EXAMINING THE CONDEMNATION CLAUSE

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Clarify. Ignore. Confuse.

In the event of a condemnation, the condemnation clause in a lease can do any one of these three things. In fact, there have been instances when the clause has managed to do all three.

There is one definitive statement I would like to make: Ignoring the potential for condemnation during the drafting of a lease dramatically increases the likelihood of unnecessary litigation between the landlord and tenant as they fight not only each other, but with the government in hopes of maximizing their respective awards. In this article, I hope to provide some insights into the problems caused by unclear drafting.

Landlord – Tenant Splits

A disagreement between the landlord and tenant is one of the most common problems encountered in the interpretation of the lease clause. Not only does the problem of a potential bonus lease arise, but there is also the issue of real property vs. personal property. These disagreements, usually caused by poor drafting of the lease, tend to strengthen the government's position and reduce the award to one or both of the parties.

The law usually reflects the government's position that the whole property has only one value and is not made up by the sum of the parts. Therefore, in most states, any award to the tenant will lead to a decrease in the amount awarded to the property owners.

So what happens if there is no condemnation clause?

Most often, the tenant will be awarded the "bonus value" of the leasehold. To clarify this statement, let's review a few relevant terms. The bonus value (now called positive leasehold value in the 4th Edition of the Dictionary of Real Estate Appraisal) is described as the difference between the market lease rate and the contract rate, present valued for the remaining term of the lease. The market lease rate is that rate charged for similar property as of the date of

value in the condemnation case. The contract rate is the rate currently charged the tenant as stated in the lease. The amount of the bonus value is an issue for the real estate appraisers.

It is important to understand bonus value for a variety of reasons. When the tenant is allowed to seek the bonus value, it reduces the owner's portion and causes them to become adversaries. Obviously, both the landlord and the tenant want the award for the whole property to be as large as possible.

When dealing with the government, the owner must prove the highest possible market rental rate in order to establish the highest property value. However, this higher market rental rate actually helps the tenant's case, as it maximizes the spread between the market rate and the contract rate. In this instance, the owner is assisting the tenant by proving a higher bonus value for the tenant, thereby weakening their own position. If the landlord and the tenant would simply recognize their dilemma and reach some agreement prior to the litigation, they could actually help each other against the government.

Even when there is a condemnation clause, sloppy drafting in the lease can create a host of other problems.

Tenant improvements become an important issue in the event of a condemnation. Many lease clauses address the issue with vague language, calling for the tenant to receive the unamortized value of their improvements in the event of a condemnation. This language is unclear and begs several questions. Does this mean the tenant improvements should be amortized over the life of the lease? Would the improvements be completely amortized before a lease extension took effect? Or should they be amortized over the useful life? Or could they be amortized per the schedule on the tenant's income tax returns? All of these possibilities exist and should be clarified in the lease before a condemnation forces the parties to resolve the issue through additional litigation.

At times, the parties include specific language in the clause which calls for the tenant to be reimbursed for fixtures, equipment, leasehold improvements or other property. Unless specified, it will be unclear as to whether the payment must come from the condemnation award or paid through relocation benefits. Should the tenant be reimbursed for the initial cost? Should the reimbursement be based on the current market value or on the tenant's book value? Again, if the language is unclear, many issues are left unresolved. Unfortunately, this will usually result in additional litigation expense.

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If the language in the clause states that the tenant may recover the value of specific fixtures, equipment or tenant improvements from the condemnation award, additional problems may arise. If there is a total acquisition, or a partial acquisition that takes a substantial amount of a building, the tenant may also be eligible for relocation benefits. Although the condemnation gives rise to the payment, these benefits are separate from the condemnation award, which typically deals only with real estate.

Relocation benefits help pay to move fixtures and equipment, as well as the expense to uninstall and reinstall the fixtures and equipment, and it includes a payment for various moving expenses. In some instances, leasehold improvements, if they are specialized, may also be included for payment within the relocation benefits. Failure to recognize the possibility of any payments due from relocation benefits may become another source of problems facing the landlord and tenant.

