

# What's in Your Condemnation Clause?

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What does the “condemnation clause” in your mortgage say? If you do not know, you are not alone. After all, the chances of a property being condemned and the condemnation clause coming into effect are slim. Nevertheless, there are several issues to consider when drafting a condemnation clause or entering a mortgage agreement.

## I. The Sovereign Power of Eminent Domain

Eminent domain is the power of the sovereign to take property for “public use” without the owner’s consent. The power of eminent domain does not require recognition by constitutional provision, but exists in absolute and unlimited form.<sup>1</sup> The power of eminent domain is described as an inherent attribute of the sovereign. Thus, there is no stated constitutional source of such power. Rather, only the limitations on such power must be stated positively by state law. The most fundamental limitation is met by the provisions found in most of the state constitutions relating to the taking of property by eminent domain requiring that the condemning agency pay “just compensation.” The legislature, of course, may prescribe more than the minimum requirement of the payment of just compensation. Such constitutional provisions, however, neither directly nor impliedly grant the power of eminent domain, but are simply limitations upon a power already in existence that would otherwise be unlimited.<sup>2</sup>

## II. Notice of the Taking and Rights of Mortgagees to Participate in Condemnation Cases

Whether a mortgagee is named a party in a condemnation case will likely depend on state law and how the term “condemnee” or “owner” is defined in a jurisdiction’s relevant statute. In some jurisdictions, the relevant statute requires that owners and any persons having an interest in the property being condemned shall be joined as parties. In others, absent an express statutory requirement, mortgagees with a mere security interest in the property condemned need not be made a party to the action.

For example, New Jersey law requires that mortgagees be listed as potential condemnees in the complaint. However, across the Delaware River, Pennsylvania law provides only that such mortgagees receive notice of the condemnation. Moreover, the notice provision under Pennsylvania law was only added in September 2006. Prior to that date, the condemning agency was not required even to provide the mortgagee notice, potentially leaving that mortgagee in the dark about the impact that a taking could have on the property securing the mortgage. Based on the varied treatment of mortgagees in condemnations throughout the country, it is best for the mortgagee to have its condemnation clause include a provision that the condemnee provide it with written notice of any attempts by governmental agencies or other entities embodied with the power of eminent domain to acquire the subject property.

The right of mortgagees and lienholders to participate in a condemnation may depend on the mortgage language itself as well as state law. That is, some courts will allow the mortgage language to govern the mortgagee’s right to participate in the condemnation. In other instances, the right of the mortgagee to participate may depend upon how that particular jurisdiction treats the mortgagee’s interest. Many jurisdictions observe that the mortgage does not pass title to the mortgaged land, but only creates a security interest in the nature of a lien upon the land. Thus, because the mortgagee does not have an ownership interest in the land, certain jurisdictions may limit the mortgagee’s participation. Yet, other jurisdictions may still follow common law where a mortgage is treated as conveying a defeasible title to the land mortgaged. In these situations, the mortgagee is most likely to be considered a condemnee with a right to seek compensation from the condemnor.

Due to the varied treatment of mortgages and the rights they convey, the method of participation by a mortgagee will vary from state to state. Some jurisdictions allow the mortgagee to participate fully in an action against the condemnor. Others allow the mortgagee to participate only to the extent necessary to claim its portion or allocation of the condemnation proceeds. Yet, a few jurisdictions only provide that the mortgagee maintains a remedy against the mortgagor. Consequently, mortgagees should seek to reserve the fullest protections and rights of participation as granted under the controlling law when drafting a condemnation clause.

## III. Rights of Parties to the Proceeds/Impact Where Rights Are Assigned to Mortgagee

Most standard condemnation clauses address the mortgagee’s right to the condemnation proceeds, and may go so far as to establish the distribution as between mortgagor and mortgagee. Typically, the clause includes a provision whereby the proceeds of any award or claim for damages in connection with any condemnation or conveyance *in lieu* of condemnation is assigned to the mortgagee. Such a clause is intended to give the mortgagee the unfettered right to the condemnation pro-

ceeds.<sup>3</sup> While this language protects the mortgagee's interest and gives the mortgagee a right to as much of the condemnation proceeds needed to satisfy the outstanding mortgage obligation, it may have unintended consequences.

### *A. Condemnor Takes Title Free and Clear of All Liens and Encumbrances*

In most cases, upon notice of the filing of a declaration of taking or similar document and the offer/deposit of estimated just compensation, the condemnor will take title to the property described in the declaration of taking in a fee simple estate, free and discharged of all right, title, interest and liens of all parties. Thus, all proprietary rights and interests in the land condemned are extinguished, and all lienors and encumbrancers, including mortgagees, are relegated for compensation to the proceeds that stand in place and stead of the land.<sup>4</sup>

### *B. Total Taking*

In a total taking, the condemnor takes the whole of a property. Once the condemnation proceeds that are in excess of the mortgage amount are paid or deposited, the principal amount of the mortgage may be deemed immediately paid. In this sense, the condemnor's payment or deposit of condemnation proceeds constitutes nothing less than a tender of payment to the mortgagee of the full mortgage obligation. Therefore, once the taking occurred and an award in excess of the principal owed is paid, the object of the mortgage transaction had been fulfilled.<sup>5</sup> That is, the borrower had received a loan and given security for it. Once the condemnor takes title to the property (usually by the filing of a declaration of taking or similar mechanism) and makes payment of its estimate of just compensation or an award of just compensation, the mortgagee with an unfettered right to the proceeds under the condemnation clause has, in essence, been tendered repayment in full.

