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EMINENT DOMAIN --VALUATION OF LEASEHOLDS -- APPORTIONMENT OF AWARD BETWEEN LANDLORD AND TENANT IN LONG-TERM LEASE

EMINENT DOMAIN — VALUATION OF LEASEHOLDS — APPORTIONMENT OF AWARD BETWEEN LANDLORD AND TENANT IN LONG-TERM LEASE — The Michigan Supreme Court had before it last fall a very unusual case [1] involving the apportionment of a condemnation award

[1] Pierson v. H. R. Leonard Furniture Co., 268 Mich. 507, 256 N. W. 529 (1934).

between landlord and tenant. Only a portion of the leasehold premises was condemned. The lease still had approximately eighty years to run; it had no market value due primarily to the depression; and it constituted the sole assets of the lessee.[2] The lease contained a clause providing for rent abatement in case part of the premises was condemned. The lessors insisted that the lessee must be content with this rent abatement and that they were entitled to the whole award. On the other hand, the lessee contended that the lessors were entitled only to the present worth of the rentals on the part taken plus the present value of their reversionary interest in such part.[3] The court, adopting a rule borrowed from a Massachusetts statute,[4] ordered: (1) that the lessors be paid the present worth of their lost rentals; (2) that the residue of the fund be turned over to the lessors who were charged with payment of interest thereon to the lessee. This interest payment was to be credited on the rent, and if there was any excess, the lessee was to have a lien on the land for that amount. At the termination of the lease the principal of this residue was to belong to the lessor absolutely.

[2] Other important facts in the case were that the lessee was in default in its rent payments, that it had received one notice of forfeiture, and that it owed a large sum for unpaid taxes. Furthermore, the leasehold was very heavily mortgaged. Of some importance too was the fact that the lessee had erected a building upon the land in accordance with the obligation imposed upon it by the lease, which also stipulated that upon termination of the lease or upon forfeiture, the building was to go to the lessor.

[3] See NIEHUSS and FISHER, PROBLEMS OF LONG-TERM LEASES 36 and 49 (1930). This book is one of the Michigan Business Studies put out by the School of Business Administration in the University of Michigan.

[4] Mass. Gen. Laws (1921), c. 79, sec. 24, p. 750. The pertinent part of this statute is as follows:

> "If a tenant for life or for years and the remainderman or reversioner sustain damages [through condemnation] . . . entire damages . . . shall be paid to . . . any person whom the parties may appoint, and be held in trust by him for their benefit according to their respective interests. The trustee shall, from the income thereof, pay to the reversioner . . . the value of any annual rent . . . which would, but for such . . . [taking], have been payable by the tenant, and the balance thereof to such tenant during the period for which his estate was limited, and upon its termination, he shall pay the principal to the reversioner. . . ."

In two features the Michigan court did not adhere to the rule laid down in this statute. In the first place, the statute provides for the payment to the lessors of the present worth of their lost rentals out of income from the award, whereas the court in this case allowed such payment to be made out of the principal fund. In the second place, the statute calls for the appointment of a trustee, while the court allowed the lessor to hold the fund himself, and merely required him to pay interest to the tenant. The court gave as its reason for not appointing a trustee the fact that there was no necessity for it. It said that if the tenant is under no obligation to pay rent or if there are various conflicting interests, it may be necessary to appoint a trustee, but that is a useless procedure where the tenant does have to pay rent.

Despite these differences between the rule embodied in the statute and that adopted by the case, the underlying principle seems to be the same.

I.

