

Real Estate Title Insurance & Construction Law

Condemning Leasehold Interests

N.J. Supreme Court rules on the mechanics of condemning leasehold interests under the Eminent Domain Act and the terms of the lease

**By Michael Miceli and
Jennifer P. Smith**

Condemnation of property, even in the best case, can raise a host of legal and procedural issues. When the condemnation involves anything less than the entire fee simple, those issues can intensify. Municipalities, property interest holders and redevelopers are often left to struggle with the problems of identifying all of the lesser interests in property, the statutory procedures for condemning those rights and the impact of private contract rights on the requirements of the Eminent Domain Act.

This spring, the New Jersey Supreme Court issued an opinion in *Town of Kearny v. Discount City of Old Bridge*, 205 N.J. 386 (2011), which simultane-

Miceli is a director and Smith is an associate in the real property and environmental group at Gibbons P.C. in Newark.

ously refined and further complicated the process for condemning a leasehold interest. Although the Court made it clear that a condemning authority may condemn a leasehold interest separate and apart from a fee-simple interest, the decision raised questions about the interpretation of typical condemnation provisions that appear in many existing leases.

The atypical facts in the case likely led to the complex conclusion. The town of Kearny designated an industrial area as an area in need of redevelopment pursuant to the Local Redevelopment and Housing Law. At least one property owner, who leased its property to various lessees, objected to the designation, subsequent adoption of the redevelopment plan and designation of another entity as redeveloper. Years later, after the original redeveloper dropped out, Kearny designated the complaining landlord as the redeveloper. The landlord then requested that Kearny condemn the leasehold interests on its

property so that the landlord could hold the property free and clear of the leasehold interests.

The landlord, acting on behalf of Kearny in the condemnation proceeding, offered one of the tenants \$250,000, including \$50,000 for relocation costs, for the value of its leasehold. The tenant submitted a counteroffer of \$3 million, which was rejected. No further negotiations occurred between the landlord and the tenant, and Kearny did not enter into separate negotiations with the tenant.

Kearny moved forward with the condemnation of the tenant's leasehold interest. The trial court found the condemnation to be valid, among other rulings. The Appellate Division affirmed the trial court's decision, but remanded to the trial court for a finding of the just compensation due to the tenant.

On remand, the question became whether the tenant had negotiated away its right to compensation through the condemnation clause in its lease. Thus, the trial court's ruling rested on the terms of the condemnation clause, which stated in relevant part:

If the Complex of which the Premises are a part, or any portion thereof, shall be taken under eminent domain or condemnation proceedings, or if suit or other action shall be instituted for the taking or condemnation, or if in lieu of any formal condemnation proceedings or actions, Landlord shall sell and convey the Premises of any portion thereof, to the governmental or other public authority, agency, body or public utility, seeking to take said land or any portion thereof, then this lease, at the option of the Landlord, shall terminate, and the term hereof shall end as of such date as Landlord shall fix by notice in writing; and Tenant shall have no claim or be entitled to any portion of any amount which may be awarded as damages or paid as the result of such condemnation proceedings or paid as the purchase price for such option, sale or conveyance in lieu of formal condemnation proceedings.

The trial court concluded that the condemnation of the leasehold interest triggered the provisions of the condemnation clause, which terminated the lease and dictated that the tenant was not entitled to any compensation. The Appellate Division affirmed. On petition to the Supreme Court, the tenant argued that it had been deprived of its property interest without due process of law and just compensation.

As initial matters, the Court confirmed that (1) the tenant was not entitled to notice of the initial designation of the property as in need of redevelopment; and (2) leasehold interests can be condemned "separate and apart from, and without condemnation

of, the fee simple." With those rulings as the backdrop, the Court tackled whether the condemnation process was proper and whether the tenant was entitled to compensation under the lease.

The Court noted that "where a fee simple is being condemned, negotiations will take place with the fee owner alone," but found that "it is obvious that where the fee is not at issue, the holder of the interest that is actually at stake is the party with whom negotiations must take place." Because, among other things, the landlord failed to undertake the required appraisals and to make an appropriate offer of just compensation, the negotiations were fatally flawed and violated the bona fide negotiation requirements set forth in N.J.S.A. 20:3-6, a portion of the Eminent Domain Act.

The Court determined that the failure to enter into bona fide negotiations was sufficient to invalidate the condemnation. Nevertheless, it went one step further to evaluate whether the condemnation clause of the lease relieved the landlord and the town from having to compensate the tenant in the event the town attempted again to condemn the leasehold interest.

The Court found that because the clause could work a forfeiture on the tenant, it should be strictly construed. Thus, "unless the clause [was] crystal clear, forfeiture should not occur." The Court interpreted the condemnation clause as depriving the tenant of compensation only upon condemnation of the entire fee or a portion of the land. Because Kearny was only seeking to condemn the leasehold interest, the Court determined that the tenant was entitled to compensation. Thus, the Court dismissed the condemnation complaint and put Kearny on notice that if it filed a new complaint, it would be required to engage in bona fide negotiations with the tenant.

The Court's ruling was not unani-

mous. Justice LaVecchia, joined by Justice Rivera-Soto and Judge Stern (t/a), filed a dissenting opinion, stating that the majority took an "unduly narrow interpretation" of the condemnation clause of the lease, and the lease simply did not afford the tenant a right to compensation in the event of the condemnation of either the fee simple or any other interest. In short, whether a condemnation touched a physical portion of the fee or a portion of any property interest in the fee (e.g., a leasehold interest), the dissenting Justices believed that it triggered the condemnation clause and terminated the lease. The parties negotiated the lease in an arms-length transaction, and, therefore, should have been bound by the lease's terms.

Furthermore, the dissenting Justices thought that the majority had elevated form over substance because both the parties acknowledged that if Kearny had condemned the entire fee and then conveyed it back to the landlord, the lease would have been terminated, and the tenant would not have been entitled to compensation. The dissenting Justices were not persuaded that the tenant should receive compensation simply because the leasehold was being condemned separate from the fee, when the tenant would have received no compensation if the town had condemned the entire fee.

There are several points to take away from this case. First, leasehold interests undoubtedly can be condemned separate and apart from fee interests. Second, when the fee interest is not being condemned, a condemning authority must follow all of the statutory requirements for bona fide negotiations with the impacted tenant. Finally, tenants and landlords should review their existing lease condemnation clauses, with a focus on the nuances of the clause, which could determine whether a tenant receives a condemnation award or not. ■