

## Memorandum 73-9

Subject: Study 36.150 - Condemnation (Compensation for Divided Interests)

Introduction

This memorandum is the first in a series that will deal with the extremely complex and difficult problems that arise in eminent domain cases where there is divided ownership of the condemned property.

This memorandum deals with the initial question of the basic valuation approach to be applied to such property. It indicates that the majority of states adhere to the undivided fee rule with its substantial problems. It next analyzes the California law and its efforts to overcome the problems of the undivided fee rule through the Lynbar approach. It suggests that the Lynbar approach is not wholly satisfactory and examines the possibility of adoption in California of the separate valuation of interests approach current in a minority of jurisdictions and in Canada. The memorandum concludes that no one of these rules is really adequate and proposes a modified California rule.

The Undivided Fee Rule

The overwhelming majority of jurisdictions in the United States adopt the approach that, where property taken by eminent domain is subject to divided interests, a lump sum award should be made for the property as a whole as if it were unencumbered and then, in a second-phase proceeding (in which the condemnor does not participate), the award is apportioned among the owners of the individual interests. The following discussion of the undivided fee rule is drawn primarily from I. L. Orgel, *Valuation Under Eminent Domain* §§ 108, 112 (1953).

In estimating compensation to owners for land held in divided ownership, the statutes and the judicial decisions usually require that compensation be first estimated in one gross amount and subsequently apportioned. These rules have their roots in reasons of judicial procedure and administrative policy since they make for speedy condemnation and precision in forecasting the probable cost of acquisition.

In the present study, we are primarily interested in the incidence of these rules of procedure on the valuation process. For it rarely happens that the lump sum award is precisely equal either to the sum of the market values of the divided interests or to the losses imposed on the owners of the separate interests by virtue of the condemnation.

It is difficult to state any general rules by which one may determine whether or not the market value of a fee simple would approximate the total amount of the damages suffered by the holders of the divided interests. It is possible, however, to distinguish between situations where the market value of the fee simple would typically be a rough measure of aggregate damages, situations where it would typically fall short of such a measure, and situations where it would greatly exceed the desired total.

The first situation is perhaps best illustrated by that of marketable land subject to a usual type of mortgage. In the condemnation of this land, it would generally be both simpler and more accurate first to base the total award on the estimated market value of the land free of the mortgage, then to allocate to the mortgagee such a portion of this award as will liquidate his claim, and finally to give the balance to the owner of the equity. To be sure, it is easy to prove that this procedure cannot result, except by accident, in a precise indemnification of the two claimants. But equally serious inaccuracies would be likely to result from independent attempts

first to assess the damages of the mortgagee, then to assess the damages of the mortgagor. The only plausible way to assess the latter's damages in most cases would be to estimate the market value of the property subject to the mortgage. While this could be done with reasonable accuracy in many real estate markets with respect to mortgages of standard types and amounts, it could not be done successfully in other cases where a market for equities is not as well established as is the market for a fee simple.

Now let us note a type of case where an award of the market value of the undivided ownership might greatly exceed the total damages suffered by the owners of the separate interests. Suppose that Blackacre, a country estate lying on a public highway, is owned in fee simple and that the owner of this estate, who also owns Whiteacre, an adjacent residential property lying far back from the public road, sells Whiteacre along with an easement of way through Blackacre, this easement affording the only convenient access between Whiteacre and the public road. Subsequent to the sale of Whiteacre along with the easement in Blackacre, another public road is constructed immediately adjacent to Whiteacre. To the owner of Whiteacre, the easement of way through Blackacre now becomes of relatively little value; yet the existence of this easement may materially depress the value of Blackacre both to its owner and to any prospective buyer. If Blackacre were now to be condemned and if the condemnor were required to pay a total award based on the market value of Blackacre as an undivided fee simple, this award might well greatly exceed the sum of the damages suffered by the owner of Blackacre and by the owner of Whiteacre.