Total Acquisitions vs. Partial Acquisitions

Dealing with the possibility of a total acquisition of the property is fairly easy. Anticipating all the possibilities of a partial acquisition falls somewhere between difficult and impossible.

In order to properly protect an owner or tenant, the clause should define what will happen in the event of a total acquisition, as well as a partial acquisition. The person drafting the clause should anticipate the possibility of a partial acquisition that may take only a portion of landscaping, drainage retention, parking, driveways or even a portion

Street widening projects can often lead to a partial property acquisition.

of the building. Ideally, the language should be site specific, rather than rely on stock or boilerplate language that attempts to cover all situations in an overly broad way.

A partial acquisition may occur in a street widening, where only a portion of the property is taken and does not involve an acquisition of any part of the building. This type of acquisition may seem like the area impacted is relatively minor, with little or no impact on the remaining property. However, even an acquisition that looks minor may impact the driveways, parking lots or drainage retention areas. In turn, this minor impact may have a major impact on the business conducted on the property. A loss of business is not compensable in the vast majority of states. In this case, although the tenant faces a potential loss of business, they will probably not be compensated for this loss by the government. The real impact on the real estate is reflected in the rental rate that can be charged for the remaining property. This directly impacts the value of the property, and the damage to the real estate is fully compensable to the parties who may collect payment, as reflected in the condemnation clause.

Often, it is the partial acquisition - which looks relatively small and harmless - that can wreak the most havoc. In one such case, the government offered the property owner the value of a small area of land and the value of the landscaping in that area. The property was used as a mini-storage facility, and there were no other improvements in the area to be acquired. The acquisition was located between the fence surrounding the improvements on the property and the adjacent street right of way. The government's appraiser didn't realize that the area to be acquired included 50% of the required on-site drainage retention area. Without the ability to direct storm water into this retention area (in the after situation), water would back up into many of the storage units and potentially damage thousands of dollars of property housed in those units. The solution was to use what little landscaped area that was left and create an underground drainage storage chamber at a cost of over $500,000! Suddenly, this seemingly minor acquisition evolved into a major problem.

In another case, the site was used for a drive-through fast food operation. An acquisition occurred where neither parking nor any portion of the building was taken, but resulted in moving the street closer to the building. The acquisition reduced the stacking distance for customers already served at the drive-in window. Those customers waiting to pull out onto the street were effectively blocking other customers from being able to advance to the drive-in window. Obviously this made the site less desirable for the intended use. The owner was only able to resolve the problem by tearing down the existing facility and rebuilding the building farther back on the property. This type of problem is rarely addressed in the condemnation clause specifically, as no portion of the building or the parking was disturbed. One possible solution would be to include a clause which allows a tenant to vacate if the premises are no longer satisfactory for their continued business. However, in this case, the landlord would be at the mercy of the tenant. Unless the landlord is willing to allow the tenant to direct his fate, the landlord needs to protect his rights in the condemnation clause from any such possible scenarios.

Another example would be an acquisition of less than 10% of the parking, an amount typically found in standard leases. If the spaces taken are near the front door, this may cause the remaining parking to be inconvenient for retail customers and result in a less desirable business location. However, if the parking area taken is near the back of the site, where employees typically park, or if the site is part of a larger shopping center with a reciprocal parking agreement, the employees may park off-site with little impact on the business conducted on the premises.

Often the loss of 10% or less of a parking lot will not trigger the possible loss of a tenant per the condemnation clause. However, the value of the site may be reduced. If the acquisition renders the site non-conforming per the local zoning authority, and if there is a casualty loss, the improvements may not be able to be

rebuilt to the same dimensions. The reduction in available parking, although less than the 10% which might allow the tenant to vacate, will reduce the size of the allowable building that can be rebuilt and may not conform to the needs of the existing tenant.

Unfortunately, these types of cases occur more often than most people realize. Therefore, it becomes critical that those drafting or reviewing condemnation clauses in leases consider how a site was (or will be) developed and the damages that might occur if there was a total acquisition and a partial acquisition, as well as the case law in a particular jurisdiction.

