Incomplete Compensation for Takings

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INCOMPLETE COMPENSATION FOR TAKINGS

THOMAS W. MERRILL

If a tribunal determines that a state actor has expropriated foreign investment property, or, under Chapter 11 of the North American Free Trade Agreement (NAFTA), that a state actor has adopted a regulation that is "tantamount to" an expropriation of foreign investment property, then that tribunal must determine the amount of compensation owed. International law has developed methods to determine the size of a compensation award when a state formally expropriates property. But the notion, reflected in Chapter 11 of NAFTA, that states may be required to pay compensation to foreign investors for what are, in effect, regulatory takings, is barely in its infancy. Consequently, the standards for determining the measure of compensation for international regulatory takings are also extremely underdeveloped. Valuation techniques that have been developed in the context of formal expropriation may not translate readily to regulations that leave possession undisturbed, but reduce the value or profitability of property.

The most obvious source to look to for guidance in determining the measure of compensation under international law is domestic takings law. The largest and best-developed body of such law is undoubtedly American constitutional law. The Fifth Amendment of the United States Constitution, which has been in

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2 See Metalcloset Corp. v. United Mexican States, Award (ICSID (Additional Facility) Case No. ARB(AF)/97/1, Aug. 30, 2000), 16 ICSID REV. – FOREIGN INV. L.J. 168 (2001), available at http://www.dfait-maeci.gc.ca/tna-nac/metalcladCorp-en.asp. I will not here enter into the debate about whether NAFTA's "tantamount to" expropriation language is properly interpreted as prohibiting regulatory takings, but will proceed on the assumption that this reading is correct.
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effect for over 200 years, requires the payment of “just compensation” for takings of property.\(^3\) For the last eighty of those years, it has been established that regulations may, in certain circumstances, impair property values so severely as to constitute a taking.\(^4\) When one examines American compensation law, however, one finds that here too there is little guidance about how to measure just compensation in regulatory takings cases. At most, American law suggests some plausible models that can be adapted to the regulatory takings context.

There is, however, a more general lesson to be drawn from American law that may shed light on this topic. The most striking feature of American compensation law—even in the context of formal condemnations or expropriations—is that just compensation means incomplete compensation. Compensation is strictly limited to what in contract law would be called “general damages”—the fair market value of the property taken. Other consequential damages incurred by the property owner are ignored. Similarly, any increment in value that reflects a gain to the taker, which might be recoverable between private parties in an action for restitution or unjust enrichment, is ignored. This strict limitation to general damages results in an award that is lower than what one would obtain under either an indemnification standard that includes consequential damages or a restitution standard.

Part IV of this Article considers several possible justifications for this rule of incomplete compensation for takings, namely, loss spreading, maintaining efficient incentives for property owners, and providing subsidies for public goods. It also considers briefly whether these justifications carry over into the international regulatory takings context. Before doing so, however, this Article will briefly review what international law and NAFTA tell us about the measure of just compensation, and the basic tenets of American constitutional law on the subject. These are the subjects of Parts I and II respectively. Following this discussion, Part III considers models that tribunals might adopt or borrow from American law in order to set compensation awards in regulatory takings cases.

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\(^3\) U.S. CONST. amend. V (“nor shall private property be taken for public use, without just compensation.”).

\(^4\) The foundational decision is Pennsylvania Coal Co. v. Mahon, 260 U.S. 393 (1922).
I

THE MEASURE OF COMPENSATION UNDER INTERNATIONAL CUSTOMARY LAW AND NAFTA

When a nation-state expropriates property that is owned by a national of another state, general principles of customary international law require that the expropriating state pay the owner "just compensation." As to what compensation is just, the authorities are somewhat equivocal. The American view, going back to diplomatic notes exchanged between Secretary of State Cordell Hull and the Mexican Ambassador to the United States regarding expropriation of American-owned land and oil rights during the Mexican Revolution of 1910-1920, has been that just compensation means "prompt, adequate and effective payment." "Prompt" means that the payment must occur at the time of the taking, or must include interest from the time of the taking to the time of payment. "Adequate" means that the compensation must equal the "fair market value" of the property taken. And "effective" means that the payment must be in an established international currency or in a currency freely exchangeable into such a currency and eligible for repatriation.

