# CONDEMNATION ISSUES IN LEASING: WHO GETS WHAT AND HOW TO GET WHAT YOUR CLIENT WANTS

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# CONDEMNATION ISSUES IN LEASING: WHO GETS WHAT AND HOW TO GET WHAT YOUR CLIENT WANTS

## I. DEFINITION OF A CONDEMNATION CLAUSE

A condemnation clause in a lease provides for the contingency that the leased premises or a part of the leased premises may be taken for a public purpose by an entity with the power of eminent domain before the lease has expired. So that it is not confused with the contingency that the property will be "condemned" for health and safety violations, the clause should clearly state its purpose is to provide for a taking of the property by an entity with the power of eminent domain. For example, the clause might include the phrase, "shall be taken by or sold under the threat of eminent domain to any entity with the power of eminent domain."

## II. NO PROVISION FOR CONDEMNATION IN THE LEASE

### A. Tenant Has A Compensable Property Interest And Will Share In The Condemnation Award

Because Texas operates under the so-called "undivided fee" rule or "unit rule," the distribution of the condemnation award is a zero-sum game. The condemned property is first valued as a whole, without consideration of how many parties own an interest in the property or the extent of each party's interest. The condemning entity will pay the market value of the property and then walk away, leaving the respective owners to fight over the distribution of the condemnation proceeds. The tenant's interest then is determined and the balance is awarded the landlord.[1]

### B. Value Of Tenant's Interest

The tenant will be compensated for the taking or damaging of its leasehold interest.[2] A leasehold interest is calculated as the present market value of the use and occupancy of the leasehold for the remainder of the lease term, plus the market value of the right to renew if such right exists, less the agreed rent the tenant must pay for the use and occupancy of the property. A leasehold interest can have a positive or negative value depending on whether the lease is under market (where the leasehold interest has a positive value), or if the lease involves an obligation to pay an over market rental rate (and thus has a negative value). For example, if the tenant was obligated under contract to pay $1,000 rent per month and market rent on the date of condemnation was $1,200 per month, the tenant would own a monthly $200 positive leasehold interest (a "leasehold advantage"). Theoretically, the tenant could sublet its leasehold interest at market rent and generate $200 of income every month. If the condemnation takes or diminishes the rent the property would receive in the marketplace, the value of the tenant's property interest, or its ability to generate subletting income, would be taken or diminished. Even where a tenant has a negative leasehold advantage, the tenant's property interest is damaged if a condemnation increases the market disadvantage. Of course, if a tenant's above market lease is terminated or "taken" by condemnation (and not merely damaged), the tenant need not pay the condemnor for getting it out of a bad situation.

### C. No Compensation For The Tenant's Business Or Personal Property In Valuing The Tenant's Interest

Because the law presumes the tenant can obtain substitute facilities if it desires, and therefore that the tenant's business is not being taken by the condemnation, no direct compensation is paid in Texas for the value of the tenant's business, or the trade name thereof, or the profits or losses thereof, or the tenant's personal property on the premises in determining the value of the tenant's compensation.[3] Such evidence can be admitted, however,

[1] *Urban Renewal Agency v. Trammell*, 407 S.W.2d 772, 774 (Tex. 1966)

[2] *State v. Parkley*, 295 S.W.2d 457, 460 (Tex. Civ. App.--Waco 1958, writ ref'd n.r.e.)

[3] *Luby*, 396 S.W.2d at 198

if it helps establish the value of the land and any building taken or damaged.[4]

**D. Tenant Will Be Reimbursed For Moving Expenses**

The tenant's personal property is not to be considered in valuing the tenant's interest in the condemnation award because the tenant has the right to move its personal property and it is not being taken. But, the tenant is entitled to reimbursement for the reasonable expenses of moving its personal property. Under the statute providing for reimbursement for moving expenses, the condemning entity may not pay more in reimbursement than the market value of the property being moved and the condemning entity may not reimburse for moving expenses that exceed a distance of 50 miles.[5] If federal monies are involved in the property acquisition, current federal regulations provide for more liberal benefits.

As a practical matter, it is not always clear as to what is personalty, and not taken, and what is damaged or rendered valueless once severed such that it might be considered part of realty taken. The general law of fixtures provides greatest guidance.

**E. Compensation For Fixtures**

Because fixtures are, by definition, part of realty, the condemning entity must compensate an owner for the taking of, or damage or destruction to, fixtures caused by a condemnation. But, if the tenant owns the improvements on the property and is on the property under a month-to-month tenancy, the condemning entities argue they may purchase the landlord's interest, give the tenant notice to vacate, and thereby sidestep the requirement of paying the tenant for any damage or destruction to its improvements.[6] This is because, as the landlord's vendee, the condemning entity is not liable for expenses for which the landlord would not be liable. If the tenant fails to exercise an option to extend a lease, and then the landlord notifies the tenant to remove the improvements, the tenant would have had no cause of action against the landlord for the value of the improvements.[7]

But, a tenant should be paid for fixtures where that tenant's lease would have been renewed, but for a condemnation, and the tenant is other than one with a month to month lease that expires after the government has stepped into the landlord's position,.[8]

**F. Effect Of A Renewal Clause In Valuing The Tenant's Interest**

The tenant's leasehold advantage is valued at the longest possible term. It is calculated as the present value of the difference between the market rent and contract rents for the remainder of the lease term *plus the renewal period if a right to renew exists.* This is because the law presumes the tenant would exercise its renewal option. For example, if the tenant has two years left on its lease when the leased premises is condemned, the tenant will receive the difference between the market rental and the contract rental for those two years. But, if the tenant has two years remaining on its lease term plus an option to renew for five more years, the tenant will receive the leasehold advantage it held for those seven years, rather than just two.[9]

**G. Effect Of A Use Clause In Valuing the Property As A Whole and In Valuing The Tenant's Interest**

When property is taken for public use under the power of eminent domain, the condemning entity must pay the market value of the property being condemned, valued at its "highest and best use."[10] The "highest and best use" is the most profitable use to the landowner that would be legally and physically possible within the

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[4] *City of Dallas v. Priolo*, 150 Tex. 423, 242 S.W.2d 176, 179 (1951).

