Federal Condemnations and Takings – A Journey Down the Yellow Book Road

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ABSTRACT

The *Uniform Appraisal Standards for Federal Land Acquisitions*, affectionately known as the "Yellow Book," is a formidable document laden with legal citations. From a practical standpoint, assuming knowledge and familiarity with appraisal standards and reporting methodology, *Section B – Legal Basis for Appraisal Standards for Federal Land Acquisitions, Section D-11 – Valuation of Mineral Properties*, and *Section D-12 – Leasehold Acquisitions* are the salient sections. This presentation examines a number of the issues and conundrums that affect the mineral appraiser in attempting to conform the requirements of the Yellow Book with the practice of the mining industry in buying and selling interests in mineral properties (i.e., the market for such interests).

INTRODUCTION

The *Uniform Appraisal Standards for Federal Land Acquisitions* (the "Standards") was first published in 1971 as a result of the work of the Interagency Land Acquisition Conference, a voluntary organization that is composed of representatives of a number of federal agencies that are involved in the acquisition of real estate for public uses. One of the principal goals of the Conference upon its formation in 1968 was the "[…] promulgation of uniform appraisal standards and guidelines for appraisal reports."[1]

In its bound form, the publication was notably recognizable by its yellow-tinged cover, thus the derivation of the informal term *yellow book* in agency and industry circles. There have been a number of revisions, the two most recent having been published in 1992 and 2000.

Subsequent to the initial publication of the UAS, the U.S. Department of the Interior, Bureau of Land Management published its *Guide to Federal Coal Property Appraisal* in 1986 (BLM Manual H-3070-1). This was followed by the publication of the original *Uniform Standards of Professional Appraisal Practice* in 1987 by The Appraisal Foundation.

After the passage of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA") and the formation of the Appraisal Standards Board and the Appraisers Qualifications Board, the *Uniform Standards of Professional Appraisal Practice* ("USPAP") were adopted as the initial appraisal standards promulgated by the Appraisal Standards Board. USPAP remains a requirement for appraisals of real property involving federal funds and is the standard in meeting the various licensing and certification requirements of the individual states. It is also the standard required by the American Institute of Minerals Appraisers.

These additional published appraisal standards are noted because of the occasional conflict between certain of the requirements of each.

CONDEMNATIONS AND TAKINGS

Many minerals appraisers most frequent encounter with USFLA arises from condemnation and takings actions at the federal level. Condemnation proceedings arise from the exercise of its right of eminent domain by the federal government by which it acquires title to the real property interests at issue. Takings arise from the resultant loss of a right through statutory or regulatory action without the loss of title to the estate being affected. Notable examples of takings involve declarations of lands unsuitable for mining coal as provided for in the Surface Mine Control and Reclamation Act of 1977 ("SMCRA") and the prohibition on mining coal beneath alluvial valley floors west of the 100th meridian, also a provision of SMCRA.

FOCUS OF PRESENTATION

Notable sections of the UAS with regard to mineral appraisals are *Section B – Legal Basis for Appraisal Standards for Federal Land Acquisitions*, *Section D-11 – Valuation of Mineral Properties*, and *Section D-12 – Leasehold Acquisitions*, which are addressed in the discussions that follow.

LEGAL BASIS FOR APPRAISAL STANDARDS

Several key provisions of *Section B* are particularly worth noting. The first of these, presented in *Section B-1*, is that **federal law controls.** The Standards note that "[…] because the meaning of *just compensation* is a matter of fundamental constitutional interpretation, questions with respect to compensation are to be resolved in accordance with federal law rather than state law."[2]

Although this concept may appear to be self-evident, given that one is dealing with federal standards, the appraiser must be particularly mindful that one's experience with state law and with industry practices don't bleed over into an appraisal being conducted under the Standards, thus threatening its acceptance.

