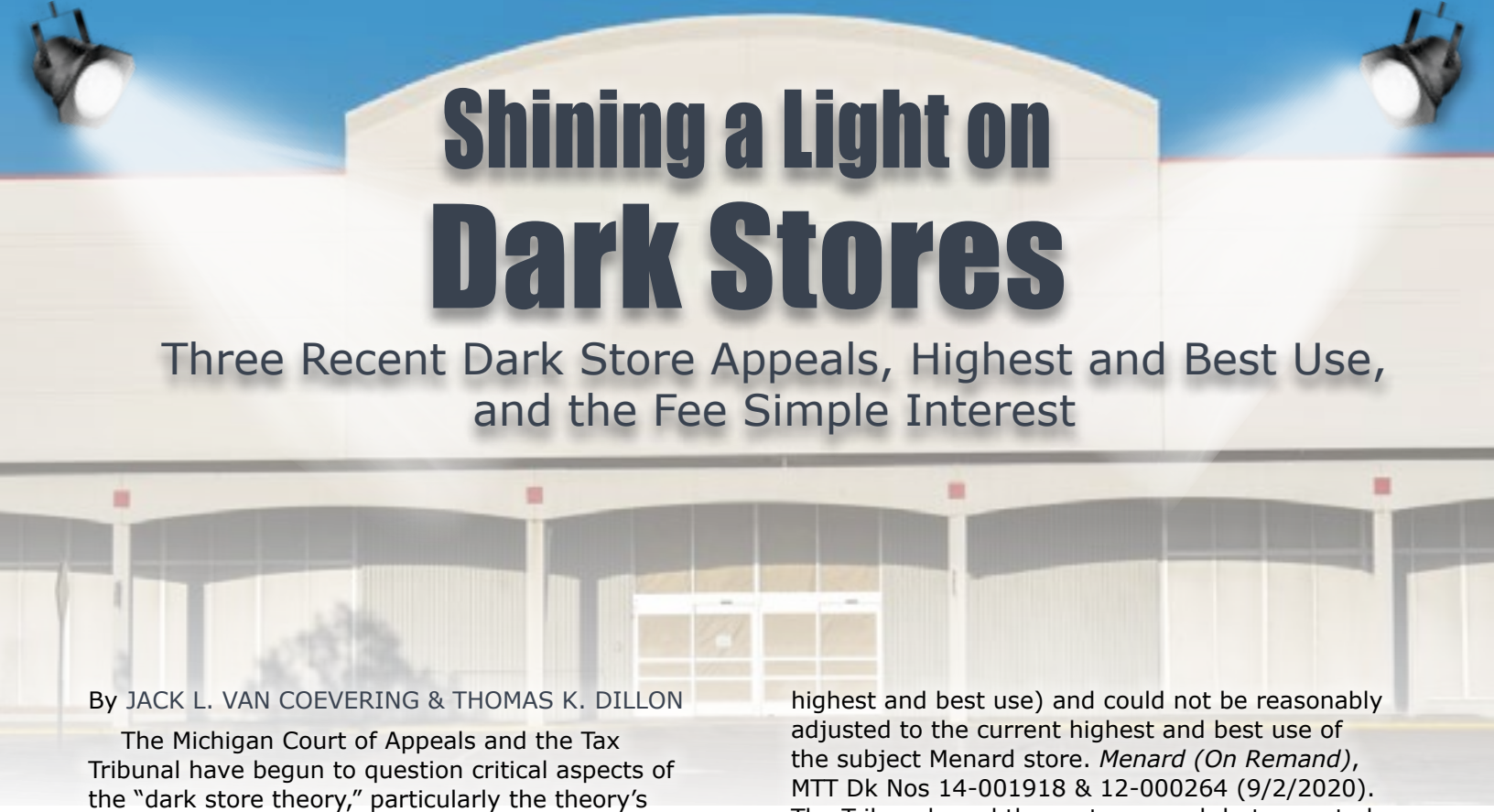

Shining a Light on Dark Stores

Three Recent Dark Store Appeals, Highest and Best Use, and the Fee Simple Interest

By JACK L. VAN COEVERING & THOMAS K. DILLON

The Michigan Court of Appeals and the Tax Tribunal have begun to question critical aspects of the "dark store theory," particularly the theory's required use of vacant stores as comparable sales and leases and its theoretical rejection of the cost approach.[1] Two recent cases illustrate the trend. A third highlights fundamental legal questions to be answered on appeal.