Further, as a result of the taking, the security no longer exists, as the property is now owned by the condemning authority. No rights of possession or enjoyment of the property remain in the mortgagor, and no issues of foreclosure or redemption exist. As a result, the mortgagor's fee interest in the premises and the mortgagee's lien thereon are destroyed and, by operation of law, both interests are transmuted to a present right to the funds to be paid by the condemnor. In short, the traditional interests of mortgagor and mortgagee with respect to real property were extinguished. All that remained was money to be divided between the parties as they had agreed.<sup>6</sup> Consequently, in the event of a total taking of the property, a typical condemnation clause will provide that the proceeds will be applied to the sums secured by the security instrument, whether or not then due, with any excess paid to the borrower.

### *C. Partial Takings*

The application of a condemnation clause can become trickier in a partial taking situation. A partial taking occurs when the condemnor takes less than the whole property owned by the mortgagor. As a result, a portion of the property covered by the mortgage is taken while a portion remains.

There are three primary ways in which a condemnation clause deals with a partial taking:

First, and most often, mortgagees with superior bargaining power are able to include in their condemnation clause a provision granting them the right to all proceeds as may be necessary to satisfy the mortgage as a result of a partial taking—no matter how inconsequential the taking may be. Such funds, as in a total taking, will be applied against the outstanding principal mortgage amount and any other unpaid charges. Such a provision grants the mortgagee the greatest amount of power to receive all the funds, a portion of the funds, or no funds.

Second, a condemnation clause may entitle the mortgagee to receive payment from the condemnation proceeds only to the extent the security of the mortgage is impaired. This can result in the complicated task of trying to determine how the partial taking has impacted the value of the remaining property. Under such circumstances, it is usually best to work it out with the property owner.

Finally, a condemnation clause may provide a mortgagee no right to the proceeds in a partial taking. Though it is rare to see a provision explicitly depriving a mortgagee of rights in a partial taking, a mortgagee may lose its right to make a claim to any of the proceeds in a partial condemnation if the language of a condemnation clause is ambiguous enough.

In addition to determining an allocation of the proceeds and the partial release of a mortgage, a partial taking may raise a series of questions concerning the impact to the remaining property secured by the mortgage:

- Would the condemnation cause the debt service ratio of the mortgage loan to be less than the debt service coverage ratio of the mortgage loan immediately before the condemnation?
- Is the remaining property sufficient to secure the outstanding mortgage amount?
- Will the taking cause a zoning violation, health violation or building code violation?

- Will the taking have a material adverse affect on the marketability or occupancy of the remaining property?
- Would the taking impact the access, visibility or storm water drainage at the mortgaged property?
- Will utility service, such as water, be impacted as a result of the taking?

In order for a mortgagee to be satisfied with responses to such questions, a condemnation clause will usually provide the mortgagee the right to withhold a release of the mortgage (or condemnation proceeds to the mortgagor) until the mortgagee is satisfied that the remaining property is of sufficient value to secure the outstanding mortgage debt.

#### **IV. Mortgage Rate of Interest versus Rule/Statutory Rate of Interest**

Many jurisdictions provide a statutory or rule rate of interest on condemnation proceeds. That is, where the condemnor deposits its estimate of just compensation or a final award of compensation into court, the condemnees are entitled to interest thereon. Moreover, where the ultimate award is greater than the condemnor's initial deposit or payment, the condemnees are generally entitled to interest on the difference. The interest rate on deposits and/or the delta between the condemnor's estimate of just compensation and the ultimate award of just compensation are usually set by statute or rule.

Absent a condemnation, mortgagees are entitled to interest on the unpaid balance of the mortgage to the date of payment as set forth in the mortgage. However, when the land is condemned, results may vary depending on the jurisdiction. If the local law considers the mortgagee a holder of legal title, the mortgagee may be entitled to the interest rate provided by law, regardless of the rate set forth in the mortgage. Again, the condemnation has in essence terminated the mortgage, and the mortgagee's rights to compensation are not different from those of any other property owner.

Where the mortgagee has no estate in the property, but only a security interest, the results are more varied. Some jurisdictions will allow the mortgagee to control the parties' rights with respect to interest. These jurisdictions provide that the mortgagee is entitled to interest at the contract rate until payment in full is made. Other jurisdictions find that because the lien was destroyed by the taking and the payment of condemnation proceeds, the mortgagee's rights were transferred to a present right to the condemnation proceeds and the mortgagee may, therefore, recover interest only at the statutory rate. Again, under this approach, the payment by the condemnor is deemed to be payment in full to the mortgagee. Consequently, in such jurisdictions, the mortgagor's obligations to make payments under the mortgage may stop on such date as the condemning agency acquires title and offers payment.

