOs and their impact in corporate governance," *Review of Financial Studies 18,* 1403-1432 (2005).
35. Anderson et al. (2009), *supra* n.5.
36. Adams, R.B., Almeida, H. & Ferreira, D., "Understanding the relationship between founder-CEOs and firm performance," *Journal of Empirical Finance 16,* 136-150 (2009); Anderson and Reeb (2003), *supra* n.4; Villalonga, B. & Amit, R., "How do family ownership, control and management affect firm value?," *Journal of Financial Economics 80,* 385-417 (2006).
37. Fahlenbrach 2009, *supra* n.1.
38. Cox, R. & Shulman, J. "The stock performance of founder-CEO firms," *Indian Journal of Economics and Business*, 143-151 (2008).
39. Cox, R. & Shulman, J., "Do real estate investment trust founders perform better?, *Journal of International Finance and Economics*, 53-62 (2010).
40. Ghosh, C., Giambona, C., Harding, J. & Sirmans, C.F., "How entrenchment, incentives, and governance influence REIT capital structure," *Journal of Real Estate and Economics 43*, 39-72 (2011).
41. The initial sample consisted of 1,469 equity REIT-years (an average of 105 unique equity REITs per year, which represented 75 percent of the average number of equity REITs for the 1999-2012 period, in accordance to the NAREIT Web site, as last accessed on 03/25/2014). Of the initial sample, 435 REIT-years were dropped due to missing either founder data or board data; 113 REIT-years were dropped because Bloomberg did not have the required financial variables for the analysis. The final sample includes 921 REIT-years, an average of 66 unique equity REITs per year.
42. In the years 2006-2008, a significant numbers of mergers and acquisitions took place as it is evidenced by the drop of the number of equity REITs from 138 in 2006 to 113 in 2008 (*Source*: NAREIT Web site, as last accessed on 03/25/2014).
43. As shown in Exhibit 5, founder CEO is highly correlated with CEO characteristics such as CEO age, CEO tenure, CEO ownership and CEO duality. Moreover, CEO age is, in addition to founder, highly correlated with CEO tenure, CEO ownership and CEO duality. Therefore, because of multi-collinearity, including all of them as independent variables in the CEOCHAIR model could result in the independent variables robbing one another explanatory power, possibly yielding wrong estimated regression parameters. One of the best solutions to this problem is to drop collinear variables from the regression equations. However, all of these variables might also have direct effects on performance, thus the results of the model specified above could reflect a spurious correlation between founder CEOs and performance that is due to the omitted variables. Thus, the bias resulting from deletion of a collinear variable must be weighed against the increase in the variance of the coefficient estimators when the variable is included. To address this problem, the adjusted R squares of different regressions with and without each variable were compared. The final model, with CEO age in the equation was found to have the highest R square. CEO age may be capturing most of the information from CEO tenure, CEO ownership, and CEO duality as the older the founder CEO is, the most likely he or she is to have a long tenure, significant equity ownership and to become the chair of the board.
44. Coles, J., Daniel, N. & Naveen L., "Boards: Does one size fit all?," *Journal of Financial Economics 87*, 329-356 (2008); Linck, J., Netter, J. & Yang T., "The determinants of board structure," *Journal of Financial Economics 8*, 308-328 (2008); Boone, A., Casares F, L., Karpoff, J. & Raheja, C., "The determinants of corporate board size and composition: An empirical analysis," *Journal of Financial Economics 85*, 66-101 (2007).
45. Fixed effect regression models are not run mainly due to the invariability of founder, the main explanatory variable in the analysis, for each REIT over time.
46. Fahlenbrach 2009, *supra* n.1.
47. Frank and Ghosh (2012), *supra* n.9.
48. Faleye 2006, *supra* n.27
49. Anderson et al. 2009, *supra* n.5.
50. Cox and Shulman 2010, *supra* n.39
51. Rose, M., "Heterogeneous impacts of staggered boards by ownership concentration," *Journal of Corporate Finance 15,* 113-128 (2009).
52. Frank and Ghosh 2012, *supra* n.9.

Condominium Lending: Lessons from the Bust

By Joel C. Solomon

Joel C. Solomon *is Of Counsel at Foley & Lardner LLP in Chicago, IL. He recently represented Corus Construction Venture, LLC (CCV) in its sales to date of 13 multifamily projects, all of which were built as condominium developments. CCV was the most prominent public private partnership between private equity (including Starwood Capital, TPG, Richard LeFrak, and Richard Perry Capital) and the Federal Deposit Insurance Corporation (FDIC).*

In 2010 it appeared that many major cities were overloaded with empty and often unfinished condominium developments, collectively containing thousands of seemingly unsellable condominiums. It appeared that the condominium boom and the bust resulting from the Great Recession of 2008 and 2009 would have a long lasting adverse impact on an important aspect of urban home ownership. Since that time however, unfinished condominiums have been completed, marketed, and sold to the investors and end users. The market gradually is coming full circle, with many new condominium projects in the planning stages or underway in major metropolitan areas such as Miami and New York.