In *Menard Inc v City of Escanaba, 315 Mich App 512, 529; 8981 NW2d 1 (2016), lv app den*, 501 Mich 899 (2017), the Court of Appeals reversed the Tribunal (Tribunal Member Abood) and held that big box stores must be valued at the stores' "highest and best use" as a first-generation big box store and not valued by reference to sales of vacant properties sold for redevelopment in a secondary market use. The Court noted that the big box retail industry's use of anti-competitive deed restrictions on big box stores prevented the sales of stores at their original use. The Court of Appeals required the Tribunal to consider the use of the cost approach if the sales of other big box stores did not reflect the big box store's current first generation use.

On remand from the Court of Appeals, the Tribunal (Tribunal Members Enyart and Gadola) determined that even though deed restrictions had little market impact, the sold properties presented were not comparable because they were redeveloped for a secondary market (a different highest and best use) and could not be reasonably adjusted to the current highest and best use of the subject Menard store. *Menard (On Remand)*, MTT Dk Nos 14-001918 & 12-000264 (9/2/2020). The Tribunal used the cost approach but accepted Menard's substantial obsolescence factor of 60%, encompassing both functional and economic obsolescence, through a comparison to sales of vacant property. The Tribunal's decision has been appealed, in part because the Tribunal determined that the legal definition of "fee simple" ownership in Michigan does not apply to properties under lease and used sales of vacant properties to determine a functional obsolescence deduction for an occupied store.

In broad respects the recent Menard decisions (from the Court of Appeals and the Tribunal on remand) confirm Michigan's long-existing treatment of big box stores in the Michigan Court of Appeals. In two earlier big box cases involving Meijer stores – *Thrifty Royal Oak v City of Royal Oak*, 130 Mich App 207; 344 NW2d 305 (1984) and *Meijer Inc. v City of Midland*, 240 Mich App 1; 610 NW2d 242 (2000) – the Tribunal and the Court of Appeals agreed that no comparable sales existed because the sales were distressed or were insufficiently comparable and did not serve as reliable benchmarks. Both cases affirmed the use of the cost approach when no comparable sales or leases existed with the subject property's highest and best use. A recent Tribunal decision involving Meijer confirms this precedent.

1 *See* Stephen F. Fanning, "Highest and Best Use and Property Rights--Does it Make a Difference?" Appraisal Journal (Summer 2018), 171-172. The "dark store theory" for valuing big-box retail property asserts that big box stores be valued as vacant and available for a secondary market use (i.e., not the original use as a big box store). The "assumed vacant and available" big box store is valued by comparison to sales of vacant stores and the store's potential income value is determined with reference to vacant stores that have been re-leased for secondary use. "Dark store theory" rejects the cost approach. By contrast, the traditional way of valuing big box properties has been to use the same three valuation methods used to value other commercial properties, such as an apartment or office buildings. The traditional methods rely on sales of comparable properties whether or not the properties were sold with lease using market rental rates to adjust for sales of existing leased or occupied stores. The cost approach is also used and adjusted to the current highest and best use.

Meijer v City of Flat Rock (16-001205, FOJ issued 9/30/2021)

In valuing a brand new 157,352 square foot Meijer, the Tribunal (Tribunal Member Enyart) rejected all comparable sales and leases submitted by Meijer and the City. The Tribunal instead relied entirely on the cost approach and found no meaningful obsolescence. The Tribunal reached a value per square foot that is close to the replacement cost new, approximately $102 per square foot (including both the Meijer store and convenience store). In reaching this conclusion, the Tribunal emphasized that the highest and best use must be consistently applied to each valuation method, reasoning that the highest and best use provides the basis for competitive supply and demand factors in the market and for the research and analysis of comparable sales.

The Tribunal gave no weight to the sales comparison approach from either party. The Tribunal found that the sales presented involved substantially older properties than the subject Meijer. Old, vacant stores sold for second generation use were not, according to the Tribunal, comparable to a new, occupied building. In recognizing the store's occupied status, the Tribunal noted approvingly that Respondent adjusted sales of vacant property upward to account for the different economics.

The Tribunal also rejected the income approach because the comparable leases were not comparable to the store's highest and best use. The Tribunal explained that because the subject was occupied, the risk with vacant comparable properties in finding a tenant did not exist with the subject. Whether or not an income approach might be valid, the leases presented were not comparable as they were mostly old junior box stores not new big box stores.