However, actual international practice, as reflected in arbitration decisions in the post-World War II era, is considerably more mixed. Often payment occurs some time after the expropriation takes place, falls short of fair market value, or is made in a currency subject to exchange controls or other limitations on repatriation. As a consequence, the customary international law norm is a good deal more qualified than the "prompt, adequate, and effective" standard historically endorsed by the United States.

Whatever uncertainties inhere in customary international law,

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8 See generally id. (noting that, in practice, owners of expropriated property have been forced to accept delayed, partial, and in-kind compensation).
the expropriation provisions in Chapter 11 of NAFTA fully embrace the American view of what constitutes just compensation. NAFTA requires the signatory states to pay “compensation” for any measure that expropriates or is tantamount to expropriation of an investment of an investor of another signatory state. The term “compensation” is in turn given a specific definition:

[compensation shall be equivalent to the fair market value of the expropriated investment immediately before the expropriation took place (“date of expropriation”), and shall not reflect any change in value occurring because the intended expropriation had become known earlier. Valuation criteria shall include going concern value, asset value including declared tax value of tangible property, and other criteria, as appropriate, to determine fair market value.]

Although this definition does not mention the word “adequate,” that term has long been understood to mean fair market value, which NAFTA unequivocally requires. Additional provisions of Chapter 11 stipulate that the compensation be paid “without delay” and with “interest . . . at a commercially reasonable rate from the date of expropriation;” that the compensation be paid in G7 currency or, if in another currency, in an amount reflecting the value in G7 currency at exchange rates prevailing on the date of payment; and that the payment of compensation be “freely transferable.” Thus, NAFTA embodies each of the lodestars of the traditional American view of international law: the compensation must be prompt, adequate (that is, equivalent to fair market value), and effective.

Customary international law also provides, at best, incomplete guidance as to how “fair market value” is to be determined. Where a state takes possession of an enterprise, as through nationalization, two techniques for ascertaining fair market value

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9 See Levy, supra note 6, at 441-43.
10 NAFTA, supra note 1, art. 1110(1), 32 I.L.M. at 641.
11 Id. art. 1110(2), at 641-42.
13 NAFTA, supra note 1, art. 1110(3), 32 I.L.M. at 642.
14 Id. art. 1110(4), 32 I.L.M. at 642.
15 Id. art. 1110(5), 32 I.L.M. at 642.
16 Id. art. 1110(6), 32 I.L.M. at 642.
are "net book value" and "going concern value." The former is a backward-looking approach that is based on the historical prices of assets (preferably adjusted for inflation), less liabilities and depreciation. The latter is a forward-looking approach that relies upon an estimate of what future earnings would have been absent the expropriation, discounted to present value (preferably using a discount rate adjusted to reflect the risk of the enterprise). Other measures of value have been advocated and applied as well. The most thorough multi-volume examination of the issue concludes ruefully that international law affords no precise rule or specific formula that can be applied across the board.

NAFTA goes part of the way toward providing greater clarification as to how a tribunal is to go about determining fair market value. The NAFTA Chapter 11 definition of compensation provides that "[v]aluation criteria shall include going concern value, asset value including declared tax value of tangible property, and other criteria, as appropriate, to determine fair market value." Merely by endorsing the use of going concern value, NAFTA provides a significant measure of guidance. Going concern value, generally understood to refer to a discounted cash flow analysis, is typically larger than net book value and would presumably be the method favored by owners of investment property, as opposed to net book value, which would more often be preferred by expropriating governments.

NAFTA also resolves a longstanding uncertainty by providing that "declared tax

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19 See id. at 461-62.


22 NAFTA, supra note 1, art. 1110(2), 32 I.L.M. at 641-42.

23 Stauffer, supra note 18, at 462.
value" can be utilized in fixing asset values. This provides a kind of floor on compensation, by estopping the expropriating government from arguing for any value lower than the one used prior to expropriation for setting taxes on the property. Finally, NAFTA rules out any reduction in compensation caused by a depression in fair market value caused by rumors of impending expropriation; in America, this is known as an "erosion taking." To be sure, these clarifications are partially nullified by the final language of the definition allowing the tribunal to use "other criteria, as appropriate," without saying what is or is not "appropriate" in the way of such "criteria."

