Valuation of the Mortgagee's Interest upon Partial Condemnation

Ken Miller
VALUATION OF THE MORTGAGEE'S INTEREST UPON PARTIAL CONDEMNATION

By Ken Miller*

I. INTRODUCTION

Government's power of eminent domain is limited by the constitutional requirement that private property owners receive just compensation for a public taking. When mortgaged property is condemned, the condemnation award must be apportioned between the owner and the lender. In the event that all of the mortgaged property is condemned, the rule of apportionment is the same in every jurisdiction. If the amount of the award exceeds the unpaid balance of the mortgage, the lender receives an amount equal to the unpaid balance. If the

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1. Eminent domain — the power of government to compel the sale of private property — is an inherent power of sovereignty. Johnson v. Joliet & C.R.R., 23 Ill. 124, 125 (1859). The constitutional provisions cited infra note 2 are merely restrictions on this power.


3. In title theory jurisdictions, the mortgage conveys a defeasible title to the mortgaged property. As a result, the mortgagee's interest is property and entitled to the same constitutional protection as other property. The mortgagee's remedy is directly against the condemnor. In lien theory jurisdictions, the mortgage creates merely a lien on the land. In the absence of express statutory requirement, therefore, the mortgagee has no remedy against the condemnor. Under the doctrine of equitable conversion, however, the award is granted in place of the land and is subject to the same liens. Moreover, most jurisdictions now provide by statute for an apportionment of the award between the owner and the mortgagee. J. SACKMAN, NICHOLS' THE LAW OF EMINENT DOMAIN § 5.741 (rev. 3d. ed. 1981) [hereinafter cited as NICHOLS].

4. E.g., Owen County v. Morgan, 22 Ky. 922, 59 S.W. 18 (1900); Collector of Taxes v. Revere Bldg., 276 Mass. 576, 177 N.E. 577 (1931); City of Detroit v. Fidelity Realty Corp., 213 Mich. 448, 182 N.W. 140 (1921); CONN. GEN. STAT. ANN. § 48-21 (West 1978); MASS. GEN. LAWS ANN. ch. 79, § 22 (West 1969). In California, the condemnor may at its option deduct the indebtedness not yet due from the award, in which case the lien would continue until the indebtedness was paid. CAL. CODE CIV. PROC. § 1265.220 (West 1982). In all other states, the mortgagee shares in the award to the extent of the unpaid balance on the mortgage without regard to maturity. E.g., Federal Trust Co. v. East Hartford Fire Dist., 283 F. 95 (2d Cir. 1922).
mortgage debt exceeds the amount of the award, the lender is entitled to the whole award. In the event of a partial taking, however, the courts have applied several different rules to determine the respective shares of the fee holder and the lender. This article analyzes the various rules and suggests an approach not yet considered by the courts.

II. THE RULES OF APPORTIONMENT

In the majority of states the lender is entitled to share in the partial condemnation award to the extent of the remaining secured indebtedness. If the remaining indebtedness exceeds the award, the lender is entitled to the entire award. Any amount received by the lender is deducted from the secured debt. One rationale offered for this rule is that a lien attaches to every portion of the land covered by it and is therefore a lien for the entire secured debt on any portion taken. Most courts, however, base the rule on the "two-fund" theory. Under this theory, upon partial condemnation, a lender has two separate funds for the security of its debt. First, it retains its security on the remaining land. Second, under the doctrine of equitable conversion, it has an equitable lien on the condemnation award since the award is a substitute for the portion of its security taken by condemnation. The lender may resort to either fund. But any recovery extinguishes its lien on both funds to the extent of the amount recovered.

The remaining jurisdictions apply the impairment-of-security rule. Under this rule, a lender is entitled to share in the award only to the extent that its security is impaired. Since the courts use several different definitions of impairment, this rule actually encompasses several approaches.

In federal condemnation proceedings and under the laws of

5. See cases cited supra note 4.
7. See authorities cited supra note 6.
10. Id. at 521-22, 52 N.E.2d at 187-88.
12. In a federal condemnation proceeding, what constitutes just compensation is a question of federal law. Georgia Power Co. v. 138.30 Acres of Land, 596 F.2d 644, 649 (5th Cir. 1979).
some states, a lender's security is deemed impaired only to the extent that the unpaid balance of the debt exceeds the value of the remaining security. This approach was labeled by one court as the "debt equivalency rule." Another approach recognized by some courts is the original ratio rule. Under this rule, the lender's right to an apportionment turns on the requirement that the value of the remaining land have the same ratio to the unpaid balance of the debt as the value of the encumbered property bore to the debt at the time of its creation.

A third view, and one preferred by most of the commentators, is the pre-take ratio rule. This rule allocates to the lender that portion of the condemnation award which preserves the ratio existing immediately prior to condemnation between the unpaid balance of the debt and the value of the encumbered property. Although no court has yet applied this rule, at least one court has used it as a factor in its apportionment determination. Finally, the approach adopted in the most recent cases to address this issue allows the trier of fact to consider various factors. These cases, however, give little guidance as to the weight to be given any individual factor.

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16. Buell Realty Note Collection Trust v. Central Oak Inv. Co., 483 S.W.2d 24 (Tex. Civ. App.) (original ratio rule a factor which trier of fact may use in its determination of whether security is impaired), aff'd, 486 S.W.2d 87 (1972).
17. 483 S.W.2d at 27 (citing M. RAYBURN, TEXAS LAW OF CONDEMNATION §§ 79, 113 (1960)). The original ratio rule is applied as follows:

\[
\text{Mortgagee's Share of Condemnation Award} = \left( \frac{\text{Mortgage Debt at Creation of Debt}}{\text{Value of Security at Creation of Debt}} \right) \times \text{Total Cash Condemnation Award}
\]

18. See, e.g., Teague, Condemnation of Mortgaged Property, 44 Tex. L. Rev. 1535, 1537 (1966) [hereinafter cited as Teague].
19. 84 Cal. App. 3d at 690, 149 Cal. Rptr. at 26. The pre-take ratio rule is applied as follows:

\[
\text{Mortgagee's Share of Condemnation Award} = \left( \frac{\text{Mortgage Debt at Time of Take}}{\text{Value of Security at Time of Take}} \right) \times \text{Total Cash Condemnation Award}
\]

20. 84 Cal. App. 3d at 690, 149 Cal. Rptr. at 29.
Before analyzing the rules mentioned above, it is interesting to consider their practical significance. All properly drafted mortgages contain a provision allocating any award rendered in total or partial condemnation of the mortgaged property. A typical provision might read as follows:

Any award of damages in connection with any condemnation for public use of or injury to said property or any part thereof is hereby assigned and shall be paid to [the mortgagee] who may apply or release such money received by him to the [owner].