Finally let us consider a case where the allocated market value of the fee simple would fall far short of indemnifying the owners of the separate interests. The same illustration that has just been given will illustrate

this point. Suppose that the easement of way through Blackacre which has been conveyed to the owner of Whiteacre has not been rendered valueless by the construction of a new road. Suppose also that the subjection of Blackacre to this easement does not seriously reduce its market value. In that case, a total award based on the market value of a fee simple in Blackacre would have to be assigned almost entirely to the owner of Blackacre in order to give him full indemnity. This would leave a very small balance for the owner of Whiteacre, whose entire property may have been rendered both useless to him and unmarketable because it has no access to a public road.

Where the disparity between the value of the undivided fee and the aggregate of separate interests is obvious, the courts in some classes of cases, but not in all, will depart from the doctrine that the value of the undivided fee is the basis of the award. They have done so in the cases dealing with the condemnation for street purposes of land unencumbered by easements of way since, in these cases, the sum of the separate value of the interests in the land is notably less than the value of the unrestricted fee. In a few opinions, they have intimated that they would assess compensation on the basis of independent valuations of the separate interests if it appeared that these interests were in sum worth much more than the undivided fee.

In the majority of cases, it is probably true that the discrepancy between the unencumbered fee value and the sum of the separate values of the divided interests is not serious, and the courts are justified in making a lump sum award. But, even in these cases, while the courts purport to pay no attention to the division of ownership, one suspects

that the admission of evidence of the values of the separate interests, prior to the determination of the undivided fee value, not infrequently leads the tribunal to estimate compensation with an eye to the subsequent apportionment.

As the foregoing analysis from Orgel indicates, there has been concern with inequities in compensation imposed by the undivided fee rule. 4 P. Nichols, *The Law of Eminent Domain* § 12.36[2] (1971), summarizes this concern as follows:

The method of valuation based upon the undivided fee has been criticized where there was a great disparity between the value of the undivided fee and the aggregate value of the separate interests. Valuation of the separate interests, under such circumstances, has been held constitutional. [Citations omitted.] It has, in fact, been intimated that where the undivided fee rule operates to the prejudice of the interest of the condemnee it might be considered unconstitutional. [Citation omitted.]

The way in which California has dealt with these problems is, to say the least, novel.

California Law

Until 1939, the only indication of how California treated the problem of divided interests was Code of Civil Procedure Section 1248:

1248. The court, jury or referee must hear such legal testimony as may be offered by any of the parties to the proceeding, and thereupon must ascertain and assess:

1. The value of the property sought to be condemned, and all improvements thereon pertaining to the realty, and of each and every separate estate or interest therein; if it consists of different parcels, the value of each parcel and each estate or interest therein shall be separately assessed.

While this section appears to have adopted a rule requiring separate valuation of the individual interests rather than a two-phase proceeding such as is required by the undivided fee rule, there were no appellate cases that make this clear. Those who practiced in the field prior to 1939 assert that there was no uniform method of conducting a condemnation trial where there were divided interests in property being taken. At times, the court would join all parties and treat the fee as though it were unencumbered; on occasions, the interested parties would have their actions tried separately; and in still other instances, the jury would return the separate valuations of the separate interests in one verdict. In reality, the procedure adopted depended upon the particular judge hearing the case or area of the state where it was tried.

In 1939, Code of Civil Procedure Section 1246.1 was enacted to read:

1246.1. Where there are two or more estates or divided interests in property sought to be condemned, the plaintiff is entitled to have the amount of the award for said property first determined as between plaintiff and all defendants claiming any interest therein; thereafter in the same proceeding the respective rights of such defendants in and to the award shall be determined by the court, jury, or referee and the award apportioned accordingly. The costs of determining the apportionment of the award shall be allowed to the defendants and taxed against the plaintiff except that the costs of determining any issue as to title between two or more defendants shall be borne by the defendants in such proportion as the court may direct.

Because condemnors in California now have a choice, they almost invariably select the two-stage procedure because of its administrative convenience for them. This is not true, of course, where they see that they can arrive at a smaller award by separate valuation of the individual interests.

