Squaring the Eminent Domain Circle

A New Approach to Land Assembly Problems

Amnon Lehavi and Amir N. Licht

The U.S. Supreme Court's *Kelo v. City of New London* decision sparked a fierce debate throughout the United States when it validated the use of eminent domain for purposes of economic development, especially when the confiscated lands are then transferred to private parties that implement the project and enjoy its gains. Opponents see the decision as pronouncing the ultimate death of the Constitution's Fifth Amendment requirement that eminent domain be restricted to property taken for "public use," claiming it grants governments a *carte blanche* for a compulsory transfer of private property from ordinary citizens to politically powerful real estate entrepreneurs.

Lobbying groups such as the Castle Coalition have argued that the *Kelo* decision has "opened the floodgates" of eminent domain abuse, spurring governments to proceed with hundreds of projects in which homes, small businesses, and other properties would be razed in favor of high-profile private developments, leaving landowners with minimal compensation based on the preproject "objective" land values (Berliner 2006).

This version of events is only partially valid, however, both in theory and in fact. Many state legislatures and courts have already taken steps to mitigate the potential overuse of eminent domain powers. Some legislatures have placed new prohibitions on the use of eminent domain, either by prohibiting its use for private economic development, redefining more stringently the terms "public use" and "blight," or otherwise increasing restrictions on the use of eminent domain for such projects (Salkin 2006).

In addition, some state courts, as in Ohio (*City of Norwood v. Horney*) and Oklahoma (*Bd. of County Comm'rs of Muskogee County v. Lowery*), have interpreted state legal limits on the use of eminent domain for private economic development more stringently than the Supreme Court's reading of the federal Constitution in *Kelo*. In this sense, post-*Kelo* reality may not necessarily be heading in only one direction.

On the policy level, a flat prohibition on the use of eminent domain to assemble land from numerous owners to allow large-scale, financially profitable projects is highly problematic. In the *Kelo* case, the 90-acre Fort Trumbull plan was presumably made with the genuine purpose of revitalizing the economy of the then-distressed City of New London. The plan included 115 privately owned properties, as well as publicly owned lands.

Such projects, involving dozens or hundreds of landowners, each holding an exclusive entitlement to a fragment of the designated project's area, could be impossible to implement if every affected property owner could veto the plan by refusing to sell his parcel. Unanimous consent is not a reasonable requirement for such large-scale projects. This problem is often referred to in the property literature as an "anticommons" dilemma, meaning that any landowner could prevent the assembly of land for its economically more efficient reorganization.

In some cases, this veto power may be benign, at least in the eye of the beholder. Susette Kelo may very well have preferred to stay in her home rather than take part in the ambitious Fort Trumbull development plan, which included construction of waterfront hotels, marinas, offices, retail spaces, and other commercial uses. In other cases, landowners of agricultural or natural landscape properties may object to new development on ideological or environmental grounds. Sometimes, however, objections might be purely financial, the result of strategic holdouts by those attempting to maximize their gains.

