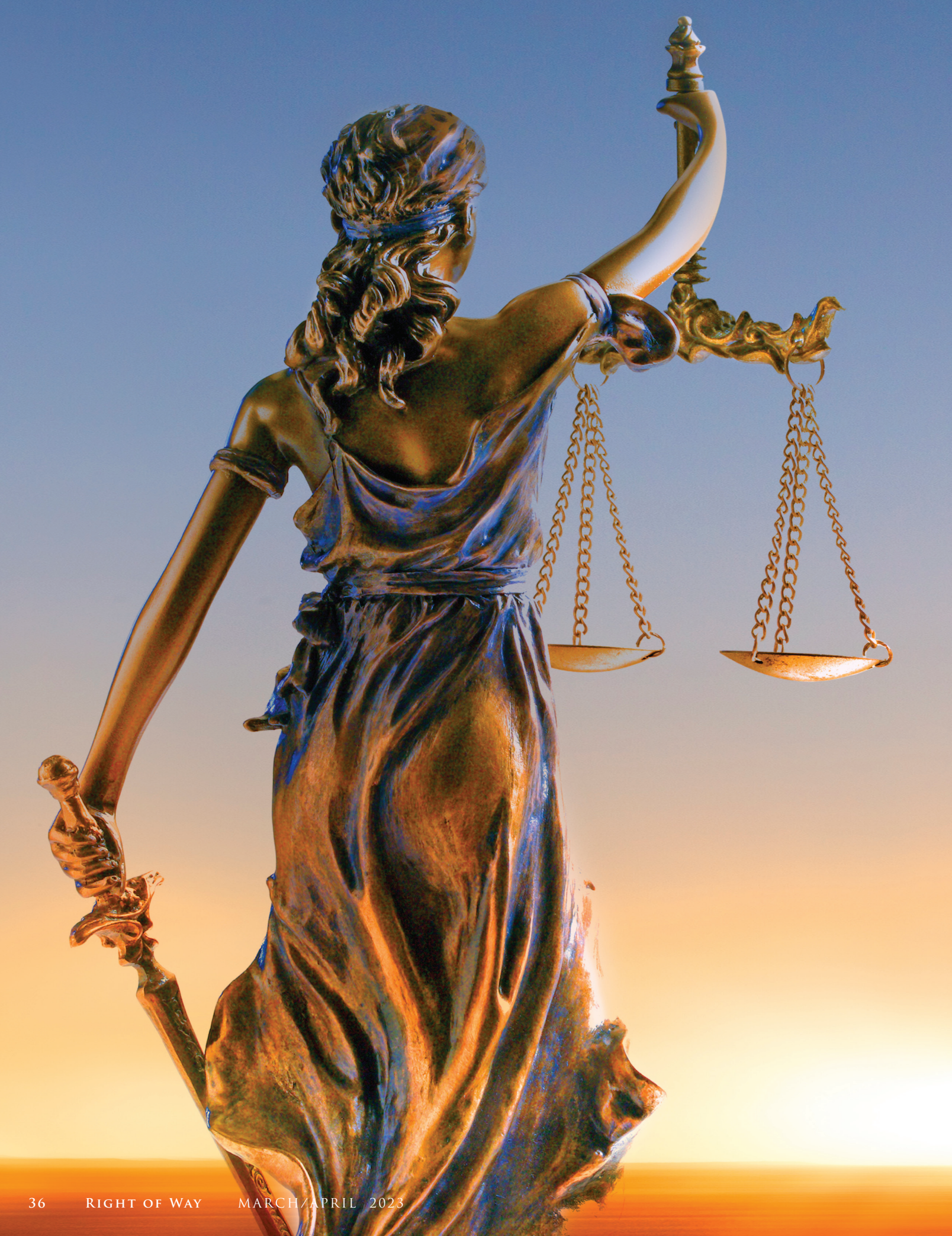

Fundamental Valuation Rules

All ROW Practitioners Should Know

Part 1

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Agents and appraisers alike should understand several fundamental rules in valuation for public projects. These principles arose from eminent domain litigation, and they do not always follow the same rules as typical appraisal practice. There are fundamental differences that the appraiser must understand in order to be competent. The acquisition agent should also understand these concepts to explain the agency's offer based on that appraisal to maximize chances of successful negotiation.