Consistent with *Menard*, the Tribunal relied on the cost approach and rejected Petitioner's claim that the new building was 74% obsolete immediately after construction, finding that the sales used to determine obsolescence were substantially older and not comparable built-to-suit properties. While Petitioner's comparable sales, according to the Tribunal, might reveal external obsolescence for older buildings, they revealed no adverse market impacts on a brand-new store. The Tribunal found no functional obsolescence because the store had functional utility, which the Tribunal explained was not undermined by the mere fact that a different retailer might renovate the property to fit its branded image. For example, while facade and color scheme may matter to an individual retailer, those aspects are not properly characterized as functional obsolescence when the property, as built, is fit for use as an owner-occupied freestanding big box store.

The Tribunal's decision regarding obsolescence seems to be an evolution from the same Tribunal Member's decision in *Menard* on remand. The Menard store in Escanaba was a brand new store that was only 3 years old when appealed. Yet the same single obsolescence calculation method rejected in *Meijer v City of Flat Rock* was accepted in *Menard (After Remand)* at the remand hearing.

Walmart v City of Bad Axe (19-001078, FOJ issued 9/27/2021)

This appeal involved a 184,435 square foot, owner-occupied Walmart store in the City of Bad Axe that was built in 2003. The Tribunal Member (Tribunal Member Abood) concluded to a true cash value of $4,270,000 ($23 psf). Much like the Tribunal Member's original decision in Menard that the Court of Appeals reversed, his recent decision in *Bad Axe* is largely identical to the reversed analysis: reliance on comparable sales and leases of vacant second-generation property and acceptance of an immediate combined 58% deduction for both functional and economic obsolescence.

The decision is remarkable because it strives to explain why, in the Tribunal Member's opinion, big box property must be valued as vacant. The central issue identified by the Tribunal and discussed throughout the decision is the Tribunal Member's conclusion that the legal definition in Michigan of "fee simple" excludes any property with a lease and that a fee simple transfer of property must be of vacant property without tenants. This issue obscured any of the typical analysis outlining the comparable properties considered and analyzing whether each property is comparable and, importantly, in light of *Menard*, whether the comparable sales and leases reflected the same continuing highest and best use of an occupied big box store.

The parties offered similar highest and best use conclusions. Walmart determined that both "owner/users and developers" were likely buyers, noting that 52% of big box purchasers were investors (purchasing an existing big box store with a lease in place). The City agreed, noting that the highest and best use was a continuation of the current use and that probable market participants were either "a user-owner or a user-tenant." For this reason, the parties used the sales comparison and income approaches. Indeed, Walmart leases a number of properties in which it operates a big box Walmart store in addition to those properties that it owns and occupies.

The Tribunal recognized that there is a *much larger market* for big box stores sold with a lease in

place (sales to investors) than big box stores sold without a lease (owner-users). Yet, as a matter of principle, the Tribunal refused to consider the entire market of sold big box stores, reasoning that sales of leased big box stores may not be considered because the legal definition of fee simple requires properties to be "unencumbered" by a lease (i.e., vacant) and further reasoning that the big box leases were "build to suit," developed and leased to a specific big box lessee. Of Walmart's comparable sales and leases, all were vacant at the time that they were marketed for sale or lease.

Unlike the Tribunal Member in the Flat Rock decision, who concluded that the property, if sold at its current highest and best use, had functional utility and was not functionally obsolete, the Tribunal Member in *Walmart v City of Bad Axe* determined that big box stores require substantial conversion whenever purchased, i.e., sold, for a different use and that big box stores are immediately obsolete once constructed. A similar rationale underlies the *Walmart v City of Bad Axe* Tribunal Member's categorical rejection of "built to suit" leases, reasoning that these leases reflected Walmart's use but did not examine whether that use had functional utility. The cost of construction, according to the Tribunal, does not equal value. This finding is contrary to the Court of Appeals' holding in *Menard*, which required use of the cost approach precisely because there was a limited market of big box store sales.

In accepting Petitioner's sales comparison approach, the Tribunal utilized several comparable building "sales" that other Tribunal Members rejected in both the *Menard (After Remand)* and in *Walmart v City of Flat Rock*. Some of these comparable sales have also been rejected in other cases because of their age, differences in market and because the buildings sold for second generation use – a different highest and best use than the continuation of the subject's use as big box retail. Though the Tribunal recognized that the Walmart store was occupied, no adjustment was made to account for the comparable properties that were vacant, dark properties. Contrary to the *Flat Rock* decision, in which the Tribunal approvingly noted that an upward adjustment to vacant properties was made because the Meijer store was occupied, the Tribunal Member in *Bad Axe* made the reverse adjustment: adjusting the income approach to account for vacancy in the Walmart store even though the Walmart was occupied.

