

Highest and Best Use

THE DOMINO EFFECT ON GOODWILL AND FF&E APPRAISAL



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Highest and Best Use

- ▶ Introduction to Highest and Best Use
- ▶ Highest and Best Use and Legal Foundations
- ▶ Highest and Best Use – Real Property
- ▶ Highest and Best Use – FF&E
- ▶ Highest and Best Use – Goodwill
- ▶ Case Law and Highest and Best Use
- ▶ Case Study

Highest and Best Use – What is It?

- ▶ *The Dictionary of Real Estate Appraisal, 7th Edition* (Appraisal Institute, 2022)
 - ▶ “The reasonably probable use of property that results in the highest value.”
- ▶ Four Tests:
 - ▶ Physically Possible
 - ▶ Legally Probable
 - ▶ Financially Feasible
 - ▶ Maximally Productive

Highest and Best Use – What is It?

5

- ▶ Three Components to Highest and Best Use
 - ▶ Use (Physical)
 - ▶ User (Market Participants)
 - ▶ Timing

Highest and Best Use – What is It?

- ▶ Why does highest and best use matter?
 - ▶ *The Appraisal of Real Estate*, 15th Edition, page 52
 - ▶ “Market value opinions are based on the highest and best use of the property.”
 - ▶ *TARE*, page 327
 - ▶ “The most probable buyer is a critical conclusion used in choosing comparable sales in the sales comparison approach.”

Highest & Best Use – Legal Foundation

7

- ▶ Judicial Council of California Civil Jury Instructions (2022) CACI No. 3502
 - ▶ The highest and best use is the most profitable legally permissible use for which the property is physically, geographically, and economically adaptable.
 - ▶ Do not consider any personal value of the property to [name of property owner] or [his/her/nonbinary pronoun/its] need for the property. Also, do not consider the particular need of [name of condemnor] for the property.
 - ▶ Where's the statute????

Sources of Authority

- ▶ *San Diego Gas & Electric Co. v. Schmidt* (2014) 228 Cal.App.4th 1280, 1288
 - ▶ Cites to State Board of Equalization Assessors' Handbook (????)
 - ▶ “that use, among the possible alternative uses, that is physically practical, legally permissible, market supportable, and most economically feasible”
 - ▶ "The highest and most profitable use for which the property is adaptable and needed or likely to be needed in the reasonably near future is to be considered, not necessarily as the measure of value, but to the full extent that the prospect of demand for such use affects the market value while the property is privately held." (*Olson v. United States* (1934) 292 U.S. 246, 255.)

Sources of Authority

- ▶ *County of San Diego v. Rancho Vista Del Mar, Inc.* (1993) 16 Cal.App.4th 1046, 1058
 - ▶ “property taken is valued based on the highest and best use for which it is geographically and economically adaptable”
 - ▶ property owner "is entitled to show a reasonable probability of a zoning [or other change] in the near future and thus to establish such use as the highest and best use of the property
 - ▶ ***Burden is on the property owner***

Examples:

- ▶ Needn't be current use
- ▶ Evidence that residential property could be used in the future as airport parking even though not developed for that particular purpose
 - ▶ [City of Los Angeles v. Decker \(1977\) 18 Cal.3d 860, 863](#)
- ▶ Evidence that “cattle grazing land” property was suitable as a proposed commercial rock quarry business
 - ▶ [People v. Andresen \(1987\) 193 Cal.App.3d 1144, 1159-1160](#)
 - ▶ [State wanted land for state-run rock quarry](#)
 - ▶ [No private rock quarry business currently on property](#)

Real Property Issues

11

- ▶ Current Use versus Different Uses
 - ▶ Alternatives to consider
 - ▶ Continued use (HABU or Interim Use)
 - ▶ Redevelopment (Demolish)
 - ▶ Convert/renovate/alter to enhance current use or change use

Real Property Issues

▶ Contributory Value

- ▶ *Emeryville Redevelopment Agency v. Harcros Pigments, Inc.*
- ▶ “[w]here condemned property includes fixtures or other improvements, they must be taken into account in determining compensation...[but that] does not mean...that improvements must always be paid for by the condemnor....”
- ▶ “Rather...[i]f the improvements serve to enhance the value of the property over its unimproved condition, the property receives the enhanced value; if the improvements serve to decrease the value of the property below its unimproved condition, the property suffers the decreased value.”