The precise explanation for the turnaround is complex, but one significant aspect is that many of the condominium construction loans in existence were supported by sound legal and underwriting infrastructure, so that banks and new investors were able to finish troubled projects and sell the extensive inventory to a market that re-emerged more quickly than many predicted. This article focuses on the fundamentals underlying such loans and emphasizes the importance of lenders taking full advantage of consent rights in the loan documents during the development process.

THE BUST

The housing boom and bust that led to the 2008 Great Recession has been well chronicled. Beginning in 2003, Corus Bank, N.A. (Corus), located in Chicago, Illinois, focused primarily on financing condominium developments on a national basis. Many of the projects involved high-rise buildings in large cities including Miami and other parts of Florida, Los Angeles, Las Vegas, Phoenix, Chicago, Houston, and other urban locations around the country.

In 2007 many loans started to exhibit signs of stress. New sales and closings for existing sales slowed. During this early phase of the slowdown, Corus entered into many loan modifications in which it agreed to delayed maturities and lowered minimum release prices for the sale of individual units, usually in exchange for an equity contribution from the borrower. For many loans, these accommodations resulted in eventual payoffs with no losses for Corus. However, once the real estate market collapsed in 2008 and 2009, condominium unit buyers who were under contract to purchase the unsold condominium units were either unable or unwilling (or both) to close on their contracts.

The economy was so bad that modifications became less effective. Many large condominium construction loans and condominium conversions plunged into default and Corus began in earnest enforcing the loan agreements, mortgages, collateral assignments, and other security instruments that comprised the governing agreements and security interests for every loan.

As a result of the changing market, the bank was required to obtain new appraisals for many of the properties that were the collateral for its loans. The appraisals resulted in significant write downs based on current market conditions. On September 11, 2009, Corus was placed into receivership with the FDIC. The bank's $4.5 billion loan portfolio

consisted almost entirely of real estate loans, including a hotel, offices and apartments, but the majority of the loans were for condominium development construction loans. Some of the projects under construction included high rise condo projects financed by loans in excess of $100 million. The FDIC as Receiver was faced with significant unfunded construction loan commitments. Once a lender has invested material dollars to fund construction, there is no turning back because a partially completed building is worth less than the investment already made. The FDIC, recognizing the demands of a large construction loan portfolio, chose to pursue a partnership with private, real estate industry specialists that among other things could better respond to complex, weekly draw requests for dozens of projects that had to be funded to prevent collapse.

THE RESPONSE

A month after it was appointed Receiver, the FDIC orchestrated one of the largest public private partnerships of the era. It transferred the portfolio of loans (some performing and many not) and about 20 large projects that the bank had acquired as "real estate owned" (REO), to a new entity called Corus Construction Venture, LLC (CCV).

It was clear that the condominium projects would have far greater value once completed, and that the ultimate recovery of the loans would be enhanced greatly, not by bulk selling at the bottom of the market, but rather by completing construction and slowly selling into the market as the economy improved. In a public bidding process, the FDIC sold 40 percent ownership of the new company, along with the right to manage the process, to a consortium of private equity investors including Starwood Capital and TPG. The private equity managing member of Corus Construction Venture was ST Residential, LLC.

ST Residential was composed of bankers from Corus Bank and experienced real estate personnel hired by the private equity managers. I transitioned from my role as General Counsel of Corus Bank to the same position at ST Residential. Through its structured finance agreement with FDIC, CCV had access to credit facilities that provided a source of capital to support the continued funding of construction loans as well as REO construction and enhancement needs. In addition, it was under no pressure to sell until the market was ready for repositioned assets. The new team set about the task of funding the constructions loans, and foreclosing or working out troubled loans with borrowers who were in default. A half dozen of the borrowers took the adversarial approach and filed Chapter 11 bankruptcy petitions. Nearly every bankruptcy resulted in CCV obtaining ownership through its subsidiaries, albeit at increased expense for both sides. In some instances, borrowers who could have negotiated a walk away incurred significant "bad boy" exposure under guaranties that allowed personal recourse for the lender's loss once a bankruptcy filing occurred. Other borrowers who were completely underwater chose to work hand in hand with ST Residential to complete the projects and maximize returns. The experience confirmed for me the importance of a borrower's character as fundamental to a successful loan.

Across the portfolio, there were hundreds of challenges arising out of entitlement issues, lien claims, and borrower lender liability claims. There were more than a thousand disputes by purchasers regarding claims for the return of their earnest money on pre-sale contracts, and countless other issues. In addition, there were many condominium projects that needed to be completed, marketed, and sold. ST Residential met each issue head on, and within a year was the owner of many multifamily projects, both rental and condo. Many of the projects were significantly upgraded by investments in entranceways, pool decks, landscaping, and lobbies.

