

OfficeIntelligencer

January 2007

GOOD FAITH NEGOTIATIONS; SO WHAT DO YOU HOLD DEAR?



Paul Suzman, Frances Sullivan, Larry Pflughoeft, Tom Baker, and Rick Page. Don MacLaren—not in photo...is “AWOL” tuning up his back country skis.

Several years ago and shortly before his death my father, in his inimitable way, asked me whether I truly understood the meaning of ‘sincere’. I stumbled through a couple of bland interpretations before he fixed me with a gimlet eye and said with the impatient air of someone with not much time remaining to pass on important lessons:

‘think man!’ he said...‘remember your Latin’, Sine = without, Cera = wax.

i.e. when letters were sealed with hard wax, if you trusted someone not to read the contents when hand delivering a communication, you would not seal it. And to this day Miss Manners would tell you when having a friend deliver a letter for you, you should not seal it. You trust them, very simply, to do **the right thing**. To be, in a word, sincere.

Not too complicated right?

Whereas in many other businesses a verbal agreement can be enforceable, under real estate law, *a lease or a purchase and sale agreement, in order to be enforceable, must be in writing, and signed by both parties.* And here, as is so often the case, the law constitutes the lowest common denominator.

Why would I say this? Because during the course of negotiations, especially in a dynamic real estate market, circumstances change; and depending on the trajectory, these changes would be either to the potential benefit or detriment of one or other party in a transaction. So if you shake hands on all the key points of a deal but during the process of documentation and prior to signature, a better offer is received, do you still have the moral obligation to go through with it? I know what my father would say.

For a strict legal interpretation however. I turned to a trusted friend, Ellen Dial, Attorney at Perkins Coie and President of the Washington State Bar Association for her take: *“To me, the moral good faith we hope for in a deal is breached when one party asks the other to expend time and resources to prepare and/or negotiate a deal when the first party really doesn’t intend to follow the negotiations through to completion. For that reason, many letters of intent include a binding obligation to negotiate in good faith for a stipulated period of time. That brings in not only the moral, but also the legal duty of good faith and fair dealing. As you know, Washington implies a duty of good faith and fair dealing in all binding contracts. That duty requires parties to make good faith efforts to perform their contractual duties and to deal fairly with one another. It also requires parties to refrain from deception and from interfering with the other party’s ability to have the benefit of the bargain that has been struck. In all cases, however, the duty applies only to a binding contractual commitment. If a letter of intent is nonbinding as to the terms of the deal, but binding as to the obligation to negotiate in good faith, that gets parties one step further down the road to a successful negotiation.”*

Continued on Page 2

OfficeLease

T 206-624-0000

F 206-464-1389

1301 Fifth Avenue

Suite 3535

Seattle, WA 98101

www.officelease.com

Commercial Real Estate Planning

Tenant & Buyer Representation

Since 1981

TABLE OF CONTENTS

GOOD FAITH NEGOTIATIONS	1
TALENT IS KING	2
WHAT WERE THEY THINKING?	3
LANDLORDS MARKET?	3
COLLEGE SPARK	4

**Need help finding the right space or with real estate negotiations?
Call OfficeLease today at 206-624-0000 or e-mail pauls@officelease.com.**

GOOD FAITH NEGOTIATIONS; SO WHAT DO YOU HOLD DEAR?

Continued from Page 2

So the bottom line is that when negotiating on behalf of a tenant or buyer one can never assume that a deal is done until it is signed by both parties. It is easy to claim that the negotiations are/were in good faith but the acid test is simply, various technical protestations or justifications aside, whether one or other party would walk away from their commitment simply to accept a better offer. And if they choose to do so, letter of the law notwithstanding, have they acted in good faith?

We always urge our clients to think very carefully before having us submit a letter of intent on their behalf. Or accept one submitted unless the landlord/seller involved is clearly of like mind. The test, to our way of thinking is *"would you honestly move forward with this transaction if the recipient accepted all the basic terms?"* in other words, will you act on their stated intent. Or do they need the 'wax' of a signature to induce performance? We trust not.

Our experience over the last 25 years of negotiating in the Greater Seattle area is that for the most part, both tenants and landlords tend to honor their word. And it is far more enjoyable for all parties concerned to be involved in open and frank negotiations. Once a deal in principal has been struck, remaining issues, including signatures while obviously needed to make the document enforceable and legally binding, should not be misused as tools of leverage to change the deal or as scapegoat to dishonor the contract.