[5] Texas Property Code § 21.043 (2001)

[6] *Fort Worth Concrete Co. v. State*, 416 S.W.2d 518 (Tex. Civ. App. – Fort Worth 1967, writ ref'd n.r.e.)

[7] *Fort Worth Concrete Co.*, 416 S.W.2d at 522-523

[8] *Almota Farmers Elevation and Warehouse Co. v. U.S.*, 409 U.S. 470, 477-8; 93 S.Ct. 791, 796-7; 35 L.Ed.2d (1973)

[9] *Forth Worth Concrete Co. v. State*, 416 S.W.2d 518, 522 (Tex. Civ. App.--Fort Worth 1967, writ ref'd n.r.e.); *Luby v. City of Dallas*, 396 S.W.2d 192, 199 (Tex. Civ. App.--Dallas 1965, writ ref'd n.r.e.)

[10] *See, e.g., State v. Windham*, 837 S.W.2d 73, 77 (Tex. 1992)

foreseeable future.[11] When a use clause in the lease restricts the tenant's use of the property, it may affect the compensation the tenant would receive in a condemnation proceeding. In that portion of the condemnation litigation to apportion the fee value (based on the property's highest and best use) between the tenant and the landlord, the landlord can be expected to argue that the tenant's leasehold interest is restricted to the value of the actual use (which would be lower based on a less valuable highest and best use of the property, as restricted).

The landlord would argue that its interest does not have a lower value because it is based on the fee value paid by the condemnor and is not limited by the tenant's actual use. This is because the landlord's interest is mathematically calculated by subtracting the tenant's leasehold interest (as limited by the use clause) from the fee value (unlimited by the use clause).

The tenant has a harder argument to make because its use is restricted for the term of its lease. But there is case law to suggest that the tenant's interest is comprised not only of the right to use the property for the limited use, but also of the ability to control a property that has a higher and better use. Without the tenant's acquiescence (abandoning the lease), the landlord cannot realize the property's true value.[12] This leverage would translate to value in the marketplace and should be considered in valuing the tenant's interest.[13]

### H. No Rent Abatement Where Part Of The Leased Premises Is Condemned

When the entire leased premises is condemned, the lease is terminated and the tenant is no longer obligated to pay rent.[14] But, when only part of the leased premises is condemned, and if there is no provision in the lease for the contingency of condemnation, the condemnation does not abate the tenant's obligation to pay rent.[15] Instead, the tenant must continue to pay the rent provided for in the lease and must seek damages from the condemning entity based on the reduced market value of the lease.[16] A partial condemnation may reduce a leasehold advantage to a leasehold disadvantage. The tenant holds a leasehold disadvantage when it has a continuing contract rental obligation that exceeds the market rent for the use and occupancy of the "after" condemnation premises. For example, if the market value of the use and occupancy of the premises before the condemnation was $100 per year and the tenant was only required to pay $90 per year under the lease, the tenant held a $10 leasehold advantage. If the condemning entity takes that advantage, it must compensate the tenant for the present value of that $10 for each of the years remaining in the lease, including the tenant's option to renew if there is one. But, if the condemning entity only takes part of the leased premises such that the tenant is still able to use the premises, but the market rent for the use and occupancy of the lease has been reduced to $70 per year, the condemning entity must compensate the tenant for the loss of its leasehold advantage plus the disadvantage that results from the condemnation. In total, under this scenario, the tenant is entitled to the presents value of $30 per year ($10 for the loss of its leasehold advantage + $20 for the resulting leasehold disadvantage) for the duration of the lease.

## III. APPORTIONMENT-ON-CONDEMNATION CLAUSE INCLUDED IN LEASE

The parties to the lease may provide for the apportionment of the condemnation proceeds in the event of condemnation. Condemnation of a leased premises is more likely to result in litigation than condemnation of a non-leased premises for two main reasons: (1) it is less likely multiple owners of property interests will agree on a settlement, and (2) even if both the landlord and tenant

[11] *State v. Hipp*, 832 S.W.2d 71, 80 (Tex. App. – Austin 1992), *rev'd on other grounds*, 867 S.W.2d 781 (Tex. 1993)

[12] *Irv-Ceil Realty Corp. v. State*, 43 A.D.2d 775, 350 N.Y.S.2d 784 (1973)

[13] And Texas courts are allowed flexibility in tailoring jury instructions defining a "leasehold advantage" in order to fit a particular use. *Urban Renewal Agency v. Trammel*, 407 S.W.2d 773, 777 (Tex. 1966).

[14] *Elliott v. Joseph*, 163 Tex. 71, 351 S.W.2d 879, 881 (1961)

[15] *Elliott v. Joseph*, 351 S.W.2d at 882.

[16] *Elliott v. Joseph*, 351 S.W.2d at 881-882.

agree on a settlement with the condemning entity, they may not be able to agree on the apportionment of those settlement funds. An apportionment clause is a way to increase the chance of settlement in the event of condemnation because it may provide for the method of calculating or method of valuing each party's interest in the property. The apportionment clause may provide for apportionment any way the parties choose.

**A. Examples of Apportionment Clauses**

1. The parties might attempt to eliminate the question of how to calculate the tenant's leasehold when the tenant's use of the property is not the highest and best use. For example, consider the situation where a tenant is using the leased premises as a warehouse, but at the time of condemnation the highest and best use of the property is for hotel re-development. Consider also that the lease only has three years remaining on its term and the condemning entity is convinced the court would hold the property could be developed for hotel within the "foreseeable future" so that the condemning entity is willing to settle on a valuation that considers hotel development as the property's highest and best use. In that situation, is the tenant's leasehold advantage calculated as leasehold advantage of a comparable warehouse property, or is the leasehold advantage valued with regard to the market ground rent for hotel tracts? The parties could agree on the answer in the lease, and avoid litigating the question, by providing that the tenant's leasehold interest is to be calculated using a market rental based either on the use the tenant is making of the premises or the highest and best use of the property as of the date of condemnation.