THE RECOVERY

Miami was the first market where condominium sales rebounded, often with cash purchases by foreign buyers. By the time the national media started reporting the story in early 2012, prices already had rebounded substantially, and by 2013 the price per square foot for some high end condominium units was approaching pre-recession levels.

In 2014, it is clear that at least for Miami and the New York City markets, condominium development and the lending that supports such developments are coming back. Condominiums, the most beleaguered of property types over the past few years, are reemerging as a desirable form of lender investment and property ownership. The ownership of hundreds of condominium projects commenced in 2005 through early 2008 have been transferred to banks or their successors through foreclosures or deeds in lieu of foreclosure. Once lenders obtained ownership, they completed projects and sold them out through individual sales as the developers had originally intended or they converted projects to multifamily rental housing and bulk sold them as multifamily investments. CCV has sold thousands of units in the larger markets, including more than 2,000 units in Southern Florida.

In secondary markets such as Las Vegas, Phoenix, and Tampa, sales values of unsold units diminished too much for the new project owners to return to a condominium sellout strategy. Fortunately, consumers have displayed an appetite for rental housing and projects in those regions were successfully repositioned to multifamily rental. As these reinvented projects have come on the market, institutional investors have snapped up both fractured (condominium declarations recorded and some units sold to individual owners) and non-fractured properties as income/rental properties. During 2012, CCV capitalized on the demand for multifamily rental projects by selling 13 separate former condominium projects (2,850 units) as multifamily assets.

The CCV public private partnership has been extraordinarily successful. Barry Sternlicht, CEO of Starwood Capital, in a *Wall Street Journal* "Deal of the Week" article, recently stated that the private equity investors had doubled their $1.4 billion dollar investment, and that "this has been a great, great risk adjusted trade for everyone." One of the reasons that the ST joint venture with the FDIC was so successful was that the legal agreements underlying the loans were comprehensive and clear. Whenever it was necessary, CCV enforced its security interests, completed construction, utilized the essential rights of the developer to market the condominium units for sale, or turned projects into multifamily rentals.

Rather than delving into the legal analysis of best practices for mortgage, loan agreements, guarantees, intercreditor agreements, and the other agreements that form the basis for a sound lender's position for a loan, this article instead focuses primarily on the "bones" of sound condominium construction loans.

FRAMEWORK FOR SOUND CONDOMINIUM CONSTRUCTION LENDING

The Lender as Underwriter

The lender and the borrower must start with a clear understanding of the purpose of the loan. What EXACTLY is the project that will be built? A construction loan by its nature contemplates loan disbursements that will occur (and remain subject to many conditions and hurdles) over 18 to 36 months. With a condominium construction loan, the parties must consider many layers of legal relationships. A lender cannot limit its requirements to a finished building that conforms to the drawings, plans, and specifications contemplated by the parties. As CCV and lenders across the country have learned, a lender must be prepared to assume ownership of a project that is subject to entitlements, contractual obligations with contractors, and the covenants, conditions, and restrictions of record that comprise a condominium regime. As a potential future owner, a lender must assure itself that every aspect of the proposed project will fully support the intended economic use.

Although no lender should unduly interfere with a borrower's business, a prudent condominium construction lender must satisfy itself that if there is a material default in a condominium loan, the lender will be able to assume ownership of the project, complete construction, and ideally market and sell the units as condominiums. The lender must have collateral that not only includes the physical project, but the full assortment of rights and entitlements that provide for the unit by unit sale of the project, and the enforceability of contracts for the purchase of units that were pre-sold to retail buyers. In the event that a given market does not support condominium sales, then Plan B for a defaulted condominium loan is to repurpose the project to a multifamily rental use for eventual sale. Thoughtful attention to details in underwriting a condominium development, and carefully drafted and well developed lender approval rights of the construction and draw process, should enable the lender to retain the potential for full economic access to the project, while avoiding the potential for lender liability.

The Borrower

While the lender is conducting its underwriting of a proposed loan, the developer/borrower often is simultaneously negotiating with multiple parties regarding the ultimate capital structure for the project. Investors likely will obtain a combination of debt and equity positions in the borrower, and often use a complex corporate structure. If any investor is seeking a mezzanine debt position in the project, a detailed intercreditor agreement should govern the subordinated rights of the junior lender vis-a-vis the borrower, the collateral, and the senior lender. The lender must be certain to understand who it is doing business with, the relationship of the various constituents, and the levers of control that have been negotiated among the borrower parties.

