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*Statistics Work Group member
From the Editor-in-Chief

Stephen T. Crosson, MAI, SRA

Thought Leadership

Dear Readers:

Each year, The Appraisal Journal recognizes exceptional work within this forum for ideas on real estate valuation, and on the following pages you will see the announcement of our 2022 article awards. It is important that we pause and acknowledge these excellent articles and their authors. In addition, we recognize the outstanding service of Kerry M. Jorgensen, MAI, who during the past year has contributed valuable volunteer hours to the Journal as vice chair of The Appraisal Journal Editorial Board.

We also have peer-reviewed feature articles and columns in this issue discussing items that you’ve been reading about in the news.

The cover article, “The Evolution of Land Trust Responsibilities in Reviewing Conservation Easement Appraisals,” examines the development of private and governmental policies and standards related to conservation easement donations and valuation of such donations. In light of IRS concerns related to overvaluation of conservation easements, the authors offer a checklist of questions to help ensure that conservation easement appraisals include the minimum information and content required by the policies and standards.


The third feature, “Market Analysis for Apartment Properties,” takes an updated look at valuation of this sector. This article discusses and demonstrates contemporary market analysis applications for apartment properties, including the impact of equilibrium vacancy on the movement of market rents. Although the focus is on apartments, the methodology is applicable to all real estate.

Also, in this issue you will find discussions on the evolving office market sector. In the current Economic Perspectives, readers will discover insights on urban real estate, especially office properties in downtown cores. The Resource Center column then looks at the varying prognostications for the office real estate market post COVID, where the timing and prevalence of a return to the traditional centralized workforce model have major implications for all players in the office market—developers, landlords, and tenants. Finally, these office sector discussions are supplemented by the 2023 NAIOP Office Space Demand Forecast found in the Notes and Issues section.

We appreciate the dedication of all who have contributed to The Appraisal Journal’s peer review process as well as the authors who have shared their knowledge with our readers. As always, we welcome your manuscript submissions and comments.

Stephen T. Crosson, MAI, SRA
Editorial Board Chair and Editor-in-Chief
The Appraisal Journal
Kerry M. Jorgensen, MAI

Kerry M. Jorgensen, MAI, is the winner of The Appraisal Journal’s 2022 Outstanding Service Award. This award recognizes the member of the Journal’s Editorial Board, Review Panel, or Academic Review Panel who during the previous year showed exceptional commitment to The Appraisal Journal through outstanding service.

Jorgensen is an active real estate appraiser. He is a member of The Appraisal Journal Editorial Board and serves as its vice chair. He has been an instructor for the Appraisal Institute for more than 35 years and has served that organization as a chapter president, on the national board of directors, and on numerous committees and project teams. He has authored courses and seminars, and is a contributor to the current editions of The Appraisal of Real Estate and The Dictionary of Real Estate Appraisal. Among his awards and honors are the 2013 Armstrong/Kahn Award for most outstanding original article published in The Appraisal Journal; the Appraisal Institute Education and Relief Foundation’s 2015 Dr. William N. Kinnard Jr. Award; an Appraisal Institute 2015 President’s Award; and the AI National Executive Committee’s 2016 Edward Adams Outstanding Board Services Award. He is currently the chair of the Appraisal Institute Body of Knowledge Committee.
Armstrong/Kahn Award

Most Outstanding Article of 2022 • Sponsored by the Appraisal Institute Education and Relief Foundation

Winning Article: “Market Rent and Highest and Best Use: Joined at the Hip?”

Barry A. Diskin, PhD, MAI, AI-GRS, David C. Lennhoff, MAI, SRA, AI-GRS, Richard L. Parli, MAI, and Stephen D. Roach, MAI, SRA, AI-GRS, are the winners of the 2022 Armstrong/Kahn Award for their article “Market Rent and Highest and Best Use: Joined at the Hip?,” published in the Spring 2022 issue of The Appraisal Journal.

The Armstrong/Kahn Award is presented by The Appraisal Journal’s Editorial Board for the most outstanding original article published in The Appraisal Journal during the previous year. Articles are judged on the basis of pertinence to appraisal practice; contribution to the valuation literature; provocative thought; thought-provoking presentation of concepts and practical problems; and logical analysis, perceptive reasoning, and clarity of presentation.

“Market Rent and Highest and Best Use: Joined at the Hip?” investigates the relationships between highest and best use, market value, and market rent. The authors present evidence and the rationale for a conclusion that as with market value, market rent also must be based on the property’s highest and best use. As a part of the investigation, three mini case studies are presented to illustrate the importance of carefully labeling and developing the appropriate rent. In conjunction with this investigation, use value is redefined and a new definition of use rent is proffered as an aid in diminishing confusion among the different types of rent.

Barry A. Diskin, PhD, MAI, AI-GRS, is the principal in the firm Diskin Property Research. He is a consulting analyst with Cushman & Wakefield. The focus of his litigation support practice includes eminent domain, property tax, and contamination issues. During 1980–2015, Diskin was a professor in the College of Business at Florida State University, where he taught courses in real estate valuation to seniors at the undergraduate level as well as graduate students, and received two university-level teaching awards. Today, his teaching activities continue as a member of the faculty of the Appraisal Institute. Diskin received a master’s degree in finance and a PhD in land economics from Georgia State University. He is a member of the Real Estate Counseling
David C. Lennhoff, MAI, SRA, AI-GRS, is a principal with Lennhoff Real Estate Consulting LLC, which is officed in Gaithersburg, Maryland. His practice centers on litigation valuation and expert testimony relating to appraisal methodology, the Uniform Standards of Professional Appraisal Practice, and allocating assets of a going concern. He has taught nationally and internationally for the Appraisal Institute, including international presentations in Tokyo, Japan; Beijing and Shanghai, China; Berlin, Germany; Seoul, South Korea; and Mexico City, Mexico. He has been a development team member for numerous Appraisal Institute courses and seminars and was editor of its *Capitalization Theory and Techniques Study Guide*, third edition. He was the lead developer for the Appraisal Institute’s asset allocation course, *Fundamentals of Separating Real and Personal Property from Intangible Business Assets*, and edited the two accompanying business enterprise value anthologies. He also authored the Appraisal Institute’s *Small Hotel/Motel Valuation* seminar. Lennhoff is a principal member of the Real Estate Counseling Group of America, a national organization of analysts and academicians founded by the late William N. Kinnard Jr., PhD. He is a past editor-in-chief of and frequent contributor to *The Appraisal Journal* and currently serves on its editorial board. He is a two-time winner of the Journal’s Armstrong/Kahn Award and Swango Award.
Richard L. Parli, MAI, is president of Parli Appraisal Inc., a full-service appraisal firm located in Warrenton, Virginia. He has been involved in advanced appraisal education for over 30 years including the development of numerous Appraisal Institute courses and seminars. He has received a number of awards from the Appraisal Institute, including the James H. Pritchett Award for significant contribution to appraisal education. He previously received The Appraisal Journal's Swango Award, and he is a four-time winner of the Armstrong/Kahn Award. Parli is author of the Appraisal Institute's newly released text *The Valuation of Apartment Properties*, third edition, and he coauthored the previous addition. Parli has been a professional faculty member of the Johns Hopkins Carey Graduate School of Business. He has an MBA in finance from the Pennsylvania State University and is a principal member of the Real Estate Counseling Group of America.

Stephen D. Roach, MAI, SRA, AI-GRS, CDEI, has been an appraiser for over forty-two years. His appraisal assignments have included significant and complex assignments throughout the United States. Roach holds a bachelor of science degree in real estate from San Diego State University, and he has extensive deposition and trial testimony experience. Roach is a contributing editor to numerous Appraisal Institute books, courses, and seminars. He currently serves on The Appraisal Journal’s editorial board. His Appraisal Institute teaching experience includes basic and advanced income capitalization courses, litigation courses, and over 200 more courses and seminars. In addition to teaching courses throughout the United States, Roach has led appraisal courses, seminars, or lectures in Switzerland, Germany, South Korea, Japan, and China. He also has served as a visiting professor of appraisal theory and practice at the International Center for Land Policy Studies and Training in Taipei, Taiwan, since 2004. Roach is a principal member of the Real Estate Counseling Group of America.

To read the award-winning article, go to http://bit.ly/Appraisal_Journal.
Winning Article: “Understanding Desktop (Bifurcated or Hybrid) Appraisals”

Sandra K. Adomatis, SRA, and Dawn Molitor-Gennrich, SRA, AI-RRS, are the winners of the 2022 Swango Award for their article “Understanding Desktop (Bifurcated or Hybrid) Appraisals” published in the Spring 2022 issue of The Appraisal Journal.

The Appraisal Journal’s Editorial Board presents the Swango Award to the best article published during the previous year on residential, general, or technology-related topics, or for original research of benefit to real estate analysts and valuers. The article must be written by an appraisal practitioner. Articles are judged based on practicality and usefulness in addressing issues faced by appraisers in their day-to-day practice; logical analysis, perceptive reasoning, and clarity of presentation; and soundness of methodology used, especially in an area of original research.

“Understanding Desktop (Bifurcated or Hybrid) Appraisals” discusses the parameters of valuation services that do not require a personal physical inspection of the subject property by the state-credentialed real estate appraiser selected for the valuation assignment. The market uses a number of terms for such valuation services with a narrow scope of work; depending on the client, the term used may be bifurcated, hybrid, or desktop valuation. Although the process of each of these alternative services may be slightly different, essentially in such services the property data collection and the valuation analysis, if any, are separate. The article aims to equip appraisers with the knowledge necessary to meet the demand for such valuation services in the current market. The discussion covers important considerations, including the appropriate scope of work, state laws, regulations, standards, and governmental agency guidelines that apply to these types of valuations.

Sandra K. Adomatis, SRA, is the 2023 president-elect of the Appraisal Institute. Her one-year term as president-elect will be followed by one year each as president in 2024 and immediate past president in 2025. She serves on AI’s Executive Committee and the policy-setting Board of Directors. She served as chair of the Finance Committee in 2022 and will serve as chair of the National Nominating Committee in 2025.

Adomatis is a real estate appraiser and consultant of Adomatis Appraisal Service in Punta Gorda, Florida. She is also an Appraisal
Institute instructor, a developer of seminars and courses, an *Appraisal Journal* article author, a contributor to textbooks, and the author of *Residential Green Valuation Tools*. Additionally, she is a national spokesperson to state and federal government agencies, energy organizations, REALTOR groups, state coalitions, national and local homebuilder groups, and utility companies. Adomatis contributed to the 2011 “Appraisal Institute Residential Green and Energy Efficient Addendum,” and to the 2014 “Appraisal Institute Commercial Green and Energy Efficient Addendum.” Internationally, she is also working with Canada to adopt the AI “Green and Energy Efficient Addendum” to their residential properties.

Adomatis is a member of the Appraisal Institute’s national Government Relations Committee. She previously served on the national Admissions Designation and Qualifications Committee (2013–15), and on the national Education Committee as chair (2012), vice chair (2011–12), and member (2009–12). She also served as president of the West Coast Florida Chapter (2009), and as education liaison for the Appraisal Institute’s Region X (2006–09). She served as member, vice chair, and past chair of the Residential Demonstration Report Writing Committee, and as grader of demonstration reports and writing assignments for the *Advanced Residential Report Writing* course, the demonstration alternative (1987–present).

She previously received *The Appraisal Journal’s* Armstrong/Kahn Award (2016) and Swango Award (2019, 2021); the Lifetime Achievement Award (2020); Henry C. Entreken Lifetime Achievement Award (2019); Outstanding Service Award (2016); President’s Award (2013); Dr. William N. Kinnard Jr. Award (2012); and Region X Volunteer of Distinction (2010).

Dawn Molitor-Gennrich (deceased), SRA, AI-RRS, CDEI, was a real estate appraiser, instructor, and appraisal course and seminar developer and reviewer; the most recent Appraisal Institute seminar she reviewed was *Desktop Appraisals (Bifurcated, Hybrid) and Evaluations*. Molitor-Gennrich’s experience was in both residential and commercial appraisal and appraisal review. She was president and owner of Molitor-Gennrich Consulting Inc., based in California, a firm that provided litigation support and advisory services in...
real property appraisal compliance. Her work frequently focused on compliance with agency standards, including Federal Housing Administration, Fannie Mae, Freddie Mac, and Consumer Financial Protection Bureau standards as well as the Uniform Standards of Professional Appraisal Practice and the Interagency Appraisal and Evaluation Guidelines. Molitor-Gennrich previously was a member of the Appraisal Standards Board, and she had served as vice president and residential appraisal manager for Union Bank of California.

To read the award-winning article, go to http://bit.ly/Appraisal_Journal.
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Recent Court Decisions on Real Estate and Valuation

Portion of residence used as boarding house not entitled to homestead tax exemption

The Florida Constitution governs “homestead property” in several ways. Homesteads are protected from forced sale by creditors. Alienation and devising of a homestead is restricted. And homesteads are exempted from certain ad valorem taxes, and a 3% cap on annual assessment increases is imposed through the “Save Our Homes” amendment. The latter two provisions are intertwined, because the 3% assessment increase cap applies only to property that is entitled to a homestead tax exemption.

The homestead tax exemption provides that “every person who has the legal or equitable title to real estate and maintains thereon the permanent residence of the owner... shall be exempt from taxation” up to specified amounts. This provision has two components: ownership and residency. At issue in the current case is the question of how to determine the scope of a property owner’s residence.

Rod Rebholz owns a two-story residential structure in Sarasota, Florida. He initially applied for a homestead exemption in 1996, and for the tax years 2004 through 2013 (as well as earlier and later years). County tax officials treated the entire structure as a homestead property. Rebholz lived in a portion of the structure at all relevant times, but he also rented a portion of the structure to at least one tenant. Rebholz lived on the bottom floor, but the upper floor had four individual rooms with their own living areas and bathrooms. At least one tenant rented one of the rooms without interruption from 1996 until 2013. He and Rebholz had a written rental agreement describing the rate for his unit.

In 2014, the Sarasota County property appraiser (Appraiser) became aware that Rebholz might have received homestead benefits to which he was not entitled. An investigation revealed the configuration of the property and its rental situation. The Appraiser revoked the homestead exemption on the 15% of the property corresponding to the known tenant, leaving intact the exemption on the remaining 85%.

In Florida, when a property appraiser determines that a person has improperly received a homestead tax exemption or Save Our Homes benefit, the law requires the appraiser to impose the additional taxes that would have been due for up to the preceding ten years, plus a penalty and interest. Therefore, the Appraiser recalculated Rebholz’s taxes for the 2004 to 2013 tax years, and applied to the non-homestead portion a 10% annual assessment increase cap, instead of the 3% Save Our Homes cap. The resulting assessment was $7,000 in back taxes. Rebholz paid the tax lien, but then sued the Appraiser for a refund and a reinstatement of homestead status to the entire property.

After a bench trial, the circuit court entered judgment in Rebholz’s favor. The court reasoned that “merely sharing the residence with a tenant does not create a classification of property not exempted,” and the Appraiser was not authorized to deny a homestead exemption for a room rented within a residence while the owner simultaneously maintains the property as his permanent residence. The court of appeal affirmed. The Appraiser appealed to the state supreme court.

The Appraiser argued that the lower courts erred at the threshold by concluding that the entire structure was Rebholz’s residence. The state supreme court agreed. In the eyes of the court, Rebholz did not use the 15% of the prop-
Property rented to a tenant as his own residence. The record left “no doubt” that Rebholz gave exclusive use of that portion to a tenant, subject to the tenant’s compliance with the terms of the rental agreement. Thus, it was not the Appraiser who divided or “carved up” Rebholz’s residence; it was Rebholz. Instead, the Appraiser applied the statutory scheme to discern the scope of Rebholz’s residence in the first instance.

The supreme court explained why the lower courts had analyzed the facts wrongly. The property was effectively a boarding house, a part of which Rebholz lived in and used as his residence. The court of appeal purported to distinguish Rebholz’s property from “a multifamily apartment of individual autonomous units.” But assuming the property owner were to live in one of those apartment units, the court failed to see a meaningful difference between that hypothetical and Rebholz’s property. Under the constitutional and statutory scheme, how an owner uses a property—not its physical structure or what it is called—dictates the availability of the homestead tax exemption.

Unlike the court of appeal, which equated Rebholz with the “countless Florida citizens” who reside within their permanent residences while working from home, the state supreme court opined that the phrase “working from home” speaks to activity occurring within property already found to be the owner’s residence. Rebholz’s case was about defining the scope of the residence in the first place. The portion of the property to which Rebholz gave exclusive use to a tenant was not Rebholz’s residence. The lower courts’ rulings were quashed, and the case was remanded to the trial court for further proceedings.

**Furst v. Rebholz**
Florida Supreme Court
April 6, 2023
2023 WL 2799413

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**Damages based on breach of real estate contract not reasonably foreseeable**

In 2011, Gulley-Hurst LLC (GH) sold a one-half interest in a landfill it owned in Texas to MSW Corpus Christi Landfill Ltd. (MSW) for $7,500,000. MSW financed the transaction by executing a promissory note payable to GH for $3,500,000 and acquiring $5,000,000 in loans. The parties entered a landfill operating agreement that provided MSW would operate the landfill and pay GH 50% of the net operating income.

Following some disagreements, MSW and GH entered into a mediated settlement agreement in 2015, which allowed MSW to purchase GH’s remaining one-half interest in the landfill within 120 days. If MSW did not purchase GH’s one-half interest by the deadline, MSW was required to sell its one-half interest back to GH.

MSW did not purchase GH’s one-half interest by the deadline. As a result, MSW was required to provide clear title to GH, and GH was required to refinance the $5 million loan and write off the $3.5 million promissory note. Thus, MSW was the seller and GH was the buyer. MSW fulfilled its requirements and conveyed the property to GH. GH wrote off the note, but did not timely refinance the loan, though it made the payments required under the loan. MSW sued GH for, among other things, breach of contract due to GH’s failure to refinance the loan.

By the time of trial, the value of the landfill had appreciated significantly, to an estimated market value of $35,470,000. A jury awarded MSW two types of damages: lost “benefit of the bargain” damages of $10,235,000, and lost “opportunity cost” damages of $372,485. The trial court had instructed the jury to calculate MSW’s benefit of the bargain damages as the difference between the market value of the property at the time of the breach and the contract price. The opportunity cost damages were calculated based on MSW’s expert testimony that
GH’s failure to refinance the loan prevented MSW from receiving another loan, the proceeds of which MSW could have invested at a return of $372,485.

After the jury’s award, the trial court granted GH’s motion for a judgment notwithstanding the verdict (JNOV), stating that the court did not submit the proper measure of damages to the jury. The court reduced the benefit of the bargain damages to $0. But the lost opportunity cost damages were left intact. The court of appeals affirmed, and both parties appealed to the state supreme court—MSW seeking to have the benefit of the bargain damages reinstated, and GH seeking to have the lost opportunity cost damages deleted.

The general rule for measuring benefit of the bargain damages is to calculate the difference between what was promised and what was received. When the breached contract is for real estate, the measure of the seller’s damages is the difference between the contract price and the property’s market value at the time of the breach. But this formula applies only when the value of the property has remained the same or decreased after the purchaser’s breach, leaving the seller unable to receive the expected value of the contract. When the property’s market value at the time of breach exceeds the contract price, the correct measure of damages is the difference between the promised contract price and what the seller received.

This result is compelled by policy and precedent. The purpose of benefit of the bargain damages is to place the seller in the same economic position he would have been in had the contract been performed. Permitting a seller to recover more than the contract price would place him in a better position than had the contract been performed, and that windfall would come at the buyer’s expense. The seller loses the opportunity to sell the property at market value not because of the buyer’s actions, but because the seller decided to contract with the buyer for a lower price.

Here, had the contract been performed, MSW would have received $7.5 million for its ownership interest in the landfill, not $10.235 million. As MSW only expected $7.5 million, the damages to which MSW is entitled are the difference between $7.5 million and what MSW received. Here, MSW received $3.5 million when GH wrote off the note, and GH made payments on the loan. GH remains obligated to refinance that loan, and MSW requested no other measure of damages. The state supreme court affirmed the trial court’s JNOV deleting the jury’s award of those damages.

The jury also awarded MSW lost opportunity cost damages based on what MSW could have received by investing the proceeds of another loan, which would be consequential damages. A plaintiff may recover consequential damages only if the parties contemplated at the time they made the contract that such damages would be a probable result of the breach. But MSW did not cite any evidence that GH knew at the time the settlement agreement was executed that MSW intended to use the refinancing proceeds to obtain another loan or that MSW would be unable to secure alternative financing if GH breached its commitment to refinance MSW’s original loan. Therefore, MSW did not show that the damages awarded based on GH’s breach were reasonably foreseeable, and the supreme court reversed the portion of the judgment awarding lost opportunity cost damages.

Thus, while GH remained obligated to refinance the loan, the supreme court affirmed the court of appeals’ judgment in part, reversed in part, and rendered judgment that MSW take nothing from its action.

MSW Corpus Christi Landfill Ltd. v. Gulley-Hurst LLC
Texas Supreme Court
March 24, 2023
664 S.W.3d 102
Tenant has standing to bring claim for prescriptive easement

The Hidden Valley Ranches subdivision (Ranches) was created in 1977 in Ravalli County, Montana. To ensure that property owners could access the individual tracts within the Ranches, a survey created a private roadway and utility easement. The Ranches’ homeowner’s association (HOA) maintains the roads subject to this easement, and maintenance of the private roads is paid for by assessments on its members, who are all property owners in the Ranches.

In 2001, Ronald Oberlander acquired leases for state school trust land covering 327 grazing acres and 352 agricultural acres. He then purchased an adjacent parcel of land within the Ranches, which he used to access the leased land by traveling over portions of two private roads maintained by the HOA.

In 2021, the HOA filed a complaint against Oberlander and applied for a preliminary injunction, alleging that Oberlander used private roads to transport his farming equipment “without an easement or legal right to do so and without contribution for the added burden and damage to the roads.” The HOA requested that the court enjoin Oberlander from using the private roads to access the leased state land for the pendency of litigation. Oberlander filed a counterclaim against the HOA and a third-party complaint against individual property owners within the Ranches whose property he entered to reach the leased land. He claimed a prescriptive easement appurtenant to his state leasehold.

The trial court dismissed Oberlander’s claim for prescriptive easement, concluding that he lacked standing to bring such a claim, reasoning that only the state could bring a prescriptive easement claim as owner of the land benefitted by such an easement. The court also enjoined Oberlander from entering upon the property owners’ properties including the Ranches private road easements for the purpose of accessing the state land.

Oberlander appealed to the state supreme court. On appeal, Oberlander argued that the trial court erred when it determined he did not have personal standing to bring a prescriptive easement claim. He maintained that his leasehold in the state land is the dominant tenement of the alleged easement, allowing him therefore to bring his prescriptive easement claim as owner of the dominant tenement. The property owners argued that Oberlander as “a mere leaseholder” did not have standing to bring a prescriptive easement claim. According to the property owners, only the owner of the land—the state—could bring such a claim.

An easement appurtenant is one that benefits a particular parcel of land, i.e., it serves the owner of that land and passes with the title to that land. The land to which an easement is attached (and which the easement benefits) is called the dominant tenement, and the land upon which a burden is held is called the servient tenement. According to the property owners, because an appurtenant easement runs with the land, it cannot attach to a leasehold interest. Thus, a leasehold cannot be the dominant tenement in a prescriptive easement claim.

The court disagreed with Oberlander’s contention that he can establish a prescriptive easement appurtenant because his leasehold itself is the dominant tenement. But earlier case law did not answer the question of whether Oberlander had standing through his leasehold interest to assert the prescriptive easement claim, i.e., whether a tenant can bring a claim for a prescriptive easement, or if only the owner of the dominant tenement can do so.

Montana, however, has a statute expressly allowing “the owner of any estate in a dominant tenement or the occupant of such tenement to maintain an action for the enforcement of an easement attached thereto.” This statute is part of the original Civil Code of 1895 and has never changed. The plain language of the statute authorizes an occupant of a dominant tenement to enforce a
prescriptive easement claim. Oberlander undisputedly occupies the dominant tenement, so he has standing to bring a prescriptive easement claim. Accordingly, the trial court erred when it determined only the owner of the dominant tenement has standing to bring such a claim.

The fact that the state did not claim a prescriptive easement does not change this result. Nothing in the statute requires the owner of the dominant tenement to support a tenant's adverse use of a property in bringing a prescriptive easement claim. Whether Oberlander can establish the alleged prescriptive easement goes to the heart of his third-party claim against the property owners, but because the trial court dismissed the claim for lack of standing, the parties did not develop the issues, facts, or legal arguments associated with the merits of Oberlander’s claim.

The supreme court reversed the trial court’s judgment, and reversed the preliminary injunction against Oberlander, since it was grounded in the improper conclusion that Oberlander lacked standing. The case was remanded for further proceedings.

Oberlander v. Hennequin III
Montana Supreme Court
March 14, 2023
525 P.3d 1176

Requirement for good-faith offer in taking satisfied despite mistaken understanding of appraisal conclusion

The Octagon Earthworks (Earthworks) are part of a system of interconnected earth structures called the Newark Earthworks that covers four square miles in Newark, Ohio. The Earthworks were built at the dawn of the Common Era with a sophisticated understanding of soil engineering and astronomy. The Earthworks align with the cycle of the moon’s orbit around the earth with geometric precision. The historical, archaeological, and astronomical significance of the Earthworks is arguably equivalent to Stonehenge or Machu Picchu. The Newark Earthworks are Ohio’s official state prehistoric monument.

Moundbuilders Country Club Company (Club) has leased the property where the Earthworks are located since 1910 and has used the site for a private club and golf course. Ohio History Connection (Connection) is a state-funded entity that became the owner of the land burdened by the Club’s lease in 1933. Connection allowed the Club to renew its lease over the years, most recently in 1997. Under the terms of the deed and the Club’s lease, Connection reserved a right of public access to the Earthworks but allowed access to be limited by the Club’s “reasonable rules.”

Eventually, Connection explored the possibility of nominating the Earthworks as a World Heritage Site with international recognition and legal protection. In order to qualify for the nomination, Connection was informed it would need to terminate the Club’s lease and physically remove the golf course.

In early 2017, in an attempt to assess the value of the Club’s leasehold before negotiating an early termination of the lease, Connection hired two appraisers. Connection’s chief executive officer reviewed the reports and believed that the appraisers had valued the leasehold at $500,000 and $795,000, respectively. Connection made a written offer to buy the Club’s leasehold for $800,000, but the Club did not respond.

After it was unable to negotiate the purchase, Connection filed an appropriation action in county court using its power of eminent domain. During discovery, Connection’s attorney discovered that the $500,000 figure in one of the appraisals was the value of the leased fee, not the value of the leasehold interest. The appraised value of the unencumbered fee simple was $2.25 million, mathematically resulting in an unspecified $1.75 million valuation of the leasehold.

The Club argued that the appropriation was
not necessary, because the purpose of seeking heritage designation was speculative and was not a public use. The Club also asserted that Connection had acted in bad faith by purposefully hiding the appraisal with the higher concluded value. After a trial, the court denied the Club’s challenges to Connection’s authority to commence appropriation proceedings. It found that Connection’s full ownership of the disputed land was required to allow public use and access, and that Connection had made a good-faith offer. The court of appeals affirmed, and the Club appealed to the state supreme court.

In Ohio, an agency seeking to acquire a property interest from a private owner through eminent domain is statutorily required to provide a written good-faith offer to purchase the property at least thirty days before it files an appropriation petition. The Club argued that the requirement of good faith is a higher standard than the mere absence of bad faith, and that the lower courts allowed Connection to prevail solely because it did not act with blatant dishonesty or ill intent. The statute provides only a tautology rather than a definition, essentially defining a “written good-faith offer” as a “written good-faith offer.”

After analyzing prior case law, the state supreme court concluded that good faith can be demonstrated by objective factors such as the party’s full cooperation in the procedural matters of a claim, rational evaluation of the risks and potential liabilities of a cause of action, and a lack of foot-dragging or other dilatory tactics. Behavior that is unreasonable, uninformed, or irrational in light of circumstances can establish a lack of good faith irrespective of a party’s subjective intentions. Applying that test, the court found no indicia of a lack of good faith. The record showed that Connection did not shop for low appraisals, and any misrepresentation about the value conclusion in one appraisal was based on a reasonable, though mistaken, understanding.

The state supreme court then turned to the question of necessity. A government agency is prohibited from using eminent domain to acquire a property that is not “necessary and for a public use.” The Club argued that the inquiry into necessity should determine not only whether the taking was for a public use, but also whether it is in the best interest of the public as a whole. The court disagreed. And though it is well-settled that public parks are public uses, the Club argued that the creation of this park would not serve the public interest. But the court, noting that the park will help preserve and ensure perpetual public access to one of the most significant landmarks in Ohio, concluded that the trial court appropriately found that the Club had not rebutted the presumption that appropriating the golf course was necessary to fulfill a public purpose.

The trial court’s decision was affirmed, and the supreme court remanded the case for the trial court to proceed to a trial in Connection’s appropriation action.

State ex rel. Ohio History Connection v. Moundbuilders Country Club Co.
Ohio Supreme Court
December 7, 2022
2022 WL 17479895

Unrecorded instrument that encumbers real estate void against subsequent good-faith purchaser except where there is constructive notice

Eugene and Carol Hanson (the Hansons) owned a property including mineral interests in Mountrail County, North Dakota. In 2006, Ritter Laber and Associates (Ritter) was part of a joint venture that was locating mineral owners and leasing their interests. A Ritter representative contacted the Hansons, and their meeting resulted in the Hansons mailing documents to one of Ritter’s partners. One document was a fully executed oil and gas lease dated December 20, 2006 (the EOG Lease). Another document, also dated December
20, 2006, was a “Side Letter Agreement” containing terms allowing Ritter to “exercise its option” to lease the minerals. If Ritter chose not to exercise the option, Ritter was required to immediately release the Hansons from any further obligation. The EOG Lease was not immediately recorded.

In April 2007, the Hansons executed a warranty deed to their son, which included the minerals in question, and it was recorded. The deed reserved a 50% life estate in the minerals. In May 2007, Ritter recorded a Memorandum of Oil and Gas Lease Option that referenced the EOG Lease. Shortly thereafter, Ritter recorded the EOG Leases and sent the Hansons a letter saying it had elected to exercise its option to lease. In August 2007, Ritter’s partner sent the Hansons a $37,000 check as total consideration for the paid-up oil and gas lease.

In September 2007, Ritter assigned the EOG Lease to EOG Resources Inc. (EOG). The assignment was recorded. Then, in December 2007, Ritter obtained an oil and gas lease from the Hansons’ son listing the tracts in question (the Northern Lease). It was recorded in January 2008 and assigned to Northern Oil & Gas Inc. (Northern) in June 2008.

Northern filed suit in 2016 requesting a declaration that it owns the disputed mineral interests. The trial court quieted title in Northern. The court reached this conclusion by determining that the transaction between the Hansons and Ritter created an option to lease, the Hansons’ son had no notice of the option, and he took title to the minerals free of it. Thus, the EOG Lease was deemed not valid insofar as it conflicts with the Northern Lease. EOG appealed.

On appeal, EOG argued that the delivery of a grant, here the fully executed EOG Lease, cannot be conditional. And even if the parties had intended to condition effectiveness of the lease upon exercise of the option, the lease would still have taken effect upon delivery. EOG thus claimed that the disputed leasehold transferred to Ritter when the EOG Lease was mailed, before the Hansons divested themselves of the mineral interests. Conversely, Northern argued the transaction created an option to lease rather than an immediately effective lease. Because the option was not exercised before the minerals transferred to the Hansons’ son, Northern claimed its lease prevails.

A transfer in writing is called a grant, and it takes effect so as to vest the interest intended to be transferred only upon the grant’s delivery. Whether a delivery of a grant has occurred depends on the grantor’s intent. For a delivery to occur, the grantor must intend to pass title. But delivery of a grant with intent that title transfer upon some contingency or condition is prohibited under North Dakota law. A conditional delivery is necessarily absolute and the instrument takes effect upon delivery, discharged of any condition on which the delivery was made. And while conditional delivery of a grant to a grantee is prohibited, the effectiveness of a real property grant itself may be conditional.

Because the Hansons were unable to recall the details of their transaction with Ritter, the only evidence of what the Hansons intended to accomplish by mailing the documents to Ritter are the documents themselves. The agreement accompanying the EOG Lease promised title would transfer to Ritter on the condition Ritter accepted the lease and paid for it. They relinquished their authority over the EOG Lease with conditions precedent to the transfer of title that were expressed in a contemporaneous agreement. Such a conditional delivery of a grant to a grantee becomes absolute. Any conditions the Hansons agreed to or created outside the four corners of the lease are void for purposes of delivery as a matter
of law. Accordingly, the supreme court held that the trial court erred by determining that the EOG Lease did not become effective upon delivery.

Having concluded that the EOG Lease was effective before the Hansons transferred the minerals to their son, the supreme court next turned to the implications of the EOG Lease being recorded after the mineral transfer. Northern claimed ownership under the lease it took from the Hansons’ son. Northern’s claim to ownership thus requires a determination that the unrecorded EOG Lease was not valid as to him.

Recording an instrument puts everyone on notice of its contents. An unrecorded instrument is valid as to the parties to the instrument and those with notice of the instrument. But an unrecorded instrument that encumbers real estate is void against a subsequent good-faith purchaser for valuable consideration.

Here, the record showed that the Hansons’ son knew that the interests had been leased before the transaction with his parents. He knew none of the details of the lease, but he repeatedly agreed that he was aware of the mineral lease. Those facts were sufficient to give rise to a determination that he was put on inquiry notice, i.e., notice sufficient to assert the existence of an interest as a fact, which in turn gives rise to a duty to investigate. Because the Hansons’ son had knowledge of the facts giving him at least constructive notice of the EOG Lease, his mineral interests were encumbered by the EOG Lease when he executed the Northern Lease. The EOG Lease was also recorded before the Northern Lease. The EOG Lease therefore takes priority.

Accordingly, the supreme court held that the trial court erred when it quieted title in Northern, and it reversed the lower court’s judgment.

**Annexation based on financial as well as growth consideration is valid**

In 2019, the City of Bellevue, Nebraska (City), considered an annexation package made up of several sanitary and improvement districts and unincorporated parcels of land in its extraterritorial jurisdiction. The City ultimately adopted ordinances annexing various areas, including a portion of land referred to as Area 9. Area 9 consisted of properties owned by Darling Ingredients Inc. (Darling) and Frank Krejci.

In May 2019, the City’s planning director had sent a memorandum to the mayor and the city council, explaining the planning department’s recommendation that the City annex Area 9 based upon the positive financial impact on the City and the natural growth and development of the City. The city council subsequently voted to adopt the ordinance annexing Area 9.

Darling and Krejci separately brought complaints against the City, alleging that the City had exceeded its annexation authority under Nebraska law, which provides that the mayor and city council may by ordinance include within the City’s corporate limits any contiguous or adjacent lands that are urban or suburban in character. Darling and Krejci argued that the City enacted the ordinance solely for the purpose of increasing revenue.

Following trial, the court declared the City’s ordinance invalid, reasoning that Area 9 was rural in character and neither contiguous nor adjacent to the City. The court did not address the question of whether the ordinance was enacted for an improper purpose. The court permanently enjoined the City from taking any action to enforce the ordinance, and the City appealed. In the first appeal, the state supreme court concluded that the annexation of Area 9 was not invalid based on the character of the use and that Area 9 was adjacent and contiguous to the City. The Court remanded to the trial court to consider the improper purpose challenges.
Upon review, the trial court entered an order determining that Darling and Krejci failed to meet their burden of establishing that the City’s annexation was motivated by an improper purpose. The court found that no evidence negated its finding that the City acquired Area 9 as part of a larger plan to annex numerous properties for the stated purpose of the “natural growth and development of the City.” The trial court found that to be a legitimate purpose.

Darling then appealed. Darling argued that the trial court erred in finding that the City’s annexation was not motivated by an improper purpose based on the evidence received at the prior trial. In Nebraska, it is improper for an annexation to be solely motivated by an increase in tax revenue. Proving that the City acted pursuant to an improper purpose was Darling’s burden, because the burden is on one who attacks an ordinance otherwise valid on its face to prove facts to establish its invalidity.

As the trial court observed, there was substantial evidence that the natural growth and development of the City was a factor in the City’s decision to annex properties, including Area 9. The City’s comprehensive plan indicated that the City consisted of 10,601 acres but needed another 7,835 acres to accommodate expected population growth by 2030. The plan included detailed annexation goals and explained that the City’s planning department would conduct an annual study consisting of a cost-benefit analysis of potential areas for annexation. Areas as to which the costs significantly outweigh the benefits were not generally considered for annexation.

The state supreme court recognized that the City considered the financial impacts of potential annexations, and not just the natural growth and development of the City. But prudent annexation planning compels the City to consider any revenue to be engendered by annexation, in light of the liabilities to be incurred. The legal proscription against annexation solely for revenue purposes does not mean that a municipality cannot consider potential revenues in deciding whether to proceed with an annexation. Thus, although the City considered the financial impact of annexing Area 9, that financial impact was not the sole basis for the annexation.

Because the state supreme court agreed with the trial court’s conclusion that Darling failed to meet its burden of establishing that the City acted for improper purpose, the court affirmed the lower court’s judgment.

**Darling Ingredients Inc. v. City of Bellevue**  
Nebraska Supreme Court  
March 24, 2023  
986 N.W.2d 757

**Homeowner entitled to homestead exemption where property owned in another state is not primary residence**

Mack Stirling has lived in his home in Leelanau County, Michigan, since 1990. His wife, Dixie Stirling, owned two rental properties in Utah. Neither Mack nor Dixie ever resided at the Utah properties. Instead, Dixie rented the properties to tenants who used the properties as their primary residences. Dixie claimed an applicable Utah tax exemption during the relevant tax years.

The Stirlings applied for the Michigan principal residence exemption (PRE) for their Leelanau County home. The County denied the application because it concluded that the Utah exemption rendered the Stirlings ineligible for the PRE. The Stirlings appealed to the Michigan Tax Tribunal, which granted the Stirlings’ motion for summary judgment. The tribunal concluded that the Utah exemption received by Dixie was not substantially similar to the PRE, primarily because to be eligible for the PRE a person had to be both an owner and occupier of the residence, while under Utah law a person was eligible if they owned a residence and had tenants occupying the home as a primary residence. The County
appealed to the court of appeals, which reversed the tribunal’s judgment, and the Stirlings appealed to the state supreme court.

Michigan’s PRE is part of the General Property Tax Act. It permits taxpayers to exempt their homestead from their local school district property tax. A taxpayer is not entitled to claim the PRE if the taxpayer owns property in a state other than Michigan for which the person or their spouse claims an exemption, deduction, or credit substantially similar to the PRE. The term “substantially similar” in this instance is not defined, but the court of appeals concluded that the requirement means that “the sister state’s exemption must be largely but not wholly alike in its characteristics and substance to the PRE.” The state supreme court adopted that definition as its own.

Comparing the two exemptions revealed that they are not alike in substance or characteristics. The Michigan law defines a “principal residence” as “the one place where an owner of the property has his or her true, fixed, and permanent home to which, whenever absent, he or she intends to return and that shall continue as a principal residence until another principal residence is established.” The Utah statute, on the other hand, provides that the fair market value of a residential property located in the state is allowed a residential exemption equal to a 45% reduction in the value of the property, and taxpayers can claim a residential exemption for each residential property they own that is the primary residence of a tenant, as well as one exemption for their own primary residence.

