

## Condemnation Clauses in Real Estate Agreements

**CERTAIN CLIENT INSTRUCTIONS** should alert counsel to consider taking a different tack. Real estate practitioners must be particularly wary when they hear, “Don’t nit pick the document, just make the deal.” Or, “Forget about the condemnation provision—this property will never be taken.” Wise counsel know that in every real property transaction, it is worthwhile to pause, concentrate, and get everything right when it comes to the issue of eminent domain.

As California’s population continues growing and the competition for the use of its real estate becomes keener, cities and other governmental agencies are reaching more frequently for their eminent domain tool. They are doing so as a means to expand their educational infrastructure,<sup>1</sup> upgrade their economic base through the addition of new retail stores or other projects that generate high revenue and jobs, and mitigate ever-growing transportation woes. The U.S. Supreme Court’s recent decision in *Kelo v. New London*<sup>2</sup> constitutes icing on the condemnor’s cake and raises the specter of condemnation in virtually all real estate transactions.

While often overlooked, typical condemnation provisions in real estate transactional documents can have unexpected and unintended consequences if an eminent domain proceeding affects the subject property. A real estate agreement cannot prevent a condemnation from occurring, but a little attention paid to the condemnation provisions can provide greater certainty, help to assure desired outcomes, and manage the parties’ expectations in the event of an eminent domain action.

All private property in California is subject to the power of eminent domain—the government’s right to acquire, or take, private property for public use.<sup>3</sup> The power can be exercised by all governmental entities—including cities, counties, school districts, redevelopment agencies, and transportation agencies—and is very difficult to repel. Although it is possible to attack successfully a decision to take private property, most challenges merely delay the inevitable. Compensation usually is the focus for a party whose property is condemned, and a well-drafted condemnation clause can ensure that the party is compensated to the extent required by law for the taken property.

The taking entity must pay “just compensation” for the condemned real property, including all interests in the property and improvements to it.<sup>4</sup> A business operated on the property also may be compensated for loss of business goodwill and is entitled to relocation benefits.<sup>5</sup> The property owner in a condemnation action must be “put in as good position pecuniarily as he would have occupied if his property had not been taken.”<sup>6</sup> Just compensation typically is computed on the basis of the fair market value of the property that is being taken.<sup>7</sup> Fair market value, in turn, is defined as the highest price the property would bring in the open market based on the property’s “highest and best use.”<sup>8</sup>

Although the obligation to pay just compensation in a condemnation action is controlled by California’s Eminent Domain Law,<sup>9</sup> a party’s entitlement to compensation will be affected by the provisions of a condemnation clause in a real estate agreement.<sup>10</sup> Depending on the nature of the agreement, a condemnation provision may:



- Allocate compensation between or among the parties to the agreement.
- Maximize the amount of compensation payable.
- Specify which parties are allowed to participate in the compensation process.
- Provide assurances—usually in the form of representations and warranties—regarding the threatened or actual existence of an eminent domain proceeding.

### Provisions for Common Contracts

A variety of clauses may achieve these objectives. Different approaches may be needed for each of the most common contracts involving real property—leases, purchase and sale contracts, options to purchase, deeds of trust, easements, and covenants, conditions, and restrictions (CC&Rs).

**Leases.** Landlords and tenants have separate and distinct interests in real property. In a condemnation action, however, the potential exists for the intermingling of these interests. Practitioners should draft lease condemnation clauses to ensure that the interests of landlords and tenants are separately compensable and that the condemnation award flows to the intended party or parties.

A lease condemnation clause should address:

- The allocation between landlord and tenant of compensation for “improvements pertaining to the realty.” The Eminent Domain Law uses this term and deems these improvements to be compensable.
- The allocation between landlord and tenant of compensation for

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any leasehold bonus value.

- The rights and obligations of the parties in the event of a partial taking.
- The allocation between landlord and tenant of compensation for any purchase option that may be contained in the lease.

