

RENT AS A FACTOR IN DETERMINING FAIR MARKET VALUE

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When valuing rented property for which no comparable facilities exist on the market, a problem arises concerning the basis to be used to determine its fair market value. The Fifth Circuit Court of Appeals faced this problem in the case of United States v. Michoud Industrial Facilities.⁽¹⁾ The court held that where no comparable property sales or rental data were available from the open market, and where the property in question had been leased at low rentals which have been established by the owner as incentives for occupancy, these rentals should be the controlling basis for valuation. The court's failure to consider factors other than current rents which might enter into the value of the land in question makes this decision a controversial one.

The Michoud case involved property consisting of some 1000 acres of raw land and 22 industrial buildings which were purchased from the federal government following World War II by the Board of Commissioners of the Port of New Orleans. As a public agency it was interested in attracting industry to the New Orleans area, and accordingly established a rent schedule for the property under which the land and buildings would be rented at a below-market rate. For some reason not given, only a small amount of the total available space had been rented at these rates before the date of taking. This fact was emphasized in the argument by the federal government that "these rentals...were either controlling [for valuation purposes] as a matter of law or they were so overwhelmingly dominant in the light of the then existing conditions as to make any different finding of valuation clearly erroneous." (2)

While the court's opinion does not say that the rents fixed should control absolutely as a matter of law, it does say that the rents reserved should be of controlling weight in these circumstances, for, as the court stated: "When it became apparent that such large quantities of the property would not move at that sub-standard price, then that price obviously was the most that could be obtained for it

at the time."(3) As a result of giving the controlling weight to the evidence of current rent levels, the amount of the condemnation award was derived by capitalizing the existing rents to the exclusion of other factors bearing on value.

Rent As Evidence Of Value

It is a familiar axiom that when property is taken by condemnation the owner is entitled to "just compensation", which is the fair market value of the property at the time of taking, determined by what would be agreeable between a willing buyer and a willing seller, neither being under any compulsion. If the property is being put to its best available use, the rent received for that use may be a factor in determining fair market value. In such cases, evidence of the rent reserved is admissible as evidence of such value.(4)

In this case, the evidence relating to rent was not submitted by the owner of the property, but by the federal government as condemnor on the premise that no comparable market sales data were available, and that other methods, such as building costs less depreciation, were not valid under the circumstances. It raised the question of whether the property was being rented for a consideration less than it could command, and, if so, whether the land was in fact being put to its highest use. Evidence which establishes value at anything less than would be received if the property were put to its highest and best use can be of very little significance for valuation purposes.

In the Michoud case, witnesses for both sides agreed that the rents were not in accord with market rates. The commission stated "The Michoud rentals were labeled pioneer, substandard and unrealistic rents, and, we believe, these rentals are not indicative of and do not represent the fair market value of the property...." Accordingly, the Commission found what it considered a more reliable basis of valuation in a comparison with sales of property fronting on a nearby industrial canal, deeming these sales to be as nearly comparable to the Michoud property as the market afforded. The court, in reversing this decision, felt that the alleged comparable data were too remote, and the Commission erred in disregarding the Dock Board's rent schedule and, in particular, the fact that extensive amounts of rental space and land had not been occupied even at these admittedly low rents and land prices.

The issue presented on appeal may be similar to that raised where a landowner has entered into an improvident lease, yielding abnormally low rental income from his property. In such cases the usual view of the courts is that

"Where property in condemnation has been leased for a particular use, evidence of what the owner can fairly and reasonably receive as rental return for such use, even though this amount differs from the rental fixed in the existing lease, is proper as a possible capitalization factor to assist in the determination of actual market value. For capitalization purposes, neither the condemnee nor the condemnor should be bound by the rental of an unreasonable or improvident lease."(5)

Instances of "unreasonable circumstances" affecting rental rates have been recognized where buildings needed rehabilitation to attract higher rents. Thus, in the case of an office building where rents were "depressed and abnormal, the result of transitory events -- bankruptcy of the owner, rumors and threats of condemnation -- factors militating against obtaining better rentals" were recognized. Under such circumstances, a New York court said, "the buildings are not in a competitive condition and position to bargain and to secure fair market rentals. Once freed of those shackling conditions, they are capable of entering into the rental market on competitive terms....And then there could be no reason to deny the buildings' increased rentals which could be derived from improvements that a prospective purchaser could feasibly and prudently make."(6)

Should an abnormally low rent or sale price, deliberately fixed as an incentive by a public agency seeking to attract new industrial activity to an area, be regarded in the same light as a rate resulting from an improvident lease or one which is affected by supervening events? Arguably, it could and should, since the Dock Board's public status and industrial promotion motives distinguish its actions from those of an ordinary landlord operating in a competitive market. But in the Michoud case the court held this factor insignificant in the face of the evident inability of the property to attract renters even at the incentive rates. Thus, principle was overridden by practical considerations and the absence of any available criterion which was not objectionable because of its speculative character.

