LESSOR AND LESSEE - APPORTIONMENT OF THE AWARD IN CONDEMNATION PROCEEDINGS

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Two major problems arise when leased property is condemned. Is the lessee entitled to some portion of the award? If so, how shall the lessee's share be determined? The majority of courts have ruled that the lessee is entitled to compensation for the interest which has been taken, unless barred by a specific provision in the lease or unless the lease terminates as a matter of law.(1) Thus, the answer to the first question is usually in the affirmative. The second question, which forms the basis of this note, is complicated by the issues that arise in highway and related governmental programs in urban areas or roadside commercial property.

BACKGROUND

Three positions regarding apportionment of the award between the lessor and the lessee have been taken by the courts.(2) One, referred to as the "before and after" rule and representing the majority position, fixes the total damages to the fee, and then apportions that amount between the landlord and tenant according to their respective interests.(3) Thus, if the damages to the fee are $100,000 and the interest of the lessee is determined to be one tenth of the award (i.e. the lessee's interest is determined to be one tenth of the lessor's interest in the fee), the landlord receives $90,000 and the tenant, $10,000.

Several considerations support this approach. First, land is the thing taken in a condemnation proceeding and the award is for the land itself, not for the sum of the different interests therein.(4) Second, and related to the first, is the feeling that the value of the property should not be enhanced by any distribution of title among individuals. Thus, Lewis' treatise on eminent domain states:

> "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."(5)

Among the alternative approaches, one applies the before and after rule but gives the lease a separate value in determining the damages to the fee.(6) Thus, the value of the fee with the lease included might be $110,000, and the lessee's interest might be determined to be one tenth of the fee and the lease combined. The condemnor would pay $110,000, the lessor receiving $99,000 and the lessee, $11,000. This approach negates both of the considerations underlying the before and after rule. Here, the award is not for the land itself, and the value of the property has been enhanced by splitting title.

The final alternative compensates the positive interests of each party separately.(7) If the landlord's interest is $100,000 and the tenant's interest is $10,000, the condemnor pays $110,000 even though the land might be worth only $100,000. In each of the latter two positions there is an inflation in value that the condemnor must bear.

In the three approaches just described the apportionment of the award depends upon the extent to which the condemnation contravenes the relative rights and obligations of the lessor and lessee, and this, in turn, depends to a great extent on whether or not there is an abatement of the rent.(8) Where the entire leased premises are taken, the entire relationship of landlord and tenant is extinguished, and the tenant is no longer liable for payment of rent. The rationale of this rule is that every landowner holds title subject to the sovereign power of the state and, therefore, the state can take the estates of both landlord and tenant for public utility. Thus, it is said that with a total taking the lessee sustains only nominal damages.

However, a partial taking of leased premises does not extinguish the landlord-tenant relationship. The lessee remains liable for the total rent and he must obtain compensation from the condemning authority. In some jurisdictions, a partial taking extinguishes part of the landlord-tenant relationship and the rent abates accordingly.(9)

COMMONWEALTH DEPARTMENT OF HIGHWAYS v. SHERROD

The Kentucky Court of Appeals encountered the problems posed by the three positions outlined above in Commonwealth Department of Highways v. Sherrod.(10) That case involved the taking of a strip for highway widening from the front of a tract of land. A portion of the tract had been leased for commercial purposes and the condemnor took part of the leased premises. Thus, a partial taking of the leased premises was involved. Previous to the Sherrod case, the Kentucky rule had been to "ascertain the present fair rental value, compare it with the rent stipulated in the contract and allow the aggregate difference for the period of the unexpired term of the lease."(11) The Court of Appeals, in Sherrod, held that this rule, by its very statement, furnished no criterion or basis for determining the lessee's damages when only part of the leased property was taken.

The court further held, after considering the following hypothetical example, that the rule was unfair, unsound, and unworkable. Suppose that the value of the property free and clear of the lease is $100,000; that the fair rental value is $12,000 and the real rental value is $6,000 per year; and that the lease has 20 years to run. Applying the Kentucky rule, as stated previous to the Sherrod case, the lessee would receive $120,000. Thus, the lessee's damages would exceed the value of the property free and clear of the lease. In overruling this rule, the court was essentially determining that the value of the property cannot be enhanced by splitting title; that damages cannot be allowed to exceed the value of the fee.

The effect of the Sherrod case is to shift Kentucky to the majority before and after rule. In applying the before and after rule, the total value is fixed for the entire fee without considering the various interests, and is then apportioned based on the relationship between the differing interests. Determination of the total value and its apportionment is based on fair market value.(12) The fair market value of the leasehold is equal to the fair market value of the land as a whole if sold free and clear of the lease minus the fair market value of the land as a whole if sold subject to the lease.

Sherrod applied the before and after rule as follows: The jury must find:

(a) The fair market value of the leased tract as a whole immediately before the taking, giving consideration to the fact that it has rental value, but evaluating it as if free and clear of the lease.

By requiring that the leased tract be evaluated as if free and clear of the lease, the court seeks to assure that the lease cannot enhance the value of the land. However, the rule leaves open the question of determining the "rental value" of the property in question.(13)

(b) The fair market value of the leased tract as a whole, immediately before the taking, if sold subject to the existing lease.

(c) The fair market value of so much of the leased tract as remains immediately after the taking, giving consideration to the fact that it has rental value, but evaluating it as if free and clear of the lease. This value would be zero if the whole tract was taken because nothing would remain to evaluate.

The judge then computes and apportions the damages:

(1) (a) - (c) is the total damage payable by the condemnor.
(2) If (b) is equal to or greater than (a), ignore (b).

The lessor would receive the total award because the leasehold would be worthless.

