

Creative Valuation Approaches For Difficult Properties

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Be sure to know a diamond in the rough when you see one.

VALUE CAN BE hidden below the surface. Oil must be drilled for many miles below the earth's surface, while diamonds must be mined. Although a property may not instantly reveal the best way to appraise or value it for just compensation purposes, a little digging into how market participants actually determine a property's utility may provide insight into methods of valuation that are distinct from the standard price per square foot or price per acre units of comparison utilized in "ordinary" cases. Discovering a "diamond in the rough" may require what is thought of as an uncommon approach to appraisers and attorneys, although it is not uncommon to the market participants who purchase similar properties in arm's-length transactions. However, applying market participant concepts in a condemnation case must be done in conformance with established law and appraisal standards.

RELEVANT LEGAL AUTHORITY • “Just compensation” takes the place of the property with respect to all rights and interests dependent on and incident to it. *Almota Farmers Elevator & Warehouse Co. v. United States*, 409 U.S. 470, 473-474 (1973); *State v. Nordstrom*, 253 A.2d 163, 165 (N.J. 1969); *In re Condemnation by the State Tpk. Comm’n of 14.38 Acres in Fee Simple*, 698 A.2d 39, 43 (Pa. 1997). Valuation is limited to the present condition of the land, but is based on the property’s highest and best use. *Desert Citizens Against Pollution v. Bisson*, 231 F.3d 1172, 1183-84 (9th Cir. Cal. 2000) (landfill); *State v. Caoili*, 639 A.2d 275 (N.J. 1994) (commercial). The property owner is entitled to receive the fair market value of the property for its current use or for any use for which it has a commercial value in the present or for which it is reasonably anticipated to have in the near future. *United States ex rel. and for Use of Tennessee Valley Auth. v. Powelson*, 319 U.S. 266 (1943) (hydroelectric facility); *Bisson*, supra, 231 F.3d at 1184 (landfill); *State v. Gorga*, 138 A.2d 833 (N.J. 1958) (commercial). Additionally, property characteristics that permit the owner to engage in a higher and better use than the condemnor should be factored into the property’s value. *Comm’r of Transp. v. Towpath Assocs.*, 767 A.2d 1169 (Conn. 2001).

Multiple considerations can arise when the highest and best use is different from the present use. The party proffering the different use must consider whether a variance or approval will be required if the highest and best use is different from the present use. *Olson v. United States*, 292 U.S. 246, 255 (1934); *Baston v. County of Kenton ex rel. Kenton County Airport Bd.*, 319 S.W.3d 401 (Ky. 2010); *Opinion of Justices*, 555 A.2d 1095, 1098 (N.H. 1989); *County of Monmouth v. Hilton*, 760 A.2d 786, 793 (N.J. Super Ct. App. Div. 2000). If the answer is yes, then the party bears the burden of establishing the likelihood of securing the required approval or variances. *Olson*, supra, 292 U.S. at 255 (1934); *Gorga*, supra, 138 A.2d at 835. That party must

also establish that the proposed use is both physically possible and financially feasible. *Jersey City Redevelopment Agency v. Mack Properties Co. No. 3*, 656 A.2d 35, 40 (N.J. Super Ct. App. Div. 1995); *South Farms Assocs. Ltd. Partnership v. Burns*, 644 A.2d 940, 944 (Conn. App. Ct. 1994). See also Nichols on Eminent Domain §64.03[6] (Matthew Bender, 3d ed. 2011). Finally, the party must establish that among permitted uses, the proposed use is maximally productive and the highest and best use. *Town of Newington v. Estate of Young*, 777 A.2d 219, 228 (Conn. Super. Ct. 2000) (describing maximally productive as “the keystone of valuation property”); *The Appraisal of Real Estate*, 279-81 (Appraisal Institute 13th ed. 2008).

