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Eminent Domain: Depreciated Reproduction Cost in the Valuation of Trade Fixtures

COMMENTS

EMINENT DOMAIN: DEPRECIATED REPRODUCTION COST IN THE VALUATION OF TRADE FIXTURES

In recent years, the power of eminent domain has been exercised frequently As growing numbers of private and corporate citizens have become embroiled in condemnation proceedings, concern has developed regarding the suitability of various methods of valuation used to compensate the owners of condemned property Traditionally, courts have determined awards on the basis of the "market value" of the condemned property, using evidence of sales of comparable properties in order to determine "market value." [1] In many instances, however, the absence of comparable sales renders this method unworkable and inequitable. Furthermore, when the property includes trade fixtures, the difficulty of applying the traditional valuation formula becomes even more difficult. As a result, some courts have reevaluated traditional "market value" determinatives and have turned to a valuation based on reproduction cost-less depreciation.

This Comment will examine the various methods used for valuation of trade fixtures. Emphasis will be placed on the use of depreciated reproduction costs, and suggested uniform criteria for the application of this valuation method will be posited from existing case law

THE DEVELOPMENT OF TRADE FIXTURES AS CONDEMNABLE PROPERTY

At common law, everything attached to realty was considered a part of it.[2] The law of trade fixtures developed as an exception to this general rule in order to protect the rights of leaseholders who had added fixtures to the property and who otherwise would have surrendered the value of such improvements upon termination of the lease.[3] The lessee was permitted to retain "removable" fixtures such as machinery, heavy equipment, custom-built installations, and other business objects—com-

1. For a discussion of the traditional approach to eminent domain and the resulting valuation problems, see Hershman, *Eminent Domain: Current Concepts and Practical Problems*, in A PRACTICAL GUIDE TO THE LEGAL AND APPRAISAL ASPECTS OF CONDEMNATION 3 (S. Searles ed. 1969).

2. KENT'S COMMENTARIES 467 (12th ed. 1873).

3. *See In re* Mayor, 39 App. Div. 589, 57 N.Y.S. 657 (App. Div. 1899).

monly called trade fixtures—so long as the removal of such items would not injure the property.[4]

The common law provided that when fixtures attached to the realty were condemned in eminent domain proceedings, the owner received compensation; this was fair, since a failure to compensate would have amounted to a confiscation of property.[5] The common law did not consider whether trade fixtures, which by definition are removable, were condemnable. In modern times, however, condemnation of trade fixtures has become common. Despite the fact that the owner of such fixtures could remove them from the appropriated realty, it is clear that in some instances the fixture bears such a relation to the condemned realty that the fixture by itself would be valueless. In these instances, a taking of the realty also amounts to a compensable "taking" of the fixture even though the fixture could be removed by its owner, who may be either a lessee[6] or a condemnee who owns both the realty and the fixtures.[7]

Although it is well established that trade fixtures *may* require compensation when the underlying realty is condemned, the circumstances which demand such compensation are unclear. There are several tests used to determine when trade fixtures are condemnable, and some of them appear to be inconsistent. Frequently, the tests involve the same inquiries which are necessary to a determination of whether the objects are removable. One court has summarized the operative principles as follows:

> Fixtures are classified as "removable" unless they are "distinctly realty." They are distinctly realty if they would be severely damaged or lose substantially all their value upon severance . . . Removable fixtures are compensable unless they are "removable with such little difficulty or loss in value as to have retained [their] personal character.[8]

4. Removable fixtures, such as machinery and other business objects, are called trade fixtures. *See generally* M. EWELL, ON FIXTURES ch. IV (1876).

5. United States v. Grizzard, 219 U.S. 180 (1910); Allen v. Boston, 137 Mass. 319 (1884); Jackson v. State, 213 N.Y. 34, 106 N.E. 758 (1914).

6. *See* Marraro v. State, 12 N.Y.2d 285, 189 N.E.2d 606, 239 N.Y.S.2d 105 (1963). In this case involving the condemnation of a number of small businesses, the court held that the tenant was entitled to the award *not* because the trade fixtures added value to the leasehold, but because they belonged to the tenant and their value represented one component of the value of property taken by the city.