It will aid in an appreciation of the value factors to be considered in determining the landlord's and the tenant's respective interests, if we begin with the factors to be considered in valuing the fee simple as a whole. Mr. Babcock, in his work on real estate valuation,[5] mentions three general methods of practical valuation. In order of their preferability, these are: (1) the income method in which rentals, business profits, or other revenues from the property are taken as the basis of computation; (2) the market comparison method in which the value is determined by a comparison with the prevailing market prices of properties offering similar advantages and uses, actual and potential;[6] (3) the replacement-cost method in which the valuation is made on the basis of the cost of producing the property, less allowances for functional deficiencies such as accrued depreciation and obsolescence. The cases, however, invariably suggest market value as the test. This is often said to be the price which a buyer, able, ready, and willing to buy, will give to a seller, ready and willing but not forced to sell.[7] Nevertheless, it does not mean that there is a real market for the property, because generally there is no such market. It merely means the price which the land would probably bring, if more than one person wanted it and if the eventual purchaser bought with knowledge of all the uses and purposes to which it might be put. The accuracy of this statement is fortified by the reflection that value is merely an indicator of probable future utilization of properties.[8] But, as has been pointed out elsewhere, market value is not a concept of simple and definite meaning,[9] and even the explanation given above is insufficient. Market value means one thing when there are actual sales of similar property, and it means another when there are no such sales. In this latter sense the market value is highly conjectural. Then, there is the case where the market value of the realty is even more conjectural, as where an owner has adapted his land to suit his own peculiar needs. To a great extent the market value, in whatever sense that term is used, may be

[5] BABCOCK, REAL ESTATE VALUATION (1932).

[6] Mr. Babcock points out emphatically that all three methods use the comparison device to a certain extent. In the income method probable future returns are determined by the comparison device. So, too, in the replacement-cost method heavy reliance is placed upon that device in obtaining the data necessary to estimate reproduction cost. Hence, the method described as the market-comparison method must be understood as limited to that valuation procedure which is used when the comparison device is the sole approach to value. See BABCOCK, REAL ESTATE VALUATION 167 *et seq.* (1932).

[7] BABCOCK, REAL ESTATE VALUATION 13 (1932).

[8] BABCOCK, REAL ESTATE VALUATION 2 (1932).

[9] See Hale, "Value to the Taker in Condemnation Cases," 31 COL. L. REV. 1 at 2 *et seq.* (1931), for a lengthy review of the various meanings of "market value."

influenced by the adaptability of the land to the taker's purpose. In short, the term "market value" seems incapable of accurate definition. It is merely the label given to a valuation compounded or derived from the various methods suggested by Mr. Babcock.

We pass now to the valuation of leaseholds for condemnation purposes. Most courts dismiss this problem with the bland assertion that the tenant is to be paid the market value of his leasehold.[10] Standing alone, however, this statement is almost meaningless. A lease, even less frequently than a fee, will have a market value in the sense of a ready market value;[11] therefore, this cannot be what is meant in the usual case. It is necessary to observe how this so-called market value is determined and what factors are considered in its determination.

The normal procedure of the real estate valuator in valuing a leasehold is this. The land is first valued in fee simple; then the present worth of the reversion and the present worth of the rentals are deducted from the fee value; what is left is the value of the leasehold.[12]

[10] 10 R. C. L. 136 at 137 (1915); 2 LEWIS, EMINENT DOMAIN, 3d ed., sec. 719, p. 1256 (1909); Yellow Cab Co. v. Howard, 243 Ill. App. 263 (1927); Mason v. City of Nashville, 155 Tenn. 256, 291 S. W. 1074 (1927); Tignor v. United States, 65 Ct. Cl. 321 (1928); In re Park Site on Private Claim 16, City of Detroit, 247 Mich. 1, 225 N. W. 498 (1929).

In addition to giving to the tenant the market value of his leasehold, the cases generally agree that upon a taking of the entire premises the relation of landlord and tenant is dissolved. See 21 L. R. A. 212 (1893) and 43 A. L. R. 1176 (1926) for cases. The same result has been reached under a statute in some jurisdictions. See Rhode Island Hospital Trust Co. v. Hayden, 20 R. I. 544, 40 Atl. 421, 42 L. R. A. 107 (1898); Spence v. Charrot, 137 App. Div. 882, 121 N. Y. S. 519 (1910). Also, some leases provide for such dissolution. 43 A. L. R. 1176 (1926). See, generally, 1 TIFFANY, LANDLORD AND TENANT 1180 *et seq.* (1910).