Conclusion

Both recent Tribunal decisions will be appealed to the Michigan Court of Appeals, joining *Menard Inc v City of Escanaba* (After Remand), COA Dk No. 325718, which is currently in the Court of Appeals awaiting oral argument and decision.

Michigan appellate court decisions are binding on all other courts if the decisions are published. The Court of Appeals' decision in *Menard Inc v City of Escanaba* remains published, undisturbed precedent. Much of the Court of Appeals' decision in *Menard* touches on different aspects of highest and best use, such as a marketability analysis of the current use as a foundation for the four-part highest and best use and the financial feasibility test of other possible uses. Highest and best use presents three alternative HBU conclusions for improved property: (1) demolish the existing improvements and redevelop the site; (2) convert, renovate, or alter the existing improvements to enhance the current use or change the use; and (3) retain the exiting improvements and continue the current use.[2] For the first two conclusions, the cost of conversion "must add at least as much value to the property as it costs. In other words, the value after conversion, renovation, or alteration less the cost of modification must be greater than or equal to the value of the property as is."[3] The Court of Appeals correctly noted that sellers do not determine highest and best use, buyers do.

In *Menard*, the Court of Appeals recognized that the Tribunal's highest and best use conclusion was to continue the big box store's current use. It found error in the Tribunal's use of properties sold for conversion because, "[g]iven the need to convert, the buyers would necessarily pay a lower price."[4] The lower price demarcates a different market and a different highest and best use: "although there is evidence of a market for big box stores when they are sold for secondary purposes, there is limited evidence about whether there is a market for big box stores at the subject property's HBU."[5] There is ample evidence of the subject property's highest and best use but few first-generation sales. Since the HBU conclusion was continuation of the current use, the Court of Appeals determined that comparable sales must reflect the current use, rejecting sales that required redevelopment for a different use that were sold to "secondary users who are required to invest substantially in the buildings to convert them into other uses."[6]

2 The Appraisal of Real Estate (Chicago: 14th ed. 2013), 345.
3 The Appraisal of Real Estate, pp. 346-347.
4 *Menard*, at 525.
5 *Menard*, at 527.
6 *Menard*, at 526, 527, 531.

On remand, the Tribunal applied this distinction by concluding that the comparable sales did not reflect the highest and best use as a continuing first-generation big box store. On appeal, the City of Escanaba maintains that the panel erred by using converted, demolished and old junior box stores as a basis for an unspecified 60% obsolescence deduction. The Tribunal's calculation compared a first generation built-to-suit property to formerly comparable, vacant properties leased in a non-competitive second-generation market. The *Meijer v City of Flat Rock* decision followed the Court of Appeals' conclusions, rejecting all comparable sales and leases as not comparable to a new big box store. The Tribunal in *Meijer v City of Flat Rock* rejected a claim of functional obsolescence because it could not find any item of obsolescence that would be supported by a 74% obsolescence deduction based on non-comparable sales and properties.

In stark contrast, the Tribunal's discussion of comparable sales and leases in *Walmart v City of Bad Axe* is opaque without any significant factual discussion and a review of the Petitioner's appraisal reveals entirely secondary market sales requiring conversion and redevelopment. Its calculation of obsolescence used a similar comparative sales method, one that the Court of Appeals questioned in *Menard Inc v City of Escanaba* – both by the Court of Appeals and raised by Escanaba in the appeal after remand – to conclude to a 58% obsolescence factor based on sales of converted and secondary market properties. As used by the Tribunal, the cost approach becomes largely a derivative mathematical exercise, in which, regardless of replacement cost new, land value and physical depreciation, the Tribunal's methodology's percentage obsolescence reduces the cost to the same final value.

A significant twist in *Walmart v City of Bad Axe* is the Tribunal's lengthy discussion of the *legal* rationale for rejecting the investor market because the Tribunal Member believed that sales to investors do not meet the legal standard of a fee simple transfer. The Tribunal concludes that its definition of fee simple, excluding any rental properties or investor-owned properties, is statutory. The fee simple issue was also appealed by the City of Escanaba following the remand hearing in *Menard Inc v City of Escanaba* (After Remand), COA Dk No. 325718.