7. In such cases the courts usually refer to the trade fixtures as "business objects." This Comment will use the terms synonymously. *Compare* Marraro v. State, 12 N.Y.2d 285, 189 N.E.2d 606, 239 N.Y.S.2d 105 (1963), *with* United States v. Certain Properties, 388 F.2d 596 (2d Cir. 1968).

8. Unitd States v. Certain Properties, 388 F.2d 596, 598 n.1 (2d Cir. 1968).

This test appears to be a combination of two basic approaches which courts have taken in determining whether trade fixtures are condemnable. The first of these approaches is an application of the common law test set forth in *Teaff v. Hewitt*,[9] which would allow compensation for those items which conform to the common law definition of fixtures, notwithstanding the fact that they may also be "removable" trade fixtures under the law of landlord and tenant. In applying this test, emphasis is placed on the intention of the parties, the use to which the item has been put, and whether there has been "actual" annexation to the realty By contrast, in the second approach emphasis is placed upon more practical economic considerations. Courts adopting this analysis allow compensation for any improvements used for business purposes if severance would destroy the fixture's value.[10] Accordingly, courts have allowed compensation for the following items: those having a high cost of removal,[11] those which were custom-built and are not a part of a readily ascertainable sales market,[12] and those which are part of an economic unit which would be rendered inoperable if separate parts were severed.[13]

In most instances, the economic approach is preferable; it allows an equitable settlement of compensation while avoiding the difficult problem of determining which improvements are affixed to the realty in such a manner as to become part of the condemned property [14]

VALUATION

The Unit Rule

After a determination that a trade fixture is condemnable, it is necessary to consider what types of evidence are admissible to show valuation. Separate valuation of trade fixtures is not allowed by those courts that subscribe to the controversial "unit rule," which requires that the land, buildings, and fixtures be valued as a unit. This rule is based on the

9. 1 Ohio St. 511 (1853). For a general discussion of the tests applied to trade fixtures, see Snitzer, *Valuation and Condemnation Problems Involving Trade Fixtures*, 16 VILL. L. REV. 467, 490-91 (1971).

10. *In re* Seward Park Slum Clearance Project, 10 App. Div. 2d 498, 200 N.Y.S.2d 802 (App. Div. 1961).

11. *E.g.*, Rose v. State, 24 N.Y.2d 80, 246 N.E.2d 735 (1969) (loss of value due to high costs in removing machinery used in ready-mix concrete and crushed stone business).

12. Marraro v. State, 12 N.Y.2d 285, 189 N.E.2d 606, 239 N.Y.S.2d 105 (1963)

13. *E.g.*, Singer v. Oil City Redevelopment Authority, 437 Pa. 55, 261 A.2d 594 (1970); Gottus v. Allegheny County Redevelopment Authority, 425 Pa. 584, 229 A.2d 869 (1967).

14. Snitzer, *supra* note 9, at 496-97.

theory that compensation for the taking of property should be no greater than the market value for the unit as it stands.[15] Thus, evidence showing a trade fixture's separate value is inadmissible. The rule has come under much criticism, however, because of its inherent unfairness, and most courts appear to be abandoning it.[16]

Depreciated Reproduction Cost

If the trade fixture is compensable and the unit rule does not bar evidence of its separate value, the court must consider what kinds of evidence are appropriate to facilitate a fair determination of value. However, because of the infinite variety of circumstances in which market value must be ascertained, there is no general rule or method for its determination.[17] Further problems arise when there is no ascertainable

15. "The claimant is entitled to compensation, not merely for so much land, so much brick, lumber, materials, and machinery, considered separately; but if they have been combined, adjusted, synchronized, and perfected into an efficient functioning unit of property, then it must be paid for that unit, so combined " Banner Mill Co. v. State, 240 N.Y. 533, 544, 148 N.E. 668, 672 (1925). *See also* Kinter v. United States, 156 F.2d 5 (3d Cir. 1946); Los Angeles v. Klinker, 219 Cal. 198, 25 P.2d 826 (1933); Chicago v. Farwell, 286 Ill. 415, 121 N.E. 795 (1918); Williams v. Commonwealth, 168 Mass. 364, 47 N.E. 115 (1897).

