Buffalo Law Review

Volume 20 | Number 1 Article 21

10-1-1970

Eminent Domain—Impermissible to Base Market Value of Condemned Land Solely on Capitalization of Income Expected to Be Realized from Buildings on Which No Work Had Been Done as of the Day of Taking

John J. Ark

On August 11, 1970, President Gustavo Diaz Ordaz proposed legislation that would ". . . kill the present system of quick divorces in . . . Juarez."[57] Chihuahua, which includes Juarez, is the only Mexican state where it is possible to establish immediate residence for the purpose of obtaining a divorce. The proposed amendment to the Mexican Nationality and Naturalization Law would establish a "federal certificate" as the only valid proof of residence for all Mexican federal, state and municipal court actions. The amendment is being considered by the congress which convened September first. "The overwhelming majority in the congress of the President's Revolutionary Institutional Party virtually assures approval."[58]

New York courts have contended with the issue of Mexican migratory divorces for many years. The product of this litigation is a body of law replete with inequities. The passage of the proposed Mexican law would deny New Yorkers the availability of "quickie" Mexican bilateral divorces. Ironically, the problems presented to New York courts by migratory divorce recognition may soon be solved by Mexico.

WARREN B. ROSENBAUM

EMINENT DOMAIN—IMPERMISSIBLE TO BASE MARKET VALUE OF CONDEMNED LAND SOLELY ON CAPITALIZATION OF INCOME EXPECTED TO BE REALIZED FROM BUILDINGS ON WHICH NO WORK HAD BEEN DONE AS OF THE DAY OF TAKING

The claimants, fee owners (Siegel et al.), had assembled a 26.78 acre parcel which was leased to the claimant tenant (Banner Holding Corp., the assignor of Arlen of Nanuet). On May 10, 1961, four months after the assemblage, the State appropriated slightly more than sixteen acres of the vacant land for highway purposes. The fee owners had paid $247,800.00 for the 26.78 acres. It was leased to the tenant for a 25-year term, at an annual ground rent after the first year of $61,250.00. The obligation of the subtenant, Korvette, was to become effective upon completion of the construction. Korvette was to pay an annual sublease rental of $285,000.00 to Banner. This sum included not only a payment for land use, but also a reward to the tenant for construction costs and risk. As of April, 1961, it was uncertain whether the claimant's land would be condemned. To guard against the eventuality of condemnation, the tenant, on April 13, 1961, obtained a ground lease on an adjacent 26-acre site. After condemna-

requires that recognition be extended to bilateral foreign divorces; *see* Comment, *Does Residence Equal Domicile? Divorce Regulation Under New York Domestic Relations Law § 250*, 16 BUFFALO L. REV. 831 (1967).

57. N.Y. Times, Aug. 12, 1970, at 1, col. 6 (city ed.).

58. *Id.*

tion the Korvette subleases were transferred to the new, adjacent site. Eventually a shopping center, larger than that planned for the original site, was built on the new site. The shopping center was completed and in operation after the taking, but before the trial. The annual ground rental of the second site to be paid by the tenant (Banner) to the fee owners was $52,500.00. To determine the value of the sixteen acres taken, the lower courts capitalized the expected rent to be received from the buildings to be built on the subject parcel. The Court of Claims[1] awarded $702,610.00 to the fee owners and $875,000.00 to the tenant. A divided Appellate Division reduced the tenant's award to $525,000.00, but affirmed the fee owner's award.[2] Appeal was taken to the Court of Appeals. *Held,* it was impermissible to base the market value of condemned land solely on capitalization of income expected to be realized from buildings on which no work had been done as of the day of taking. *Arlen of Nanuet, Inc. v. State,* 26 N.Y.2d 346, 258 N.E.2d 890, 310 N.Y.S.2d 465 (1970).

