# Lingering effects of the recession on the commercial real estate market

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The commercial real estate market, which encompasses apartment complexes, hotels, industrial parks, malls, office buildings and many other properties used for business purposes, is a cyclical industry whose fate is closely tied to the rise and fall of the economy. In good times, property owners enjoy a huge demand for office space and a steady stream of rental income. Consumers also tend to spend more, boosting demand for retail space. On the other hand, when economic conditions are tough, businesses scale back on office space. This means skyrocketing vacancy rates and decreasing rents for property owners. Those with retail space also suffer as consumers tighten their purse strings and shy away from purchases.

When the Great Recession hit in late 2007, the $6-trillion U.S. commercial real estate market was pummeled. While it took a less serious beating than the residential market, commercial real estate confronted a number of challenges that inevitably amplified the risks faced by property owners.

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Vacancy rates soar. Demand for office space took a nosedive as employers were forced to trim their payrolls in the thick of the economic turmoil. U.S. office vacancy rates soared to 17.4 percent in the second quarter of 2010, with the market losing 1.8 million square feet of occupied space — the highest level since 1993.  A building is considered vacant when less than 31 percent of its square footage is leased.  While the market has shown slight recovery as the vacancy rate dipped to 16.6 percent in the third quarter of 2010 then down somewhat more to 16.4 percent in the next quarter, vacancy rates have not returned to their pre-recession level.

Vacant properties pose a greater number of hazards than occupied buildings. Abandoned buildings, for one, are more prone to fire. According to the U.S. Fire Administration, over 12,000 fires are reported in vacant structures annually, resulting in an estimated $73 million in property damage per year.  Glass breakage, water leakage and wind damage also are common problems. In addition, vacant buildings are frequent targets of arson, theft, vandalism and other crimes. Apart from having to deal with increased exposure to losses caused by physical damage to the vacant property, owners also face potential liability exposures from people who may have been injured in the property.

Defaults rise. Amid the downturn, decreasing rents also pushed properties into bankruptcy, default and foreclosure. Many property developers defaulted on loans, causing real estate wars between developers and lenders. When developers fail to pay their loans, they run the risk of facing foreclosures from lenders. An added pressure comes in the form of insurance coverage implications that may arise from this trend. Bankruptcies and foreclosures increase the likelihood of claims. As Real Estate Investment Trusts (REITs) lose their properties to lenders, for example, the possibility of partnership liability suits and other management liability issues also increases. The risk of damage to unoccupied commercial property, as well as potential expensive losses, also goes up as foreclosures create more empty spaces. During the transition period when property ownership becomes murky, insurance coverage issues may also spark problems as parties pass the blame to escape liability.

[1] "Office Vacancy Rate in U.S. Climbs to 17-Year High, Reis Says," Bloomberg BusinessWeek. 06 July 2010.

[2] "Consolidations, downsizing trigger need for vacant building coverage," Insurance Journal. 01 November 2009.

[3] "Public Safety," National Vacant Properties Campaign.

One of the latest in a series of foreclosures that took place in the aftermath of recession involves the Town Square entertainment and retail center along Las Vegas Boulevard, a joint venture between Centra Properties and Turnberry Associates. After an ugly legal battle, the $500-million development was foreclosed upon in early March 2011 by lenders which included Bank of Nova Scotia and Deutsche Bank. During the recession, the property suffered from extremely low vacancy and the developers were unable to meet debt obligations totaling nearly $512.5 million including about $449 million in principal balance, $42 million of accrued default interest and $22 million in late charges. The developers had been negotiating with lenders to fend off foreclosure, but Bank of Nova Scotia filed a motion in January to proceed with foreclosure.

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Directors and officers take a hit. The financial meltdown coupled with heightened scrutiny from shareholders also took a toll on directors and officers in many industries as they saw a wave of litigation. The executives in the real estate market were not exempted. Advisen's Master Significant Cases and Actions Database (MSCAd™) recorded 71 securities cases filed in the real estate sector between 2007 and 2010. Twenty-three of these cases were securities class action suits, 21 were securities fraud suits filed principally by regulators and law enforcement agencies, and 14 involved breach of fiduciary duties. Other cases tracked involved derivative shareholder action, Financial Industry Regulatory Authority (FINRA) sanctions, merger objection, order audit trail system violations, and proxies and solicitation violations. The year 2007, when the recession struck, was a particularly active year.