Both federal and state courts have rejected permitting collateral matters involving calculation of costs and profits as too remote. *Monongahela Navigation Co. v. United States*, 148 U.S. 312 (1893); *Kimball Laundry Co. v. United States*, 338 U.S. 1 (1949); *Port of New York Auth. v. Howell*, 157 A.2d 731, 734 (N.J. Super. Ct. Law Div. 1960), *aff’d*, 173 A.2d 310 (N.J. Super. Ct. App. Div. 1960); *State, by Comm’r of Transp. v. Inhabitants of Phillipsburg*, 573 A.2d 953 (N.J. Super. Ct. App. Div. 1990). However, the facts surrounding the operation of a business on a property may be considered when determining the property’s fair market value. *Trenton v. Lenzner*, 109 A.2d 409, 415-16 (N.J. 1954) (parking lot); *King v. Minneapolis Union Ry. Co.*, 20 N.W. 135, 136 (Minn. 1884); *Voigt v. Milwaukee County*, 149 N.W. 392 (Wis. 1914).

Indeed, just compensation has been considered a flexible concept. *Westchester County Park Comm’n. v. United States*, 143 F.2d 688, 692 (2d Cir. 1944), *cert. denied*, 323 U.S. 726 (1944) (citing *United States ex rel. and for Use of Tennessee Valley Auth. v. Powelson*, 319 U.S. 266 (1943)); *Lenzner*, supra, 109 A.2d at 415-16. This flexibility permits the courts to “adjust the rigid rules of law to the requirements of justice and indemnity in each particular case.” *Westchester County Park Comm’n.*, supra, 143 F.2d at 692; see also

United States v. 237,500 Acres of Land, 236 F. Supp. 44, 51 (S.D. Cal. 1964), *aff'd per curiam*, 404 F.2d 336 (9th Cir. 1968) (citing United States Supreme Court cases for examples of flexibility in establishing just compensation). This flexibility can also be important to appraisers as they decide how to best appraise a property for its fair market value.

APPRAISAL STANDARDS • An appraiser’s determination of fair market value is guided by established principles set forth by the Uniform Standards of Professional Appraisal Practice (“USPAP”). Appraisal reports should include certain statements related to the report’s purpose, the subject property, the relevant appraisal approaches, the effective date of valuation, and a description of the comparable sales and details of each transaction.

Appraisers traditionally employ one or more approaches to value in a given case. These include the sales comparison or comparable sales approach (used when such data is available), the cost or reproduction approach (used especially in cases involving special purpose or unique properties or as corroboration for other approaches) and the income approach (used for properties capable of income-production). The appraiser must assure, in tandem with counsel, that all legally compensable items for which the owner is entitled to compensation have been considered by the appraiser and that no legally non-compensable items have been included.

Although appraisers employ one or more of the three traditional approaches to value, the way the information is analyzed within each approach is the key to finding the real value of a “diamond in the rough” property.

REAL-WORLD EXAMPLES • As stated in *Appraisal of Real Estate*, supra, “[l]ike units must be compared” because “[a]ppraisers use units of comparison to facilitate comparison of the subject

and comparable properties.” Importantly, “sales should be analyzed to determine which unit of comparison has the closest correlation with the comparable sales.” Established standards other than price per square foot or acre have been recognized for different property types. *Id.* at 306. Some of these standards include the following:

Property Type	Typical Units of Comparison
Apartment Properties	Price Per Apartment Unit/Price Per Room
Factories	Price Per Machine Unit
Restaurants, theaters, and auditoriums	Price Per Seat
Hotels	Price Per Guest Room
Tennis and racquetball facilities	Price Per Court
Parking Lots	Price Per Parking Space
Agricultural properties	Price Per Animal Unit

