VALUERS AND THE LEGAL SYSTEM - CONTEMPORARY LEGAL ISSUES

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INTRODUCTION

The following is a wide ranging and broad analysis of current legal issues affecting the valuer today. The aim is to show the legal environment, as arguably, the most important environment in the valuation system. That is, the all pervasiveness of law touches all valuation problems. I will examine the issues under the common valuation headings.

COMPENSATION ISSUES

WHATEVER HAPPENED TO COMPENSATION FOR INJURIOUS AFFECTION?: There has been a clear trend for town planning authorities not to pay compensation for serious injurious affection caused by a change in a town planning scheme. For example, a downward zoning or heritage listing. Generally, compensation is only paid if the land is reserved for a public purpose and under the SA legislation, full and proper compensation is paid only if "hardship" is proved. This is contrary to rules of equity, valuation and legal theory applying to compensation. It is possible for the government to down zone land for a "quasi" public purpose without paying any compensation.

REGULATION VERSUS DEPRIVATION: This raises the "regulation versus deprivation" debate which has been recognized in a number of US courts (Stein, 367-371). The AIVLE should be aware of this problem and lobby the relevant authorities to pay full and proper compensation when substantial value is lost through a change in zoning or a detrimental listing.

The method of allowing *transferable title rights* for heritage listings and controls on subdivision (Mt Lofty Management Plan) is "Clayton's" compensation only.

SITE GOODWILL?: Another compensation problem which becoming more evident is the separation of a personal business interest from the land value when a business is partly or wholly destroyed by a public work. It is becoming increasingly difficult to separate the two with franchise and quasi franchise (eg retail service station operators) land uses. Under compensation theory compensation is only paid for *site goodwill* as personal goodwill stays with the operator and therefore, is transferable and not lost. However, an examination of the court cases concerning *site goodwill* are less than convincing. Invariably what the courts have allowed as *site goodwill* should have been part of the land value (eg *Bickle*) or personal goodwill. In fact it appears that there is no such thing as site goodwill.

COMPENSATION FOR NATIVE TITLE: Under *Mabo* and the *Racial Discrimination Act 1975 (Cth)* compensation is payable for the compulsory taking of "native title". Although Mabo has little effect in South Australia as the case clearly states that the alienation of land by way of Pastoral Lease extinguishes any native title and applies only to leases granted over native title since 1975 (the date of the of the *Racial Discrimination Act*). S10 of that Act states that if South Australia does not pay adequate compensation for lands taken, it is in breach of the Act.

The concept of native title raises a new perspective on land compensation as compensation theory has developed according to English concepts of proprietary ownership (*Milirrpum*). For example, non pecuniary factors such as "custodians or protectors of the land" are ignored, being similar to "sentimental value" (See Appraisal One, 19-3/4, *Grace Bros* case). However, it is obvious that a High Court which has so carefully and thoroughly recognised native title will now have to recognise the peculiar attributes of native land uses in compensation claims. However, there is still doubt about what is meant by "native title" and the extent of the land use will not be known until the first compensation cases are heard. The court may take a narrow view (only the traditional native land uses such as hunting and gathering are recognised) however, it is more likely they will take a wide or broad view (including modern activities such as mining and pastoral land uses). In the latter case the compensation payable will approach freehold value.

MINI MABO: If the narrow view were adopted there would be little compensation payable because under s47 of the Pastoral Land Management & Conservation Act "traditional" native land uses are already allowed and protected.

NEW METHODS OF VALUATION

There are a number of problems in the valuation profession arising from the increasing divergence between valuation theory (as taught in academia) and the legal system. This leaves the practising valuer in a quandary. How can he/she use the new methods and techniques if they are not recognised by the courts? After all, the courts are the final arbiters of value as a number of professional liability cases underline and as does the expense of professional indemnity insurance.

It is of interest to note that the NSW government has prepared a bill to go before parliament which will limit the liability of professional advisers including valuers. If this is passed and South Australia follows suit, there will be a dramatic reduction in professional indemnity insurance premiums and valuers will be given freer reign. The Institute could adopt an active role in promoting such a bill in South Australia.

Educators and the many non valuers promoting new methods of valuation tend to blame the courts for being to slow and/or conservative when it comes to the "new" methods and even the profession generally, for not wholeheartedly grasping and embracing them. In my mind such a view is naive, ignoring the realities of a real world of litigation and threatened litigation against the valuer. For example, in Sydney there is a blacklist of clients who tend towards litigation.