As Hector noted in Shakespeare's Troilus and Cressida **"...Life every man holds dear; but the dear man holds honour far more precious-dear than life."**

Paul Suzman Pauls@officelease.com
As always, we value your comments.

TALENT IS KING

Washington's annual economy ranks 14th nationally at \$238 Billion, based on 2004 Gross State Product figures. This represents 2% of our National economy. Comparing this with the recent Fortune survey of the 100 Best Companies to Work For, Washington hosts 7 of the top 100 (REI - 9, Starbucks - 28, Microsoft - 42, Nordstrom - 46, Perkins Coie - 48, Russell - 63, WAMU - 87). Although not altogether scientific, it is encouraging to note that a state representing 2% of the economy hosts 7% of the Best Companies to Work For.

The reasons for this fortunate imbalance are not nearly as varying as the services these companies provide. Each of these companies focuses on their people; recruiting top talent and developing innovative programs to retain them. Everything from exceptional benefits to tuition reimbursement to recognition to profit sharing to lifestyle, these leading companies understand the wave of the future. They all focus on their people.

In his Essentials Series, Tom Peters raves about the defining ingredient for a successful business in today's economy: Talent.

"The industrial age is over. The white collar paper-pushing age is over. Great products are not enough. Great services are not enough. The new sources of value-added are all about creativity, imagination, and intellectual capital. And that stuff is all about... talent. We have entered the age of Talent. People's talent, their creativity, their intellectual capital, their entrepreneurial drive is all there is."

How can your business benefit from recognizing these observations and finding a simple way to enter the age of talent? One of the most strategic solutions may be something as basic

as your office space. Each of the 7 WA companies recognized in Fortune's Best Companies to Work For has their own image that is reflected in their office space (retail included).

As you work on evolving your business, pay attention to what leading companies are doing with their office space. How do they set themselves apart? How do they use their office space to recruit and retain top talent? How do they use their space to inspire? How do they use office space to build community within their organization?

You'll find that many of them are using their office space as a business tool. There a number of things you can do now to move in this direction.

1. Make space needs part of your long-term business planning.
2. Thoroughly survey the market for opportunities.
3. Plan to negotiate from strength.
4. Tailor your lease to your business and your plan.
5. Implement rule #1 immediately.

Looking at your office space as a strategic asset can lead to an important step in the evolution of your company. Your culture is a product of your corporate values and the talent who make up your company.

Tom Baker Tomb@officelease.com

\$575 PER RENTABLE SQUARE FEET... WHAT WERE THEY THINKING?

We'll tell you...

\$575/RSF – is the record price paid for a Seattle area office building! This one is for the Civica Office Commons in downtown Bellevue which only last year sold for \$458/RSF. How can buyers possibly justify such prices?

To help answer this question, we needed to go back to our recent article on “Cap Rates” and how they are used to establish the price of a building. You’ll recall it is a quick way to translate the average triple net (NNN) rent role to the value of the property. This requires taking into account associated costs (frequently reducing income to about 97%) and the probable occupancy rate (usually assumed to be 95% for large multi-tenant buildings, but as low 80-85% for smaller low rise buildings with just a few tenants). But what return can an investor really expect from the traditional CAP Rate of say 7-8%?

It is a complex question depending on both “knowns” and assumptions about what happens each year over the projected holding period. The “knowns” include the purchase price and how it will be financed which depends on how much you can borrow (usually 70-75%), the mortgage rate that sets the annual debt service and the loan fees and costs (frequently about 1.5% of the loan amount).

The assumptions about the future are what really determine the probable return on your original down payment, or equity investment. While the initial rental role, future lease terminations and first year operating costs are known, you must assume what they will be each year to the end of the projected holding period. This requires projecting (guesstimating) future operat-

ing costs and rental rates, vacancy rate, leasing commissions, tenant improvement allowances, and capital reserves for such things as roof replacement. And finally what will be the ultimate selling price that has to reflect the market CAP rate and rental role at that time.

A recent analysis for a client gives an idea of what to expect. When assuming the same 8.6 CAP rate on both purchase and sale for a ten year holding period, the before tax Internal Rate of Return (IRR) was 13.8% and after tax 11.2% for the top tax bracket owner. Different assumptions gave somewhat different, but similar numbers. Thus, the “real” return is likely to be somewhat higher than the assumed CAP rates.

So what does this say about the \$575/RSF paid for Civica? This premium quality building is essentially fully leased with an average rental role of ~\$31/RSF/yr NNN. This gives a 5.2 CAP rate that might represent a real after tax return of 7-7.5%. That’s not bad as a core portfolio holding compared to a stock market return that averages no better than 10%/year. If the building were to be owned by a pension fund, like many of the recent record purchase price properties are, the return would be even better since they pay no taxes.