The universal use of such clauses, if enforceable, would render moot the issue of apportionment between mortgagors and mortgagees. The paucity of recent decisions on this question indicates that these clauses are frequently used and are considered enforceable. But in at least one state—California—there is a serious question as to the enforceability of such clauses. Interestingly, California has rendered one of the most recent reported decisions on the issue of apportionment. In that case, *People ex rel. Department of Transportation v. Redwood Baseline, Ltd.*, part of a parcel of land encumbered by two trust deeds was condemned. Although the trust deeds contained the usual provision that any condemnation award shall be paid to the trust deed holder, the trial court ordered an apportionment of the award. From this judgment, the owner appealed. On appeal, the trust deed holders did not assert any right they might have had to the condemnation award under the provision. As a result, the court did not rule on the enforceability of the provision.

Under section 1265.225 of the California Code of Civil Procedure, however, it is likely that such provisions are unenforceable. This section provides as follows:

(a) Where there is a partial taking of property encumbered by a lien, the lienholder may share in the award only to the extent determined by the court to be necessary to prevent an impairment of the security, and the lien shall continue upon the part of the property not taken as security for the unpaid portion of the indebtedness.

(b) Notwithstanding subdivision (a), the lienholder and

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23. 84 Cal. App. 3d 662, 149 Cal. Rptr. 11 (1978).
24. Id. at 668, 149 Cal. Rptr. at 14-15.
25. Id. at 670, 149 Cal. Rptr. at 16.
the property owner may at any time after commencement of
the proceeding agree that some or all of the award shall be
apportioned to the lienholder on the indebtedness.

Although this section did not become effective until after the Redwood
decision was rendered, the Redwood court nonetheless briefly discussed it. As noted by the court,

The Law Revision Commission Comment to section
1265.225 states that the section "codifies the case law principle
that a lienholder is entitled to share in the award only to the
extent of the impairment of his security notwithstanding any
agreement to the contrary entered into at the time of the creation
of the indebtedness on which the lien is based."26

The court suggests, however, that "although it is probably now of only
academic interest," the cases cited by the Commission do not invalidate
all such provisions.27 Since section 1265.225 does not explicitly bar a
waiver of the rights it confers, however, the issue raised by the court is
not merely academic. Although the court's unstated assumption—that
the section impliedly bars waiver—is probably correct, it is important
to unveil the reasoning underlying this conclusion.

The language of the statute supports the court's conclusion. Signifi-
cantly, subdivision (b) of Section 1265.225 allows waiver "notwith-
standing subdivision (a)." If subdivision (a) were not intended to
invalidate contrary agreements, subdivision (b) would be superfluous.
Since a statute should be construed so that every part of it is given
significance and effect,28 there is a presumption that subdivision (a)
bars waiver. In addition, an interpretation of the section as barring
waiver before but not after commencement of the condemnation pro-
ceeding is consistent with California's general statutory scheme relating
to liens. The anti-deficiency protections, for example, may be waived
after but not before the loan is made.29 The rationale for this rule is
that although "necessity often drives debtors to make ruinous conces-
sions when a loan is needed," after the loan is made all the rights have
been established and there is no longer any pressure to give up these
rights.30 Finally, it is interesting to note that the legislature included a
specific provision explicitly granting to the parties to a lease the power

26. Id. at 671 n.7, 149 Cal. Rptr. at 16 n.7 (quoting 13 CALIFORNIA LAW REVISION COM-
MISSION REPORTS 1225 (1975)) (emphasis added by the court).
27. 84 Cal. App. 3d at 671 n.7, 149 Cal. Rptr. at 16 n.7.
29. SECURED TRANSACTIONS, supra note 22, at § 9.31.
to fix apportionment by agreement.\textsuperscript{31} If the legislature intended similar treatment respecting mortgages, it could be argued that it would have included such a provision in the sections dealing with encumbrances.

It appears, therefore, that at least in California the rules of apportionment significantly affect the rights of mortgagors and mortgagees upon partial condemnation. Furthermore, these rules generally apply to all liens, and vendors' liens and other non-consensual liens will rarely be subject to a provision fixing apportionment of a condemnation award.

III. A CRITICISM OF THE RULES OF APPORTIONMENT

A. Original Ratio Rule and Debt Equivalency Rule

Apportionment rules should be fashioned to approximate a result which the parties would have agreed upon if they had the legal ability and the foresight to make such an agreement. The original ratio rule does not accomplish this objective. As pointed out by the\textit{Redwood} court, there are three reasons why the original ratio rule does not reflect the real bargain of the parties. First, where the debt is amortized, both parties expect the margin of security to increase with each payment.\textsuperscript{32} Second, the original ratio is irrelevant to the expectations of successors in interest to the original parties.\textsuperscript{33} Third, "it is hardly likely the parties will be ignorant of the historical rise in the value of land."\textsuperscript{34} The debt equivalency rule is even worse than the original ratio rule because it completely ignores the parties' mutual expectation that the mortgagee will have a margin of security over and above the amount of the debt.

