PROPERTY TRANSACTIONS: A NOTE ON ETHICS

Jon Robinson and Richard Reed
The University of Melbourne

Pacific Rim Real Estate Society, Ninth Annual Conference
Brisbane, 19-22 January 2003

The professions are a conspiracy against the laity. George Bernard Shaw.

Abstract:
Some activities that are applied in the property market to facilitate transactions have the potential to lead to unethical behaviour. Two conditions required for a sale price to be acceptable as market value are that the transaction is at arm's length and the parties to the transaction are knowledgeable and prudent. The well-known difficulties associated with access to market pricing information are exacerbated by several of these activities including dummy bidding at auctions, two-tier marketing and the provision of lease incentives. Added to these is a common requirement that any negotiation be commercial-in-confidence. The lack of information has the potential to distort the market and this has been well publicised in recent times particularly in the residential market.

The definition of market value is visited and the nature of ethics in property transactions is outlined. Several examples of activities that could lead to unethical behaviour are described. It is concluded that unethical behaviour is hard to identify. Some recommendations are included for consideration and discussion.

Keywords: ethics, insider trading, market information, market value, property market

INTRODUCTION

Property transactions require a meeting of minds between a vendor and a purchaser. It is a truism that the vendor will seek to obtain the highest price possible whilst the purchaser will seek to pay as little a possible. In addition, the advisers associated with transactions are likely to tend towards advocacy rather than impartiality and emphasise this commercial dichotomy. This applies not just to property transactions but also to any good or service. A negotiation process explicitly or implicitly takes place until a price is agreed between the two parties and then the transaction proceeds. The detail of the negotiation and its intensity depends upon the subject of the negotiation, which in turn depends upon its relevant market. As is well understood, different markets operate at different levels of efficiency and this is generally consequent upon the different levels of available market knowledge particularly in respect of knowledge about market prices and knowledge about certain events that may affect market prices.

The price that is ultimately agreed between the two parties to a negotiation usually defines market value ***provided that certain conditions are met***. Two important conditions are that the negotiation is at arm's length and that the parties are knowledgeable.

In recent times, some high profile practices in the property industry have created confusion in the market place particularly in respect of what constitutes market value. These include two-tier marketing, rental guarantees provided by vendors, lease incentives provided by landlords and "dummy" bidding at auctions. The boundary lines between various levels of value have come under pressure, and values may vary according to different perspectives. For example, two-tiered markets are continually being identified, although which tier reflects true market value? Should it depend on the number of buyers in a specific tier, even though both categories of buyers are willing? The answer lies in the level of market knowledge available to and obtained by the parties to the negotiation.

Partly due to the increased pressure in a competitive society, vendors, purchasers and their respective representatives have sought to increase their likelihood of achieving a transaction. A great deal has been made of the vendors' attempts to obtain the highest possible price to the extent that legislation is being contemplated to outlaw some practices such as dummy bidding (Reed *et al*, 2002). Recently, comments have been made about purchasers' attempts to keep prices low. At times this may lead away from the definition of market value, and towards unethical behaviour in the quest for a sale. However, this falls short of deceptive and illegal behaviour – or does it? These activities have tended to lower the perception of real estate as a transparent investment medium in an era in which property openly competes with an increasingly professional and up to date stock and share market.

The relationship between the advisory role and the sales role can also cause an ethical dilemma. On the one hand, the adviser must act as an expert in advising the vendor. Then the adviser, wearing an agent's hat, may act as an advocate in the transaction. The dilemma occurs in the undertaking of the two activities by the one person or firm.

The purpose of this paper is to debate the ethics extant in arriving at a sale price at market value. It is particularly concerned with the effects of imperfect market knowledge on transactional outcomes and suggests that this is where ethical problems are likely to arise. It is also concerned with the notion of arm's length and suggests that additional ethical problems may arise in this regard. The paper concludes with some recommendations of ways in which the transparency and ethics of property transactions may potentially be improved.

MARKET VALUE

The definition of market value attempts to quantify exactly what an "arm's length sale" actually is, and just as importantly, what it is not. The International Assets Valuation Standards Committee (API, 2002, p26) defines market value as "the estimated amount for which an asset should exchange on the date of valuation between a willing buyer and a willing seller in an arm's length transaction after proper marketing, wherein the parties acted knowledgeably, prudently and without compulsion". There are several key words and phrases, which take the effect of conditions that, must apply for a price to represent market value:

- on the date of valuation
- willing buyer and willing seller
- arm's length transaction
- after proper marketing
- parties acted knowledgeably
- parties acted prudently
- parties acted without compulsion.

