



THE REASONABLY PROBABLE STANDARD IN HIGHEST AND BEST USE ANALYSIS

Implications for eminent domain

BY ROBERT M. GREENE, CRE, MAI, SRA, Ph. D

An easily overlooked portion of the definition of highest and best use is the three-word phrase, “reasonably probable use.” The most recent edition of *The Dictionary of Real Estate Appraisal* defines highest and best use as “The reasonably probable use of property that results in the highest value.” This standard became common during the late 1970s and early 1980s, and its adoption paralleled the change of market value definitions from “highest price” to “most probable price.” Since then the phrase has been widely adopted in the literature of real estate valuation and eminent domain case law. (For a complete history, see *Nichols on Eminent Domain*, the legal profession’s basic compendium on eminent domain.)



In the valuation of properties in relatively stable markets, reasonably probable use is easily ascertainable. However, in markets that are undergoing transformation, the estimation of reasonably probable use presents a unique challenge to the appraiser, who must expand his or her investigations and make judgments—based on market evidence—beyond the scope of work of the everyday assignment. The following provides some background and suggests a possible protocol for assignments where the reasonably probable standard requires special care, research and judgment.

A Countermeasure

The reasonably probable standard, when properly applied, is an effective countermeasure against valuation based upon speculative uses that unreasonably inflate the estimate of market value. For example, a hayfield located on the edge of town might legally be developed with a high-rise office tower or a regional shopping center with correspondingly high land values, but is either of those uses reasonably probable?

Less understood but equally important is that the reasonably probable standard is also a countermeasure against *undervaluing* that same hayfield based upon its current or previous use as a hayfield. The reasonably probable standard protects equally against the speculation of excess optimism and the speculation of excess pessimism. Speculation itself is not bad; it is the very nature of real estate investment. However, if the appraiser relies on evidence of reasonably probable use provided by market participants, the appraiser is not speculating at all. Instead, the appraiser is evaluating the credibility and the creditability of the market indicators.

Reviewing Definitions

The Uniform Appraisal Standards for Federal Land Acquisition (UASFLA or “Yellow Book”) is sometimes thought to be antagonistic toward the concept of speculation, but that is not actually the case. Although the current edition acknowledges that “a property’s highest and best use is ordinarily its existing use on the date of value,” it goes on to say that “courts describe this precept as a *presumption* in favor of a property’s existing use; others simply regard an existing use as ‘compelling evidence of highest and best use when a different proposed use is asserted.’” Yellow Book concludes, however, that “any reasonably probable use

should be considered to the extent a property’s potential for such use affects its market value.”

The Appraisal Institute defines highest and best use as 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. In practice, reconciliation of the Appraisal Institute definition with the Yellow Book guideline is best accomplished through thoughtful consideration of what the market is advising concerning the reasonably probable use.

A Protocol for Evaluation

Challenges in applying the reasonably probable standard arise in the case of properties undergoing transition. Examples include transitional properties that lie immediately outside an existing boundary (such as city limits or an urban growth boundary) or properties in evolving neighborhoods that have retained an outdated zoning. This includes industrial zoning in an area where surrounding zoning and development (often redevelopment) are commercial or mixed-use commercial and residential. Because the evaluation of highest and best use that is different from a property’s previous or existing use falls upon the appraiser, the following provides some guidelines and procedures for consideration of reasonably probable use.

Organizing a clear and logical analysis of reasonably probable use can benefit from grouping the issues into categories: physical factors, legal factors and feasibility issues. In the normal order of highest and best use analysis, physical and legal factors precede feasibility analysis. But in the case of transitional properties, feasibility issues



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the most
common failure
in the analysis
of reasonably
probable use
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(changes in demand and the profitability of alternative uses) are the driving factors that create changes in reasonably probable use.

- **Feasibility**

It should be remembered that feasibility is the true engine of reasonably probable use. It is the motivation of possible profit that puts pressure on the market to change a neighborhood or a property from one kind of use to another. There is a spectrum of levels of feasibility analysis. *Inferred analysis*, which relies on extrapolating trends from general market data, is more common and is often adequate in stable markets. However, *fundamental analysis*—which quantifies demand and supply in light of projected and quantified data for market trends such as population growth, household and per-capita income, and other economic and demographic factors—is the most persuasive kind of feasibility analysis. Fundamental analysis is best explained in Stephen F. Fanning's classic text, *Market Analysis for Real Estate: Concepts and Application in Valuation and Highest and Best Use*.

In stable markets, most appraisers rely on inferred analysis. The appraiser surveys surrounding properties and makes an inference that the kind of use available for the subject property will be consistent with nearby and surrounding uses.

In areas of transition, however, the uses of surrounding properties are in the process of becoming obsolete. Therefore, a fundamental demand analysis will provide sound support for reasonably probable use.