All appraisals that involve partial or total acquisition of private rights for public use may result in litigation. Even if few parcels on a project actually result in condemnation proceedings, the underlying principles applicable in a litigation setting also apply in the initial appraisal that does not yet contemplate condemnation. The following concepts are almost universally applicable and influence the appraiser's scope of work in the valuation of real property for public projects. In other words, there are some things the compensation must and must not consider.

1. Just Compensation Standard

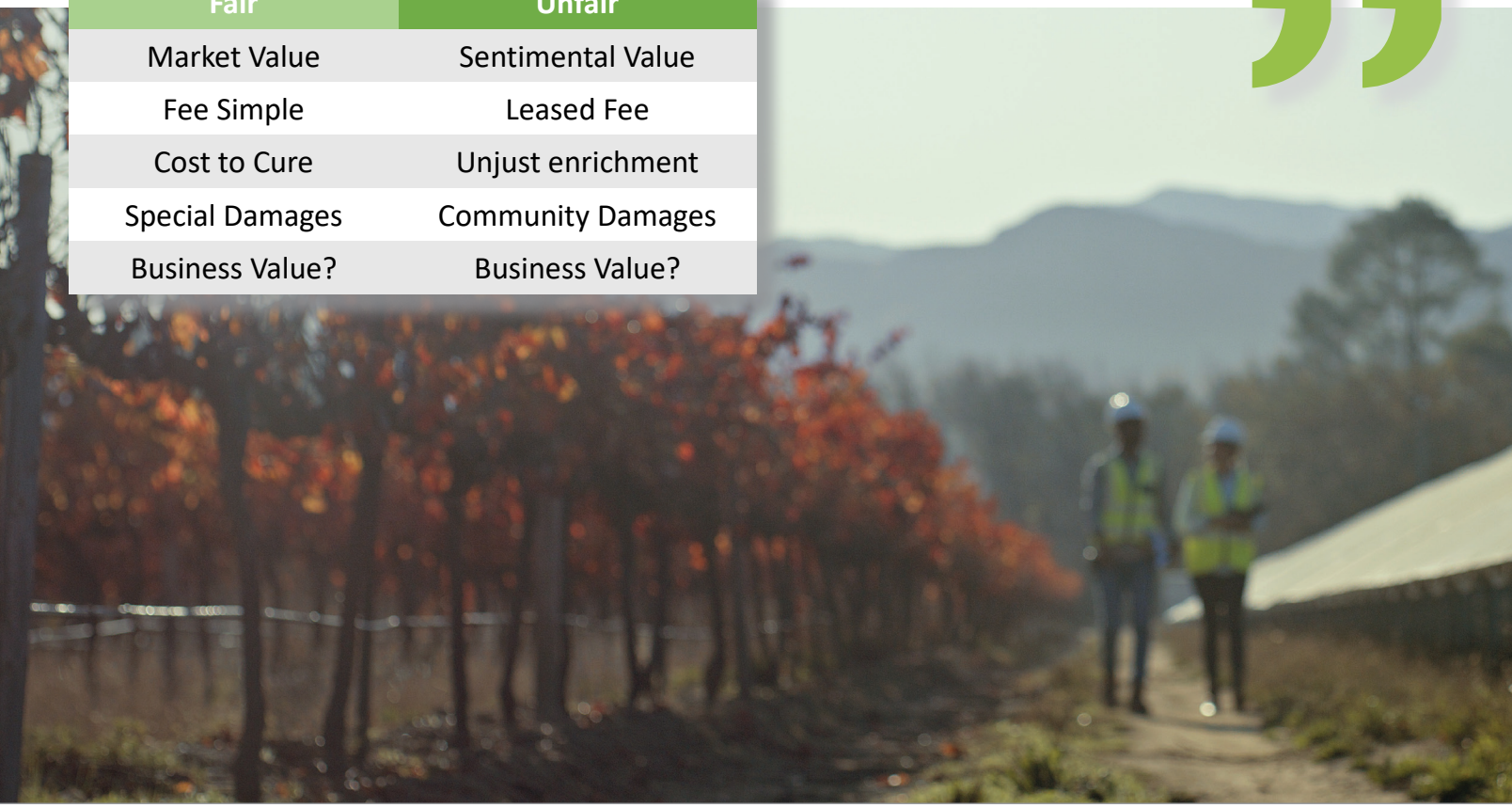
Although not all states explicitly state payment for private property must be based on "just compensation" it must always be fair, adequate and based on legal precedent. Compensation is based on "market value" because the courts find that to be what is just. Courts in various jurisdictions have differing opinions about what is just or fair. For example, some believe that just compensation should include a loss business value while others do not. Some believe that it is fair for benefits to offset compensation while others do not. In another example, some courts believe landowners should not be paid for a loss of frontage land if the same can be re-established on the remainder, while others believe the measure of what is acquired should be only based on frontage value. The appraiser only estimates differences in value based on statute and precedent. It is up to the courts (trier of fact) to decide what is "just."

