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1987

### Bargaining in the Shadow of Eminent Domain: Valuing and Apportioning Condemnation Awards Between Landlord and Tenant

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#### Recommended Citation

Victor P. Goldberg, Thomas W. Merrill & Daniel Unumb, *Bargaining in the Shadow of Eminent Domain: Valuing and Apportioning Condemnation Awards Between Landlord and Tenant*, 34 *UCLA L. REV.* 1083 (1987).

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BARGAINING IN THE SHADOW OF  
EMINENT DOMAIN: VALUING AND  
APPORTIONING CONDEMNATION  
AWARDS BETWEEN LANDLORD  
AND TENANT

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Thomas W. Merrill\*\*  
and Daniel Unumb\*\*\*

INTRODUCTION

Who has a constitutionally protected "property" interest when the government condemns land subject to a lease? Is it the landlord? The tenant? Or do both parties have property rights that entitle them to compensation? Further, how should the size of the total condemnation award be determined? Should we value the property rights of the landlord and the tenant separately and sum? Or should we value the entire parcel as if it were an undivided fee simple and apportion the award between the landlord and the tenant? If the condemnation award is based on the value of a fee simple and apportioned, who should make this division? Is

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The authors would like to thank Charlotte Crane, John Drobek, Richard Epstein, Dennis Ferrazzano, Herbert Hovenkamp, Carol Rose, Eva Saks, and David Van Zandt for their helpful comments on earlier drafts. The paper's title was inspired by Cooter, Marks & Mnookin, *Bargaining in the Shadow of the Law: A Testable Model of Strategic Behavior*, 11 J. LEGAL STUD. 225 (1982), and Mnookin & Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L.J. 950 (1979).

this an issue of constitutional law as to which the courts have the final say? Or do the principles of constitutional law enunciated by the courts merely provide "default rules," *i.e.*, rules that apply only if the parties fail to address the issue of compensation in the lease?

In this article, we offer a normative framework for answering these questions. Our approach evolved by working backwards. We started with the question of how to apportion condemnation awards between landlord and tenant. Why, we asked, should courts do the division? Why not let the parties do it themselves? Insofar as commercial leases are concerned, all the prerequisites for efficient bargaining would seem to be present here: a small number of parties (two), an established vehicle for conducting the negotiations (the lease), and both parties typically represented by counsel. Furthermore, provided the issue is addressed in the lease—before condemnation takes place—there should be no problem of *ex post* strategic behavior.<sup>1</sup>

Once we recognized the desirability of allowing the parties to resolve the apportionment issue by private agreement, the answer to the second question—how to establish the size of the total award—fell into place. The so-called undivided fee rule is clearly superior to valuing the interests of the landlord and tenant separately and summing, because the former establishes a structure that facilitates private agreements. Under the undivided fee rule, the government's only interest is in the size of the total award, established by valuing the property as if there were no lease. Once the total award is fixed, the government in effect drops out of the picture. What begins as an eminent domain proceeding ends up resembling a private interpleader action, with the landlord and tenant fighting over the division of a fixed stake. On the other hand, if the interests of the landlord and tenant were valued separately and then summed, it is unclear what role, if any, condemnation clauses would

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1. When we investigated the matter, we found that long-term commercial leases routinely *do* include so-called "condemnation clauses" that specify how condemnation awards should be apportioned between landlord and tenant. The soundness of the theory was confirmed by practice. For examples of the condemnation clauses, see 2 M. FRIEDMAN, *FRIEDMAN ON LEASES* §§ 665-82 (1983); 7A P. ROHAN & M. RESKEN, *NICHOLS ON EMINENT DOMAIN* § 11.07, at 11-16-11-37 (3d ed. 1984).

play. The valuation of each separate interest would affect the size of the total award payable by the government, and thus the government's interests would be directly implicated by the terms of any private agreement concerning compensation. Assuming the government was not a party to these agreements, it could not be bound by them. Condemnation clauses would inevitably become irrelevant, and the issues of both apportionment and the size of the total award would have to be decided by the courts.

Once we settled on the desired approaches to the apportionment and total valuation questions, the answer to the first issue, concerning who should have a constitutionally protected property right, became obvious: it doesn't really matter. The assignment of property rights will not affect the value of the total award, since that is determined by valuing the property as an undivided fee. And the assignment of property rights will not control the ultimate apportionment of the award, because the parties can freely contract around the apportionment rules by negotiating an appropriate condemnation clause.

Although we developed our framework by working backward from condemnation clauses, for expository purposes we will proceed forward. In Part I, we will consider briefly the question of who should have a constitutionally protected property right. As suggested above, the important question is whether the parties can negotiate around the compensation rules established by law. We argue that in the only context in which both the landlord and the tenant are likely to have significant rights to compensation—long-term commercial leases—it makes sense to allow the parties to waive their constitutional rights and substitute a private agreement governing the distribution of condemnation awards.

In Part II, we address the question of how to determine the size of the total award. Here, we strongly endorse the traditional undivided fee rule. No matter how the award is apportioned, the sum of the landlord's and the tenant's individual awards should always equal the value of the undivided fee simple. The undivided fee rule will not only facilitate *ex ante* agreements between landlord and tenant concerning the apportionment of condemnation awards, we argue that it is also correct as a conceptual matter.

In Part III, we maintain that the total award should, if possible, be apportioned between the landlord and tenant by *ex ante* agreement, rather than by *ex post* litigation. By allowing the parties to allocate the condemnation award by prior agreement, we maximize their ability to tailor the relief to their specific circumstances. Furthermore, a clear *ex ante* agreement will minimize strategic behavior<sup>2</sup> that shrinks the total award available for division. When courts set aside a condemnation clause in order to apportion the award in a way that seems, *ex post*, to be more "fair," they encourage conduct that ultimately leaves landlords and tenants as a class worse off.

In Part IV, we analyze the leading modern Supreme Court decision concerning the condemnation of leased property—*Almota Farmers Elevator & Warehouse Co. v. United States*.<sup>3</sup> The decision illustrates the confusion that arises when courts fail to distinguish between the value of the total award and its division among the contending parties. In analyzing *Almota*, we highlight one bona fide problem: the possibility that the government and the landlord might collude to reduce the amount of compensation the tenant would otherwise be entitled to receive under the lease.

Finally, in concluding, we suggest ways in which our framework for handling the condemnation of leased property might prove useful in resolving other issues that arise in eminent domain, such as the condemnation of future interests and the condemnation of contractual rights.

## I. THE TENANT'S RIGHT TO COMPENSATION

The established rule states that both the landlord and the tenant have a constitutionally protected "property" in-

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2. By "strategic behavior," we refer to what economists often describe as "rent seeking behavior." In order to avoid obvious confusion between economic rents and lease rents, however, we will forego any references to rent seeking in this paper and will speak only of strategic behavior. In general, both terms refer to wasteful or inefficient competition, as opposed to efficient or wealth-maximizing competition. See generally TOWARD A THEORY OF THE RENT-SEEKING SOCIETY (J. Buchanan, R. Tollison, & G. Tullock eds. 1980); Klein, Crawford, & Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978); Merrill, *Rent Seeking and the Compensation Principle*, 80 Nw. U.L. REV. 1561 (1987).

3. 409 U.S. 470 (1973).

terest when leased property is taken in eminent domain.<sup>4</sup> There is a natural inclination, at least on the part of lawyers, to attach great significance to this fact. If the tenant has a constitutionally protected property right, then he is entitled to compensation under the just compensation clause of the fifth amendment;<sup>5</sup> if the tenant does not have a property right, he is not.<sup>6</sup> It is also well established, however, that the landlord and tenant, by agreeing upon an appropriate condemnation clause as part of the lease, may modify the division of any condemnation award that would otherwise be directed by the courts.<sup>7</sup> This rule significantly modifies the first rule, rewriting it to say in effect that the tenant has a constitutionally protected property right *absent language in the lease to the contrary*. Thus, the property label does not resolve the question of compensation in an eminent domain proceeding. It merely establishes a default rule that applies in the absence of a contrary specification of rights in the lease.

We will not, at this point, ask what the correct default rule should be.<sup>8</sup> The more important question here is

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4. *United States v. General Motors Corp.*, 323 U.S. 373, 377-78 (1945); *Kohl v. United States*, 91 U.S. 367, 377 (1876).

5. "[N]or shall private property be taken for public use, without just compensation." U.S. CONST. amend. V. The Supreme Court has held that the takings clause applies to the states through the fourteenth amendment's due process clause. *Penn Central Transp. Co. v. New York City*, 438 U.S. 104, 122 (1978). Furthermore, all states either have takings clauses in their state constitutions or otherwise recognize as a matter of state constitutional law that the government must compensate for a taking of private property. 1 J. SACKMAN & P. ROHAN, *NICHOLS ON EMINENT DOMAIN* § 1.3, at 1-91 (3d ed. 1985). We do not in this article differentiate between federal and state constitutional law in considering the appropriate approach to the condemnation of leased property.

6. Note that the question whether the tenant's interest is "property" for constitutional purposes is distinct from the question whether the tenant's interest is properly categorized as a property right or a contract right at common law. *See generally Hicks, The Contractual Nature of Real Property Leases*, 24 *BAYLOR L. REV.* 443 (1972). Contract rights have been held to be "property" within the meaning of the takings clause, at least when the government appropriates the entire contractual interest. *See United States Trust Co. v. New Jersey*, 431 U.S. 1 (1977); *Lynch v. United States*, 292 U.S. 571 (1934); *Omnia Commercial Co. v. United States*, 261 U.S. 502 (1923). Under these authorities, if the government condemns a leasehold estate outright, the tenant would appear to be entitled to compensation, whether or not his interest is held to be a property right at common law.

7. *See United States v. Petty Motor Co.*, 327 U.S. 372 (1946); 4 M. FRIEDMAN, *supra* note 1, at 490; 7A P. ROHAN & M. RESKIN, *NICHOLS ON EMINENT DOMAIN* § 12.42[2], at 12-793; 5A G. THOMPSON, *THOMPSON ON REAL PROPERTY* § 2583 (1978).

8. In Part III, we suggest that the default rule is probably wrong, as indicated by the frequency with which the parties contract around it. But if contractual

whether the parties should be allowed to contract out of the default rule, *i.e.*, should be allowed to waive their constitutional rights to compensation.<sup>9</sup> We can think of two possible reasons why the parties should not be allowed to waive their rights. First, one or both of the parties could lack contractual capacity, either in the strict traditional sense of infancy, insanity, or duress,<sup>10</sup> or in the loose modern sense of "unequal bargaining power."<sup>11</sup> Second, waiver of the right to compensation could impose external costs on third parties.<sup>12</sup> On close examination, however, neither of these reasons applies to the situation under review. Apportionment of condemnation awards between landlord and tenant is a significant issue only in the case of long-term commercial leases, and contractual incapacity and third party effects are not plausible reasons for refusing to enforce provisions in long-term commercial leases.

To see why apportionment of condemnation awards becomes an issue only in the world of long-term commercial leases, it is useful to begin by considering why tenants holding short-term leases rarely press takings claims, and why, when they do, such claims have generally been denied.<sup>13</sup> Assume a tenant, T, has leased an apartment for a term of one year at a rental of \$500 per month. Six months into the term, the government condemns the building in which the apartment is located. The general constitutional rule, as we have seen, is that T has a property right entitled to compen-

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modification is freely available, and is enforced by the courts, the choice of an inefficient default rule is probably not a major concern.

9. The general rule, of course, is that constitutional rights may be waived. For example, suspects may waive their fourth amendment rights by agreeing to a search, *Schneekloth v. Bustamonte*, 412 U.S. 218 (1973), and government employees may waive their first amendment rights by agreeing to submit future writings to prior review by their agency. *Snepp v. United States*, 444 U.S. 507 (1980).

10. See Epstein, *Unconscionability: A Critical Reappraisal*, 18 J.L. & ECON. 293 (1975).

11. See, e.g., Goldberg, *Institutional Change and the Quasi-Invisible Hand*, 17 J.L. & ECON. 461 (1974); Trebilcock, *The Doctrine of Inequality of Bargaining Power: Post-Benthamite Economics in the House of the Lords*, 26 U. TORONTO L.J. 359 (1976).

12. See Epstein, *Why Restrain Alienation?* 85 COLUM. L. REV. 970 (1985) (discussing contexts in which free alienation may impose costs on third parties); Rose-Ackerman, *Inalienability and the Theory of Property Rights*, 85 COLUM. L. REV. 931 (1985).

13. See 2 J. SACKMAN & P. ROHAN, *NICHOLS ON EMINENT DOMAIN* § 5.06[4], at 5-129 (3d ed. 1985) (tenants with a month-to-month lease have no compensable property interest).

sation. Indeed, T *has* lost a valuable interest—the right to possession of the apartment for the next six months.

