

Confronting the Conflict of Interest Dilemma in Commercial Real Estate Representation

Could a pair of decisions, made four months and half a world apart, threaten the future of dual-agency representation in commercial real estate? The idea may not be as far-fetched as it sounds.

In November 2016, the California Supreme Court upheld an appeals court ruling that associates working for the same brokerage firm owe identical fiduciary responsibilities to each party and must be transparent in disclosing germane information. In the context of a commercial real estate deal, this means that brokers working in a firm that represents both a landlord and a potential tenant must disclose everything they know to both parties, short of the leasing price the landlord is willing to accept and the rent the tenant is willing to pay.



In the aftermath of this decision, commercial real estate experts suggested that California could circumvent the ruling by passing legislation to shift the legal agency relationship with the client from the brokerage to the individual broker, as Colorado and some other states have done.

However, the initial reaction from the state legislature was to float a pair of bills that would have further restricted dual agencies. One bill would have banned the practice outright, while the other would have clarified and expanded existing disclosure requirements. Met with intense resistance from the traditional real estate sector, both bills were pulled before reaching a vote.

In London the following March, the Royal Institution of Chartered Surveyors (RICS), a global real estate accreditation body that certifies property and construction professionals, dramatically limited the ability of dual agency representation among



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its members beginning January 1, 2018. In a binding declaration of professional standards and guidance, RICS stated, "An RICS member or regulated firm must not advise or represent a client where doing so would involve a Conflict of Interest or a significant risk of a Conflict of Interest; other than where all of those who are or may be affected have provided their prior Informed Consent."

The statement continues, "Informed Consent may be sought only where the RICS member or regulated firm is satisfied that proceeding despite a Conflict of Interest is: (a) in the interests of all of those who are or may be affected and (b) is not prohibited by law, and that the conflict will not prevent the member or regulated firm from providing competent and diligent advice to those that may be affected."

The document adds several thresholds that must be met to ensure there is no conflict of interest, as well as data collection and reporting requirements when a member chooses to proceed with dual agency representation.

While these decisions alone do not spell the end of the long-entrenched dual agency model, they are part of a newly heightened awareness of the potential for conflicts of interest when the same brokerage firm is sitting on both sides of the negotiating table.

Basics of the Conflict of Interest

The practice of brokers serving both landlords and tenants is widely accepted and has been for decades. This is true even though a conflict is inevitable when the tenant's needs and the broker's incentives are incompatible – which is often the case in dual agency situations. Landlords, to whom the broker has a fiduciary obligation, want the highest rates and the fewest concessions. Conversely, tenants would like the lowest rates and the best concessions they can wrangle from the process. Something has to give and, for a variety of reasons, the advantage typically goes to the landlord.

The simple reality is that brokers who represent both tenants and landlords can't possibly be fully objective. Brokers have an obligation to bring tenants to their company's listings. Given the opportunity to steer a tenant toward their own company's listing or toward a competitor's, which is more likely to be their choice? This arrangement is clearly not in the tenant's best interests.

Follow the money and you'll see that the battle for a dual agency broker's attention is actually no contest. Based on the public filings of large, full-service commercial real estate firms, approximately 85% of their revenue comes from representing landlords through leasing, property management, or investment sales. Furthermore, publicly traded firms face tremendous pressure from shareholders and Wall Street to grow revenue, pushing these companies even closer to the money source and increasing the likelihood of slanting their service toward the landlord and away from the tenant.

For example, it is generally in the tenant's best interests to receive an expense audit every year, while many landlords would rather limit or avoid this step. Brokers that represent the landlord as well as the tenant may be far less likely to push for this provision for fear of upsetting their client.

It is telling that the industry's largest dual agency firms offer standard conflict of interest disclaimers in their public filings. One company announces that its diverse business lines and broad client base subject it to "numerous potential, actual or perceived conflicts of interest," while another notes that conflicts can occur when "the primary duty of loyalty we owe to one client may potentially be weakened or compromised by a relationship we also maintain with another client or third party."

As the challenges to dual agencies grow, however, the practice is being questioned more frequently. Many CFOs are more thoroughly scrutinizing their company's real estate decisions, performing greater



due diligence in examining their outsourcing relationships and focusing on the bottom-line implications of such potential conflicts. New rules from the Financial Accounting Standards Board (FASB) are expected to ramp up the pressure on financial managers and corporate real estate professionals even further when they go into effect in 2019 and 2020.

Studies Identify Conflict Issues

Apprehension about conflicts of interest was one finding in a 2015 Watkins Research Group study. It revealed that most corporate tenants polled were “very concerned” about the potential of conflicts, saying that they would prefer to work with a tenants-only service provider.

This is one of multiple studies that underscore the conflict of interest that inherently exists when a commercial real estate firm represents both the landlord and the potential tenant, even when separate brokers or separate offices of the same firm are involved.

A 2014 study by the Center for Real Estate and Urban Analysis at The George Washington University determined that “unlike other U.S. markets, including but not limited to the residential real estate market and the domestic capital markets, the U.S. commercial leasing market lacks transparency and equal access to the same quantum of information by all parties.”

The report continues, “The market is driven by the supply of available

premises for lease and not by the demand for such premises. As a consequence, the status quo...supports the interests of landlords and their brokers, to the detriment of tenants.” It adds that the lack of a central governing organization has prevented the commercial real estate industry from addressing the issue, to the detriment of tenants.

Further, a 2016 analysis by the University of Leeds argued that “conflicts of interest that undermine clients in subtle ways may well go unnoticed and unpunished” and that the “Chinese walls” that dual agency firms ostensibly use to avoid conflicts can be easily breached.