Ordinarily, both the lessor and lessee are considered 'owners' of the condemned property.[3] The lessor is entitled to damages to his reversionary interest and the lessee to damages to his leasehold interest. Two basic methods are available to evaluate the various interests. Under the first method the entire value of the property is determined and the compensation is apportioned among the landlord and his various tenants.[4] The second method derives a composite value from the total of all the separate interests.[5] Regardless, the desired objective is to appraise the value of each interest independently[6] and to deduct the leasehold value from the entire value of the fee.[7] Damages should be real, not imaginary or speculative,[8] and if a peculiar factual situation exists, an extraordinary appraisal method can be used.[9] All awards must be within the standard of "just compensation" as required by the United States and New York State Constitutions.[10] To accomplish this the courts look to the fair market value of the property.

1. Arlen of Nanuet, Inc. v. State, 50 Misc. 2d 934, 272 N.Y.S.2d 565 (Ct. Cl. 1966).
2. Arlen of Nanuet, Inc. v. State, 31 App. Div. 2d 221, 296 N.Y.S.2d 117 (3d Dep't 1968).
3. *See* People v. Thornton, 122 App. Div. 287, 106 N.Y.S. 704 (3d Dep't 1907).
4. *See In re* New York and Brooklyn Bridge, 137 N.Y. 95, 32 N.E. 1054 (1893).
5. *See* Pekofsky v. State, 15 Misc. 2d 358, 180 N.Y.S.2d 930 (Ct. Cl. 1958).
6. *See In re* New York and Brooklyn Bridge, 137 N.Y. 95, 32 N.E. 1054 (1893).
7. *See In re* Pier 39, 62 App. Div. 271, 70 N.Y.S. 1127 (1st Dep't), *aff'd,* 168 N.Y. 254, 61 N.E. 249 (1901).
8. *See* Sparkill Realty Corp. v. State, 268 N.Y. 192, 197 N.E. 192 (1935).
9. *See* St. Agnes Cemetery v. State, 3 N.Y.2d 37, 143 N.E.2d 377, 163 N.Y.S.2d 655 (1957).
10. Under the fifth amendment of the United States Constitution, no governmental authority can seize private property without payment of just compensation. By force of the due process clause of the fourteenth amendment, this requirement is extended to the states and their subdivisions. *See* Scott v. Toledo, 36 F. 385 (N.D. Ohio 1888). Notwithstanding, N.Y. CONST. art. I, § 7(a) provides: "Private property shall not be taken for public use without just compensation."

> By fair market value is meant the amount of money which a purchaser willing but not obliged to buy the property would pay to an owner willing but not obliged to sell it, taking into consideration all uses to which the land was adapted and might in reason be applied.[11]

The fair market value received should equal open market value (*e.g.* the comparable sales value of similar properties). If the open market value is unobtainable, other valuation methods must be employed. The fair market value may be based on the best or most advantageous use available.[12] In turn income or profits may be used as evidence as to the best available use of the property.[13] To determine present market value, consideration may be given to either prospective or available uses other than the property's present use.[14] Generally, any criteria which the business world would use in arriving at market value are admissible.[15] However, lost income, profits and productivity are not compensable.[16] Profits due to the location of the property are a more reliable index of value than are those due to entrepreneurial skills.[17] The more remote or contingent the use and resulting income, the less weight it will be given in determining market value.[18] Actual rental value, which may be determined by either rent reserved in the property or similar property,[19] is admissible as evidence of fee value.[20] However, the rental value must be reasonable and continuous to serve as a basis for fair market value.[21]

> The capitalization of the income method of valuating property is based on the idea that the net income derivable from a use of the property to which it is best adapted, when capitalized at the prevailing local rate of investment returns, will produce a sum which is the practical equivalent of its true value.[22]

Any income derived from sources other than the property must not be capitalized (*e.g.* entrepreneurial skills and good will).[23]

