Best Practices Related to Deprivation-Related Property Valuations

Valuation analysts ("analysts") are often called on to measure economic damages in instances related to property deprivations. A property deprivation occurs whenever a property owner/operator is "deprived of" the ownership, operation, or economic enjoyment related to a property ownership interest. That property subject to the deprivation event could include tangible property or intangible property. For example, the tangible property subject to the deprivation event could include real estate and tangible personal property. The intangible property subject to the deprivation event could include a business ownership interest, an intangible asset or intellectual property, or a commercial contract right. The various types of property deprivation events could include a condemnation and eminent domain action, an international expropriation action, a tangible property or intangible property damages event, or intellectual property infringement, a dissenting shareholder appraisal rights or a shareholder oppression action, or a breach of a commercial contract. This discussion summarizes the many factors that analysts (and the tangible property or intangible property owner/operator and the legal counsel) should consider when measuring economic damages by reference to a deprivation event-related property valuation.

The original version of this discussion was published in the Spring 1992 issue of Insights. *That original discussion was titled "Valuation Standards regarding Deprivation Appraisals." Robert F. Reilly, CPA, was the author of the original discussion.*

Introduction

This discussion considers the property valuation aspects—and economic damages measurement aspects—of what are commonly called deprivation event analyses. In particular, this discussion summarizes the theoretical concepts and the practical applications of so-called property deprivation analyses.

These deprivation-related concepts and applications affect the following:

- The purpose and the objective of the analysis
- The standards of value and the premises of value that may be applicable in the analysis
- The generally accepted property valuation approaches and methods that may be applied
- The reporting of the deprivation-related property valuation and/or damages analysis conclusions

Of course, with regard to property deprivation claims, the standard (or the definition) of value applied, the premise of value applied, the property valuation approaches and methods considered, the property valuation analysis procedures performed, and so forth, may all be influenced by the statutory authority, judicial precedent, and administrative rulings of the legal or political authority in which the property deprivation occurred.

With regard to economic damages deprivation claims, the same considerations are appropriate. That is, the definition of economic damages, the application of lost profits and other damages measurement methods, the use of ex-post versus

ex-ante damages analyses, the consideration of the post-damages event book of wisdom, the selection of the appropriate damages measurement date, the selection of damages measurement variables (e.g., pretax versus post-tax income considerations, present value discount rates, interest rates), and the like, may all be influenced by the relevant judicial precedent, administrative rulings, and statutory authority.

The applicable valuation fundamentals may also be influenced by the type of deprivation event that has occurred—and by the type of asset, property, or business interest that suffered the deprivation event. Nonetheless, there are certain valuation principles and valuation standards that are generally accepted across many types of property deprivation valuation analyses.

This discussion introduces many of these generally accepted property deprivation valuation principles and standards.

The Nature of a Property Deprivation Valuation Analysis

A deprivation-related property valuation is often conducted when a deprivation event has occurred or when the property owner/operator is being threatened with a deprivation event. In such a deprivation event, the legal owner/operator of a property is "deprived of" the ownership of, the possession of, the use of, or the economic enjoyment of a particular tangible property, intangible property, business ownership interest, intellectual property, or intangible contract right.

Typically, in a deprivation event, the party subject to the deprivation (the property owner/operator) loses some portion (or all) of its bundle of legal rights related to the property. The party subject to the deprivation (the property owner/operator) may also lose some portion (or all) of the economic value related to that bundle of legal rights.

Typically, in a deprivation event, the party responsible for the deprivation event receives some portion (or all) of the total bundle of legal rights related to the subject tangible property or intangible property. And, the party responsible for the deprivation event receives some portion (or all) of the economic value related to that bundle of legal rights.

In short, in a deprivation-related action, the party subject to the deprivation event (normally the property owner/operator) is economically disadvantaged. And, usually, the party responsible for the deprivation event is economically advantaged.

"To appropriately compensate the property owner/operator subject to the deprivation . . . , a deprivation-related property valuation may be performed."

