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lished. Similarly, solid waste problems are more clearly visible and seem to pose less of a causal relationship problem. If municipal police power is to realize its objective of the protection of the health, safety and welfare of local inhabitants, newly arising ecological problems must fall within its circumscription. While waiting for Congress and the state legislatures to act, municipal police power has great pragmatic utility.

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NEGATIVE LEASEHOLDS: THE PROPERTY-CONTRACT DISTINCTION AND A FAILURE OF JUST COMPENSATION

In recent years, eminent domain has been utilized and expanded to satisfy certain material needs of the public sector.[1] Public authorities clearly possess the power to acquire private property for public purposes.[2] However, the continued existence and ultimate success of programs entailing land acquisition depends on (1) the receptiveness of courts to public takings; (2) legislative authorization and appropriation; and (3) an absence of public indignation over the disruptions to private expectations inherent in public takings of private property.[3] Public indignation can be neutralized best by a system which provides just compensation for takings of private property.[4] This comment will explain and evaluate one instance where there is a failure of just compensation. The situation arises when property encumbered with a leasehold is condemned and taken in a falling real

1. For an analysis of the historical development of eminent domain, see Kratovil & Harrison, *Eminent Domain—Policy and Concept*, 42 CALIF. L. REV. 596 (1954).

2. Under the fifth amendment of the United States Constitution, no governmental authority can seize private property without payment of just compensation. By force of the due process clause of the fourteenth amendment, this requirement is extended to the states and their subdivisions. *See* Scott v. Toledo, 36 F. 385 (N.D. Ohio 1888). Notwithstanding, N.Y. CONST. art. 1, § 7(a) provides: "Private property shall not be taken for public use without just compensation." *See* Sackman, *The Right to Condemn*, 29 ALBANY L. REV. 177, 180-83 (1965).

3. *See* Baker, *Condemnation: Concepts and Consequences of Public Intervention in the Landlord-Tenant Relationship*, 9 KAN. L. REV. 399, 400 (1961).

4. This is closely aligned to the idea of indemnification for public takings. *See* Polasky, *The Condemnation of Leasehold Interests*, 48 VA. L. REV. 477, 535 (1962) [hereinafter cited as Polasky].

estate market. The uncompensated item is the "negative" leasehold.

Just compensation, the desired standard in eminent domain, applies to both the public taker and the property owner.[5] Ordinarily just compensation is determined by the property's "market value."[6] "Market value," particularly in a complete taking, is based on the "fee value," that is, the value of the property as if it were unencumbered and individually owned. Three basic methods are used in ascertaining fee value: (1) market data or comparable sales; (2) capitalization of income; and (3) reproduction costs.[7] This comment will focus in particular on the use of the capitalization of income method, where the income base is rent. The rental base can be either the market[8] or contract[9] rent. Schematically, the evaluation procedure works as follows:

Contract rent[10] or Market rent —*yields*→ rental value basis —*yields*→ *capitalization* fee value[11] —*yields*→ fair market value[12] —*yields*→ Just Compensation.

The use of either market or contract rent as the capitalization base has been sanctioned statutorily in New York:

5. *See* Searl v. School Dist., 133 U.S. 553 (1890); New York, O. & W. Ry. v. Livingston, 238 N.Y. 300, 144 N.E. 589 (1924).

6. *See In re* Board of Water Supply, 277 N.Y. 452, 14 N.E.2d 789 (1938).

7. *See* Sengstock & McAuliffe, *What is the Price of Eminent Domain?*, 44 J. URBAN L. 185 (1966).

8. "Market rent is the 'fair market value' of the leased property at the time of appraisal. It may be greater or less than the amount stated in the lease. It is the rental that the property can command in the open market at any given time for its highest and best use." Sando, *Appraisal of Leasehold Interests*, 1961 INST. ON EM. DOM. 79, 82 [hereinafter cited as Sando].