16. *See generally* Annot., 1 A.L.R.2d 878, 902-03 (1948); United States v. City of New York, 165 F.2d 526, 528 (2d Cir. 1948). One situation which limits the use of the unit rule is found in landlord-tenant cases. If the unit rule were applied, the award to the tenants would be no more than the amount by which the entire building, including fixtures, was valued—a small award when divided proportionately among many tenants. In the leading case of Marraro v. State, 12 N.Y.2d 285, 189 N.E.2d 606, 239 N.Y.S.2d 105 (1963), the court, after determining that the fixtures were compensable to the tenants as trade fixtures, held that equity required a separate consideration of the value of these fixtures to achieve just compensation. The value of the fixtures as separate units enhancing the whole was found to be a more accurate method of determining the value of the fixture to the individual tenants whose interests were being taken. Thus the basis for separation of value is two-fold: a recognition of the equitable nature of just compensation by attempting to give the owner of a fixture an accurate value of its worth, and a recognition of the economic realities of modern appraisal methods which often consider separate component costs, even when the language of the court is in terms of the unit rule.

17. In fact, the rules in this area of eminent domain appear conflicting. For example, a Connecticut court states that no single method is controlling, and that all factors must be considered, while a Louisiana court holds that the depreciated reproduction cost method may be used only where there is no evidence of comparable sales involving similar improvements. *Compare* Moss v. New Haven Redevelopment Agency, 146 Conn. 421, 151 A.2d 693 (1959), *with* State Dept. of Highways v. Poulyn, 160 So. 2d 387 (La. Ct. App. 1964). A New York court does not allow the depreciated reproduction cost method unless the building in question is a specialty or unique, while in Washington this method may be employed whenever the building is suited to its appurtenant land. *Compare* City of Binghamton v. Rosefsky, 29 App. Div. 2d 820, 287 N.Y.S.2d 249 (App.

market at all—a difficulty which often arises when trade fixtures are involved.[18] In such cases, other methods of valuation must be employed. One such method seeks to determine value by ascertaining the depreciated reproduction cost of the condemned fixture.[19] Since this method generally yields a high measure of compensation, its use frequently is urged by claimants.[20] Many courts seem reluctant to consider depreciated reproduction costs—and will use the method only in narrowly defined circumstances—while others are willing to admit such costs as evidence of value even where a market value could be determined by other, more traditional means.

In *United States v. Certain Properties*,[21] the justification for using depreciated reproduction cost[22] was explained by Judge Friendly substantially as follows: Normally, just compensation is assured through an application of the market value method, using evidence of a fairly contemporaneous sale of comparable property as a basis for the award. But when such evidence is not procurable, the court must endeavor to reconstruct what a hypothetical purchaser would pay for the trade fixture for use in the premises being condemned. It is assumed that such a purchaser would pay no more than the current cost of comparable new fix-

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Div. 1968), *with* State v. Wilson, 6 Wash. App. 433, 493 P.2d 1252 (1972). Equally confusing is the reasoning of the courts, often consisting of little more than the recitation of some equitable terms such as "just compensation," and "fairness." State v. Braddock, 160 So. 2d 279 (La. Ct. App. 1964). *See generally* 1 J. BONBRIGHT, VALUATION OF PROPERTY 54-65 (1937).

18. *See* United States v. Certain Properties, 388 F.2d 596, 600 (2d Cir. 1968).

19. *See, e.g.*, State v. Wilson, 6 Wash. App. 433, 493 P.2d 1252 (1972). Other approaches involve reference to comparable sales, which will be treated later in the text, and to capitalization of income. Income capitalization—the present value of the future earnings foregone by the taking of the property in question—is another method of determining market value which has been accepted by some courts. *See, e.g., In re* James Madison Houses, 17 App. Div. 2d 317, 234 N.Y.S.2d 799 (App. Div. 1962). Other courts, however, consider the speculative nature of future income to be significant; thus the use of this type of evidence should be limited. *E.g.*, State v. Bare, 141 Mont. 288, 377 P.2d 357 (1962). For a further discussion of this valuation method see 4 P NICHOLS, THE LAW OF EMINENT DOMAIN § 12.3121[3] (rev. 3d ed. 1964).