When the entirety of the property subject to a lease is condemned, the lease terminates, and the tenant's obligation to pay rent ceases.<sup>11</sup> Nevertheless, the tenant's entitlement to compensation in the condemnation action survives and is not affected by the lease termination.<sup>12</sup> The condemnation clause, if one is present, generally will control the rights of the parties to compensation in the condemnation action.<sup>13</sup> In the absence of a condemnation clause, entitlement to compensation may be determined by examination of other lease provisions, such as those for alteration or termination. Unfortunately for the tenant, however, there is a good chance that a tenant will not be compensated for improvements it owns unless the condemnation clause properly provides for compensation for them. In particular, the issues of compensation for improvements and for leasehold bonus value must be addressed specifically in the condemnation provision to avoid unexpected and undesired results for either the landlord or the tenant.

"Improvements pertaining to the realty" is a statutory term of art defined as items installed by any method for use on the real property that cannot be removed without substantial economic loss or causing substantial damage to the property.<sup>14</sup> These items may include buildings, structures, machinery, equipment, furnishings, and fixtures. Improvements pertaining to the realty are compensable notwithstanding the fact that the tenant under the lease may have the right or obligation to remove them upon expiration of the lease.<sup>15</sup> Also, while these items may be considered personal property in the contract between the landlord and the tenant, for purposes of the condemnation proceeding they are compensable as part of the realty.<sup>16</sup>

"Improvements pertaining to the realty" may be a meaningful term of art to those who litigate eminent domain but not to those who negotiate leases. In lease condemnation clauses, these improvements generally are referenced by terms that are common in the real estate industry, such as "tenant improvements" or "trade fixtures." These real estate terms are not mentioned in the Eminent Domain Law, so issues related to whether tenant improvements or trade fixtures are compensable, and who is entitled to compensation, are litigated frequently. These differences in terms are more than semantics. They can have surprising outcomes that can be avoided by simply referring to tenant improvements and trade fixtures in the con-

demnation clause of the lease as improvements pertaining to the realty and clearly stating which party is entitled to compensation.

Also compensable in a condemnation action is the loss of the right to possess the premises for the rent provided for in the lease during the remaining unexpired term of the lease, including any option terms (whether or not the options have been exercised at the time of commencement of the condemnation action). The value of the lease possessory right often is referred to as the leasehold bonus value and is apportioned from the compensation for the fee interest in the property.<sup>17</sup> A leasehold bonus value claim typically is not negotiated in advance by the parties, but it may entitle the tenant to a significant share of the compensation for the fee and thus lead to an unexpected and severe result. Fortunately for the landlord, a tenant may waive its right to compensation for leasehold bonus value, and many condemnation clauses include such a waiver.

The appropriateness of a tenant waiver of leasehold bonus value depends on the nature of the lease. For example, it is not uncommon for long-term ground leases to be subject to a significant leasehold bonus value claim, because the market lease rates often increase over time at a rate that exceeds the rent amounts scheduled in the lease, resulting in the tenant having the right to possess the premises at below market rents. The leasehold bonus value claim in the context of a ground lease may amount to 50 percent, or more, of the compensation awarded for the fee title to the real estate. Given the tenant's long-term use and possessory expectations, as well as the fact that ground leases usually delegate to the tenant many of the risks of ownership, the tenant's receipt of some or all of this compensation is not necessarily unfair or unwarranted. In shorter commercial leases (5 or 10 years), however, the leasehold bonus value claim—which may still amount to several hundred thousand dollars depending on the scheduled lease rate and the length of the remaining unexpired term—is less likely to be an appropriate part of the tenant's expectation. The landlord typically asserts that the landlord, not the tenant, is in the business of owning the property and taking the risks and reaping the rewards associated with that ownership. Accordingly, the landlord should receive all compensation paid for any taking of fee title to the property whether arising from increases in market rents or otherwise.

