

Condemnation: The Impact of Environmental Contamination on Property Valuation

Jack Fersko and John J. Reilly

American College of Real Estate Lawyers Program Materials

2006

Author - Jack Fersko

Introduction:

The ability of government to condemn property through the exercise of eminent domain is limited by the Fifth Amendment of the United States Constitution: no person shall be deprived of property without due process of law, property may only be taken for a “public use,” and the property owner must be awarded “just compensation.”ⁱ Just compensation is measured by the fair market value of the property at the time of the taking, which is determined by what a hypothetical willing buyer will pay a hypothetical willing seller, neither under any compulsion to act.ⁱⁱ In light of the United States Supreme Court’s decision in *Kelo v. City of New London*,ⁱⁱⁱ the central focus in municipal redevelopment projects no longer will be on whether a municipality may condemn property, but rather what the municipality must pay to the property owner.^{iv} Because so many urban redevelopment projects involve former industrial facilities that are burdened with environmental contamination arising from their historic use, the impact of such contamination will be a central issue in many future condemnation proceedings.

Currently, case law reflects a sharp divide among the jurisdictions on the issue of whether environmental contamination is a legitimate component of valuation in a condemnation proceeding. “[T]he decisions that admit such evidence [conclude] that environmental contamination is a property characteristic that necessarily affects value.”^v Conversely, courts that exclude evidence of contamination “view the issue as more complicated than merely denominating contamination as a characteristic of land.”^{vi} Instead, they reason that the problem of potential double liability, the involuntary nature of condemnation, due process concerns and the summary nature of the condemnation proceeding require the evidence to be excluded from the condemnation action.^{vii} A Connecticut decision, *Northeast Connecticut Economic Alliance, Inc. v. ATC Partnership*,^{viii} (“*Northeast*”) and a New Jersey decision, *Housing Authority v. Suydam Investors*,^{ix} (“*Suydam*”) exemplify the split over the valuation of environmentally contaminated properties that have been taken by eminent domain. The *Northeast* case is particularly significant because in addition to considering the effect of contamination on market value, it also considers reimbursements and contributions from public funds and prior owners in the valuation process.

I. Discussion

a. Decisions Considering Environmental Contamination

Courts that include the effect of environmental contamination in the valuation process reason that contamination is a property characteristic that will influence the decision making of a purchaser and thereby inherently affects value.^x Environmental contamination may adversely affect a property's value by imposing limitations on its use and requiring the expenditure of substantial sums of money to remediate the condition. Additionally, environmental contamination may impact a purchaser's ability to obtain financing and may subject a purchaser to cleanup liability and third party tort liability.^{xi} Even after a successful cleanup, a remediation stigma may persist and further decrease property value.^{xii} Also, remediated land usually is subject to higher financing costs because lenders fear future liability despite current cleanup efforts.^{xiii} Because these are factors considered by a "hypothetical buyer," ignoring them would result in a fictional value.^{xiv}

Despite the consensus among these cases that evidence of contamination is appropriate in the valuation component of the eminent domain proceeding, there is no clear agreement regarding the correct methodology for calculating the effect of contamination on "just compensation." Often, the first instinct is to reduce the award by the cost of remediation, but some courts reject this simple cost reduction method^{xv} and reason that a jury must weigh all the relevant evidence, including the nature and extent of contamination, the reasonable measures required to correct the conditions, and the reasonable cost of those measures.^{xvi}

Other cases emphasize that evidence relating to contamination is only relevant insofar as it is probative of the fair market value of the property.^{xvii} A condemnation action is an in rem proceeding.^{xviii} Such a proceeding is not designed to assign liability for environmental contamination and the value of the property is not necessarily affected by whether its owner would be liable for the contaminated state of the property.^{xix} Nevertheless, evidence of contamination is relevant if the contamination can be shown to affect value.^{xx}

In *Finkelstein v. Department of Transportation*,^{xxi} the court specifically established a requirement that evidence of comparable sales of contaminated property be introduced to substantiate a claimed decrease in the value of the property based upon environmental conditions.^{xxii} It reasoned that "[a]n opinion as to a decrease in value cannot be a mere surmise that because property is contaminated, it logically follows that the value of the property is decreased. There must be a factual basis through the evidence of comparable sales..."^{xxiii}

b. Decisions Excluding Evidence of Environmental Contamination

On the other side of the debate, several jurisdictions exclude evidence of contamination primarily due to the complexity inherent in environmental matters, which conflicts with the summary nature of a condemnation proceeding.^{xxiv} While these cases admit that contamination is relevant to land value, they conclude instead that it should be considered in a separate proceeding.^{xxv} A good example is the New Jersey Supreme Court's decision in *Suydam*.^{xxvi} *Suydam* held that in a condemnation action

environmentally contaminated property is to be valued as though remediated. It reasoned that “to the extent contamination...is subject to cure, it [is arguably] not an immutable condition of land and...its remediation is more like a transactional cost than a value concept.”^{xxvii}