2. The parties could provide for the appropriation of any future condemnation proceeds without reference to the leasehold value by providing that one party will receive the first $100,000 (for example) of any condemnation award and the other party will receive the remainder. The parties could also provide that the stipulated amount is reduced or increased by a certain percentage every year. This method has the potential problem that the party who is to receive the first $100,000 will want to settle with the condemning entity for that amount and the other party will not want to settle with the condemning entity until the condemning entity agrees to a settlement far in excess of $100,000.

3. The lease should provide for which party will be responsible for paying litigation costs in the event no settlement is reached with the condemning entity (or a settlement is reached only after legal costs have been incurred), or how those costs will be shared.

4. The parties should provide whether the stipulated recovery for a tenant includes fixtures. In one case, where the lease provided that the landlord would receive the first $325,000 of any condemnation award and the tenant would receive the rest, the court did not permit the landlord to receive compensation for the tenant's fixtures in order to reach the stipulated amount because the court held the tenant had a paramount right to receive compensation for the appropriation of its fixtures if, under the terms of the lease, it reserved ownership and title to the fixtures.[17]

## IV. TERMINATION-ON-CONDEMNATION CLAUSE INCLUDED IN LEASE

**A. Purpose**

The purpose of a condemnation clause is to terminate the lease, either in whole or in part, in the event the leased premises is condemned. The effect of a termination on a condemnation clause, standing alone, is to terminate the tenant's interest in the property and extinguish any right of the tenant to share in the condemnation award. Because a termination clause extinguishes the tenant's interest in the property, the landlord is able to negotiate with the condemning entity without including the tenant in the negotiations. And the condemning entity, under certain circumstances, may assert a termination clause to rebut a tenant's claim for compensation.[18]

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[17] Jay M. Zitter, Annotation, *Validity, Construction, and Effect of Statute or Lease Provision Expressly Governing Rights and Compensation of Lessee Upon Condemnation of Leased Property*, 22 A.L.R. 5th 327 § 60[a] (1994), citing *Arlow v. Vinyl Masters, Inc.*, 402 N.Y.S.2d 649 (2d App. Dep't. 1978).

[18] *United States. v. Petty Motor Co.*, 327 U.S. 372, 66 S.Ct. 596, 599, 90 L.Ed. 729 (1946) (a condemning entity, as the landlord's vendee, can assert

**B. Difference Between Termination by Condemnation and Termination By Lease**

The difference between the lease terminating by the condemnation of the leased premises and the lease terminating by the terms of the lease because of the condemnation is that the tenant only has an interest in the condemnation proceeds if the lease terminates by the condemnation instead of the lease.[19]

**C. Termination Clauses Must Be Carefully Drafted**

Termination clauses must be carefully drafted because the court will construe a clause to save the tenant's interest if the language of the clause and the circumstances of the case possibly permit.[20] That is, the court will interpret the clause strictly to favor not terminating the tenant's interest or the lease.

1. Examples Of Clauses That Did Not Effect Termination Of The Lease
   a. *"It is specially understood and agreed by and between Lessor and Lessee that in the event the demised premises are condemned for public use by any governmental agency, or other entity with the power of condemnation, this lease shall cease and terminate and be of no further force and effect, and Lessee shall have no claim or demand of any kind or character in and to any award made to Lessor by reason of such condemnation."*[21]

In this case, the lease included two properties separated by a road. The property north of the road was used as a clothing store and the property south of the road was used for parking. Only a portion of the south tract was condemned. The court held the condemnation clause in the lease did not require an automatic, total and final termination of the lease agreement (as the tenant contended it did) because the clause did not state the lease would terminate if "the demised premises, *or any part thereof*," was condemned.[22]

   b. *A lease did not automatically terminate on condemnation where it provided that condemnation would terminate the "further liabilities" of both the landlord and tenant.*[23]

2. Examples Of Clauses That Did Effect Termination Of The Lease
   a. *"If the whole or any part of the demised premises shall be taken by Federal, State, county, city or other authority for public use, or under any statute, or by right of eminent domain, then when possession shall be taken thereunder of said premises, or any part thereof, the term hereby granted and all rights of the Lessee hereunder shall immediately cease and terminate, and the Lessee shall not be entitled to any part of any award that may be made for such taking, nor to any damages therefor except that the rent shall be adjusted as of the date of such termination of the Lease."*[24]

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an automatic termination clause to dispose of a tenant's interest in the condemned property)

[19]"The issue is not *whether* the leasehold is terminated upon condemnation but *why*. Absent a termination clause, the lease terminates because the leasehold interest has been appropriated for public use, thus giving rise to a right of compensation. With a termination clause . . ., the leasehold interest terminates and expires by the terms of the very contract that created the interest in the first place. Thus, no property interest of the lessee has been appropriated for public use and there is no *constitutional* right to compensation." *Bi-State Development Agency of Missouri-Illinois Metropolitan Dist. v. Nikodem*, 859 S.W.2d 775, 780 (Mo. Ct. App. 1993).

[20]*E.g., Norman's, Inc. v. Wise*, 747 S.W.2d 475, 477 (Tex. App. – Beaumont 1988, writ denied)

[21]*Norman's, Inc. v. Wise*, 747 S.W.2d at 476

[22]Norman's, Inc. v. Wise, 747 S.W.2d at 476-477

[23]26 Am. Jur. 2d *Eminent Domain* § 264 (1996), citing *Maxey v. Redevelopment Authority of Racine*, 288 N.W.2d 794 (Wis. Ct. App. 1980)

[24]*United States v. Petty Motor Co.*, 66 S.Ct. at 598-599 fn 4

In this case, the tenant did not contest that the lease terminated on condemnation. However, the United States Supreme Court did make this comment on the clause: "We are dealing here with a clause for automatic termination of the lease on a taking of property for public use by governmental authority. With this type of clause, at least in the absence of a contrary state rule, the tenant has no right which persists beyond the taking and can be entitled to nothing."[25]

c. *"Should the leased property be taken by right of eminent domain the lease shall be terminated."*[26]

