#36.150 3/30/73

Memorandum 73-31

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

Attached to this memorandum is a draft statute of the chapter dealing with compensation for divided interests. The decisions made by the Commission at the March 1973 meeting with regard to the two-stage proceeding and use of the undivided fee rule are incorporated in the draft. Other features of the draft are discussed below.

Accrual of Right to Compensation

Code of Civil Procedure Section 1249 provides that the right to compensation "accrues" as of the date summons is issued. It has been said that compensation must be paid to the owners as their respective interests appear at that time. Cf. People v. Klopstock, 24 Cal.2d 897, 151 P.2d 641 (1944).

While this general statement is fine in theory, it appears to have been more honored in the breach than in the observance. There has been a whole line of cases, for example, that in effect ignores the rule of accrual for purposes of compensating a lessee for his property even if no summons issues or a complaint is even filed. See, e.g., Concrete Service Co. v. State of California, 274 Cal. App.2d 142, 78 Cal. Rptr. 923 (1969). Also, where there are changes in ownership following "accrual," the right to compensation appears to follow the transfer. This is true at least of cases where the property is subsequently sold or where rights in the compensation to be awarded are alienated. More difficult problems arise where a lease is terminated or mortgage foreclosed after the time the right to compensation "accrues." The varieties of possible situations are so numerous that the courts must look to each one to determine who is entitled to the award and what his share should be.

The staff believes that it would not be helpful to keep the general rule indicating that the right to compensation accrues at issuance of summons and accordingly has omitted it from the draft statute and, instead, we propose that each specific problem be handled separately.

Effect of Taking on Leasehold

Where property subject to a leasehold is condemned, the condemnation in effect cancels or frustrates the lease, and performance on both sides is excused. But, where there is a partial taking of property subject to a leasehold, the law in California and in a majority of United States jurisdictions requires the lessee to continue to pay full rental for the remainder of his term; in this situation the lessee is entitled to offset his obligation by receiving, out of the total award, such sum as will be the present equivalent of the future rent attributable to the part taken. The leading case on this point is City of Pasadena v. Porter, 201 Cal. 381, 257 P. 526 (1927).

This approach to the leasehold in a partial taking case has been roundly criticized, primarily because it gives the whole award for the future rentals to the lessee and leaves the lessor to receive his compensation as it accrues and as the lessee sees fit to pay. The authorities and text writers are unanimous that the majority rule is erroneous. Nichols indicates it is unfair and possibly unconstitutional; Powell labels the position regrettable; Orgel, unreasonable; Walsh, unjust and inconsistent; and the other treatise writers and law review articles that have discussed the question have called for a modification of the majority rule. For an excerpt from an excellent discussion dealing with leasehold valuation generally and its particular application to the partial taking situation, see Horgan and Edgar, Leasehold Valuation Problem in Eminent Domain, 4 U.S.F. L. Rev. 1, 4-12 (1969)(Exhibit I).

A few jurisdictions have made statutory efforts to mitigate the severity of the majority rule. Massachusetts, for example, provides the ingenious solution of having the award paid to a trustee, who will invest the award and pay the rental over to the lessor as it accrues. See Mass. Gen. Laws, Ch. 79, § 24.

A much more direct and satisfactory solution, however, is simply to invoke a pro rata rent reduction or, if the value of the property for the purposes for which it is leased is destroyed by the condemnation, invocation of the doctrine of frustration. Louisiana accomplishes this result directly for, because it is a civil law jurisdiction, the law of contracts is applicable to leases:

> If, during the lease, the thing be totally destroyed by an unforeseen event, or it be taken for a purpose of public utility, the lease is at an end. If it be only destroyed in part, the lessee may either demand a diminution of the price, or a revocation of the lease. In neither case has he any claim of damages. [La. Stat. Ann. --C. C. Art. 2697.]

The Louisiana courts have expressly applied this provision to condemnation cases in both whole and partial takings.

In common law jurisdictions where the general contract rules do not apply to leaseholds, express provisions for pro rata reductions in partial taking cases will be necessary. West Virginia has such an express provision:

> Whenever the whole of any tract of land which is under lease is taken under the power of eminent domain, the liability of any tenant of such land to pay rent thereon shall terminate unless the lease expressly provides otherwise.
>
> If any part of a tract of land which is under lease, or any easement or other interest in such land, is taken under the power of eminent domain, the rent of any tenant of the land shall, unless the lease expressly provides otherwise, be reduced in the proportion which the value of the land or interest taken bears, at the time of such taking, to the total value of the land upon which rent was payable, under the lease.

> The foregoing provisions shall not affect nor impair any right which a tenant of land may have to compensation from the person exercising the right of eminent domain, for the value of his lease, or other property upon the leased premises belonging to him, or in which he may have an interest, if such value shall exceed the amount of the rent from the payment of which he is relieved by virtue of the provisions of this section. [W. Va. Code § 37-6-29.]

Ontario and Manitoba, Canada, have similar provisions, and the Law Reform Commission of British Columbia has recommended enactment of the same in its 1971 Report on Expropriation. Cf. Ontario, The Expropriations Act, 1968-1969, § 35:

> (1) Subject to subsection 2, where only part of the interest of a lessee is expropriated, the lessee's obligation to pay rent under the lease shall be abated pro tanto, as determined by the board.
>
> (2) Where all the interest of a lessee in land is expropriated or where part of the lessee's interest is expropriated and the expropriation renders the remaining part of the lessee's interest unfit for the purposes of the lease, as determined by the Board, the lease shall be deemed to be frustrated from the date of the expropriation.

The staff recommends adoption of a comparable provision in California changing the rule of City of Pasadena v. Porter. See Sections 1250.120 and 1250.130.

Mortgages

Where property taken by eminent domain is subject to a mortgage or mortgages, the general rule is that the mortgagees are entitled to satisfy their debts out of the award in their order of priority, with the amount left over, if any, going to the mortgagor. Actually, this general rule is rarely invoked since the mortgage instrument as a rule provides the same result by agreement of the parties, e.g.:

> Any award of damages in connection with any condemnation for public use of or injury to said property or any part thereof is hereby assigned and shall be paid to beneficiary who may apply or release such money received by him in the same manner and with the same effect as is provided for disposition of proceeds of fire or other insurance.

Code of Civil Procedure Section 1248(8) gives the condemnor the option to take the property subject to the mortgage, the award to the mortgagor being the difference between the award and the amount outstanding on the mortgage.

In either of these situations, it is not clear whether the mortgagee has the right to a deficiency judgment against the mortgagor should the amount of the award be insufficient to satisfy the mortgage. The Commission may wish to propose antideficiency legislation to specifically cover this situation although the staff draft does not include such a provision.

Code of Civil Procedure Section 1246.2 provides that the amount payable to the mortgagee where property subject to a mortgage is taken shall not include any prepayment penalty. Whether this provision applies only where the condemnor has elected to take the property subject to the mortgage pursuant to Code of Civil Procedure Section 1248(8) or whether it applies also to the situation where the mortgagor is left to pay off the mortgage from the award is not clear. In either case, the staff believes that there should be some relief from the prepayment penalty in the situation where the mortgagee's interest is paid from the mortgagor's award, for it seems unfair to impose all the burdens of the involuntary taking on the mortgagor. Accordingly, the draft statute makes clear that there is no prepayment penalty where the condemnor assumes the mortgage and adds a provision to include in the award the amount of any prepayment penalties incurred by the mortgagor where he is obligated to pay off the mortgage. Section 1250.230. A provision could be included in the statute that no prepayment penalty could be imposed by the mortgagee when property is acquired for public use, but such a provision might present a constitutional problem if it were made applicable to mortgages executed prior to the effective date of the provision. We have not researched this constitutional problem.

More difficult problems of treatment of mortgages arise, as with leases, where there is a partial taking. Although in most jurisdictions the rule is that, in the case of a partial taking of property subject to a mortgage, the mortgagee is entitled to all of the award, in California, the rule is that the mortgagee is entitled to the award only if his security is impaired by the taking. See, e.g., Sacramento etc. Drainage Dist. v. Truslow, 125 Cal. App.2d 478, 270 P.2d 928 (1954). A recent case goes so far as to hold that this is the case even where an express provision in the mortgage gives the right to compensation to the mortgagee. See Milstein v. Security Pac. Nat'l Bank, 27 Cal. App.3d 482, 103 Cal. Rptr. 16 (1972)(Exhibit II).

There appear to be no cases indicating what the result would be if there is an impairment of security although the practitioners have informed us that, in this situation, the mortgagee is entitled only to a share sufficient to allay the impairment of security. The staff believes that it is best to leave this problem to case development as well; the reason there are so few cases in the area apparently is that the bulk of the problems that arise are provided for in the mortgage agreement.

Where there are several mortgages on property involved in a partial taking, Code of Civil Procedure Section 1248(9) invokes a special rule of apportionment of the award among the senior and junior lienholders to the extent the senior lienholder's security in the remainder is not impaired. The purpose of this provision and the manner of its operation are described in the extract from Review of Selected 1969 Code Legislation (Cal. Cont. Ed. Bar 1969), attached as Exhibit III. The staff is not aware of the need for any changes in this provision, which is continued in Section 1250.220.

There is one general mortgage valuation problem that cuts across all of the areas described above: whether the mortgagee should be compensated for his security interest at its contract value or at its market value. The staff believes that a very strong argument can be made for awarding the mortgagee the market value of his interest. An excellent study and recommendation on this point by the Law Reform Commission of British Columbia is attached for the Commission's consideration as Exhibit IV. The staff draft does not include any provision of the type discussed.

Vendors and Purchasers

The Uniform Vendor and Purchaser Risk Act is codified as Civil Code Section 1662:

> 1662. Any contract hereafter made in this State for the purchase and sale of real property shall be interpreted as including an agreement that the parties shall have the following rights and duties, unless the contract expressly provides otherwise:
>
> (a) If, when neither the legal title nor the possession of the subject matter of the contract has been transferred, all or a material part thereof is destroyed without fault of the purchaser or is taken by eminent domain, the vendor cannot enforce the contract, and the purchaser is entitled to recover any portion of the price that he has paid;
>
> (b) If, when either the legal title or the possession of the subject matter of the contract has been transferred, all or any part thereof is destroyed without fault of the vendor or is taken by eminent domain, the purchaser is not thereby relieved from a duty to pay the price, nor is he entitled to recover any portion thereof that he has paid.
>
> This section shall be so interpreted and construed as to effectuate its general purpose to make uniform the law of those states which enact it.
>
> This section may be cited as the Uniform Vendor and Purchaser Risk Act.

The provision was enacted in 1947 and appears to have dealt adequately with problems that arise where property subject to an executory sales contract is condemned. The staff is aware of no need for change.

Option Holders

Under present California law, the holder of an option to lease or purchase property acquired by eminent domain is not entitled to share in the award even though he may have paid substantial amounts for the option and even though the price at which he is entitled to exercise the option is well below the market price of the property. See East Bay Mun. Util. Dist. v. Kieffer, 99 Cal. App. 240, 278 P. 476 (1929), and People v. Ocean Shore R.R., 90 Cal. App.2d 464, 203 P.2d 579 (1949). Whether the holder of an option may exercise the option following the commencement of condemnation proceedings and thereby become entitled to the award is not settled. It seems particularly harsh to require the property owner to battle out the condemnation award and then, if it appears that the option price is below the award, allow the option holder to exercise the option and take the difference.

Because option agreements rarely specify rights and liabilities in the case of condemnation, the staff believes it may be helpful to provide a set of rules that will control absent express agreement. The staff suggests that the holder of an option to purchase or lease property that is not exercised at the time of commencement of an eminent domain action be entitled to exercise the option after commencement with provision for protection of the owner against unreasonable delay of exercise. This scheme is codified in Section 1250.310.

Future Interests

Where property acquired by eminent domain is subject to a present possessory interest and a contingent future interest, particularly worrisome problems in allocating the award may arise.

The "easy" case is the life tenant-remainderman situation, for here the fact of reversion is certain to occur upon the death of the life tenant so that ultimately the estate is bound to vest in the remainderman. Where condemnation interrupts this arrangement, while it is not possible to determine with certainty how long the life tenant would have survived, it is possible to compensate the life tenant for the market value of his interest based on actuarial tables and give the balance of the award for the property to the remainderman. This sort of apportionment may be unduly harsh on the life tenant, however, for the present value of the life tenancy may not be adequate to invest to present the same yield the life tenancy itself would have provided. Thus, at least one California case has imposed a trust on the condemnation proceeds to be invested and paid out to the tenant until his death and the corpus then distributed outright to the remainderman. Estate of Giacomelos, 192 Cal. App.2d 244, 13 Cal. Rptr. 245 (1961).

The more difficult cases arise where there is a possibility of reverter or a right of reentry. The courts generally, California's included, have held that the reversionary interests are so speculative and contingent here that they should not share in the award. See, e.g., Romero v. Dep't of Public Works, 17 Cal.2d 189, 109 P.2d 662 (1941); People v. City of Fresno, 210 Cal. App.2d 500, 26 Cal. Rptr. 853 (1962); People v. City of Los Angeles, 179 Cal. App.2d 558, 4 Cal. Rptr. 531 (1960); City of Santa Monica v. Jones, 104 Cal. App.2d 463, 232 P.2d 55 (1951). The courts have indicated in dictum that the reversioner might be able to share in the award if the reversionary interest has a special value or if the possibility of reverter were more than just speculative but rather an imminent possibility. The courts have never had occasion to apply these rules, however.

The consequences of this rule can be particularly harsh and unfair. Consider the facts of the leading case of Romero v. Dep't of Public Works, supra, for example. Here the grantor sold property to a railroad for the sum of one dollar on condition that the railroad would build its line and maintain service, the real consideration for the sale being the benefits the grantor would derive from the rail service. The grantor included the express reservation that, should the property cease to be used for those purposes, the land would revert. The Division of Highways then entered and took the property for a public highway. Under Romero, the railroad received full market value for property it acquired for a dollar while the reversioner received nothing.

Similar situations arise where a grantor donates property to a municipality for, e.g., park purposes (this was the case in People v. City of Los Angeles, supra). The grant contains the reservation that, if the property is not used for those purposes, it is to revert to the donor. The Division of Highways takes the property and the city, which paid nothing for it, takes the award. The reversioner gets nothing.

These results have been extensively criticized. See, e.g., Browder, The Condemnation of Future Interests, 48 Va. L. Rev. 461 (1962), and Note, Compensation for Possibilities of Reverter and Powers of Termination Under Condemnation Law, 20 Hastings L.J. 787 (1969). The latter is a good brief article oriented toward California law and is reproduced as Exhibit V.

Courts in other jurisdictions have on occasion devised solutions to the future interest problem that yield more equitable results than denying the reversioner any compensation. These include: (1) awarding the full amount of compensation to the reversioner, (2) apportioning the award between the parties on a market value or actuarial basis, and (3) holding the funds in trust to be applied to the same purpose as the original grant and, if not so applied, to revert. The staff believes that all of these are viable approaches to compensating future interests, but their application to particular cases must depend on the fact situation in the case, the intent of the parties, and the like. The most we can do by legislation, perhaps, is to indicate to the courts that there are other options available than outright award to the holder of the possessory interest and to encourage them to make use of the other options. See Sections 1250.410 and 1250.420.

Restrictive Covenants

Although in the past restrictive covenants have been held not to be a compensable property interest in California, the Supreme Court in the recently decided case of Southern California Edison Co. v. Bourgerie (Exhibit VI) has reversed this holding, declaring violations of building restrictions in deeds compensable. In light of this recent holding, the staff believes that corrective legislation in this area is no longer necessary.

Costs of Defense Among Interest Holders

One commentator has suggested that the costs of defending an eminent domain action be spread among the holders of interests, particularly in the mortgage situation:

> Should the owner who defends or brings the action be entitled at least to his litigation expenses from the award even where the trust deed provides that the entire award shall be paid to the beneficiary-lender? Should the answer to this question depend on whether the beneficiary-lender participates in the trial preparation and the trial? [Miller, Recent Developments in the Eminent Domain Field, 40 The Appraisal Journal 286, 292 (1972).]

Since the staff understands that the commentator will be present in person at the April meeting, we will defer to him to expound upon these ideas.

Respectfully submitted,

Nathaniel Sterling
Staff Counsel

Memorandum 73-31

EXHIBIT I

[4 U.S.F. L. Rev. 1, 4-12 (1969).]

Leasehold Valuation Problem in Eminent Domain

*by John P. Horgan and William R. Edgar**

II

VALUATION OF THE LEASEHOLD INTEREST

California follows the general rule that the measure of the lessee's compensation is the market value of his leasehold interest. The market value of a lease is measured by the difference, if any, between the *economic rent* and the *contract rent*.[15] The economic rent is that rent which the property would command on the open market at present assuming it was unencumbered by any lease and otherwise available for occupancy by a new

[8] United States v. Certain Lands, etc., 39 F.Supp. 91, (E.D.N.Y. 1941); United States v. Certain Space, etc., 71 F.Supp. 986, (N.D. Calif. 1947); Fort Worth Concrete Co. v. State, 416 S.W. 2d 518 (Tex.) (1967).

[9] Commonwealth Dept. of Highways v. Fultz, 360 S.W.2d 216 (Ky.) (1962).

[10] Hanna v. Hampden County, 250 Mass. 107; 145 N.E. 258 (1924); Emerson v. Somerville, 166 Mass. 115, 44 N.E. 110 (1896); Tate v. State Highway Com. 226 Mo.App. 1216, 49 S.W.2d 282 (1932); Lyons v. Philadelphia & R. R. Co., 209 Pa. 550, 58 A. 924 (1904).

[11] Shaaber v. City of Reading, 150 Pa. 402, 24 A. 692 (1892).

[12] People ex rel. Dept. of Public Works v. Lundy, 238 Cal.App.2d 354, 47 Cal.Rptr. 694 (1965).

[13] A. W. Duckett & Co. v. United States, 266 U.S. 149 (1924).

[14] People ex rel. Dept. of Public Works v. Lundy, 238 Cal.App.2d 354, 47 Cal.Rptr. 694 (1965).

[15] People ex rel. Dept. of Public Works v. Rice, 185 Cal.App.2d 207, 8 Cal.Rptr. 76 (1960); 4 Nichols Eminent Domain, §12.42(3) (3rd ed.); Canterbury Realty Co. v. Ives, 216 A. 2d 426 (Conn.) (1966).

tenant. The contract rent is the rent provided for in the lease. If the economic rent exceeds the contract rent the lease has a market value to the extent of the difference. If, on the other hand, the contract rent exceeds the economic rent, the lease has no value for in this circumstance it is plain that the lessee is paying more than market value for his lease and therefore has nothing which is saleable in a competitive market.