MRA: The "new" methods most often mentioned are DCF (discounted cash flow which being derived from mortgage versus leasing problems in commerce have been around since the late 1960s) and MRA (multiple regression analysis). MRA has not really got off first base as a practising valuation method except in the fevered minds of a number of academics. Therefore, I will not consider it here except to say that the main problem is that the practising valuer rarely has a sufficient number of sales necessary to provide a predictive value range within reasonable limits at 95% probability.

DCF: Of greater concern is the gushing endorsement of DCF from a number of quarters (usually non valuers) as a valuation panacea. This has culminated in a position paper of the Institute which although recognising some of the method's shortcomings is still unsatisfactory as it does not address a number of the most important and inherent shortcomings in the method. In this paper I am only concerned with the legal perspective, a perspective which is either ignored or glossed over by the promoters of DCF. The leading case is the *Albany* case.

THE ALBANY CASE

In *Albany v Commonwealth of Australia* (1976) 12 ALR 201 the High Court was asked to address a number of valuation problems for compensation purposes, for a large parcel of land east of Darwin. The area of the subject land was large, 4508 acres. The purpose of the acquisition was "the planned development and control of the City of Darwin and its adjacent areas"(203). The plaintiff claimed that the acquired lands had a highest and best use of urban and residential development. It was a large (1612+2896 acres) and highly speculative development. Jacobs J made the following comments on the cash flow:

> "..the estimate of incomings and outgoings in the projected number of years of development takes account of the estimated rise in the value of the land over the period and the estimated increase in development costs over that period. The figures selected by the plaintiff's valuers in this connection are an 8% rise per annum in the price of land sold and a 6% rise per annum in development costs. In this respect particularly, *factors are introduced into the subdivisional projection which are not present in the commonly adopted method of valuation on the basis of a hypothetical subdivision.* " (20) (my emphasis)

Later in the case:

> "I should now say that I am not satisfied that this could be an acceptable method of valuation in the present case. *I express no opinion upon the question whether or not, in other circumstances and in other cases, a method of valuation by way of discounting the anticipated cash flow is a proper method of valuation of land.* There is no evidence that the application of this method has either in theory or in experience produced results consistent with methods of valuation upon the basis of hypothetical subdivision which has, where necessary, been applied in the past" (210) (my emphasis)

Great play has been made on the italicised part of Jacob J's statement but unfortunately almost all the areas in which DCF is used and promoted have the same degree of uncertainty and speculation as in this case. There are some areas where DCF is the best method of valuation and that is where the projected cash flow is known with reasonable certainty and these are the types of valuations that his honour is referring to. Therefore, the question when deciding whether or not a DCF is applicable is, "how speculative is the cash flow ?"

DCF introduces an extra element into the valuation method; *time*. That is, DCF is a *temporal* method of valuation while the traditional "hypothetical development" method is *non temporal*. This applies particularly in relation to:

1. The period of the development. This is an important and sensitive factor in DCF:

2. Forecasted prices and costs:

> "It would appear to be necessary in projections based on discounted cash flow to take account of rises in costs and likely rises in prices obtained. Rises in costs for the purposes of the analysis have been estimated at 6% per annum and rises in prices at 8% per annum. It is hardly necessary to remark that the basing of a present value upon projections of this kind could be very dangerous without allowing for a wide margin of error by means of a heavy discount factor". (217)

The case well illustrates the problems facing a judge when a purported valuation includes a number of speculative elements and particularly when the DCF is very sensitive to those variables. The problem is to determine the quality or reliability of the evidence given by the opposing parties in the court. Ultimately and typically, sales are resorted to because direct sale evidence is higher quality and more reliable evidence than a complex discounted cash flow which relies for its integrity on the reliability of a number of variables within the cash flow. The variable become less reliable down the time line.

Decisions in court cases are determined under the *adversary* system, a factor which those of us in valuation must never forget as all practising valuers deserve their day in court. If one party argues a valuation incorporating a number of speculative elements while the other party argues with concrete and direct evidence (such as the use of sales by way of direct comparison with say, opportunity cost adjustments), the judge will always favour the more direct evidence. If subjective probabilities are applied to the components of value classified by Jacobs J the two methods can be compared as follows:

	DCF	HYPOTHETICAL DEVELOPMENT
	PROBABILITY	
Time of development:	0.4	0.6
Number of blocks:	0.8	0.9
Cost/lot:	0.3	0.5
Prices to be obtained:	0.2	0.8
Period of time for sale:	0.3	0.6'
Rate of discount:	0.6	0.8
Overall probability:	**0.0035**	**0.1037**

Subjective or Bayesian probabilities are the way judges evaluate the evidence proffered in court. Overall probability is according to Baye's "multiplication rule".

