

CONDEMNATION

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by Steven A. Hirsch

WHAT EVERY REAL ESTATE PRACTITIONER SHOULD KNOW

Condemnation issues and practice have come out of the shadows. Public debate sparked primarily by redevelopment efforts and the 2005 *Kelo v. City of New London*¹ case has elevated the visibility of this area of law and has focused our clients' attention on how it affects their property. You are more likely to be asked basic condemnation questions by your client now than you were ten years ago.

Condemnation practitioners are a strange breed. Formerly shunted to the back corners of the real estate practice cocktail party, they are still not used to their comparative rock star status today. Most of us tend to be "litigators," so there is a further disconnection with the rank and file members of this section. Several of us, however, own pocket protectors, maintain a set of different colored pens, and think and act from time to time like more traditional real estate practitioners. Moreover, we are willing to help our transactional colleagues keep abreast of this important area of law.

Condemnation issues pervade the world of real estate practice. Occasionally our clients may be hit with a demand notice or lawsuit condemning all or a portion of their property. But more often, the potential impact of a taking must be considered in

negotiating and drafting lending instruments, leases, or purchase contracts. Condemnation issues affect property tax assessments, environmental and land use planning, and generally our clients' short and long range development horizons.

So it is a strange new condemnation world, and one where each of us should have a working knowledge of the basics of condemnation law. With no warranties or representations that it is complete or fits every circumstance that will arise, this article attempts to set forth those basics so that a practitioner can spot and address issues involving condemnation law.

1. Do condemnors have to give my client any notice before condemning?

In the not so distant past, the answer to this question was no. Nor did condemnors have to share their appraisals of fair market value. All that has changed: to institute a condemnation action now, under A.R.S. § 12-1116(A), a condemning entity must make a statutory offer to pay a specific amount at least twenty days before filing a condemnation action, and must provide one or more appraisals that support the amount of the proposed compensation.



2. *What are the basic time frames and steps in a condemnation action?*

In state court, following the statutory offer, an action is brought in superior court as are other civil complaints. Usually the condemnor will seek a quick taking of the property, or “immediate possession,” so that the project for which the property is being taken can start while the matter rides the court calendar towards eventual determination of just compensation by a jury or judge. Immediate possession is accomplished in an order to show cause proceeding that typically takes place within 30 to 60 days of the filing of the action. In such a proceeding, the condemnor must demonstrate that the use for which the property is being taken is authorized by law, and the taking is necessary to such use, and must also establish the “probable damages” to each owner, possessor or person having an interest in each parcel of land sought to be condemned. So long as the project is clearly for a public and necessary use, and the amount of just compensation proposed is considered fair, the parties usually stipulate to immediate possession, the condemnor posts the “probable damages” sums with the court, and the property owner may withdraw the posted sums after possession is granted (at penalty of having to pay back any overage with interest if it is later shown that the value was overstated).

After the immediate possession issues are resolved, a condemnation action typically takes its place in line with other civil actions (a statutory entitlement to priority seems to be honored more in the breach), and generally the sole matter left to be resolved is the fair market value owed to the property owner for the taking. The preliminary “probable damages” number is inadmissible at trial. If the matter is relatively straightforward and involves an owner representative and an appraiser testifying against a condemnor representative and an opposing appraiser, discovery should proceed on a relatively brisk basis, and the matter often is ready to be tried within a year to eighteen months of filing. In circumstances where the taking is larger or is a partial taking in which severance damages are implicated, many different experts may be needed, and many valuation and related legal issues must be resolved before trial. These cases will take longer to get to trial. Jury trials are always available in condemnation actions, although sometimes the parties stipulate to try the matter to the court. ADR mechanisms are becoming increasingly popular given the costs of litigation, especially where the “spread” between the condemnor and the condemnee’s number is relatively small.