Dixie claimed an exemption under the Utah law as the owner of a property that is the primary residence of a tenant. The state supreme court held that this Utah exemption is not substantially similar to the Michigan PRE because it does not require the subject property to be the owner’s residence. The exemption is in substance a landlord tax exemption; the PRE, by contrast, is in substance a homestead exemption.

A person cannot principally reside in two places. But the Stirlings do not claim to reside in two different residences. They steadfastly maintained that they reside exclusively in Michigan, and they never represented to Utah that their Utah property was their primary residence. Given that the touchstone of the PRE—owner residency—is not in any way relevant to the claimed Utah landlord exemption, these two provisions are not, as a matter of law, largely alike in characteristics or substance.

The state supreme court therefore held that the Utah tax exemption claimed by Dixie was not substantially similar to Michigan’s PRE, and therefore the Stirlings were eligible to claim the PRE. The tax tribunal’s order granting summary judgment to the Stirlings was reinstated.

Stirling v. County of Leelanau
Michigan Supreme Court
March 24, 2023
2023 WL 2627986

Reasonable amount of time needed to trigger cessation-of-production clause

Tres C LLC (Tres C) owns certain mineral interests in a 320-acre lot in Blaine County, Oklahoma, that were formerly owned by George and Coral Cowan. In 1955, the Cowans executed an oil and gas lease (Lease) in favor of a lessee. Under its habendum clause, the Lease would remain valid for a primary term lasting ten years and then, so long as a producing well was drilled, for a secondary term lasting as long as oil or gas could be produced. The Lease also contained a cessation-of-production clause that provided “if, after the expiration of the primary term of this lease, production on the leased premises shall cease from any cause, this lease shall not terminate provided lessee resumes operations for drilling a well within sixty days from such cessation.”

During the primary term of the Lease, the lessee drilled and completed a well (the Cowan Well). The Cowan Well produced oil and gas in
Cases in Brief

paying quantities, and the Lease moved into the secondary term defined by the habendum clause shortly after completion.

In 2012, Raker Resources LLC (Raker) purchased the interest in the Cowan Well and became the operator of the Cowan Well. When Raker first acquired the Cowan Well, the well was producing, but at low rates. The well had good pressure, though, so under Raker’s supervision, production increased by twenty-fold within the first year. Things continued as normal until early 2016, when Tres C’s royalty checks from Raker began to arrive sporadically. Tres C hired a lawyer, who sent a letter to Raker claiming that the production records for the Cowan Well showed that the well had ceased producing in paying quantities, so the Lease had expired by its terms and the well should be plugged and abandoned.

Raker responded that the well was still producing in paying quantities, and it provided figures showing the gas production for each month since January 2012. The figures showed a dip in production in December 2015 but nothing out of the ordinary. The Cowan Well became profitable again, but “not too profitable.”

Then in September 2016, the Cowan Well experienced another month of low production and unprofitability, and the well failed to produce anything by mid-October. Raker was proactive in trying to address these production problems, including by using soap to aerate the fluid and moving a compressor to the Cowan Well to help draw fluid out of the wellbore. The Cowan Well was back in operation by November 4, and it was producing enough gas to meet the benchmark for profitability. Still, October, November, and December 2016 would prove to be unprofitable for the Cowan Well.

Meanwhile, Tres C entered into a lease option agreement with J&R Energy Resources (J&R), whereby J&R would fund legal proceedings to secure the release and termination of the Lease in exchange for Tres C’s promise to give J&R an exclusive option to file a top lease later. Ultimately, J&R exercised its rights under the lease option and filed an equitable quiet title action on Tres C’s behalf in February 2017. The petition alleged that the Cowan Well had ceased producing in paying quantities, and that the Lease had therefore expired.

Tres C offered an expert who opined that the well ceased to produce in paying quantities in September 2016, relying on a three-month period. Raker and the other defendants offered witnesses who opined that the Cowan Well maintained production, either through actual profitability or mere capability. Raker’s witness concluded that in various twelve-month periods over the relevant time, the well was profitable. Raker’s witness did not think a three-month period was adequate for determining whether the well had become unprofitable.

The trial court issued judgment cancelling the Lease in favor of Tres C. When comparing the well’s net revenues and lifting costs, the trial court found that the Cowan Well ceased to produce in paying quantities because lifting costs exceeded revenues in September 2016 and the next two months. Having found a cessation of production, the trial court found that Raker did not restore production in paying quantities within the sixty-day grace period of the cessation-of-production clause. Consequently, the trial court quieted title and entered judgment in favor of Tres C.

Raker appealed, alleging that the trial court erroneously held that production ceased any moment profitability is interrupted, instead of analyzing profitability over a reasonable accounting period. Whether a well remains capable of production should be evaluated over a reasonable lookback period, and the sixty-day savings period does not become relevant until a longer lookback period demonstrates a cessation, not merely an interruption, of profitable production. Stated more broadly, the issue concerned how to determine whether production that maintains a gas lease under the habendum clause has ceased, including whether a cessation-of-production clause
plays any role in narrowing the window of time that should be considered.

The state supreme court agreed with Raker that the trial court erred in determining that a cessation of production had occurred based on three months of unprofitability. A three-month period “is, as a matter of law, too short for determining whether a cessation of production in paying quantities has occurred.”

The supreme court reasoned that a cessation-of-production clause is only implicated where production has already ceased. Such a provision is a “savings clause” that defines the grace period for reestablishing production in paying quantities. Therefore, the cessation-of-production clause and the sixty-day period therein have no bearing on anything that is done before the cessation occurs, including an assessment of whether a cessation has occurred.

Second, it is not the purpose of a cessation-of-production clause to establish an accounting period. Otherwise, leasehold operators subject to a sixty-day clause would be required to commence drilling operations immediately upon sustaining a slight loss for one month without regard to whether they believed the next month’s production might be profitable, because another month of slight loss could result in forfeiture of the lease. This would “indubitably burden leasehold operators with a duty to market continually” to maintain profitable production necessary to sustain the lease.

The reasonable amount of time needed for assessing a well’s profitability and for determining whether a cessation has occurred is typically much longer than three months, varying based on the facts and circumstances in each case. Here, Raker was still in the process of testing whether the Cowan Well’s pressure and fluid build-up problems could be remedied by the installation of a compressor or by using more soap. Such a temporary interruption in profitable production should not trigger the sixty-day time limit in the cessation-of-production clause, particularly since that clause was really designed to provide a grace period for protecting Raker’s leasehold interest.

Accordingly, the supreme court determined the trial court erred by relying on a three-month time period for assessing whether a cessation of production had occurred. Judgment should have been entered in favor of Raker because Tres C failed to meet its burden of proof. The court therefore quieted title in favor of Raker.

Tres C LLC v. Raker Resources LLC
Oklahoma Supreme Court
February 14, 2023
2023 WL 1990113

Encroaching improvements not acquisitive prescription where no just title can be shown

Lot 289 and Lot 290 in the Flower Estates Subdivision in Covington, Louisiana, are adjacent neighboring parcels with frontage along Louisiana Highway 21. Lot 290 had been owned by Dayle Bradford or Bradford Land Company LLC (collectively, Bradford) since 1977. Lot 289 has been owned by Oliver Montagnet or Montagnet Properties #2 LLC (collectively, Montagnet) since 1998. Both lots were purported to be 100 feet wide and 400 feet deep.

In 1999, Montagnet completed construction of a commercial building, parking lot, and other improvements on Lot 289. A survey was performed that shows that the building was within the boundaries of Lot 289. The city reinspected the property and found items not in compliance with the city ordinances, including a five-foot setback requirement. In 2006, in connection with a loan, Montagnet again requested a survey, which indicated that the improvements on Lot 289 were within the boundary lines for Lot 289.

Beginning in 2006, the Louisiana Department of Transportation and Development (DOTD) began a government expropriation of certain
property for the widening of a section of Highway 21. Portions of Lots 289 and 290 fronting Highway 21 were procured for the project. During the project, surveyor Bonneau & Associates was hired to survey the lots. The Bonneau survey showed that the DOTD acquired 6.97 feet from the boundary between Lot 289 and Lot 290, but Bonneau also notified Bradford that Montagnet’s improvements might be encroaching on Lot 290.

Bradford did not take any action until August 2009, when its attorney sent a letter to Montagnet alleging that the improvements on Lot 289 encroached onto Lot 290 and demanding equitable rent for the property encroached upon. Eventually, in September 2011, Bradford filed suit against Montagnet, asserting that Montagnet constructed parking structures, concrete pads, sewer and drain cleanouts, and piping across the boundary line into Lot 290 illegally and without Bradford’s permission. Bradford sought removal of the encroachments and reasonable rent, as well as damages.

The trial court held a two-day trial in July 2020. Each party submitted a separate survey and the testimony of an expert surveyor. Bradford offered the Bonneau surveys, which showed that the 1999 improvements on Lot 289 extended more than three feet past the boundary line. Montagnet’s surveys showed that none of the improvements extended over the boundary line. Montagnet also asserted that even if it was not the title owner of the disputed area, it possessed the land in good faith and with just title for over ten years, and it was therefore the owner by acquisitive prescription.

The trial court fixed the boundary line as depicted in the Bonneau survey. The court found that Bonneau’s opinions showed definitive proof of the boundary line since they relied on the record title documents and the subdivision plats, after finding that the boundary could not be located based on the subdivision plats alone. Bonneau also surveyed the entirety of the Highway 21 corridor in the area, and they used that data to determine the boundary location. Montagnet’s surveys, on the other hand, only located the building on Lot 289 with a vague reference to concrete parking and did not identify the other site improvements at all.

Because the trial court found that the improvements on Lot 289 encroached onto Lot 290, the court ordered the establishment of a predial servitude. A predial servitude is a charge on a servient estate for the benefit of a dominant estate. Legal servitudes are limitations on ownership for the benefit of the general public or for particular persons. In such a case, the court allows the encroaching structure to remain, but the owner of the structure acquires a predial servitude on the land occupied by the structure upon payment of compensation for the value of the servitude taken and for any other damages suffered by the neighbor.

With respect to damages, the trial court adopted the values determined by Bradford’s expert appraiser, who appraised the fair market value of the portion of Lot 290 used by Montagnet at $14.50 per square foot. The appraiser opined that the servitude should have a width of six feet and be a straight line, resulting in a total appraised value of $33,500. The court awarded Bradford those damages for the value of the predial servitude but declined to award Bradford rent. Montagnet appealed.

Montagnet’s appeal involved two issues: whether the boundary line was properly set or should it have been adjusted for acquisitive prescription, and whether the compensation was correctly determined.

Louisiana law provides that “the requisites for the acquisitive prescription of ten years are possession of ten years, good faith, just title, and a thing susceptible of acquisition by prescription.” At issue was whether Montagnet had just title. To have just title over a particular property, one must have a recorded act translative of title that contains a description of the property. Montagnet pointed to a consent judgment it obtained in the 1998 litiga-
Montagnet also argued that the trial court erred in fixing the boundary line when it adopted surveys with “defects and inconsistencies.” The court of appeal disagreed, stating that the state supreme court had established that in cases where boundary questions exist, the legal guides for determining the location of a land line are, in order: natural monuments, artificial monuments, distances, courses, and quantity. A survey predicated on sound surveying principles should be accepted unless the record shows it is incorrect. Here, the record showed that Bonneau had surveyed the entire highway in the area, locating monuments along the front and rear property boundaries for all of the lots in the area. The court found a reasonable basis for the trial court’s factual finding regarding the location of the boundary line between Lots 289 and 290.

Finally, Montagnet challenged the amount of damages. Montagnet argued that the actual size of the encroachment was 526 square feet of concrete parking and 32 square feet of gravel. Accepting the appraiser’s valuation of $14.50 per square foot, Montagnet argued that the value for the actual size of the encroachment should be $8,091.

Bradford’s appraiser testified that a six-foot buffer was fairly small, considering the encroachment of 4.6 feet determined by Bonneau. The court of appeal found no error by the trial court in the granting of a six-foot straight-line predial servitude or in its calculation of the compensation for the value of the servitude. The court did amend the judgment of the trial court, though, to order the predial servitude to include an award of interest owed by Montagnet on the $33,500 from the September 2011 date of demand until paid.

The judgment of the trial court in favor of Bradford was affirmed, subject to the amendment to include the award of interest.

Bradford Land Company LLC v. Montagnet Properties #2 LLC
Louisiana Court of Appeal, First Circuit
November 17, 2022
356 So. 3d 1101

Where an intangible necessary to the productive use of property can be fairly identified and valued, assessors must deduct that amount from assessment

In the late 1990s, the City of Los Angeles (City) decided its downtown convention center was uncompetitive in the national market because it lacked an adjoining convention hotel. The City concluded that a large hotel project would be publicly beneficial but privately uneconomic: a private developer would be unlikely to speculatively build such a hotel because the cost would outweigh the private payoff. So, the City agreed to pay Olympic and Georgia Partners LLC (Olympic) a monthly subsidy to build a tall convention hotel, which today is a feature of the downtown Los Angeles skyline. The City agreed to pay Olympic the room tax the City collects from Olympic’s guests.

Although Olympic owns the hotel, it contracted with two established hoteliers—Ritz-Carlton and Marriott (collectively, the Managers)—to manage and operate the hotel. Olympic’s hotel operates under the Managers’ respective flags and franchises. Olympic pays a percentage of the hotel’s gross revenues and cash flow to the Managers for their management services. But the Managers also made a one-time, up-front payment of $36 million to Olympic as “key money,” which was later described as a discount the Man-
agers paid to secure their deal with Olympic, akin to a cash rebate given by a dealership to prompt a car sale on credit.

Once Olympic completed construction, Los Angeles County (County) sought to value the new building and levy property taxes upon it. In the proceedings at the County Assessment Appeals Board (AAB), Olympic argued that the assessor should subtract from the hotel’s assessment three amounts for intangible value: $80 million attributable to the value of the City subsidy; $36 million key money payment from the Managers; and $34 million attributable to “hotel enterprise assets,” namely flag and franchise value, assembled workforce, and miscellaneous other intangibles. Olympic offered the opinion and testimony of a business valuation expert, who used established appraisal methods to identify and value the enterprise assets.

The AAB rejected Olympic’s request. Regarding the subsidy, the AAB ruled it would include the $80 million because it was an intangible that ran with the land and associated with ownership of the property. The AAB reasoned that the key money was a payment received in exchange for a tangible right in real property. Finally, the AAB was not persuaded that the enterprise assets could be isolated from the real estate value.

Olympic took the matter to the superior court. At trial, the court ruled that the AAB was right to include the subsidy and discount in its valuation, but that the enterprise assets should be deducted. Olympic and the County both appealed the adverse portions of the judgment.

The court of appeal began its analysis by recounting California law on intangibles. Only select forms of intangible property can be directly taxed; all other intangibles are immune from direct property taxation. A 2013 decision from the state supreme court resolved an earlier contradiction in treatment of intangible assets by holding that when using the income method to ascertain property value, assessors must quantify and subtract income fairly ascribed to such assets. Although it is not always possible to articulate a basis for attributing a separate stream of income to an intangible asset, where the taxpayer can fairly identify and value an intangible necessary to the productive use of the property, assessors must deduct that amount from the final assessment.

Turning to the intangibles at issue here, the court began with the subsidy paid by the City. It was both intangible and capable of valuation. It also plainly contributed to the hotel’s income stream, and it was necessary because, without it, the hotel would not have been built. The County’s argument that the subsidy runs with the land was irrelevant, because running with the land is not part of the relevant test. It was necessary for the AAB to deduct the subsidy.

Moving to the $36 million key money payment, the court described the amount as a discount. The discount was not income to the hotel; it was a price break the Managers gave the hotel on payments from the hotel. A discount is not income, so the County’s argument that the key money was like prepaid rent was not persuasive. Likewise, it was not relevant that the contract gave the Managers rights and duties tied to the use of the hotel property. The payment meets the test to require deduction from the assessment.

Finally, the court turned to the enterprise assets. The AAB rejected those deductions because Olympic did not own the intangibles, and the expert’s analysis was not compelling or reliable. But the court disagreed, finding that the evidence must be meaningfully analyzed.

The County argued that its assessment identified and completely removed the value of Olympic’s interest in the Manager’s franchises and workforces because “the deduction of the hotel owner’s payment of a franchise fee to an operator completely accounts for the value of the franchise affiliation and the associated workforce. The court found this argument “incorrect.” If the franchise fee were so high as to account completely for all intangible benefits to a hotel owner, the owner would have no reason to agree to the fran-
chise deal. The article offered by the County, written by an appraiser, contained “no empirical support for the illogical premise that every franchise fee wipes out all intangible benefits a franchise agreement might offer a hotel owner.” Accordingly, the Court reversed the superior court’s and AAB’s ruling that the subsidy and key money are taxable as real property, but affirmed the trial court’s order remanding for the AAB to value and deduct the hotel enterprise assets. The court expressly ordered that the values of the subsidy, the key money, and whatever values the AAB assigns to the enterprise assets be excluded from the property assessment and ordered further proceedings.

Olympic and Georgia Partners LLC v. County of Los Angeles
California Court of Appeal, Second District
April 7, 2023
90 Cal. App. 5th 100

Note: On July 12, 2023, the California Supreme Court granted a petition to review the Court of Appeal’s decision. 531 P.3d 966.

Trade fixture installed in leased property can be removed prior to termination of lease

In August 2006, Urge Food Corporation (Urge) and EBC Properties LLC (EBC), as tenant and landlord, respectively, entered into a thirteen-year lease contract in which Urge rented a commercial retail space in a strip mall in Adelphi, Maryland. The lease permitted Urge to freely make improvements and alterations to the premises, so long as such improvements did not affect the building’s structure. The lease further provided that such improvements, including trade fixtures, not permanently affixed to the building would remain Urge’s property unless abandoned in the event of default or the termination of the lease. In the event of default, EBC reserved the right to terminate the lease and repossess the premises, including all of Urge’s property deemed abandoned therein.

The lease imposed on Urge the responsibility to pay two categories of rent: “basic rent,” which was the yearly cost for Urge to use and enjoy the premises, and “additional rent,” which included common area maintenance costs like utilities and security. Failure to pay either type of rent would be treated as a default under the lease.

When Urge took possession, the premises were completely empty, and Urge undertook extensive efforts to ready the location for its intended use as a grocery store. Urge installed numerous chattels, including deli counters, a bakery, display cases, and interior freezer cases. Urge also installed four walk-in coolers connected to the outside of the building that required holes to be cut in an exterior wall. EBC approved all such improvements.

Shortly after Urge began operating its grocery store, crime became an issue. After notifying EBC and finding their response insufficient, Urge began hiring its own security personnel to keep watch of its store and parking lot, but not the other properties in the strip mall. By December 2017, roughly a decade later, EBC also became concerned about crime and hired its own security company to patrol the entire strip mall property. When EBC sought proportional compensation from Urge, Urge refused to pay, maintaining that it did not see a need to pay for redundant security services. EBC pointed out that security costs were part of the common area maintenance (CAM) charges that Urge was required to pay as additional rent.

Through counsel, EBC sent a letter to Urge in May 2019 noting that the lease was set to terminate on September 30, 2019, at which point Urge should vacate the premises. The letter also demanded Urge cure its breach pertaining to $52,084 in unpaid CAM charges. A subsequent letter warned Urge that failure to pay the overdue amounts would be considered a default under the lease, and reminded Urge that, in the event of default, the lease prevented Urge from removing its installed chattels.
Planning to move to a new location, in September 2019, Urge began removing most of the items it had installed as it prepared to vacate. After a confrontation with EBC’s security personnel, EBC told their security not to intervene and to avoid conflict with Urge.

Later that month, Urge filed a complaint, alleging that EBC breached the lease by preventing Urge from removing all of its property, including the exterior walk-in coolers, which were trade fixtures. EBC counterclaimed, alleging that Urge breached the lease by failing to pay additional rent and then further breached by removing fixtures. Following a trial, the court found Urge to be in default for its failure to pay the CAM charges. But the chattels Urge installed at the premises were all trade fixtures, and had not been permanently attached to the realty. As such, the chattels remained the property of Urge, which could remove the items prior to the conclusion of the lease. And while Urge had an obligation to return the premises to their original state, by locking Urge out of the building, EBC prevented Urge from removing its chattels and repairing the damage to the premises. EBC appealed.

The appellate court first found that the trial court was factually and legally correct in finding that the property installed by Urge constituted trade fixtures because of their movable status coupled with Urge’s clear intention to use them to carry out its grocery business. Whether a chattel changes from personal property to a fixture attached to the realty is a mixed question of fact and law. The general rule is that whatever is once annexed to the freehold becomes part of it, and cannot afterwards be removed except by the person who is entitled to the inheritance. The exception to this common law rule pertains to trade fixtures, which are not treated as part of the realty but remain removable by the tenant. A trade fixture is an item affixed to realty for the purpose of enabling the tenant to perform a trade, which can be removed without material or permanent injury to the realty.

Here, the record contained ample evidence from which the trial court arrived at the sound conclusion that the chattels installed by Urge prior to the operation of their grocery business constituted trade fixtures. The court therefore affirmed the trial court’s ruling that the chattels installed by Urge were trade fixtures, and Urge could remove them prior to termination of the lease, barring any controlling provisions of the lease to the contrary.

Urge’s breach of the lease due to its failure to pay the outstanding additional rents was not before the appellate court. But germane to the matter regarding the removal of the trade fixtures, though, is the timing of when Urge defaulted, and how that default affected other rights and obligations under the lease. The lease defined the tenant’s default as a failure to pay rent within ten days of written notice and provided the landlord the option upon such default of terminating the lease. Reading the various lease provisions in concert, the appellate court agreed with EBC that Urge was in default when it failed to cure within 10 days of receiving notice of its delinquency. As such, EBC could have exercised its remedies under the lease at any point between the close of the ten-day notice period and the actual termination date of the lease. But EBC never took such steps, allowing Urge to remain on the premises until the end of the lease term, so Urge retained its ownership of the trade fixtures. Consequently, Urge did not commit further breach by removing its trade fixtures.

The appellate court did, however, reverse the trial court in one respect. Both the common law regarding trade fixtures and the terms of the lease required Urge to repair the damage to the premises caused by the installation and removal of its trade fixtures and to do so by the end of the lease term. Thus, by the express provisions of the lease, Urge’s repairs were to have been completed by September 30, 2019. The appellate court “struggled to decipher” the evidence as to whether and how Urge may have been frustrated in completing
its contractual obligations. Urge’s witness testified that Urge would have completed all repairs had its efforts not been thwarted by EBC’s security personnel. But EBC’s security manager testified he was instructed not to interfere with Urge’s access to the premises. Based on this conflicting testimony, the court found insufficient clarity in the trial court’s ruling that Urge was relieved from this obligation and the resulting damages.

Accordingly, the trial court’s findings as to Urge’s ownership of the trade fixtures were affirmed, but the case was remanded to the trial court for further proceedings on the question of whether Urge’s failure to repair the premises should result in liability for damages regarding the repairs.

EBC Properties LLC v. Urge Food Corp.
Maryland Appellate Court
February 28, 2023
290 A.3d 1053

Ambiguous contract language requires weighing of external evidence

29 Main Street LLC (29 Main Street) owns a building in New Milford, Connecticut, a portion of which has been leased to the US Postal Service (USPS) since 1969. The building is located on a prime corner on the town green. The 1969 lease provides a purchase option for the property, giving the government the “option to purchase the fee simple title to the leased premises, including the underlying land,” at certain times and prices. There was also another, subsequent lease for additional portions of the property executed in 2000. On the same day as the execution of the 2000 additional space lease, a USPS contract officer executed a Memorandum of Lease (Memorandum) memorializing certain terms of the 2000 additional space lease.

Eventually, USPS exercised its purchase option, but the parties disagreed about the scope of the option in the lease, ultimately leading to litigation in the US District Court for the District of Connecticut. The district court granted summary judgment in favor of USPS. The district court concluded that the 1969 lease was unambiguous, and therefore did not require or permit consideration of extrinsic evidence concerning the parties’ intent. 29 Main Street appealed to the Second Circuit Court of Appeals.

When construing the terms of a contract, a court must first consider whether the relevant provisions are ambiguous. A contract is ambiguous if it is susceptible to two different and reasonable interpretations, each of which is found to be consistent with the contract language. When a contract’s terms are ambiguous, the weighing of external evidence is required and the matter is not amenable to summary resolution.

The court of appeals found that the purchase option in the 1969 lease is ambiguous because it is susceptible to more than one reasonable interpretation. The ambiguity surrounds the parties’ use of the phrase “leased premises, including the underlying land.”

On the one hand, in its description of the leased premises, the lease contains metes-and-bounds language describing the contours of the entire subject property. So “fee simple title to the leased premises, including the underlying land” could mean “fee simple to… the underlying land” of the entire subject property and the entirety of the structures built on top of that land. This was the interpretation adopted by the district court. By deleting the “leased-premises” qualifier, the district court concluded that the subject of the sale was title to the underlying land and, as a matter of law, the entire building thereon.

But on the other hand, the 1969 lease makes clear that the leased premises did not include all of the subject property. It expressly carved out spaces from the leased premises, resulting in a lease that covered only about 80% of the first floor and less than 10% of the basement. Thus, it is equally plausible that “fee simple title to the
leased premises, including the underlying land” would include only the leased portions of the building and the land underlying those areas, but not the balance of the subject property or the land beneath the unleased portions.

Because there are two different and reasonable interpretations of the language in the 1969 lease consistent with the contract language, the district court erred in granting summary judgment to USPS; the matter required a weighing of external evidence as to the intended meaning of the 1969 lease.

29 Main Street also argued that the 2000 Memorandum extinguished the purchase option in the 1969 lease. The parties executed an additional lease to cover areas of the first floor and basement that were not leased under the 1969 lease. The 2000 Memorandum declares that “there are no purchase options available.” 29 Main Street argued that this language conflicts with and thus supersedes the purchase option in the 1969 lease.

The court of appeals did not agree with 29 Main Street. The court found that nothing about the natural and ordinary meaning of the language in the 2000 Memorandum—which did not even reference the 1969 lease—suggests that the parties intended to have the 2000 Memorandum supersed, modify, or rescind the 1969 lease. Thus, the court of appeals agreed with the district court that the no-purchase-options language is unambiguous and susceptible to only one reasonable interpretation—that there are no purchase options with regard to the property covered by the 2000 lease of additional space.

In light of the ambiguity surrounding the 1969 lease, but not the 2000 Memorandum, the district court erred in granting summary judgment to USPS. Its judgment was vacated, and the case was remanded for further proceedings.

29 Main Street LLC v. U.S. Postal Service
US Second Circuit Court of Appeals
May 4, 2023
2023 WL 3243478

In partition of property, the parties’ relative ability to timely buy out interests is appropriate equitable consideration

Beverly Wells and her brother Robert Newton each owned a half-interest in a property in Stowe, Vermont, as tenants in common. The property is 0.39 acres and contains two buildings separated by a shared driveway leading to a parking area at the rear of the lot. One building was a single-family home, and the other was a 1,500-square-foot office building.

At some point, Beverly transferred her interest to her children Newton and Jason Wells (the Wellses), and Robert transferred his interest to Pall Spera. Prior to Beverly’s transfer of her interest, she signed a partnership agreement with Spera, which provided certain duties and rights accruing to each owner, and established accounting procedures to distribute profits and pay expenses.

By 2017, the house on the property had fallen into significant disrepair, so the Wellses began a major reconstruction project on the house. Without first obtaining Spera’s consent, and eventually over his objection, the Wellses spent $394,632 on labor and materials. The Wellses prepared and submitted to the town an application to subdivide the property, but Spera refused to sign it. The Wellses filed suit seeking to partition the property.

The court appointed three commissioners and directed them to determine whether the property could be divided, assigned to one of the parties, or sold. They were also ordered to determine the fair market value of the property and each party’s equitable share. The commissioners held an evidentiary hearing in 2021. Neither party obtained an appraisal. Newton Wells, who was not a real estate broker and did not have specialized training in Vermont real estate matters, testified that the combined value of the property was $2,000,000. Spera, who was a real estate broker, testified that the property’s value was $1,500,000,
with one-third attributable to the office building and two-thirds to the house. The commissioners credited Spera’s testimony.

The commissioners also found that the property was nonconforming, and division would result in increased nonconformity with respect to lot size and setback requirements. The probability of obtaining variances for the nonconformities was “unlikely at best.” Also, physical changes to the parking area under separate ownership would greatly inconvenience separate owners.

Based on these findings, the commissioners concluded that physical division would cause great inconvenience to the parties. Subdivision without zoning approval would likely render the divided properties unmarketable, thereby decreasing the combined value of the property. Finding division inequitable, the commissioners awarded Spera first right of assignment due to his ability to buy out the Wellses’ interest immediately, while the Wellses would have required a loan to do so, and because partition would constitute dissolution of the partnership agreement. The court entered judgment adopting the commissioners’ findings, and the Wellses were awarded half of the $1,500,000 value plus half of their reconstruction costs. The Wellses appealed to the state supreme court.

The Wellses’ contention on appeal was that the commissioners’ conclusions regarding potential zoning violations were mistaken as a matter of law, and alternatively that the commissioners abused their discretion by awarding first right of assignment to Spera and miscalculated their equitable interest.

The Wellses first argued that the failure to divide the property offends the long-standing preference to order partition in kind over assignment or sale. The court agreed that partition in kind is favored over assignment, but it noted that the test used to determine if division is possible is whether it would materially decrease the property’s value. Given the serious zoning hurdles, the commissioners concluded that the property could not be physically divided without creating great inconvenience to the parties and doing so “has the very real potential to materially decrease or perhaps even extinguish the property’s value.” Thus, the issue is not whether the commissioners concluded partition in kind was inequitable purely because division would create zoning violations; instead, the question is whether the commissioners’ findings regarding potential zoning violations supported their conclusion that division would materially decrease the property’s value.

The court left for another day the question of whether zoning violations alone can override a court’s power to divide real property. But taken together, the commissioners’ findings demonstrated that they did not abuse their discretion in determining that division would cause great inconvenience to the parties. The trial court did not err in accepting that portion of the commissioners’ report.

The Wellses further argued that the commissioners erred in how they assigned the property to Spera. The Wellses maintained that any debt they would incur to buy out Spera is not a proper equitable consideration in assigning the property. But the court disagreed. Citing precedent, the court noted that the parties’ relative abilities to timely buy out each others’ interests are appropriate equitable considerations. Furthermore, the commissioners’ decision to assign the property to Spera was based on both the ability to pay and fairness with respect to the partnership Spera otherwise wished to continue.

Finding no error in the trial court’s decision to adopt the report of the commissioners, the court affirmed.

Wells v. Spera  
Vermont Supreme Court  
March 17, 2023  
293 A.3d 330
Different rules control compensation for eminent domain powers and police powers

DEKK Property Development LLC (DEKK) owns a four-acre lot at the southeast corner of State Highway 50 and County Highway H in Kenosha County, Wisconsin. The parcel has one driveway connecting it with Highway 50, which runs along the parcel’s north edge, and one driveway connecting it with Highway H, which runs along its western edge.

In 2019, the Wisconsin Department of Transportation (DOT) sought to acquire a part of the property, a strip of land abutting Highway H, as part of a project to improve Highway 50. DOT commissioned an appraisal of the property as required by state statute. The appraisal valued the part of the parcel that was to be taken and explained that DOT was not seeking to acquire any access rights. But the report also noted that the driveway between the property and Highway 50 would have to be closed, and that DOT would not compensate DEKK for the closure, because the building the driveway served had been demolished and redevelopment of the parcel would require new driveway approvals at a location farther from the intersection.

After DOT provided the appraisal report to DEKK, DEKK asked about the lack of compensation for the driveway closure. A DOT employee explained that at the time of the acquisition the driveway would remain in place, and that any revocation of the access point would be non-compensable now—because it had not happened yet—and if it did occur, it would be revoked through DOT’s police power. DOT then issued an offer to DEKK as required by statute, offering $272,100 for the permanent taking. It did not offer to purchase any access rights, nor did it reference any driveway closures. DEKK did not challenge the purchase of its land or the related easements.

After DOT issued the offer, DEKK filed an action under one of the state taking statutes, Wisc. Stat. § 32.05(5), challenging DOT’s right to remove DEKK’s rights of access to Highway 50.

Shortly afterwards, DOT sent a letter to DEKK providing official notice that it planned to remove the existing driveway. The letter explained that DEKK could contest the removal by submitting an objection letter. It is not clear if DEKK took advantage of this administrative review process. But after receiving the notice, DEKK filed a motion for a temporary restraining order and injunction to prevent DOT from closing the driveway. The circuit court granted the motions, and DOT appealed. The court of appeals reversed, reasoning that DOT was within its rights to close the driveway without compensation as an exercise of police power. DEKK appealed to the state supreme court.

When DOT determines that it is necessary to take private property under its eminent domain authority, it must pay just compensation. But not all state actions that affect private property result in a compensable taking. Injuries to property that result from a valid exercise of the state’s police power are generally not compensable. Compensable eminent domain and non-compensable police power actions can occur contemporaneously, and DOT may exercise both powers as part of the same highway construction project.

When DOT exercises its eminent domain authority, it must follow the procedures in Wis. Stat. § 32.05, namely obtaining an appraisal, negotiating with the owner, and making an offer to purchase the property. If the owner rejects the offer, the owner may file a “right to take” action under § 32.05(5).

But § 32.05(5) is just one of several statutes that enable property owners to challenge DOT actions affecting private property. The appropriate statute depends on the facts of the case and the nature of the challenged governmental action. The statutes are not, however, interchangeable, and even if a construction project results in damages that are compensable under a particular statute, those damages cannot be recovered in a
claim brought under the wrong statute. Moreover, even when DOT undertakes different projects that are part of the same overall highway construction project, that does not necessarily merge each project into a single compensable act, even when the projects affect the same property owner and occur at the same time.

DEKK filed its claims under § 32.05(5). That statute sets out a process by which DEKK may “contest the right of the condemnor to condemn the property described in the offer.” Thus, if the offer had addressed DEKK’s access to Highway 50, or if DEKK sought to challenge DOT’s right to take the parcel, then § 32.05(5) would be the proper procedural mechanism by which DEKK could bring its claim. Here, the offer addressed only permanent and temporary takings along Highway H, and that parcel did not touch the driveway to Highway 50. The offer did not indicate that DOT was seeking to remove any access rights.

Thus, the court concluded that § 32.05(5) was not the appropriate means for determining the nature of DEKK’s access rights to Highway 50, whether those rights were being impeded, or whether such impediment is compensable. The court did not need to decide whether DEKK might recover damages for the driveway closure through a different procedural avenue, but in this case, the trial court should have granted summary judgment in DOT’s favor.

DEKK Property Development LLC v. Wisconsin Dep’t of Transportation
Wisconsin Supreme Court
April 18, 2023
988 N.W.2d 653

Property taken by adverse possession cannot be conveyed in mortgage

In 1982, John and Suzan Driscoll purchased property at 19 Crestwood Road in North Reading, Massachusetts. They had a house built on their lot, and they moved there in late 1982. The neighboring lot, 17 Crestwood Road, was sold to Diane Russo (who eventually remarried and took the name Thornton). She moved into the newly built home in 1984. When the Driscolls and Russo moved to Crestwood Road, the front yards were unfenced and their lawns were continuous.

In 1985, Russo built an in-ground pool. To meet local regulations, a large part of the backyard was surrounded with a solid fence. One part of the fence ran parallel to, but nine feet inside, the property line between the lots. Another part of the fence ran parallel to, but sixteen feet inside, the property line with the abutting lot at 15 Crestwood Road. A house was later built on 15 Crestwood Road. John Driscoll’s brother, Fred, and his wife Michelle ultimately purchased the house.

In 1986, John and Suzan installed a pool in their backyard and also built a fence around their rear yard. The fence began at the side of their residence, then encroached five feet into 17 Crestwood, then ran parallel to the property line until meeting the corner of the Russo fence. Thus, the two fences effectively surrounded a portion of 17 Crestwood Road and made that area appear to be part of John and Suzan’s yard.

Thornton did not give John and Suzan permission to install their fence on her lawn, but after it was built, John and Suzan maintained the enclosed area exclusively. They chose its landscaping, and installed part of their irrigation system within it. At all times, John and Suzan’s maintenance of the enclosed area was or should have been apparent to Thornton.

When Fred and Michelle moved to 15 Crestwood in 1989, the fence had already been built, and they maintained the area between the fence and their property line. Shortly after moving in,
they installed a playset in the area (without obtaining permission from Thornton). In 1998, Fred and Michelle built a two-foot-tall retaining wall running perpendicular to the property line, which encroached into 17 Crestwood by seventeen feet. The wall’s construction caused the area to be surrounded by artificial barriers, and Fred and Michelle continued to maintain the area exclusively. Fred and Michelle’s activities in the area, and those of their children and grandchildren, were obvious to Thornton.

Fred and Michelle also created a garden bed in the corner of their property in 1992. The bed encroaches into 17 Crestwood, as does the under-water irrigation system installed by Fred and Michelle. As with the other areas, Thornton never gave permission to extend the garden into her property. There were also unenclosed areas of the front yard that both Thornton and Fred and Michelle mowed and maintained.

In February 2015, Thornton granted a mortgage on the property to Quicken Loans, which was later assigned to Rocket Mortgage. The mortgage states it includes the entirety of 17 Crestwood Road. The mortgagor was not granted a right to possess 17 Crestwood, however, prior to default or foreclosure under the mortgage.

The conflict eventually resulted in Thornton suing the various Driscolls for trespass, with the Driscolls counterclaiming that, by virtue of their landscaping and other activities, they had respectively acquired areas of 17 Crestwood by adverse possession. The case was tried by the Massachusetts Land Court in 2022.

Title by adverse possession can be acquired only by proof of nonpermissive use that is actual, open, notorious, exclusive, and adverse for twenty years. To establish “actual” use, the claimant must prove changes upon the land that constitute control and dominion over the premises commonly associated with ownership. The use must also be “adverse,” but under state law, if the claimant establishes actual, open, and exclusive use of a disputed area for 20 years, a rebuttable presumption arises in favor of the claimant that his use is adverse.

The court found that the strongest claim for adverse possession was that of John and Suzan over the enclosed area. They continuously used the area after 1986, well over twenty years prior to counterclaiming adverse possession. The court found that all of the requirements of the five-part test were met. The fact that Thornton erected the first of the fences that subsequently surrounded the enclosed area did not defeat John and Suzan’s claim.

The court found that at the other end of the spectrum were the Driscolls’ claims regarding unenclosed lawn areas. Routine lawn maintenance, with little or nothing more, does not serve to sufficiently exert dominion and control or place the true owner on notice of an adverse claim. This is particularly true where, as here, the property’s rightful owner concurrently maintained the disputed area in the same manner as the claimant.

Fred and Michelle’s activities in the garden bed and area enclosed by the wall fell between these extremes. Once they built the wall, the area was enclosed on three sides, and their maintenance and construction in the area showed dominion and control. Similarly, the garden bed was landscaped, maintained, and controlled by Fred and Michelle. But the area outside the wall and fence, though similarly dominated and controlled by Fred and Michelle, was only controlled beginning in 2005 when they added a water feature in the area. Thus, twenty years had not passed by the time Thornton sued them for trespass, so it was not taken by adverse possession.

