Compensation for Leasehold Takings and Apportionment of Awards

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Abstract

This article describes and analyzes the manner in which compensation is determined for a taking of real property encumbered by a lease, and how the compensation awarded is apportioned or distributed between lessor and lessee. Most condemning authorities subscribe to the undivided fee rule, which requires an analysis of market value or market rental value of the property impacted by the taking to reflect the property as a whole and as if unencumbered by the lease and under single ownership, prior to apportionment of the award between lessor and lessee. In those few jurisdictions that adhere to the aggregate-of-interests rule, the analysis of market value or market rental value strictly reflects the individual interest or estate held by each party with legal ownership in the property taken, and each interest is compensated separately. This article presents a number of cases to highlight the multifaceted issues confronted by appraisers in the valuation and distribution of condemnation awards in takings that involve leasehold interests.

Introduction

Appraising real property for condemnation/expropriation proceedings requires an awareness of terms and rules specific to eminent domain, and their interpretation and applicability in various jurisdictions. Takings, especially partial takings, that involve leasehold interests can present unique and complex valuation challenges in analyzing the distribution of proceeds from a condemnation award. How an award is distributed among competing interest holders of a property depends on the language of the lease, including the length of the remaining term of the lease, renewal options, contract rent, and, most importantly, the condemnation clause. In the absence of a condemnation clause, the court will provide instructions as to how an award is to be distributed between the lessor and the lessee(s).[1]

The governmental power to take real property for public or quasi-public use by eminent domain is conditioned on an obligation of the condemning authority to pay just compensation to the owner. Just compensation is typically measured by market value. The Uniform Appraisal Standards for Federal Land Acquisitions (UASFLA)[2] defines *market value* as follows:

> Market value is the amount in cash, or on terms reasonably equivalent to cash, for which in all probability the property would have sold on the effective date of value, after a reasonable exposure time on the open competitive market, from a willing and reasonably knowledgeable seller to a willing and reasonably knowledgeable buyer, with neither acting under any compulsion to buy or sell, giving due consideration to all available economic uses of the property. [Section 1.2.4]

As for the taking of a leasehold interest, just compensation requires consideration of a property's market rental value, as if held in fee simple under one ownership, consistent with the

1. See Richard O. Duvall and David S. Black, "Dividing the Pie: Compensating Landlords and Tenants in Takings of Leased Real Property," *The Appraisal Journal* (January 2001): 1–10.
2. Interagency Land Conference, *Uniform Appraisal Standards for Federal Land Acquisitions*, 2016 ed. (Washington, DC: US Government Printing Office, 2016); download available at http://bit.ly/UASFLA.

undivided fee rule. UASFLA describes *market rental value* as follows:

> The rental price in cash or its equivalent that the leasehold would have brought on the date of value on the open competitive market, at or near the location of the property acquired, assuming reasonable time to find a tenant.
>
> As with market value, the federal definition of *market rental value* requires willing and reasonably knowledgeable market participants, not compelled to buy or sell, giving due consideration to all available economic uses of the property. Temporary acquisitions also require a rigorous, well-supported analysis of highest and best use—as in permanent acquisitions. As a district court recently held, "only direct evidence of market rental value, to the exclusion of remote, hypothetical conjecture, should be considered in ascertaining just compensation for a taking." In keeping with the unit rule (Section 4.2.2), market rental value must be determined for the property as [an unencumbered] whole, regardless of any sub-leases or other subsidiary interests into which it may have been divided. [Section 4.7; case citations omitted]

UASFLA further specifies,

> The appraiser should not consider the fact that a property may be under lease to a third party, except to the extent that the rent specified in the lease may be indicative of the property's market rental value. [Section 1.5.4.1]

The guarantee of just compensation is intended to protect the property owner, but also protects the public by limiting its liability to losses that can be appropriately attributed to the taking. As the California appellate court has noted, "A landowner is not entitled to be placed in a better position financially than he was before the condemnation; neither is the…[condemning authority] required to pay more than land is worth."[3]

The Unit Rule or Undivided Fee Rule

Compensation awards for takings, whether *partial* or *whole*, are premised on the concept of market value in its highest and best use, and most jurisdictions follow the "unit rule" or undivided fee rule by disregarding all ownership interests in the real property other than the fee simple estate and assuming single ownership. Not all jurisdictions subscribe to the unit rule.[4]

The unit rule covers both *ownership interests* and *physical components* of real property, which are defined in UASFLA as follows:

> **Ownership Interests (the Undivided Fee).** A property with multiple ownership interests or estates—such as lessor and lessee, life tenant and the holder of the remainder, or mortgagor and mortgagee—must be valued as a whole, embracing all of the rights, estates, and interests of all who may claim, and as if in one ownership. For example, in an acquisition of property in fee simple absolute, the property must be appraised as an undivided fee. Similarly, in acquisitions of less-than-fee interests, the interests being appraised must be valued as if under single ownership. The market value of the whole is later apportioned among "the respective interest holders…either by contract or judicial intervention." This is because just compensation is for the property itself, not the various ownership interests; thus, "the appraised value of the property represents the whole fee." This aspect of the unit rule ensures the public is not charged twice in federal acquisitions. [4.2.2.1; case citations omitted]
>
> **Physical Components.** Buildings and improvements, timber, crops, sand, gravel, minerals, oil, and so forth, in or upon the property are to be considered *to the extent they contribute to the market value of the property as a whole*. "[I]t is firmly settled that one does not value the [ ]land as one factor and then value the improvements as another factor and then add the two values to determine market value." Rather, the measure

3. *San Diego County Water Authority v. Mireiter*, 18 Cal. App. 4th 1808, 1817, 23 Cal. Rptr. 2d 455 (1993), court quoting *City of Fresno v. Cloud*, 26 Cal. App. 3d 113, 123, 102 Cal. Rptr. 874 (1972).

4. A minority of states, including Arkansas, Arizona, Iowa, Maryland, Nebraska, Pennsylvania, and Utah, and the District of Columbia use the "aggregate of interest rule." The aggregate of interest rule values each individual property interest holder's interest, and then adds the value of each interest to determine the value of the whole property. For additional discussion of the unit rule, see Kinnon W. Williams and Jake J. Stillwell, *Inslee Best* (blog) "The Unit Rule: Misunderstood and Rightly So," October 4, 2017, available at http://bit.ly/2yHVTAZ; and Jill S. Gelineau, "Landlord/Tenant Apportionment Issues in Eminent Domain," *The Practical Real Estate Lawyer* (September 2014): 27–30, available at http://bit.ly/Gelineau.

> of just compensation is the market value of the entire property—not the total of the money values of the separate items. As a result, in developing an opinion of value for federal acquisitions, the appraiser must consider all the elements that 'contribute to make the property valuable, all…that detract from it, and finally, weighing all those elements, determine [the market value of] the single piece of property…." acquired. [Section 4.2.2.2; case citations omitted]

The reasoning behind the undivided fee rule is described in *County of Clark v. Sun State Properties*,[5] where the Nevada Supreme Court stated,

> The duty of the public to make payment for the property which it has taken is not affected by the nature of the title or by the diversity of interests in the property. The public pays what the land is worth, and the amount so paid is to be divided among the various claimants, according to the nature of their estates.[6]

In *Re Country Side Restaurant, Inc.*,[7] the Wisconsin Supreme Court reiterated the underlying public policy objective of the undivided fee rule:

> The unit rule is designed to protect the interests of the condemnor and not to protect the interests of a condemnee. The condemnees, irrespective of their interests, are indeed constitutionally entitled to just compensation, but contracts between the owners of different interests in the land should not be permitted to result in a total sum which is in excess of the whole value of the undivided fee.