B. Majority Rule

The majority rule also has serious shortcomings. As stated above, this rule entitles the lender to share in the condemnation award to the extent of the remaining secured indebtedness. This rule often works to the disadvantage of the borrower. If prevailing interest rates exceed the interest rate under the loan, the lender will apply its share of the award to the mortgage debt, thereby depriving the borrower of the benefits of an advantageous loan and relieving the lender of the burdens of a disadvantageous loan. On the other hand, if prevailing rates are lower than the interest rate under the loan, the borrower cannot free itself

\begin{itemize}
\item \textsuperscript{32} 84 Cal. App. 3d at 685, 149 Cal. Rptr. at 26.
\item \textsuperscript{33} \textit{Id.}
\item \textsuperscript{34} \textit{Id.} at 683, 149 Cal. Rptr. at 25.
\end{itemize}
from a disadvantageous loan as a result of a partial condemnation, for in this case, the lender can simply release its entire share of the award to the borrower. Unless the borrower is then able to prepay the mortgage debt from the proceeds of the award without penalty, the borrower will remain obligated to pay the lender above-market interest. As discussed below, the borrower is rarely entitled to prepay its loan without penalty following partial condemnation. Accordingly, under the majority rule, when prevailing interest rates are lower than the rate under the loan, the borrower suffers a loss.

The courts have universally held that where the language of the mortgage does not specifically authorize prepayment penalties for involuntary prepayment, the lender may not collect a prepayment penalty from either the borrower or the condemnor. On the other hand, where the mortgage provided for a prepayment penalty in the event of condemnation, the only court to address the issue held the provision enforceable. This raises two questions. First, is it correct to allow lenders to extract penalties for involuntary prepayment by inserting an explicit provision in the mortgage? Second, if it is not correct, does a borrower’s prepayment of the mortgage debt from the proceeds of a partial condemnation award constitute an involuntary prepayment so that no penalty could be exacted regardless of the terms of the mortgage?

Although a borrower has the right to pay the secured debt according to the mortgage agreement until the lender forecloses, the borrower is not entitled to prepay unless the mortgage agreement so provides. Prepayment penalty provisions, however, have recently been challenged as unenforceable liquidated damages provisions. In Meyers v. Home Savings & Loan Association, for example, plaintiffs based their challenge of prepayment penalties on Garrett v. Coast & Southern Federal Savings & Loan Association, in which the California Supreme

37. SECURED TRANSACTIONS, supra note 22, at § 4.19.
38. Since limitations on liquidated damages are an express limitation on the freedom of contract, a challenge based on such limitations cannot be defeated by the existence of an explicit provision in the mortgage.
40. 9 Cal. 3d 731, 511 P.2d 1197, 108 Cal. Rptr. 845 (1973). There is also a statutory
Court held late charges void as improper liquidated damages. The court in *Meyers* distinguished *Garrett* on the ground that a prepayment penalty is a charge for alternative performance of the contract and affirmed the lower court's denial of plaintiff's claim.

It is arguable, however, that *Meyers* is not applicable to the case of an involuntary prepayment. Significantly, in *Meyers* the prepayment was made at the instance of the owner-debtor. In the case of a partial condemnation award, however, the lender may elect to apply the proceeds to the debt or release the funds to the debtor. Since there has been no voluntary act on the part of the owner-debtor, a prepayment penalty in such a case could not be deemed a charge for alternative performance of the contract. As a result, *Meyers* may be distinguishable, and it is arguable therefore that the limitations on liquidated damages should apply to the prepayment charge.

A good argument may be made, however, that limitations on liquidated damages provisions do not apply to prepayment penalties when prepayment is the result of a contingency, such as condemnation, which is beyond the control of both parties to the mortgage. In *Lazzareschi Investment Co. v. San Francisco Federal Savings & Loan Association*, for example, the property securing the loan was sold under a court order in a divorce action and the buyer had to obtain new financing in order to consummate the transaction. The court held that the lender was entitled to collect a charge for the prepayment which was necessitated by the involuntary sale. In rejecting application of the statutory limitation on liquidated damages, the court stated: "[The cases applying this limitation] are concerned with breach of contract in some manner. In the instant case, there has been no breach. . . . Indeed, in the case before us there is the opposite of default, that is, a payment made before the promissor was obligated to make it."  

Assuming *arguendo* that penalties for involuntary prepayment constitute liquidated damages, consider whether such penalties satisfy the applicable requirements. Most courts will enforce a liquidated damages provision only in the event that the fixing of actual damages would be impractical and the amount agreed upon is a reasonable esti-

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41. See CALIFORNIA CONTINUING EDUCATION OF THE BAR, CONDEMNATION PRACTICE IN CALIFORNIA § 10.14 (1973) [hereinafter cited as CONDEMNATION PRACTICE IN CALIFORNIA]. A lienholder "need not appear in the [condemnation] action, and installment payments on the debt will continue as though there had been no condemnation." *Id.*


43. *Id.* at 307, 99 Cal. Rptr. at 420.
mate of the loss. Clearly, a lender's loss from prepayment is not impractical to determine. In general, such loss is equal to the sum of the following two components: first, the amount, if any, that the present value of payments under the original mortgage exceeds the present value of the payments under a new loan of equivalent risk that the lender could arrange under existing market conditions, and second, the increased administrative costs caused by the termination of the loan before its maturity. As a result, assuming it is applicable, the limitation of liquidated damages bars the exaction of an involuntary prepayment penalty.

Assuming again that penalties for involuntary prepayment are unenforceable, the question now is, if the lender releases the partial condemnation award to the borrower, is the borrower's subsequent prepayment involuntary? Since the borrower is free to purchase additional property with these funds, it can place itself in approximately the same position it occupied prior to condemnation. Thus the borrower has a real choice of whether to prepay a portion of the debt or maintain its original position. As a result, prepayment would constitute an alternative performance of the contract, and the liquidated damages limitation would not apply to a prepayment charge imposed thereon. Accordingly, even assuming the unenforceability of penalties for involuntary prepayment, lenders may penalize borrowers that prepay the mortgage debt from the proceeds of a partial condemnation award.