9. "The stated rental in the lease is known as the contract rent—it is the amount that may be collected by the lessor for the term specified, even though fair rental of the property at the time of appraisal may be greater or lesser than the amount specified." *Id.*

10. "[I]f property is rented for the use to which it is best adapted, the actual rent reserved, capitalized at the rate which local custom adopts for the purpose, forms one of the best tests of value, and accordingly, evidence of the rent actually received at a time reasonably near the *punctum temporis* at the taking, should be admitted." 4 NICHOLS, THE LAW OF EMINENT DOMAIN, § 12.3122 (J. Sackman, rev. 3d ed. 1962). *Contra, In re* City of New York, 16 N.Y.2d 497, 208 N.E.2d 172, 260 N.Y.S.2d 439 (1965).

11. "Rental value tends to prove fee value, because other things being equal, the income from property is a measure of its market value. Rental value is capable of exact determination . . . ." Ettlinger v. Weil, 184 N.Y. 179, 183, 77 N.E. 31, 32 (1906).

12. *See* School Dist. #13 v. Wicks, 227 N.Y.S.2d 768 (Sup. Ct. 1962).

> Upon the trial of any claim for the appropriation of real property or an interest therein, evidence of the price and other terms upon any lease, relating to any property taken or to be taken or to any other property in the vicinity thereof shall be relevant, material and competent, upon the issue of value or damage and shall be admissible on direct examination, if the court shall find (1) that such sale or lease was made within a reasonable time of the vesting of title in the state, (2) that it was made in good faith in the ordinary course of business, and (3) in case such sale or lease relates to other than property taken or to be taken, that it relates to property which is similar to the property taken or to be taken . . . .[13]

Reliance on the contract rental assumes both that the contracting parties dealt at arms length,[14] and that the rent is indicative of the property's "highest and best" use.[15]

Historically, upon the taking of a fee encumbered by a leasehold, the lessee has been awarded the "bonus value" or difference between the market and contract rents when the former is greater than the latter.[16] Essentially, the lessee is awarded the "benefit of the bargain" inherent in the lease. However, the converse is not true. The lessor is not awarded for his "negative" leasehold. A "negative" leasehold exists when the contract rent (which is referred to as the reserved rent, or, the amount due under the lease) is greater than the market rent. Because of a previously made contract, the lessor receives more rent for the premises than he would receive if the lease were currently negotiated.

I. The Undivided Fee Rule as the Majority Rule in the United States

Eminent domain is regarded as an in rem proceeding, in which the land itself is taken and not the separate interests based on individual claims relating to the land. This is due to the undivided fee rule as stated in *Lewis,* a leading treatise on eminent domain.

13. N.Y. Ct. Cl. Act § 16(3) (McKinney Supp. 1970-71).
14. Union Ry. v. Hunton, 114 Tenn. 609, 88 S.W. 182 (1905).
15. Stone v. Delaware, L. & W.R.R., 257 Pa. 456, 101 A. 813 (1917).
16. *See, e.g.,* Great Atlantic & Pacific Tea Co. v. New York, 22 N.Y.2d 75, 84, 238 N.E.2d 705, 712-13, 291 N.Y.S.2d 299, 305-06 (1968). Also, the lessee's interest will have a market value "if the improvements constructed by the lessee have enhanced the value of the land." Sando at 82.

> When there are different interests or estates in the property, the proper course is to ascertain the entire compensation as though the property belonged to one person and then apportion this sum among the different parties according to their respective rights. The value of property cannot be enhanced by any contract arrangements among the owners of different interests. Whatever advantage is secured to one interest must be taken from another, and the sum of all the parts cannot exceed the whole.[17]

Practicality, simplicity and consistency are usually given as the main reasons for the rule's use.[18] The courts can avoid the often complex question of apportionment, thereby concentrating on the problem of land valuation. Condemnors, knowing that courts will award no more than the unencumbered fee value, can estimate more accurately acquisition costs. Assuredly, the allowance of awards for "negative" leaseholds would increase both indirect costs in the form of ascertaining speculative or conjectural claims, and direct costs, should the proven claims be allowed.

II. How the Undivided Fee Rule Affects "Negative" Leaseholds

Assume that the lessor and lessee have a rental agreement for $3,000 per annum for 20 years. The expected rate of return is 6%, thereby making the capitalization factor 11.469.[19] As economic conditions change, the possibility of "bonus" or "negative"

17. 2 J. Lewis, Eminent Domain § 716 (3d ed. 1909) [hereinafter cited as Lewis].