But under modern landlord-tenant law, condemnation of the entire leased premises is regarded as an event terminating the lease.<sup>14</sup> In effect, the condemnation excuses T from paying what would otherwise be a binding obligation to pay the landlord, L, \$3,000 over the next six months. If we assume that the fair market value of the six months' lost possession is roughly equal to the contract rent (as it generally would be for short-term leases),<sup>15</sup> then the release of the \$3,000 debt exactly offsets the value of the lost possession. Thus, rather than have a complicated three-way transaction whereby T seeks \$3,000 in compensation from the government, and then turns the \$3,000 over to L in satisfaction of the debt created by the lease, the law has short-circuited the process by forgiving T's \$3,000 debt to L. In the language of takings literature, the cancellation of T's lease obligation

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14. See RESTATEMENT (SECOND) OF PROPERTY § 7.1(1) (Tent. Draft No. 2, 1974); 2 R. POWELL & P. ROHAN, REAL PROPERTY § 247[2], at 372.143; 4 J. SACKMAN & P. ROHAN, NICHOLS ON EMINENT DOMAIN § 12.42[1], at 12-785 (3d ed. 1985). The early rule seems to have been that eminent domain, not being an eviction by the landlord or one holding by paramount title, did not affect the covenant to pay rent. See, e.g., *Parks v. City of Boston*, 32 Mass. (1 Pick.) 198 (1834); *Folts v. Huntley*, 7 Wend. 211 (1831); *Footte v. City of Cincinnati*, 11 Ohio 408 (1842). This is consistent with the well known decision in *Paradine v. Jane*, Aleyn 27, 82 Eng. Rep. 897 (K.B. 1647), which held that physical ouster of the tenant by a third party not acting under direction of the landlord does not excuse payment of rent. Courts began to change the rule in the later part of the nineteenth century, but did not agree on the underlying rationale. See *Corrigan v. Chicago*, 144 Ill. 537, 33 N.E. 746 (1893) (while condemnation may not be a technical eviction, where entire tract is taken it is, in effect, an eviction by paramount title); *O'Brien v. Ball*, 119 Mass. 28 (1875) (landlord cannot continue to collect rent on an estate after he no longer owns the estate); *Lodge v. Martin*, 31 A.D. 13, 14, 52 N.Y.S. 385, 386 (1898) (“[N]either justice nor reason . . . would permit a party to collect rent for the use and occupation of lands which he does not own.”). Nichols advances another reason for this transformation which, unlike the others, is concerned with the circumstances of the landlord rather than the tenant: after the tenant has been deprived of occupation, and has been given compensation for his loss, the tenant's obligation to pay rent would be an unsecured personal liability. “Such an arrangement would not only be inequitable, but would probably be unconstitutional, as it would amount to depriving the owner of his security for rent without compensation . . . . Termination of the obligation to pay rent [is preferable] . . . even if it is not easy to justify this practice upon strict legal theory.” 4 J. SACKMAN & P. ROHAN, NICHOLS ON EMINENT DOMAIN § 12.42[1], at 12-786 (3d ed. 1985).

15. At least in the absence of sudden and unanticipated changes in property values or currency values.



provides him with "implicit in-kind" compensation for his loss of possession.<sup>16</sup>

To be sure, T may have a subjective attachment to the apartment or may especially value the lease for other reasons.<sup>17</sup> Indeed, it is plausible to assume that, at least at the beginning of the lease, the tenant always attaches greater value to the leasehold than is reflected in the contract rent—otherwise he would not agree to the lease. But it is well established that the government is not constitutionally required to compensate T for lost subjective value or consumer surplus.<sup>18</sup> Thus, if T were actually to seek compensation, he would be awarded the market rental value, which in a short-term lease should equal, or at least closely approximate, the contract rent.

As the foregoing example suggests, the difficult issues surrounding the condemnation of leased property are almost exclusively a by-product of long-term leases. Only with long-term leases are we likely to see a substantial divergence between market rent and contract rent, or substantial capital improvements by the tenant, or other circumstances that generate out-of-pocket losses for the tenant above and beyond the implicit compensation afforded by cancellation of the lease.

Typically, long-term leases are commercial.<sup>19</sup> Thus we can be fairly confident that contractual incapacity is not a

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16. See R. EPSTEIN, *TAKINGS: PRIVATE PROPERTY AND THE POWER OF EMINENT DOMAIN* 195–215 (1985); Michelman, *Property, Utility, and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law*, 80 HARV. L. REV. 1165, 1182, 1218–26 (1967).

17. See Radin, *Residential Rent Control*, 15 PHIL. & PUB. AFF. 350 (1986) (discussing the "personhood" interests that residential tenants may have in their leasehold).

18. *United States v. General Motors Corp.*, 323 U.S. 373, 379 (1945); *United States v. Miller*, 317 U.S. 369, 375 (1943). We do not question this rule here. It could be that the rule is bad, but if so, it should be changed across the board, not simply in cases in which there happens to be leased property.

19. There are exceptions of course. See, e.g., *City & County of Honolulu v. Midkiff*, 62 Haw. 411, 616 P.2d 213 (1980), involving a condemnation that took place on property subject to one of Hawaii's long-term residential ground leases. See generally *Hawaii Hous. Auth. v. Midkiff*, 467 U.S. 229 (1984). The lease in question included a condemnation clause that protected the tenant's interest in improvements, but awarded the bonus value to the landlord, 616 P.2d at 215, exactly what one would expect to find in a long-term commercial lease. Nevertheless, the court remanded for findings as to whether the clause, by depriving the tenant of any share of the appreciation in land values that had taken place after the lease was negotiated, was "unconscionable." *Id.* at 218.

pervasive problem. Typically, both the landlord and the tenant have large economic stakes in a long-term commercial lease; both parties are represented by counsel who specialize in such matters; and leases are subject to careful review and often negotiated clause by clause. Even in the case of a small retail store operator dealing with a large shopping center, the tenant is likely to require financing, and the mortgagee will generally take steps to ensure that its interests, and thus indirectly the tenant's interests, are protected in the event of condemnation. Of course, there may be isolated cases involving long-term commercial leases in which it is appropriate to speak of asymmetric access to information, "unequal bargaining power," or even insanity. But it is highly unlikely that a majority, or even a substantial minority, of cases present these issues, or at least present them in such an acute form that we should adopt a rule prohibiting parties from contracting about condemnation awards.

If contractual incapacity is seldom an issue in the case of long-term commercial leases, there is even less reason to believe that contractual modification of condemnation awards will implicate the interests of third parties. The sole function of condemnation clauses is to determine the landlord's and tenant's respective shares of condemnation awards only after *the government* has made a decision to change the allocation of resources by condemning property (presumably to devote it to some other use). Such clauses have very little effect on the use to which the property is put, the way it is maintained, or other resource allocation issues that might affect third parties.<sup>20</sup> Because condemnation clauses do not themselves affect the allocation of resources, it is highly unlikely that they impinge on the interests of third parties.<sup>21</sup>

In short, this is an area in which the institution of contract should work well. In such a context, rules of constitu-

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20. In Part IIIB, *infra*, we consider a partial exception to this point that arises in situations in which tenants construct permanent improvements.

21. In fact, condemnation clauses should have no effect on the distribution of wealth between landlords and tenants as a class, provided both landlords and tenants have the capacity to make rational, well-informed decisions about the financial impact of different lease terms. If tenants as a class agree to clauses that award landlords a larger share of condemnation awards than landlords would obtain under the default rules, then tenants as a class presumably receive some offsetting benefit in terms of concessions on other clauses, or lower rents.

tional entitlement should be understood as default rules, and private agreements modifying the default rules should be presumptively enforceable. The legal regime thus should be constructed, if at all possible, to facilitate rather than to frustrate private ordering.

## II. THE UNDIVIDED FEE RULE

The traditional rule that governs the condemnation of leased property can be stated quite simply: the government pays the fair market value of the interest it *acquires*. Usually (but not always) this will be an undivided fee simple. Thus, no matter how fractionalized or fragmented the state of title may have been before the taking, if the government acquires a fee simple, it must pay for a fee simple.

Historically, the conceptual basis for the undivided fee rule is that eminent domain is an action *in rem*. The government is condemning a particular piece of property—a “res”—not the various interests that different parties have in the property.<sup>22</sup> As a leading nineteenth century case put it, eminent domain entails a taking “not of the rights of designated persons in the thing needed, but of the thing itself.”<sup>23</sup> The government must accordingly pay the value of the “thing,” not the value of the various bundles of rights that have been taken from the condemnees.

Whatever its conceptual foundations, the undivided fee rule minimizes the government’s involvement in the condemnation of leased property. Under the undivided fee approach, the government’s sole interest is in establishing what compensation would be owed if the property were subject to unified ownership. Once this is settled, the government steps aside and lets the owners of the various fractional interests divide the award.<sup>24</sup> This framework allows the par-

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22. This is why federal eminent domain actions often have names such as *United States v. 50 Acres of Land*, 469 U.S. 24 (1984) and *United States v. 564.54 Acres of Land*, 441 U.S. 506 (1979). The land is literally the defendant.

23. *Crane v. City of Elizabeth*, 36 N.J. Eq. 339, 343 (1882); see also *A.W. Duckett & Co. v. United States*, 266 U.S. 149 (1924); *Monongahela Navigation Co. v. United States*, 148 U.S. 312, 326 (1893); *United States v. Dunnington*, 146 U.S. 338, 352-53 (1892); Johnston, “*Just Compensation*” for Lessor and Lessee, 22 VAND. L. REV. 293, 313-16 (1969).

24. See, e.g., *Vivian v. Board of Trustees*, 152 Colo. 556, 383 P.2d 801, 803 (1963) (“Once the reasonable market value of property subject to eminent domain proceedings has been established, the apportionment of that amount among

ties to apportion the compensation by condemnation clauses—*ex ante* agreements negotiated as part of the lease. (In Part III, we explain why the parties would rationally want to resolve the apportionment question this way.)

Those who have questioned the undivided fee rule have not done so out of any professed hostility toward condemnation clauses. Rather, the opponents of the rule have generally rested their case, either explicitly or implicitly, on the notion that the sum of the parts may not equal the whole. We shall consider six such arguments. On close examination, it turns out that these arguments spring less from a disagreement with the undivided fee rule than from some other valuation principle associated with eminent domain.

The most important (and controversial) of these other valuation conventions is what we will call the opportunity cost formula for determining just compensation. In effect, the Supreme Court has held that the measure of just compensation is the condemnee's opportunity cost—"what a willing buyer would pay in cash to a willing seller."<sup>25</sup> This means, first of all, that the condemnee cannot recover any value added to property by the government project that gives rise to the condemnation.<sup>26</sup> The condemnee is entitled only to the value of the property in its highest and best use *other than* uses made possible only by the exercise of eminent domain. Second, it means that the condemnee is not entitled to compensation for what may be generically called consequential damages.<sup>27</sup> That is, the condemnee cannot recover for losses that would remain after a hypothetical sale to a third party, such as lost subjective value (consumer sur-

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persons claiming an interest therein is a matter of no concern to the condemnor.").

25. *United States v. Miller*, 317 U.S. 369, 374 (1943). *See also* *United States v. 50 Acres of Land*, 469 U.S. 24, 25 n.1 (1984). Notwithstanding that the market value standard is well established, language of indemnity persists in taking cases. *See, e.g.*, *United States v. Reynolds*, 397 U.S. 14, 16 (1970) ("The owner is to be put in the same position monetarily as he would have occupied if his property had not been taken.").

26. *United States v. Miller*, 317 U.S. at 375-82; *Olson v. United States*, 292 U.S. 246, 256 (1934); 3 J. SACKMAN & P. ROHAN, *NICHOLS ON EMINENT DOMAIN* § 8.61, at 8-136-37.

27. *See* *United States v. Petty Motor Co.*, 327 U.S. 372, 377-78 (1946); *United States v. General Motors Corp.*, 323 U.S. 373, 379 (1945); *Mullen Benevolent Corp. v. United States*, 290 U.S. 89 (1933); *Mitchell v. United States*, 267 U.S. 341, 344 (1925).

plus), lost profits, lost business goodwill, relocation costs, and attorneys fees.<sup>28</sup>

Commentators have long debated the propriety of the opportunity cost formula.<sup>29</sup> We take no position on this issue. We accept the basic policy as given, and submit that, whether or not the opportunity cost formula is sound, it is improper for courts to take the existence of a divided fee as an excuse to subvert the formula. In other words, there is no principled justification for applying the opportunity cost measure of compensation to takings of fee simple property, and some other standard—such as full indemnification—to takings of property subject to divided ownership. If the opportunity cost formula is to be discarded, it should be discarded across the board—and above board.<sup>30</sup>

#### A. *Divided Ownership Enhances Value, Ex Ante*

Perhaps the most intuitively appealing argument supporting the proposition that the sum of the parts may be dif-

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28. See 2 J. SACKMAN & P. ROHAN, *NICHOLS ON EMINENT DOMAIN*, (3d ed. 1985): *id.* § 5.24 (business goodwill); *id.* § 8.10 (relocation costs); *id.* § 14.01 (consequential damages); *id.* § 14.24[4] (attorney fees); see also Annotation, 58 A.L.R.3d 566 (goodwill or "going concern" value as an element of lessee's compensation for taking leasehold in eminent domain).

29. See R. EPSTEIN, *supra* note 16, at 195-215; Blume & Rubinfeld, *Compensation for Takings: An Economic Analysis*, 72 CALIF. L. REV. 569, 619-20 (1984); Merrill, *The Economics of Public Use*, 72 CORNELL L. REV. 61 (1986).

30. There are suggestions in the literature that courts are more likely to adopt indemnification standards when valuing the tenant's interest, in part because there is no active secondary market. See Polasky, *The Condemnation of Leasehold Interests*, 48 VA. L. REV. 477, 519 (1962) (citing 4 J. SACKMAN & P. ROHAN, *NICHOLS ON EMINENT DOMAIN* § 12.42(3) (3d ed. 1985)) ("actual value," "intrinsic value to owner"); see also *Orange State Oil Co. v. Jacksonville Expressway Auth.*, 110 So. 2d 687 (Fla. Dist. Ct. App. 1959) ("value to owner"). This can create a problem for the landlord. If the courts apply the opportunity cost formula in setting the value of the undivided fee, but then at the apportionment stage apply an indemnification standard in valuing the tenant's interest, the landlord can end up short-changed. This potential problem is recognized in *Harco Drug, Inc. v. Notsla, Inc.*, 382 So. 2d 1 (Ala. 1980), where the tenant attempted to claim what amounted to noncompensable business profits as part of the value of its leasehold. The court stated that

[u]nder the existing undivided fee rule, similar considerations . . . could not have gone into computing the total award to the property owner . . . . Therefore, an award to the lessee on the basis of the leasehold's 'highest and best use' would amount to the owner's paying the lessee a sum which was not included in the total award made by the condemnor and which the owner did not in fact receive.

*Id.* at 5.

ferent from the whole rests on the observation that property values are often enhanced by a division of ownership.<sup>31</sup> Indeed, the frequency with which property is leased suggests that this arrangement is value-enhancing. Leasing is economically beneficial because it permits specialization of functions. The lease arrangement allows the landlord to specialize in providing relatively fixed assets, such as land and buildings, and allows the tenant to concentrate on providing relatively mobile assets, such as inventory, advertising, and labor. The arrangement is analogous to that between a firm and its workers. The firm owns relatively fixed assets, such as a factory and machinery, and hires workers because the return on this investment will be higher if workers operate the machinery than if the owners attempt to do so themselves. Similarly, workers will hire on with the firm because their productivity, and hence their return, will be higher for a given level of effort if they are able to work with machinery rather than without it.