Typically, the ultimate objective of the deprivation-related property valuation is to quantify the amount of fair and just compensation to the property owner/operator to compensate that owner for the economic disadvantage associated with the deprivation event.

Most often, that amount of fair and just compensation is quantified to restore the property owner/operator to the level of—or the amount of—economic well being associated with the legal rights (including, but not limited to, property possession, dominion, and control) that the owner/operator enjoyed just prior to the deprivation event.

Some analysts may associate the term "property" in a deprivation context with the term "real estate" (e.g., land, land improvements, and buildings) and/or "real property" (e.g., legal interests in real estate, such as leases, development rights, mineral and natural resource exploitation rights, etc.).

However, with regard to a deprivation event analysis—and in a deprivation property valuation context—the term "property" should be much more broadly defined.

In addition to real estate, the term property includes tangible personal property, intangible assets and intellectual properties, contract rights, going-concern business entities, business ownership interests, and debt and equity securities. All of these types of "property" may be subject to a deprivation event.

The Types of Deprivation-Event-Related Property Valuations

There are numerous types of—and circumstances related to—a property deprivation. To appropriately compensate the property owner/operator subject to the deprivation (and to exact the appropriate amount of compensation from the party responsible for the deprivation event), a deprivation-related property valuation may be performed.

When examined individually, each of these types of property valuation analyses is specific to a particular type of deprivation legal claim. However, when considered collectively, many of these types of property valuation analyses share common practical and conceptual issues across different types of deprivation legal claims:

- Condemnation and eminent domain
- Tangible and intangible property damages
- Intellectual property infringement
- Squeeze-out transactions and shareholder oppression items
- Breach of commercial contract

The above list presents five disparate types of legal claims. However, from a damages measurement perspective, there are some common threads that run through these different legal issues.

In all cases, one party has been damaged as the result of the actions of another party. In all cases, the first party suffers the deprivation of certain property rights. Those property rights could include real property ownership, tangible personal property ownership, intangible personal property ownership, business interest ownership, or contract rights (and related reasonable expectations) ownership.

And, another common thread is that one way (out of many ways) to measure the amount of damages suffered by the deprived party is to estimate the value of the property rights that are being deprived.

In the category of the condemnation and eminent domain deprivation, analysts may include all instances of municipal or government agency/authority condemnation, the nationalization of a private owner's property and industry, and the local, national, or international expropriation of any type of property.

In these instances, a national government, state government, municipality, other governmental agency with condemning authority, or a private entity with condemning authority, may assert dominion over private property. The condemnation or eminent domain action is typically justified because it is initiated on account of a public exigency and in the public good.

In such instances, the condemning authority (public or private) performing the deprivation has an obligation to provide adequate compensation to the private owner/operator of the realty, personalty, business, or contract rights subject to the taking.

In the category of the property damages deprivation, analysts may include tangible property damages and intangible property damages. Tangible property damages may include fire, theft, and other actual or constructive larceny. An example of such tangible property damages would be the felonious arson and malicious burning of a factory, warehouse, or other commercial real estate. Examples of intangible property damages may include slander, libel, and other forms of damage to a party's name, reputation, and goodwill.

For example, the party damaged by an actionable defamation may include an individual, a professional practice, or a commercial business entity. Another example of an intangible property damages event may be a tortious interference with the claimant's business opportunity.

In the category of the intellectual property infringement-related deprivation, analysts may include patent, trademark, copyright and other intellectual property infringement actions.

Prior to the infringement, the legal owner/operator of the intellectual property enjoyed special legal rights and legal protections—and the associated economic benefits of such special protections. As the result of an unauthorized use or other infringement, the infringing party deprived the intellectual property owner/operator of the full rights and economic benefits of the subject intellectual property.

In the category of the squeeze-out transaction or the shareholder oppression deprivation, the deprived party previously owned a common or a preferred equity ownership interest, partnership interest, or other ownership interest in a business entity. And, that equity interest owner enjoyed a certain level of legal rights and a certain amount of economic satisfaction associated with that ownership interest.

