

# CLARK HILL Journal

## The DestiNY USA Litigation: Government's Right to Extinguish Contract Terms Through Eminent Domain, Potentially Without Just Compensation

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### Introduction

A condemnation case winding its way through the New York courts pits a local development authority acting in concert with a shopping center developer in a battle against several major retail tenants. The local development authority owns a shopping center location in fee simple and leases it to a private developer. The private developer/landlord entered into a series of subleases with the retail operators in the shopping center. The Appellate Division of the Supreme Court of the State of New York authorized a local development agency to acquire and extinguish, through eminent domain, specific leasehold rights which would have allowed tenants to review and approve changes in the layout, design, parking and traffic circulation of the shopping center. The agency deemed such condemnation necessary to facilitate construction of an expanded development called DestiNY USA. The Appellate Division rejected the tenants' arguments that the taking was an improper extension of government powers because it involved the taking of purely contractual rather than real property rights and violated the Contract Clause of the United States Constitution. The Court of Appeals has declined to review the Appellate Division decision and the tenants are evaluating pursuing potential federal remedies.

If the local development agency ultimately prevails in the DestiNY USA litigation, both landlords and tenants should be conscious of the potential implications of the expansion of government power to interfere with and disturb contractual rights and obligations that resulted from arms-length bargaining. While in the DestiNY USA litigation, the government entity is acting in concert with the developer/landlord, both landlords and tenants should be aware of the possible danger to their contract rights from the exercise of the power of eminent domain. In addition, while the obligation of the government agency to pay just compensation has been recognized, the extent to which the compensation required will be just or realistically reflect the actual damages caused has yet to be determined.



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### The Project

The Syracuse Industrial Development Agency ("SIDA") is working in conjunction with The Pyramid Companies and Carousel Center, L.P. (collectively, "Pyramid") to create DestiNY USA. DestiNY USA is planned as a mix of traditional retail space, hotels, and other recreational or entertainment type uses including an aquarium. SIDA hopes that DestiNY USA will become a major tourist attraction in upstate New York.

In the 1980's Pyramid proposed to construct Carousel Center, a 1.5 million square foot shopping center and tourist destination. SIDA utilized its eminent domain power to obtain the property necessary to construct Carousel Center, which had been previously occupied by heavy industrial uses. SIDA owns the Carousel Center and permits Pyramid to use and occupy it, paying all expenses and collecting all revenue until 2007 when SIDA will convey Carousel Center to Pyramid.

Shortly after the completion of Carousel Center, J.C. Penney

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Corporation, Inc. (“J.C. Penney’s”), Kaufmann’s Carousel, Inc. (“Kaufmann’s”) and Lord & Taylor Carousel, Inc. (“Lord & Taylor”) (collectively, “Tenants”) became major tenants of Carousel Center. As part of their sub-leases, Tenants obtained various rights and interests with respect to:

(1) changes in the layout of Carousel Center, including its design and configuration, and the addition or withdrawal of any property comprising Carousel Center; (2) the parking and traffic circulation at Carousel Center; (3) the easements in and through Carousel Center, including those for parking, use of the common areas, access and ring roads, utility facilities, and accent and exterior lighting; (4) the design, phasing, and timing of all construction of improvements at Carousel Center; (5) the obligations of the other department stores in Carousel Center, the permitted and prohibited uses of the property, and the leasing of the available retail store space; and (6) the operation and management of Carousel Center under the Carousel Center name.

*In the Matter of Kaufmann’s Carousel, Inc., et al. v SIDA, et al*, 750 N.Y.S.2d 212, 216 (4th Dept. 2002). Kaufmann’s and Lord & Taylor also obtained \$1 options to purchase their building pad and surrounding parking.

Kaufmann’s and Lord & Taylor obtained additional contractual promises directly from SIDA through non-disturbance agreements that were executed concurrently with their respective sub-leases with Pyramid. In the non-disturbance agreements, SIDA promised not to disturb or in any way adversely affect the possession and other rights of Kaufmann’s and Lord & Taylor under their subleases with Pyramid.

Following the development of Carousel Center, Pyramid and SIDA began working together to construct a new 850,000 square foot retail

development called Carousel Landing. Carousel Landing was proposed for a location across the street from Carousel Center. In late 1997, Pyramid proposed to expand, reconfigure and connect Carousel Center with Carousel Landing, creating DestiNY USA.

### **The Procedural Posture of the Matter and the Substantive Rulings of the Appellate Division**

On April 30, 2002, SIDA set forth its Resolution and Determination of Findings pursuant to New York Eminent Domain Procedure Law (“EDPL”) § 204. Tenants challenged the Resolution and Determination of Findings of SIDA. Pursuant to EDPL, such challenges are filed directly with the New York Supreme Court Appellate Division. Tenants challenged SIDA’s determination of necessity on two important substantive grounds and a number of other procedural grounds that are not relevant to this discussion.