When problems occur during the long road from conceptual drawings to ultimate sales, the lender must fully comprehend the motivating objectives and relative leverage for the borrower constituents. For example, an institutional

investor will have a perspective different from an entrepreneurial developer who has invested a large portion of its assets into the project. A well-drafted loan agreement requires approval of the organizational structure as evidenced by the governing documents and approval of all agreements with affiliates.

The Loan Purpose

No lender should approve a loan for a project without a thorough analysis of whether the market will accept the development, and consideration of the economics. Lenders must fully understand the project to be built in relation to the market. For example, the detail should include the location (site plan), the number of floors, the number and configuration of residential units, a description of the commercial units, the parking, access points, and ceiling heights. Square footage of units must be described precisely for all key aspects of the project, especially the units to be sold. Beyond the basic outline of what the project will contain, the loan documents should require approval of detailed plans and specifications. The lenders should use qualified consultants and carefully consider both feasibility and desirability of the proposed project with respect to floor layouts, mechanical, electrical, plumbing, life safety, and site plan issues. In addition, the parties must agree on finish standards, which they should then memorialize in the loan agreement. This should include the kitchen finishes, fixtures, windows, floors, etc.

The Contractor, Professionals, and the Construction Process

The selection of a competent and well-funded general contractor is fundamental to the success of the project. The general contractor and important sub-contractors must be capable of conforming to the plans and specifications, the construction schedule, and the budget. The choice of the general contractor must be carefully underwritten, with due consideration to the contractor's experience on relevant similar construction, its reputation and abilities, and consideration of its financial strength. In addition to the choice of the company, the lender should identify and vet the contractor's key personnel who will be responsible for the specific project. The contractor should not be affiliated with the borrower. The lender also should analyze the type and terms of the construction contract. If the borrower fails, in most circumstances the lender will still want the original contractor to complete the job. The construction contract is collaterally assigned to the lender, who should have notice and cure rights for any claimed default. In addition to the general contractor, the lender should review and underwrite material ancillary contracts for design professionals, owner's representatives, and key consultants.

Once construction commences, the lender must monitor every aspect of the process. I firmly believe that the monthly sign off by an inspecting architect or other consultant is wholly inadequate by itself. As a start, the reporting documents for the project construction should include modified AIA G702 and G703 forms, pay applications for subcontractors, suppliers and materialmen, a lien waiver and tracking log, a contingency transfer record, a change order log, drawings and specifications changes log, shop drawings and submittal log, permits and development authority approvals, including municipal inspection log, and a drawings and specifications changes log. This is far from an exhaustive list, but it illustrates the nature and extent of dynamic information a lender must watch as a project is being built. A knowledgeable staff that truly understands the process is essential to making sure an on-time, in-balance (with the budget) project is being built that conforms to the original expectations.

Entitlements, Building Permits, Zoning, and Utilities

The lender and lender's counsel must fully understand the entitlements for the project. Whether it is a pure residential project, or a mixed use development, the lender must carefully examine entitlements (zoning, permits, special uses, flood zone issues) allowing the project to be built and used as contemplated. There often are quirky aspects unique to most projects, such as easements for access to a property from different streets, temporary easements for staging construction in urban areas, and location specific sewer laws. There may be air rights, and there may be municipal obligations that paved the way for the development entitlements. In a project in Honolulu, for example, in order to create the sewer access necessary for the project, the developer had to form a separate company called a "hui" with adjacent property owners. The hui constructed and paid for the sewer infrastructure that resulted in the hui members (or other owners who purchased the hui's credits) obtaining rights to use the sewer system. Also, it is not unusual for sales centers to be on separate property that may be leased from a third party. Assuring access to a sales center for a major project is critical to the marketing and sales that will monetize the

project. If it includes built out model units, the sales center represents a material item in the budget.

The lender must understand all of the continuing and subsequent obligations of the owner. For example, the borrower may have granted entitlements subject to future performance by the developer of an exterior art contribution, a play lot, or other public benefit. Without fully understanding the entitlement process, the lender could easily miss an obligation of this nature, and the inherent cost it creates. Similarly, a prevailing wage requirement could affect assumptions regarding costs to complete based on local union prevailing wages. Assurances with respect to compliance for entitlements may include zoning opinions from qualified counsel, architect's certifications, and comfort letters or other assurances from the relevant governmental authorities. In addition, the lender must obtain evidence of all necessary utilities for the contemplated project, and appropriate environmental and soil reports.

In addition to the entitlements, the lender must carefully study the condominium regime. During the boom years the issues associated with stepping into the developer's shoes seemed remote. The lender typically was paid off after a little over half of the units were sold. However, as we have learned in the past few years, a lender has to be prepared to take ownership and to be subject to the condominium regime as drafted.