The court, having concluded that some areas of 17 Crestwood were taken by adverse possession, then turned to the question of the 2015 mortgage on the property. Mortgage transactions are conveyances of title in Massachusetts, because Massachusetts is a “title theory” state. That means that when the owner/borrower grants a mortgage in a property, the owner is conveying to
the mortgagee/lender the owner’s legal title in the property, with equitable title remaining with the owner. It is axiomatic, however, that a grantor can only convey that which is theirs to convey; thus if a person lacks title to a property, they have nothing to convey to a mortgagee.

Thornto lost the enclosed area to John and Suzan in 2006 (twenty years after the 1986 construction of the fence) and the garden bed to Fred and Michelle in 2012, before Thornton granted the mortgage. The mortgage thus did not include those areas, and the new owners of those areas hold their title free and clear of the mortgage.

The situation was different, though, for the area enclosed by Fred and Michelle’s wall. The wall was built in 1998, so Thornton still had title to that area at the time she granted the mortgage in 2015. By virtue of state statute, Thornton validly granted the mortgage, notwithstanding Fred and Michelle’s long-open, obvious, adverse, and exclusive use of the area. But under Massachusetts law, a mortgagee who lacks possession of a mortgaged property generally is unable to protect the premises from an adverse possessor’s activities. The recording of a mortgage puts the adverse possessor on constructive notice, though, that a disputed property is subject to a mortgage, so the adverse possessor is free to continue or suspend his possession of that property.

Given these factors, the court held that Fred and Michelle had acquired the area behind their wall subject to the mortgage. Fred and Michelle were, however, ordered to remove all encroachments from the areas not taken by adverse possession. Thus, the Driscolls all took some of 17 Crestwood by adverse possession, and Thornton was granted relief from the Driscolls’ trespass on the property that remained hers.

Thornton v. Driscoll
Massachusetts Land Court
September 8, 2022
2022 WL 4102263

Determination of loss value and covered loss value are separate determinations

Edmond and Kathleen Krafchow owned real property on the island of Maui. There were three structures on the property: a villa, a cottage, and a garage. The structures were insured under separate insurance policies issued by Dongbu Insurance Co. (DB) to the Krafchows. A homeowners policy covered the villa, while the cottage and the garage were covered by dwelling fire policies.

The policies contained appraisal provisions. If both parties failed to agree on the amount of loss, either may demand an appraisal of the loss. Each party would choose a competent and impartial appraiser, and the appraisers would choose an umpire. The appraisers would separately set the amount of loss, and if they disagreed, the matter would go to the umpire. A decision agreed to by any two would set the amount of the loss.

The structures and their contents were damaged because of a wildfire. The Krafchows made insurance claims for their loss. DB tendered over $300,000 to the Krafchows under reservations of rights, pending preparation of final settlement figures. DB also raised issues about coverage and limits of liability. The parties disagreed on the amount of the Krafchows’ loss. The Krafchows invoked the appraisal provisions of the insurance policies, but DB did not name an appraiser. The Krafchows then sued DB, alleging that DB breached the insurance policies by failing to participate in the appraisal process.

The Krafchows filed a motion to compel appraisals, which DB opposed. DB argued it was premature to appraise the amount of loss because coverage issues had not been resolved. The trial court granted the motion to compel appraisal, without referring to insurance coverage, and appointed a retired judge to serve as umpire.

Edmond and Kathleen Krafchow owned real property on the island of Maui. There were three structures on the property: a villa, a cottage, and a garage. The structures were insured under separate insurance policies issued by Dongbu Insurance Co. (DB) to the Krafchows. A homeowners policy covered the villa, while the cottage and the garage were covered by dwelling fire policies.

The policies contained appraisal provisions. If both parties failed to agree on the amount of loss, either may demand an appraisal of the loss. Each party would choose a competent and impartial appraiser, and the appraisers would choose an umpire. The appraisers would separately set the amount of loss, and if they disagreed, the matter would go to the umpire. A decision agreed to by any two would set the amount of the loss.

The structures and their contents were damaged because of a wildfire. The Krafchows made insurance claims for their loss. DB tendered over $300,000 to the Krafchows under reservations of rights, pending preparation of final settlement figures. DB also raised issues about coverage and limits of liability. The parties disagreed on the amount of the Krafchows’ loss. The Krafchows invoked the appraisal provisions of the insurance policies, but DB did not name an appraiser. The Krafchows then sued DB, alleging that DB breached the insurance policies by failing to participate in the appraisal process.

The Krafchows filed a motion to compel appraisals, which DB opposed. DB argued it was premature to appraise the amount of loss because coverage issues had not been resolved. The trial court granted the motion to compel appraisal, without referring to insurance coverage, and appointed a retired judge to serve as umpire.
The parties’ selected appraisers did not agree on the amount of loss. The umpire agreed with the Krafchows’ appraisals, which each stated that the appraisers “carefully examined the documents and/or the damaged property and/or evidence thereof and have determined the following values and loss.” Each appraisal established actual cost value for various categories of loss, reduced the appraised amount by a deductible amount, and stated that the award “shall be payable within twenty calendar days.”

At a later court hearing to confirm the appraisals, DB argued that the function of appraisers is to determine the amount of damage resulting to various items submitted for their consideration; it is not their function to resolve questions of coverage and interpret provisions of the policy. The trial court rejected the argument that the appraisers and umpire exceeded their scope of authority, because the court ordered them to determine the appraisal amounts. DB appealed from the order granting the Krafchows’ motion to confirm the appraisals.

On appeal, DB contended that the trial court erred by adopting the appraisals, because the appraiser and umpire exceeded their authority when they considered insurance coverage issues and decided whether the policies provided coverage for certain claimed loss. The appellate court agreed.

The appraisal provisions in the insurance policies state that the appraiser and the umpire, if necessary, are to determine the amount of loss. None of the policies defined the word loss, though the word appeared 258 times in the homeowners policy and 149 times in each of the dwelling fire policies, with and without qualifiers. The court thus gave the word its common meaning as a “decrease in amount, magnitude, value, or degree.”

DB and the Krafchows disagreed on the amount of the Krafchows’ loss because of the wildfire. The insurance policies require that the amount of loss be determined by the appraisers and, if needed, the umpire. But not all of the loss is necessarily insured or covered under the insurance policies: DB’s liability to pay for a loss is limited by the coverage provisions exclusions, and other terms and conditions of the policies. The appraisal provision does not limit itself to covered loss; it does not preclude appraisal of non-covered or excluded loss; and it does not empower the appraisers to consider policy or coverage defenses.

Under the circumstances of this case, the unqualified word loss in the appraisal provision refers to the Krafchows’ loss because of the wildfire, not what DB is obligated to pay under any of the Krafchows’ insurance policies. The appraisers and umpire had no power to decide what amounts DB owed to the Krafchows under the insurance policies, because those coverage issues must be decided by the trial court.

Because the appraiser and umpire exceeded their powers, the trial court erred by granting the Krafchows’ motion to confirm the appraisals, and by denying DB’s motion to vacate the appraisals. The case was remanded to the trial court for further proceedings.

**Krafchow v. Dongbu Insurance Co.**
Intermediate Court of Appeals of Hawai‘i
February 17, 2023
525 P.3d 697

**Owners of life estate can execute leases that extend beyond their lifetime**

In 1987, C Bar J Ranches owned 100% of the surface and minerals of property located in Laramie County, Wyoming. In May 1987, C Bar J sold the property to William and Charlotte Hutton (Huttons) and provided them a warranty deed conveying the property and one-half of the existing mineral rights. It reserved one-half of the mineral rights for twenty years, providing that at the end of the twenty years, the mineral rights would become the property of the purchaser.
In 1992, before C Bar J’s twenty-year reserved mineral interest terminated, the Huttons sold the property to the Woods family by a contract for deed. A warranty deed conveying the property to the Woods was held in escrow pending the Woods’ performance of their obligations under the contract. The deed granted the Woods “all rights” to the property, but reserved a life estate in all minerals owned by the Huttons and the right to develop those minerals during their lifetimes. On termination of this reservation, the interest would be owned by the Woods. In 2008, the Woods fulfilled the terms of the contract and recorded the deed.

Also in 2008, the Woods entered into two separate contracts for deed, one with Kristin Deselms and one with Hugh Deselms. By those deeds, the Woods conveyed the property and “one-half of the oil, gas, and other minerals” the Woods “now owned” or would later acquire, and reserved the other half for their lives and their children’s lives. The Huttons’ reservation was expressly noted. The Deselms completed their obligations under the deed contracts and recorded the deeds in 2013.

In 2010, after C Bar J’s twenty-year reserved mineral interest terminated, the Huttons leased all of their mineral interests to Cirque Resources, with an option to extend. Cirque exercised its option in 2015, and through a series of assignments in 2018 and 2019, North Silo Resources (NS) acquired Cirque’s interests under the lease and is the current mineral lessee.

NS filed suit seeking a declaration as to the percentage of the mineral estate encumbered by its lease. NS asserted that the deed between C Bar J and the Huttons transferred one-half of the minerals to the Huttons outright and one-half of the minerals to the Huttons as a vested remainder subject to C Bar J’s reservation. Therefore, the Huttons own a life estate in 100% of the minerals, measured by the lives of William and Charlotte Hutton. Accordingly, NS argued that its mineral lease encumbered 100% of the minerals.

The Deselms, the Woods, and the Huttons interpreted the transactions differently. They asserted that the minerals reserved by C Bar J were unvested, and that they had not vested when the Huttons sold the property to the Woods in 1992. The Huttons’ reservation of a life estate in all minerals from the property was limited to the minerals conveyed and did not include minerals reserved by C Bar J. The reserved, unvested minerals transferred to the Woods when the twenty-year contingency expired. Thus, they asserted that the Huttons owned a life estate in 50% of the minerals; the Woods received the 50% C Bar J remainder and subsequently sold half to the Deselms, along with half of their future interest in the Huttons’ half, resulting in them owning a present 25% life estate; and the Deselms own a present interest in 25% of the minerals and a future interest in 25% of the minerals reserved by the Huttons. From that position, they argued that NS’s lease encumbers only 50% of the minerals (those subject to the Huttons life estate).

Following NS’s filing of its lawsuit seeking to quiet title to its mineral lease, the remaining parties filed motions to dismiss, which the trial court largely granted, along with summary judgment motions. The court concluded that the Huttons owned only 50% of the minerals and NS’s lease covered only the Huttons’ 50% mineral interest measured by the life estate of the Huttons. NS appealed.

In construing deeds affecting mineral interests, Wyoming courts focus on the general intent of the parties, concentrating on the purpose of the grant. The parties do not dispute that after the conveyance from C Bar J, the Huttons owned all the surface estate and 50% of the mineral estate. They disagree about the effect of the C Bar J reservation. NS claims the deed vested title to half of the minerals in the Huttons outright and gave them a vested remainder in the other half. After twenty years, the Huttons realized the remainder, giving them a life estate in 100% of the minerals.
The other parties asserted that the reserved minerals did not transfer to the Huttons, because the Huttons had only a contingent remainder, and ownership of the reserved minerals had not yet vested in the Huttons when they sold the property to the Woods.

The state supreme court found the deed to be unambiguous. C Bar J retained a present interest in the reserved half of the mineral estate, and conveyed the remainder of this interest on the expiration of twenty years. A remainder is a future interest created in a transferee. A property interest vests at the point when no contingency can defeat the interest. The remainder created by the deed was vested if some person took the estate under terms that no contingency could defeat. The passage of twenty years was certain to occur and thus was not a contingency that could be defeated.

Here, the Huttons acted as owner of all the mineral rights in the property. They executed an oil and gas lease with Cirque in 2010, and through 2015 they accepted bonus payments under that lease for 100% of the net mineral acreage. None of the other parties did anything indicating that they owned mineral interests during this time. It was not until August 2019, after NS began drilling operations on the property, that the other parties took quarrel with the ownership of the mineral rights. Given the unambiguous terms of the deed, the Huttons received a vested remainder in the reserved 50% of the minerals.

The trial court concluded that the Huttons only owned 50% of the minerals, and they reserved only those minerals that they owned when they entered into the contract with the Woods. But the court held that the Huttons owned a vested remainder in the C Bar J reserved minerals when they executed that contract for deed, and the Huttons expressly reserved “all minerals they may own” for their lifetimes. This clearly reserved a life estate in their presently held mineral interest and their vested remainder. The Woods therefore received the property subject to the Huttons’ reservation of a life estate in 100% of the mineral interests and the executory rights to lease those minerals.

The final question of deed interpretation regarded the scope of the Huttons’ right to encumber the minerals. The trial court concluded that the Huttons’ executive rights permitted them to execute leases, but any such lease is limited by the life estate and cannot extend beyond their lifetimes. NS argued that because the Huttons reserved the mineral estate and executive rights for life, they can execute leases that extend past the life estate.

As a matter of first impression, the court held that while typically a lease executed by a term interest holder would not endure beyond the interest holder’s estate, if a life tenant is granted the power to lease but cannot bind future interests, there would be very little utility to the power because of the natural reluctance of any lessee to accept a lease that might be terminated by the death of the lessor. Here, the reservation of rights limits the period during which the Huttons have the right of making, executing, and delivering leases to their lifetimes. It does not, however, limit the nature of the leases that the Huttons can make. The Huttons retained the power to execute oil and gas leases that extended beyond their lifetimes.

Accordingly, the court held that the lease to NS remains in effect according to its terms, even when the Huttons life estate terminates. The Huttons owned 100% of the mineral interests in the property for their lifetimes, and thus NS’s mineral lease encumbers 100% of the minerals. The trial court’s judgment was reversed.

North Silo Resources LLC v. Deselms
Wyoming Supreme Court
October 26, 2022
518 P3d 1074
Predevelopment lease to a government agency does not constitute a public work construction contract

PSP NE, LLC (Developer) owns land in Luzerne County, Pennsylvania. In July 2019, the Pennsylvania Department of General Services executed a twenty-year lease of a facility to be constructed by Developer and used by the State Police as a barracks and training center. Developer hired, at its own expense, engineers, architects, and others to develop plans incorporating State Police specified requirements. Developer also selected the contractors to prepare the site and build the facility. To finance the construction, Developer took out a bank loan for $15,400,000. The loan was secured by Developer’s land, the facility to be built, Developer’s personal guarantee, and an assignment of all leases. Upon completion, the State Police would take occupancy of the building as tenant and begin lease payments.

The predevelopment lease provided that if the Commonwealth terminated or cancelled the lease before completion of the twenty-year term, the Commonwealth would reimburse Developer for any unamortized costs of renovations, but that would leave Developer with a loss of any difference between the total project and unamortized costs.

In response to a request from Developer for confirmation that its construction of the facility to be leased to the Commonwealth was not subject to the Pennsylvania Prevailing Wage Act (Act)—which ensures that workers employed on public works are paid not less than the prevailing minimum wages—the Bureau of Labor Law Compliance (Bureau) informed Developer that the Act covers the construction project. The Bureau explained that although Developer will provide the initial funds for this project, the lease payments from the State Police will reimburse this initial outlay and, as such, are the ultimate source of funds for this construction.

Developer filed a grievance with the Pennsylvania Prevailing Wage Appeals Board (Board) seeking review of the determination of the Bureau. The Board issued a decision denying Developer’s grievance and affirming the Bureau’s determination. In reaching this decision, the Board applied a state supreme court decision providing that a “public work” is one that involves work performed under contract “paid for in whole or in part with funds from a public body.” Because Developer’s loan agreement required the Commonwealth’s lease payments to be sufficient to cover Developer’s debt service, this established funding by a public body. Developer would recover its amortized construction costs either through rental payments or reimbursement of unamortized costs should the lease terminate early. The Board thus concluded that the agreement did not establish a landlord-tenant lease but rather a public work or construction contract subject to the Act.

Developer appealed to the Commonwealth Court, raising several issues that effectively turned on the single question of whether construction of the facility is a public work subject to the Act. A public work does not require a public body to be directly involved, only that the project must be paid for in whole or in part with public funds.

Developer focused on several factors in arguing that the Act does not apply to its construction project: the Commonwealth did not own the land, did not hire Developer to construct the facility for the Commonwealth to own, and did not provide any funding for the construction of the facility. Developer used its own funds and its own bank loan to purchase the land and construct the facility. The only funds ever to be generated from a public body would be in the form of rent and only after construction was complete and the State Police took occupancy. The rent payments merely give the State Police the right to occupy the facility.

The Bureau, conversely, contended that the predevelopment lease placed the financial risk of the construction upon the Commonwealth,
Cases in Brief

because it must cover unamortized construction costs should the lease terminate early. Further, the lease has a potential thirty-year duration, should it be extended, which constitutes a real estate transfer for purposes of the tax laws. This supports the Board's conclusion that Developer has been engaged to construct a public work within the meaning of the Act.

The court analyzed the economic reality of the transaction, since that is what controls rather than simply referring to the labels appended to documents. Here, the predevelopment lease states that the State Police shall pay rent for the use and occupancy of the premises, not for construction. Developer funded the construction and solely bears responsibility for the repayment of the loan. In short, the economic reality is that Developer provided the funds for the construction of the facility to be leased to the Commonwealth.

The court concluded that the Board erred in holding that the lease was not a bona fide lease. Because Developer established a bona fide lease, the burden shifted to the Bureau, which did not present any evidence that the contractual arrangement was not as it seemed, such as evidence that the reversionary interest was fictional because the building would cease to be useful by the end of the lease term.

Additionally, the court rejected the Bureau's argument that the predevelopment lease effected a real estate transfer. State law treats a build-to-suit lease with a thirty-year term as a transfer that triggers a realty transfer tax. Here, the lease provides one twenty-year term followed by two five-year renewal terms. Renewal of the lease agreement beyond the initial twenty-year term, though, is speculative and not certain. And even assuming the lease effected a real estate transfer for purposes of the tax laws, that is not a factor to be used to determine whether the lease is a construction contract for a public work.

Ultimately, if developers did not expect to cover their construction costs with rental payments, few commercial buildings would ever be built. But Developer's expectation that, over time, it would recover its costs did not convert the bona fide lease into a construction contract. The court reversed the Board's determination and held that the Act did not apply to Developer's construction project.

PSP NE LLC v. Pennsylvania Prevailing Wage Appeals Board
Commonwealth Court of Pennsylvania
March 30, 2023
292 A.3d 1175

Damage to property after closing delay by buyer does not release buyer from specific performance

Duane Bender owned property near Shepherd, Montana. A dispute arose between Bender and Stacey Rosman regarding Rosman's use of a road crossing Bender's property over which Rosman claimed to have an easement to access his residence. Bender filed suit against Rosman in 2018 alleging trespass and tortious interference with contract, and seeking to quiet title.

In December 2019, prior to trial, the parties reached a settlement agreement through mediation. The settlement agreement provided for the purchase of Rosman's property by Bender. The agreement stated that Bender agreed to purchase Rosman's property "for a sum equal to the greater of the appraised value or $170,000." The closing was to be on or before April 1, 2020, and Bender would not be obligated to purchase the property if it was not "in substantially the same condition on the date of closing" as it had been at the time of the inspection. Finally, the parties agreed to specific enforcement of the agreement if it was breached by any party.

Following the execution of the agreement, Bender conducted a walkthrough of the property and scheduled an appraisal for January 2020. But
Bender cancelled the appraisal on the day it was scheduled to occur, and he continued to delay the proceedings. After more delays, Rosman hired an appraiser who valued the property at $202,000. Bender never fulfilled his obligation under the agreement to have the property appraised, so only the appraisal commissioned by Rosman was timely accomplished.

In time for the April 1, 2020 closing, Rosman vacated the property in preparation for delivering possession to Bender. However, Bender rejected the appraisal and insisted he would only pay $170,000 for the property, and failed to close by the deadline. Rosman filed an emergency motion asking the court to enforce the settlement agreement, but attempts to conduct a hearing were hampered by a series of delays solely attributable to Bender. The night before the case was set for a final hearing, the residence on the property burned and was a complete loss. When the case was later heard by the trial court, the court issued an order enforcing the agreement and concluding that, under the agreement, Bender was required to purchase the property for $202,000. Bender appealed.

Settlement agreements are contracts, subject to the provisions of contract law. There was no dispute that a contract for sale of the property was formed by the parties’ agreement. Rather, the parties dispute the effect of the agreement’s terms. Bender argued that he is not obligated to purchase the property because it burned down and was therefore not in “substantially the same condition” as when he inspected it. Bender alternatively argued that the agreement’s language functions as a “risk of loss provision” that assigned the risk of loss to Rosman as the seller. Rosman countered that the property burned after the contractual closing deadline was missed due to Bender’s breach, and therefore the doctrine of equitable conversion dictates the risk of loss lay with Bender.

A “condition precedent” is one that is to be performed before some right dependent thereon accrues or some act dependent thereon is performed. A condition precedent can apply to either the formation of a contract (which predicates the existence of the contract on satisfaction of the condition) or the performance of the contract obligation (which predicates the duty to perform on satisfaction of the condition). Non-satisfaction of a condition precedent to contract formation renders the contemplated contract non-existent, whereas non-satisfaction of a condition precedent to performance generally constitutes a breach of an enforceable contract.

The state supreme court concluded that the agreement had two conditions precedent: that Bender would pay for an appraisal of the property for the purchase price to be set; and that the property remain in substantially the same condition at closing. Rosman was bound to sell the property for the purchase price determined upon appraisal, and Bender was bound to commission an appraisal and purchase the property if the condition of the property remained substantially the same. Thus, the parties formed an agreement that included provisions that functioned as conditions precedent to performance of the agreement.

If Rosman did not adequately maintain the property to the agreed date of closing, then the condition precedent would fail, and Bender would be excused from purchasing it. Conversely, if Rosman adequately maintained the property to the date of closing, the condition precedent would be satisfied, and Bender would be obligated to purchase the property. Here, the record showed that the condition of the property remained the same through April 1, 2020, the contractual date of closing. Thus, no later than April 1, 2020, Bender was required to purchase the property at the determined purchase price. Bender repeatedly interfered with the process, all in an effort to force Rosman to sell the property for $170,000 in contravention of the agreement’s appraisal process, and that was the reason closing did not occur by that date.

As for the condition precedent that Bender
obtain an appraisal, a condition may be waived by the party for whose benefit it is made. It may not be waived by the party it binds. There was thus no merit to Bender’s assertion that his failure to pay for an appraisal freed him from the obligation to buy the property. Only Rosman could wield non-satisfaction of that duty to excuse himself from performance, and he did not.

Finally, as to the assignment of risk of loss, Montana courts have adopted the doctrine of equitable conversion to adjudicate interests of parties. Under the doctrine generally, when a contract for sale of real property is formed, the beneficial interest of the property vests with the buyer, while the seller retains legal title only as security for the purchase price. When a contract is silent regarding allocation of risk of loss, equitable conversion places upon the buyer the risk of loss during the course of the contract.

Bender argued that the provision requiring the property be kept in the same condition through closing assigned the risk of loss to Rosman. The court agreed, but not in the way Bender intended. Had the property burned down before closing, this language would excuse Bender from his contractual obligation to purchase the property, and thus it placed the risk of loss on Rosman as the seller. But the operable period of this provision was limited in duration, placing the risk of loss upon Rosman only through closing. The closing deadline was breached by Bender, the risk of loss thereafter shifted to Bender, and the property burned three months later.

Because Bender breached his vested performance obligation to purchase the property by the closing deadline, his breach triggered the agreement’s specific enforcement provision. Rosman was entitled to relief, and the trial court’s judgment in favor of Rosman was affirmed.

Bender v. Rosman
Montana Supreme Court
July 18, 2023
2023 WL 4571938

Board of Equalization may substitute alternative valuation approach for tax purposes where statutory approach does not produce actual value

In 2017, Western Tabor Ranch Apartments LLC (Western) acquired a 49-unit apartment complex in North Platte, Nebraska, for $1,340,000. Under a land use restriction agreement with the Nebraska Investment Finance Authority, the property was subject to rent restrictions until 2046. Before Western acquired the property, a private appraisal indicated the leased fee interest in the property had a market value of $1,350,600.

For the 2018 tax year, the Lincoln County assessor’s office (Assessor) attempted to appraise the property using the income approach, as contemplated by statute. The statute supports a preference for the income approach to result in the most accurate determination of the actual value of rent-restricted housing projects. To facilitate this income approach, the statute requires that owners of rent-restricted housing projects file annual reports that detail the actual income and expense for the prior year. Each county assessor must use that actual income expense data to value such properties, unless certain exceptions applied.

For 2018, the Assessor received two different income and expense reports for the property for 2016 that resulted in significantly different valuations. Under the first report, the value of the property would be $1,040,800. Under the second report, the value was $1,546,500. The Assessor’s practice for all rent-restricted properties was to average the last three years of available income and expense reports. Doing so here resulted in a market value of $1,519,000 for 2018. And because Western did not file the required reports for the 2019 and 2020 tax years, the Assessor carried over the same income calculation from 2018. Western protested the 2018, 2019, and 2020 assessments, and the county Board of Equaliza-
tion (Board) affirmed the Assessor’s value for each year. Western appealed to the state Tax Equalization and Review Commission (TERC).

At the TERC hearing, Western's owner testified that he was unaware that the property was rent restricted and subject to the statute. He argued that the purchase price and private appraisal were evidence that the property’s actual value was lower than the Assessor’s $1,519,000 assessment. The Assessor testified that it lacked enough information to determine which income report to use, and that using a single year of data for 2018 would have resulted in a higher value than using three years of data as the Assessor had done.

TERC determined that the appraisal rebutted the presumption that the Board acted with sufficient competent evidence and satisfied Western’s burden to demonstrate that the Board's decision was arbitrary or unreasonable. TERC reasoned that the statute did not change the overall requirement that all real property be valued at its full market value. The Assessor failed to use any of the statutory methods of valuation in carrying over its 2018 value for 2019 and 2020. Thus, TERC accepted the appraisal’s valuation of $1,350,600 for all three tax years. The Board appealed to the state supreme court.

On appeal, the Board argued that TERC erred by determining that its decision to uphold the Assessor’s value of the property was unreasonable. The Board claimed that the statute required TERC to use the income approach to calculate actual value, and TERC was not permitted to consider the private appraisal as evidence of the property’s actual value. On appeal, the state supreme court did not agree.

Although appraisal is not an exact science, Nebraska’s statutes provide a framework for assessing real property and appealing those assessments. With limited exceptions, all real property shall be valued at its actual value (i.e., market value). Because this case involves a rent-restricted housing project, it is specifically governed by the statute requiring the use of an income approach to value such properties. The statute provides three exceptions: assessors can use any accepted method to value property if the owner fails to timely file actual income data; assessors can use an alternate method if the assessor believes the income approach does not result in a valuation at actual value; and the assessor can adjust the capitalization rate using a similar procedure.

All three exceptions, though, contemplate scenarios where the income approach methodology will not result in the most accurate determination of actual value of the rent-restricted project. But nothing in the statute permits the use of actual income and expense data from years other than the prior year, and nowhere does the statute contemplate using multiple years of data when using the income approach.

For the 2018 tax year, an income and expense report was required by July 2017 for the previous year, 2016. Two reports showing such data were timely provided, and therefore the first exception to the statute was not at issue. The fact that two conflicting reports were submitted for 2016 does not alter the statute’s requirements. The statute did not allow the Assessor to average the 2016 data with earlier years. If the two data sets caused the Assessor to doubt the accuracy of the income approach valuation, it should have petitioned to use a different valuation method under that exception rather than substituting its own modified income approach.

For 2019 and 2020, the case was just as clear. Nothing in the statute allows for the prior year’s value to be simply carried forward, even if no new income reports are filed. Carrying over the 2018 income approach calculation “only compounded the violation” of the statute. There was also no evidence that the Assessor determined the actual value of the property for 2019 and 2020 based on any generally accepted methodology.

Finally, the supreme court rejected the Board’s argument that TERC was subject to the restric-
tions of the statute and therefore erred by adopt-
ing the independent appraisal. TERC has the
power and duty to determine whether the income
approach would result in actual value and to sub-
stitute whatever method TERC deems suitable to
determine actual value. TERC was therefore free
to consider the appraisal, and given the similarity
between the sale price and the appraisal, the
court ruled that TERC’s valuation was supported
by competent evidence.

TERC’s determination that the assessed value
of the property was arbitrary and unreasonable
was affirmed, as were its determinations of the
actual value of the property.

Lincoln County Bd. of Equalization v.
Western Tabor Ranch Apartments LLC
Nebraska Supreme Court
June 23, 2023
991 N.W.2d 889

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The Evolution of Land Trust Responsibilities in Reviewing Conservation Easement Appraisals

by Richard J. Roddewig, JD, MAI, and Anne S. Baxendale

Abstract
More than 37.9 million acres of land in the United States are protected by conservation easements. This is an area greater than the combined size of New Hampshire, Vermont, Massachusetts, and Connecticut. Much of that acreage has been protected through the charitable donation of the conservation easement to a land trust or a public agency and supported by a “qualified appraisal” signed by a “qualified appraiser” in compliance with Internal Revenue Service (IRS) regulations. This article explores the evolution of land trust standards for the review of those supporting appraisal reports in light of IRS and US Senate concerns related to overvaluation of conservation easements and abusive tax shelter transactions. The article concludes with a checklist of the questions land trusts could ask when reviewing the appraisals to ensure the appraisals meet the minimum information and content required by IRS regulations and appraisal profession standards.

Introduction: Conservation Easements and the Land Trust Movement

Land trusts and public agencies in the United States hold more than 220,000 conservation easements protecting about 37.9 million acres of land.1 Most, but not all, of that protection has resulted from the charitable donation of the partial interest in real property represented by the components of the bundle of rights transferred from the fee owner to the land trust in the recorded conservation easement document. The acreage protected by those conservation easements is greater than the combined land and water area of the states of New Hampshire, Vermont, Massachusetts, and Connecticut. In some states—Virginia, for example—almost 5% of the entire land area of the state is now protected by conservation easements.

Acreage protected by conservation easements has grown exponentially since the late 1970s, when Congress first enacted legislation allowing a charitable deduction for the donation of partial interests in land to qualifying governmental agencies and qualifying nonprofit organizations when the donation is intended to protect lands with significant conservation, open space, or scenic character.2 Much of that land is protected by conservation easements held by state and local land trusts. By 1988, acreage protected by


2. Prior to 1976, federal tax laws made it difficult to donate an easement and receive a deduction for a charitable contribution. Amendments to the Internal Revenue Code in 1969 limited the charitable deduction involving real property—with only a few exceptions—to situations in which the donation involved the taxpayer’s entire interest in the property. The Tax Reform Act of 1976 contained a provision that modified the charitable donation rules to allow a charitable contribution deduction for a “lease …, option to purchase, or easement” to a qualifying organization “exclusively for conservation purposes.” IRC § 170(f)(3)(Bxiii).
Conservation easements held by local and regional land trusts had grown to 300,000 acres. By the year 2000, land trust easements were in place protecting 2.5 million acres and by 2015 had increased to 16.7 million acres. The most recent 2020 analysis indicates that more than 20.2 million acres of land are protected by conservation easements held by the more than 1,280 active state and local land trusts.

**Appraisals and Conservation Easements**

The real estate appraisal profession has long played a critical role in the history of the land trust movement to protect significant scenic land, natural habitat, and open space. A charitable donation of a conservation easement must be supported by an appraisal of the easement value. A limited number of appraisers were involved in the 1930s in the valuation of less-than-fee interests acquired by the National Park Service to protect the scenic character of the Blue Ridge Parkway and the Natchez Trace Parkway, and in the 1950s and 1960s in conservation easement acquisition programs in Wisconsin to protect the Great River Road, in Minnesota and the Dakotas to protect wetlands important to migratory waterfowl flyways, and in New York State to protect fishing streams. However, little was published between the 1930s and 1970s in the appraisal literature related to the appropriate techniques for the appraisal of such easements.


Despite this increasing attention of the appraisal profession on how to value conservation easements, few guidelines were available to the profession. This became particularly clear in the late 1970s and early 1980s when the US Fish and Wildlife Service published a report on the effect of wetland conservation easements on land values in the Dakotas and Minnesota, and the appraisal profession and the land trust movement jointly published a booklet titled *Appraising Easements: Guidelines for Valuation of Historic Preservation and Land Conservation Easements.*

4. “Gaining Ground,” Demographics, Land Trust Alliance website, accessed September 15, 2023, https://bit.ly/3Zty4ZT. The information collected by the Land Trust Alliance does not include the number of historic buildings protected by historic preservation easements. Donation of conservation easements on historic buildings individually listed in the National Register of Historic Places or within districts listed in the National Register also qualifies for a charitable donation under the income tax code. When conservation easements held by governmental entities, as distinct from nonprofit land trusts, are also counted, the total protected acreage exceeds 37 million acres as discussed earlier.
6. The sequence of legislation resulting in this change included the Tax Reform Act of 1976, additional legislation in 1977, and the Tax Treatment Extension Act of 1980. The latter required that conservation easements be donated in perpetuity to be deductible.
ments, and perhaps because of that attention, the Internal Revenue Service (IRS) became concerned with the quality of the appraisal reports it was seeing in its reviews of tax returns showing a charitable deduction for the donation of a conservation restriction. The IRS filed a series of challenges to the values in conservation easement appraisals beginning in the late 1970s. To better ensure the quality and essential content of such appraisal reports, the Tax Reform Act of 1984 included language requiring every charitable donation of a conservation easement with a value in excess of $5,000 to be supported by a “qualified appraisal” report completed by a “qualified appraiser.”

The 2020 text Appraising Conservation and Historic Preservation Easements, published by the Appraisal Institute in conjunction with the Land Trust Alliance, summarizes the qualified appraisal content requirements as follows:

### The Qualified Appraisal

For an appraisal report to be “qualified,” it must at a minimum contain the following content:

- A description of the property in sufficient detail,
- A description of the physical condition of the property,
- The date or expected date of the charitable donation,
- A summary of the terms of any agreement between donor and donee relating to the use, sale, or disposition of the property,
- The name, address, and taxpayer identification number of the qualified appraiser and of the appraiser’s employer,
- A summary of the appraiser’s qualifications including background, experience, education, and any membership in professional appraisal organizations,
- A statement that the appraisal was prepared for income tax purposes,
- The date on which the property was appraised,
- The appraised fair market value of the easement on the date of donation,
- The method of valuation used to determine fair market value of the easement,
- The specific basis for the valuation, e.g., comparable sales used, “before and after” method, statistical sampling, subdivision development analysis, and
- A description of the fee arrangement between the donor and appraiser.

Despite the addition of those requirements, the IRS continued to have concerns about the quality of the qualified appraisal reports it was receiving and continued to file lawsuits between the mid-1980s and the late 1990s challenging the valuation conclusions in those reports. However, potential easement valuation abuse was not a significant topic in the news media during the 1980s and 1990s; it was a significant topic of concern only among those involved in the conservation and historic preservation easement field.

Public interest in conservation easements and their possible overvaluation surged in the early 2000s as a result of a series of investigative journalism articles in the Philadelphia Inquirer, Washington Post, Denver Post, and other media outlets alleging abuses in various conservation easement

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11. Although the terms qualified appraisal and qualified appraiser were added to the tax code in 1984, it was not until the Treasury Department later issued implementing regulations that the minimum content of a “qualified appraisal” was clearly set forth. The regulations related to those terms could be found at Treas. Reg. §1.170A-13(c)(3) and (c)(5) until July 30, 2018, and are now at §1.170A-17(a) and (b).


14. For example, some in the land use law field argued that protecting land through perpetual conservation easements in the absence of some type of coordinated state or local plan for what lands should and should not be protected is a “serious” problem that results in “dumb growth” rather than “smart growth” in the right places, and that nonprofit land trusts face “daunting enforcement challenges” due to the perpetuity requirement that will inevitably get worse over time. John D. Echeverria, Skeptic’s Perspective on Voluntary Conservation Easements, Georgetown Environmental Law & Policy Institute (August 31, 2005): 1–4, available at https://bit.ly/3PUGrmEP.
programs. The alleged abuses included board member conflicts of interest, faulty appraisals, and inappropriate use of the charitable donation of easement deduction by members of Congress. Those news stories resulted in investigations into alleged easement program abuses by congressional committees and by state legislative committees in Colorado and South Carolina. Those investigations in turn led to additional news stories and enforcement actions by the IRS as well as to new legislation and additional regulations by the US Department of the Treasury.

The results were easement provisions in the Pension Protection Act of 2006 and new regulatory guidance from the IRS related to the required content of a “qualified appraisal” and who could be considered a “qualified appraiser.” The appraisal requirements added by notice and regulation included the following:

- A requirement that the appraisals be prepared in accordance with generally accepted appraisal standards and in accordance with any regulations or other guidance issued by the Secretary of the Treasury.
- Inclusion in the appraisal of a declaration that “because of the appraiser’s background, experience, education, and membership in professional associations, the appraiser is qualified to make appraisals of the type of property being valued.”
- Inclusion of a statement in the appraisal acknowledging that a “substantial or gross valuation misstatement” may subject the appraiser to a civil penalty.

Also added by regulation were requirements for the timing of the appraisal report completion. To be a “qualified appraisal,” the report could not be prepared any earlier than 60 days before the date of donation of the conservation or historic preservation easement, nor any later than the date on which the taxpayer filed the federal income tax return (with extensions) for the year in which the charitable donation was made.

Land Trust Appraisal Review Standards Prior to 2015

Even before the media reports in the early 2000s, some in the land trust community had developed standards and practices related to a review of “draft” and final easement appraisals as part of the process for accepting conservation easement donations. The Land Trust Alliance, the umbrella educational and public policy organization for the land trust community with more than 950 land trust members, adopted its first set of standards and guidelines for responsible operation of its member organizations in 1989 and updated and revised those guidelines in 1993, 2001, and 2004. Standard 10 of the 2004 version was titled “Tax Benefits,” and paragraph B dealt with land trust responsibilities related to easement appraisals as follows:

B. Appraisals. The land trust informs potential land or easement donors (preferably in writing) of the following: IRC appraisal requirements for a qualified appraisal prepared by a qualified appraiser for gifts of property valued at more than $5,000, including information on the timing of the appraisal; that the donor is responsible for any determination of the value of the donation; that the donor should use a qualified appraiser who follows Uniform Standards of Professional Appraisal Practice; that the land trust will request a copy of the completed appraisal; and that the land trust will not knowingly participate in projects where it has significant concerns about the tax deduction.

Paragraph C of the 2004 Standard 10 then warned that the review by the land trust of the transaction and the appraisal supporting it “does not make assurances as to whether a particular land or easement donation will be deductible, what monetary value of the gift the IRS and/or

15. For a detailed discussion of these newspaper investigations, see Roddewig and Brigden, supra, 18–22.
18. See IRS Notice 2006-96, Section 3.03(2).
state will accept, what the resulting tax benefits of the deduction will be, or whether the donor’s appraisal is accurate.”22 However, paragraph D went on to state that “if the land trust has significant reservations about the value of the gift, particularly as it may impact the credibility of the land trust, it may seek additional substantiation of value or may disclose its reservations to the donor.”23 That language meant land trusts had a responsibility to somehow review the appraisal and its conclusions.

But that language created a potential dilemma for many land trusts. How far should a land trust go in reviewing the appraisal? Should it simply have a checklist to make sure that the various technical qualified appraisal requirements (summarized earlier in this article) were met? Or should it also somehow check the accuracy of the valuation conclusion itself? If so, how? Should it actually have an experienced real estate professional, preferably an appraiser, review the appraisal report and somehow sign off on its accuracy?