First, Tenants asserted that SIDA was attempting to acquire contractual rights that were not interests in real property. GML § 858 only authorized SIDA to acquire “real property or rights or easements therein.” Tenants argued that SIDA was not authorized to independently acquire what Tenants asserted were actually contract rights since an eminent domain taking generally relates to a permanent physical occupation of property or at a minimum a real acquisition of a real property interest. Tenants stressed the fact that SIDA already held fee simple ownership of the property that they occupied pursuant to their subleases with Pyramid.

Second, tenants argued that SIDA’s proposed taking was an unconstitutional impairment of contract that violated Article I, Section 10 of the United States Constitution, which provides

in relevant part that “[n]o State shall . . . pass any . . . Laws impairing the Obligation of Contracts.”

In *Kaufmann’s Carousel*, the Appellate Division rejected the arguments made by Tenants and upheld SIDA’s determination of necessity. The Appellate Division relied upon EDPL 103(f), which defines real property as including “all land and improvements, . . . all easements and hereditaments, corporeal or incorporeal, and every estate, interest and right, legal or equitable, in lands or water, and right, interest, privilege, easement and franchise relating to the same, including terms for years and liens by way of mortgage and otherwise.” The Appellate Division specifically found that the statute is “broad enough to encompass an interest in real property such as a leasehold interest.” *Id.*, at 218. The opinion did not substantively analyze Tenants’ arguments that the rights being obtained were mere contract rights arising in conjunction with the real property interests conveyed in the subleases.

Similarly, the Appellate Division rejected petitioner’s claim that SIDA’s acquisition of contract rights abrogated the Contract Clause of the United States Constitution. The court held that it is “well established that ‘the exercise of powers that are inherent in and essential to the effective operation of government such as eminent domain, cannot be contracted away and are not subject to the Contract Clause.’” *Id.*, at 221.

J.C. Penney’s filed a petition with the Court of Appeals seeking appeal by right because J.C. Penney’s contended that *Kaufmann’s Carousel* implicates important constitutional issues. Kaufmann’s and Lord & Taylor filed a petition seeking leave to appeal from the Court of Appeals on a discretionary basis. The Court of Appeals has determined that it will not review the Appellate Division decision, either by right or by leave. Tenants are evaluating any potential federal remedies

that may exist because the litigation implicates the United States Constitution.

## **The Effect of the Destiny USA Litigation Upon the Shopping Center Community**

The shopping center community should monitor the DestiNY USA litigation closely for several reasons. Expanding government's eminent domain rights may facilitate future development. However, allowing government to selectively acquire and extinguish discreet contractual rights through condemnation overturns positions obtained by parties following substantial bargaining. While SIDA is working on behalf of the landlord in the DestiNY USA litigation, the roles could easily be reversed to the detriment of landlords and developers. Finally, while the Appellate Division's decision recognizes significant additional governmental rights to acquire property and contractual interests, the government's responsibility to pay realistic just compensation may not be expanded commensurately. While wise public policy would require both questions to be addressed simultaneously, New York condemnation procedure bifurcates the questions.

An ultimate ruling in favor of SIDA will be a tool to spur development. The long-term national trend in the area of eminent domain law has seen an expansion of the right of government to acquire private property and facilitate development. Eminent domain is no longer limited to acquisition of property to build roads and other infrastructure such as utilities or schools and other government related buildings. Rather, eminent domain is frequently used when government determines that a particular type of development on private property should be replaced with another essentially private development in order to obtain societal benefits such as the creation of jobs or general economic growth.

In fact, the current dispute would have never arisen if SIDA did not have the power to condemn heavy industrial uses known as "Oil City" that formerly occupied the Carousel Center property. The original acquisition of Oil City was subject to EDPL proceedings. In *Sun Co., Inc. v. SIDA*, 209 A.D.2d 34, 625 N.Y.S.2d 371 (4th Dept. 1995), *app. dismissed*, 86 N.Y.2d 776, 631 N.Y.S.2d 603 (1995), the Appellate Division upheld SIDA's authority to acquire property for an expansion of Carousel Center, but determined that SIDA failed to comply with certain procedural requirements. In *Mobil Oil Corp. v. SIDA*, 224 A.D.2d 15, 646 N.Y.S.2d 741 (4th Dept. 1996), the Appellate Division again upheld SIDA's constitutional and statutory authority to acquire the property for the Carousel Center expansion and determined that SIDA complied with all procedural requirements. Condemnation was used as a tool to facilitate retail development.

However, in the current DestiNY USA litigation, SIDA is attempting to exercise its eminent domain powers in an expanded and disturbing manner. Pyramid and Tenants negotiated leases containing provisions that insured that Tenants would be active participants in the operation and evolution of Carousel Center. Now, rather than allowing Pyramid and Tenants to engage in bargaining based upon the frameworks established in their contracts, SIDA is extinguishing the contractual provisions that provided Tenants with bargaining leverage. Tenants will be forced to operate in an environment that will be radically different than they envisioned when they executed their subleases, despite the fact that their contracts allowed them to prevent changes from occurring without their input and consent.