C. Pre-take Ratio Rule and Ad Hoc Approach

The remaining two rules will be discussed in the context of Redwood, one of the most recent cases in any jurisdiction to address the question of the respective rights of borrowers and lenders to a partial condemnation award. Redwood involved the partial taking of a parcel encumbered by two trust deeds. The trial court ordered an apportionment under which the post-take security-to-debt ratios of the liens were in between the original security-to-debt ratios and the pre-take security-to-debt ratios.

On appeal, for reasons not clearly articulated, however, the court

44. Restatement of Contracts § 339 (1932).
45. If the award were truly just compensation, the mortgagor should be able to obtain a parcel of property of approximately the same quality and quantity as the parcel condemned.
46. 84 Cal. App. 3d at 668, 149 Cal. Rptr. at 14-15.
47. The court's only criticism of the pre-take ratio rule was as follows:
   The greater the lienholder's margin of security immediately before the take, the greater will be the proportion of the award allocated to the lienholder. Conversely,
held that the pre-take ratio rule should merely serve as a factor in the
determination of the extent of impairment together with many other
factors including, inter alia, the legal permissibility of a deficiency judg-
ment, the interest rate charged compared with the prevailing interest
rate in similar transactions, and any facts bearing on the likelihood of
default by the debtor. In upholding the trial court's award, however,
the court merely pointed out that "the apportionment made by the
[trial] court did not even fully restore" the pre-take security-to-value
ratios. No other factors were discussed.

Although it was not articulated in Redwood, the most compelling
reason for rejecting a strict application of the pre-take ratio rule is that
the value of a mortgage or trust deed may be radically altered even
though its existing security-to-debt ratio is maintained. Particularly
during recent years, when prevailing interest rates have fluctuated
greatly, the face amount of a mortgage has borne little resemblance to
its market value. As a result, where a debtor is allowed or compelled to
prepay a portion of the secured debt without penalty or recompense, as
the case may be, the debtor will realize a gain or loss equal to the differ-

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84 Cal. App. 3d at 686-87, 149 Cal. Rptr. at 27. The court's initial observation, however, is
incorrect. In fact, the greater the lienholder's margin of security before the take, the smaller
will be its share of the award. And the smaller the lienholder's margin of security prior to
the take, the greater will be its share of the award. An example will support this point.
Assume the pre-take security-to-debt ratio is $200,000 to $100,000, and the portion taken is
valued at $50,000, reducing the security to a value of $150,000. To restore the 2-to-1 pre-
take ratio, the lienholder would have to get $25,000 and the debtor-owner $25,000. The
post-take security-to-debt ratio would be $150,000 to $75,000 or 2 to 1. Now suppose the pre-
take security-to-debt ratio is $200,000 to $180,000 and the portion taken is again $50,000,
reducing the value of the security to $150,000. To restore the 10 to 9 pre-take ratio, the
lienholder would have to get $45,000 and the owner-debtor $5,000. The post-take securityto-debt ratio would then be $150,000 to $135,000 or 10 to 9. In the second case the
lienholder's pre-take margin of security was smaller than in the first case, but in the second
case his share was larger than in the first case.

48. 84 Cal. App. at 688, 149 Cal. Rptr. at 28.
49. Id. at 691, 149 Cal. Rptr. at 28.
50. Another argument against a strict pre-take ratio rule is based on statutory construc-
tion. In section 1265.230 of the California Code of Civil Procedure, the impairment-of
security test is mandated for use in allocating a partial condemnation award between junior
and senior lienholders in certain circumstances. However, this section also prescribed the
pre-take ratio rule as the indicator of impairment. Since the legislature failed to make such
a prescription with respect to apportionment between owner and lienholder, the presump-
tion is that the pre-take ratio rule should not be strictly applied in this context.
ence between the amount paid and its proportionate market value as part of the secured indebtedness. Although over the long run there will be equivalent gains and losses to debtors and creditors, these gains and losses increase the risks of lending and borrowing and result in unfairness as to each individual case.

The Redwood court implicitly recognized this fact by including as a factor in the impairment determination the interest rate charged compared with the prevailing interest rate in similar transactions. However, although this ad hoc approach may produce the right result in many cases, it creates several problems that could be avoided by a simpler, more direct standard. The problems arising from this approach can best be understood when examined in two different contexts: (1) when the interest rate charged exceeds prevailing interest rates, and (2) when the interest rate charged is lower than prevailing interest rates.

1. When the interest rate charged exceeds the prevailing interest rates

Assuming that the interest rate charged is comparable to the rates prevailing at the time the mortgage was created and that interest rates have since decreased, the mortgage now offers a premium in the way of greater-than-market interest income that it did not offer at the time of its creation. As a result, the market value of the mortgage has probably increased in one of two ways. First, if the mortgage includes a provision providing for a prepayment penalty, the lender will only accept prepayment if such penalty is also tendered. Exacted in this way, the charge is known as an option penalty. Second, if the loan agreement omits any mention of prepayment rights, the lender is in a position to demand a penalty when the borrower attempts to prepay. This penalty is called a non-option penalty.

Upon partial condemnation, a lender sharing in the award must either apply part of its share to the mortgage debt or release its entire share to the borrower. If it applies part of its share to the debt, it will lose interest income for the amount prepaid since it is assumed that the interest charged under the loan exceeds the interest it could expect to

51. See supra note 48.
52. Other factors affecting its value include the financial position of the debtor, the market's expectation of future interest rates, the terms of the mortgage, and the supply and demand of mortgage money. In some situations, changes in these factors might have a greater and opposite effect on value than a change in interest rates.
54. Id.
earn on the prepaid funds under prevailing market conditions. On the other hand, if it releases its entire share to the borrower, it will suffer a reduction in its margin of security.