20. Searles, *The Legal and Appraisal Aspects of Specialty Properties*, in PRACTICAL GUIDE TO THE LEGAL AND APPRAISAL ASPECTS OF CONDEMNATION 65, 66 (S. Searles ed. 1969).

21. 388 F.2d 596 (2d Cir. 1968).

22. Courts often treat the terms "reproduction cost" and "replacement cost" similarly in arriving at an amount of compensation. Although used interchangeably, there is a significant difference between them. Reproduction cost is the cost of replacing the subject improvement with one that is an exact replica. Replacement cost is the cost of replacing the property new with allowance for the depreciation of the fixture. For a detailed discussion of these terms, see Smith, *Legal Aspects of the Cost Approach*, 31 ALA. LAWYER 473 (1969).

tures less an appropriate allowance for deterioration from use and obsolescence.[23]

Although the validity of the depreciated reproduction cost method is generally accepted, a uniform test of its applicability has not been fashioned. Any discussion of depreciated reproduction cost would be incomplete without an analysis of the limitations which have been—and should be—placed upon its use.

Limitations on the Use of Depreciated Reproduction Cost

1 Use of Comparable Sales

Many courts advance the position that the best evidence of market value is the sales price of comparable property Accordingly, they conclude that if evidence of relevant comparable sales is available, evidence of depreciated reproduction cost in valuing trade fixtures is inadmissible. Although relevancy presents many problems which are beyond the scope of this discussion, it may be noted that relevancy generally is determined by examining four basic elements: geographical proximity, proximity in time, similarity in quality, and similarity of market conditions.[24] Thus, if these elements are present, evidence of comparable sales is admissible to show value, and the use of other methods of valuation, such as depreciated reproduction cost, is disallowed.

By contrast, other courts have demonstrated a willingness to examine evidence of depreciated reproduction cost even if evidence of relevant comparable sales is available.[25] It is argued that such evidence should be admitted because it tends to show what price a hypothetical purchaser would be willing to pay for the condemned property [26]

It is submitted that if evidence of a comparable sale exists, the depreciated reproduction cost should not be examined. A court should base its finding of value on concrete market evidence, rather than on a hypothetical buyer's propensity to pay a speculative sum. The American Bar Association, recognizing the superiority of this approach, has stated: "[T]he best method of arriving at market value is the use of recent

23. 388 F.2d at 600.

24. Sengstock & McAuliffe, *What is the Price of Eminent Domain?*, 44 J. URBAN L. 185 (1966) *See also* Commonwealth v. Oakland United Baptist Church, 372 S.W.2d 412 (Ky. 1963); *In re* Armory Site, 282 S.W.2d 464 (Mo. 1955); People v. Rivera, 70 P.R.R. 292 (1949).

25. Sengstock & McAuliffe, *supra* note 24, at 224.

26. *Id.*

[actual] sales of comparable property " [27] Accordingly, the lack of adequate comparable sales evidence should be a prerequisite to the use of depreciated reproduction cost.

2. Reasonableness of Replacement and Specialties

Even assuming a lack of adequate comparable sales data, many courts impose further limitations on the use of depreciated reproduction cost. For example, some courts require that the condemned improvement be unique or a "specialty" before reproduction costs can be used.[28] This prerequisite is in many instances another way of viewing the comparable sale requirement. Thus, if an object is peculiar or unique, it is logical to conclude that there will not be evidence sufficient to establish a comparable sale. The concept of specialty is explained in the following manner:

> It occasionally happens that a parcel of real estate taken by eminent domain is of such a nature, or is held or has been improved in such a manner, that, while it serves a useful purpose to the owner, if he desired to dispose of it he would be unable to sell it at anything like its real value. A church, or a college building, or a club-house located in a town in which there was but one religious society, or college, or club, might be worth all it cost to the owners, but it would be absolutely unmarketable. So, also, in many states an owner of land abutting upon a public street might be satisfied with the fact that he owned the fee of the street, and was thus able to protect himself against the use of the street for other than street purposes without compensation; but it would be almost impossible for him to sell his interest in the street to a private purchaser. Even such a piece of property as a mill site or a reservoir site, or a factory or store of abnormal size may to a somewhat lesser degree, be difficult to dispose of, though of great value to its owner.[29]

The mere finding that condemned personalty is unique and virtually unmarketable should not, however, lead automatically to a conclusion

27. ABA COMM. ON CONDEMNATION AND CONDEMNATION PROCEDURE OF THE SECTION OF LOCAL GOVERNMENT LAW 38 (1962). *But see* Kansas City & T. Ry v. Vickroy, 46 Kan. 248, 26 P. 698 (1891); *In re* Civic Center, 335 Mich. 528, 56 N.W.2d 375 (1953); Minneapolis-St. P. Sanitary Dist. v. Fitzpatrick, 201 Minn. 442, 277 N.W 394 (1937).