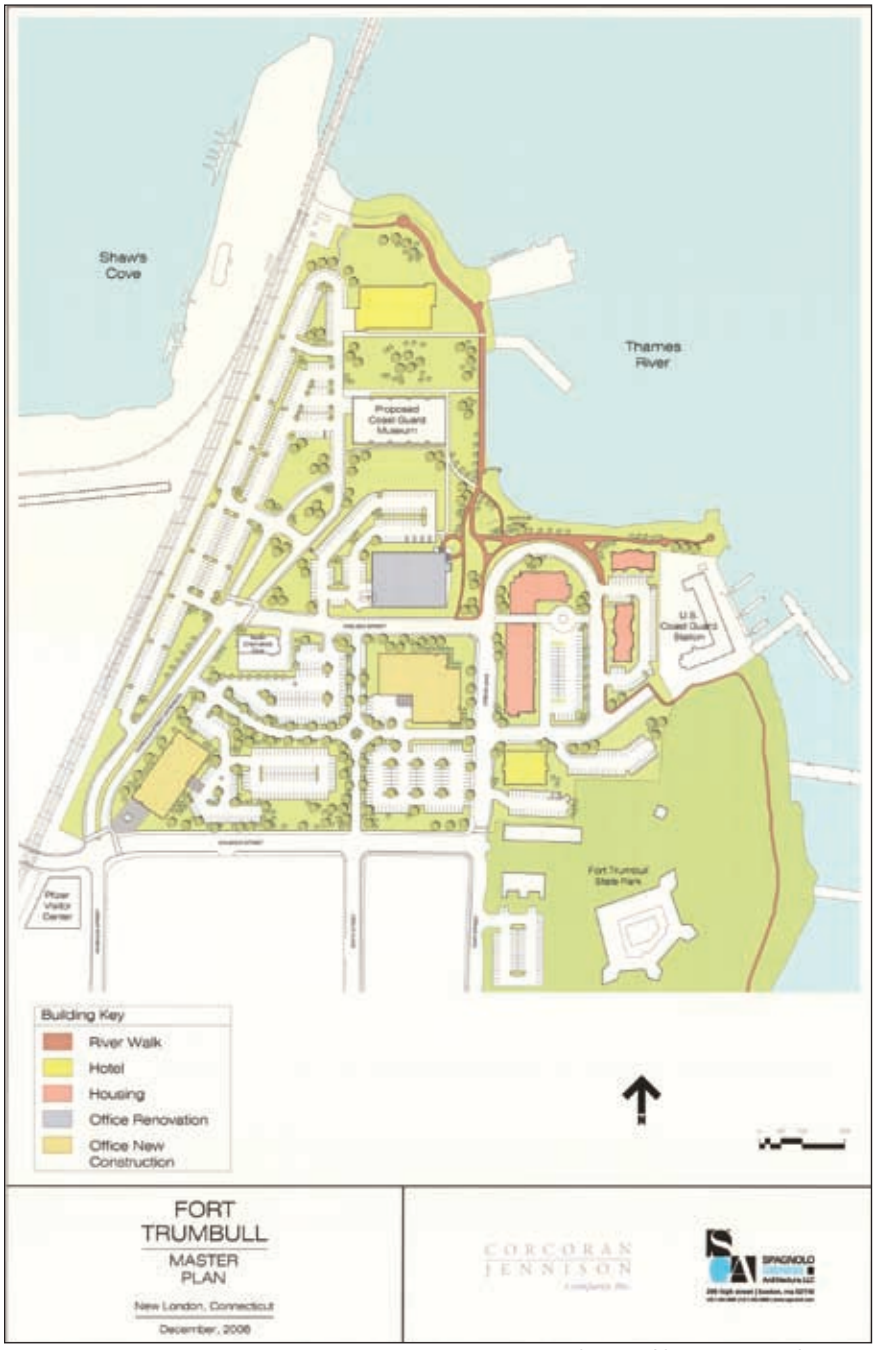
Large-scale contractual land assembly sometimes disguises the identity of the purchaser (as in the now-famous cases of Walt Disney's secret purchases

of thousands of acres from numerous property owners in Florida and in Virginia). In other cases, the collective action problem might unfairly reward strategic holdouts with a substantial premium, or cause the plans to fail altogether, thus preventing innovation, economic growth, and the realization of genuine public preferences. In addition, successful grassroots organization for urban development and redevelopment projects in the United States seems to be limited to the nonprofit community development corporations (CDCs) and community land trusts (CLTs), which aim primarily at the provision of affordable housing.

The current legal regime creates an uneasy dichotomy. When the use of eminent domain for certain types of for-profit developments is forbidden, projects offering private and public benefits may not happen. Alternatively, when eminent domain is validated to solve the anticommons problem, the government and third parties that take part in the project enjoy the entire increment in the assembled land value, since compensation to the previous landowners is based on the preproject fair market value.

A landowner restricted to such a measure of compensation is denied both the "subjective premium" (that is, the unique value that people often place on their properties, especially their homes) and the chance for a share in the appreciation brought about by the future project (Fennell 2004). This compensation regime can seem unfair, and it distorts governmental decision making by further encouraging use of its eminent domain power even when it may be socially undesirable or unnecessary for practical purposes.

Our research proposes a novel solution for "squaring the eminent domain circle" when large-scale, for-profit projects require the assembly of land from private property owners. Our proposed model would turn the landowners into *pro rata* shareholders in a development corporation that would acquire unified ownership of the land and the development project.



