

**CONDEMNATION OF LEASED PROPERTY:
DIVIDING THE PIE BETWEEN LANDLORD AND TENANT**

Gary L. Birnbaum*

What happens when a duly authorized condemning authority seeks to acquire, by use of the power of eminent domain, *leased real property*? Does the just compensation award belong to the landlord (lessor), the owner of the underlying fee, or to the tenant (lessee), the party with the right to undisturbed possession of the property? If the just compensation payment is to be divided between the lessor and the lessee, what is the theoretical (and mathematical) basis for the division?

The answers to these questions are not complex. The valuation of fractional interests in leased land (improved or unimproved) is founded upon real property principles familiar to all attorneys. It is in the application of these principles that the analysis often goes astray.

I. The “Bundle of Rights”

We begin our analysis with the most fundamental of property law principles. Real property involves a so-called “bundle of rights.” Collectively, all of the sticks in the bundle comprise the fee title. While there may be many fractional interests (e.g., easements, mortgages), a common situation involves only two fractional interests -- the owner of the property and his or her tenant.

In this situation, the owner is appropriately referred to as the “lessor” (or landlord) and the holder of the possessory interest for a limited time is called the “lessee” (or tenant). In appraisal jargon, the fractional interest of the lessor is called the “leased fee;” the interest of the lessee is referred to as the “leasehold” estate.

II. Constitutionally Protected Property Interests

The leased fee and the leasehold estate are constitutionally protected property interests. The United States Supreme Court (among other courts) has observed that the term “property” (as used in the Takings Clause of the Fifth

* Mr. Birnbaum is the Managing Director of Mariscal, Weeks, McIntyre & Friedlander, P.A. in Phoenix, Arizona. He also serves as Associate Dean for Graduate Studies and Program Development at the Sandra Day O’Connor College of Law at Arizona State University where he teaches courses on real estate valuation and private property rights. Among other achievements, Mr. Birnbaum is a contributing author of *Nichols on Eminent Domain* and has been elected a Fellow of the American College of Trial Lawyers.

Amendment to the United States Constitution) includes both the real property interest referred to as “a fee simple,” as well as the interest known as “estate or tenancy for years.” In short, the Takings Clause “is addressed to every sort of interest the citizen may possess.” United States v. General Motors Corp., 323 U.S. 373, 378 (1945). If the fractional interest constitutes “property,” then its acquisition by the government requires the payment of just compensation to the interest owner. Alamo Land & Cattle Co., Inc. v. Arizona, 424 U.S. 295, 303 (1976). “Just compensation” refers to the fair market value of the interest condemned.

III. The Nature of the Two Real Property Interests

The “leased fee” consists of both the right to receive rents during the term of the lease *and* the value of the reversion (residual ownership of the property) upon termination or expiration of the lease. The “leasehold” represents the right to occupy and use the property during the term of the lease and during any available option or extension periods.

Algebraically, the foundational valuation principle may thus be stated as follows:

$$\begin{array}{rcccl} \text{Value of the leased} & & \text{Value of the} & & \text{Value of the} \\ \text{fee} & + & \text{leasehold} & = & \text{fee simple} \\ \text{(landlord's interest)} & & \text{(tenant's interest)} & & \text{estate} \end{array}$$

Of course, if any two of the three variables in this equation are known, the missing variable may be readily computed.

IV. Leasehold Advantages and Disadvantages

In common parlance, a lease can be a “good” lease, a “bad” lease, or a “market” lease. If a lease is at market rate, it has no fair market value. Because other similar properties of equal utility are theoretically available, the economic principle of substitution informs that no other market participant would pay the lessee to assume this lease, and that the lessor would not pay anyone to relieve it of the burdens associated with the lease.

On the other hand, not all leases are “market” leases. If the contract (lease) rent is *below* the prevailing (and projected) market rate, than the lessee has a “leasehold advantage.” In contrast, if the contract rent exceeds the market rent, then the lease has a “leasehold disadvantage.”

V. Computing the Value of the Leasehold

In light of these observations, computation of the value of the leasehold estate is neither difficult to understand nor mathematically challenging. If the lease is a “market lease,” the leasehold estate has no fair market value. If the

lease is advantageous to the lessee, the leasehold advantage (the value of the leasehold) may be computed as follows:

$$\text{Leasehold advantage} = \text{PV (market rent – contract rent)} \times \text{Number of rental periods remaining under the lease}$$

In other words, the value of a leasehold interest is equal to the present value of the monthly (or other periodic) savings when the lease rate is compared to the market rate, computed over the remaining term of the lease. The term would generally include the period of any option or extension right likely to be exercised.

The computation is essentially identical when there is a “leasehold disadvantage.” If the contract rent *exceeds* the market rent, then each month the lessee suffers a loss when the lease payment is compared to market rent. Computed over the term of the lease and then discounted to present value, the result will be a leasehold disadvantage or, stated differently, a *negative* leasehold value. In sum, the value of a leasehold may be positive, negative, or zero, but it is rarely difficult to compute if the lease agreement is available and market rents are ascertainable.

