

COMMERCIAL LEASE CONDEMNATION CLAUSES[†]

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In General

Lease provisions governing the parties' rights when the leased premises are subject to taking through eminent domain commonly receive little attention during the negotiation and drafting process. Such provisions, however, may affect not only the landlord's and the tenant's rights with respect to the premises and each other, but also may affect both the landlord's and the tenant's right to receive just compensation for any taking. The sample lease provisions contained in the next Part provide templates that practitioners may adapt to protect their clients' interests, whether the client is the landlord or the tenant, and whether the leased premises are being taken in whole or in part.

Sample Clauses

Automatic Termination

If [percentage] or more of the [useable floor area / premises / parking area] is taken through eminent domain, including a conveyance in lieu of a taking, this Lease will automatically terminate as of the [date that title is vested in the condemning agency / date that Landlord or Tenant is notified of the taking / date that the condemning agency takes possession of any portion of the Premises / other date to be agreed upon by the parties]. Notwithstanding this termination, Tenant is required to pay rent through the date that it actually surrenders possession of the Premises.

Landlord Termination Option

If Landlord is notified in writing by a condemning

agency that more than [percentage] of the [useable floor area / premises / parking area] [will / may] be taken through eminent domain, Landlord may terminate this Lease by providing written notice to Tenant. Within [time period] after Landlord notifies Tenant that Landlord is terminating this Lease, Tenant must surrender possession of the Premises to Landlord. After Tenant surrenders possession, the parties' obligations under this Lease are terminated, provided that Tenant surrenders possession in accord with this Lease and pays rent through the date of surrender. [If Landlord does not exercise its termination option within {time period} after being notified of the taking, then the option to terminate lapses and this Lease continues in full effect.]

Tenant Termination Option

If a condemning agency notifies Landlord or Tenant in writing that [percentage] of the [useable floor area / premises / parking area] [will / may] be taken through eminent domain, then Tenant may terminate this Lease by providing written notice to Landlord. Within [time period] after Tenant notifies Landlord that Tenant is terminating this Lease, Tenant will surrender possession of the Premises to Landlord. After Tenant surrenders possession, the parties' obligations under this Lease are terminated, provided that Landlord returns the security deposit to Tenant as provided in this Lease. [If Tenant does not exercise its termination option within {time period} after being notified of the taking, then the option to terminate lapses and this Lease continues in full effect.]

Mutual Termination Option

If a condemning agency notifies Landlord or Tenant

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in writing that [percentage] of the [useable floor area / premises / parking area] [will / may] be taken through eminent domain, either Landlord or Tenant may terminate this Lease by providing written notice to the other. If Landlord exercises this termination option, then Tenant will have [time period] to surrender possession of the Premises to Landlord. If Tenant exercises this termination option, then Tenant must surrender possession of the Premises to Landlord within [time period]. After Tenant surrenders possession, the parties' obligations under this Lease are terminated, provided that Tenant surrenders possession in accord with this Lease and pays rent through the date of surrender. [If neither party exercises its termination option within {time period} after being notified of the taking, then the option to terminate lapses and this Lease continues in full effect.]

Compensation to Landlord

If any portion of the Premises is taken through eminent domain, including a conveyance in lieu of a taking, Landlord and Tenant agree that all compensation paid for the Premises, including any value of Tenant's leasehold interest in the Premises, will be paid to and be the property of Landlord. Tenant may seek compensation for any of its own trade fixtures, business interruption, going concern, moving expenses, and other items, provided that Tenant's compensation is not in diminution of Landlord's compensation for the Premises.

Landlord Exculpation

If any portion of the Premises is taken through eminent domain, including a conveyance in lieu of a taking, Tenant has no claim against Landlord for the value of any unexpired term of this Lease.

Tenant's Compensation

If any portion of the Premises is taken through eminent domain, including a conveyance in lieu of a taking, Landlord and Tenant agree that Tenant reserves its right to seek compensation for the loss of, or the taking's effect on, Tenant's leasehold interest in the Premises. In addition, Tenant may seek compensation for any of its own trade fixtures, business interruption, going concern, moving expenses, and other items.

Rent Reduction

If any portion of the Premises is taken through eminent domain, including a conveyance in lieu of a taking, and this Lease is not terminated, Landlord and Tenant agree that the Annual Base Rent for the Premises

shall be reduced based on a ratio of the [useable floor space / square footage / parking area] that remains after the taking to the [useable floor space / square footage / parking area] of the original Premises.

Restoration

If any portion of the Premises is taken through eminent domain, including a conveyance in lieu of a taking, and this Lease is not terminated, then Landlord shall [immediately / promptly / as soon as practicable] restore the Premises, including [the building / parking area / greenbelt / other items to be determined by the parties] to a condition [reasonably comparable / as close as practicable / substantially similar] to the Premises' condition before the taking [less the portion of the Premises lost to the taking]. [In no event shall Landlord be required to spend more on restoring the Premises than Landlord receives as compensation for the taking.]

Notification

If either Landlord or Tenant is provided written notice by a condemning agency that any portion of the Premises is proposed to be acquired for a public improvement through eminent domain, then that party shall promptly notify the other party in writing.