But the fact that the division of ownership can increase the value of property does not mean that the sum of the parts is greater than the whole. It simply means that the *potential* for dividing the fee in advantageous ways should always be taken into account in fixing the value of the undivided fee. For example, assume that L owns a large house which is currently used as a single family residence. Next, assume that the rental value of the house in this use is \$500 per month, but if subdivided into apartments, the house's total rental value would be \$1000 per month. In valuing the property upon condemnation, should we capitalize \$500 per month (based on current use) or \$1000 per month (based on the highest and best use)? The answer clearly is that we should base compensation on the highest and best use,<sup>32</sup> which in this case assumes the potential for subdividing into apartments. Indeed, if the market value of the house were determined by examining the sale prices of comparable properties, these prices would presumably reflect the fact that large houses can be and often are subdivided into apartments and leased.

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31. See Johnston, *supra* note 23, at 300-01.

32. See United States ex rel. TVA v. Powelson, 319 U.S. 266, 275 (1943) ("The value may reflect not only the use to which the property is presently devoted but also that use to which it may be readily converted.").

Note that the opportunity cost formula implicitly distinguishes between the highest and best use to which a *single* parcel of property can be put, and the highest and best use to which *many* contiguous or otherwise related parcels might be put. Suppose that L's tract would have a ground rent value of \$2000 per month if assembled with nineteen other contiguous parcels to make room for a shopping center. Should this potential use be considered the highest and best use for the property? The answer generally given is no,<sup>33</sup> and the rationale is straightforward. First, given the multiplicity of owners and the absence of any clear definition of the scope of the project, the terms and the conditions of the proposed assembly are highly speculative. Second, the presence of numerous different parcels subject to separate ownership increases transaction costs and the likelihood of holdouts, and makes it unlikely that the parcel will ever be assembled, at least without calling upon the power of eminent domain. Consequently, the value added by assembly of numerous contiguous properties would probably be attributable only to the government's exercise of eminent domain, and hence would be properly excluded under the opportunity cost formula.<sup>34</sup> In contrast, where a single parcel is involved, or where there are several related parcels under single ownership, one owner can make the appropriate decisions about use without having recourse to eminent domain.<sup>35</sup> In this interpretation, therefore potential value is, thus, taken into account.

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33. See *City of New York v. Sage*, 239 U.S. 57, 61 (1915); *United States v. Chandler-Dunbar Water Power Co.*, 229 U.S. 53, 80-81 (1913). But see *Olson v. United States*, 292 U.S. 246, 256 (1934) (suggesting that enhanced value caused by combination may be considered "if the possibility of combination is reasonably sufficient to affect market value."). Conversely, if a single owner holds other parcels either contiguous to or adaptable for integrated use with the parcel being taken, courts will frequently add an increment of value known as "assemblage" or "plottage" value to the subject parcel. See Annotation, *Eminent Domain—Assemblage or Plottage*, 8 A.L.R.4th 1202 (1981).

34. See *City of New York v. Sage*, 239 U.S. at 61 ("The City is not to be made to pay for any part of what it has added to the land by thus uniting it with other lots, if that union would not have been practicable or have been attempted except by the intervention of eminent domain.").

35. In the next subsection we consider the intermediate case where a single parcel is subject to multiple ownership, *i.e.*, is divided between landlord and tenant. We argue that the landlord-tenant case should be subject to the highest and best use rule applicable to single parcels, rather than the rule that applies to many

In short, the unique value of a particular lease does not directly affect the determination of the total value of property subject to condemnation. The value of a present lease is relevant only as *evidence* of what the highest and best leasing arrangement would be. Of course, the terms and conditions of existing leases may be relevant to the question of apportionment. An above-market lease may enhance the landlord's share; a below market lease may enhance the tenant's share. But in neither case should it affect the size of the total award.

B. *Divided Ownership Reduces Value, Ex Post*

The preceding argument is one manifestation of a more general point. The value of property can often be enhanced by repackaging the "bundle of rights" in a manner that is value-increasing. If the land is presently unencumbered, the freedom to lease, to grant an easement, or to restrict future uses or changes in title will make the land more valuable to potential buyers. The other side of the coin is that once the land has been encumbered, its value to future purchasers may be adversely affected if tastes and preferences or other circumstances change. For example, property located on a residential street may be restricted to single family use, but the street may eventually turn into a commercial strip. These changed circumstances will reduce the value of the property as a residence, but enhance its potential value as a retail outlet. If the owners of the various interests in the property were able to bargain with each other costlessly, they could negotiate a release of any restrictions that are no longer beneficial, thereby overcoming this problem.<sup>36</sup> But there can be considerable bargaining difficulties. For example, suppose a ten-year lease provides that the property cannot be sublet or assigned without L's permission. After five years have elapsed, the value of the property to a different type of tenant has increased sharply, so the property could be sublet at twice the current rental. Under the lease, L does

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parcels, where aggregation of interests is generally prohibited in determining just compensation.

36. This is a simple application of the Coase Theorem, which holds that, in a world of zero (or at least very low) transaction costs the initial distribution of entitlements will not affect the allocation of resources. See Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).



not have the unilateral right to terminate the lease and capture the increased value himself, nor does T have the unilateral right to capture the increased value by subletting or assigning. While clear gains from trade would result from either prematurely terminating the lease or waiving the restriction on subletting, it is possible that strategic bargaining by the two parties would prevent their reaching either of these outcomes.<sup>37</sup>

The parties have an incentive to consider these potential future problems when negotiating the lease, and often they do. When they do not, it is often difficult to know what agreement they would have reached. However, in the context of a government condemnation, such agreement is easy to determine: *ex ante*, the parties would always agree, if they considered the matter, that any provision in the lease (such as a prohibition of subletting or assigning) that prevents the property from achieving its highest and best use would automatically *terminate* in the event of a taking by eminent domain. Failure to include such a clause would be equivalent to rejecting free money. It seems unreasonable to attribute such a perverse desire to the parties absent explicit evidence that this is their intent.

Significantly, the undivided fee rule operates exactly like such a lease clause. By requiring the total award to equal the value of an unrestricted fee simple, the rule computes the condemnation award in a way that ignores any restriction on use that, *ex post*, would diminish the value of the property. Thus, the undivided fee rule is consistent with the hypothetical contract reasonable parties would have made if they had considered the matter.

At first blush, this feature of the undivided fee rule might appear at odds with the previously noted rule refusing to recognize any potential value created by assembling many contiguous or otherwise related property interests. The undivided fee rule in effect "assembles" the separate interests of the landlord and tenant into a single unified interest, eliminating any paper encumbrances, *i.e.*, restrictive clauses

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37. For discussion of this point in the context of servitude, see Sterk, *Freedom from Freedom of Contract: The Enduring Value of Servitude Restrictions*, 70 IOWA L. REV. 615 (1985).

in the lease,<sup>38</sup> that might diminish the value of the whole. But on closer examination, this tension disappears. Here, unlike agreements involving many contiguous parcels, there is nothing speculative about the agreement the parties would reach had they considered the matter. They would always agree to eliminate paper encumbrances that would reduce value in the event of condemnation. In addition, there is no question here but that the "assembly" of the individual interests would be agreed upon without use of the power of eminent domain. One party—the landlord—has a direct negotiating relationship with each tenant, and formal negotiation always occurs in the course of drawing up the lease. Consequently, here, unlike agreements involving many contiguous parcels, application of the undivided fee rule to override paper encumbrances is consistent with the opportunity cost formula.

### C. *Offsetting Benefits*

Some commentators have argued that if there is a marked discrepancy between the market value of the undivided fee and the values of the various interests considered separately, the court should depart from the undivided fee rule.<sup>39</sup> The case generally cited to support this proposition is *Boston Chamber of Commerce v. Boston*.<sup>40</sup> This, however, is a misreading of the decision—a misreading abetted by Justice Holmes' obscure exposition. The misinterpretations arise because of Holmes' implicit application of the "offsetting benefits" rule;<sup>41</sup> once this is recognized, *Boston Chamber of Commerce* becomes a simple case which does precisely what we have suggested: it ignores paper encumbrances that re-

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38. Note that a lease encumbrance is different in this respect from a physical encumbrance. If the property includes a physical structure, the opportunity cost measure of compensation is the value of the property with the structure in place, or its value in another use less the cost of removing the structure, whichever is higher. The cost of removing a physical structure is a real cost which could be substantial. The cost of removing a paper restriction, however, is zero. The undivided fee rule recognizes this distinction by ignoring lease encumbrances, including the lease and all its peculiar terms, in fixing the size of the total condemnation award.

39. See L. ORGEL, VALUATION UNDER THE LAW OF EMINENT DOMAIN § 111 (2d ed. 1953) (referring to *Boston Chamber of Commerce* as the leading case); Johnston, *supra* note 23.

40. 217 U.S. 189 (1910).

41. Discussed *infra* notes 45-46 and accompanying text.

duce value *ex post* and allows the parties to divide the award *ex ante* as they see fit.

Although the division of the fee in *Boston Chamber of Commerce* involved an easement rather than a lease, the facts are still instructive. The Boston Chamber of Commerce owned a parcel of land (the servient estate) over which it had granted an easement in the form of a private street to the Central Wharf and Wet Dock Corporation (the dominant estate). The City of Boston condemned the land in question in order to build a public thoroughfare. The parties stipulated that the value of the property as an undivided fee simple was \$60,000. However, given the improbability that the Wharf Company would have agreed to release the easement and permit the fee to be developed for other purposes, they further stipulated that the value of the servient estate alone was only \$5,000. After the City had taken the land, the Chamber of Commerce and the Wharf Company agreed to eliminate the easement (which is exactly what they would have agreed upon *ex ante* if they had anticipated the taking). Accordingly, they asked to be compensated for the value of the land as an unrestricted fee simple—\$60,000. The City objected, arguing that the Chamber of Commerce was entitled to \$5,000, the value of its separate interest, and the Wharf Company was entitled to nothing, “as it lost nothing by the superposition of a public easement upon its own.”<sup>42</sup>

The trial judge gave a directed verdict for \$5,000 which was affirmed by the Massachusetts Supreme Court and the United States Supreme Court. Justice Holmes stated that it would not be proper to allow a simple joinder of interest after the taking had occurred in order to make the City “pay for a loss of theoretical creation suffered by no one in fact.”<sup>43</sup>

*Boston Chamber of Commerce* seems to repudiate the undivided fee rule. As we have seen, the rule rests (in part) on a presumed intention that the parties would have agreed to release all paper encumbrances that would interfere with maximizing the value of the fee. *Boston Chamber of Commerce* seems to say that such a release should not be permitted, because it would result in an undeserved windfall. This

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42. *Boston Chamber of Commerce*, 217 U.S. at 193.

43. *Id.* at 194.

reading of the case, however, is neither compelled nor desirable.

First, it is not correct to say that the condemned property was "really" worth only \$5,000. The owner of the dominant estate lost a valuable property right. It is reasonable to presume that the easement was worth at least \$55,000. If it were worth significantly less, then the Chamber of Commerce could have purchased a release of the easement from the Wharf Company and converted the land to the higher valued alternative use.<sup>44</sup> Approaching the problem from a slightly different angle, we can ask, what was the highest and best use of the undivided fee? If the Chamber of Commerce owned an undivided fee, it could have used the land in such a way as to capture its highest value—\$60,000. Alternatively, it could have sold an easement (or leased the land) to the Wharf Company. Its value in this latter use should be at least \$55,000, otherwise the Chamber of Commerce would not have agreed to this arrangement. The precise magnitude of the value of the easement is unimportant, what is important is that the easement was clearly valuable, and that Holmes recognized that it was valuable.

Given that a valuable easement was taken, how could Holmes characterize this as "a loss of theoretical creation suffered by no one in fact"? The answer is that while the condemnor took a valuable easement with one hand, it returned a nearly equally valuable public right of way with the other. Some jurisdictions, including Massachusetts,<sup>45</sup> allow the condemnor to offset benefits generated by the project in determining the final amount of "just compensation" payable to the condemnee.<sup>46</sup> Holmes in effect applied the offsetting benefits doctrine without stating that he had done so. Because the public right-of-way was nearly as valuable to the Wharf Company as the private easement, the net result was to deny it all compensation.

The result would be no different had the fee been unified. Suppose the Wharf Company owned the land in fee simple. It would lose its private road plus whatever value might be obtained from the balance of the fee (mineral or

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44. This is another application of the Coase Theorem. *See supra* note 36.

45. *See, e.g.*, *Hilbourne v. County of Suffolk*, 120 Mass. 393 (1876).

46. This again manifests the point that explicit compensation is not required when implicit compensation has been given. *See supra* text accompanying note 16.

excavation rights, air rights, rights to future development, etc.) which, we may assume, was worth \$5,000. Against this, however, it would receive the use of the public right-of-way. If the offsetting benefits rule were not applied, the Wharf Company would receive the full value of the parcel based on its highest and best use—\$60,000. If the offsetting benefits rule were applied, the Wharf Company would receive \$5,000. Thus, regardless of the form of ownership, the parties would receive a total of \$60,000 if the offsetting benefits rule were not applied and \$5,000 if it were applied. That the fee was divided is irrelevant to the outcome.<sup>47</sup>

Thus, correctly analyzed, *Boston Chamber of Commerce* does not establish an exception to the undivided fee rule. The case demonstrates only that, regardless of the form of ownership, the offsetting benefits rule can be a complicating factor in determining the correct measure of just compensation.

#### D. *Negative Leasehold*

Because condemnation is regarded as an event that cancels the lease, the tenant's property right is in most cases equal to his benefit of the bargain. Thus, the tenant is entitled to compensation for the "bonus value": the difference between the contract rent and the market rent for the term of the lease. If the market rent exceeds the contract rent, the bonus is positive. If the reverse is true, the bonus would be negative.<sup>48</sup> Some argue that when the bonus is negative—*i.e.*, the tenant holds a so-called "negative leasehold"—the sum of the parts may be greater than the whole.<sup>49</sup>

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47. In fact, the statute under which the land was condemned required the application of the undivided fee rule. It provided:

[The jury] shall first find and set forth in their verdict the total amount of damages sustained by the owners of such property, estimating the same as an entire estate and as if it were the sole property of one owner in fee simple; and they shall then apportion such damages among the several parties whom they find to be entitled thereto  
 . . . .