In those cases where the economic rent exceeds the contract rent, giving the lease a market value, this excess is sometimes referred to as the *bonus value* of the lease. More properly, however, it is the *market value*. A simplified, yet instructive, example of the mathematical process of deriving the market value from a comparison of the economic and the contract rents is found in the case of *Yellow Cab Co. v. Howard*,[16] where the court finds:

> The dimensions of the premises are 180 feet by 112 feet or 20,160 square feet, which at 48 cents per square foot [*the economic rent*] is \$9,676.80 per year. The lease had one year, nine months to run or 1¾ years; \$9,676.80 for 1¾ years is \$16,934.40. Rent reserved in lease for 1¾ years at \$6,000.00 per year [*the contract rent*] is \$10,500.00. Deducting \$10,500.00 from \$16,934.40 is \$6,434.40, or the value of the leasehold. Yellow Cab Company is entitled to recover judgment for the sum of \$6,434.40.
> (Bracketed material added for clarity.)

The foregoing example is undoubtedly an over-simplification of the process but it does illustrate the important concept that the market value of a leasehold is generally measured by the difference between the economic and the contract rents. Unquestionably some 40 years after that decision and in a highly sophisticated and computerized age, the valuation expert would say that the calculation is too primitive in that it does not reduce the difference between the economic and contract rents to a *present value* through the discounting process. Such a criticism is undoubtedly valid since the lessee is being paid this bonus or market value *in praesenti* rather than in installments over a period of 21 months. Since the lessee will be receiving his compensation in a lump sum now, rather than waiting for periodic payments, it is obvious that if that lump sum were calculated on the unmodified basis of the sum total of all the periodic payments which he would receive, that he would be receiving more than just compensation. By definition, capitalization is the process of converting into a present value a series of anticipated future annual installments of income. The capital amount, called the capitalized value, is in effect the sum of the

[16] 243 Ill.App. 263 (1927).

anticipated annual rents less the loss of interest until the time of collection. In the *Yellow Cab* case, the unmodified sum, which the court awarded —$6,434.40—is clearly more than just compensation because in the normal course of events the lessee would not realize this amount in one lump sum at present but would have to wait for the passage of some 21 months. If he is paid the whole amount *now* he would be enriched by the amount of interest he could earn on that lump sum over the 21 month period. Therefore it becomes necessary to discount the lump sum to a present worth or value and this becomes the current value of the right to collect future payments. The sum of $1.00 in hand today, is worth exactly that. As the time until collection increases, the present day value of the amount to be collected diminishes. This discount in value is due to the loss of interest in the interim. In its simplest terms, therefore, capitalization is a deduction of interest *in advance* from each anticipated future income payment. Thus if the present worths of each anticipated future installment payment are added together, the present value of the total income stream is obtained. This discounting principle is not peculiar to eminent domain valuations but finds broad application in personal injury actions where a substantial majority of the courts require a plaintiff to reduce his economic losses, such as loss of earnings or loss of contributions to a survivor to their present value.[17] While this requirement of discount is not generally applied to damages for pain and suffering since such damages are not capable of accurate mathematical determination, it is generally recognized that economic detriment is capable of objective and mathematical ascertainment. The courts, generally, feel that a plaintiff who receives a cash lump sum award for his economic detriment which will only be realized periodically in the months and years to come, is being excessively compensated if he does not give a discount for the lump sum cash received. In theory, the plaintiff who receives the lump sum can put these funds to work and earn interest on the investment. It is clear, therefore, that this discounting principle has more than a limited application in the appraisal field and is a technque with which lawyers generally would do well to become familiar.[18] To complete the mathematics, then, if, in the *Yellow Cab* case, we use an interest rate of 6% and discount for time we find that the present value of the lessee's interest is $5,923.32 or

[17] Noble v. Tweedy, 90 Cal.App.2d 738, 203 P.2d 778 (1949) (and cases cited therein).

[18] Generally, *see*, SCHMUTZ, THE APPRAISAL PROCESS (1953); AMERICAN INSTITUTE OF REAL ESTATE APPRAISERS, APPRAISAL TERMINOLOGY AND HANDBOOK (1954 ed.); Hollebaugh, *The ABC's of Capitalization Tables*, THE APPRAISAL JOURNAL, April, 1955, p. 225; Noble v. Tweedy, 90 Cal.App.2d 738, 203 P.2d 778 (1949).

$511.08 less than the sum awarded by the court.[19] The difference in the lump sum amount and the discounted sum indicates that this could be a substantial factor in a case involving large amounts and is therefore a procedure which should never be overlooked in the valuation of a future income stream.

Regardless of the refinements, however, this serves as a comprehensible illustration of the mechanics of establishing the market value of a lease.

No California case has set out this process with such simplicity or clarity, yet it is established in this state that the value of a leasehold is its market value.[20]

In the recent case of *Costa Mesa Union School District of Orange County v. Security First National Bank*,[21] the Court of Appeal, citing the older cases, restates the *general* principles regarding the rights of lessees and the measure of the value, if any, of their leasehold estates. The court says at pages 10 and 11:

> In a condemnation action a tenant is entitled to a sum which will compensate him for his pecuniary loss as a result of the exercise of the power of eminent domain (4 Nichols, *Eminent Domain* (3rd ed.) §12.42(3).). The guiding principle of just compensation is reimbursement to the owner for the property interest taken; he is entitled to be put in as good a position pecuniarily as if his property had not been taken; he must be made whole, but is not entitled to more [citation]. In an eminent domain action the lessee is entitled to the fair market value of his leasehold interest in the part taken [citations]. A tenant's interest under a lease for a term of years is subject to ownership and is held as any other interest in land is held, subject to the exercise of the power of eminent domain. [citations] 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. [citations]

Other California cases also restate the principle that the market value of the leasehold is the criterion of the lessee's damages.[22] These California

[19] Using Present Worth of One Dollar Per Annum Table [Inwood Coefficient] interpolated for 21 months and assuming installments payable *at end of year*.

[20] Kishlar v. The Southern Pacific R.R. Co., 134 Cal. 636, 66 Pac. 848 (1901); City of Oakland v. Pacific Coast Lumber and Mill Co., 171 Cal. 392, 153 Pac. 705 (1915); People ex rel. Dept. of Public Works v. Rice, 185 Cal.App.2d 207, 8 Cal.Rptr. 76 (1960).

[21] 254 Cal.App.2d 4, 62 Cal.Rptr. 113 (1967).

[22] People ex rel. Dept. of Public Works v. Rice, 185 Cal.App.2d 207, 8 Cal.Rptr. 76 (1960); Sacramento etc. Drainage Dist. v. Truslow, 125 Cal.App.2d 473, 270 P.2d 928 (1954); County of Los Angeles v. Signal Realty Co., 86 Cal.App. 704, 261 Pac. 536 (1927).

decisions are in accord with the generally accepted rule in other jurisdictions.[23]

It is clear, therefore, that whether a leasehold interest has a market value depends upon there being an excess of the *economic rent* over the *contract rent*. The economic rent, as a valuation matter, is derived from rentals of comparable properties in the vicinity at or about the time of the taking and would indicate the "going rents" in the vicinity and thus what the tenant could expect to receive upon the sale or assignment of his lease. The contract rent, of course, is the rent provided for in the lease and which the tenant, his vendee or assignee would be obligated to pay to the lessor. If the contract rent exceeds the economic rent the tenant would be entitled to receive nothing, but if the economic rent exceeds the contract rent, the *difference* would be the basis for establishing the market value of the lease and hence the amount of money to which the tenant would be entitled after conversion to present value.[24] Having thus determined the generally accepted rule for measuring the value of the lessee's remaining term, what, if any, are the differences in the valuation approach where the condemnation is not of the *total* leased property (as has thus far been assumed) but only of a *part* of the leased property? In this area the various jurisdictions do not follow a uniform rule. Some of the other states rely upon case law and others base their holdings on specific statutory provisions. California law, fortuitously or not, is clear in this area. In this state, in the case of a partial condemnation of the

[23] Corrigan v. City of Chicago, 144 Ill. 537, 33 N.E. 746 (1893); John Hancock Mutual Life Ins. Co. v. United States, 155 F.2d 977 (1st Cir. 1946); United States v. Advertising Checking Bureau, 204 F.2d 770 (7th Cir. 1953); Pierson v. H. R. Leonard Furniture Co., 268 Mich. 507, 256 N.W. 529; 29A C.J.S. Eminent Domain, §143(b), note 71. The general rule is well stated in State of Nebraska v. Platte Valley Public Power & Irrigation District, 147 Neb. 289, 300, 23 N.W.2d 300, 308 (1946) as follows:

> "The general rule is that 'If a leasehold interest is taken, or injured, the lessee is entitled to a sum which will restore the money loss consequent to the taking or injury. This consists generally of the fair market value of the leasehold or unexpired term of the lease, and is said to be the difference between the rental value of the remainder of the term and the rent reserved in the lease.'"

[24] Garfield Homes, Inc. v. State of New York, 44 Misc.2d 738, 255 N.Y.S.2d 16 (1964); Balog v. State of Nebraska, 177 Neb. 826, 131 N.W.2d 402 (1964); Commercial Delivery Service, Inc. v. Medema, 7 Ill.App.2d 419, 129 N.E.2d 579 (1955); United States v. 425,031 S.F., 187 F.2d 798 (3rd Cir. 1951); Luby v. City of Dallas, 396 S.W.2d 192 (1965); Pierson v. H. R. Leonard Furniture Co., 268 Mich. 507, 256 N.W. 529 (1934); State of Nebraska v. Platte Valley Pub. Power & Irrig. Dist., 147 Neb. 289, 23 N.W.2d 300 (1946); Department of Public Works & Bldgs. v. Bohne, 415 Ill. 253, 113 N.E.2d 319 (1953); Corrigan v. Chicago, 144 Ill. 537, 33 N.E. 746 (1893).

leasehold interest, the lessee remains under a continuing obligation to pay the *full* rent.[25]

City of Pasadena v. Porter[26] is the leading case on this subject in California and was, at the time of its decision in 1927, a case of first impression. Its principal holdings have not been modified in the intervening years and to the date of this writing it remains the law in California, and it has been cited numerous times in subsequent cases for the principles which it first established.[27]

City of Pasadena established two very important principles which are still applicable in condemnation proceedings involving the *partial* taking of leased premises. First, in the absence of an agreement between the landlord and tenant, there is no pro rata abatement of the rent and the tenant remains under an obligation to pay the *full* rent for the remainder of the term. Secondly, in such a situation, the lessee is entitled to offset this obligation by receiving, out of the total award, such sum as will be the present equivalent of the future rent attributable to the *part taken*.[28]

In *City of Pasadena* the landlord and tenant were made defendants in a condemnation action instituted by the city. The property sought to be condemned was business property owned by Porter, and leased to her tenant. Only a *part* of the leased property was the subject of the condemnation action. It should be noted here that the tenant did not own the building or other improvements on the leased premises, and had no interest therein except to use the land and improvements under the terms of his lease and accordingly no compensation was awarded to him for any *improvements* on the condemned property.[29] This is an important factual point in the case as we shall see when we later take up the question of compensation for tenant's improvements. In *City of Pasadena* the tenant leased commercial premises having a front footage of 35 feet under a lease which ran 10 years from August, 1924, at a monthly rental of $700.00, being the equivalent of $20.00 per front foot per month. The condemnation action sought to acquire only a portion of the leased premises, to wit, 8.3 feet of the frontage. As of the date of the issuance of the summons the

[25] City of Pasadena v. Porter, 201 Cal. 381, 257 Pac. 526 (1927).

[26] *Id.*

[27] *See* People v. Ganahl Lumber Co., 10 Cal.2d 501, 75 P.2d 1067 (1938); Giraud v. Milovich, 29 Cal.App.2d 543, 85 P.2d 182 (1938); Noble v. Tweedy, 90 Cal.App.2d 738, 203 P.2d 778 (1949); Sacramento etc. Drainage Dist. v. Truslow, 125 Cal.App.2d 478, 270 P.2d 928 (1954); Waters v. Waters, 197 Cal.App.2d 1, 17 Cal.Rptr. 95 (1961); Dix Box Co. v. Stone, 244 Cal.App.2d 69, 52 Cal. Rptr. 847 (1966); Carl v. Erich, 217 Cal.App.2d 233, 31 Cal.Rptr. 628 (1963).

[28] Clark v. Erich, 217 Cal.App.2d 233, 235, 31 Cal.Rptr. 628 (1963).

[29] People v. Ganahl Lumber Co., 10 Cal.2d 501, 511, 75 P.2d 1067 (1938).

lease had an unexpired term of 114 months. Referees were appointed by the trial court, they returned their valuations which the trial court adopted and the subsequent judgment in condemnation was affirmed by the Supreme Court. It was held that where only a portion of the demised premises is taken and a portion remains which is susceptible of occupation that the tenant is bound to pay the full rent according to the terms of the lease. This holding was based upon the premise that the court has no power, in the absence of an agreement between the parties,[30] to reform or revise the lease and thereby to impose a *pro rata* reduction in the rent.

The equities of such a pro rata rent reduction were strongly urged on the appeal but the Supreme Court, noting respectable authority favoring such a reduction, adhered to what it found to be the "decided weight of authority" and in this case of first impression established the California rule, a strong and persuasive dissent by Curtis, J. notwithstanding.

Now, how did the court compensate the tenant for the loss of a part of his leasehold estate in view of the fact that he must continue to pay the full contract rent of $700.00 per month as stipulated in the lease for the remaining 114 months of the term? The $700.00 per month was equivalent to $20.00 per front foot for the 35 front feet under lease. The City took 8.3 front feet which amounts to a monthly rental of $166.00 for the part taken and which under the holding of the case the tenant still must pay although his use and enjoyment of this area has been denied him. The court found by computation that a sum of $14,839.88 placed in the hands of the lessee and invested by him at an interest rate of 6% per annum, compounded semi-annually, and drawn on at the rate of $166.00 per month for the remainder of the term, would exactly reimburse the tenant for the $166.00 per month which he was obligated to pay to the lessor for the condemned area of the leasehold, and that upon payment of the last month's rent, the entire sum, principal and interest would be exhausted. This, then, is the formula which California has adopted to compensate the lessee for his continuing obligation to pay the full contract rent when only a portion of the leased premises are condemned. To many commentators this rule is less equitable than a pro rata rent reduction but regardless of dissent it is still the rule in this state and lawyers and appraisers will have to live with it. In fact, peculiarly enough, it is also the rule in a majority of the jurisdictions.[31]

Under the majority view, enunciated in *City of Pasadena,* the rule,

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30 Waters v. Waters, 197 Cal.App.2d 1, 17 Cal.Rptr. 95 (1961).

31 2 Nichols, Eminent Domain, §5.23(3) (3rd ed. 1962); 3 Tiffany, Real Property, §904 (3rd ed. 1939); Lee v. Indian Creek Drainage Dist. No. One etc., 246 Miss. 254, 148 So.2d 663 (1963).

therefore, is that when the entire leasehold is condemned in fee, the measure of compensation to the lessee is the present value of the unexpired leasehold (economic rent minus contract rent, converted to present value). When the leasehold is only partially condemned, however, the full rental obligation continues unabated. The rental value before and after the condemnation must be computed and the measure of damages is the difference between the two wherein the rental value after the condemnation is subtracted from the rental value before the condemnation. This difference is then converted into a fund, given to the lessee, invested by him at a fixed rate of interest so that he is enabled to make his monthly rental payments on the condemned portion of the leasehold and the fund, both principal and interest, is exhausted with the last monthly rental payment due under the lease.

Majority rule or not, this cumbersome and unrealistic legerdemain postulates some very unreal conditions. First of all it assumes, contrary to the fact, that the condemned portion of the leasehold is still in private ownership and is still encumbered by the lease, when in fact that portion has passed into the ownership of the condemnor and both lessor and lessee are excluded from it. Secondly this rule further compounds the first assumption by regarding the condemned portion as still an income producing piece of property and in furtherance of this fallacy hands over to the lessee a sum of money which really represents a component of the value of the lessor's reversionary interest in the condemned portion, which sum, of course, is expected to be paid to the lessor by the lessee in installments until the expiration of the lease term. A close examination of the mathematics of *City of Pasadena* is interesting. Using round figures, the total award for all interests was $36,000.00 which included $29,000.00 as the value of the *land* taken. As the total of $36,000.00 was apportioned the lessor and fee owner received $17,000.00 and the lessee received $19,000.00 which included some $15,000.00 which represented the fund from which he will eventually pay the lessor a total of $18,924.00—in monthly installments of $166.00 for the remaining 114 months of the term. It is at once apparent that this is a classical example of deferred compensation and it is also obvious that at the time of the apportionment the lessor and fee owner has in hand a sum which is far less than the value of the *land* taken, the value of which was set at $29,000.00! If all goes well, of course, the lessor and fee owner will eventually be fully compensated. In the meanwhile, however, his tenant is in possession of the fund. He has the responsibility of prudently investing it and making the required monthly payments. What if he is improvident? What if he absconds? What if he becomes insolvent? These are the grave questions which arise under this majority rule. The risks which it forces upon the lessor over the 9½ year period are totally unwarranted in view of the easy, practical and realistic solution of prescribing a pro rata reduction in the reserved rental. The effects of the majority rule are the stuff of which nightmares are made. If the lessee should default and even if the lessor should re-let for his account, and assuming no change in rental values, the most he could obtain would be $534.00 per month for the new tenant would rent only the space which remains available. The extra $166.00 would never be recovered for this represents rental payments for premises no longer in private hands and available for rent. The risks and hazards which the lessor must endure are therefore clear. They are pointed out here not with any real hope of changing the rule, but rather to suggest that leases should be drawn with the partial condemnation problem in mind. A carefully written lease can provide for a pro rata reduction in the rent in the event of a partial taking of the leasehold estate and thus the parties can be spared the consequences which the majority rule would otherwise visit upon them.

In those situations, however, where the lease does not contain a pro rata rent reduction clause and there is a partial taking of the leasehold estate, lawyers and appraisers will be involved in the difficulties which have just been outlined. It is incumbent upon the practitioner to acquaint himself with the mathematical gyrations which he must perform in such an event. It must be made clear, however, that *City of Pasadena* in no way alters the compensation to which a lessee may be entitled, in addition, for such items as fixtures and improvements which he has installed, and which, as against the lessor, he has a right to remove. Nor does that case affect in any way the general rules, heretofore discussed, for measuring the market or bonus value of a lease. In *City of Pasadena* the question of tenant's improvements was not involved but there was a bonus value in the lease. This was awarded to the tenant in accordance with the market value rule of leasehold valuation. Finally, then, *City of Pasadena* does not in any way alter the law in these areas. Its principal effect is in the valuation treatment of the continuing rental payments which must be made for that portion of the leasehold which has been condemned.