[11] See McMillin Printing Co. v. Railroad Co., 216 Pa. 504 at 511, 65 Atl. 1091 at 1094 (1907), where it is said, "market value is an unsatisfactory test of the value to a tenant of a leasehold interest. It is really no test at all, because a lease rarely has any market value. Generally it is not assignable at the will of the tenant. . . . The right of which he is deprived and for which he is entitled to full compensation is the right to remain in undisturbed possession to the end of the term. The loss resulting from the deprivation of this right is what he is entitled to recover." See 10 R. C. L. 136 (1915) for an expression of the same view.

[12] This procedure fits in very well with the normal method of apportioning the condemnation award, where more than one party is beneficially interested. Such method is that first the value of the property as though owned by one party is ascertained, and then the amount is divided among the respective owners. See City of Waco v. Messer, (Tex. Civ. App. 1932) 49 S. W. (2d) 822, with which compare Arnold v. Fort Worth & D. S. P. Ry., (Tex. Civ. App. 1928) 8 S. W. (2d) 298 (lump award to defendants claiming separate estates held erroneous). See also In re Daly, 29 App. Div. 286, 51 N. Y. S. 576 (1898). In Minnesota a statute adopts the same procedure. See State, by Youngquist v. Anderson, 176 Minn. 525, 223 N. W. 923 (1929). In Alabama the Code fully sets out the manner of apportioning the award. See Alabama Code of 1928, sec. 7501.

Theoretically, it seems that the result should be the same whether the tenant's interest is determined by subtraction in the manner stated, or is determined by a direct valuation of the interest itself. Practically, however, it is probable that the tenant has a distinct burden of proof, when the direct method is used. He will be bound to show each of the value factors for which an allowance in his favor is to be made.[13]

The factors to be considered in valuing the leasehold cannot be exhaustively stated. Nor is it possible to assign a fixed value to any of them. The problem is analogous to that of deciding on a reasonable rent at the time when the lease is made.[14] At most one can suggest what some of these factors are. If the lease contains a covenant for renewal or an option to purchase, these should be considered in valuing the leasehold. The few cases in point have made allowance for this.[15] The value of the leasehold is also enhanced by the buildings and other fixtures which the tenant attaches to the leased premises, whether or not he may remove them at the end of the term, provided that the lessor must pay for them if he elects to keep them. The cases are unanimous in holding that in condemnation proceedings the tenant is to be allowed the value of such fixtures.[16] The converse proposition follows logically also. That is, if the tenant may not remove the fixtures but they are to belong to the lessor, their value is not to be included in calculating the value of the leasehold.[17] Other factors to

[13] To avoid these difficulties of proof and controversies, it is customary to provide expressly in long-term leases how a condemnation award is to be shared by landlord and tenant. Three types of total condemnation clauses are most common. These are:

1. The present value clause. Under this the lessor receives a sum equal to the present value of the rentals remaining to be paid, plus the present value of his right to receive back the property at the end of the term. The lessee receives the residue of the award.

2. The land-to-lessor clause. By this the lessor gets the portion of the award given for the land, and the lessee gets the award made for the building.

3. The capitalized rental clause. Under this the lessor takes an amount equal to the capitalized value of the rentals payable under the lease, and the lessee takes the rest.

The first clause is probably the most equitable, for the second gives to the lessor the entire increase or decrease in land value, while the third entirely disregards any changes in land value in computing the lessor's share. For an excellent treatment of this matter and criticism of each of these clauses, see NIEHUSS and FISHER, PROBLEMS OF LONG-TERM LEASES 39-47 (1930).

[14] On this point see 21 COL. L. REV. 802 (1921).

[15] On the matter of renewal covenants, see cases cited in 2 LEWIS, EMINENT DOMAIN, 3d ed., sec. 719, p. 1257 (1909). On options to purchase as extending to the award, see Cullen & Vaughn Co. v. The Bender Co., 122 Ohio St. 82, 170 N. E. 633, 68 A. L. R. 1332 and annotation at p. 1338 (1930).

[16] 75 A. L. R. 1495 (1931).