The courts interpret just compensation to be measured by the fair market value of the "property," which is the interest protected by the Constitution. Intangible property such as goodwill is *generally* not considered compensable because courts often consider intangibles to be portable rights not fixed to a single property. A good example is the flag of a hotel and its management that can be moved to a different building. It is not tied to the land. Application of this concept varies greatly between jurisdictions, so an appraiser needs to consult with legal counsel to be aware of the nuances.

Fair	Unfair
Market Value	Sentimental Value
Fee Simple	Leased Fee
Cost to Cure	Unjust enrichment
Special Damages	Community Damages
Business Value?	Business Value?

Since just compensation is based on what the hypothetical "market" would pay, landowners are not compensated based on their interpretation of value. Rather, the market determines what has value and how it is to be measured. Consider the example of an industrial property used by the owner to store equipment which can only be moved with oversized trailers but can no longer turn into the property after the acquisition. The ROW practitioner must ask themselves if this is a change in use which would be recognized by the overall market. If the heavy equipment can no longer access the site, can the property be put to a similar marketable use?

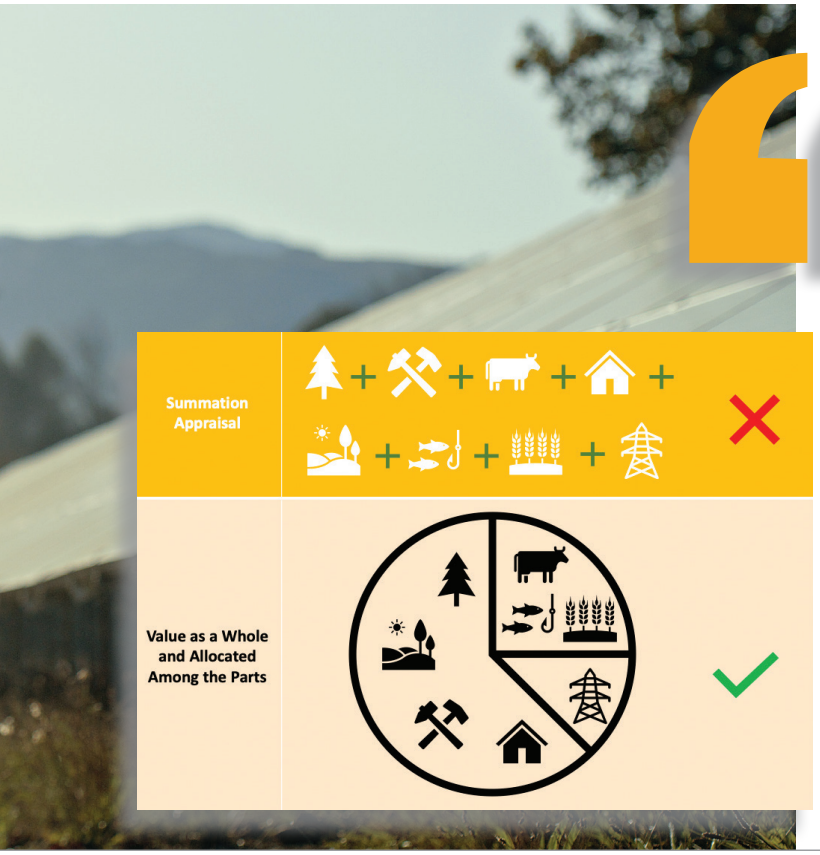
> **The purpose of appraisal for right of way is not to estimate just compensation, only to appraise differences in the market value of property resulting from an acquisition.[2]**