Memorandum 73-31

EXHIBIT II

[Civ. No. 39473. Second Dist., Div. One. Aug. 28, 1972.]

MORRIS MILSTEIN et al., Defendants and Respondents, v.
SECURITY PACIFIC NATIONAL BANK, Defendant and Appellant.

SUMMARY

Over the objection of the beneficiary of a trust deed, the trial court entered an interlocutory order in an eminent domain proceeding that part of an amount deposited by the condemner be distributed to the landowner for the purpose of repairing a building damaged in connection with the taking. After entry of a final order of condemnation and deposit of the balance of the award, the court ruled that the trust deed beneficiary was not entitled to any portion thereof and apportioned the entire amount to the landowner. The deed of trust contained a provision obligating the trustor to restore any building damaged, and it also provided that the beneficiary would be entitled to all condemnation awards and that it could release moneys so received or apply same to the indebtedness secured. (Superior Court of Los Angeles County, Benjamin B. Ostrin Temporary Judge.*)

The Court of Appeal dismissed the beneficiary's appeal from the interlocutory order and affirmed the final order of apportionment. The court held that the covenant of good faith and fair dealing implied in every contract required that the beneficiary exercise its discretion under the trust deed in such fashion that it distribute to the trustors all proceeds in excess of those necessary to recoup any impairment in security caused by the eminent domain proceeding. Inasmuch as the trial court had found on substantial evidence that the security was not impaired, the court concluded that the trustors were entitled to all of the proceeds. (Opinion by Thompson, J., with Wood, P. J., and Clark, J., concurring.)

*Pursuant to Constitution, article VI, section 21.

HEADNOTES

Classified to McKinney's Digest

(1a-1c) Eminent Domain § 58—Compensation—Persons Entitled to Compensation—Apportionment Between Landowner and Lienholder.—In an eminent domain proceeding involving the taking of property by the state that included the front of a commercial building, the trial court properly apportioned the entire amount of the award to the landowners, where, though a deed of trust of the property provided that the beneficiary should be entitled to all such compensation, it further stated that the beneficiary "may" either apply the proceeds to the debt or cause them to be paid to the trustor, where the instrument also required the trustor to restore any improvement that might be damaged or destroyed, and where there was substantial evidence that the beneficiary's security was not impaired. Under such circumstances, the covenant of good faith and fair dealing implied in every contract required that the beneficiary exercise its discretion under the trust deed in such fashion as to distribute all of the condemnation proceeds to the trustors.

[See **Cal.Jur.2d, Rev.**, Eminent Domain, § 95; **Am.Jur.2d**, Eminent Domain, § 257.]

(2) Eminent Domain § 58—Compensation—Persons Entitled to Compensation—Apportionment Between Landowner and Lienholder.—Absent a contractual provision to the contrary, a lienholder on property which is condemned in an eminent domain proceeding is entitled to compensation only if his security is impaired.

(3a, 3b) Contracts § 156—Interpretation and Effect—Terms Implied as Part of Contract.—The law implies in every contract whose terms do not negative its application a covenant of good faith and fair dealing, i.e., the implied promise by the parties to the contract each to do everything that the contract presupposes they will do to accomplish their purpose. Such a covenant, however, will not be implied to vary the express unambiguous terms of a contract.

COUNSEL

Lillick, McHose, Wheat, Adams & Charles, Anthony Liebig and Douglas S. Westwater for Defendant and Appellant.

Fadem & Kanner and Gideon Kanner for Defendants and Respondents.

OPINION

THOMPSON, J.—This is an appeal from an interlocutory order of the trial court decreeing, over the objection of appellant, beneficiary of a deed of trust, that $19,085 of a deposit in court in an eminent domain proceeding be distributed to respondents, trustors and landowners, and from a final order of apportionment decreeing that the entire proceeds of the condemnation award be distributed to respondents. We dismiss the appeal from the interlocutory order and affirm the final order of apportionment.

Respondents are the owners of commercial property in the County of Los Angeles. On April 19, 1965, they executed a deed of trust of the property to defendant Equitable Trust Company to secure an indebtedness of $50,000 to Security First National Bank, predecessor in interest to appellant Security Pacific National Bank. The deed of trust provides that respondents convey the subject real property in trust to defendant Equitable Trust Company "FOR THE PURPOSE OF SECURING (1) Payment of the sum of $50,000.00 with interest thereon according to the terms of a promissory note or notes of even date herewith, made by Trustor, payable to the order of Beneficiary [Security First National Bank] . . . ; (2) Performance of each agreement of Trustor herein contained; (3) Payment of any and all obligations now or hereafter owing from any Trustor hereunder to Beneficiary and secured by mortgage or deed of trust of real property. . . ." The printed portion of the deed of trust states in darker and larger print than its body, "TO PROTECT THE SECURITY OF THIS DEED OF TRUST, TRUSTOR AGREES:." There follow three numbered paragraphs obligating the trustor to preserve the property and maintain it in good repair, including the duty "To complete or restore promptly and in good and workmanlike manner any building or improvement which may be constructed, damaged or destroyed . . . and pay when due all costs incurred therefor . . .," to make all payments and perform all acts called for by the deed of trust, and to repay all sums "expended hereunder" by the beneficiary or trustee. In the same larger and darker print, the deed of trust provides, "IT IS MUTUALLY AGREED THAT:." There follow printed paragraphs (4) through (19). Paragraph (4) reads in pertinent part: "Should the property or any part thereof be taken or damaged by reason of any improvement or condemnation proceeding, . . . Beneficiary shall be entitled to all compensation, awards, and other payments or relief therefor, and shall be entitled at its option to commence, appear in and prosecute in its own name, any action or proceedings, or to make any compromise or settlement in connection with such taking or damage. All such compensation, awards, damages, rights of action . . . are hereby assigned to Beneficiary, who may after deducting therefrom all its expenses, including attorney's fees, release any moneys so received by it or apply the same on any indebtedness secured hereby."

In October 1969, the City of Los Angeles commenced an eminent domain action to acquire a 10-foot strip of the property, taking immediate possession and depositing $38,075 in court pursuant to Code of Civil Procedure section 1243.5.

The eminent domain proceeding involved the taking of the front of a building located on respondents' property. Pursuant to Code of Civil Procedure section 1243.5, respondents moved to withdraw the deposit to permit repairs on the building necessitated by the taking. Appellant, as the beneficiary of a deed of trust on the property, objected. After a hearing pursuant to Code of Civil Procedure section 1243.7, subdivision (f), the trial court found, on substantial evidence, that the security of the deed of trust, then securing an unpaid balance of approximately $32,000, had not been impaired by the eminent domain proceeding and ordered $18,000 of the deposit distributed to respondents. On September 10, 1970, respondents filed a second application, this time to withdraw the remaining balance on deposit with the court. The application was granted over appellant's objection.

By stipulation of the parties, a judgment and final order of condemnation was entered on March 24, 1971, fixing the total award in eminent domain at $43,000, $5,915 more than the amount originally deposited by the condemner. The condemner deposited the additional sum in court. Appellant moved for an order of apportionment pursuant to Code of Civil Procedure section 1246.1. It presented no evidence that its security had been impaired or that it had been damaged by the taking. The trial court ruled that appellant was not entitled to any portion of the condemnation award and apportioned the entire amount to respondents.

(1a) On this appeal from the order of apportionment, appellant contends that it is entitled to a portion of the award equal to the unpaid balance of the loan secured by the deed of trust upon the condemned property by reason of paragraph (4) of the printed portion of the deed of trust. We conclude that an implied covenant of good faith and fair dealing precludes the construction argued by appellant.

(2) Respondents argue and appellant concedes that, absent a contractual provision to the contrary, a lienholder on property which is condemned in an eminent domain proceeding is entitled to compensation only if his security is impaired. (*Sacramento etc. Drainage Dist.* v. *Truslow,* 125 Cal.App.2d 478, 499 [270 P.2d 928, 271 P.2d 930].) **(1b)** Appellant contends, however, that paragraph (4) of the printed portion of the deed of trust vests in the beneficiary, here Security Pacific National Bank, the unqualified right to the proceeds of any condemnation action. Such is not a fair reading of paragraph (4). That paragraph goes beyond stating that in the event of an eminent domain proceeding the condemnation award shall be paid to the beneficiary to be applied upon the secured debt. It states that the beneficiary "may" either apply the proceeds to the debt or cause them to be paid to the trustor, debtor. The critical phrase is ambiguous when read in conjunction with other provisions of the deed of trust particularly in the context of the case at bench, a partial taking in an eminent domain proceeding of improved property securing the loan. While the paragraph states that the beneficiary "may" release the proceeds of condemnation or apply them on the indebtedness, it cannot be construed as vesting an absolute discretion in the beneficiary as might an acceleration clause. Such a construction is precluded by the obligation upon the trustors imposed by another paragraph of the deed of trust to repair damage caused by the taking. It is inconceivable that the parties intended other than that the proceeds of a partial taking in eminent domain would be available for that purpose. Since paragraph (4) does not grant absolute discretion to the beneficiary with respect to distribution of the fund available from condemnation, we must seek the intended limitation on that discretion. We find it in the implied in law covenant of good faith and fair dealing.

(3a) California law implies in any contract whose terms do not negative its application a covenant of good faith and fair dealing (*Flying Tiger Line, Inc.* v. *U.S. Aircoach,* 51 Cal.2d 199, 203-204 [331 P.2d 37]), i.e., the implied promise by the parties to the contract each to do everything that the contract presupposes they will do to accomplish its purpose. (*Milton* v. *Hudson Sales Corp.,* 152 Cal.App.2d 418, 431 [313 P.2d 936]; *Harm* v. *Frasher,* 181 Cal.App.2d 405, 417 [5 Cal.Rptr. 367]; Witkin, Summary of California Law (7th ed. (1960) 1969 Supp.) Contracts, § 242.)

(1c) The purpose of the note and deed of trust is that respondents shall have the use of the funds loaned on the terms and at the interest rate specified in the note, and that appellant shall have the security provided by the deed of trust. To carry out that purpose, the implied covenant of good faith and fair dealing requires that appellant beneficiary exercise its discretion with respect to the condemnation fund in such fashion that it distribute to respondent borrowers all proceeds in excess of those necessary to recoup any impairment in security caused by the eminent domain proceeding. Since the trial court concluded on substantial evidence that appellant's security is not impaired, respondents are entitled to all of the proceeds of the eminent domain action.

Appellant argues that *Cherry* v. *Home Sav. & Loan Assn.*, 276 Cal. App.2d 574 [81 Cal.Rptr. 135], precludes the result which we here reach. *Cherry* validates a "due on sale" provision in a deed of trust against a claim of a covenant of good faith and fair dealing argued to impose a limitation upon the power of the lender to accelerate the debt upon sale of the property securing it. *Cherry* is distinguished from the case at bench by the fact that there the court concluded that the contract was unambiguous in permitting acceleration. (276 Cal.App.2d at p. 576.) **(3b)** It thus falls within the traditional rule that a covenant of good faith and fair dealing will not be implied to vary the express unambiguous terms of a contract. *Cherry* quite properly declines to rewrite a contract to relieve a party of what may be an unjust bargain. (276 Cal.App.2d at p. 580.) Here we are not called upon to rewrite a contract but rather to construe internally ambiguous provisions of a deed of trust. We utilize the implied covenant of good faith and fair dealing to do so. By applying that covenant to impose a general limitation upon the rights of the parties, we avoid the essentially impossible task of rewriting the contract to reflect what the parties would have said had they anticipated the problem of a partial taking in eminent domain.

The judgment is affirmed. The appeal from the interlocutory order is dismissed.

Wood, P. J., and Clark, J., concurred.

Memorandum 73-31

EXHIBIT III

[Pages 92-94]

Review of
Selected 1969 Code Legislation

California Continuing Education of the Bar

1248 (amended): Allocation Between Lienholders in Eminent Domain Actions

AB 930; Stats 1969, ch 1256

When a parcel is encumbered with a first trust deed or other senior lien and a portion is encumbered with a subordinate lien as well, condemnation of all or part of the smaller portion may result in an award inadequate to satisfy both liens. Chapter 1256 prescribes a procedure for allocating eminent domain awards between senior and junior lienholders of condemned property. CCP 1248(9).

Both senior and junior lienors may be entitled to assignment of any condemnation award in accordance with contract terms. See California Condemnation Practice 1.17 (Cal CEB 1960). Under terms providing for automatic assignment of a condemnation award, the award may be appropriated to pay the entire remaining indebtedness of the first lien, with the remainder going to the beneficiary of the second. After condemnation, the security of the junior lien creditor may have become nearly or totally inadequate to cover the outstanding indebtedness. If the debt secured by the junior lien is a purchase money obligation, for which there is no personal recourse under deficiency judgment legislation (CCP 580b), the debtor may default with impunity. See California Civil Procedure During Trial 22.13 (Cal CEB 1960). Under former law, default of the debtor may leave the purchase money lienholder without remedy, despite the fact the condemnation award would have been ample to satisfy both his claim in full and a part of the senior lien proportional to the reduction of the senior lienor's security. The debtor's remaining interest in the parcel condemned may be of far less value than the outstanding debt the parcel formerly secured.

The new procedure of allocation is designed to allow adjustment of the condemnation award so that both the senior and junior lienholders will retain security interests proportionate to those existing before the taking. When the award is sufficient, both will be paid in full. If the award is not sufficient, it will be tentatively allocated to pay the full amount of the senior lien with any balance to the junior. At that time, the court will determine the adequacy of the remaining property to secure the junior lien. If it determines that the junior lienholder's security is disproportionately low, the court may make adjustments to the tentative allocation to place the junior in the same relative position as before the taking. The adjustment, made by reducing the allocation to the senior and adding to that of the junior, is permissible only if it preserves the proportional security of the senior lienholder.

The new provision is not applicable to unsecured debts owing to either the senior or junior lienholders. Nor does it prevent the plaintiff from exercising his option under CCP 1248(8) of deducting from the judgment the amount of indebtedness of liens not due at the time of judgment.

The law becomes effective July 1, 1970.

EXHIBIT IV

[Pages 137-148]

LAW REFORM COMMISSION OF BRITISH COLUMBIA

report on

EXPROPRIATION

(PROJECT No. 5)

1971

G. *Mortgages*

1. *Introduction*

The determination of compensation payable to a mortgagee on expropriation presents a special set of problems. The various kinds of mortgages, such as standard mortgages, discount mortgages, and participating mortgages, should be treated under a method of valuation which will provide a just result for all concerned—the mortgagee, the mortgagor and others with an interest in the land, and the expropriating authority.

The Commission has had special assistance in this area from Professor S. W. Hamilton, of the Faculty of Commerce and Business Administration at the University of British Columbia. He prepared a paper for the Commission in which he proposed that mortgagees be compensated on the basis of the market value of their securities rather than on the traditional basis of the balance outstanding at the time of expropriation. His proposal was supported by Professor Todd. The Commission believes it has considerable advantages over the traditional approach and was very interested in having comment on it from those in the various sectors of the mortgage business.

Compensation for mortgagees on the basis of market value was advocated before the Clyne Commission. The Vancouver Board of Trade, in making its submission to the Clyne Commission, urged the adoption of market value for discounted mortgages.[61] The Clyne Report did not deal with mortgages as a separate problem. Under the heading of "Valuation of Several Interests," however, that report states that the "market value of the separate interests should be separately assessed. . . ."[62]

Since market value for mortgages would be a departure from the traditional method of paying the balance outstanding, the report discusses the alternatives at some length. An appendix at the end of Part G of this chapter contains a series of illustrations, prepared by Professor Hamilton, in which the two methods are compared.

The problem of compensating mortgagees for interest loss during the time that they are reinvesting funds is a separate problem from valuation and is dealt with later under "Disturbance damages."

[61] At pp. 20, 21. *See* paragraphs 37, 38. [62] P. 147.

2. *What is a mortgage?*

A mortgage is a security for the performance of some obligation, most usually a debt. The mortgage document normally contains

(*a*) A contractual promise (referred to as the covenant) to repay money loaned; and

(*b*) A transfer of property to the lender by way of security.

The property is returnable (redeemable) on repayment of the loan. Generally, while the mortgage is in existence and not in default, the borrower (mortgagor) is entitled to have possession of and use the property. The transfer of property, by way of mortgage security, involves transfer of title to that property to the lender (mortgagee). Should the mortgagor default, the mortgagee has thus two means of obtaining payment. He can realize on the security and he can sue on the personal promise to repay.

To the lender, the mortgage is an investment. In return for an immediate outlay of capital, he is entitled to be paid a sum, or more usually a series of sums, at some time, or times, in the future. The sum or sums to which he becomes entitled includes the return of the capital and the interest thereon. It is very much as if he had purchased an annuity for cash. The value of his investment in the market depends on the rate at which the capital will be repaid, the interest rate set in the mortgage, and the extent of risk. The mortgage investment always has a current market value, which will fluctuate with changes in the prevailing rates of interest. The market value of the mortgage will only be the same as the balance owing under the mortgage when the interest contracted for under the mortgage and the prevailing market rate for mortgages of similar risk are identical.

3. *The effect of expropriation*

Since expropriation will take away the mortgagee's security and will interfere with the relationship between the mortgagor and the mortgagee, what rights should the mortgagee be given in substitution? If rights are given to the mortgagee so as to create a legal relationship between the expropriating authority and the mortgagee, what should the consequences be for the mortgagor?

The present practice in British Columbia, which is the traditional position in jurisdictions which adopted the English *Lands Consolidation Clauses Act, 1845,*[63] is that the mortgagee is paid the balance outstanding (so long as that balance does not exceed the value of the land). The amount so paid is then deducted from the value of the land. The mortgagor is then entitled to what is left. The compensation received by the mortgagor will depend, therefore, not on the value of the mortgage at the time of expropriation, but on the balance outstanding under the mortgage at that time.

4. *Methods of treatment*

There are three ways in which the expropriated mortgage may be treated—

(*a*) Assumption by the expropriating authority of the mortgagor's position:

(*b*) Payment to the mortgagee of the outstanding balance at the time of expropriation; and

(*c*) Payment to the mortgagee of the market value of his security at the time of expropriation.

[63] *See* the *Lands Clauses Act*, R.S.B.C. 1960, c. 209, ss. 93-99.