The court held the tenant had no estate or interest in the property remaining after the taking to sustain a claim for compensation, except that the tenant might be able to recover for removal expenses, fixtures or other improvements.[27] Because the case does not discuss any remainder property or give any other indication the condemning entity only took part of the leased premises, it is presumed that the entire leased premises was condemned.

d. *"If the whole or any substantial part of the demised premises should*

*be taken for any public or quasi-public use under any governmental law, ordinance or regulation, or by right of eminent domain, or should be sold to the condemning authority under threat of condemnation, this Lease shall, at the option of the landlord, terminate and the rent shall be abated during the unexpired portion of this Lease effective when the physical taking of said premises shall occur."*[28]

Though this clause provides for termination at the option of the landlord, the court held the lease automatically terminated (without the need for the landlord to properly exercise the option) where the entire leased premises was condemned.[29] This clause invites litigation, however, as concerns what may or may not be a "substantial part."

e. *"If the whole or any part of demised premises shall be sold in lieu of condemnation or shall be taken or condemned by any competent authority for any public or quasi public use or purpose, then, and in that event, the term of this lease shall cease and terminate from the date when the possession of the part so taken shall be required for such use or purpose, and without apportionment."*[30]

**D. Types Of Termination Clauses**

Termination clauses can be either automatic, optional, or mixed. An automatic termination clause provides the lease terminates automatically in the event of condemnation. An optional termination clause is generally drafted to apply to partial condemnations.[31] A third alternative is a mixed clause that provides, for example, for automatic termination in the event the entire leased premises is condemned and optional termination in the event of partial condemnation.

1. Examples of Optional and Mixed Clauses

a. Optional. *"If the whole or any substantial part of the demised premises should be taken for any public or quasi-public use under any governmental law, ordinance or regulation, or by right of eminent domain, or should be sold to the condemning*

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[25] *United States v. Petty Motor Co.*, 66 S.Ct. at 599

[26] *Evans Prescription Pharmacy, Inc. v. County of Ector*, 535 S.W.2d 704, 704 (Tex. Civ. App. – El Paso 1976, writ ref'd)

[27] *Evans Prescription Pharmacy, Inc. v. County of Ector*, 535 S.W.2d at 704, 706

[28] *J.R. Skillern, Inc. v. leVison*, 591 S.W.2d 598, 599 (Tex. Civ. App. – Eastland 1979, writ ref'd n.r.e.)

[29] *J.R. Skillern, Inc. v. leVison*, 591 S.W.2d at 599, 600

[30] Jay M. Zitter, Annotation, *Validity, Construction, and Effect of Statute or Lease Provision Expressly Governing Rights and Compensation of Lessee Upon Condemnation of Leased Property*, 22 A.L.R. 5th 327 § 8 fn 28 (1994) (describes this as the "usual clause")

[31] *See J.R. Skillern, Inc. v. leVison*, 591 S.W.2d at 599, 600 (holding that an option condemnation clause in favor of the landlord results in the automatic termination of the lease if the entire leased premises is condemned)

*authority under threat of condemnation, this Lease shall, at the option of the landlord, terminate and the rent shall be abated during the unexpired portion of this Lease effective when the physical taking of said premises shall occur."*[32]

This clause was given as an example of a clause that resulted in termination (above) because the court held this clause effected an automatic termination of the lease when the entire premises was condemned. As a practice pointer, lease also should specifically provide for the manner in which the option-holder must exercise the option and provide that the lease will not terminate unless and until the option is exercised in such manner.

b. Optional. *"If, during the term of this lease, a part only of said premises be taken for public use under right of eminent domain, and if the remainder, in the opinion of the lessee, is not suitable for its purpose, lessee, at its option, may cancel and terminate this lease, but if it shall not elect so to do, the monthly rental thereafter to be paid shall be reduced by an amount which bears the same ratio to that herein provided for as the area taken bears to the total area prior to such taking."*[33]

Prior to the condemnation, the tenant used the leased property as a gas station. The condemnation destroyed the property's use as a gas station, but the tenant chose not to exercise its option to terminate because it wanted to share in the condemnation award. The landlord argued unsuccessfully that the court should construe the lease to automatically terminate because its purpose was destroyed by the condemnation. The court held the lease only provided for termination at the tenant's option and, if the tenant did not exercise that option, the lease did not terminate.[34]

c. Optional. *"Whether or not any portion of the Leased Premises may be taken by such authority* [an authority having the power of eminent domain], *either Landlord or Tenant may nevertheless elect to terminate this Lease or to continue this Lease in effect in the event any portion of any building in the portion of the Shopping Center outlined in green, or more than twenty five percent (25%) of the Common Area of the Shopping Center be taken by such authority."*[35]

The tenant exercised its option to terminate the lease when more than 25% of the common area was taken by condemnation. The landlord contested the tenant's right to terminate because the condemning entity did not actually physically "possess" the relevant part of the premises, even though it acquired title to the premises. The court held the tenant had the right to exercise its option to terminate because the lease did not limit the option to a taking of actual physical possession.

2. Mixed.

*"If the entire premises be taken in Eminent Domain proceedings, then the lease shall terminate. If any taking of less than all the leased premises * * * is such as substantially to impair the usefulness of the property for lessee's purposes, then at the lessee's option the lease may be terminated; but if the taking if of a portion which does not substantially impair for Lessee's purposes, that is, any portion of the area, as for example, any condemnation for a sidewalk or alley way, or if any condemnation of the right to use for some definite or indefinite period shall occur, it is agreed * * * that the rights, duties and obligations of the parties hereto under the terms of this instrument shall be modified fairly with such abatement of rent as shall fairly and equitably adjust the rights, duties and obligations of the parties hereto under the changed circumstances. . ."*[36]

[32] *J.R. Skillern, Inc. v. leVison*, 591 S.W.2d at 599

[33] *Texaco Refining and Marketing, Inc. v. Crown Plaza Group*, 845 S.W.2d 340, 342 (Tex. App. – Houston [1st Dist.] 1992, no writ)

[34] *Texaco Refining and Marketing, Inc. v. Crown Plaza Group*, 845 S.W.2d at 342

[35] *Weingarten Realty Investors v. Albertsons, Inc.*, 66 F.Supp.2d 825, 840 (S.D. Tex. 1999), *aff'd*, 234 F.3d 28

[36] *Houghton v. Wholesale Electronic Supply*, 435 S.W.2d 216, 218 (Tex. App. – Waco 1968, writ ref'd n.r.e.).

