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The Nets and NBA Economics

David Stern would have you believe the Brooklyn-bound franchise embodies everything wrong with the league's finances. It's not true.

By Malcolm Gladwell(http://www.grantland.com/search/_/query/malcolm-gladwell) POSTED SEPTEMBER 26, 2011

Ten years ago, a New York real estate developer named Bruce Ratner fell in love with a building site at the corner of Atlantic and Flatbush Avenues in Brooklyn. It was 22 acres, big by New York standards, and within walking distance of four of the most charming, recently gentrified neighborhoods in Brooklyn — Park Slope, Boerum Hill, Clinton Hill, and Fort Greene. A third of the site was above a railway yard, where the commuter trains from Long Island empty into Brooklyn, and that corner also happened to be where the 2, 3, 4, 5, D, N, R, B, Q, A, and C subway lines all magically converge. From Atlantic Yards — as it came to be known — almost all of midtown and downtown Manhattan, not to mention a huge swath of Long Island, was no more than a 20-minute train ride away. Ratner had found one of the choicest pieces of undeveloped real estate in the Northeast.

But there was a problem. Only the portion of the site above the rail yard was vacant. The rest was occupied by an assortment of tenements, warehouses, and brownstones. To buy out each of those landlords and evict every one of their tenants would take years and millions of dollars, if it were possible at all. Ratner needed New York State to use its powers of "eminent domain" to condemn the existing buildings for him. But how could he do that? The most generous reading of what is possible under eminent domain came from the Supreme Court's ruling in the *Kelo v. New London* case. There the court held that it was permissible to seize private property in the name of economic development. But *Kelo* involved a chronically depressed city clearing out a few houses so that Pfizer could expand a research and development facility. Brooklyn wasn't New London. And Ratner wasn't Pfizer: All he wanted was to build luxury apartment buildings. In any case, the Court's opinion in *Kelo* was treacherous ground. Think about it: What the Court said was that the government can take your property from you and give it to someone else simply if it believes that someone else will make better use of it. The backlash to *Kelo* was such that many state legislatures passed laws making their condemnation procedures tougher, not easier. Ratner wanted no part of that controversy. He wanted an airtight condemnation, and for that it was far safer to rely on the traditional definition of eminent domain, which said that the state could only seize private property for a "public use." And what does that mean? The best definition is from a famous opinion written by former Justice Sandra Day O'Connor:

> *Our cases have generally identified three categories of takings that comply with the public use requirement. ... Two are relatively straightforward and uncontroversial. First, the sovereign may*

> *transfer private property to public ownership — such as for a road, a hospital, or a military base. See, e.g.,* Old Dominion Land Co. v. United States, *269 U. S. 55*(http://caselaw.lp.findlaw.com/cgi-bin/getcase.pl?navby=case&court=US&vol=269&invol=55) *(1925);* Rindge Co. v. County of Los Angeles*, 262 U. S. 700*(http://caselaw.lp.findlaw.com/cgi-bin/getcase.pl?navby=case&court=US&vol=262&invol=700) *(1923). Second, the sovereign may transfer private property to private parties, often common carriers, who make the property available for the public's use — such as with a railroad, a public utility, or a stadium.*

A *stadium*. The italics are mine — or rather, they are Ratner's. At a certain point, as he gazed longingly at the corner of Atlantic and Flatbush, a light bulb went off inside his head. And he bought the New Jersey Nets.

Earlier this year, NBA commissioner David Stern was interviewed by Bloomberg News. Stern was expounding on his favorite theme — that the business of basketball was in economic peril and that the players needed to take a pay cut — when he was asked about the New Jersey Nets. Ratner had just sold the franchise to a wealthy Russian businessman after arranging to move the team to Brooklyn. "Is it a contradiction to say that the current model does not work," Stern was asked, "and yet franchises are being bought for huge sums by billionaires like Mikhail Prokhorov?"

"Stop there," Stern replied. "... the previous ownership lost several hundred million dollars on that transaction."

This is the argument that Stern has made again and again since the labor negotiations began. On Halloween, he and the owners will dress up like Oliver Twist and parade up and down Park Avenue, caps in hand, while their limousines idle discreetly on a side street. And at this point, even players seem like they believe him. If and when the lockout ends, they will almost certainly agree to take a smaller share of league revenues.

But Stern's success does not change how *strange* the NBA position is. There is first of all the hilarious assumption that owning a basketball franchise is a business — at least as that word is used outside of, say, the president's mansion in Pyongyang. [1] But beyond that is a second, equally ridiculous assumption, which is that the economics of basketball teams are principally about *basketball*. As it turns out, they are not.

Bruce Ratner's original plan for the Atlantic Yards site called for 16 separate commercial and residential towers and a basketball arena, all designed by the superstar architect Frank Gehry. The development would be home to roughly 15,000 people, cost in excess of $4 billion, total more than eight million square feet, and make his company — by some calculations — as much as $1 billion in profit. To put that in perspective, the original Rockefeller Center — one of the grandest urban developments in American history — was seven million square feet. Ratner wanted to out-Rockefeller the Rockefellers.