One of the largest securities class action settlements in the commercial real estate sector over recent years involved The Mills Corporation, owner and developer of shopping centers. In 2006, the Iowa Public Employees' Retirement System accused the company and its officers of overstating net income and funds from operations, violating the Generally Accepted Exchange Accounting Principles (GAAP). It further accused The Mills Corporation of misrepresenting the adequacy and quality of its internal controls over financial reporting. A settlement was reached between the plaintiffs and the defendants in November 2008 to dismiss claims against Mills, the company's former executives and directors, its underwriters and successors, in exchange for a payment of $165 million for the benefit of the class. Auditor Ernst & Young and private real estate company KanAm Group also paid $30 and $8 million, respectively.

Layoffs contribute to lawsuits. As the recession deepened, over eight million Americans lost their jobs. A major employer of skilled workers, the real estate industry had to let go of real estate agents, architects, carpenters, engineers and many other laborers owing to the cessation of new commercial property developments. The problem with layoffs is that they often result in grave discontent among staff. Lawsuits for breach of contract or unfair dismissal, discrimination claims, wage and hour lawsuits, and workers compensation claims are likely to increase with layoffs.

[4] "Town Square foreclosed on, Forest City takes over leazzsing," Las Vegas Info Newspaper. 09 March 2011

Disgruntled buyers sue developers. The market saw a sharp drop in property values amid the crisis, leaving property owners struggling as values slid to levels lower than those of their mortgages. This resulted in lawsuits from disgruntled buyers who accused developers either of breaching their contract or not delivering on promises. One South Florida attorney alone has filed about 1,500 suits for condominium buyers seeking refunds under a federal law regulating condo sales. On the flip side, some developers are now suing buyers who backed down on their purchases.

## Re-evaluating risk management

The financial turmoil has been painful for commercial real estate. While the market has began slowly inching its way to recovery, industry observers warn that challenges are still likely to persist in the foreseeable future. With these challenges come various risks such as potential property damage, heightened scrutiny from shareholders, foreclosures by lenders, lawsuits from disgruntled buyers and increased discontent among staff owing to dismissals.

One of the major lessons learned from the recession is that risk management is a crucial part of any company's business strategy. Unfortunately, many property owners and developers learned this the painful way. Keeping the lessons learned from the recession in mind, companies in the commercial real estate market must:

- Build risk management into operations throughout an organization. Over recent years, the risk management processes of companies across all industries have come under increased private and regulatory scrutiny. With this trend, many saw the need to establish a range of mechanisms and processes to manage risk across all aspects of a company. These mechanisms are collectively known as Enterprise Risk Management (ERM). The recession highlighted the need for ERM and was a factor in more companies starting ERM programs.
- Ensure adequate insurance coverage. Businesses must assure they have a comprehensive program that fully addresses their needs. The Mills Corporation case, which involved a whopping $165 million settlement (excluding defense costs), clearly demonstrates that very large losses can occur in the real estate industry. A huge settlement spells nightmare for any business, and companies do not need to discover after the fact that they did not purchase enough limits to cover the loss. Buyers should take into consideration the interplay of a number of factors such as the limits available in the marketplace, the types of cases that may be filed and the practices of peers.
- Review coverage for vacant properties. Owners of vacant buildings must look carefully at risks involved in owning such property. Moreover, they should examine the conditions, terms and restrictions that apply to their insurance policy. Since insurance companies feel that they are assuming a greater risk when insuring a vacant building, some insert a "vacancy clause" in the policy. This clause means that there is no coverage for loss caused by building glass breakage, sprinkler leakage, theft, vandalism and water damage when a building is vacant for more than 60 consecutive days before the loss occurs. It also reduces the amount normally paid for loss or damage caused by fire or wind.

[5] "Buyers Sue Trump as Miami's Condo Prices Plummet," Bloomberg. October 16, 2009.

[6] "Lessons of economic downturn help shape program designs," Business Insurance. 17 October 2010.

- Benchmark coverage across-the-board against peers. Benchmarking or the process of comparing one's business processes and performance metrics to best practices of peers has become an important exercise across all industries over the past decade. To find out if the coverage purchased is adequate relative to best practices, property owners, managers and developers can use benchmarking to determine how their risk management programs and their coverage for various lines of business compare to the competition. Common insurance benchmarks include types of coverage purchased, limits purchasing patterns, levels of retention selected, loss amounts and competitiveness of insurance premiums.

The Great Recession has amplified the many risks faced by the commercial real estate market. As the economy sees gradual improvement, business activities in commercial real estate and other sectors are expected to pick up. The next challenge is to ensure that firms will have enough coverage to address the higher capacity of activities that the recovery will bring and the corresponding risks that they will pose.

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