When we turn from cases involving expropriation in the classic sense (where the government takes possession of property) to regulatory takings, we find no guidance at all in international law as to how to measure just compensation. This no doubt reflects the fact that regulatory takings have not received the same unequivocal condemnation in international law that formal expropriations have. NAFTA likewise provides no help here. Its specification of "valuation criteria," which refers to measures like going concern value and declared tax value, is clearly tailored to formal expropriation, where the government acquires full possession of the property. These measures are less relevant to regulatory takings, where the government does not acquire possession of the property, but merely impairs its value.

II
FAIR MARKET VALUE IN AMERICAN CONSTITUTIONAL LAW

NAFTA's basic directive about the measure of compensation, applicable both to formal expropriations and regulatory takings, is that "[c]ompensation shall be equivalent to the fair market value of the expropriated investment immediately before the expropriation took place." This is a restatement of the most basic axiom of American constitutional law of compensation. Thus, one

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24 Compare NAFTA, supra note 1, art. 1110(2), 32 I.L.M. at 641-42, with Roger P. Smith, Real Property Valuation for Foreign-Wealth Deprivations, in VALUATION VOL. 1, supra note 17, at 152-54 (discussing the controversy surrounding the use of tax assessments to value real property).
25 NAFTA, supra note 1, art. 1110(2), 32 I.L.M. at 641.
obvious step to take in seeking further to particularize the NAFTA standard is to look to established legal principles and valuation practices under American law.\textsuperscript{27}

American constitutional law has long held that an owner of property taken by the government is entitled to the "fair market value" of the property determined as of the time it is taken.\textsuperscript{28} Fair market value, in turn, has been defined to mean the amount that a willing buyer would pay a willing seller of the property, taking into account all possible uses to which the property might be put other than the use contemplated by the taker.\textsuperscript{29}

All of this sounds straightforward, but as astute observers have long recognized, the concept of fair market value is essentially a fiction in the context of takings of property. Fair market value would perhaps be more easily ascertainable if takings took place in thick markets in which there were many buyers and sellers. If the government, for example, were to take a tanker of oil, one could look to the price of oil prevailing in the relevant market on the date of the taking in order to fix its fair market value. In practice, however, government condemnations occur almost exclusively in thin markets, where there is only one seller who has a monopoly over some resource needed for a public project. Takings are forced exchanges of unique property rights, typically rights in land, that occur in circumstances where voluntary exchange has failed and there are no good substitutes for the land in question insofar as the condemning authority is concerned.\textsuperscript{30} In this context, there is no market and hence no "fair market value."

How do courts determine the fair market value of an asset for which there is no market price? The answer is that the value is fixed based on an opinion or educated guess about what the

\textsuperscript{27}This strategy has been exploited by others in seeking to fill out the content of international law. See Smith, supra note 24, at 142-65 (developing a synthesis of American, Canadian, and British domestic law practices to give content to the intentional law standard of just compensation for nationalizations of property).

\textsuperscript{28}See DANA & MERRILL, supra note 26, at 169.

\textsuperscript{29}See United States v. Miller, 317 U.S. 369, 374-75 (1943); 4 JULIUS L. SACKMAN, NICHOLS ON EMINENT DOMAIN § 12.02[1], at 12-60 to 12-67 (rev. 3d ed. 2002).

negotiated price of the property would have been if, contrary to fact, the owner had sought to sell it and a willing buyer had sought to buy it on the day of the taking. This opinion or educated guess about price is developed by using various valuation techniques similar to those used in appraising property in other non-market contexts, such as establishing tax values, determining a distribution of assets to stakeholders upon partition or dissolution of a business entity, or listing property for sale. The four most common techniques recognized in American compensation law are: (1) examination of recent sales prices for the property in question; (2) examination of recent sales prices for other properties in the area deemed to be comparable to the property in question; (3) capitalization of the actual or potential rental value of the property in question; and (4) calculation of the cost of rebuilding the property minus depreciation to reflect its age and wear and tear. Different jurisdictions have different rules about which techniques are most preferred, and often the determination of which approach to use is left to the discretion of the tribunal, depending on the circumstances of the case.

What actually happens in a case in which there is a dispute about the measure of compensation? Basically, the condemning authority introduces evidence, often through the testimony of expert witnesses, which follows one or more of the foregoing valuation techniques, and tends to show that the property has a relatively low value. The owner then introduces evidence, often using rival expert witnesses, which follows one or more of these techniques and tends to show that the property has a relatively high value. The tribunal, which may include a jury depending on the jurisdiction, will then have to determine which evidence is most persuasive. Sometimes, it will accept the valuation submitted by one party or the other; often, it will reach a compromise between the positions of the two parties. The number picked by the tribunal is deemed to be the "fair market value" of the property and becomes the measure of just compensation which the taker must pay to the owner, along with interest from the date of the taking.