Following adoption of Section 1246.1, numerous cases indicated that California had adopted the undivided fee rule:

[T]he property to be taken is valued as if owned by a single person, regardless of separate interests therein. [People v. S. & E. Home-builders, Inc., 142 Cal. App.2d 105, 107, 295 P.2d 53, (1956).]

In determining the amount of the award, the general rule is that the market value is to be determined by considering the property as a whole and as if owned by one person, regardless of the separate interests therein. [El Monte School Dist. v. Wilkins, 177 Cal. App.2d 47, 54-55, 1 Cal. Rptr. 715, (1960).]

Where there are separate interests in the land taken, the property is to be valued as if owned by a single person, regardless of the separate interests therein, subject to apportionment. [Costa Mesa Union School Dist. v. Security First Nat'l Bank, 254 Cal. App.2d 4, 11, 62 Cal. Rptr. 113, (1967).]

However, in 1967, the leading case of People v. Lynbar, Inc., 253 Cal. App.2d 870, 62 Cal. Rptr. 320 (1967), came down. The case is attached as Exhibit I. Lynbar held that prior court expressions of the undivided fee rule were dicta and not applicable; that Section 1246.1 is a procedural statute only, embodying a two-stage trial but not necessarily the undivided fee rule; that use of the undivided fee rule ignores market reality in cases where the value of the whole as encumbered differs from the value of the whole in an unencumbered state; and that, since the Constitution requires that each owner of property or a property interest be compensated for his loss, the undivided fee rule may violate this constitutional principle when applied to a situation where the value of the fee as encumbered exceeds the value of the fee in an unencumbered state.

The test enunciated in Lynbar appears to be a strict market value test: the condemnation award should be based on the value the fee as encumbered would have on the open market.

Subject to certain limitations which are not here relevant, to arrive at this value one must take into consideration all those things upon which such parties, dealing with each other in the open market, would reasonably rely. [Citation omitted.] For this purpose the property, together with all of its compensable attributes, must be valued as the condemnor finds it, including without limitation thereby, the state of its title, and in this case, the Tidewater leasehold. [Citations omitted.] We say this because this very valuable leasehold is one of the things which such a buyer and seller would consider in the open market in fixing the price at which the ownership of the property would be transferred. To say that the existence of such a lease should be ignored by resorting to the legal fiction and legal pretense of a single owner is to ignore the realities of the market place. [Footnote omitted.] If compensation is to be just and if the property owner is to be made whole for the involuntary loss of his property to the state, this cannot be permitted to happen. [253 Cal. App.2d at 881-882, 62 Cal. Rptr. at (emphasis added).]

The holding in Lynbar that property subject to a leasehold should be valued in light of the favorable leasehold has both case and statutory precedent. The California Supreme Court has held that, in a case involving the condemnation of property subject to a favorable leasehold, the appraiser could value the fee with the bonus value of the leasehold added:

[I]t is the general rule that income from property in the way of rents is a proper element to be considered in arriving at the measure of compensation to be paid for the taking of property. [People v. Dunn, 46 Cal.2d 639, 641, 297 P.2d 964, (1956)(Exhibit II attached).]

Likewise, Evidence Code Section 817 provides in pertinent part:

817. When relevant to the determination of the value of property, a witness may take into account as a basis for his opinion the rent reserved and other terms and circumstances of any lease which included the property or property interest being valued or any part thereof which was in effect within a reasonable time before or after the date of valuation. . . .

Cases following Lynbar have, in dictum, cited Lynbar with approval.

See, e.g., San Francisco Bay Area Rapid Transit Dist. v. McKeegan, 265

Cal. App.2d 263, 71 Cal. Rptr. 204 (1968), and City of Santa Barbara v.

Petras, 21 Cal. App.3d 506, 98 Cal. Rptr. 635 (1971). See also County of Los Angeles v. American Sav. & Loan Ass'n, 26 Cal. App.3d 7, Cal. Rptr.