---

11. 4 NICHOLS ON EMINENT DOMAIN § 12.2[1] (3d rev. ed. 1962).
12. *See* St. Agnes Cemetery v. State, 3 N.Y.2d 37, 143 N.E.2d 377, 163 N.Y.S.2d 655 (1957).
13. *See* Burdick v. State, 276 App. Div. 1052, 95 N.Y.S.2d 869 (4th Dep't 1950), *aff'd*, 302 N.Y. 670, 98 N.E.2d 478 (1951).
14. *See* Mattydale Shopping Center, Inc. v. State, 303 N.Y. 974, 106 N.E.2d 59 (1952).
15. *See* Brainerd v. State, 74 Misc. 100, 131 N.Y.S. 221 (Ct. Cl. 1911).
16. *Cf.* St. Agnes Cemetery v. State, 3 N.Y.2d 37, 143 N.E.2d 377, 163 N.Y.S.2d 655 (1957).
17. *See* Sauer v. City of New York, 44 App. Div. 305, 60 N.Y.S. 648 (1st Dep't 1899).
18. *See In re* Blackwell's Island Bridge, 118 App. Div. 272, 103 N.Y.S. 441 (1st Dep't 1907).
19. N.Y. CT. CL. ACT § 16 (McKinney 1963).
20. *See* Ettlinger v. Weil, 184 N.Y. 179, 77 N.E. 31 (1906); *In re* Blackwell's Island Bridge, 118 App. Div. 272, 103 N.Y.S. 441 (1st Dep't 1907).
21. *See* City of Mount Vernon v. Centennial Church of African, 277 App. Div. 775, 96 N.Y.S.2d 764 (2d Dep't 1950).
22. 19 N. Y. JUR. *Eminent Domain* § 191 at 430 (1961).
23. *See In re* Site for School of Industrial Arts, 2 Misc. 2d 403, 154 N.Y.S.2d 402 (Sup. Ct. 1956).

Ordinarily, compensation is determined as of the time of taking.[24] The objective of compensation is to place the owner in the same position after the taking as he was prior to it.[25] This is often accomplished through comparable sales which are based on actual market value data. The best available data exist when the condemned parcel has been involved in a recent sales transaction.[26] Comparable sales of similar lands also are admissible as evidence of market value. If discrepancies between the parcels are apparent, the value must be adjusted accordingly.[27] Judicial guidelines regarding comparability are geographical proximity, similarity in quality, size and use, proximity in time and approximations of conditions.[28]

The fundamental issue in *Arlen of Nanuet, Inc. v. State* was:

> . . . whether it is permissible to fix the market value of land, completely bare when condemned, solely on the basis of capitalization of income expected to be realized from buildings and other extensive improvements not yet financed, on which no work had ever been begun on the day of taking.[29]

Capitalization of realizable income has been used as an appraisal method in certain instances. In *Sunnybrook Realty Co. v. State*,[30] the rent of the land taken was based on the amount of gasoline sold on the premises. In rationalizing the use of capitalization of realizable income, the court pointed out, "[t]he rental value was based on the profit derived from the business conducted on the property and the property was unusual because of its location and the installation thereon."[31] Three factors are clear from the case: the property's uniqueness was significant in promoting the use of the capitalization method, the capitalization method was only one factor utilized in the evaluation, and the use of the capitalization method was not binding since the Appellate Division reduced the award.

In *St. Agnes Cemetery v. State*,[32] the court reiterated that capitalization of profits had been condemned as a theory of appraisal, and that business profits were not allowable. However, the court "adopted the rule that present value of 'clearly to-be-expected future earnings may be considered.' "[33] In that case the State had condemned unused cemetery land for

24. *See In re* Board of Water Supply, 277 N.Y. 452, 14 N.E.2d 789 (1938).

25. *See In re* Fourth Avenue, 221 App. Div. 458, 223 N.Y.S. 525 (1st Dep't 1927), *aff'd*, 247 N.Y. 569, 161 N.E. 186 (1928).

26. *See In re* Jennings Street, 207 App. Div. 170, 201 N.Y.S. 799 (1st Dep't 1923).