Real Property Issues

13

- ▶ Cost to Cure vs. Diminution in Value
 - ▶ *People ex rel. Department of Public Works v. Hayward Building Materials Co.*
 - ▶ “...the condemnor is entitled to the adoption of the criterion of damage which produces the smaller result.”

Real Property Issues

14

▶ Interim Use

▶ How long is an interim use?

▶ Aren't all uses an interim use?

▶ Is an interim use the highest and best use?

Consistent Use Doctrine

15

- ▶ Prohibits a real property owner from obtaining value for the land with a highest and best use that is different from the actual use of the land.
 - ▶ 7 Cal. Real Est., Determining highest and best use, § 24:25 (4th ed.) (“the highest and best use used for valuing the property must be consistent with the use of the property for purposes of valuing ...business goodwill.”))
- ▶ “...[L]and cannot be valued based on one use while improvements are valued based on another use.”
 - ▶ Appraisal Institute, Appraisal of Real Estate (15th ed.2020), p. 315;

Consistent Use Doctrine

16

- ▶ ***Spano v. State of New York***, (1964) 22 A.D.2d 757, 253 N.Y.S.2d 730
- ▶ FACTS:
 - ▶ Current use was residential
 - ▶ HBU was commercial
 - ▶ Existing buildings would need to be removed to permit any commercial use
- ▶ HELD: “It was error ... to award anything for the value of the buildings while at the same time fixing the land value for commercial usage since the two bases are entirely inconsistent”
- ▶ Commercial value of land not enhanced by value of existing bldgs

Consistent Use Doctrine

17

- ▶ *Emeryville Redev. Agency v. Harcros Pigments, Inc.* (2002) 101 Cal.App.4th 1083, 1110-11
- ▶ FACTS:
 - ▶ HBU was to redevelop to mixed use shopping center
 - ▶ FF&E were incompatible with HBU; did not enhance HBU value
 - ▶ Property could not “be developed with the equipment in place.”
- ▶ ARGUMENT: interim use (existing use carries on temporarily until property ready for change)
- ▶ LEGAL CONCEPT: elements affecting value which, while **possible**, are not reasonably **probable**, should be excluded
- ▶ HELD: must have substantial E that interim use not only **possible**, but **probable**

Harcros Example

18

- ▶ Defense expert Gimmy was asked how would one go about continuing the existing use while still pursuing development as shopping center,
 - ▶ “You have to get entitlements and get the property clean.”
- ▶ But “getting the property clean” would be *incompatible* with the continued presence of existing improvements (i.e., mfg. equipment).
- ▶ Re “entitlements,” owner did not show regulatory delay that might reasonably be expected re getting entitlements.

Highest & Best Use – FF&E

- ▶ Overview of FF&E Appraisal
- ▶ Definition of Improvements Pertaining to the Realty (IPRs)
 - ▶ Article 3 of the California Code of Civil Procedure, § 1263.205
- ▶ Compensation for IPRs
 - ▶ Article 3 of the California Code of Civil Procedure, § 1263.210

Highest & Best Use – FF&E

▶ Appraisal Definitions

- ▶ Replacement Cost New

- ▶ Depreciation

- ▶ Effective Age

- ▶ Estimated Remaining Life

- ▶ Fair Market Value in Place

 - ▶ Article 4, § 1263.320 of the California Code of Civil Procedure

- ▶ Forced Liquidation Value

Highest & Best Use – FF&E

- ▶ Appraisal Process
 - ▶ Coordination Real Property and FF&E
 - ▶ Classification of IPRs vs. Movable
 - ▶ Measurements, model, serial number

Highest & Best Use – FF&E

► Typical Valuation

Depreciation = Effective Age/Normal Life

Replacement Cost New = \$50,000 (Walk-in Cooler)

Effective Age 5 / Normal Life 20 = 25% Dep. Factor

$\$50,000 \times (1 - 25\%)$ or $-\$12,500 = \$37,500$ FMV

Highest & Best Use – FF&E

▶ Highest and Best Use Valuation

Depreciation = Effective Age / (Effective Age + Remaining Life)

Replacement Cost New = \$50,000 (Walk-in Cooler)