These issues can be addressed as part of a lease's condemnation clause with the following language:

Any award for the taking or damaging of all or any part of the Premises under the power of eminent domain, or any payment made under the threat of the

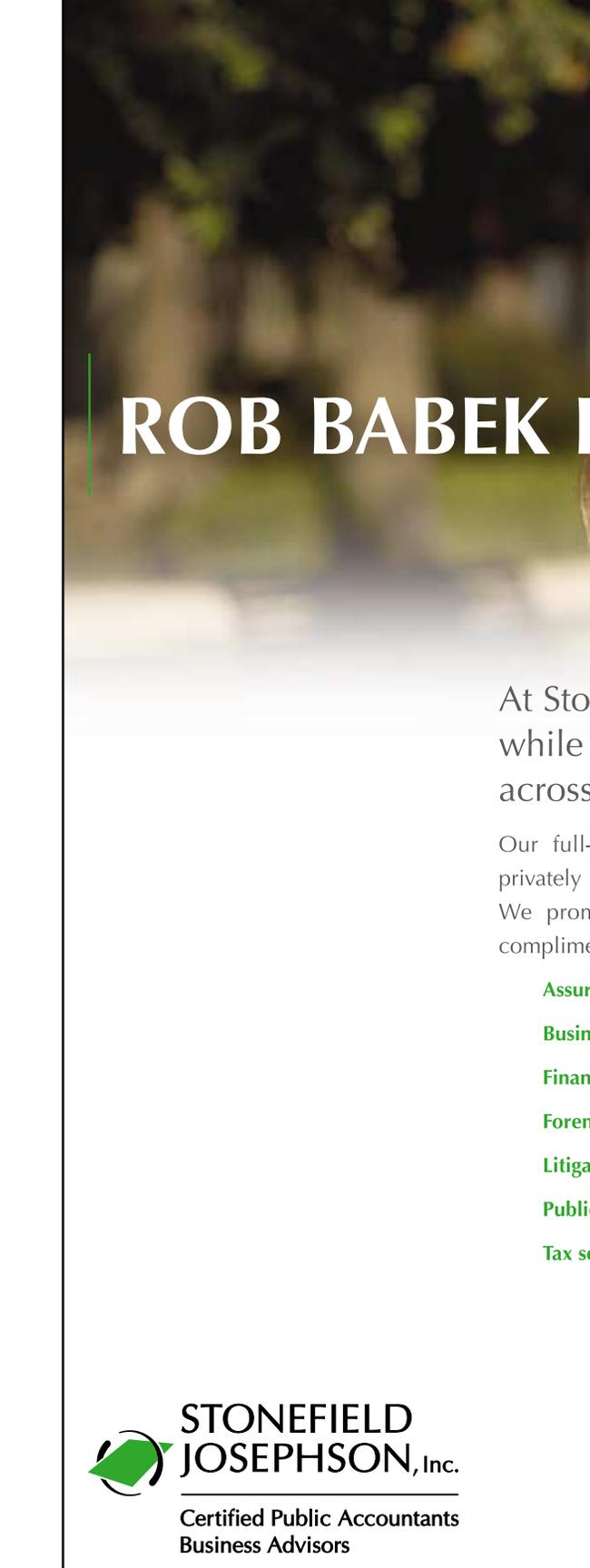
exercise of such power, shall be the property of Landlord, except that Tenant shall be entitled to compensation separately awarded to it, if any, for improvements pertaining to the realty owned by Tenant, loss of business goodwill and relocation benefits.

The foregoing clause effects a waiver by the tenant of its leasehold bonus value claim, but preserves the tenant's entitlement to compensation for its improvements pertaining to the realty.

When only a portion of the property subject to a lease is condemned, it may be appropriate for the lease to be terminated or for the terms of the lease to be modified. Examples of partial takings include the loss of spaces in a parking lot, or the taking of portions of a building or part of an industrial yard, each of which may or may not prevent the tenant from using the premises for the tenant's intended purposes. If the lease does not address termination upon a partial taking, the Eminent Domain Law leaves the issue up to the judge,<sup>18</sup> specifying that the lease terminates if the court determines "that an essential part of the property...is taken or that the remainder...is no longer suitable for the purposes of the lease."<sup>19</sup>

The court in a partial taking action may not find in a particular case that an essential part of the property has been taken or that the remainder is no longer suitable for the intended purposes, or the court may make such a finding in a situation in which the landlord or the tenant would prefer that the lease remain in effect, with modifications. Therefore, the possibility of a partial taking should be addressed in the condemnation clause during the negotiation of the lease agreement, when the parties are able to negotiate the circumstances under which a termination, partial termination, or modification of the lease would be appropriate. As alternatives to termination, the condemnation clause may provide the landlord the opportunity to restore, repair, or reconstruct any improvements or otherwise mitigate the impact of the taking to preserve the tenancy and identify specific circumstances or events that would justify the termination of the lease, even if the statutory partial taking termination standard is not met. A well-drafted condemnation provision that addresses partial termination should include a waiver of the parties' statutory right to terminate the lease if the parties want a different standard to apply.