The definition of "fee simple" (*see* MCL 554.2) existed when the General Property Tax Act was enacted in the 1890s. Michigan courts construed the term to mean "an estate in, and individual ownership of, real property, *without any limitation* as to duration, disposition, or descendability." *Rathbun v State*, 284 Mich 524 (1938) (emphasis added). In Michigan, the fee simple estate includes leased property. *Winter v State Hwy Commr.*, 376 Mich 11; 135 NW2d 364 (1965). This statutory and common law definition is consistent with Black's Law Dictionary and has remained unchanged by Michigan courts. The existence of encumbrances (for example, possession by a renter or lessee) does not affect the fee simple ownership interest or the owner's ability to convey the fee simple interest. *Darr v First Federal Sav & Loan Ass'n.*, 426 Mich 11; 393 NW2d 152 (1986). This definition and construction of fee simple existed when the definition of "true cash value" was written into statute, MCL 211.27. In both the *Menard* remand hearing and the *Walmart v Bad Axe* decision, the Tribunal rejected Michigan's longstanding legal definition in favor of the fee simple definition espoused in *The Dictionary of Real Estate Appraisal*, which defines fee simple as, in pertinent part: "Absolute ownership unencumbered by any other interest or estate."

The Dictionary of Real Estate Appraisal definition of fee simple can be traced back to its first edition in 1984 and has since undergone multiple different amendments, including the new requirement that the property be "unencumbered."[7] The non-attorney drafters of *The Dictionary of Real Estate Appraisal* had no intention of changing the common-law definition of fee simple.[8] The recent interpretation that the owner must have possession to convey a fee simple is also debated. None of the restatements were adopted by Michigan courts, nor have Michigan courts rejected Michigan's long-standing common law definition for the definition found in the *Dictionary of Real Estate Appraisal*. Instead, the Michigan Legislature recognized a traditional method of valuing investor property by requiring an evaluation of whether rent should be contract rent or market rent. MCL 211.27 (5).

Faced with exactly this decision between a state's longstanding common law definition and the non-legal definition from the *Dictionary of Real Estate Appraisal*, the Ohio Supreme Court held, in *Meijer Stores LTD Partnership v Franklin Cty. Bd. of Revision*,[9] that:

> The appraisal industry uses the term "fee simple" to refer to unencumbered property—or to

7 See the attached *History of Fee Simple*.
8 At the *Menard* remand hearing, Peter Korpacz, who chaired the Appraisal Institute committee that wrote the definition of fee simple for the first edition of *The Dictionary of Real Estate Appraisal*, testified that the committee intended only to modernize the definition and to keep the definition consistent with *Black's Law Dictionary*.
9 *Meijer Stores Ltd. Partnership v Franklin Cty. Bd. of Revision*, 122 Ohio St. Ed 447; 912 N.Ed.2d 560 (2009).

property appraised as if it were unencumbered. This distinction is not one recognized by the law.[10]

The Ohio Supreme Court also rejected the Tribunal's assertion in *Walmart v City of Bad Axe* that owner-occupied property could not be compared to sales of big box rental property. The Ohio Supreme Court reasoned that while the Meijer property was not "encumbered with a lease," nothing prevented Meijer from leasing the property to realize its income potential.[11]

A fair reading of the Court of Appeals' published decision in *Menard Inc v City of Escanaba* suggests that comparing an owner-occupied big box store in a thriving market to a vacant building sold for a second-generation use is a confusion of two different highest and best uses. All three cases agree that the highest and best use of the big box store is continued current use of a built-to-suit property. Recent Tribunal decisions provide further insight: sales of rented, built-to-suit big box properties exist. The Tribunal in *Meijer v City of Flat Rock* was not presented with those sales, noting that the comparable sales were not comparable to the subject build-to-suit property. The Tribunal in *Walmart v City of Bad Axe* rejected the built-to suit market for a secondary market premised on a legal determination that rental property is not owned in fee simple and that big box properties must be evaluated as if vacant. The forthcoming appeals of *Menard Inc (After Remand)*, *Walmart v City of Bad Axe*, and *Meijer v City of Flat Rock* will provide answers to some or all of these questions.

10 *Meijer Stores Ltd. Partnership v Franklin Cty. Bd. of Revision*, fn 4.
11 *Meijer Stores Ltd. Partnership v Franklin Cty. Bd. of Revision*, at 452-453.

