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Eminent Domain

The Risk And The Reality

By Dean Dennis



their neighborhoods. If the city of New London could force an old widow to sell the family homestead so that Pfizer, the pharmaceuticals manufacturer, could build a new research facility, what could be next?

Indeed, much of the initial hysteria about *Kelo* was overblown. Wal-Mart has little interest in most neighborhoods. But the reaction of people across the country in all walks of life was genuine and real: How can that be right? How can that be fair? Isn't private property one of the essential rights protected by the Constitution?

As noted by Justice Sandra Day O'Connor in her dissenting opinion, "Under the banner of economic development, all private property is now vulnerable to being taken and transferred to another private owner, so long as it might be upgraded—i.e., given to an owner who will use it in a way that the legislature deems more beneficial to the public—in the process."

Indeed, this is exactly what has happened to Arcadia Self-Storage in Arcadia, Calif. And it may be coming to self-storage facilities near you.

When the United States Supreme Court decided *Kelo v. City of New London* last summer, eminent domain—the sovereign right of the government to take private property for public use—became a hot topic of conversation. Suddenly, what had been a sleepy backwater of the law that was of interest to no one but government officials, a handful of property rights lawyers, and those owners immediately affected, became the darling topic of the cocktail

circuit. You see, the Supreme Court actually held that, in addition to acquiring property for public works, the government may legally take private property—even a family home—and, upon paying compensation, give it to another private party all in the name of the "greater public good."

In this case, the greater good was economic development. Suddenly, people imagined Wal-Mart® stores springing up in

An Attractive Target?

In Arcadia, the number one sales tax producer is a large Mercedes-Benz dealership. Under the banner of redevelopment, the city is forcibly acquiring five private businesses, including Arcadia Self-Storage, to enable the dealership to expand its repair and maintenance operations and better serve its customers. And although Arcadia has yet to formally file an eminent domain lawsuit, the downside for the city if it doesn't acquire these properties is that it could be devastating financially. The auto dealership has threatened to leave town and take its sales tax money machine to another neighboring community if it cannot get the space it needs.

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Similarly, in Hoboken, N.J., the city is contemplating a plan to take a U-Store-It facility by eminent domain and hand it to a developer for a 150-unit luxury condominium complex. While upscale residential is not the sales tax generator that an auto dealership is, luxury housing does tend to attract upscale businesses and can be used as a powerful generator for economic redevelopment.

So from sea to shining sea, private property is increasingly being singled out for involuntary acquisition by a government looking to transfer property from what it regards as underperforming uses to other, "more beneficial," private users.

These scenarios, or ones like them, are being played out in the cutthroat competition between neighboring communities for the major sales tax producers—a category that does not include self-storage. In many cities and towns, that fact may make self-storage facilities attractive targets for high-minded "redevelopment efforts." And this may be true no matter how new and shiny your facility looks.

Why Is Self-Storage Vulnerable?

Increasingly, the properties slated for acquisition need not be in ramshackle condition or in the gun sights of the building inspector. Properties being acquired today are in perfectly good shape and in many cases, producing a generous return for the own-

ers. They just also happen to be "underutilized" properties when it comes to a city's ever expanding desire for sales tax revenue.

What makes self-storage companies vulnerable to eminent domain? The list is pretty obvious:

- Most self-storage facilities are not locally owned. With a nod of the cap to former House Speaker Thomas P. "Tip" O'Neill, "all politics are local." This is especially true for government acquisitions where it is more important who you know rather than what you know. An absentee self-storage landlord often does not have the local political stroke needed to avoid eminent

domain. When the city fathers are searching out just the right spot for the next big project, they are not going to pick those properties owned by the pillars of the community, the chamber of commerce president, or the local Elks or American Legion Lodge. But an out-of-town owned self-storage business? Perfect.

- Most self-storage tenants are month-to-month. One of the complexities of eminent domain is the cost and hassle of relocating and compensating long-term tenants. In many states, a tenant with a lease may be entitled to compensation for the economic value of the remaining lease term, the loss of business goodwill in a given location, the cost of relocating to a new facility, and fixtures, equipment, and inventory.