**Purchase and sale contracts.** For a typical commercial real estate purchase and sale contract, in which the entire time period from execution of the agreement to closing typically does not exceed 90 days, condemnation is primarily a buyer's due diligence concern. Although there is no centralized clearing-



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house for information regarding potential eminent domain proceedings, there are several steps that practitioners can take on behalf of their buyer (or tenant) clients to gain access to all the available pertinent information:

- Conduct a review of the preliminary title report to determine if the property is within a redevelopment area. Title reports may or may not show this information. Indeed, title companies may take the position that filed descriptions of redevelopment areas are not part of the public record they are required to search, disclose, and insure. Thus counsel should consider the preliminary report to be only one of the available resources.
- Round up the usual suspects. Contact local agencies that may be likely condemners, such as counties, cities, school districts, water districts, Caltrans, and local redevelopment agencies. Inquire about proposed projects, including parks, schools, public facilities, and street and highway expansions or improvements. It may not be practical to contact every conceivable agency, but cities, counties, redevelopment agencies, and school districts are among the most common condemning authorities and should be contacted in each instance. Common sense and a property-specific diligence plan will help determine the appropriate scope of due diligence.
- Ask the seller to represent and warrant in

the purchase and sale agreement whether the seller has been contacted by any governmental agency or other entity regarding the possible acquisition of all or a portion of the property, and whether any governmental agencies or other entities have requested or conducted environmental investigations or appraisal inspections. Governmental bodies generally conduct environmental investigations and appraisal inspections in advance of making a condemnation offer.

The condemnation clause in a purchase and sale contract also should address which party bears the risk of loss—and which party is entitled to the condemnation award if the property is condemned before the transaction is completed. In the absence of a relevant contractual provision, the party who bears the risk of loss at the time the condemning authority may take possession of the property generally is entitled to the owner's portion of the award.<sup>20</sup> If neither legal title nor possession has been transferred to the purchaser by the time the condemning authority may take possession, the seller receives the award; if the purchaser has either title or possession at that time, the purchaser receives the award.<sup>21</sup> The statutory scheme may appear fair at first blush, but it may create an undesirable result for many reasons. The seller and purchaser may agree that the purchaser can enter the

property early to make repairs, begin planning, or even commence a work of improvement. If a full or partial condemnation occurred, it would be unexpected and unfair for the purchaser to receive the condemnation proceeds simply by virtue of having an early possession right. Additionally, the parties may desire that payments for partial takings be handled contrary to the statutory protocol, such as by allowing the purchaser to continue with the transaction and receive an assignment of, or credit for, proceeds payable to the seller.

Finally, a condemnation clause in a purchase and sale agreement should provide that the property conveyed includes all actions, causes of action, and all rights to insurance and condemnation proceeds pertaining to the property. This makes certain that the purchaser may participate in and receive any award from a condemnation proceeding, even one that may have commenced before the closing of the purchaser's acquisition.

**Options to purchase.** The owner of an unexercised option to purchase real property or improvements possesses a compensable property right in a condemnation action. In the absence of a clause in the option agreement to the contrary, the measure of damages to the optionee is the excess, if any, of the condemnation compensation above the option purchase price.<sup>22</sup> Once again, many option agreements fail to address the possibility of condemnation, and a landowner might be surprised to find a portion of the compensation flowing to the optionee—a situation that could have been prevented by including the optionee's waiver of compensation in the agreement.