18. *See* 1 L. Orgel, Valuation Under the Law of Eminent Domain § 109 (2d ed. 1953).

19. Money currently due is considered to be worth more than money due in the future because postponing the enjoyment into the future diminishes its value. Capitalization is the procedure of discounting money due in the future. To account for the prospective diminution, a rental income stream is discounted by a compound interest factor. The result is a present value lump sum that, upon compounding at the discounting interest rate, will yield the fully-compensated amount at the expiration of the lease term. The amount of the reduction should equal the interest aggregate which the condemnee will realize in the market from investment of his principal. Thus, if the lessor were to receive, according to the lease, $1.00 per year for 20 years, to give him presently $20.00 compensation would be an excessive award. The condemnee could invest the $20.00 award at 6%, thereby having a sum of $64.14 at the end of the 20 year period. In accord, the $20.00 initial lump sum should be reduced to its present worth, or the amount that if deposited today at 6% compound interest, would equal $20.00 at the end of 20 years. This amount, according to capitalization tables, is $11.469. *See* Sando at 85.

values arises. If the market value rises to $4,000, the tenant will enjoy a per annum "bonus" of $1,000. If the market is depressed and the market value falls to $2,000, the lessee will suffer a per annum "loss" or "negative" value of $1,000.

SITUATION I—RISING MARKET

		Capitalization Rate 6% *for* 20 *years*	*Fee Value*	*Award to lessor*
Market rent	$4000	11.469	$45,879.60	.....
Contract rent	$3000	11.469	.....	$34,409.70
"Bonus" to lessee	$1000	11.469	.....	$11,469.90

SITUATION II—FALLING MARKET

		Capitalization Rate 6% *for* 20 *years*	*Fee Value*	*Award to lessor*
Market rent	$2000	11.469	$22,938.00	$22,938.00
Contract rent	$3000	.....	.....	.....
"Negative" to lessor	($1000)	.....	.....	.....

As indicated above, either contract or market rent may be used to determine rental value, which, after capitalization, will yield fee value. Under the undivided fee rule, market rent must be considered in Situation I to assure adequate awards to both lessee and lessor. The lessee is entitled[20] to his "bonus" value (that is, the capitalized value of $1000 for 20 years at 6% or $1,000 x 11.469 or $11,469). The lessor is entitled to the value of the contract rent (that is, the capitalized value of $3000 for 20 years at 6% or $3000 x 11.469 or $34,409). The capitalized value of the market rental, $45,879, is also the total of the lessor and lessee awards. Thus, in Situation I, the lessor gets only his contractual expectations; not the full market value of the property as represented by the total award. The difference is allocable to the lessee's award. In accord with *Lewis'* statement

20. The usual reason given for awarding the "bonus" value is that the lessee could sublet the property, if the lease so provided, for a rent greater than his contractual obligation.

that "whatever advantage is secured to one interest must be taken from another . . . ," the lessee clearly has partially absorbed the award to the lessor.

Through use of the "condemnation clause," the market place has adjusted to this possibility.

> Most leases drawn today carry an eminent domain clause extinguishing the rights of the lessee if the property is taken in condemnation proceedings.
>
> . . . .
>
> Lessees today will generally consent to the inclusion of the eminent domain clause unless the lessee has made substantial improvements to the property . . . .[21]

A condemnation clause would have the effect in Situation I of precluding the lessee from sharing in the original award and allowing the lessor to take an award equal to the entire fee value.

Under the rationale of the undivided fee rule, that the public authority should not be financially encumbered by the contractual relations of private persons, the basis for compensation in Situation II is also the market rental. As in Situation I, the award "ceiling" is the capitalized value of the market rental (that is, $2000 x 11.469 or $22,938). The lessee is entitled to nothing. Ordinarily, by merger of the leasehold and reversion upon condemnation, the rental obligation is terminated.[22] The lessee is there-

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21. S. McMICHAEL & P. O'KEEFE, LEASES: PERCENTAGE, SHORT AND LONG TERM 17 (5th ed. 1959). 2 NICHOLS' THE LAW OF EMINENT DOMAIN, *supra* note 10, § 5.23[2] maintains:

> It has been held that the law does not look with favor on clauses causing forfeiture of the lessee's interest on condemnation, hence, a lease covenant will be construed not to have that effect if its language and the circumstances possibly permit.