Unlike most civil actions, a judgment following a verdict or court ruling does not end a condemnation case, and does not effect a transfer of title. Rather, the judgment acts as notice to the condemnor of what amount to pay (typically a sum in addition to the earlier immediate possession deposit, with statutory interest running from the date of possession). At this stage, the condemnor has a right to abandon the case under circumstances where the verdict is too high (at the price of paying the condemnee’s attorneys’ fees, expert witness expenses and costs). Assuming the condemnor wishes to pay the judgment, the condemnee then files a satisfaction of judgment, and the court issues a final order of condemnation. The final order of condemnation is tantamount to a deed. It is recorded, and legally transfers title as recited in the order.

3. *Whose interests are foreclosed in a condemnation action?*

Think of a condemnation action as a judicial foreclosure action. The condemnor typically gets a litigation guarantee report at the onset, preparing the complaint so that it names each and every party who could claim an interest in the property. Assuming each defendant is properly served, they either appear and advocate for their share of the condemnation proceeds, are defaulted out of the case, or otherwise disclaim interest in the proceeds. In this way, the final order of condemnation results in a transfer of clear title to the condemnor. A notice of lis pendens is always recorded at the onset of condemnation proceedings in order to establish the priority of the condemnation claim in the event of post-filing transfers of interests among any of the parties holding property interests in the condemned parcel.

4. *Do all condemnors have the right of immediate possession?*

No. Under the Arizona Constitution, the power of condemnation is inherent only in the State, and can only be delegated to other governmental entities or private concerns by express statutory grant. Although all governmental and most quasi-governmental entities have the power of immediate possession, some entities were delegated condemnation power without the power of immediate possession. An example is Arizona Public Service Company (compare Salt River Project, which as a quasi-governmental entity, has the power of immediate possession). This is why many common transmission corridor projects involving both APS and SRP that result in condemnation have SRP as the plaintiff entity filing the condemnation case. An Arizona federal district court





recently held that interstate natural gas pipeline companies condemning property under the Natural Gas Act generally do not have immediate possession powers.

5. *What about property taxes?*

As you might expect, the property taxing authorities have legislatively pushed their way to the front of the condemnation payment line. Before even immediate possession deposit sums may be withdrawn, the County Treasurer must be assured of getting the first dollars to pay any current or past due property tax assessments. At times this sparks collateral litigation over the amount of taxes due, or whether the statutory tax lien encumbers the condemnation proceeds. Generally, however, the property tax man is going to come before a lender, mechanic's lien holder, or other claimants to the funds.

6. *Do the condemnation procedures differ for a federal taking?*

Yes. There are a entirely different set of procedures and valuation formulas in federal condemnation practice. Many procedures are inconsistent with the usual state court proceedings, so practitioners must be aware of the differences. Federal rules provide for determinations of fair market value by a commission as opposed to a jury, although the Arizona federal practice is to permit valuation issues to go to a jury when requested.

7. *Are there special judges, panels or commissioners to deal with special valuation issues in condemnation?*

Unlike many other states, in Arizona, there are not. Condemnation actions come out of the civil hopper and are assigned to judges together with dog bite and car accident cases. Consideration has been given to create a special division to deal with the unique issues arising in condemnation (just as the Tax Court has been created), but to date those efforts have not borne fruit. The condemnation practitioner needs to be prepared to present a procedural primer on condemnation practice, especially to many of the newer judges who may come from a criminal practice background, or even those with a civil background that did not involve condemnation law.

8. *Who can condemn?*

This is a broad question. Under state statutes, the right of eminent domain may be exercised by the state itself, a county, a city, town, village or political subdivision. The great majority of condemnation actions are brought by the state (usually the Arizona Department of Transportation), the counties, or municipalities. Private utility companies and railroads also have the power of

eminent domain for purposes of expanding their services. Under some unique circumstances, individuals and non-utility private companies may have the power to condemn. Our statutes allow private parties to condemn property for the establishment of private easements of necessity²; obviously, those actions are usually more contested as to the substantive entitlement to taking the private way of necessity, although valuation for the taking is sometimes equally at issue.

