

# The Color of Just Compensation

## Toning black letter law in utility condemnation cases.

**G**overnment agencies sometimes condemn privately owned operating utilities for their own use. Water companies, landfills, hydro-electric plants, and transportation lines are examples.

But these cases pose a problem: How to measure "just compensation," especially when regulators set the rates charged (and profits earned) by a privately owned utility at artificially low levels, even when the commodity is scarce and the need for the service high. What elements underlie valuation when there are no recent sales of similarly situated, or "comparable," utility properties to look to?

Courts emphasize flexibility in setting "just compensation" under the Fifth Amendment and similar provisions of state constitutions. Yet, all too often, condemnation commissioners and trial courts adhere to "black letter" rules of valuation. In fact, many circumstances compel a variation—a "toning"—of the black letter law.

"Value," or "market value," is ordinarily measured by the purchase price that, in all probability, would emerge from fair negotiations between an owner who is willing, but not forced, to sell, and a buyer who is willing, but not forced, to buy. That definition raises another question: What is the highest and best use to which the condemnee could legally have put his property?

Fact-finders normally employ three methods to determine market value: 1) the comparable sales approach, 2) the reproduction cost approach, and 3) the capitalization of income approach. In most cases, these methods are applied mechanically. The adjudicator examines comparable sales; if there are none, it looks to reproduction cost minus depreciation or capitalization of income. Other "rules" of condemnation often come into play: "The value of the property must be determined based upon the value in the hands of the condemnee, not in the hands of the condemnor"; "Comparable sales is always the best indicator of value"; "The business profits of the condemnee cannot be considered in determining value"; and "Lost earnings of related companies are not to be considered."

Nevertheless, courts have recognized that "just compensation" is not always a black-and-white

process. Sometimes the "light" of the circumstance must be allowed to tone the black letter rules.

### Black Letter Rule:

*Measure value of property in the hands of the condemnee (utility), not the condemnor.*

What if regulation depresses utility rates? In that case, should adjudicators look to the prospective unregulated income of the condemnor as an indication of value? The answer depends on the circumstances.

Nichols, in his treatise, *Eminent Domain*, frames the issue as dependent upon whether price controls create a market that is "purely artificial," or whether regulations leave standing a "free, open, and competitive market."<sup>1</sup> The U.S. Supreme Court has put it this way: Where price regulation and control create a special hardship, such pricing may not form the basis of a determination of just compensation.<sup>2</sup>

So when does price regulation create a special hardship? If the price regulation does not cover all similarly situated utilities, or does not effectuate the valid governmental purpose throughout the franchise area, then fundamental fairness should demand reliance on unregulated rates to set just compensation.

**A utility's value is often tied inextricably to the unique characteristics of the land itself—a stream, reservoir, or watershed.**

For example, suppose that a particular state regulates the "tipping fees" charged to solid waste haulers for disposal at privately owned landfills, but not at public landfills. Suppose further that 18 out of 20 landfills in the state are public and, being unregulated, charge an average of \$80 per ton to tip. Suppose regulators had set a tipping fee of only \$40 per ton at a privately owned landfill subject to condemnation. Clearly, the hearing commissioners in the

<sup>1</sup>Nichols, *Eminent Domain*, (Rev. 3d Ed.), vol. 4, Sec. 12.04.

<sup>2</sup>*U.S. v. Commodities Trading Corp.*, 339 U.S. 121, 129 (1950).

## More Than Scrap

Some 30 years ago, the Port Authority of New York and New Jersey condemned the tunnels and railway system that comprised the "Hudson Tubes" (now known as the PATH System). A long-standing private railway linking 33rd Street, Manhattan, with terminals in Hoboken and Jersey City, NJ, the Hudson Tubes faced bankruptcy.

It would have cost at least \$100,000 to plug the tunnels. Other assets, including over 200 passenger cars, an electrical transmission and distribution system, electrical substations, and passenger stations, would have required \$32 million to rehabilitate.

But the New York court went beyond black letter law and considered the value of the property in the hands of the condemner: "A condemner should not be permitted to tell [the former owner]: 'It's only worth scrap or less.'"

*Port Authority Trans-Hudson Corp. v. Hudson Rapid Tubes Corp.*, 20 N.Y.2d 457, 231 N.E.2d 734, 285 N.Y.S.2d 24 (1967), cert. denied, 390 U.S. 1002 (1968).

condemnation case should look beyond the regulated rate. If the \$80-per-ton tipping fee reflects the market, commissioners should use that higher fee to capitalize income to set property value. This result violates black letter law, but satisfies notions of fundamental fairness.