The undivided fee rule works well when all interests in a property are held in a single ownership. The rule, however, can be problematic when applied to property in which there is more than one interest held by different or unrelated parties involving easements (dominant and servient tenements), leases of different tenancies[8] (terminating, perpetual, or perpetually renewable[9]), or life estates. In theory, the combined value of the individual interests should equal the value of the property as a whole in fee simple. A Utah court pointed out a potential problem of apportionment of a lump sum condemnation award under the undivided fee rule:

> It is taken for granted that the sum of the values of the divided interest will be exactly equal to the value of the fee as embodied in the total award. In reality, however, the result of a valuation of the undivided estate is often that the total compensation is materially less than an amount sufficient to indemnify the separate claimants, leading one authority to analogize that "in that case the court finds itself in the place of the head of the household who must superintend the carving up and distribution of a chicken which is really not big enough to go around."[10]

The most common type of economic interest in real property is created when a fee simple interest is divided by a lease of any duration,[11] whereby the lessor and lessee each obtain partial interests, which are stipulated in contract form and are subject to contract law. The divided interests resulting from a lease represent two distinct but related interests—the leased fee interest of the lessor and the leasehold interest of the lessee. Additional economic interests, including subleasehold or sandwich interests,

5. In *County of Clark v. Sun State Properties*, 72 P.3d 954 (2003), the Nevada Supreme Court rejected the aggregate of interests rule, noting that the condemnation award exceeded the market value of the whole property before the taking.
6. Court quoting 4 Julius J. Sackman, *Nichols on Eminent Domain*, rev. 3rd ed. (2002), § 12.05[2], at 12-112; see also 1 Lewis Orgel, *Valuation under the Law of Eminent Domain*, 2d ed. (1953), § 109, at 464.
7. *Re Country Side Restaurant, Inc.*, 340 Wis. 2d 335, 814 N.W.2d 159 (2012).
8. *Tenancy for a term* is "a tenancy whose duration is known in years, weeks, or days from the moment of creation. Also termed *tenancy of a period*; *tenancy for years*; *term for years*; *term of years*; *estate for a term*; *estate for years*; *lease for years*." *Black's Law Dictionary*, 9th ed. (St. Paul, MN: Thomson Reuters, 2009), s.v. "tenancy for a term."
9. *Perpetual lease* is "an ongoing lease not limited in duration," and a *perpetually renewable lease* is "a lease that a tenant may renew for another period as often as it expires, usu. By making a payment upon exercising the right." *Black's Law Dictionary*, 9th ed, s.v. "perpetual lease."
10. *Utah Dept. of Transp. v. FPA West Point, LLC*, 2012 UT 79, 304 P.3d 810 (2012), citing *Harco Drug, Inc. v. Notsla, Inc.*, 382 So. 2d 1 (Ala. 1980), Alabama Supreme Court quoting text Orgel, *On Valuation under Eminent Domain*, at 482.
11. *Black's Law Dictionary*, 9th ed., defines a *lease* as "a contract by which a rightful possessor of real property conveys the right to use and occupy the property in exchange for consideration, usu. rent."

can be created.[12] The value of each interest must be considered in apportioning a condemnation award between any competing claims of the lessor and lessee in those jurisdictions that apply the undivided fee rule in determining compensation for a taking of real property.

Apportionment of Awards

In the context of eminent domain, apportionment is the judicial allocation of condemnation proceeds where there are conflicting claims of compensation awarded for the property taken.[13] Apportionment involves the ratio analysis between the lessor's and lessee's interests prior to the allocation of the dollar amount attributed to each position.

Under the *undivided fee rule*, distribution of a condemnation award among competing interests is in proportion to the value of each property interest determined separately. During the award phase, all parties with a compensable interest in the real property usually work cooperatively to achieve the largest award statutorily permissible for the taking based on credible appraisal evidence. In the apportionment phase of the condemnation award, these same entitled parties often become adversaries, each one retaining an appraiser and striving to obtain the largest share of the award for itself.

According to the Kentucky appellate court in *Commonwealth of Kentucky, Department of Highways v. Sherrod*,[14] a condemnation award and its distribution among different interests in the same property must be consistent with the following procedure:

> When there are different interests or estates in the property the proper course is to ascertain the entire compensation as *though the property belonged to one person* and then apportion this sum among the different parties according to their respective rights. *The value of the property cannot be enhanced by any distribution of the title or estate among different persons or any contract arrangements among the owners of different interests.* Whatever advantage is secured by one interest must be taken from another, and the sum of all the parts cannot exceed the whole.

The Kentucky court ruled that the market value of a lessee's leasehold interest must be ascertained by application of residual analysis:[15]

> The fair market value of the leasehold (if any) can be ascertained by simply subtracting the fair market value of the land as a whole if sold subject to lease, from the fair market value of the land as a whole if sold free and clear of the lease….[A]ny departure from this strict rule of fair market value can result only in hopeless confusion.

On this basis, only the following steps, referred to as the "Sherrod Rule," are required in deriving the amount of compensation that is available for distribution in a taking encumbered by a leasehold interest:

Step 1: Analyze the market value of the property as a whole *immediately before the taking*, giving consideration to the fact that the property is capable of generating rental income, but evaluating the income potential of the property *as if unencumbered by the lease*.

Step 2: Analyze the market value of the property as a whole *immediately before the taking, if sold encumbered by the lease* (i.e., pre-taking leased fee value).

Step 3: Analyze the market value of the property as remains *after the taking*, giving consideration to the fact that the property is capable of generating rental income, but evaluating the property *as if unencumbered by the lease*.

12. For a full discussion of the various economic interests, see Appraisal Institute, *The Appraisal of Real Estate*, 14th ed. (Chicago: Appraisal Institute, 2013), 70–72.
13. For example, Florida law provides, "Where there are conflicting claims to the amount awarded for any parcel, the court, upon appropriate motion, shall determine the rights of the interested parties with respect to the amount awarded for each parcel and the method of apportionment." § 73.101, Florida Statutes (1993).
14. *Commonwealth of Kentucky, Department of Highways v. Sherrod*, 367 S.W.2d. 844 (1963), citing *Korthage v. Commonwealth, Ky.*, 296 S.W.2d 476, which quoted from 2 *Lewis on Eminent Domain*, 3rd ed., Sec. 716., 1253.
15. The *residual* is the "quantity left over; in appraising, a term used to describe the result of an appraisal procedure in which known components of value are accounted for, thus solving for the quantity that is left over"; Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 6th ed. (Chicago: Appraisal Institute, 2015), s.v. "residual."

If the market value in Step 3 is less than the market value in Step 1, the difference is the loss in market value attributed to the taking or the contributory value of the taking, and it is this amount that is apportioned between the lessor and lessee. Of course, if the entire property is taken, there is no Step 3 analysis to be conducted.

Application of Sherrod Rule

To illustrate application of the Sherrod Rule, assume a freestanding single-tenant big box retail store with a gross leasable area of 120,000 square feet on a 480,000-square-foot (11.0193 acres) site, reflecting a site coverage of 25%. The store is under lease for a remaining term of 30 years. The starting annual contract rent is at $10.00 per square foot, and the lease has an index provision, which is expected to keep the rent up with inflation. The discount rates being used in this example are real yield rates applied to constant dollars.

In the Step 1 analysis on a pre-taking unencumbered basis, similar properties are currently being leased at an annual rent of $12.00 per square foot, indexed to keep pace with inflation, and prospective purchasers are anticipating a rate of return or capitalization rate (R)[16] of 7.0%. The post-taking analysis in Step 3 indicates the property, as if unencumbered by the lease, is capable of generating an annual net rent of $11.00 per square foot, and the projected income has been capitalized at an overall capitalization rate of 7.0%.

In Step 2, a 6.75% discount rate is applied to the lease income, and the reversion, which is also expected to keep pace with inflation, has been discounted at 7.0% in analyzing the value of the leased fee interest pre-taking. Applying the format outlined in *Sherrod*, the condemnation award and allocation of the award in this example is shown in Exhibit 1.

As Exhibit 1 indicates, in Step 1, the market value of the property *before* the taking is based on an unrestricted highest and best use and as if *unencumbered* by the lease, consistent with the undivided fee rule. In Step 2, the market value of the property represents the lessor's leased fee interest and reflects the terms and conditions of the lease, including the contract rent. (If this amount is equal to or greater than the amount in Step 1, no residual value is attributable to the lessee's leasehold interest, thus entitling the lessor to the entire award.) In Step 3, the market value of the property *after* the taking is based on an unrestricted highest and best use, and as if *unencumbered* by the lease.