The lender's best course, therefore, would be to apply part of its share of the award to the debt and attempt to obtain a prepayment penalty for the amount prepaid to recover its lost interest income. If the mortgage agreement contains no provision for a prepayment penalty, the lender will not be in a position to exact a prepayment charge from the borrower since, in this case, it is the lender who is making the prepayment by applying part of its share of the award to the mortgage debt. As a result, the value of the mortgage will almost certainly decrease no matter how the condemnation award is apportioned. On the other hand, if the loan agreement does impose a penalty on prepayment, and if such provision is enforceable under these circumstances, the lender may be able to avoid a loss. It is questionable, however, whether such a provision could be enforced.

Section 1265.240 of the California Code of Civil Procedure provides that “[w]here the property acquired for public use is encumbered by a lien, the amount payable to the lienholder shall not include any penalty for prepayment.” However, this section is probably limited to the question of whether the condemnor must pay the penalty. It does not necessarily resolve the question of the mortgagee’s right to claim the penalty independently of the condemnee-mortgagor. In any case, as stated earlier, under these circumstances a prepayment penalty is unenforceable unless the mortgage specifically authorizes a penalty for involuntary prepayment. In addition, as discussed above, there is an argument, albeit a weak one, that a penalty for involuntary prepayment constitutes an unenforceable award of liquidated damages despite a provision in the mortgage explicitly authorizing such penalty.

Unlike the trust deed holders in Redwood, a lender facing falling interest rates and unable to exact a prepayment penalty following partial condemnation might decide that it is better to give up some of its margin of security than lose interest income by demanding and accepting a share of the award. However, as previously noted, there is

55. If the borrower is personally liable for the debt and has other assets, it is conceivable that a decrease in the lender's margin of security will not affect the value of the mortgage.
56. It should be noted that the lender can only avoid a total loss if the prepayment penalty fully compensates him for the loss of the value of the mortgage, including administrative costs of arranging a new mortgage.
57. CAL. CIV. PROC. CODE § 1265.240 (West 1982).
58. SECURED TRANSACTIONS, supra note 22, at § 4.21.
59. See CONDEMNATION PRACTICE IN CALIFORNIA, supra note 41, at § 10.14.
no way for a lender in this situation to avoid coming out with less value after the condemnation proceedings than before. As a result, the ad hoc approach\(^60\) fails in these circumstances to afford lenders just compensation.\(^61\)

A possible solution to this dilemma would be to allow the lender to recover a prepayment penalty. This alternative, however, creates further difficulties. First, as to those lenders who use non-option penalties, there is no pressure on the borrower to bargain; thus, there is no way to exact a charge for prepayment. Second, where the prepayment penalty is provided in the mortgage agreement, the lender might compel prepayment by applying part of its share of the award to the mortgage debt in situations where the borrower would otherwise have elected to avoid the penalty by performing according to the agreement. Finally, if the penalty is fixed in advance, there is no assurance that it will accurately approximate the lender's loss.

Another alternative would be to require the condemnor to pay a prepayment penalty to the lender. There are two obstacles to this solution. First, many states follow the undivided fee rule which limits the condemnation award to the value the property would have if held as an undivided fee.\(^62\) Under a strict application of this rule,\(^63\) the condemnor could not be required to pay such a penalty. Second, in California, it is provided by statute that "where the property acquired for public use is encumbered by a lien, the amount payable to the lienholder shall not include any penalty for prepayment."\(^64\)

2. When the interest rate charged is lower than the prevailing interest rates

In this case, the value of the mortgage has probably diminished.\(^65\) At first blush it would seem that in the event of partial condemnation, the only way fully to compensate the owner-debtor would be to give it the entire award. This may be seen from the fact that the owner-debtor's net worth almost certainly decreases with each dollar that it is

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60. Despite its deficiencies, the ad hoc approach generally provides greater protection for the lender than all but one of the other suggested standards.

61. Just compensation means that "[t]he owner is to be put in as good position pecuniarily as he would have occupied if his property had not been taken." United States v. Miller, 317 U.S. 369, 373 (1942).

62. See 4 Nichols, supra note 3, at § 12.1.

63. For a loose application of this rule see People ex rel Dep't of Pub. Works v. Lynbar, Inc., 253 Cal. App. 2d 870, 62 Cal. Rptr. 320 (1967).

64. See supra text accompanying note 58.

65. See supra note 52 and accompanying text.
compelled to prepay. On the other hand, the lender will suffer a loss if it receives none of the award since its margin of security will be diminished. Although this apparent dilemma may be solved under the ad hoc approach, it requires a complex balancing of several factors.

Consider first the case where a solvent owner-debtor is personally liable on a note secured by a mortgage. Since a reduction in the lender’s margin of security would not significantly reduce the value of the mortgage, neither party would suffer a loss if the owner-debtor received the entire award. Now, however, consider the case where the owner-debtor has given a non-recourse mortgage or where he has limited liability or assets. If the owner-debtor receives the entire award, the value of the lender’s mortgage will be reduced due to the decrease in its margin of security. On the other hand, if the lender receives the entire award, it will have a gain (and the owner-debtor a loss) because the lender can reloan the money at higher interest rates (and the owner-debtor must finance any new purchase at higher rates). Accordingly, to determine the correct apportionment, the trier of fact must allocate so as to strike a balance between the lender’s loss from reduced margin of security and its gain due to involuntary prepayment. This, however, poses complex valuation problems.

IV. THE LIEN DIVISION RULE

The best approach to the problem of partial condemnation is one which is relatively simple. Under the solution proposed by this article, hereinafter referred to as the “lien division rule,” the condemned portion of the property is treated as a separate parcel encumbered by a separate lien. Accordingly, upon partial condemnation, the owner re-

66. Since the value of the mortgage has probably diminished, any apportionment to the lender is, in effect, a paying off of the mortgage debt for more than it is worth. It might be thought that the owner-debtor can “capture” the value of its low interest mortgage only if the mortgage agreement does not contain a due on sale clause. This is not so for two reasons. First, if the value of the mortgage has diminished substantially below the amount of its unpaid balance, the lender will certainly allow the borrower to pay off the debt at less than the amount left owing. Second, if the borrower desires ownership of a certain quantity of land, partial condemnation without full apportionment to him would force him to borrow money at higher interest rates to purchase additional land.