The report authors interviewed a sampling of business representatives, lawyers and commercial real estate experts in England and Wales, concluding that many tenants lack the time, expertise or information to adequately assess the quality of the service they receive from a dual agency broker.

The Leeds study also criticized RICS’ guidance in this area. “More could be done to promote the enforcement in practice of the RICS guidance,” it said. “At present, RICS is not doing enough to help clients, not only to understand the duties of member agents under its guidance, but also to know how to bring complaints against them. It is also concerning that many agents are not subject to any code that is as strong as the RICS guidance, even despite its weaknesses.”

At the time of the study, RICS was in the process of researching and assessing its conflict of interest stance. This eventually led to the changes announced in March.

In response to the Leeds study, Gary Strong, the group’s director of practice standards and technical guidance, said, “RICS absolutely agrees that this is a major issue and one that we have been engaged in tackling over the last 18 months. We invited the team at Leeds University to participate in our work when we were commencing the current review and we now welcome the findings of this report which we will consider amongst the consultation responses we receive.”

What are the Possible Remedies?

In the legal industry, it is considered common sense when one law firm represents the plaintiff and another represents the defendant. Each side hires its own advocate to ensure objectivity and accountability. Doing it any other way is, of course, a conflict of interest.

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Thus, one potential remedy is for the commercial real estate industry to adopt a rule similar to the American Bar Association's Model Rule of Professional Conduct. It states that, "A concurrent conflict of interest exists if the representation of one client will be directly adverse to another client."

The legal industry concluded a long time ago that a single entity cannot adequately and ethically serve two masters on the same matter. Why has the commercial real estate industry been so slow to address this obvious problem?

One answer you'll hear from dual agency defenders is that the conflict with a landlord/client often doesn't present itself until a relationship with the tenant has proceeded a long way down the line. This may or may not be a valid point, but it is insufficient to justify the overwhelming evidence of the inherent conflict of interest found in dual agency representation.

This leads to tenant advisory firms, which differ from traditional commercial firms in many ways. In addition to the obvious focus on tenants only, these firms cannot rely solely on deal-oriented transactions. For this reason, tenant

advisory firms offer comprehensive corporate services such as strategic planning, lease administration, lease audits and program/project management.

Some traditional brokers provide these allied services as well, but may not prioritize them among their other offerings because they typically aren't as lucrative as transaction-based services are. For a tenant-only firm, the comprehensive service approach enhances their value proposition to the tenant client and takes the relationship beyond one based in a single transaction.

Tenant rep firms act as an extension of their client's corporate real estate department, and there is never any question about where their allegiance lies. With an objectivity that dual agency brokers may not have, tenant-only firms can aggressively press a landlord for better terms without concern of compromising an existing or potential landlord-client relationship.

A tenant advocate's role goes far beyond basic matters of the rent and the lease length. Instead, the goal should be to build as much flexibility into the arrangement as possible, including areas such as termination rights, contraction and expansion rights, building expense audits and so on. It is only commonsense to wonder if a dual agency broker will push as hard for a tenant if the result creates an uncomfortable situation with a landlord who is also a client of the firm.

At the same time, industry consolidation has vastly expanded the likelihood that a dual agency broker will have an existing relationship with both the client and the landlord, while consequently furthering the case for tenant rep firms. A recent analysis of the five largest commercial real estate companies in the U.S. found that they represent over 1.9 billion square feet of office space nationally on behalf of landlords.

Are Dual Agency Firms Doomed?

It is unlikely that the dual agency model will disappear in the immediate future. It is far too entrenched in the current commercial real estate industry to go away overnight. However, as conflict of interest concerns increase, the potential grows for more legislative and regulatory limitations on the practice.





There are precedents whereby drastic changes were made to a long-existing model. For example, because of abuses, scandals and the collapse of companies such as Enron and WorldCom, the financial services industry is now subject to far more scrutiny and regulation than it once was. The Sarbanes–Oxley Act of 2002 sought to increase accountability and transparency in an industry that largely policed itself.

One important objective of Sarbanes-Oxley was to address conflicts of interest in financial auditing. Prior to Sarbanes-Oxley, a company’s financial auditing firm could also provide other – often more lucrative – consulting services. This created a potential conflict of interest, as any negative reports or actions taken by the auditor could potentially jeopardize their broader business relationship.

The commercial real estate industry appears to be moving – slowly – toward attempting to resolve at least the appearance of conflict of interests inherent in the dual agency approach. The limitations that result may not be as severe as they are in the financial, legal and other professional services industries, but they seem sure to evolve in that general direction.

In the meantime, it is incumbent upon tenants to more diligently probe for conflicts of interest that could negatively affect the service they receive from their broker. Steps they can take include:

 **Research the Broker.** Get references and recommendations, and research the track record of the broker on similar deals. Have conflicts arisen before? Do their tenant clients believe they got their money’s worth? Did they return the next time they needed help?

 **Raise the Issue Early in the Relationship.** When engaging a broker, the tenant company’s lead representation should ask, upfront, about any potential conflict that could arise. Get a list of the firm’s landlord clients, current listings and asset/property management agreements with companies that could potentially be sitting on the other side of the negotiating table.



Insist on Full Disclosure. Ask for an accounting of the fees or commissions that landlords are paying them, as well as bonuses or discounts.



Become Educated on Current Trends and Standards. Ask your broker, other real estate professionals, friendly competitors and any other business executives you know about their leasing experience. This includes the going per-square-foot rates in your area; expansion, contraction and termination provisions; the implications of a property sale or change in ownership, and so on.



Consider the Bottom Line Implications. Ultimately, how well will the broker help you achieve your goals, including finding the best space for the right term within your budget. Real estate is a top expenditure for most companies, so it’s critical to get it right.