The *Nichols* position would represent an additional interference with contractual expectations. Not only would the courts have ended the tenurial relationship, but they also would have abrogated a market adjustment necessitated by the initial act. Such a result only would seem justified when extraordinary public policy was involved. Ordinarily, condemnation clauses have been upheld in New York. *See* Syracuse Grade Crossing Comm'n v. Delaware L. & W. R.R., 197 Misc. 192, 97 N.Y.S.2d 279 (Sup. Ct. 1941), *aff'd*, 290 N.Y. 632, 49 N.E.2d 131 (1943).

Clearly, condemnation clauses do not establish the rights and duties of the condemning authority. *See In re* John C. Lodge Highway, 340 Mich. 254, 65 N.W.2d 820 (1954).

22. In accord with the theory that the land owner holds title subject to the state's sovereign power, upon a total taking of a fee interest by the state for a public purpose, the leasehold relationship is extinguished. *See* Woodruff, *Legal Damages in the Partial Taking of a Leasehold Interest*, 1963 INST. ON EM. DOM. 137, 138. By the merger of the leasehold and reversion, the lessee's rental obligation is terminated. *See* Polasky at 493. However, authority is split as to the limits of the lessee's

by relieved from an uneconomical situation, with no deleterious effect. The undivided fee rule, that the determined fee value represents the total sum to be paid by the condemnor, prevents the lessor from realizing the advantage inherent in the original lease. Since the lessee is entitled to no award, nothing exists from which the "negative" leasehold increment, allocable to the lessor, can be taken. A condemnation clause would be of no effect in this instance.

The problem is that the lessee receives benefit in a rising market, particularly to the detriment of the lessor, in that the lessee's award comes out of the unencumbered fee value (assuming no condemnation clause). The lessor, however, is not protected in a falling market. The lost "negative" leasehold which results from a falling market could have been of value to the lessor in several ways. First, the lessee is contractually obligated to pay the rent. Second, particularly when a financially potent lessee is involved, the lessee, desiring relief from the onerous liability, may decide to purchase the lease. Third, should it benefit the lessor to renegotiate the lease, the negative leasehold represents leverage to affect alternative gains at the lessee's expense (for example, in exchange for a renegotiation, the lessee might be willing to surrender his right to his own fixtures in favor of the lessor). Finally, in the instance where the lessee has built a building on the lessor's land, a "negative" leasehold "may cause the fee interest to encroach upon the value of [the] building."[23]

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liability upon a partial taking of a leasehold estate where an interest less than the fee exists and the remainder is occupiable. The majority view assumes that the lessee's rental obligation continues undiminished. Therefore, the lessee is entitled to an award for the value of his future rental payment as diminished by the taking. *See* Note, 43 IOWA L. REV. 279, 280 (1958). The minority view invokes a *pro tanto* dissolution of the tenurial relationship, thereby extinguishing the rent as to the taken portion of the premises and apportioning the remainder. *See* 2 NICHOLS' THE LAW OF EMINENT DOMAIN, *supra* note 10, § 5.23[3]; 1 L. ORGEL, VALUATION UNDER EMINENT DOMAIN § 121 (2d ed. 1953); 2 R. POWELL, REAL PROPERTY 242 (1950); 2 W. WALSH, REAL PROPERTY § 184 (1947).

23. AMERICAN INST. OF REAL ESTATE APPRAISERS, THE APPRAISAL OF REAL ESTATE 397 (1954). The encroachment could occur as follows: In addition to our above example assume the lessee built a commercial building worth $70,000 on the leased land. The operation of the building produces a net income to the lessee of ten per cent (or $7,000 per annum). Market rental for the land is $2,000. However, the contract rent for the ground lease is $3,000. The lessor's interest will "encroach" upon the value of net income received from the building to the amount of the "negative" leasehold.