In this example, applying the format as set out in *Sherrod*, the damages or contributory value of $1,714,286 calculated in Step 4 represents the loss in market value occasioned by the taking,

Exhibit 1 Case Study Example, Application of Sherrod Rule

Step 1: Pre-taking market value as if unencumbered by the lease	$20,571,429
(120,000 sq. ft. on 11.0193 acres @ $12.00 per sq. ft.) ÷ 0.07	
Step 2: Pre-taking market value encumbered by the lease	$17,974,995
Annual rent (120,000 sq. ft. on 11.0193 acres @ $10.00 per sq. ft.) $1,200,000	
PV ($1,200,000 for 30 years discounted @ 6.75%) $15,272,586	
PV reversion ($20,571,429 deferred 30 years @ 7.0%) $2,702,409	
Step 3: Post-taking market value as if unencumbered by the lease	$18,857,143
(120,000 sq. ft. on 10.8816 acres @ $11.00 per sq. ft.) ÷ 0.07	
Step 4: Contributory value of taking	$1,714,286
Step 1 minus Step 3: $20,571,429 – $18,857,143	

16. The *capitalization rate* is the "ratio of one year's net operating income provided by an asset to the value of the asset; used to convert income into value in the application of the income capitalization approach," *The Dictionary of Real Estate Appraisal*, 6th ed., s.v. "capitalization rate."

Exhibit 2 Case Study Example, Apportionment Calculation

Apportionment of Interests	
Lessee's interest in fee simple estate (Step 1 – Step 2) ÷ Step 1 ($20,571,429 – $17,974,995) ÷ $20,571,429	12.622%
Lessor's residual interest in fee simple estate (1 – 0.12622)	87.378%
Allocation of Award	
Lessee ($1,714,286 × 0.12622)	$216,377
Lessor ($1,714,286 – $216,377) or ($1,714,286 × 0.87378)	$1,497,909
Total Award	**$1,714,286**

and it is this amount that is apportioned between the lessee and lessor. The apportionment calculations are shown in Exhibit 2.

The Sherrod Rule treats the value of the lessee's leasehold interest as the amount left after the value of the lessor's leased fee interest has been deducted from the fee simple value of the property. If one rate of return or discount rate is applied in analyzing the value of the lessor's leased fee interest, and a different rate is applied in analyzing the value of the lessee's leasehold interest, then the percentage awarded to each party changes, and the order of priority to the compensation award is reversed (i.e., lessee's interest valued first; lessor's interest treated as a residual).

A separate and initial analysis of the value of the lessee's leasehold interest in the example shows how apportionment of the compensation award changes between the lessee and lessor.

Analysis of Lessee's Leasehold Interest

In analyzing the value of a lessee's leasehold interest, appraisers should undertake the following investigations, plus any other investigations relevant to the valuation:

- Thoroughly read an executed copy of the lease, including any amendments, to gain an understanding of the provisions of the lease. (Seek competent legal advice if the meaning of specific clauses is unclear.)
- Confirm the area of the demised premises. (Comparisons of any market rental data involving a space lease should be analyzed on a consistent unit of measurement.)
- Determine the status of the lease. (Is the tenant in good standing? Are there any rent or expense arrears?)
- Identify any clauses pertaining to condemnation and analyze their impact in the context of the taking. (How is entitlement to a condemnation award to be treated and analyzed in respect of the lessor's and lessee's interests in the property?)
- Identify any use restrictions and permitted uses in the lease and analyze their impact in the context of market demand and highest and best use. (Is there sufficient demand for the uses permitted in the lease?)
- Identify any parking ratio requirements in the lease. (Important for all types of uses, especially retail. Loss of parking may terminate a lease or cause a permanent structural vacancy, depending on the use.)
- Determine the remaining term of the lease and consider any options to renew or extend the lease and analyze their impact in the context of marketability. (Has the tenant complied with notification requirements to renew or extend the term of the lease, if applicable?)
- Determine if the lease is assignable, and, if so, on what terms and conditions. (Is the landlord entitled to share in any rental advantage? If an assignment of the lease readjusts the contract rent to market rent, there is no rental advantage.)
- Identify the contract rent and its terms of payment, and any rent adjustment formulas. (If retail, make note of percentage and overage rent clauses, and investigate historical volume of retail sales.)
- In a retail shopping center identify any nonbuild area (avoidance of visual obstruction of tenant's premises) in the lease that may be impacted by the taking.
- Consider mortgage financing constraints, including terms and conditions, imposed on the leasehold interest either by the lease or by the lending community.[17]

17. Financeable leases tend to exceed 50 years (including option terms), to allow a lender to recover its investment in a leasehold mortgage, and require a lease term of 10 to 30 years longer than the maturity date according to a number of investment risk-rating agencies (S&P – 20 years; Duff & Phelps – 10 years; Fitch – 10 years; Moody's – 30 years). See Stephen E. Friedberg and David M. Alin, *Structuring Financeable Ground Leases and Leasehold Mortgages*, October 12, 2017, Strafford webinar presentation, http://bit.ly/2zjKZAY.

Typically, the measure of damages for a taking of a leasehold interest is the market value (or market rental value) of the unexpired term of the lease over and above the rent stipulated to be paid. Although the formulation appears straightforward, various elements could be relevant depending on the facts of the case, and whether the real property is residential, commercial, retail or industrial.

In the case study example, the lessee enjoys a rental advantage of $2.00 per square foot, which is the spread between the market rent of $12.00 per square foot and the contract rent of $10.00 per square foot; the annual rental advantage is $240,000 (120,000 square feet at $2.00). The remaining term of the lease is 30 years. There is no restriction on assignment of the lease, and there is sufficient demand for the permitted uses listed in the use clause of the lease. However, it is unlikely that mortgage financing would be available for a prospective purchaser of the leasehold interest, consisting only of possession and use rather than ownership of the building. Overall, the leasehold position is a less desirable investment than the leased fee position, and a risk premium of 200 basis points is considered warranted, increasing the rate of return (discount rate) from 7.0% to 9.0%. On this premise, the market value of the lessee's leasehold interest can be computed as shown in Exhibit 3.

Using the calculations from Exhibit 3, the award apportionment can be revised for the lessee and lessor as shown in the calculations in Exhibit 4.

While the total amount of the condemnation award of $1,714,286 remains unchanged in this example, the allocation of the award to the lessee has been reduced by $10,834 or 5.0%, from $216,377, and the allocation of the award to the lessor has been enhanced by an off-setting amount, increasing from $1,497,909 to $1,508,743.

According to *The Appraisal of Real Estate*, fourteenth edition, the market value of the leased fee and leasehold estates should each stand on its own merits, with the combined results compared to the market value of the fee simple estate for the same property, and a favorable lease can *never* enhance the market value of the fee simple estate.[18]

Exhibit 3 Case Study Example, Computation of Market Value of Lessee's Leasehold Interest

Lessee's rental advantage	
(120,000 sq. ft. × $2.00 per sq. ft.)	$240,000
PV rental advantage, 30 years discounted at 9.00%	
($240,000 × 10.273654)	$2,465,677

Exhibit 4 Case Study Example, Revised Apportionment Calculation

Apportionment of Interests	
Lessee's interest in fee simple estate	11.99%
(Step 1 – Step 2) ÷ Step 1	
($2,465,677 ÷ $20,571,429)	
Lessor's residual interest in fee simple estate	88.01%
(1 – 0.1199)	
Allocation of Award	
Lessee ($1,714,286 × 0.1199)	$205,543
Lessor ($1,714,286 – $205,543) or ($1,714,286 × 0.8801)	$1,508,743
Total Award	**$1,714,286**

Lease Condemnation Clauses

A condemnation clause will typically address both a partial and a total taking of the leasehold interest. Parties to a lease can stipulate the manner in which an award made by a condemning authority for a partial or total taking of the leasehold interest will be distributed between them and also dictate the obligations and rights of both lessor and lessee.

Distinguishing Market Rental Value from Rent Payable during Remaining Lease Term

In *State v. Parkey*,[19] the Texas appeals court disallowed the jury award of $20,000 to Parkey and Smith (lessees) for the taking of the leasehold interest. The leasehold consisted of an

18. *The Appraisal of Real Estate*, 14th ed., 441.

19. *State v. Parkey*, 295 S.W. 2d 457 (Tex. Civ. App. 10th Dist. 1956).

1,800-square-foot building measuring 60 feet parallel to the road frontage by a depth of 30 feet. At trial, stipulated evidence indicated that the ground covered in the leasehold was worth $2,400, and that the improvements were worth $14,000, indicating a fee value of $16,400, and that the "rental value of commercial property was usually placed at such amount as to yield a gross return to the owner of the leased property of 12% per annum on his capital investment," all estimated as of February 1, 1956, the date of the taking. The suggested annual economic rent (market rent) is $1,968 ($16,400 × 0.12) or $164 per month ($1,968 ÷ 12). Ramsey, the owner of the property that had been partly encumbered by a lease to Parkey and Smith, reached an agreement with the condemning authority prior to commencement of this proceeding.