An avaricious lender might add to the owner-debtor’s loss by exacting a prepayment penalty. Since here prepayment benefits the lender, a court might invalidate the penalty as exorbitant.

67. This would be true if the owner purchased the property for use other than as a residence and financed the purchase through anyone but the seller. CAL. CIV. PROC. CODE § 580b (West 1976).

68. If the owner-debtor wants to continue holding the same quantity and quality of land, he would have to obtain financing to purchase additional property.
ceives the value of its equity in the condemned portion, and the lender is entitled to that percentage of the value of the mortgage that the value of the parcel taken bears to the value of the entire property. The mortgage debt would then be reduced not by the amount received by the lender but by that portion of the unpaid balance that the value of the land taken bears to the value of the entire parcel.

Consider how this rule would work in the context of falling interest rates. Assume a parcel worth $200,000 is encumbered by a mortgage with an unpaid balance of $80,000 and a value of $120,000 due to a fall in interest rates. A portion worth $50,000 is condemned. The remaining portion is worth $150,000; that is, there are no severance damages. Under the lien division rule, the lender would receive $30,000 (($50,000/$200,000) x $120,000) and the owner would receive the remaining $20,000 ($50,000 - $30,000). The lender would then have been compensated for the loss of its lien as to the condemned portion of the property. Since that portion constitutes one-fourth of the value of the original mortgage estate, one-fourth of the mortgage debt would be extinguished. Thus, the unpaid balance of the mortgage would be $60,000 ($80,000 - (¼ x $80,000)), and the value of the remaining land would be $150,000. Under the ad hoc approach, if the lender received $30,000 and applied it to the mortgage debt, the debt would be reduced by the entire $30,000 and the lender would lose above market interest income. Thus, the lender's best course would probably be to release its portion of the award to the debtor, thereby reducing the lender's margin of security but preserving its high interest income.

The lien division rule is as easily applied in the context of rising interest rates. Assume a parcel worth $200,000 is encumbered by a non-recourse mortgage with an unpaid balance of $120,000 and a value of $80,000 due to a rise in interest rates. A portion worth $100,000 is condemned and the remaining portion is worth $100,000. Under the lien division rule, the lender would receive $40,000 (($100,000/$200,000) x $80,000) and the owner would receive the remaining $60,000 ($100,000 - $40,000). Under the ad hoc approach, if the lender received nothing it would be left with a note for $120,000.

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69. It might be argued that since the owner's equity in the entire parcel is $120,000 ($200,000 - $80,000) and since one-fourth of the parcel has been taken, the value of his equity taken is $30,000 (¼ x $120,000). This formula ignores the fact that in selling the property, the owner must either prepay the mortgage or sell the property subject to the mortgage. In either case, it is the value of the mortgage, not its face amount, that will be deducted from the value of the land.
secured by a mortgage on a parcel worth $100,000. As a result, the value of its mortgage would be less after condemnation than before since there would no longer be any margin of security. If the lender received the entire award of $100,000, the borrower who had an equity of $120,000 ($200,000 — $80,000) before condemnation would be left with an encumbered parcel worth $100,000. Consequently, it would lose $20,000 ($120,000 — $100,000) as a result of condemnation. Thus, the court would be required to find an equitable apportionment where both parties would be indemnified for their loss.

The lien division rule is not without difficulties. The first arises from the fact that a lien is thought to attach to every portion of the land covered by it. As a result, it appears inconsistent to divide the lien into two parts, each securing a fraction of the debt. Legal issues, however, should not be resolved by metaphysical analysis. Instead, the suggested rule should be examined in light of the economic realities of the transaction. The lienholder suffers extinguishment of a portion of the secured debt and loses a portion of the security. In return, it receives a sum equivalent to the market value of the property rights taken from it. Since it receives just compensation, it has no complaint.

Second, this approach might be criticized for the valuation problems it creates. For example, the value of the mortgage must be determined at the time of the taking. But though not made explicit, the ad hoc approach, as outlined in Redwood, prescribes the same determination. Indeed, the factors which the Redwood court said should be considered in the apportionment decision are the same factors which are used to determine the value of a mortgage. In addition, even after the value of the mortgage has been determined, the ad hoc approach requires the court to engage in complex balancing. For clarification, consider the following example. Assume a parcel of property worth $200,000 is encumbered by a non-recourse mortgage with an unpaid balance of $100,000 and a value due to a fall in interest rates of $120,000. A portion worth $100,000 is condemned, and the remaining portion is worth $100,000. Under the lien division rule, the lender would receive $60,000 (($100,000/$200,000) × $120,000) and the owner would receive the remaining $40,000 ($100,000 — $60,000). The unpaid balance of the mortgage, $50,000 ($100,000 — (½ × $100,000)), would encumber the remaining parcel. Under the ad hoc approach the court

70. For example, in Ward v. Union Bond & Trust Co., 243 F.2d 476 (9th Cir. 1957), the court recognized that installment land sale contracts are economically equivalent to mortgages. Accordingly, the court opined that a vendee could demand a judicial foreclosure despite his lack of legal title.
would try to minimize the lender's loss. If the lender received the entire award, and assuming there was no prepayment penalty, its loss would be $20,000 ($120,000 - $100,000). If it received none of the award, it would be left with a note for $100,000 secured by a mortgage on a parcel worth the same amount. Without a margin of security its mortgage would be worth considerably less than its face amount. The court would be required to find an equitable apportionment where these losses were minimized.

Third, it might be argued that by paying the lender a premium over the proportionate unpaid balance of the mortgage when the mortgage interest rate is above market, the condemnor is in fact awarding the lender a prepayment penalty. Under this view, the lien division rule is merely the ad hoc approach amended to permit the lender to recover a prepayment penalty. However, the lien division rule has an important advantage because it fixes the "prepayment penalty" at an amount which indemnifies the lender for loss of value. A prepayment penalty established by contract might be too high or too low under the circumstances.