2. Unit Rule/Undivided Fee/Unified Fee

Valuation of the fee simple estate is required by what is known as "the Unit Rule," which requires an appraisal for a partial acquisition to be valued as a single unit instead of the sum of its estates or parts. The courts believe this is a measure of just compensation because it reflects the most the market would pay for real property, not as if sold in pieces. As stated in United States v. Wise, 131 F.2d 851 (4th Cir. 1942) "a shrewd, able purchaser who was interested in that property… when he finally came to determine what he would pay, it would be a single figure." This principle prohibits offers to be made based on the sum of such considerations as: independent value of easements and the unencumbered land, the value of a lease combined with the underlying fee value, or the value of improvements in one use (e.g., residential) added to the value of the land in another use (e.g., commercial). Additionally, the courts generally consider market value to be no more than what the property would be worth with all interests under unified ownership. In other words, the most a property can be worth in the eyes of the courts is as a unified unit.

> *The "undivided-fee rule" provides that when a tract of land is taken by eminent domain, because the land itself is taken by a paramount title rather than through the separate estates of different persons having interests in the land, the compensation awarded is for the land itself and not for the sum of the different interests therein. The duty of the public to make payment for the property which it has taken is not affected by the nature of the title or by the diversity of interests in the property. The public pays what the land is worth, and the amount so paid is to be divided among the various claimants, according to the nature of their respective estates. …Julius L. Sackman, Nichols on Eminent Domain § 12.05[1] (3d ed.2001)*[3]



The Unit Rule applies to:

- Unified Interests: valuing all interests together as fee simple (tenant, leased fee, partnerships, family members, etc.)
- Unified Parcel: all components in and on the land must be valued together (improvements, timber, floodplain, upland, easements, etc.). If necessary, the value of the individual parts of the property can be allocated after the tract has been valued as a single unit.

This rule is intended to reflect actual market behavior. For example, consider a property located in a rural residential area where agricultural and recreational uses are common, and part of the tract is encumbered by floodplain. If the appraiser adds together values for the floodplain component to the value of the upland component, the property as a whole could be undervalued. If the apprasier had utilized rural residential comparables with floodplain or had correctly analyzed the true use potential of the floodplain, this violation of the Unit Rule could have been avoided.

The Unit Rule also applies in the appraisal of property after an acquisition. A challenge arises when the appraiser values easement acquisitions as part of the whole, then deducts that calculated value from the remainder with no further analysis of the property after the acquisition. This practice implies the before-minus-acquisition value will always be the same as the true market value of the property after imposition of the easement. Of course, such practices may be legitimately accepted by local jurisdictions when widely practiced by the appraiser's peers, or even prescribed by agencies in certain low-value acquisitions.

"Value can be no more than what the "market" would pay for the real estate as a unified holding."[4]

3. Fee Simple Estate

The valuation of the "fee simple" estate is really not a separate principle from the Unit Rule, but it is important enough to discuss independently. In most condemnation valuations, an appraiser is to value the "fee simple estate" only.

