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VALUATION OF THE MORTGAGOR'S INTEREST IN EMINENT DOMAIN

The general rule for the valuation in eminent domain of property subject to split ownership is to first value the property as an unencumbered fee, and then to apportion the award between the owners of the various interests.[1] The fact that property is subject to a mortgage or a lease is immaterial with respect to the total amount of compensation paid by the condemnor. In a recent series of cases, however, in which the federal government has acquired Wherry Act housing on military installations, the government has condemned only the mortgagor's interest by assuming an unpaid mortgage balance. The only method of property valuation available in these cases was the capitalization of income method, and the courts were faced with the unique question of when in the capitalization process to give consideration to the unpaid mortgage balance.

The Wherry Housing Act of 1949[2] was enacted by Congress for the purpose of increasing the supply of rental housing accommodations available to military and civilian personnel on military installations. To insure success the Act was drafted in such a way as to make the program attractive both to the owner-sponsor who constructed the project and the mortgage banker who supplied the capital. The projects were constructed on government land subject to long term leases to the owner-sponsor at nominal annual rents. In arranging the financing for these projects, the Federal Housing Administration estimated the original cost of construction, and then authorized federally-insured mortgages representing approximately ninety per cent of this estimated cost. The owner-sponsors were subject to Federal Housing Administration regulations in such matters as rents, charges, capital structure, rate of return, and method of operation. In 1952, Congress enacted the Capehart Act,[3] announcing a new policy with regard to military housing. Under the Capehart Act, the federal government, and not government-sponsored private enterprise, was to construct and operate housing projects on military installations. Therefore, government acquisition of all Wherry housing projects located on military bases where construction of Capehart housing had been ap-

1. 1 L. ORGEL, VALUATION UNDER THE LAW OF EMINENT DOMAIN 461 (1953).
2. 12 U.S.C. § 1748 (1964).
3. 42 U.S.C. § 1594(a) (1964).

proved was made mandatory in order to avoid competition between the Wherry projects and the newer Capehart projects.

As a result of this mandate in the Capehart Act, extensive litigation has arisen involving the valuation of the Wherry projects. The courts are now in agreement that capitalization of net income is the appropriate method for determining the fair market value of the projects.[4] The main problem facing the courts has been to determine at what point in the capitalization process to consider debt service (amortization of the mortgage). The owner-sponsors have maintained that net income should be capitalized before the deduction of debt service, the balance of the unpaid mortgage then being subtracted from the total figure. The government has maintained that the net income should be capitalized after the deduction of debt service.

The general rule on this point is that no deduction can be made for amortization in determining the income to be capitalized for valuaton purposes.[5] The reason for the rule is obvious when one conceives of a property whose entire earnings are being paid out in interest and amortization of a mortgage.[6] In such a case, if the debt service were deducted before the capitalization of income, the absurd result would be reached that the value of the property is zero. The courts in the Wherry cases, however, have not uniformly followed this rule. As many courts have deducted the debt service before the capitalization as after, and no Wherry case has ever been reversed because of the use of one system or the other.

The most recent Wherry case is *Sill Corp v. United States.*[7] According to pretrial agreement, the capitalization issue was given to the jury, which apparently decided to use the government's method of capitalizing income after the deduction of debt service.[8] On appeal,

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4. Reproduction cost less depreciation has been rejected in United States v. Benning Housing Corp., 276 F.2d 248 (5th Cir. 1960); comparable sales has been rejected in United States v. Tampa Bay Garden Apartments, Inc., 294 F.2d 598 (5th Cir. 1961).

5. J. BONBRIGHT, THE VALUATION OF PROPERTY 910 (1937).

6. The rule is derived from cases involving valuation for property tax assessment. Note the similar theories behind valuation for property tax assessment and eminent domain, as opposed to valuation for income tax purposes where the opposite rule is applied. *See* De Luz Homes v. County of San Diego, 45 Cal. 2d 546, 290 P.2d 544 (1955).

7. 343 F.2d 411 (10th Cir. 1965), *cert. denied,* 382 U.S. 840 (1965).

8. The government experts, capitalizing after deduction of debt service, arrived at valuations of $294,000 and $302,000. The owner's experts, capitalizing before deduction of debt service, arrived at valuations of $1,100,000, $1,111,000, $1,200,000 and $1,300,000. The jury awarded a verdict of $302,000.

the United States Court of Appeals for the Tenth Circuit affirmed, holding neither method so palpably erroneous that it was legally inadmissible. It is a consideration of this particular problem, possibly peculiar to Wherry cases, that has led courts, as in the *Sill* case, to capitalize after the deduction of debt service, contrary to the general rule.