*Boston Chamber of Commerce v. Boston*, 195 Mass. 338, 345, 81 N.E. 244, 245 (1907), *aff'd*, 217 U.S. 189 (1910).

48. The tenant's interest also includes the value of improvements to which he has title. The higher the value of these improvements, *ceteris paribus*, the less likely it is that the leasehold would have a negative value.

49. See Polasky, *supra* note 30, at 492 n.59.

In order to evaluate the validity of this claim, consider the following example. L leases property to T for \$1000 per month. The market value of the leasehold subsequently falls to \$500 per month. If the property is condemned, the undivided fee rule requires that the total award be based on the fair market value of the fee, which would be \$500 per month capitalized. Note, however, that L has really lost much more than this. He has lost not only the right to earn \$500 per month, but also the right to earn an additional \$500 per month for the duration of the favorable lease with T. The capitalized value of this second right plus the fair market value of the fee is clearly greater than the value of the fee alone. In this situation, the argument runs, the sum of the parts is greater than the whole.

The argument, however, fails to consider that although L is undercompensated by the undivided fee rule, T is *overcompensated*. In effect, the taking of the property has released T from the obligation to pay an additional \$500 per month—the contract rent minus its fair market value. This windfall gain exactly offsets L's loss, leaving on net the value of the undivided fee. If the law required full compensation for L in the event of a negative leasehold, but did not require T to disgorge his windfall gain,<sup>50</sup> then the whole would indeed be less than the sum of the parts. But this divergence in the value of the unencumbered fee from the value of the parts would be an illusion created by a failure to reckon the windfall to T.

Rigorous adherence to the undivided fee rule eliminates the negative leasehold problem. The government compensates for the value of the unencumbered fee and leaves the task of dividing up the award to the landlord and tenant. The possibility of a negative leasehold is a contingency for which the parties could have planned when entering the lease. If they thought that full compensation to the landlord was appropriate, they could design a condemnation clause that required the tenant to make an additional payment to the landlord if the fee were taken by eminent domain. For reasons discussed in Part III, it is unlikely that the parties would choose such a division. Indeed, the typical condem-

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50. See *id.* at 492 ("No cases have been found, and it is unlikely that any court will so decide at the present time, that the lessee contribute or pay the negative value of his interest upon a complete taking.").

nation clause awards the entire bonus, positive or negative, to the landlord.

E. *The Valuation of Interrelated Parcels*

Suppose the values of parcels A and B are contingent upon the use to which the other is put. For example, A may have easement rights to B's beach, and B may have easement rights to A's beach. Or A and B may have reciprocal covenants limiting each to use as a single family residence. If only A is taken, how should this parcel be valued? Should we take into account A's rights in B in setting the award to A?<sup>51</sup> Alternatively (or additionally), should B have a separate action for compensation for its loss of rights in A?<sup>52</sup> These are extremely difficult problems when servitudes are involved.<sup>53</sup> However, these valuation problems rarely arise in the landlord-tenant context, except perhaps in the partial taking of a shopping center. If the condemnor were to take the flagship store, the value of the remaining stores and of the entire center would be adversely affected.

To what extent should the losses of the other tenants be reckoned in the condemnation proceeding? The losses should be taken into account, but not directly. If the reduction in value would have been taken into account if the shopping center had been operated as an undivided fee, then it should be treated the same way if the various units are leased. The damage is the difference between the highest and best use for the land (and structures) before the taking and the highest and best use which remains after the taking. The price terms of the leases with the various tenants should not be taken into account when determining the overall magnitude of the taking. Those terms (along with the con-

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51. If the result of the taking happens to be beneficial to B, should the recipient be taxed? The legal treatment of the problems of offsetting benefits is discussed above in the context of *Boston Chamber of Commerce*.

52. [T]he mere fact that the taking of one piece of real estate may result in a material fall in the value to the owner (possibly even in the market value) of the owner's real-estate holdings is apparently insufficient to bring the case into the category of a partial-taking case. There must be a very obvious *physical* relationship between the property that is taken and the property that is left in order to induce the court to allow a recovery of damages to the remaining property.

L. ORGEL, *supra* note 39, § 47, at 228-29.

53. See, e.g., *Southern Cal. Edison Co. v. Bourgerie*, 9 Cal. 3d 169, 507 P.2d 964, 107 Cal. Rptr. 76 (1973).

demnation clauses) should only be considered when determining the apportionment of the award.<sup>54</sup>

#### F. *Valuation Difficulties*

Appraisal of property is a complicated, imperfect business. A fee simple is generally easier to value than other interests, because it is more likely that there will be an active secondary market. Thus, the value of the fee can often be developed by examining sales of comparable property. Partial interests like leases are only rarely bought and sold in a secondary market. Thus, valuation of these sorts of interests must be developed in some other way, such as by capitalizing current rental value. These indirect methods of computing fair market value are dependent on uncertain values (*i.e.*, the current rental value and the discount rate) which are generally speculative and contentious.

Not surprisingly, an appraiser using the best available valuation techniques may arrive at a value for the whole that differs markedly from the value given by a second appraiser valuing the landlord's and tenant's interests separately.<sup>55</sup> But the fact that divergent measures of value exist does not prove that the undivided fee rule is wrong. It simply means that we must determine which method of valuation provides the best estimate. For the reasons stated, that will generally be valuation of the unencumbered fee simple.

If the award must be apportioned between the landlord and the tenant, then divergent measures of value present a problem. The best solution to this problem is a system of apportionment that would make it unnecessary for courts to measure the value of the separate interests. One way of ac-

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54. The leases might include terms which allow for a modification of the rent in the face of changed circumstances. Shopping center leases routinely provide for such modifications. See B. POLLACK, *BUSINESS AND LEGAL PROBLEMS OF SHOPPING CENTERS* 78-79 (J. McCord ed. 1968); *id.* at 102 (sample lease).

55. The likelihood that these values will diverge increases substantially if the appraisers are allowed to use techniques that are unsound. Our interest in the condemnation of leaseholds was initially stimulated by *City of Ashland v. Price*, 318 S.W.2d 861 (Ky. 1958), a case presented in C. GOETZ, *CASES AND MATERIALS ON LAW AND ECONOMICS* 163 (1984), as an illustration of how courts can misunderstand the concepts of interest rates and discounting. In *Ashland*, the court valued the leasehold interest by first calculating the bonus value for each year and then summing these values without discounting them. Cf. *Land Clearance for Redevelopment Corp. v. Doernhoefer*, 389 S.W.2d 780, 788 (Mo. 1965) (requiring discounting, but noting that, at least as of 1965, this was a *minority* position).



completing this—perhaps the only way—is to apportion the award by condemnation clauses negotiated when entering into the lease. We now turn our attention to this topic.

### III. DIVIDING THE AWARD

The tenant's right to share in the condemnation award arises from the characterization of his interest as a property right. As discussed in Part I, the property label merely establishes the default rule. The tenant is entitled to compensation only if the parties do not agree otherwise. If this apportionment rule were a good one, the parties would choose it even if the tenant were not entitled to compensation as a matter of law. In fact, the frequency with which parties contract out of the default rule demonstrates that it is generally not desirable.

Does this mean the rule should be changed? If we were writing on a blank slate, we would change it. Fewer resources will be consumed in negotiating and drafting leases if the default rules are efficient, *i.e.*, if they reflect the result upon which the parties would generally agree in any event. But we are not writing on a blank slate. There are probably tens of thousands of leases in force that have been drafted with the existing default rules in mind. It is not clear how these leases would be affected by a modification in the relevant background understanding. Moreover, it is not realistic to think this issue is one that will attract the attention of law reformers any time soon.

A more sensible approach is to continue to recognize the existing default rules, predicated on the notion that the tenant has a compensable property right, but to facilitate—rather than frustrate—contractual revision of these rules. If courts read condemnation clauses with a sympathetic eye, interpreting the inevitable ambiguities in a manner that effectuates the bargain reached by the parties *ex ante*, then it will be of little consequence that most parties do not like the default rules. Unfortunately, the courts have taken the opposite tack, especially in recent years. They increasingly view condemnation clauses with suspicion, if not hostility, and construe ambiguities in such a way as to undermine clauses that give a large share of condemnation awards to the landlord.

The remainder of this Part is organized as follows. First, we discuss the advantages of establishing a mechanism for dividing the condemnation award at the time the lease is negotiated, rather than waiting until a taking actually occurs. Second, we ask what terms a reasonable landlord and tenant would include in a condemnation clause. Third, we discuss judicial hostility toward condemnation clauses, especially those that increase the landlord's share of the award.

A. *Ex Ante Division*

Commercial leases cover a wide variety of landlord-tenant relationships, ranging from a standard lease of space, to complicated arrangements whereby the landlord and tenant both provide capital improvements, to long-term ground leases in which the tenant erects a high-rise office building. The parties' interests will vary with the circumstances. Even a good default rule could not accommodate all of these interests. However, if we encourage the parties to allocate condemnation awards *ex ante*, they can create a system of protection that is responsive to their unique needs and that provides the correct incentives for the parties to interact cooperatively over time. This is simply a variation on the standard argument for freedom of contract, and the allocative advantages of private ordering.

A second and less obvious reason for settling the apportionment issue *ex ante* is that it minimizes the potential for strategic behavior that may ultimately leave both parties worse off. Suppose the government condemns valuable property encumbered with a long-term lease. The award is, say, \$20 million, and the rules for division have not been specified in the lease. At the time of the taking both parties have an incentive to expend considerable resources in litigation, pursuing a larger share of the award. The amount they expend will depend on the potential rewards to litigation activity. Thus, if there were an unambiguous rule that the entire award goes to the landlord, there would be no incentive for the tenant and landlord to litigate against each other. On the other hand, under a rule that the tenant is entitled to the discounted value of the difference between the contract rent and the market rent, the parties could expend considerable resources in establishing the market rent and the proper discount rate; if the contract rent was to be adjusted

during the life of the lease (or if it was to be determined in part as a percentage of the gross sales or some other measure), the parties would have an incentive to spend even more.

Every dollar spent in litigation is, of course, a dollar that ends up in the pocket of neither the landlord nor the tenant. The net award available to them is the gross award less the amount they expend in litigation. Consequently, it is in their mutual interest when entering into the lease to adopt rules that discourage strategic behavior, since the larger net award without such behavior can potentially make both parties better off.<sup>56</sup> Even if the solution involves 100% of the award going to the landlord (as will often be the case), the arrangement can be mutually beneficial. The tenant may obtain offsetting concessions from the landlord, or may receive a modest rent concession. But even if there is no explicit quid pro quo or bargaining over the issue, competition in the commercial rental market, if it is sufficiently vigorous, should cause rents to fall. Of course, since *ex ante* the likelihood of condemnation is low, the rent reduction is apt to be small.<sup>57</sup>

The point is the familiar one about the dangers of bilateral monopoly. If the apportionment issue is settled when the lease is drafted, neither side is in a position to engage in strategic behavior. The market for leases is likely to be fairly

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56. This, of course, is the basic reason why parties to long-term commercial contracts frequently agree to arbitration, rather than litigation, as a means of resolving disputes that arise during the course of the relationship.

57. The low probability of condemnation introduces a complication that makes it impossible to prove a priori that condemnation clauses are more efficient than *ex post* litigation. Suppose that negotiation of a condemnation clause satisfactory to both parties would cost \$100, and that *ex post* litigation over apportionment of a condemnation award would cost \$10,000. Nevertheless, negotiation would minimize the total expenditure of resources only if the probability of condemnation is at least .01. If the probability is less—if it is say .009—then the expected cost of litigation would be only \$90 (.009 x \$10,000), which is less than the cost of negotiating a satisfactory condemnation clause. Under such circumstances, one would expect that the parties would either not negotiate a condemnation clause, or that they would spend such a small amount of resources in negotiations that the resulting clause would not necessarily reflect their true interests. Although we cannot prove that the low-probability problem is insubstantial, we note (a) that many if not most long-term commercial leases *do* include condemnation clauses, and (b) that as we shall see in the next subsection, the provisions of these clauses generally seem to make sense given the circumstances of the parties. There is thus some circumstantial evidence that the low probability problem is not so serious that it destroys the case for condemnation clauses.

competitive on both the landlord's and the tenant's side, and if either party holds out, the other can seek a different bargaining partner. But if the apportionment issue is not settled in the lease, each side in effect has a monopoly over a valuable resource—its consent to a particular division of the condemnation award. Conceivably, the parties could negotiate the apportionment *ex post* without engaging in strategic behavior. But this seems unlikely. The problem is similar to the division of a large estate in the absence of a valid will. The greater the potential rewards, the more difficult it will be for the interested parties to resist litigating.<sup>58</sup> By adopting a clear lease clause dictating the apportionment of any future condemnation award, the parties, like Ulysses, strap themselves to the mast and avoid the siren song of strategic behavior.