Courtesy of Corcoran Jennison Companies

Current U.S. and English Legal Regimes

The prevailing land use regulation and land tax laws in the United States make the *Kelo* case and the use of eminent domain for private development particularly dramatic, especially compared to other countries. A private developer who receives regulatory approval for a development project, including rezoning of the land or granting of a building permit, enjoys nearly the entire increment to the land value, and bears only a small portion of the total costs to the government and to affected parties in the surrounding community.

On one hand, following the U.S. Supreme Court decisions in *Nollan v. California Coastal Comm'n* and *Dolan v. City of Tigard*, local governments are limited in their ability to require exactions from the developer. On the other hand, the U.S. tax regime imposes no betterment tax on the increased value of

A Holdout's Last Stand

This dramatic photograph illustrates the case of a defiant homeowner in Washington, DC, who refused all offers from private developers, even rejecting payments of $2 to $3 million for his 116-year-old townhouse, which was assessed for just under $200,000 (Layton 2006). This was not a public project, and eminent domain could not be used to force him to transfer his property.

Austin L. Spriggs and his wife, Gladys, have owned this house since 1980, and now use it as an office for the family's small architecture firm. When developers began purchasing property along this area of Massachusetts Avenue near the Convention Center and Union Station in 2003, Spriggs resisted. All his neighbors eventually sold their homes and small commercial buildings, but Spriggs could not be persuaded. He became a holdout who threatened to prevent the assembly of land along a rapidly redeveloping stretch of prime urban space.

Two developers working together finally determined they would build around the townhouse. Their plans envision a 12-story office building and an upscale condominium that will wrap around the Spriggs house and tower above it. In the meantime, the house has been secured at the developers' expense, and it is monitored daily to be sure it does not slip off its tenuous base.

The end of this holdout's story is not yet known, but according to the president of a Maryland-based pizza chain, Spriggs intends to open a pizza franchise just in time for the condominium dwellers and office workers who will move to his neighborhood during 2007 (Layton 2006).

land resulting from the governmental regulatory "givings." This state of affairs presents the landowners with a "win all or lose all" situation: retaining their land ownership interests within the project and enjoying its gains, or being unwillingly bought out through eminent domain for compensation based on the preproject value. It is no wonder, therefore, that the post-*Kelo* public and legal waters are so stormy.

In this context, recent developments in England offer an interesting comparison. As in the United States, the English legal regime gives governments a broad mandate to assemble private land for urban regeneration projects and to pass on the land to private developers. The case of *Alliance Spring Co Ltd v. First Secretary of State* dealt with a major redevelopment scheme resulting from the Arsenal Football Club's need for a larger stadium. Validating the use of land assembly through compulsory purchase (eminent domain) for this mainly private development, the court held that the Islington Council, the local planning authority, was within its authority to take property for the new stadium and to produce and promote a larger scheme "which it regarded as a comprehensive redevelopment of the area in the public interest."

These governmental powers have been further broadened by the Planning and Compulsory Purchase Act of 2004, which allows the use of compulsory purchase for development or redevelopment that promotes or improves the economic, social, or environmental "well-being" of the area in question.

At the same time, however, in contrast to the United States (although some American skeptics would argue otherwise), the English Crown holds all landed property development rights (Connellan 2002). In theory, private landowners have no development rights in their property until these are explicitly granted by a governmental agency. This gives local governments in England substantial latitude both in deciding whether to grant planning permits and in negotiating with the developer over its planning obligations.

An influential analysis of housing supply in England by economist Kate Barker (2004) considered the role of planning obligations (either requiring the developer to perform certain actions, or having him pay a sum to the planning authority that will then itself take the said action). The Barker report suggests that planning obligations actually fulfill two different economic roles: as a vehicle for compensating affected parties for the negative externalities arising from the development, and as an informal tax on land betterment.

Barker recommended that these two functions be separated so that planning obligations could be scaled back and restricted to dealing with the actual impacts of the development, whereas a new tax would extract some of the windfall gain that accrues to landowners. This tax would be passed on to the local community to help share the benefits of growth and manage its impacts. It would also allow the community to provide the infrastructure necessary to support housing growth, while still preserving private development incentives.

The government has accepted the Barker recommendations, and in December 2005 issued a consultation paper setting out the proposed features of the new tax, Planning-Gain Supplement (PGS), which "would capture a modest portion of the value uplift on land for which full planning permission has been granted" (Her Majesty's Treasury 2005). By doing so, England, which has had experience with betterment taxes since 1947, seems on its way to using taxation to share the benefits of land value increments between the developer and the public (Connellan 2002).

