

Compensating compulsorily acquired trade related leases



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In the May 2019 edition of this Journal, we published an article on the Court of Appeal’s decision in *Roads and Maritime Services v United Petroleum Pty Ltd* [2019] NSWCA 41 (*United*). The case was, and remains, significant because it had the effect of substantially narrowing the types of financial costs, including loss of profits, that may be claimed by dispossessed business owners as ‘disturbance’ under sections 55(d) and 59 of the *Land Acquisition (Just Terms Compensation) Act 1991* (*JTC Act*).

We then observed that the implications of some matters dealt with by the Court remained unclear – chief among which was a statement of principle to the effect that the market value of commercial land put to its ‘best economic use’ reflects its capacity to generate a profit in the future. Properly applied, this proposition provides a formula with which to value the overall freehold estate in land, and, consequently, a new perspective on the valuation of leasehold interests. This notion is at first blush complementary to the traditional ‘profit rental’ approach (where the difference between market rent for a comparable property and the passing rent being paid can be quantified and claimed by a dispossessed tenant). Looked at more closely, however, it suggests that in certain circumstances a lease may have market value separate to, and despite, any ‘profit rental’.

The market value of land

United concerned the resumption of a leasehold interest in a service station, terminable on one month’s notice. The lessee made a disturbance claim for the loss of its capitalised profits from the future operation of the service station site. The Court of Appeal considered that such a claim was impermissible because, among other reasons, ‘the financial return for the commercial use of the land’ based on its ‘best economic use’ would ordinarily be reflected in its market value (Basten JA at [20] and [49]). Relevantly, the lessee had apparently eschewed a claim for market value because of the limited tenure of its lease.

His Honour’s observation seems readily applicable to land owned and operated by the same legal person. However, where

Snapshot

- In resumption cases, the NSW Court of Appeal has stated that the market value of commercial land reflects its capacity to generate a profit.
- This principle explains the traditional approach to the valuation of leasehold interests by reference to any ‘profit rental’.
- It also suggests that in certain circumstances a lease may have market value separate to, and despite, any ‘profit rental’.

land is leased, there are two compensable interests in the land to which the principle may be taken to apply.

In support of his view in *United*, Basten JA referred to Payne JA’s judgment in *Moloney v Roads and Maritime Services* [2018] NSWCA 252 (*Moloney*), where Payne JA (Beazley P and Basten JA agreeing) had determined that the ‘market value of the acquired land included the capacity of that land to generate a profit in the future’ (*Moloney* at [99]). In so deciding, his Honour agreed with the trial Judge, Pain J of the Land and Environment Court (*LEC*), who had cited with approval Miller AC’s judgment in *Parfett v Roads and Maritime Services* [2014] NSWLEC 1182 (*Parfett*).

Pain J adopted Miller AC’s discussion of the ‘value’ of land: ‘[T]he value of a particular area of land, at a nominated point in time, can be described, in economic terms, as equal to the present value of all the benefits that will flow from its ownership having regard to its highest and best use’ (*Parfett* at [66]).

Two critical points can therefore be observed. First, the Court in *United* used the term ‘land’ in its ordinary sense to refer to the undivided freehold estate (i.e. the physical land) and not as defined in section 4 of the *JTC Act* (i.e. including an ‘interest in land’). Second, the proposition that the market value of land includes its capacity to generate future profits is qualified. The assessable profits are limited to the financial return capable of being derived from its ‘highest and best use’ or the ‘best economic use’ of the land.

Understood in this way, the principle provides guidance for the assessment of the market value of the freehold estate in all circumstances. It has direct application to section 56(2) of the *JTC Act*, which caps the sum of the market value of all interests in land to the ‘market value’ of the ‘freehold’ (Hodgson JA at [85] in *AMP Capital Investors Limited v Transport Infrastructure Development Corporation* [2008] NSWCA 325). But it also offers an alternate approach to the assessment of the market value of a leasehold estate.

Where the land is leased, the freehold is comprised of the owner’s reversionary interest and the lessee’s leasehold estate.

Where the arrangement is at arm's length, the market value of the freehold is comprised of, and divisible between, the two interests. By corollary, the market value of one of the interests is assessable by deducting from the value of the freehold the market value of the other interest. In this way, the formula explains the traditional approach to the valuation of leasehold interests by reference to any 'profit rental' and exposes circumstances where that method is inadequate.