[17] 75 A. L. R. 1495 at 1500 (1931). However, the tenant retains a right to compensation for his interest in fixtures, which he might remove, notwithstanding an

consider are: the revenue produced from the premises, the physical aspects of the property, and the particular location of the premises — all bases for calculating actual or potential income.[18] Furthermore, if because of the tenant's good management of the property, its value has risen, that too should be considered.[19] Another factor that one might expect to be taken into account, namely the profits made by the tenant from the use of the premises, is ignored in most of the cases or rejected as too difficult of accurate measurement.[20]

So far we have been concerned with the proper method in valuing the leasehold and with the various value factors which in the aggregate represent what the tenant owns. A new complicating factor is introduced when only a part of the leased premises is condemned. Here we have to consider not only all the matters heretofore mentioned but also the effect of the loss of the part taken on the potential uses of what remains. Has the type of business for which it is suited been affected? One cannot simply apportion value on the basis of area. The part taken may have been the heart of the property, or the taking may have rendered the premises too small for the tenant's use. On the other hand, we can imagine cases where taking the rear part of a lot, which was only partially occupied by a business block, might affect the value of the tenant's potential uses in only small degree. Accordingly, it seems that like other value factors the taking of a portion of the leased premises is a factor to which no definite weight can be assigned. Its weight will have to be determined with reference to the facts of the particular lease.

In the Michigan case referred to at the outset of this comment,[21] there were present certain peculiar factors, such as the tenant's default in rent payments, his insolvency, and the severe economic depression, which would seem to limit the tenant's claim to the abatement in rental provided for in the lease. If the lease had no present worth, how could the tenant complain if he was restricted to this abatement? Surely none

agreement that he should receive nothing from the award for his leasehold interest. In re Allen St. & First Avenue, 256 N. Y. 236 at 243, 176 N. E. 377 at 379 (1931).

[18] See BABCOCK, REAL ESTATE VALUATION 44 *et seq.* (1932), where the author mentions the principles to be used in securing the necessary data.

[19] Still another value factor should be noted. Some courts allow the tenant to recover the cost of removing personalty or fixtures used in the prosecution of the business in which he is engaged. Although, strictly speaking, this is not a value factor, it is so closely related thereto that for the sake of completeness it seems proper to include it. See 34 A. L. R. 1523 (1925) for cases on both sides of this question.

[20] Fiorini v. City of Kenosha, 208 Wis. 496, 243 N. W. 761 (1932); In re Park Site on Private Claim 16, City of Detroit, 247 Mich. 1, 225 N. W. 498 (1929). But, *contra*, Hart Bros. v. Dallas County, (Tex. Civ. App. 1926) 279 S. W. 1111.

[21] Pierson v. H. R. Leonard Furniture Co., 268 Mich. 507, 256 N. W. 529 (1934).

of the value factors heretofore mentioned could be included in measuring his interest. This reasoning, it must be admitted, would be stronger if the lease were for a short term or if it had only a short period to run. In the instant case, however, the lease still had eighty years to go. Therefore, the tenant's interest was more like that of an owner. The state is not entitled to expropriate an owner's interest without paying a price which reflects future values as well as immediate present worth. Why should this lessee's interest be treated as worthless because it had no immediate exchange value in a period of extreme depression? After all, economic conditions may change in the years to come, and the leasehold may increase in value. This argument is strengthened by the definition of value as set out earlier in this comment, namely, value is merely an indicator of probable future utilization of properties.[22] That is why the valuation process must of necessity deal with predictions and forecasts and why it is never precise in result. The ultimate basis of all valuation is earning expectancy, and since this may change as a result of various influences, the decision of the Michigan court seems basically sound, especially in view of the tenant's earnest contention that his lease still had a substantial value.[23]

2.

The second major question involved in the Michigan case related to the manner of compensating the tenant for his interest. There is a sharp split in the decided cases on how to adjust the relationships between the parties, when there has been a partial taking by eminent domain. Some courts have decreed an abatement of the rent,[24] and have awarded the whole fund to the landlord; while others have held the covenant to pay rent unaffected, but have awarded the tenant a sum sufficient to pay the subsequently accruing rent on the portion taken.[25]

[22] See BABCOCK, REAL ESTATE VALUATION 2 (1932).