(*a*) *Assumption by the expropriating authority of the mortgagor's position*

Here, the expropriating authority would assume the liabilities that existed under the mortgage and make the payments coming due until it was paid off. This could be provided for at the option of either the expropriating authority or the mortgagee, or both could have the option.

The consequence of this assumption would be to substantially alter the mortgage contract. The property has been removed as security and in its place there would be imposed on the expropriating authority a statutory obligation to pay. Whether this is a fair exchange would depend upon the continued financial solvency of the particular expropriating authority. Thus, the position of a mortgagee may depend on which expropriating authority happened to take over the mortgage. Whether or not such assumption should relieve the mortgagor from his personal covenant to repay would be a matter which would require careful consideration.

Where the mortgagee would get his money through such an assumption, i.e., according to the terms of the mortgage, he could not generally complain, at least where the expropriating authority was the Provincial Government or an expropriating body whose financial prospects were not in question. In fact, in practically all cases he would be in a better position than before. He will now have repayment virtually guaranteed. For example, in the case of a Provincial Government expropriation, a high-risk second mortgage would be replaced by a low-risk Government-guaranteed annuity. The result would be to enhance the capital value of the mortgage security and provide the mortgagee with a windfall at the expense of the taxpayer. The Government would be paying more than it should.

The Commission believes that mortgagees should be treated in the same way as other persons whose interests in property have been expropriated. No one has ever seriously suggested that landlords should receive, instead of an immediate capital sum, the payments that their tenants would have made under their leases. Mortgagees should receive compensation in the form of an immediate capital payment.

(*b*) *Payment of the outstanding balance*

This is the traditional method, as has already been mentioned, and the one which has always been applied in this Province.

The Ontario, Manitoba, and Federal legislation all retain the outstanding-balance method, although in Ontario a number of special provisions have been adopted to deal with some of the method's shortcomings.

The Ontario Law Reform Commission recommended that mortgagees should be entitled to be paid the outstanding balance out of the market value of the compensation.[64] That Commission recognized that this would be unfair in two situations—[65]

(i) *Difference in interest rates*

The prevailing interest rates at the time of expropriation may be such that either the mortgagor or mortgagee would suffer a loss. Where prevailing rates were lower than the rate contracted for in the mortgage, the Ontario Commission recommended that the mortgagee receive disturbance damages for the loss he would sustain based on the difference between those rates and

[64] P. 31. [65] Pp. 32–34, 41, 42.

the period (if any) for which the principal payment was postponed, such period not to exceed five years.[66] Where prevailing rates were higher, the Commission recommended that the mortgagor should receive as disturbance damages the value of the difference in rates based on the balance of the term of the mortgage and the manner in which the principal was to be repaid.[67]

(ii) *Relief to mortgagor where deficiency*

The Ontario Commission noted that a purchaser might buy property with a small down payment at an inflated price or at the crest of a boom.[68] If the market value of such property, on subsequent expropriation, was less than the purchase price, the owner might lose part or all of his investment. Not only that, if the compensation was insufficient to pay off the mortgage, the owner would be liable to pay the deficiency to the mortgagee because of his personal covenant. The Ontario Commission concluded that nothing could be done for the owner in so far as the loss of his investment was concerned since "expropriating authorities should not have to protect purchasers from the vicissitudes of the market." It did recommend, however,[69]

(1) where the mortgage was a purchase-money mortgage and the market-value portion of the compensation was not sufficient to pay the amount outstanding on the mortgage, the mortgagor should be relieved of any liability on the covenant for the deficiency; and

(2) where a bonus was paid on any mortgage, and there were insufficient funds to pay out the mortgagee, liability should be reduced by deducting the amount of the bonus from the deficiency.

The Ontario legislation implemented the above recommendations of the Ontario Commission, with one exception. [70] The statute provides that mortgagees shall be paid out of market value *and* damages for injurious affection,[71] whereas the Commission had recommended that mortgagees be entitled to be paid only out of the market-value portion of the compensation.

The Federal legislation,[72] which adopts the outstanding-balance principle, contains no special provisions, perhaps for constitutional reasons, to relieve the mortgagor from liability to his mortgagee for deficiencies. It does provide for the giving of disturbance damages to a mortgagor where prevailing rates are higher than the rate contained in the mortgage, but does not provide for damages to a mortgagee where the prevailing rates are lower.

(c) *Payment of the market value*

The Commission believes that the market-value principle should be applied to the owners of lands free of encumbrances, to mortgagors, landlords, and tenants, and the owners of easements and all other interests in land. Why should mortgagees be an exception? Why is it that they are exceptions in the Ontario and Federal legislation?

There appear to be three reasons for the existence and retention of the traditional approach. First, expropriating authorities have been entitled to redeem mortgages under legislation based on the English *Lands Clauses Consolidation Act, 1845.*[73] The expropriating authorities were entitled to a discharge of the mortgage on payment of the principal and interest owing

[66] P. 41. A provision to this effect is contained in s. 99 of the *Lands Clauses Act*, R.S.B.C. 1960, c. 209.
[67] P. 42. [68] P. 32. [69] Pp. 32, 33. [70] Ss. 17, 20. [71] S. 17 (3). [72] Ss. 24 (8), 30.
[73] *See* the *Lands Clauses Act*, R.S.B.C. 1960, c. 209, ss. 93–99.

(and certain other costs and six months' additional interest). Second, the outstanding-balance method has the advantage of being readily understood and simple to determine. Third, there has been a kind of hypnotic fascination with the sum owed under the mortgage, even though that sum is payable by deferred payments. The mortgage has been viewed as an isolated contract rather than an investment.

Some of the shortcomings of the outstanding-balance method have been met in Ontario by special legislative provisions. But the shortcomings are met by penalizing the expropriating authority. For example, if prevailing interest rates are higher than the rate set in the mortgage, the mortgagee will be delighted to get the outstanding balance so he can reinvest at the higher rates. Expropriation will have resulted in the substitution of a more valuable investment for him. Meanwhile, the mortgagor does not lose out because he will get disturbance damages to compensate him for having now to pay higher mortgage rates than before. Without a provision to pay disturbance damage, as exists in Ontario, it would, of course, be the mortgagor who would suffer. The mortgagee's compensation, representing an amount greater than the market value of his security, would be deducted from the over-all value of the property, and the mortgagor would receive the balance.

Using the market-value principle would avoid all the difficulties of trying to make the outstanding-balance method fair by creating a number of complicated exceptions. It would also meet, to a large extent, the problems created by deficiencies, bonus clauses, and participating mortgages.

For the market value principle to work, there has to be a market for mortgages. Is there such a market that will be satisfactory for the purposes of determining compensation for mortgagees? The Ontario Commission thought not, stating that "the mortgage market is a peculiar one and it may not be fair to subject mortgagees to its peculiarities,"[74] but its report does not indicate whether an investigation of the mortgage market was carried out. Professor Hamilton, on the other hand, assures us that there is a mortgage market in British Columbia that is appropriate for this purpose. The working paper was sent to a number of lending institutions and others involved in the mortgage business for their views.

Some lending institutions may argue that the market-value principle would not produce fair results for them, based on their experience in the past 20 years. Many low-interest, long-term mortgages given 15 or so years ago have been paid off, usually to enable purchasers to obtain fresh financing. No doubt the lending institutions are glad to get the outstanding balance in these situations, representing as it does considerably more than the market value of their security in these times of relatively high interest rates. One may well ask whether the lending institutions would become more enthusiastic about the market-value principle if there was a substantial decline in interest rates.

Generally, the response to the working paper was in favour of applying the market-value principle to mortgages. Dean White stated that he strongly supported Professor Hamilton's proposal and that he thought the Ontario provisions in respect of compensation for mortgages are "illogical and entirely inconsistent with the basic principle on which compensation is to be awarded." The Superintendent of a major life insurance company in the mortgage field said that he was in complete agreement with Professor Hamilton, commenting that there is "no logical reason to use market value of the real estate itself

[74] P. 31.

while some other yardstick is maintained for financial interests." The District Mortgage Manager of a major banking institution, which has a substantial mortgage portfolio in this Province, stated that "it is difficult to build up a strong argument against compensating mortgagees on the basis of market value," although he questioned the contention that a mortgage investment has a current value, using the common definition as a price "a willing seller will accept from a willing buyer." The Commercial Mortgage Department of a large real estate firm wrote us that the market-value method should be adopted, stating that "there is no question that a secondary mortgage market exists." On the other hand, a distinguished Judge stated to us that he was "not persuaded that there is a sound reason for adopting the proposed market-value principle," adding that such a principle might "produce bad effects on corporate financing through bonds and debentures." A practising lawyer wrote us that "the general cost to the public of an inquiry as to the market value would exceed the value of the security itself and therefore is impractical." He said that he could see few inequities arising where a mortgage was paid on the basis of the outstanding balance. Professor W. F. Bowker, the Director of the Alberta Institute of Law Research and Reform, informed us that the Institute had spent considerable time on market value "and have indeed inclined toward it." The Institute, while recognizing that there is a market for housing mortgages, appears to be concerned over difficulties in establishing the market value of mortgages given for commercial purposes, such as those for business complexes and high-rises.

We have concluded that the market-value principle should apply to mortgages, and we so recommend.

Were the market-value principle adopted, Professor Hamilton proposed that the mortgagor's liability on the personal covenant should come to an end, and with this the Commission agrees.

What has been said about the valuation of mortgages also applies to agreements for sale. These two forms of security property should be dealt with in the proposed legislation as "security interests." A "security interest" should be defined as an interest in land that is held by its owner as a security for the payment of money, or the discharge of some other obligation, and include all mortgages and agreements for sale.

The Commission, therefore, recommends:

1. *Owners of a security interest should be paid the market value of the security.*

2. *All the rights of the owner of the security, and any collateral thereto, should be converted into a claim for compensation, and the person who gave the security should be relieved from any claim for a deficiency.*

3. *A security interest should be defined as an interest in land that is held by its owner as a security for the payment of money, or the discharge of some other obligation, and includes all mortgages and agreements for sale.*

Apportionment—What should happen to a mortgage when only part of the mortgaged property is expropriated? The Ontario Law Reform Commission recommended:[75]

> Where only part of the mortgaged property is expropriated, the mortgagee should be entitled to be paid out of the compensation for the property taken a sum that would leave the ratio between the balance outstanding on the mortgage, after such payment, and the value of the mortgaged premises

[75] P. 34.

remaining the same as existed prior to the expropriation between the balance outstanding at that time and the value of the entire mortgaged property.

The Ontario Commission pointed out this formula could be applied where only part of a parcel of land is taken and also where a mortgage covered several or many parcels of land, contiguous or otherwise.

The Ontario legislation contains a provision implementing the recommendation, with two modifications.[76] The statute provides that not only market value but damages for injurious affection should be taken into account in working out the ratio. There is also a proviso that payments made by the security holder after the date of expropriation or injurious affection should be taken into account.

Since claims for injurious affection may arise subsequent to the determination of the compensation payable to the mortgagee, it would appear preferable, for administrative reasons, not to take damages for injurious affection into account in determining the apportionment.

The Federal legislation also adopts the apportionment principle.[77] No reference is made to damages for injurious affection. The proviso in the Federal provision differs from that in the Ontario statute, the former being confined to the interest element in any payment. This appears to mean that the capital portion of any payment made after expropriation would be taken into account in the compensation payable in the case of an Ontario expropriation, and in the balance owing on the mortgage on the unexpropriated land in the case of a Federal expropriation.

Manitoba has a provision which is the same as that in the Ontario Act, except that the ratio is based on the compensation payable apart from disturbance damages.[78] This means that, in Manitoba, the value to the owner of any special economic advantage is taken into account.

This Commission recommends an apportionment provision, which is similar to that recommended by the Ontario Law Reform Commission:

Where only part of the property subject to a security interest is expropriated, the owner of that security interest should be entitled to be paid a sum that would leave the ratio between the market value of the security interest, after such payment, and the value of the secured premises remaining the same as existed prior to the expropriation between the market value of the security interest at that time and the value of the entire secured property.

Should some special provision be made for collateral mortgages? One person suggested that they might be dealt with on some sort of apportionment basis. The mortgagee might, for example, be entitled to be paid out of the market-value portion of his mortgage an amount that would leave the ratio between the debt secured and all the secured assets, after such payment, the same as existed prior to expropriation. Since there are such a variety of situations in which collateral mortgages can be given, and since the occasions in which such mortgages are expropriated are likely to be very few, we think it would be preferable to have collateral mortgages governed by the general mortgage provisions we propose. We do not, in any event, believe apportionment is a suitable concept in relation to collateral mortgages. The mortgagee should be entitled to the market value of his security interest, which might be the only security he holds. He can always renegotiate the loan position with the borrower who gave the collateral mortgage. Legislation in other jurisdictions which we have studied makes no special provision for collateral mortgages.

[76] S. 17 (6). [77] S. 24 (8) (c). [78] S. 33 (5).

APPENDIX

Materials prepared by Professor S. W. Hamilton comparing the "market value" and "outstanding balance" methods of determining compensation for mortgagees:

1. *Definitions*

The "outstanding balance" is defined as the present value of all future mortgage payments discounted at the contract rate of interest.

The "market value" is defined as the present value of all future mortgage payments discounted at the mortgage rate of interest for a given class (risk) of mortgage.

2. *Outstanding balance—unfair situations*

The use of the outstanding balance, in its strict interpretation, creates a number of inequities, as illustrated below. (All illustrations in the Appendix are based on semi-annual compounding of interest.)

(*a*) *Original discount mortgages*—Consider the practice of writing "discount" or "bonus" mortgages. For example, a mortgagee lends $7,832 in cash but receives a mortgage for $10,000, at 10 per cent in order to raise the real rate of interest (*see* Illustration 9). If the property were immediately expropriated, the mortgagee would recover $10,000 based on the outstanding balance of the mortgage. If a second mortgagee lends $7,832 in cash and receives a mortgage for $7,832 at 14 per cent, which is the market rate, the second mortgagee would receive only $7,832 as an expropriation award. While the practice of initiating "bonus" mortgages is not as common as it was 10 years ago, a similar situation may arise in different forms today.

(*b*) *Assignee discount mortgages*—Consider the case of an investor purchasing a five-year-old existing mortgage. The mortgage has a remaining term of 20 years at a contract rate of 10 per cent. The outstanding balance at the date of purchase is $18,798 and the purchase price is $20,159, reflecting a general decline in market interest rates over the past five years.[78] If the property were immediately expropriated, the purchaser of the mortgage would receive, based on the outstanding balance, only $18,798, having just invested $20,159. This is a common situation arising whenever market rates for mortgages are changing over a period of time. As the secondary market for mortgages develops, the situation where mortgagees have purchased and sold mortgages at market value rather than the outstanding balance will become increasingly common.

(*c*) *Implicit discount mortgages*—One further situation involving implicit bonus financing should be mentioned and this refers to vendor financing involved in the sale of property (*see* Illustration 10). The illustration represents a common practice among vendors. Whether the bonus is implicit or explicit does not alter the fact that a bonus exists in the mortgage.

(*d*) *Participation mortgages*—A final weakness of the outstanding balance as a basis of compensation arises from the practice of writing mortgages containing a participation clause, for example, a mortgage loan containing a clause that the mortgagee receives 2 per cent of the gross income from the property in addition to the contract rate on the mortgage. Using the strict interpretation of the outstanding balance, the mortgagee would receive no consideration for the 2-per-cent participation when, in fact, the mortgagee has sacrificed something else in the mortgage to obtain this participation.

(*e*) *Standard mortgages*—It may be argued that the above illustrations are in some way different from the position of a mortgagee who advances the full face value of the mortgage and does not assign the mortgage. Unfortunately, even in this case, valuation based on the outstanding balance will create inequities as between mortgagees facing expropriation at different times in a business cycle. If the current rate for new mortgages exceeds the contract rate on an existing mortgage, the mortgagee is made better off by the expropriation award based on the outstanding balance (*see* Illustration 1). If the current rates are below the contract rate, the mortgagee would be made worse off through expropriation where the award is based on the outstanding balance (*see* Illustration 3). Only in the event that current rates are similar to the existing contract rate would mortgagees be placed in equal positions through expropriation.

3. *Market value*

(*a*) *General*—The reasons for dwelling on the weaknesses of the outstanding balance as a basis of compensation were not so much to discredit the approach but

[78] It has been assumed that the mortgage is not one subject to s. 10 of the *Interest Act*, R.S.C. 1970, c. I-18, e.g., the mortgagor is a corporation.

rather to identify the weaknesses in order to find a preferred solution. It will be demonstrated that awards based on the market value of the mortgage will overcome each of the weaknesses referred to above in the use of the outstanding balance method.

If the basis of compensating a mortgagee is the *market value* of the mortgage at the date of notice of expropriation, the resulting awards will be more equitable between all parties concerned. Before examining the various situations in relation to the market value, several general observations can be made. While the determination of the outstanding balance on a mortgage is a relatively simple matter subject to little disagreement, the determination of the market value is somewhat more difficult, and subject to appreciably more controversy. In order to determine the market value, some evidence as to the market interest rate for a mortgage in a given risk class is required. To the extent that there is disagreement, it will likely rest with the determination of the appropriate interest rate. While the secondary market for mortgages is not as active as that for bonds and stocks, sufficient volume and expertise exists to resolve the problem. Most certainly, the market information concerning mortgages is more readily available than the corresponding market data for real property, either fee-simple or leasehold estates. Several companies specialize in the purchase and placement of mortgage contracts and could provide expert evidence, much as an appraiser produces expert evidence on real property.

It is frequently argued that a mortgagee may receive less than the funds advanced and outstanding if the award is based on market value (*see* Illustration 2). This point relates to the rights of the mortgagee prior to expropriation. A mortgagee has a right to receive a series of annuity payments, and, aside from any remedies contingent on default, the mortgagee generally does not have a claim for the outstanding balance. It is the time series of payments that is expropriated, not the capital sum as represented by the outstanding balance. Using the market value as a basis of expropriation enables the mortgagee to reinstate himself in a position of equivalent risk and earnings after expropriation. The market-value basis produces awards which are equitable in the case of original discount mortgages (*see* Illustration 9), in the case of assignee discount mortgages (*see* Illustrations 2, 4), in the case of implicit discount mortgages (*see* Illustration 10), and in the case of participation mortgages.

(*b*) *The "call clause"*—The use of the "call clause" in mortgages (commonly a five-year clause) reduces the difference in the awards based on the two approaches. In general, the shorter the term for any given mortgages the less will be the difference in awards based on the two approaches. (Compare Illustrations 1, 2, 5, 6.)