As a result of the squeeze-out transaction, freeze-out procedure, or shareholder oppression action, the stockholder/partner is involuntarily deprived of his/her investment property and of his/her legal rights and the associated economic satisfaction.

In the category of the breach of commercial contract deprivation, the deprived party entered into a contract—and paid valuable consideration—in reasonable expectation of the enjoyment of certain contract-related legal rights and certain economic benefits. The subject commercial contract may call for the purchase or the sale of an asset, for the consumption or provision of goods and services, and the like.

The point is that the claimant expected to enjoy the economic benefits associated with specified contract rights. As the result of the wrongful action of the contract counterparty, the claimant is deprived of the value of those contract rights.

Prior to the contract breach, the party suffering the deprivation event enjoyed a quantifiable level of economic satisfaction. As a result of the breach, that party was involuntarily deprived of that level of economic satisfaction.

Typically, in this case, the objective of the deprivation valuation analysis is to quantify the amount of compensatory value required to restore the aggrieved claimant to that party's predeprivation level of economic satisfaction.

Appropriate Deprivation Event Analysis Standards of Value

Valuation analysts—and the deprived party's litigation counsel—understand that there are numerous alternative standards (or definitions) of value that can be estimated for the same asset, property, or business ownership interest. Some of the alternative standards of value include the following:

- Fair value
- Fair market value
- Investment value
- Acquisition value
- Strategic value
- Owner value
- Use value
- User value
- Many others

Essentially, each of these alternative standards of value answer the same question: Value to whom? Of course, the identification of that "whom" is slightly different in each standard of value. Various alternative standards of value may be applicable in the case of a property deprivation valuation analysis.

Summary descriptions of some of the more common standards of value are presented below. These summary definitions are presented for purposes of this discussion. And, the following definitions are not intended to comply with any particular set of valuation professional standards:

- Fair market value—The price that the hypothetical typical (or average) willing buyer will pay to the hypothetical typical (or average) willing seller for a property. In this common definition of value, the buyers and sellers are both hypothetical and unspecified.
- Market value—The price agreed to for the subject property by the same hypothetical wiling buyer and hypothetical willing seller concept in the "fair market value" standard of value with a few additional conditions placed upon the arm's-length transaction (e.g., that value will be stated in a cash equivalency price and in local currency.)
- Acquisition value—The price for the subject property that would be paid by a specific, identified buyer (or business acquirer).
- Use value—The price that the subject property would receive in a specific and specified use (which may be different from the subject property's current use).
- Investment (or investor) value—The price that a buyer would pay for the subject property by reference to that buyer's required rate of return to an investment (without consideration to the price that the property owner would sell the property for).
- Owner value—The price that the current property owner would pay (to buy the property itself) in its current use (which may be substantially different from what the property may be worth to any other particular buyer, to any other user, or to the marketplace in general).
- Insurable value—The price required (in terms of current cost) to replace the subject property.
- Collateral value—The price that a secured creditor would expect to receive in a sale of the property after a foreclosure of a security interest related to a secured loan on the property.

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- Ad valorem value—The price of the property indicated by the application of a statutory valuation formula used by a taxing jurisdiction.
- Contributory value—The contribution of the subject property to the total value of an identified bundle (or unit) of properties
- Fair Value—The price of the property that results in an equally fair and equitable result to both the buyer and the seller; a price at which neither the buyer nor the seller is advantaged or disadvantaged; in a business ownership interest deprivation matter, the pro rata value of the total business enterprise without the application of any valuation discounts or adjustments for relative lack of ownership control and relative lack of security marketability

In U.S. generally accepted accounting principles ("GAAP") accounting, there is also a measurement of asset and liability value called "fair value."

This property deprivation discussion does not consider that GAAP-related fair value measurement standard of value.

The above list includes several common alternative standards of value. This list is not intended to be exhaustive. None of these alternative standards of value are implied to be "better" than any other standard of value.