There is no need to dwell on these conditions except to state that the key words in the definition in the context of this paper are "arm's length" and "knowledgeably". The common law puts the onus on the purchaser in any transaction by the acceptance of the term *caveat emptor* meaning buyer beware.

As will be seen later, the information available to the market is often of poor quality, unclear, wrong, misleading or a combination of these. Examples are provided to demonstrate that some activities that are commonly applied in the industry in order to enhance transactions may be unclear and misleading and give the impression of being unethical activities. This is particularly exacerbated in the housing market that generally constitutes households and small investors with limited knowledge who may not appreciate the value of independent advice and for whom there is an emotive aspect associated with home ownership, a sense of fairness and natural justice. This leads to potential problems with the arm's length nature of the sales.

Even though investment in property has consistently been viewed as a valuable component in most portfolios, the proportion of property allocation has decreased to low levels since the cycle of the 1980s/90s. The conventional difficulties of property when compared to stocks and shares - heterogeneity, immobility, indivisibility, and illiquidity - had been well understood and attempts, some successful, had been made to overcome them. Other differences that had been listed but possibly not fully appreciated have begun to assume importance in the ethics debate. Property comprises a series of highly localised sub-markets in which exists a lack of transparency in negotiations, and a lack of market knowledge of prices and sale volumes. This compares with the share market which is highly centralised and in which transactions take place that are fully transparent (except perhaps in mergers and acquisitions and management buyouts) confident in full knowledge of prices and sales volumes. Both broad markets suffer from potentially unethical practices and all of these practices tend to result from the fact that one of the parties to the transaction is in the possession of less than full knowledge; in other words, there may not be a level playing field.

ETHICS

Ethics may be defined as the science of morals and morals, in turn, defined as principles associated with distinguishing between right and wrong (see for example the Shorter Oxford English Dictionary, 1973). Moral as an adjective seems to be interchangeable with ethical. Morality is associated with actions, volitions, character and the outcomes include customs, rules, conduct, judgement, behaviour, advice, laws. The discussion about and application of ethics requires a context and the context of this paper is transactions in respect of real property, in particular, sale and purchase transactions and leasing and letting transactions. This context requires a combination of business ethics and professional ethics which are, to a significant extent, based upon the personal ethics of individuals but which are also codified by the professions and, where relevant, their regulators. But whence personal ethics. It is tempting to fall back upon such saws as “do unto others as you would have them do unto you” which arise out of the personal faiths of individuals but this can cause a diversion into faith-based ethics as distinct from reason-based ethics. “Rational ethics deals with decision-making and consequences” (McCoy, 2001, p56).

A business consists of an arrangement for the production and sale of commodities (goods) whilst a profession consists of an occupation requiring intellectual skill (services). A property transaction requires elements of both of these but there is strong evidence to suggest that the two activities should be separate and distinct in order to accomplish the *arm’s length* of the transaction. In addition, the concept of *caveat emptor* can only apply to the business component of the transaction and not the professional component. Thus the buyer and seller must protect themselves by being armed with the necessary market knowledge. But they are supposed to *be protected from* unethical behaviours by the remedies available in tort and by codes of professional ethics that define the profession (API, 2002; Atkinson, 2002; Featherston, 2002). Without a code of ethics, and ethical behaviour, there is no profession.

In a market that boasts perfect information, fair-trading will usually be the rule. In the property market, the circumstances that usually prevail are somewhat less than perfect information. In this case, fair-trading depends upon the parties to the transaction and their advisers. Property transactions take place in a market in which prices are set in a climate of confidentiality, negotiations are cloaked in secrecy citing a requirement for a *commercial-in-confidence* embargo, information is not instantly available from a central repository, inaccuracies abound in the recording of such information as is available.

It is asserted in this paper that the nature of the imperfection of market knowledge in property leads to behaviour that appears to have overtones of *insider trading*. In the share market, insider trading refers to transactions that take place when one party is in possession of information that is not available to the other party, ie, “dealing for profit in areas in which the person dealing has privileged information” (Carew, 1988, p125). The information is used to the benefit of the insider and the detriment of whomever is negotiating with the insider (including large numbers of investors in the community in the case of stock market investors).

