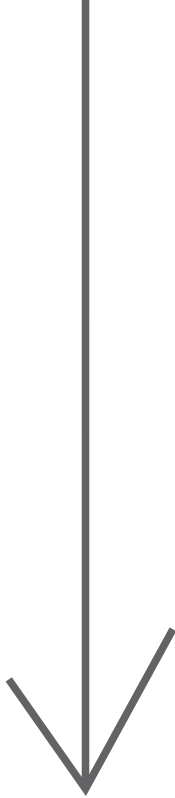


SHOULD LAND **BE VALUED** AS ENTITLED?

Case studies for ensuring proper just compensation

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In today's right of way environment, the valuation of property rights can be a complex process. Depending on the property type and the rights to be acquired, a valuer must have a standard of care which assures that not only the value of the rights taken are accurately measured, but that the property owner receives their constitutional right of just compensation without a waste of public funds.

The value of acquired property rights becomes more complicated when the agency seeks to acquire only a portion of property—particularly a portion of land from an improved property. In this type of acquisition, how should the value of the part taken reflect the way in which the land is developed? More specifically, how should the value of the land to be taken reflect the fact that the land is entitled?

In this article, we will discuss the concept of entitlements, how they provide value to land, and how to appropriately measure the value of a partial acquisition of land on property that is already entitled for the highest and best use of the land.

The Impact of Entitlements

According to the sixth edition of *The Dictionary of Real Estate Appraisal*, which was published by the Appraisal Institute in 2015, an “entitlement” is governmental approval for items such as annexation, zoning, utility extensions, number of lots, total floor area, construction permits and occupancy or use permits. Since governments frequently regulate how land can be used, entitlements are a necessary process in developing real estate. Real estate developers must comply with a variety of land use issues and requirements, which can include zoning, general

plans, specific plans, environmental studies, public improvement or dedication requirements, on and off-site improvement requirements and various impact fees. By complying with these requirements, developers can ensure compatibility with neighboring land uses as well as obtain the desired entitlements to subdivide or develop property.

In many parts of the country, the entitlement process can be considered a nominal issue; there is an often-told story that in some markets, a developer can file an application in the morning, go to lunch and get development approvals by the afternoon. However, in states like California, the entitlement of a site can be both a costly and timely process. For example, in downtown Los Angeles, it may be common for the governmental approval process to take up to five years (or more) to obtain entitlements to develop or redevelop a property. Coastal development can also be especially challenging; between satisfying additional coastal jurisdiction requirements and the need for public access, entitlements may take up to 10 years or more to achieve (if at all).

Obtaining environmental approvals in states like California also can be a challenge because approvals can involve multiple agencies with each agency (and its staff) having its own views toward development. Depending on the position of the agencies, there can be a vast difference in institutional attitudes toward development. There can also be conflicting agendas between agencies that share jurisdiction over a development project. In the experience of at least one of the authors of this article, some agencies are flat out anti-development, sometimes under the banner of being or claiming to be “pro-environment.” Even when expressing a legally unsustainable position, the sometimes hostile attitude of staff can create significant and costly delays to a development project. In such an environment, the existence of entitlements can reflect the highest and best use of a property and be of even greater value.

For this reason, after site plan approval has been achieved and permitting has been obtained for development, the value of the land may increase substantially. With all else equal, a property with these approvals can be substantially more valuable because a developer or user can bypass the time, cost, hassle and risk associated with obtaining these approvals and start construction. Another way of putting this is that a property with entitlements may have a different highest and best use than one without; the highest and best use of an entitled property may be to develop immediately while the highest and best use of the unentitled property may be to seek entitlements while devoting the property to possible interim uses.

Measuring the Value of Entitled Land

So what happens when the rights to be acquired involve land that is part of an improved property? In this case, the land has already been through the approval process and construction has occurred. With this fact in mind, it is important to recognize a few issues.