Land Leases

Land leases are subject to even more problems than an improved property when a condemnation occurs. These additional problems are caused by the separate ownership of the land and the building involved. The language in the condemnation clause must be more precise in defining terms and articulating the rights of the parties in leased properties.

Typically in a land lease, the fee owner receives the present worth of the income stream provided in the lease, plus the reversion of the land at the end of the lease, and the reversionary value in any improvements that are to remain at the end of the lease.

In instances where vacant land is leased to a tenant who makes any improvements on the site, the language should address the issues in a slightly different way. If the condemnation clause is ignored, the tenant may be awarded the bonus value (if any) of the land lease. For the real estate appraisers who are involved, obtaining data on land leases is very difficult. Therefore, a determination of a true market lease rate for vacant land will be difficult. Recognizing this dilemma beforehand may allow the parties to agree on a formula or method for determining the various values in advance.

When drafting a condemnation clause for the lease of vacant land, the parties should be aware that the method used by the real estate appraisers who appraise the condemned land will be to value the property at its highest and best use. The highest and best use of the property is defined as: "the reasonable probable and legal use of vacant land or an improved property, which is physically possible, appropriately supported, financially feasible, and that results in the highest value." According to The Dictionary of Real Estate Appraisal, Fourth Edition, the four criteria the highest and best use must meet are legal permissibility, physical possibility, financial feasibility, and maximum productive.

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There are times when the value of the vacant land, at its highest and best use is different than the value of the same land as a component of an improved property. For example, assume vacant land is under a lease to a scrap metal dealer on a 20-year term. If there is industrial development in the area surrounding the property after the lease begins, and if a condemnation occurs in the 10th year of the lease, the value of the land at its highest and best use would likely be for industrial development. However, encumbered by the lease, an industrial development is not possible, and the land may have a lower market value as encumbered.

Consider another example in which vacant land is on a 99-year lease for an office building, and a condemnation occurs during the lease. The rent adjustment clause, if one exists, will become critical. Assume that the lease has a condemnation clause which gives the value of the land to the landowner and the value of the building to the tenant. In this instance the clause is too simple. Is the value of the land to be its valued as if unencumbered and at its highest and best use? Or alternatively, is its value as encumbered by the lease where the owner is entitled to the

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present value of the existing and anticipated cash flow discounted to present value at the current date plus the residual value of the property at the end of the lease. To avoid confusion, the parties to a lease of this nature should obviously articulate the value they intend to split in advance.

If the land lease described above is fairly old, the lease rate might well be below the market rate. Older leases often had fixed periodic rent increases, which have not kept pace with the market. In the event of a condemnation, the tenant may have an interest in the value of the land due to a "bonus value" lease situation, where the contract rate is less than the market rate. Properties in this situation are sometimes more at risk for a condemnation, especially when a city plans to redevelop some of the older areas. Parties involved with these older properties may want to review their leases. Given the potentially large financial impact, property owners trapped with a bad condemnation clause such as this may find that the best alternative for them in case of a condemnation is to fight the attempted acquisition.

Many land leases allow the tenant to recover the unamortized value of their improvements in the event of a condemnation. Again, what is the definition of unamortized? It could be the value found in the tenant's tax return. It may be the value of those improvements as if amortized over their useful life. Should it be the value amortized over the initial term of the lease if any options to renew are not automatic? If the parties fail to define their terms, they may find themselves relying on real estate appraisers. Typically, the appraisers for the government do not deal with issues arising from unamortized values of tenant improvements, so both the landlord and the tenant will need to hire appraisers and fight it out in court. Therefore, the better the parties define their terms up front, the better the chances of avoiding additional litigation.