The court held a partial condemnation that destroyed the tenant's use of the premises did not automatically terminate the lease. The condemning entity took the building the tenant had erected and 55% of the land on the leased premises. But, the tenant determined the remaining 45% of the premises was useful for parking and access to the adjacent tract, on which the tenant was able to build. The landlord sought, unsuccessfully, to have the lease declared automatically terminated because the landlord did not want the property used as a driveway and parking lot.

**E. The Relationship Between The Use Clause And The Termination Clause**

The use clause not only potentially affects how the property as a whole and the tenant's interest are valued (as discussed in section II(B)(4),above), but it may also play an important role in whether a partial condemnation of the leased premises terminates the lease. The parties may draft the lease to provide for automatic termination in the event partial condemnation destroys the property for the uses permitted in the use clause. Or, the termination clause may provide for termination at the tenant's option if the lease destroys the tenant's use of the premises (presumably the tenant would not agree to give the power to the landlord to determine whether to terminate the lease if the premises was no longer suitable for the tenant's purposes). The cases below exemplify some situations that may arise when the condemnation interferes with the tenant's historical use of the property.

1. Cases Exemplifying The Importance Of The Use Clause And The Importance Of The Tenant's Use At The Time Of Condemnation

a. In *County of McLennan v. Shinault*,[37] the lease contained the following condemnation clause, which provided for automatic termination in the event a partial taking resulted in the property no longer being suitable for the use the tenant was making of the property at the time of condemnation:

*"If condemnation results in taking only a part of the demised premises, this lease contract and agreement shall remain in full force and effect so long as the remaining portion thereof is capable of being used for the purpose to which lessee had heretofore used such property, with a reduction in the rental price proportionate to the decreased utility to the land remaining."*[38]

b. In *Houghton v. Wholesale Electronic Supply*,[39] the

condemnation destroyed the tenant's use of the property, but the tenant did not exercise its option to terminate because the property was still useful for a different purpose. Though the condemnation destroyed the building the tenant had erected on the leased premises and left only 45% of the leased land remaining, the tenant was able to erect a new building on the adjacent tract. The tenant determined that the remaining 45% of the original leased premises would be useful for access and parking to benefit the adjacent tract. The landlord sought to have the lease declared terminated on the grounds that the use of the premises as a driveway and parking lot violated the use clause of the lease. The condemnation clause and use clause were as follows:

i. Condemnation Clause: *"If the entire premises be taken in Eminent Domain proceedings, then the lease shall terminate. If any taking of less than all the leased premises is such as substantially to impair the usefulness of the property for lessee's purposes, then at the lessee's option the lease may be terminated . . ."*[40]

ii. Use Clause: *"Lessee is specifically permitted and authorized to use the leased premises for the storage, handling, shipping, display and sale of goods and merchandise (including without limitation electrical and electronic items) and related activities and for any other lawful business purpose or purposes. Provided, however, anything stated to the contrary notwithstanding, it is expressly understood*

[37] *County of McLennan v. Shinault*, 302 S.W.2d 728 (Tex. Civ. App. -- Waco 1957, no writ).

[38] *County of McLennan v. Shinault*, 302 S.W.2d at 730-731.

[39] *Houghton v. Wholesale Electronic Supply*, 435 S.W.2d 216 (Tex. App. – Waco 1968, writ ref'd n.r.e.).

[40] *Houghton v. Wholesale Electronic Supply*, 435 S.W.2d at 218.

*and agreed that the leased premises shall not be used for any purpose which tends to substantially reduce the value of the leased property."*[41]

The court held (in favor of the tenant) that the use of the remainder of the leased premises for access and parking complied with the use clause and could not substantially reduce the value of the remainder.[42] As a practice pointer, the landlord should consider restricting the tenant's use of the premises to a specific list of permitted uses or to the use the tenant is making of the property at the time of condemnation. This would have resulted in termination of the lease and the landlord and tenant could then have entered into a new lease for any different use of the property.

c. In *Texaco Refining and Marketing, Inc. v. Crown Plaza Group*,[43] the condemnation clause granted the tenant an option to terminate in the event condemnation destroyed the purpose of the lease. When a partial condemnation did destroy the purpose of the lease (a gas station), but the tenant refused to exercise its option to terminate, choosing instead to share in the condemnation proceeds, the landlord sought to have the lease declared automatically terminated. The court held the lease could not automatically terminate on condemnation because it provided for termination only at the tenant's option, which the tenant did not exercise.[44] The court also rejected the landlord's complaint that the tenant acted in bad faith by continuing to renew the lease even though it was too small to be used as a gas station because, the court said, the tenant had no duty to the landlord to act in good faith in an ordinary commercial contract where there was no special relationship between the parties.[45]

i. Condemnation Clause: *"If, during the term of this lease, a part only of said premises be taken for public use under right of eminent domain, and if the remainder, in the opinion of the lessee, is not suitable for its purpose, lessee, at its option, may cancel and terminate this lease, but if it shall not elect so to do, the monthly rental thereafter to be paid shall be reduced by an amount which bears the same ratio to that herein provided for as the area taken bears to the total area prior to such taking."*[46]

**F. Include A Provision For Rent Reduction or Abatement**

Remembering the rule that the court will strictly construe a termination clause to find that the lease did not terminate and the tenant did not forfeit its interest in the condemnation award if the language of the lease or the circumstances possibly permit, a termination clause should always include a rent reduction or abatement provision. After all, why would the tenant give up its right to share in the condemnation award if the tenant is not released from its obligation to pay rent? Therefore, in the situation that a leased property is taken by condemnation and the lease contains a termination clause but does not provide for rent abatement, the landlord should notify the tenant that the lease is terminated and no further rent payments will be accepted. A tenant in that same situation may want to consider attempting to bypass the termination clause in order to receive a portion of the condemnation proceeds by continuing to tender rent payments despite the condemnation. To avoid this situation, the lease should provide for rent abatement if it includes a termination clause. Consider the following examples:

1. <u>General provision for adjustment</u>

a. Lease provided that in the event of condemnation, "the term hereby granted and all rights of the Lessee hereunder shall immediately cease and terminate, and

[41] *Houghton v. Wholesale Electronic Supply*, 435 S.W.2d at 218.