27. *See* United States v. 15.3 Acres of Land, 154 F. Supp. 770 (M.D. Pa. 1957).

28. Sengstock and McAuliffe, *What is the Price of Eminent Domain? An Introduction to the Problems of Valuation in Eminent Domain Proceedings*, 44 J. URBAN L. 185, 198-206 (1966).

29. 26 N.Y.2d at 351, 258 N.E.2d at 891, 310 N.Y.S.2d at 466.

30. 11 App. Div. 2d 888, 203 N.Y.S.2d 286 (3d Dep't 1960), *aff'd*, 9 N.Y.2d 960, 176 N.E.2d 203, 217 N.Y.S.2d 227 (1961).

31. 11 App. Div. 2d at 889, 203 N.Y.S.2d at 287.

32. 3 N.Y.2d 37, 143 N.E.2d 377, 163 N.Y.S.2d 655 (1957).

33. *Id.* at 45, 143 N.E.2d at 382, 163 N.Y.S.2d at 663. Since the capitalized value was based on a previously obtained sales price (*i.e.*, sold plots) the method actually employed was capitalization of comparable sales.

highway purposes. Due to the peculiarity of the land, the court based valuation on the net average selling price which could be received for the condemned, but heretofore unsold, plots. It pointed out that "[e]vidence of the value of the burial plots, therefore, was not used by the court to allow a loss in business profit but to determine the value of the cemetery land."[34] In *Mattydale Shopping Center v. State*,[35] a case involving a proposed shopping center, the Court of Appeals reinstated a Court of Claims judgment based on a claimant's mere intentions to build. The claimant had four executed leases and showed the rent from eight proposed stores would amount to $32,400. He also had an expert witness who valued the leases at $126,000, whereas the State's appraiser valued them at $57,000. The Court of Claims award of $79,000 was reduced to $57,000 by the Appellate Division. The Appellate Division reasoned:

> It is apparent from the findings that the court, in determining the fair market value of the premises, took into consideration prospective profits derived from future rentals. In this we believe the court erred.[36]

The Court of Appeals reinstated the award of the Court of Claims "upon the ground that the finding of the Court of Claims in respect of the value of the appropriated property is in accordance with the weight of the evidence."[37] *Mattydale* has led to divergent interpretations as to whether capitalization of future income is allowable. It has been interpreted as permitting the inference that "potential income to be derived from property if developed to its highest and best use is an element in determining market value."[38] Contrarily, it has been interpreted as not permitting capitalization of future income under any circumstance.[39] This latter interpretation assumes that the court did not alter the Appellate Division rationale, but expressly predicated its reinstatement upon the weight of the evidence as determined by the Court of Claims.[40] *Levin v. State*,[41] on which the *Arlen*

34. *Id.* at 46, 143 N.E.2d at 382, 163 N.Y.S.2d at 663.
35. 303 N.Y. 974, 106 N.E.2d 59 (1952).
36. 279 App. Div. 704, 108 N.Y.S.2d 832, 833 (4th Dep't 1951).
37. 303 N.Y. at 976, 106 N.E.2d at 62.
38. 19 N.Y. JUR. *Eminent Domain* § 189 at 429 & n.17 (1961).
39. 4 NICHOLS ON EMINENT DOMAIN § 12.3121[3] (3d rev. ed. 1962).
40. This conclusion is drawn from the Appellate Division ruling in Levitin v. State, 12 App. Div. 2d 6, 7-8, 207 N.Y.S.2d 798, 799-800 (3d Dep't 1960), which was decided after *Mattydale*.

> Such a method of evaluation of vacant, unimproved land is completely unprecedented. There is no authority cited by claimants in support of it and none is to be found, for how can income be capitalized to produce a residual land value when the appropriated land is neither producing income nor equipped to produce such income?
> . . . .
> This is not to say that prospective use of highest and best use and its influence on a prospective purchaser may not be an influence in the determination of market value. But a claim is improper where it is based entirely on hypothetical profits estimated from a non-existent business.

