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Economic Returns on Historic Properties

RALPH C. MENAPACE, JR.*

Certain problems are raised in the measurement of economic returns on properties subject to landmark regulation and in the evaluation of the adequacy of those returns. The focus of my talk will be the hardship relief provisions of the New York City Landmarks Law under which an owner may apply to the Landmarks Commission for a Certificate of Appropriateness; this certificate would permit the alteration or demolition of the landmark structure because of insufficient return.[1]

The more aggressive enforcement of the New York City Landmarks Law which is expected in light of the *Penn Central*[2] decision and the increase in the numbers of commercial properties designated as landmarks may bring these hardship provisions into increased prominence in the near future as more owners seek relief. As of this date, no one has successfully prosecuted an application for economic hardship before the New York City Commission.

Substantial restrictions can be placed on historic structures in the interest of landmark preservation without payment of compensation to the owners of the properties. If, however, the restrictions go too far, or, in the words of the Supreme Court, have an "unduly harsh impact"[3] on a particular property, the owner must be given relief from the restrictions or paid compensation; if not, the regulation constitutes a taking. It is unclear how to determine how far is too far or what is "unduly harsh."

The Supreme Court suggests various verbal formulations of this concept: one is that the owner must be left with a "reasonable beneficial use" of the property;[4] another is that the property, as regulated, must be "economically viable";[5] a third is that the property, as regulated, must be capable of yielding a "reasonable return" to its owner.[6] A fair conclusion is that the court deliberately avoided any single formulation and may, in future cases, approve various methods of applying a hardship test.

It is clear, however, that economic hardship will be consid-

ered by the Court. Legislatures must, therefore, address the problem and landmark preservation laws must in some way provide relief to those landmark owners who can show economic hardship. In the *Penn Central* case, the affirmance of the New York court's decision was based on the Supreme Court's view that a continuing process was involved. Penn Central could come back with a plan for a smaller or different tower. If the economic situation should change or if Penn Central could make a better case proving its economic hardship, some relief would have to be offered.[7]

The New York City Landmarks Law has provisions, enacted before *Penn Central,* which address the difficult issues involved in determining what constitutes a sufficient economic return on landmark properties.[8]

The owner of a building or other structure designated as a landmark, who can establish that the "improvement parcel," which includes the structure, "is not capable of earning a reasonable return" — defined by the statute as six percent of the value of the property[9] — may apply to the Landmarks Preservation Commission for a Certificate of Appropriateness to alter or demolish the improvement on the ground of insufficient return.[10] Normally the value of the property is the assessed value for real estate tax purposes, but in certain limited circumstances, the statute permits the Commission to find another valuation.[11] If the parcel involved is not tax exempt, and if the applicant shows a good faith intent to proceed "immediately" (in the case of demolition) or "with reasonable promptness" (in the case of alteration), the Commission must within a specified period develop a plan to preserve the landmark and generate a reasonable return thereon for the owner.[12] Such a plan, subject to approval of the Board of Estimate, may consist solely or in part of exemption from real estate taxes.[13] If no acceptable plan is developed within the specified time, the Commission may recommend to the Mayor that the city acquire the property by condemnation or otherwise.[14] If no such recommendation is made, or if the city does not elect to acquire property, the owner is then free to proceed with the proposed alteration or demolition.[15]

The situation with respect to tax-exempt properties differs in that the statute has no express remedy for the property owner unless, in addition to insufficient return, the owner shows (1)

that he has entered into an agreement to sell the property, (2) that the proposed purchaser has a good faith intent to proceed promptly with a proposed alteration or demolition upon purchase, and (3) that the improvement is no longer adequate to fulfill the purposes of the owner to which it is and had been devoted. If these additional showings are made, the Commission must within a specified period find a purchaser who is willing to purchase the property subject to the landmark restrictions and on terms and conditions reasonably equivalent to those offered by the original proposed purchaser. Failing this, the Commission may recommend to the Mayor that the city condemn or otherwise acquire the property. If this is not done within a specified period, the owner is free to proceed with the sale of the property, and the purchaser can proceed with alteration or demolition.[16]

The statutory provisions with respect to tax-exempt properties do not provide a remedy for the owner who wishes to retain title to the property and alter or demolish it for his own purposes. However, the New York courts in *Sailors' Snug Harbor,*[17] *Lutheran Church,*[18] and *Penn Central,* held that if the owner could show maintenance of the landmark physically or financially prevents or seriously interferes with the charitable purposes of the owner, a court would imply a remedy, which, as in the *Lutheran Church* case, might be to free the property from all restrictions under the Landmarks Law.