Virtually all of these alternative standards of value could be estimated for the very same asset, property, or business ownership interest. And, the result of such an analysis would be different (and possibly quite different) "values" for the very same asset, property, or business interest.

In the case of deprivation-event-related property valuations, some statutory authority or judicial precedent may require the estimation of the fair market value standard of value. However, with regard to dissenting shareholder appraisal rights matters and shareholder oppression claims, many jurisdictions apply the fair value standard of value.

While the relevant statutory authority and judicial precedent controls the standard of value that the valuation analyst will follow, fair value is often considered to result in a fair and equitable treatment of the property owner in the case of an involuntary transaction, taking, or conversion of the subject property.

There are jurisdiction-specified statutory definitions of fair value that apply in shareholder rights litigation matters. In these types of litigation matters, a corporation (or its board of directors) has primary duties to the company shareholders. In addition, the corporation controlling shareholder has fiduciary duties to the corporation noncontrolling shareholders.

In these statutory fair value litigation matters, there are a number of basic tenets that are common to the concept of fair value (at least in terms of how they affect the deprivation valuation analysis).

First, a willing buyer/willing seller transaction is not necessarily contemplated. This is because, most deprivation events do not involve a "wiling" seller. Generally, the party subject to the deprivation had no intention to—and does not currently want to—sell his/her property. The property deprivation is typically involuntary. And, other than the party responsible for the property deprivation event, there may not be a willing buyer for the subject property.

Second, the objective of the deprivation valuation analysis typically is not to estimate the likely activity of a hypothetical marketplace. The objective of this deprivation event analysis is to restore the property owner to his/her economic status before the deprivation event occurred.

As the word "fair" implies, fair value quantifies the (fair and) just compensation to the property owner who was involuntarily deprived of the economic enjoyment of the subject property.

There is another standard of value that is not as widely used in judicial decisions or in the professional valuation literature. However, this alternative standard of value may be appropriately descriptive of the purpose and objective of deprivation valuation analysis: compensatory value.

In many respects, the compensatory value standard is analogous to the fair value standard. However, the term "compensatory value" is more expository of (1) the particular purpose of the deprivation-related valuation analysis and (2) the answer of the common standard of value question: Value to whom?

Compensatory value is the value of the subject property to the property owner, where that current owner is the party subject to the taking, the expropriation, the economic damage event, or some other involuntary conversion. And, the general interpretation of compensatory value is: The value that will result in a fair and reasonable amount of compensation for the deprived property and that will restore the property owner to the level of economic satisfaction enjoyed just prior to the deprivation event.

Although it is not commonly cited in professional valuation textbooks, such a standard of value is an intuitively and intellectually appealing measurement of the compensation in a property deprivation valuation analysis.

Appropriate Deprivation Analysis Premises of Value

In a property deprivation valuation analysis, the valuation analyst typically does not have to decide the appropriate standard of value, description of property subject to the deprivation event/valuation analysis, or deprivation event/valuation date. These valuation analysis fundamentals are often decided by the client's legal counsel and are documented in a written engagement letter.

However, for many types of valuation analyses, one of the first valuation analysis fundamentals that the analyst will decide is: What is the appropriate premise of value to apply to the subject property? There are at least four alternative premises of value that may be appropriate to a deprivation-event-related property valuation analysis.

The valuation of virtually any type of asset, property, or business ownership interest can be estimated based on each of these alternative premises of value:

- Value in continued use, as part of a mass assemblage of assets, operating as part of a going-concern business enterprise
- Value in place, as part of a mass assemblage of assets, but not operating in current use as part of a going-concern business enterprise
- Value in exchange, on piecemeal basis (and not part of a mass assemblage of assets), where the exchange is part of an orderly disposition of assets
- Value in exchange, on a piecemeal basis (and not part of a mass assemblage of assets), where the exchange is part of an involuntary disposition (also called a forced liquidation)

Virtually any type of property subject to a deprivation event can be valued based on each of these four alternative fundamental premises. Of course, the value conclusion based on each alternative premise of value, for the same property, may be materially different.