Ratner knew this would not be easy. The 14 acres he wanted to raze was a perfectly functional neighborhood, inhabited by taxpaying businesses and homeowners. He needed a political halo, and Ratner's genius was in understanding how beautifully the Nets could serve that purpose. The minute basketball was involved, Brooklyn's favorite son — Jay-Z — signed up as a part-owner and full-time booster. Brooklyn's borough president began publicly fantasizing about what a professional sports team would mean for his community. The Mayor's office, then actively pursuing an Olympic bid, loved the idea of a new arena in Brooklyn. Early on, another New York developer, Gary Barnett, made a competing play for the railway yard. Barnett's offer was, in many ways, superior to Ratner's. He didn't want the extra 14 acres, so no land would have to be expropriated from private owners. He wasn't going to plunk a small city down in the middle of an already crowded neighborhood. And he *tripled* the value of Ratner's offer. Barnett lost. He never had a chance. He wanted to build apartments. Ratner was restoring the sporting glory lost when the Dodgers fled for Los Angeles. As Michael Rikon, one of the attorneys who sued to stop the project, ruefully concluded when Ratner's victory was complete: "It is an aphorism in criminal law that a good prosecutor could get a grand jury to indict a ham sandwich. With regards to condemnations in New York, it can fairly be said that in New York a condemnor can condemn a Kasha Knish." [2] Especially if the kasha knish is being eaten to make way for a professional basketball arena.

Ratner has been vilified — both fairly and unfairly — by opponents of the Atlantic Yards project. But let's be clear: What he did has nothing whatsoever to do with *basketball*. Ratner didn't buy the Nets as a stand-alone commercial enterprise in the hopes that ticket sales and television revenue would exceed players' salaries and administration costs. Ratner was buying eminent domain insurance. Basketball also had very little to do with Ratner's sale of the Nets. Ratner got hit by the recession. Fighting the court challenges to his project took longer than he thought. He became dangerously overextended. His shareholders got restless. He realized had to dump the fancy Frank Gehry design for something more along the lines of a Kleenex box. Prokhorov helped Ratner out by buying a controlling interest in the Nets. But he also paid off some of Ratner's debts, lent him $75 million, picked up some of his debt service, acquired a small stake in the arena, and bought an option on 20 percent of the entire Atlantic Yards project. This wasn't a fire sale of a distressed basketball franchise. It was a general-purpose real estate bailout.

Did Ratner even care that he lost the Nets? Once he won his eminent domain case, the team had served its purpose. He's not a basketball fan. He's a real estate developer. The asset he wanted to hang on to was the arena, and with good reason. According to Ratner, the Barclays Center (the naming right of which, by the way, earned him a cool $400 million) is going to bring in somewhere around $120 million in revenue a year. Operating costs will be $30 million. The mortgage comes to $50 million. That leaves $35 million in profit on Ratner's $350 million up-front investment, for an annual return of 10 percent. [3] "That is pretty good out of the box," Ratner said in a recent interview. "It will increase as time goes on." Not to mention that the rental market in Brooklyn is heating up, the first of Ratner's residential towers is about to break ground, and his company also happens to own two large retail properties directly adjacent to Atlantic Yards, which can only appreciate now that there's a small city going up next door. When David Stern says that the "previous ownership" of the Nets lost "several million dollars" on the sale of the team, he is apparently not counting the profits on the arena, the eminent domain victory, the long-term value of that extra 14 acres, or the appreciation of Ratner's adjoining properties. That is not a lie, exactly. It is an artful misrepresentation. It is like looking at a perfectly respectable kasha knish and pretending it is a ham sandwich.

And let's not forget Mikhail Prokhorov. How does he feel about buying into the financial sinkhole that is professional basketball? The blog NetsDaily(http://www.netsdaily.com/) [4] recently dug up the following quotation from a 2010 interview Prokhorov did with the Russian business newspaper *Vedomosti*:

"We have a team, we're building the arena, we've hired professional management, we have the option to buy into another large project, the building of an office center. For me, this is a project with explosive profit potential. The capitalization of the team will be $700 million after we move to Brooklyn. It will earn approximately 30 [million]. And the arena will be worth around $1 billion."

Let us recap. At the very moment the commissioner of the NBA is holding up the New Jersey Nets as a case study of basketball's impoverishment, the former owner of the team is crowing about 10 percent returns and the new owner is boasting of "explosive" profits. After the end of last season, one imagines that David Stern gathered together the league's membership for a crash course on lockout etiquette: stash the yacht in St. Bart's until things blow over, dress off the rack, insist on the '93 and '94 Cháteau Lafite Rothschilds, not the earlier, flashier, vintages. For rich white men to plead poverty, a certain self-discipline is necessary. Good idea, except next time he should remember to invite the Nets.