In Florida, after the Great Recession commenced, the specter of significant responsibilities and developer liabilities arising from claims by the Homeowner's Association after formal turnover was deterring lenders and new buyers from investing in distressed condominiums. In 2010, in response to the concern of the investor community, Florida responded uniquely by passing the Distressed Condominium Relief Act. Briefly, the statute provided significant relief for bulk purchasers (including foreclosing lenders) from developer's liabilities under Florida law. The law allows a bulk assignee to avoid responsibility for statutory developer warranties, and relieves a bulk assignee from the prior developer's failure to fund previous assessments or resolve budget deficits. The key point is that in a severe downturn, absent extraordinary legislative relief, a lender who seeks to assume ownership of unsold condominiums may inherit many duties and obligations of the developer pursuant to state law. Lender's counsel must understand the specific state laws and draft agreements that contain the broadest possible limitations of potential successor developer liability including waivers of potential claims. In some states, the risks could include claims asserting liability for construction defects. Lenders should specify detailed insurance requirements that include coverage broad enough that it will respond not only to perils such as fire and wind, but in addition will respond to future claims for construction defects in the event the lender (or its affiliate) steps into the owner's shoes.

Lender's also should ensure that the developer has retained the rights necessary to have maximum flexibility for the sales and marketing of the project, and that the developer will maintain effective control of the project as long as permissible under applicable state law. The lender should understand the funding of the common expenses as well as the state law reserve requirements. In certain cases, even after sales commence, a developer or a successor owner may be entitled to pay the difference between collected assessments from third party unit owners and the actual costs of operation, rather than the actual assessments for the unsold units. The loan agreement should contain covenants by the borrower requiring that it fulfill its obligations under the condominium documents and state law, and prohibit unauthorized changes. The lender should also understand the timing of the turnover of the association to the condominium purchasers under applicable state law, and should appreciate the nature and extent of the turnover obligations, which can be substantial. In other words, the lender must assume it will own the project, and assure itself that the developer is exercising high standards of care and diligence.

Project Budget

Fundamental underwriting includes the analysis of the proposed project budget and study of the individual line items. Even with a guaranteed maximum price contract or a stipulated sum contract, there typically are many open items that have not been determined at the point when a loan is being underwritten or even closed. Many of those undetermined items will be provided for in the construction contract as allowances. A careful analysis of allowances is critical to make sure that the $300,000 line item for "bathroom sinks and fixtures" is adequate to purchase the appropriate level of finishes for the price points associated with this project. Otherwise, a future budget shortfall (out of balance) could be hidden in the allowances line items. Closely related to the budget analysis is the decision whether to insist on a Performance Bond requiring that a surety guaranty performance of the general contractor's obligations including payment of sub-contractors and material suppliers.

The lender should study various contingencies as part of the budget analysis. The loan budget usually will contain a soft cost contingency and a hard cost contingency, separate and apart from the contingency that is incorporated in the construction contract. The adequacy of the contingencies is important, but so is the timing of how the contingencies may be drawn. For example, in the first phase of the project, it is reasonable to allow some additional percentage of the contingency in excess of a strictly pro rata amount. But the lender also should retain reasonable percentages of the contingency in reserve until project completion. In addition, a contingency should not be available to cover an interest payment shortfall in the event the interest reserve line item is depleted or unavailable for some other reason.

Upgrades

A unique feature of condominium sales are upgrades. Upgrades are part of the sales and marketing process, and may have a material impact on the developer's profits. An upgrade typically is any alteration from the approved construction finish standards that results in extra cost to complete the unit. The loan agreement should carefully regulate all aspects of upgrades so that the borrower does not agree to changes that increase the lender's exposure. A reasonable approach is that upgrade costs to the borrower should not exceed 70 percent of the charges to the condo unit purchaser, and (if allowed by local law) the entire upgrade costs should be funded from the upgrade deposits. The borrower should place upgrade deposits into a specified upgrade deposit escrow account, and the lender will retain a perfected security interest in the account. In addition, notwithstanding a buyer who requests outlandish upgrades, the borrower should not be able to over-improve or make odd improvements to units under contract that are not customary in the market. The lender should retain approval rights on upgrades for a dollar value that exceeds a certain amount, and for unusual upgrades. No pink granite floors!

Pre-Sales

Most lenders require that contemplated projects achieve significant pre-sales (pre loan contracts with buyers). Lenders presume that the pre-sale contracts provide significant comfort that the market accepts the project, and that upon completion the loan will be quickly reduced by the sale of pre-sold units. For pre-sales to offer meaningful support for a loan, the lender must assure itself that the contracts are enforceable under state and federal law. As a starting point, contracts must comply with state condominium laws, conform to the requirements of state approved offering memorandums, and be immune from defenses involving fraud. Fortunately, Congress recently has amended the Interstate Land Sales Full Disclosure Act to remove its applicability to condominiums.