As a result of those issues, land trust practices related to appraisal reviews have varied widely. Most require that the easement appraisal be submitted well before the date when the easement was to be recorded. Some land trusts added real estate appraisers to their board of trustees and tasked them with reviewing the appraisals. Other land trusts retained appraisers as necessary to review the appraisal reports and respond to the appraiser hired by the landowner with any comments and concerns. Other land trusts developed their own lists of real estate appraisers whom they considered to have the education, experience, and competency to meet the tax code definition of a qualified appraiser experienced in preparing such appraisal reports. A key consideration in making a list of approved appraisers was whether their prior conservation easement appraisal reports had been accepted by the IRS. Land trusts with such lists of appraisers would provide the list to the prospective donee and let the landowner/taxpayer select the one to undertake the work.

So at a minimum, land trusts attempting to comply with the 2004 Standard 10 appraisal language simply checked whether the appraisal report had the language indicating compliance with the qualified appraisal and qualified appraiser requirements in the tax code. If the report did not, the land trust would ask the appraiser to amend the report before the donation was accepted by the land trust and the easement document recorded.

Whether that minimum level of appraisal review was enough, however, came into question within the land trust community as a result of actions by the IRS after 2015 related to syndicated conservation easements and the appraisals supporting them.

**Syndicated Conservation Easement Donations and Material Advisors in Listed Transactions**

In 2016, the IRS noticed a significant increase in the number of individual tax returns claiming a charitable deduction for the donation of a conservation easement. An IRS review of 2015 tax-year returns identified 169 syndicated partnerships in which the partners were claiming a share of a charitable deduction of the value of a conservation easement.24 In tax year 2016, the IRS identified an additional 249 conservation-related syndicated partnerships. IRS staff review appraisers became concerned about the content of many of the appraisal reports supporting those syndications.

As a result of those concerns, the Treasury Department issued IRS Notice 2017-10 in December 2016.25 The notice described easement syndications as “tax avoidance transactions” and classified conservation easement syndications as

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\text{\textendash}}\text{\textendash}22. Land Trust Alliance, \textit{Land Trust Standards and Practices}, 12. \\
25. In November 2022, the US Tax Court set aside Notice 2017-10 because, in the court’s opinion, the IRS had not complied with proper administrative procedures before issuing the notice. See \textit{Green Valley Investors, LLC v. Commissioner}, 59 T.C. No. 5. The IRS has responded with proposed regulations that restate the essence of Notice 2017-10 and are being proposed in accordance with the Administrative Procedure Act.
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“listed transactions,” a designation that creates significant reporting requirements for the syndicators and their material advisors. An essential element of the promotional tax avoidance scheme, according to the IRS in that notice, is an appraisal “that greatly inflates the value of the conservation easement based on unreasonable conclusions about the development potential of the real property.”

One of the most significant concerns for land trusts was the Treasury Department definition of a material advisor in a listed transaction. Material advisors are defined as those who “provide any material aid, assistance or advice with respect to the organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction” and who receive at least $10,000 in compensation for such aid, assistance, or advice.

**Material Advisor Responsibilities and Penalties**

Material advisors are required to file Form 8918 with the IRS in which the advisor discloses it acted as a material advisor in a listed transaction and then includes information about the transaction. The penalty for inadvertently failing to file as a material advisor in a listed transaction or for reporting inaccurate information is the greater of $200,000 or 50% of the gross income derived by the material advisor from the transaction. If the failure to file is found by the IRS to be intentional, the penalty increases to the greater of $200,000 or 75% of the gross income derived by the material advisor. There is also a $10,000-per-day penalty for a material advisor who fails to provide the IRS with a list of advisees involved in the listed transaction.

**Land Trusts and the IRS Definition of a Material Advisor**

No charitable donation deduction for a conservation easement can be taken unless there is a land trust to accept the donation, to negotiate with the landowner over the content of the easement document, to sign the final easement document as the grantee of the donation, and then to see that the easement document is properly recorded and then monitored. Land trusts typically require a cash contribution from the donor as part of the transaction, and in many if not most conservation easement transactions, that contribution will exceed the $10,000 threshold required to be

26. All material advisors involved in listed transactions must file an IRS Form 8918 Material Advisor Disclosure Statement. Information to be provided to the IRS and IRS Notice 2017-10 require material advisors involved in conservation easements “to report to the IRS any conservation easement transactions that include (1) promotional materials, (2) pass-through entity attracting investors, and (3) charitable contributions that equal or exceed 250% of the investors’ initial investment as well as (4) the contribution and deduction”; “material advisors” are defined as those who provide “material aid, and assistance or advice” about the transaction and receive at least $10,000 in compensation.” Roddewig and Brigden, *Appraising Conservation and Historic Preservation Easements*, 2nd ed., 30, citing 26 CFR 301.6111-3(b)(3)(ii)(B).


28. Internal Revenue Service, *Instructions for Form 8918 (06/2017): Material Advisor Disclosure Statement* (For use with Form 8918 (Rev. December 2011) or later revision). That form and the instructions for it have been updated since 2017. The subsequent revisions did not change the definition of a material advisor. The most recent revision is dated 11/2021 and is simply titled “Instructions for Form 8918 (11/2021).” It is available at www.irs.gov/instructions/i8918.

29. Internal Revenue Service, 26 CFR § 301.6111-3, Disclosure of Reportable Transactions, which states in part: “To be considered complete, the information provided on the form must describe the expected tax treatment and all potential tax benefits expected to result from the transaction, describe any tax result protection with respect to the transaction, and identify and describe the transaction in sufficient detail for the IRS to be able to understand the tax structure of the reportable transaction and the identity of any material advisor(s) whom the material advisor knows or has reason to know acted as a material advisor....”

30. 26 CFR § 301.6707-1. Failure to furnish information regarding reportable transactions.


32. Land trusts approached by donors inspect the property and review its conservation characteristics to determine if it meets the conservation purposes definition in the tax code. Conservation purposes that qualify for protection by a conservation easement include preservation of land areas for outdoor recreation or for public education; protection of natural habitats or ecosystems; open space preservation for scenic enjoyment of the public (but only if in line with a clearly delineated governmental conservation policy or yielding a significant public benefit); and preservation of a historically important parcel of land or a certified historic structure. IRC 170(h)(4)(A) and Treas. Reg. §1.170A-14(d).
considered a material advisor.\textsuperscript{33} Does that make a land trust a “material advisor” if the conservation easement donation is syndicated? In the wake of the issuance of IRS Notice 2017-10, the land trust community has asked itself that question. A presentation at the 2017 national “rally” sponsored by the Land Trust Alliance summarized the definition of a material advisor in the tax code and stated that “(g)enerally speaking, land trusts are not a ‘material advisor’ to a transaction for purposes of this Notice [IRS Notice 2017-10]”\textsuperscript{34} and then asked the following questions:

But what about negotiating an easement? Or signing Form 8283? Or any of the many other tasks land trusts must complete to facilitate a donation? Does any of that work make a land trust a “material advisor”?\textsuperscript{35}

The presentation then answered the questions as follows:

No. Under normal circumstances, the usual and customary tasks associated with conservation easement transactions will not make a land trust a “material advisor” for purposes of this Notice….The IRS isn’t trying to trick land trusts. The Service knows what being a donee involves, and the Service wouldn’t have specifically provided an exclusion for accepting a donation if the donee’s usual and customary tasks would require the donee reporting itself as a “material advisor.”\textsuperscript{36}

The 2017 Land Trust Alliance Rally presentation did not cite any explicit IRS exclusion of non-syndicated conservation easement transactions from the definition of material advisor and simply concluded by analogy that the language in the listed transaction Notice 2017-10 related to conservation easements was quite different from the language in other, similar notices in which “charities and nonprofits that received donations were specifically included by being made parties to the [listed] transaction.”\textsuperscript{37} Later, the Land Trust Alliance claimed that additional IRS Notice 2017-29 generally exempted charitable donees from being considered a material advisor, but that claim of such a broad exemption for land trusts is called into question by recent IRS proposed regulations.\textsuperscript{38} Subsequent court cases ruled that “the IRS lacks the authority to identify listed transactions by notices, such as Notice 2017-10, and must instead identify such transactions by following the notice and public comment procedures that apply to regulation.”\textsuperscript{39} The IRS in December 2022 proposed regulations incorporating most but not all of the requirements in Notice 2017-10 and Notice 2017-29. Those proposed regulations have been put into the regular public comment process and are not yet final.\textsuperscript{40}

The most significant difference between the earlier notices and the proposed rules, at least from the point of view of land trusts that accept conservation easements, is the absence of a clear exclu-

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\textsuperscript{33} The cash contribution covers the cost of inspecting the property to determine if it has the necessary conservation characteristics, negotiating the protections and wording in the conservation easement document, and preparing a “baseline conditions report” against which future actions affecting the conservation character of the protected property can be measured, and contributes to the legal defense fund that the larger land trusts set aside to monitor the easement and enforce the protections. While smaller land trusts accepting easements on smaller properties may require a donation of less than $10,000, most donations involving larger properties such as those involved in syndicated conservation easement transactions are accompanied by donations that exceed the regulatory material advisor $10,000 threshold, and land trust studies have supported the appropriateness of cash donations as high as $85,000 to $150,000. See, for example, Pennsylvania Land Trust Association, “Costs of Conservation Easement Stewardship,” Draft new edition in process May 19, 2020, available at https://bit.ly /4Bum0cm; and Ben Guillon, “Conservation Easements,” Western Landowners Alliance, June 20, 2018.


\textsuperscript{35} Land Trust Alliance, IRS Notice 2017-10: What Land Trusts Need to Know, 36.

\textsuperscript{36} Land Trust Alliance, IRS Notice 2017-10: What Land Trusts Need to Know, 36–37.

\textsuperscript{37} The 2017 presentation went on to state: “In short, if the IRS wanted information from land trusts, it had the power to demand it.” Land Trust Alliance, IRS Notice 2017-10: What Land Trusts Need to Know (2017), 37, available at https://bit.ly/3LFoZGK.


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The Evolution of Land Trust Responsibilities in Reviewing Conservation Easement Appraisals

The proposed regulations include some additional penalty and tax provisions on material advisors that do not comply with the reporting regulations. As a result, the question of whether a land trust that accepts a conservation easement donation is or is not a material advisor continues to be an open one.

The 2017 Changes to Land Trust Alliance Appraisal Review Standards

Despite, or perhaps because of, the uncertainty as to whether land trusts can be considered material advisors, the Land Trust Alliance between 2015 and 2017 undertook a comprehensive updating of its Standards and Practices for land trust operation after the announcement of IRS Notice 2017-10. The Land Trust Alliance’s updated 2017 Standard 10, titled “Tax Benefits and Appraisals,” contained three subsections. The general paragraph of the 2004 Standard (quoted earlier in this article) was substantially modified, and separate standard practices were shown for appraisals in general and specifically related to syndicated conservation easements. Standard 10 paragraph C, “Avoiding Fraudulent or Abusive Transactions,” states land trusts

1. Review, on the land trust’s own behalf, each transaction for consistency with federal and state income tax deduction or credit requirements
2. Evaluate the Form 8283 and any appraisal to determine whether the land trust has substantial concerns about the appraised value or the appraisal
3. Discuss substantial concerns about the appraisal, the appraised value or other terms of the transaction with legal counsel and take appropriate action, such as:
   a. Documenting that the land trust has shared those concerns with the donor
   b. Seeking additional substantiation of value
   c. Withdrawing from the transaction prior to closing
   d. Or refusing to sign the Form 8283
4. When engaging in transactions with pass-through entities of unrelated parties, particularly those offered or assembled by a third party or described as a syndication by the IRS [syndicated conservation easements],
   a. Require a copy of the appraisal prior to closing
   b. Decline to participate in the transaction if the appraisal indicates an increase in value of more than 2.5 times the basis in the property within 36 months of the pass-through entity’s acquisition of the property, the value of the donation is $1 million or greater and the terms of the transaction do not satisfy the Land Trust Alliance Tax Shelter Advisory.

In language somewhat similar to language in 2004 Standard 10, revised 2017 Standard 10 paragraph A “Landowner Notification” states that the “donor is responsible for any determination of the value of the donation” and then warned land trusts not to make any assurances related to:

1. Whether a particular land or conservation easement donation will be deductible
2. What monetary value of the gift the IRS and/or state will accept
3. What the resulting tax benefits of the deduction or credit will be, if any.

However, paragraph D of the 2004 Standard 10, which had stated “if the land trust has significant reservations about the value of the gift, particularly as it may impact the credibility of the land trust, it may seek additional substantiation of value or may disclose its reservations to the donor,” does not appear in the revised 2017 version of the Land Trust Alliance Standards. But the 2016 Accreditation Requirements Manual of the Land Trust Alliance continues the more detailed

41. The Land Trust Alliance letter sent to the IRS on February 5, 2023, expressed concerns that the proposed regulations “do not include an exclusion for donee organizations as material advisors.” Land Trust Alliance Comments on IRS and REG-106134.
44. Land Trust Alliance, Standards and Practices, 17.
45. Land Trust Alliance, Standards and Practices, 16.
practice standard of the 2004 standards. The 2016 update to the manual states that an accredited land trust must evaluate the appraisal that supports the conservation easement donation and “determine whether it [the land trust] has significant concerns about a landowner’s tax deduction” and then states that “one or more of the following may trigger the organization to have significant concerns:

- The appraised value does not appear to be defensible in light of the organization’s knowledge of local land values
- The deduction claimed is significantly in excess of the donor’s cost or adjusted basis (if recent)
- Multiple unrelated parties are owners of the property using a pass-through entity and may be passing through deductions disproportionate to their respective interests in the property
- The land has been recently acquired by a pass-through entity
- Donors are being advised or managed by a “promoter” (A “promoter” is a person or entity that is being paid to help facilitate the proposed contribution and/or is being paid to otherwise promote, organize or secure the transaction (other than the entity’s formal legal counsel).)

The 2016 Accreditation Requirements Manual went on to state that if the land trust has concerns about the appraisal, it must take appropriate actions to resolve those concerns. Among the appropriate actions required are “sharing the concerns regarding the appraisal in writing with the landowner” and “seeking additional substantiation of value.” Then the manual offers a “checklist” that includes the required elements of a “qualified appraisal” as stipulated by IRS regulation and listed earlier in this article. Five of the twelve items in the checklist, however, are asterisked in the manual with the notation that for those elements the manual “does not expect the organization will assess whether the data presented in the appraisal are accurate and/or valid.”

Sections 10C2 and 10C3 of the 2021 Accreditation Requirements Manual is less detailed in its requirement related to appraisals; it simply states that the land trust must “evaluate” the appraisal to determine if “the land trust has substantial concerns about the appraised value or the appraisal” and if it does, it should discuss those substantial concerns with its legal counsel and then take “appropriate action,” which could include “seeking additional substantiation of value.”

Senate Committee on Finance 2020 Report on Inflated Appraisals in Syndicated Conservation Easement Donations

In March 2019, the Senate Committee on Finance launched its own investigation into syndicated conservation easements and issued its report in August 2020. The report states that “an inflated appraisal” is the “engine of every syndicated conservation-easement transaction.” Actual conservation easement appraisal reports were critiqued in detail by the committee. The most common red flag in those appraisals—indicating a likely overvaluation—was “a consistent pattern of land (or interest in a partnership holding land) sold in an arm’s length transaction, followed shortly thereafter by an appraisal asserting land values multiple times higher than the value established in that

47. The Land Trust Alliance has a program to review the quality of state and local land trust conservation easement programs and practices. Land trusts that comply with the Land Trust Standards and Practices developed by the Land Trust Alliance can be “accredited.” According to the Land Trust Alliance, the “accreditation seal is a mark of distinction in land conservation” and “is awarded to land trusts meeting the highest national standards for excellence and conservation permanence.” Land Trust Accreditation Commission, Accreditation Requirements Manual (Saratoga Springs, NY: March 2018), 2, available at https://bit.ly/3RCg7oQ.


49. Land Trust Accreditation Commission, Accreditation Requirements Manual (2016), 39. The five items are as follows: (1) the qualifications of the appraiser signing the report; (2) the method of valuation used to determine the value of the easement; (3) the “specific basis for the valuation, such as inclusion of comparable sales transactions”; (4) the statement in the appraisal related to whether it deals with all contiguous property owned by the donor or a family member; and (5) the statement in the appraisal as to whether any “non-easement property” has been enhanced in value.


51. Committee on Finance, 6.
prior arm's length transaction.” That, according to the Senate Committee on Finance, “clearly calls into question the accuracy of these appraisals.”

The Senate Committee on Finance report pointed to the following three components of the faulty appraisals it reviewed as driving the overvaluations: (1) failure to properly summarize and analyze the recent purchase price of the land; (2) an improper claim that some type of land development was the highest and best use; and (3) supporting the value for development with a faulty discounted cash flow (DCF) analysis. Included in the Committee on Finance report were excerpts from an actual appraisal report in a syndicated conservation easement transaction in Alabama. The report listed various problems with the highest and best use analysis and DCF analysis in that appraisal and also identified various problems in its sales comparison approach section as follows:

- Overstating value by not deducting costs associated with the time necessary to approve, construct, market, and sell developed homes...
- Failing to include evidence of market demand for developed homes...
- Failing to include data on economic, jobs, population, and household growth...
- Falsely stating that no comparable sales could be found to help value the property before granting easement but then incorporating comparable sales for valuing property after granting easement, including sales from other states...
- Assuming economic feasibility of building extensive access roads to support non-contiguous development while possibly crossing wetlands and floodlands...
- Failing to consider availability and costs associated with extending sewers and public utilities to the property...
- Failing to consider wet-soil issues...
- Failing to support claims that developments have necessary approvals...
- Falsely claiming property is accessible from multiple public roads...

Implications of IRS Actions and 2020 Senate Finance Committee Report for Land Trust Appraisal Review Responsibilities

What are the implications for land trusts of the recent pronouncements by the IRS and the Senate Committee on Finance regarding appraisal abuses related to conservation easement donations?

While the potential penalties associated with failing to register as a material advisor or properly disclose information on Form 8918 are significant, they may or may not be specifically applicable to the typical conservation easement donation situation in which a land trust is involved given the uncertainty created by the proposed IRS regulations issued in December 2022 and the Land Trust Alliance response. However, there are other financial penalties and financial risks to land trusts that can result simply from the IRS determining that a land trust has been involved in a syndicated conservation easement or even been involved in an overvalued conservation easement donation. First, the IRS has filed actions against those involved in what it describes as “abusive transactions” involving syndicated conservation easement donations. Some of those actions have included not only promoters and organizers but also land trusts and the appraisers who prepared the conservation easement appraisals. Second, some investors in conservation easement donations supported by allegedly inflated appraisals have filed class action lawsuits to recover unspecified monetary damages from the accountants, attorneys, appraisers, environmental consultants, and land trusts involved in the donations. Third, there have been other actions involving conservation easements not involved in syndications in which the values reported in the supporting appraisals have been challenged.

So, what are the implications for land trusts from these challenges to the quality of appraisals?

52. Committee on Finance, 12.
53. Committee on Finance, 48.
55. For example, in a lawsuit filed by the State of New York against the Donald J. Trump Revocable Trust and members of the Trump family and Trump employees, People of the State of New York v. Donald J. Trump, et al., Supreme Court of the State of New York, County of New York, Complaint Filed 9/21/2022, the attorney general of the State of New York alleged that inflated easement appraisals resulted in loss of tax revenues to the state.
supporting conservation easement donations? How should land trusts respond?

As stated earlier in this article, land trusts are potentially caught in a bind. On the one hand, they rely on information provided by the landowner as to whether the donation is somehow part of a syndicated conservation easement, and land trust standards of practice emphasize that the donor, not the land trust, is responsible for determining the value of the easement donation. But at the same time, Standard 10 of the Land Trust Alliance Standards and Practices advises land trusts to evaluate the appraisal report before accepting the conservation easement donation and, if it has reservations about the values in the appraisal, take steps to check the accuracy of the report.

Land trusts should continue to check the appraisal reports to make sure they include the language required by the IRS to be included in a “qualified appraisal” report. They should also check to make sure that the appraiser signing the report has included in the appraisal the required statements concerning the appraiser’s qualifications and experience and is therefore a “qualified appraiser” under Treasury Department regulations.

Checking for the other telltale signs of an abusive transaction, such as a “before” easement donation value of the property that is more than 2.5 times the price recently paid for the property, is another critical review step. So, appraisals should be checked to see if the most recent purchase price paid for the property is discussed in the report. That prior purchase price should then be compared to the pre-easement “before” value of the property as stated in the report. But even an appraised pre-easement value that is less than 2.5 times a recent purchase price could be part of an inflated and improperly supported easement appraisal.

As discussed earlier in this article, the Senate Committee on Finance focused on several additional elements that indicate a potentially abusive appraisal and an inflated conservation easement value. The Committee’s concerns, in addition to the comparison of the pre-easement value to a recent purchase price, can be recategorized as related to three primary elements of every appraisal report: (1) the market analysis indicating the demand for land in the area; (2) the highest and best use analysis that often tests a claimed development potential through a discounted cash flow analysis; and (3) the selection of the comparable sales supporting the pre-easement “before” value.

The Appraising Conservation and Historic Preservation Easements text published by the Appraisal Institute contains in-depth discussion of market analysis, highest and best use analysis, discounted cash flow analysis, and proper selection of comparable sales. It includes detailed examples of proper market and highest and best use analysis, proper consideration of all the factors that must be included in a discounted cash flow analysis, and proper selection and analysis of both pre-and post-easement comparable sales supporting a sales comparison approach.

The necessary market analysis in a conservation easement appraisal may sometimes be included as a separate section of the appraisal report, but it can also be included as part of the highest and best use analysis section of the report. The fifteenth edition of The Appraisal of Real Estate published by the Appraisal Institute shows the six steps in a market analysis (see Exhibit 1).

The fifteenth edition of The Appraisal of Real Estate also makes it clear that proper highest and best use analysis requires considerable experience and skill and proper judgment from an appraiser but is critical to the appraisal process. The 2020 Senate Committee on Finance report focused on the faulty analysis and lack of support for the conclusions in the “before” easement value highest and best use analyses in the abusive appraisals it described. A sidebar from The Appraisal of Real Estate shown in Exhibit 2 notes that the highest and best use analysis must be “appropriately supported.”

Highest and best use analysis in both the “before” and “after” easement valuation scenarios involves answering the following four questions:

1. What uses are physically possible?
2. Of the physically possible uses, which ones are legally permissible?
3. Of the physically possible and legally permissible uses, what uses are financially feasible?
4. And, finally, which of the uses that are physically possible, legally permissible, and financially feasible results in the “highest present value”?

The Evolution of Land Trust Responsibilities in Reviewing Conservation Easement Appraisals

Exhibit 1 The Six Steps in a Market Analysis

Step 1. Property productivity analysis: analyze competitive characteristics of the subject property
Step 2. Market delineation: identify demand sources and competitive area
Step 3. Demand analysis: estimate current demand and predict future demand
Step 4. Supply analysis: survey existing supply and predict future changes
Step 5. Residual demand analysis: analyze the interaction of supply and demand
Step 6. Subject capture analysis: determine conclusions of marketability analysis, i.e., predict performance of the subject property

Source: Figure 15.1 in The Appraisal of Real Estate, 15th ed. (Chicago: Appraisal Institute, 2020).

Exhibit 2 The Difficulty of Defining Highest and Best Use

The definition of highest and best use has evolved over time to address the common understanding of the topic. Traditionally, the explanation of the term has been more elaborate than the definition introduced in the 14th edition of The Appraisal of Real Estate. For example, earlier definitions of the term included ambiguous language that has often been commented on but never defined, as seen in the entry for the term in the fifth edition of The Dictionary of Real Estate Appraisal:

**highest and best use**
The reasonably probable and legal use of vacant land or an improved property that is physically possible, appropriately supported, financially feasible, and that results in the highest value. The four criteria the highest and best use must meet are legal permissibility, physical possibility, financial feasibility, and maximum productivity. Alternatively the probable use of land or improved property—specific with respect to the user and timing of the use—that is adequately supported and results in the highest present value.

The precise meaning of “appropriately supported” has been debated in the appraisal literature almost since the basic template of this definition of highest and best use was developed in the mid-1970s.


That series of questions must be answered sequentially in a highest and best use analysis “before” considering the easement. The result of that analysis is the use that would result in the “most probable” price that a “willing buyer would pay a willing seller.” That most probable price equates to the fair market value of the property before considering the effect of the restrictions contained in the conservation easement document.

Inflated conservation easement appraisals typically involve abuses in the application of the “physically possible” and “legally permissible” elements of that four-part highest and best use analysis requirement. In the abusive appraisals, the significant difference between the “before” easement value conclusion and the actual recent purchase price paid for the land is typically based on a conclusion that some type of land development is both physically possible and legally per-

57. The Senate Committee on Finance report on page 6 states that mining or residential development is typically the alleged physically possible, legally permissible, and financially feasible use that results in the highest present value.
Peer-Reviewed Article

Appraising Conservation and Historic Preservation Easements recognizes its importance in appropriately supported feasibility analysis. A reversion. The analyst specifies the quantity, variability, timing, and duration of the income streams and the quantity and timing of the reversion, and discounts each to its present value at a specified yield rate. " The Dictionary of Real Estate Appraisal, 7th ed. (Chicago: Appraisal Institute, 2022), s.v. "discounted cash flow analysis."

61. Advisory Opinion 33 in the USPAP Advisory Opinions states the following about the importance of DCF analysis: "DCF analysis has become a requirement of many real property clients and other intended users. These users of appraisal services favor the inclusion of DCF analysis as a management tool in projecting cash flow and return expectations, capital requirements, refinancing opportunities, and timing of future property dispositions. DCF analysis is regarded as one of the best methods of replicating steps taken to reach investor buy/sell/hold decisions and is often a part of the exercise of due diligence in the evaluation of an asset." Appraisal Standards Board, Advisory Opinion 33 (AO-33), in USPAP Advisory Opinions, 2020–2021 Edition (Washington, DC: Appraisal Foundation, 2020), Lines 14–19.


59. An appraisal report conclusion that rezoning is reasonably probable must be supported by market evidence such as rezoning applications, actions by municipalities, and interviews with planning and zoning officials." The Appraisal of Real Estate, 15th ed., 309.

60. Discounted cash flow analysis can be defined as "the procedure in which a discount rate is applied to a set of projected income streams and a reversion. The analyst specifies the quantity, variability, timing, and duration of the income streams and the quantity and timing of the reversion, and discounts each to its present value at a specified yield rate." The Dictionary of Real Estate Appraisal, 7th ed. (Chicago: Appraisal Institute, 2022), s.v. "discounted cash flow analysis."

58. The Senate Committee on Finance report on page 3 describes the typical tax deduction situation in a syndication as follows: "Although the various offerings differ in their specifics, the general outcome is the same: for every dollar a taxpayer pays to a promoter to become an ‘investor’ (or a ‘partner’ or a ‘member’) in a syndicated conservation-easement transaction, he or she commonly purchases a little more than four dollars’ worth of tax deductions” and “[f]or most taxpayers involved, this ultimately means that for every dollar paid to tax-shelter promoters, the taxpayers saved two dollars in taxes they did not pay.” As an example, assume land is purchased for $250,000 but is appraised for $1,500,000 “before” the easement and only $15,000 “after” the easement. The charitable deduction would be $135,000 and the tax savings to taxpayers at the top current federal income rate of 35% would be $49,950, almost exactly twice the $25,000 investment. The investors get their original $25,000 back plus an additional $24,950 in tax savings.

59. An appraisal report conclusion that rezoning is reasonably probable must be supported by market evidence such as rezoning applications, zoning hearings, actions by municipalities, and interviews with planning and zoning officials." The Appraisal of Real Estate, 15th ed., 309.

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The Evolution of Land Trust Responsibilities in Reviewing Conservation Easement Appraisals

Approach to the “before” value of the easement. The DCF result may indicate a value many times higher than actual land prices in the market area in which the property to be protected by easement is located. So, in order to justify the result of the faulty DCF feasibility, the sales comparison approach may use sale prices from locations in a different geographic market area many miles away (and sometimes even in another state) rather than actual sale prices paid for similar land in the immediate vicinity of the property on which the easement is being donated. Instead of comparing the value that results from the DCF analysis to prices actually paid for land in the same market area, the faulty appraisals typically simply fail to include consideration of actual sale prices paid for similar land in the same market. Exhibit 3 shows an actual analysis of the claimed “before” value of land in a conservation easement appraisal compared to the actual prices paid in 31 other land sale transactions in the local market area where the protected property is located.

Conclusion: The Importance of an Appraisal Review Checklist in the Appraisal Review Process

Not every land trust has an appraiser on its board to review proposed conservation easement appraisals. Some type of checklist of factors to review is, at a minimum, necessary to undertake a supportable and appropriate initial appraisal review. Some land trusts, recognizing that need, have developed such an appraisal review checklist. While there is no one generally accepted and recognized checklist—either approved by the Land Trust Alliance or recognized as the legal minimum to meet land trust due diligence related to a conservation easement appraisal—there are basic elements that should be included in an appraisal report, and various red flags are raised if they are missing.

The Appendix at the end of this article presents one such possible checklist, which comprises more items than might be relevant in every conservation easement situation. The checklist

Exhibit 3 A Comparison of the Taxpayer Appraisal Value Conclusion to Actual Market Evidence of Prices Paid for Similar Properties in Local Market Area (price per acre)
focuses on eleven general elements of a conservation easement appraisal:

1. General compliance with appraisal standards of practice including the reporting and analysis of any recent purchase price paid for the property;
2. The information required by IRS regulations to make the report a “qualified appraisal” and to confirm that the appraiser is a “qualified appraiser”;
3. Information related to identification of any contiguous property or other property owned by the donor or related parties and analysis of benefits or enhancements;
4. Information in the appraisal related to disclosure of a syndicated conservation easement donation;
5. The elements in a proper highest and best use analysis and in a properly supported discounted cash flow (DCF) analysis included to support a land development market feasibility analysis and “before” easement value;
6. The market area in which the property is located and the comparable sales selected and analyzed in a “before” easement sales comparison approach;
7. Consideration and analysis of any actual prices paid to purchase conservation easements similar to the easement that is being donated;63
8. The easement-protected property sale discussion and analysis used to arrive at an “after” easement value;
9. Consideration of the contribution to value of any existing improvements on the property;
10. Consideration of the contribution to value from any income generated by rent, crops, or other sources; and
11. Appraisal Addenda items including a draft or final easement document, important statements related to appraisal based on a draft rather than final easement document, and inclusion of the baseline condition report64 in the Addenda.

The first five elements listed as well as the seventh element directly or indirectly relate to IRS regulation notices or to concerns about abusive appraisals raised in the 2020 Senate Committee on Finance report. The eighth element relates to the “after” easement analysis of prices paid for land already protected by a conservation easement. Neither the IRS notices nor the Senate Committee on Finance report focuses in any significant way on potential abuses in the “after” easement value analysis, but there are ways in which an abusive conservation easement appraisal report could undervalue the “after” easement as a way to increase the difference between the “before” and “after” values and therefore increase the size of the charitable donation deduction. As the questions in the Appendix checklist indicate, the land trust should review the “after” easement section of the appraisal report to determine if the easement-protected comparable sales are in the same general market area and involved protections comparable in scope to those in the conservation easement that is the subject of the appraisal.

One way to check on the appropriateness of the after-easement sales selected by the appraiser is to use the National Conservation Easement

63. There have been thousands of direct purchases of conservation easements on land that has scenic, agricultural, or historic significance. However, many of these purchases have been by various federal, state, and local government entities whose motivations may not be typical of other marketplace participants. Even when easements are purchased by land trusts, there may be difficulties analyzing the sale prices because many such easement acquisitions involve “bargain sales” in which some portion of the purchase price is paid in cash, and the difference between that cash payment and the market value results in a charitable donation deduction for the taxpayer. There may also be difficulties in comparing the easement document in the sale transaction and adjusting the easement purchase price for differences between the protections it provides and the protections to be provided by the conservation easement that is being appraised. For a detailed discussion of some of those issues, see generally, Roddewig and Brigden, Appraising Conservation and Historic Preservation Easements, chapter 15, and especially pages 248–249.

64. The land trust accepting the conservation easement typically prepares a “baseline condition report” that describes the condition of the important conservation features of the property to be protected as of the date of acceptance of the conservation easement donation. It typically contains text describing the condition of the protected features, a map or series of maps, and photos. The information in the baseline condition report can then be referenced in later years when monitoring any significant changes to the protected property and its important conservation characteristics.
Database (NCED)\textsuperscript{65} to identify conservation easements in the vicinity of the subject property and to determine if any of them are included as comparable sales in the appraisal report. Exhibit 4 is an example of the type of map generated using the interactive NCED website to locate conservation easements in the Texas hill country west and north of San Antonio. Clicking on the easement-protected property on the map indicates the size of the protected acreage, the holder of the conservation easement, and when the easement was put into effect. The location of the conservation easements utilized in the “after” value analysis can be compared to the easements shown in an NCED map. If the appraisal does not reference any of the conservation easement–protected properties in the local market area, the reason could be that none of those easement-protected properties have sold or it could be because the appraisal simply ignored those sales. In any event, such a discrepancy between conservation easements in the local market area and those listed in the appraisal report could be a reason to request more information from the appraiser related to the sales history, if any, of the local market easement-protected properties.

The checklist in the Appendix is not intended to be an exhaustive list of the questions that could be asked related to a conservation easement appraisal. There are many other elements of a conservation easement appraisal that could be reviewed and would be part of a formal appraisal review by a licensed appraiser under the Uniform Standards of Professional Appraisal Practice (USPAP). The checklist is also not intended to cover every possible question related to IRS appraisal requirements or to appraisal concerns raised in the Senate Committee on Finance report or in tax court and district court cases involving conservation easement appraisals. Not every question is applicable to every conservation easement appraisal situation. However, the answers to the questions that are included in the checklist can be a good test of whether the appraisal raises any “substantial concerns” that would require the additional “substantiation of value” that Standard 10 of the Land Trust Alliance Standards says accredited land trusts should undertake or demand from the property owner and the appraiser. Many of the elements of a conservation easement appraisal referenced in the questions are not discussed in any detail in this article. Detailed information on every appraisal element listed in the Appendix checklist and why the questions are important can be found in the second edition of the Appraisal Institute’s \textit{Appraising Conservation and Historic Preservation Easements}.

\textsuperscript{65} The NCED is a database of privately and publicly held conservation easements compiled from both land trusts and public agencies; see “Explore” at www.conservationeasement.us.
About the Authors

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Anne S. Baxendale is a senior vice president with JLL Valuation & Advisory Services LLC. She specializes in modeling and analysis of large-scale market and transactional data using custom-built databases and geographic information system (GIS) spatial analysis technology. She is a past contributor to The Appraisal Journal and holds a bachelor of science degree in political science from the University of Dayton and master of urban planning and policy degree from the University of Illinois Chicago. Contact: Annie.Baxendale@jll.com

Disclosure: JLL Valuation & Advisory Services works on conservation easement assignments for both taxpayers as well as federal government agencies including the Internal Revenue Service and the U.S. Department of Justice.

