Eminent Domain and Deeds of Trust

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The right to take private property for public use is well established. The power is known as "Eminent Domain" and has a long history in the law. The Fifth Amendment to the Unites States Constitution provides that private property may not be taken for a public use without "just compensation." In addition to the Constitution, the power of eminent domain, is also regulated by state statutes. This regulation includes the power of certain private utilities, usually govered by a state's "Public Utilities Commission," to condemn for purposes related to their provision of utility services.

In a 2005 case, *Kelo v. City of New London, Conn.*, the United States Supreme Court held that the taking of private property to be used by another private party for the purpose of economic redevelopment (i.e., a private use that would generate higher taxes to the municipality) satisfies the "public use" requirement of the Fifth Amendment. The background there saw the City of New London faced with significant challenges following decades of economic decline, which led a state agency in 1990 to designate the City a "distressed municipality." Ultimately, this resulted in the taking of the property involved there. The implication of the *Kelo* decision is that public entities can now take property for almost any reason dressed as "the public good."

That being the case, the question to lenders is how to protect your collateral if the property secured by your deed of trust becomes subject to an action in eminent domain.

Code of Civil Procedure §1265.220 provides when property secured by a deed of trust is condemned, and the secured debt is not due at the time of the condemnation judgment, the owner is entitled to receive the value of the property taken, but the condemning agency will deduct the amount due the secured lender from the amount due the owner and pay only the remaining balance to the owner. If the condemnor pays the proceeds to the owner without deducting the amount of a preexisting lien, it cannot later recover the amount of the secured debt from the owner.

The lien of a deed of trust is a compensable property interest protected by the Fifth Amendment. Upon condemnation of property that is subject to a deed of trust, the lender loses its lien on the real property, but the condemnation award is substituted for the property and the lender obtains a lien on the condemnation proceeds. When the secured debt is not due, the condemning agency can hold the proceeds that are equivalent to the unpaid balance of the secured debt, subject to the lender's lien, and pay the installments due on the secured debt as they mature. In the alternative, at the option of the condemning agency, the debt can be paid in full at any time, and the lender is not entitled to any prepayment penalty (assuming there was a prepayment penalty clause in the note).

What happens when only a portion of a property subject to a deed of trust is taken? Code of Civil Procedure §1265.225 provides that the condemnation proceeds must be allocated between the lender and the owner. The lender is entitled to receive the portion of the proceeds to the extent that the security has been impaired by the part of the property taken. Upon the partial taking, either the property owner and lender can agree on the apportionment of the debt, or the court may determine that the lender will share in the award to the extent necessary to prevent an impairment of the security.

A typical form deed of trust provides that upon any condemnation of the property that is security for the lien, all of the proceeds must be paid to the lender whether the amount of property taken is all of the security or only a portion of it. However, the contrary statutory provision for the allocation of the condemnation award may supersede the provisions in the

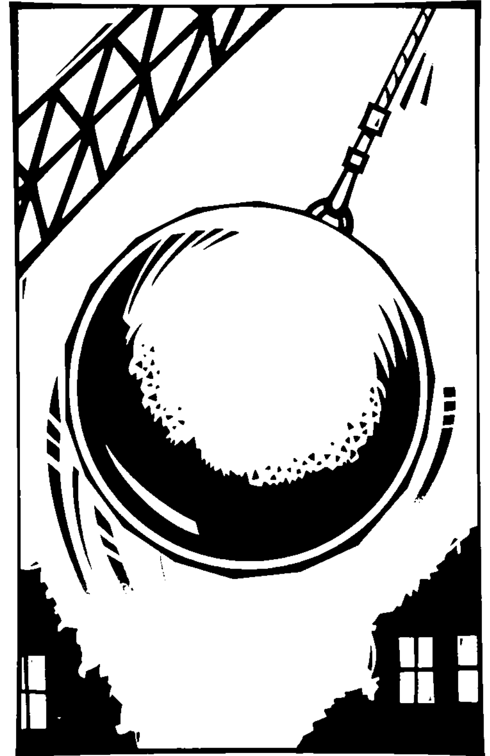
continued on page 10

Eminent Domain - *continued from page 9*

deed of trust. A carefully drafted deed of trust would have the borrower waive the benefit of Code of Civil Procedure §1265.225, but no California court has interpreted whether that waiver may be valid.

Moreover, certain waivers have been deemed invalid by California courts because the rights that have been waived are deemed fundamental. For example, the California Supreme Court held in *Grafton Partners L.P. v. Superior Court*, that a predispute contract waiving the right to jury trial is unenforceable under the California Constitution. On the other hand, there are waivable rights in this context. For example, in *Union Bank v. Gradsky*, the Court held that the derivative right of a guarantor to subrogate against a borrower after a nonjudicial foreclosure could be waived. And the California legislature actually codified the *Gradsky* waiver in Civil Code §2856. Nevertheless, it is unclear whether the borrower's waiver of an award allocation between the borrower and a lender is closer to the fundamental right of a jury trial (which cannot be waived) or the guarantor's subrogation right (which can be waived).

Where does all of this leave a lender? At a minimum, each trust deed should provide that all condemnation proceeds are assigned to the lender and that the lender is to be reimbursed for all of its costs (including legal fees) in connection with any eminent domain action. The lender should have the unfettered discretion to apply the proceeds first to its costs and then to the principal amount owed on the loan, regardless of whether the loan is due at the time. The borrower should waive the benefits of Code of Civil Procedure §1265.225, which may or may not be valid, but puts the lender in a stronger negotiating position with the borrower as to the allocation of the award between the borrower and the lender. ▼



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