9. *Can a client get reimbursement for its residential or business relocation expenses when it is condemned?*

Generally, yes. Relocation benefits, such as inventory expenses, disconnect/reconnection charges, moving expenses, reestablishment costs, and the like, are recognized in state and federal law, and are determined and paid separately from the condemnation process in an administrative procedure. The applicable regulations are tricky, and many condemnees overlook substantial entitlements by not being aware of their rights to recover relocation benefits. Such benefits are also available to tenants and lessees of improvements on real property, even where lease provisions allocate 100 per cent of the proceeds for the real property taken to the fee owner. It is always a good idea in any significant taking to engage the services of a relocation specialist; in some cases, the recovery of relocation entitlements far exceed the amount in controversy in the condemnation action.

10. *Can my client recover its demonstrated business losses arising from a condemnation?*

In most circumstances, no. Business losses are not recoverable under Arizona law, even in circumstances where it is indisputable that the condemnation project resulted in reduced net income to a business. Sometimes the facts support a theory that the property has undergone a change in its highest and best use, which may support a lessening of value in the after taking situation, but that is measured in terms of diminution in value to the property itself, not separate losses to the business being conducted on the property.

11. *What is the latest with Kelo and Proposition 207?*

As mentioned above, the United States Supreme Court 2005 opinion in *Kelo v. City of New London* sparked vigorous discussion about the propriety of using the power of eminent domain for economic redevelopment purposes. A 5-4 majority ruled that eminent domain could be used for such purposes, but the position taken in the vigorous dissents has ended up carrying the day. Two years earlier, in *Bailey v. Myers*, the Arizona Court of



Appeals had issued a contrary opinion.^{3/} Under Arizona’s constitutional prohibition of takings for private purposes, the City of Mesa was not allowed to condemn Bailey’s Brake Shop as part of a redevelopment project. Following *Kelo*, and continued efforts by condemners in Arizona to take property for redevelopment purposes (including the Tempe Marketplace cases in 2005), our voters overwhelmingly passed Proposition 207, the “Private Property Rights Protection Act,” in 2006.^{4/} Prop 207 set higher hurdles for condemnation actions brought for purposes of redevelopment, and also provided that a property owner could bring a claim if government enactments or land use laws reduced the fair market value of property. A great majority of the states have passed similar legislation.

Especially in these tight economic times, condemnation purely for redevelopment purposes has died, for now. Many felt that Prop 207’s claim procedures would open floodgates of property owners seeking just compensation for reasonable land use regulations affecting real property value. This has clearly not been the case, and not a single such case has yet made it to trial. Rather, the probable legacy of Prop 207 is to give government agencies pause in considering the adoption of sweeping land use initiatives that reduce or eliminate an owner’s right to use their property. Stay tuned.

12. How is the interest of a lender or other lien holder dealt with in a condemnation case?

As stated above, assuming the security interests are properly documented, a pre-filing litigation guarantee title report will show any liens encumbering the subject property, and the lender will be named as a co-defendant in the condemnation case. If not, the condemner would be taking title subject to the lien. What happens next is a function of the language in the security documentation and the relationship between lender and borrower. When times were better and commercial loans were performing smoothly with no defaults and healthy equity margins, lenders would typically tender the defense of the action to the property owner and merely passively monitor the case. Application of condemnation proceeds to the loan balance, usually provided for in standard deeds of trust, were a matter of negotiation. In current times, the condemnation can be a “gift horse” to the lender. Condemnation cases now often trigger more aggressive involvement by the lender as a means of seeking sums to pay down the loan balance. Sometimes the parties agree to reserve their claims against each other in order to combine forces to seek the highest fair market

value from the condemner, and engage in ADR mechanisms or a separate hearing to determine the allocation of those proceeds and their application to the loan balance. With the lender typically being entitled to reimbursement of its own fees from the borrower, on top of the borrower’s expenditure of fees for its own counsel, there is a high motivation to resolve such disputes early.


13. What happens in a lease situation where a lessor and lessee dispute both the amount of just compensation offered and the allocation of proceeds among them?