The above table underlines the dilemma facing a valuer who wishes to employ DCF. Under the legal adversary system his valuation will be compared against that of the opposing expert. If the opposing expert uses a more traditional and direct method of valuation consisting of fewer parts each of which has a higher probability of being correct (because they are contemporary or non temporal), the judge must accept the evidence of the traditional method in preference to the DCF method.

THE USE OF COMPARABLE SALES

The courts have over a long period emphasized the use of comparable sales as the true test of market value. The law in this case is reasonably well settled although there is still some argument about the use of "out of line" sales as evidence of value (Hornby, Part 3). The case that best illustrates the court's preference for sales evidence even if the sales would appear to be non comparable is the Seatainer's case (*Leichhardt Council v Seatainer Terminals (1976) 24 The Valuer 500)*. The Supreme Court of NSW had the opportunity to use a method of valuation other than direct comparison of sales with opportunity cost adjustments. However and again, the Court chose the more reliable sale evidence. However, the uniqueness of this case is the large degree of adjustment which was allowed to the "comparable" sale.

The land in question was raw land below the high water mark at Glebe Island and vested in the MSB by statute. The site was improved into a modern container terminal at great cost. Leichhardt Council appealed against the valuation of the site for property tax purposes on the basis that the site should have been valued using the "cost method" rather than by direct comparison.

The problem was that there were no sales of comparable lands available and it was basically a unique site. That was the reason that the cost approach was preferred in the lower court. Moffit J argued that the process of judicial decision is founded on reasoning based on facts which includes experience. I would tend to say the same about valuations as the court system allows the "art" of valuation, history and experience to become part of the valuation system.

Moffit J used a sale at Botany Bay of industrial land with no water frontage in an area not developed industrially to the same degree as the subject site. Therefore, the sale required extremely large adjustments to make it comparable to the subject site. The difference was arrived at by an adjustment based on a sale in a highly industrialised area and having some water frontage but quite different in type, access location to the subject site. Then, a further adjustment was made to allow for the deep water frontage of the subject site. Both adjustments were substantial:

1. Initial price: $350 000/ha

2. Adjusted by reference to the second sale to about $600 000/ha

3. To this was added $100 000/and $120 000/ha respectively (the site was treated as two separate parcels of land) to allow for the deep water frontage .

Therefore, final adjusted figure was about twice the initial sum. In valuation practice it is hard to imagine such a sale as being comparable" and applying *Seatainers*, there cannot be a situation where there are no comparable sales (see also *Bingham* and *Griffith Producers* cases). His honour argued that the cost method involved the making of a judgment or an adjustment which is arbitrary in that it lacks support from any experience such as sales experience. The cost method must be subject to a judgment being made as to whether the price will bring to account cost or less than cost. It is difficult to determine the requisite discount on the actual cost particularly in the absence of sales evidence. Therefore, expressly and impliedly he has singled out two problems with the cost method:

1. Cost is only a reliable method for the valuation of buildings if those buildings represent the highest and best use of the site - *Horn v Sunderland* Corp.

2. If the buildings are the highest and best use then the accrued depreciation can only be reliably determined from comparable sales. This is a circular argument as if there are comparable sales then there is no need for the cost method and direct comparison can be used.

Ash J in the same judgment agreed with Moffit J. Concerning the "comparable: sale:

> "Quite unable to put these sales aside as being irrelevant or slightly relevant so that they should not be considered; and that view is only *emphasized when an experienced valuer has currently applied his judgment to appropriate adjustments for the valuation of the subject lands*". (my italics)

MASS VALUATION AND LEGAL ISSUES

The legal environment plays an important role in the type and nature of the property tax system and as a control on the possible excesses of the taxing authority. There are a number of necessary criteria for a good property tax system from an equitable, valuation and legal point of view. These include:

1. The property tax base should be easily understood by the taxpayer. That is, it must relate to market values and market prices.

2. There should be a simple and cheap appeal process (preferably by way of a tribunal). This limits the use of computer valuations in the property tax system as the appeal system will only recognize a "human" valuer.

3. Following from point 2, "class actions" will soon be here which will allow a whole subareas within the local government to appeal against the "tone" of their valuations. As has happened in the USA this can force a whole new valuation of that sub area by human valuers.

4. It is doubtful that the courts would allow a MRA model to be used which includes the previous valuation as the most important and sensitive single variable. That is, such valuations cannot be new valuations.