Parkey and Smith entered into a lease with Ramsey for a term of 10 years from September 17, 1952, with an option to renew for a further term of 10 years at a fixed rent of $175 per month, provided written notice was submitted by July 17, 1962. As of February 1, 1956, the remaining term of the initial 10-year lease was about 7.5 years and the contract rent was fixed at $175 per month. The lessee's rental payment of $175 per month for 17.5 years, including the 10-year renewal option, would have amounted to total rental payments of $35,750, as summarized in Exhibit 5.

Exhibit 5 *Parkey* Rental Payments Computation

Existing term	
Years 3–10 (7.5 years, 2/1/56 to 9/16/62)	$15,750
($175 per month × 90 months)	
Renewal Option	
Years 1–10 ($175 per month × 120 months)	$21,000
Total Rental Payments (undiscounted)	**$35,750**

In the *Parkey* case, the lessee's appraiser testified that "the reasonable cash market value of the leasehold interest…on February 1, 1956 was about $42,000," while failing to consider market rent in analyzing the prospect of a rental advantage; the jury awarded $20,000 to the lessee for its leasehold interest.

The lessee's appraiser presented the "market value of the leasehold interest" as being synonymous with the "amount of rent someone would be willing to pay to occupy the leased premises for 17 years," but he did not establish the existence of a leasehold rental advantage (the difference between market rent and contract rent), a prerequisite to the valuation of a leasehold interest.[20]

The appraiser's market rental estimate of $42,000 was bolstered by three other witnesses who testified that the "cash market value of the leasehold interest," was $43,500, $45,000, and $47,000, respectively. None of these witnesses testified as to *the market value of the leased premises*, and each testified that his estimate was based on the assumption that the lessee would extend the lease for an additional 10 years.[21]

The jury failed to understand and connect the following instructions in awarding the lessees $20,000 for their leasehold interest:

> You are instructed that by the leasehold interest of the defendants Parkey and Smith is meant the right to the use and occupancy of the land described in their lease… for the balance of the lease term, upon the payment of the rental and the performance of the other terms of the lease.
> [and]
> You are instructed further that by the term "*reasonable market value of the leasehold interest', is meant the price the leasehold interest would bring when offered for sale by one who desires to sell but is not obliged to sell, and is bought by one who desires to buy but is under no necessity of buying.*" [emphasis added]

In *Parkey*, the following factors would be considerations in the analysis:

20. In *Pokorny v. Local No. 310*, 38 Ohio St. 2d 177 (1974), the Ohio Supreme Court reversed an appeals court ruling that failed to permit evidence of comparable rentals as proof of market rent and overturned an award based on a failure to discount the "bonus value" for the remaining term of the lease. The court said that in estimating the fair market value of the leasehold interest, the annual rental advantage, if any, during the remaining lease term would be discounted to present value at an appropriate rate.

21. The court noted the purported option to extend the lease occurred *after* the lessor had conveyed title to the leased property to the condemning authority and was done "solely for the improper purpose of bolstering the amazing testimony of their expert witnesses on the damage issue."

- The apparent annual rental disadvantage is $132 ($11 per month) based on the implied economic rent of (12% of $16,400) $1,968 ($164 per month) attributed by the condemning authority's appraiser to the demised premises as if unencumbered by the lease, in comparison to the contract rent of $2,100 ($175 per month) pursuant to the lease.
- The total rent payable over the remaining 7.5 years of the existing lease amounts to $15,750 ($175 per month × 90 months), which is $26,250 or 62.5% less than the market rental value of $42,000, as estimated by the lessee's appraiser
- The total rent payable over 17.5 years, including the 10-year option, amounts to $35,750 ($175 per month × 210 months), which is $7,250 or 17.3% less than the market rental value of $42,000, as estimated by the lessee's appraiser.
- The market rental value of $42,000, estimated by the lessee's appraiser, is $6,250 more than the $35,750 in total rent payable by the lessee over 17.5 years, including the 10-year option.
- The market rental value of $42,000, estimated by the lessee's appraiser, is $25,600 or 156% higher than the uncontested market value of $16,400 indicated by the condemning authority for the demised premises, as if unencumbered by the lease.

On the basis of this analysis, no potential purchaser would have paid $42,000 as the market rental value for the lessee's leasehold interest, which as a fee simple interest was worth only $16,400.

Allocation of Condemnation Award to Sublessee for Business Losses Pursuant to a Condemnation Clause

In *City of Roeland Park v. Jasan Trust*,[22] the Supreme Court of Kansas heard an appeal involving a dispute between a lessee, BCB, L.L.C. (BCB) and its sublessee, Payless Shoesource, Inc. (Payless) over the apportionment of a condemnation award involving the taking of a shopping center owned by Jasan Trust (Jasan).

Payless operated a store in the shopping center pursuant to an "Amended and Restatement of Lease Agreement" (lease). The lease was originally executed in 1989 between Volume Shoe Corporation (VSC) as lessee and the May Department Stores Company (May) as lessor for an initial term of 10 years, expiring in July 1999. Subsequently, VSC transferred its interest in the lease to Payless, and BCB acquired May's interest. Payless extended the term of the lease to July 31, 2009. The condemnation clause in the lease, stated,

> All damages awarded for the taking of said Common Area and Common Area Improvements or the Demised Premises, or any part thereof, shall be payable in the full amount thereof to and the same shall be the property of Landlord, excluding but not limited to any sum paid or payable as compensation for loss of value of the leasehold. Tenant shall be entitled only to that portion of any award expressly stated to have been made to Tenant for *loss of business*, moving expenses, the loss of value and cost of removal of stock, furniture, and fixtures owned by the Tenant, and the unamortized value of Tenant's leasehold improvements using the straight-line method of amortization over the primary term of this Lease, to the extent of proceeds received by Landlord.

On May 28, 2004, the City of Roeland Park (City) condemned the shopping center for a proposed redevelopment project. After court-appointed appraisers determined the market value of the undivided fee interest at $6,500,000, the trial court apportioned the award, granting the property owner Jasan, $2,200,000 and the lessee BCB, $4,300,000. At a later hearing, Payless's testimony that it had sustained $502,991 in *lost profits* went unchallenged.

Pursuant to the condemnation clause in the lease agreement between BCB, the lessee, and Payless, the sublessee, the court later apportioned BCB's award of $4,300,000 between BCB and Payless, granting Payless $502,991 for lost profits, a judgment sustained on appeal. As noted by the Kansas Supreme Court,

> [U]nder Kansas law, a tenant is entitled to compensation if his or her leasehold interest is damaged by the exercise of eminent domain. However, if the lease itself

22. *City of Roeland Park v. Jasan Trust*, 281 Kan. 668 (2006).

> includes a provision in respect of the rights of the parties in the event of the condemnation of the leased premises, such a provision is controlling, if applicable to the particular case. This rule acknowledges that the allocation of risks in such circumstances is a matter to which the parties are free to bargain.

Entitlement to Condemnation Award—Lessee's Option to Purchase

In *City of Peerless Park v. Dennis*,[23] the Missouri appeals court affirmed a lower court's ruling that a lessee's unexercised option to purchase was a compensable interest. However, the appeals court found that the trial court erred in calculating the distribution of the proceeds from the condemnation. The pertinent part of the condemnation clause in the lease stated as follows:

> In the event the premises shall be taken by or pursuant to any governmental authority or through the exercise of the right of eminent domain, Landlord and Tenant shall join and cooperate in resisting such proceeding if such resistance is feasible and desirable, and if it is not, shall join and cooperate prosecuting *their respective claims for damages* incurred from the unsuccessful exercise of such right or proceeding. [emphasis added.]

The lease contained an "Option to Purchase and Right of First Refusal," which provided in part,

> Tenant shall have the pre-emptive right during the term of this Lease to purchase said premises. The sale price shall be…$120,000.00 if purchased within the first twelve months of this lease [08-03-1992 to 08-02-1993]. The sale price shall escalate at the rate of 5% annually thereafter, throughout the term of this lease. Tenant shall give Landlord…60 days written notice in advance of Tenant's intent to purchase.

Dennis leased the property to CHC under a 10-year lease dated August 3, 1992. CHC used the property as a seasonal parking lot. On July 22, 1998, the City of Peerless Park (City) condemned the 1.5-acre lot, and $250,000 was awarded for the taking. The trial court awarded $209,429.05 to Dennis, and CHC was awarded $40,570.95.