Fair market value is not the only standard that could be adopted to implement the just compensation requirement. One

31 4 Sackman, supra note 29, § 12.02[1], at 12-72; see also 1 Lewis Orgel, Valuation Under the Law of Eminent Domain §§ 136-138 (James C. Bonbright, ed., 2d ed. 1953); 2 id., §§ 188-189.
32 See Smith, supra note 24, at 141 (noting two alternative standards, "value
alternative would be to set compensation equal to the benefit received by the taker from acquiring the property. This restitution or unjust enrichment standard would generally result in higher awards of compensation than the fair market value standard. This is because condemnations of land typically increase the value of the property taken on a dollar-per-square-foot basis. The taking is often part of a project to assemble many contiguous parcels of land, which have a higher unit value after assembly than they previously did. Alternatively, the property may have some other strategic value that makes it especially valuable to the taker. Even in regulatory takings cases, the value of the property to society at large should be higher in its regulated state than it will be in its unregulated state—at least this will be true if the regulatory system is functioning properly. Under established rules for determining just compensation, however, compensation is based on the highest and best use of the property other than the use contemplated by the taker. Thus, the increment in value created by the taking goes to the taker (or society at large) rather than the owner.

Another alternative to fair market value would be to set compensation based on the loss to the owner. Such an indemnification standard would also generally result in higher awards of compensation relative to fair market value. The most striking deviation between the fair market value standard and an indemnification standard involves consequential damages. The American fair market value test ignores all consequential damages associated with condemnation, such as lost future profits, lost business goodwill associated with the location of the property, moving expenses, and attorneys fees. A standard of indemnification presumably would require compensating owners to the taker" and "value to the owner").

33 Id.

34 See Merrill, supra note 30, at 98 tbl. 1 (presenting a table summarizing the reasons why condemning authorities use eminent domain, with land assembly being the most common).

35 See United States v. Causby, 328 U.S. 256, 261 (1946).

36 Language in some decisions suggests an indemnification standard. See, e.g., United States v. Reynolds, 397 U.S. 14, 16 (1970) ("The owner is to be put in the same position monetarily as he would have occupied if his property had not been taken."). But there is no indication that the Court, in making these statements, was qualifying or repudiating the fair market value standard.

37 See, e.g., United States v. Petty Motor Co., 327 U.S. 372, 377-78 (1946). As noted below, some types of consequential damages are compensated in partial takings cases.
Perhaps even more importantly, the fair market value standard ignores all subjective value that the owner attaches to her property above and beyond the market's valuation. There are numerous reasons why owners may subjectively value their property more than the market does, ranging from psychological attachment to the property, to features of the property that have been customized to the owner's tastes, to nontransferable benefits associated with the location, to a desire to avoid the hassles of moving. We know subjective value is usually positive if for no other reason than that an owner who values the property at less than its fair market value will generally sell it. Conversely, if an owner has not sold the property, it is likely that the owner has a subjective value higher than market value.

An indemnification standard would result in a lower award than fair market value only in those relatively rare cases where an owner obtains some offsetting benefit from the taking. This may include enhanced value to an unrelated parcel of property, which might be taken into account in determining what compensation is required in order to make the owner whole. This is the one area where the market value standard works to the advantage of the owner—offsetting benefits to the owner are also disregarded under the fair market value test.

Why American constitutional law has adopted what is in effect an incomplete measure of compensation—at least relative to other possible measures of compensation—is left largely unexplained by the leading decisions and treatises on the topic. This issue is revisited in Part IV.

In summary, "fair market value," as understood in American constitutional law, is an impersonal standard of compensation, but not an objective one. It is impersonal in the sense that it abstracts away from elements of value that are personal to a given owner of property—whether it be the private owner before the taking occurs or the public owner afterwards. But this does not mean that fair market value is an objective standard, in the sense that one can look up the value in some register of prices. Fair market value usually must be constructed inferentially from other evidence, and

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38 See, e.g., United States v. Miller, 317 U.S. 369, 376-77 (1943). As noted below, offsetting benefits are taken into account in many jurisdictions in partial taking cases. See, e.g., id. at 376.
hence necessarily entails an element of discretionary choice. This exercise of discretion is constrained primarily by conventions regarding permissible valuation techniques. These conventions, in turn, are not universal, but vary significantly by time and place. International law, no doubt, should consider the conventions recognized by domestic law in determining how to measure fair market value. But there is no single right answer as to which conventions are preferred in which circumstances. International law conventions of valuation will have to be developed over time, in light of accumulated experience.