Another problem with land leases that often develops involves establishing the value of the land in the event of a condemnation. While the lease clause may clearly spell out which party is entitled to what part of a potential award, the establishment of the land value comes down to the opinion of the various real estate appraisers involved. In valuing improved commercial property, most appraisers attempt to use all three approaches to value – market, income and cost. Both the market and income approaches do not break down the value of the components between the land and the building. Appraisers will often attempt to avoid the cost approach due to issues associated with determining depreciation. However, the cost approach is the only approach which addresses the value of the land independently. If the appraisers hired by the government do not use the cost approach, then it may become the responsibility of the parties to retain independent appraisers to determine the value of the land. Even in this instance, they need to be given direction on the land value to be determined – either as encumbered by the lease or free of encumbrances. (If the land is valued free and clear of encumbrances, it will be the highest and best use of vacant land. If it is valued as encumbered by a lease, the value is limited by the rental rate in the lease.) In these instances, the parties can provide clarification in the condemnation clause which binds them on the method for determining the value of each party's interest, which should not impact the amount of compensation to be ultimately obtained from the government.

Other Potential Problems

At times, the condemnation clause attempts to redefine condemnation to include other governmental actions generally known as "police powers." Clauses that allow the tenant to vacate the property for any change in driveways, traffic patterns and new street medians involve the government's police powers, not the condemnation power.

Although certain governmental actions may have an impact on the ability of the tenant to do business, they may not be compensable under condemnation law (or any other claim). Properties have a right to reasonable access to the adjacent street system, but do not

have a right to the traffic flow on that street. It is under this same theory that the placing of a median on a city street is generally allowed without compensation to the property owners who are impacted.

While it is commonplace for major retailers to include language in the condemnation clause of their lease to deal with changes of traffic patterns, it may later become a source of contention with the property owner if the government causes a change of the traffic pattern without compensation. It isn't clear that the tenant can terminate a lease if a traffic pattern is changed when there is no condemnation. If the parties want a clause to deal with a change in traffic patterns or access points, they would be better served putting this language elsewhere in the lease rather than tying it to the condemnation clause.

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The parties should also understand that the property has the right of "reasonable ingress and egress." That doesn't mean the owner gets as many driveways as he desires. While the courts have rarely defined "reasonable," the parties should recognize this and define their own version of what is reasonable in hopes of avoiding future litigation.

At times, a government project will have several parts. Some portion may not be built immediately and will be projected for completion years in the future. Although the general rule in a condemnation case is that you assume the project is complete on the date of value, unreasonable delays in a portion of the project may not benefit the property owner and give rise to what is known as delay damages. In the event of a partial taking under these circumstances, both the landlord and the tenant need to be aware of the timing of all aspects of a project and how it will impact the value of their interest in the property. If a property is currently occupied by a tenant with 10 years remaining on a lease, but the benefit of a portion of a project is not anticipated to occur for 12 years, is the existing tenant entitled to any portion of that benefit? This is a question that we have never seen addressed in a condemnation clause.

If there is a total acquisition, condemnation clauses often call for the termination of the lease as of a specific date. While this is appropriate, it needs to be accurate. At times, title passes to the government upon the declaration of taking, which is typical when a federal case is filed. Most condemnation clauses ignore this possibility. The more typical clause that addresses this issue calls for termination when the government takes possession of the property. Unless the condemnation is a federal acquisition, this is probably the best time for all parties to terminate the lease. If, per the language in the clause, the termination is to take place when title passes at the end of a case, the tenant may be responsible for lease payments for years beyond when the property needs to be vacated as, in most states, title passes at the end of a case after payment has been made by the government.

Summary

Hopefully, these various scenarios have served to provoke those who are potentially involved in these situations to pay closer attention to the condemnation clause. Certainly no one is expected to anticipate all the potential problems that a condemnation acquisition can cause to a property. However, the parties to the lease must at least recognize that the government has found more and more reasons for governmental acquisitions and realize that it could happen to most any property.

To return to the original hypothesis, the clause can serve to clarify, ignore or confuse. If the parties would take time to review the potential issues in a coherent manner, it would go a long way to eliminating unnecessary litigation. Obviously, ignoring the potential for condemnation is not acceptable, and any attempts to clarify this will always benefit the parties. ◉