After the downturn, borrowers seeking cancellation and the return of their earnest money attacked every conceivable weakness in their contracts. To defend against the possibility of buyers seeking cancellation of their pre-sale contracts, lenders should insist that every possible protection is built into the purchase agreement. For example, borrowers made fraud claims against developers based on discrepancies in the measurement of unit square footage. Developers often were guilty of using one formulation for measuring the size of units that was larger in marketing materials than in actual condo drawings. To avoid defenses to pre-sales, the description of how square footage will be measured should be clear (*e.g.*, "condominiums shall be measured from the interior of the glass in the exterior walls, the middle of demising walls between Units, and to the public side of any common area walls"). In addition, purchase contracts should contain protective language stating that borrowers should only rely on square footage representations in the contract, and further allowing for some deviation in the finished units which is inherent in the construction process.

CONCLUSION

The goal of this article is to provide an overview of the key issues in condominium construction lending. While a lender may hope that it will be paid off by completion and sale of a condo project, it must underwrite the deal as if it will exercise remedies and become the developer. In a worst case scenario of taking ownership of a project, the lender will step into a complicated, multi-faceted asset, which includes state law developer obligations, relationships with contractors, potential buyers and actual unit owners, and regulators. The lender may have to finish construction, market the project, consummate sales, and manage a condominium community. The law relating to foreclosures and interim remedies such as appointment of receivers vary widely from state to state, and therefore local law must be carefully considered. Although a cardinal rule of lending is that the lender should not run the borrower's business, the lender must be diligent and specific in legitimate loan requirements to manage the risks of a condominium loan without veering into the thicket of lender liability.

Real Estate Tax Update

By Jill H. Loftus, Alan Naragon, Edward Herald, Patrick Barrett, Christopher Jetter, and Jaclyn Burke

Jill H. Loftus *is a tax partner,* ***Alan Naragon*** *is a principal,* ***Edward Herald*** *is a director,* ***Patrick Barrett*** *is a manager, and* ***Christopher Jetter*** *and* ***Jaclyn Burke*** *are senior associates at PricewaterhouseCoopers LLP in Chicago, IL. The authors may be reached by email at* jill.h.loftus@us.pwc.com, alan.naragon@us.pwc.com, edward.a.herald@us.pwc.com, patrick.barrett@us.pwc.com, christopher.m.jetter@us.pwc.com, *and* jaclyn.a.burke@us.pwc.com, *respectively.*

TAX COURT RULES AGAINST REAL ESTATE DEVELOPMENT COMPANY'S USE OF TAX DEFERRAL PROVISION

On June 2, 2014, the US Tax Court ruled that a real estate development company, The Howard Hughes Co., LLC (HHC), could not use a certain method of accounting used by homebuilders that defers taxes until project completion, resulting in an approximate $144 million tax assessment. In *The Howard Hughes Co., LLC v. Commissioner* [142 T.C. No. 20], the Tax Court held HHC could not use the completed contract method of accounting because it developed infrastructure for neighborhoods but did not construct homes.

Background

HHC owns, manages, and develops commercial, residential, and mixed-use real estate throughout the country. In 2012, HHC challenged the IRS over an approximate $144 million tax assessment it received in 2011. The IRS claimed HHC under-paid taxes in 2007 and 2008 on land sales that were part of a large master-planned community outside Las Vegas known as Summerlin.

HHC sold land to builders and, in some cases, to individuals who intended to construct and sell homes as part of Summerlin. In some instances, HHC developed the land prior to sale; however, HHC was never obligated to construct any residential dwelling units under any of its contracts, which included pad sales, finished lot sales, custom lot sales, and bulk sales. In 2007 and 2008, HHC used the completed contract method of accounting when computing gain or loss from these contracts.

Completed Contract Method of Accounting

The Internal Revenue Code (Code) provides special rules for income recognition in the case of long-term contracts. Generally, taxpayers must use the percentage-of-completion method of accounting, which results in the recognition of taxable income for the duration of the contract. However, an exception for certain home construction contracts allows taxpayers to account for income from long-term contracts under the completed contract method, which defers income until the completion of the contract. The use of the completed contract method is preferred by most taxpayers but has long been challenged by the Internal Revenue Service (IRS) because of the substantial deferral of income.

Court Considerations

The court addressed whether the long-term contracts were home construction contracts and therefore eligible for use of the completed contract method as opposed to the percentage of completion method. A home construction contract is a long-term contract under which 80 percent or more of the total estimated contract costs are reasonably expected to be attributable to construction activity with respect to dwelling units and improvements to real property directly related to, and located on the site of, those dwelling units.

The IRS argued that HHC must use the percentage of completion method instead of the completed contract method because the home construction contract exception requires HHC to build dwelling units or to build improvements to real property directly related to and located on the site of such dwelling units. On the other hand, HHC contended that the statute does not limit the availability of the completed contract method only to those taxpayers who build the dwelling units and/or real property improvements related to and located on the dwelling units' lots.