SEE NEXT PAGE FOR APPENDIX >

Additional Resources

Suggested by the Y. T. and Louise Lee Lum Library

Appraisal Institute

• Education
  • Advanced Land Valuation: Real Solutions to Complex Issues
  • Community Land Trust Appraisal Training
  • Valuation of Conservation Easements
  • Valuation of Conservation Easements and Taxes [webinar]

• Lum Library, Knowledge Base [Login required]
  • Conservation—preservation—scenic easements

• Publications
  • Appraising Conservation and Historic Preservation Easements, Second Edition
  • Land Valuation: Real Solutions to Complex Issues

US Department of Agriculture—Agricultural Conservation Easement Program
https://www.nrcs.usda.gov/programs-initiatives/acep-agricultural-conservation-easement-program
## Appendix  Conservation Easement Appraisal: Land Trust Review Checklist

<table>
<thead>
<tr>
<th>Checklist Item No.</th>
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<th>Applicability</th>
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<tbody>
<tr>
<td>1.A</td>
<td>Is there a “Certification” signed by the appraiser?</td>
<td>Yes</td>
</tr>
<tr>
<td>1.B</td>
<td>Is there a “Statement of Assumptions and Limiting Conditions”?</td>
<td></td>
</tr>
<tr>
<td>1.C</td>
<td>Is the appraiser's state license number shown under the signature line?</td>
<td>Yes</td>
</tr>
<tr>
<td>1.D</td>
<td>Are those who provided “significant appraisal assistance” listed in the Certification?</td>
<td>Yes</td>
</tr>
<tr>
<td>1.E</td>
<td>Is there a description of the “significant appraisal assistance” provided somewhere in the report?</td>
<td>Yes</td>
</tr>
<tr>
<td>1.F</td>
<td>Is there a “Scope of Work” description?</td>
<td></td>
</tr>
<tr>
<td>1.G</td>
<td>Does the appraisal include a detailed description of the appraiser’s qualifications?</td>
<td>Yes</td>
</tr>
<tr>
<td>1.H</td>
<td>Is there a description of the appraiser’s “competency” to undertake an appraisal of this type of property?</td>
<td>Yes</td>
</tr>
<tr>
<td>1.I</td>
<td>Is there a date of inspection listed or a statement that the property was not personally inspected?</td>
<td>Yes</td>
</tr>
<tr>
<td>1.J</td>
<td>Is there a clear description of the property appraised?</td>
<td>Yes</td>
</tr>
<tr>
<td>1.K</td>
<td>Is there a discussion of any recent (within the prior three years) leases, offers, or sales of the property?</td>
<td>Yes</td>
</tr>
<tr>
<td>1.L</td>
<td>Does the appraisal state it was prepared in accordance with USPAP?</td>
<td>Yes</td>
</tr>
<tr>
<td>1.M</td>
<td>Does the appraisal (and the Statement of Assumptions and Limiting Conditions) contain a statement that a hypothetical condition has or has not been used in arriving at the opinions of value in the report?</td>
<td>Yes</td>
</tr>
<tr>
<td>1.N</td>
<td>If the appraisal states that it is based on a hypothetical condition, does the appraisal explain the reason for including a hypothetical condition and a statement that the opinion of value could be significantly different if the hypothetical condition was not used?</td>
<td>Yes</td>
</tr>
<tr>
<td>1.O</td>
<td>If more than one approach to value is used, is there a discussion of the differences in the results of each approach and a reconciliation of the differences that support the appraiser’s final conclusion of value?</td>
<td>Yes</td>
</tr>
<tr>
<td>1.P</td>
<td>If more weight is given to the results of one of the approaches to value than to another, is there reasoning and support for that weighting in the reconciliation of the approaches?</td>
<td>Yes</td>
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<tr>
<td></td>
<td><strong>Element 2: Compliance with IRS Qualified Appraisal and Qualified Appraiser Requirements</strong></td>
<td></td>
</tr>
<tr>
<td>2.A</td>
<td>Does the report state it was prepared “for income tax purposes” to support the charitable donation of a conservation easement?</td>
<td></td>
</tr>
<tr>
<td>2.B</td>
<td>Is the appraiser’s name, address, and taxpayer identification number included?</td>
<td></td>
</tr>
<tr>
<td>2.C</td>
<td>If the appraiser’s taxpayer ID number is not included, is the name, address, and taxpayer ID number of the appraiser’s employer included?</td>
<td></td>
</tr>
<tr>
<td>2.D</td>
<td>Is the date of the charitable donation or expected date of donation included?</td>
<td></td>
</tr>
<tr>
<td>2.E</td>
<td>Does the date of donation match the date of easement recording?</td>
<td></td>
</tr>
<tr>
<td>2.F</td>
<td>Does the date of value match the date of donation or expected donation?</td>
<td></td>
</tr>
<tr>
<td>2.G</td>
<td>Is the date that the appraisal was signed/prepared included in both the text and the Certification?</td>
<td></td>
</tr>
<tr>
<td>2.H</td>
<td>Is the date of the signed appraisal no earlier than 60 days before the date of donation/recording?</td>
<td></td>
</tr>
<tr>
<td>2.I</td>
<td>Is there a description of the appraiser’s qualifications/competency to appraise a conservation easement?</td>
<td></td>
</tr>
<tr>
<td>2.J</td>
<td>Is there a “declaration” that because of the appraiser’s experience, education, and membership in professional organizations, the appraiser is qualified to appraise the conservation easement on this particular property?</td>
<td></td>
</tr>
<tr>
<td>2.K</td>
<td>Is there a statement acknowledging the “substantial or gross valuation misstatement” penalties?</td>
<td></td>
</tr>
<tr>
<td>2.L</td>
<td>Does the summary of the appraiser’s qualifications include background, experience, education, and any membership in professional appraisal organizations?</td>
<td></td>
</tr>
<tr>
<td>2.M</td>
<td>Is there a detailed description of the “property” including its “physical condition”?</td>
<td></td>
</tr>
<tr>
<td>2.N</td>
<td>Is there a statement that the purpose of the appraisal is to determine the “fair market value” of the conservation easement?</td>
<td></td>
</tr>
<tr>
<td>2.O</td>
<td>Is there a definition of fair market value and/or market value and a statement as to whether the two terms are assumed to have the same meaning?</td>
<td></td>
</tr>
<tr>
<td>2.P</td>
<td>Is there a summary of the terms and restrictions in the easement agreement including any restrictions on use, sale, or disposition of the property?</td>
<td></td>
</tr>
<tr>
<td>2.Q</td>
<td>Is there a description of the “fee arrangement” between the appraiser and the donor of the easement?</td>
<td></td>
</tr>
<tr>
<td>2.R</td>
<td>Is there a description of the “method of valuation” used?</td>
<td></td>
</tr>
<tr>
<td>2.S</td>
<td>Does the appraisal arrive at a conclusion concerning the “fair market value” of the conservation easement?</td>
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<tr>
<td></td>
<td><strong>Element 3: Compliance with IRS Contiguous Property and “Other Property” Enhancement/Benefit Rules</strong></td>
<td></td>
</tr>
<tr>
<td>3.A</td>
<td>Does the appraisal describe the inquiries made or research conducted to identify all “contiguous property” owned by the donor or the donor’s family?</td>
<td></td>
</tr>
<tr>
<td>3.B</td>
<td>Does the appraisal “describe” all contiguous property owned by the donor or the donor’s family?</td>
<td></td>
</tr>
<tr>
<td>3.C</td>
<td>Does the appraisal then value the entirety of the contiguous property owned by the donor or the donor’s family?</td>
<td></td>
</tr>
<tr>
<td>3.D</td>
<td>Does the appraisal consider the value of the “contiguous property” both “before” as well as “after” considering the effect of the conservation easement?</td>
<td></td>
</tr>
<tr>
<td>3.E</td>
<td>Does the appraisal describe the inquiries made or research conducted to identify “other property” owned by the donor or a related person?</td>
<td></td>
</tr>
<tr>
<td>3.F</td>
<td>If “other property” is identified, does the appraisal summarize why it was, or was not, included in the value analysis “before and after” considering the conservation easement?</td>
<td></td>
</tr>
<tr>
<td>3.G</td>
<td>If no “contiguous property” or “other property” is identified in the appraisal, does the appraisal state that inquiries were made and the appraiser is relying on representations made by others that are reasonably believed to be accurate?</td>
<td></td>
</tr>
<tr>
<td>3.H</td>
<td>Does the appraisal consider “other benefits” such as cash received in a bargain sale transaction involving the charitable donation of the easement?</td>
<td></td>
</tr>
<tr>
<td>3.I</td>
<td>Does the final “fair market value” reported in the appraisal reflect any offsetting effects on value from any benefits received?</td>
<td></td>
</tr>
<tr>
<td>3.J</td>
<td>If the appraisal “identifies” but does not consider the value of all “contiguous” or “other property,” is there a clear statement of assumptions or limiting conditions related to the exclusion of consideration of their value in the appraisal assignment?</td>
<td></td>
</tr>
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</table>

|                    | **Element 4: Compliance with IRS Syndicated Conservation Easement Rules** |               |
| 4.A                | Does the appraisal contain a statement concerning the involvement of syndicated tax benefits or donation of a syndicated conservation easement? |               |
| 4.B                | Does the appraisal include a discussion/analysis of any recent purchase transactions involving the subject property within the 36 months “before” the donation of the conservation easement? |               |
| 4.C                | Is the appraised value of the property “before” considering the conservation easement more than 2.5 times the purchase price paid within 36 months prior to the donation of the conservation easement? |               |

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<tr>
<td>4.D</td>
<td>Does the appraisal report contain a statement that inquiries were made to the donor concerning the taxpayer’s purchase price “basis” in the property and whether the conservation easement has been (or is planned to be) “syndicated” to investors?</td>
<td>Yes No NA</td>
</tr>
<tr>
<td>4.E</td>
<td>Does the appraisal report indicate the results of the inquiries to the donor related to syndication of the conservation easement to investors?</td>
<td>Yes No NA</td>
</tr>
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**Element 5: Compliance with Generally Recognized Appraisal Methods for Highest and Best Use and Discounted Cash Flow (DCF) Analysis**

<table>
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<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>5.A</td>
<td>Does the appraisal contain a definition of <em>highest and best use</em>?</td>
<td>Yes No NA</td>
</tr>
<tr>
<td>5.B</td>
<td>Does the appraisal separately consider the highest and best use of the entire property (including any contiguous property) both “before” as well as “after” considering the conservation easement?</td>
<td>Yes No NA</td>
</tr>
<tr>
<td>5.C</td>
<td>Does the appraisal separately discuss and analyze the highest and best use of the property “as improved” and the highest and best use of the land “as if vacant” on the date of value?</td>
<td>Yes No NA</td>
</tr>
<tr>
<td>5.D</td>
<td>Are each of the four prongs of highest and best use analysis (i.e., physically possible uses, legally permissible uses, financially feasible uses, and maximally productive use) discussed in detail both “before” and “after” considering the conservation easement?</td>
<td>Yes No NA</td>
</tr>
<tr>
<td>5.E</td>
<td>Is there a clear and detailed discussion of any physical limitations on use of the property (e.g., slope issues, soil conditions, vegetation, road access and frontage, property shape or size, water quality, water rights or utility availability issues, etc.) in considering the highest and best use of the property “before” considering the conservation easement?</td>
<td>Yes No NA</td>
</tr>
<tr>
<td>5.F</td>
<td>Is there a discussion of any existing restrictions of record (e.g., other easements, covenants, long-term leases, mineral rights, etc.) on the legally permissible uses of the property “before” considering the conservation easement?</td>
<td>Yes No NA</td>
</tr>
<tr>
<td>5.G</td>
<td>Is there a discussion and analysis of any existing land use restrictions imposed by zoning, planning, wetland, slope, environmental, etc. regulations on the property “before” considering the restrictions imposed by the conservation easement?</td>
<td>Yes No NA</td>
</tr>
<tr>
<td>5.H</td>
<td>If the appraisal assumes a zoning change, is there information and analysis included to support a conclusion that a change in zoning or subdivision approval is “reasonably probable” in the near future and would be approved by the local zoning and planning authorities?</td>
<td>Yes No NA</td>
</tr>
<tr>
<td>5.I</td>
<td>If some type of subdivision of the property is considered “legally permissible” and “physically possible” before considering the easement, is there any comparison of alternative possible discounted cash flow analyses showing supportable variations in potential lot numbers, lot sizes, lot prices, development costs, and absorption periods included as part of the analysis of “financial feasibility”?</td>
<td>Yes No NA</td>
</tr>
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<thead>
<tr>
<th>Checklist Item No.</th>
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</thead>
<tbody>
<tr>
<td>5.J</td>
<td>Does the appraisal contain a detailed description and analysis of the market area in which the property is located?</td>
<td></td>
</tr>
<tr>
<td>5.K</td>
<td>Is the described market area focused on the actual geographic area where the subject property is located?</td>
<td></td>
</tr>
<tr>
<td>5.L</td>
<td>Does the described market area include areas outside the state in which the subject property is located?</td>
<td></td>
</tr>
<tr>
<td>5.M</td>
<td>Is there a map in the report showing the defined market area?</td>
<td></td>
</tr>
<tr>
<td>5.N</td>
<td>Does the report contain a discussion and analysis of how the market area for the subject property was selected?</td>
<td></td>
</tr>
<tr>
<td>5.O</td>
<td>Is there a discounted cash flow (DCF) analysis included in the report either as part of the highest and best use analysis or as a separate approach to value?</td>
<td></td>
</tr>
<tr>
<td>5.P</td>
<td>Is there market support (i.e., supply and demand analysis) in the appraisal for any lot or subdivided parcel pricing included in the highest and best use analysis or in a DCF analysis?</td>
<td></td>
</tr>
<tr>
<td>5.Q</td>
<td>Is there market support (i.e., supply and demand analysis) in the appraisal for any absorption rate of subdivided lots or parcels included in the highest and best use analysis or in a DCF analysis?</td>
<td></td>
</tr>
<tr>
<td>5.R</td>
<td>Is there support in the appraisal for development costs used in any DCF analysis?</td>
<td></td>
</tr>
<tr>
<td>5.S</td>
<td>Does any DCF analysis included in either the highest and best use section or in the valuation section of the appraisal include a delay for the time needed to obtain any zoning, planning, or other development approvals?</td>
<td></td>
</tr>
<tr>
<td>5.T</td>
<td>Does any DCF analysis included in either the highest and best use section or in the valuation section of the appraisal include a delay for the time needed to extend utilities and infrastructure to the entire property or to sections of the property?</td>
<td></td>
</tr>
<tr>
<td>5.U</td>
<td>Does any DCF analysis include as a development cost a developer’s fee or management expense?</td>
<td></td>
</tr>
<tr>
<td>5.V</td>
<td>Does any DCF analysis include an expense related to legal and title fees and broker’s commissions associated with selling individual lots or subdivided parcels?</td>
<td></td>
</tr>
<tr>
<td>5.W</td>
<td>Does the DCF analysis indicate how the discount rate was selected and indicate the source of that data?</td>
<td></td>
</tr>
<tr>
<td>5.X</td>
<td>Is there a clear and compelling discussion of the effect, if any, of the provisions of the conservation easement on the “before” highest and best use?</td>
<td></td>
</tr>
<tr>
<td>5.Y</td>
<td>Does the appraisal utilize a DCF analysis to arrive at the “after” easement highest and best use and/or the “after” easement value of the property?</td>
<td></td>
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### Appendix (continued)

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<tr>
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<tbody>
<tr>
<td><strong>Element 6:</strong> The Sales Comparison Approach—“Before” Considering the Conservation Easement</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6.A</td>
<td>Does the appraisal identify the “market area” within which a search was conducted for possible comparable sales?</td>
<td></td>
</tr>
<tr>
<td>6.B</td>
<td>If the sales used to value the property “before” the easement are located at a considerable distance from the subject property, is there an explanation in the appraisal for why sales closer in proximity to the subject property were not used?</td>
<td></td>
</tr>
<tr>
<td>6.C</td>
<td>Is there a map showing the location of the comparable sales used?</td>
<td></td>
</tr>
<tr>
<td>6.D</td>
<td>Is there an “adjustment” grid indicating how the prices indicated by the comparable sales were compared to the subject property and analyzed?</td>
<td></td>
</tr>
<tr>
<td>6.E</td>
<td>Are the comparisons between the comparable sales and the subject in the adjustment grid shown as “qualitative” in nature (e.g., inferior, superior, similar, etc.)?</td>
<td></td>
</tr>
<tr>
<td>6.F</td>
<td>If “qualitative” adjustments are made in the adjustment grid, is there a discussion of the basis for each of the qualitative comparisons and how the appraiser arrived at the final conclusion concerning the superiority, inferiority, or similarity of the comparable (as adjusted) to the subject property “before” considering the conservation easement?</td>
<td></td>
</tr>
<tr>
<td>6.G</td>
<td>Are the comparisons between the comparable sales and the subject in the adjustment grid shown as “quantitative” in nature (e.g., 10% inferior, 5% superior, similar, etc.)?</td>
<td></td>
</tr>
<tr>
<td>6.H</td>
<td>If “quantitative” adjustments are made in the adjustment grid, is there a discussion of the basis for each of the quantitative adjustments and how the appraiser arrived at the final conclusion concerning the percentage superior, percentage inferior, or similarity of the comparable (as adjusted) to the subject property “before” considering the conservation easement?</td>
<td></td>
</tr>
<tr>
<td>6.I</td>
<td>Does the appraisal discuss and analyze any needed adjustments for differences between the dates when the comparable sales sold and the date of value of the subject property?</td>
<td></td>
</tr>
<tr>
<td>6.J</td>
<td>If the comparable sales are significantly different from the subject property in size, is there a discussion and analysis of any adjustments to the comparable sales needed to account for those differences?</td>
<td></td>
</tr>
<tr>
<td>6.K</td>
<td>Is the zoning of the comparable sales indicated, and is there a discussion and analysis of any adjustments to the comparable sales needed to account for the differences between the zoning of the comparable sales and the zoning of the subject property on the date of value?</td>
<td></td>
</tr>
<tr>
<td>6.L</td>
<td>Has the appraiser “weighted” the comparable sales by giving more “weight” to one or more of the comparable sales than to others?</td>
<td></td>
</tr>
<tr>
<td>6.M</td>
<td>Has the appraiser given more “weight” to the comparable sales requiring the least number or level of adjustment as recommended in IRS Publication 561?</td>
<td></td>
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### Appendix (continued)

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<tr>
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</thead>
<tbody>
<tr>
<td>6.N</td>
<td>Does the summary of the comparable sales used include the names of buyers and sellers, deed book and page number, date of sale and selling price, amount and terms of any mortgage, assessed value, etc. as discussed in IRS Publication 561?</td>
<td>Yes</td>
</tr>
</tbody>
</table>

**Element 7: The Sales Comparison Approach—Consideration and Analysis of Actual Easement Sales**

<table>
<thead>
<tr>
<th>Item</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>7.A</td>
<td>Does the appraisal discuss whether there are actual easement purchases that can be used to directly value the subject conservation easement?</td>
</tr>
<tr>
<td>7.B</td>
<td>If the use of actual easement sales is rejected, is the support for that conclusion provided in the report sufficient to indicate that no “meaningful or valid comparison” to the subject easement can be made?</td>
</tr>
<tr>
<td>7.C</td>
<td>If actual sales are used to value the conservation easement, does the appraisal compare and contrast the protections and provisions in those other easement documents to the protections and provisions in the subject easement being appraised?</td>
</tr>
<tr>
<td>7.D</td>
<td>If the easement purchases used as comparable sales were made by a unit of federal, state, or local government, is there analysis and support for a conclusion that they were negotiated arm’s-length transactions?</td>
</tr>
</tbody>
</table>

**Element 8: The Sales Comparison Approach—“After” Considering the Conservation Easement**

<table>
<thead>
<tr>
<th>Item</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>8.A</td>
<td>If the appraisal does not utilize actual prices paid by purchasers of conservation easements, does the appraisal utilize prices paid for properties encumbered by conservation easements as evidence of the “after” value of the entire contiguous property that is the subject of the appraisal?</td>
</tr>
<tr>
<td>8.B</td>
<td>Does the appraisal identify the “market area” within which a search was conducted for possible “after easement” comparable sales?</td>
</tr>
<tr>
<td>8.C</td>
<td>If the sales used to value the property “after” the easement are located at a considerable distance from the subject property, is there an explanation in the appraisal for why sales closer in proximity to the subject property were not used?</td>
</tr>
<tr>
<td>8.D</td>
<td>Is there a map showing the location of the “after” comparable sales used?</td>
</tr>
<tr>
<td>8.E</td>
<td>Is there a comparison of the terms, restrictions, and protections in the conservation easements protecting the “after” easement comparable sales with the terms and restrictions in the conservation easement on the property that is the subject of the appraisal report?</td>
</tr>
<tr>
<td>8.F</td>
<td>Do the terms, restrictions, and protections in the conservation easements on the comparable “after” easement sales appear to be sufficiently comparable to those in the easement on the subject property to justify their use as comparable sales?</td>
</tr>
<tr>
<td>8.G</td>
<td>Is there an “adjustment” grid indicating how the prices indicated by the comparable easement encumbered sales were compared to the subject property and analyzed?</td>
</tr>
</tbody>
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### Appendix (continued)

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<tr>
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</thead>
<tbody>
<tr>
<td>8.H</td>
<td>Are the comparisons between the “after” easement comparable sales and the subject property “after” considering the easement in the adjustment grid shown as “qualitative” in nature (e.g., inferior, superior, similar, etc.)?</td>
<td>Yes</td>
</tr>
<tr>
<td>8.I</td>
<td>If “qualitative” adjustments are made in the adjustment grid, is there a discussion of the basis for each of the qualitative comparisons and how the appraiser arrived at the final conclusion concerning the superiority, inferiority, or similarity of the comparable (as adjusted) to the subject property “after” considering the conservation easement?</td>
<td>Yes</td>
</tr>
<tr>
<td>8.J</td>
<td>Are the comparisons between the comparable sales and the subject in the adjustment grid shown as “quantitative” in nature (e.g., 10% inferior, 5% superior, similar, etc.)?</td>
<td>Yes</td>
</tr>
<tr>
<td>8.K</td>
<td>If “quantitative” adjustments are made in the adjustment grid, is there a discussion of the basis for each of the quantitative adjustments and how the appraiser arrived at the final conclusion concerning the percentage superior, percentage inferior, or similarity of the comparable (as adjusted) to the subject property “after” considering the conservation easement?</td>
<td>Yes</td>
</tr>
<tr>
<td>8.L</td>
<td>Has the appraiser “weighted” the comparable sales by giving more “weight” to one or more of the “after” easement comparable sales than to others?</td>
<td>Yes</td>
</tr>
<tr>
<td>8.M</td>
<td>Has the appraiser given more “weight” to the “after” easement comparable sales requiring the least number or level of adjustment as recommended in IRS Publication 561?</td>
<td>Yes</td>
</tr>
<tr>
<td>8.N</td>
<td>Does the summary of the “after” easement comparable sales used include the names of buyers and sellers, deed book and page number, date of sale and selling price, amount and terms of any mortgage, assessed value, etc. as discussed in IRS Publication 561?</td>
<td>Yes</td>
</tr>
</tbody>
</table>

**Element 9: Consideration of the Contributory Value of Any Improvements**

<table>
<thead>
<tr>
<th>Checklist Item</th>
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</tr>
</thead>
<tbody>
<tr>
<td>9.A</td>
<td>Are there any improvements on the subject property?</td>
</tr>
<tr>
<td>9.B</td>
<td>Does the appraisal include a description of those improvements on the land and consideration and analysis of their contribution, if any, to the “before” value of the entire contiguous property by the conservation easement?</td>
</tr>
<tr>
<td>9.C</td>
<td>Does the appraisal consider and discuss the effect, if any, of the conservation easement on the value of any improvements on the property?</td>
</tr>
<tr>
<td>9.D</td>
<td>Is the contributory value, if any, of the improvements “before” considering the conservation easement discussed and analyzed as part of the sales comparison approach to the value of the contiguous property? <em>(This can be especially important in the valuation of easement-encumbered ranch properties with improvements.</em>)</td>
</tr>
<tr>
<td>9.E</td>
<td>Do the adjustments to improved comparable sales used in the “before” easement valuation analysis consider the contribution to value due to any differences between the improvements on the comparable sale property and the improvements on the subject property?</td>
</tr>
</tbody>
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## Appendix (continued)

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<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>9.F</td>
<td>Do the adjustments to improved comparable sales used in the “after” easement valuation analysis consider the contribution to value due to any differences between the improvements on the comparable “after” easement sale properties and the improvements on the subject property?</td>
<td>Yes</td>
</tr>
<tr>
<td>9.G</td>
<td>Does the appraisal include a cost approach to value of the improvements?</td>
<td>No</td>
</tr>
<tr>
<td>9.H</td>
<td>If a cost approach to the value of the improvements is included, does the appraisal include an analysis of the remaining useful life of the improvements and a discussion and analysis of the appropriate physical, functional, and external obsolescence factors affecting the “before” easement value of the improvements?</td>
<td>No</td>
</tr>
<tr>
<td>9.I</td>
<td>If a cost approach to the value of the improvements is included, does the appraisal include discussion and analysis of the effect, if any, of the conservation easement on the remaining useful life of the improvements and a discussion and analysis of the effect, if any, of the conservation easement on the appropriate physical, functional, and external obsolescence factors affecting the “after” easement value of the improvements?</td>
<td>No</td>
</tr>
</tbody>
</table>

### Element 10: Analysis of Contribution to Value from Existing Income from Rent, Crops, or Other Sources

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<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>10.A</td>
<td>Does the existing property generate income from rent, crops, or other sources?</td>
<td>Yes</td>
</tr>
<tr>
<td>10.B</td>
<td>Does the appraisal include a discussion and analysis of recent income from rent, crops, or other sources and expenses, if any, associated with producing that income?</td>
<td>Yes</td>
</tr>
<tr>
<td>10.C</td>
<td>Does the appraisal arrive at a contribution of any net income from rent, crops, or other sources to the value “before” considering the conservation easement by capitalizing that net income?</td>
<td>No</td>
</tr>
<tr>
<td>10.D</td>
<td>Is the net income used to arrive at a capitalized “before” easement value section of the report significantly different from the actual net income generated from rent, crops, or other sources in recent years?</td>
<td>Yes</td>
</tr>
<tr>
<td>10.E</td>
<td>If the net income considered and capitalized in the “before” easement appraisal is significantly different from actual net income generated in recent years, is there a discussion and analysis of why a different net income was used in estimating the “before” value of the property?</td>
<td>Yes</td>
</tr>
<tr>
<td>10.F</td>
<td>If the existing or potential income of the subject property has been &quot;capitalized” into a direct estimate of “before” easement value, is there discussion of capitalization rates and support provided for the selection of the capitalization rate used?</td>
<td>No</td>
</tr>
<tr>
<td>10.G</td>
<td>Has the income productivity of the entire contiguous subject property been considered and compared to the income-generating potential, if any, of comparable sales used in the sales comparison approach to arrive at the “before” easement value of the subject property?</td>
<td>Yes</td>
</tr>
<tr>
<td>10.H</td>
<td>Has the effect, if any, of the conservation easement on that income productivity potential been considered and discussed in the “after” easement value section of the appraisal report?</td>
<td>No</td>
</tr>
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<tbody>
<tr>
<td>11.A</td>
<td>Does the appraisal contain an Addenda?</td>
<td></td>
</tr>
<tr>
<td>11.B</td>
<td>Does the Addenda contain a copy of the signed and recorded conservation easement?</td>
<td></td>
</tr>
<tr>
<td>11.C</td>
<td>If the appraisal was prepared before the acceptance and recording of the final conservation easement, does it contain a copy of the latest draft of the easement as of the date the appraisal was submitted?</td>
<td></td>
</tr>
<tr>
<td>11.D</td>
<td>If the appraisal is based on only a “draft” conservation easement document, does the appraisal clearly state that it is based on a draft rather than the final recorded conservation easement?</td>
<td></td>
</tr>
<tr>
<td>11.E</td>
<td>If the appraisal is based on only a “draft” conservation easement document, does the appraisal report clearly state that the appraised value of the conservation easement could be substantially different if the terms, restrictions, and protections in the final recorded easement are substantially different from the terms, restrictions, and protections in the draft conservation easement on which the appraisal is based?</td>
<td></td>
</tr>
<tr>
<td>11.F</td>
<td>If the appraisal is based on only a “draft” conservation easement document, does the appraisal include a clear statement that the appraiser is assuming that the terms, restrictions, and protections in the final recorded conservation easement will be substantially the same as the draft easement on which the appraisal is based?</td>
<td></td>
</tr>
<tr>
<td>11.G</td>
<td>If the appraisal was prepared based on a draft easement, are the terms, restrictions, and protections in the final signed and recorded easement sufficiently similar to those in the draft easement?</td>
<td></td>
</tr>
<tr>
<td>11.H</td>
<td>Does the appraisal Addenda include a copy of the baseline condition report?</td>
<td></td>
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The Price Is Right?  
The Impact of a Scenic View on the Pricing of Residential Property

by David Wyman, PhD, and Chris Mothorpe, PhD

Abstract

This study explores the real estate market’s reactions to changes in proximate view amenities by examining home sales before, during, and after the construction of a new reservoir in Fayette County, Georgia. The study’s findings reveal large increases in the price premium for parcels adjacent to the new reservoir, with higher-quality lake views earning the highest price premium. The study also finds the market anticipated the price premium for soon-to-be waterfront properties, with prices starting to increase prior to the opening of the reservoir and continuing to increase afterwards. In contrast, the price of interior non-view properties remained relatively flat in constant dollars. Overall, the study shows the inclusion of micro-spatial and temporal view variables in pricing models can help appraisers, researchers, and real estate professionals ensure accurate pricing.

Introduction

One of the more vexing issues in residential appraisal is the estimation of the value of a view. The quality of a scenic view is determined by the geometric relationship between a property site and its surrounding topography; however, the complexity of this relationship means neighboring properties can have radically different view corridors and thereby generate dissimilar view premiums. Thus, the explicit pricing premium for any given view amenity is site specific. Extensive research has established a general hierarchy in the pricing of views. Typically, properties with no view amenity are situated at the base of the pyramid with price premiums increasing for higher quality views of open space, golf course, and water views respectively. Waterfront adjacent properties with higher-quality views earn the highest price premium.

The construction of Lake McIntosh (Fayette County, Georgia) in a community of pre-existing residential properties provides the opportunity to gain insights on the real estate market’s valuation of view amenities. This study exploits the construction of a new reservoir to estimate the price premiums for scenic views before, during, and after the construction of the Lake McIntosh reser...

4. Fayette County, Georgia, is located on the southwest side of the Atlanta Metropolitan area.
The construction of Lake McIntosh led to increased market value for all impacted residential properties. With over 53,000 man-made reservoirs in the United States—constituting approximately 48% of all lakes—reservoirs are an important water management tool, while potentially serving as a view amenity for residential properties. Second, the study examines to what extent the real estate market anticipated the rise in property prices associated with the construction of Lake McIntosh. Third, the study area includes extensive spatial heterogeneity with neighboring properties sharing different view amenities, including views of a golf course, woods, a creek, two ponds, and a lake. Using discrete geospatial tools, the hierarchical scope of pricing premiums for these different view amenities is examined. Finally, the study hypothesizes that the construction of Lake McIntosh did not impact the sale prices of non-lake view parcels.

The results reveal support for all four study hypotheses. In comparison to interior non-view parcels, the price premium increased by 165% for lake-impacted parcels with a pre-existing pond view and by 784% for lake-impacted parcels with a pre-existing forest view. Also, lake-impacted parcels with a pre-existing forest view sold at a price premium of 2.33% before construction of Lake McIntosh, compared to a premium of 8.58% during the construction and a 20.56% premium after its construction. These results support the study’s second hypothesis—the real estate market anticipated the rise in property prices due to the construction of Lake McIntosh. The micro-spatial results reveal a clear hierarchy in the pricing of views with higher-quality water views of Lake McIntosh commanding the highest price premium.

Interestingly, the construction of the lake did not have any transferable impact on the pricing of non-lakefront property in the nearby Planterra Ridge subdivision. This may be due to negligible lake views from interior properties in the subdivision. To protect the quality of the water, Fayette County created an undisturbed buffer between the water line at 780 MSL (mean sea level) and 790 MSL where the cutting of trees or bushes is prohibited. The growth of vegetation in this undisturbed buffer acts to minimize any view corridor in an already heavily wooded area of rolling hills. Additionally, the standard lakefront home in the subdivision is a two-story residence, which further limits lake views from interior properties. Complementing earlier view studies on the valuation of scenic views, the current study provides appraisers, developers, researchers, and policymakers with reference points to help construct future pricing models of view amenities.

The next section details background information on the study area and presents the literature review. The subsequent sections discuss the empirical methodology and the data. This is followed by presentation of the empirical results, with conclusions and recommendations for future research.

### Background Information

#### Lake McIntosh and Planterra Ridge Subdivision

Lake McIntosh is a 650-acre reservoir within the Fayette County, Georgia, water system formed for the primary purpose of providing approximately 10 million gallons of drinking water per day to county residents. The area that eventually became Lake McIntosh was identified as a potential reservoir site in the 1960s, and Fayette County began purchasing land in the 1980s; however, approximately 30 years passed before the US Army Corps of Engineers approved the 404-water discharge permit in 2007. The Lake McIntosh dam was built between January 2010 and November 2012, and Lake McIntosh achieved full pool in February 2013.

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The Planterra Ridge subdivision sits on the eastern shore of Lake McIntosh, and the subdivision consists of 435 single-family homes built between 1993 and 1999. Prior to the creation of Lake McIntosh there were two nearby, pre-existing ponds (the Western Pond and Eastern Pond) adjacent to the different portions of the Planterra Ridge subdivision; however, Lake McIntosh subsumed the Western Pond and enlarged the Eastern Pond once it reached full pool. In addition to bordering Lake McIntosh, the northwest portion of the subdivision borders the Line Creek Nature Area, which is a 70-acre public preserve owned by the city of Peachtree City, Georgia. Exhibit 1 displays the locations of Lake McIntosh, the Western Pond, the Eastern Pond, and the Line Creek Nature Area relative to the Planterra Ridge subdivision. Exhibit 2 shows the change in view amenities using satellite photos. Panel A of Exhibit 2 displays the Planterra Ridge subdivision on March 17, 2004, while Panel B of Exhibit 2 displays the same area 10 years later.

Parcels were assigned to a view amenity group if the parcel is adjacent to the view amenity; there are five view amenity groups: (1) Eastern Pond; (2) Woods/Lake; (3) Line Creek; (4) Western Pond; and (5) No View Amenity. Exhibit 3 maps the Planterra Ridge parcels according to their assigned view amenity group. There are 54 parcels, representing approximately 12% of all parcels in Planterra Ridge, with a view of Lake McIntosh, and these lakeview parcels can be subdivided into two groups. The group entitled Woods/Lake consists of 31 parcels; these parcels had either a wooded or forest view prior to the construction of Lake McIntosh and a view of Lake McIntosh after 2012. The group Western Pond consists of 23 parcels; these parcels had a view of the Western Pond prior to 2013 and a view of Lake McIntosh after 2012. Exhibit 3 also shows there are 18 parcels adjacent to the Line Creek Nature Area (Line Creek group), and 12 parcels with a view of the Eastern Pond within the Eastern Pond group. Although not depicted, the southern end of the neighborhood is intertwined with several holes of the Planterra Ridge golf course, and there are 81 parcels with golf course frontage.

**Literature Review**

View amenities are not a homogenous good, and many studies are not directly comparable due to the use of differing methodologies, spatio-temporal variation in customer preferences, and the site-specific quality of the view. Researchers have examined the capitalization of

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10. The groups are nearly mutually exclusive as there is only one parcel belonging to more than one group. This parcel belonging to the Western Pond and Eastern Pond groups is not depicted in Exhibit 2; however, it was controlled for both amenities in the empirical analysis.

Exhibit 2  Satellite Photos 2004–2014

Panel A  Panel B


Exhibit 3  Parcel View Types

Planterra Ridge Parcel

View Type
- Eastern Pond
- Woods/Lake
- Line Creek
- None
- Western Pond and Lake McIntosh

Other Feature
- Eastern Pond
- Line Creek Nature Area
- Western Pond
- Lake McIntosh
the scenic quality of view amenities including water, mountain, and other open space views. Rodriguez and Sirmans\(^\text{12}\) estimate that the value of a good view (as classified by the Office of Assessment of Fairfax County) adds an 8% price premium to a residential property. A review by Crompton of thirty studies\(^\text{13}\) uncovers a price premium starting at 20% for residential properties adjacent to a passive park with variations dependent upon type of park and park proximity. Using a zonal approach, Lutzenhiser and Netusil\(^\text{14}\) identify significant price premiums for proximity to five different open spaces—cemeteries, urban parks, natural area parks, golf courses, and specialty parks—with natural area parks earning the largest price premium.

The concept of a hierarchy of price premiums is also revealed in studies with scenic views of mountains and water.\(^\text{15}\) For example, a study of waterfront residential properties in Tampa Bay found a hierarchy of water view properties with bayfront properties earning an average price premium of 107% followed by river (62%), canal (61%), lake (15%), and pond (3.1%) views compared to non-waterfront properties.\(^\text{16}\) Other studies confirm a hierarchy in the pricing of views including price premiums of 8% for views of non-recreational lakes in Nebraska\(^\text{17}\) and approximately 56% for unobstructed views of Lake Erie.\(^\text{18}\) Similarly, a study of residential properties in Bellingham, Washington, found a hierarchy of water views with price premiums ranging from 8% to 59%, depending on the quality of the view and distance from the water.\(^\text{19}\)

Research on the pricing of the view amenity reveals non-linearity in distance-decay effects. Bourassa, Hoesli, and Sun\(^\text{20}\) estimated a price premium of 59% for residential water views in Auckland, New Zealand, with the price premium decaying with distance from the coastline. They conclude a single, binary variable fails to account for the multidimensional elements of the view aesthetic. Conroy and Milosch\(^\text{21}\) found that houses within 500 feet of the coast near San Diego earn an estimated price premium of almost 102%, declining to 62.8% at a distance from the coast of 500 to 1,000 feet, with the premium disappearing beyond six miles from the coast.

The emergence of geographic information systems (GIS) has offered researchers access to viewshed analysis and other advanced spatial modeling techniques. Mothorpe and Wyman\(^\text{22}\) created a GIS spatial variable for water view area to estimate the quality of the water view by measuring the area of water view available for water view properties. They found that a 1% marginal increase in water view area is associated with a 3.85% increase in prices for waterfront properties on Lake Lanier, Georgia.

The estimates provided in the above studies illustrate the substantive “private benefits” accruing to residential property owners from proximate view amenities.\(^\text{23}\) Next, we discuss the empirical methodology used in the current study.

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\(^{12}\) Rodriguez and Sirmans, “Quantifying the Value of a View in Single-Family Housing Markets.”

\(^{13}\) Crompton, “The Impact of Parks on Property Values: A Review of the Empirical Evidence.”


\(^{16}\) Dumm, Sirmans, and Smersh, “Price Variation in Waterfront Properties over the Economic Cycle.”


\(^{19}\) Benson, Hansen, and Schwartz Jr., “Water Views and Residential Property Values.”

\(^{20}\) Bourassa, Hoesli, and Sun, “What’s in a View?”


\(^{23}\) Lutzenhiser and Netusil, “Effect of Open Spaces on a Home’s Sale Price.”
Empirical Methodology

The empirical strategy in this study includes a series of semi-log, spatial hedonic models to estimate the marginal implicit prices of a set of independent variables, with a comparison of the marginal prices between the models. The generic hedonic model is shown in equation (1).

\[
\ln(P_{it}) = \alpha + X_{it}\beta + Z_{it}\theta + Y_t + \epsilon_{it} \tag{1}
\]

In equation (1), \( \ln(P_{it}) \) is the natural log of the inflation-adjusted sale price (in July 2022 dollars) for home \( i \) in year \( t \), \( X_{it} \) is a matrix of variables measuring view amenity quality, \( Z_{it} \) is a matrix of observed, exogenous property and spatial characteristics, \( Y_t \) is a vector of year fixed effects, and \( \epsilon_{it} \) is the error term. The matrix \( Z_{it} \) includes the age of the home at time of sale, the square of age, the square feet, the size of the parcel, basement square feet, the number fireplaces, and a binary variable indicating if the parcel is adjacent to a golf course. Year fixed effects capture macroeconomics shocks impacting all home sales. Finally, robust standard errors are used to control for heteroskedascity in the error term in lieu of cluster-robust standard errors since the home sale data is spatially concentrated in one subdivision.

The coefficients of interest in equation (1) are in the vector \( \beta_j \), which capture price impacts from nearby view amenities, and the pricing impacts are measured for the four view amenity groups—Western Pond, Woods/Lake, Line Creek, Eastern Pond—relative to parcels without a nearby view amenity. For discussion purposes, we index the coefficients in \( \beta_j \) by \( j = 1, 2, 3 \), which capture price impacts for the four amenity groups in Model 2 employs sales between 2006 and 2012 to reveal the market’s valuation of the view amenities during the construction of Lake McIntosh. Model 3 employs all sales after 2012—the period after Lake McIntosh was completed. For discussion purposes, each model’s estimated coefficients is indexed by \( k \) \((k = 1, 2, 3)\) in order to discuss and compare coefficients between models. The coefficient \( \beta_{jk} \) yields the average price impact for view amenity group \( j \) from model \( k \). For example, \( \beta_{13} \) is the coefficient associated with the Western Pond group in Model 3.

With this notation each hypothesis can be expressed as a comparison of two or more coefficients. Exhibit 4 describes the four study hypotheses and displays the comparison of coefficients. Hypothesis 1 \((H_1)\) stipulates that the construction of Lake McIntosh led to increased market valuations for all impacted parcels. To empirically test \( H_1 \), we compare changes in the pricing impacts for Western Pond parcels and Woods/Lake parcels between Model 1 and Model 3. If Lake McIntosh increased market valuations of parcels in these groups, then the market valuation of Western Pond parcels increases \((\beta_{13} > \beta_{11})\) and the market valuation of Woods/Lake increases \((\beta_{23} > \beta_{21})\).

Hypothesis 2 \((H_2)\) states the real estate market anticipated the value of the future amenities and valuations began to rise during Lake McIntosh’s construction. \( H_2 \) is examined by comparing the pricing impacts for the Woods/Lake group before the construction of Lake McIntosh was announced (Model 1) to the pricing impact during the construction phase (Model 2). If the market anticipated the future view amenity, then \( \beta_{22} > \beta_{21} \). Hypothesis 3 \((H_3)\) states a hierarchy in the pricing of water view quality exists with higher-quality water view commanding higher price premiums. To test \( H_3 \), we compare the pricing impacts for the Western Pond parcels in Model 3 to the pricing impact for the Woods/Lake parcels. Since Western Pond parcels have a better view of Lake McIntosh relative to the Woods/Lake group, we expect \( \beta_{13} > \beta_{23} \); i.e., the pricing impact for Western Pond parcels is greater than the pricing impact for the Woods/Lake group. The final hypothesis, \( H_4 \), states the construction of Lake McIntosh did not impact the market’s valuation of the non-lake view amenities. To test \( H_4 \), we compare the pricing impacts for Eastern Pond par...
parcels and Line Creek parcels between Models 1, 2, and 3. If the construction of Lake McIntosh did not impact the valuation of the other view amenities, then the pricing impacts associated with those amenities will be relatively similar; i.e., $\beta_{31} = \beta_{32} = \beta_{33}$ and $\beta_{41} = \beta_{42} = \beta_{43}$.