There appear to be three broad categories of behaviour as shown in Figure 1, although the boundaries between these groups are often fuzzy at times, and appear to be constantly changing. Ethical behaviour is represented by the category at the left of the diagram, which, in a valuation context, conforms, to the definition of market value with both a willing buyer and willing seller involved in the transaction process. Both parties are fully conversant with the market, and their representatives have acted in good faith at all times.

However, the perception of market value becomes clouded when information is either not available or is obfuscated by jargon and this provides the potential to move to the middle of Figure 1. It is the boundary between these two categories, which at times becomes unclear. For example, dummy bidding and two-tier marketing could result in prices that appear to have shifted to the right. The distorted market price is considered to be outside the definition of market value in that the conditions of acting knowledgeably and prudently are not met. These practices have recently received considerable media attention, the first was originally perceived as a common and acceptable means of assisting the auction process and the second simply relied upon *caveat emptor*.

The third category is entitled 'Illegal Practices', and is strictly controlled by legislation as both the buyer and/or the seller may enter into a contract of sale as a result of deceitful or purposely misleading practices such as misrepresentation. And there are sanctions in the criminal legislation to deal with fraud and secret commissions. There are remedies at law and in equity to compensate in these circumstances.

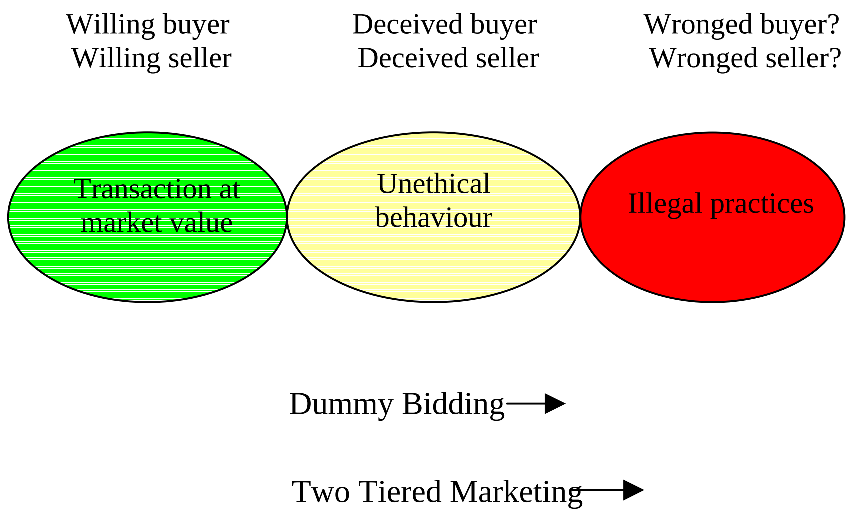

Figure 1 – The 3 broad categories relating to market price-setting behaviour.

Of major concern is the changing relationship of various transfer practices. It appears that due to increased pressure to achieve a transaction, certain process have evolved out of the definition of market value at the left of the diagram. As these practices have become more prevalent and come under increased media attention over time, the legal framework has been modified to outlaw such behaviour. Thus, it appears that many of these methods of advancing sales have their origins in market value, although are now identified, examined and legislated against. The aim of property professionals is to shorten this process, while at the same time minimising exposure to the media and the negative sentiment to investment in property.

SOME EXAMPLES

Sales, auctions and tenders

Freehold property is commonly sold by way of private sale or auction. Tendering or sealed bidding is used but less commonly. In the case of the private sale, the vendor establishes the asking price and negotiations take place with individuals interested in purchasing until one of them offers a price at or close to the asking price. The asking price is known at the outset of negotiations and the purchaser must decide whether to meet that price or whether to offer something less. If the purchaser meets the price without further negotiation, the purchaser will be unsure as to whether the property could have been acquired for less; if the purchaser tries to negotiate the price downwards, an alternative buyer may appear causing the purchaser to lose the property. Sometimes, the vendor may raise the asking price, particularly where there are several buyers negotiating the purchase of the property. The negotiation period becomes important as the longer the period, the greater will be the availability of information about market prices. Thus purchasers must trade off the potential to pay less with the potential to lose the property to another purchaser or to ultimately pay more as the vendor adjusts the asking price in the face of the improved market information. It is unlikely that any of the above would be considered to be unethical by either vendors or purchasers; these activities are simply the exhibition of prudence by the negotiating parties. For best results, both parties would need to be knowledgeable about the market and it is this type of transactional process in which the term *caveat emptor* plays a part. An unethical practice that arises in private negotiations in a rising market is one in which a price has been agreed between vendor and purchaser and a third party offers a higher price which is accepted by the vendor to the detriment of the initial purchaser. This is colloquially known as *gazumping* and is really a breach of an equitable contract unless a sale note has been signed by both parties in which case it is a breach of a legal contract in which the purchaser has remedies at law.