Finally, it might be contended that the lien division rule would violate the statutory prescription against imposing prepayment penalties on condemnors. This contention is unsound. The suggested approach is merely a rule of apportionment. Since the premium paid the lender is taken from the owner-debtor's share, the condemnor is not penalized. From the owner-debtor's viewpoint this is a fair allocation since he or she receives a share of the award equal to the market value of the property taken from him or her.

In sum, the lien division rule applied in the face of rising or falling interest rates is simpler and more rational than the ad hoc approach. In addition, where there is a market for mortgages the lien division rule offers an important advantage insofar as market prices may be used to determine apportionment.

V. CONDEMNATION AND THE LEASEHOLD MORTGAGE

Absent a prohibition in the lease, the lessee is legally entitled to encumber the leasehold estate. State law restrictions on lenders, however, limit the ability of the lessee to mortgage his estate. In Massachusetts, for example, insurance companies may invest in loans upon

71. See supra text accompanying note 64.
leasehold estates only if the property subject to the lease is unencumbered.\textsuperscript{73}

It is important to note at the outset that the leasehold mortgagee’s share in a condemnation award is limited to the amount the lessee would otherwise have received if his estate were unencumbered.\textsuperscript{74} The lender will therefore be concerned that the lease gives the tenant a large enough share of any condemnation award to protect the lender’s interest.\textsuperscript{75} However, leases often provide that the lessee receive no share of the award.\textsuperscript{76} In most states, the parties to a lease or mortgage can waive the constitutional and statutory provisions governing condemnation. In California, however, there is statutory authority which seems to bar waiver of the statutory measure of apportionment between mortgagors and mortgagees in partial condemnation proceedings.\textsuperscript{77} Conversely, section 1265.225 of the California Code of Civil Procedure permits the parties to a lease to fix by agreement their respective rights in any condemnation award.\textsuperscript{78} There is no explicit statutory indication as to which rule controls when a lessor and a leasehold mortgagee press competing claims to a partial condemnation award. If a court gives effect to a lease provision allocating the entire award to the lessor, the mortgagee could argue that the court is violating its non-waivable right to an amount of the award necessary to prevent an impairment of the security. However, it appears that section 1265.225 is intended only to bar a waiver by the mortgagor and not the mortgagee. In subsection (a) it is provided that the “lienholder may share in the award only to the extent . . . necessary to prevent an impairment of the security.”\textsuperscript{79} This subsection seems to limit rather than guarantee the lienholder’s share. Such a construction is consistent with California’s general statutory regulation of mortgagees and trust deed holders. Many of the provisions fixing the relative rights of mortgagees and mortgagors bar waiver by the mortgagor.\textsuperscript{80} In no provision is waiver by the mortgagee barred.

\textsuperscript{73} Mass. Gen. Laws Ann. ch. 175, § 63(7) (West Supp. 1981); ABA Section of Real Property, Probate and Trust Law, Committee On Leases, Ground Leases and Their Financing reprinted in B. Goldstein, Modern Real Estate Transaction 669, 670 (3d ed. 1980) [hereinafter cited as ABA Report].

\textsuperscript{74} Since the leasehold mortgage encumbers the leasehold estate, the leasehold mortgagee cannot lose more than the reduction in the value of the leasehold.

\textsuperscript{75} ABA Report, supra note 73, at 677.

\textsuperscript{76} See infra note 85.

\textsuperscript{77} See supra notes 24-31 and accompanying text.


\textsuperscript{79} Id. § 1265.225(a).

Consequently, it seems that under these circumstances the lease agreement should be given effect.81

In the event that the lease makes no provision for apportionment or otherwise fails to allocate the entire condemnation award to the lessor, the lessee's share must then be apportioned between the lessee and the leasehold mortgagee. It is therefore necessary first to consider how a condemnation award would be apportioned between a lessor and a lessee in the absence of an agreement fixing their respective shares in such award.

A. Apportionment Between Lessor and Lessee

The compensable interests of the parties to a lease are generally limited to the lessee's interest in the leasehold, subject to the rent, and the lessor's reversionary interest and the rent.82 Under the undivided fee rule followed by the majority of jurisdictions, the gross condemnation award is determined by appraising the property as an undivided fee.83 This is typically accomplished by capitalizing the fair rental value of the property at the time of condemnation.84 The lessee's award is then calculated and deducted from the gross award. The residue is given to the lessor.

In general, the lessee's share is equal to the value of its interest in the leasehold. When the economic rent (fair rental value) of the property subject to the lease exceeds the rent reserved in the lease, the lessee possesses a bonus value leasehold. Upon total condemnation, the lease terminates, as does the duty to pay rent; in the absence of any agreement to the contrary,85 the lessee is entitled to receive an award equal

81. It is interesting to consider what should result when the lease agreement allocates the award to the lessor and the mortgage agreement allocates the award to the lender. First, unless the lessor consented to the mortgage agreement, the lessee could not give away a greater share of the award than it would be entitled to. As to the remaining conflict between the agreements, the one first to be executed should control, for the lessee would then have given away its entire rights to the award, and the later agreement would be ineffective.

82. Corrigan v. City of Chicago, 144 Ill. 537, 33 N.E. 746 (1893). See also Note, Condemnation, Compensation and "Negative" Leaseholds, 43 Fordham L. Rev. 841 (1975) [hereinafter cited as "Negative Leaseholds"].