While landowners in England face the same threat of losing ground (literally) for private developments, the conflicting interests are at least more balanced there, in that the project's developer must share its gains with the public. In this respect, the public element of the use of compulsory purchase is more highly developed in England than is currently the case in the United States. Yet even under the English legal regime, let alone under the American (federal) regime, landowners are not only forced to transfer their land for large-scale private developments implemented by others, but are compensated on the much lower predevelopment land values.

This situation has prompted numerous calls for changes in U.S. legal doctrine, using either mechanisms that are already in existence in other countries (such as the planning tool of land readjustment, which is used in many European and Far East countries), or on theoretical suggestions for reforms, such as changing the fair market value compensation formula in certain circumstances. Thomas Merrill (1986) has suggested awarding condemnees 150 percent of the fair market value when there are "suspect" conditions in the eminent domain process, such as a high subjective value

Courtesy of the Institute for Justice

Susette Kelo, standing in front of her home, was the lead plaintiff in *Kelo v. City of New London.*

for the land, a potential for rent-seeking by the government or interested third parties, or fear of a deliberate bypass of potential market purchases. Although such a rule of thumb of increased compensation might have a general deterrent effect on governments, it could result in undercompensation or overcompensation for landowners. In any case, it does not create a reliable financial link to the risks and rewards of the planned project.

The Proposed Model: A Special-Purpose Development Corporation

Cases of land assembly for economic development are rife with market failures, and their circumstances vary considerably. Some landowners are not compensated for the exceptionally high emotional value they place on their land, while others receive a price that reflects not only its market value but also the harm caused to their sense of autonomy. It is exceedingly difficult, moreover, to distinguish a landowner's opportunistic holdout behavior from regular bargaining. In addition, while some development projects may be promoted by benevolent public authorities, one cannot rule out scenarios in which eminent domain proceedings are initiated by opportunistic private developers who are motivated by the below-market compensation to current landowners.

Our proposed model would restore market mechanisms to the extent possible in such cases. A market-based solution would take advantage of the market's powerful price system to align the interests of landowners, public authorities, and land developers.

How does one place the eminent domain circle in the market square? The answer is through a special-purpose corporation. The economist Ronald Coase (1937) observed that firms are solutions that people devise to overcome market failures, in particular when parties fail to reach a contractual agreement because they fear that the other party will behave opportunistically. Firms concentrate the equity capital that is crucial for their functioning in a separate legal entity, a corporation. In exchange equity investors receive nonfixed claims against the corporation in the form of shares. These shares are tradable and, in theory, their price should reflect their true economic value as the net present value of future corporate profits.

U.S. law has developed elaborate doctrines and rules regarding corporations that can be utilized to mitigate the problems that currently haunt eminent domain. We propose that a public authority exercising its eminent domain powers for an economic development project incorporate a special-purpose development corporation (SPDC) for that project. This corporation may be set up as a subsidiary of a municipality's regular development corporation, to which the municipality will have delegated its eminent domain powers. For instance, the City of New London delegated its eminent domain powers to the New London Development Corporation (NLDC), which in turn negotiated a 99-year ground lease for $1 with Boston-based developer Corcoran Jennison.

Under our proposal, NLDC would have set up a subsidiary as a SPDC for the Fort Trumbull Municipal Development Project. Next, the municipality or a designated representative would exercise the city's eminent domain power to take the private property and then grant certain rights in the land (such as a 99-year ground lease for $1) to the SPDC. These rights would be the SPDC's sole material asset.

Landowners whose land was condemned would have the choice of two forms of compensation: (1) just compensation under current law, which is based on the preproject fair market value; or (2) shares in the SPDC in proportion to the landowners' contribution. From a financial point of view, this would be equivalent to offering landowners a real option to purchase SPDC shares for the equivalent of the legal just compensation,

while at the same time granting them the just compensation to cover the purchase cost. The SPDC would emerge from this stage with numerous shareholders. In this scenario, Susette Kelo, together with ten other landowners of Parcel 4A in the Fort Trumbull Project, might have received 2.67 percent of the SPDC issued stocks for their 2.4-acre share in the 90-acre project.