The second provision to be noted, presented in *Section B-2*¸ is the **market value criterion**. As with virtually every definition of market value, the criterion of market value for just compensation incorporates the concept of a willing buyer and willing seller. The Standards provide the following definition as being that adopted by appraisers in applying the Standards for use in federal land acquisitions:[3]

> Market value is the amount in cash, or in terms reasonably equivalent to cash, for which in all probability the property would have been sold on the effective date of the appraisal, after a reasonable exposure time on the open competitive market, from a willing and reasonably knowledgeable seller to a willing and reasonably knowledgeable buyer, with neither acting under any compulsion to buy or sell, giving due consideration to all available economic uses of the property at the time of the appraisal.

Several points are worth noting regarding this definition, as summarized below.[4]

- Adding adjectives such as *fair* or *cash* to the term *market value* does not alter its meaning for use in federal land acquisitions.
- The Supreme Court has held that the Fifth Amendment allows the owner only the fair market value of his property; it does not guarantee him a return on his investment.
- The concept of "reasonable exposure time" has not been defined by the federal courts, with the appraiser admonished in the Standards not to link their estimates of market value to a specific exposure time.
- The concept of "reasonably knowledgeable" does not require buyers and sellers to be all-knowing, simply that they have knowledge possessed by typical willing buyers and willing sellers in the marketplace. Two opinions of note in this regard are:

  "The market from which a fair market value may be ascertained need not contain only legally trained (or advised) persons who fully investigate current land use regulations; *ignorance of the law is every buyer's right."*.[5](emphasis supplied)

  "Consideration should be given to "a relevant market made up of investors who are real but are speculating in whole or major part."[6]

Of particular note to appraisers, and an issue that I have encountered a number of times, has to do with the determination of *just compensation.* As the Standards note:

> "[t]he ascertainment of compensation is a judicial function, and no power exists in any other department of government to declare what the compensation shall be or to prescribe any binding rule in that regard" (internal citation omitted), because the meaning of *just compensation* is a matter of fundamental constitutional interpretation, and the ability to make binding interpretations of the Constitution rests only with the United States Supreme Court."[7]

Appraisers should take particular note and realize that their role is to estimate market value. Under no circumstance should the appraiser state that the estimate of value derived represents just compensation.

APPROACHES TO VALUE

As is typical, it is expected that the appraiser will consider the three basic approaches to value—Sales Comparison, Cost, and Income.

With regard to the **Sales Comparison Approach**, the Standards note that although it is understood that all of the three approaches are based on the interpretation of market value, "[…] the federal courts recognize that the sales comparison approach is normally the best evidence."[8] This presumption by the courts is of particular concern in many mineral appraisals, notably because of 1) a predisposition on the part of many mineral appraisers to believe that the sales comparison approach simply cannot be used and, 2) the common use of the Income Approach by industry in valuing mineral properties as candidates for acquisition, occasionally even those that are not in production.

Two comments are offered in this regard. First, in my experience the Sales Comparison Approach can be used quite adequately in mineral appraisals, albeit, perhaps, with a little extra effort involved. In many instances, sales of undeveloped properties can be uncovered through adequate searches of public land records, particularly when severed mineral estates are involved. This is particularly true for oil and gas and for coal, since within those basins that such potential occurs there is frequently a relatively active market for undeveloped properties. For those undeveloped properties containing metal deposits for which sufficient exploration has been conducted to quantify reserve and resource potential, sales of undeveloped properties can be used to derive values on the basis of contained metal.

Points particularly worth noting regarding the use of the Sales Comparison Approach are as follows:

- Although sales t**o** a condemning authority are generally not admissible, the reasons for excluding such sales are not applicable to sales **by** a condemning authority.[9]

- Sales involving exchanges of property generally are not admissible, with such sales generally considered to be unreliable indicators of market value and to involve too many collateral issues.[10]

  Although the use of exchanges may, at first consideration, seem an unlikely occurrence when gathering sales data, such exchanges under Section 1031 of the Internal Revenue Code, which historically were confined in large part to commercial and industrial real estate parcels, are becoming increasingly common for mineral-bearing properties.