(*c*) *Mortgagee's preference*—Mortgagees in general may prefer the use of the outstanding balance rather than the market-value approach to valuing mortgages. This is due in part to the simplicity in determining the outstanding balance, the fact they receive the amount of the cash advanced in the case of standard mortgages and in part because the economy has experienced a long period of rising interest rates. In a period of rising interest rates, awards based on the outstanding balance will be greater than those based on the market value. In a period of falling interest rates, mortgagees in general would find the market value to be a more acceptable basis of compensation.

In many cases mortgages do not continue to full maturity, usually because the property has been sold and refinancing is necessary to facilitate the purchase. Thus, even in a period of rising interest rates, where it is to the advantage of mortgagors to retain their existing mortgages, a mortgagee may anticipate payment in full, based on the outstanding balance, some years prior to maturity. In these cases, mortgagees may perceive themselves as being placed at a disadvantage if expropriation awards are based on the market value rather than the outstanding balance. This will arise since the market value represents the present value of future payments discounted at a market rate rather than the (lower) contract rate. Two responses to the mortgagee's preference in this respect may be made here. First, for every mortgage that is paid out prior to maturity in a period of rising interest rates, a far larger proportion would be paid in advance during periods of declining interest rates. This would imply that in a period of declining interest rates, mortgagees would be better off receiving awards based on market value relative to awards based on the outstanding balance. Second, if prepayment of mortgages is a common practice, the market discount rate should reflect this fact. If investors expect mortgages to be paid prior to maturity, this information will be incorporated into their investment decision by the discount (interest) rate.

(*d*) *The Province's second-mortgage loans*—Special mention should be made concerning Government of British Columbia second-mortgage loans. These loans represent a unique mortgage in that they are (generally) nontransferable and issued at a lower-than-normal interest rate. Since the mortgagee in these cases would be the Provincial

Government, the problem of compensation could be resolved through a general arrangement with the Province to base the claim on the outstanding balance rather than market value. This suggestion reflects the extremely unique nature of these mortgages, and the relationship of the mortgagee and the expropriating parties.

4. Illustrations of mortgage valuation under each approach

The following illustrations are presented to indicate the differences which would exist under the two approaches. (These examples are not intended to reflect current market conditions and ignore disturbance claims.)

Basic data for Illustrations 1 to 8

Original mortgage loan $10,000
Amortization term .... 25 years
Contract interest rate .... 8 per cent compounded semiannually
Monthly payments $76.32
Expropriation occurs at the time of the 24th payment.

Illustration 1

No five-year call clause, current mortgage rates 10 per cent compounded semiannually, award based on the outstanding balance.

AWARD=$9,721.78, which is the present value of the remaining 276 payments of $76.32 discounted at 8 per cent semiannually.

If the mortgagee reinvested $9,721.78 for 23 years at 10 per cent semiannually (current rate), he would receive a monthly annuity of $88.69. Hence he is made better off by $12.37 per month for 276 months.

Illustration 2

No five-year call clause, current rates for loans of similar risk is 10 per cent semiannually, award based on the "market value" of the mortgage.

AWARD=$8,323.31, which is the present value of the remaining 276 payments of $76.32 discounted at 10 per cent semiannually.

If the mortgagee reinvested $8,323.31 for 23 years at 10 per cent semiannually, he would receive a monthly annuity of $76.32, the same as before expropriation.

Illustration 3

No five-year call clause, current interest rates for loan of similar risk is 6 per cent semiannually, award based on outstanding balance.

AWARD=$9,721.78 (same as Illustration 1).

If the mortgagee reinvested $9,721.78 for 23 years at 6 per cent semiannually, he would receive a monthly annuity of $64.49. Hence he is worse off by $11.83 per month for 276 months.

Illustration 4

No five-year call clause, current rates for loans of similar risk is 6 per cent semiannually, award based on "market value" of the mortgage.

AWARD=$11,530.43.

If the mortgagee reinvests $11,530.43 for 23 years at 6 per cent semiannually, he will receive a monthly annuity of $76.32, the same as before expropriation.

Illustration 5

Five-year clause, current interest rates for loans of similar risk is 10 per cent semiannually, award based on the outstanding balance.

AWARD=$9,721.78 (same as Illustration 1).

The five-year clause has no impact if the award is based on the outstanding balance.

Illustration 6

Five-year call clause, current interest rates for loans of similar risk is 10 per cent semiannually, award based on the market value.

AWARD=$9,237.75.

The award is greater than in Illustration 2 since, in the absence of expropriation, the mortgagee had a claim to receive $76.32 for 60 months plus the outstanding balance

($9,213.50) due at the end of the 60th month. If the investor were to reinvest the $9,237.75 for 23 years with a three-year call, he *would* receive $76.32 per month plus $9,213.50 at the end of three years, exactly his position before expropriation. In practice, the mortgagee would likely reinvest with a new five-year call, not a three-year call, and require monthly payments to fully amortize the mortgage in 25 years.

Illustration 7

Five-year call clause, current interest rates for mortgages of similar risk is 6 per cent compounded semiannually, award based on outstanding balance.

AWARD=$9,721.78 (same as Illustrations 1 and 3).

Illustration 8

Five-year call clause, current interest rates for mortgages of similar risk is 6 per cent compounded semiannually, award based on market value.

AWARD=$10,237.04.

If the mortgagee were to reinvest $10,237.04 for 23 years at 6 per cent semiannually with a three-year call he *would* receive $76.32 per month for 36 months plus $9,213.50 at the end of three years.

SUMMARY OF ILLUSTRATIONS 1 TO 8

	Current Rate (Per Cent)	Outstanding Balance	Market Value	Difference
No call clause	10	$9,721.78	$8,323.31	$1,398.47
	6	9,721.78	11,530.43	*−1,808.65*
	8	9,721.78	9,721.78	*Nil*
Five-year call	10	9,721.78	9,237.75	484.03
	6	9,721.78	10,237.04	*−515.26*
	8	9,721.78	9,721.78	*Nil*

1. If interest rates remain constant, either method of valuation gives the same answer.

2. As the mortgage term declines (or alternatively the time until the call takes effect) the difference in the awards based on the two methods is reduced. In the case of 10 per cent current interest, no call, the difference is $1,398.47, while with the call it is only $484.03. Hence the shorter the time to maturity the less the difference between the two approaches.

Bonus and Discount Mortgages

Illustration 9

Consider the following case which arises quite commonly in the market but not in the form which is presented below. A borrower obtains a cash advance of $7,832 to be secured with a mortgage. The borrower is offered two alternative repayment plans. The first is to promise to repay $7,832 at 14 per cent compounded semiannually over 20 years with monthly payments; the second is to promise to repay $10,000 at 10 per cent compounded semiannually over 20 years with monthly payments. In either case the monthly payments are $95.17 for 240 months.

Assume that two years later the property supporting the mortgage is expropriated and that the current mortgage rate for this risk class of mortgage is now 16 per cent compounded semiannually. Four possible awards might be considered for the mortgagee—

(*a*) Award based on the outstanding balance where the borrower had selected the first alternative.

AWARD=$7,657, which is the present value of the 216 remaining monthly payments of $95.17 discounted at 14 per cent compounded semiannually.

(*b*) Award based on the outstanding balance where the borrower selected the second alternative.

AWARD=$9,643, which is the present value of the 216 remaining monthly payments of $95.17 discounted at 10 per cent compounded semiannually.

(*c*) Award based on the market value given the first alternative was selected.

AWARD=$6,910, which is the present value of the 216 remaining monthly payments of $95.17 discounted at 16 per cent compounded semiannually.

(*d*) Award based on market value given the second alternative was selected.

AWARD=$6,910, which again is the present value of the 216 remaining monthly payments of $95.17 discounted at 16 per cent compounded semiannually.

SUMMARY OF ILLUSTRATION 9

	Straight Mortgage	Bonus Mortgage
Outstanding balance	$7,657	$9,643
Market value	6,910	6,910

Using the market value as a basis of compensation, the mortgagee receives the same award independent of the form in which the mortgage is written while using the outstanding balance as a basis of compensation, a difference of $1,986 exists due solely to the form in which the mortgage is written.

Illustration 10

As previously mentioned, bonus mortgages seldom arise in the form presented above. The situation arises in a more subtle manner. Assume a vendor is selling a home subject to an existing first mortgage of $20,000. The vendor is offering the home for $33,000 with $3,000 down payment and a vendor second mortgage of $10,000 at 10 per cent compounded semiannually with a 20-year term. Alternatively, the vendor is prepared to sell for $30,832 cash to the existing first mortgage. This is the common manner in which a bonused mortgage arises. If the second mortgage were granted and the current rate for such a mortgage was 14 per cent compounded semiannually, the vendor could sell the second mortgage and realize $7,832 cash plus the $3,000 down payment. Hence his willingness to accept $10,832 cash to the existing first mortgage.

Memorandum 73-31

EXHIBIT V

COMPENSATION FOR POSSIBILITIES OF REVERTER AND POWERS OF TERMINATION UNDER CONDEMNATION LAW

Condemnation of land has increased greatly in recent years, resulting in a reevaluation of traditional ideas and their applicability to modern circumstances. The purpose of this note is to contrast the traditional handling of possibilities of reverter and powers of termination in eminent domain proceedings with the more recent handling of these interests, and to set forth the position that California has taken with respect to them.

Possibilities of reverter and powers of termination are lumped together in this note, and by the courts,[1] for they pose the same valuation problems in condemnation. The primary valuation difficulty is that, although both are considered to be contingent interests,[2] neither is subject to the Rule Against Perpetuities.[3] They may, therefore, continue as contingent interests forever. The differences between these two interests do become significant, however, once the limiting event or condition subsequent has occurred. For example, the possibility of reverter immediately becomes a possessory estate regardless of the owner's intention, while the power of termination does not become possessory until the owner manifests his election that the granted estate is forfeited.[4] These mergers of interests, however, present little difficulty, as the handling of the award in these cases is largely uncontrovertible.[5]

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[1] Browder, *The Condemnation of Future Interests*, 48 VA. L. REV. 461, 472 (1962) (citing cases); *see, e.g.*, Puerto Rico v. United States, 132 F.2d 220, 221 (1st Cir. 1942); People *ex rel.* Department of Pub. Works v. Fresno, 210 Cal. App. 2d 500, 504, 26 Cal. Rptr. 853, 855 (1962); Santa Monica v. Jones, 104 Cal. App. 2d 463, 467-68, 232 P.2d 55, 58 (1951); 1 RESTATEMENT OF PROPERTY § 53 (1936).

[2] *See* Johnson v. Los Angeles, 176 Cal. 479, 486, 168 P. 1047, 1049 (1917); Strong v. Shatto, 45 Cal. App. 29, 35, 187 P. 159, 162 (1919); L. SIMES, HANDBOOK OF THE LAW OF FUTURE INTERESTS 29 (2d ed. 1966).

[3] L. SIMES, *supra* note 2, at 118.

[4] *See* People *ex rel.* Department of Pub. Works v. Fresno, 210 Cal. App. 2d 500, 504-05, 26 Cal. Rptr. 853, 855-56 (1962) (general discussion of these differences).

[5] Where the limiting event has occurred it is obvious that the holder of the possibility of reverter is entitled to the entire award as he is then the holder of the entire fee. In the case of a power of termination, however, the holder of the non-possessory estate must take certain steps to effect a forfeiture. If he fails to take such steps within a reasonable time, he will be found to have waived his right of re-entry. *See* Browder, *supra* note 1, at 474.

Majority Position

For the most part the courts have refused to allow possibilities of reverter and powers of termination to share in any condemnation award.[6] In doing so the courts have generally relied on one or more of three grounds: 1) the interest that the owner has in a possibility of reverter or power of termination is too remote and speculative; 2) the owner's interest is taken at the same time as the possessory estate and, therefore, there is no disuser during the existence of the future interest that would result in the forfeiture of the possessory estate; 3) the performance of the condition is excused by operation of law.

The most common ground for denying recovery is that possibilities of reverter and powers of termination are too speculative, remote, or contingent to be subjected to valuation.[7] The leading authority is a New York case, *First Reformed Dutch Church v. Croswell*,[8] which held that any rights inherent in these interests were mere possibilities and "possessed no value capable of estimate."[9] Similarly, a New Hampshire court[10] found that there was "no method by which the value of the interest could be assessed which would rise above the dignity of a guess"[11] so that it was a "matter too indefinite and vague for pecuniary estimation."[12] A Massachusetts court[13] reached the same conclusion, stating that such interests were "too remote and contingent to be the subject of an estimate of damages."[14] The federal courts have also generally denied participation in condemnation awards to the owners of possibilities of reverter and powers of termination.[15] For example, in *Puerto Rico v. United States*[16] it was held that these interests were only speculative and that "it is elementary law that damages cannot be assessed by mere guesswork."[17]

6 Browder, *supra* note 1, at 472.

7 *E.g.*, Beard's Erie Basin, Inc. v. New York, 142 F.2d 487, 489 (2d Cir. 1944); Puerto Rico v. United States, 132 F.2d 220, 222 (1st Cir. 1942); United States v. 16 Acres of Land, 47 F. Supp. 603, 604 (D. Mass. 1942); Romero v. Department of Pub. Works, 17 Cal. 2d 189, 194-95, 109 P.2d 662, 665 (1941); People *ex rel* Department of Pub. Works v. Fresno, 210 Cal. App. 2d 500, 515, 26 Cal. Rptr. 853, 862 (1962); People *ex rel.* Department of Pub. Works v. Los Angeles, 179 Cal. App. 2d 558, 574, 4 Cal. Rptr. 531, 542 (1960); Chandler v. Jamaica Pond Aqueduct Corp., 125 Mass. 544, 547 (1878); Lyford v. Laconia, 75 N.H. 220, 226, 72 A. 1085, 1089 (1909). *See generally* 1 L. ORGEL, VALUATION UNDER THE LAW OF EMINENT DOMAIN § 119, at 516 (2d ed. 1953).

8 210 App. Div. 294, 206 N.Y.S. 132 (1924).

9 *Id.* at 295, 206 N.Y.S. at 134.

10 Lyford v. Laconia, 75 N.H. 220, 72 A. 1085 (1909).

11 *Id.* at 226, 72 A. at 1089.

12 *Id.* at 228, 72 A. at 1090.

13 Chandler v. Jamaica Pond Aqueduct Corp., 125 Mass. 544 (1878).

14 *Id.* at 547.

15 *E.g.*, Beard's Erie Basin, Inc. v. New York, 142 F.2d 487, 489 (2nd Cir. 1944).

16 132 F.2d 220 (1st Cir. 1942).

17 *Id.* at 222.

The second ground, that there is no reversion or breach of the condition during the *existence* of the future interest,[18] also had its beginnings in the *Croswell* decision.[19] That court had reasoned that the seizure was of the entire title at the same instant and that there was, therefore, no interval of time during which a reverter could occur. When the church ceased the specified use, the possibility of reverter was no longer in existence. Thus, "[a]t the moment of appropriation there had been no disuser."[20] In *United States v. 2.02 Acres of Land*,[21] the court specifically relied on *Croswell* in adopting this ground for denying recovery.[22]

The third ground for denying recovery is that the condition is excused by operation of law.[23] The courts hold that the owner of the possessory estate has not voluntarily ceased the required use of the land, but has been compelled to do so by the condemning authority. Compliance with the condition is therefore excused and no forfeiture results: "[I]t is uniformly held that realty does not revert where the use specified in the deed is discontinued solely because of a taking under the power of eminent domain."[24] The courts generally first determine that the interest has not become possessory on either of the last two grounds, then hold that the interest has no value in and of itself, being too speculative and remote. Under this approach, the owner of the interest is entitled to no more than nominal damages.[25]

Critique

It is apparent that the courts that have adopted the general rule of denying compensation to the holder of the possibility of reverter or the power of termination, regard interests in land as having no value apart from actual possession of the land. They simply disregard "any interest the likelihood of whose eventuality cannot be gauged."[26] By so disregarding these interests they have, of course, avoided the real problem—the valuation of these interests. One court,[27] in examining

[18] *See, e.g., id.* at 221-22.

[19] First Reformed Dutch Church v. Croswell, 210 App. Div. 294, 295, 206 N.Y.S. 132, 133-34 (1924).

[20] *Id.*, 206 N.Y.S. at 134.

[21] 51 F. Supp. 56 (S.D.N.Y. 1943), *aff'd sub nom.*, Westchester County Park Comm'n v. United States, 143 F.2d 688 (2d Cir. 1944).

[22] *Id.* at 61.

[23] *See, e.g.*, People *ex rel.* Department of Pub. Works v. Los Angeles, 179 Cal. App. 2d 558, 4 Cal. Rptr. 531 (1960); Santa Monica v. Jones, 104 Cal. App. 2d 463, 232 P.2d 55 (1951); Lyford v. Laconia, 75 N.H. 220, 72 A. 1085 (1909); First Reformed Dutch Church v. Croswell, 210 App. Div. 294, 206 N.Y.S. 132 (1924). *Contra*, Lancaster School Dist. v. Lancaster County, 295 Pa. 112, 144 A. 901 (1929).

[24] State v. Independent School Dist. No. 31, 266 Minn. 85, 91, 123 N.W.2d 121, 126 (1963) (citing cases).

[25] Cases cited note 23 *supra*.

[26] L. ORGEL, *supra* note 7, at 516.

[27] Midwestern Developments, Inc. v. Tulsa, 374 F.2d 683 (10th Cir. 1967).

the reasoning of a prior decision that it had cited favorably, simply stated that "such interests were not possessory and too uncertain to admit of compensation, therefore, not property in the constitutional sense."[28]

But the issue may not be so easily avoided, since "the preferred view today is that *all* varieties of future interests are existing interests."[29] Possibilities of reverter and powers of termination are contingent interests in land[30] and contingent interests have "achieved status as a protectable interest for many purposes."[31] Most states have provided that possibilities of reverter are freely alienable[32] and powers of termination are becoming so in more and more states.[33] Should not these interests be entitled to a just compensation when taken by condemnation?

The fact that they cannot be given an exact value should not be a deterrent to valuation. The Supreme Court[34] has stated that at times the determination of a just compensation "involves, at best, a guess by informed persons"[35] and that "[w]here, for any reason, property has no market [value], resort must be had to other data to ascertain its value; and, even in the ordinary case, assessment of market value involves the use of assumptions, which make it unlikely that the appraisal will reflect true value with nicety."[36]

Possibilities of reverter and powers of termination are "property interests possessing at times considerable value"[37] apart from the possibility that they may become possessory. The grantor may convey the land for the purpose of attracting certain business or institutions into an area where he has other holdings. For example, a property owner that desires a railroad to locate near his property might convey a portion of his land for a nominal sum on the condition that a railroad be constructed on such land.[38] By reserving in himself and

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28 *Id.* at 687.