[42] *Houghton v. Wholesale Electronic Supply*, 435 S.W.2d at 219.

[43] *Texaco Refining and Marketing, Inc. v. Crown Plaza Group*, 845 S.W.2d 340 (Tex. App. – Houston [1st Dist.] 1992, no writ).

[44] *Texaco Refining and Marketing, Inc. v. Crown Plaza Group*, 845 S.W.2d at 342.

[45] *Texaco Refining and Marketing, Inc. v. Crown Plaza Group*, 845 S.W.2d at 342.

[46] *Texaco Refining and Marketing, Inc. v. Crown Plaza Group*, 845 S.W.2d at 342.

the Lessee shall not be entitled to any part of any award that may be made for such taking, nor to any damages therefor *except that the rent shall be adjusted as of the date of such termination of the Lease*."[47]

b. Lease provided that in the event the whole or any substantial part of the leased premises was condemned, the landlord held the option of terminating the lease, at which point "*the rent shall be abated during the unexpired portion of this Lease effective when the physical taking of said premises shall occur.*"[48]

2. Provision for proportionate adjustment

a. Lease provided that in the event of partial condemnation, if the remaining portion was still capable of being used for the tenant's purpose, the lease would remain in effect "*with a reduction in the rental price proportionate to the decreased utility to the land remaining*."[49]

b. Lease provided that in the event of partial condemnation, the tenant held the option to terminate, but if the tenant did not exercise its option, *"the monthly rental thereafter to be paid shall be reduced by an amount which bears the same ratio to that herein provided for as the area taken bears to the total area prior to such taking."*[50]

3. Provision for "equitable" adjustment.

Lease provided that if a partial condemnation did not "substantially impair" the leased premises for the tenant's purposes, the lease would continue in effect but

*"the rights, duties and obligations of the parties hereto under the terms of this instrument shall be modified fairly with such abatement of rent as shall fairly and equitably adjust the rights, duties and obligations of the parties hereto under the changed circumstances. That is, should ½ of the premises be condemned, then the minimum rental would be ½ of the monthly rental. If Lessor and Less cannot agree as to the amount of the rent in the event of a partial condemnation, an appraisal shall be had by appraisers* (one appointed by each party, with a third appraiser to be appointed by the appraisers or the U.S. District Judge)."[51]

The appellate court held that where condemnation left only 45% of the leased premises remaining, the rent was reduced 45% from its original $450 per month to $202.68 per month and no appraisal was required.[52]

4. Provision for fixed reduction.

Where, at the time the lease was executed, the parties to the lease had information regarding a proposed condemnation and specifically provided in the lease for the anticipated condemnation (for example, that the tenant would not construct improvements in the area to be condemned), the lease set a fixed reduction in the rent to take effect once the anticipated condemnation occurred: *"the rent for the remainder of the property not so taken shall be reduced automatically and simultaneously $100.00 per month and this lease shall continue to remain in full force and effect."*[53]

## V. ASSIGNMENT PROVISION

An assignment clause is sometimes included in the lease in addition to or in lieu of a termination clause. It is useful for two reasons: (1) it supports the termination clause (remember that the court will find the tenant did not forfeit its rights if the circumstances possibly permit) and (2) it may be used to broaden the tenant's forfeiture to include improvements (because, as discussed below, a termination clause only forfeits the tenant's right to

[47] *United States v. Petty Motor Co.*, 66 S.Ct. at 599 fn 4.

[48] *J.R. Skillern, Inc. v. leVison*, 591 S.W.2d at 599.

[49] *County of McLennan v. Shinault*, 302 S.W.2d at 730-731.

[50] *Texaco Refining and Marketing, Inc. v. Crown Plaza Group*, 845 S.W.2d at 342.

[51] *Houghton v. Wholesale Electronic Supply*, 435 S.W.2d at 218.

[52] *Houghton v. Wholesale Electronic Supply*, 435 S.W.2d at 219-220.

[53] *Ervay, Inc. v. Wood*, 373 S.W.2d 380, 382 (Tex. Civ. App. – Dallas 1963, writ ref'd n.r.e.).

compensation for its leasehold and does not forfeit the tenant's right to compensation for its improvements).

**A. Examples:**

1. *"the Lessee shall not be entitled to any part of any award that may be made for such taking, nor to any damages therefore"*[54]

2. *"lessee shall have no right or interest in the proceeds received by the lessor in such condemnation, for such property taken"*[55]

3. *"It is expressly understood and agreed that any and all damage and payment awarded or collected for such taking of the property for any public purpose shall belong to and be the property of the Lessor, whether such damage be awarded as compensation for diminution in value to the leasehold or to the fee of the premises herein leased and Lessee shall assert no right or claim to any damage as the result of any such taking"*[56]

4. *"It is specially understood and agreed by and between Lessor and Lessee that in the event the demised premises are condemned for public use . . . Lessee shall have no claim or demand of any kind or character in and to any award made to Lessor by reason of such condemnation"*[57]

## VI. CONSIDER THE IMPROVEMENTS

One goal of a termination-on-condemnation clause is to provide for the most efficient manner of achieving a settlement or final judgment in a condemnation proceeding (on the premises that such is easier to do with fewer parties involved). But, a termination clause may not achieve this goal if the lease does not provide for the improvements on the condemned property also, because the tenant may be entitled to part of the condemnation award to compensate for damage to the improvements if the tenant retains ownership to the improvements on termination of the lease.[58]

**A. Solutions**

1. Provide For The Tenant To Receive A Set Amount For The Improvements Off The Top

This is similar to the proposed apportionment solution where one party will receive a fixed amount off the top of the condemnation proceeds, leaving the other party to negotiate for a greater total amount in order to have a recovery for itself. If the parties have agreed that the tenant owns all the improvements on the property, the tenant has a right to be compensated with condemnation proceeds for any damage to those improvements, even if the tenant's lease expires on condemnation and it has no right to seek compensation for the destruction of its leasehold advantage.[59] But, the landlord and tenant can agree on the value of the improvements or on a method of valuing the improvements so that the tenant is not really a party to settlement negotiations.