- Sales made after the date of an acquisition are not, as a matter of course, excluded from consideration as comparable sales. As the Standards note, such sales can be used with appropriate caution and restraint "[…] if they meet the usual standards of comparability and are not otherwise incompetent as evident of value."[11]

The **Cost Approach to Value** is generally considered by the courts to be the least reliable method of valuation.[12] In this context, however, the use of this approach is generally restricted to improvements associated with real estate, with the two techniques being replacement cost and reproduction cost.

Of more concern in mineral appraisals, however, is the fact that the attempted use of the Cost Approach in such appraisals involves real property interests, not tangible assets. As a general statement, it is my position that a given mineral property simply cannot be reproduced or replaced, given that each deposit is a unique combination of geologic factors beyond man's ability to replicate.

In some instances, the value of an undeveloped mineral-bearing property is based on the perception that historic exploration costs in some fashion comprise the *replacement cost* of the property. There are a number of fallacies involved in the use of the Cost Approach in this fashion, not the least of which is the fact that multiple and overlapping exploration programs often have been conducted. Perhaps the most that can be said about the use of the Cost Approach in this manner is that it may reflect the value of the work that was conducted in bringing the deposit to the level of knowledge that is available at the appraisal date. However, this is not necessarily equivalent to the value of the deposit.

Over the years, perhaps the most controversial aspect of mineral appraisals in condemnations and takings has been the use (or the attempted use) of the **Income Approach to Value.** As noted previously, the courts historically have favored the Sales Comparison Approach, with the Standards admonishing that "[…] the appraiser should consider both the courts' obvious preference for the sales comparison approach and the fact that "[h]istorically, the capitalization of income approach to value has been suspect." "[13]

The Standards go on to note that property for which the highest and best use is for mineral production may be appraised by an income approach, although there is a cautionary note that this approach should not be used by an appraiser who is not thoroughly experienced in appraising mineral properties.[14] This cautionary note is one which all of us who consider ourselves **mineral** appraisers strongly agree, having encountered from time-to-time appraisals prepared by real estate appraisers who may be highly qualified to appraise real estate but who have little or no knowledge of what creates value for a mineral deposit, much less understand the deposit itself.

The Income Approach to Value is discussed in the Standards in more detail in Section D-11. Valuation of Mineral Properties, addressed below.

VALUATION OF MINERAL PROPERTIES

Of particular note in appraising mineral properties is the need for the appraiser to understand the *unit rule*. In essence, this rule recognizes that a property is to be valued as a whole, with due consideration being given to all of the components that create value.[15] These components are to be considered only with regard to how they enhanced or diminish value and one is not to use what is termed a *cumulative* or *summation* appraisal. As cited in the Standards:

> "In the case of land that is underlaid with marketable minerals, . . . the existence of those minerals is a factor of value to be considered in determining the market value of the property, but the landowner is not entitled to have the surface value of the land and the value of the underlying minerals aggregated to determine market value."[16]

The requirements of the unit rule are becoming increasingly more difficult to reconcile, in that not only is the mineral estate legally severable from the surface estate, but also that discrete portions of the mineral estate are routinely severed in many geographic areas. These include, among others, the oil and gas estate, coal bed methane rights, the coal estate and, within the coal estate, specific coal beds, sand and gravel deposits, and other industrial rocks and minerals such as clays. Several points of note in this regard are as follows:

- Care must be taken in dealing with certain types of deposits, such as sand and gravel, with some states recognizing these as part of the surface estate and others considering them to be severable.

- Whether the deposit is to be mined by surface or underground methods can be of significance. For example, underground mining of many deposits creates no impediment to the use of the surface, with the value of the highest and best use of the surface and the value of the extraction of the mineral deposit having no linkage to each other.
- For those deposits to be mined by surface methods, it is generally necessary to include a terminal value for the surface, recognizing, of course, the condition in which the surface is anticipated to be left.
- An issue worthy of further investigation by us as individual mineral appraisers is the nascent recognition in some circumstances that the sum of the discrete values of severable estates may best represent the value of the property as a whole.