41. 13 N.Y.2d 87, 192 N.E.2d 155, 242 N.Y.S.2d 193 (1963).

of Nanuet, Inc. decision relies, sheds light on this conflict. In *Levin* the court was faced with the capitalization of realizable income. The State contended that the lower courts erred "in basing the award upon a capitalization of income from a projected but nonexistent structure."[42] The Court of Appeals reasoned that the Court of Claims, which wrote no opinion, did not rely on capitalization of net income since its award was less than the claimant's estimated value. According to *Levin*'s rationale, the *Mattydale* difference between the claimant's estimated value ($126,000) and the court's award ($79,000) would indicate other than strict reliance on the capitalized value of the executory leases. According to both *Levin* and *Arlen,* "executory leases and agreements—relating to land vacant on the day of the taking—may be given some weight as enhancing the value of the vacant parcels."[43] Even though no indication is given as to how they would be applied, they should never be given the weight of existing income flows as was done by the lower courts.

The *Arlen* court viewed the use of capitalization of expected income as the basis for fixing the market value of land as "a distortion of the realities of the situation, of the condition of the property still vacant and unimproved."[44] As far as the lower courts' treatment of the ground lease, the court felt at most they should have capitalized only the rentals for the first ten years. Nevertheless, the court believed the other terms of the lease should not have been deemed self-executing. Since construction had not begun on the "built-on" site as of the appropriation day, this ignored the principle that fair compensation is to be determined as of the day of taking, not as of the time of trial. The Court of Appeals pointed out that the lower courts' evaluation of the leasehold interest was improper. They had capitalized the subtenant's rent of $285,000 (after first deducting an estimated return on the buildings and ground rental). The court stated this was erroneous for several reasons: (1) the appropriated plot at the time of the taking was vacant land, not a shopping center, and (2) the sublease rental of $285,000 included construction costs and risks as well as the rental value of the land. Mere financial agreements and construction plans do not transform raw land into a *fait accompli.* The ground lease, however, was reflective of the land's value. Evidentiary weight could be given to the sublease's value, but not to the extent or use employed by the lower courts. At best the court felt these criteria should be used as evidence of the highest and best use of the land. The court mandated that upon retrial, the property was to be evaluated by viewing comparable sales. The court reasoned that this should be done by comparing the sales prices and ground rentals paid

42. *Id.* at 89, 192 N.E.2d at 155, 242 N.Y.S.2d at 194.

43. Arlen of Nanuet, Inc. v. State, 26 N.Y.2d at 352, 258 N.E.2d at 892, 310 N.Y.S.2d at 468.

44. *Id.* at 353, 258 N.E.2d at 892, 310 N.Y.S.2d at 468.

for neighboring or competitive lands. The Court of Appeals specifically referred to the $52,500 ground rent paid for the "built-on" site. Also mentioned was the original $61,250 ground rental. The latter would be proper because it "reflected the opinion of experienced businessmen as to the value of this vacant land for shopping center use."[45] The Court of Claims was directed to follow settled procedure in determining the value of a tenant's leasehold interest which survives the taking.[46] First, the value of the unencumbered fee must be determined. Second, the tenants' interest is to be valued, based upon the value of the economic rental of the land less the rent reserved in the ground lease. If the tenant's leasehold is found to be equal to or greater than the economic rent, there should be no recovery. Conversely, recovery will be allowed if the economic rent is greater than the rent reserved in the lease. Finally, the tenant's value is to be deducted from the total award. The remainder is the fee owner's award. Ostensibly, the desired increase in the capitalization rate is to reflect an increased risk in the investment, not originally recognized. The effect of the rate increase will be to reduce the claimants' award.