(1972)(attached as Exhibit III), for an interesting discussion of the merits of the undivided fee rule, the separate valuation of interests approach, and the Lynbar rule.

The Lynbar approach, while it appears to operate adequately in situations where the value of the whole is enhanced by divided interests, presents problems where the value of the whole is diminished by the existence of divided interests. Dictum in a portion of the Lynbar opinion denying a petition for rehearing unfortunately adopts the position that a strict market value approach would be applicable in such a situation:

If the actual rent under the existing lease is above the fair market value of the parcel taken, ordinarily the fair market value of that parcel will be enhanced and the condemnor must pay more for it by way of just compensation. If, on the other hand, the actual rental value under the existing lease is less than such fair rental value, ordinarily the fair market value of the parcel taken will be reduced accordingly and the condemnor then pays less by way of just compensation. In either event the condemnor pays for what it takes in the condition the parcel was on the date of valuation or condition. [253 Cal. App.2d at 884, 62 Cal. Rptr. at (emphasis in original).]

This comment was the basis of an attack on the Lynbar approach by Horgan & Edgar, Leasehold Valuation Problem in Eminent Domain, 4 U.S.F. L. Rev. 1 (1969). The more considered commentary, however, indicates not that the Lynbar approach should be abandoned, but rather that it should be used in those cases where the value of the whole would be enhanced by divided interests; in other cases, the undivided fee rule would control. See, e.g., Note, The Undivided Fee Rule in California, 20 Hastings L.J. 717 (1969); Kanner, And Now for a Word From the Sponsor: People v. Lynbar, Inc., Revisited, 5 U.S.F. L. Rev. 39 (1970); Comment, Negative Leaseholds:

The Property-Contract Distinction and a Failure of Just Compensation,

21 Buffalo L. Rev. 174 (1971). Cf. Clayton v. County of Los Angeles,

26 Cal. App.3d 390, 394 n.6, Cal. Rptr. , n.6 (1972):

If real property worth \$100,000 is subject to a lease at the economic rent, the lease--by definition--is neither a burden on the lessee, nor does it have any bonus value. The owner of the property would therefore receive the entire award, \$100,000. If, however, the lease has a bonus value of \$25,000 then, if the law is to keep the promise of the Lynbar dictum--the condemner will only suffer a judgment of \$75,000. This however, means that the court will be \$25,000 short when, after the condemner is discharged, it attempts to award both the lessor and the lessee just compensation for their respective interests. This result is used as the reductio ad absurdum in Horgan and Edgar [citation omitted]. Mr. Kanner [citation omitted] argues persuasively that the holding of Lynbar compels no such absurdity.

There are other problems, however, even with a Lynbar-undivided fee combination approach. Suppose, for example, the fee is subject to an easement that decreases its value and yet, at the same time, is subject to a favorable lease of the Lynbar type. Application of either the Lynbar or the undivided fee rule will fail to adequately take into account both the interest of the lessor and the interest of the easement holder. This will probably be true of most cases where there are several interests in the property being taken.

The Lynbar-undivided fee approach is also incapable of dealing with the situation where the interest in property does not affect the fee at all and yet is quite valuable to the owner of the interest. Typical of this situation is the easement that does not burden the servient tenement and yet supplies the only access to the dominant tenement. Since Lynbar looks to the value of the fee as encumbered, it would compensate at the straight fee value. The total award must then be split between the owner of the fee and the owner of the easement; one or the other (or both) will be denied full compensation for his interest.

### Separate Valuation of Interests

The foregoing examples illustrate the inadequacies of both the undivided fee rule and the Lynbar rule. They suggest that perhaps a more fair method of valuation of property subject to divided interests is to value each interest separately and make the award on that basis. This would also be procedurally and economically simpler for the individual property owner since he would be required to participate only in his part of a one-stage proceeding.