There is tacit recognition of the lack of linkage between individual uses of some portion of the mineral estate and the use of the surface in the discussion in Section D-11 regarding the *consistent use* theory and its relationship to highest and best use analysis. With regard to the consistent use theory, the Standards state that the "land cannot be valued on the basis of one use while the improvements [or minerals] are valued on the basis of another."[17] The Standards go on to cite, as an example, that it is improper:

> "to value a property for agricultural purposes and then add a substantial value increment for gravel deposits under the surface of the land. If the gravel is mined, the land, in all probability, will have no value for agricultural purposes during or after the mining operation. However, if the mineral deposit were oil, a concurrent use of the surface for grazing purposes would not, in most instances, be a violation of the consistent use theory.'[18]

This citation is in accord with several of the points set forth in the bullet points next above and further illustrates some of the complexities involving mineral appraisals and the need for a complete understanding of mining methods and their impact (or lack thereof) on the surface estate.

Section D-11 also comments further on the use of the **Sales Comparison Approach** in valuing mineral properties, again reinforcing the courts' general position that this approach is usually considered the best evidence of value. Of particular note is the citation that:

> "[e]lements of sales of quite distant properties, even those with different mineral content, may be comparable in an economic or market sense when due allowance is made for variables."[19]

I have found this to be useful in my personal experience, particularly in valuing the mineral estate when no specific mineral potential has been identified or for which such potential is believed to exist but for which exploration and quantification is lacking. It is worth noting that the selling price of mineral interests for which no specific potential has been identified tend to remain relatively constant within a fairly narrow range over time and across broad geographic areas.

One final comment worth noting in Section D-11 regarding the Sales Comparison Approach to Value involves the selection of the appropriate unit of comparison used by participants in the market, noting that:

> "However, arriving at a valuation by multiplying an assumed quantity of mineral reserves by a unit price is almost universally disapproved by the courts."[20]

In my experience, it appears that this comment is a reflection of efforts in many instances at utilizing the anticipated price of the extracted mineral as the comparable, not the price that someone was willing to pay for title to the mineral in the ground.

Section D-11 addresses the use of the **Income Approach to Value** in some detail. The Standards recognize that the most appropriate method involves yield capitalization, typically a discounted cash flow (DCF) analysis. The Standards further state that:

> "The income that may be capitalized is the royalty income, and not the income or profit generated by the business of mining and selling the mineral. For this reason, the income capitalization approach, when applied to mineral properties, is sometimes referred to as the *royalty income approach*.[21]

This limitation to the use of royalty does not recognize the value of the *right to mine* that may be held by the operator of a mineral property by virtue of either ownership or by virtue of holding a *leasehold estate*, a topic that is addressed in Section D-12 and which is addressed further in this presentation.

The Standards also caution the appraiser to avoid estimating value to a specific owner (which constitutes *investment value*) as opposed to the value of the appraised property if placed for sale on the open market. This is a distinction that appraisers are frequently required to confront and overcome in dealing with their clients in condemnation and taking proceedings, with said clients insisting that it is "their" value that is to be considered, rather than the rather amorphous concept of market value.

The final paragraph in Section D-11 addresses (and recognizes) that one of the most critical factors in the use of the DCF method is the selection of the discount rate.[22] As any experienced mineral appraiser knows, this is frequently the ultimate battleground in gaining acceptance of the estimate of market value developed by use of a discounted cash flow method.

The one short paragraph above does not do justice to the factors involved and the pros and cons of alternative discount rate selection processes, but does impart what I believe to be the guiding principle in selecting discount rates, and that is that they must be "[…] derived from and supported by direct market value."[23] This topic alone is sufficiently complex to warrant an entire presentation.

LEASEHOLD ACQUISITION

When a lease is entered into regarding any portion of the rights for a parcel of real property, two estates are created—the *leasehold* (held by the lessee) and the *leased fee* (held by the lessor). Section D-12 of the Standards addresses the acquisition of the **leasehold estate**

For purposes of my discussion that follows, leases are differentiated into two types—ground and/or space leases by which the lessee either occupies the surface or specified space within a building, and mineral leases, which convey the *right to mine* (that is, to extract) for a specified mineral to the lessee.