28. *E.g.*, United States v. Certain Property, 306 F.2d 439 (2d Cir. 1962) (admission of the replacement cost of a building as evidence refused due to lack of uniqueness).

29. P. NICHOLS, *supra* note 19, § 12.32 at 217-38.

that evidence of its depreciated reproduction cost is best suited to determine its value. Courts should also consider whether it would be reasonable for an owner to replace his special object with a substitute. The need for such an inquiry was illustrated in *In re Lincoln Square Slum Clearance Project.*[30] There, the court posited an obsolete lighthouse as an example to demonstrate that the depreciated reproduction cost method is not always applicable to specialties. The court hypothesized that a condemned lighthouse, although unique, probably would not be replaced. Hence, in such a situation the owner should not recover replacement costs.

Other decisions have elucidated the concept of "reasonableness" of replacement. *State v. Wilson,*[31] for example, states that one indication of reasonableness is whether a replacement may be suited to the land on which it is to be located. Another factor, discussed in *United States v. Buhler,*[32] is the likelihood that a hypothetical purchaser would reproduce the improvement after purchasing the realty

The need to consider the reasonableness of replacement is aptly illustrated by the result reached by one court which failed to employ this limitation. In *Port of New York Authority v. Hudson Tubes Corp.,*[33] the court awarded compensation in excess of what "anybody in his right mind would reasonably have paid" for the improvement.[34] Instead of deciding that the unprofitable nature of the business would render its replacement unreasonable, thereby limiting the award to the price for which the property could be sold on the existing market, the court fashioned a larger award in order to avoid "manifest injustice." [35] Compensation for an unprofitable improvement, however, is not "just compensation," since the award must also be fair to the condemning authority [36] Although the preceding cases did not concern trade fixtures, it may be suggested by analogy that reasonableness of replacement be uniformly adopted as a prerequisite to the use of depreciated reproduction cost in valuing condemned trade fixtures.[37]

30. 15 App. Div. 2d 153, 222 N.Y.S.2d 786 (App. Div. 1961), *aff'd,* 12 N.Y.2d 1086, 190 N.E.2d 423, 240 N.Y.S. 30 (1963).

31. 6 Wash. App. 443, 493 P.2d 1252 (1972).

32. 305 F.2d 319 (5th Cir. 1962).

33. 20 N.Y.2d 457, 231 N.E.2d 734, 285 N.Y.S.2d 24 (1967).

34. Searles, *supra* note 20, at 70.

35. Port of N.Y. Authority v. Hudson Tubes Corp., 20 N.Y.2d 457, 468, 231 N.E.2d 734, 738, 285 N.Y.S.2d 24, 30 (1967).

36. United States v. Delaware, Lackawanna & W Ry., 264 F.2d 112 (3d Cir. 1959).

37. *See e.g.,* United States v. Certain Parcels of Land, 102 F Supp. 854 (S.D.N.Y.

3. Cost of Removal

A third limitation on the use of the depreciated reproduction cost in valuing trade fixtures is found in decisions which restrict condemnation awards to the lesser of two dollar amounts—either the depreciated reproduction cost of the condemned personalty, or the cost of removing the fixture from the condemned realty Although courts traditionally have refused to allow removal costs,[38] the equity of an approach using cost of removal as its basis has been presumed in recent state and federal statutes.[39] It also has been affirmed in court decisions.