Similarly, in a recent New York case, the court affirmed a condemnation award reflecting the full value of property operated as a landfill, even though a municipal ordinance banned private landfills, which had led the municipal condemner to offer compensation only for the property's next best use—as a county recreational area. It declared that, "an owner whose property has been taken is not to be limited to the use he made of the property, but is entitled to the market value based on the most advantageous use, even though the owner may not have been utilizing the property to its fullest potential when it was taken."<sup>3</sup>

When a condemning authority takes a utility by eminent domain, condemnation commissioners should consider the value of the utility in the hands

of the taker. The black letter rule that shuns this consideration has no place where the market of owners and operators consists largely of governmental agencies. Thus, the relevant inquiry in these cases should be: What would the government pay voluntarily to purchase the utility if it had no condemnation power? If the agency believes that it needs to provide the service, it would probably pay an amount approaching, but somewhat less, than the cost to establish the utility itself, plus an amount representing the risks involved in constructing and establishing a new business (entrepreneurial incentive), minus depreciation.

Moreover, the acquisition of a utility by a governmental agency may result in increased profits because of a synergy between the new utility and an already owned utility. If the government owns a sewage plant, for example, it might use the treated sludge as cover material at a landfill it acquires instead of paying for disposal, at substantial savings. Also, landfill operators can sell the methane gas byproduct as a fuel. These factors are relevant in determining what a non-coerced buyer—in this case a governmental agency—would have paid after negotiations with a non-coerced seller.

### **Black Letter Rule:**

*Disregard profits of business conducted on the property.*

While it has been said that business profits are inadmissible evidence of the value of the land on which the business is located,<sup>4</sup> this rule often proves unjust in utility condemnations, since the condemnation effectively ejects the owner from its business.

It is unjust because the value of a utility is often inextricably tied<sup>5</sup> to the unique characteristics and income-producing capabilities of the land itself—a stream located on the land of an electric company; a reservoir on property owned by a water company; a quarry pit surrounded and underlaid by natural barriers, ideal for landfill purposes. In most condemnations, the condemnee can use the proceeds to restart its business anew at a different location. But where the condemnee's business is inextricably tied to the condemned land, the business is terminated.

In utility condemnations, the value of the land in business use must often be considered if the condemnee is to be justly compensated for the taking (*see sidebar*).

### **Black Letter Rule:**

*Ignore income of affiliates of the condemnee.*

Regulators usually limit the rate of return earned by utilities through a cost-plus formula. But state laws generally allow regulated utilities to form

<sup>3</sup>*Town of Esopus v. Gordon*, 557 N.Y.S.2d 732, 162 A.D.2d 829 (1990).

<sup>4</sup>*St. Louis Housing Auth. v. Bainter*, 297 S.W.2d 529, 534 (Mo.1957).

<sup>5</sup>*See, City of St. Louis v. Union Quarry & Constr. Co.*, 394 S.W.2d 300 (Mo.1965), capitalizing income from landfill operations to set value for a condemned landfill, in lieu of relying on comparable sales of nearby residential property, since the business was deemed "inextricably related to and connected with the land."

related companies to provide services to the utility at market rates that include market rate profits. Should "just compensation" for utility property reflect profits earned by unregulated affiliates?

Bearing in mind that a utility condemnation will often effectively put the owners out of business (since it is often difficult to reestablish the utility due to a lack of suitable sites or franchise restrictions), a good argument can be made that adjudicators should consider the income earned by unregulated affiliates when valuing the loss from the taking of regulated property.

Courts have recognized in other contexts that legal niceties must sometimes yield to achieve just compensation under the Constitution. A prevailing rule in condemnation is that damages are only to be awarded to the owner of the property being

---

<sup>6</sup>See, e.g., *Dept. of Transp. v. Arnold*, 268 S.E.2d 775, 154 Ga.App. 502 (1980); *Housing Auth. of Newark v. Norfolk Realty Co.*, 71 N.J. 314 (1976).

condemned; owners of adjacent or nearby lots, under normal circumstances, cannot recover damages in the condemnation proceeding. Courts recognize an exception where there is unity of use and ownership between separate lots, and the value of the lot not being condemned has been diminished as a result of the condemnation.<sup>6</sup>

Such reasoning could, and probably should, be extended to utility condemnations, to allow compensation for the lost profits of related entities whose business is inextricably tied to the condemned property. ▼

---

*William D. Grand is a member of the Woodbridge, NJ, law firm of Greenbaum, Rowe, Smith, Ravin & Davis. In a recent condemnation case, the firm obtained a \$34-million award for the owners of a landfill after the condemnation authority had appraised the property at \$3.5 million.*