In Section D-12, the acquisition of a leasehold estate by the federal government addresses a ground and/or space leases by which the government will occupy and use the property for a specified period of item under terms specified by the lease.

The more common occurrences that a mineral appraiser will face are those instances in which the federal government is acquiring title to the mineral estate (whether by the direct taking of the mineral estate or by the taking of the fee simple estate), after which the leased fee estate will be extinguished. Compensation to the holder of the leased fee estate (that is, the owner of the estate) is recognized in this circumstance, with the Income Approach to Value being the accepted technique. Value with this technique is based on the present worth of the projected loss of future royalty payments.

What is more problematic is the effort to obtain compensation for the holder of the leasehold estate (that is, the entity engaged in the extraction of the mineral estate). It is at this point that the distinction between the holder of a ground and/or space lease and that of a mineral lease becomes blurred.

Typically, leasehold estates in condemnation are treated as if they were commercial or industrial leases, with the compensation paid to the lessee essentially being the difference between contract rent and market rent. Compensation is thus required when the rental cost to replace the lease with another for a property of equal utilization exceeds the rental cost in the lease being taken. This anticipates that a business or other commercial activity is being forced to relocate and bases compensation on the increased cost to the lessee of gaining new space. Case law and practice are well established that the holder of the leasehold estate is not entitled to compensation for the loss of profits arising from the taking (that is, *businessman's profits*).

The difference between *businessman's profits* and the value of the right to mine has been recognized at the federal level in a number of instances, two of which are worth citing. In the first, a case styled Jack S. Foster, et al. v. The United States and tried in the late 1970's, it was affirmed in a subsequent opinion[24] that:

> "The property interest …to be valued in these proceedings on remand, is the plaintiff's leasehold interest, sometimes termed "operator's interest" or "working interest."

The opinion further states that:

> "The property to be valued is the entire mineral interest in the right to extract and remove dolomite from a specific site."

That the value of the loss of the right to extract (that is, the right to mine) does not equate to *businessman's profits* is affirmed further in the opinion as follows:

> "The value placed on an operator's interest is not compensation for the consequential damages of lost future business profits; it is compensation for the taking of an interest in real property."

In the second instance, a case filed in 1983 styled Whitney Benefits, Inc. ("Whitney"), et al. v. The United States, an inverse condemnation involving coal was alleged arising from the provisions of the Surface Mine Control and Reclamation Act of 1977. In this circumstance, the leased fee estate was owned by Whitney and the leasehold estate was owned by Peter Kiewit Sons' Co. ("Kiewit").

Plaintiffs' estimate of value was established using discounted cash flow methodology to estimate the present value of a forecast cash flow to be received from the development by Kiewit of the coal rights owned by Whitney.

In response, it was the U.S.'s position that this was an inappropriate attempt to determine fair market value based on the capitalization of business profits. In this response, the U.S. relied on a case involving General Motors,[25] stating the DCF method was not permitted because it included a component of value attributable to the leasehold owned by Kiewit and thus included the value of "lost profits." In further support of its position, the U.S. cited a case involving Cloverport Sand & Gravel Co.,[26] the following portion of which was cited in the Whitney opinion:

> "The Court must draw a distinction between the capitalization of income generated by the property itself and income derived from a business conducted on the property. Federal courts have frequently criticized and rejected valuations based on the capitalization of profits as being uncertain and speculative. Profits derived from business activities depend to a greater extent upon the amount of capital invested and the good fortune, business skill and management with which the business is conducted than upon the land itself."

In its valuation, the U.S. presented two estimates of value derived from forecasts of royalties to be received by Whitney, thus valuing only the leased fee estate owned by Whitney to the exclusion of the leasehold estate owned by Kiewit. In his opinion in the Whitney Benefits case, Judge Smith of the U.S. Claims Court noted as follows in this regard:

> "This is clearly a misapplication of eminent domain law. This is not a lost profits case. This case involves coal reserves, the value of which can be measured only by their ability to produce income. Simply stated, an operator's interest in a mineral estate is a compensatory property interest."

