

Economic Impacts, The *Bennett* Decision and Investment-Backed Expectations

By

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1. Introduction

Regulatory takings litigation arises because property owners dispute the "fairness" of their bearing the cost for a public benefit. Private costs have become large in recent decades due to the increase in government regulations such as wetlands protection. Economic injuries have been the heart of plaintiff actions, but the courts have mostly avoided decisions based on economic evidence and standard economic practice. (A key exception is the *Whitney Benefits* decision.)

Economic decision rules can clarify notions of reasonable investment-backed expectations, economic viability, and such language that is defined only vaguely in takings cases, and not at all in actions related to the Endangered Species Act (ESA.) Business case law has made considerable progress at conforming court determined notions of economic damages to standard economic practice; but this progress has not leaped into the Court of Claims. The Supreme Court *Bennett* Decision gives impetus to conform court decisions related to economic impacts of critical habitat designation under the ESA to standard economic practice.

1.1 Three Unanswered Questions From *Bennett* Decision

The Supreme Court's March 19, 1997, *Bennett* Decision (Brad Bennett, et al, v. Michael Spear, et al, No. 95-813, 1997 U.S. Lexis 1921) affirmed 9-0 that private property owners have the right to require the Secretary of the Interior to "take into consideration the economic impact . . . of specifying a particular area as critical habitat." Justice Scalia, writing for the Court, affirmed that the intent of the ESA, Section 1533 (b)(2), is "to avoid needless economic dislocation produced by agency officials zealously but unintelligently pursuing their environmental objectives." (Lexis 1921, 39.)² With 75 percent of endangered species inhabiting private land, according to a 1993 estimate by The Nature Conservancy, the *Bennett* Decision emphasizes landowners' legal remedy of seeking recovery of economic losses due to ESA restrictions that transform the use of their land from private objectives—timber production, minerals extraction, farming, recreation activities, real estate development—to habitat for endangered species.

Access to court, however, does not imbue the courts with any more clarity on economic practice than existed prior to the *Bennett* Decision. The Supreme Court merely reversed the lower courts' rulings and remanded the *Bennett v. Spear* dispute to the Oregon court for re-hearing. This will be the first hearing on the economic evidence because the lower courts ruled on law that the ranchers and Irrigation Districts had no standing to discuss their economic injuries. The Oregon court must deal with three economic questions that remain opaque in takings law:

- What will the courts measure to take into consideration the "economic impacts?"

- When does an "economic impact" become an "undue economic hardship?"
- How will the courts evaluate "needless economic dislocation?"

ESA has produced only a few takings cases, but the *Bennett* Decision may "open the barn door." This article suggests how current economic practice answers the three questions with reference to land use takings case law.

2. Takings Law Unpredictability Traced to Economic Considerations in *Penn Central*

Regulatory takings originate with *Pennsylvania Coal v. Mahon*, 260 U.S. 393 (1922). The opinion written by Justice Oliver Wendell Holmes asserted that a regulation may be so onerous that the landowner's economic interests are irreparably harmed. Unfortunately, the Court's decision test was so vague that courts ever since have wondered how to know "if a regulation goes too far, it will be recognized as a taking." The 1922 Court made no attempt to define the concept of "too far," pointedly leaving the determination to an ad hoc balancing of the facts and circumstances of each individual case.

While the criteria to examine Chief Justice Holmes' balancing standard have received copious debate, particularly since *Penn Central Transportation v. City of New York*, 438 U.S. 104 (1978), a predictable balance test has eluded the courts. The decision remains dependent on "ad hoc factual inquiries" into the "character of government action" compared to the "severity of private economic impact." *Penn Central* established the phrases above as two prongs to evaluate in the balance, but did not say how they should be balanced. *Agins v. City of Tiburon*, 447 U.S. 255 (1980), applied a two-prong legal test derivative of the *Penn Central* language to determine whether a regulatory taking had occurred, subsequently called the *Agins test*. *Agins* was decided on the first criterion of the *Agins* test: legitimate state interests were advanced by reducing the density of his development project. No ruling was made on the economic viable uses of the property because Mr. *Agins* had not applied for a building permit. Hence, *Agins* did not alter *Penn Central's* economic logic.

Unfortunately, *Penn Central* got the debate off on the wrong economic foot by misfocusing severity of economic impact on value remaining in the property rather than the lost lease income from the proscribed building opportunity, stated to be "at least \$3.0 million annually." (438 U.S.116.) Justice Brennan's decision keyed on the assets of the ongoing rail business, which were not diminished by the prohibition on building above the rail yard. The intangible asset value at issue, the prospective income from the use of the air rights above the terminal, however, was 100 percent lost.