With self-storage tenants, who can usually be terminated on 30 days notice, the condemning authority will have none of these problems. If a storage tenant has no expectation of being able to remain in that location for more than 30 days, it generally has no compensable interests. The condemning agency can move quickly to obtain possession of the property without the messiness of compensating tenants.

- In many areas, self-storage facilities have a scarce commodity: land. If you asked urban planners what is the most difficult part of their job, many would tell you finding land for the projects they want to complete. In Los Angeles, for example, the Los Angeles Unified School District is in the process of acquiring land for over 80 new public schools. How to fit these new schools, each requiring from five to 25 acres, into an urban landscape that is largely built out is a serious challenge.

To assemble the needed real estate, eminent domain is indispensable. And self-storage facilities could provide part of the answer. Twenty or more years ago, storage facilities were often built on underutilized parcels and sometimes involved excess land that could be used for storing RVs or boats. Especially in urban areas, the luxury of readily available land exists no more. And these storage parcels are now being eyed for what public agencies regard as higher and better uses.

- Self-storage facilities are generally not sympathetic uses. There is an unwritten (and occasionally written) rule in many communities that city fathers will not use eminent domain to acquire residential properties, no matter how great the need for a public project. Forcibly kicking someone out of his or her home, no matter how generous the compensation offered, runs counter to many Americans' sensibilities. That the city of New London was taking people's longstanding family homes to demolish and transfer to Pfizer is the single reason the case caused such a stir. If the target had been a fish company or a shipyard, nobody would have much noticed.

As well, long-established popular businesses serving the needs of a community can also obtain the free pass exemption from eminent domain. In the Arcadia case, the city had to back off a planned condemnation of Rod's Grill, a historical Route 66 greasy spoon diner that had been a favorite in town for many years. Rod's Grill hung banners in its storefront windows urging the com-

munity to “Stop Eminent Domain.” It circulated petitions to all its customers urging the city to reverse course. And guess what? The citizens did just that in the next election cycle by electing city council members who pledged to save Rod’s Grill.

Despite the fact that many people now regard their self-storage unit as an absolute necessity, it does not stir the same emotion as the taking of a widow’s home or an institutional favorite like Rod’s Grill. As a result, public acquisition of self-storage may not generate much community reaction or vehement opposition. For city officials seeking out the path of least resistance, a non-emotional target makes imminent good sense.

TYPICAL EMINENT DOMAIN PROCESS

While the exact details of acquiring property by eminent domain vary from jurisdiction to jurisdiction, the process generally works like this:

- The property owner is notified by mail and will soon be visited by a government employee, often a “right-of-way” agent, who will further explain why the owner’s property is needed.
- The government will appoint an independent appraiser to evaluate the land and come up with a fair price to pay the land owner for his or her land—the “just compensation.”
- The property owner and the government may negotiate to come up with a final price to be paid the property owner. In some cases, a judge or a court-appointed arbitrator will be called in to oversee the negotiation.
- The owner is paid the agreed price and ownership of the property is transferred to the government.

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- Self-storage produces little or no sales tax revenue. And this may be the big kicker that convinces local officials to target self-storage for acquisition. As local government looks for more creative ways to finance public projects, large sales tax producers have become the lynchpin to almost every community’s strategy. Indeed, many of the eyebrow raising projects using eminent domain have been to benefit big box retailers or auto malls (the proverbial sales tax cash cow) at the expense of other “underperforming” businesses.

In Lancaster, Calif., the city attempted to drive out a perfectly profitable 99 Cents Only Store® to pave the way for a bigger and better Costco®—even though the 99 Cents Only Store was producing a modest amount of sales tax and Costco already had an existing location in the city. The city simply could not risk losing Costco to a neighboring community. Period.