[23] Another point that might support the decision is the fact that the lessee had to cure its defaults within thirty days after payment of the award. Otherwise, the lessors could forfeit the lease, and then their obligation to pay interest to the lessee was to cease. Furthermore, the lessors were to have this right upon any default on the part of the lessee. It would therefore seem that if the lessee complied with these conditions, it should be entitled to something in addition to a rent abatement. To express these ideas in another way, the court did not entirely ignore the tenant's default and the forfeiture possibilities in distributing the award.

[24] See 43 A. L. R. 1176 at 1182 (1926). Occasionally, a statute provides for the rent abatement. See In re Daly, 29 App. Div. 286, 51 N. Y. S. 576 (1898); Hinrichs v. New Orleans, 50 La. Ann. 1214, 24 So. 224 (1898).

[25] See 12 A. L. R. 826 at 831 (1921); 43 A. L. R. 1176 at 1177 (1926); 53 A. L. R. 686 (1928). This view, which is taken by the majority of the courts, is severely criticized in 16 CAL. L. REV. 48 (1927) and in 1 TIFFANY, LANDLORD AND TENANT 1186 (1910). It is based upon the argument that there has been no eviction by the landlord, and therefore the liability of the tenant to pay rent is unaffected.

Criticisms of both of these methods suggest themselves. In this Michigan case the court admits that in many instances a mere abatement in rental would not fully compensate the lessee. The difficulties of fixing an appropriate abatement are manifold, and the fixing of it does not usually involve any consideration of damage to the tenant through loss of his profits [26] and through loss in value of fixtures he may have installed.[27] Even if these are considered, there is but a nominal allowance for them, since those losses are not capable of being accurately measured.[28] In short, if the rent is abated, all of the problems of partial valuation are raised.[29] These are avoided if the lease is regarded as intact and the tenant remains obligated to pay the full rent. On the other hand, if the court awards the tenant a certain sum with which to pay future rentals, then the landlord is made to bear the risk of the tenant's continued solvency.[30] This risk may take on Gargantuan proportions, if the lease has a long time to run.

These problems are so serious that it has become common practice to provide for their solution by inserting express condemnation clauses

This argument would apply with equal force to the case of total condemnation, but the cases cited in note 10, supra, show that the courts do not take that view in such a situation.

[26] See note 20, supra.

[27] Though the cases collected in 75 A. L. R. 1495 (1931) show that the courts award to the tenant the value of his removable fixtures in case of condemnation, it does not follow that this loss will be considered in determining a rent abatement.

[28] Some more adequate compensation than a mere rent abatement seems essential. This should be so despite a provision in the lease for rent abatement in case of condemnation. Such provision ought not to preclude a tenant's sharing in the award, unless it expressly bars the tenant or does so by necessary implication. To support such a position, the court need only point to the well-settled maxim that the lease is to be construed most strongly against the lessor, especially if such a construction will be equitable to both parties. See Patterson v. Butterfield, 244 Mich. 330, 221 N. W. 293 (1928).

[29] Another criticism of abating the rent was suggested in City of Pasadena v. Porter, 201 Cal. 381, 257 Pac. 526 (1927), 53 A. L. R. 686 (1928), where it was contended that no apportionment could be made in the condemnation proceeding, for the court sitting therein lacks equitable jurisdiction, and accordingly has no power to revise the lease. However, the answer to this argument is that even if condemnation proceedings are special, the court administering them is one of general jurisdiction, and hence may dispose of all the issues before it. The courts have this equitable power as an incident of the right to review and correct the award of damages. For a more elaborate discussion of this matter, see 16 CAL. L. REV. 48 at 54 *et seq.* (1927). See also Peterson v. City of Minneapolis, 175 Minn. 300, 221 N. W. 14 (1928). That even commissioners can apportion the award, see In re Seventh Avenue and Varick St. in City of New York, 196 App. Div. 451, 188 N. Y. S. 197 (1921). But *contra*, City of St. Louis v. Rossi, 333 Mo. 1092, 64 S. W. (2d) 600 (1933).