29 1 AMERICAN LAW OF PROPERTY § 4.1, at 407 (A.J. Casner ed. 1952) (emphasis added).

30 Cases cited note 2 *supra*.

31 1 L. SIMES & A. SMITH, THE LAW OF FUTURE INTERESTS § 136, at 117 (2d ed. 1956).

32 1 AMERICAN LAW OF PROPERTY § 4.70, at 530 (A.J. Casner ed. 1952); 2 R. POWELL, THE LAW OF REAL PROPERTY § 281 (1967); *see* 2 RESTATEMENT OF PROPERTY § 159 (1936).

33 2 R. POWELL, *supra* note 32, at § 282; *see, e.g.*, CAL. CIV. CODE §§ 699, 1046.

34 United States v. Miller, 317 U.S. 369 (1942).

35 *Id.* at 375.

36 *Id.* at 374.

37 Comment, *The Effect of Condemnation Proceedings Upon Possibilities of Reverter and Powers of Termination*, 38 U. DET. L.J. 46 (1960).

38 *See, e.g.*, Romero v. Department of Pub. Works, 17 Cal. 2d 189, 191, 109 P.2d 662, 663 (1941) ("one dollar and the benefits to be derived from the construction and operation of [the] railroad . . . ."); Santa Monica v. Jones, 104 Cal. App. 2d 463, 232 P.2d 55 (1951).

his heirs a possibility of reverter or a power of termination, the grantor seeks to ensure that the railroad will locate there and that if they do not, he will have his land back. Such an interest is a valuable asset to the grantor. Similar situations arise where land is conveyed to a church or hospital and the grantor desires to be sure that the land will be used exclusively for such purposes.[39] It is also common for a grantor to seek to ensure that certain undesirable businesses, such as taverns or factories, will not locate there.[40] In all such cases the grantor has specifically refrained from conveying all that he has and, in most cases, what he has conveyed is less valuable than it would be with no restrictions placed on its use. To give the entire condemnation award to the grantee, which is based on the value of the land for the best possible use, would be to pay him for rights that in fact he never had.

One final problem with the general rule is that it can be used to defeat the interest of the grantor or his heirs. In one instance[41] a school seeking to acquire an athletic field had initially desired to purchase the land, but resorted to eminent domain on learning that a condition in the deed precluded any sale.[42] The school thereby defeated the interest of the grantor and his heirs, leaving them with nothing to show for the interest they once had held. The owner of the determinable fee, however, who had paid only a nominal consideration for the property, found himself substantially enriched. This is certainly not just compensation. A minority of courts, recognizing these inequities, have arrived at methods of valuating and protecting these interests.

Minority Positions

The Mississippi court, in *Hemphill v. State Highway Commission*,[43] after inquiring into the nature of future interests in general, concluded that the mere fact that an estate is not vested does not mean that it is not protected under federal law.[44] The court then "decline[d] to follow the majority rule which denies compensation

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39 *See, e.g.*, Lutes v. Louisville & N.R.R., 158 Ky. 259, 164 S.W. 792 (1914) (church); United Baptist Convention v. East Weare Baptist Church, 103 N.H. 521, 176 A.2d 325 (1961) (church); State v. Federal Square Corp., 89 N.H. 538, 3 A.2d 109 (1938) (library); *In re* Cook's Will, 243 App. Div. 706, 277 N.Y.S. 26 (1935) (hospital); First Reformed Dutch Church v. Croswell, 210 App. Div. 294, 206 N.Y.S. 132 (1924) (church); Banner Baptist Church v. Watson, 193 Tenn. 290, 246 S.W.2d 17 (1951) (church).

40 By limiting the use to which the land may be put, the grantor can prevent undesirable elements from acquiring or locating on the land. For example, a conveyance for residential purposes only would achieve this purpose.

41 State v. Independent School Dist. No. 31, 266 Minn. 85, 123 N.W.2d 121 (1963).

42 *Id.* at 90, 123 N.W.2d at 125.

43 245 Miss. 33, 145 So. 2d 455 (1962).

44 *Id.* at 48, 145 So. 2d at 462, *citing* 1 L. SIMES & A. SMITH, *supra* note 31, at § 136.

to owners of all future interests taken by the state. There is no rational basis for such a general doctrine. It is not equitable, and it is not consistent with other legal principles related to such existing estates in land . . . ."[45] In support of valuation the court pointed out that one "who possesses an interest which he can sell has an interest for which he ought to be paid upon taking or condemnation by the state."[46]

The harshness of the general rule was apparent to the American Law Institute as well. Section 53(c) of the Restatement of Property provides that the holder of the possibility of reverter or power of termination is entitled to participate in the award when it is found that the happening of the condition or limiting event is "*imminent*." However, no guidelines were provided as to what was to be considered imminent. The Institute in recognizing this noted that "[n]o more definite rules for the division of the award between the owner of the estate in fee simple defeasible and the owner of the future interest have been established either by decision or by statute."[47] The Institute left this for the courts and legislatures to work out for themselves. The result has been that while the section has been widely recognized by the courts,[48] the necessary imminence that would justify participation in the award has been found in only a few instances.[49] Courts have shown such reluctance to find this requisite imminence[50] that one court was led to conclude "that the owner of the future interest is not adequately protected by [the Restatement] rule . . . ."[51]

Recently, some courts have found a more effective means of protecting these interests. The basic principle behind these latter decisions is that "in a condemnation situation, the parties are not contending over an indivisible parcel of real estate but rather over a sum of money which can be divided between the parties if necessary

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45 Hemphill v. State H'way Comm'n, 245 Miss. 33, 51, 145 So. 2d 455, 463 (1962).

46 *Id.*

47 1 RESTATEMENT OF PROPERTY § 53(c) (1936).

48 *E.g.*, United States v. 1,111.15 Acres of Land, 44 F. Supp. 449 (E.D. Ill. 1942); People *ex rel.* Department of Pub. Works v. Fresno, 210 Cal. App. 2d 500, 517, 26 Cal. Rptr. 853, 863 (1962); Santa Monica v. Jones, 104 Cal. App. 2d 463, 474-75, 232 P.2d 55, 62-63 (1951); *see* People *ex rel.* Department of Pub. Works v. Los Angeles, 179 Cal. App. 2d 558, 574, 4 Cal. Rptr. 531, 541-42 (1960) (applying rule but not mentioning Restatement by name).

49 *See, e.g.*, United States v. 2,184 Acres of Land, 45 F. Supp. 681 (W.D. Ark. 1942); Chew v. Commonwealth, 400 Pa. 307, 161 A.2d 621 (1960).

50 *See, e.g.*, Santa Monica v. Jones, 104 Cal. App. 2d 463, 232 P.2d 55 (1951), in which the court determined that the various breaches of conditions subsequent were not sufficient to give rise to the exercise of the power of termination.

51 State v. Independent School Dist. No. 31, 266 Minn. 85, 95, 123 N.W.2d 121, 129 (1963).

in the interest of substantial justice."[52] The results of these decisions may be divided into three basic categories: (1) the entire award goes to the holder of the defeasible fee who holds it on the same condition as that on which he held the land; (2) a lump sum award is divided between the parties; or (3) a combination of these two.

The first category has resulted chiefly where the grantor has conveyed the land on a condition that it be used for some charitable purpose.[53] *In re Cook's Will*,[54] a New York decision, held that where land had been conveyed to a hospital on the condition that it be used only for the hospital, the proceeds of the condemnation award were to be deposited in a separate fund. The hospital was entitled to the income from this fund on the condition that it be used only for hospital purposes. This result is subject to the criticism that the hospital, which had a defeasible fee in the property taken, got no more than is the customary condemnation award for a life estate under similar circumstances.[55] However, the limitation in this case is analogous to a life estate, for if the land were no longer used for hospital purposes the hospital would necessarily cease to exist.

In a later New Hampshire decision,[56] land was conveyed on the condition that it be used solely for Baptist worship. Upon condemnation of the land, the court established a constructive trust in the amount of the award, under which the church could utilize all the funds, so long as they were used for Baptists purposes. This result seems more equitable than that of the *Cook* decision, as it preserves the intent of the grantor as nearly as possible and also provides some measure of assurance that this intent will be carried out.[57]

The second category of cases has resulted in a division of the lump sum award between the parties. In *State v. Independent School District No. 31*,[58] the Minnesota court adopted this method, recognizing that possibilities of reverter and powers of termination were not adequately protected by the Restatement rule,[59] and held that in "some situations the possibility of reverter may have more than nominal

52 Comment, *supra* note 37, at 54.

53 Cases cited note 39 *supra*.

54 243 App. Div. 706, 277 N.Y.S. 26 (1935).

55 See L. SIMES, HANDBOOK OF THE LAW OF FUTURE INTERESTS 116 (2d ed. 1966). It is arguable that mere "income for his life might be said to fall short of full compensation for a fee simple." *Id.*

56 United Baptist Convention v. East Weare Baptist Church, 103 N.H. 521, 176 A.2d 325 (1961).

57 The results in these cases may be explained by the particular circumstances which would allow an application of the cy-pres doctrine, but this would not prevent a similar handling of non-charitable limitations or conditions.

58 266 Minn. 85, 123 N.W.2d 121 (1963).

59 *Id.* at 95, 123 N.W.2d at 129. This particular case has been cited in a later federal decision as an example of special circumstances that would allow the holder of such a future interest to participate in the award. *See* Midwestern Developments, Inc. v. Tulsa, 374 F.2d 683, 688 (10th Cir. 1967).

value."[60] This division of the lump sum award is based on the fact that valuation in condemnation is predicated on market value and that often limitations upon the use of property prevent its being used in the most beneficial way.[61] The court found that since the restricted use is not taken into account in determining the amount of the award, which is based on the value of the land for its best possible use, an inequity often results.[62] Consequently, the owner of the defeasible fee should be entitled only to that proportion of the award that the value of his restricted interest bears to the unrestricted value, with the balance going to the holder of the possibility of reverter. Where the restricted use has a value equal to or greater than the reasonable market value, the holder of the future interest is only entitled to a nominal award.[63] It is worth noting that the court felt inclined to take this approach even though no attempt was made by the owner of the possibility of reverter to establish the value of his interest.[64]

The third method of handling possibilities of reverter and powers of termination by the minority courts is that adopted by the Ohio court in *Ink v. Canton*.[65] It is a synthesis of the first two methods. In that case, the land under condemnation had been conveyed to the city on the condition that it be used as a public park.[66] The court stated that where the grantee has paid full market value for the property, compensation to the grantor should be denied since any award paid to him would amount to a windfall.[67] But where the grantee paid little or nothing for the fee, the amount by which the value of the unrestricted fee exceeds the value of the restricted fee should be paid to the grantor. Since the grantor in *Canton* expressly refrained from conveying the whole estate to the grantee, and received nothing for what he did convey, the court concluded that at the time of appropriation by the state the grantor was entitled to the difference in the value of the property as measured with and without restrictions.[68] In such a situation, the court held the right not too remote or contingent for purposes of valuation.[69]

The court next considered the argument that the whole award should go to the grantee because the grantor's condition, imposed only to compel the grantee to make a specified use of the property, had been excused by the condemnation and was no longer effective.[70]

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60 State v. Independent School Dist. No. 31, 266 Minn. 85, 96, 123 N.W.2d 121, 129 (1963).

61 *See* id. (citing cases and other authorities).

62 *See id.* at 96-97, 123 N.W.2d at 129.

63 *Id.* at 97, 123 N.W.2d at 129-30.

64 Id. at 92, 123 N.W.2d at 126.

65 4 Ohio St. 2d 51, 212 N.E.2d 574 (1965).

66 *Id.* at 52, 212 N.E.2d at 575.

67 *Id.* at 55, 212 N.E.2d at 577.

68 *Id.*

69 *See id.*

70 *See id.* at 55-56, 212 N.E.2d at 577.

The court found that, regardless of this argument, it "does not represent a reason for giving the grantee the value of something he has not lost (i.e., the amount, if any, by which the value of the property taken exceeds its lesser value for the restricted use that the grantee could have made of it) where the grantor expressly refrained from conveying that something to him."[71] The court then pointed out that in the usual situation involving possibilities of reverter or powers of termination there is only land to be awarded, while in the case of eminent domain there is an award of money, which can and should be divided where the situation dictates.[72]

The court further provided that since the city had undertaken a fiduciary responsibility by accepting the conveyance, any money that the city received should be held in trust subject to the same conditions under which the property was held, and any money not used for Ink Park purposes should revert to the grantor.[73] This solution was possible because only a portion of the park was taken by the condemning authority, and it was not an undue burden to require that the award be used in conjunction with the remaining portion of the park. In this way the court prevented the city from being unjustly enriched, while also assuring that the award given would be used for the purposes specified in the original conveyance and not for other purposes.

There are two more minority approaches that should be mentioned. First, some courts have directly controverted the majority position, holding that the grantor alone is entitled to the award.[74] The rationale for such a position has been that the taking by the government amounts to a *breach* of the conditions imposed by the grantor, and the land, therefore, reverts to the grantor. However, in at least one instance[75] where the court awarded the entire judgment to the grantor, it did so only to give effect to the particular intent of the grantor, which by the terms of his deed indicated that a taking by eminent domain would *in fact* operate as a breach of the condition regardless of the city's power to prevent it.[76] The position of other cases giving the grantor the entire award cannot be so justified. As such, their position is untenable and almost universally rejected.[77]

A second possible approach would be to use the Internal Revenue Service method of valuating future interests for Federal Gift Tax

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71 *Id.* at 56, 212 N.E.2d at 577-78.

72 *Id.* at 56-57, 212 N.E.2d at 578, *citing* 1 L. Simes & A. Smith, The Law of Future Interests § 2013 (1966), Comment, *The Effect of Condemnation Proceedings Upon Possibilities of Reverter and Powers of Termination*, 38 U. Det. L.J. 46, 54 (1960).

73 Ink v. Canton, 4 Ohio St. 2d 51, 58, 212 N.E.2d 574, 579 (1965).

74 *E.g.*, Pedrotti v. Marin County, 152 F.2d 829 (9th Cir. 1946); Crowl v. Tidnam, 198 Okla. 650, 181 P.2d 549 (1947); Lancaster School Dist. v. Lancaster County, 295 Pa. 112, 144 A. 901 (1929).

75 Pedrotti v. Marin County, 152 F.2d 829 (9th Cir. 1946).

76 *See id.* at 831.

77 *See* cases cited note 24 and text accompanying note 24 *supra*.

purposes by the use of actuarial tables.[78] While this solution necessarily would be limited to situations where the particular contingency is dependent on the life of a particular person, or the outliving of one person by another, it remains, nevertheless, as a possibility.

California Position

California requires that each separate estate or interest in land shall be valued individually in condemnation proceedings.[79] Possibilities of reverter and powers of termination should fall within this provision since the courts hold that they are interests in property.[80] However, the Supreme Court of California, in its only decision directly in point, has adopted the majority position denying compensation for reversionary interests. *Romero v. Department of Public Works*[81] dealt with the condemnation of a narrow strip of land held by a railroad under a deed that was given on the consideration of one dollar plus "benefits to be derived by [the grantor] from the construction and operation of a railroad . . . ."[82] The deed provided that the land was to be used only for railroad purposes and that if such use ceased, the land was to revert to the grantor.[83] The court found that the performance of the condition was made impossible by operation of law, and that since the limiting event had not occurred prior to condemnation, the future interest was too speculative and remote to have any compensable value.[84] The court did recognize that possibilities of reverter and powers of termination should have a separate valuation, but only where the land taken has some special value to the owner apart from the use of the land, such as the value of mineral rights.[85] The effect was to award the railroad the value of the land for its best possible use even though the lesser value for the restricted use was acquired for only a nominal sum.

In more recent California cases the rule set forth in the Restatement of Property has been recognized, yet no court has found such imminence of the terminating event that would allow the holder of the possibility of reverter or power of termination to share in the

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[78] *See* Treas. Reg. 25.2512-5(d). *See also* 5 R. POWELL, THE LAW OF REAL PROPERTY § 666, at 112-21 (1967).

[79] "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. *Value*. 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." CAL. CODE CIV. PROC. § 1248(1).

[80] Johnston v. Los Angeles, 176 Cal. 479, 168 P. 1047 (1917); Strong v. Shatto, 45 Cal. App. 29, 187 P. 159 (1919); *see* 29 CALIF. L. REV. 525, 526 (1941).

[81] 17 Cal. 2d 189, 109 P.2d 662 (1941).

[82] *Id.* at 191, 109 P.2d at 663.

[83] *Id.* at 191, 109 P.2d at 664.

[84] *Id.* at 194, 109 P.2d at 665.

[85] *Id.* at 195, 109 P.2d at 665.

award.[86] In *Santa Monica v. Jones*[87] the court determined that the land had been conveyed to the railroad on a condition subsequent as in the *Romero* case. The deed stipulated that if the land was not used for railway purposes, or the railway should cease to run a daily passenger service, or any structures not necessary to the operation of the railroad were constructed thereon, the land would revert to the grantor.[88] Relying directly on *Croswell* the court held that the taking by the government did not amount to a breach of the condition, and even if it were a breach, the heirs had not elected to declare a forfeiture of the possessory estate.[89] The court found that forfeiture was not imminent even though the railroad had made application on several occasions to discontinue passenger service.[90]

In finding no imminence the court cited a New York case, *Carter v. New York Central Railroad*,[91] as authority. However, while the question of immimence was raised in the New York case, the actual decision was based on a determination that the possibility of reverter had no "value capable of estimate."[92] Moreover, the California court even went so far as to say that a breach of the condition subsequent prior to condemnation would not entitle the heirs of the grantor to participate in the award.[93] The court did not go into the question of a special value apart from the use of the land, which was raised in *Romero*, but simply stated that no such value was alleged.[94] This result was reached despite the fact that California requires a separate valuation of all interests in the land.[95]

In *People ex rel. Department of Public Works v. Los Angeles*,[96] land had been conveyed to the City of Los Angeles for the purposes of a public park. The land was deeded on the condition that it be used exclusively for a public park to be known as Griffith Park. The state subsequently condemned part of the land for the construc-

86 *See* People *ex rel.* Department of Pub. Works v. Fresno, 210 Cal. App. 2d 500, 517, 26 Cal. Rptr. 853, 863 (1962); People *ex rel.* Department of Pub. Works v. Los Angeles, 179 Cal. App. 2d 558, 574, 4 Cal. Rptr. 531, 541-42 (1960); Santa Monica v. Jones, 104 Cal. App. 2d 463, 474-75, 232 P.2d 55, 62-63 (1951).