2. Assign All Rights In The Condemnation Award, Including Compensation For Damage To Any Improvements, To The Landlord

The landlord may be able to negotiate for all the condemnation proceeds, even if the tenant owns the improvements. If so, the lease should include an assignment provision whereby the tenant assigns its right

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[54] *United States v. Petty Motor Co.*, 66 S.Ct. at 599 fn 4.

[55] *County of McLennan v. Shinault*, 302 S.W.2d at 730.

[56] *Ervay, Inc. v. Wood*, 373 S.W.2d at 382.

[57] *Norman's, Inc. v. Wise*, 747 S.W.2d at 476.

[58] 26 Am. Jur. 2d *Eminent Domain* § 265 (1996) (a lease provision terminating the lease and assigning damages) to the landlord has been interpreted as only depriving the tenant of compensation for the value of the leasehold and not as depriving the tenant of compensation for improvements).

[59] *See, Evans Prescription Pharmacy, Inc. v. County of Ector*, 535 S.W.2d at 704, 705 (where the lease included a termination clause, the condemning entity still paid the tenant for damages to its trade fixtures and the court held that the tenant could recover for its fixtures and improvements even though it was not entitled to recover for its leasehold interest).

to any and all proceeds of the condemnation to the landlord, including proceeds that represent compensation for improvements.[60]

a. Example. Where the lease provided that the tenant assigned its rights to the condemnation award if a specific part of the leased premises was condemned ("*It is expressly understood and agreed that any and all damage and payment awarded or collected for such taking of the property for any public purpose shall belong to and be the property of the Lessor, whether such damage be awarded as compensation for diminution in value to the leasehold or to the fee of the premises herein leased and Lessee shall assert no right or claim to any damage as the result of any such taking*")[61] and that the tenant could remove its improvements at the end of the lease term,[62] the court held the tenant was entitled to no portion of the condemnation proceeds for that part of the premises.

3. Provide That The Tenant May Remove Any Improvements It Has Placed On The Property At The End Of The Lease Term

When the lease includes a termination clause, the condemning entity will step into the shoes of the landlord on the date of condemnation. The condemning entity must allow the tenant a reasonable time to remove its improvements and the condemning entity will not usually be required to pay the tenant for the improvements, even if it is impossible to move them, if the landlord would not have been required to pay for them. But, see section II(B)(2), above.

a. Examples.

i. See the example in section VI(A)(2)(a), immediately above[63].

ii. Where the lease provided that the tenant owned the improvements, but the lease had expired before the date of condemnation and the tenant was still on the property on the date of condemnation as a month-to-month tenant only (because at the time the lease was to be renewed, the parties knew the property was about to be condemned and so had not renewed the lease), the court held the tenant had no compensable right in the condemnation proceeds despite the damage to its improvements because if the landlord, the condemning entity's vendor, had elected not to continue the tenancy and had notified the tenant to remove the improvements, the tenant would have had no cause of action against the landlord for the value of the buildings, and the condemning entity, as the landlord's vendee, "obviously assumed the same relationship to appellant [the tenant] previously borne by its vendor."[64]

iii. But, see §II(B)(4), above, where a tenant recovers even though the lease expired where there was an expectation it would continue but for the condemnation.

iv. Note: The government cannot avoid paying for improvements by claiming a lease, that let a tenant remove his building at the end of his lease, converted the improvements to personalty for which compensation is not paid.[65]

4. Provide That The Landlord Owns The Improvements At The End Of The Lease Term

If the lease includes a termination clause, the landlord will obtain ownership of the improvements (presuming that the landlord did not already own the improvements) on the date of condemnation because that will also be the end of the lease term. Therefore, if the lease provides that the landlord will own the improvements at the end of the lease term, the tenant will

[60] *See* 26 Am. Jur. 2d *Eminent Domain* § 265 (1996).

[61] *Ervay, Inc. v. Wood*, 373 S.W.2d at 382.

[62] *Ervay, Inc. v. Wood*, 373 S.W.2d at 382.

[63] *Ervay, Inc. v. Wood*, 373 S.W.2d at 382.

[64] *Fort Worth Concrete Co.*, 416 S.W.2d at 520, 522-523.

[65] *Texas Pig Stands, Inc. v. Krueger*, 441 S.W.2d 940, 945 (Tex. Civ. App.--San Antonio 1969, writ ref'd n.r.e.)

have no compensable interest in the condemnation proceeds even if the tenant owned the improvements before the property was condemned.

### B. Make Some Provision For Improvements Even If It Is To Award All Compensation For Improvements To The Tenant

Even if the parties agree that the tenant should receive all the compensation for damage to the tenant's improvements in the event of condemnation, the parties should so provide in the lease in order to avoid litigation. For example, in *County of McLennan v. Shinault*,[66] the court held the tenant was bound to its measure of damages provided in the lease (compensation for its improvements only) where the lease provided that in the event the leased premises or any part thereof was condemned, the tenant would have *"no right or interest in the proceeds received by the lessor in such condemnation, for such property taken. . . However, in the event any of the demised premises shall be taken as hereinabove mentioned and proceeds received for the removal of improvements thereon, or damages to such improvements, then and in that even such amount or amounts received as damages or for the removal of property shall belong to the lessee and paid directly to him."*[67]

## VII. LENDERS SHOULD CONSIDER CONDEMNATION

The mortgagee should not lend money for development without requiring a provision in the lease that the first distribution of condemnation proceeds will be applied to pay off the loan. If the loan is sought by the tenant, the mortgagee should not make the loan if the lease is already in effect (without subordination or lease amendment) and it has a termination clause. The parties may still contract for the landlord to receive the remainder of the money after the loan is paid off by providing therefor in an assignment clause.