Rent Abatement for Interference

If any governmental action substantially interferes with access to the Premises via [streets providing access to the premises] for more than [number] days, and the interference has a materially adverse effect on Tenant's business at the Premises, then Tenant may abate its Rent by a percentage equal to the percentage of Tenant's [gross sales / gross revenue / or other figure to be agreed upon by the parties] for the period of the interference. [Landlord may demand that Tenant produce documentation demonstrating the reduced {revenue, sales, etc.} attributable to the governmental action.]

Statutes and Common Law

Under Michigan common law, an exercise of the power of eminent domain that results in a tenant's eviction from the leased premises does not constitute a breach of the landlord's covenant of quiet enjoyment.¹ One of the conditions of all leases is that the tenant is "subject to such interference or disturbance of his possession as results from the exercise by public authorities of their rights, under either the power of eminent domain or police regulations."² The tenant's recourse, if any, is against the condemning agency under the law of eminent domain.



Whenever property is taken through eminent domain, the property's owners are entitled to just compensation for their property.³ In Michigan, the Uniform Condemnation Procedures Act (the UCPA)⁴ applies to every exercise of eminent domain.⁵ The UCPA defines the property's "owners" to include any person possessing an interest in that property.⁶ A property's tenant possesses an interest in the property, and therefore is an owner under the UCPA.

Absent a lease provision governing division of the condemnation proceeds, as an owner of the premises the tenant will generally possess a right to compensation for the value, if any, of its leasehold interest. Leasehold values will vary depending on a number of factors.⁷ For example, a tenant with only a month-to-month lease possesses a leasehold interest in a property, but that interest may have no value because it is easily terminable.⁸ On the other hand, a tenant with a long-term lease may be entitled to significant compensation depending on the amount of the contract rent. If the contract rent is less than the prevailing market rent at the time of the taking, then the present value of the difference between the market rent and the contract rent through the end of the lease's term represents the value of the tenant's leasehold interest.⁹ If the contract rent exceeds the prevailing market rent, however, the leasehold may not have value, and the tenant may not be entitled to compensation for its leasehold interest in the property.

Any award to the tenant for the value of the tenant's leasehold interest will likely come at the landlord's expense. Courts have taken the approach that property must be valued based on its fee ownership, and the sum of the values of different interests in the property cannot exceed the value of the property's fee. In other words, the value of the tenant's leasehold interest and the value of the landlord's ownership cannot exceed the value that the property would have had if the property had only one owner.¹⁰ Therefore, in dividing the compensation award between a landlord and a tenant, courts will subtract the value of the tenant's leasehold interest from the value of the property's fee ownership. The tenant is awarded the value of its leasehold interest and the remaining value is awarded to the landlord as compensation for its fee and reversionary interest.¹¹

These general rules can be altered, however, by a lease provision governing the landlord's and the tenant's rights in condemnation. Michigan law permits landlords and tenants to agree in advance about their rights if the leased premises are condemned.¹² Commonly, the parties to a lease will include a provision terminating

the lease upon condemnation of the leased premises. In *City of Muskegon v Lipman Inv Corp*,¹³ the Court of Appeals held that a provision terminating the lease upon condemnation of the leased premises leaves the tenant with no leasehold interest for which it can recover compensation. A termination provision should therefore ensure that the entire value of the fee interest is awarded to the landlord.

Such a provision, however, would not prohibit the tenant from seeking compensation for matters separate from its leasehold interest. For example, regardless of whether the tenant may recover compensation for its leasehold interest, the tenant generally will be entitled to compensation for either the value of, or the costs to relocate, any trade fixtures that were on the leased premises.¹⁴ Similarly, a tenant may be entitled to compensation for business interruption damages or for the going concern value of its business, regardless of whether it is entitled to compensation for its leasehold estate in the underlying property.¹⁵

Tips, Traps, and Thoughts

Condemnation will never touch most properties. But, condemnation may be more likely for some premises than for others, such as a premises that fronts on a narrow, congested road. In such an instance, determining which party may terminate the lease in the event of condemnation and when the lease may be terminated can be important bargaining points during negotiations.

Regardless of the likelihood of condemnation, however, one party or the other will likely seek to have a condemnation termination provision included within the lease. In drafting such a provision, a number of factors must be taken into account. One critical factor is the time that the termination option is activated. A termination option will generally depend on the landlord's notice of a potential condemnation, which can arrive in a variety of forms. For example, property owners often are contacted by condemning authorities about possible condemnation long before they receive a statutory good faith offer under the UCPA, let alone a summons and complaint in a condemnation action. Thus, the parties to the lease must decide whether to provide that, whoever possesses the option to terminate the lease, termination is authorized upon the first written notice from a condemning agency that the premises may be condemned, or at some later time, such as upon receipt of a good faith written offer, the date that a condemnation action is filed, or the date that title to any portion of the leased premises actually transfers to the condemning agency.