The valuation analyst will often select the appropriate premise of value for the subject property based on the following:

1. The purpose and the objective of the valuation assignment
2. The actual physical and functional status of the subject property
3. The analyst's highest and best use ("HABU") conclusion with regard to the subject property

> **"It is possible . . . that the act of the deprivation event itself could change the functional or economic status of the subject property."**

In the case of a deprivation-related property valuation, it is generally accepted that the valuation analyst should apply the premise of value that would have been appropriate on the day before the deprivation event occurred. For example, if the property was (or was part of) a going-concern business enterprise just prior to the deprivation event, then it should be valued based on the premise of value in continued use.

It is possible (and, often, likely) that the act of the deprivation event itself could change the functional or economic status of the subject property.

To illustrate this point, let's assume that a hotel property was operating as a going-concern business enterprise just prior to an eminent domain condemnation action. At the moment after the condemnation event, the hotel property ceased its hospitality-related going-concern business operations.

In this example, the subject hotel property should still be valued based on the premise of value in continued use (as part of a going-concern business enterprise). This premise of value would be appropriate in this analysis because that was the functional status of the subject hotel property just prior to the deprivation event.

To value this hypothetical hotel property based on any other premise of value would economically disadvantage the property owner in this example. To value the subject property based on any other premise or value could also economically advantage the condemning authority in this example.

This result would occur because the condemning authority could (theoretically) restore the subject hotel to its operational status before the deprivation event and then enjoy the value increment in the hotel—without having paid the property owner for that value increment.

In a deprivation-event-related property valuation analysis, applying a premise of value other than a premise that was appropriate just prior to the

deprivation event may not achieve a fair value (meaning equitable to the property owner) or a compensatory value (meaning the measurement of the just compensation to the property owner).

Special Valuation Factors to Consider in a Deprivation-Related Property Valuation

As implied above, there are a number of special considerations that the analyst should be mindful of when preparing a deprivation-related property valuation. Of course, numerous judicial decisions have described different factors, based on the specifics of each individual case before each finder of fact.

Various statutes also specify (or imply) lists of special valuation factors to consider, based upon the type of deprivation event that has occurred. And, various academic and practitioner analysts have postulated special valuation factors to consider, based upon the type of property subject to the deprivation analysis.

The following discussion represents a consensus of valuation factors that should typically be considered by analysts in deprivation-related property valuations. These valuation factors are general in nature so as to apply to the valuation of various types of subject properties and to various types of deprivation event situations.

First, in the property valuation analysis, the analyst should ignore the deprivation event itself, and all of the effects of the deprivation event on the subject property. In other words, the subject property should be valued as if the deprivation event (and any resulting decrement in the subject property value) had not occurred.

This hypothetical condition (that the deprivation event itself has not occurred) may be the basis upon which the analyst can make a comparative analysis for purposes of quantifying one measure of compensatory value—that is, the fair value of the subject property before the deprivation event less the fair value of the subject property after the deprivation event.

Second, the analyst should ignore all subsequent events after the occurrence of the deprivation event (i.e., after the deprivation event valuation date). Reliance only on information that is known or knowable is a generally accepted procedure in a property valuation analysis.

Of course, the analyst may also be asked to quantify the property owner's economic damages in addition to the subject property valuation. In an economic damages analysis, reliance on the book of wisdom (i.e., all events subsequent to the valuation date and up to the damages report date) is a generally accepted damages measurement procedure.

In the case of deprivation-event-related property valuations, it is often difficult (but necessary) for the analyst to ignore the substantial economic effects of time and the deprivation event itself on the subject property.

Third, the analyst should ignore the deprivation event itself (and the associated effects of the deprivation even) during the selection of the appropriate premise of value. Generally, the selection of the appropriate premise of value is a threshold test. If the subject property was operating as a going-concern business prior to the deprivation event, then it should be valued based on the premise of value in continued use.

For example, if our illustrative hotel was open for business prior to the deprivation event, then it should be valued based on a value in continued use premise. This premise of value would be appropriate even if the deprivation event has affected the hotel business operations.