III
AMERICAN MODELS FOR DETERMINING COMPENSATION FOR REGULATORY TAKINGS

Nearly all the applicable precedent in American law on the determination of just compensation has been developed in the context of exercises of traditional eminent domain authority, analogous to formal expropriations in international law. American compensation law provides very little guidance about how to determine compensation in regulatory takings cases. The reason for this paucity of authority is that, to date, relatively few regulatory takings cases have been litigated to a final judgment awarding compensation. Regulatory takings claims are subject to a variety of exhaustion requirements, which often have the effect of wearing down the claimant, or, if the claimant persists, inducing a settlement. In those cases where courts reach the merits, the substantive law tends to favor the government, meaning that only a fraction of claims result in any finding of liability. Even if a court finds that a regulation constitutes a regulatory taking, the

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39 For a starting point in considering how this might be done, see Smith, supra note 24, at 142-64.
40 For a recent exception to this generalization, see 520 East 81st Street Associates v. New York, 2002 N.Y. LEXIS 3459 (Nov. 14, 2002) (resolving issues about the measurement of just compensation in the context of a regulatory taking).
42 For an overview of the various doctrines of regulatory takings law, see DANA & MERRILL, supra note 26, at 86-168.
government can respond in a variety of ways, including dropping
or modifying the regulation, which may eliminate the need to
determine just compensation.\footnote{See First English Evangelical Lutheran Church v. County of Los Angeles, 482 U.S. 304, 321 (1987). First English also establishes that the government may have to pay compensation for a “temporary taking” during the time the regulation remains in effect. \textit{Id.} at 322. But the Supreme Court has recently ruled that whether or not regulations subsequently rescinded constitute a temporary taking is governed by the \textit{ad hoc} balancing approach associated with \textit{Penn Central Transportation Co. v. New York City}, 438 U.S. 104 (1978); such regulations will not be presumed to be \textit{per se} takings even if they prohibit all developmental uses of the land. \textit{See} Tahoe-Sierra Pres. Council, Inc. v. Tahoe Reg’l Planning Agency, 535 U.S. 302 (2002).}{43} Consequently, if one looks to American constitutional law for guidance as to how to determine just compensation in an international regulatory takings case, it will be necessary to extrapolate from other features of American law originally designed for other purposes.

\textbf{A. The Partial Takings Model}

One model that could be used to determine the measure of just compensation in regulatory takings cases would be based on the rules that apply in cases of partial takings. Many (perhaps most) condemnations are partial takings; that is, the taker acquires only a fraction of the owner’s property and leaves the balance in the owner’s hands. This will often occur, for example, when the taking is for a highway or a utility right-of-way. Regulatory takings are nearly always partial takings, in the sense that the regulation does not reduce the fair market value of the property to zero, but leaves some positive increment in value, although less than the value of the property without the regulation. Hence, we could attempt to derive the measure of compensation in regulatory takings cases by treating regulatory takings like partial takings.

The American rules for computing fair market value in partial takings cases differ somewhat from those applied in total takings cases. In a partial taking, the owner is awarded not only the fair market value of the part that is taken, but also damages for loss in value to the part that is not taken.\footnote{See Bauman v. Ross, 167 U.S. 548, 574 (1897); 4A SACKMAN, \textit{supra} note 29, § 14A.01[2], at 14A-4.} These are sometimes referred to as “residuum damages.” In addition, states are permitted (but not required) to reduce the award of compensation in partial takings by taking into account offsetting benefits to the part of the
property that is not taken. These can be called residuum benefits.

The combined effect of these rules is that the compensation standard for partial takings shifts part way toward an indemnification standard. The law does not shift all the way to full indemnification, because consequential damages, such as lost profits and goodwill and attorneys fees, continue to be uncompensated in the partial takings situation. What the law does in the partial takings situation, in effect, is to compute the fair market value of what the owner has before the taking, then compute the fair market value of what the owner has after the taking, and award the owner the difference. The partial takings rules can thus be seen as a variant on the fair market value approach, with the twist that one does not seek the fair market value of what is acquired by the government (the usual rule), but rather the fair market value of what is taken from the owner. This twist, in effect, shifts the compensation standard part way toward an indemnification standard.