In *Rose v. State*,[40] a condemnation proceeding involved a crushed stone and ready-mix concrete business which used heavy machinery The court held that the state was required to pay either replacement costs less depreciation or the costs of removal, whichever was less, stating: "If the cost of removal is less than the difference between salvage value and present value in place, this is all the claimant is entitled to recover. The State is not required to place a claimant in a better position than he was before the taking by helping him to finance a new facility" [41]

A subsequent decision, *City of Buffalo v. J W Clement Co.*,[42] extends this approach by stating that the condemnee has an actual duty to mitigate his damage by removing his trade fixtures. Although the courts in *Rose* and *City of Buffalo* take a realistic view of condemnation law by considering both equitable and economic factors, they failed to address the following problem: If an owner has fixtures, only some of which are removable, and the removable fixtures are of little value apart from the

1952), *aff'd sub nom.* United States v. Knickerbocker Printing Corp., 212 F.2d 894 (2d Cir.), *cert. denied*, 348 U.S. 875 (1954). "[T]rade fixtures, in effect, are considered as improvements to the realty" 102 F Supp. at 858.

38. *See, e.g.*, United States v. General Motors, 323 U.S. 373 (1945). The court stated that condemnation awards are restricted to the value of the object, and refused to consider consequential damages such as removal costs.

39. *See, e.g.*, Chapter V of the Federal-Aid Highway Act of 1968, 23 U.S.C. §§ 501-12 (1970), *amending* 23 U.S.C. §§ 501-12 (Supp. V, 1968); CONN. GEN. STAT. REV. § 13a-73 (1963).

40. 24 N.Y.2d 80, 246 N.E.2d 735, 298 N.Y.S.2d 968 (1969)

41. *Id.* at 83, 246 N.E.2d at 740, 298 N.Y.S.2d at 976.

42. 28 N.Y.2d 241, 269 N.E.2d 895, 321 N.Y.S.2d 345 (1970). In this case involving the condemnation of a printing company, the court held that where machinery in a condemned building was an integral part of the business, but was movable at less cost than its value in place, the city was required to pay only removal costs. The court reasoned that a condemnee is entitled only to be put in as good a position as he had occupied before the condemnation. This theory is not viable, however, in a situation where such machinery cannot be relocated or used in a fully operating unit.

complete industrial unit, an award which would force the owner to remove these fixtures in mitigation of damages would yield an inequitable result.

This problem was ameliorated in *Singer v. Oil City Redevelopment Authority*[43] in which the court adopted an industrial unit approach, allowing removal costs only when the removable fixtures would constitute an operating unit, and where a location for these fixtures was available. When both of these conditions are met, and the cost of removal is less than the depreciated reproduction cost of the fixtures, the replacement cost less depreciation should not be awarded.

This approach suggests one solution to the *City of Buffalo* problem, since it considers the value of a trade fixture in relation to the entire operational unit. The problem of forced removal of trade fixtures which have a removal cost lower than their replacement cost when there is no guarantee that they will be relocated is solved by *Singer*: the ability to relocate as a full operating unit is a precondition to forced removal. This approach is economically fair to the owner since he is placed in the same position he occupied before removal; he continues to have the use of his trade fixtures in an operating unit. It also serves the interests of the condemnor, since it will mean smaller condemnation awards when such cost is less than the reproduction cost less depreciation. In terms of the equitable and economic considerations underscoring the law of condemnation of fixtures, this appears to be a valid limitation on the depreciated reproduction cost method.

Conclusion

Although the law of fixtures is not completely clear, some rules for determining the value of condemned trade fixtures have emerged in recent cases. Specifically, in determining whether the depreciated reproduction cost method is applicable to the valuation of business objects, the courts must first determine that the items are indeed trade fixtures, and hence compensable. Next, the court must find the unit rule inapplicable, thus permitting the use of a method of compensation which values fixtures separately Finally, it can be concluded that the use of the depreciated reproduction cost method for the valuation of trade fixtures generally provides just compensation, but its use is subject to several limitations. Specifically, this method of valuation should be available only where: (1) there is inadequate evidence of comparable sales, (2) the

43. 437 Pa. 55, 261 A.2d 594 (1970).

fixtures could be replaced reasonably, and (3) the cost of removal would not reasonably compensate the condemnee. Uniform judicial acceptance of these tests to determine the applicability of depreciated reproduction cost evidence in the valuation of condemned trade fixtures would add rationality and fairness to an unsettled area of the law