One of the great forgotten facts about the United States is that not very long ago the wealthy weren't all that wealthy. Up until the 1960s, the gap between rich and poor in the United States was relatively narrow. In fact, in that era marginal tax rates in the highest income bracket were in excess of 90 percent. For every dollar you made above $250,000, you gave the government 90 cents. Today — with good reason — we regard tax rates that high as punitive and economically self-defeating. It is worth noting, though, that in the social and political commentary of the 1950s and 1960s there is scant evidence of wealthy people complaining about their situation. They paid their taxes and went about their business. Perhaps they saw the logic of the government's policy: There was a huge debt from World War II to be paid off, and interstates, public universities, and other public infrastructure projects to be built for the children of the baby boom. Or perhaps they were simply bashful. Wealth, after all, is as often the gift of good fortune as it is of design. For whatever reason, the wealthy of that era could have pushed for a world that more closely conformed to their self-interest and they chose not to. Today the wealthy have no such qualms. We have moved from a country of relative economic equality to a place where the gap between rich and poor is exceeded by only Singapore and Hong Kong. The rich have gone from being grateful for what they have to pushing for everything they can get. They have mastered the arts of whining and predation, without regard to logic or shame. In the end, this is the lesson of the NBA lockout. A man buys a basketball team as insurance on a real estate project, flips the franchise to a Russian billionaire when he wins the deal, and then — as both parties happily count their winnings — what lesson are we asked to draw? The players are greedy.

Malcolm Gladwell is a staff writer at the New Yorker *and the author of* The Tipping Point(http://www.amazon.com/Tipping-Point-Little-Things-Difference/dp/0316346624/ref=sr_1_1?ie=UTF8&qid=1313689021&sr=8-1) *,* Blink(http://www.amazon.com/Blink-Power-Thinking-Without/dp/0316010669/ref=sr_1_1?s=books&ie=UTF8&qid=1313689047&sr=1-1) *,* Outliers(http://www.amazon.com/Outliers-Story-Success-Malcolm-Gladwell/dp/0316017930/ref=sr_1_1?s=books&ie=UTF8&qid=1313689072&sr=1-1) *and most recently,* What the Dog Saw(http://www.amazon.com/What-Dog-Saw-Other-Adventures/dp/0316076201/ref=sr_1_1?s=books&ie=UTF8&qid=1313689099&sr=1-1) *. He is a consulting editor for Grantland.*

Previously from Malcolm Gladwell:
"Psychic Benefits" and the NBA Lockout(http://www.grantland.com/story/_/id/6874079/psychic-benefits-nba-lockout)

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1. This was the point of my first Grantland piece(http://www.grantland.com/story/_/id/6874079/psychic-benefits-nba-lockout) . An NBA

franchise is not really a business. It's a luxury good, like a piece of art, which means that making calculations about profits and losses makes no sense. Since then, TrueHoop's indefatigable Henry Abbott dug up this gem from Cleveland owner Dan Gilbert. It dates back to before the lockout. Gilbert, let us recall, has been one of the ringleaders of the players-are-greedy brigade.

"To me, NBA franchises are like pieces of art. There are only 30 of them. They aren't always on the market, especially a franchise that would have been such a natural fit. … If you just looked at the Cavaliers in terms of revenues, profits and balance sheets — and you paid this amount for it — people would say 'You're insane! You're nuts.' But if you look at all the tentacles, the impact on our other venues, it makes tremendous sense. We have now opened a Cleveland office [of Quicken Loans] and that's tremendously successful. Our employees love it that we're associated with the Cavs and can come to games — that helps us attract and keep better people. There are a lot of nonprofit things that can be done with pro sports. It brings an unbelievable amount of excitement."

What's the matter, Danny? Don't like your Rembrandt any more?

2. Kasha is whole-grain buckwheat — Jewish soul food — and some would argue the only appropriate filling for a knish. Curious? Try Knish Nosh on Queens Boulevard and 67th Road in Queens — if for no other reason than that is the best restaurant name *ever*.

3. The economics of stadiums, of course, deserves its own separate article. But here's a small point, courtesy of my friend David Goldhill. Most stadiums — the Barclays Center included — are subsidized in some way by local government. The logic is this. An arena will bring a certain level of new economic activity to a neighborhood, which will generate tax revenues. So it makes sense for a city to put some portion of those expected revenues toward the construction of an arena. NBA owners love these deals. If there's no basketball season, however, then the tax revenue cities bank on to pay for their investment disappears. Goldhill says that in that case, owners really ought to reimburse the municipalities that gave them money. But has anyone even *mentioned* this possibility? The NBA plutocracy voted not to play basketball right after taking money from local taxpayers on the promise that they would play basketball. How do these guys sleep at night?

4. NetsDaily is really very good. Even better is the brilliantly obsessive coverage of the Atlantic Yards project at Norman Oder's Atlantic Yards Report(http://www.atlanticyardsreport.blogspot.com/) , in which every twist and turn in the entire story has been faithfully and astutely chronicled. I could not have written this without Oder's help.