III. Criticism of the Undivided Fee Rule

Predictably, the undivided fee rule is most often criticized in cases "where there is a great disparity between the value of the undivided fee and the aggregate value of the separate interests as separately evaluated."[24] Mr. Justice Holmes' opinion in *Boston Chamber of Commerce v. Boston*[25] is frequently cited as holding contrary to the undivided fee rule. Holmes wrote:

> [T]he Constitution does not require a disregard of the mode of ownership—of the state of the title. It does not require a parcel of land to be valued as an unencumbered whole. . . . It merely requires that an owner of property taken should be paid for what is taken from him. . . . And the question is what has the owner lost, not what has the taker gained.[26]

Caution must be exercised, however, in relying on this case. Although Mr. Justice Holmes did disavow strict adherence to limits set by the undivided fee value, he did so not to increase an award, but to reduce an award. In the *Boston* case, the "whole" as determined by the undivided fee rule was considerably greater than the sum of the parts. To have awarded the fee owner the full value of the undivided fee would have been to make an award

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Present annual net income from building.....$7,000
Market rental value of land.....$2,000

Balance imputable to building.....$5,000

However, the contract rent is greater than the market rent. Thus, the "actual" computation becomes:

Present annual net income.....$7,000
Contract rent (ground lease).....$3,000

Balance imputable to lessee's equity in his building.....$4,000

It becomes apparent that through the "negative" leasehold, the lessor embraces part of the value of the lessee's building in that the lessee must pay $1,000 of his $5,000 building net income to the lessor. Upon taking, the lessor is not awarded for this last encroachment. Even though this might appear to be merely a "paper" loss, it shows more clearly how the lessor is not compensated for property taken from him.

24. Sackman, *Partial Taking of a Leasehold Interest*, 1961 Inst. on Em. Dom. 35, 39.

25. 217 U.S. 189 (1910).

26. *Id.* at 195. A owned the fee which was subject to easements of way, light and air in B. C held a mortgage covering the property. The city took this private way, making it a public thoroughfare. A, B and C joined in an agreement that any award was to be made as if the land was singularly held in fee simple. This was not allowed by either the Massachusetts Supreme Judicial Court, (195 Mass. 338, 81 N.E. 244 (1907) or the United States Supreme Court (217 U.S. 189 (1910)).

considerably in excess of the actual damages.[27] As indicated by this case, in the vast majority of instances where exception has been made to the undivided fee rule, the purpose has been to avoid giving an excessive award to the condemnee.[28] However, a few instances exist where the rule was rejected because the sum of the interests exceeded the ceiling as set by the undivided fee value. In *Baltimore v. Latrobe*[29] the court said:

> [O]wing to the peculiar character . . . of property, if it be proven that the reversioner's interest was worth $10,000 and the leaseholder's $52,500, the latter sum could be allowed, although the whole property, if no ground rent had been on it, would only have been worth $60,000.[30]

In part, *Latrobe* suggests an alternative method to the undivided fee rule. "Aggregating the interests of the separate owners"[31] is recognized by case law in New York as an alternative to the undivided fee rule.[32]

> They [appraisers] may appraise the entire value of the premises and then apportion such value among the fee owners and tenants, or they may in the first instance appraise the value of each sep-

27. Polasky, at 486 n.43 refers to the Holmes' statement: "[A] number of courts have departed from the 'rem' concept and indicated that the legal mandate requires compensation to the owner for that which has been taken from him." Holmes reasoned, however, that the owner was not entitled to compensation since nothing was taken.

28. *See, e.g.*, Arkansas State Highway Comm'n v. Fox, 230 Ark. 287, 322 S.W. 2d 81 (1959).

29. 101 Md. 621, 61 A. 203 (1905).

30. *Id.* at 631, 61 A. at 206. In this case the city condemned nearly three-fourths of a plot of land owned by trustees but leased to tenants for ninety-nine years, with a perpetual renewal option. Due to the irredeemable nature of the leasehold, peculiar to that state, the leasehold interest was usually far more valuable than the reversion. The Court of Appeals of Maryland ruled that the tenant should continue to pay the original ground rent.