Two sets of variables are used to capture the pricing impact from view amenities. The first set contains a series of binary variables—one for each view amenity group. The second set contains a continuous variable measuring the view quality of Lake McIntosh for the Western Pond and Woods/Lake groups and two binary variables for the Eastern Pond and Line Creek group. Our continuous measure of Lake McIntosh view quality—Water View Area—measures the natural log of the area of water view of Lake McIntosh available for each residential parcel. Only parcels in the Western Pond and Woods/Lake groups have positive values since no other parcels have a view of Lake McIntosh. In the pre-lake and construction periods, the Water View Area variable captures the view area of the area that would eventually become Lake McIntosh.

There are three sources of potential bias in the estimates. The first two are attributes separate from but highly correlated with water views. Previous studies identify a negative relationship between flood risk and home sale prices, while other studies find a positive relationship between sale prices and lake access. Therefore, the presence of flood risk or waterfront access makes it difficult to identify the separate pricing impacts from flood risk, water access, and water view quality using the hedonic methodology. Across the entire subdivision, there are a relatively low number of homes within a 100-year flood zone at time of sale. For example, 6 of 1,132 sales in the sample (approximately 0.5%) are in a 100-year flood zone. To determine the impact of sales within the 100-year flood zone on the coefficients, we estimate the models with and without sales in the 100-year flood zones and compare the coefficients. These comparisons demonstrate that sales in the 100-year flood zone do not significantly impact the sign, significance, or magnitude of the estimates; therefore, the main empirical results are based on the full sample of sales.

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27. These results are available from the author upon request.
To argue water access is not inflating the estimated coefficients for lake view premiums, we note the lake is surrounded by an undisturbed buffer between 780 mean sea level (MSL) and 790 MSL. Property owners are prohibited from cutting trees, bushes, and grasses (in the undisturbed buffer) as a water quality control measure. Thus, while it is possible for a property owner to have a direct path to Lake McIntosh, property owners are prohibited from building structures such as docks directly on the lake. The only direct access to the lake is provided at Lake McIntosh Park available to all Fayette County residents for a fee. Additionally, use of the lake is restricted to fishing and access is restricted to non-gas-powered boats such as canoes, paddleboards, and sailboats. Therefore, we believe any lake access premium will be negligible and not inflating the lake view estimates.

The third source of bias may be the misclassification of parcels. In particular, we are concerned with assigning a parcel to the No View Amenity group when the parcel is impacted by a view amenity. We examine the potential for the misclassification of parcels by estimating our three models but exclude any sale where the underlying parcel is adjacent to a parcel in the Western Pond or Woods/Lake group. The table of the results is omitted for brevity, but Wald t-tests indicate the coefficients are not statistically different from the main table of results; therefore, we conclude parcel misclassification is not biasing estimates.

Data

The Fayette County Tax Assessor’s office provided real estate transactions and home characteristics data covering December 1993 to June 2022. The transactions data includes the sale date, nominal sale price, and sale type, while the home characteristics data includes variables such as the year built, square footage, and number of fireplaces. The nominal sale prices are adjusted to June 2022 real prices using monthly inflation data from the US Bureau of Labor Statistics, and the data is cleaned to remove all non-fair market value, non-arm’s-length transactions. The final data set consists of 1,132 home sales across 432 parcels.

The Fayette County, Georgia, geographic information system department provided a digitized parcel map of the Planterra Ridge subdivision. Using the parcel map and satellite imagery data from ER5’s ArcMap platform, we created a digital map of the four nearby view amenities and the Planterra Ridge golf course. By combining the digital parcel data with the geographic features, every parcel could be manually assigned to a view amenity group if it is directly adjacent to the amenity. We then follow the Mothorpe and Wyman approach and use the viewshed tool in ESRI’s ArcMap software to calculate the natural log of the view area of Lake McIntosh for parcels in the Western Pond and Woods/Lake groups.

To determine flood zone status of each sale, we assigned each sale to the Q3 and the DFIRM datasets. A sale is in the 100-year flood zone if the flood zone intersects the home’s foundation and the 100-year flood zone was active at the time of sale. Finally, we removed sales from the 100-year flood zone if the homeowners successfully petitioned the Federal Emergency Management Agency to be removed and the sale occurred after the date of the petition. There were three such cases in the Planterra Ridge neighborhood; this information is available through the National Flood Hazard Layer (NFHL) website.

Panel A of Exhibit 5 displays summary statistics for building and transaction characteristics. The average home sale contains approximately

29. Nelms, “Lake McIntosh Is Now Officially Open for Public’s Use.”
30. These results are available upon request from the corresponding author.
31. We identify non-fair market value, non-arm’s-length transactions using the Fayette County tax assessor’s validity code, which classifies real estate transactions according to the transaction conditions and deed type, and the classification codes are bank sale, foreclosures, fair market value, short sale, tax sale, or other. We clean the data by removing any transaction not classified as a fair market value transaction.
33. The Q3 data is a digital representation of the original flood maps that became effective in the 1970s and 1980s. Prior to publication of the National Flood Hazard Layer (NFHL), the Federal Emergency Management Agency published the digital flood insurance rates maps (DFIRMs). For the Planterra Ridge subdivision, there are no changes between the DFIRMs and NFHL maps, and the effective date for the DFIRMs is September 26, 2008.
The Price Is Right? The Impact of a Scenic View on the Pricing of Residential Property

### Exhibit 5 Summary Statistics

<table>
<thead>
<tr>
<th>Variable</th>
<th>Mean</th>
<th>Std. Dev.</th>
<th>Min.</th>
<th>Max.</th>
<th>Note</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Panel A: Building and Sale Characteristics</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real Price</td>
<td>448,372</td>
<td>99,746</td>
<td>265,170</td>
<td>947,934</td>
<td>June 2022 dollars</td>
</tr>
<tr>
<td>Square Feet</td>
<td>2536.11</td>
<td>342.09</td>
<td>1788.00</td>
<td>4233.00</td>
<td>Square feet of living area excluding the basement</td>
</tr>
<tr>
<td>Age</td>
<td>8.08</td>
<td>8.77</td>
<td>0.00</td>
<td>28.00</td>
<td>Home age at time of sale, in years</td>
</tr>
<tr>
<td>Fixtures</td>
<td>8.20</td>
<td>2.13</td>
<td>3.00</td>
<td>17.00</td>
<td>Count of bathroom fixtures</td>
</tr>
<tr>
<td>Fireplaces</td>
<td>1.03</td>
<td>0.21</td>
<td>0.00</td>
<td>2.00</td>
<td>Count of fireplaces</td>
</tr>
<tr>
<td>Basement Area</td>
<td>689.62</td>
<td>769.97</td>
<td>0.00</td>
<td>2827.00</td>
<td>Basement square feet</td>
</tr>
<tr>
<td>Acres</td>
<td>0.48</td>
<td>0.12</td>
<td>0.32</td>
<td>1.35</td>
<td>Lot size, in acres</td>
</tr>
<tr>
<td>Golf Course</td>
<td>0.16</td>
<td>0.37</td>
<td>0.00</td>
<td>1.00</td>
<td>Binary (181 sales)</td>
</tr>
<tr>
<td>100-Year Flood Zone</td>
<td>0.01</td>
<td>0.07</td>
<td>0.00</td>
<td>1.00</td>
<td>Binary (6 sales)</td>
</tr>
<tr>
<td>Pre-Lake Period</td>
<td>0.67</td>
<td>0.47</td>
<td>0.00</td>
<td>1.00</td>
<td>Binary (760 sales); sale between 1993 and 2005</td>
</tr>
<tr>
<td>Construction Period</td>
<td>0.10</td>
<td>0.30</td>
<td>0.00</td>
<td>1.00</td>
<td>Binary (111 sales); sale between 2006 and 2012</td>
</tr>
<tr>
<td>Post-Lake Period</td>
<td>0.23</td>
<td>0.42</td>
<td>0.00</td>
<td>1.00</td>
<td>Binary (261 sales); sale after 2012</td>
</tr>
<tr>
<td>Eastern Pond</td>
<td>0.03</td>
<td>0.17</td>
<td>0.00</td>
<td>1.00</td>
<td>Binary (33 sales)</td>
</tr>
<tr>
<td>Western Pond</td>
<td>0.03</td>
<td>0.18</td>
<td>0.00</td>
<td>1.00</td>
<td>Binary (38 sales)</td>
</tr>
<tr>
<td>Woods/Lake</td>
<td>0.05</td>
<td>0.23</td>
<td>0.00</td>
<td>1.00</td>
<td>Binary (60 sales)</td>
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<tr>
<td>Line Creek</td>
<td>0.04</td>
<td>0.20</td>
<td>0.00</td>
<td>1.00</td>
<td>Binary (49 sales)</td>
</tr>
<tr>
<td>No View Amenity</td>
<td>0.84</td>
<td>0.37</td>
<td>0.00</td>
<td>1.00</td>
<td>Binary (953 sales)</td>
</tr>
<tr>
<td>Lake View</td>
<td>0.20</td>
<td>0.86</td>
<td>0.00</td>
<td>6.25</td>
<td>View area of Lake McIntosh, in square miles</td>
</tr>
<tr>
<td>Lake View—Western Pond</td>
<td>3.47</td>
<td>1.60</td>
<td>1.01</td>
<td>6.25</td>
<td>View area of Lake McIntosh for Western Pond group, in square miles</td>
</tr>
<tr>
<td>Lake View—Woods/Lake</td>
<td>1.64</td>
<td>1.69</td>
<td>0.09</td>
<td>5.39</td>
<td>View area of Lake McIntosh for Woods/Lake group, in square miles</td>
</tr>
</tbody>
</table>

Note: There are 1,132 sales in the sample.

2,500 square feet of living space, sits on a half-acre lot, and sold for $450,000. Approximately 16% of the sample, or 181 sales, have golf course frontage, and approximately 1% of the sample (6 sales) are situated in the 100-year flood zone. Roughly two-thirds of all sales (760 sales) occur in the pre-lake period, while 10% (111 sales) occur in the construction period and 23% (261 sales) occur in the post-lake period. Panel B of Exhibit 5 displays summary statistics for each amenity group. The vast majority of parcels in the Planterra Ridge subdivision—84% (948 sales)—are in the No View Amenity group and are not directly adjacent to an amenity. The Woods/Lake group consists of 65 sales or 6% of the sample, while the Line Creek group consists of 49 sales or 4% of the sample. The Western Pond and Eastern Pond groups contain roughly 3% of the sample. Finally, across all parcels, the average view of Lake McIntosh is 0.20 square miles; however, for those sales in the Woods/Lake group the average view area is 1.64 square miles and for those parcels in the Western Pond group the average view area is 3.47 square miles.

Exhibit 6 displays sale counts (Panel A) and mean sale price by amenity group (Panel B) and
The pre-lake period contains the highest number of home sales; however, the pre-lake period is the longest and contains the years when the subdivision was first created (when a higher number of home sales occurred). The construction period contains the lowest sale count, not only because it is the shortest duration, but also because it overlaps with the 2008 financial crisis and resulting housing market downturn. The post-lake period’s sale count falls between the sale count for the pre-lake and construction periods.

Panel B of Exhibit 6 displays the unconditional mean sale price by view amenity group and sale period. The differences in the mean sale price between view amenity groups support the testable hypothesis listed in Exhibit 4. The change in mean sale price between the pre-lake and post-lake period for the Western Pond group is $125,377 (20.8%), while for the Woods/Lake group the change is $196,708 (41.4%). In contrast, the unconditional mean sale price change for the Eastern Pond group is $6,119 (1.1%), for the Line Creek group the change is $50,115 (10.3%), and for the No View Amenity group the change is $73,493 (17.9%). Thus, the two groups impacted by the construction of Lake McIntosh, the Western Pond and Woods/Lake groups, experienced much larger increases in mean sale price relative to the other amenity groups, which supports hypothesis H1. Additionally, a comparison of the mean sale price for the Woods/Lake group across the pre-lake, construction, and post-lake period reveals the mean sale price increased in each period. This trend supports hypothesis H2 that the real estate market anticipated the value of the future amenity and prices began to rise during Lake McIntosh’s construction.

Exhibit 7 plots the unconditional, mean sale price in the Planterra Ridge subdivision by year. The sale price trend roughly follows the national housing market trend. Home sale prices increased between 1993 and 1999 before regressing in 2000. The market then experienced another long period of increasing sale prices, between 2001 and 2007, until the housing market crashed in 2008. Sale prices continued to decline until they reached a low point in 2013. After 2013, the market experienced rapid price increases between 2014 and 2017, a stable period between 2018 and 2020 where prices in the subdivision remained level and then a rapid increase in prices in 2021.
and 2022. Overall, the data in Exhibit 7 strongly supports the notion of including year fixed effects in the empirical model to capture macroeconomic shocks impacting all home sales.

Results
Exhibit 8 presents the study’s main empirical results. Columns (1), (2), and (3) report estimates employing the first set of view amenity measures (binary variables for each view amenity group) for the pre-lake, construction, and post-lake periods, respectively. Columns (4), (5), and (6) are similar to columns (1), (2), and (3) except they employ the second set of view amenity measures (continuous view area for the Western Pond and Woods/Lake groups and binary variables for the Eastern Pond and Line Creek groups). Overall, the results indicate that the real estate market values view amenities. The empirical estimates indicate the market valuation for water views range between 8% and 31%, or $36,000 to $138,392 at the mean sale price.

The estimates in Exhibit 8 columns (1), (2), and (3) provide evidence of the following trends regarding the Western Pond and Woods/Lake groups. First, the real estate market’s valuation of the Western Pond group was 11.6% (or $52,000 at the mean sale price) in the pre-lake period but increased to 31% ($138,000) in the post-lake period. Both pricing impacts are statistically significant at the 1% level, and the percent change in magnitude is 165.4%. Second, the market valued the Woods/Lake group amenity more in the pre-lake period relative to a No View Amenity group by 2.3% ($10,000) but the valuation impact is not statistically significant. During the construction period, the market’s valuation for the Woods/Lake group view amenity increased to 8.6% ($38,000), and the valuation further increased to 20.6% ($92,000) in the post-lake period. The percent change in magnitude between the pre-lake and post-lake period is 795.7%, which is much greater than the percent change for the Western Pond group amenity.

The results for the Western Pond and Woods/Lake coefficients in columns (1), (2), and (3) of Exhibit 8 provide evidence supporting hypotheses H₁, H₂, and H₃. More specifically, the results
show that the construction of Lake McIntosh increased the market valuation for impacted parcels, defined as those in the Western Pond and Woods/Lake groups. Exhibit 9 illustrates the differential price impacts for parcels with no pre-existing water view (the Woods/Lake group) relative to those with a pre-existing water view (the Western Pond group), and there are two important trends. First, both groups experienced increases in the price premium after the construction of Lake McIntosh. Second, the price premium for the Woods/Lake group increased during the construction period (2006 to 2012) and then increased again after 2012. The stepwise increases for the Woods/Lake group provide evidence that the real estate market valued the future view amenity long before it actually existed. The results also provide evidence of a hierarchy in the pricing of views, with Western Pond parcels enjoying the highest price premium followed by Woods/Lake parcels. The Line Creek and Eastern Pond parcels were priced lower followed by residential properties with no view amenity.

Additional evidence supporting the notion the real market anticipated the future view amenity can be found by examining key words in the public comments of MLS listing data. Exhibit 10 shows the results of keyword search for the word “lake” in the 659 MLS listings for the Planterra Ridge subdivision between 1996 and 2018, broken down by period and amenity group. The keyword search shows that only 1.2% of listings mentioned the word “lake” in the pre-construction period compared to 12.5% of listings during the construction period and 30.2% during the post-lake period. For the Western Pond and Woods/Lake groups, the increase in the number of listings with the word “lake” is even more pronounced. For example, 0% of listings in the Woods/Lake group in the pre-lake period contained the word “lake”; however, the percentage rises to 37.5% in the construction period and 100% in the post-lake period. We surmise that the potential formation of Lake McIntosh was not a major selling point before its construction, but the market was increasingly aware during its construction and reacted through anticipatory price increases.

The empirical results also support hypothesis H₄, which states the construction of Lake McIntosh did not impact the sale prices of non-lake view parcels. The market’s valuation for a parcel in the Eastern Pond group remained relatively stable, varying between 8.1% ($36,000) and 10.9% ($49,000) across all three time periods. The estimated price impacts for the Eastern Pond parcels are similar in magnitude for the market’s valuation of Western Pond group parcels during the pre-lake period. The market valuation for the Line Creek group also remained relatively stable, ranging from 5% in the post-lake period to 13% in the construction period (between $23,000 and $58,000); though, we note the pricing impact is statistically insignificant in the post-lake period.

Columns (4) through (6) of Exhibit 8 employ continuous water view area measures for the Western Pond and Woods/Lake group and binary variables for the Eastern Pond and Line Creek groups. During the pre-lake period, a 1% increase in the view of the Western Pond group and the area that would eventually become Lake McIntosh led to a 0.68% increase ($3,000 at the mean sale price) compared to a 1.63% increase ($7,000) in the post-lake period. Both pricing impacts are statistically significant at the 1% level. Woods/Lake parcels experienced a 0.17% increase in sale price ($800) for a 1% increase in view quality during the pre-lake period, but the coefficient is not statistically significant. During the construction period, the pricing impact is statistically significant and increased to 0.55% ($2,500), while the pricing impact increased to 1.28% ($5,750) in the post-lake period. Similar to columns (1) through (3), we find relatively stable market valuations for the Eastern Pond and Line Creek groups across columns (4) through (6). Combined, the results in columns (4), (5), and (6) provide further evidence supporting the main hypothesis.

The estimated coefficients for the other independent variables are as expected. Larger homes, homes with more bathroom fixtures, homes with basements, and golf course front homes earn higher market valuations. The coefficient for the age of the home at time of sale is negative and statistically significant in the construction period, but statistically insignificant during the pre-lake and post-lake period. A likely explanation for this trend is the relatively small variation in the year of construction (all homes were constructed in a seven-year time span) relative to other contemporary valuation studies.
## Exhibit 8 Regression Results

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<td>(0.00132)</td>
<td>(0.00353)</td>
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<td>0.187***</td>
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<td>0.00551*</td>
<td>0.0128***</td>
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<td>0.00551*</td>
<td>0.0128***</td>
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<tr>
<td></td>
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<td></td>
<td>0.0017</td>
<td>0.00551*</td>
<td>0.0128***</td>
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<tr>
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<td>(0.0513)</td>
<td>(0.0573)</td>
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<td>Line Creek</td>
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<td>0.122***</td>
<td>0.0505</td>
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<td>Square Feet</td>
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<td>Age</td>
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<td>0.00388***</td>
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<td>(0.0107)</td>
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<td>Bathroom Fixture</td>
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<td>Fireplaces</td>
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<td>Basement (sq. ft.)</td>
<td>9.64e-05***</td>
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<td>7.95e-05***</td>
<td>9.61e-05***</td>
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<td>7.97e-05***</td>
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<td></td>
<td>(5.91e-06)</td>
<td>(1.58e-05)</td>
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<td>(1.58e-05)</td>
<td>(1.36e-05)</td>
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<tr>
<td>Acres</td>
<td>0.155***</td>
<td>0.336***</td>
<td>0.0613</td>
<td>0.154***</td>
<td>0.337***</td>
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<td>(0.0367)</td>
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<td>(0.0850)</td>
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<td>Golf Course</td>
<td>0.126***</td>
<td>0.0785**</td>
<td>0.0730*</td>
<td>0.125***</td>
<td>0.0769**</td>
<td>0.0698*</td>
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<td>Constant</td>
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<td>(0.0392)</td>
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<td>(0.197)</td>
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Notes: The dependent variable is the natural log of the inflation-adjusted sale price; robust standard errors in parentheses.

*** p<0.01, ** p<0.05, * p<0.1
Exhibit 9  Estimate Price Impacts by Group

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<th>Year</th>
<th>Eastern Pond</th>
<th>Western Pond</th>
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<th>Line Creek</th>
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<td>30</td>
<td>20</td>
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<td>1999</td>
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<td>5</td>
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<tr>
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<td>5</td>
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<td>0</td>
<td>15</td>
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<tr>
<td>2009</td>
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<td>0</td>
<td>0</td>
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<td>0</td>
<td>0</td>
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<td>0</td>
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</tr>
<tr>
<td>2019</td>
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<td>0</td>
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Exhibit 10  Keyword Search “Lake”

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<tr>
<th>Panel</th>
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<th>Line Creek</th>
<th>Control</th>
<th>Total</th>
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<tr>
<td>Panel A: All Listings</td>
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<tr>
<td>Pre-Lake</td>
<td>12</td>
<td>5</td>
<td>13</td>
<td>8</td>
<td>294</td>
<td>332</td>
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<td>8</td>
<td>12</td>
<td>136</td>
<td>168</td>
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<tr>
<td>Post-Lake</td>
<td>2</td>
<td>6</td>
<td>10</td>
<td>10</td>
<td>131</td>
<td>159</td>
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<td>Panel B: Listings Mentioning “Lake”</td>
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<tr>
<td>Pre-Lake</td>
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<td>2</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>4</td>
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<td>3</td>
<td>3</td>
<td>8</td>
<td>21</td>
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<tr>
<td>Post-Lake</td>
<td>1</td>
<td>6</td>
<td>10</td>
<td>6</td>
<td>25</td>
<td>48</td>
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<td>Panel C: Percentage Mentioning “Lake”</td>
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<tr>
<td>Pre-Lake</td>
<td>16.67%</td>
<td>40.00%</td>
<td>0.00%</td>
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<tr>
<td>Construction</td>
<td>28.57%</td>
<td>100.00%</td>
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<td>5.88%</td>
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<tr>
<td>Post-Lake</td>
<td>50.00%</td>
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<td>100.00%</td>
<td>60.00%</td>
<td>19.08%</td>
<td>30.19%</td>
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Conclusion

This study of the Planterra Ridge subdivision offers the opportunity to estimate the price premium for a scenic view ex-ante and ex-post the recent construction of Lake McIntosh. Carefully defining the amenities groups, we estimate a series of spatial hedonic models over different sub-samples of the data. The data show that view premiums for residential properties after the construction of Lake McIntosh increased by 165% to 784%, depending on the ex-ante view quality. Further, the results indicate the real estate market anticipated the value of the future amenity, leading to increases in the price premium long before Lake McIntosh was completed. Echoing prior studies, the differentiated quality of the view amenity leads to a hierarchy of pricing premiums. The importance of measuring site-specific scenic views is confirmed by the dissimilar pricing premiums that even neighboring residential properties enjoyed. Overall, this study reveals that the inclusion of micro-spatial view variables in pricing models can help appraisers, researchers, and real estate professionals ensure the “price is right.”

About the Authors

David Wyman, PhD, serves as an associate professor in the Department of Management and Marketing and as the director of the Center for Entrepreneurship at the College of Charleston School of Business. Wyman’s academic research in entrepreneurship and real estate has been cited in publications ranging from The Wall Street Journal to Links magazine. He has received two major university teaching awards: Undergraduate Student Government Excellence in Teaching Award from Clemson University and Business Professor of the Year award from the University of San Diego. Wyman is a successful entrepreneur with over fifty products invented/licensed to major toy companies. One of his inventions, the bluffing game “13 Dead End Drive,” has celebrated its twenty-fifth anniversary with over three million copies sold. Wyman has a PhD from the University of Aberdeen, Scotland, an MBA from Cranfield University, and a BA in honors economics from Cambridge University, England. Contact: wymandm@cofc.edu

Chris Mothorpe, PhD, is an associate professor and chair of the Department of Economics at the College of Charleston. Mothorpe’s research is concentrated in real estate economics and focuses on the impact of spatial amenities on real estate markets. Mothorpe has published research in various academic journals including Regional Science and Urban Economics, Resources and Energy Economics, Journal of Real Estate Research, Journal of Housing Research, and The Appraisal Journal. Prior to his appointment at the College of Charleston, Mothorpe earned a PhD in economics from Georgia State University and a master of science in economics and a bachelor of science in applied mathematics from the Georgia Institute of Technology. Contact: Mothorpeca@cofc.edu

Additional Resources

Suggested by the Y. T. and Louise Lee Lum Library

Appraisal Institute

Lum Library, Knowledge Base [Login required]

Residential properties—externalities
Market Analysis for Apartment Properties

by Richard L. Parli, MAI

Abstract
Market analysis is arguably the most important part of the valuation process. Without an accurate and comprehensive market analysis, a property’s highest and best use cannot be determined reliably and the accuracy of the three approaches will be seriously diminished. This article discusses and demonstrates contemporary market analysis applications for apartment properties, including the impact of equilibrium vacancy on the movement of market rents. Although the focus is on apartments, the methodology is applicable to all real estate.

Markets and Market Analysis

The term market analysis refers to the study of the supply of and demand for a specific type of property in a specific market area. The purpose of market analysis is the collection and study of market data required to conclude highest and best use and to apply the approaches to value. A market is defined as "a gathering of people for the buying and selling of things; by extension, the people gathered for this purpose." Real estate markets are divided into two distinct categories: the capital market and the fundamental market, as shown in Figure 6.1.

The capital market is the market in which the value of a property is measured against the supply of and demand for competing, similar properties. This market consists of buyers and sellers, both involved in a real estate transaction and both acting as market participants. Market value looks primarily to the capital market for evidence of value as revealed in transactions. Activity in the capital market is evidence of the vitality of the fundamental market.

The fundamental market is the market of users of real estate: the owners, the tenants, and the customers, all also acting as market participants. These are the users of real estate who make real estate valuable by producing or supporting demand (occupancy) for its space. Therefore, market analysis is primarily concerned with the fundamental market: the tangible expression of the needs and desires of users. For apartment properties, the users are the tenants, and the market analysis is primarily concerned with analyzing the competitive position of apartment properties to current and potential tenants. The results of this analysis will be applied in analyzing the capital market, all of which is necessary to arrive at a supportable opinion of value.

The Need for Market Analysis

Real estate activity differs in two respects from the pricing and marketing of any other product. First, real estate parcels are unique, whereas most other items, such as personal property, are sold as though they are identical (like shoes of the same type).
style and brand) or sold as identical (like shares of common stock in the same corporation). Real estate, on the other hand, consists entirely of marketable items that differ from one another. Although there are garden apartments in identical buildings with highly similar locations, they have different maintenance requirements. Moreover, most apartments are not found in identical buildings. Even condominium apartments with the same floor plan on the same floor of the same new building have different vistas and orientations to sunlight. And value differences are often ascribed to different floors.

Second, real estate parcels are immobile, whereas all items of, say, personal property are not stationary. Only real estate is sold with acknowledged variations in description and quality; only real estate is not gathered together at the seller’s market location or delivered to another convenient location where buyers can inspect the property before purchase. Only real estate cannot be transported to a different, more advantageous market. In short, real estate is a unique product because each property is different and each property is stationary. Because of this uniqueness, analysis of the local market in the development of an appraisal is critical.

In the context of apartment property appraisals, market analysis examines the factors that lead households to live downtown or in a suburb, to rent or to buy either flats or duplexes, to select small or large buildings, and to rent within certain price parameters.

An appraiser’s analysis of the apartment market tends to be an ongoing activity that is general rather than specific to a given assignment. The analysis that is property-specific is known as a marketability study. An apartment appraiser’s marketability study includes familiarization with reported inventories of similar apartment properties categorized by physical differences such as size and building age, price or rent differences, or location differences. A penetrating marketability study may be formally reported (either as part of or as independent from a market value appraisal) in developing opinions of absorption and feasibility. In appraisal practice, the appraiser’s reported conclusions of absorption and feasibility are site-specific but are not value-related analyses.

The Need for Apartments
Real estate exists to house economic activities, supply services, and provide amenities to meet human needs. This is no less the case for apartment real estate, a type of amenity. The need for this type of amenity in a market area is related to economic and demographic characteristics of that market area. The economic and demographic characteristics that drive the need for apartment properties are referred to as the fundamental force of demand—the actual generator of demand. The generator of demand for apartment properties is population.

Apartments are a subset of housing units, which are what is consumed by households. As shown in Figure 6.2, as the population changes in a market area, the number of needed households changes, leading to a change in demand for housing units. In most cases, a certain portion of the change in demand for housing units includes a change in demand for apartment units. Thus, the need for apartments in a market area is directly tied to the population of that market area and the demand within that population for apartment living.

### Figure 6.2 Changes in Demand

<table>
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<th>A Change in Population</th>
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<tbody>
<tr>
<td>Leads to</td>
</tr>
<tr>
<td>A Change in Households</td>
</tr>
<tr>
<td>Which Leads to</td>
</tr>
<tr>
<td>A Change in Demand for Housing Units</td>
</tr>
</tbody>
</table>

**The Goal of Market Analysis**

Market analysis is ultimately concerned with determining whether marginal or residual demand exists for a given property use and, if so, the extent of that demand. In this sense, the purpose of market analysis is to investigate the marketability of potential uses for a property and thereby lay the foundation for the analysis of their feasibility and conclusion of the property’s highest and best use. This conclusion will be as specific as the market suggests. For example, market analysis will reveal when development should take place, the density of the development, and whether a proposed multifamily development should be owner-occupied condominiums or renter-occupied apartment units.

An appraiser’s analysis of the apartment market tends to be an ongoing activity that is general rather than specific to a given assignment. An apartment appraiser’s marketability study includes...
becoming familiar with reported inventories of similar apartment properties categorized by physical differences such as size and building age, price or rent differences, or location differences. Ultimately, market analysis is concerned with predicting the future performance of a specific property. It is the result of a disciplined process that is an economic study of the market over the long term; it is not a valuation technique but rather a process that develops the components to first apply highest and best use analysis and then reliably develop the valuation.

Market analysis is essential to the valuation of both existing and proposed apartment properties. Existing properties normally have an operating history—that is, a record of occupancy, rents, and expenses. The use determination for an existing property is likely to be straightforward. Although future occupancy and income cannot be certain, a reasonable cash flow forecast can be developed on the basis of market analysis. For a proposed property on a site that is either vacant or under another use, however, there is no history of operations. Therefore, there is greater uncertainty and, consequently, greater risk. In that case, market analysis becomes more critical to an accurate valuation.

The appraiser is required to develop an independent market analysis for every assignment. Some assignments may require nothing more than a macroeconomic study of the general market conditions affecting a particular property type. Known as a market study, this analysis looks at broad supply and demand conditions affecting the property type. If reliable, credible results for a specific property can be drawn from a market study, no additional research need be done. When a market study does not produce reliable results, the analysis must go beyond a market study to what is referred to as a marketability study. This type of market analysis is a microeconomic study that focuses on how a particular property will be absorbed, sold, or leased under current or anticipated market conditions. A marketability study is appropriate for most valuation assignments because it is property-specific and identifies and measures the market that surrounds and has an effect on a particular property. Whichever is developed, both a market study and a marketability study must produce a prediction of a specific property’s future performance because market value is based on the present worth of future benefits.

Levels of Market Analysis
In real estate appraisal, there are four recognized levels of market analysis: A, B, C, and D. Levels A and B rely on current and historical market conditions to infer (project) future supply and demand conditions. Levels C and D analyze current and historical market conditions, but in addition they include fundamental analysis to forecast subject-specific supply, demand, absorption, and capture over the property’s holding period. As the letters suggest, the level of analytical depth in a C or D study is greater than the depth of A and B studies.

The level of market analysis required depends on several key considerations, but mainly the size and complexity of the property as well as the size and condition of the market. Ultimately, however, the choice is a function of reliability; an appraiser is only required to do what is necessary to produce reliable results. A Level A study is technically nothing more than a market study. It requires the least amount of work because it includes market conditions for a property type only and relies upon generally available published information. The strength of the market is implied through recent sale and lease comparables. A Level A study is therefore only reliable for small, non-complex properties in a stable market. If the property is not small or non-complex or if it is in an unstable market, Level A is inadequate. The appraiser must supplement the analysis by going to at least a Level B study in order to produce reliable results.

A Level B study—the lowest level of a true marketability study—takes the information from Level A research and supplements it with property-specific information. The performance of comparable properties is considered and compared with the history of the subject property (if a history exists). Market strength is implied through total market demand. Historical trends—for the market, comparable properties, and the subject—are relied upon to indicate the subject property’s

2. Level D studies are excluded from further consideration here because they incorporate greater use of personal surveys and statistical analysis than is typically necessary with apartment property valuation.

3. Client needs can also play a role in the selection of the level of market analysis. Regulatory requirements dictate that market analysis is a required ingredient under USPAP and FIRREA, but neither document indicates the appropriate level for any given assignment.
future performance. A Level B analysis is the highest marketability level that relies strictly on current and historical information. This information is used to infer that future market conditions will replicate past market conditions, so it is necessary not only for the market to be stable currently but also for the market to be expected to be stable in the future.

If a property fails to meet at least two of the three characteristics listed above (small, non-complex property in a stable market), a Level B marketability study is probably inadequate, and the appraiser would need to further supplement the analysis with a Level C marketability study. For instance, a relatively large apartment property with unique features in a declining market could only be understood with a Level C marketability study. In such a case, all three characteristics are lacking because the property is neither small nor simple and the market is not stable. A Level B marketability study could not produce reliable results under those conditions.

A Level C analysis considers current and historic market conditions, but in addition it includes fundamental analysis to forecast subject-specific supply, demand, absorption, and capture over a specified period. Future demand and absorption are forecast on the basis of projections of the growth of population, income, and employment, which are the fundamental factors underlying the demand for real estate. By forecasting supply and demand, a determination can be made as to whether there will be an excess of supply, an excess of demand, or a balanced market. Once market conditions are established, judgments can be made about absorption, prices, rents, and leasing.

The decision criteria for which level of market analysis is appropriate for each appraisal assignment is summarized in Figure 6.3. For a Level A study to be appropriate, the property must be relatively small with few tenants (or owner-occupied), and the market must be stable and expected to remain that way by most market participants. For example, assuming a stable market, a market analysis of the 1930 Curtis Street property would likely conform to the Level A requirements, and a market analysis of the Commuter Highway Apartments would qualify for at least a Level B study. Conversely, a Level C analysis is appropriate when the inverse is true for at least two of the factors. When only one of the inverse factors is present, a Level B study may produce reliable results.

**Figure 6.3 Market Analysis Reliability Continuum**

<table>
<thead>
<tr>
<th>3 of 3</th>
<th>1 of 3</th>
<th>2+ of 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Simple Property</td>
<td>Complex Property</td>
<td></td>
</tr>
<tr>
<td>Small Property</td>
<td>Large Property</td>
<td></td>
</tr>
<tr>
<td>Stable Market</td>
<td>Unstable Market</td>
<td></td>
</tr>
</tbody>
</table>

Ultimately, judgment is the only way to resolve the large, complex market stability conditions. Large and complex are relative terms that require comparison with other properties in the market area. Market stability may be evident through observation. Choosing the right level of marketability study is as much about the future as it is about the present. After all, the appraiser is expected to know the current market condition, and market analysis is expected to reveal future conditions. Whichever level can reliably do this is the correct level.

**The Market Analysis Process for Apartment Valuation**

Regardless of whether a Level B or C marketability study is appropriate, the market analysis must proceed through six basic steps:

1. Property productivity analysis
2. Market delineation
3. Demand analysis and projection/forecast
4. Competitive supply analysis and projection/forecast
5. Demand and supply study or equilibrium analysis
6. Capture analysis

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4. This procedure is explained in Stephen Fanning, *Market Analysis for Real Estate*, 2nd ed. (Chicago: Appraisal Institute, 2014). The market analysis process is a fundamental component of highest and best use analysis. The first of the steps described here deals with a physically possible and legally permissible use, and the remaining steps provide essential information for determining the financial feasibility of a use.

Step 1. Property Productivity Analysis
The appraiser investigates the productive attributes of the subject property at the outset. These are features that shape the productive capabilities and potential uses of the property—i.e., its physical, legal, locational, and amenity attributes. Identifying the potential uses of the property allows the appraiser to target potential users or the most likely market segment for the property.

Step 2. Market Delineation
In the second step of market analysis, market delineation identifies the market area—that is, the area in which similar properties compete with the subject property for probable tenants. The market area varies with the type and character of the apartment property (studio/efficiency versus luxury units). This process of differentiating the subject property and other directly competitive properties from the broader stock of similar properties is called market disaggregation. Market delineation also identifies the most likely tenants based on consumer profiles—i.e., features such as income, age, and lifestyle. The process of differentiating the most probable tenants from the broader population is called market segmentation.

Market delineation pinpoints the precise market segment to which the property will appeal by establishing the spatial dimensions and behavioral components of market demand and supply. The market area is the area where current and future household growth is measured (and compared to current and future supply). It focuses on a property’s connection to:
- Major employment centers
- Transportation corridors
- Desirable locational amenities

Which of these three items will be most influential in determining an apartment property’s market area is dependent on the location and the typical tenant profile. For example, the most important consideration for a building in an urban location that appeals to young singles and couples would be proximity to an employment center; the most important consideration for a building in a suburban location that appeals to all age groups would be proximity to transportation corridors that provide access to employment centers; and proximity to a desirable amenity might be the most important consideration for an age-restricted apartment building in any type of location.

Having determined the dominant influence on a property’s market area, the next step is to determine how this market area relates to the entire community. Issues that should be considered include
- The direction and pace of residential growth
- Socioeconomic composition
- Political boundaries
- Physical boundaries

It should be obvious that being located in the direction of residential growth is preferable to not being located in the direction of residential growth. However, growth direction can change over time, possibly due to a change in support facilities (such as the arrival or departure of a major grocery store), so the attractiveness of the general area should be weighed.

The socioeconomic composition of the area should be focused on the average household income. This information can be used to segment demand, as is necessary to applying Step 3.

An apartment market area has boundaries that may be influenced by the presence of political boundaries. For example, a transportation corridor may form the boundary between two counties, one of which has rent control laws while the other has significantly higher real estate taxes. It would be unlikely that both counties should be in the same market area.

Physical boundaries, including roads, rivers, and mountains, can strongly influence an apartment’s market area.

Ultimately, it is the tenant profile that strongly influences an apartment property’s market area. Real estate agents and property managers classify tenants under two categories. Tenants by choice are those who choose to live in rental units; tenants by circumstance are those who must seek rental accommodations either because their lives are in some degree of flux or they cannot afford to purchase a permanent residence. Tenants by choice usually sign a formal lease, occupy their unit for an extended period, and cause fewer problems for the management. Tenants by choice are mostly career-oriented persons (singles or couples), empty nesters (older couples whose children are grown), and retired persons or senior citizens. Tenants by circumstance are more transitory, have less commitment to maintaining their apartments, and are less likely to invest effort or money on creating a formal, homelike environment.
Tenants by circumstance include out-of-town students, singles who have recently entered the job market, and families with young children. Whereas families with young children tend to be less mobile, students generally lease for short tenancies. Singles lacking job security may vacate on short notice, and students and singles often give rise to collection losses.

What is clear is that tenants by choice are preferred since they have a greater commitment to the real estate. It can be concluded that the greater the occupancy of tenants by circumstance, the greater the risk and expense to ownership.

Step 3. Demand Analysis and Projection/Forecast
Market demand for apartment units in a market area is a function of the households in that market area and their preference for apartment living. Predictions of future need are based on the current and recent past occupancy (i.e., demand) of apartment units in the market area. Current occupancy is generally recognized as an expression of current demand. Coupling this with historical occupancy should produce a reliable relationship between households and demand for apartment occupancy. For example, current and historical household change can be used to predict future household change. Likewise, current and historical apartment occupancy can be used to predict future occupancy and its relationship to future households. For instance, if current and historical data indicates that apartment occupancy represents 40% of households, it is reasonable to expect that future households will also be 40% apartments. This application of extrapolation to trend analysis can be performed (if necessary) for such factors as apartment building type, including affordability, and the characteristics of their occupants. By so doing, the predictions of current demand can be refined and adjusted to apply to not just rental apartments in general but to match the subject property type.