Is "reasonable return" as defined by the New York statute sufficient to constitute a "reasonable return" which will satisfy the constitutional standard established in *Penn Central?* Is six percent a sufficient rate of return? Assessed value for tax purposes may be significantly less than fair market value. Rent control precedents suggest that six percent may be held to be a sufficient rate of return.[19] The Supreme Court's reference to "investment-backed expectations"[20] further suggests that as long as actual cost to the owner of the landmark does not significantly exceed assessed value, no serious constitutional problem is posed. It may be advisable to consider amendment of the statute to relate the rate of return in some way to the prime rate of interest, although the extreme fluctuations in the prime rate in recent years makes this questionable. Retaining the six percent rate will create problems in future litigation.

It is not clear in New York today whether assessment for tax purposes reflects to any extent the burden of landmark restrictions. Would partial or total exclusion from assessed value of the property of the value of development rights not useable because of landmark regulation pose a problem? The constitutional requirement that property be capable of earning a "reasonable return" refers to the return on the value of property after regulation, rather than the value absent regulation. *Penn Central* would be undercut if the reasonable return test were based on a valuation of the property based on the "highest and best use."

Certain factors considered in determining whether constitutional standards are met may not be held to be relevant in determining whether the statutory six percent return test has been met. For example, it is not clear whether the availability of possible air rights transfers can or should be considered. The statutory test refers to the capability of the property to yield the required return under "reasonably efficient and prudent management."[21] Therefore, it is possible to argue that revenue from air rights transfers should be considered, since diligent management would at least explore the possibility of deriving revenues from such transfers.

In *Penn Central,* the Supreme Court rejected the contention that air rights over the Terminal should be viewed as a property interest separate from the Terminal, a property interest that was completely destroyed when the railroad was denied permission to build an office tower over the Terminal. In doing so, the Court approved as the relevant property unit, even though it was not literally applicable, the unit defined in the Landmarks Law, that is, the city tax lot that includes the landmark structure.[22] What about the possibility of arguing hardship by subdividing landmark properties so as to create interests which would be completely demolished by the regulation? The New York statute prohibits that.[23] If the landmark involves more than one tax lot at the time of designation, the several tax lots together constitute the applicable unit for determining hardship.[24]

The application of Rockefeller Center Incorporated (RCI) for a Certificate of Appropriateness to demolish Radio City Music Hall poses another aspect of this problem. In this case the

tax lot in which the Music Hall is located covers the entire city block from Fifth to Sixth Avenues between 50th and 51st Streets and includes several substantial office buildings as well as the Music Hall. RCI contended at the public hearing on its application that, notwithstanding statutory language, the Commission, to be fair, should treat the Music Hall and the land under it, exclusive of the remaining land and buildings, as the relevant unit for determining the adequacy of the economic return. Although not without merit, the contention is difficult to sustain in light of the clear language of the statute, which speaks of the return upon the "improvement parcel(s) which includes the landmark." The term "improvement parcel" is defined as the unit of real estate which includes the landmark and the landmark site "which is treated as a single entity for the purpose of levying real estate taxes."[25] Moreover, the difficulties raised in determining the proper allocation of real estate taxes as between the Music Hall and the office structures also included in the tax lot suggest that reasons of practicality militate against the contention of RCI. Furthermore, the decision to keep the entire complex of buildings in one tax block is a decision made by the owner, and, therefore, it is arguable that the owner should have to live with the consequences of that decision.

A related issue is presented by the "flagship" theory which was advanced by the Court of Appeals in its decision in *Penn Central.*[26] The Court of Appeals there stated that some part of the revenues of Penn Central's properties in the area around Grand Central could fairly be attributed to the Terminal by analogy to a "flagship" store in a shopping center which draws business for the entire shopping center.[27] Even though the Supreme Court did not comment on this argument, it may have some relevance in the Music Hall situation. The Music Hall, as one of the amenities of Rockefeller Center, arguably is responsible in some measure for the economic success of the office buildings in the entire complex.