A Full View Of Value

The decision in the Michoud case illustrates Justice Holmes' warning that hard cases make bad law. The court here does not reject the majority view that "rental income is not to be taken as the sole test

of value, but is only one of many elements to be taken into consideration." (7) Nor does it appear to deny that all characteristics which make property valuable should be taken into consideration so long as they are not speculative and may be realized in the near future. (8) A defense of the court's holding, however, demands acceptance of its premise that the failure to secure occupancy even at abnormally low rents, resulting in the existence of a large amount of comparable land and building space currently unoccupied and available to prospective renters, was the most significant fact bearing on the present and future prospects of the landlord.

Carried to its logical end, use of this reasoning might penalize a land developer who, despite incentive rents, happened not to have secured full occupancy of his rental property at the time of condemnation. The practice of using low rent incentives is so widespread that such a result could easily be viewed as unfair. Fairness in the application of this approach required that realism be used in analyzing the prospects of securing renters and comparing the results of rent capitalization with other market data.

The court in the Michoud case must be understood as limiting its decision to the circumstances of a case where it is convinced that the amount of vacant land and building space was so great (85 to 95 percent) that it necessarily must dominate any prospect for future rentals, and where no non-speculative evidence of other uses for the property is available. Since the circumstances relating to these factors change from case to case, the scope of the evidence admitted should be broad enough to allow the court to determine whether an existing lease reflects the actual value of the property being condemned, and, if not, what other elements of actual value are ascertainable. (9)

Footnotes

- (1) 322 F. 2d 698 (5th Cir., 1963).
- (2) *Ibid.*, at 702.
- (3) *Ibid.*, at 704.
- (4) *Department of Public Works & Buildings v. Kirkendall*, 415 Ill. 214, 112 N.E. 2d 611 (1953). See 5 Nichols on Eminent Domain (3d ed.), §19.21.
- (5) Dissenting opinion in *United States v. Michoud Industrial Facilities*, note 1, *supra*, at 715.
- (6) *Application of Port Authority Trans-Hudson Corp.*, 265 N.Y.S.2d 925 (1965) at 941.
See also, *Olson & French Inc. v. Commonwealth*, 399 Pa. 266, 160 A. 2d 401 (1960), where influence of imminent condemnation was held to justify disregarding existing rent level of condemned property. And, where the court was persuaded that existing rents were abnormally high, it was held in *Saunders v. State ex rel Department of Highways*, 70 Nev. 480, 273 P. 2d 970 (1954), that they should be disregarded in the interest of considering all elements of value.
- (7) *Kaperonis v. Iowa State Highway Commission*, 251 Ia. 415, 417, 100 N.W. 2d 901, 903 (1960).
- (8) *Midwestern Gas Co. v. Mason*, 31 Ill. 2d 340, 201 N.E. 2d 379 (1964).
See also, *State Highway Department v. Robinson*, 103 Ga. 12, 118 S.E. 2d 289 (1961), stating that market value and actual value are usually synonymous, and that market value is the general yardstick in a condemnation proceeding. In circumstances where actual value and market value differ, the jury should consider the actual value and use of the property as the basis for the award which most accurately will compensate the owner.
As to additional elements which may be considered, one court has said: "Evidence of the cost, selling price, replacement value, depreciation, use value, junk value, location of the property, demand for it, and many other things may be shown." *Hard & Rand, Inc. v. Biston Coffee Co.*, 41 F.2d 625, 627 (8th Cir., 1930).
- (9) *Clark v. United States*, 155 F. 2d 157 (8th Cir., 1946); *United States v. 190.71 Acres of Land in Lake County, Illinois*, 300 F.2d 52 (7th Cir., 1962).