The rationale for shifting part way toward an indemnification standard in partial takings cases has never been clearly spelled out. One possible explanation is that the indemnification standard is inherently preferable, but courts are constrained from adopting it in the total takings context by high administrative costs. If one were to engage in an analysis of residuum damages and residuum benefits in the total takings context, it is not clear what property one would use as a baseline in undertaking this analysis. Without any clear line to demarcate the inquiry, it could mushroom into an open-ended set of arguments and counter-arguments that would magnify administrative costs several times over. In partial takings cases, by contrast, the inquiry into residuum damages and residuum benefits is carefully confined to damages and benefits to the part of the owner’s property that remains after the taking.

Another possible explanation is that partial takings are especially prone to unfair outcomes under the fair market value approach. 45 See 3 SACKMAN, supra note 29, § 8A.03[2], at 8A-58 to 8A-60. 46 See, e.g., United States v. 8.41 Acres of Land, 680 F.2d 388, 392-94 (5th Cir. 1982). Some courts do not proceed this way, but rather ask the trier of fact to find the fair market value of the interest acquired by the government, and then make adjustments for damages to the part that remains and offsetting benefits to the part that remains. But the before-and-after comparison is the “simplest and perhaps the most widely used approach in severance damage determinations.” Georgia-Pacific Corp. v. United States, 640 F.2d 328, 336 (Ct. Cl. 1980).
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standard. Consider, for example, a partial taking that leaves the owner landlocked. This could effectively reduce the value of the residual property to zero, but there would be no compensation for this loss under a standard that awards only the fair market value of what the government has acquired. Alternatively, consider a partial taking that puts a public street through to land that was previously landlocked. Here, the taking transforms land that was previously worth very little into a valuable asset, yet under the fair market value standard, the government would be required to pay some compensation to the owner, even though he has already received a substantial windfall. Shifting to a rule that awards the fair market value of what is taken eliminates both of these extreme outcomes.

A final possible explanation is that partial takings, unlike total takings, interfere with the scale of the owner’s unit of property, thereby generating an additional type of cost that the government needs to take into account in structuring its takings. Suppose, for example, that A owns a city lot and the government wants to take eighty percent of the lot for a new street. Under ordinary rules, the government would pay the fair market value of what it acquires—eighty percent of the lot. It is not unlikely, however, that the twenty percent that remains after the taking will be too small to build on, and hence has been rendered largely worthless. Limiting the government to paying for the eighty percent of the lot that it acquires would thus create an external cost to the owner that the government would have no incentive to take into account. The result might be that takers would have an incentive to act strategically to structure their takings as partial takings in order to leave owners with uncompensated losses. Whatever the explanation, partial takings present an important, albeit limited, exception to the general rule that the government pays the fair market value of the interest it acquires. In this context, the government pays the fair market value of what the owner loses.

The partial takings rules could be adopted for determining just compensation in regulatory takings cases. In effect, the tribunal would take a snapshot of fair market value of the property before the regulatory taking, and a snapshot of fair market value after the regulatory taking, and would award the difference to the owner.\footnote{\[47\] This is essentially the approach recently endorsed by the New York Court of Appeals. See 520 East 81st Street Associates v. New York, 2002 N.Y. LEXIS 702}
The difference in fair market value before and after would, in effect, represent the capitalized (negative) value of the regulatory restriction which has, by hypothesis, been determined by the tribunal to be a regulatory taking.

B. The Public Utility Model

A second possible model from American law that could be adopted for determining just compensation in regulatory takings cases is the approach followed in public utility cases. It has long been established that regulatory ceilings on rates and charges of public utilities are subject to review under the Takings Clause. The public utility cases also present a situation similar to that present in regulatory takings, in the sense that the government has not taken title to property nor has it deprived the owner of possession. Rather, the government has imposed a system of regulation on the property that restricts the freedom of the owner to determine its use or to set prices for its use, thereby impairing the value of the property.