But the basic question is whether it is realistic to assume that the building will remain fully leased into the future for at least today’s premium \$31 NNN rent. Presently they are asking only \$16-18 for the 1.4% that is not leased. Century Square, the first of the modern high rises in Seattle CBD, gives us a hint. When it was built in 1986, the basic rent was \$22 NNN for ten years with a five year extension option at \$33. This seemed high at the time. The actual rental rate for the five year extension was set at ~\$17 NNN by arbitration. And today the building has a high vacancy rate and is asking \$15-20 NNN! So caveat emptor!

Don MacLaren Donm@officelease.com

SEATTLE AREA OFFICE SPACE: A COMING LANDLORDS’ MARKET? JANUARY 2007

In the Spring 2004 OfficeIntelligencer, as the market was starting to recover from the bottom of the recent business cycle, Officelease produced a five year forecast of how and when we thought the market might recover. At that time vacancy rates in Seattle, while down from a high of over 15%, were still over 12% and rental rates averaged about \$25.50/RSF/year gross for class A office space, little changed from the preceding year and way below the previous peak of over \$35 based on OfficeSpace.com data.

We applied the ‘Hysteresis Loop’ concept to make our forecast. A Hysteresis Loop is observed when the stress-strain plot of a material being stressed doesn’t match that of the same material as it is unstressed. In the office market the stress-strain relationship plots vacancy rate versus rental rate. For Fall of 2006 we then forecast that the recovery would have progressed to a vacancy rate of 8.3% and that the average rental rate would increase \$1.50/RSF from the previous year to \$27.25/RSF.

OfficeSpace.com recently reported that the vacancy rate was down to 8.1%, but the average rental rate had only increased to \$25.70/RSF. Cushman & Wakefield gave a very similar figure of \$26.19/RSF although they indicated this was \$1.67/RSF higher than the second quarter.

There now seems to be little doubt that the market is well on its way to transitioning into a landlords’ market with vacancy rates of less than 8% and rapidly rising class A average rents approaching \$30/RSF.

Rick Page Rickp@officelease.com

College Spark Washington

www.collegespark.com



OfficeLease is proud to be of service to and to feature various non profits in the Puget Sound area. OfficeLease is currently working with College Spark Washington. College Spark provides valuable service to the community by funding programs in Washington state that help low-income students become college-ready and earn their undergraduate degrees.

Washington has a strong community college system that is worth investing in. In July, College Spark announced its participation as the Washington funding partner in Achieving the Dream: Community Colleges Count. Achieving the Dream is a national initiative which College Spark has committed \$3.8 million over the next 5 years. The Achieving the Dream initiative emphasizes the use of data to improve outcomes at the community college level including helping more students earn degrees, earn certificates or transfer to other schools to continue their education.

More than sixty percent of Washington college students attend public two-year institutions. Community college is often the gateway for low-income students to begin their college career. *Achieving the Dream* specifically works with community colleges that serve the highest percentage of low-income students and students of color. In Washington, those schools are Big Bend Community College, Highline Community College,

Renton Technical College, Seattle Central Community College, Tacoma Community College, and Yakima Valley Community College.

College Spark's other grant program focus's on community grant. The Community Grant Program, which started in 2005, makes grants to organizations and institutions throughout Washington state that are helping low-income students improve their academic achievement, prepare for college life and graduate from college.

College Spark Community Grantees include:

- Community organizations and program providers
- Technical and community colleges
- Four-year colleges and universities
- Other educational institutions
- Public agencies

For more information about College Spark funding activities, the Achieving the Dream initiative, or College Spark grantees please visit www.collegespark.com.

College Spark is thankful to OfficeLease, and particularly Larry Pflughoeft, (larryp@officelease.com) who has worked tirelessly to secure just the right office in lower Queen Anne to accommodate its modest growth over the next few years.

A Client Comments:

Paul, I've enjoyed working with you immensely and greatly appreciated your help on bringing this complicated deal to a successful conclusion. Your broad knowledge of this market, attention to detail, and focus on practical solutions was invaluable. You were always available and brought a higher than usual level of sophisticated experience that was reassuring to all the parties.

I look forward to working with you on our next transaction.

*John G. Casagrande
Senior Counsel, Special Programs
Bright Horizons Family Solutions*

(50,000SF build-to-suit 15 year lease for a private elementary school)