The Tax Court ruled in favor of the IRS, concluding that HHC's contracts were not home construction contracts. The court determined a taxpayer with no direct construction costs could not simply include common improvement costs for the purposes of meeting the requirements of the qualifications for the classification of a home construction contract. The court stated that its opinion drew a "bright line" that "a taxpayer's contract can qualify as a home construction contract only if the taxpayer builds, constructs, reconstructs, rehabilitates, or installs integral components to dwelling units or real property improvements directly related to and located on the site of such dwelling units."

Shea Homes Inc. v. Commissioner

Although the Tax Court ruled against HHC, another developer was successful in its case against the IRS, *Shea Homes Inc. v. Commissioner* [142 T.C. No. 3]. In the February 12, 2014, decision, the Tax Court agreed with Shea Homes that it could defer profits under the completed contract method on home sales. In contrast to HHC, Shea Homes both developed the land and built homes. HHC was under no contractual obligation to build homes and its contracts were merely for the sale of land.

Summary

The use of the completed contract method, especially with respect to home construction contracts, continues to be challenged by the IRS. The opinion in Howard Hughes arguably draws a bright line test in determining whether a contract that does not include the construction of dwelling units can qualify as a home construction contract. As a result, land developers currently using the completed contract method to recognize income related to their long-term contracts should reevaluate their application of that method to determine the potential impact of this decision.

NEW GUIDANCE ON THE SAFE HARBOR FORMULA FOR MORTGAGE LOANS AS REAL PROPERTY FOR REIT PURPOSES

The IRS recently released Revenue Procedure (Rev. Proc.) 2014-51, which provides new guidance on the treatment of certain mortgage loans for REIT qualification purposes.

Background

Section 856 of the Code sets forth certain income and asset tests with which a company must comply in order to qualify as a REIT. The Code requires that at least 75 percent of the assets held by the REIT at the end of each quarter consist of real estate assets, cash, and other assets outlined in the Code. In general, real estate assets are defined as real property and interests in real property, including interests in mortgages on real property.

Value of Mortgage Loans

Following the recent recession, the IRS released Rev. Proc. 2011-16 in an effort to provide REITs greater flexibility when modifying or purchasing distressed mortgage debt. Specifically, the revenue procedure provided a safe harbor formula for mortgage loans for purposes of the 75 percent asset test. With the recovery of the economy in recent years however, it has been noted that a REIT may actually find its percentage of qualifying assets as determined under Rev. Proc. 2011-16 being reduced as the value of the underlying real estate collateral and, in turn, the debt increase in value. In response to voiced concern from the real estate industry, Rev. Proc. 2014-51 modifies and supersedes Rev. Proc. 2011-16, seeking to correct this known anomaly in the safe harbor formula.

Under the previous safe harbor formula, the amount considered a qualifying mortgage loan was the lesser of the loan value or value of the real estate at the time the loan was made, purchased, or modified. This amount was included in the numerator of the 75 percent asset test while the denominator included the loan at its fair market value at the end of the quarter. Therefore, if the property increased in value, the denominator would increase but the numerator would remain the same, effectively resulting in an erosion of the taxpayer's qualifying assets percentage even while the property value increased. Rev. Proc. 2014-51 corrects this inconsistency by modifying the formula so that the

numerator and denominator move simultaneously with the value of the mortgage.

The Takeaway

Rev. Proc. 2014-51 provides a much needed update to the previous safe harbor formula and ensures assignment of a more accurate value to mortgage loans for purposes of the 75 percent asset test. Although Rev. Proc. 2014-51 corrects this key issue, it is important to note that the IRS has yet to address another perceived flaw in Rev. Proc. 2011-16 relating to the approach it outlines for applying the interest apportionment rules, which may result in the disallowance of a significant amount of interest income under the 75 percent income test for REITs. As such, REITs, particularly those contemplating the purchase of distressed debt, should continue to follow updates related to Rev. Proc. 2011-16.

PROPOSED CHANGES TO ANTI-INVERSION LEGISLATION COULD IMPACT INTEREST DEDUCTIBILITY IN COMMONLY USED CORPORATE STRUCTURES

On July 31, 2014, Representative Sander Levin of Michigan, Ranking Member of the House Ways and Means Committee, released a discussion draft of the Stop Corporate Earnings Stripping Act of 2014, a complement to the previously introduced Stop Corporate Inversions Act of 2014. The draft bill aims to limit the motivations for US companies to enter into inversion transactions, a cross-border business combination in which a company relocates it corporate headquarters to a lower-tax country.