85. The lessor and lessee may provide in the lease for a certain apportionment of the award. E.g., Cal. Civ. Proc. Code § 1265.160 (West 1982). Leases often provide that the lessee receive no share of the award. 2 M. Friedman, Friedman on Leases § 13.3 (1974); "Negative" Leaseholds, supra note 82, at 843.
to the present value of the periodic bonus rent\(^{86}\) for the unexpired term of the lease.\(^{87}\) In the event of partial condemnation, however, there is a split of authority regarding treatment of the lessee and lessor. Under the majority rule, if the remainder of the leased property is still suitable for the purposes of the lease, the duty to pay the entire rent continues.\(^{88}\) In this case, however, the lessee is entitled to receive the present equivalent of the economic rent attributable to the part taken over the unexpired period of the lease.\(^{89}\) This rule has been criticized because the "right to the unabated rent is now secured only by the property remaining after condemnation, which could operate to the prejudice of the lessor in the event the lessee fails financially or otherwise."\(^{90}\) As a consequence, a growing minority of states have adopted the rule that partial condemnation terminates the lease as to the part taken and extinguishes the rental obligation allocable to that portion.\(^{91}\) The lessee then receives the present value of the bonus rent attributable to the part taken. If the remainder of the property is still suitable for use consonant with the lease, the minority rule preserves the lease and the rental obligation as to the remainder.\(^{92}\)

A valuation dilemma arises, however, in connection with a negative leasehold — that is, a leasehold under which the contract rent exceeds the economic rent at the time of condemnation. Because the lessee's leasehold interest is valueless, the lessee does not share in the award. Nevertheless, if the undivided fee rule is strictly applied, the property will be appraised according to its fair rental value, and the lessor-owner will be deprived of the benefit of its bargain with the lessee. This is the majority rule in total condemnation cases. However, in People ex rel. Department of Public Works v. Lynbar, Inc.,\(^{93}\) and two other recent decisions,\(^{94}\) the undivided fee rule was overlooked in order to compensate the owner-lessee for the loss of an advantageous lease. In these cases, the court ordered an appraisal of the condemned prop-

\(^{86}\) The bonus rent is the difference between the economic rent and contract rent. See "Negative" Leaseholds, supra note 82, at 844.


\(^{88}\) E.g., Gluck v. Mayor of Baltimore, 81 Md. 315, 323, 32 A. 515, 516 (1895).

\(^{89}\) Id. The lessor receives the amount remaining after the lessee's share is subtracted from the gross condemnation award.

\(^{90}\) "Negative" Leaseholds, supra note 82, at 847 n.37. See also Horgan & Edgar, Leasehold Valuation Problem in Eminent Domain, 4 U.S.F.L. Rev. 1, 11 (1969).

\(^{91}\) E.g., CAL. CIV. PROC. CODE § 1265.120 (West 1982); W. VA. CODE § 37-6-29 (1966).

\(^{92}\) See supra note 91.

\(^{93}\) 253 Cal. App. 2d 870, 62 Cal. Rptr. 320 (1967).

rerty to include the contract rent for the unexpired term of the lease. Under both approaches, however, the lessee reaps a windfall—in one case at the lessor’s expense, in the other, at the expense of the condemning authority. The obvious solution, as pointed out by at least one commentator, is to require lessees holding negative leaseholds to pay the difference between the contract rent and the economic rent of the property at the time of condemnation.

When only part of the leased property is condemned, there are three possible approaches to apportionment. As stated above, under the majority rule, the duty to pay the entire rent continues unabated and the lessee is awarded the present value of the future rent attributable to the part taken. Although this rule places the lessor in a less secure position with respect to the lessee, it has the virtue of preserving the lessor’s benefit of the bargain. Under the other two approaches, the lease and the obligation to pay rent are terminated as to the part condemned, but they remain in force with respect to the remainder. Under one view, the part condemned is appraised according to its fair rental value. Consequently, the lessor is deprived of the benefit of above-market rental payments on this portion. Another view, not yet adopted by any court but deducible from the rule in *Lynbar*, would preserve the lessor’s benefit of the bargain by valuing the part taken according to the contract rent for the expired term.

**B. Apportionment Between Lessee and Leasehold Mortgagee**

The lessee’s share of a partial condemnation award, as determined by agreement between the lessor and lessee or, absent agreement, according to the rules discussed above, is apportioned between lessee and the leasehold mortgagee according to the rules of apportionment governing the respective rights of mortgagors and mortgagees. As an illustration, consider the following example. A parcel with a fair rental value of $200,000 is subject to a 99-year lease. The present worth of the rent reserved in the lease is $160,000. The leasehold is encumbered by a mortgage with a face amount of $209,000 and a value of $16,000. A portion of the parcel, worth $100,000, is condemned. There are no severance damages—that is, the remaining portion has a fair rental value of $100,000. First, the lessee’s award must be determined. Under the majority rule, the lease would remain in effect and the lessee would receive an amount equal to the fair rental value of the part taken or

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95. “Negative” Leaseholds, supra note 82, at 855.
96. See supra note 91 and accompanying text.
$100,000. Under the pre-take ratio rule, the lender would receive that amount which would maintain the security-to-debt ratio existing immediately before condemnation. Since the pre-take ratio was $40,000/$20,000, the lender would receive $10,000, resulting in a post-take ratio of $20,000/$10,000. According to the lien division rule, the lender would receive the proportion of the value of the mortgage that the value of the security taken bears to the value of the entire security, or $8,000 (($20,000/$40,000) \times $16,000). Since the condemned portion constitutes one-half of the leasehold estate, one-half of the mortgage would be extinguished. Thus, the unpaid balance on the mortgage would be $10,000 ($20,000 - (\frac{1}{2} \times $20,000)). Under the majority rule, the lender would share in the award to the extent of the remaining secured indebtedness, or $20,000.

VI. Conclusion

Under the present law, upon partial condemnation of mortgaged property it is unlikely that both the borrower and the lender will receive just compensation for the loss of their respective interests in the condemned property. The majority rule usually over-compensates the lender at the borrower's expense, while the original ratio rule, the debt equivalency rule, and the pre-take ratio rule frequently over-compensate the borrower at the lender's expense. The ad hoc approach followed in a few states does not allocate fairly the condemnation award in many cases. In other cases, it theoretically accomplishes a fair allocation of the award, but the ad hoc approach requires a complex balancing of many variables. On the other hand, the position suggested by this article, the lien division rule, compensates each party for the value of its interest in the condemned property by a simple calculation based on the value of the property and the value of the mortgage encumbering the property.