The trial court found that CHC would have exercised the option to purchase the property at the end of the lease term in 2002, 4 years after the taking. For the purpose of illustration, the base option price of $120,000, adjusted for 9 years to 2002, results in a future option price of $186,159 ($120,000 × 1.05^9), without consideration of the estimated value of the fee simple interest in 2002, which presumably would have been more than the $250,000 fee simple value of the property in 1998.

Absent a termination clause, the trial court found that the lease terminated because CHC's leasehold interest had been appropriated for public use, thus giving rise to a right of compensation. The appeals court concluded that because the market value of the property was greater than the option price, CHC would have exercised the option on the day of the condemnation award (July 22, 1998). Accordingly, the appeals court ruled that CHC's interest in the property should be the difference between the option price and the condemnation award (market value) on the date of the taking.

An assumed triggering of the option to purchase on the date of the taking effectively precluded CHC from claiming "bonus value" for the remaining term of the lease.[24] CHC could have claimed either the value created by its option to purchase or the present value of the rental advantage for the remaining term of the lease, but CHC could not claim an entitlement to both. Presumably, both of CHC's leasehold benefits would be analyzed by an appraiser in determining the value of the lessee's interest in the property taken, using the following analysis:

> Adjusting the Year 1 option price of $120,000 by 5%, compounded annually for 5 years, to the date of the taking, increased the option price to $153,154 ($120,000 × 1.05^5), which results in an award of $96,846 ($250,000 – $153,154) for CHC's leasehold interest, with the lessor's entitlement restricted to the option price of $153,154.

23. *City of Peerless Park v. Dennis*, 42 S.W.3d 814 (2001).

24. "The bonus value can be more precisely defined as the present value of the difference between economic rent, i.e., the value of market rental, and the contract rent through the remaining lease term. The bonus value usually assumes importance only in long-term commercial leases." *New Haven Unified School Dist. v. Taco Bell Corp.*, 24 Cal. App. 4th 1473, 1478–1479, 30 Cal. Rptr. 2d 469 (1994), internal citations omitted.

Apportionment of Condemnation Award—Partial Taking of Leased Land

In *Trump Enterprises, Inc. v. Publix Supermarkets Inc.*,[25] the Florida appeals court overturned the trial court's apportionment of the condemnation award in a partial taking of leased land by the Department of Transportation (DOT). Publix owned the shopping center in which Trump Enterprises (Trump) leased an outparcel on which it operated a restaurant. DOT's taking consisted of a strip of land along the frontage of the shopping center for the purpose of road widening. The condemnation award for the land taken was $250,000, all of which went to Publix. The taking consisted of 15,357 square feet, of which 5,333 square feet, or 34.7%, were within Trump's leasehold. If Trump exercised all of the lease options, Publix would be entitled to the rental income for 24.25 years. Trump continued to pay the same contract rent after the taking, but the trial court denied Trump's claim for compensation on the following grounds:

> [T]he land taken from the property leased to this restaurant only included a grassy area which ran along side the road. *None of the building occupied by the restaurant was affected by the taking and no parking spaces were lost. The restaurant continues to be profitable*.

As noted by the appeals court, the trial court failed to recognize that the lease (sublease) agreement was for the lease of *unimproved* land. "Neither the 'continued profitability' of the restaurant business, nor the fact that Trump's business suffered no damage should have been factored into the equation." The appeals court approved of the method employed by Trump's appraiser in analyzing the portion of the $250,000 condemnation award to which Trump was entitled. Trump's appraiser testified that a total of 15,357 square feet of land was taken, of which 5,333 square feet were within Trump's leasehold, accounting for 34.73% of the total land taken. The appraiser then calculated that 34.73% of the $250,000 equaled $86,825, which represents the condemnation proceeds paid to Publix for that portion of the leasehold land taken. The appraiser testified,

> Publix would be entitled to a rental income stream for 24.25 years, if the lease options were all renewed, and to a reversion 24.25 years after the taking. A value of $8,600 in today's dollars was assigned as the difference between the value of the reversion before the taking and the value of the reversion after the taking.…The net amount of $78,225 represents the condemnation proceeds to which Trump would be entitled…for the value of its leasehold taken.

Because Publix will continue to receive rent unabated from the lessee for the next 24.25 years, it is only the return of the leasehold land in 24.25 years for which the lessor is entitled to be compensated. The present value of $8,600 attributed to the lessor's reversionary interest of $86,825 in the land included in the leasehold, deferred 24.25 years, indicates a discount rate of 10.0%. Exhibit 6 shows the analysis for apportionment of the award.

Exhibit 6 Apportionment of Award, Partial Taking of Leased Land, *Trump Enterprises v. Publix*

Contributory value of land taken in fee simple (15,357 sq. ft.)	$250,000
Contributory value of leasehold land taken in fee simple (5,333 sq. ft.) (5,333 sq. ft. ÷ 15,357 sq. ft.) × $250,000	$86,825
Less: PV of lessor's reversion of $86,825, deferred 24.25 years, discounted @ 10.0% ($86,825 × 0.099049)	$8,600
Residual value of lessee's leasehold interest in land taken (5,333 sq. ft.) ($86,825 – $8,600)	$78,225

Equitable Apportionment of Condemnation Award to Lessee and No Obligation to Mitigate Damages

In *City of Puyallup v. Hogan*,[26] the Washington State appeals court confirmed the right of a lessee, Borders Group, Inc. (Borders), to share in a condemnation award, and, in a case of first impression, ruled that tenants in condemnation proceedings do not have a duty to mitigate damages. A small portion of Hogan's shopping center

25. *Trump Enterprises, Inc. v. Publix Supermarkets Inc.*, 682 So. 2d 168 (1996).

26. *City of Puyallup v. Hogan*, 168 Wash. App. 406, 277 P.3d 49 (2012).

(Center) experienced significantly reduced access due to an expropriation by the City of Puyallup. Hogan argued that the damages to the center were $11,900,000, but the jury awarded Hogan $5,150,000 for the taking. At the apportionment trial, Borders, the anchor tenant, was apportioned $722,603.80 of the condemnation award, double the calculated amount, "for equitable adjustment because of the unique variables." The trial court's rationale for equitably doubling Borders's apportionment was explained as follows:

> [T]he trial court first observed that Borders' space was roughly 23 percent of the Center's total area and that its equitably increased award approximated "the average of 23 [percent] (Borders' square foot percentage of the [p]roperty) of $2,300,000 (the amount Hogan believe[d] should be apportioned) and 23 [percent] of $5,150,000 (the amount Borders [thought] should be apportioned)." The trial court next observed that its equitably adjusted award was also proportionate to the amount of damages Hogan claimed the jury actually awarded specifically to Hogan in the trial's first phase. [brackets in original]

The appeals court concluded that "the trial court's exercise of its equitable discretion to double Borders's apportionment was not manifestly unreasonable." Accordingly, the appeals court held that the trial court did not abuse its discretion in increasing Borders's apportionment.

Borders entered into a lease for space in the Center in 2000. The lease included an initial 15-year term, plus five successive 5-year options to renew. Article 22, the condemnation clause in the lease, stated, in pertinent part, as follows:

> (a) *Demised Premises/Ingress and Egress*. If (i) any portion of the demised premises is expropriated, or (ii) any point of ingress and egress to the public roadways…is materially impaired by a public or quasi-public authority…so as to render, in [Border's] sole reasonable opinion, the demised premises unsuitable for the operation of [Border's] business in the normal course, then [Border's] shall have the option to terminate this lease….During any expropriation or impairment…or whether or not this Lease is terminated as a result of such expropriation or impairment, [Hogan] shall endeavor to provide a reasonable alternative to the impaired point of ingress and egress for the duration of any such expropriation or impairment.
>
> (b) *Termination*. If this Lease is terminated pursuant to this Article 22, then any rent paid in advance under this Lease shall be refunded to [Borders], and [Borders] shall have an additional sixty (60) days following the termination date within which to remove [Borders'] property from the demised premises; provided, however, that Rent shall be adjusted from and after the date of such expropriation in proportion to the portion of the demised premises in which [Borders] elects to continue operating after such expropriation as shall equal the unamortized portion of [Borders'] expenditures. *Such amortized portion* of [Borders'] expenditures shall be determined by multiplying such expenditures by a fraction, the numerator of which shall be the number of remaining years of the Lease term at the time of such expropriation, and the denominator of which shall be the number of remaining years of the Lease term at the time of such expenditures shall have been made, plus the number of years for which the Lease term has been subsequently extended; provided, however, [Borders] shall have such right to share in a condemnation award only if the award for such *unamortized expenditures* is made by the expropriating authority in addition to the award for the land, building and other improvements (or portions thereof) comprising the demised premises, although [Borders'] right to receive compensation for damages or to share in any award shall not be affected in any manner hereby if said compensation, damages or award is made by reason of the expropriation of any land or buildings constructed, made or owned by [Borders]. [brackets as in original; emphasis added.]