This problem is a result of the fact that the government, upon taking possession, assumes the unpaid mortgage balance. In most eminent domain cases involving split ownership, the property is first valued as an unencumbered fee. The award is then apportioned between the owners of the different interests. Thus if the property were subject to a mortgage, the debt service, or amortization of the mortgage, would not receive consideration until after the valuation of the property.[9] In the Wherry cases the government has in effect forced this apportionment before the valuation of the property by assuming the unpaid mortgage balance.

The courts in the Wherry cases have attempted to solve this problem by examining the personal position of the owner-sponsor. As previously stated, the reason for the rule that income is to be capitalized before deduction of debt service is obvious when one conceives of a property whose entire earnings are being paid out in interest and amortization of a mortgage. The court in the *Sill* case indicates that the fallacy of this argument in Wherry cases *may* be that the only interest taken is the possessory right in a lease. Unlike the usual case, the owner-sponsor of a Wherry project can acquire no equity through the amortization of the mortgage. The nature of his estate is purely possessory—the right to the income after the discharge of all of the burdens. Because of this fact, many of the courts in the Wherry cases have refused to use the general rule; instead, they capitalize the income after the deduction of debt service.[10]

It is at least questionable whether the use of one system or the other is critical to the owner-sponsor's amount of recovery. The Wherry cases have been decided on many different issues involving all three variables in the use of the capitalization of income method of valuation, i.e., capitalization rate, income to be capitalized, and economic life of the project. In *United States v. Certain Interests in*

9. Note the similarity between this method of valuation and the apportionment and capitalization of net income *before* the deduction of debt service.

10. Another problem of lesser importance that has led the courts away from the general rule has been the avoidance of the usual problem of extinction of interest because of the continuation of the project after condemnation.

Property in Cumberland County,[11] the lower court capitalized income before the deduction of debt service. On appeal, the government did not argue that the income should be capitalized after the deduction of debt service, but instead argued that the District Court has erred in substituting its own finding that the project had an economic life of 35 years for that of a court-appointed commission which found that the project had an economic life of 30 years. The Court of Appeals for the Fourth Circuit affirmed, stating that the evidence supported a finding that the economic life of the project was 35 years.

In *United States v. Certain Interests in Property in Monterey County,*[12] the income was capitalized after the deduction of debt service. Again, the owner-sponsor did not argue that the income should be capitalized before the deduction of debt service, but instead argued that the government's evidence concerning comparable sales was in violation of a pretrial agreement that the method used in valuation of the property would be capitalization of income and not comparable sales. The District Court correctly distinguished between the use of comparable sales as direct proof of the value of the condemned property, and the use of the sales price of comparable property by an expert to arrive at a realistic and just capitalization rate for the property condemned. The Court held that the government's use of comparable sales was for the latter purpose, and not in violation of the pretrial agreement.

These two cases aptly demonstrate two of the many issues on which the Wherry cases have been decided. Because of the presence of so many issues, the courts have reached widely divergent results, depending mainly on which issues are argued. These results vary from a per unit award of $1,029 to a per unit award of $3,603.[13] Although all of these decisions were reached in cases involving similar Wherry housing projects, several of the cases have completely ignored the mortgage amortization problem, and in no case has there been a reversal because of the use of one method or the other for handling mortgage amortization.

Chief Judge Arraj in *United States v. Certain Interests in Property in Adams County*[14] states that "it seems clear to the court that either

11. 296 F.2d 264 (4th Cir. 1961).

12. 186 F. Supp. 167 (N.D. Cal. 1960), *aff'd,* 308 F.2d 595 (1962).

13. United States v. Certain Interests in Property in Cascade County, 205 F. Supp. 745, 755 (D. Mont. 1962).

14. 239 F. Supp. 822, 824 (D. Colo. 1965).

system could be used, and the choice of one system over the other does not seem critical. Rather, it is the choice of the rate and time factors that is important." This statement may be correct with regard to the Wherry cases because of the great number of variables involved in valuing the Wherry projects. The courts, however, must strive for a definite answer to the mortgage amortization problem because of its obvious importance in any condemnation case in which the condemning agency condemns only a partial interest. In such a case the personal income loss of the condemnee may be quite a bit less than the "market value" of the condemned property, and courts must determine which of these methods constitutes "just compensation." It is only after this question is resolved that the courts will be able to handle the mortgage amortization problem effectively.

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