Next we envision that the SPDC could either negotiate land rights with the private developer who initiated the project, or auction its land rights. In many cases, the sole buyer would be the same developer. If a bidding war ensued among several private developers, it would benefit the SPDC and its shareholders. Then the SPDC would distribute the net proceeds from the sale as dividends to its shareholders. In the final stage, the SPDC would dissolve when its role was finished.

The proposed model thus separates the two components of eminent domain: just compensation; and the taking, which remains an involuntary nonmarket transaction. The justification for takings in economic development projects lies primarily in the likelihood of market failure due to collective action problems and opportunistic behavior. Whether eminent domain should be exercised in such a context is beyond the scope of our proposal, although the U.S. Supreme Court in *Kelo* approved its use in this way as a constitutional matter.

Our model suggests a significant modification to the just compensation component of eminent domain. Under current law this compensation, notwithstanding the term "fair market value," bears only a weak relation to market conditions. We propose to link this compensation more closely to market value. The SPDC shares of landowners who elected to receive them will be transferable, and ideally these shares would trade on a stock market. If the number of shareholders is large enough, the SPDC may face disclosure requirements under federal or state securities laws. The upshot is that the SPDC share price will reflect the best assessment of the value of the entire land plot in light of the planned development and in light of publicly available information. The land-owners-turned-shareholders would be able to sell their shares outright or await the dividend distribution.

There may be numerous permutations on the basic scenario described above. For instance, the municipality might participate in the SPDC in different capacities, especially if public land is included in the project. Under an alternative compensation scheme, participating landowners may receive shares based on other additional factors, such as property value. It may also be possible to allow homeowners to hedge against a drop in the share price to avoid financial loss on the sale of their residence. Or, bidding for land rights may take the form of a tender offer for the SPDC shares.

We intend to elaborate on these issues in future work. For now it is enough to say that the proposed mechanism will create the right incentives for private developers and for public authorities to exercise eminent domain powers in projects that are truly welfare enhancing.

ABOUT THE AUTHORS

AMNON LEHAVI *is assistant professor and director of real estate studies at the Radzyner School of Law, Interdisciplinary Center Herzliya (IDC), Israel. Contact: alehavi@idc.ac.il.*

AMIR N. LICHT *is professor of law and dean at the Radzyner School of Law, Interdisciplinary Center Herzliya (IDC), an affiliated professor at Boalt Hall School of Law, University of California, Berkeley, and research associate at the European Corporate Governance Institute in Brussels. Contact: alicht@idc.ac.il.*

COURT CASES & REFERENCES

Alliance Spring Co Ltd v. First Secretary of State, [2005] EWHC 18 (Admin).

Bd. of County Comm'rs of Muskogee County v. Lowery, 136 P.3d 639 (Okla. 2006).

City of Norwood v. Horney, 853 N.E.2d 1115 (Ohio 2006).

Dolan v. City of Tigard, 512 U.S. 374 (1994).

Kelo v. City of New London, 545 U.S. 469 (2005).

Nollan v. California Coastal Comm'n, 483 U.S. 825 (1987).

Barker, Kate. 2004. Review of housing supply – Delivering stability: Securing our future housing needs, final report. *http://www.hm-treasury.gov.uk/media/0F2/D4/barker_review_report_494.pdf*

Berliner, Dana. 2006. *Opening the floodgates: Eminent domain abuse in the post-*Kelo *world.* Arlington, VA: Castle Coalition, Institute for Justice.

Coase, Ronald. 1937. The nature of the firm. *Economica* 4: 386–405.

Connellan, Owen. 2002. *Land value taxation in Britain: Experience and opportunities.* Cambridge, MA: Lincoln Institute of Land Policy.

Fennell, Lee Anne. 2004. Taking eminent domain apart. *Michigan State Law Review* 2004: 957–1004.

Her Majesty's Treasury. 2005. Planning gain supplement: A consultation. *www.hm-treasury.gov.uk/media/F59/D3/pbr05_planninggain_449.pdf*

Layton, Lyndsey. 2006. A solitary stand at the precipice. *Washington Post,* May 3: A01.

Merrill, Thomas. 1986. The economics of public use. *Cornell Law Review* 72: 61–116.

Salkin, Patricia. 2006. Swift legislative (over)reaction to eminent domain: Be careful what you wish for. *Probate & Property* 20(4): 44–50