While the current DestiNY USA litigation involves a developer/landlord seeking to uphold a broader distribution of powers to a condemning authority, it

is easy to envision a situation in which a landlord such as Pyramid would be making the same arguments as Tenants are now.

Presumably, a developer/landlord like Pyramid contracting with a government entity like SIDA to construct a shopping center would insist upon contractual language preventing SIDA from developing a competing shopping center in close proximity. If the Appellate Division's decision in Kaufmann's Carousel stands, the government entity could simply acquire and extinguish that contractual right and proceed with its development, to the detriment of the landlord/developer.

In addition, the government entity could acquire and extinguish any negotiated restrictions in leases restricting tenants from opening store locations within a specified geographical radius or even extinguish the lease itself. Such an action would allow the tenant to open in the competing center, to the detriment of the landlord. In this example, the roles of the landlord/developer and tenants would be reversed.

An even more absurd result could theoretically occur. Rather than acquiring and extinguishing contractual rights, the government could acquire and exercise those rights, essentially giving the landlord a new and not-so-silent partner in the development.

Scenarios such as these are unsettling to both landlords and tenants that argue that straightforward bargaining and respect for contractual rights and obligations are important. The obvious retort to this argument is that government cannot condemn private property rights without paying just compensation. However, setting aside the difficulty of proving damages stemming from the acquisition and extinguishment of discreet clauses in leases, this response may not hold true as a matter of law. The DestiNY USA litigation provides a perfect example.

The Court of Appeals has held on a number of occasions that a property owner is not entitled to receive just compensation due to the diversion of traffic or relocation of a public right-of-way, even where a portion of the owner's property is permanently acquired, so long as reasonable access remains. In *Bopp v. State of New York*, 19 N.Y.2d 368; 227 N.E.2d 37; 280 N.Y.S.2d 135 (1967), the property owners operated a lodge and restaurant located directly across the street from a mountain resort area along a state highway called Route 28. The state obtained a very small portion of the owner's property as part of a larger project that relocated Route 28. Rather than being located directly on Route 28, the property was accessible only along a 700-800 foot access road from Route 28 that involved a sharp turn. In addition, the property was no longer visible from Route 28. In *Bopp*, the project resulted in a reduction of the highest and best use of the property and a substantial diminution in its value. However, the Court of Appeals determined that "under these circumstances, the owner of the property is not entitled to damages incurred because access is no longer as direct as it once was or because the newer or remaining access is less than ideal . . . Nor

are damages recoverable because traffic no longer passes in front of the claimant's property or because his property is no longer visible to those traveling on the main highway." *Id.*, at 39.

SIDA is attempting to obtain Tenants' contractual right to prevent realignment and reconfiguration of the shopping center that could have the effect of reducing access, reducing traffic counts and reducing visibility. The Appellate Division did conclude that the takings were appropriate "as long as J.C. Penney and the other Carousel Center petitioners received just compensation for the value of the leasehold interests that are being acquired by condemnation." *Kaufmann's Carousel*, at 218. However, if past precedent such as *Bopp* is followed, compensation could be denied for these classes of damages. In effect, Tenants could receive no compensation for some or all of the contractual rights that were acquired.

## Conclusion

While an extension of government's right to exercise eminent domain may be a convenient tool in facilitating new development, the cost of that convenience is the unsettling of bargained-for contractual positions. To prevent

government from acting to extinguish rights without providing adequate compensation, contracts should be drafted to shift the financial burden of such takings upon the party working in concert with the government.

In the DestiNY USA litigation, Tenants would have had significant leverage when engaged in bargaining during their approval of the alterations of the Carousel Center. That bargaining leverage will be destroyed if the condemnation efforts of SIDA are upheld. Therefore, if the Appellate Division's decision in *Kaufmann's Carousel* stands, both landlords and tenants should engage in an additional layer of analysis when negotiating leases to avoid such a result. Both landlords and tenants should consider the potential ramifications if rights and obligations contained in their leases are acquired and extinguished. If discreet lease provisions are condemned, contractual terms that might prove useful include granting an option to terminate a lease early, requiring increases or reductions in rent in the event that rights or obligations are extinguished, granting relocation rights, reimbursement of construction costs, granting rights of first refusal, or paying a stipulated liquidated damages amount.

**Stephon B. Bagne** has specialized in representing property owners involved in condemnation proceedings during his entire career. His expertise in representing property owners in condemnation cases is widely recognized. Stephon has represented all types of property owners in a variety of situations including vacant and improved property, partial and total takings, easement and fee acquisitions, involving commercial and residential properties. Stephon has successfully challenged the necessity of takings and negotiated less onerous acquisitions in partial taking matters. He regularly speaks and writes about eminent domain and other real estate law issues for a variety of professional organizations. **Contact him at: [sbagne@clarkhill.com](mailto:sbagne@clarkhill.com) or 313-965-8897**

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