In the case of the auction sale, the vendor establishes a reserve price, which is generally understood to be a price below which the vendor would not sell. The reserve price is similar to the asking price in a private sale except that all parties do not know the reserve from the outset. The auction sale comprises simultaneous negotiations between the vendor and more than one purchaser. The purchasers are in competition with each other and the property is normally sold to the highest bidder or, where the highest bid is lower than the reserve, the property is *passed in* and the vendor enters into exclusive negotiations with the highest bidder to finalise the price. If no agreement is reached and the purchaser walks away from negotiations, the vendor will open negotiations with the next highest bidder and so on until a sale is agreed. At this point, the negotiating process takes on the appearance of a private sale. The public auction is commonly used in a rising market in the hope that competition amongst the bidders will achieve a price higher than the reserve. In falling markets, a practise known as *dummy bidding* has arisen in which individuals who have no intention of purchasing the property are planted in the auction crowd to give the appearance of *bona fide* bidders. In addition, the auctioneer may state that the vendor reserves the right to bid. The obvious object of dummy bidding is to deceive genuine bidders into thinking that others are prepared to pay more for the property; in other words, the information that they have obtained is false or misleading. The purpose of the vendor’s bid is less clear. They are sometimes used to get the bidding process started usually at a price well under the vendor's reserve price. They may sometimes be used to try to draw out a genuine bid at the reserve price. In all situations, the dummy bid and the vendor's bid are clearly made to cause genuine bidders to keep bidding up the price. The community has come to view this practice as unethical as it may drive prices to higher levels than should be paid. It is clear that if two or more genuine bidders continue to compete, then vendor's bids and dummy bids probably do little to distort the process. However, it is equally clear that the pricing process is probably distorted if the bids of a single genuine bidder are being ramped up in competition with dummy bids. It is this sort of process in which *caveat emptor* may become a refuge. It is one thing to be knowledgeable about market conditions; it is another to be knowledgeable about distorted market pricing.

Sales by tender or sealed bid are relatively common for major commercial properties. In these cases, purchasers submit prices at which they would be prepared to buy and the highest price so submitted becomes the sale price. Of course the vendor would have a reserve price as above and would reserve the right to negotiate with the highest bidder. This process obviously requires that the purchaser be very knowledgeable as there would be unlikely to be a second opportunity to make an offer for the property. This process also offers the least opportunity for price distortion.

Two-tier marketing

Two-tier marketing occurs where the nature of the market gives rise to two levels of prices in the same market. This is invariably the result of a lack of knowledge about market prices. Two examples have become common. The first is the establishment of high asking prices for interstate and foreign purchasers than the prices asked of and offered by purchasers who are closer to the market locality. In all other respects, the high asking price example follows of the private sale as outlined above. The purchaser either pays the price asked or negotiates a lower price. The potential lack of ethics occurs where it is known that purchasers from outside the market will not have the local knowledge and may be swayed by the asking prices in relation to prices in the market in which they currently reside. The higher levels of price that are negotiated in this way do not reflect market value due to the lack of prudence fuelled by the lack of knowledge that has driven the transaction. These purchasers are colloquially known as *wood ducks.* However, the wider range of sale prices recorded over the two tiers ultimately distorts the general levels of market prices.

The second example involves the difference between rents negotiated in vacant possession lettings and the passing rents paid by sitting tenants. These examples arise as a result of poor understanding of the definition of market value rather than a lack of ethics. However, rents are often distorted during rent review procedures on the basis that passing rents on comparable premises are included in the lists of evidence collected by landlords and tenants. Consequently, rental increases may be agreed at review without the necessary knowledge that a passing rent represents the market value *at the time the rent was originally negotiated*. In some cases, rental values are agreed and even determined in these circumstances and they appear to be the result of a lack of knowledge or a lack of arm's length.