Criticism of this case was raised in City of St. Louis v. Rossi, 333 Mo. 1092, 64 S.W.2d 600 (1933):

> What the court there really seems to have finally decided was, not the proper amount of damages, but the necessity of apportioning the ground rent . . . in connection with determining the damages. . . . [I]t might be proven that a whole property would be worth $60,000, while the interest of the leaseholder and the reversioner together would be worth $62,500; but it would seem more reasonable that the whole property would be in fact worth $62,500 because of the ground rent lease, but would have been worth only $60,000 if not so leased. It is, of course, true that a favorable lease does increase the value of property, and that the amount of income which is derived from property is always properly considered in determining its value.

Id. at 1106, 64 S.W.2d at 606.

31. *See* Note, *The Undivided Fee Rule in California*, 20 HASTINGS L.J. 717 (1969).

32. *See* Great Atlantic & Pacific Tea Co. v. State, 22 N.Y.2d 75, 84, 238 N.E.2d 705, 710, 291 N.Y.S.2d 299, 305 (1968).

> arate interest and thus ascertain the entire value. The process in each case must obviously be substantially the same. They must in any event appraise the value of each interest separately.[33]

Ordinarily the two evaluation methods do not conflict.[34] "Both cases apply the same principle, namely, that the several values of separate interests in the same property must generally equal the valuation of the whole unencumbered fee."[35] If either method is used, substantially the same results should follow. A discrepancy between the results of the two methods should, however, serve as a warning. "This suggests that the two methods may be used mathematically as a check of the one upon the other, and a discrepant result should require a review of valuation procedures rather than the dominance of one result over the other."[36] According to New York law, in Situation II, if the "aggregated" method had been used for appraisal (thereby capitalizing the contract rent), a significant difference between this amount and the "undivided fee ceiling" (the capitalized market rent) would subject the "aggregated" evaluation of the appraisers to judicial review. The valuation basis used in deriving the aggregated amount determines whether this method is allowed. One must distinguish clearly the use of contract rent as either evidence or criterion of value. If the contract rent were the criterion of value (as would be necessary to assure an award for the "negative" leasehold), the contract amount would have to stand on its own evidentiary merits. The use of contract rent implies that it is closely correlated with market value. Since market value is the favored standard, when a discrepancy exists between the rent which the market would support and contract rent, the latter will succumb.

Evidentiary acceptance of *Latrobe* and the "aggregation of interests" method seems to be inversely related to the size of the difference between the "aggregated evaluation" less the undivided fee amount. Regardless, *Latrobe* implicitly states that the undivided fee rule should be maintained barring an exceptional situ-

33. *In re* New York & Brooklyn Bridge, 137 N.Y. 95, 97, 32 N.E. 1054 (1893).

34. *Cf.* Pekofsky v. State, 15 Misc. 2d 358, 180 N.Y.S.2d 930 (Ct. Cl. 1958).

35. Arlen of Nanuet, Inc. v. State, 26 N.Y.2d 346, 364, 258 N.E.2d 890, 899, 310 N.Y.S.2d 465, 478 (1970).

36. *Id.*

ation. It should also be emphasized that the protected interest in *Latrobe* was that of the lessee.

IV. The Lessee is Also Favored in Tax Law

In a particular situation in tax law, the lessor also does not receive preferential treatment. An analysis of the prohibition against capital gain treatment for payments received by the lessor upon the cancellation of a lease will shed light on the above problem. In *Hort v. Commissioner*,[37] the lessor agreed to cancel the sublessee's lease in consideration of the latter's payment of $140,000. The petitioner (lessor), arguing for capital gain treatment, contended that the amount received was due to "the difference between the present value of the unmatured rental payments and the fair rental value [of the premises] for the unexpired term of the lease."[38] The Supreme Court, however, concluded that "[t]he cancellation of the lease involved nothing more than relinquishment of the right to future rental payments in return for a present substitute payment and possession of the leased premises,"[39] thereby, resulting in ordinary income for the petitioner.