#### B. *Apportioning the Award*

Other things being equal, the best apportionment rule would avoid any *ex post* measurement of the parties' respective interests. Measurement of the separate interests increases the costs of a condemnation proceeding both directly, as resources are expended in measurement, and indirectly, by providing an incentive for strategic behavior. The standard condemnation clause avoids the measurement problem by having the lease terminate upon condemnation and giving the entire award to the landlord. It is not necessary, however, that the landlord receive 100% of the award. Any fixed percentage would serve the same purpose (including 100% to the tenant). A clause that allocated the first \$100,000 to the landlord, the next \$100,000 to the tenant, and the remainder to the landlord would also eliminate mea-

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58. See generally Buchanan, *Rent Seeking, Noncompensated Transfers, and Laws of Succession*, 26 J.L. & ECON. 71 (1983). For example, when Howard Hughes died intestate in 1976, the absence of a will clarifying the financial interests of surviving parties, combined with the enormity of the "prize"—estimated at \$1.5 billion—provoked an explosion of litigation. See, e.g., *Howard Hughes Medical Inst. v. Neff*, 640 S.W.2d 942 (Tex. 1982) (Medical Institute claims to be principal beneficiary of lost will); *Moore v. Neff*, 629 S.W.2d 827 (Tex. 1982) (woman claims to have married Hughes at sea in 1949). In addition, the states of California and Texas engaged in extensive litigation over which jurisdiction was entitled to death taxes on the Hughes estate. See, e.g., *California v. Texas*, 457 U.S. 164 (1982); *Cory v. White*, 457 U.S. 85 (1982). Although the two states reached an agreement over death taxes in 1984, the proceeds of the estate still have not, at least as of this writing, been distributed to Hughes' legal heirs.

surement costs.<sup>59</sup> Since other things are not always equal, the efficient condemnation clause will not always employ a mechanical apportionment rule. For example, the parties may be concerned with protecting their respective interests in fixed investments, or providing correct incentives for future behavior, and these concerns may overcome the preference for certainty. Nevertheless, it is important to recognize the considerable value of a mechanical apportionment rule both when designing and interpreting condemnation clauses.<sup>60</sup>

How, then, should the initial lease allocate the award? We will consider four different cases: (1) condemnation of a standard space lease in which the tenant has made no investment in the property beyond removable trade fixtures; (2) condemnation of the leasehold where the tenant has constructed permanent improvements; (3) a partial taking of the leasehold interest; and (4) a temporary taking of the leasehold interest.

### 1. The Standard Space Lease

In the space lease, the value of the landlord's interest is the capitalized value of the contract rent plus the reversion, *i.e.*, the capitalized value of the stream of rents that will be earned after the termination of the lease term. The tenant's interest is the bonus value—the capitalized value of the difference between the market rental value and the contract rent. *Ex post*, the contract rent may turn out to be a terrific bargain so there is a large positive bonus value; alternatively, it may turn out to be a great disaster so there is a large negative value. But, as long as there is no systematic bias when the parties enter into the lease, the expected value of the bonus will be zero. The expected bonus value of *litigated* leases will not be zero, of course. Tenants with a negative leasehold or no bonus value have no incentive to litigate.

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59. See 7A P. ROHAN & M. RESKIN, NICHOLS ON EMINENT DOMAIN § 11.07[5] – [7] (3d. ed 1984) for examples of such clauses.

60. For some general reflections on the function of mechanical entitlement determination rules in bargaining, see Merrill, *Trespass, Nuisance and the Costs of Determining Property Rights*, 14 J. LEGAL STUD. 13 (1985). For example, the use of precise lines to delineate the boundaries of private property facilitates the transfer of property by lowering the costs of determining what is being bought and sold and of enforcing the bargain when subsequent disputes arise.

The only cases that will make it to court are ones in which tenants believe that there is a large positive bonus.<sup>61</sup>

As previously noted, the established default rule awards the bonus value to the tenant.<sup>62</sup> This is equivalent to tying the leasehold to the purchase of a lottery ticket. The prize is the possibility that the bonus value at the time of condemnation will turn out to be positive and large. The implicit price of the ticket will reflect two factors. First, since the landlord is not compensated for the value of a negative leasehold, but the tenant is compensated for the value of a positive leasehold, the contract rent will have to be greater to reflect this asymmetry. Second, the costs of litigation to determine the value of the bonus will be borne, in part, by the tenant. It is conceivable that if the leasehold and the lottery ticket were unbundled, some tenants would still want to enter the lottery. Nevertheless, given the low odds and uncertain return, and the high costs likely to be incurred in collecting the prize (because of strategic behavior), it is unlikely that the tenant will find this an appealing investment.

Not only is the bonus lottery unlikely to have much appeal for the tenant, there are affirmative reasons for transferring the bonus to the landlord. *Ex ante*, the parties will maximize the size of any future condemnation award if they appoint one person to represent their interests in litigation (or settlement negotiations) with the government. A single agent avoids the need for duplicate representation by counsel, and eliminates the coordination costs that result if both parties try simultaneously to maximize the total award from the government and to obtain the highest division of the award for themselves. As between the tenant and the landlord, the landlord would seem to be the better candidate to serve as the agent. At the time the lease is drafted, it is virtually certain that the landlord will be involved in any future

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61. A sample of leases not involved in condemnation proceedings might on average have a positive bonus value; yet this would not necessarily be inconsistent with the proposition that the expected value of the bonus, *ex ante*, would be zero. If the probability that a leasehold will be terminated prematurely is greater for negative than for positive bonus value leaseholds, then the pool of surviving leaseholds would on average have a positive bonus value.

62. *United States v. Petty Motor Co.*, 327 U.S. 372 (1946); M. FRIEDMAN, *supra* note 1, § 13.3, at 504.4; 7A P. ROHAN & M. RISKIN, *NICHOLS ON EMINENT DOMAIN* § 11.03, at 11-6; 5A THOMPSON ON EMINENT DOMAIN § 2583, at 255 (5th ed. 1978).

condemnation proceedings, because his interest in the stream of rental payments and in the reversion will always have some positive value. But it is a matter of chance whether the tenant will be involved, because we do not know ex ante whether the bonus value will be positive or negative. By transferring the bonus to the landlord, the parties can ensure that a single agent will be able to pursue the value of an unencumbered fee simple and will thereby maximize the size of the net total award. Recognizing this, it would be rational for the parties to agree ex ante to transfer the bonus (if any) to the landlord, in return for some offsetting concession to the tenant, such as a small reduction in rent (whether explicitly bargained for or not).

## 2. Permanent Improvements

If the tenant plans to construct permanent improvements on the leased property, drafting a condemnation clause is more difficult. Some of these problems will be considered in the discussion of *Almota* in Part IV. There, a lease clause that gave the tenant the right to remove its permanent improvements prior to the expiration of the lease raised problems involving both the total magnitude of the taking and the apportionment of the shares. Here our concern is entirely with the apportionment question.<sup>63</sup>

The default rule is that the tenant is "entitled to recover for the buildings and fixtures to the extent that they add to the rental value of the unexpired term."<sup>64</sup> The theory underlying the rule is that buildings and fixtures installed by the tenant are "personal property" during the term of the lease, but become part of the "real property" when the lease comes to an end.<sup>65</sup> Thus, insofar as the buildings and fixtures increase the fair market value of the leasehold—what the tenant could obtain through subletting or assigning the lease—the tenant is entitled to this increment of value. The landlord is, however, entitled to the increment of value by

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63. We ignore the practical problems of distinguishing between improvements that are fixtures treated as part of the realty and movable chattels which are not. For purposes of analysis, all improvements are assumed to be fixtures.

64. 4 J. SACKMAN & P. ROHAN, *NICHOLS ON EMINENT DOMAIN* § 13.121[2], at 13-69 (3d ed. 1985).

65. *Id.*

which the buildings and fixtures enhance the value of the landlord's reversionary interest.

The rule is an invitation to throw away money. The parties must determine at the time of the condemnation the value of the land absent the tenant's improvements and the value of the land as improved, then subtract the former from the latter in order to determine the increment in market value attributable to the improvements; further, they must determine an appropriate depreciation formula and discount rate in order to allocate this increment between the leasehold and reversionary interests. Additionally, they must decide whether capital gains or losses associated with the improvements accrue to the landlord or the tenant. These determinations will add considerably to the cost of awarding compensation under the rule.

If the tenant plans to install permanent improvements, the lease usually includes a condemnation clause that alters the default rule. A clause that gives 100% of the award to the landlord would still minimize strategic behavior and would permit the parties to maximize the value of the net total award. But there are several reasons why the parties will probably not agree to such a pro-landlord provision in these circumstances.

First, unlike the bonus, the expected value of tenant improvements is positive, not zero. This value is, approximately, the undepreciated value of the improvements in place at the time of the taking less their scrap value if removed.<sup>66</sup> The tenant will clearly insist on being compensated for these improvements one way or another. Compensation could occur *ex ante* in the form of reduced rent, as it typically does with respect to bonus value. Or it could occur *ex post* by adopting a formula giving the tenant some share of the condemnation award attributable to improvements.

Negotiation of *ex ante* compensation would present a number of stumbling blocks in these circumstances. First, the parties would have to agree on the original value of the improvements (which typically have not yet been constructed), an appropriate depreciation schedule, and an ac-

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66. The tenant would not install the improvements initially if he did not expect to make at least a normal rate of return on the investment.



counting method for capital gains and losses, among other issues. Second, they would have to agree on the probability of condemnation, when it would occur, and whether it would be full, partial, or temporary—all of which would be sheer guesswork. The high level of uncertainty would make it extremely difficult to agree on a number. By comparison, it would be much easier to agree on a formula that would apportion the value of tenant improvements *ex post*.<sup>67</sup>

Second, the tenant will often find it necessary or desirable to borrow in order to construct buildings or improvements. The mortgagee is likely to insist upon protection of its security interest in the improvements through the drafting of an appropriate condemnation clause, rather than accepting the position of an unsecured creditor in the event of a condemnation.<sup>68</sup>

Third, when major improvements are involved, both parties will be concerned with decisions made by the other party during the term of the lease. Allocating 100% of the value of improvements to either party could destroy the post-formation incentives of the other to cooperate. To be sure, such distortion is not likely to be large since the probability of condemnation is not high. But if the tenant is to construct (and maintain) major improvements during the term of the lease, his behavior may be influenced by knowing that all the value added by the improvements would go to the landlord in the event of a condemnation. This would be of particular concern if the probability of condemnation increases during the term of the lease.

This problem of postformation incentive can be minimized by adopting a condemnation clause that apportions the increment in value attributable to improvements be-

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67. To be sure, many of these same uncertainties are present insofar as the bonus is concerned, and yet the parties routinely agree to *ex ante* compensation for the bonus. But recall that the expected value of the bonus is zero. The tenant's right to the bonus is thus the kind of completely speculative interest that can easily be traded off for relatively more certain gains. The tenant's improvements, however, have a positive expected value—probably a very substantial value—and simply cannot be ignored.

68. 7A P. ROHAN & M. RESKIN, NICHOLS ON EMINENT DOMAIN § 11.07[1], at 11-16 (3d ed. 1984), and M. FRIEDMAN, *supra* note 1, § 13.6, at 529, contain several examples of condemnation clauses written to provide protection to mortgagees.

tween the landlord and tenant.<sup>69</sup> Designing a formula that accomplishes this, and yet retains a sufficiently mechanical quality to minimize strategic behavior, can be very difficult. The simplest rule is to pay the tenant his costs of construction less depreciation as per formula. This works best if all the construction takes place at the beginning of the lease. For example, the parties can award the tenant a percentage of the original cost equal to the number of years remaining under the lease divided by the total years under the lease. Note that capital gains and losses in this case are similar to the bonus in the space lease. The expected value is approximately zero.

When there is construction and tearing down of structures taking place over the entire life of the lease, the additional uncertainty requires a more complicated apportionment formula. In these circumstances, the parties may opt for a clause that requires that the unencumbered land and the structures be separately valued at the time of condemnation. Such a solution, however, raises much of the strategic behavior problem presented by the default rule.<sup>70</sup> Alternatively, they may agree to a clause that calls for arbitration, a trustee, or even good faith to determine the apportionment of value attributable to improvements.<sup>71</sup> Such mechanisms may mitigate, but cannot eliminate, the costs of strategic behavior.

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69. Kaplow, *An Economic Analysis of Legal Transitions*, 99 HARV. L. REV. 509 (1986), argues that compensation for takings induces people to overinvest; if they are assured of compensation, they will have an incentive to be careless, to put capital improvements in places where they do not belong. We need not get involved here in a debate over this question. We are only comparing the relative incentive to invest in capital improvements depending on the presence or absence of compensation. *Ceteris paribus*, there will be a greater incentive to invest if there is compensation, and the parties may decide *ex ante* that they want the decisionmaker to have an incentive to invest.

70. *Cf.* Pennsylvania Ave. Dev. Corp. v. One Parcel of Land, 670 F.2d 289 (D.C. Cir. 1981), discussed *infra* at text accompanying notes 87-94.

71. *Id.* at 296 (arbitration clause); Dep't of Pub. Works & Bldgs. v. Metro. Life Ins. Co., 42 Ill. App. 2d 378, 383, 192 N.E.2d 607, 610 (1963) ("fair and equitable" division); 7A P. ROHAN & M. RESKIN, NICHOLS ON EMINENT DOMAIN § 11.07[1], at 11-16 (3d ed. 1984) (arbitration clause); 2 M. FRIEDMAN, *supra* note 1, § 13.6, at 546 (arbitration clause). Alternatively, the parties could provide for an independent appraiser to assemble the data and render a decision, thereby eliminating the representation costs which will still be incurred in an arbitration proceeding.

Thus when tenant improvements are substantial and continue over the term of the lease, the parties may be faced with an unhappy choice between a simple allocation formula that may not accurately reflect the values of their respective inputs, or a more accurate method of apportionment that introduces the potential for strategic behavior.

### 3. Partial Takings

Partial takings are much more common than total takings, and give rise to serious difficulties because the impact of the taking is almost impossible to predict in advance. A taking that shaves off one or two feet of frontage for a street widening may have no impact; a taking that deprives the tenant of all off-street parking may destroy the entire value of the lease.

To complicate matters, the default rules are especially unsatisfactory in this area. Although a total taking will terminate the lease, the case law is very unclear about how extensive a partial taking must be in order to terminate a lease.<sup>72</sup> If the lease does not terminate, the majority rule is that the tenant must continue to pay the full contract rent, but is entitled to a lump sum award from the government reflecting the discounted loss in the value of the leasehold caused by the taking. The minority rule is that the rent will be reduced to reflect the loss in the value of the leasehold.<sup>73</sup> In either case, the landlord is entitled to compensation for damage to his reversionary interest.

The majority rule presents valuation difficulties because of the need to determine the damage to tenant's interest, select a discount rate, and so forth. It also increases the risk of tenant default. If the tenant has received a lump sum award and yet remains liable for full contract rent at a time when the lease is worth much less than the contract rent, there is obviously an incentive for the tenant to walk away.<sup>74</sup>

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72. 2 M. FRIEDMAN, *supra* note 1, § 13.201, at 629. See, e.g., *Saugus Auto Theatre Corp. v. Munroe Realty Corp.*, 366 Mass. 310, 318 N.E.2d 615 (1974) (Commonwealth took land comprising fifteen percent of leased area operated as a drive-in theater; the trial court found this was not substantial enough to terminate lease; the court of appeals reversed and held that it was; supreme judicial court reversed and held that it was not).