87 104 Cal. App. 2d 463, 232 P.2d 55 (1951).

88 *Id.* at 468, 232 P.2d at 58-59.

89 *Id.* at 472-73, 232 P.2d at 61.

90 *Id.* at 471, 232 P.2d at 60.

91 73 N.Y.S.2d 610 (Sup. Ct. 1947).

92 *Id.* at 614.

93 Santa Monica v. Jones, 104 Cal. App. 2d 463, 473, 232 P.2d 55, 61 (1951). This holding caused one writer to comment that such reasoning represented blind adherance to the rule of *Croswell*. Comment, *The Effect of Condemnation Proceedings Upon Possibilities of Reverter and Powers of Termination*, 38 U. DET. L.J. 46, 50 (1960).

94 *See* Santa Monica v. Jones, 104 Cal. App. 2d 463, 474, 232 P.2d 55, 62 (1951).

95 CAL. CODE CIV. PROC. § 1248(1).

96 179 Cal. App. 2d 558, 4 Cal. Rptr. 531 (1960).

tion of the Golden State Freeway. The court first determined that the land was held on a condition subsequent[97] and that there was no breach of the condition prior to condemnation.[98] The court then concluded that any interest that the heirs had in the land was "so remote, speculative and contingent as to justify no consideration by the court . . . ."[99] As in *Santa Monica v. Jones*, no evidence was presented by the claimant as to the value of his right.[100]

The most recent California case is *People ex rel. Department of Public Works v. Fresno*[101] in which a large parcel of property was conveyed to the City of Fresno for municipal purposes, including use as a municipal airport, and "for no other purpose."[102] The heirs of the grantor were named as co-defendants in the condemnation proceeding, along with the city. The trial court had determined that the city's interest in the property had terminated, and awarded the entire amount of compensation to the heirs of the grantor.[103] In overruling the trial court, the appellate court assumed for the purposes of adjudication that the conveyance created a determinable fee,[104] and found that there had been no reversion prior to the taking. Further, since the cessation of the required use was involuntary, the taking itself did not cause a reversion.[105] The court further found that there was no evidence of imminent reversion at the time of condemnation.[106] The court held that the non-compensability rule for "speculative" contingent interests, as developed in prior California cases dealing with conditions subsequent, applied with equal force to the reversionary interest incident to a determinable fee.[107] However, the court did at least recognize those cases that imposed the grantor's conditions upon the award, and indicated that such a provision under the facts of *Fresno* would be proper.[108] Concededly, the city itself had volunteered this stipulation, but the willingness of the court to implement such a provision under the right circumstances may be an indication that some measure of protection will be afforded these interests in California condemnation proceedings.

Conclusion

In the words of a Mississippi court, "there are other soundly rea-

[97] *Id.* at 570, 4 Cal. Rptr. at 539.
[98] *Id.* at 575, 4 Cal. Rptr. at 542.
[99] *Id.* at 574, 4 Cal. Rptr. at 542.
[100] *Id.* at 575, 4 Cal. Rptr. at 542.
[101] 210 Cal. App. 2d 500, 26 Cal. Rptr. 853 (1962).
[102] *Id.* at 503, 26 Cal. Rptr. at 854.
[103] *Id.* at 504, 26 Cal. Rptr. at 855.
[104] *Id.*
[105] *Id.* at 509, 26 Cal. Rptr. at 858.
[106] *Id.* at 517, 26 Cal. Rptr. at 863.
[107] *Id.* at 515, 26 Cal. Rptr. at 862.
[108] *Id.* at 518, 26 Cal. Rptr. at 863 (citing favorably cases noted in section on minority position).

soned cases, in a minority, holding that a future interest in land which is not tenuous and which is capable of evaluation is a compensable right when taken or damaged by the state for public use."[109] Such a result would appear to be dictated in states such as California where future interests are classified as property, and all property interests are required to have a separate valuation in condemnation proceedings.

The recent trend has been in favor of protecting these interests. California apparently recognizes this trend as favorable, as evidenced by its general recognition of the Restatement rule and the language of *Fresno* indicating approval of the imposition of the grantor's conditions upon the grantee's award. It is also important to note that there have been no major California decisions on this point subsequent to the decisions by the Minnesota and Ohio courts, which made the first major breakthroughs in this area.

It is suggested that these interests do have a value in and of themselves, apart from any likelihood of their becoming possessory. Concededly, the condemnation of land by a public authority does not effect a reversion to the grantor or his heirs, or a breach of the condition subsequent. But the mere fact that the interests have not become possessory is no reason to deny their participation in the award. Unfortunately, in so denying participation, the courts have limited themselves by implication to the idea that value lies only in possession of the land or in the possibility thereof. It should be recognized that in certain instances these interests do have independent value, and it is necessary to formulate means of estimating and protecting them.

*Roger A. Grable**

[109] Hemphill v. State H'way Comm'n, 245 Miss. 33, 50, 145 So. 2d 455, 463 (1962) (citing cases).

* Member, Second Year Class

Memo 73-31 EXHIBIT VI

C O P Y

IN THE SUPREME COURT OF THE STATE OF CALIFORNIA

IN BANK

SOUTHERN CALIFORNIA EDISON COMPANY,
Plaintiff and Respondent,
v.
RICHARD D. BOURGERIE et al.,
Defendants and Appellants.

L.A. 30095
(Super. Ct. 86635)

The sole question at issue is whether a building restriction in a deed constitutes "property" for purposes of article I, section 14, of the California Constitution[1/] so that compensation must be made to a landowner who has been damaged by the construction of an improvement which violates the restriction on land acquired by eminent domain.

In 1964, defendants purchased a tract of land in

1/ Article I, section 14, of the California Constitution provides in part, "Private property shall not be taken or damaged for public use without just compensation having first been made to . . . the owner . . . ."

(SEE DISSENTING OPINION)

Santa Barbara from the Bank of America; the bank retained a portion of the tract adjoining defendants' property on the west. The deed from the bank to defendants provided that the property transferred could not be used for an electric transmission station, and the land retained by the bank was made subject to the same restriction. Plaintiff, Southern California Edison Company (Edison), a public utility, sought to acquire the bank's land by eminent domain, for the purpose of building an electric substation.[2/]

In its complaint against the bank, Edison joined defendants, alleging that they owned or claimed some right, title or interest in the bank's land. Defendants answered, asserting that the bank's land was burdened with a restriction in their favor, and that they would be damaged by the proposed electric substation Subsequently, the bank and Edison entered into a stipulation for judgment in which the bank agreed to permit Edison to acquire the bank's land for a specified sum. The action proceeded to trial on the issues relating to the propriety of the condemnation,and the trial court rendered judgment in

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2/ Section 1001 of the Civil Code provides that any person may acquire private property by eminent domain for any use specified in section 1238 of the Code of Civil Procedure. Section 1238 of the Code of Civil Procedure states that the right of eminent domain may be exercised by any public utility for electric power facilities.

Edison's favor, holding that the property sought to be condemned would be applied to uses authorized by law. It held also that the restriction forbidding the construction of an electric transmission station on the bank's land did not create a compensable property interest in defendants.

In attacking the basic issue defendants fire two salvos. First, they maintain that a building restriction constitutes "property" as that term is used in article I, section 14, of the California Constitution and, therefore, a taking must be compensated whether the plaintiff seeking condemnation is a governmental entity or a private party. Second, they assert even if a restriction is not viewed as compensable property when the condemner is a governmental entity, nevertheless a private, profit-making corporation such as Edison may not violate the restriction without compensating the property owner in whose favor it runs. We need not reach the second of these issues since, as will appear, we conclude that whether the condemner is a public or private entity, a building restriction constitutes "property" within the meaning of article I, section 14, and compensation must be paid whenever damage to a landowner results from a violation of the restriction.

The trial court ruled against defendants in reliance upon Friesen v. City of Glendale (1930) 209 Cal. 524, and

Lombardy v. Peter Kiewit Sons' Co. (1968) 266 Cal.App.2d 599. In Friesen, a case we have not reexamined in over four decades, the court held: a building restriction is not a property right but merely a negative easement or an equitable servitude; such an interest is, in essence, a contractual right cognizable in equity as between the contracting parties but not binding upon the sovereign since parties may not by mutual covenants in private contracts create for themselves an estate in land entitling them to compensation by the state; moreover, if plaintiffs' position were sustained, each landowner in the tract to which the restriction applied as well as the encumbrancers of the various lots would be necessary parties to a condemnation suit, thereby greatly increasing the cost of condemnation. In Lombardy the Court of Appeal denied compensation on the authority of Friesen.

A majority of jurisdictions which have considered the matter hold that building restrictions constitute property rights for purposes of eminent domain proceedings and that a condemner must compensate a landowner who is damaged by violation of the restriction. (Horst v. Housing Auth. of County of Scotts Bluff (Neb. 1969) 166 N.W.2d 119, 121; Meredith v. Washoe County School District (Nev. 1968) 435 P.2d 750, 752-753; U.S. v. Certain Land in City of Augusta, Maine (S.D.Me. 1963) 220 F.Supp. 696, 700-701; School District

No. 3 v. Country Club of Charleston (S.C. 1962) 127 S.E.2d 625, 627; Town of Stamford v. Vuono (Conn. 1928) 143 A. 245, 249; Allen v. City of Detroit (Mich. 1911) 133 N.W. 317, 320; see cases collected in 4 A.L.R.3d 1137; 2 Nichols on Eminent Domain (3d ed. 1970) § 5.73[1].) The Restatement of Property also adopts this view. (Rest., Property, § 566.) Friesen and other cases adhering to the minority view have been sharply criticized by law review commentators. (See, e.g., Aigler, Measure of Damages for Extinguishment of Easement by Condemnation, 1945 Wis.L.Rev. 5; Stoebuck, Condemnation of Rights the Condemnee Holds in Lands of Another (1970) 56 Iowa L.Rev. 293; Spies & McCoid, Recovery of Consequential Damages in Eminent Domain (1962) 48 Va.L.Rev. 437; Comment (1955) 53 Mich.L.Rev. 451.)

We are impressed with the cogent criticism of the conceptual underpinnings of Friesen. First, it is unquestioned that building restrictions constitute property rights for some purposes (Mock v. Shulman (1964) 226 Cal.App.2d 263, 269-270; see 5 Powell on Real Property (1971) § 671, p. 147). Furthermore, it is difficult to justify affording compensation for the appropriation of an easement, which is unquestionably compensable "property" (see 2 Nichols on Eminent Domain (3d ed. 1970) § 5.72), while denying payment for violation of a restriction.

Both easements and building restrictions may be created by agreements between private parties and, therefore, upon condemnation in both situations the financial burden of the condemner is increased solely by virtue of agreements made between private parties.[3/] Equally important, the violation of a building restriction could cause far greater damage in monetary value to a property owner than the appropriation of a mere right of way. To establish a substantive distinction by merely labeling one a property interest for which compensation must be made and the other a mere contractual right which may be appropriated by a condemner without any compensation is inequitable and rationally indefensible.

[3/] Professor Aigler, in his article, Measure of Damages for Extinguishment of Easement by Condemnation, op. cit. supra, 1945 Wis.L.Rev. 5, 23-24, footnote 44, offers this analysis: " . . . But surely it is possible for a landowner by his own act, for instance by improving his land with buildings, trees, etc., to increase the amount of compensation he is entitled to receive on condemnation. The condemning unit cannot expect to get off by paying for the taken land only in its natural state untouched by the hand of man and unaffected by developments in the neighborhood. Likewise he may clearly get increased compensation if he has acquired valuable easements (legal) apurtenant [sic] to the land taken, and if the legal easement he has acquired burdens the taken land for the benefit of his land which is not taken, the authorities all agree that he is entitled to compensation. Why, then, should compensation be denied when the increase in value or the interest extinguished was created by covenant instead of by a deed of conveyance and is called an equitable instead of a legal easement? The contract in these situations creates property rights."

We need not contemplate in depth the somewhat esoteric dialogue on the appropriate characterization of a building restriction. One writer has perceptively declared that the "no-property-interest argument is less the motivation for denial of compensation than it is a rationalization for a result desired for other reasons" (Stoebuck, op. cit. supra, 56 Iowa L.Rev. at p. 306). An objective analysis reveals the real basis for the decisions which deny compensation for the violation of building restrictions by a condemner relates to pragmatic considerations of public policy rather than abstract doctrines of property law, and it is upon these issues of policy that jurisdictions choose between the minority and majority views. (Compare Wharton v. United States (1st Cir. 1907) 153 F. 876, expressing in dictum the minority concept, with the most frequently cited case for the majority position, Town of Stamford v. Vuono, supra, 143 A. 245.)[4/]

[4/] The rationale of the Connecticut court in Stamford (at pp. 248-249) seems irrefutable: "The plaintiff also contends that these restrictions, in so far as they prohibit the erection of a high school or other municipal building upon the restricted property, are void as against public policy. The argument in support of this contention is that no contractual agreement between the owners of property should be permitted to prevent the use of that property by an agency of the state when its use is required in the exercise of a governmental function, that to require the state to make compensation for the right taken would interfere with this governmental function, and therefore

Denial of compensation has been justified upon the ground that the cost of constructing public projects will be substantially increased if compensation must be provided by a condemner for the violation of a restriction. In addition, it is asserted that a condemner might be required to join a large number of landowners as defendants in cases where the benefit of the restriction runs to numerous lots, and that this could result in inhibiting the condemner's ability to acquire essential property.[5/] Finally, it has been suggested that landowners might "pluck valuable causes

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should not be permitted. The fallacy of the argument lies in the assumption of its minor premise that the requirement that the state compensate the owner of the dominant tenement for the taking of his interest in the servient tenement actually interferes with the exercise of any governmental function. There is, of course, a clear distinction between the rights of the private owner of land which is subject to a restrictive easement and those of a governmental agency which requires for public purposes the use of the land in violation of the restriction. The private owner may not violate the restriction; if he attempts to do so he may be restrained by injunction. The governmental agency may not be restrained from making such use of the property as the public purpose for which it is acquired may require, but, if that involves the taking of private property it must make compensation for the same. When, therefore, property subject to a restrictive easement is taken for a public use, it has been held that the owner of the property for whose benefit the restriction is imposed is entitled to compensation. . . . Such restrictions are in the nature of an easement constituting an interest in the land upon which they are imposed."

[5/] Professor Aigler referred to the "lively imagination" of a Texas court which saw 10,000 possible claimants. (Aigler, Measure of Damages for Extinguishment of Easement by Condemnation, op. cit. supra, 1945 Wis.L.Rev. at p. 32.)

of action from the thin air" by entering into agreements imposing restrictions whenever condemnation proceedings are on the horizon. (Arkansas State Highway Commission v. McNeill (Ark. 1964) 381 S.W.2d 425, 427.)

We find these reasons for denying compensation to be unpersuasive. Conceding the possibility that the cost of condemning property might be increased somewhat by awarding compensation for the violation of building restrictions, we cannot conclude that such increases will significantly burden exercise of the power of eminent domain. As a practical matter some takings would result in negligible damage to the owners of the restriction (e.g., public works such as parks or access roads); if the character of the improvement were such that damage to some landowners would result (e.g., schools or fire stations), it is likely that only those immediately adjoining or in close proximity to the improvement would suffer substantial injury, even in highly restricted areas. As to the procedural difficulties, while they are not here involved and we need not decide the issue, it has been posited by some authorities that a condemner need only selectively join in the action landowners whose property is most likely to be damaged by the violation of the building restriction; there are other remedies for excluded owners who anticipate the improvement will result in damage to their property. (See Stoebuck, *op. cit. supra*, 56 Iowa L.Rev. pp. 307-308.) Finally, the speculative possibility that some unduly acquisitive landowners might in bad faith enter into restrictive covenants solely for the purpose of collecting compensation would not justify the denial of compensation to all property owners, including those acting in good faith. If bad faith or sharp practices were established, a court could properly refuse to allow compensation.

Under the minority view, compensation is denied to persons whose property may have been damaged as a result of the violation of a valid deed restriction, thereby placing a disproportionate share of the cost of public improvements upon a few individuals. Neither the constitutional guarantee of just compensation, nor public policy permit such a burdensome result. The United States Supreme Court has recently declared, "The constitutional requirement of just compensation derives as much content from the basic equitable principles of fairness . . . as it does from technical concepts of property law." (U.S. v. Fuller (1973) 41 U.S.L.Week 4159.) Our conclusion to harmonize California law with the majority rule is in conformity with this salutary principle.

For all the foregoing reasons, Friesen v. City of Glendale, supra, 209 Cal. 524, is overruled and Lombardy v. Peter Kiewit Sons' Co., supra, 266 Cal.App.2d 599, is disapproved to the extent that they are inconsistent with the views herein expressed.

The judgment is reversed insofar as it determines that defendants are not entitled to be compensated for the violation of the restriction. In all other respects the judgment is affirmed.

MOSK, J.

WE CONCUR:

WRIGHT, C.J.
TOBRINER, J.
SULLIVAN, J.
*KAUS, J.

*Assigned by the Chairman of the Judicial Council.

C O P Y

SOUTHERN CALIFORNIA EDISON CO.
v. BOURGERIE

L.A. 30095

DISSENTING OPINION BY BURKE, J.

I dissent. The majority opinion extends the provisions of article I, section 14, of the California Constitution to a degree previously unrecognized in this state, thereby substantially affecting future eminent domain proceedings. This case alters long-standing California law to conform with the rule in the "majority" of American jurisdictions on the issue of compensability of a "taking" of building restrictions in eminent domain proceedings. However, in doing so, the majority discards the conceptual bases supporting the prior California position without submitting persuasive reasons justifying the change.

It has been stated "a determination that 'property' has been 'taken' is merely descriptive of the end result, the conclusion reached, rather than of the reasons that impelled the conclusion. The very question to be decided in a case of this character [eminent domain proceedings involving a violation of a building restriction] is whether, after all relevant factors are weighed, it can be said that a property right does exist as between the condemner and the person claiming compensation." (Kratovil & Harrison, Eminent Domain-Policy and Concept (1954) 42 Cal.L.Rev. 596, 630; italics added.)

