

Appraisal/Commercial Lease: Washington Appellate Court Addresses Impact of Soil Contamination on Rental Calculation



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The Court of Appeals of Washington (Division 1) (“Court”) addressed in an October 12th opinion whether the appraised value of a commercial property should have included the presence of soil contamination. See *Thomas Center Owners Association v. The Robert E. Thomas, Trust, et al.*, 2020 WL 6036828.

The appraisal was being undertaken in accordance with a lease provision providing for the calculation of monthly rental.

A condominium owners’ association (“Association”) is a party to a ground lease (“Lease”) with the Robert E. Thomas Trust (“Trust”). The lease provided for a monthly rent adjustment every 10 years using an appraisal process. The monthly rental was calculated to be:

. . . an amount equal to six (6%) per cent per space per annum of the appraised fair market value of said leased premises. . . the amount so determined by an appraisal . . .

The Association and the Trust jointly appoint one appraiser. If they are unable to agree on one appraiser, then each shall appoint an appraiser and those two shall appoint a third appraiser. They will then calculate a fair market value binding upon the parties.

In 2013 the parties appointed Peter Shorett (“Shorett”) as appraiser to determine the new rent effective September 1, 2013. Shorett appraised the land at \$5.5 million. He included in the appraisal report a limiting condition noting no hidden or unapparent conditions of the property such as asbestos, soil contamination or unknown environmental factors. Shorett subsequently stated that additional information caused him to increase his valuation to \$6.6 million which the Association did not accept.

The Trust learned in 2014 that a property across the street (“Hadley Property”) from the leased premises was contaminated by Tetrachloroethylene (“PCE”). A report prepared for a previous owner of the Hadley Property indicated that a drycleaner had operated on the Thomas property in the late 1960s and 70s. This determination stated that it was a recognized environmental condition which is defined as:

. . . the presence or likely presence of any hazardous substances or petroleum products on a property under conditions that indicate an existing release, a past release or the material threat of a release of any hazardous substances or petroleum products into structures on the property or into the ground, groundwater or surface water of the property.

The Trust undertook investigative testing at the Thomas property and confirmed the presence of PCE. The owners of the Hadley Property subsequently filed suit against the Association, the Trust and other parties for offsite contamination.

The Association asserted that the lease appraisal process could not proceed until the contamination issue was resolved. It sued the Trust seeking a declaratory judgment that:

- It had no liability related to the contamination, and
- An injunction enjoining the re-evaluation of the lease rent until the nature and extent of the contamination and remediation liability had been determined.

The trial court granted partial summary judgment requiring the Association to participate in the appraisal process.

The Trust and Association each appointed appraisers. The appraisers then appointed a third appraiser ("Brackett").

In 2017 Brackett informed the parties' counsels that the appraisers were close to completing the work without additional information about the contamination issue. The appraiser asked if they would receive further guidance or information on the contamination issue.

The Trust's counsel suggested to Brackett that the appraisers:

1. Complete the appraisal analysis of the Thomas Center Property, as unimpaired as of the required appraisal date. Just so that task is done.
2. Place an interim hold on the appraisal valuation of the property, as impaired, as of the appraisal date, pending completion of further studies and information which are now commencing...
3. When your group is ready to prepare a final report, we request that the report be prepared in "DRAFT" form and that we and our clients have a reasonable opportunity to review, comment, question the report before your group prepares a final report.

NOTE: For the sake of caution, I want to reiterate my position that as of the appraisal date, the contamination which has been there [for] decades was not known to the parties and [therefore] is not a relevant factor in valuation. I understand that Chris disagrees and that your group may disagree. I just want to make clear that I have not waived or conceded that point.

The Association informed the appraisers that it did not know when additional information would be forthcoming regarding the contamination.

The appraisers subsequently concluded the fair market value was \$5.5 million as "clean." They further stated that the valuation was made with "ongoing litigation with respect to onsite environmental contamination" and that the best available information indicates that the issue of contamination would become known after the revaluation date. Their appraisal further noted:

With regard to the retrospective receipt of information related to contamination, it is noted that the highest and best use of the property would call for a full investigation of the contamination, and ultimate clean-up. It is standard practice to appraise a property as clean, and then address contamination liability as a separate matter. Typically, when development property such as this sells in the market place, the price of the property is differentiated from the cost of clean-up. The price paid for the property, as clean, is then used to help fund clean-up, presuming the owner is responsible for the cost of clean-up. Typically, relevant funds would be escrowed pending development of the project, and the money used to clean up the site during the development process. In this manner other sources of clean-up funds can be obtained from potentially liable parties, and insurance proceeds, if any.

We reiterate that issues of liability and related impacts to fair market rent will be dealt with in the ongoing litigation, outside of the market rent determination process.

The Association's appraiser did not agree. While he did not dispute the "clean" valuation, he stated not enough information was available to provide an "as is" valuation.

The Association asked the trial court to vacate the appraisal decision. The Trust asked the court to enforce the lease adjustment provision using the appraisal.

The trial court granted the Trust request on summary judgment, finding that the process as completed was not fundamentally wrong.

The Court on appeal noted the two parties' position on fair market value:

- The Association argued fair market value must consider soil contamination
- The Trust argued that the appraisers exercised their professional discretion determining that it was standard practice to appraise a property as clean and then address contamination liability as a separate matter

The Court stated that it was obligated to determine if the appraisers acted in an arbitrary and capricious manner and ignored the terms of the lease by excluding consideration of contamination when determining fair market value. The lease did not define fair market value nor specify a method an appraiser must use to determine it.

Fair market value is defined by the Washington state courts as:

. . . the amount of money which a well informed buyer, willing but not obliged to buy the property, would pay, and which a well informed seller, willing but not obligated to sell it, would accept, taking into consideration all uses to which the property is adapted and might in reason be applied.

The Court characterized the pending issue as an unusual use of an appraisal. It stated that the contamination issue is complex and the applicable law largely undeveloped at the time the lease was written.

The appraisers followed the Uniform Standards of Professional Appraisal Practice ("USPAP") which indicates that appraisals of contaminated properties are sometimes developed on an assumption, while extraordinary, that the property is free of contamination. The USPAP states that a clean appraisal is an acceptable practice under certain conditions.

The December 2018 appraisal report referenced the absence of a Phase I assessment at the renewal date and that the liability issues were unknown and unresolved. The appraisal report reiterated that it was standard practice to appraise a property as clean and that contamination liability can be addressed as a separate matter.

The Court found, because it is standard practice to appraise a property as clean, along with the unusual facts, that the appraisers did not act arbitrarily capriciously when it evaluated the fair market value as clean.

A copy of the Opinion can be downloaded [here](#).