Notably, the technical definition of fee simple is not the same as the colloquial meaning in valuation. Practitioners tend to say the "fee simple" estate is appraised, but tracts are virtually never conveyed without some preexisting encumbrances or restrictions. When property is acquired by eminent domain, "The measure of 'just compensation' under the Fifth Amendment for the taking of property in fee simple ordinarily is the fair market value… of the property in fee ownership as of the time of taking irrespective of the number and kind of interests existing in it."[5] A property's loss in value due to *existing* encumbrances which the market recognizes as a value reduction must be considered in the appraisal of the current condition of the "fee" estate. Therefore, the "fee simple estate" is really the underlying interest, subject to existing encumbrances and conditions.

The market value of the leased fee estate is generally not considered in right of way appraisal. Additionally, tenant-owned fixtures and permanent improvements are valued as a part of the fee simple estate.[6] If a leasehold interest is impacted by the acquisition, compensation is divided among the fee owner and leaseholder in a private settlement or is allocated by the courts. Appraisers only value the leasehold when specifically requested by the client, generally to apportion compensation among the interest holders.

> *In condemnation proceedings, where there are different estates in the property or where the property is under a lease to a third party, the valuation of the various estates or leasehold interest is usually determined by ascertaining the market value of the property with the improvements thereon as though owned exclusively by one party, and, in the absence of damages to other property not taken, this ordinarily determines the extent of the liability of the party condemning the property. Such amount, when so determined, should then be apportioned among the lessee and the owners of the various estates in the land.*[7]

Valuation of the fee simple estate typically implies:

- the property owner will be paid for leased improvements as-though at stabilized occupancy (ignoring poor management, but considering all other physical, legal, and economic characteristics)
- rents are based on the market, not actual leases (leased fee may be greater or less than fee simple)
- capitalization rates for ground leases must be at market (not solely upon last sale)
- market-based lease terms (not peculiar to the individuals)

Improper application of the fee simple standard can happen when a property is subject to high vacancy due to oversupply, but the property is valued as though there were less competition.

An appraiser may believe the fee simple standard requires occupancy to be at its historical best. For example, a hotel may be in an area where recent construction of other hotels has increased its vacancy. The temptation may be to erroneously "stabilize" occupancy from a historical time before the competition was constructed, which was superior to current market conditions.

The "fee simple" standard of the Unit Rule poses challenges to appraisers and negotiators in various ways. For example, buyers may invest in an asset based on the sum of a ground lease, leases of building space within the real property, and the additional income generated in the property because it is operated by a particular brand or company. But the Unit Rule is generally interpreted to disallow consideration of leases to a specific party if that party would pay more or less than market rates. If a property is particularly suited to specialized uses, misapplication of the Unit Rule can sometimes be resolved by a precise identification of the most probable buyers for such properties.

In practice, the standard valuation methodologies available may inherently include intangibles like "blue sky" or goodwill. For example, a dealership sells with the goodwill it has built with local patrons and can be virtually inseparable from the real estate. The decision for an agency to include such value can be a business decision based on the realities of project acquisition and resources available for litigation. ✪

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[1] *Eaton, J.D., Ibid., (p. 19); Real Property Valuation in Condemnation* (Appraisal Institute, 2018), (p. 14);

[2] *Uniform Appraisal Standards for Federal Land Acquisitions, 2016,* p. 90.

[3] *State of Texas v. Joe L. WARE and the Estate of Christine Ware,* No.03-01-00516-CV (Court of Appeals of Texas, Austin, 2002)

[4] *Uniform Appraisal Standards for Federal Land Acquisitions, 2016,* p. 97.

[5] *U.S. v. 6.45 Acres of Land, 409 F.3d 139* (3d Cir. 2005)

[6] *Almota Farmers Elev. & Whse. Co. v. United States,* 409 U.S. 470 (1973)

[7] State of Texas, Appellant, v. Joe L. Ware and the Estate of Christine Ware, citing Julius L. Sackman, *Nichols on Eminent Domain* § 12.05[1] (3d ed.2001)

Other citations are available upon request.

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