Suydam also recognized that while contamination may be a factor that affects property value, it is not to be considered in the determination of just compensation. Instead, issues of liability and remediation are more appropriately resolved in an ancillary or separate proceeding. “Valuation is a relatively straightforward [process] with which condemnation commissioners are...experienced...[and o]mitting the complications of contamination from the valuation process thus advances the speed and efficiency that are the hallmark of eminent domain proceedings.”^{xxviii} Moreover, a separate cost-recovery action allows potentially liable third-parties to be brought into the action, specific defenses to be raised, burden of proof issues to be addressed, and the full panoply of discovery to be pursued, all of which are factors incompatible with the summary nature of the condemnation action.^{xxix}

Furthermore, due process concerns are avoided through the bifurcation of condemnation and cost-recovery actions. This approach avoids the property owner’s exposure to the risk of double liability—receiving a discounted contamination—impacted property valuation in the condemnation action while still subject to a subsequent cost recovery action.^{xxx} Moreover, valuing property as if remediated assures just compensation consistent with the notion of “highest and best use.” If property is valued as contaminated, then it does not permit the property owner to ever realize value based upon uses permitted once remediated.^{xxxi} This concept is consistent with the recognition that there is no direct correlation between remediation cost and its impact on value.^{xxxii}

Under the *Suydam* approach, the condemnor must deposit in court the full amount of the value of the property as if remediated. Upon motion by the property owner to withdraw the funds from court, the trial court, based upon a proof hearing if necessary, will keep on deposit the estimated amount of remediation costs pending the conclusion of a separate cost recovery action.^{xxxiii} Consistent with the *Suydam* notion of just compensation is the expectation that the estimated remediation costs should be based on the highest and best use of the property, rather than as required for the public project for which the taking is necessary.

The *Suydam* trust escrow approach is useful because of the complexity involved in determining the appropriate cleanup cost amount. Often, the nature and extent of the contamination is not fully ascertainable until the public project actually is undertaken, which typically follows the condemnation action. Moreover, this approach may help to ensure adequate funding, since a condemnor which only has to deposit the value of the property as contaminated may not have the funds necessary to complete a cleanup.

c. An Additional Twist

In addition to the primary split of decisions on the handling of environmental contamination in the valuation process, the Connecticut Supreme Court in *Northeast* added a unique third position. While the Connecticut court reiterated the rationale that contamination necessarily affects the value of land and therefore should be considered in the “just compensation” process, it departed from other decisions by concluding that the availability of cleanup cost contributions and reimbursement is also a relevant factor in the determination of value. Specifically, the court held that state economic development grant funds, and the possibility of recovery from prior property owners under state and federal environmental law, should be factored into the fair market value calculation. It reasoned that “it would be inequitable to consider the impact of environmental contamination on the property’s value...but exclude evidence of grant money that plausibly might mitigate the negative financial impact of the pollution [to a] buyer.”^{xxxiv} Furthermore, the court reasoned that “[a] potential buyer would seek all sources of funds to reimburse or defray the environmental costs” and, therefore, these funding sources affect the property’s fair market value.^{xxxv} The court did not require an actual award of the funds but only a showing that the award was reasonably probable.^{xxxvi}

Additionally, the court found a reasonable possibility of recovery from prior owners under federal and state environmental laws. While the holding did not determine liability, the court was satisfied that there was a “variety of meritorious claims and defenses to present legitimate issues for litigation” under these statutes.^{xxxvii} Accordingly, there was at least a reasonable probability of recovery pursuant to environmental statutes and, therefore, it was appropriate to consider the possibility of contribution.^{xxxviii}

II. Conclusion

The condemnation of contaminated properties presents the challenge of satisfying the constitutional imperative of just compensation while maintaining the essential summary nature of eminent domain proceedings. As indicated herein, case law is split on how to achieve this goal. Some courts have chosen to address contamination as simply another value factor to be considered in the determination of the lump sum of just compensation, while others have chosen to segregate and isolate the contamination factor, consistent with the mandate of just compensation, through the escrow approach to preserve the summary nature of the proceedings. There is merit to both sides of the argument, but at the same time each approach presents issues and problems that will continue to require judicial attention.

i Specifically, “[n]o person shall...be deprived of...property, without due process of law; nor shall private property be taken for public use, without just compensation.” U.S. Const. amend. 5.

ii Housing Auth. v. Suydam Investors, 177 N.J. 2, 14, 826 A.2d 673, 680 (N.J. 2003) (quoting County of Monmouth v. Hilton, 334 N.J. Super. 582, 587, 760 A.2d 786, 788 (N.J. App. Div. 2000).

iii 125 S.Ct. 2655, (2005).