A seminal fact that has not emerged in legal discussion of this important case is that the court rejected *Penn Central's* accounting testimony presented in trial! *Penn Central's* claim of an operating loss for the existing terminal was not only disregarded, the evidence was misfocused backward to show that *Penn Central* could not afford the upkeep on the historic landmark, rather than forward to emphasize the lost rental income opportunity. No competent showing of *Penn Central's* "reasonable return" with and without the building project was proffered.

Justice Brennan's attention to the amount of value remaining, rather than the value lost, abrogated the essential economic efficiency³ implicit in Justice Holmes' 1922 balancing decision. Balancing the cost of regulation that "goes too far" with the public gain cannot be achieved if the economic impact of the regulation is not factored into the decision process. The decision to compensate the owners—or not—should have been based on the balancing test implicit—but not recognized—within *Penn Central* to determine whether the foreclosed opportunity was somehow worth less to society than preservation of the Grand Central Terminal. Arguably, the benefits of preserving the historic Penn Central landmark were so substantial and indivisible that "justice and fairness" should have required the preservation costs to be borne by the taxpayers of New York as Justice Rehnquist argued in his dissenting opinion.(438 U.S.138-151.) Justice Brennan's majority parcel-as-a-whole ruling, however, has become the legal benchmark. So long as the property owner retains some economically viable use of the entire property, compensation for a taking was not awarded until *Whitney Benefits*. (*Whitney Benefits, Inc. and Peter Kiewit Sons v. United States*, 926 F.2d 1169 (1985); 18 Cl.Ct. 394 (1989); 752 F.2d 1554 (1985) cert. denied., 116 L.ED 2d 354 (1991).)

3. Considerations of Economic Impacts Due to Regulation: First Question

Some believe that the courts are moving toward a position of more "fairness" for private property owners by exhibiting a willingness to shift the burdens of regulation more broadly to society. The *Bennett* Decision lends support to that belief. If "economic impacts" are to be considered in the takings debate, substantial clarity such as found in *Whitney Benefits* must be the standard.

The first question to be answered by this article is:

- What do you measure to take into consideration the "economic impacts" of a taking?

3.1 Necessary and Sufficient Conditions

Two standards emerge from the Supreme Court's rulings that offer guidance about relevant economic content of takings law. These can be read as the economist's necessary and sufficient conditions.

1. Economic impact *per se* is a necessary, but not a sufficient basis, to prevail in a takings claim unless the loss is 100 percent (e.g., *Lucas* categorical taking), in which case it is necessary and sufficient.
2. Interference with reasonable investment-backed profit expectations can be a sufficient basis for a favorable takings decision if the loss from the distinct project is sufficient to undermine the economic viability of the entire property; i. e., if the regulation "denies an owner economically viable use of his land." (*Carson Harbor Village Ltd. v. City of Carson*, 37 F.3d 468, 473 (9th Cir. 1994) is another reference to this standard.)

Williamson County RPC v. Hamilton Bank, 473 U.S. 172 (1985) added the word "profit" to the *Penn Central* language, clarifying exactly what investors expect. *San Diego Gas and Electric v. City of San Diego*, 450 U.S. 621 (1981) clarified that economically viable use explicitly included profits from "reasonable future uses." Both of these cases reversed the *Andrus v. Allard*, 444

U.S. 51, 13 ERC 2057 (1979) standard that "loss of future profits . . . provides a slender reed upon which to rest a takings claim. . . . [a] speculation that courts are not specifically competent to perform." By 1989, the New York Court of Appeals had conformed its views to standard economic practice by focusing on expected profits in determining investment-backed expectations as the criterion by which to measure a takings claim in *Seawall Associates v. City of New York*, 542 N.E.2d 1059, *cert. denied*, 110 S.Ct 500 (1989).

In *Florida Rock IV (Florida Rock Industries v. United States*, 18 F.3d 1560, 1994, the court confirmed that the economic loss need not be 100 percent to justify compensation:

Nothing in the language of the Fifth Amendment compels a court to find a taking only when the Government divests the total ownership of the property: the Fifth Amendment prohibits the uncompensated taking of private property without reference to the owner's remaining property interests.

Florida Rock IV not only advanced the law to conform with economic practice, it mitigated *Penn Central's* value remaining faulty theory of economics. Regardless of the value remaining in Florida Rock's property, the court ruled that Florida Rock's land investments to mine limestone were frustrated by the Corps of Engineers' regulation.

A reasonable projection of the dollar flows of the lost business opportunity is the standard for estimating economic injury. The second prong of the *Agins test* would be met if these losses undermine the economic viability of the entire property. For example, if Mr. Bennett could demonstrate that the diversion of water eliminated his ability to make loan payments on the ranch property operated for many years before the 1995 USFWS Biology Opinion was promulgated, this would be evidence of interference with reasonable investment-backed expectations. Even if the ranchers owned the land, associated livestock and ranching equipment outright, if the loss of water caused the investment either to become economically non-viable, this would be clear evidence of interference with reasonable investment-backed expectations.