[30] 1 TIFFANY, LANDLORD AND TENANT 1185 (1910); 2 LEWIS, EMINENT DOMAIN, 3d ed., sec. 718, p. 1255 (1909). These two authorities agree that the most satisfactory solution is that the taking should operate to extinguish the rent obligation either *in toto* or *pro tanto*.

in all long-term leases. There are two types of partial condemnation clauses most commonly found in long-term leases today.[31] The first, which may be called the present-value clause, calls for a division of the award by giving the lessor the present worth of the abated rent plus the present worth of the award, payable as of the end of the lease. Under this each party is immediately paid for his interest in the land condemned, and his interest in the remaining land is left practically untouched.[32] The second, which may be called the rent-abatement clause, provides that after repairs to the premises are made, the lessor shall receive the entire residue of the award, and the rent shall be abated annually by an amount representing 5 per cent of the award paid to the lessor.[33] This clause differs from the first in that the lessee receives payment for the loss of his interest only in the form of reduced rentals. If the interest rate used in figuring the rent abatement is the same as that used in setting the original rental, then the payments[34] to each party will be substantially the same under the second clause as under the first. Still the practical operation of the two clauses is different, for by the method set up in the first clause, the lessor must risk

[31] See NIEHUSS and FISHER, PROBLEMS OF LONG-TERM LEASES 49 *et seq.* (1930), and compare clauses discussed in note 13, supra.

[32] The operation of this can best be explained by an example. Assume that the condemned premises were leased for $50,000 per year on a 5 per cent basis. (This means that the lessor's profit was 5 per cent annually.) Assume also that the land has doubled in value and that the lease still has 90 years to run. Assume still further that half the premises are taken and that the award is $1,000,000. To make the problem as simple as possible, let us assume that the land remaining is worth one-half as much as the whole land was worth before condemnation. Thus, the rent abatement will be $25,000. Now, under this condemnation clause the lessor will receive $12,387 (the present value of the award payable 90 years hence) plus $518,497 (the present value of the abated rentals for the remaining 90 years) or a total of $530,884. The rate of discount used to determine the two sums to which lessor is entitled is 5 per cent, a figure generally, though not universally, employed. The balance of the $1,000,000 will go to the lessee.

[33] Using the same figures as those in the hypothetical case presented in note 32, supra, the lessor would receive the lump payment of $1,000,000 under this clause, and the rent would be abated annually by $50,000 or 5 per cent of the award. Since that abatement equals the total rent reserved in the lease, the lessee would be left in possession free from the obligation to pay rent. Here again it is not essential that the interest rate used in figuring the rent abatement be 5 per cent. Still, it usually is.

[34] Besides the $530,884 which the landlord gets under the first clause, he also has the right to receive $25,000 rental until the end of the term on the remainder of the property, and at the end of the term, it will revert to him. These additional rights are also worth $530,884. So, in all, the lessor's interest would be $1,061,768 and the lessee's would be the remainder. Similarly, under the second clause the total value of the lessor's interest would be $1,000,000 plus the right to receive back the premises in ninety years, a right that is worth $12,387

All of the illustrations and calculations used in notes 32, 33, and 34 are taken from NIEHUSS and FISHER, PROBLEMS IN LONG-TERM LEASES 51-52 (1930).

the tenant's continued solvency. On the other hand, the rent abatement would seem to be ample compensation for the tenant, if the lease were for only a short term, because the tenant has it entirely within his own power whether or not the lease shall continue.

The one clear rule to be extricated from this rather involved analysis is that no rule, inflexible or otherwise, can be laid down with respect to the value factors that comprise the tenant's interest or with respect to the manner of distributing the condemnation award between landlord and tenant. As complex as the problem is when the whole leasehold is condemned, it becomes even more so when there is only partial condemnation. Furthermore, when the lease is for a long term instead of only a short term, new considerations intrude. No fixed weight can be given to each of the variety of factors to be considered. All the court can do is work out the fairest possible solution in the light of the particular circumstances, and this the Michigan court seems to have done in the present case.

M. C. D.