73. 2 M. FRIEDMAN, *supra* note 1, at 494.

74. A few courts have responded to this concern by ordering the lump sum payment placed in trust. See *id.* § 13.201, at 496 (citing *Stubbings v. Village of*

The minority rule reduces the risk of default, but still encourages strategic behavior because of the necessarily imprecise process of determining how much the leasehold is "really worth" after the partial taking.

Where a standard space lease is involved, the parties will often modify the relevant default rule by giving either the tenant, the landlord, or both the option to terminate upon a partial taking. Thus, if the tenant finds that the lease has been materially impaired, he can terminate, and can either negotiate a new lease with the landlord or relocate elsewhere. Similarly, if the landlord finds that the taking creates too great a danger of default, the landlord can terminate. The option to terminate here functions somewhat like the threat of partition in a joint tenancy. It is the Sword of Damocles that induces a renegotiation of terms in light of the new realities. The opportunity for strategic behavior is limited by the knowledge that if either side presses its advantage too far, the other will simply exit from the relationship.

When more is involved than a standard space lease, however, the option to terminate may create incentives for strategic behavior. For example, if the tenant has constructed significant improvements or would incur substantial consequential damages upon early termination, the landlord could threaten to invoke the option in the event of a minor taking, thereby exploiting the tenant's vulnerability in order to secure favorable concessions. Alternatively, if the landlord has incurred significant costs in customizing the property for a particular tenant, the tenant could threaten to terminate in the event of a minor taking in order to secure concessions from the landlord.

When the option to terminate could give rise to strategic behavior, there are several possible solutions to the partial takings problem, none of which is completely satisfactory. One is to adopt a mechanical formula that reduces the rent in the event of a partial taking (*e.g.*, in proportion to the number of square feet that have been taken). Unless the lease property is relatively homogeneous, however, this approach will not accurately reflect the diminution

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Evanston, 136 Ill. 37, 43-44, 26 N.E. 577, 578 (1891)); *Pierson v. H.R. Leonard Furniture Co.*, 268 Mich. 507, 524-25, 256 N.W. 529, 535 (1934). A few states have statutes that protect the landlord by placing the award in trust. *See* MASS. GEN. L. ch. 79, § 24 (1969).

in value. Alternatively, the parties may agree to add language to the lease requiring that an option to terminate be exercised only when it is "reasonable" to do so. This solution, however, could give rise to yet another layer of strategic behavior, in the form of disputes over what is "reasonable." Finally, the parties may agree to a provision that allocates all or part of the condemnation award to restore any improvements that have been taken.<sup>75</sup> This last possibility, however, raises many of the problems associated with cost-plus contracts, especially if the tenant is to do the restoration.<sup>76</sup> The tenant will have an incentive to spend generously and assign various costs to restoration in order to increase his share of the pie.

Clearly, there is no ideal solution to the problem of partial takings, especially when the tenant has made significant improvements. It is significant, however, that even with all the difficulties of condemnation clauses in this area, the parties generally prefer to deal with the problem *ex ante*, by condemnation clauses, rather than subject themselves to default rules that have a high potential for strategic behavior.

#### 4. Temporary Takings

Temporary takings, for example government condemnation of a leased warehouse during wartime, present some of the same problems as partial takings, but there are interesting twists. Uncertainty about the scope of the taking is still the primary concern. Here, however, there is uncertainty about the duration of the taking, not its physical dimensions.

The default rule treats the temporary taking like a compulsory sublease imposed on the tenant by the government. The tenant remains liable to the landlord for the contract rent throughout the period of the temporary taking.<sup>77</sup> The tenant is then awarded the fair market value of the leasehold for the term of the temporary taking, discounted to present

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75. 7A P. ROHAN & M. RESKIN, NICHOLS ON EMINENT DOMAIN § 11.03[3]-[10], at 11-17-11-36 (3d ed. 1984).

76. If the landlord has installed improvements and is to do the restoration, there might be an incentive to underspend. Although this would reduce the value of the landlord's reversion, the reversion may be a long way off, and might be little affected by current expenditures on improvements.

77. 2 M. FRIEDMAN, *supra* note 1, § 13.202, at 637.

value and paid in a lump sum. If the temporary taking goes on beyond the term of the primary lease, then the tenant is off the hook altogether. In addition, under the decisions in *General Motors* and *Kimball Laundry*,<sup>78</sup> the tenant subject to a temporary taking, unlike all other condemnees, is entitled to compensation for certain consequential damages, such as the costs of relocation and storage expense, and any destruction of the going concern value of its business.

Because the default rule keeps the primary landlord-tenant relationship intact, strategic behavior is a lesser problem here. From the tenant's perspective, the main problems relate to the difficulty of finding substitute facilities, compounded by uncertainty over the duration of the government's occupation. Temporary takings, even if originally for less than the term of the primary lease, are often subject to renewal. Thus, the primary tenant may have to remove his trade fixtures and inventory to a new location, and move back again if the government does not renew. In the meantime, it may be quite difficult to find substitute facilities with a sufficiently flexible term to allow the tenant to resume his prior lease if the government elects not to renew.

If the primary lease is a standard space lease, the usual response to these difficulties is a condemnation clause that simply terminates the lease in the event of a temporary taking. The expected bonus value is zero, and for the reasons previously discussed, the tenant will agree *ex ante* to transfer the bonus to the landlord. Termination also eliminates the tenant's conundrum about the need to find substitute quarters while he awaits the government's pleasure.

When the primary lease involves substantial tenant improvements, the default rule, which treats the taking like a compulsory sublease to the government, is preferable to termination. Note that here, unlike in other situations involving tenant improvements, the landlord and tenant will not need to haggle over the apportionment of their respective interests in the improvements. The tenant will presumably be compensated for the value added by his improvements during the occupation of the government, because the government pays for the fair market value of the leasehold.

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78. *Kimball Laundry Co. v. United States*, 338 U.S. 1 (1949); *United States v. General Motors Corp.*, 323 U.S. 373 (1945).

When the tenant returns he can then enjoy the remaining value of the improvements, just as if the lease had not been interrupted. If the temporary taking is extended to include the full length of the original lease term, then the tenant is no worse off than he would have been under the original lease, and the market value formula should have provided him with a fully amortized recovery of the value of the improvements.

C. *The Judicial Response to Condemnation Clauses*

The appropriate place to begin in considering the courts' treatment of condemnation clauses is *United States v. Petty Motor Co.*<sup>79</sup> At issue in that case were several condemned leases, one of which included a lease clause that provided:

If the whole or any part of the demised premises shall be taken by Federal, State, county, city, or other authority for public use, or under any statute, or by right of eminent domain, then when possession shall be taken thereunder of said premises, or any part thereof, the term hereby granted and all rights of the tenant shall immediately cease and terminate, and the tenant shall not be entitled to any part of any award that may be made for such taking, nor to any damages therefor except that the rent shall be adjusted as of the date of such termination of the Lease.<sup>80</sup>

The U.S. Supreme Court enforced the clause as written and denied the tenant any recovery for bonus value. *Petty Motor* is still widely cited for the proposition that the tenant can contract away any and all right to compensation upon condemnation where there is a properly drafted condemnation clause.

Although *Petty Motor* is still good law, courts in recent years have been inclined to read condemnation clauses narrowly and construe them against the landlord. In some instances, the narrow interpretation is at least plausible; in others, however, the court's rewriting of the lease is unjustified.

*Maxey v. Redevelopment Authority of Racine*<sup>81</sup> is an example of the former. It involved a ninety-nine year lease which

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79. 327 U.S. 372 (1946).

80. *Id.* at 375-76 n.4.

81. 94 Wis. 2d 375, 288 N.W.2d 794 (1980).

provided that condemnation "shall terminate the further liabilities of both the landlords and tenants under this lease," but did not specifically state, as did the lease in *Petty Motor*, that the tenant was entitled to no portion of the condemnation award. The Wisconsin Supreme Court, citing the proposition that the law "abhors a forfeiture unless stated in most explicit terms,"<sup>82</sup> held that this was insufficient to deprive the tenant of any compensation for his bonus value.

Viewed as a matter of discerning the intentions of the parties, the result in *Maxey* is not necessarily wrong. The question is: what did the parties assume the effect of condemnation would be in the absence of any lease provision? The older common law rule was that the ouster of the tenant by a third party did not qualify as a constructive eviction, and hence did not excuse the tenant from future payment of rent.<sup>83</sup> If the parties assumed this was the default rule, then the principal purpose of the termination clause would be to excuse the tenant from further payments of rent upon condemnation. Such a clause would not necessarily imply that the tenant was waiving any claim to a portion of the condemnation award based on bonus value. The modern rule is that condemnation, at least a total condemnation, terminates the lease and discharges the covenant to pay rent.<sup>84</sup> If *this* was the assumed background rule, then the inclusion of a termination clause in the lease might signal an intention to apportion 100% of the condemnation award to the landlord.<sup>85</sup>

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82. *Id.* at 403, 288 N.W.2d at 806.

83. *See supra* note 14. When the lease was drafted in 1915 there was no Wisconsin authority on whether condemnation discharged the tenant's obligation to pay rent. Not until 1965, in a decision involving a partial taking, did the Wisconsin Supreme Court observe that it was "settled in other jurisdictions" that a total condemnation would act to terminate the lease. *See Kilps v. Pawinski*, 27 Wis. 2d 467, 134 N.W.2d 470 (1965).

84. *See supra* note 14.

85. It is possible that the parties would include such a clause only out of fear the rule of automatic termination might again change. But it has been argued, with some force, that against the background of the modern rule of automatic termination, the inclusion of a termination clause signals an intent to award the entire proceeds of condemnation to the landlord. *See* 1 AMERICAN LAW OF PROPERTY § 3.55, at 292 (Casner ed. 1952) ("Inasmuch as the rule is that the lease terminates upon a taking of the whole property without express provision to that effect, the express provision is construed as being intended to deny to the lessee any compensation for his leasehold."); M. FRIEDMAN, *supra* note 1, § 13.3, at 648 (discussing a case where the tenant unsuccessfully argued that since lease terminated by law, clause was surplusage and did not cut off his rights).



Given that the lease in *Maxey* was sixty years old, it is not implausible that the original parties assumed (or at least feared) the application of the early common law rule.

Moreover, we can ask if it is likely that the parties intended to give the entire award to the landlord. *Maxey* did not involve a simple space lease. Rather, the lease required the tenant to construct a movie theater. Since tenants who construct substantial improvements generally do receive a share of the award, it seems reasonable to interpret the clause in favor of the tenant's claim. Hence, the court could have ruled for the tenant without invoking the maxim about the law abhorring a forfeiture.<sup>86</sup>

Other decisions, however, can be explained only as evidencing judicial hostility to the intentions of the parties. *Pennsylvania Avenue Development Corp. v. One Parcel of Land*,<sup>87</sup> illustrates how a court that begins with the proposition that a lease should be interpreted "so as to prevent forfeiture"<sup>88</sup> can reach a result that is plainly contrary to the parties' agreement. In that case, L leased land to T for a period of up to ninety years with a fixed annual rental for the first thirty years. T owned improvements on the land which, of course, would revert to L upon termination of the lease. The condemnation clause clearly distinguished between the portion of the condemnation award attributable to the land, and the portion attributable to the tenant's improvements. With respect to the former, it provided unequivocally that the leasehold would be terminated upon condemnation, and, "[n]otwithstanding any statute or rule of law to the contrary, landlord shall be entitled to receive the total proceeds of the award made in such proceeding."<sup>89</sup> With respect to

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86. A similar sort of ambiguity was present in *United States v. Right to Use & Occupy 3.38 Acres of Land*, 484 F.2d 1140 (4th Cir. 1973), where the lease provided that it would terminate upon condemnation, but the tenant would have the right to file and prosecute its claims for damages against the condemnor. *Id.* at 1143. A possible explanation for this type of clause is that many states have statutes providing compensation for losses, such as moving expenses, which do not come under the constitutional standard. *See, e.g.*, N.J. STAT. ANN. § 20:4-1 et seq. (West 1987) (Relocation Assistance Act). The tenant might ask to have such a clause included in the lease in order to foreclose a possible argument by the state that these rights were waived when the tenant agreed to termination of the lease upon condemnation.

87. 670 F.2d 289 (D.C. Cir. 1981).

88. *Id.* at 292.

89. *Id.* at 295.

the improvements, the lease provided unequivocally that the value of the improvements would be divided according to the fraction of the ninety year term remaining, *i.e.*, the further into the term, the larger the portion of the award for improvements going to L.

Despite the explicit terms of the condemnation clause, the court seized upon one sentence to find an "ambiguity" that, under the presumption against forfeitures, allowed T to recover the bonus value as well as his fractional share of the improvements. The sentence that the court found ambiguous committed the parties, in the event of condemnation, to request that the court make a separate determination of "the value of the Demised Premises considered as vacant and unimproved land plus the value of the interest of the landlord in the improvements on the land, and the value of the tenant's leasehold estate *including* his interest in the Improvements on the other."<sup>90</sup> The Court found the word "including" ambiguous. If the leasehold really terminated upon condemnation, reasoned the court, then the tenant would be entitled to nothing other than his share of the improvements, so why say "including"? Thus, because the parties used the word "including" instead of another phrase (such as "that is") in one sentence dealing with procedures in a long and elaborate condemnation clause that was otherwise completely unambiguous, the court rewrote the agreement to allow T rather than L to reap the benefit of rising real estate values.<sup>91</sup>

The animating force behind a decision such as *Pennsylvania Avenue Development Corp.* is hard to fathom. It appears from the decision that both L and T were real estate professionals.<sup>92</sup> The "elaborate" lease and the conveyancing through a "complicated chain of title"<sup>93</sup> were obviously accomplished with the advice of legal counsel. It is unlikely

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90. *Id.* (emphasis added).