**Deeds of trust and financing agreements.** The condemnation clause in a deed of trust or other financing agreement should address how the outstanding obligation is to be satisfied, including interest and attorney's fees, in the event that all or a portion of the collateral is taken by eminent domain. The lienholder generally has a priority interest in the condemnation award to the same extent as it would have a priority interest in the proceeds of a typical sale. Under California law, however, the lender is not entitled to enforce a prepayment penalty provision in a condemnation action.<sup>23</sup>

The lender should become a party to the action, whether or not it is named or served, as a "person" who claims an interest in the condemned property.<sup>24</sup> An adequately collateralized loan usually can be satisfied from the initial deposit of probable compensation that the condemning authority places with the court in order to obtain possession.<sup>25</sup> The lienholder can seek an order in the condemnation proceeding authorizing distribution of the proceeds that are necessary to satisfy the lien.<sup>26</sup> Often, the borrower's attorney will

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facilitate satisfaction of these obligations from the deposit to minimize the accrual of interest and to avoid, or at least minimize, the borrower's obligation for the lienholder's attorney's fees. When the borrower is cooperative, the distribution can be accomplished by a stipulated order. The loan documents should include the right of the lienholder to have condemnation proceeds paid to the lienholder, because this will be a necessary allegation to obtain an order.

If the deposit is insufficient to satisfy the outstanding balance or if there are other disputes, the matter may be resolved in a judicial apportionment of the final condemnation award.<sup>27</sup> In unusual circumstances, when a loan is significantly undercollateralized and the borrower walks away from the property, the lienholder actually may choose to be the one to defend the action (in the borrower's name or otherwise) to seek greater compensation and maximize recovery on its loan. The Eminent Domain Law does not specifically provide this right, so the lender can protect itself by including this right in the deed of trust or financing agreement.

For partial takings in which a significant portion of the property is condemned, impairment of security may also be an issue. Under the Eminent Domain Law, a lienholder is entitled to share in the condemnation award for a partial taking "only to the extent determined by the court to be necessary to prevent an impairment of the security."<sup>28</sup> This statute applies even if a condemnation clause provides otherwise.<sup>29</sup> The lien will remain on the property not taken. The Eminent Domain Law also addresses the allocation of an award for a partial taking among senior and junior lienholders.<sup>30</sup>

Rather than attempting to deal with the issue of allocation for a partial taking, the deed of trust or financing agreement—or the subordination and intercreditor agreement if there are multiple loans secured by the same property—may be better served by focusing on the use of funds and the effect of the taking on the contractual relationship. Specifically, the parties may prefer to apply the condemnation award for a partial taking to the repair, restoration, or reconstruction of the property and improvements. Alternatively, if the taking exceeds a certain percentage or dollar value, the parties may choose to have the proceeds used to pay down the loan and have the lending relationship terminate.

Easements and CC&Rs. Condemnation clauses are often conspicuously absent from easement agreements or agreements establishing CC&Rs. Easements or CC&Rs should address compensation for the different interests and the rights and obligations of the parties in the event of a taking. In the absence of an agreement to the contrary, if the servient

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tenement is acquired, or the dominant tenement's interest is otherwise extinguished or damaged, just compensation will be determined as the diminution in the value of the dominant tenement measured before and after the taking.<sup>31</sup>

The characterization of a condemnation provision as boilerplate tends to diminish the attention that parties should be willing to devote to it as they negotiate their real estate agreements. A condemnation clause can materially affect the rights of the parties. By crafting carefully tailored condemnation provisions, practitioners can help their clients avoid unpleasant surprises and unintended consequences from an eminent domain proceeding involving the subject property. ■

<sup>1</sup> For example, the Los Angeles Unified School District has a plan that calls for the development of a \$14 billion campus building program to be completed by 2012, with eminent domain as one of the contemplated acquisition tools. *See, e.g.,* Cara Mia DiMassa, *An Education in Expansion*, L.A. TIMES, Nov. 23, 2004, at A1.

<sup>2</sup> *Kelo v. New London*, 125 S. Ct. 2655 (2005). In a 5-4 decision, the U.S. Supreme Court ruled that the taking of property by the government from one private party to give to another private party constitutes a "public use" so long as it is done with the hope of creating jobs, increasing tax revenue, or otherwise providing economic stimulation. Justice O'Connor, writing for the dissent, sees the decision as an abandonment

of the public use restriction on the government's eminent domain power, leaving open the possibility that any property may be taken by the government: "Nothing is to prevent the State from replacing any Motel 6 with a Ritz-Carlton, any home with a shopping mall, or any farm with a factory."

<sup>3</sup> U.S. CONST. amend. IV; CAL. CONST. art. 1, §19.