- **Physical Factors**

A reasonably probable use must meet all the criteria of what is physically possible, including size, shape, topography, availability of utilities and location. If a proposed use will require utilities or other amenities not presently available

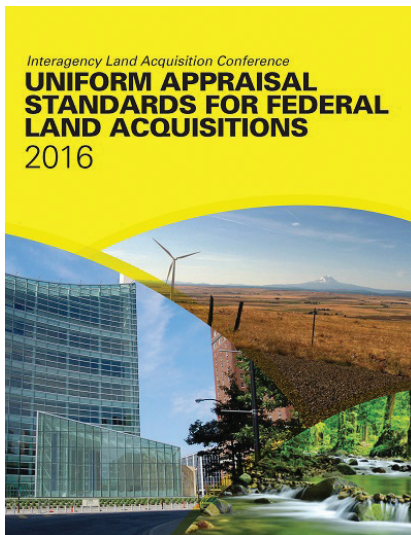
on site, the costs and feasibility of providing them—including their cost, the length of time required to make them available and any other obstacles to their development—need to be considered in the valuation. If a deduction is to be made in the valuation or in the feasibility analysis, it needs to include hard costs, soft costs and appropriate recognition of risk in accounting for delays.

- **Legal Factors**

Legal factors include any legal requirements that may be impediments or enablements to a proposed use. This analysis, however, is not strictly a legal criterion. Attorneys and government bureaucrats may adopt the most pessimistic outlook in analyzing legal issues. In times of transition, however, a strong motivation for change is revealed by good fundamental market analysis. “This is the way we’ve always done it” is not a valid argument.

An analysis of reasonably probable use should also consider the experience and testimony of typical purchasers for the property type and use in question. This may include developers, brokers and investors, who should be interviewed and whose observations should be scrupulously transcribed, accurately recorded and cited in an appraisal report. To repeat, buyers and sellers—typical buyers and typical sellers for the type of property in question—are the ones who determine what use is reasonably probable.

In my experience, the most common failure in the analysis of reasonably probable use arises when an appraiser fails to carefully consider the likelihood of change. The appraiser assumes that because the change has not yet happened, he or she must treat it as though it *cannot* happen. It is the responsibility of the appraiser, however, to make an informed and educated estimate of that likelihood. The source of that judgment—and the research it requires—is the subject of the next section of this article.



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Finally, the last step in estimating reasonably probable highest and best use is to analyze which one or more of the possible uses that have passed the tests of physical possibility, legally permissibility, and feasibility is the most profitable use. In transitional areas, this requires fundamental supply and demand analysis.

Who Decides?

How does the appraiser assess what is reasonably probable and, more importantly, who determines what is reasonably probable? Because feasibility in a changing market is driven by its participants—buyers, sellers, developers and investors—they are the ones the appraiser should consult. They should be interviewed (with their interviews transcribed) and their experience, opinions and judgments should be included, considered and evaluated in the appraiser's analysis and conclusions. Those sorts of interviews are not always conducted by appraisers in the ordinary course of business, but they are essential to establishing reasonably probable use for properties undergoing transition.

Because the reasonably probable standard is frequently associated with issues of speculation, it is useful to consider a court case that is approvingly cited in the *Uniform Appraisal Standards for Federal Land Acquisition*. “While market participants may speculate, appraisers cannot. The finder of fact must not, itself, speculate, i.e., guess, about potential end uses or markets when the speculation is so remote or improbable that one would not invest his money in it.” (*Fla. Rock Indus., Inc. v. United States*)

The important point here is that market participants are the ones who determine what is reasonably probable. The appraiser's responsibility is to evaluate the market evidence. A rigorous application of a thoughtful protocol for estimating reasonably probable use, including research into the thinking of the relevant market participants, can provide an efficacious framework for insulating the appraiser from charges of inappropriate speculation.

In Summary

Eminent domain requires special attention to the reasonably probable standard because condemnation short-circuits some of the protections for the property owner that are inherent in an otherwise free and open market.

- If a property owner has an unreasonably high estimate of the value of his or her property, he or she can offer it on the market on that belief. If there are no offers or if the offers are unacceptably low, the property owner has three choices: 1) lower the asking price; 2) decline the offer and wait for a better one; or 3) take it off the market. In no case—except for duress, which is excluded in estimates of market value—is a property owner compelled to sell.

- On the demand side, a typical purchaser has similar options. The would-be buyer can make a lower offer and if the seller declines, the buyer can: 1) withdraw the offer; or 2) raise the offer. In no case is a purchaser obligated to purchase.

However, in eminent domain cases, the self-correcting mechanisms of the market place are suspended. The appraiser's assessment of reasonably probable use—and the value appropriate to that use—is an important safeguard available to the property owner and also serves as protection for the condemnor. In short, the appraiser's proper observance of the reasonably probable standard is a protection for all parties participating in this effort to estimate market value for just compensation. ✪



Robert M. Greene is the Chief Appraiser for the State of Washington Department of Natural Resources, which oversees more than five million acres. Prior to his present position, he was the President of G&A Valuation, Inc., Director of Litigation Support Services for Integra Realty Resources—Portland, Director of the Real Estate Advisory Group for the Chicago office of Stout, Risius, Ross, Inc., and an appraiser in the offices of MaRous and Company. From 1983 to 1996, he owned and operated Robert M. Greene and Associates, a real estate appraisal firm in Kalamazoo, Michigan.