Regardless of this varied treatment, it may be best for the parties to contract for the payment of interest in the event of a condemnation. There is precedent whereby parties to a mortgage may agree, upon apportionment of the award in a condemnation action between mortgagor and mortgagee, that the mortgagee shall receive the difference between the statutory rate of interest and the contract rate of interest.

#### **V. Prepayment Penalties**

In several cases where a mortgage is prepaid as a result of a condemnation or a sale *in lieu* of or under threat of condemnation, courts have held that the prepayment penalty provided for in the mortgage need not be paid because the prepayment is not being made voluntarily. The thought is that a condemnee, who is in no way asked to have his or her property condemned, should not be made to pay this penalty.<sup>7</sup> This result—no payment of a prepayment penalty in a condemnation action—may even be achieved by statute.<sup>8</sup>

In other jurisdictions, courts may allow the contract language to control.<sup>9</sup> Thus, despite the fact that the prepayment has resulted from a condemnation, courts have concluded that the mortgagor must pay the prepayment penalty because of the contractual agreement to do so. Nevertheless, many jurisdictions provide by statute that such loss should be passed on to the condemnor. The objective of such a provision is to make the mortgagor whole by placing it in the same financial position it sat in prior to the taking. Further, such provisions take into account the fact that the payment was not made voluntarily, but resulted due to the sovereign's superior power of eminent domain.

#### **VI. Payment of Mortgagee's Reasonable Attorney Fees and Costs in Condemnation**

More and more, condemnation clauses in mortgages include provisions requiring a mortgagor to pay all attorney fees and costs incurred by the mortgagee in connection with a condemnation action. These expenses may include the mortgagee's attorney's work in reviewing the condemnation documents and the condemnation clause in the mortgage. They also may include the mortgagee's contact with the mortgagor or condemnor to discuss the case. And, if permitted, they may include a mortgagor's challenge to a taking, even if against the will of the mortgagor. Such fees can quickly mount up.

Obviously, such a provision represents the significant bargaining power of a mortgagee over a borrower. Hopefully, however, such a provision is not seen as a boon for counsel for a mortgagee. Rather, mortgagees and mortgagors should attempt to work out the payment of the mortgage with the condemnation proceeds on their own to minimize costs to all involved. Too often, counsel brought in for a mortgagee is unfamiliar with condemnation practice, creating unnecessary work and placing a strain on the relationship between the mortgagor and the mortgagee. In most condemnation cases involving a mortgage, the payment to the mortgagee from the condemnation proceeds can be handled with a simple phone call and a payoff statement.

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<sup>1</sup>*Albert Hanson Lumber Co. v. United States*, 261 U.S. 581, 43 S. Ct. 442, 67 L. Ed. 809 (1923); *Georgia v. Chattanooga*, 264 U.S. 472, 44 S. Ct. 369, 68 L. Ed. 796 (1924).

<sup>2</sup>See *Georgia v. Chattanooga*, *supra*, 264 U.S. 472, 479-480; *United States v. Parcel of Land*, 100 F. Supp. 498 (D. D.C. 1951).

<sup>3</sup>See *City of Orange Twp. v. Empire Mortgage Servs.*, 341 N.J. Super. 216, 223 (App. Div. 2001) (citing *Jala Corp. v. Berkeley Sav. and Loan Ass'n.*, 104 N.J. Super. 394, 401 (App. Div. 1969)).

<sup>4</sup>3 Nichols on Eminent Domain § 9.01[2] (Matthew Bender, 3rd ed. 2007), citing *United States v. 194.08 Acres of Land, More or Less, Situated in St. Martin Parish*, 135 F.3d 1025 (5th Cir. 1998), et al.

<sup>5</sup>See *Empire Mortgage*, *supra*, 341 N.J. Super. at 227-228; *City of Englewood v. Exxon Mobile Corp.*, 2009 N.J. Super. LEXIS 30 (App. Div. Feb. 10, 2009).

<sup>6</sup>See, e.g., *Empire Mortgage*, *supra*, 341 N.J. Super. at 223.

<sup>7</sup>See *Landohio Corp. v. Northwestern Mut. Life Mortg. & Realty Investors*, 431 F. Supp. 475, 480 (N.D. Ohio 1976) (“[W]hen the state coerces the sale of a mortgagor’s property through the exercise of its condemnation power, the mortgagor is relieved of the contractual duty to render a prepayment premium to the mortgagee, unless the parties have explicitly agreed that such a payment shall be made even in the event that the mortgagor is forced to sell his property.”)

<sup>8</sup>See California Code of Civil Procedure § 1265.240 (“Where the property acquired for public use is encumbered by a lien, the amount payable to the lienholder shall not include any penalty for prepayment”).

<sup>9</sup>See note 7, *supra*.