91. For a persuasive critique of the canon of construction that every word in a document must be given significance, see Posner, *Statutory Interpretation—in the Classroom and in the Courtroom*, 50 U. CHI. L. REV. 800, 812 (1983).

92. The landlord was the National Press Building Corporation and the tenant was apparently a real estate investment partnership consisting of six individuals and an entity called the S & L Management Company, Inc. 670 F.2d at 290-91.

93. *Id.* at 291.

that condemnation was unanticipated.<sup>94</sup> In these circumstances, it is difficult to imagine any story about unconscionability or "unequal bargaining power" that would justify fly-specking the lease in order to give the tenant a larger share of the condemnation award.

In fact, despite general agreement that parties may apportion condemnation awards *ex ante* in the lease, these provisions are often litigated. Several commentators have asserted that these disputes occur because the clauses tend to be poorly drafted.<sup>95</sup> A more likely explanation is the natural tendency of the tenant to seek to avoid the bargain he made when condemnation was perceived as a remote possibility. This would appear to be the only logical explanation for disputes such as whether a clause providing for termination of the lease on "condemnation by public authorities," included condemnations by eminent domain.<sup>96</sup> The court in this particular case, fortified by the presumption against forfeitures, found that the clause did not include condemnations by eminent domain. This result indicates an even stronger explanation for these conflicts: the tenants are often successful.<sup>97</sup> By construing condemnation clauses against the landlord when there is a discrepancy between what the tenant would normally receive under the default rules and the amount the tenant is allocated by the lease, courts exacerbate the potential for strategic behavior that inheres in the apportionment problem. Further, they increase

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94. The condemned property included the National Theater Building on Pennsylvania Avenue in Washington D.C., and was a prime site either for historic preservation or the construction of future government office buildings. *Id.*

95. See, e.g., L. ORGEL, *supra* note 39, § 121, at 527; Broadman, *Providing in the Lease for the Event of Condemnation*, in A PRACTICAL GUIDE TO THE LEGAL AND APPRAISAL ASPECTS OF CONDEMNATION § 147, at 152 (S. Searles ed. 1969). To be sure, some are poorly drafted. For example, in *Dep't of Pub. Works & Bldgs v. Metropolitan Life Ins. Co.*, 42 Ill. App. 2d 378, 383, 192 N.E.2d 607, 610 (1963), the condemnation clause in a ninety-nine year lease stated that "any and all condemnation awards or judgments shall be divided fairly and equitably between the fee simple estate and the leasehold estate."

96. *Belmont Clothes, Inc. v. Pleet*, 229 Md. 462, 184 A.2d 731 (1962).

97. See, e.g., *Urban Renewal Agency v. Wieder's, Inc.*, 53 Or. App. 751, 632 P.2d 1334 (1981) (clause that terminates lease and allows tenant to recover business losses and relocation costs from condemnor and not from landlord does not preclude tenant from recovering bonus value); *In re Condemnation by the Commonwealth Dep't of Transp.*, 38 Pa. Commw. 535, 394 A.2d 657 (1978) (termination clause ineffective to bar tenant from sharing in award notwithstanding specific provision in lease providing for reduced rent during first two years of tenancy in consideration of possibility of condemnation).

the costs of *ex ante* apportionment by making it extremely difficult for the parties to design efficient condemnation clauses.

The modern cases suggest that courts do not understand the primary rationale behind condemnation clauses: elimination of costly strategic behavior that leaves both landlord and tenant worse off. On the contrary, courts seem to view disputes between landlords and tenants as simply a matter of achieving after-the-fact justice. Looking backwards, condemnation clauses that award 100% to the landlord seem "unfair," and the temptation is clearly to give the tenant something. We hope that we have shown that, on a more rigorous analysis, there are serious shortcomings with such an approach. Here, as elsewhere, judicial insistence on viewing disputes strictly from an *ex post* perspective can leave other similarly situated persons worse off.<sup>98</sup>

#### IV. *ALMOTA* AND THE EXPECTATION OF RENEWAL

*Almota Farmers Elevator & Warehouse Co. v. United States*<sup>99</sup> is the leading modern case on condemnation of leased property. The U.S. Supreme Court held that a tenant who made substantial improvements to condemned property was entitled to compensation for the value of those improvements. The Court further required that the probability of renewal of the tenant's lease should be taken into account when assessing the value of the improvements.<sup>100</sup> The decision in *Almota* is extremely muddled, in large part because the Court fails to indicate what question it is answering. Is the government's total liability affected by taking the expectation of renewal into account in valuing the tenant's improvements?

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98. See Easterbrook, *Foreward: The Court and the Economic System*, 98 HARV. L. REV. 4 (1984).

99. 409 U.S. 470 (1973).

100. In so ruling, the Court distinguished *Petty Motor*, a case not involving improvements, where it had held that a tenant is *not* entitled to compensation for the mere expectation that the lease would have been renewed. See *United States v. Petty Motor Co.*, 327 U.S. 372, 380 n.9 (1946) (evidence showing that landlord and tenant had a habit of regularly renewing the lease does not expand the scope of the tenant's compensable property right) (citing *Emery v. Boston Terminal Co.*, 178 Mass. 172, 185, 59 N.E. 763 (1901)); see also *Riebs v. Milwaukee County Park Comm.*, 252 Wis. 144, 31 N.W.2d 190 (1948) (despite testimony that landlord intended to allow month-to-month tenant, who had leased site for several years, to remain at least another season, tenant's compensation limited to value of thirty day lease).

Or is the issue of renewal relevant only to the division of the award between the landlord and tenant? The Court's failure to confront these questions is the source of much of the confusion.

The facts in *Almota* were simple. The Almota Farmers Elevator Company leased land from a railroad adjacent to the tracks. It had been using the land under successive leases since 1919. The lease authorized Almota to make improvements to the land, and provided that Almota could remove any improvements it made at any time during the life of the lease. Almota had constructed a grain elevator and other extensive improvements on the land. When the government instituted eminent domain proceedings in 1967, Almota had a twenty-year lease with seven and one-half years yet to run. The contract rent was a mere \$114.20 per year, and the value of the structures in place, it was stipulated, was \$274,625.<sup>101</sup> After acquiring the railroad's interest through a negotiated settlement, the government sought to acquire Almota's interest by condemnation.

The government's proffered compensation was for the use and occupancy of the buildings for the remainder of the lease term and for the salvage value of the buildings. Since salvage value was considerably less than the value of the improvements in place, Almota argued that it was entitled to an award reflecting the value of the improvements in place beyond the expiration of the lease term. In a five to four opinion, the Court agreed. A buyer of the leasehold interest in an arm's length transaction, the Court asserted, would have been willing to pay Almota for the improvements in place:

It seems particularly likely in this case that Almota could have sold the leasehold at a price that would have reflected the continued ability of the buyer to use the improvements over their useful life . . . . In a free market, Almota would hardly have sold the leasehold to a purchaser who paid only for the facilities over the remainder of the lease term, with Almota retaining the right . . . of salvage.<sup>102</sup>

Thus, the Court held that the fair market value of Almota's interest was something more than the capitalized value of

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101. *Almota*, 409 U.S. 470 (Petition for Certiorari, at 3, 9).

102. 409 U.S. at 475.

the improvements for the balance of the term plus their salvage value. It was also, apparently, something less than the full value of the assets in place, since that value would presumably have to be discounted to reflect the fact that Almota had only an expectation, rather than a right, of renewal.

*Almota* raises what the leading treatise on eminent domain has described as "an interesting problem."<sup>103</sup> The problem is this: the tenant's improvements have added substantially to the value of the fee. Under the ordinary default rule, this value would be apportioned between the landlord and tenant, with the tenant receiving the value attributable to the remaining lease term, and the landlord the value attributable to the reversion.<sup>104</sup> Under the lease, however, the tenant also has the right to remove the improvements up to the last day of the term.<sup>105</sup> Where there is such a right of removal, courts generally hold that the landlord is *not* entitled to any of the value attributable to improvements as part of his reversion.<sup>106</sup> Yet if neither the landlord nor the tenant is entitled to the value of the improvements in place beyond

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103. 4 J. SACKMAN & P. ROHAN, NICHOLS ON EMINENT DOMAIN § 13.121[1], at 13-63 (3d ed. 1985).

104. See *supra* Part III(B)(2).

105. It would often be value-enhancing for the parties to a long-term lease to give the tenant the unilateral power to make decisions regarding construction, alteration, and removal of structures, subject to the proviso that no physical harm is done to the landlord's interest. Absent such a provision, the landlord could withhold consent for an alteration, unless the tenant agreed to compensate for that consent. Giving control over the structures to the tenant reduces the potential costs that would arise from the landlord's strategic behavior. These benefits are offset in part by an increased incidence of strategic behavior by the tenant at the time of lease renegotiation. But the parties can often structure the lease so as to dampen the tenant's incentives to play games. For example, in *Helvering v. Bruun*, 309 U.S. 461, 464 (1940), a ninety-nine year lease prohibited tearing down any building in the last three and one-half years of the term.

106. This result does not inevitably follow. One could argue that unless the tenant *actually* removes the improvements, the mere right to remove will not defeat the landlord's claim to a property interest in the improvements as part of his reversion. The general rule, however, in Washington and elsewhere, is that the landlord is not entitled to compensation for fixtures, structures, or other improvements where the lease gives the tenant the right to remove improvements. See *Seattle & Mont. Ry., v. Scheike*, 3 Wash. 625, 29 P. 217 (1892); *State v. Obie Outdoor Advertising, Inc.*, 9 Wash. App. 943, 516 P.2d 233 (1973); Annotation, 17 A.L.R.4th 337, 398 (1982); see also *In re Chicago, Rock Island & Pac. Ry.*, 753 F.2d 56, 58-59 (7th Cir. 1985) (grain elevator holds over after end of lease, fair rental value determined on basis of value of unimproved land because tenant had right to remove improvements).

the end of the lease term, then what happens to this increment in value? As Nichols puts it:

If the condemnor has to pay the whole additional value of the real estate due to the existence of the buildings and fixtures, either the landlord or the tenant will receive more than his interest is actually worth. Whether this is one of the cases in which the value of the real estate as such is disregarded and the total value of the separate interests in the real estate is the proper measure of compensation is not yet entirely clear.<sup>107</sup>

The *Almota* "problem" disappears, however, if we distinguish carefully between the total size of the award and the apportionment of the award between the landlord and tenant. The fact that the tenant can remove the structures does not mean that the total award should be less than the value of an undivided fee simple. This is simply another instance of our point in Part II that paper encumbrances which reduce the value of the property *ex post* should be ignored. If the parties had considered the impact of the right to remove improvements on condemnation value when they negotiated the lease, they would have included a clause terminating this right upon condemnation. Such a provision would maximize the net total value of the condemnation award.<sup>108</sup> The same result is achieved, of course, by applying the undivided fee rule.

Thus, it is not correct, as Nichols suggests, that application of the undivided fee rule in this context means that "either the landlord or the tenant will receive more than his interest is actually worth." The total award should be based on the highest and best use of the property, which includes the value of the structures in place. There is no "windfall" involved in such an award, because the parties could have costlessly realized such a value through the proper lease agreement, *i.e.*, an agreement that the tenant's right to remove would terminate upon condemnation. Indeed, they could achieve such a result in other ways as well: the tenant

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107. 4 J. SACKMAN & P. ROHAN, NICHOLS ON EMINENT DOMAIN § 13.121[1], at 13-63 (3d ed. 1985).

108. The government conceded this point at trial. The Court (to government lawyer): "[If] on the day before the condemnation action was filed . . . the Almota Company had conveyed this property to the railroad company, you would be paying them about five times as much as you are offering them now. Mr. Mcrae: Yes, your honor." *Almota Farmers Elevator & Warehouse Co. v. United States*, 409 U.S. 470 (1973) (Petition for Certiorari, at 87).

could agree to sell the improvements to the landlord; the landlord could agree to sell the reversion to the tenant; or both could agree to sell their respective interests to a third party, who would then hold the undivided fee. The point is that the separate rights of the parties, in the right combination, are necessarily worth the value of the undivided fee. Consequently, the parties should be compensated for the value of an undivided fee.

Given that the property should be valued as an undivided fee simple, how should the award be apportioned? As should be clear from our prior discussion, the default rule does not really matter as long as the parties are free to modify it by prior negotiation. The simplest default rule here, perhaps, would be to award the tenant the *difference* between the value of the undivided fee as improved and the value of the land as unimproved. In effect, the tenant would be entitled to the value of the improvements in place *as if* the lease would be perpetually renewed. Using such an approach, there would be no need to value the "expectation" of renewal or to discount the value of the improvements in place for the probability of nonrenewal. Should the parties find that this apportionment is overly generous to the tenant or otherwise inappropriate, they could simply draft a condemnation clause to apportion the value attributable to the improvements in a different way.

Under the framework of analysis proposed by this paper, the *Almota* problem is easy. Why then did the Supreme Court find it necessary to create a new right to compensation for the expectation of renewal? The basic problem was that the Court failed to perceive the distinction between the size of the pie and the division of the pie. The reason it failed to make this distinction was probably because the landlord, the railroad, was not a party to the case. The issue therefore was regarded by both the litigants and the Court as a simple two-party dispute between the tenant and the government, with the prior settlement with the railroad treated as irrelevant.<sup>109</sup>

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109. It is not at all clear, however, that the ultimate payor of *Almota's* compensation would be the government. By finding that *Almota* has a right to compensation, the Court does not preclude a finding that the government might have a subsequent action against the railroad to indemnify it for its payment to *Almota*. In a similar case where the tenant was not a party to the transaction between the



Since the railroad's compensation was determined by negotiation, the obvious question is: how much did it receive and on what was this award based? The Court did not say.<sup>110</sup> The record strongly intimates that the railroad received comparatively little in the way of compensation.<sup>111</sup> Given the established rule that the landlord is not compensated for the value of improvements when the tenant has a right to remove, the railroad was probably compensated for the capitalized value of the future stream of rental payments—which was low—and for its reversionary interest in the unimproved land. If this is correct, then the government was in the position of arguing that it did not have to pay anything for the value of the improvements in place after the end of the lease term. It is not implausible that the Court instinctively recoiled from this argument. As Justice Powell observed in his concurring opinion: "It would be unjust to allow the Government to use 'salami' tactics to reduce the amount of one property owner's compensation by first acquiring an adjoining piece of property or another interest in the same property from another property owner."<sup>112</sup> The Court's instincts were sound, but its solution was unfortunate. Essentially, the Court responded to a perceived inadequacy in the *total compensation* by adjusting the *apportionment rules*.

