

**ABA 2009 20th Annual Spring Symposium**

**Real Property, Trust & Estate Law**

**April 30 – May 1, 2009**

**The Real Estate Market's Impact on Valuation Disputes**

**I. Real Property Assessment Appeals in a Declining Market**

- a. New downturn, not the same as the old downturn
  - i. The last broad decline in commercial real estate values, which occurred in early 1990's, was brought on primarily by overbuilding.
  - ii. Current decline is due to the a) real estate asset bubble and related financial market turmoil and b) broader economic contraction that negatively impacts the fundamentals of commercial real estate (i.e., tenant base).
- b. How do you establish value when all market participants agree that the value of commercial real estate has declined substantially, but there are very few sales that indicate as much?
  - i. Lack of Sales
    1. In a deflationary economy investors are reluctant to purchase commercial real estate due to the uncertainty of the asset's value and owners are unlikely to sell the asset at a loss, resulting in a stagnant transactions market.
    2. As a result, there is scant quantifiable data to definitively demonstrate the price declines that everyone agrees have occurred.
    3. Therefore, your focus must be on gathering evidence of the weakening of certain individual variables so as to demonstrate that the overall market has been negatively impacted by the surrounding events.
  - ii. Commercial Real Estate Variables Most Affected by Downturn -
    1. Capitalization Rates
      - a. Increase in Cap Rates - The largest factor in run-up of commercial real estate prices over the past five years was the compression of capitalization rates. In the District of Columbia the capitalization rates used by the assessor's

office for Class A properties decreased by 70% from TY2005 to TY2009 (capitalization rates are inversely related to values).

- b. Market Surveys – When there are no sales to derive capitalization rates you must rely on market participants to determine what the going capitalization rates are. As market participants are ultimately the individuals who will determine the asset values, their opinions are very important during periods in which there are few sales from which capitalization rates can be derived.

## 2. Vacancy Rates –

- a. New Product – while the construction boom of the mid 2000's was not as extensive as the early '90's there is still quite a bit of new product overhang which recently came on-line or is slated to in the next few years.
- b. Broad Based Economic Downturn – the current recession and accompanying high unemployment figures decrease tenant demand.
- c. Impact of hard-hit legal and financial sectors on Class A properties.
- d. Shadow Space – Leased but not occupied space. Casts a pall over the market, as sublet space grows.

## 3. Rents –

- a. Supply and Demand - Uptick in vacancy will have a corollary effect of decreasing market rents.
- b. Creditors – Minimum rent floors in financing agreements inhibit owner's ability to reduce rents in accordance with the market.
- c. New leases should begin to demonstrate decreased base rents and increased tenant concessions.

## II. Eminent Domain

### a. Abnormal Markets –

- i. 1) depression, 2) boom 3) war
- ii. Standard of Proof - “The primary fact to be established is that the existing condition on the date that property is acquired by eminent domain is truly abnormal in character.” Nichols on Eminent Domain, Valuation of Fee

Interest, Abnormal Market, Depression, Permanent Depression, Chapter 12B.06[1][b], p. 35, 3d Edition.

b. Depression Market

i. Temporary Depression

1. “Improper to take temporary depression conditions into account, instead of considering pre-depression conditions.” *Id.* at 36; *See United States v. Inlots*, 91 U.S. 367
2. Fair Market Value – The actual value means the fair market value of the property during a fair market at “normal times.” *See Howell v. State Highway Department*, 167 S.C. 217.

ii. Permanent Depression

1. What is Permanent? – “Where the depression continues for such a length of time as to assume the characteristic of permanency.” *Nichols on Eminent Domain*, at 37.
2. Divided Views
  - a. Temporary Depression View – there are no actual buyers so the fictitious buyer would not be averse to paying the pre-depression price. *Id.*; *See Central States Life Ins. Co. v. Koplak Co.*, 288 U.S. 687.
  - b. Depressed Value View – purpose of just compensation is to give the owner an equivalent to the value of land in money. In a depression, the money granted will purchase more than in normal time, therefore the exchange is equal. E.g., if the buyer wishes to take the money he receives for the condemned property he should be able to purchase a comparable property for a similar price, notwithstanding the fact that a permanent depression exists. *See Alishausky v. MacDonald*, 117 Conn. 138.