While each of these reasons why self-storage properties are susceptible to eminent domain rings true, there is also at least one significant disincentive for public agencies to acquire self-storage. Price. In any condemnation case, the condemning agency must pay the property owner fair market value as “just” compensation. And while there will always be disagreement on the price to be paid for individual properties, there can be no disagreement that the fair market value of self-storage properties as a real estate investment category has increased dramatically as land values have continued to skyrocket and cap rates have dropped. To the extent that self-storage properties have outpaced other real estate investments in overall value growth, an agency seeking to acquire a storage site by eminent domain may have to think twice.

Plotting A Course Of Action

If a public entity is considering acquiring your storage property for a public project, what is the best course of action? Although laws vary from state to state, in most places fighting the “right to take” (i.e., the government’s legal entitlement to acquire your property separate and apart from the question of what compensation should be paid) is a futile, throwing-good-money-after-bad effort. From time to time, there is an example of an

owner who has prevailed in challenging the right to take, but these are rare situations. So the first big challenge when the government knocks at your door is resigning yourself to the fact that the acquisition will indeed happen.

Once reality settles in, the owner’s efforts should be focused on increasing the compensation the government will pay. The condemning authority will typically make an initial offer of just compensation far below the fair market value it is constitutionally obligated to pay by using its stable of “lower than a snake’s belly” government appraisers. The job of the owner is to hire advisers, both legal and appraisal, who have substantial experience with eminent domain. Your family attorney and friendly real estate broker probably do not have the requisite expertise to navigate these choppy waters. But with the right team in place, the results are often very satisfactory for the impacted owners.

There are also some hidden benefits to eminent domain. For example, in California and many other states, a property owner whose facility is taken by eminent domain can legally avoid a pre-payment penalty in its financing agreements with a lender. If an owner has been locked into an unfavorable loan by a sizable pre-payment penalty on sale, acquisition by eminent domain will eliminate that obligation as a matter of law.

Similarly, sale of an investment property often requires a 1031 exchange to avoid unnecessary capital gains treatment. The difficulty with a 1031 exchange arises from the relatively short time periods given to identify replacement property and complete the transaction. Under the Internal Revenue Code provisions on eminent domain, the time periods for completing the equivalent of a 1031 exchange are quite generous. The IRS gives those owners who are condemned plenty of time to find and acquire replacement property without adverse tax consequences.

What does the future hold for public agencies seeking to use eminent domain to acquire underperforming properties and exchange them for sales tax juggernauts? It will probably take another two years before the real effects are known.

With the classic “be careful what you ask for” consequences of a high profile legal decision, the political blowback from the *Kelo* case has been swift and strong. Many communities and approximately 40 states have

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adopted or are considering bans on eminent domain to assist other private owners with "economic development." During this last election cycle, voters in Orange County, Calif., removed this weapon as an option for their elected county supervisors. Ronald Chen, New Jersey's new Public Advocate, announced that his first priority will be to review the use of eminent domain for private development. And in other places, while no legislation has been formally proposed, state and local legislative bodies have been intimidated by the anticipated negative reaction if they use eminent domain for private development.

Even occasionally communities are rising up in opposition to the use of eminent domain for heretofore well-accepted public improvement projects like roads, libraries, and schools. It remains to be seen whether this negative reaction to *Kelo* and its "chilling effect" on local government use of eminent domain continues or fades along with the memory of the case.

Since many property owners will never be affected by eminent domain, arguments about the use or abuse of the government's acquisition power are more theoretical than immediate. Even sophisticated real estate owners regard eminent domain as a very distant threat—if a threat at all. The eminent domain clause in long-term leases remains the most overlooked and under-negotiated provision in the contract. Yet when the city development director knocks at your door and expresses an interest in acquiring your self-storage project, the impacts are very real and often surprisingly emotional and upsetting for property owners. If the discussion generated by *Kelo* has done one thing, it has been to raise the level of public debate about eminent domain so that such an extreme power of government will not be used frivolously and the rights of all citizens to acquire and retain private property as they see fit will be protected.



Dean Dennis practices eminent domain and land use law with Hill Farrer & Burrill in Los Angeles, California.