The jurisdictions that have adopted the approach of separate valuation of interests in this country are in a distinct minority. Arizona, Georgia, and Utah have done so through court implementation of statutes similar to California's Code of Civil Procedure Section 1248, supra (the only California law prior to 1939). The other states that have adopted the separate valuation technique (such as Maryland, Massachusetts, Missouri, and Nebraska) have done so on a limited basis only where separate valuation would yield a substantially different total award than the undivided fee rule, whether greater or less. Maryland Rule U19(g) provides express authority for such an approach:

The inquisition shall set forth the amount of damages, if any, to which each defendant or class of defendants is entitled or, if the court so orders, the total amount of damages awarded or both.

Jurisdictions outside the United States make extensive use of the separate valuation of interests approach. For example, the Ontario Expropriations Act, Section 16 provides:

Where there are more separate interests than one in land, other than the interest of a security holder or a vendor under an agreement for sale, the market value of each separate interest shall be separately valued.

In this connection, the Law Reform Commission of British Columbia, Report on Expropriation p. 135 (1971), should be of interest:

The present practice in British Columbia appears to be to value different interests in land separately, except in the case of mortgages and agreements for sale. Where there is a mortgage or agreement for sale, the amount owing is calculated and deducted from the over-all market value of the land; the mortgagor or purchaser, as the case might be, is then entitled to the balance.

The reason for separate valuations is that separate interests may have different standards of value. This has been long-recognized in expropriation law. Thus, the totality of the values of the various separate interests in a parcel of land may exceed, or be less than, the market value of the land, as an undivided fee.

The Ontario Law Reform Commission recommended that the expropriation statute should make clear that separate valuations should be made where there are different interests, except in the case of mortgages and vendors' interests under agreements for sale. This recommendation was implemented in the Ontario statute. The Ontario Commission also recommended that, where such separate valuations are made, they should be made at the same time and by the same body, but this proposal was not implemented.

The Clyne Commission recommended that all interests be valued separately, and by the same Judge and at the same time.

We propose, as the Clyne Commission did, that all valuations should be separate. This is particularly important in view of our proposal on mortgage valuation, which is discussed at length in Part G of this chapter.

Accordingly, we recommend:

Where there are separate interests in land, the market value of each should be determined separately.

There are real problems with separate valuation of interests, however. To begin with, separate interests that affect value can be easily created by contract with the aim to increase the damage award in condemnation. This was the concern of one dissent to People v. Dunn, supra, (Exhibit II). Any time we depart from a strict undivided fee rule, this problem can arise.

Separate valuation can also fail to provide adequate compensation where the separate interests are legitimately created. Suppose, for example, that the fee is severely burdened by an easement that is of little value to the owner of the easement but is more in the nature of a convenience to him.

Separate valuation of each interest would result in a very low award to the fee owner and little or nothing to the owner of the easement. This could be quite unfair to the fee owner who might easily be able to extinguish the easement for a small amount and have a readily salable and valuable full fee, absent the interruption by the condemnation. Moreover, it might well be that the easement is of tremendous value to the easement holder, yet would be unsalable on the market because it has value only for him; he would get nothing under a separate valuation formula. Neither of these problems arises under the undivided fee rule.

Perhaps the greatest drawbacks to a separate valuation approach for our purposes are its procedural ramifications. Under either an undivided fee test or the Lynbar test, the valuation of property is conducted in a two-stage operation. The first stage is the only stage the condemnor is involved in to provide a single lump-sum award. The condemnor is not forced to litigate each individual interest. It is not forced to spend the time and money involved in individual appraisals and negotiation and other administrative burdens.

Moreover, it would appear that, in the vast majority of the cases, separate valuation trials for each interest would be wasteful, for the property owners have either agreed how the award is to be split or their contracts (e.g., leases) prescribe how it is to be split if at all. In these situations, a first-stage trial as to total value is obviously the best way to proceed.

Finally, some sorts of interests simply should not or cannot be valued separately. Examples of these are mortgages, rights under sale contracts, and options to purchase, which might well be simply deducted from the award to the owner

Staff Proposal

Each of the three major approaches to valuation of property subject to divided interests discussed in this memorandum--the undivided fee rule, the Lynbar rule, and the separate valuation rule--has serious drawbacks, both substantive and procedural.