Sometimes you have a three-ring circus in these circumstances. The battle is over the “diameter of the pie,” that is, the amount of total just compensation that can be recovered from the condemner, and the “size of the piece of pie,” that is, the allocation of the sums recovered among the lessor, lessee and potentially other interests. These cases get interesting in circumstances where there is a long-term ground lease or other fractionalized interests in the subject property, where the parties opposing the condemner may include a long-term ground lessor with a remainder interest, the ground lessee, individual tenants, sub-tenants and the occasional mechanic’s lien holder or individual lenders to any of those interests. Again, as in the loan scenario outlined above, the best practice is for the co-defendants to bury the hatchet as to allocation of their respective interests in order to focus on recovery of just compensation from the condemner, then return to the question of allocation among themselves. At times, however, analogous to a bankruptcy proceeding, the parties just can’t get along, and the result may be a free-for-all condemnation trial where different parties are seeking different things from each other. Juries frequently throw up their hands in such settings, especially where sophisticated appraisal techniques are employed and there are complex allocation arguments among the various defendants. Early intervention by competent real estate counsel can save all of the parties, including the condemner, substantial time and money in these circumstances.

14. Can public utility plant and property be condemned? How about a Certificate of Convenience and Necessity?

Yes on both counts under Arizona procedure. A typical example is a municipality deciding to go into the water or electric business and instituting a condemnation action against a private water or electric company doing business within its present or future borders. These takings, generally under Title Nine of the Arizona Revised Statutes, involve more complex right-to-take analyses, and also employ more unusual and creative methods of





appraisal. As cities and towns around the state's major metropolitan areas grow, there have been increasing instances of Title Nine takings, and some wide disparities in the evidence as to what a yet-to-be-built-upon CCN area is worth for condemnation purposes. Also, in Title Nine utility takings cases, unlike standard condemnation cases, business goodwill or "going concern value" is recoverable.

15. Can we win our attorney's fees and expenses if we win the valuation case?

Unlike a few other states, the answer in Arizona is no. Even if a jury sides 100 per cent with your evidence, neither the condemnor nor the condemnee may recover its attorney's fees and expenses as the prevailing party in a condemnation case. An exception is when a condemnor abandons its case, or is determined not to have the right to brought it in the first place. Also, Arizona's courts have recently allowed the use of an offer of judgment procedure, which allows a property owner to recover double its taxable costs and its expert witness fees if a verdict comes in higher than a written offer made to the condemnor before trial.

In Arizona, representation of property owners is typically on a contingency fee or straight hourly basis. As evidenced by the 2008 *City of Scottsdale v. Toll Brothers* verdict in excess of \$80 million, the stakes in these cases can be high. Even in the smaller cases, however, often the property owner's livelihood or retirement nest egg is

in the balance. Although many efforts have been made to add a component of recovery of attorney's fees for the prevailing party to our condemnation statutes, the legislature has been hesitant to do so.

16. What is the future of condemnation in Arizona?

Like many areas of the law, public attitudes and sentiments toward the use of condemnation have swung like a pendulum. Our founding fathers recognized that the appropriate use of eminent domain is necessary as a baseline governmental function of a properly operating society. In a growing state like Arizona, public facilities such as roads, drainage facilities, transportation infrastructure, public entertainment facilities, and other such projects may at times require the power of eminent domain to proceed. At present, however, the *Kelo* backlash has driven many public boards and commissions to the other side of the pendulum in using condemnation only as a last resort. This hostility towards the use of condemnation will inevitably change with time, and it is a given that each of us will encounter some aspect of a condemnation issue in our real estate practices, perhaps on a regular basis. Spotting such issues and providing for their resolution early will make you a better real estate lawyer. 📄

ENDNOTES

1. 125 S.Ct. 2655 (2005).
2. A.R.S. §§ 12-1201 et seq.
3. 206 Ariz. 224, 76 P.3d 898 (App. 2003).
4. A.R.S. §§ 12-1131 et seq.

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