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government and the landlord, the court noted: "It is immaterial to the present case whether the lessee could recover from the lessor a share of the amount paid to the lessor by the city, or whether the city can now recover from the lessor the amount of any overpayment." *Universal Container Corp. v. City of Cambridge*, 361 Mass. 58, 61, 278 N.E.2d 727, 729 (1972).

110. To be sure, the Court did not receive any help from the litigants. The court of appeals noted in its opinion:

Prior to the commencement of the condemnation action here under review, the United States had settled with the fee owner, the Railroad, for the railroad's interest in the land here in question. We are not advised as to the terms of that settlement. Neither party to this case urges that those terms would be relevant in this case.

*Almota*, 450 F.2d 125, 126 (9th Cir. 1971), *rev'd*, 409 U.S. 470 (1973). Similarly, in the Briefs to the Supreme Court, neither side felt it necessary to apprise the Court of the terms of the award.

111. We base this on the inference that if the government had fully compensated the railroad for the reversion, the government lawyers would have stressed the point in the subsequent litigation with *Almota*, contending that it should not be forced to pay twice.

112. 409 U.S. at 480 (Powell, J., concurring).

The new default rule created by *Almota* is subject to criticism on a number of grounds. First, although the problem that gave rise to *Almota* is the tenant's unilateral right to remove improvements, the Court's new rule is stated broadly, and apparently applies to all cases involving tenant improvements. Second, by saying that the tenant is entitled to have his expectation of renewal considered in valuing improvements, the Court called into question the general rule that the tenant is not entitled to compensation for any expectation of renewal. This uncertainty has already led to additional litigation.<sup>113</sup> Finally, as Justice Rehnquist emphasized in his dissent, valuation of the tenant's expectancy will create considerable difficulty. For example, should a one year tenant be given some compensation for the (slight) probability of a fifty year occupancy?<sup>114</sup> The new default rule therefore increases the administrative costs of eminent domain proceedings, and gives further impetus to strategic behavior. All of these problems could have been avoided simply by applying the undivided fee rule and a fairly conventional apportionment rule.

Although *Almota* itself could have been resolved by a routine application of the undivided fee rule, the facts of the case suggest another issue concerning the division of the award—one that could in fact have an indirect effect on the magnitude of the award. If the landlord (or the tenant) reaches a separate agreement with the government, is it possible for that party to devise a settlement that increases the amount it receives while at the same time decreasing the amount the government must pay? That is, given the rules for sharing the award, is it possible for the government and the landlord (or the government and the tenant) to improve their respective lots at the expense of the nonsettling party?

Suppose, for example, that instead of simply taking the land as it did in *Almota*, the government induced the railroad to relocate its tracks, rendering the improvements useless

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113. See *Alamo Land & Cattle Co. v. Arizona*, 424 U.S. 295 (1976); *United States v. 57.09 Acres of Land*, 757 F.2d 1025 (9th Cir. 1985); *United States v. Weyerhauser Co.*, 538 F.2d 1363 (9th Cir. 1976), *cert. denied*, 429 U.S. 929 (1976); *Rowland v. United States*, 8 Cl. Ct. 267 (1985), *aff'd*, 790 F.2d 92 (Fed. Cir. 1986).

114. *Almota*, 409 U.S. at 485 (Rehnquist, J., dissenting).

save for their salvage value.<sup>115</sup> The opportunity for both the government and the landlord to profit at the expense of the tenant would be considerable in this case, since the tenant would lose his interest in the structures in place for the duration of the remaining lease period.

If it were possible to prevent this kind of opportunistic behavior costlessly, the initial lease would do so. Preventing such behavior would increase the expected size of the total award, and, by sharing the gains, both parties could be better off. Prevention of opportunistic behavior is not, however, without cost. Thus, we face the familiar question of what are the benefits and costs of policing this behavior? We also face the related question of who should decide. That is, should the balancing be a matter to be determined by the parties in their lease? Should the courts determine only default rules that can be replaced by private agreement? Should the courts impose a duty of good faith on the landlord and/or the government?

We need not resolve these questions here. The important point is that the question of whether the expectation of renewal is a compensable interest is a red herring.<sup>116</sup> The crucial question is whether it is possible for the landlord and condemnor to profit at the expense of the tenant. If it is, then we can raise such issues as the ability of tenants to protect themselves *ex ante*, and the good faith of the landlord and condemnor. The tenant's expectation of renewal could conceivably be evidence on those issues, but it would not itself be regarded as a compensable property right.

#### IMPLICATIONS FOR OTHER PROPERTY RIGHTS SUBJECT TO CONDEMNATION

Genuinely difficult conceptual problems arise when the government condemns leased property. Courts can go a long way toward resolving these problems, however, if they keep two things in mind. First, the sum of the parts should always equal the value of an undivided fee simple. Second,

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115. For a case in which this was the alleged strategy of the government, see *United States v. 12.18 Acres of Land*, 623 F.2d 131 (10th Cir. 1980).

116. In two cases that raise this question, *Jefferson County*, 623 F.2d 131 (10th Cir. 1980), and *Western Robidoux Printing & Lithographing Co. v. Missouri State Highway Comm'n*, 498 S.W.2d 745 (Mo. 1973), the courts center the analysis on whether the tenant's expectancy of renewal is compensable.

in dividing up the total award, condemnation clauses should be favored rather than discouraged. Both of these propositions reflect what is, in effect, hornbook law. But the failure to understand the rationale behind these propositions has often led courts into equivocation and confusion. The uncertainty created by this state of affairs has probably increased the incidence of strategic behavior that occurs when the government condemns property encumbered with a lease.

The analysis of the impact of condemnation on landlord-tenant relations may also provide some lessons for other areas of eminent domain. Two areas in particular may be worth reconsideration: condemnation of future interests and condemnation of contractual rights.

In the future interests area, the problem usually arises when the government takes land which has been transferred for some charitable or public purpose and is held subject to a possibility of reverter or right of entry in the heirs of the grantor. The facts of *Ink v. City of Canton*<sup>117</sup> are typical. In *Ink*, land was given to the City to be used as a public park, with a reversionary interest in the grantors' heirs should the land cease to be used as a public park. Years later, the state condemned most of the land for a highway. In such cases, courts seem to have no trouble applying the undivided fee rule, perhaps because the grantee's interest is called a "defeasible fee." They are divided, however, about the appropriate rule of apportionment. A majority hold that the grantee is entitled to 100% of the proceeds of the condemnation. A minority hold that the heirs of the grantor are entitled to 100% of the condemnation. In the *Ink* case, the court rejected both of these rules, and decreed that the award should be apportioned between the parties in accordance with the fair market values of their respective interests.<sup>118</sup>

The *Ink* approach is an invitation to disaster. It is extremely difficult to develop the fair market value of a defeasible fee, and even more difficult to develop the fair market value of the heirs' possibility of reverter. There is little or no secondary market for either interest to which we can look

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117. 4 Ohio St. 2d 51, 212 N.E.2d 574 (1965).

118. *Id.* at 60, 212 N.E.2d at 579.

for comparable prices. Moreover, the possibility of reverter, and perhaps also the defeasible fee, will yield no cash flow that can be capitalized to produce a value. *Ink's* apportionment rule would therefore lead to extensive strategic behavior.

In addition, *Ink* erroneously assumes that the *ex post* fair market value of the parts will add up to the market value of a fee simple. This assumption is wrong for two reasons. First, the restriction or use imposed by the grantor will probably reduce the market value of the property. For the original grantor, the subjective value attached to the creation of a public park bearing his name will equal or exceed the value of the property in any other use. But the *ex post* valuation of such a restriction by the market will probably be otherwise reflected in the *ex post* valuation of the market. Second, a deep discount will be required because of the virtually non-existent secondary market for both of these peculiar interests. This does not mean that the undivided fee rule is wrong. As explained in Part II(B), paper encumbrances that reduce value *ex post* should be ignored, and the undivided fee rule accomplishes this. But a court that assumes that the value of the undivided fee can be apportioned by determining the *ex post* market value of the individual interests will be led into a mass of confusion, as was the *Ink* court.<sup>119</sup>

The ideal solution, as in the case of leases, would be to establish apportionment by condemnation clause. Unfortunately, condemnation clauses are rarely, if ever, encountered in this area, probably because an attempt by the grantor to dictate the distribution of a future condemnation award

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119. A court that understood this could continue to apply the undivided fee rule, and yet try to apportion the award by valuing *one* interest separately, and giving the balance to the second party. But the fair market value of either interest considered separately will be very small. The value of the City's interest would depend on whether there is a secondary market for private parks. (There will not be a secondary market for public parks—i.e., those that do not charge admission. If the grant requires that the park be open to the public without charge, then the market value is probably zero.) And the heirs' interest is analogous to a lottery ticket that requires relatively high monitoring costs to determine whether there has been a payoff. Given that each interest, by itself, will have a fairly low value, the critical question would be which of the two interests should be valued first. General considerations of "fairness" invoked by the *Ink* court can no more answer this question than they can tell us which of the two parties should get 100%.

would violate the Rule Against Perpetuities.<sup>120</sup> Barred from using a condemnation clause, the grantor's second preference, we think, would in most cases be to give the proceeds to the grantee. This is because the primary purpose of the gift over to the heirs is not to benefit the heirs, but to provide a "penalty" to enforce compliance with the original grant. Moreover, it would be administratively difficult to locate the heirs years or even decades after the original grant; if they could be located, they might engage in strategic behavior contesting their respective shares. Finally, the posthumous gift over could entail unexpected tax consequences for the grantor's estate. Thus, in the imperfect world of future interests where condemnation clauses are not available, the majority rule awarding 100% of the condemnation proceeds to the grantee is probably the correct default rule.

Note, too, that the majority rule is similar to what one finds in landlord-tenant condemnation clauses with respect to bonus value. Here, too, the *ex ante* value of the heirs' interest, like the tenant's bonus, is zero, or at least close to zero. Thus, based on the pattern of responses in the landlord-tenant area, we would expect to find that the heirs' expectancy is not the kind of interest that the grantor would be anxious to protect in the event of condemnation.

The government rarely condemns contractual rights, but when it does, the same kind of triangular pattern of relationships exists as in the landlord-tenant context. In *Omnia Co. v. United States*,<sup>121</sup> for example, the government requisitioned a large quantity of steel plate from Allegheny, which had been under contract to deliver the steel at below-market prices to Omnia. Omnia sued the United States in the Court of Claims, contending that the government had taken its contractual rights without paying just compensation. The Supreme Court denied the claim, distinguishing between a case in which the government appropriates a contract—where the Court said compensation would be required—and a case in which the government merely frustrates a contract

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120. The argument would be that the grantor is attempting to create an executory interest that would not necessarily vest within any life in being plus twenty-one years. The interest of the heirs is not itself subject to the Rule because of the historical quirk that exempts possibilities of reverter and rights of entry from the Rule.

121. 261 U.S. 502 (1923).

or makes performance of a contract impossible—where the Court said compensation is not required.

*Omnia* has been criticized for elevating form over substance. The buyer under the original contract (*Omnia*) lost a valuable right—the benefit of its bargain with the seller—no matter how the government's action is characterized.<sup>122</sup> Note, however, the close parallel between the buyer-seller relationship and the tenant-landlord relationship. As long as the government pays the seller the fair market value of what is taken—here the steel plate—the apportionment of the award between the parties can be handled by *ex ante* agreement. Thus, *Omnia* could have protected itself from the loss of the benefit of its bargain by insisting on a clause in the original contract that would provide it with a share of the total compensation in the event of a government requisition of the steel plate.

In fact, just as the tenant will commonly assign the bonus value to the landlord, so the buyer will commonly assign his benefit of the bargain to the seller. The chosen instrument for doing so is the so called "force majeure" clause, which excuses the seller from further performance in the event of certain contingencies, including, typically, a government taking.<sup>123</sup> The reasons why the buyer would agree to a force majeure clause are similar to those that support transfer of the bonus to the landlord. *Ex ante*, the benefit of the bargain is zero, and the parties have much to gain, should the government interfere with the contract, by eliminating strategic behavior and sidebar arguments over apportionment. The buyer can be compensated for giving up his rights by offsetting concessions from the seller, such as a modest reduction in the price, whether or not this is bargained for explicitly.<sup>124</sup>

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122. See, e.g., R. EPSTEIN, *supra* note 16, at 92-94.

123. In *Omnia*, the seller specified in his offer that "all agreements [are] contingent upon strikes, accidents, or other causes beyond our control." Record at 7, *Omnia Co. v. United States*, 261 U.S. 502 (1923).

124. The complete story in *Omnia* is slightly more complicated. The steel plates contract between *Omnia* and Allegheny appears to have been deliberately set at a price below market in order to compensate *Omnia* for the transfer of certain machinery and mill equipment to Allegheny that *Omnia* could not use, given a war-induced shortage of labor and materials. Petitioner's Brief, at 1, *Omnia*, 261 U.S. 502. Thus, the expected value of *Omnia*'s contract was positive, not zero, making the case more analogous to one of permanent tenant improvements than to the bonus. Nevertheless, the basic point remains sound. *Omnia*

In short, *Omnia* was correctly decided, but for the wrong reasons. The government need not compensate the buyer when it takes the subject matter of the contract. The reason for this is not, however, because it is important to differentiate between “appropriations” and mere “interferences” with contracts. Rather, compensation is not required because the buyer can bargain with the seller in advance of any taking, and thus is in a position fully to protect his interests. Indeed, the default rule in the contracts area—no compensation to the buyer—probably comports more with the intentions of the parties than does the default rule in the landlord-tenant area, where the tenant has a compensable property right but routinely bargains it away.

*Omnia* suggests, once again, that it is important to remember the potential for *ex ante* bargaining whenever government condemnation implicates multiple parties. If courts recognize that bargaining takes place in the shadow of eminent domain, the substance of eminent domain law will be strengthened.