<sup>4</sup> CODE CIV. PROC. §§1263.010, 1263.205.

<sup>5</sup> CODE CIV. PROC. §1263.510; GOV'T CODE §§7262 *et seq.* Generally the rights of a business to compensation for loss of business goodwill and relocation benefits are not directly affected by a condemnation clause.

<sup>6</sup> *United States v. Miller*, 317 U.S. 369, 373 (1943).

<sup>7</sup> CODE CIV. PROC. §1263.310.

<sup>8</sup> CODE CIV. PROC. §1263.320. In certain limited situations, such as property owned by nonprofit organizations and special use property, valuation is computed based on the replacement cost of the taken property. CODE CIV. PROC. §1263.321.

<sup>9</sup> CODE CIV. PROC. §§1230.010 *et seq.*

<sup>10</sup> *See* CODE CIV. PROC. §1265.160; *Dix Box Co. v. Stone*, 244 Cal. App. 2d 69 (1966) (lease provided that tenant would not share in condemnation award notwithstanding that statutory sharing might have been available); *City of Beverly Hills v. Albright*, 184 Cal. App. 2d 562 (1960) (lease provision by which tenant divested itself of right to fixtures operated to bar tenant from compensation when the fixtures were taken).

<sup>11</sup> CODE CIV. PROC. §1265.110.

<sup>12</sup> CODE CIV. PROC. §1265.150.

<sup>13</sup> CODE CIV. PROC. §1265.160. *See also* *City of Vista v. Fielder*, 13 Cal. 4th 612, 618 (1996) ("[I]f the lease does not provide to the contrary, the rules in question [Eminent Domain Law] apply.")

<sup>14</sup> CODE CIV. PROC. §1263.205. *See also* *County of San Diego v. Cabrillo Lanes, Inc.*, 10 Cal. App. 4th 576

(1992) (providing judicial interpretation of §1263.205).

<sup>15</sup> CODE CIV. PROC. §1263.210.

<sup>16</sup> *Concrete Serv. Co. v. California ex rel. Dep't of Pub. Works*, 274 Cal. App. 2d 142 (1969).

<sup>17</sup> CODE CIV. PROC. §§1260.220, 1265.150. At trial, the jury will first determine the amount of compensation to be paid by the condemnor for the taking of the real property. Once the amount of compensation is determined, in the same proceeding the jury will "determine the respective rights of the defendants in and to the amount of compensation awarded and shall apportion the award accordingly." CODE CIV. PROC. §1260.220(b).

<sup>18</sup> CODE CIV. PROC. §§1265.120, 1265.130.

<sup>19</sup> CODE CIV. PROC. §1265.130.

<sup>20</sup> *Redevelopment Agency v. Maynard*, 244 Cal. App. 2d 260, 265 (1966). *See generally* CODE CIV. PROC. §1662 (Uniform Vendor and Purchaser Risk Act).

<sup>21</sup> *Brick v. Cazaux*, 9 Cal. 2d 549 (1937); *County of Santa Clara v. Curtner*, 245 Cal. App. 2d 730 (1966).

<sup>22</sup> *County of San Diego v. Miller*, 13 Cal. 3d 684 (1975).

<sup>23</sup> CODE CIV. PROC. §1265.250.

<sup>24</sup> CODE CIV. PROC. §§1250.230, 1250.320.

<sup>25</sup> The condemnor must make a deposit of probable compensation, in the amount of its highest appraisal, in order to secure prejudgment possession of the property. CODE CIV. PROC. §§1255.010, 1255.410.

<sup>26</sup> CODE CIV. PROC. §1255.210.

<sup>27</sup> CODE CIV. PROC. §1265.220.

<sup>28</sup> CODE CIV. PROC. §1265.225(a).

<sup>29</sup> CODE CIV. PROC. §1265.225(b) & Law Revision Commission cmt. (providing that the lienholder and the borrower may agree "after commencement of the proceeding" to apportion the condemnation proceeds without regard to impairment of security).

<sup>30</sup> CODE CIV. PROC. §1265.230.

<sup>31</sup> *Redevelopment Agency v. Tobriner*, 153 Cal. App. 3d 367, 372 (1984).

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