A portion of the site was taken to extend a road. After the taking and road construction, access would be significantly reduced, with a much narrower entrance-only and the road located within a few feet of Borders' store. The parties conceded that the trial court correctly applied the proper formula for apportioning a condemnation award:

> [A] proportional distribution of a lump-sum award based upon the ratio each separately valued condemned interest bears to the total of all separately valued condemned interests bears to the total of all separately valued interests.[27]

At trial, Hogan argued that Borders acting as a reasonable tenant would go dark, break the lease, and relocate, leaving Hogan to bear $2,200,000 in retenanting costs. Borders countered that it would likely sublease its space at the Center, and that its renewal options would be essential to quality subtenants. The trial court sided with Borders and calculated damages through all its renewal options until 2040, with 8 years remaining on the initial 15-year term at the time of the 2007 expropriation. Borders's leasehold was diminished by $7.00 per square foot annually until 2040 and was discounted to a present value of $1,400,000. Hogan's argument that Borders had a duty to mitigate its damages by breaking the lease and by not exercising any of its renewal options was rejected by the appeals court.

The court's apportionment analysis was based on Hogan's total damage claim figure of $11,900,000, rather than the $5,150,000 actually awarded by the jury. Of the $5,150,000 awarded, only $2,300,000 in damages was attributed to the impaired access as the amount to be apportioned between Hogan and Borders. The remaining $2,850,000 of the award was not related to the impaired access. The detailed calculations of the apportionment of the $5,150,000 award between Hogan and Borders—reduced by the apportionment paid to Key Bank, another tenant in the Center—are summarized in Exhibit 7.

Exhibit 7 Apportionment of Award to Lessee, *Puyallup v. Hogan*

Center's damage (total loss of market value due to taking), as presented by Hogan during compensation phase of trial)	$11,900,000
Less: PV of diminution of Borders's leasehold ($7 per sq. ft. through 2040)	1,400,000
Hogan's fee valuation (less apportionment paid to Key Bank)	**$10,500,000**
Less: Damages not related to impaired access (i.e., the taking and cost to cure)	2,850,000
Value of Hogan's remainder damages	**$7,650,000**
PV of diminution of Borders's leasehold ($7 per sq. ft. through 2040)	$1,400,000
Total of Hogan's and Borders's separate remainder damage valuations	**$9,050,000**
Proportion of total remainder damage valuations	
- Hogan ($7,650,000 ÷ $9,050,000)	84.53%
- Borders ($1,400,000 ÷ $9,050,000)	15.47%
Awarded compensation	**$5,150,000**
Less: Damages not related to impaired access	2,850,000
Damages for impaired access (i.e., amount to be apportioned)	**$2,300,000**
Apportionment of compensation award for impaired access	
- Hogan ($2,300,000 × 0.845304)	$1,944,199
- Borders ($2,300,000 × 0.154696)	$355,801

27. See *State v. Spencer*, 90 Wash. 2d at 421–422, 583 P.2d 1201; "[U]nder the *Spencer* formula, if the taking does not terminate a leasehold, the trial court should (1) determine the total value of the separate property interests condemned, (2) calculate the ratio each of those separately valued property interests bears to the total value of the condemned property, and (3) apply those ratios to the total just compensation actually awarded for the taking to determine the proportional share of the award for each property interest….Because Hogan presented evidence that just compensation for Puyallup's taking was $11,900,000 but the jury only awarded $5,150,000 total just compensation, the *Spencer* formula applies."

Apportionment of Condemnation Award—Taking of Whole Property, Leasehold Value and Lease Renewal Option

A lessee's leasehold value calculated to include an option to renew the lease was addressed by the Supreme Court of Missouri, in *Land Clearance for Redevelopment Corporation v. Doernhoefer*.[28] The taking consisted of the whole property, which included a site improved with a three-story building under lease, with A. & L. Dunn Mercantile & Loan Company (Dunn) as lessee. The commissioners made a lump sum award of $190,000 as the market value of the property. Subsequently, $21,875 of the award was apportioned to Dunn as the "bonus value" of its leasehold interest. At the time of the March 11, 1963 taking, Dunn's lease had a remaining term of 7.5 years, with an option to renew for a further term of 10 years.

Appraisers for both the lessor and lessee considered the lease favorable to the lessee. Dunn had been the largest and oldest of the pawnbrokers in St. Louis (in business since 1873) and had spent more than $60,000 on tenant improvements. The trial court ruled that Dunn would have exercised the 10-year renewal option, with the rental advantage, but for the taking of the property. The rental advantage was the difference between market rent and contract rent, under the current use and occupancy, and was fixed at $1,250 annually for 17.5 years, resulting in a (undiscounted) "bonus value" of $21,875 ($1,250 × 17.5).

On appeal, entitlement to the rental advantage as if the option to renew had been exercised was upheld, but the trial court's failure to discount the rental advantage to present value was considered an error in calculating the bonus value assigned to Dunn's leasehold interest. The court stated,

> We are of the opinion that the discount factor should be applied under the particular facts of this case; that this lessee is entitled only to the capitalized [discounted] value of the bonus. The principle is that of an annuity…. The discounted sum, presently to be awarded in one lump sum, with a given rate of interest compounded, will equal the amounts which would have come due annually by the expiration of time under the operation of the lease….An example of the injustice of presently awarding lessee the full amount in one lump sum will suffice. Take the last year's bonus of $1250, which under the operation of the lease (absent condemnation) would not have enured to lessee's benefit until August 31, 1980. To award to lessee that particular installment in full as of March 11, 1963 would give lessee its use 17½ years in advance of the time lessee otherwise would have been entitled to it. To be fair about it that installment should be discounted to the sum which, compounded at the proper rate of interest, would equal $1250 by 1980. The evidence indicated that there is a universally accepted method of applying the principle of discount known as the Inwood table…[citation omitted] This or some other formula shown by the evidence to be generally accepted should be applied, at the proper rate of interest, to discount to present value the bonus which would have been recovered in 17½ annual accruals in the future. The award is excessive to the extent that it exceeds this amount.[29]

In *Doernhoefer*, the court should have discounted the $21,875 to present value. Applying an 8.0% discount rate to the annual rental advantage of $1,250 for 17.5 years results in a present value of $11,561 ($1,250 × 9.249170), which is $10,314 or 47.15% less than the undiscounted $21,875 ($21,875 – $11,5614) awarded to Dunn in error by the trial court.

Apportionment of Condemnation Award—Long-Term Ground Leases

The significance of bonus value in long-term leases was addressed by the California appeals court in *New Haven Unified School District v. Taco Bell Corporation*:[30]

> The bonus value usually assumes importance only in long-term commercial leases. Condemnation of the leased premises serves to terminate a lease, releasing the lessee from further obligation to pay rental; thus, the value of the lost possession must be offset by the value of the cancelled rental obligation. In short-term leases, the lessee will have at best a small claim against the condemning authority. In long-term leases…the lessee may still have no claim if the lease rental equals or exceeds the market rental. But the parties may some-

28. *Land Clearance for Redevop. Corp. v. Doernhoefer*, 389 S.W.2d 780 (1965).

29. *Doernhoefer*, 389 S.W.2d at 788–789.

30. *New Haven Unified Sch. Dist. v. Taco Bell Corp.*, 24 Cal. App. 4th 1473 (1994).

> times miscalculate, or bargain away, increases in market rental over the lease term. Where this occurs in the negotiation of long-term leases, the lease bonus may amount to a considerable sum.[31]

In a partial taking of a property under a long-term lease, where there is no loss of rental income to the lessor, the apportionment of an award limits the lessor's share to the value of the taking at the time of condemnation, deferred until the expiry of the term of the lease and discounted at an appropriate rate to present value. Post-taking, during the remaining term of the lease, the lessee continues to pay the same rent even though the use and occupancy of the demised premises have been diminished. In this situation, most of the loss in value occasioned by the taking is sustained by the lessee. Accordingly, the lessee is entitled to the lion's share of the award.