Further, the timing of the termination option can be a double-edged sword for both landlords and tenants. Upon learning that the leased premises may be condemned, the landlord may want to promptly evict the tenant so that it can negotiate with the condemning agency without any constrictions or interference from the tenant. On the other hand, condemnation can be a protracted process, with condemning agencies sometimes contacting property owners years before actually acquiring the owners' property.¹⁶ In such a circumstance, the landlord may not want to evict the tenant and relinquish rental income until condemnation is imminent. From the tenant's point of view, the tenant may desire to promptly move on to a new location upon learning that the leased premises may be condemned. The specter of condemnation can cause entire neighborhoods to deteriorate,¹⁷ or subject miles of road frontage to protracted construction work.¹⁸ A tenant may desire to leave such an area as quickly as possible. Conversely, if the condemnation affects only a limited area, or if the lease is favorable for the tenant, then the tenant may want to maintain its tenancy until the latest possible date. Typically, the party possessing the termination option will want the broadest possible discretion. Thus, determining which party possesses the termination option and discretion to exercise that option can be important points during lease negotiations.

Another important factor to address in drafting a condemnation termination provision is the type of condemnation. One possibility is that the premises will be only partially taken. If the lease is terminable upon a certain portion of the premises being taken, then the portion of the property that must be taken to activate the termination provision must be tailored to the parties and the premises. Partial takings, especially takings for road widening, often encompass only frontage and greenbelt areas. Nevertheless, the percentage of the premises taken may permit one party or the other to essentially escape the lease through the condemnation termination provision. Tenants should pay particular attention to the amount of the premises that must be taken to activate the termination. After all, even a taking encompassing a small percentage of the premises could eliminate an amenity that is essential to the tenant, such as parking. Similarly, a taking from a property's frontage can affect the property's zoning status.¹⁹ Thus, a tenant must provide itself with the flexibility necessary to address a taking that may be small as a portion of the premises' area, but removes an important amenity or creates zoning violations going forward. That flexibility could be provided by a provision empowering the tenant to terminate the lease or by a provision establishing a rent-abatement

mechanism. In fact, a rent-abatement mechanism can be employed to address various reductions in the leased premises' utility that do not rise to a level that requires terminating the lease.

Under *City of Muskegon v Lipman Inv Corp*,²⁰ terminating a lease under a condemnation provision should ensure that the landlord does not share an award for the premises' value with the tenant. Regardless, the cautious approach is for the landlord to include an additional provision making explicit that the premises' value belongs to the landlord. Other advisable provisions include those emphasizing that the landlord is not liable to the tenant if the premises are taken and requiring notification to ensure that both parties are aware of a pending condemnation and can act to protect their rights.

Checklist

- Does the lease address the possibility of condemnation?
- Does the lease include a condemnation termination provision?
- What type of notice activates the termination option?
- May the landlord, the tenant, or either one terminate the lease?
- What portion of the leased premises must be lost to a partial taking to activate the termination option?
- Is the portion of the leased premises that must be lost to a partial taking to activate the termination option tailored to the property, the landlord, and the tenant?
- Does the lease provide for a rent-adjustment mechanism if part of the leased premises is taken through eminent domain?
- Does the lease specify that any award for the leased premises' value will be paid to the landlord?
- Does the lease preserve the tenant's right to seek compensation for its leasehold interest?
- Does the lease exculpate the landlord and tenant from any further liability if the leased premises are taken?
- Does the lease contain a condemnation notification provision?



Endnotes

1. *Tucker v Gvoic*, 344 Mich 319; 74 NW2d 29 (1955).
2. *Id.* at 323-24.
3. See Const 1963, art 10, §2.
4. MCL 213.51 *et seq.*
5. See MCL 213.75.
6. See MCL 213.51(f).
7. See *In re Gratiot Ave*, 294 Mich 569, 574-75; 293 NW 755 (1940).
8. See, e.g., *State Hwy Comm'n v L&L Concession Co*, 31 Mich App 222, 228 n8; 187 NW2d 465 (1971).
9. See *Pierson v HR Leonard Furniture Co*, 268 Mich 507, 521; 256 NW 529 (1934).
10. See 4 Nichols on Eminent Domain §12.05[1] (rev ed, 1997).
11. See, e.g., *City of Muskegon v Berglund Food Stores, Inc*, 50 Mich App 305, 314; 213 NW2d 195 (1973) (dividing the award for a property's fee value between the landlord and tenant).
12. See, e.g., *In re John C Lodge Hwy*, 340 Mich 254, 263; 65 NW2d 820 (1954).
13. 66 Mich App 378, 381; 239 NW2d 375 (1976).
14. See *id.* at 382; *John C Lodge Hwy*, *supra* at 264.
15. See *Lipman Inv Corp*, *supra* at 382; *L&L Concession Co*, *supra* at 230-31.
16. See, e.g., *City of Detroit v Cassese*, 376 Mich 311, 316-18; 136 NW2d 896 (1965).
17. See *id.*
18. See, e.g., *State ex rel Miller v Filler*, 168 Ariz 147, 151; 812 P2d 620 (1991).
19. See, e.g., *Dep't of Transp v Van Elslander*, 460 Mich 127, 128; 594 NW2d 841 (1999) (where a taking for a road widening created a setback requirement violation).
20. 66 Mich App 378, 381; 239 NW2d 375 (1976).