VI. Computing the Value of the Leased Fee

Appraisal instructors often exhibit diabolical glee when they observe attorneys and others unfamiliar with leasehold valuation techniques struggling to determine the value of the lessor’s interest (leased fee) under a lease. The uninitiated often engage in a wholly unnecessary exercise in mathematical gymnastics in an effort to compute the present value of the leased fee interest. First, they project current lease rates to the expiration date of the lease. Then, they capitalize the future income flow to derive a future value. Then, they discount the future value to a present value. Finally, they add the residual value thus determined to the present value of all rental payments to be received during the term of the lease. The result is, of course, the present value of the leased fee, but so many judgments have been injected into the equation (*e.g.*, terminal capitalization rate, lease period discount rate, residual value discount rate) that the reliability of the mathematical result is at best somewhat suspect.

There may be times when such an approach is required. More often, however, simple algebra is the answer.

Recall the three-variable equation set forth in Section 3. The value of the fee simple estate can invariably be estimated using common appraisal approaches (sales comparison approach). The value (positive, negative, or zero)

of the leasehold may be computed in the manner outlined in Section 5. The fair market value of the leased fee (lessor’s interest) is then simply:

$$\text{Leased fee value} = \text{Fee simple value} - \text{Leasehold value}$$

If there is no leasehold advantage or disadvantage (*i.e.*, in the case of a market lease), the value of the leased fee (lessor’s interest) is equal to the fee simple value. If there is a leasehold disadvantage (negative leasehold value), the value of the leased fee may actually exceed the value of the fee! This is not a surprising result, since the lessor will have the right to residual ownership of the property *and* the right to receive *above-market* rents during the lease term.

VII. Dividing the Pie

In a condemnation case then, in the absence of a contract provision mandating a different result, the lessor is entitled to receive the fair market value of the leased fee and the lessee is entitled to receive the value of the leasehold estate. Thus, the pie is divided.

Must the sum of the leased fee and the leasehold always equal the value of the fee? In theory, yes. In practice, there is one anomaly.

Suppose, for example, a lessee has a lease with a substantial negative value (leasehold disadvantage). Hypothetically, let us assume that the fee value of a rental property is \$500,000 and that the leasehold disadvantage is \$200,000. What is the value of the leased fee?

$$\text{Leased fee} = \text{Fee value} - \text{Leasehold } (\$-200,000)$$

$$= \$500,000$$

Leased fee = \$700,000

However, in a condemnation action, the lessee can never receive less than zero dollars for the property interest condemned. In other words, you never have to pay the government for taking your property interest regardless of its (negative) value. Accordingly, in the hypothetical illustration, unless precluded by the relevant statutory scheme, the lessee will receive nothing, the lessor will argue for \$700,000 (the leased fee value), and the condemning authority will protest that in no event should it ever be required to pay more than the fee simple value of the property condemned.

VIII. Condemnation Provisions in Leases

The foregoing discussion explains the division of the condemnation/just compensation award *in the absence* of a controlling lease provision. In fact, no lease should ever be executed without a detailed provision defining the rights of the lessor and lessee in three distinct circumstances: a total taking, a substantial partial taking, and an insubstantial partial taking that allows continued, beneficial occupancy by the lessee.

Moreover, even the most adhesive leases may provide protection for one party (usually, the lessee) beyond that provided by the law in the absence of a controlling lease provision. Assume, for example, that a shopping center tenant installs \$100,000 in fixtures only to find the entire property condemned one year later. Absent a written lease provision, either (i) the fixtures would be deemed personal property removable by the tenant; or (ii) the fixtures would be deemed part of the real estate. If the lease provided that all condemnation compensation was the property of the lessor (a common provision), the lessee would likely receive nothing for the leasehold and nothing for the relatively new fixtures. An alternative lease provision might allow the lessee to recover the unamortized portion of the fixtures value from the compensation award, even though it provided for no other compensation for the leasehold estate.

IX. Conclusion

Every lease should include an eminent domain provision defining the relative rights of the lessor and the lessee in the event of condemnation. Nevertheless, understanding how the respective interests of the lessor and the lessee are viewed and valued in the absence of such a clause may assist real estate attorneys in the drafting process and help you to explain to your client why those two pages of “boilerplate” are essential to his or her protection.

Additional Materials

THE APPRAISAL OF REAL ESTATE 475-79 (12th ed. Appraisal Institute 2001).

R. Duvall & D. Black, *Dividing the Pie: Compensating Landlords and Tenants in Takings of Leased Real Property*, THE APPRAISAL JOURNAL, January 2001, at 1.

Annotation, *Eminent Domain: Measure and Elements of Lessee's Compensation for Condemnor's Taking or Damaging of Leasehold*, 17 A.L.R. 4TH 337 (1982).

V. Goldberg, et al., *Bargaining in the Shadow of Eminent Domain: Valuing and Apportioning Condemnation Awards Between Landlord and Tenant*, 34 U.C.L.A. L. REV. 1083 (1987).

J. Zitter, Annotation, *Validity, Construction and Effect of Statute or Lease Provision Expressly Governing Rights and Compensation of Lessee Upon Condemnation of Leased Property*, 22 A.L.R. 5TH 327 (1994).