This approach to apportioning a condemnation award in a partial taking of a long-term lease, which apportions the proceeds by valuing the leasehold first, has been adopted by most jurisdictions and is distinguished from the treatment of short-term leases, as noted in *State ex Rel. Dept. of Transportation v. Gee*.[32] In *Gee*, however, the appeals court ruled that "*all* cases of apportionment of the proceeds of a condemnation [award] between lessor and lessee, [the court] must apply the approach…of apportioning by valuing the leasehold first," regardless of the length of the lease. The court noted,

> persuasive authority which approaches apportionment in the case of a long-term lease differently from apportionment in the cases of a short-term lease. These cases approach apportionment of a condemnation award for property subject to a short-term lease by valuing the lessee's interest in the leasehold first…but apportion the award when a long-term lease is involved by first valuing the lessor's present interest in the reversion and in the future rental payments."

In *Gee*, a lease was executed on June 15, 1964, for an initial term of 25 years, with two 25-year options, which, if exercised, could extend the term to 2039. The lease provided for rental payments of $2,000 a month ($24,000 annually), with an escalator clause tied to a cost of living index for adjustments beginning in 1979. In no event was the rent to fall below $24,000 a year. On February 7, 1970, following construction of a shopping center by the lessee, and in anticipation of the partial taking to widen the highway, the lease was amended to provide, "In the event a reduced rental cannot be mutually agreed upon, Lessor and Lessee agree upon a continuation of the same rental with Lessor receiving no portion of the condemnation award."

The taking occurred on November 26, 1974, and the award was for $28,650; the court apportioned $1,500 to Gee (lessor) and $27,150 to Madison (lessee). After discounting, the award of $28,650 for the taking as if unencumbered on the date of the condemnation was adjusted at a rate of 6% to a present value of $668 (equals $649).[33] Gibson, a partner in Madison, simply attributed the residual amount of $27,982 to the lessee Madison. The court rejected this method of allocating the award, as there was no direct evidence supporting the diminished value of the lessee's leasehold estate amounting to 95% of the award. The court stated that in order to have supported an apportionment of the award to the lessee, it was incumbent on the appraiser to thoroughly read and interpret relevant provisions of the lease in analyzing market rent and presenting the value of the lessee's interest *first* in apportioning the award.

In *Department of Public Works v. Metropolitan Life Insurance*,[34] the Illinois appeals court overturned the apportionment of an award of $14,600 for a partial taking for a road widening, in which the tenant lessee received $8,300 and the owner landlord received $6,300. The land taken on

31. The court in *Taco Bell*, referencing Victor P. Goldberg, Thomas W. Merrill, and Daniel Unumb, "Bargaining in the Shadow of Eminent Domain: Valuing and Apportioning Condemnation Awards between Landlord and Tenant," 34 *UCLA L. Rev.* (1987): 1083, 1086–1092, available at http://bit.ly/2AHb6nk.

32. 565 S.W.2d 498 (Tenn. Ct. App. 1977).The court in *Gee* stated that under Tennessee law it was bound not to apply the long-term approach and must instead apply an approach to all leases consistent with the short-term rule, which values "the lessee's interest as excess of value of the leasehold over rentals due for the unexpired term." See *Shelby County v. Barden*, 527 S.W.2d (Tenn. 1975).

33. Factor for $1.00 deferred 65 years is 0.022653; present value of $28,650 is $649 ($28,650 × 0.022653).

34. *Dept. Pub. Wks. V. Metropolitan Life Ins. Co.*, 42 Ill. App. 2d 378, 192 N.E.2d 607 (1963).

June 1, 1960, consisted of 11,960 square feet or approximately 1.69% of the entire leased tract of 705,960 square feet. Except for a small frame building housing a tavern, the leased area was vacant. The condemnation clause in the lease included the following provision:

> [u]pon partial or total condemnation, the lessee has the right to prosecute claims for injury to its interest and that any condemnation award is to be divided fairly and equitably between the fee simple estate and the leasehold estate.

On April 18, 1956, the parties entered into a 99-year lease of approximately 16.2 acres, commencing May 1, 1956 and ending April 30, 2055, at an annual rental of $8,000, payable semiannually, "which rental is subject to no deductions or abatements whatsoever." The lease gave the lessee an "option to purchase the tract for $160,000 exercisable between the 14th [May 1, 1970] and 20th [April 30, 1976] lease years."

As observed by the appeals court,"[t]he long-term leasehold [with a remaining term of 95 years as of June 1, 1960] contains all the economic attributes of fee ownership, subject only to the reserved annual rental, and may be developed, sold or otherwise treated as though the fee itself," but without the right to "encumber the lessor's title." In deciding that the lessee was entitled to the entire award of $14,600, a number of metrics were presented to support the lessee's entitlement to the entire award:

- The value of the fee estate at $705,960 (lessor's valuation) is $489,960 in excess of the undiscounted cost of acquiring the fee at $224,000 (8 years rent $64,000 + $160,000 purchase option).
- The value of the fee estate at $1,058,940 (lessee's valuation) is $842,940 in excess of the undiscounted cost of acquiring the fee at $224,000 (8 years rent $64,000 + $160,000 purchase option).
- The present value of the leased fee interest at $286,000 (lessor's estimate) exceeds by $62,000 the cost of acquiring the fee at the aggregate (undiscounted) amount of $224,000 (8 years rent $64,000 + $160,000 purchase option).

The court said that under the terms and conditions of the existing lease, no prudent purchaser would ever pay either $705,960 (the landlord's valuation of the fee interest) or $1,058,940 (the tenant's valuation of the fee interest). Nor would a prudent purchaser ever pay the present value of the leased fee interest of $286,000 (the lessee's estimate), as conceded by the lessor's appraiser. The lessor had bargained for a return and yield of 5% by fixing the lessee's option price at $160,000 and annual rent at $8,000.

Due to a rapidly rising real estate market and a vast improvement to the highway system, market rent attributed to the demised premises was estimated at $41,600 per year by the lessor, resulting in an annual rental advantage of $33,600 over the contract rent of $8,000 paid by the lessee. Even if the lessee chose not to exercise the option to purchase the property and continued for the next 95 years to enjoy the annual rental advantage of $33,600, discounted at, say, 6%, 100 basis points above the rate attributed to the leased fee position, the present value of the rental advantage (bonus value) would be $557,791 ($33,600 × 16.600932).

If the property were not encumbered by the lease and by the option to purchase, capitalizing the annual market rent of $41,600 results in a value of $832,000, which the lessor is unable to realize for 95 years, the remaining term of the lease. This is computed by discounting $832,000 to be received in 95 years at 5%, which results in a present value of $8,075 ($832,000 × 0.009705), equal to less than 1.0%. As demonstrated, the time value of money has an eroding effect on value when receipt of the reversionary interest in the property, the only entitlement of the lessor in this partial taking, is postponed long-term.

Since the landlord has only a reversionary interest 95 years after the condemnation date, the determination is predicated upon establishing a sum that, if deposited now at compound interest would eventuate, upon termination of the leasehold, to the amount estimated as his loss. According to the appeals court, this amount may be determined as follows:

> Assume that the subject land taken represents an area equal to 1.69% of the leasehold and is valued three ways: the gross amount of the award ($14,600), the value of the fee as per the landlord's witness ($11,930 or 1.69% of $705,960), and the value of the fee per the tenant's witness ($17,896 or 1.69% of $1,058,940).

The present value for each of these is determined by applying the following adjustments:

- The present value of the landlord's reversion of $14,600 on June 1, 1960, deferred 95 years and discounted at 5% (0.00971) is $141.70.
- Based on the landlord's fee simple value of $705,960, the present value of $11,930, deferred 95 years and discounted at 5%, is $115.84.
- Based on the tenant's fee simple value of $1,058,940, the present value of $17,896, deferred 95 years and discounted at 5% is $173.77.

In all three scenarios, the value of the landlord's leased fee interest is nominal, ranging from $115.84 to $173.77, further supporting the trial court's decision to allocate the entire condemnation award of $14,600 to the lessee.