The first issue is to remember that one of the most basic appraisal theories is that land is generally valued as though vacant and available for its highest and best use. In the highest and best use analysis, a valuer conducts various tests to determine which use results in the highest land value, including tests for what is legally permissible and financially feasible. If the property to be taken includes land of an improved property, it is important to consider the legal approvals in place for the property if the current use represents the highest and best use as if vacant. However, in many instances the value added by entitlements (whether it be in the form of reduced costs to develop, fewer delays in starting construction or use) can be overlooked. This can be due to a lack of familiarity with the development and entitlement process or a simple failure to recognize and reflect the contributory value of the entitlements in place.

One case study related to this issue involves a nominally improved site being sought by a local school district for construction of a neighborhood school. This particular property had been recently purchased by a local homebuilder who had been under contract for a year and a half while going through the process of changing the zone, changing the general plan and obtaining subdivision approvals for a residential development before finally closing on the property. At the time the homebuilder put the property under contract, it was unentitled and the land use regulations would have permitted a maximum of about five residential units per acre. The entitlements obtained



by the homebuilder permitted development at a density approaching 20 residential units per acre—a use that was very much in demand in the subject’s market area. The price paid by the residential developer not only reflected the lower density in place at the time of the contract and the fact that the land was unentitled, but it also considered that there was substantial risk and cost associated with obtaining approvals for a higher-density development.

The Uniform Standards of Professional Appraisal Practice (USPAP) requires appraisers to “(a) analyze all agreements of sale, options, and listings of the subject property current as of the effective date of the appraisal; and (b) analyze all sales of the subject property that occurred within the three (3) years prior to the effective date of the appraisal.” Further, an appraisal report must summarize “the results of analyzing the subject sales, agreements of sale, options, and listings in accordance with Standards Rule 1-5.” Although a recent arm-length sale of the subject property is often considered to be the best evidence of its value, if the property has changed physically, legally or economically since the sale, then this may not be the case.

In the valuation of the proposed school site for condemnation purposes, it was not appropriate to give much weight to the original purchase price paid by the homebuilder because of the change in land use regulations that were obtained by the purchaser. After all, note that USPAP also requires appraisers to “identify and analyze the effect on use and value of . . . existing land use regulations.” When the school district began negotiating with the homebuilder after its recent purchase, it was imperative to emphasize that the denser land use and approvals provided much more value than what existed no more than a few months prior to the negotiations. This considerable value increase as a result of the now-entitled site could be measured using sales of entitled residential sites, particularly one located in the same jurisdiction as the subject property that indicated a value more than twice the amount of the original purchase price.

In this case, the appraisal firm retained by the school district acknowledged the subject’s entitled status, but they used mostly unentitled sales to value the subject property (the exception being one sale in a substantially inferior market). By failing to utilize entitled land sales (especially the entitled sale in the same city as the subject), the appraisal firm did not properly quantify the

value of the entitlements. Ultimately, the homebuilder and the school district settled at an amount far closer to the conclusion reflecting entitled land sales.

In contrast, the reverse problem can occur when the acquiring entity proposes that it will “mitigate” the impacts of a partial taking by offering to convey unentitled or differently entitled land. In one example, the condemning agency sought to utilize excess land from properties adjoining the owner’s remaining parcel to reduce the loss of parking caused by the project. In the valuation exchange and subsequent settlement negotiations, the agency argued for an offset to damages based upon the additional land having equal value to that of the part taken. While both properties were generally put to commercial use, the owner’s land had obtained a conditional use permit and variance as part of its original entitlements that allowed it to maximize the value of its development. Furthermore, the property owner had spent hundreds of thousands of dollars, if not more, to obtain the land use approvals necessary for the development. The land to be transferred (as configured by the condemning agency) did not comply with those entitlements. The entitlement issue spawned years of litigation (with multiple trips to the appellate court). Ultimately, the case resolved with a condition of resolution including agency approval that the reconfigured property complied with the remaining property’s entitlements.