Apart from adopting one of these approaches wholesale, with its particular problems and advantages, the only realistic hope for improvement the staff can visualize is to take the California law and rid it of some of its worst features. The staff proposal is to codify the undivided fee-Lynbar mix presently in effect in California but to remedy the obvious defects in the existing California law. A draft statute to accomplish this objective is set out as Exhibit IV.

Respectfully submitted,

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EXHIBIT IV

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CHAPTER 6. COMPENSATION FOR DIVIDED INTERESTS

Article 1. General Provisions

§ 1250.010. Procedure for compensating divided interests

1250.010. Where there are divided interests in property acquired by eminent domain, the amount of compensation shall be first determined as between plaintiff and all defendants claiming an interest in property. Thereafter, in the same proceeding, the trier of fact shall determine the respective rights of the defendants in and to the amount of compensation awarded and shall apportion the award accordingly.

Comment. Section 1250.010 is intended as a procedural section only, adopting a two-stage valuation procedure where there are divided interests in property. Cf. People v. Lynbar, Inc., 253 Cal. App.2d 870, 62 Cal. Rptr. 320 (1967). It is the same in substance as the first sentence of former Section 1246.1 except that the procedure may no longer be invoked at the option of the plaintiff but is now mandatory in all cases.

§ 1250.020. Amount of compensation for divided interests

1250.020. (a) Subject to subdivision (b), where there are divided interests in property acquired by eminent domain, the amount of compensation shall be based on the value of the property as if it were owned by a single person in an undivided state.

(b) Where the aggregate value of all the interests in the property exceeds the amount provided in subdivision (a), the amount of compensation shall include an amount sufficient to compensate all the interests in the property.

Comment. Section 1250.020 provides the general rule for the amount of compensation to be determined in the first stage where there are divided interests in the property taken.

Subdivision (a) states the basic rule of the undivided fee, long a feature of California law. See, e.g., People v. S. & E. Homebuilders, Inc., 142 Cal. App.2d 105, 107, 298 P.2d 53, (1956); El Monte School Dist. v. Wilkins, 177 Cal. App.2d 47, 54-55, 1 Cal. Rptr. 715, (1960); Costa Mesa Union School Dist. v. Security First Nat'l Bank, 254 Cal. App.2d 4, 11, 62 Cal. Rptr. 113, (1967). Of course, where the condemnor seeks to acquire only a limited interest in the property, as in the case where the condemnor already owns an interest in the property and seeks only the remainder, the compensation required by subdivision (a) is not the value of the undivided fee but only the value of the "property acquired" as if held in an undivided state. Cf. Federal Oil Co. v. City of Culver City, 179 Cal. App.2d 93, 3 Cal. Rptr. 519 (1960); County of Los Angeles v. American Sav. & Loan Ass'n, 26 Cal. App.3d 7, Cal. Rptr. \_\_\_\_ (1972).

Subdivision (b) provides for compensation of amounts in excess of the undivided fee value provided in subdivision (a). Prior law allowed such

§ 1250.020

amounts in excess of the undivided fee in cases where the value of the fee was "enhanced" by the existence of an interest. See People v. Lynbar, Inc., 253 Cal. App.2d 870, 62 Cal. Rptr. 320 (1967); see also People v. Dunn, 46 Cal.2d 539, 297 P.2d 964 (1956). Subdivision (b) expands this rule to make clear that the existence of interests of value should be compensated regardless whether they serve to enhance or diminish the value of the fee.

§ 1250.030. Costs of apportionment among divided interests

1250.030. The costs of determining the apportionment of the award shall be allowed to the defendants and taxed against the plaintiff except that the costs of determining any issue as to title between two or more defendants shall be borne by the defendants in such proportion as the court may direct.

Comment. Section 1250.030 is the same as the second sentence of former Section 1246.1.