Step 4. Competitive Supply Analysis and Projection/Forecast
Existing and anticipated supply is inventoried according to building category, age, size, location, and rents. Anticipated supply includes properties that are under construction, in planning, or proposed. Trend analysis is not typically used here since current and past construction may not be indicative of future construction. Future construction estimates should be based on what is under construction and approved and/or proposed projects. Multifamily housing starts and construction activity tend to vary with interest rates.

Step 5. Demand and Supply Study or Equilibrium Analysis
The inventory of supply and estimate of demand are compared to determine whether marginal or residual demand exists or whether such demand can be forecast at some point in the future. There may be an oversupply (i.e., low occupancy) of apartment space in some markets. The two types of oversupply are technical, which is when available units exceed potential tenants, and economic, which is when available space is priced beyond the affordability of potential tenants. The latter condition exists typically at the early stages of an oversupplied market, when landlords are reluctant to acknowledge that a reduction in rental rates is necessary to meet diminished demand.

Equilibrium analysis involves not only the analysis of data but also an understanding of the market. Market conditions reflect the interaction of short-term real estate cycles, which are governed by the availability of credit and the level of interest rates, and long-term or secular business cycles, which depend on broad demographic and employment trends. The appraiser also studies indicators of market activity, such as the terms of available financing, number of mortgages recorded, values of multifamily sales, and range between listing and acquisition prices/rentals.

The identification of equilibrium vacancy is a product of market equilibrium analysis. That is, there is a level of vacancy in a market that will result in no upward or downward pressure on rents. Such a vacancy rate for a market is referred to as equilibrium vacancy. When a market is in such condition, increasing occupancy puts upward pressure on rents, and decreasing occupancy puts downward pressure on rents. Knowing the equilibrium vacancy for a market will give insight as to when rents will change. For example, without the market vacancy being above the equilibrium vacancy rate, there should be no upward pressure on rents, and consequently no increase in market rent. Conversely, upward pressure on rents should not be experienced until market vacancy is below equilibrium vacancy.
Step 6. Capture Analysis
When the subject and competitive properties are highly comparable, the analyst may assume that each property will capture a proportionate or pro rata share of total or marginal demand. When this is not the case, the productive attributes of the subject property are ranked against those of competitive properties. The property productivity analysis performed in Step 1 is particularly useful at this stage. The ranking reveals any special advantage of the subject or comparable properties and helps in forecasting the subject's probable market share under existing and future conditions. Regardless of what level of market analysis is employed, capture analysis is ultimately concerned with the future performance of the subject property.

Case Study: Commuter Highway Apartments
To demonstrate the market analysis process, consider a hypothetical property named Commuter Highway Apartments. Commuter Highway Apartments is a complex of 150 housing units in seven garden apartment buildings on a rectangular site of approximately eight acres. The property has received adequate maintenance and is in average physical condition for its 28-year age. The gross building area is 152,700 square feet; the rentable area is 142,300 square feet, with an average room size of 238 square feet for the 598 apartment rooms. The location is 25 miles south of Major City in Beautiful County. Since the Commuter Highway Apartments is a relatively large, but not complex, project currently operating in a stable market, a Level B marketability study should produce reliable results. The purpose of a marketability study is not just to confirm current market conditions but to predict future market conditions (revealed in Step 5) and the subject property’s future performance within that market (determined in Step 6). With these goals in mind, we will proceed through the traditional six-step process of market analysis for the Commuter Highway Apartments property.

Step 1. Property Productivity Analysis
Property productivity analysis is defined as an analysis of a property’s capacity to deliver goods and services to meet human needs, house economic activities, and supply amenities. In this first step of the market analysis process, the appraiser analyzes the subject property's physical, legal, and locational attributes, and notes the following information.

Subject’s Physical Attributes
The subject property is an ±8-acre site developed with a 28-year-old garden apartment complex known as Commuter Highway Apartments, located in Anytown, USA. The complex consists of 150 units in 7 two-story buildings, with 31 one-bedroom units, 90 two-bedroom units, and 29 three-bedroom units.

The building improvements are on a concrete foundation and have frame construction with shingle roofing and siding with some decorative brickwork. Although it is 28 years old, the exterior has been maintained and upgraded to contemporary standards. The building common areas and unit interiors contain a similar quality of construction as competitive units in the immediate market area, including painted drywall and carpet in primary rooms and tile floors in bathrooms, kitchens, and foyers.

Project amenities include
- On-site management
- Clubhouse/fitness center
- Swimming pool
- Tot lot
- Picnic area

Unit features include
- Deck or patio in each unit
- Washer and dryer in each unit

It is concluded that the improvements are typical garden apartment units with typical amenities for the market area.

Subject’s Legal Attributes
The subject property is zoned RM-1 and is a conforming, legal use. There are no known deed restrictions or covenants that impact the current or future legal use of the property. The property could be converted from a rental project to condominium use without requiring county approval.

Subject’s Locational Attributes
The analysis of locational attributes focuses on the impact of these attributes on real estate in the same category as (or similar to) the subject property, which in this case is the apartment market. This analysis is divided into two parts. First,
emphasis is placed on land-use trends surrounding the subject and the linkages between the subject and existing complementary and competitive land uses. Next, the suburban growth structure is analyzed, with particular emphasis placed on the direction of growth and pertinent factors affecting suburban growth in this area, such as public planning for growth, population trends, and an initial consideration of the competitive developments.

This analysis provides information essential to delineating the market for the subject property and to identifying its potential competition. The results of this analysis advance the marketability and highest and best use analysis for the subject.

Land Use Trends and Linkages
The subject is located in the Commuter Highway corridor within a market area that runs generally between the New Town area to the south and the southern portion of the Old Town area to the north. The Commuter Highway is just east of an interstate highway at this point and has remained a parallel but secondary commuter route. The area provides very good access to employment centers.

The immediate area is dominated by multifamily residential but includes a 20-acre parcel to the north that is zoned to permit multifamily use to a density of 320 units. No plans were uncovered regarding the development of this site.

Retail is located in the Old Town area to the north and the New Town area to the south. Village Square Shopping Center, a neighborhood center with a grocery store, is located one mile north, and over 10 acres of commercial land remains undeveloped surrounding this center. Single-unit attached townhouses and multifamily garden apartments extend south from the shopping center along Commuter Highway. Behind the townhouses and apartments is an area of single-unit detached homes, partially completed and currently under final construction.

One mile to the south is a public elementary and middle school. Further south, leading to New Town, is undeveloped land, with portions zoned industrial; no plans for development were uncovered.

The subject area and Old Town are closely linked, both by a good highway connection and by the interaction of housing, schools, and services. Anytown residents frequently drive to Old Town for school activities, shopping, churches, entertainment, and social gatherings. According to apartment managers, there is direct competition between the apartment complexes in Anytown and Old Town.

It is clear that the subject has a locational advantage due to its frontage on Commuter Highway and good linkages to complementary land uses.

Growth Trends
Discussions with management personnel and owners of apartment complexes in Anytown and Old Town indicate that there is a growing apartment market. This is evidenced by the recent completion of The Virginian Apartments and its full lease-up at the rate of 6.75 units per month. Two competitive complexes in Old Town, Hunt Country Commons and Highland Manor, have remained fully leased for several years. However, there is no known current development or expansion of apartments in the Old Town area.

Property Productivity Analysis Conclusions
The subject location is considered ideal for apartment development within the relatively small community of Anytown. It is clear that growth of the community is from in-migration that is driven by a desire for mid-level housing at prices (including rents) that are below those available at close-in locations. This relationship is expected to continue into the foreseeable future.

Step 2. Market Delineation
The second step of market analysis is often referred to as market area delineation, which is “the process of identifying the geographic area where a majority of competition is located and from which a majority of demand is drawn.”

This is done by determining where and from whom the demand is likely to come and necessarily includes identifying the location of the subject’s competition for this demand.

Delineating the Market and Trade Areas
The subject’s market area is distinct from its trade area. The trade area (also referred to as the competitive market area) is “the geographic area immediately surrounding the subject prop-

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erty in which it competes for tenants with its direct and most proximate competition.”⁶ In contrast, the market area is “the portion of the local economy, other than the trade area, from which the subject property can draw tenants and which contains indirect competition.”⁷ Often, the two areas are one in the same in that competition for tenants is distributed throughout the area from which tenants are drawn. When this is not the case, the trade area is the most important delineation for inferred analysis (Levels A and B), while the market area is most important for fundamental analysis (Level C). Regardless of which area is used, it is of paramount importance that once the geography is defined, it must be consistently applied in both the demand and supply analysis.

It is clear that a property’s trade area and market area are defined by both demand and supply factors. Primary competition is located in the trade area; secondary competition is located within the greater market area. In this case, the subject’s market area is defined as the area within a 10-mile radius of the subject property. The boundaries for this area were selected for the following reasons:

• The boundaries incorporate the Old Town area, which provides secondary competition with Anytown.
• Data for this area is readily available.

The subject property’s trade area is defined primarily by supply factors (the primary competition). The subject’s primary competition is within the Anytown community, centering around the intersection of Commuter Highway and Powell’s Run Boulevard. The type and size of an apartment complex is directly related to its proximity to employment and services, and to pricing. In the case of 6200 Commuter Highway, the trade area appeals primarily to commuters who drive substantial distances and has a recent history of full occupancy. Anytown has developed as a focus of apartment development within the market area.

The reasons that potential tenants might choose to live in apartments in the trade area should also be evaluated. It is not readily evident what attracts tenants to the Anytown area since it is a generally remote and sub-rural area and not particularly conducive to apartment living. In response to a trade area survey, local apartment managers identified the following reasons why tenants would consider the Anytown apartment market:

• Lower prices. This is, by far, the primary reason. Indications are that at least a $100–$200 per month rent savings is required to entice relocation to the Anytown trade area from the less remote markets.
• Location within a 45-minute or less commute to various employment centers.

These characteristics provide a first look at the types of tenants who are typical of the subject trade area.

**Most Probable Users**
Demand for apartment properties is typically made up of the following three demographic components:

• Young and upwardly mobile renters
• Moderate-income, permanent renters
• Empty nesters or seniors

The aging of Generation X—that segment of the population born after the Baby Boomers and now approaching peak wage-earning capacity—will likely be the most significant component of demand over the next two decades. Numbering 66 million, Gen Xers make up 20% of the overall population. As the Gen Xers become empty nesters, many will opt for more manageable, amenity-outfitted apartments over single-unit housing with its associated maintenance costs. In view of their longer life expectancies, Gen Xers will also begin to seek senior housing, a category that ranges from retirement communities to congregate facilities.

Typically, senior housing consists of apartment-style units in a community setting where common services such as housekeeping, meals, organized activities, transportation, security, and nursing care are often provided. Senior housing is expected to become a growth industry over the next two decades.

The generation that precedes the Gen Xers (the Baby Boomers) and the generation that follows

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⁷ Rabianski, “Apartment Market Area Delineation.”
the Gen Xers (the Millennials) will also exert apartment demand. Baby Boomers are well into retirement and the benefits of being empty nesters. Millennials include those persons born between 1980 and the mid-1990s. Numbering 72 million, Millennials make up over one-fifth of the overall population. Lifestyle changes account for the smaller household size of Gen Xers and Millennials, which consist of single-person households and double-income households without children. These younger and smaller households will seek moderate- and low-income housing.

Additional considerations include the fact that minority and immigrant populations continue to grow. These segments of the population will also fuel demand for moderate and low-income housing. Having abandoned many of its low-income housing programs, the federal government is encouraging the private sector to meet growing demand in this area through fiscal incentives and underwriting guarantees. A review of the demographic data available (shown in Table 6.1) shows the characteristics of the current residents in the market area (10-mile radius) as compared to the immediate trade area.

### Table 6.1 Demographic Data

<table>
<thead>
<tr>
<th>Category</th>
<th>Trade Area</th>
<th>10-Mile Radius (Market Area)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average household income</td>
<td>$65,511</td>
<td>$77,329</td>
</tr>
<tr>
<td>Median age</td>
<td>30 years</td>
<td>36 years</td>
</tr>
<tr>
<td>Average household size</td>
<td>1.99</td>
<td>2.92</td>
</tr>
<tr>
<td>Renter occupancy rate</td>
<td>39.1%</td>
<td>23.4%</td>
</tr>
</tbody>
</table>

This comparative data shows that as the population moves closer to the subject property, the average household income declines, the median age decreases, the average household size decreases, and the rate of renter occupancy increases. Generally, this trend is consistent with increasing demand for apartments in the immediate subject area.

In the trade area survey of apartment managers, a profile of the typical tenants emerged:

- 25 to 35 years old
- 50% single
- 50% have at least one child
- Tenant annual incomes typically range from $50,000 to $60,000

These are the characteristics normally associated with the young and upwardly mobile group.

### Step 3. Demand Analysis and Forecast

Residential demand is driven by the need for household shelter. Current demand is often reflected by the occupancy of existing household units within the defined trade and market areas. Future demand is measured by the growth in the number of households that is forecast to take place within the defined market area. Demand for apartment housing units can be segmented to identify those who desire rental units in the subject's affordability range.

A Level B demand analysis relies upon inferred methods to predict the need for future housing units. Inferred analysis, often referred to as trend analysis, is “an attempt to estimate future changes in value...by investigating past market behavior.”

In order to accomplish this, an analyst considers historical growth and construction trends as well as trends in market and subject rental and vacancy rates. The premise is that the past can be relied upon as an indication of future market conditions.

If historical data is considered inadequate or unreliable, an appraiser should perform a Level C analysis by supplementing the inferred analysis with fundamental analysis. Fundamental analysis looks to outside, third-party sources to predict demand for a particular property type and incorporates their forecasts of changes in demand for that property type. These outside sources could be commercial demographers, noncommercial demographers, or government demographic sources. By segmenting this demand into type and affordability, the future demand for units in the subject property type can be forecast.

In this case, we have determined that past and current market conditions should be sufficient in gauging the future performance of the subject property. Therefore, only inferred data will be considered.

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8. Demographic data on defined areas is available from various commercial providers.
10. For an in-depth description of a rental apartment Level C market analysis, see Market Analysis for Real Estate.
Current Market Conditions

The subject is an older, masonry, garden apartment complex and it competes with similar properties within the trade area. The six apartment complexes listed in Table 6.2 are the subject’s competition.

When at or below stabilized occupancy, actual trade area occupancy is considered a reliable indication of current demand. In fact, with a Level B analysis, this is the only measure of current demand available to the appraiser. In this case, frictional vacancy for the trade area is reported to be 5%, and equilibrium vacancy is estimated at 6%. Since the actual vacancy is 6%, it is concluded that current market demand for garden-style rental units in the trade area is 1,594. With a Level B analysis, future demand can only be estimated based upon existing and historical market conditions.

**Table 6.2 Competitive Properties**

<table>
<thead>
<tr>
<th>Name</th>
<th>Age (years)</th>
<th>Number of Units</th>
<th>Occupied Units</th>
<th>Current Occupancy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commuter Highway (Subject)</td>
<td>28</td>
<td>150</td>
<td>143</td>
<td>95%</td>
</tr>
<tr>
<td>Chesapeake</td>
<td>30</td>
<td>170</td>
<td>161</td>
<td>95%</td>
</tr>
<tr>
<td>Shenandoah Park</td>
<td>25</td>
<td>170</td>
<td>156</td>
<td>92%</td>
</tr>
<tr>
<td>Longview</td>
<td>12</td>
<td>374</td>
<td>355</td>
<td>95%</td>
</tr>
<tr>
<td>Bayvue</td>
<td>8</td>
<td>584</td>
<td>550</td>
<td>94%</td>
</tr>
<tr>
<td>The Virginian</td>
<td>2</td>
<td>41</td>
<td>41</td>
<td>100%</td>
</tr>
<tr>
<td>Linden Park</td>
<td>5</td>
<td>198</td>
<td>188</td>
<td>96%</td>
</tr>
<tr>
<td>Total/averages</td>
<td>16</td>
<td>1,687</td>
<td>1,594</td>
<td>94%</td>
</tr>
</tbody>
</table>

**Table 6.3 Household Trends**

<table>
<thead>
<tr>
<th>Year</th>
<th>Households</th>
<th>Compounded Annual Growth Rate</th>
<th>Average Absolute Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>10 years ago</td>
<td>7,747</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5 years ago</td>
<td>8,775</td>
<td>+2.5%</td>
<td>206/year</td>
</tr>
<tr>
<td>Current</td>
<td>9,908</td>
<td>+2.5%</td>
<td>227/year</td>
</tr>
</tbody>
</table>

Historical Growth and Construction Trends

The breakdown of historical and current households for the trade area is presented in Table 6.3.

Of the 2,161 new households located in the trade area over the past 10 years, county records indicate that 903 were new rental units. These figures indicate that 42% of new housing has been multifamily rental, which confirms that recent residential development in the trade area has been consistent with the established character of the community (reported to be 39% rental in the previous section).

Figure 6.4 details the multifamily residential building activity over the past 10 years and shows an average growth of about 91 multifamily units per year.

The 80 units developed three years ago were an age-restricted (active adult) project that does not compete directly with the subject. Adjusting for this indicates a growth of about 87 apartment units per year.

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11. In this case, stabilized occupancy is “the occupancy of a property that would be expected at a particular point in time, considering its relative competitive strength and supply and demand conditions at the time, and presuming it is priced at market rent and has had reasonable market exposure. A property is at stabilized occupancy when it is capturing its appropriate share of market demand.” The Dictionary of Real Estate Appraisal, 7th ed., s.v. “stabilized occupancy.”

12. If actual occupancy in a trade area produced a vacancy rate significantly more or less than the frictional rate, a Level C analysis would be necessary to determine the level of pent-up (unsatisfied) demand or excess supply.
**Historical Market and Subject Occupancy Rates**

The occupancy rate for the trade area over the previous 10 years is shown in Figure 6.5.

The precipitous drop eight years ago in market occupancy, as well as the subject’s occupancy, is credited with the opening of the 584-unit Bayvue Apartments. A second, lesser drop occurred five years ago with the opening of the 198-unit Linden Park apartments. As Figure 6.5 shows, the subject’s occupancy has generally outperformed the market; the market is currently at 94% while the subject has remained at or near 95% occupancy over the last four years. The trade area occupancy also recovered and has been at stabilized occupancy over the last three years.

**Market and Subject Rental Rates**

The current and historical rental rates per square foot for the subject and its primary competition are shown in Table 6.4.

Over the previous four years, the trade area has
experienced about a 12% average appreciation in rents, or a rate of about 3% per year. These increases correspond to the lack of excess space beginning two years ago and reflect an increase in real demand unaffected by special landlord concessions. The market growth rate from the last two years represents increases under near stabilized occupancy conditions. The subject property's rental growth rate over the past two years of 5% per year was recorded under stabilized occupancy conditions.

**Demand Conclusions**
The demand experienced in the trade area has been inconsistent with evidence of no clear pattern over the past 10 years. The average historical absorption pace has been about 90 units per year. This pace is expected to continue over the next five years. Therefore, current and future demand is concluded as shown in Table 6.5.

**Step 4. Competitive Supply Analysis**
Supply analysis is concerned with (1) the current and future competitive supply in the trade area and (2) a qualitative ranking of this supply. **Inventory and Predicted Supply**
We have previously determined that there are currently 1,687 garden apartment units within the defined trade area that compete with the subject. The survey indicates that these units (including the subject property) have an average occupancy rate of 94%.

Investigation with the county planner uncovered only one project submitted and nearing approval. This 150-unit project is likely to break ground in the near future and come online in two years.

The appraiser’s survey of the vacant and available sites suitable for the development of garden-style, multifamily units that would compete with the subject uncovered 20 acres in two 10-acre parcels. At 16 units per acre, each could support about 160 units. It is likely that one of these properties will be developed in the next five years. Therefore, current and future supply is concluded as shown in Table 6.6.

Note that 62 units are expected to be built per year over the next five years. This compares favorably with the 64 units added per year over the previous five years.

### Table 6.4 Rental Rates

<table>
<thead>
<tr>
<th>Name</th>
<th>Current</th>
<th>Total Increase</th>
<th>Two Years Ago</th>
<th>Total Increase</th>
<th>Four Years Ago</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commuter Highway (subject)</td>
<td>$1.26</td>
<td>10%</td>
<td>$1.15</td>
<td>3%</td>
<td>$1.11</td>
</tr>
<tr>
<td>Chesapeake</td>
<td>$1.25</td>
<td>8%</td>
<td>$1.16</td>
<td>2%</td>
<td>$1.13</td>
</tr>
<tr>
<td>Shenandoah Park</td>
<td>$1.30</td>
<td>8%</td>
<td>$1.20</td>
<td>2%</td>
<td>$1.18</td>
</tr>
<tr>
<td>Longview</td>
<td>$1.23</td>
<td>7%</td>
<td>$1.15</td>
<td>2%</td>
<td>$1.13</td>
</tr>
<tr>
<td>Bayvue</td>
<td>$1.15</td>
<td>9%</td>
<td>$1.06</td>
<td>3%</td>
<td>$1.02</td>
</tr>
<tr>
<td>The Virginian</td>
<td>$1.26</td>
<td>9%</td>
<td>$1.16</td>
<td>3%</td>
<td>$1.12</td>
</tr>
<tr>
<td>Linden Park</td>
<td>$1.30</td>
<td>10%</td>
<td>$1.18</td>
<td>4%</td>
<td>$1.14</td>
</tr>
<tr>
<td>Average</td>
<td>$1.25</td>
<td>9%</td>
<td>$1.15</td>
<td>3%</td>
<td>$1.12</td>
</tr>
</tbody>
</table>

### Table 6.5 Demand Trends

<table>
<thead>
<tr>
<th></th>
<th>Current</th>
<th>+1 Year</th>
<th>+2 Years</th>
<th>+3 Years</th>
<th>+4 Years</th>
<th>+5 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current demand</td>
<td>1,594</td>
<td>90</td>
<td>90</td>
<td>90</td>
<td>90</td>
<td>90</td>
</tr>
<tr>
<td>Additional demand</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total demand</td>
<td>1,594</td>
<td>1,684</td>
<td>1,774</td>
<td>1,864</td>
<td>1,954</td>
<td>2,044</td>
</tr>
</tbody>
</table>
**Table 6.6** Supply Trends

<table>
<thead>
<tr>
<th></th>
<th>Current</th>
<th>+1 Year</th>
<th>+2 Years</th>
<th>+3 Years</th>
<th>+4 Years</th>
<th>+5 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current supply</td>
<td>1,687</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Additional supply</td>
<td>150</td>
<td>160</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total supply</td>
<td>1,687</td>
<td>1,687</td>
<td>1,837</td>
<td>1,837</td>
<td>1,997</td>
<td>1,997</td>
</tr>
</tbody>
</table>

**Table 6.7** Ranking

<table>
<thead>
<tr>
<th>Name</th>
<th>Age (Years)</th>
<th>No. of Units</th>
<th>Avg. Rent per Sq. Ft.</th>
<th>Current Occupancy</th>
<th>Location Rating</th>
<th>Amenities Rating</th>
<th>Age/Cond. Rating</th>
<th>Total Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Linden Park</td>
<td>5</td>
<td>198</td>
<td>$0.99</td>
<td>96%</td>
<td>5</td>
<td>4</td>
<td>4</td>
<td>13</td>
</tr>
<tr>
<td>Longview</td>
<td>12</td>
<td>374</td>
<td>$0.94</td>
<td>95%</td>
<td>4</td>
<td>4</td>
<td>4</td>
<td>12</td>
</tr>
<tr>
<td>Bayvue</td>
<td>8</td>
<td>584</td>
<td>$0.85</td>
<td>94%</td>
<td>3</td>
<td>5</td>
<td>4</td>
<td>12</td>
</tr>
<tr>
<td>The Virginian</td>
<td>2</td>
<td>41</td>
<td>$0.96</td>
<td>100%</td>
<td>3</td>
<td>3</td>
<td>5</td>
<td>11</td>
</tr>
<tr>
<td>Commuter Highway (subject)</td>
<td>28</td>
<td>150</td>
<td>$0.96</td>
<td>95%</td>
<td>4</td>
<td>3</td>
<td>3</td>
<td>10</td>
</tr>
<tr>
<td>Shenandoah Park</td>
<td>25</td>
<td>170</td>
<td>$0.99</td>
<td>92%</td>
<td>3</td>
<td>2</td>
<td>3</td>
<td>8</td>
</tr>
<tr>
<td>Chesapeake</td>
<td>30</td>
<td>170</td>
<td>$0.95</td>
<td>95%</td>
<td>3</td>
<td>3</td>
<td>2</td>
<td>8</td>
</tr>
</tbody>
</table>

**Ranking of Competitive Supply**

In Table 6.7, the subject and competition are rated qualitatively on a scale of 1 (worst) to 5 (best) for location, age/condition, and amenities.

The amenities category includes consideration of unit characteristics and project characteristics. There is certainly some overlap with age/condition, which could dictate the character of the unit amenities as well as the project amenities. For example, older units may not have many of the amenities expected in the modern market (individual HVAC, private washer/dryer, high-tech connections), while the project may have amenities that are not currently in high demand (tennis courts, basketball courts). The location rating includes consideration of surrounding influences and accessibility of complementary services including shopping, restaurants, and employment centers.

The location rating shows the subject to be near the middle but the best of the older units due to its superior location. Thus, of the older units, the subject should be able to best compete in the future market.

**Step 5. Demand and Supply Interaction**

Often referred to as *equilibrium analysis*, the fifth step in the six-step market analysis process is to compare the current and forecasted demand with current and projected/forecasted competitive supply. The goal is to understand the economic forces expected to affect the trade area over the study period. This relationship is summarized in Table 6.8.

The analysis indicates a slight excess of supply in the current market but positive residual demand at the end of Year 1 and continuing on through the five-year forecast.

**Step 6. Capture Analysis**

The purpose of a marketability study is to predict the future performance of the subject property—that is, to predict how much of the residual or total demand the subject should capture. This marketability study has determined that the current market for garden apartment units in the trade area is 94% occupied. Occupancy is forecast to reach 95% by the end of the first year and remain at this level over the five-year horizon. Stabilized occupancy for the Commuter Highway Apartments is therefore concluded to be 95%.

The trade area has seen increasing rents over the past four years at an average rate of 3% per year, and this should continue over the five-year
The subject property is one of the older projects in the trade area but has the advantage of a superior location. Rental rates have increased by about 5% per year over the past two years but by only about 3% per year over the four-year study period. The evidence indicates that the subject should continue to outperform the existing competition in the trade area but probably not at the most recent level. A 4% growth rate for the Commuter Highway Apartments is inferred from the data.

Table 6.8 Equilibrium Analysis

<table>
<thead>
<tr>
<th></th>
<th>Current</th>
<th>+1 Year</th>
<th>+2 Years</th>
<th>+3 Years</th>
<th>+4 Years</th>
<th>+5 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current demand (units)</td>
<td>1,594</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Additional units demanded</td>
<td></td>
<td>90</td>
<td>90</td>
<td>90</td>
<td>90</td>
<td>90</td>
</tr>
<tr>
<td>Total demand</td>
<td>1,594</td>
<td>1,684</td>
<td>1,774</td>
<td>1,864</td>
<td>1,954</td>
<td>2,044</td>
</tr>
<tr>
<td>Frictional vacancy @ 5%</td>
<td>84</td>
<td>89</td>
<td>93</td>
<td>98</td>
<td>103</td>
<td>108</td>
</tr>
<tr>
<td>Supportable demand</td>
<td>1,678</td>
<td>1,773</td>
<td>1,867</td>
<td>1,962</td>
<td>2,057</td>
<td>2,152</td>
</tr>
<tr>
<td>Supply (units)</td>
<td>1,687</td>
<td>1,687</td>
<td>1,687</td>
<td>1,837</td>
<td>1,837</td>
<td>1,997</td>
</tr>
<tr>
<td>Additional units supplied</td>
<td></td>
<td>150</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total supply</td>
<td>1,687</td>
<td>1,687</td>
<td>1,837</td>
<td>1,837</td>
<td>1,997</td>
<td>1,997</td>
</tr>
<tr>
<td>Residual demand (units)</td>
<td>(9)</td>
<td>86</td>
<td>30</td>
<td>125</td>
<td>60</td>
<td>155</td>
</tr>
</tbody>
</table>

Summary

Market analysis is defined by the six-step process, which lays out a roadmap to guide the analysis. Regardless of which level of marketability study is pursued, the investigation and analysis associated with the first two and last three steps should vary only in terms of depth of research and intensity of analysis. Step 3 varies because fundamental data is analyzed in a Level C analysis only, while inferred data is relied on in Level A and B analyses.

About the Author

Richard L. Parli, MAI, has been involved in advanced appraisal education for over 30 years, has developed numerous Appraisal Institute courses and seminars, and is a regular contributor to The Appraisal Journal. He has an MBA in finance from The Pennsylvania State University and has been a professional faculty member of the Johns Hopkins University Carey Graduate School of Business. He has received a number of awards from the Appraisal Institute, including the James H. Pritchett Award for significant contribution to appraisal education, The Appraisal Journal’s Armstrong/Kahn Award for best original article (three-time recipient), and the Swango Award for best original article by an appraisal practitioner. Parli is the president of Parli Appraisal Inc., a full-service appraisal firm located in Warrenton, Virginia. Contact: rparli@parliappraisal.com
An Urban Doom Loop? Not So Fast!

The Economic Perspectives column offers insights by guest columnists on factors currently at play in economics, real estate, and financial markets. This edition of Economic Perspectives looks at changes affecting urban real estate.

The French have a saying, “plus ça change, plus c’est la même chose,” meaning the more things change, the more they remain the same. It is perhaps the signal feature of modernity that modern society favors change. In this, the French and Americans share a bias going back to the late eighteenth century, when both societies pursued change through revolutions.1 History has highlighted the assistance of the Marquis de Lafayette as well as the French assistance in the form of money, armaments, and naval support without which the American victory over the British could never have been achieved.2 Indeed, it might be said that without change there is no such thing as history. And it is equally true that without critical thinking, there is no such thing as history, but Thucydides cautioned that “people are inclined to accept all stories of ancient times in an uncritical way…. Most people, in fact, will not take trouble in finding out the truth, but are more inclined to accept the first story they hear.”3

The discipline to investigate stories, to weigh them in the crucible of evidence and experience, continues to be needed today. We are reminded to be wary of the “narrative fallacy,” the tendency to weave large stories with supposedly broad implications out of partial and perhaps ephemeral bits of information.4 That is likely what we are seeing in the current proclamation that America’s cities are in the grip of an “urban doom loop,” with perhaps irreversible consequences for real estate values. The catchphrase urban doom loop gained currency in the COVID-19 dislocation, and stems in large measure from research by

Opinions presented in this article are solely those of the author and do not constitute legal or financial advice.


3. Thucydides, History of the Peloponnesian War (New York: Penguin Classics, 1972). Thucydides was a rough contemporary of Herodotus in the fifth century BCE, and the two are generally recognized as the earliest historians.

Columbia University’s Stijn Van Nieuwerburgh. The most substantive of his recent papers was published in November 2022 by the National Bureau of Economic Research (NBER). In it, he examines data for the pandemic period (2019 to mid-2022) and then presents forecasting models that suggest urban economic losses and real estate market value declines will be substantial and long-lasting. Van Nieuwerburgh presents a detailed and careful review of implications for employment, innovation, productivity, and municipal finance as well as the expected consequences for real estate investment values, especially as reflected in publicly traded instruments such as REITs and CMBS. In a classic case of internet thought dilution, however, the business and popular press as well as the blogger legion have latched on to the urban doom loop catchphrase without the original author’s sense of discipline and academic caution.

The Phenomenon of Change

As I see it, a more careful and nuanced understanding of the phenomenon of change would help a lot in assessing the outlook for cities and for real estate. The real estate world has long understood that change comes principally in five basic forms: cycles, trends, maturation, change of state, and disruption. In our complex world these basic forms of change are rarely found in their pure state. Most often we find the forms of change interacting in some combination, as illustrated in the Exhibit 1 matrix.

Since the pandemic of the 2020s can be identified as a disruption, we should examine how that interacts with the other four common types of change. The various interactions and the results of each interaction are named in the far-right column of the Exhibit 1 matrix. Let’s consider in more detail two results from disruption interaction—chaos and vector break.

Disruption + Cycles = Chaos
Real estate investment professionals monitoring cycles do so with an eye toward the future, rather than a simple interest in how the past has brought us to the present. They seek advantage in anticipating how cyclical movement, predicated on fluctuations around equilibrium, will more or less predictably drive toward the next phase of market conditions. Predictability, then, helps such investors achieve tactical advantages in getting ahead of change, at least notionally.

Disruption, though, is about unpredictability, or discontinuous change. Recognizing that even in disruptive conditions there remains a powerful

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8. The matrix is drawn from a forthcoming textbook by Merrie Frankel, Hugh Kelly, and Constantino Korologos, Real Estate Capital Markets: Evolution, Structure, Participants (San Diego: Cognella, 2023), chapter 6. The matrix shows Leibniz’s Axiom at the interaction of cycles and trends. German mathematician Gottfried von Leibniz notably observed that “nature has established patterns originating in the return of events, but only for the most part.” That axiom means that even as cycles work toward equilibrium or regression to the mean, the cyclical pattern ends at a different point from the beginning—it does not return to square one. That’s why the study of risk treats decision-making as one of probabilities, not certainties. See Peter L. Bernstein, Against the Gods: The Remarkable Story of Risk (New York: John Wiley & Sons, 1996), 4–5.
tendency of cyclical patterns to assert themselves, 
investors are left to cope with countervailing 
forces leading to uncertain outcomes. Although it 
is rarely called by name, much less treated as an 
accurate descriptor of real estate capital markets, 
science is increasingly willing to apply a specific 
term to this condition—chaos.9

The impact of disruption on real estate and 
economic cycles can be best understood by recog-
nizing that real estate markets are complex adap-
tive systems. The literature on the behavior of 
such systems is extensive. A basic observation is 
that complex systems are ensembles with a 
dynamic of interactions, but a system’s behavior 
may not be predicted merely by the behavior of its 
components.

To be clear, “complexity” and “chaos” are not 
synonyms. However, scientists such as Betten-
court et al. who study complex adaptive systems 
carefully assert that such systems may function on 
the edge of chaos. These scientists employ the 
rigor of advanced mathematics to understand sys-

tem behavior and do so to surprising effect.10 
Nevertheless, progressive adaptation promotes an 
increase in diversity. In the words of one author, 
“complexity breeds diversity, which increases 
complexity, which breeds diversity.”11 Put another 
way, such systems are co-adaptive and at a very 
minimum should be understood as ill-suited for 
the simplification normally articulated in the pre-
dictions of cyclical recurrence.

Both the economy as a whole and cities as a 
partial subset can be studied as complex adap-
tive systems moving on the edge of chaos. One 
key insight on the economics side is that perhaps 
equilibrium is not all it is cracked up to be. Instead 
of developing expectations based on the state of a 
system that never truly settles down, perhaps we 
need a perspective that emphasizes comprehen-
sion and explanation.

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9. This term has spread widely into popular discussion. An early treatment of the phenomenon was by James Gleick, *Chaos: Making a New Science* (New York: Viking, 1987) explored the butterfly effect or “sensitive dependence upon initial conditions” as a way to understand the unpredictable ramifications of apparently small differences upon changes in a system.


The study of urban change, in line with the work of Bettencourt et al., has been intensively pursued by Michael Batty of University College, London, and others. Batty explores the impact of scale (urban size) and hierarchy (a city’s rank-order in a network of cities). These are factors that not only differentiate urban areas from each other but also help direct the kinds of land use (e.g., building forms) most likely to be economically successful. Naturally, this investigation needs to consider the pace of growth, but here a new factor of uncertainty is introduced. Batty and others have noted that the acceleration of growth factors in a city (however desirable such growth may be), interacting with each other over time, can have a destabilizing effect physically, socially, and economically. Focusing on dynamics, Batty says, “we consider disequilibrium to be a more characteristic state of urban systems” than stability and relative predictability.

If nothing else, such analysis cautions us against jumping to conclusions about what the pandemic disruption portends for expected future performance in real estate cycles.

**Disruption + Trends = Vector Break**

There seems to be a consensus that the world is now in a post-COVID period, although I think a better term would be late-COVID period, as the coronavirus is still active globally. For the week ending July 12, 2023, there were 191,922 new cases of COVID-19 and 647 deaths registered by the World Health Organization (WHO).

Beyond the raw numbers of cases and deaths, the disruptive impact of the novel coronavirus must be considered in terms of the aggregate social and economic dislocation experienced over the course—still not completed—of this deadly disease. Such disruptive changes cannot be turned off like a spigot. Even if new cases and deaths fell to zero, the worldwide impacts would linger.

The progressive urbanization of the American economy is one of the longest and most well-established trends affecting US real estate as a whole. The urban doom loop narrative anticipates that COVID is causing a vector break, a disruptive shift with a long-term consequence of greater population dispersion from the cities.

The percentage distribution of the US urban population measured in all decennial census counts is presented in the Exhibit 2 graph. The COVID pandemic appeared to interrupt that upward trend in urbanization, first seen in the flattening of the curve in 2020, and then in an absolute decline at the height of the public health emergence in 2020–2021. The 2020 drop in population was most acutely felt in urban areas with populations of one million or more, while smaller metros sustained modest growth, and non-metropolitan areas saw their first increase in population in years. Net domestic migration accounted for

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14. That brought the world cumulative total to 768 million cases and 6.95 million deaths, figures that the WHO acknowledges are likely to be substantial undercounts. In the United States, cases have surpassed 103 million, with 1,127,157 deaths attributed to the virus. Data from the WHO Coronavirus (COVID-19) Dashboard, data accessed on July 18, 2023, https://COVID19.who.int/.
15. According to the US Census Bureau, “Urban areas, defined as densely developed residential, commercial, and other nonresidential areas, now account for 80.0% of the US population.” Press Release CB22-CN.25, December 29, 2022. As the Exhibit 2 graph shows, the United States became a majority-urban society around 1920. Globally, the urban population surpassed the 50% mark in 2007, according to UNESCO estimates.
the differential, although population growth in major cities was also hampered by sharply reduced international migration and the jump in mortality triggered by the coronavirus.

Digging more deeply into the data, the metro areas with the greatest numeric losses were New York, Los Angeles, San Francisco, and Chicago. While large metro areas in the Sunbelt continued to grow, even markets such as Dallas, Phoenix, Houston, and Austin saw their expansions decelerate. Does this indeed indicate a shift in the historic vector of urban growth? And what might that mean for real estate use and property investment?

Candidly, this seems to be an open question as of this writing (in July 2023). Demographically, the tide of population out-migration appears to at least be ebbing, if not reversing. The years 2021 and 2022 did not seem to be strong candidates for an urban rebound, given unemployment followed by inflation and political turmoil in that period. These factors prompted many to head out of cities in search of more affordable options perceived to offer a better quality of life. Yet of the nation’s 50 largest cities, 46 experienced renewed population growth in 2022. The exceptions (those decreasing in population) were Baltimore, Detroit, Memphis, and Milwaukee. New York, Houston, Dallas, and Phoenix all bounced back moderately, while urban areas like Atlanta, Austin, Charlotte, Denver, and Seattle all enjoyed significant population expansion in 2022.