MARKET VALUE

Just when we thought the definition of market value was well and truly tried, determined and dried after *Spencer* and *modified Spencer* (*Turner* and *Closer Settlement* cases), academia finds a number of American textbooks and "here we go again!" Yet the law in Australia is deceptively simple; market value is the "willing buyer and willing seller theory" under *Spencer* and the Institute can sign as many agreements concerning international standards as it likes but the practising valuer has to determine value according to *Spencer*. Why? because the courts say so. However, the modern interpretation of Spencer is *modified Spencer*. This basically relates the normative definition to market exposure:

> "The market value of land is that price agreed to between a buyer and seller after the property has been typically promoted and exposed in the market place as for that type of property".

ANNUAL RENTAL VALUE: It is interesting to see that much of the latest litigation on market value has come about through disputes on rental determinations or trying to decide what is market rent or annual market value. This raises another important and fundamental valuation question; how do the courts see annual rental value? Is it something fundamentally different from a lump sum value? The answer should be no but the courts have had a lot of trouble with this concept.

WILLING LANDLORD WILLING TENANT THEORY: This theory is derived from Spencer and is the starting point of all rental values. Applying modified Spencer; "it is that lease agreed to between the lessor and lessee after a typical period of promotion, negotiation and exposure of the property". Since the law applicable to annual values is that applying to lump sum values I am a little dubious about reading too much into some the lower court judgments as I am sure many would have been lost on appeal.

The main problem with determining rents is that the valuer is forced to work under definitions of value as defined in the lease document. As has been stated on a number of occasions; "the lease is a contract and the parties are bound by that contract" (a plea here for "plain english" leases). Two recent cases which seem have got the method right are *AOTC* and *TASAL*. Both decisions were concerned with the inclusion or exclusion of rent incentives received by lessees when rents of comparable properties are taken into account for the purpose of rent review.

In *Ropart* and the *ANZ Executors & Trustee* decisions lease provisions directing valuers to "take no account" of, or to "disregard" rent incentives, were effective to achieve that result. According to these cases valuers must take the "rent" paid according to the lease without discounting the value of incentives received by lessees, in whatever form. With respect I think this approach is incorrect. The problem springs from ignoring basic valuation theory as applied to lump sum valuations. For example, if a sale of land occurs it must ALWAYS be related to the contract of sale and it is not a suitable sale for valuation purposes unless subject to "normal terms and conditions". If a sale occurs which is not subject to normal terms and conditions it can be adjusted using compound formulae into an "equivalent cash price" (ECP) (Hornby, pp 16-3/4). The courts should be analyzing leases in exactly the same way.

The "rent" paid cannot be divorced from the terms and conditions of the lease agreement. For example, it is accepted that if a lease agreement is subject to a premium then it must be converted into an "annual rental equivalent" (ARE) using compound formula (Hornby, pp 16-2/3). Similarly the opposite to premiums; "incentives", must be taken into account when determining the "rent" being paid under a lease agreement. Therefore, a number of court decisions are wrong when they equate rent with the "base rent" or "residue rent" paid under the lease agreement. When a rental determination refers to "rent" it is not a stand alone money payment but must be part of the lease agreement with its terms and conditions and incentives.

As stated above, rental value is subject to "normal terms and conditions". Therefore, if all or nearly all, leases are being offered with incentives (eg rent free periods) then that is the market rent and no adjustment is required. Adjustment is only required if the terms and conditions are not typical or normal (*Fed Comm of Land Tax v Duncan*).

The above analysis indicates that there is ambiguity in current typical rent determination clauses. That is, on the one hand they ask for a market rent ignoring incentives (indicating that the rent with incentives should be reduced) when on their other hand, the real intention is to use the base rent only. If the drafters of such clauses wish to keep the rent high using only the base rent they must be more specific in the construction of the clause (use a formula) because the courts will tend to strike down such clauses if there is any doubt or ambiguity. For example, in *Colonial Mutual* where the direction to determine "current open market value" "exclusive of any incentives" was interpreted to mean that those incentives should be taken into account and thus reduce the rental value. The judge pointed out that the clause did not say (as in *Ropart)* that the valuer should take no account of incentives and it is probable that the provision was drafted on behalf of the lessor to try and achieve the directly opposite result.

In *Tasal* it was held that when the rent review clause requires a determination of the current annual market rental, without any directions relating to rent incentives, the valuer can take the rent incentives into account. This is obviously the better view.

I also take issue with the courts and industry's use of "open market rent" as being something different from "market rent". In my opinion they are both the same. These cases illustrate the uncertainty of the courts in this area of valuation and therefore, making rental determinations most difficult. It is hoped that some Australian High court cases will appear soon to determine the proper method once and for all.

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