Today's majority opinion is founded upon the tenuous proposition that a building restriction is substantially equivalent to an easement. Since an easement is a compensable property interest, and since both easements and building restrictions bear some similar characteristics, the majority concludes that a violation of a building restriction in a condemnation action is a taking of a property interest, and is likewise compensable. Yet an easement is an affirmative right of use, whereas a building restriction is wholly negative in character, amounting to no more than a promise not to use property in a particular manner. Although the majority characterizes the distinction between compensability for easements and noncompensability for building restrictions as "inequitable and rationally indefensible," a number of jurisdictions have found the policies underlying the distinction to be reasonable and persuasive.[1/]

1/ By reason of this decision California conforms with the rule followed by the majority of jurisdictions in

(Fn. 1 continued)

The California doctrine denying compensation for a "taking" of building restrictions was first announced in Friesen v. City of Glendale, 209 Cal. 524, which the majority now overrules. The reasons espoused in support of the holding in Friesen appear equally as cogent today as when that case was decided. In Friesen the court held a building restriction amounted to no more than a contract right, enforceable in equity as between the parties or their successors with notice, and did not attain the status of a compensable property interest.2/ Other courts have concluded similarly. (Moses v. Hazen, 69 F.2d 842; Houston v. Wynne, 279 S.W. 916; Board of Public Instruction v. Bay Harbor Islands, 81 S.2d 637; Anderson v. Lynch, 188 Ga. 154; Doan v. Cleveland Short Line R. Co., 92 Ohio 461.) The majority fail to explain what reasons now compel a contrary rule.

(Fn. 1 continued)

the United States. However, the number of jurisdictions adhering to the minority view is substantial. (See cases collected in 4 A.L.R.3d 1137; 2 Nichols on Eminent Domain (3d ed. 1970) § 5.73[2].)

2/ See 5 Powell on Real Property (1971) section 671, page 144, where a promise respecting the use of land is recognized as a type of contract between the parties which did not constitute property at common law.

The conceptual premises underlying eminent domain proceedings add further support to the holding in Friesen. In Smith v. Clifton Sanitation District, 134 Colo. 116, 120, the court remarked "We think it is fundamental that where a company, corporation or agency of the state is vested with the right of eminent domain and has acquired property through eminent domain proceedings and is using the property for public purposes, no claim for damages arises by virtue of such a convenant as in the instant case, in favor of the owners of other property on account of such use by the condemner. Were the rule otherwise the right of eminent domain could be defeated if the condemning authority had to respond in damages. . . ." The above remarks focus on the added expense which a damages award would impose in future eminent domain actions. Such an award could "defeat" the right of eminent domain in at least two ways. Initially, an award of damages to land owners benefitted by a building restriction may be so prohibitive as to require termination of the contemplated condemnation action. Secondly, although the public entity might be able to pay the damage awards and proceed with the public use of the condemned property, the financial burdens involved may outweigh the expected benefit to the public.

Each of these is an equally unacceptable alternative which the majority's decision imposes on those entities possessing powers of eminent domain.3/

Additionally, damage awards in future eminent domain actions may present complex procedural entanglements. If each parcel in a residential subdivision is mutually benefitted and burdened by a building restriction, then upon violation of the restriction by condemnation proceedings and inconsistent use, the problem is raised as to which persons have compensable property interests requiring joinder in the action. The owner of every benefitted parcel should be joined if, as the majority concludes, each has suffered a taking of "property."4/

3/ Since only a small number of parties conceivably have been injured by the violation of the building restriction in this case the increased condemnation costs caused by damage awards may be insubstantial. However, the factual circumstances presented by this action should not blind the majority from recognizing that in similar situations the number of injured parties claiming damage may be so numerous as to make the use of eminent domain prohibitive.

4/ The majority cites Stoebuck, Condemnation of Rights the Condemnee Holds in Lands of Another (1970) 56 Iowa L.Rev. 293, 307-308. There the author states that individuals suffering a "technical" injury may be compensated by a settlement agreement. He also proposes a highly questionable procedure to dispose of the claims of such persons who have a compensable property interest taken: "A major safety valve for the condemnor is that holders of the smaller claims cannot, practically, afford to press their claim very hard. . . . Perhaps

(Fn. 4 continued)

Also, since lienholders and mortgagees maintain a present proprietary interest in the benefitted property, they too may possess a right to have that interest considered and protected.[5] These are substantial procedural hurdles which, because of the majority's refusal to consider, may return to haunt us in the near future.

I would affirm the trial court judgment denying compensation for the violation of the restriction on the basis of the Friesen case and Lombardy v. Peter Kiewit Sons' Co., 266 Cal.App.2d 599. The following commentary places the problem in true perspective:

"Decision on the scope of compensation in eminent domain is simply a question of policy. [Citation.] If we are at all correct in concluding that fundamental fairness requires compensation for consequential loss if feasible, the policy decision becomes one simply of the practicalities. The answer lies in the economic information which will be revealed by inquiries beyond the

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(Fn. 4 continued)

the condemnor would even be justified in failing to join those with nominal claims, putting the burden on them to join the action or later bring an inverse condemnation action. Neither of these responses would be likely to occur unless property owners' losses were more substantial than expected."

5/ See 17 Cal.Jur.2d, Eminent Domain, section 95; 154 A.L.R. 1110, "Rights of Morgagee in Award in Eminent Domain Proceedings."

reach of the courts, which are largely confined to information presently available or collected by litigants. Therefore, these questions may be more satisfactorily explored by legislatures." (Spies & McCoid, Recovery of Consequential Damages in Eminent Domain (1962) 48 Vir. L.Rev. 437, 457-458.)

BURKE, J.

I CONCUR:

McCOMB, J.

CHAPTER 6. COMPENSATION FOR DIVIDED INTERESTS

Article 1. General Provisions

§ 1250.010. Procedure for compensating divided interests

1250.010. (a) Except as provided in subdivision (b), where there are divided interests in property acquired by eminent domain, the value of each interest and the injury, if any, to the remainder of such interest shall be separately assessed and compensation awarded therefor.

(b) Notwithstanding subdivision (a), the plaintiff may require that the amount of compensation be first determined as between plaintiff and all defendants claiming an interest in the 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 retains the existing California scheme of permitting a plaintiff the option of having the interests in property valued separately or as a whole. Subdivision (a) retains the procedure formerly provided by Section 1248(1)-(2). Subdivision (b) retains the procedure formerly provided by the first sentence of Section 1246.1. It is intended as procedural only. Cf. People v. Lynbar, Inc., 253 Cal. App.2d 870, 62 Cal. Rptr. 320 (1967). For the rules governing the amount of compensation where the plaintiff elects a two-stage proceeding, see Section 1250.020.

§ 1250.020. Amount of compensation for divided interests

1250.020. (a) Subject to subdivision (b), where the plaintiff requires that the amount of compensation be first determined as between plaintiff and all defendants claiming an interest in the property, 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 amount of compensation provided in subdivision (a) is not sufficient to compensate all the interests in the property, the amount of compensation shall include an amount sufficient to compensate all the interests in the property.

Comment. Section 1250.020 provides the general rules for the amount of compensation to be determined in the first stage where the plaintiff elects a two-stage proceeding.

Subdivision (a) states the undivided fee rule, 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).

Subdivision (b) provides for compensation of amounts in excess of the undivided fee value provided in subdivision (a). Prior law allowed such amounts in excess of the undivided fee in cases where the value of the fee was enhanced by the existence of a leasehold. 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) makes clear that the amount of compensation awarded must be sufficient to permit compensation for all interests in the property. This rule applies in any case in which the value of all interests if valued separately would total to an amount in excess of the undivided fee value.

§ 1250.030. Costs of apportionment among divided interests

1250.030. Where the plaintiff requires that the amount of compensation be first determined as between plaintiff and all defendants claiming an interest in the property, 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 in substance as the second sentence of former Section 1246.1.

Article 2. Leases

§ 1250.110. Termination of lease in whole taking

1250.110. Where all the property subject to a lease is acquired for public use, the lease terminates.

Comment. Section 1250.110 codifies the rule that the taking of the entire demised premises for public use by eminent domain or agreement operates to release the tenant from liability for subsequently accruing rent. See, e.g., City of Pasadena v. Porter, 201 Cal. 381, 387, 257 P. 526, (1927); Carlstrom v. Lyon Van & Storage Co., 152 Cal. App.2d 625, 313 P.2d 645 (1957). This rule does not apply if there is an express provision to the contrary in the lease. See Section 1250.150.

§ 1250.120. Partial cancellation of lease in partial taking

1250.120. Except as provided in Section 1255.130, where part of the property subject to a lease is acquired for public use, the lease is cancelled as to the part taken and remains in force as to the remainder, and the rent reserved in the lease that is allocable to the part taken is extinguished.

Comment. Section 1250.120 abrogates the rule in City of Pasadena v. Porter, 201 Cal. 381, 257 P. 526 (1927), and numerous cases following it that required continuation of the lessee's full rental obligation for the duration of the lease in cases of a partial taking of property subject to a lease. Section 1250.120 requires a pro rata abatement of the rental obligation; for a comparable provision, see W. Va. Code § 37-6-29 (19__). The requirements of Section 1250.120 do not apply where there is an express provision to the contrary in the lease. See Section 1250.150.

§ 1250.130. Termination of lease in partial taking

1250.130. Where part of the property subject to a lease is acquired for public use, the court may, upon petition of any party to the lease, terminate the lease if the court determines that an essential part of the property subject to the lease is taken or that the remainder of the property subject to the lease is no longer suitable for the purposes of the lease. Upon such termination, compensation shall be determined as if there were a taking of the entire leasehold.

Comment. Section 1250.130 is new to California law. It provides for termination of a lease in a partial taking case where the taking in effect destroys the value or utility of the lease for either of the parties and requires compensation by the condemnor accordingly. Section 1250.130 is not applicable in cases where there is an express provision in the lease covering the situation.

§ 1250.140. Time of termination or partial cancellation

1250.140. The termination or partial cancellation of a lease pursuant to this article shall be at the earlier of the following times:

(a) The time title to the property is taken by the person who will put it to the public use.

(b) The time the plaintiff is authorized to take possession of the property as stated in an order for possession.

§ 1250.150. Remedies of parties not affected

1250.150. Nothing in this article affects or impairs:

(a) The rights and obligations of the parties to the lease to the extent that such rights and obligations in the event of the acquisition of the property for public use are expressly provided in the lease.

(b) Any right a lessee may have to compensation for the taking of his lease in whole or in part or for the taking of any other property in which he has an interest.

Article 3. Encumbrances

§ 1250.210. Acquisition of property subject to encumbrances

1250.210. Where property acquired by eminent domain is encumbered by a mortgage or other lien, and the indebtedness secured thereby is not due at the time of the entry of judgment, the amount of such indebtedness may be, at the option of the plaintiff, deducted from the judgment and the lien of the mortgage or other lien shall be continued until such indebtedness is paid; but the amount for which, as between the plaintiff and the defendant, the plaintiff is liable under Section 1245.710 may not be deducted from the judgment.

Comment. Section 1250.210 is the same in substance as former Section 1248(8).

§ 1250.220. Allocation of award among encumbrancers in partial taking

1250.220. (a) Where property is encumbered by a mortgage or other lien and only a portion of the encumbered property is acquired by eminent domain, and where the property being taken, or some portion of it, is also encumbered by a mortgage or other lien which is junior to the first-mentioned lien and such junior mortgage or other lien is against only a portion of the property encumbered by the senior mortgage or other lien, it shall be determined whether the award is sufficient in amount so that the amounts owing to the holders of such senior and junior liens may be paid in full from the award.

(b) If it is determined that the award is not sufficient in amount to pay in full such senior and junior liens, the amount of indebtedness which is secured respectively by the senior and junior liens on the property taken, and which will be paid from the award or deducted from the judgment pursuant to Section 1250.210, shall be determined as follows:

(1) The total amount of the award which will be available for payment to the senior and junior lienholders shall be determined. Such amount shall tentatively be allocated first to the senior lien up to the full amount of the indebtedness secured by the senior lien, and the remainder, if any, shall tentatively be allocated to the junior lien.

(2) It shall then be determined whether the payment to the junior lienholder of the amount tentatively allocated to the junior lien together with elimination of the junior lien on the property taken would cause the junior lienholder's security remaining after the taking, if any, to be of less value in proportion to the indebtedness owing after the taking than was the value

of his security prior to the taking in proportion to the indebtedness to him prior to the taking.

(3) If it is determined that the proportionate security of the junior lienholder would be reduced by the taking if only the tentative amount allocated to the junior lien were paid to the junior lienholder, the tentative allocations to the senior and junior liens shall be adjusted. To make such adjustment, there shall be deducted from the amount tentatively allocated to the senior lien and there shall be added to the amount tentatively allocated to the junior lien an amount sufficient, considering the junior lienholder's remaining lien on property not taken, to preserve the security of the holder of the junior lien for amounts which will remain owing to him after payment to him from the award. Deduction shall not be made from the amount tentatively allocated to the senior lien to the extent that the remaining amount allocated to the senior lien, if paid to the senior lienholder, would cause the security of the senior lienholder remaining after the taking to be of less value in proportion to the amount remaining owing to him after such payment than the value of his security prior to the taking, in proportion to the amount secured by his lien before such payment.

(4) No adjustment of the tentative allocations shall be made if it is determined that the security of the junior lienholder which will remain after the taking appears to be sufficient in value to satisfy the indebtedness which will remain owing to the junior lienholder after the taking.

(c) The amounts tentatively allocated to such senior and junior liens, adjusted by such deduction and addition, if any, are the amounts of indebtedness owing to such senior and junior lienholders which are secured by their respective liens on the property taken, and any other indebtedness owing to the senior or junior lienholders shall not be considered as secured by the property to be taken. If the amount of such indebtedness payable to either the senior or to the junior lienholder is not due at the time of entry of the judgment, and the plaintiff makes the election provided in Section 1250.210, the indebtedness which shall be deducted from the judgment is the indebtedness in the amount so determined, and the lien shall continue until that amount of indebtedness is paid.

Comment. Section 1250.220 is the same in substance as former Section 1248(9). This recodification is not intended to affect any rules relating to the right of the encumbrancer to any part of the award where there is no impairment of the security. See, *e.g.*, *Milstein v. Security Pac. Nat'l Bank*, 27 Cal. App.3d 482, 103 Cal. Rptr. 16 (1972).

§ 1250.230. Prepayment penalty under mortgage or trust deed

1250.230. Where property acquired by eminent domain is encumbered by a mortgage or deed of trust:

(a) If the plaintiff makes the election provided in Section 1250.210, the amount payable to the mortgagee or beneficiary under the deed of trust shall not include any penalty for prepayment.

(b) If the plaintiff does not make the election provided in Section 1250.210, the compensation for the property shall include an amount sufficient to cover any penalty for prepayment incurred by the mortgagor or trustor under the deed of trust.

Comment. Section 1250.230 supersedes former Section 1246.2. Under the former section, it was not clear whether elimination of prepayment penalties occurred in cases where the plaintiff did not elect to take property subject to a mortgage under Section 1250.210. Section 1250.230 makes clear that, in such a situation, the compensation for the property should include an amount adequate to cover any prepayment penalty expense incurred by reason of the taking. The compensation provided in subdivision (b) is in addition to the compensation provided in Government Code Section 7263 (payments to cover certain refinancing costs).

Article 4. Options

§ 1250.310. Unexercised options

1250.310. Unless the option expressly provides otherwise:

(a) The holder of an unexercised option to acquire an interest in property may, after the commencement of an eminent domain proceeding, exercise the option at any time before its expiration or termination pursuant to subdivision (b). Upon such exercise, the option holder is entitled to the compensation awarded for the interest acquired by such exercise.

(b) An unexercised option to acquire an interest in property is terminated if, after the commencement of an eminent domain proceeding, the owner of the interest serves notice of intent to terminate on the holder of the option and the holder of the option fails to exercise the option within 30 days following service of such notice.

Comment. Section 1250.310 provides a procedure whereby an option that is not exercised at the time of commencement of an eminent domain proceeding may receive compensation upon exercise of the option. This marks a departure from previous law. Cf. East Bay Mun. etc. Dist. v. Kieffer, 99 Cal. App. 240, 278 P. 476 (1929), and People v. Ocean Shore R.R., 90 Cal. App.2d 464, 203 P.2d 579 (1949).

Article 5. Future Interests

§ 1250.410. Contingent future interests

1250.410. Where property acquired for public use is subject to a contingent future interest, upon petition of the holder of such interest or upon petition of any other person having an interest in the property, the court may order that the compensation awarded for the property be held in trust, or be distributed outright in whole or in part to either the owner of the contingent future interest or the owners of other interests in the property, or both, in such a manner as to effectuate as nearly as possible the probable intention of the instrument creating the contingent future interest, taking into consideration the circumstances of the original grant, the compensation if any paid to the grantor, the remoteness of the contingency, and any other factor that has a bearing on such probable intent.

Comment. Section 1250.410 makes clear that, where there are contingent future interests in property acquired by eminent domain, such interests may be entitled to compensation despite any implications to the contrary in such cases as Romero v. Department of Public Works, 17 Cal.2d 189, 109 P.2d 662 (1941); People v. City of Fresno, 210 Cal. App.2d 500, 26 Cal. Rptr. 853 (1962); People v. City of Los Angeles, 179 Cal. App.2d 558, 4 Cal. Rptr. 531 (1960); City of Santa Monica v. Jones, 104 Cal. App.2d 463, 232 P.2d 55 (1951).

Section 1250.410 requires that the court do what is equitable under the particular facts of the case without regard to technical rules such as the failure of reversion where the estate is interrupted by condemnation. It permits a wide variety of possible solutions including, but not limited to, granting the whole award to either the possessory or the reversionary interest, apportioning the award among the interests on a reasonable basis including market value or actuarial factors, and imposing a trust on the proceeds under the same conditions as the original grant of land. See discussion in Note, Compensation for Possibilities of Reverter and Powers of Termination Under Condemnation Law, 20 Hastings L.J. 787 (1969). *Cf.* Estate of Giacomelos, 192 Cal. App.2d 244, 13 Cal. Rptr. 245 (1961).

§ 1250.420. Property subject to life tenancy

1250.420. Where property acquired for public use is subject to a life tenancy, upon petition of the life tenant or any other person having an interest in the property, the court may order, rather than an apportionment and distribution of the award based on the value of the interest of life tenant and remainderman, that the compensation be held in trust and invested and the income distributed to the life tenant for the remainder of the tenancy, or such other arrangement as will be equitable under the circumstances.

Comment. Section 1250.420 provides the court express statutory authority to devise an equitable solution where property subject to a life tenancy is taken and an outright division of the award would not result to substantial justice under the circumstances of the particular case. See Estate of Giacomelos, 192 Cal. App.2d 244, 13 Cal. Rptr. 245 (1961)(trust imposed on proceeds).