For example, the deprivation event may have caused the subject hotel to experience lower occupancy and less profits than it enjoyed historically, compared to industry benchmarks. After the deprivation event, the subject hotel may still be a going-concern business (although it may have a decreased value as a going-concern business compared to its historical value).

Fourth, the analyst should ignore the actions of the party responsible for the deprivation event, both before and after the actual deprivation event. In the

case of a condemnation or eminent domain action, for example, the state may have performed certain actions prior to the issuance of the actual condemnation notice that would have a decremental effect on the value of the subject property.

Using our hypothetical hotel to illustrate this point, such state actions may include closing down most access roads to the subject hotel, changing the zoning of the subject property, starting major highway construction directly adjacent to the subject hotel, and the like. However, the analyst should factor out all of these deprivation-event-related effects from the deprivation-related property valuation.

In other words, the analyst should value the subject property on the date before any detrimental deprivation-event-related activities occurred.

Fifth, the analyst will typically not consider many of the valuation discounts (or other valuation adjustments) that may normally apply in a willing buyer/willing seller market-value-based valuation.

To illustrate, let's assume that our illustrative hotel is a private corporation, with a number of shareholders. Let's also assume that the hotel is subject to a condemnation action deprivation event and that one of the four equal shareholder/property owners is seeking compensation for the deprivation event.

Normally, the analyst may discount the total business enterprise value of the private corporation property owner due to its illiquidity. Normally, the valuation analysts may also discount the owner's pro rata equity value of the closely held corporation due to the lack of marketability of securities in private corporations.

Normally, the analyst may discount the owner's pro rata value due to the noncontrolling ownership nature of the subject equity interest (i.e., related to its lack of control of the subject hotel operations). And, normally, the analyst may discount the owner's pro rata equity value due to any other restrictions on the transferability of the private company shares (e.g., for buy/sell agreements, etc.).

However, in a deprivation-related valuation analysis, none of these stock valuation discounts would typically apply to our hotel shareholder. These stock valuation discounts may apply in valuing the hotel business ownership interest under a willing buyer/willing seller definition—but our hotel shareholder is not a willing seller.

The hotel shareholder was perfectly content to own his/her 25 percent of the privately owned hotel. He/she had no intention of selling the ownership interest. Instead, the shareholder was involuntarily deprived of the value of the business ownership interest.

If these valuation discounts were applied in the deprivation valuation, then the four hotel company owners would collectively receive much less than the total market value of the subject hotel. Accordingly, the four owners would be economically disadvantaged. And, the state (i.e., the condemning party responsible for the deprivation event) would be economically advantaged. This is because state condemning agency would be able to "buy" the subject hotel for much less than its total market value.

Summary and Conclusion

In a deprivation event, a property owner/operator is being "deprived of" the ownership, operation, use, or economic benefit of a type of property. That type of property could include real estate, tangible personal property, intangible assets and intellectual property, business ownership interests, or contract rights.

A property deprivation action is typically a legal event. Accordingly, the analyst may seek legal instructions from the client's counsel with regard to the statutory authority, administrative rulings, and judicial precedent that may be applicable to the deprivation-related valuation analysis or damages analysis.

One measure of damages related to the deprivation event is to estimate the value (or value diminution) related to the deprived property.

Before performing a deprivation-event-related property valuation, the analyst should understand the purpose and objective of the valuation (within the property deprivation context), the nature of the deprivation action, and the type of property subject to the deprivation event.

The analyst should consider the appropriate standard of value and the appropriate premise of value in order to conclude the compensatory value of the subject property. The appropriate standard of value (and the appropriate property valuation approaches and methods) may be different than those that would be applicable in the typical hypothetical willing buyer/hypothetical willing seller concept.

Since the deprivation-event-related property valuation relates to an involuntary transaction, the analyst should conclude an economic value that represents a fair and just measure of compensation for the damage suffered by the property owner/operator that experienced the deprivation event.