Given the long-term trend of urban growth, why should there be any surprise that major cities would prove resilient? The answer, at least in part, can be attributed to the narrative fallacy mentioned earlier. Harvard economists Edward Glaeser and David Cutler confronted such expec-

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tations in their 2021 book. While recognizing the serious challenges confronting cities—especially large, dense cities—in the 2020s, they write, “there is a way to bring cities back stronger, but it is not simple…. We must recognize that we do not have all the answers. We must have the humility to learn before we can transform.”

Real estate investors have intuitively taken such an admonition to heart. The initial demographic turmoil that saw significant migrations away from large and dense cities triggered a sharp reduction in transaction volumes. For instance, investment volumes for real estate during 2019–2020 fell 39% in New York, 37% in Los Angeles, 37% in San Francisco, 19% in Dallas, 31% in Washington DC, 17% in Boston, 25% in Atlanta, 59% in Seattle, and 33% in Chicago. This profile of a reversal of urban advantage was amplified in both traditional and social media, setting the stage for the real estate sector to succumb to the narrative fallacy of a vector break for capital flows in a putative era of a new normal.

Like the post-2020 return of population growth to cities, so too the 2021 and 2022 property investment data show varying transaction volumes in their vectors. Data recently suggest investment patterns returning to a preference for some cities in 2022 and early 2023. New York and Washington, DC, saw their investment volumes back at 2019 levels by 2022. Los Angeles (up 18%), Dallas (up 80%), Atlanta (up 55%), and Chicago (up 26%) saw net increases in capital flow from the immediate pre-pandemic volume. On the other hand, San Francisco was down 27%, Boston down 9%, and Seattle down 31%. So, the evidence of a vector break for real estate capital is, at best, mixed.

### Economic Foundation of Major Cities

To further investigate the economic foundation of major metro areas, let’s turn to a framework that was both familiar and informative in the pre-COVID era, the taxonomy of 24-hour cities, 18-hour cities, and 9-to-5 cities. For ease of reference, Exhibit 3 lists 21 cities within those clusters.

#### Exhibit 3 Major Metro Markets by Type

<table>
<thead>
<tr>
<th>24-Hour Cities</th>
<th>18-Hour Cities</th>
<th>9-to-5 Cities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Boston</td>
<td>Austin</td>
<td>Atlanta</td>
</tr>
<tr>
<td>Chicago</td>
<td>Charlotte</td>
<td>Dallas</td>
</tr>
<tr>
<td>Las Vegas</td>
<td>Denver</td>
<td>Los Angeles</td>
</tr>
<tr>
<td>Miami</td>
<td>Houston</td>
<td>Minneapolis</td>
</tr>
<tr>
<td>New York</td>
<td>Nashville</td>
<td>Philadelphia</td>
</tr>
<tr>
<td>San Francisco</td>
<td>Portland</td>
<td>Phoenix</td>
</tr>
<tr>
<td>Washington, DC</td>
<td>San Diego</td>
<td>Seattle</td>
</tr>
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</table>

These 21 metro areas play an outsized role in the US economy. Overall, urban economies dominate the United States, with 88% of total gross domestic product (GDP). The Office of Management and Budget defines 366 metro areas, but these 21 metros account for 45% of the US output of goods and services—21% by the seven 24-hour markets, 16% by the seven 9-to-5 markets, and 8% by the seven 18-hour markets. Moreover, these 21 metros represent 39% of total US employment, or 60 million jobs. The labor

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market distribution is 26.4 million jobs in the 24-hour metros, 22.3 million jobs in the 9-to-5 metros, and 11.1 million jobs in the 18-hour metros. And while US productivity averages $130,400 per worker (GDP/employment), these 21 markets are well above the national norm: $149,400 per worker for the 24-hour cluster; $143,100 per worker for the 9-to-5 cluster; and $138,200 per worker for the 18-hour cluster.22

Benchmarks of Sustainable Demand
For real estate investors, labor market and productivity metrics are key benchmarks of sustainable demand. In brief, output reflects revenue and output per worker contributes to profitability. Profits are what enable tenants to pay the rent, and that in turn is what supports property values. So, it should not be surprising that investment capital is attracted to cities where high-revenue, high-productivity, and substantial labor markets are concentrated.

When it comes to aggregate commercial property investment for the four quarters through early 2023, the chart in Exhibit 4 demonstrates that the 21 selected metros punch above their weight. The 24-hour group, at $10.6 billion, shows a 24% share of total volume, with the 9-to-5 cluster close behind at $9.9 billion, or 23%. The 18-hour group, which has garnered much attention with the fast-growing Sunbelt rising stars, tallies $3.1 billion in investment real estate deals, a 7% share. For the rest of US markets, while the pie chart seems to indicate diffused investor interest with $19.7 billion, or 46%, remember that this is divided among 345 MSAs, or 94% of all metro areas.

There is an additional nuance to take into consideration with the benchmarks. The taxonomy classifies the 21 metros based on their characteristics as observed over the period from the late 1980s through 2014. During that period, investors enjoyed superior performance in the 24-hour cluster as measured by total returns in the NCREIF portfolio; this made such metros a capital magnet as monitored by the broader investment flows reported by Real Capital Analytics (which has since been acquired by MSCI). But this did not go unnoticed by those markets in the 18-hour and 9-to-5 categories. Many of those cities have made a deliberate attempt to replicate the live-work-play profile of the 24-hour cities. The following presents a few examples.

• Atlanta has grown its Midtown area into a dense, mixed-use district. Not only is there an office core, but convenient walk-to-work

Exhibit 4 Distribution of US Transaction Volume by Metro Type

<table>
<thead>
<tr>
<th>4-Quarter Transaction Volume (Millions of Dollars)</th>
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</thead>
<tbody>
<tr>
<td>10606.5</td>
</tr>
<tr>
<td>19663.5</td>
</tr>
<tr>
<td>9913.1</td>
</tr>
<tr>
<td>3113.1</td>
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</tbody>
</table>

Source: MSCI Real Assets (data through 1Q23)

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rental housing and condominiums fill the neighborhood. Atlanta’s High Museum and Symphony Hall are here. Piedmont Park and the Atlanta Botanical Gardens provide significant outdoor amenities. There is a rich assortment of eating and drinking establishment cultivating nightlife.

- Los Angeles has, over time, taken a struggling downtown and established a vibrant corridor running from the Disney Center at the head of Bunker Hill to the Staples Center in the South Park neighborhood. Los Angeles, long synonymous with automobile traffic congestion, has invested in a mass transit system facilitating commuting. Downtown Los Angeles added 19,500 residential units for the decade ending 2022, boasting a population of more than 82,700.

- San Diego’s Gaslight District and Denver’s LoDo have staked a claim to national attention in reclaiming formerly tattered areas and making them showcases for those cities’ urban cores. Likewise, Austin and Nashville have parlayed the mix of entertainment, commercial businesses, government, and top educational institutions and have become vibrant attractors of both corporations and new residents.

- Recently, Philadelphia has appointed a “director of the night time economy” to advance its status toward 24-hour robustness.

So, as New York and San Francisco have taken the brunt of the COVID disruption, other metros are not running away from the 24-hour city model. The doom loop narrative seems to be at least premature, if not ultimately mistaken. This is, in my experience, at least the fifth time that New York has been written off. The current troubles pale compared to New York’s 1970s Fiscal Crisis, where the city lost 800,000 residents and 600,000 jobs. At the height of the crack cocaine crime epidemic, the sunset of Gotham was widely proclaimed. After 9/11, the conventional wisdom was that companies would flee Manhattan as a permanent target of terrorism. The Global Financial Crisis was expected to harm the world’s financial center as its major banking institutions melted down.

Output reflects revenue and output per worker contributes to profitability.

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23. During this era, the 44-story 1166 Sixth Avenue building, which opened in 1976, was famously referred to as “the towering fiasco” as it sat vacant for years; however, by 1979 the market had picked up and it was occupied and functioning. See Leonard Sloane, “New Episode in the 1166 Saga: Success at Last,” New York Magazine, https://bit.ly/3YaCx1E.


25. The present author, to the contrary, published research suggesting that the behavior of displaced firms that were in or near the World Trade Center on 9/11 predicted a successful return of Lower Manhattan if Ground Zero were rebuilt as commercial office buildings and related facilities. See Hugh F. Kelly, “The New York Regional and Downtown Office Market: History and Prospects After 9/11: A Report for the Civic Alliance” (August 9, 2002) and “A Planning Framework to Rebuild Downtown New York,” The Civic Alliance Draft Report (Regional Plan Association, 2002).

There is at least a solid probability that the doom-saying around cities in 2023 will prove an excessive, perhaps myopic, reaction to the undeniable challenges of the late-COVID era.

To return to the era of America’s founding noted in the opening to this essay, Thomas Jefferson and others articulated what has been an anti-urban bias that has persisted in our history.27 Jefferson wrote, “I view great cities as pestilential to the morals, the health, and the liberties of man.” Yet, as the data presented earlier show, cities—and particularly the “great cities”—are the engines of America’s economic prosperity. They have proven resilient over the course of nearly 250 years of US history, and I expect they will again rebound as we pass through the 2020s.

About the Author
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The COVID-19 pandemic disrupted the traditional framework of how and where people work, and consequently the office real estate market. The office real estate market—especially central business districts—were developed based on the assumption that workers would congregate in offices. COVID-19 restrictions, however, put that work model on hold. Now, with the health crisis over, there are varying prognostications on the degree to which the centrally assembled office workforce model will be reengaged. Both the timing and the prevalence of return to the traditional model have major implications for all players in the office market—developers, landlords, and tenants. The following resources offer a variety of viewpoints on the office market’s strength and future.

“The Office Real Estate Market: From COVID Disruption to Uncertain Future,” by Anthony DellaPelle, is one article addressing the major changes in office demand and the office market arising from the pandemic (Real Estate Issues 47, no. 10, May 2, 2023, https://bit.ly/3K603qK). The article discusses building functionality and utility, particularly with respect to functional obsolescence, a major concern for appraisers of office buildings. The article notes prior to the COVID-19 pandemic, the US office real estate market had been subject to contraction for approximately a decade as businesses tried to lower overhead by implementing various “open office” concepts such as hoteling and/or hot-desking. The results of these methods have been mixed ... the average pre-COVID space-per-worker just prior to the pandemic stood at approximately 190 s.f. of office space per worker. ... Though many businesses have successfully integrated their workers’ return to the physical office with full or partial week schedules, it is inevitable that at least some workers will never return to the office and that hybrid work schedules for a significant percentage of office workers may be here to stay. For the tenants that are signing on now, there is evidence that they are asking for even less space-per-worker than prior to the pandemic; with the average being down to 175 s.f. of office space per worker.1

As office leases are begin[ning] to come to maturity, vacancy rates are rising to a national average of 18.2% throughout most of the nation.2 Faced with growing vacancies, office owners are left with only a few options: (1) lower rents in order to preserve current tenants and to entice new tenants to sign on; (2) maintain current rental rates expecting that the office building is attractive enough to lessees that they will eventually come back; (3) make changes to the building; or (4) sell the property at a time when the sale price may not be optimal.

The office market for tenants and investors depends heavily on how the appraised property relates to developing newer market standards, norms, and expectations. A building not meeting market standards likely has functional obsolescence. If not economically feasible to cure the deficiency, then conversion to another use, or repurposing, must be considered based on market demand for an alternative use, physical possibility, and legal permissibility (may be public and private considerations) as well as a cost-benefit analysis.

Propmodo presents several discussions on the post-pandemic office market. An April 2023 article, “Opening the Doors: Measuring the Return to the Office,” by Courtney Porcella (https://bit.ly/3Yn97xz), helps in understanding the post-COVID office changes. This commentary observes, “US offices hit a notable milestone in January as the never-ending return to work saga continues: for the first time since 2019, weekly average occupancy exceeded 50 percent of pre-pandemic levels according to Kastle access data. … Even before COVID-19 crept into the world, most occupancy estimates hovered around 75-85 percent at best.”

Propmodo also offers an informative video covering “Calculating Office Utilization” (https://bit.ly/3YokBku), which should be of interest to those involved in analysis of office functionality and utility, as well as office building consulting, appraising, and analysis.

Related office market analytical tools are addressed in the June 2023 article “4 Atypical Ways Investors Are Looking at the Office Market” by Holly Dutton (https://bit.ly/442FByf). This article cautions that while various data reports “come out quarterly, sometimes even monthly, and offer a useful snapshot of fundamentals like office vacancy rates, leasing and sales volume, and often a breakdown of activity in sub-markets … in today’s complicated economic landscape, it helps to look at other sources and take a more thorough approach.” The article goes on to address supplementary analysis of office markets, which consider foot traffic (not just for retail), cellphone usage, badge swipes, venture capital funding, and job-posting data.

Another Propmodo piece discusses how some office buildings have one or more tenants offering co-working space. Approaches for valuing co-working spaces in office buildings is addressed in the May 2023 article “Real Estate Professionals Are Adopting New Approaches for Valuing Co-Working Spaces” by Holly Dutton (https://bit.ly/3DNh1XJ). The article notes that after the pandemic accelerated remote work trends, “large corporate occupiers saw carving out space for co-working as a smart component of their overall office strategy.” This, however, presents the question of how it’s valued within the context of an office building.

Flexible office space …means that the real estate industry, and the lenders that service them, are becoming more savvy in the way they underwrite these spaces....

There’s no question that co-working and flex spaces can be harder to value and are often looked at as riskier, but there are instances where these kinds of spaces can end up being more favorable than traditional office space. … Co-working operators may not have been the most desirable tenant in the past and may even be the last tenant of choice now, but a lot of office owners would rather have a building occupied than manage through vacancy. …And as advances in technology continue to grow and better support virtual collaboration, it underscores how much value flex space provides to the office market.

3. A June 20, 2023, Wall Street Journal article, “Wall Street Sours on America’s Downtowns,” by Heather Gillers, notes cellphone activity (and its change over time) is another factor for assessing the health of downtowns.
A third Propmodo article by Holly Dutton, “Single-Use Office Campuses Face Subleasing Conundrum,” December 2022 ([https://bit.ly/3KxcgVG](https://bit.ly/3KxcgVG)), comments that “available sublease space is hitting all-time highs, some companies that built all-in-one corporate campuses sequestered away from central business districts and high-traffic areas are finding themselves with extra space and a lot of competition to fill.” Several examples of such situations and cases are cited and discussed.

The office sector flight to quality is a consequence of the difficult office market for investors. The office market is, in most urban markets, suffering from low occupancy and valuation challenges. But there are some silver linings in some geographic areas for some office types and submarkets. This is addressed in a June 2023 Propmodo piece, “The Data behind the Office Sector’s Flight-to-Quality,” by Barbra Murray ([https://bit.ly/3KBk7l8](https://bit.ly/3KBk7l8)). Here, in the opinion of many, if not most, the general office sector is apparently some distance from a rebound—except for the high-end segment, trophy, signature, and Class A properties.

A June 2023 Propmodo piece, “Higher Office Sales Volume Doesn’t Always Mean Higher Leasing Volume” ([https://bit.ly/3qP7FhG](https://bit.ly/3qP7FhG)), observes that “office vacancy and occupancy rates are often discussed when assessing the health of office markets. However, comparing office sales to office leasing can also provide interesting perspectives.

Office Conversions: Market Changes and Repurposing Improved Properties

Challenges in Repurposing Office Buildings

Repurposing or converting an office building to an alternative, more in-demand use may represent the highest and best use, and may be the use motivating a buyer. The challenges are important considerations for appraisers, however, as they evaluate the highest and best use of existing office buildings.

A Propmodo article on the subject, “Many Office Buildings Can’t Be Repurposed due to Excessive Tension,” by Franco Faraudo ([https://bit.ly/44fQz3](https://bit.ly/44fQz3)), notes that the housing shortage leads “most people to the obvious conclusion that we should repurpose office buildings into apartments and condos. … But, as good of an idea as it sounds, there are many reasons why this will not work for most office buildings.”


Converting office buildings into residential units is a painstaking process that involves some serious architectural gymnastics… To convert these buildings into apartments, developers must divide these large spaces into smaller units, often requiring significant modifications to the structure and layout of the building.

Non-Residential Alternative Uses of Office Buildings

The physical and legal problems encountered can make a conversion to residential use extremely expensive—often keeping it from being economically feasible.

A Propmodo article notes, however, that office conversions are not limited to residential alternative use. “Vacant Office Buildings Are Being Converted for Non-Housing Purposes Too” (https://bit.ly/44gUzAO) addresses repurposing of office properties for a variety of nonresidential uses that may make more economic, physical, and market sense, such as conversions to hotel, lab, self-storage, retail, education uses, or event space. Another Propmodo article, “Owners Are Getting Creative with Vacant Office Conversions” (https://bit.ly/3QP9dfs), also addressing alternative repurposing, states,

Aside from the most common conversions of office to residential and industrial, ... companies [are] repurposing unused office space into storage, small gyms, co-working space, and even micro-schools. ... Cities with high office vacancy rates...are launching incentive programs to help owners and developers make the transition. But it is still a niche strategy in the real estate industry that is constrained by a number of factors, including regulatory barriers, construction costs, and simply not having the right infrastructure to support a major change.

Depending on the location, life science uses are sometimes a possibility for office building conversions; this depends on physical, legal, economic, and market feasibility. Among the benefits of life science conversion is a shortened timeline for occupancy. New construction of a life science development typically requires 3–5 years, while conversion projects may take only 1–2 years. In addition, life science assets provide the landlord with more money than standard office leases—rent growth in this sector has significantly outpaced that of office buildings for over five years.5

But life science costs of conversion are high, as discussed in “What Makes a Good Life Sciences Real Estate Conversion?,” Propmodo (https://bit.ly/3E0GYTD). This article notes “it can cost twice or even three times as much to fit out typical office space to install the necessary plumbing, ventilation, clean rooms, loading docks, and other specialized needs. ...In general, life science buildings require more storage to account for chemical storage and hazardous waste disposal. ...ample shipping and loading zones... backup generators and ventilation and fire suppression systems.”

Despite these issues, the life science property sector has seen record growth that is expected to continue. For more on this sector, see discussions in “The Emergent Biomanufacturing Ecosystem Will Launch a New Era of Real Estate Investment,” Propmodo (https://bit.ly/3qDDweI), and “After ‘Odd Year’ for Life Sciences, What’s Next?,” Propmodo (https://bit.ly/45evzeP).

Economics and Trends Impacting the Office Market

Appraisers might be interested in learning more about the factors that have contributed to the current situation of office properties.

Interest rates. A Wall Street Journal article, “Rising Interest Rates Threaten to Expose Office Buildings’ Inflated Values” (October 31, 2022), observes that “cheap debt fueled a decadelong boom in US office values, offsetting the impact of years of rent increases that didn’t keep pace with inflation. Now that the long period of easy credit

is over, office-building owners are bracing to see how much less their properties are actually worth.” Another Wall Street Journal article, “America’s Office Glut Started Decades before the Pandemic” (August 23, 2022), describes how the office sector was struggling with soft demand long before COVID-19 and how low interest rates masked those problems, pushing values to record highs even as rents fell.

Between 1997 and the end of 2021, effective office rents...in the 50 biggest US markets fell by 16%, adjusted for inflation, according to data from Moody’s Analytics. And yet office-building values rose by an inflation-adjusted 91% during that period.

Since the COVID pandemic, particularly with the 2022–2023 interest rate increases, the relatively high prices (compared to effective rent) have come down markedly, with vacancies continuing to climb in most markets. Conversely, we are now seeing the effect of increasing interest rates, and occupancy problems, on the office investment market and office values.

**Fewer workers in offices.** The current state of office properties is also related to the shift away from workforce density in central locations. The Wall Street Journal has a number of articles looking at the gloomy prospects related to this trend. One piece, “Wall Street Sours on America’s Downtown” (June 20, 2023), points out “on average, offices in major metro areas have half as many workers compared with before the pandemic.” Another article, “The Return to the Office Has Stalled” (May 16, 2023), reports data demonstrating this new reality: “Office buildings are only about 50% as full as before COVID-19 across 10 major metro areas, according to keycard tracking by Kastle Systems, a building-security company. Federal transit data show public-transportation ridership at less than 70% of pre-COVID levels in major metro areas.” An earlier article, “Office Vacancies Send Real Estate Investors for the Exits” (April 6, 2023), said, “Now, with white-collar workers spending more time in their home offices, a phenomenon that shows few signs of ending, investments linked to downtowns are trading at falling prices in volatile markets.” As one “indication of investor worries, those who buy a common type of low-rated commercial mortgage-backed security are demanding 9.25 percentage points more interest than that on 10-year Treasury Bonds [as of June 12, 2023] according to research from Bank of America. This spread is three times as big as before the pandemic for such securities, which finance a property mix that is around 30% office space.”

In general, real estate investment trusts (REITs) holding downtown real estate have not been favored by investors, particularly since the 2020–2021 COVID era. Commercial mortgage-backed securities’ (CMBS) price and yield levels vary according to returns from alternative investments (e.g., Treasuries and corporate bonds), perceived risk, and market outlook. Keeping that in mind, The Wall Street Journal reported in “Distress in Office Market Spreads to High-End Buildings” (March 28, 2023) that

a small corner of the US bond market, so-called commercial mortgage-backed securities, or CMBS, have taken a beating for over a year owing to fears that owners of business parks, high-rises and other office properties could default on loans extended at a time of different work habits and lower financing costs. Prices of bonds backed by commercial mortgages have recently dropped to levels not seen since the early days of the pandemic, pointing to a growing economic threat stemming from office vacancies and rising interest rates.

In Real Estate Issues, “The Office Market Reckoning Is Nigh” by Andrew Nelson (47, no. 12, May 8, 2023; https://bit.ly/4SyXw7) also looks at “the impact that reduced office tenant demand has on property capital markets.” It reports that the return to office debate “is largely settled: workers won’t be sitting at their company desks...
nearly as often as before the pandemic.” The article points out that firms and workers are leaving the top 6 markets (New York, Chicago, Washington, San Francisco, Boston, and Los Angeles), and vacancy rates have soared in these markets. The author notes “already property values have fallen more in the office sector than in any other property sector, while investment returns have been the lowest. And that pain will only intensify as market conditions weaken further.”

The author points out that tenant demand and occupancy dropped significantly after the pandemic, as have rents, sale prices, transaction volume, and absorption. He notes, however, that in 2022 the drop was muted for several reasons; among them, firms were in medium to long-term leases and thought they would need the space later, and office-using parts of the economy had fewer layoffs (except tech grew). The vacancy rate is expected to rise as leases expire and firms reduce space. “The best indication of future leasing intentions is the amount of unused space firms are making available for sublease. Colliers estimates that sublease availability has doubled from pre-pandemic levels to almost 250 million square feet. …Most of that space will eventually be counted as vacant landlord space once the leases roll from the tenants’ responsibility. Thus, expect vacancy rates to spike over the next two years.”

The author also notes that “in a stunning reversal of fortune, office demand is shifting away from downtown markets, especially in the dominant office market as vacancies rose higher and faster in downtown markets than in suburban markets. …This shift is the opposite of what usually occurs after market downturns, when tenants leverage falling rents to trade up from commodity suburban space to more desirable downtown offices.”

Further, the author discusses changes in capitalization rates, falling values, REITs returns by property sector (comparing office returns to other sectors such as industrial, residential, health care, etc.), and changing capital markets. Over a dozen citations and endnotes document the points made and provide the reader with additional resources.

In the same issue of Real Estate Issues readers will find “Evolving the Office Space: How Commercial Spaces Are Adapting for Hybrid Employees” (https://bit.ly/45f6el6). This piece speaks to changing standards for office functionality with design considering hybrid employees working some days from home and some days in the office. “Hybrid models present an excellent middle ground for those wanting time at home but also needing time in the office. Flexibility is a priority for many job seekers in today’s economy. In fact, a McKinsey study reveals 87% of workers accept opportunities to work in a flexible format. This format is popular because employees have more autonomy over their schedule, workstations and daily workflow.” A 2022 Gallup survey reported in “The Advantages and Challenges of Hybrid Work” (https://bit.ly/3KJnxm0) explores the benefits of hybrid work as it rises in the United States and worldwide as “hybrid working is the new normal.” To bridge the gap between in-office and remote workplaces, office design has become “resimercial,” which introduces residential elements into the office space. To learn more about this office trend, read “The Rise of Resimercial Design in the Workplace” (April 2022, https://bit.ly/47ARNJF).

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Digging Deeper

Appraisers can access a wealth of additional information about office markets and office properties by visiting the websites of stakeholder organizations. On the next page, you’ll find a listing of some of these organizations as well as niche information related to design trends and obsolescence.

6. Remember, functionality and design are important to appraisers as they must consider functional obsolescence points in all approaches. The appraised functionality of the appraised property is compared to market standards, which change with the times.
Additional Office Market Resources

Professional Associations
Several major professional and trade organizations involved with office building development and management are valuable resources for appraisers needing information related to the office sector market. The following seven are among the most well-known and respected commercial real estate organizations.

1. **Building Owners and Managers Association (BOMA) International**—a primary source of information on office building development, leasing, building operating costs, sustainability, local and national building codes, legislation, occupancy statistics, and technological developments. (www.boma.org)

2. **CCIM Institute (CCIM)**—a commercial real estate professional organization providing opportunities through its education program. (CCIM.com)

3. **National Association of Realtors (NAR)**—America’s largest trade association representing members involved in all aspects of the residential and commercial real estate industries. (www.nar.realtor)

4. **NAIOP, the Commercial Real Estate Development Association**—an organization for developers, owners, and related professionals in office, industrial, and mixed-use real estate. (www.naiop.org/research-and-publications/)

5. **Society of Industrial and Office Realtors (SIOR)**—research and publications including SIOR Report and SIOR Pulse Blog. (www.sior.com)

6. **US Green Building Council (USGBC)**—topical articles and research. (www.usgbc.org/)

7. **Institute of Real Estate Management (IREM)**. (www.irem.org and www.irem.org/publications)

For names and descriptions of additional organizations, see “List of Top Commercial Real Estate Associations,” https://bit.ly/3QFlm5G.

Office Design Trends
Design trends may be of importance for appraisers and others considering the extent of functional obsolescence in an office property. Here are some resources that may have publications, periodical writings, and research papers of interest to office appraisers.

- **Allwork.Space “2023 Future of Work Forecast: Office Design Is Ever-Evolving; Here Are 5 Trends for 2023.”** This report discusses (1) net zero buildings, (2) solidifying how hybrid and remote work will shape physical office space, (3) data-driven design strategies, (4) multi-modal design, and (5) greenwashing, as well as additional related topics and writings. (https://bit.ly/3YE5svu)


- **“7 Commercial Office Design Trends for 2023.”** Looks at approaches to open-concept workspaces. (www.dgicommunications.com/commercial-office-design/)

- **“Office Design Trends in 2023.”** Addresses hybrid work spaces, collaborative spaces, natural light, energy efficiency, “smart” offices and technology, and amenities to retain employees. (www.iofficecorp.com/blog/office-design-trends-2023/)

- **“Modern Office Design: Features and Trends in 2023.”** Highlights differences between modern and traditional office design as well as the latest trends. (https://foyr.com/learn/modern-office-design-features-and-trends/)
The Build-to-Rent Market

The post-COVID era has also seen changes in the residential real estate market. There has been notable interest in single-family built-for-rent housing developments in response to problems with housing shortages and affordability. A December 2022 ManageCasa.com article, “Built to Rent Housing Market Exploding,” pointed to the lack of options for affordable housing as the impetus for interest in build-to-rent housing (https://bit.ly/47B9cBY).

More recently, a July 2023 Real Estate Issues article, “Build-to-Rent Homes: A Promising Solution to Chronic Housing Shortages,” observed that “when homeownership is increasingly out of reach for many, build-to-rent (BTR) housing offers a desirable alternative to traditional homeownership. First, BTRs provide flexibility that traditional homeownership cannot match. Second, BTRs are often built to higher standards than traditional rental properties, and third, BTRs offer a high-quality home without homeownership mortgage and maintenance obligations. Where available, BTRs are quickly becoming a preferred option for many young families, empty-nesters, and itinerant retirees. Yet several local governments have enacted laws banning BTR developments.” The article addresses the importance of innovative housing, zoning, bias, and exclusion (https://bit.ly/45dneat).

The National Association of Home Builders (NAHB) reports that “with the onset of the Great Recession and declines for the homeownership rate, the share of built-for-rent homes increased in the years after the recession. While the market share of single-family built-for-rent homes is small, it has clearly expanded. Given affordability challenges in the for-sale market, the SFBFR market will likely retain an elevated market share as the sector cools.” However, NAHB also reports that during the 2023 second quarter there was a slight decline in single-family built-for-rent (https://bit.ly/3P2WEMo).

In February 2021, Forbes reported on “Build-to-Rent (BTR): Detached Housing and the Future of Multifamily” (https://bit.ly/47G77EI). Since this was published, BTRs have grown in many communities in the United States. The article points to the benefits of such developments:

The real innovation in the build-to-rent space lies in the improved experience for tenants. BTR provides tenants with all of the best aspects of single-family rentals and upgrades the experience by developing all homes inside a professionally managed, amenity-rich community all without burdening residents with HOA costs.

BTR properties have broad appeal. They are simultaneously attractive to seniors, singles and families.

Those unfamiliar with this residential sector might want to start by reading CBRE’s “Build-to-Rent (BTR) Overview,” especially its “Introduction to Build-to-Rent” (June 12, 2023, https://bit.ly/3P1GbqP). The article states

BTR developments are new residential communities, increasing US housing supply and helping to address the nation’s housing shortage. BTR communities have the characteristics of single-family homes, built for renters desiring features not typically offered with multifamily properties.

Most BTR properties consist of 50 or more homes or townhomes and operate similarly to multifamily assets. A defining characteristic of BTR is that nobody lives above or below residents. BTR properties are owned by investors and professionally managed, often with community amenities.

The discussion provides information about the various types of BTR, such as horizontal attached or detached homes, two-story townhomes, cottages, traditional detached single family, and upscale luxury single family. It goes on to provide information about differences between BTR and “scattered SFR” for individual and institutional investors. Further, this piece has worthy exhibits covering such material as average mortgage pay-
ment vs. rent; housing surplus and shortage; housing unit shortages in four regions of the country; premium paid to own vs. rent for US and over 20 metro areas; and other statistics and comparisons helpful to the market analyst including apartment vs. BTR vacancy; average apartment rent vs. BTR rent; BTR vs. apartment growth rates 2013 through 2022; the 15 largest BTR markets; alternative methods of investing in BTR; and related insights.

A number of articles provide information from the investor and renter perspectives. Rocket Mortgage offers “Build-to-Rent Homes: A Renter’s and Investor’s Guide to a Hot Real Estate Trend” (April 2023, https://bit.ly/3P31ut6). This writing provides extensive information on the topic as well as pros and cons for renters, buyers, and investors. Another Rocket Mortgage piece, “Everything You Need to Know about Rent-to-Own Homes” (August 2023, https://bit.ly/3KRbhjp), explains the pros and cons of these arrangements. This gets into lease-option agreements, lease-purchase agreements, characteristics, provisions, features, cautions with each, and conclusions. Similarly, the Redfin blog offers advice in “Build-to-Rent Homes: What You Need to Know about the Future of Single-Family Rentals” (August 2022, https://bit.ly/45BirjY). Topics include motivations and role of developers, individuals, and investors; reasons for popularity and growth; pros and cons for tenants, individuals, and investors; investment alternatives; and ADUs as an option.

Forbes’s January 2023 forecast on the sector, “‘Built-for-Rent’ Single-Family Housing Forecast: Easing in 2023 and Booming in 2024/2025” (https://bit.ly/3qBiNIf), states, “When considering the outlook for this segment, which is universally regarded as one of the strongest segments of real estate, it is important to look both short-term and long-term. Here we consider both horizons.”

About the Author

Dan L. Swango, PhD, MAI, SRA (Retired), is president of Swango Real Estate Counseling and Valuation International in Tucson, Arizona. He is experienced in valuation and consulting involving equity investment, debt security, risk reduction, profit optimization, estate planning and settlement, buy/sell opportunities, and eminent domain.

Swango is an instructor and communicator with domestic and international experience. He is namesake of The Appraisal Journal’s Swango Award, past Editorial Board chair and editor-in-chief of The Appraisal Journal, and a current member of the Journal’s Review Panel. Contact: danswango@yahoo.com
Office Space Demand Forecast, Second Quarter 2023

About This Column
The national office market experienced total negative net absorption of 21.3 million square feet through the fourth quarter of 2022 and the first quarter of 2023, bringing the vacancy rate to 17.8 percent, the highest level since the second quarter of 1993. The NAIOP Office Space Demand Forecast predicts that net absorption of office space—the amount that is leased or occupied less the amount that is vacated—will remain negative through 2023, but will turn positive in 2024. The forecast accounts for the possibility of a recession in 2023, with economic growth in 2024 expected to support a recovery in the office market. The forecast projects that positive net absorption will total approximately 30.6 million square feet in 2024.

Demand for Office Space Expected to Shrink through Early 2024
The national office market experienced total negative net absorption of 21.3 million square feet through the fourth quarter of 2022 and the first quarter of 2023, bringing the vacancy rate to 17.8 percent, the highest level since the second quarter of 1993.¹ The COVID-19 public health emergency officially ended in the United States on May 11, 2023, but remote and hybrid work arrangements remain largely in place and continue to negatively affect demand for office space.

A currently strong labor market is combining with fears of a looming recession to limit occupiers’ interest in signing new leases. With the unemployment rate at 3.4 percent,² the lowest since 1969, the competition for talent is supporting the continuation of hybrid and remote work policies. Although a gradually growing share of employers are requiring employees to come into the office four or five days a week, three days remains the norm in many office-using industries, and a minority of employers require fewer days in the office or allow a large share of their employees to be fully remote. Average office occupancy across the 10 metropolitan markets tracked by Kastle Systems remains at only 49.9 percent.³ At the same time, few firms are interested in expanding the amount of space they lease as they prepare for a potential recession later this year. As a result, while office-using employment has risen to 5.4 percent above pre-pandemic levels, occupied office space is 3.5 percent below pre-pandemic levels, and the average amount of office space per employee has fallen to a 22-year low of 152 square feet.⁴

A recent study by CBRE has found that 80 percent of the total increase in vacancy between the beginning of 2020 and the end of 2022 has been concentrated in only 10 percent of office buildings, suggesting that the functional obsolescence

Notes & Issues
by Hany Guirguis, PhD, and Michael J. Seiler, DBA

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1. CBRE, Market Fundamentals data as of Q1 2023.

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of a relatively small share of buildings is also contributing to higher vacancy rates. Until these buildings are retrofitted, repurposed, or demolished, a surplus of obsolete space will likely pose a headwind for the broader office market. High interest rates have slowed office deal volumes and will likely limit the number of retrofit and conversion projects this year.

It remains to be seen how an actual recession might reshape the dynamic around hybrid and remote work. In the short term, however, a recession would weaken demand for office space. Weakness in the tech sector, for example, has led to layoffs, further suppressing demand for office space in several metro areas and contributing to an increase in the availability of subleased space, with technology firms now accounting for 23 percent of all sublease availability.

Given these trends, net office space absorption in the remaining three quarters of 2023 is expected to be negative 24.4 million square feet. Moving forward, the forecast projects that net absorption will turn positive in 2024 and will total approximately 30.6 million square feet for the year (Figure 1).

**Economic Factors**

Economic growth slowed to 1.1 percent in the first quarter of 2023, down from 2.6 percent in the fourth quarter of 2022. Year-over-year inflation, at 4.9 percent in April 2023, is trending in the right direction, although prices were 0.4 percent higher than in March. The previously noted record-low unemployment rate has helped keep the economy afloat despite continued interest rate increases by the Federal Reserve.

Real disposable personal income rose in the first quarter by 3.4 percent, meaning individuals

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have slightly more discretionary funds to make purchases. The Consumer Sentiment Index rose 2.4 percent in April to 63.5 percent, though it remained 2.6 percent lower than in April 2022. Continued uncertainty about the economy among consumers and businesses is likely to limit their expenditures, contributing to slower economic growth.

The Forecast Model

The model that informs this forecast draws from historical data on the economy and office real estate absorption to project future demand. Recent trends in office absorption suggest office-sector performance will reflect economic conditions, as in past economic cycles. To account for the possibility of a recession, the current forecast assumes there is a 60 percent chance of one occurring in the second half of 2023. This baseline out-of-sample forecast is illustrated in Figure 1. If a recession does occur, actual net absorption is expected to turn more sharply negative in 2023. If a recession does not occur, absorption will be higher than the current forecast.

Table 1 provides the expected range in net absorption if a recession does not occur in 2023. Figure 1 assigns these values a 40 percent weighting. Table 2 assumes that the economy experiences a recession beginning in the second quarter of 2023, based on an analysis of the inverted yield curve and Conference Board Leading Economic Indicators. Figure 1 assigns these values a 60 percent weighting.

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Actual Versus Forecast

Figure 2 compares the forecast to actual net absorption. The forecast value tallies the most recent forecast data for each quarter in the year. The forecast for 2022 was 43.0 million square feet, which was 38.2 million square feet more than the 4.8 million square feet absorbed for the year. The forecast for 2021 was −30.9 million square feet, which is 7.2 million square feet less than the −23.7 million square feet absorbed for the year.

Key Inputs and Disclaimers

In January 2016, the NAIOP Research Foundation published “Forecasting Office Space Demand,” a model that forecasts net absorption of US office space on a quarterly basis for eight consecutive quarters. Created by researchers Hany Guirguis, PhD, of Manhattan College, and Joshua Harris, PhD, CRE, CAIA, the model is similar to that used for the NAIOP Industrial Space Demand Forecast, which successfully projected a drop and rebound in net absorption of industrial space in 2009 and 2010. (The industrial space demand model was created by Guirguis along with Randy Anderson, PhD, then at the University of Central Florida.) Below are the leading, coincident, and lagging variables used in the office space demand forecast.

- **The growth rate in real gross domestic product (GDP)** captures the broadest level of macro-economic activity, reflecting the value of all goods and services produced each year.
- **Corporate profits of domestic industries** directly capture the financial capacity and growth of firms that may need to expand. Profits are a source of retained earnings, so they provide a clue about how much money is available to fund investments in plants and equipment, an investment activity that raises productive capacity.
- **Total employment in the financial services sector** is a direct measure and proxy for office-using employment that best fits with changes in office space demand.
- Two variables from the Institute for Supply Management’s Non-Manufacturing Indices serve as proxies for a sentiment measure on the future health of office-using firms. The ISM-NM Inventories Index measures increases and decreases in inventory levels, while the ISM-NM Supplier Deliveries Index measures how long it takes suppliers to deliver parts and materials that are integral to service-sector businesses.
- **Core Personal Consumption Inflation Rate (PCE Inflation).**

These measures make possible an accurate two-year forecast of net absorption of office space nationwide. The methods used in the forecast are dynamic rather than static, to account for the changing nature of the underlying macro economy. Office absorption data are provided by CBRE Econometric Advisors, which assumes no responsibility for this forecast. The absorption forecast tracks with CBRE office data and may
vary when compared to other datasets. Data include office buildings in the US with a minimum rentable building area that ranges from 10,000 to 150,000 square feet, depending on the market. The current forecast is based on first-quarter 2023 data.

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