Essentially, there are three appraisal techniques used in assessing condemnation damages: comparable market data, capitalization of income, and reconstruction costs.[47] Capitalization of realizable income is allowed as an appraisal technique under certain circumstances: when the rent is related to income, when the property is exceptionally peculiar and no other method is available, or when the income to be derived from the property illustrates the property's best use. (Caution must be exercised in the latter, since the "best use" is only one factor utilized in the evaluation.) The claimants in *Arlen of Nanuet, Inc.* did not qualify under any of the above circumstances. The *Levin* Court of Claims did not rely on capitalization of realizable income as alleged by the State. Thus, the Court of Appeals did not explicitly rule out its use. *Levin* allowed evidence of prospective rentals as one factor a purchaser might use "in determining the price to pay."[48] The *Levin* court was content that the Court of Claims "fixed a market value well within the range of testimony."[49] It assumed that the lower court did not use the claimants' method since the award was less than their claim. No opinion existed to refute this assumption. Due to the Court of Claims' extensive

45. *Id.* at 356, 258 N.E.2d at 894, 310 N.Y.S.2d at 471.

46. This procedure applied by the *Arlen of Nanuet, Inc.* court is found in Great Atlantic & Pacific Tea Co. v. State, 22 N.Y.2d 75, 84, 238 N.E.2d 705, 712, 291 N.Y.S.2d 299, 305-06 (1968).

47. *See generally* Sengstock and McAuliffe, *What is the Price of Eminent Domain? An Introduction to the Problems of Valuation in Eminent Domain Proceedings*, 44 J. URBAN L. 185 (1966).

48. 13 N.Y.2d at 92, 192 N.E.2d at 157, 242 N.Y.S.2d at 196.

49. *Id.* at 93, 192 N.E.2d at 157, 242 N.Y.S.2d at 196.

opinion, the Court of Appeals in *Arlen of Nanuet, Inc.* was obligated to reverse and remand. Had the trial court given no opinion, and slightly changed the judgment, although relying on their original appraisal method, the judgment might have been upheld. However, by refuting the capitalization of the $285,000.00 sublease rental, the court implicitly ruled out the use of capitalization or realizable income derived from sources other than the property itself.

> To state the matter somewhat differently, the sublease rental of $285,000 (payable by Korvette) was to be the reward to the tenant for investing several million dollars in construction costs and for gambling on the eventual success of the shopping center. The land was simply one component of the enterprise.[50]

As a result, the court invoked the use of comparable sales.

> Upon the retrial, the value of the entire land—that is, the value of all the interests in the land—should be determined by reference to the sales prices and ground rentals paid for neighboring or competitive lands.[51]

However, the court does not explicitly point out how the standard based on comparable sales is to be implemented. Since the court goes on to criticize only the size of the capitalization rate and not its use, it may be inferred that the base as determined through comparable sales, is to be capitalized. In accord, when capitalization of rental income is to be used, the base must be either realized at the time of appropriation or verified through comparable sales data. Since no rental income had been realized at the time of appropriation, the court's use of comparable sales was unavoidable and sensible. There appears to be no conflict between the court's intended use of the comparability method and the recommended guidelines. The court might have been less eager to forego capitalization of income in favor of comparable sales had not a favorable factual situation existed (*i.e.* the use of an adjacent "built-on" site). Regardless, *Arlen of Nanuet, Inc.* explicitly states what was implicit in *Levin, i.e.,* the extent to which capitalization of income is to be used in condemnation appraisal. The necessary exceptions set forth in *St. Agnes Cemetery*[52] are still viable, but, the rationale of the Court of Claims in *Mattydale Shopping Center,* although not explicitly upheld by the Court of Appeals,[53] has been rendered questionable by the present case.

JOHN J. ARK

---

50. 26 N.Y.2d at 355, 258 N.E.2d at 894, 310 N.Y.S.2d at 470.
51. *Id.* at 356, 258 N.E.2d at 894, 310 N.Y.S.2d at 471.
52. 3 N.Y.2d at 45, 143 N.E.2d at 382, 163 N.Y.S.2d at 663.
53. 303 N.Y. 974, 106 N.E.2d 59 (1952).