The discussion draft from Congressman Levin could further limit the deductibility of interest payments made by c-corporations to certain related shareholders, including taxable REIT subsidiaries. The discussion draft contains revisions to the various "earnings stripping" rules under Code § 163(j) that limit the deductibility of intercompany interest payments. In particular, the draft would: (1) eliminate the current safe harbor which provides that the interest limitation does not apply when the debt to equity ratio is less than 1.5 to 1; (2) decrease the amount of income that can be reduced by interest deductions when Section 163(j) does apply from 50 percent of income to 25 percent of income; and (3) limit any carryover of disallowed excess interest expenses to five years.

If the legislation is eventually passed, it would have an impact on REITs and the structuring of loans between entities. However, in the current political environment, much uncertainty exists for potential legislative or administrative change under the earnings stripping rules being passed in the near future.

FINAL REGULATIONS FOR DISPOSITIONS OF TANGIBLE DEPRECIABLE PROPERTY AND GUIDANCE ON ASSOCIATED ACCOUNTING METHOD CHANGES RELEASED

On August 14, 2014, the IRS released final treasury regulations under Section 168 of the Code regarding the disposition of tangible depreciable property (the final disposition regulations). The final disposition regulations modify the proposed disposition regulations released during September 2013 (the proposed disposition regulations), and are designed to help taxpayers further analyze their current method of accounting and make any needed changes. Shortly following the release of the final disposition regulations, the IRS also released Rev. Proc. 2014-54, which provides rules pursuant to which taxpayers may make accounting method changes under the final disposition regulations.

Final Disposition Regulations

The final disposition regulations give taxpayers guidance regarding dispositions of tangible depreciable property, including partial dispositions, as well as guidance on the general asset account (GAA) elections. While retaining many provisions related to the proposed disposition regulations, the final disposition regulations clarify:

- The determination of the unadjusted depreciable basis of a disposed asset in a GAA or multiple asset account;
- The determination of the unadjusted depreciable basis of a disposed portion of an asset; and
- The manner for making certain disposition elections for assets in the GAA election when a demolition is planned.

All taxpayers are required to comply with the final disposition regulations for tax years that begin on or after January 1, 2014, though several implementation options are

available for tax years beginning after January 1, 2012, and before January 1, 2014.

Accounting Method Change Procedures

Rev. Proc. 2014-54, which modifies prior guidance outlined in Rev. Proc. 2014-17 and certain sections of Rev. Proc. 2011-14, provides needed guidance for implementing accounting method changes under the final disposition regulations. In short, Rev. Proc. 2014-54 includes: (1) accounting method change rules for dispositions of tangible depreciable property; (2) a listing of accounting method changes available; and (3) application of statistical sampling. Consistent with prior guidance, Rev. Proc. 2014-54 also provides for a late partial disposition election whereby taxpayers may recognize a gain or loss on disposition of a portion of an asset instead of further depreciating the asset. The revenue procedure extends the time to make the election by an additional year.

In addition, the revenue procedure also permits taxpayers to treat the revocation of a GAA election as a change in method of accounting. However, due to certain tax rules related to the demolition of structures, those considering a GAA revocation should ensure they understand the effects the revocation could have on the underlying assets in the event of a planned demolition in the near future.

The Takeaway

The final disposition regulations give taxpayers a chance to reevaluate their current methods of accounting to determine if they comply with the final disposition regulations. In doing so, it is important taxpayers understand that certain aspects of the final disposition regulations may yield favorable results and other aspects could lead to less favorable results. In implementing any necessary changes, Rev. Proc. 2014-54 provides important procedural guidance. As noted above, there may be opportunities to take advantage of certain accounting method changes; however, taxpayers should be mindful of the limited timeframe by which they must make the necessary elections.

CALIFORNIA COURT RULES IN FAVOR OF CONTROLLING INTEREST TRANSFER TAX

A California Court of Appeals recently ruled that the California Documentary Transfer Tax (DTT), a tax imposed at the city and county level on transfers of realty, applies to transfers of controlling interests in legal entities that hold California real property. In arriving at its decision in *926 North Ardmore Avenue, LLC v. Country of Los Angeles* [Cal. App. Ct., No. B248536 (9/22/14)], the Court looked to California's property tax code for guidance, holding that a transfer of interest or change in ownership occurs when, in general, one individual or entity obtains ownership of more than 50 percent of an entity that owns real property. Though the ruling specifically applies to Los Angeles County, the court, in its analysis, reviewed provisions of the state DTT statutes that the county had adopted. As such, this raises questions of whether the decision could set a precedent for all local jurisdictions across that state that adopted sections of the state DTT model whereas previously only certain cities and counties had applied this interpretation of "realty sold." Regardless of whether a precedent is set, the ruling provides greater support for the assessment of transfer tax based on the substance of the transaction rather than the legal form and is one of which taxpayers should be mindful.