Allocation of Condemnation Award—Lessee Must Prove Damages in Partial Taking Where Rent Continues Unabated

In *Department of Transportation v. M & T Enterprises of Mt. Pleasant*,[35] the Supreme Court of South Carolina for the first time addressed a partial taking of a leasehold interest. The October 2004 taking involved a strip of land along the highway frontage, totaling 4,245 square feet. In 2001, the lessee, Walgreen, entered into a lease for a term of 75 years, with possession of the newly constructed building scheduled for April 2002. Walgreen was in possession of the building before the filing of a condemnation notice on October 29, 2004. The owner, M & T Enterprises, was apportioned the entire award of $100,000, but the court found that Walgreen had not offered evidence that its leasehold estate had sustained any loss as a consequence of the taking. The court stated,

> Tenant [Walgreen] "has offered absolutely no evidence that the leasehold estate today is worth less than the leasehold estate that it held" on the date the Lease was either executed or delivered. ...Tenant is "only entitled to the difference between what they pay in rent and what the property could be leased for."...

Before and after the taking, Walgreen continued to pay the same monthly rent of $31,083.33 ($373,000 annually). Walgreen's appraiser testified that the lessee was entitled to a rent reduction of $491.07 per month in accordance with the condemnation clause in its lease, which stated:

> Tenant shall be entitled to the award in connection with any condemnation insofar as the same represents compensation for or damage to Tenant's fixtures, equipment, non-permanent leasehold improvements and other property of Tenant, moving expenses as well as the *loss of leasehold* estate (i.e., the unexpired balance of the lease term immediately prior to such taking); Landlord shall be entitled to the award insofar as same represents compensation for or damage to the fee remainder (including damage to the Building structure, and other permanent leasehold improvements made at the expense of Landlord…). [emphasis added]

Walgreen's appraiser determined the land in the lease contributed 37.4% to the total value of the property before the taking, and that the taking amounted to 4.22% of the total site area. Since the taking only involved land and not the building, the appraiser determined that the taking represented 1.58% of the value of the property as a whole. Accordingly, the present value of 1.58% of the monthly rent of $31,083.33 or $491.07 per month ($5,892.84 annually) over the remaining term of the lease of 75 years, applying discount rates of 7.2% and 6.4%, was estimated at $81,400 ($5,892.84 × 13.813337) to $91,200 ($5,892.84 × 15.475996), with Walgreen's appraiser ultimately concluding a market value loss of $81,400.

As noted by the South Carolina court, unlike the "bonus value" calculation in a *total* taking,[36] a different method of valuation commonly applies in a *partial* taking:

> While there is a split of authority on the matter, the general rule in other jurisdictions is that, "where only a portion of the leasehold is condemned, the measure of damages is the difference between the fair market value of the lease before and after the taking."
> ...
> The fundamental rationale driving this view is two-fold. First, "it has generally been held that that which is taken or damaged is the group of rights which the so-called owner exercises in his dominion of the physical thing."... Additionally, "[t]he right to occupy, for a day, a month,

35. *Dept. of Transp. v. M & T Enterprises of Mt. Pleasant, LLC.*, 379 S.C. 645, 667 S.E.2d 7 (2008).

36. Court referencing *City of Riverside v. Progressive Inv. Club of Kan. City, Inc.*, 45 S.W.3d 905, 911 (Mo. Ct. App. 2001).

> a year, or a series of years, in and of itself and without reference to the actual use, needs, or collateral arrangements of the occupier, has a value." Thus, a lessee, as temporary holder of these rights upon the leased premises, possesses a thing of value which must be compensated if taken unless the parties agreed otherwise. Second, if the lessee was paying exactly the fair market value of the leasehold prior to the partial condemnation, then there is no bonus value; as such, "if the condemnation reduces the value of the leasehold while the lessee is still required to pay the same amount of monthly rent, damages result to the extent that the lessee now pays a rent greater than the fair market value of the property." Under such circumstances, it is this value for which the lessee is normally compensated in a partial taking. In its simplest form, "the measure of damages of a tenant is the market value of what is lost." [citations omitted.]

The court acknowledged a lessee's right to bonus value in a partial taking of a leasehold interest where a rental advantage exists, unless precluded by agreement with the lessor, but ruled that a claim for damages to a leasehold interest must be proven by the lessee:

> [E]ven though Tenant [Walgreen] did not actually occupy or use the strip of condemned property…, it still paid rent for the total leased premises, which included the condemned area, and had dominion over it until taken. Furthermore, Tenant continues to pay the same monthly rent now as it did before the taking. Consequently, absent an agreement otherwise, Tenant normally would be compensated in accordance with the common law rule for a partial taking upon proof of such damage, which is the difference between the fair market value of the lease before the taking, and the fair market value of the lease after the taking, projected over the remaining term of its lease and discounted to its present worth.

The appeals court upheld the trial court ruling denying Walgreen any entitlement to the condemnation award for failing to prove damages to its leasehold, as "the burden is on a party pleading a fact to prove it," while also acknowledging that Walgreen's appraiser failed to apply the proper formula in computing damages in a partial taking and had erred by applying a total taking analysis.

Aggregation of Interests—Lessor's and Lessee's Interest in Partial Taking Assessed Separately

In *Utah Department of Transportation v. FPA West Point*,[37] the taking was an access point easement (access) to West Point Shopping Center, owned by FPA West Point (FPA), with Kmart Corporation (Kmart), a lessee and anchor tenant, also claiming an interest in the access. Kmart operated a department store pursuant to a lease of nearly 30 years, and the access allowed customers to enter the property directly in front of the Kmart store. Kmart claimed that by taking the access, the Utah Department of Transport (DOT) substantially and materially impaired Kmart's access, causing Kmart's lease to terminate pursuant to its terms. DOT's commissioned appraisal report estimated the market value of the taking of FPA's interest at $1,250,000, but the appraisal report did not contain an opinion regarding the value of Kmart's interest in the property. FPA filed a motion asking the court to order separate just compensation proceedings, a motion affirmed by the Utah Supreme Court.

In reaching its decision to adopt the aggregate-of-interests rule,[38] the Utah Supreme Court stated:

> We conclude that (1) the plain language of the Assessment Statute, (2) our case law interpreting a former version of the Assessment Statute, and (3) our case law interpreting…the Utah Constitution [Takings Clause] all support the conclusion that the district court was correct in determining that the aggregate-of-interest approach is the correct approach for assessing the value of individual interests in condemnation proceedings.
>
> "*[T]he condemnor pays each of the several owners the fair market value of his, her, or its property interest even [if] the total amount paid exceeds the fair market value of the property as if owned by a single owner.*" This approach ensures that all individual interests are accounted for and that each individual interest holder 'is made whole by placing him in the position he would have occupied but for the taking.' [citations omitted; emphasis added]

37. *Utah Dept. of Transp. v. FPA West Point, LLC*, 304 P.3d 810 (2012).

38. Also known as the "separate valuation" or "independent valuation" rule.

Conclusion

Most jurisdictions apply the undivided fee rule when private property is taken by governmental agencies for public or quasi-public use under eminent domain statutes. This compels appraisers to consider only the fee simple estate under single ownership when analyzing market value or market rental value of real property for the purpose of assisting condemning authorities in determining just compensation. Only after a condemnation award has been issued does it become necessary to apportion the award among all competing interests with a legal right to share in the condemnation award.

The apportionment of an award in the taking of a leasehold interest is based on valuations of the separate estates of the lessor and lessee, and how the award is to be distributed between the lessor and lessee is dictated either by a condemnation clause or by the court. In those few jurisdictions that apply the aggregate-of-interests rule, the property rights of the lessor and lessee are valued separately and directly in determining the amount of compensation to which each party is entitled, regardless of whether the combined amount is less or greater than the market value of the property in fee simple.

About the Author

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Additional Resources

Suggested by the Y. T. and Louise Lee Lum Library

Appraisal Institute Y. T. and Louise Lee Lum Library—Available Condemnation Books

- *Real Property Valuation in Condemnation* (Appraisal Institute, 2018)
- *The Law of Eminent Domain: Fifty-State Survey* (American Bar Association, 2012)
- *Eminent Domain: A Handbook of Condemnation Law* (American Bar Association, 2011)
- *Current Condemnation Law: Takings, Compensation and Benefits*, 2nd ed. (American Bar Association, 2006)

LexisNexis Matthew Bender, *Nichols on Eminent Domain*

Available in many law libraries; to purchase, go to http://bit.ly/LexisNexisNichols

US Department of Transportation, Federal Highway Administration—Real Estate

https://www.fhwa.dot.gov/real_estate/index.cfm