(3) However, if (b) is less than (a), subtract (b) from (a) to obtain the value of the leasehold. Then divide that figure by (a). The result will be the percent of ownership interest the lessee is deemed to have had in the leased tract before condemnation.

(4) Multiply (1) and (3) to ascertain the lessee's share of the total damages.

These principles may be illustrated by the following example: Suppose that the value of the leased tract immediately before the taking is set by the jury at $100,000. Suppose, further, that the jury finds that the value of the leased tract immediately before the taking, if sold subject to the lease, is $75,000 and that the value of the remainder of the leased tract after the taking is $50,000. In this hypothet, the condemnor would have to pay $50,000. The lessee's interest is 25% ($100,000 minus $75,000 divided by $100,000) and his award would be $12,500 with the lessor receiving $37,500.

The Kentucky court indicated that the rule illustrated above would be applicable in every condemnation of a leasehold interest. No distinction was made between cases in which an entire tract of land was taken and cases of partial takings. The decision thus leaves

the rationale of the case uncertain in at least one respect. It neither rejects nor reconciles the premise that condemnation has the effect in law of extinguishing the landlord-tenant relationship, and thus nullifying both the rights and liabilities of the parties to the lease. And, it offers no other premise on which the cases involving the taking of an entire tract may be supported.

CONCLUSION

The before and after rule is perfectly reasonable and viable if one is willing to accept the underlying considerations which it serves. The condemnor is protected because a lump sum value for the land is determined and apportioned. Such is not the result when applying the alternative rules. In each case the value of the land may be enhanced by the lease, or leases, and the judgement may result in the condemnor paying far more than the value of the land. Thus, only the majority position adequately protects the condemnor.

However, the before and after rule may place the lessee in an unsatisfactory position as a direct result of the application of the fair market value concept. Fair market value compensates the condemnee (and lessee) only for the loss of the physical property, and does not recompense for incidental business damages, such as the loss of good will, relocation expenses or the inability to relocate, and losses due to business interruption.(14) A burden is thus placed on the lessee, and the net result is that an interest whose value is not fully reflected in the condemned land goes uncompensated.(15) Another difficulty with the fair market value test is that leases are not normally bought and sold, and expert appraisal varies greatly, thereby making market value an unsatisfactory test of leasehold value.(16) Still, market value is the most workable concept that has been developed in land valuation and the shortcomings are outweighed by the advantages. Rather than search for a new concept, it would seem more advantageous to work within the framework of the market value concept to achieve a more uniformly equitable solution for the lessee.

What are the alternatives? First, it might be possible to redefine fair market value to include the incidental business damages suffered by the lessee. This change would compensate the lessee and protect the condemnor. However, fair market value, as used in the before and after rule, applies to both the lessor and lessee, and incorporation of the lessee's business damages would disrupt the balance that fair market value attempts to achieve.(17) The change in meaning would necessitate a restatement of the before and after rule.

Second, one might apply the before and after rule as it is presently stated and understood. After this step is performed, the incidental business damages to the lessee could be separately determined. Who pays these damages -- condemnor or landlord? If the condemnor must pay, the net result is the same as that reached by the alternative positions to the before and after rule; only the reasoning differs. If these damages are deducted from the lessor's award, the effect is that he is penalized for leasing his land. It would not be equitable to impose such a penalty. Splitting the payment of the "extra" judgement between the lessor and condemnor would accomplish little more than a division of the burden and would beg the issue.

Within the framework of the market value concept, that rule seems best which discounts the value of the lease entirely in the initial condemnation award, thus avoiding an unfair burden on the condemning authority. The Sherrod case should be welcomed for having taken this position, although some ambiguities remain in the opinion. Nevertheless, even a strong statement by an appellate court will not prevent sympathetic juries from inflating a condemnation award in order to aid business tenants faced with hardship. Some method of compensating directly for business losses might be a more certain and equitable manner of handling this problem.

Footnotes

(1) 2 Powell, Real Property 286 (1950).

(2) Exploratory research indicates that there is a great deal of confusion in this field.

(3) Lesar, Landlord and Tenant, 1963 Annual Survey of American Law 499 (1963).

(4) 17 U. Miami L. Rev. 245, 259 (1963).

(5) 2 Lewis, Eminent Domain 1253 (3rd ed. 1909).

(6) 48 Va. L. Rev. 477, 490 (1962).

(7) Ibid.

(8) 4 Nichols, Eminent Domain 308, 314 (3rd. ed. 1952).

(9) 14 Baylor L. Rev. 232, 234 (1962).

(10) 367 S.W. 2d 844 (Ky. 1963).

(11) City of Ashland v. Price, 318 S.W. 2d 861, 863 (Ky. 1958).

(12) See Note, 3 A.L.R. 2d 286 (1949) (concerning determination of fair market value).

(13) This is sometimes spoken of as the determination of the "economic rent" of the land, or the amount of rent that reasonably could be expected if the property were available for rent. Under the theoretical concept of economic rent, it is a fair, proper and reasonable rental which would result from informed, intelligent, and prudent bargaining in the usual course of business. Contract rent generally approximates economic rent at the time when a lease is made, but as time elapses, economic conditions change, and the two levels diverge. See Moser, L. "Leases", in American Association of State Highway Officials, Acquisition For Right-of-Way, (Washington, D. C. 1962).

(14) 67 Yale L.J. 61 (1957).

(15) For an interesting discussion concerning a similar statutory problem consult 113 U. Pa. L. Rev. 787 (1965).

(16) 113 U. Pa. L. Rev. 787, 791 (1965).

(17) There is some ambiguity in this point in the Sherrod case.