The 'profit rental' approach

Traditionally in resumption cases, the market value of the lessee's lease has been calculated by capitalising and discounting the 'profit rental', if any, over the unexpired term of the lease.

The 'profit rental' method was endorsed by Isaacs J of the High Court of Australia in *Minister v New South Wales Aerated Water and Confectionary Company Limited* (1916) 22 CLR 56; [1916] HCA 48. In determining the compensation payable to the lessee, Isaacs J concluded that the 'mere value of the tenancy itself' depends on 'the difference between the actual rental paid by him and the improved annual rental that the property is worth... multiplied by the number of years' purchase ... determined by the character of the property and by the length of the term or tenancy' (at p81-82).

The approach has since been consistently adopted by the LEC in several cases, including by Pain J in *McDonald's Australia Limited v Transport Infrastructure Development Corporation* [2006] NSWLEC 796 (at [14]).

Reconciling 'profit rental' with the principle in *United*

The majority of commercial leases concern office, retail, or industrial premises where the 'best economic use' of the land is reflected in its use by the owner as an investment property. In these cases, the land does not hold additional value to the lessee by contributing to the profitability of the lessee's operations on that land. The physical attributes of the premises which make it more desirable to a lessee are a function of the land's 'best economic use' and reflected in the market rent payable for the property. The profits generated by the lessee's business are therefore not part of the revenue flowing from the best economic use of the land. The entirety of the economic benefit of the land is held by the owner and reflected in the rental income stream paid by the lessee capitalised at an appropriate rate.

This is so unless the passing rental is less than market. In such cases, the owner's reversionary interest in the land (measured by capitalising the passing rental stream) is less than the full value of the freehold (measured by capitalising the market rental stream) for the term of the lease. The difference reflects the 'profit rental' and, in these circumstances, the lessee's market value, being its 'share of the full value of the land' (Williams J in *Geita Sebea v The Territory of Papua* (1941) 67 CLR 544 at 559; [1941] HCA 37).

'Profit rental' an insufficient measure of market value

This analysis demonstrates, however, the limits of the 'profit rental' approach. 'Profit rental' is only appropriate as a mea-

sure of the lessee's interest where the best economic use of the land is as an investment property. Where the endeavour undertaken by a lessee represents the best economic use of the land, the value of its lease must also be reflected in the land's capacity to generate profits in the future.

This exception applies directly to a specific category of commercial properties where the business is intrinsically tied to the land. The International Valuation Standards Council ('IVSC') has referred to them as 'trade related' properties, being 'any type of real property designed for a specific type of business where the property value reflects the trading potential for that business' (IVSC, 'The Valuation of Trade Related Property: Discussion Paper') ('IVSC Paper'). They include hotels, service stations and theatres.

Relevantly, the best economic use of such land is the carrying out of a business of the kind to which the land is specifically suited. It is important to note that the subject of the analysis is a hypothetical business of 'a reasonably efficient operator' (IVSC Paper at [9]). It is not to be confused with a valuation of the actual business in occupation, although it is recognised that the difference between these two concepts may in some circumstances be difficult to distinguish.

Applying Basten JA's principle to these cases, the value of the freehold of 'trade related' properties can be calculated by 'capitalising annual maintainable earnings [of the relevant use] at an appropriate discount rate' (*United* at [20]). Where the property is leased and the lessee is carrying out the relevant use, the lessee's 'share of the full value of the land' is reflected in the future maintainable earnings of the land. For the term of the lease, the market value of the owner's reversionary interest in the land is assessable by capitalising the rental payable by the lessee. As with the 'profit rental' approach, the balance of the freehold after deducting the market value of the owner's interest represents, it is argued, the market value of the lease.

This can be expressed in the formula, $LMV = FMV - ORI$, where:

- LMV is the 'leasehold market value'
- FMV is the 'freehold market value' assessed by capitalising the annual maintainable earnings from the best economic use of the commercial land at an appropriate rate for the term of the lease
- ORI is the 'owner's reversionary interest' assessed by capitalising the passing rental paid by the lessee for the term of the lease.

Conclusion

When properly construed, Basten JA's principle in *United* explains the traditional 'profit rental' approach but also identifies its limitations in cases of resumptions of 'trade related' properties where the relevant use is carried out by the lessee. In those cases, it might fairly be said that the principle provides a formula by which the true market value of the lessee's interest can be calculated. **LSJ**