Other Considerations for Valuing Entitled Land

In the previous school district scenario, the property owner had recently obtained approvals to develop the site to its highest and best use. Because of this, the site was much more valuable as entitled than if those approvals were not obtained. On the other hand, entitlements may not have as much value if the approvals do not correlate with the highest and best use.

For example, say an agency is looking to acquire a two-acre commercial property that is developed with a small retail building, but it is located in an area zoned for dense multifamily development in a market that is undersupplied with housing. If the underdeveloped retail property is ripe for multifamily redevelopment, the value of the land as a multifamily site may be considerably more than the site as retail, regardless of the approvals in place for the existing retail use.



Depending on the property, the valuer must be aware of the factors that influence value, as well as understand the regulations guiding valuations for condemnation.



That said, it is also important to recognize that even if the existing improvements do not represent the highest and best use, the very existence of improvements may add value in the form of cost savings for future redevelopment. This can be true even knowing that demolition costs will be incurred to remove these improvements. An example of this is found in the 2002 California appellate case of *Warmington Old Town Associates v. Tustin Unified School District*. The court ruled that a homebuilder (*Warmington*) was only obligated to pay school fees imposed by the school district just for the increase in “assessable space,” not for the entire new development. The property’s previous development (and correlating approvals) were able to save the homebuilder almost \$100,000 in fees. In 2013, another case (*Cresta Bella, L.P. v. Poway Unified School District*) cited *Warmington* and reached a similar conclusion: fees cannot be imposed for the square footage already in existence at the time of the new development project absent a study that reasonably supports that reconstruction of preexisting square footage increases student population.

This is one example of how the existing improvements create value, but the point is that there can be a demonstrable difference between vacant land and land where the highest and best use is different from the existing use. The benefit of developed, entitled land over vacant land, even when subject to transition to a higher and better use, can be seen when considering that the entitled land is already approved for a certain intensity of parking, traffic counts and other development criteria that vacant land has yet to satisfy. Depending on the property, the valuer must be aware of the factors that influence value, as well as understand the regulations guiding valuations for condemnation.

An additional factor to consider is that entitlements give rise to legally vested rights. Vested rights provide certainty and protection from later changes in the attitudes of the local land use jurisdiction toward the property in question. (See *HPT IHG-2 v. City of Anaheim* (1999) 243 Cal.App.4th 188, 199-200 [where the City was estopped from changing the hotel development’s entitlements on which it had relied in developing the multi-million dollar hotel complex].) The legal protection afforded by obtaining legally vested rights is an important fact that often gets ignored when only unentitled vacant land sales are used to value already entitled properties. The

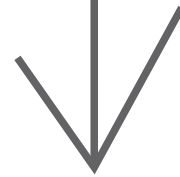
protection afforded by having such legally vested rights can mean the difference of millions of dollars in compensation when public projects impact multi-million dollar developments, such as occurred in *HPT IHG-2*. Appraisals that ignore such entitlements and reliance on such appraisals can put the acquisition budgets in peril and potentially create years of litigation that otherwise could have been lessened, if not avoided, had appropriate credit been given to the entitlements at the outset of the acquisition process.

Conclusion

There are elements that influence value which may differ depending on where one is in the country. In markets like California, the existence of entitlements can create significant value. As shown in our case studies, what was legally permissible were approved uses that created significantly more value than unentitled land, even if the property was recently purchased at a price far below the price of other entitled sites due to the time, cost and entrepreneurial effort expended during the homebuilder's one-and-a-half-year endeavor.

In valuing rights to be acquired on improved property, it is important to consider the value of approvals because they may add value to the land. As demonstrated in the *Warmington* and *Cresta Bella* cases, the existence of improvements constituted a saving in development fees, a value-add which is entirely attributed to the land as improved because these savings would result if the improvements were removed for redevelopment.

The valuation of property rights can be complex. However, if a property to be acquired is part of an improved property—and if the use of the property as improved is the highest and best use—then it may be appropriate to consider the value of the land as entitled. If done properly, the property owner can be made whole and the public agency may be able to avoid or significantly lessen a protracted and expensive dispute over just compensation. ✪



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