Effective Age 5 / (EA 5 + RL 3) = 62.5% Dep. Factor

$\$50,000 \times (1 - 62.5\%)$ or $-\$31,250 = \$18,750$ FMV

Highest & Best Use – FF&E

- ▶ What Now? Well, it depends!
- ▶ No rule of thumb, take each property with a higher and better use on a case-by-case basis.
- ▶ Ask the FF&E appraiser to submit separate appraisals with different assumptions for various scenarios. Cover your bases.
- ▶ Coordination and consistency are key

Consistent Use Doctrine - Goodwill

25

- ▶ *Emeryville Redev. Agency v. Harcros Pigments, Inc.* (2002) 101 Cal.App.4th 1083, 1110-11
- ▶ FACTS: Business incompatible with HBU of property
- ▶ LEGAL CONCEPT: loss of goodwill must be **caused by the taking** [CCP 1263.510(a)(1)]
- ▶ HELD: no loss of GW b/c
 - ▶ True cause was “inevitable transition” of the property to the HBU
 - ▶ continued operation of defendant's business was incompatible with HBU
 - ▶ Allowing recovery of GW would give business a windfall

Highest & Best Use – Goodwill

26

- ▶ Overview of Goodwill Loss
- ▶ § 1263.510 Basis for Compensation of Goodwill
- ▶ Same FMV definition

Highest & Best Use – Goodwill

27

- ▶ Timing of redevelopment
 - ▶ Immediate scraper or interim use?
- ▶ Tenancy
 - ▶ Owner occupied or tenant?
 - ▶ How many years left on lease?
- ▶ Real Estate Intensive Businesses
 - ▶ Hotel/motel, self storage, agriculture, gas station, etc.

Highest & Best Use – Goodwill

28

- ▶ Going Concern vs. H&B Use Value
 - ▶ Methodology – Market & Income Approaches
 - ▶ Different Applications

Highest & Best Use – Goodwill

29

- ▶ Key Differences:

- ▶ Rent

- ▶ Multipliers/Cap Rates

- ▶ FF&E

Highest & Best Use – Goodwill

30

	<u>Going</u> <u>Concern</u>	<u>Interim</u> <u>Use</u>	<u>H&B Use</u>
Profit Before Rent	\$ 100,000	\$ 100,000	\$ 100,000
Rent	<u>(50,000)</u>	<u>(25,000)</u>	<u>(75,000)</u>
EBITDA	50,000	75,000	25,000
Multiplier	<u>7</u>	<u>2</u>	<u>7</u>
Total Business Value	350,000	150,000	175,000
Less:			
Fixtures & Equipment - Improvements	150,000	50,000	150,000
Fixtures & Equipment - Movable	<u>25,000</u>	<u>25,000</u>	<u>25,000</u>
Indicated Goodwill	\$ 175,000	\$ 75,000	\$ 0

Highest & Best Use – Case Study

31

- ▶ 9 acres in San Bernardino County
- ▶ Improved with meat “processing” facility and single-family residence/mobile home
- ▶ Property and business owner the same

- ▶ Zoning – Regional Commercial zoning
 - ▶ Uses incl. but not limited to:
 - ▶ big box retail
 - ▶ regional commercial mall
 - ▶ restaurants
 - ▶ medical offices
 - ▶ car dealerships
 - ▶ gas stations
 - ▶ banks
 - ▶ food preparation



Euclid Avenue

Mayhew/Sultana Avenue

Pine Avenue



LIZZE CUSTOM PROCESSING
RASTRO LIZARRAGA
7310 PINE AVENUE

WE SELL	SE VENDE
• GOATS	• CHIVOS
• SHEEP	• BORREGOS
• PIGS	• PUERCOS
• CATTLE	• BECERROS

MEAT SHOP CARNICERIA
909 | 597-6109 909 | 393-5660

LIZZE CUSTOM PROCESSING
7310 PINE AVENUE
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- ▶ Both RE appraisers assumed H&BU redevelopment
- ▶ Property owner claimed probable change in zoning to industrial
- ▶ Both sides used Agency FF&E appraisal
- ▶ Goodwill
 - ▶ Agency \$428k
 - ▶ Business \$5 million

H&B Use Takeaways

38

- ▶ Coordinate experts
- ▶ Alliances and interests may change
- ▶ Applies to apples expert opinions
- ▶ Perception problems