In the public utility cases, a variation on the fair market value standard is used—the fair return on investment standard. Conceptually, the fair return standard operates in a manner similar to the fair market value standard—the objective is to determine just compensation based on benchmarks that reflect the behavior of other actors in the relevant market. In public utility cases, one key understanding is that the regulated firm is entitled to recover only its reasonable costs of providing the service in question. Inflated costs and padded expenses are disallowed. It is assumed that, if the firm were operating in a competitive environment, it would be able to recover from consumers only reasonable costs; any attempt to charge for excessive costs would result in loss of business to competitors. Another key understanding is that the regulated firm is entitled to earn a rate of return on investment comparable to the return that investors expect to receive before

3459 (Nov. 14, 2002) (adopting the before and after market value test and awarding interest on the difference from the date of the regulatory taking).


49 See Smyth v. Ames, 169 U.S. 466, 547 (1898) ("[W]hat the public is entitled to demand is that no more be exacted from it for the use of a public highway than the services rendered by it are reasonably worth.").
committing funds to investments having commensurate risks. In a competitive market, the firm would be able to attract investment capital only if it were able to provide a return at least as high as investors require before committing funds to other investments of similar risk.

The task of the regulatory agency, or the court under the public utility model, therefore, is twofold. First, it must scrutinize all costs incurred by the regulated firm in order to determine whether they satisfy the standard of reasonableness. Second, it must estimate the return on investment that would be generated under a proposed rate order and compare this to the market rate of return for investments of comparable risk. If the proposed order fails to provide for recovery of all reasonable costs or if it provides a return on investments that falls below the market rate of return, then the just compensation standard requires that the regulatory agency provide a rate increase or otherwise eliminate the gap in order to avoid an unconstitutional outcome.

In practice, courts give regulatory agencies broad discretion in determining what constitutes a fair return on public utility investment. For example, the Supreme Court has said that regulators are free to value investment property using either a book value method or a replacement cost method. The Court has also permitted regulators to impose rates on certain services below cost, so long as the total effect of the regulatory regime permits a fair return on investment. The constitutional standard, however, lurks in the background and has played an important role in structuring the inquiry that occurs in public utility rate cases.

The approach followed in the public utility cases could also be applied to regulatory takings issues, such as those presented by strict environmental or land use controls. The general task would

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50 See Duquesne, 488 U.S. at 314 ("One of the elements always relevant to setting the rate under . . . is the return investors expect given the risk of the enterprise.").


52 See Verizon, 535 U.S. 467 (holding that the use of the term "cost" in ratesetting legislation implies broad methodological leeway).

be to develop a model of what an otherwise identical firm that incurred only reasonable costs would expect to earn as a return on investment in a competitive environment. The tribunal would then calculate the expected return on investment of the firm subject to the regulatory taking, after making adjustments to eliminate any unreasonable costs the firm may be incurring. If the impact of the control measure would drive the return on investment below the benchmark fair rate of return, the government, as in the public utility cases, would be required to provide compensation sufficient to close the gap between the anticipated rate of return and the benchmark rate of return. The amount of compensation, as under the partial takings methodology, should, in theory, represent the capitalized (negative) value of the regulatory restriction which has, by hypothesis, been determined by the tribunal to be a regulatory taking.

C. Integrating the Approaches into International Law

Each of the two proposed approaches to determining compensation for regulatory takings has a natural affinity with one of the two principal methods of determining just compensation under existing customary international law—the net book value method and the going concern value method. The partial takings model is a variant on the net book value approach with the difference being that, under the partial takings model, one determines net book value twice—before and after the regulation takes effect. Just compensation is equal to the difference between the two values. The public utility model is analogous to the going concern value or discounted cash flow approach, with the twist that now, under the public utility model, one calculates the going concern value twice—once for a hypothetical investment of equivalent risk and again for the actual investment as subject to the regulatory restriction. Just compensation is equal to the difference between the two values. The parallelism between the two suggested models and the two established tests for measuring compensation in expropriation cases suggests that either of these models could be integrated into international law without too much difficulty.

This does not mean, however, that the two models would yield identical results.54 In particular, each model adopts a

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54 Cf. Stauffer, supra note 18, at 470-71, 485-88 (arguing for a “congruence
different baseline for determining the amount of compensation due because of a regulatory taking. The partial taking model adopts as a baseline the financial status quo ante of the firm prior to the imposition of the offending regulation. Compensation is designed to make this entity whole, in the sense of restoring it to the financial condition that it enjoyed before the regulation took effect. The public utility model, in contrast, adopts as a baseline the financial condition of a hypothetical firm operating in a competitive environment, but otherwise subject to comparable risk, prior to the imposition of the offending regulation. Compensation here is not designed to restore the firm to the status quo ante, but rather to restore it to the situation that would exist in a competitive market in which the firm recovers only its reasonable costs and earns only a reasonable (that is, risk-adjusted) rate of return on investment.