The petitioner's argument necessarily had to encompass an analogy to the sale of a premium bond (that is, when a bondholder sells a bond for a premium, he receives capital gain treatment on the difference between the contract interest rate and the depreciated market rate). The Court, however, analogized the lease in *Hort* to the bond situation in *Helvering v. Horst*.[40] There the Court held that even though the taxpayer assigned to his son the bond's interest coupons, his own retention of the bond corpus precluded the assignment of the tax liability inherent in the interest coupons. The *Hort* Court declared that in both *Horst* and *Hort* the basic corpus units, that is the bond and lease, were property. The bond interest coupons were characterized as items of gross income flowing from the property. By analogy, upon the lessor's retention of a reversion in the underlying property, the lessee's lump-sum payment was in lieu of his rental

37. 313 U.S. 28 (1941).
38. *Id.* at 29.
39. *Id.* at 32.
40. 311 U.S. 112 (1940).

obligation. This was to be considered as ordinary income since the rent flowed from the property.

To continue the analogy, the lessor's cancellation of the lease, while maintaining a reversion in the underlying premises, did not end his property interest. Quite clearly, the Court did not envision the cancelled lease as a converted property interest. Since the Court equated the reversion with a failure to convert the property,[41] thereby not fulfilling an intent of capital gains policy, the lump-sum payment was to be treated as ordinary income. In sum, the taxpayer argued that the lessee's payment was due to the appreciated value of the lease as a reflection of market fluctuations, not dissimilar to the "negative" leasehold situation. The Court reasoned the payment was equivalent to an ordinary income flow.

As typified in *Commissioner v. McCue Bros. & Drummond, Inc.*,[42] the consideration received by the lessee for vacating premises still under lease, is given capital gain treatment. In *McCue Bros.*, the court held *Hort* inapplicable since there "reliance was placed on the fact that the payment took the place of what ordinarily would be payments for rent."[43] The Commissioner argued that "no sale or exchange" existed because "the contractual right was not transferred, but was released and merely vanished."[44] The court held, however, "the right of possession under a lease or otherwise, is a more substantial property right which does not lose its existence when it is transferred. . . . Moreover, the transaction seems closer to those cases holding that gain derived by the holder of a life interest upon sale to the remainderman is to be taxed as a capital gain."[45]

Arguably, these results depend upon property and contract concepts. Similar to bond interst, rent stems from a promise or obligation to pay. Implicit in *Hort's* analogy to the bond situation is that the promise is based on contract.

Historically, however, the lessee's interest has been considered a purchased interest in land. This interpretation was borne out in *McCue Bros.* Possibly the reason for the courts' reluctance

41. *See*, Del Cotto, *"Property" in the Capital Asset Definition: Influence of "Fruit and Tree,"* 15 BUFFALO L. REV. 1 (1965).
42. 210 F.2d 752 (2d Cir. 1954).
43. *Id.* at 753.
44. *Id.*
45. *Id.*

to expand contract principles to encompass lessee interests to the same extent they have in the instance of the lessor is the historic protection of the lessee's possessory interest.

Apart from the tax area, the property notion is indicated further in the instance of a partial taking. "The majority view . . . [is] that a partial taking [through condemnation] does not relieve the lessee from liability for the entire contract rental as stipulated in the lease.[46] The lessee must look to the condemning authority for compensation."[47]If the lessee's interest were contractual, the elimination of the consideration by the taking of the premises would end the relationship. The lessee's leasehold, however, is considered to be a property interest which he holds in the land; thus, it is not extinguished by a failure of consideration.

Tax law apparently distinguishes contract from property rights. If the landlord were to sell his entire fee, the income would be capital gain. Even though the amount received might be the capitalized fair market rental value, if no reversion were retained, property would have been converted, thereby justifying capital gain treatment. When the property interest is not fully transferred, because of the retention of a reversion, only a contractual interest is considered to be extinguished. Courts apparently consider the value of this extinction to be based on a rental prepayment since the lessor has only given up his right to receive rent. On the other hand, the lessee gives up an interest in land clearly recognizable as property in the classical sense.

When a leased premises is condemned, the public authority need only compensate for property taken. Assuredly, the lessee's interest qualifies as property. Likewise, the lessor's premises qualifies as property. In our original example the criterion chosen for evaluating the taking was the capitalized value of the rental income. As pointed out, the evaluation standard is fair market rental. The $3,000 contract rent in Situation II (falling market) can be separated into $2,000 supportable by market conditions, and $1,000 attributable specifically to the contractual relationship. Thus, in the falling market situation, the difference between the market rent ($2,000) and contract rent ($3,000) is due neither to the present market value, nor to a property interest,

46. *See* discussion in *supra* note 22.