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Tom is a senior associate at Foster Swift Collins and Smith and specializes in State and Local Tax. Tom assisted at the remand hearing in *Menard Inc v City of Escanaba* (*After Remand*), COA Dk. No. 325718. Tom has also worked with Jack in defending local governments from "dark store" appeals.

History of Fee Simple Definitions

Appraisal Terminology (1938)
absolute fee simple. The largest possible interest or esttate in property, subject, however, to the limitations of Eminent Domain, Escheat, Police Power, and Taxation. An inheritable estate.

Appraisal Terminology and Handbook (1954)
fee simple. An absolute fee: a fee without limitation to any particular class of heirs or restrictions.

Appraisal Terminology and Handbook (1962)
fee simple. An absolute fee; a fee without limitations to any pañicular class of heifs or restrictions, but subject to the limitations of eminent domain, escheat, polic power, and taxation. An inheritable estate.

Appraisal Terminology and Handbook (1967)
fee simple. An absolute fee; a fee without limitations to any particular class of heirs or restrictions, but subject to the limitations of eminent domain, escheat, polic power, and taxation. An inheritable estate.

Real Estate Appraisal Terminology (1975)
fee simple. An absolute fee; a fee without limitations to any particular class of heirs or restrictions, but subject to the limitations of eminent domain, escheat, polic power, and taxation. An inheritable estate.

Real Estate Appraisal Terminology, Revised Edition (1981)
fee simple. An absolute fee; a fee without limitations to any particular class of heirs or restrictions, but subject to the limitations of eminent domain, escheat, polic power, and taxation. An inheritable estate.

The Appraisal of Real Estate, Eighth Edition (1983)
A person owning all of the rights is said to have fee simple title. Fee simple title is regarded as an estale without limitations or restrictions.

The Dictionary of Real Estate Appraisal (1984)
fee simple estate. Absolute ownership unencumbered by any other interest or estate; subject only to the limitations of eminent domain, escheat, police power, and taxation.

Real Estate Appraisal Terminology, Revised Edition (1984)
fee simple. An absolute fee; a fee without limiations to any particular class of heirs or restrictions, but subject to the limitations of eminent domain, escheat, police power, and taxation. An inheritable estate.

The Appraisal of Real Estate, Ninth Edition (1987)
A person who owns all the property rights is said to have fee simple title. A fee simple estate implies absolute ownership unencumbered by any other interest or estate.

The Dictionary of Real Estate Appraisal, Second Edition (1989)
fee simple estate. Absolute ownership unencumbered by any other interest or estate subject only to the four powers of government.

The Appraisal of Real Estate, Tenth Edition (1992)
A person who owns all the property rights is said to have fee simple title. A fee simple estate implies absolute ownership unencumbered by any other interest or estate.

The Dictionary of Real Estate Appraisal, Third Edition (1993)
fee simple. Absolute ownership unencumbered by any other interest or estate; subject only to the limitations imposed by the govermental powers of taxation, eminent domain, police power, and escheat.

The Appraisal of Real Estate, Eleven Edition (1996)
A person who owns all the property rights is said to have fee simple title. A fee simple estate implies absolute ownership unencumbered by any other interest or estate.

The Appraisal of Real Estate, Twelfth Edition (2001)
The most complete form of ownership is title in fee. Such ownership establishes an interest in real property known as fee simple interest--i.e., absolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by the governmental powers of taxation, eminant domain, police power, and escheat.

The Dictionary of Real Estate Appraisal, Fourth Edition (2002)
fee simple estate. Absolute ownership unencumbered by any other interest or es:ate, subject only to the limitations imposed by the governmental powers of taxation, eminent domain, police power, and escheat.

The Appraisal of Real Estate, Thirteenth Edition (2008)
The most complete form of ownership is the fee simple interest--i.e., absolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by the govermental powers of taxation, eminant domain, police power, and escheat.

The Dictionary of Real Estate Apprnisal, Fifth Edition (2010)
fee simple estate. Absolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by the govermental powers of taxation, eminent domain, police power, and escheat.

The Appraisal of Real Estate, Fourteenth Edition (2013)
The most complete form of ownership is the fee simple interest--i.e., absolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by the governmental powers of taxation, eminant domain, police power, and escheat.

The Dictionary of Real Estate Appraisal, Sixth Edition (2015)
fee simple estate. Absolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by the governmental powers of taxation, eminent domain, police power, and escheat.

Source: Complied by Michael McKinley, AI staff member