The application to the Commission of Radio City Music Hall for a Certificate of Appropriateness raises another question. The land underlying the Music Hall — and most of Rockefeller Center — is owned by Columbia University and leased on a long-term basis to RCI. Thus, there is a dual ownership of the "improvement parcel" which includes the Music Hall: Columbia

owns the underlying land and RCI owns the buildings, subject to Columbia's reversionary interest in the buildings upon expiration of the lease.

At the public hearing on its application, RCI showed ground rent as an expense item in the income statements for the Music Hall — which showed significant losses. Although no explanation of this treatment of ground rent was presented, presumably the rationale is that the buildings, exclusive of the underlying land, can and should be treated as the relevant economic unit in determining economic hardship.

The appropriate economic unit should include both the land and the building. Nothing in the language of the statute would appear to sanction the division of buildings from land in the "improvement parcel" any more than there is sanction for separating the landmark structure, including its underlying land, from the unused air rights above the landmark. The statute defines the improvement parcel to include all of the land and all of the improvements within the tax lot which includes the landmarks, open land, and other improvements. The capability of earning a return on that unit is called for by the statute. This makes economic sense, since to hold otherwise could require the demolition of a landmark because the terms of a ground lease unduly favored the owner of land as against the lessee.

The statute does not contemplate a horizontal division of the improvement parcel any more than it contemplates a vertical division. There would seem to be even less justification in policy since "economic viability" of the property should be viewed in terms of the parcel as a whole: the Supreme Court took this view and looked at the parcel as a whole when Penn Central attempted to treat the air rights over the Terminal as separate from the Terminal.[28] In any event, RCI itself uses the combined assessed valuation of the land and structures in quantifying the six percent return that it asserts it should be receiving on the property.

The problems posed in determining the adequacy of return on landmarked properties are complex and difficult. They involve issues as different as tax assesment policies and the legal and practical aspects of air rights transfers. All that is clear is that these issues will be increasingly in the forefront of preservation law.

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1. NEW YORK, N.Y., ADMIN. CODE ANN. § 207-8.0 (Williams 1976).

2. Penn Cent. Transp. Co. v. New York City, 438 U.S. 104 (1978).

3. *Id.* at 127.

4. *Id.* at 138.

5. *Id.* at 138 n.36.

6. *Id.* at 136.

7. *Id.* at 136-37, 138 n.36.

8. NEW YORK, N.Y., ADMIN. CODE ANN. § 207 (Williams 1976 & Supp. 1981).

9. *Id.* § 207-1.0v(1).

10. *Id.* § 207-8.0.

11. *Id.* § 207-1.0v(2).

12. *Id.* § 207-8.0b.

13. *Id.* § 207-8.0c.

14. *Id.* § 207-8.0g(1).

15. *Id.* § 207-8.0g(2).

16. *Id.* § 207-8.0i.

17. Trustees of Sailors' Snug Harbor v. Platt, 29 A.D. 2d 376, 288 N.Y.S.2d 314 (1st Dep't 1968).

18. Lutheran Church in America v. City of New York, 35 N.Y.2d 121, 316 N.E.2d 305, 359 N.Y.S.2d 7 (1974).

19. *See, e.g.,* Felner v. Office of Rent Control of the New York City Dep't of Rent and Housing Maintenance, 27 N.Y.2d 692, 262 N.E.2d 217, 314 N.Y.S.2d 11 (1970); Plaza Mgt. Co. v. City Rent Agency, 25 N.Y.2d 630, 254 N.E.2d 227, 306 N.Y.S.2d 11 (1969); I.L.F.Y. Co. v. City Rent and Rehabilitation Ad., 11 N.Y.2d 480, 184 N.E.2d 575, 230 N.Y.S.2d 986 (1962).

20. Penn Cent. Transp. Co. v. New York City, 438 U.S. at 124.

21. NEW YORK, N.Y., ADMIN. CODE ANN. § 207-1.0c (Williams 1976).

22. Penn Cent. Transp. Co. v. New York City, 438 U.S. at 130-31.

23. NEW YORK, N.Y., ADMIN. CODE ANN. § 207-1.0j (Williams 1976).

24. *Id.*

25. *Id.*

26. Penn Cent. Transp. Co. v. City of New York, 42 N.Y.2d 324, 366 N.E.2d 1271, 397 N.Y.S.2d 914 (1977).

27. *Id.* at 333-34, 366 N.E.2d at 1276-77, 397 N.Y.S.2d at 920.

28. Penn Cent. Transp. Co. v. New York City, 438 U.S. at 130-31.