Published Articles (Cont.)

iv *Kelo* affirmed the principle that economic development is a legitimate “public purpose” for which a municipality may condemn property. Although the Court did not address the topic of just compensation because it was not “directly presented by this litigation,” it did specifically note that issues of fairness regarding the measure of just compensation are important. *Id.* at 2668 n.21.

v *Suydam*, 826 A.2d at 685. *See also* *Redev. Agency of Pomona v. Thrifty Oil Corp.*, 4 Cal. App. 4th 469 (Cal. App. 1992); *Northeast Ct. Econ. Alliance, Inc. v. ATC P’ship*, 776 A.2d 1068 (Conn. 2001); *Finkelstein v. Dept. of Transp.*, 656 So.2d 921 (Fla. 1995); *Silver Creek Drain Dist. v. Extrusions Div., Inc.*, 663 N.W.2d 436 (Mich. 2003); *Tennessee v. Brandon*, 898 S.W.2d 224 (Tenn. Ct. App. 1995).

vi *Suydam*, 177 N.J. at 21, 826 A.2d at 685. *See also* *Dep’t of Transp. ex rel People v. Parr*, 633 N.E.2d 19 (Ill. App. 1994); *Aladdin, Inc. v. Black Hawk County*, 562 N.W.2d 608 (Iowa, 1997); *City of New York v. Mobil Oil*, 783 N.Y.S.2d 75 (N.Y. App. Div. 2004).

vii *Id.*

viii 861 A.2d 473 (Conn. 2004).

ix *Suydam*, *supra* note 2.

x *See, e.g., Brandon*, 898 S.W.2d at 226-7; *Finkelstein*, 656 So.2d at 924 (discussing the impact contamination has on purchaser considerations).

xi *Northeast*, 776 A.2d at 1081.

xii The concept of stigma refers to a decrease in property value due to the fear that some contamination may remain undetected, or that the current standards of cleanup will be found insufficient in the future. *Finkelstein*, 656 So.2d at 924. *See also* *Suydam*, 177 N.J. at 21, 826 A.2d at 685.

xiii *Brandon*, 898 S.W.2d at 226.

xiv *Silver Creek Drain Dist. v. Extrusions Div., Inc.*, 663 N.W.2d 436, 443 (Mich. 2003)

xv *Id.*

xvi *Brandon*, 898 S.W.2d at 227.

xvii *Silver Creek Drain Dist.*, 663 N.W.2d at 443; *Finkelstein*, 656 So.2d at 925-6.

xviii *Silver Creek Drain Dist.*, 663 N.W.2d at 436.

xix *Id.*

xx *Finkelstein*, 656 So.2d at 922.

xxi *Id.*

xxii *Id.*

xxiii *Id.* at 925. The problem here is the fact that the character and extent of contamination tends to be unique to a given piece of property, and it therefore would be difficult to locate similar property upon which to draw a comparison. However, the further development of brownfields may increase the usefulness of this method. *See Aladdin, Inc. v. Black Hawk County*, 562 N.W.2d 608, 616 (Iowa 1997). *See also* Robert I. McMurry & David H. Pierce, *Environmental Contamination and Its Effect on Eminent Domain*, 1993 ALI-ABA: Eminent Domain And Land Value Litigation 133, 162. *But see* James R. Arnold, *Valuation of Contaminated Property: 1997* 1997 ALI-ABA: The Impact of Environmental Law on Real Estate and Other Commercial Transactions 933, 970, (citing Peter Patchin, *Contaminated Properties and the Sales Comparison Approach*, 62 Appraisal Journal (No. 3) (July 1, 1994) (acknowledging that there are few contaminated property sales, but that the effect of stigma is more readily recognized by courts)).

xxiv *Aladdin*, 562 N.W.2d at 616.

xxv *Id.*

xxvi *Suydam*, *supra* note 2.

xxvii *Id.* at 22, 826 A.2d at 686. The court distinguished its prior holding in *State, by Comm’r of Transp. v. Shein*, 283 N.J. Super. 588, 662 A.2d 1020 (App. Div.1995), *certif. denied*, 143 N.J. 325, 670 A.2d 1066 (N.J. 1996), which held that environmental issues *should* be considered in determining market value. In that case, the environmental issue involved the existence of wetlands and other physical land characteristics. *Id.*

xxviii *Id.* Subsequent to *Suydam*, Bill A4089 was the subject of committee hearing in the New Jersey Assembly. This bill would have overruled *Suydam* and required that the presence of contamination be considered in calculating the fair market value of the property at issue. The bill was not adopted.

xxix *Id.* at 24, 826 A.2d at 687.

xxx *Id.* at 22-23, 826 A.2d at 686.

xxxi *Id.*

xxxii **Inmar Assoc., Inc. v. Carlstadt**, 549 A.2d 38 (N.J. 1988).

xxxiii *Suydam*, 177 N.J. at 24, 826 A.2d at 687. *See also* *City of New York v. Mobil Oil*, 783 N.Y.S.2d 75 (N.Y. App. Div. 2004).

Published Articles (Cont.)

xxxiv *Id.* at 486. This holding conflicts with the Florida case, discussed in part IIa *infra*, which specifically excluded consideration of contamination in the circumstance in which reimbursements from a state program were involved. *See Finkelstein, supra* note 5..

xxxv *Id.* at 488.

xxxvi *Id.* at 492. “[Expert testimony] about the availab[ility] of grants, as well as the fact that the state already had awarded funds to Northeast, established that it [is] reasonably probable that such funds are available.” *Id.* at 486.

xxxvii *Id.*

xxxviii *Id.*