Accordingly, the Court in Whitney rejected the U.S.'s position that the inclusion of Kiewit's leasehold estate was inappropriate and proceeded to make its award on this basis.

This distinction is not applicable for the vast majority of mineral leases, with the rights granted under the lease being the right to extract and physically remove a portion of the real property interests, whether some portion of the surface or some portion of the subsurface. Such an operation differs from the conduct of a business enterprise on the surface or within occupied space that can simply be relocated to another site. The mineral appraiser is well advised to become familiar with case law in this regard and with the techniques that have been used to obtain compensation for value of the loss of the right to mine.

In this regard, the *residual technique of reserve valuation* has long been used (or attempted to be used) in placing a value on the right to mine distinct from any incremental difference between contract rent and market rent. This technique has not always been accepted by the courts, but is a longstanding technique for valuing the mineral estate in some states for the purpose of assessing *ad valorum* property taxes.

With the evolution of increasingly complex financial reporting standards, the residual technique is no longer recognized as adequately apportioning value to the mineral estate, in that it typically subtracts the value of non-mineral bearing property and improvements, plant and equipment, certain intangible assets such as above-market sales contracts, and working capital from the business enterprise value that has been developed and allocating the remaining value (that is, the *residual)* to the mineral estate or to the reserves being extracted.

With this approach, the contribution of the various asset categories to the value of the business enterprise are thus implicitly assumed to reflect only the cost to replace them without regard to the financial return that should be expected from their use. Under current financial reporting standards, the approach in more common use is the *multi-period excess earnings method*, by which an implicit return is credited to each asset category before subtracting from the business enterprise value.

A mineral appraiser who intends to use some variation of the development of a business enterprise value in the course of appraising a mineral interest is well advised to become familiar with this technique and to incorporate it into any effort to use the residual-type technique in allocating value to the mineral estate, since it can be argued that this is the approach used by the market.

The successful use of a residual approach to valuing the mineral estate is fraught with difficulties in any circumstance in federal condemnations and takings because of the long-standing proscription against the inclusion of businessman's profits in the determination of just compensation, notwithstanding the case law cited above. Attempting to explain the difference between profits to be made from the operation of a business in a factory or in office space (which business arguably can be equally well-run at some other location) with those derived from the extractive process (which cannot simply be packed up and moved) is a considerable challenge, and one that makes mineral appraising such an intellectually rewarding effort.

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[1] *Uniform Appraisal Standards for Federal Land Acquisitions (2000),* Foreword
[2] *Ibid*, p.30
[3] *Ibid.* p.30
[4] *Ibid.* pp 30 - 32
[5] *Florida Rock Industries, Inc.* v. *United States,* 18 F.3d 1560, n.12 (Fed. Cir. 1994)

[6] *Florida Rock Industries, Inv.* v. *United States*, 791 F.2d 893, 903 (Fed. Cir. 1986)
[7] *Uniform Appraisal Standards for Federal Land Acquisitions (2000)*, p. 32
[8] *Ibid.* p. 37
[9] *Ibid.* p. 39
[10] *Ibid.* p.39
[11] *Ibid.* p. 39
[12] *Ibid.* p. 41 ff.
[13] *Ibid*. p. 42 (internal citation omitted)
[14] *Ibid*. p. 44
[15] *Ibid.* p. 95
[16] *Ibid.* p 95 (internal citation omitted)
[17] *Ibid.* p. 96 (internal citation omitted)
[18] *Ibid.* p. 96 (internal citation omitted)
[19] *Ibid.* p. 96 (internal citation omitted)
[20] *Ibid.* p. 97 (internal citation omitted)
[21] *Ibid.* p. 97
[22] *Ibid*. p. 98
[23] *Ibid.* p. 99 (internal citation omitted)
[24] *Foster v. United States*, 2 Cl. Ct. 426 (1983)
[25] *United States v. General Motors Corp.*, 323 U.S. 373, 89 L. Ed. 311, 65 S. Ct. 357 (1945)
[26] *Cloverport Sand & Gravel Co. v. United States*, 6 Cl. Ct. 178, 191 (1984)

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