## VIII. HOLDOVER TENANT OR MONTH-TO-MONTH TENANT

There is some authority that a holdover tenant can stand in no better position than it held under its expired lease.[68] Potentially this means that if the expired lease included a termination clause, the holdover tenant has no right to any condemnation proceeds if the leased premises is condemned during the holdover period, even though the lease has expired according to its terms. Generally, this will not be a concern because a holdover tenant will hold a month-to-month tenancy, which is not compensable in condemnation.[69]

The predictable situation where there would be a holdover tenant on the date of condemnation was presented in *Fort Worth Concrete Company v. State*.[70] In that case, the lease had a renewal clause but the tenant did not exercise its right to renew because condemnation was imminent at the time the original lease term ended. Instead of renewing the lease, the landlord and tenant agreed the tenant would continue to occupy the premises and continue paying rent month-to-month until the condemning entity took possession of the property. The tenant had erected improvements on the property which were still there on the date the property was condemned. The tenant did not claim any right to compensation for its leasehold interest, but did claim it was due compensation for the damage to its improvements. The court denied its claim, reasoning (1) that a tenant by sufferance or from month to month has no interest that entitles him to compensation when the leased property is condemned and (2) that the condemning entity, as the landlord's vendee, was not liable for costs the landlord would not have been liable to pay (and the tenant would have had no cause of action against the landlord for the

[66] *County of McLennan v. Shinault*, 302 S.W.2d 728 (Tex. Civ. App. -- Waco 1957, no writ).

[67] *County of McLennan v. Shinault*, 302 S.W.2d at 730.

[68] Jay M. Zitter, Annotation, *Validity, Construction, and Effect of Statute or Lease Provision Expressly Governing Rights and Compensation of Lessee Upon Condemnation of Leased Property*, 22 A.L.R. 5th 327 § 59 (1994), citing *Conklin v. State*, 361 N.Y.S. 2d 743 (3d App. Dep't. 1974), *aff'd*, 343 N.E.2d 755.

[69] *Fort Worth Concrete Company v. State*, 416 S.W.2d at 521.

[70] *Fort Worth Concrete Company v. State*, 416 S.W.2d at 518 (Tex. Civ. App. – Fort Worth 1967, writ ref'd n.r.e.).

value of the improvements if the landlord had elected not to continue the tenancy).[71]

## IX. CONCLUSION

### A. Factors To Consider When Drafting A Condemnation Clause

1. Apportionment of the condemnation award in the event of a whole taking
2. Apportionment in the event of a partial taking
3. If the tenant is to receive some compensation, how to value the tenant's interest and what role the use clause plays in that valuation
4. What effect the use clause will have on the value of the entire property
5. Which party is to receive compensation for improvements
6. When the lease will terminate, when it will not, whether it will terminate automatically or at one party's option
7. Circumstances in which rent will be abated or reduced and by how much
8. Lender's requirements

### B. Recommendations

1. Do not use the language that condemnation will "terminate the further liabilities of lessor and lessee" as a termination clause. It may not extinguish the tenant's interest in the condemnation proceeds.

2. The landlord should consider negotiating for a narrow use clause to prevent the tenant from using the premises for an undesirable purpose if the condemnation leaves the premises unsuitable for the purpose the tenant was making of it at the time of condemnation. Of course, the converse is true for the tenant

3. But, both parties should consider the effect of a restrictive use clause on the value of the property on the date of condemnation.

4. Do not use the language that condemnation of the "demised premises" will terminate the lease because such language may result in automatic termination only if the entire premises is condemned. Consider whether the lease should automatically terminate if only part of the premises is condemned, which part, and draft the lease to provide for that contingency.

5. If the landlord negotiates to hold an option to terminate, the tenant should negotiate to include the manner in which the landlord must exercise that option and draft the lease to provide that it will not terminate unless and until the landlord exercises the option (to prevent surprise automatic terminations when the whole or a substantial portion of the leased premises is condemned under the theory that the landlord must have intended to exercise the option)

6. If a specific condemnation project is anticipated at the time the lease is drafted, do specifically draft the lease to provide for the anticipated taking. But, do not fail to consider that a different condemnation, which is not anticipated, may occur in the future. This may result in two condemnation clauses: one that provides for the anticipated condemnation and one that provides in general for any condemnation that may occur.

7. Provide for rent abatement. And remember, anything less than an objectively determined calculation for the abatement could lead to litigation.

8. If the tenant is on the leased premises under a lease that will permit it to share in a condemnation award and which includes a renewal option, the tenant should exercise the renewal option even if condemnation is known to be imminent at the time the original lease term expires in order to share in the condemnation award.

9. If a lease contains a termination clause but no provision for rent abatement, the tenant should consider continuing to tender rent in an effort to bypass the termination clause and receive a portion of the condemnation proceeds. The landlord should notify the tenant the lease has terminated and no further rent payments will be accepted.

[71] *Fort Worth Concrete Company v. State*, 416 S.W.2d at 521, 522-523.

10. Even if the landlord is not able to negotiate for a termination clause, it should consider attempting to negotiate for a termination of any renewal option if the leased premises is condemned. The tenant should consider the effect of renewal options on the valuation of its leasehold interest in the event of condemnation.

11. Be very leery of providing for subjective criteria for terminating a lease, such as providing for termination is the "tenant's use of the property is *substantially* impaired." Where parties will be able to fairly disagree on whether such criteria has been met, their use invites litigation.

12. Be careful of apportionment provisions, or rent abatement provisions, that bear no relationship to actual economic considerations, such as providing that lease payments will be reduced after a condemnation in proportion to the land area lost (where the loss of little area, but of all the parking area, may cause a disproportionate damaging of the leasehold value).