Each individual property and type of use presents valuation issues to be addressed at trial. Take, for example, an automobile dealership property. The land comes in all shapes and sizes, with different types and sizes of buildings. Urban dealerships often have vertical or multi-story space with little land, while dealerships on suburban highways or in rural areas may ordinarily contain single story structures with substantial highway frontage and surface parking for the display and inventory of

automobiles for sale. One recent case involved the total taking of a suburban highway dealership containing a half-acre lot with a two-story, 11,000 square foot building — much smaller in size than nearly all other “comparable” highway dealerships. The parcel was an island between three roads and an off-ramp for a major highway which had been in operation as a dealership for more than 20 years before the taking. The parcel was special for several reasons. Its location on the major highway and between the roadways provided it with a superior location because cars were displayed for sale on all four sides, including the second-floor showroom that was visible from the highway, and on an exterior ramp leading from the parking area to the showroom. Additionally, the property had the ability to display approximately 100 cars for sale “as of right” — 75 outside and 25 in the showroom. It was a pre-existing non-conforming use, exempt from modern setback requirements, so that virtually every inch of the property up to the property lines was covered with cars on display. Other dealerships in the area required two or three acres to operate at the same level of functionality — a 100-car capacity.

The condemnor’s appraiser employed a comparable market sales and cost approach, and applied a standard price per-square-foot methodology to reach a reconciled value for the property; however, none of that appraiser’s comparables enjoyed the same density (or intensity) of use as did the subject property. At a minimum, reliance upon these comparables would either result in the need to make significant adjustments, or (as was the case with the condemnor’s appraisal) the comparables would not accurately measure the differences between them and the subject property. The resulting value, according to the condemnor’s appraiser, was much lower than other dealerships which were competitive with the subject, mainly because the subject property was “penalized” for being much

smaller in size, even though it was comparable in utility and function. In contrast, the owner’s appraiser and attorneys recognized the unique qualities of this property and sought to value the property from a market participant’s view. Interviews with the client, other dealership owners, and industry experts indicated that two factors were most important for every car dealership:

- The number of cars visible from the street frontage; and
- The number of cars that can be held on the lot in general.

These interviews, along with examination of the comparable sales, guided the appraiser and attorney toward a strategy of determining the subject property’s value based on the number of cars for sale that the property could hold. An automobile dealership broker was retained as an expert witness to provide the foundation for the conclusion that the single-most important value determinant for automobile dealership real estate is the number of cars the dealership property could display and store for sale.

Applying this methodology, and relying on all three approaches to value, the price “per car” or “per space” provided the means to paint the valuation picture in the proper light and resulted in a significantly higher valuation. Consider these facts comparing two of the comparable dealerships in this case to the subject and the obvious conclusion:

	Subject	Sale #1	Sale #2
Sale Price	???	\$3,250,000	\$4,800,000
Land/(sf)	23,392	24,481	87,120
Price/sf			
land	???	\$132.75	\$55.00

	Subject	Sale #1	Sale #2
Building (sf)	11,064	14,000	22,100
Price/sf building	???	\$232.00	\$217.20
Car Capacity	99	74	118
Price Per Car	???	\$43,919	\$40,678

The “per car” approach created a more equitable and accurate way to measure the utility and the value of the subject than the dollar per square foot or acre approach and, significantly, reflected the way that the market viewed and measured the value of automobile dealerships. This case proceeded to trial, and the jury awarded \$3,400,000 for the subject property, which translated to \$145/sf of land (much higher than the comparables), or \$307/sf of building (much higher than the comparables). Either of those prices and units of compar-

ison might have been difficult to justify for the subject if the valuation was just based on a per square foot basis without digging deeper, since each comparable dealership was larger than the subject in other ways. However, the “density” of the subject (approximately 100 cars) made it more useful than either comparable, and the jury verdict translated to a value of \$34,343 per car, which was a *lower* price per unit than the comparables (\$40,000/car and \$43,000/car), and therefore easier to justify.

CONCLUSION • Standard units of comparison or valuation methods can fail to satisfy constitutional just compensation requirements. Not every property will reveal a diamond in the rough, but valuing a property using market standards can yield a more reliable indication of fair market value, making a property owner whole and providing full indemnity for the loss occasioned by the taking. By investigating how market participants approach their valuation decisions, a glimpse of the diamond may begin to appear before it is fully revealed through a little extra work and research.

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