Lease incentives

In markets that are oversupplied, the vendor or landlord may offer the purchaser or tenant an incentive to consummate a transaction. This is equivalent to the annual motor vehicle sales just prior to the release of the new model in which the vendor offers the vehicle with *cash back* to the purchaser. The market value of the car is the asking price less the amount of cash back. In property, the market rental value is the asking rent (called the *face rent*) less the annual equivalent of the incentive. This was particularly prevalent during the office market cycle of the late 1980s/early 1990s in which the over-supply of office space in the capital cities exceeded 25% of the total space available. Substantial incentives are being offered at the time of writing in most capital cities in Australia.

On the face of it, the incentive is offered to assist in the letting. But the incentives are usually hidden by confidentiality requirements in the documentation. Accordingly, the market knowledge could comprise only the face rent. This led to clear distortions of market rental value that could result in overvaluations where a valuer relied upon the evidence. The over-valuations may have suited borrowers of finance and corporate balance sheets, but the effect of the incentives was to cloud the transparency of market information. The analysis required to establish market rental values at specific dates could provide a wide range of rental values. In many cases, none of these represented true market rental value. For example, a face rental of \$400 pm^{2}pa in a 10 year lease with a typical incentive of 5 years rent free could result in an effective market rental value of \$150 if the incentive is applied to the whole lease termor *negative* \$475 if the incentive is applied to the period until the next review. Only the valuer associated with this negotiation would be in a position to know. Although this lease transaction may be observed in the market place, others relying upon it would have imperfect knowledge about the details.

Rental guarantees

Another form of incentive has been common for multi-unit residential developments that were often marketed by vendors who offered a rental guarantee to purchasers - a form of cash back. Once again, this was an activity that had the effect of obscuring the true position in an over-supplied market. Thus its use could convince purchasers to buy, financiers to lend, and could "postpone" a downturn in the market.

SOME CONCLUSIONS AND RECOMMENDATIONS

All of the examples and activities outlined above that might be questioned in ethical terms are about the potential to distort pricing information in a market in which it is already very difficult to obtain relevant and dependable information. The pricing information is distorted because some of the conditions associated with the definition of market value have been contravened, particularly the concept of the arm's length transaction and the assumption that the parties, especially the purchaser, are knowledgeable.

The property industry cannot continue to ignore unethical or marginally ethical behaviour and successfully compete with other investment media. It cannot continue to seek refuge behind the mantra of *caveat emptor*.

Unethical behaviour is extremely hard to identify and little legislation exists to combat unethical behaviour. The press are quite keen to highlight stories of poorly treated vendor/purchasers particularly in the unsophisticated residential investment market populated by small "mum and dad" investors armed with the latest from a "how to get real estate rich" seminar.

What can be done to rectify the problem of inadequate information? One answer would be to record property transaction details in a central easily accessible location. The recently proposed privacy legislation preventing the release of transactional information is counter-productive and needs to be reconsidered. The benefits of any associated privacy are far outweighed by the costs associated with continuing transactions in a state of blissful ignorance.

Another answer would be to require that recent valuations be prepared and included in the property details required to be provided by vendors as part of the due diligence process. The alternative view would be to state that buyers should obtain the advice. The due diligence process is costly, particularly so for homebuyers who may inspect several properties and who could not afford the inspection reports and valuations that could protect them. In addition, market prices could be artificially set by the valuation process rather than by market activity.

A third answer would be to continue with the proposed legislation relating to agency behaviour in which dummy bidding and the like would be outlawed. The difficulties associated with the identification of dummy bids are likely to doom to failure this initiative.

In the final analysis, the application of ethical principles is required in any activity associated with human interaction and indeed with wider interaction in the natural and man-made environment. A general awareness of the importance of ethical behaviour needs to be instilled in parties involved in real estate transactions (see for example Izzo, 2000).

References

Atkinson HG (2002): Ethics and professional conduct. *Appraisal Journal.* **70/3**:332-335.

Australian Property Institute (2002): *Professional Practice 2002.* API: Deakin, ACT.

Carew E (1988): *The Language of Money.* Sydney: Allen & Unwin.

Featherston JB (2002): Ethics: a matter of trust. *Appraisal Journal.* **70/3**:337-341.

Izzo G (2000): Compulsory ethics education and the cognitive moral development of sales people: a quasi-experimental approach. *Journal of Business Ethics.* **28/3**: 223-241.

McCoy BH (2001): Business faith and ethics: making the connection. *Real Estate Issues.* **26/1**: 54-57.

Reed R, Robinson J & Williams P (2002): The adverse effect of dummy auction bidding on market values. *Australian Property Journal* **37/3**: 202-205.