47. Woodruff, *Legal Damages in the Partial Taking of a Leasehold Interest,* 1963 INST. ON EM. DOM. 137.

but to the contractual relationship of the private parties. Condemning authorities currently are not responsible for the indemnification of frustrated private expectations. As indicated by the above quotation in *Lewis* "the value of property cannot be enhanced by any contract arrangements among the owners of different interests."[48] In sum, not dissimilar to tax policy, the undivided fee rule is a manifestation of the property-contract distinction, with the former receiving favored treatment.

V. CONCLUSION

Unquestionably, the use of the undivided fee rule and market value are well-founded. However, as illustrated above their use can result in a usurpation of private expectations for public purposes. The failure to recognize "negative" leaseholds has not gone unnoticed.[49] Courts assuredly do not consciously intend compensation to the lessee in a rising market, and exoneration of him in a falling market, both to the derogation of the lessor. Only if extensive condemnation and a severe depression of real estate value coincided, would widespread discontent with this problem possibly be nurtured. Even though reliance on market value does present a legal anomaly, its use is sensible in that it protects the condemning authority from indemnifying unscrupulous contracts. A possible solution is a different valuation standard. The law might consider invoking a standard of "market or reasonable contract rent, whichever is higher." Indeed, the courts have shown a tendency in this direction.

> [R]eserved rents, while not recognized by the courts as in themselves a measure of rental values, and therefore as a figure which can properly be capitalized to secure the 'fair market value' of the

48. LEWIS, *supra* note 17.

49. The appraisal profession has generally recognized "negative" leaseholds and seems to feel they represent a compensable interest. T.C. Hitchings, Jr., a member of the appraisal profession, probably has expressed the most succinct argument in favor of awarding the lessor the value of the "negative" leasehold:

> If the leased fee value is genuinely greater than the real estate value (because of an excess rental payment backed by strong credit), this appraiser is of the opinion that the value of the leased fee should be appraised and reported. Orgel and other writings apparently to the contrary notwithstanding . . . . [I]t would seem to be manifestly unjust to deprive a property owner of a contractual right to receive a substantial sum of money without compensation.

Hitchings, *The Valuation of Leasehold Interests and Some Elements of Damage Thereto*, 1960 INST. ON EM. DOM. 61, 71, 72.

> premises, are nevertheless often admitted as 'evidence' of rental value, and thereby of market value. Unless there is very clear proof that the reserved rents are not representative of current rental value, the condemnor may have difficulty in getting them excluded from the evidence. Once they are admitted, we may surmise that they exercise an influence on the jury's award in gross.[50]

Arguably, the courts' allowance of extrinsic evidence is their recognition of and adjustment for the above illustrated inequity. Furthermore, the use of the condemnation clause could be considered a "market place" adjustment for the apparent inequity. Both the tax laws' inconsistency and the above award discrepancies appear to be manifestations of the law's inability to determine whether the landlord-tenant relationship is contractual, property, or both. In the meantime, hopefully, the standard of "market or reasonable contract rent, whichever is higher" will be sufficiently flexible to reflect economic fluctuations, while considering both public cost and the viability of contractual expectations. At best, however, a new standard, unless accompanied by an essential redefinition of the tenurial relationship to reflect today's changing economic conditions, would merely alleviate the symptoms without curing the illness.

JOHN J. ARK

POSSESSION OF DANGEROUS DRUGS IN A CAR—NEW YORK'S CRIMINAL PRESUMPTION STATUTE

INTRODUCTION

Growing public awareness and concern for the problem of drug abuse has led to considerable state legislation designed to curb the illegal use of dangerous drugs, including marijuana and other nonnarcotics. Because drug use is a victimless crime, and it is done in private, it is extremely difficult to arrest someone in the *act* of using drugs. Instead, mere *possession* of drugs is made an offense. However, proof of actual possession is often difficult when the defendant is not found to be in actual physi-

50. 1 L. ORGEL, VALUATION UNDER EMINENT DOMAIN § 123 (2d ed. 1953).