On the other hand, if the ranchers suffered losses of irrigated feed crops that reduced their profits from ranching 75 percent when their water supply was taken to protect endangered fish, the government, following *Penn Central*, might argue that "some value remains." The correct question to answer, however, is whether investment-backed expectations are sufficiently eroded with a 75 percent reduction of profits, not whether some value remains.

3.2 Criteria to Assess Economic Impacts

How do you measure necessary and sufficient economic impacts to support a compensatory taking? Investment-backed expectations arise when project proponents invest with the expectation that they will obtain income and capital gains from the development of their property. This must be demonstrated by evidence. The following criteria show the information required to measure and demonstrate the severity of economic impacts caused by a regulation.

1. Establish the timing and amounts of invested capital, and property interests to demonstrate a legitimate, investment-backed expectation.

2. Document actual and/or planned activities at the site proscribed by the regulation that show the lost opportunity:
 - Ability of the property and business to supply the activities/uses intended; and,
 - Market conditions that create the opportunities foreclosed by the regulation.
3. Establish time period of the loss: a specific temporary period, or in perpetuity.
4. Estimate the reduced profits caused by the regulatory constraint.
5. Estimate tangible asset values reduced by the regulatory constraint:
 - Determine portion of property retaining any economic use, if any.
 - Does economic viability of the entire property remain, although at a lower level?
6. Determine elements of risk related to the project:
 - Project completion risk
 - Product market risk (i.e, sales)
 - Financing risk
 - Other risks.
7. Capitalize the lost earnings at a discount rate consisting of the enterprise's cost of capital, plus risk factors to reflect the level of uncertainty of future cash flows.

The opportunity foreclosed by the unforeseen regulation that prohibits the planned economic use of the assets is the appropriate measure of loss—the *Wheeler IV* standard, not existing uses. (*Wheeler [IV] v. City of Pleasant Grove*, 833 F.2d 267 (11th Cir. 1987.)) Loss is keyed to the property's planned (demonstrable) use. Criterion 2 above emphasizes the *Wheeler IV* standard in that lost future opportunity is the basis for economic injury if supported by a concrete plan to supply the product or service and evidence of a market to rule out the notion of speculative future cash flows. Nonetheless, uncertainty and risk, which can never be 100 percent eliminated, are explicitly incorporated within criteria 7 and 8.

3.3 Tool to Measure Investment-backed Expectations

Value for any asset in use, or for which a use is proposed, is determined by computing the net present value (NPV) of future cash flows from the sale of services and/or products produced from the asset. Discounted cash flow analytic methods (DCF models) are used to determine this value, called the investment value or economic value of the asset. A change in economic value reflects the change in expected cash flows to be earned from using the property, in present value terms.

The correct expression of the change in value is the change in discounted cash flow, as measured by the DCF model. The DCF model is shown in Equation 1.

$$NetPresentValue = \sum_{t=1}^T \frac{CF_t}{(1+k)^t} \quad (1)$$

Where CF_t = Cash flows (after tax) in period t , k is the project hurdle rate (or required rate of return), t is the time period, and T is the length of the project.

In a takings case, the diminution in economic value of the property and related business is the proper measure of loss because case law refers to "economically viable use," "beneficial use," and "investment-backed expectations" of use. Loss of direct use of the asset, giving rise to loss of direct income, is typically at issue in a takings case, e.g., loss of development potential of part (*Penn Central*, *Nollan*, *Florida Rock*), or all (*Lucas*, *Whitney Benefits*) of the property.

4. Evaluation of Undue Economic Hardship: Second Question

The DCF model is used to determine both the NPV and the Internal Rate of Return (IRR) decision tests used in investment analysis. The decision thresholds within these tests are:

- If $NPV > 0$, accept.
- If $IRR >$ minimum required (hurdle) rate of return, accept.

These tests represent the most rigorous approach to evaluate "investment-backed expectations" associated with any property—and the loss thereof due to regulation. These decision tests provide a useful way to answer the second question postulated within this article:

- When does an economic impact become "undue economic hardship?"

Corporate investment decision makers have an expected, indeed required, *ex ante* hurdle rate of return associated with any project of a certain risk. This hurdle rate is higher than the average cost of capital to the firm because of the firm's mix of debt and because some the firm's portfolio of projects may earn returns below expectations. Anticipating this outcome, the firm requires that *ex ante* hurdle rates for projects of comparable risk include risk premiums above the average *ex post* cost of money. Criteria 7 and 8 above embed this concept.

Owners expect the project *ex ante* NPV to be positive when the cash flows are discounted with the appropriate hurdle rate, k . If the unanticipated regulation reduces the NPV, but it remains positive, this is certainly an "economic impact," but it may not be sufficient to constitute "undue economic hardship." (Whether or not it is sufficient to justify an uncompensated taking is yet another question, the answer to which depends on the balance of two prongs of the *Agins test*.) "Undue economic hardship" is tantamount to frustration of "investment-backed expectations." The economic decision rule by which to judge that the taking has reduced fatally the expected return on investment is when the regulation causes NPV swings from positive to negative.

The NPV in the calculation refers to that of the incremental project, not the NPV of the ongoing enterprise. In a situation such as Penn Central's prohibited incremental investment in a new building, a regulation-proscribed project could not reduce the NPV of the ongoing enterprise below zero. However, reasonable investment-backed expectations related to the incremental project would be driven to zero, and stockholders' expectations could be reduced. This situation emphasizes that the remaining value of the enterprise has no bearing on the calculation of the economic impact of the regulation-proscribed incremental project. The loss *per se* must be measured and compared with the gains from the regulation to achieve economic efficiency. The value remaining should be a moot point. The value of the ongoing enterprise should have no interest to the court. The change in NPV of the project, not the change in NPV of the firm, is the relevant criterion. In the *ad hoc* process that has ensued since *Penn Central*, a misplaced notion—value remaining—has insinuated itself onto the balance scales where value taken should appear.

5. Sensitivity Analysis to Find Needless Economic Dislocation: Third Question

The *Bennett* Decision is clear in its direction that agencies "prevent uneconomic jeopardy determinations:"

"The obvious purpose of [Section 1536(a)(2)] is that each agency 'use the best scientific and commercial data available' to ensure that the ESA not be implemented haphazardly. . . . [A]nother objective (if not, indeed, the primary one) is to avoid needless economic dislocation." (U.S. Lexis 1921 at 12.)

Agencies are directed to find the alternative which minimizes the economic impact of achieving the regulatory purpose; i.e., avoid needless economic dislocation. The DCF model is perfectly suited to the task of evaluating project alternatives.

The third question to be answered in this article is:

- How will the courts evaluate "needless economic dislocation?"

The DCF model is sufficiently robust to evaluate the effect of regulatory alternatives on the property owner. The economic effects of any number of scenarios can be evaluated with the DCF model, and "sensitivity analysis" can be performed to identify and rank order how much NPV is affected by various regulatory alternatives. "Needless economic dislocation" is simply defined as the difference between NPVs of two cases which yield comparable protection of the public's interest, but different "economic impacts" on the property owner.

6. Policy Conclusions

If the *Bennett* Decision is likely to "open the barn door" on claims of economic impacts due to critical habitat determination, courts must measure the economic values lost and not the value remaining. Decision rules to evaluate economic impacts consistent with takings case law are: If the regulatory prohibition reduces NPV, which remains positive, this is an economic impact. If the prohibition causes the NPV of the entire project to go negative, this is proof of "undue economic hardship" and tantamount to complete frustration of "investment-backed expectations."

Even if "some economic use" remains, if it is insufficient to provide an adequate return to the original investment, *Florida Rock* established that it has no bearing on conclusions related to economic losses. "Needless economic dislocations," measured as the difference between NPVs of different regulatory alternatives achieving similar public benefits, must be avoided.

Although obvious to everyone not schooled in the torturous logic of takings law, courts remain confused about how to consider "some economic use" remaining, even after *Florida Rock IV*. Justice Brennan's attention to the amount of value remaining, rather than the value lost, confounded the essential economic efficiency implicit in Justice Holmes' 1922 balancing decision. In the *ad hoc* process that has ensued since *Penn Central*, a misplaced notion—value remaining—has insinuated itself onto the balance scales where value taken should appear. *Penn Central* headed the courts in the wrong economic direction.

Is Exxon less entitled to experience a legitimately compensable taking than the hardware store around the corner because of the differences in balance sheet conditions? Reduction in the value of the assets is the essential element that brings forth takings litigation, and it is the essential element for one side of the balance scale in the takings determination. Economic efficiency dictates that private values lost must be compared to societal values gained to assure that our economic lives are improved by the agency's regulatory prohibition that brought on the law suit. Continuing to focus on economic value remaining instead of amount of economic injury assures that takings litigation will not be decided on the basis of reasonable investment-backed expectations and the balancing of facts and circumstances to achieve economic efficiency.

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2. The interested reader can consult Eric L. Garner, "Bennett v. Spear: The Supreme Court Levels the Playing Field," California Water Law & Policy Reporter, May, 1997, for background.

3. Economic efficiency implies nothing more complicated than that resources be used and traded until all parties and society are made better off by the outcome. In a takings case, this implies that the decision must balance the loss in property value with the public's gain from the regulation to discover whether society would be better off with the foreclosed use of the property or with the intended regulatory purpose.