This contrast suggests that the two models should be deployed in different circumstances. The partial takings model makes most sense in circumstances where the firm that has suffered the regulatory taking is operating in a competitive environment when the taking occurred, making it likely that its cost structure has been constrained by the forces of competition. This might be the case, for example, where the firm competes in a national or international market, but the regulatory taking has been imposed by a local unit of government that has jurisdiction over only this firm and not others. The public utility model makes more sense in circumstances in which the firm operates in a monopoly or oligopolistic market and there is reason to question whether its cost structure has been constrained by effective competition. In these circumstances, awarding compensation equal to the difference between fair market value before and after the taking has the effect of locking in any wasteful or padded costs that were present before the taking and implicitly treats them as an entitlement. It is also plausible to assume the partial takings approach, with its simple before-and-after snapshot approach, would generally entail lower administrative costs than the public utility approach, which requires a review of the reasonableness of costs and the

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principle under which the two methods are close proxies for each other when net book value is adjusted for inflation and accounting conventions).

construction of the return on investment that would be earned by a hypothetical firm subject to comparable risks in a competitive environment. This consideration suggests that the partial takings model is preferable in those circumstances where it is otherwise acceptable to use it.

IV
RATIONALES FOR INCOMPLETE COMPENSATION

American just compensation law raises a more fundamental question about the quantum of compensation when the government expropriates property or engages in a regulatory taking. Why does the law opt for an impersonal measure of compensation—the fair market value standard—that generates a relatively stingy award relative to other possible standards, such as a restitution standard or an indemnification standard? In other words, why does American law insist on incomplete compensation for government takings of property? This part considers three possible justifications for a rule of incomplete compensation for takings: loss spreading, maintaining efficient incentives, and the desirability of subsidizing public goods.56 It then considers what implications these explanations may have for establishing compensation awards for international regulatory takings.

A. Loss Spreading

The first rationale, loss spreading, appears at first to be highly paradoxical. How is it that incomplete compensation in an individual case leads to a superior spreading of losses when one views the matter from a more systemic perspective? One must develop the argument in stages.

The first thought that springs to mind in looking for a justification for the fair market value standard is that its impersonality means that it can be applied at a lower cost than either of the two rival standards (indemnification or restitution). The fair market standard, as noted in Part II, is not really an "objective" standard. There is no "market price" that can be observed, and hence the value must be developed using various imperfect valuation techniques. Yet even with all of its

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56 This analysis tracks DANA & MERRILL, supra note 26, at 169-90.
weaknesses, the market value standard is less fraught with valuation difficulties than either value to the taker (the restitution standard) or value to the owner (the indemnification standard) would be.

Determining the value to the taker would be difficult, because the takings power is often used for public projects, such as highways, parks, or a clean environment, that have no commercial measures of value. For example, there are usually no sales of comparable properties devoted to such uses, nor are there likely to be any rental values that can be capitalized. In regulatory takings cases, the valuation problem would be even greater. Government regulations challenged as takings are usually designed to provide large-scale public goods, such as a clean environment. The benefits that these programs provide are important and are highly valued by people, but reducing those benefits to a sum of money is a perilous enterprise.\(^5\)

Determining the value to the owner would be difficult because owners often have reasons for their attachment to their property that are difficult to verify. If the owner of a house with a fair market value of $100,000 says that he would not sell for anything less than $200,000, how do we know whether this is an honest statement of the owner's subjective attachment to the house, as opposed to a negotiating ploy designed to obtain a higher award of compensation? The market value standard, with its impersonal approach, thus undoubtedly conserves on valuation costs relative to the indemnification standard as well.

It is tempting to dismiss these savings in valuation costs as simply a preference for general social utility at the expense of doing full justice to individual property owners. But it is also possible to defend incomplete compensation on loss spreading grounds. Perhaps the most influential discussion of just compensation in terms of loss spreading is the now-classic article by Frank Michelman.\(^5\) Michelman introduced the concept of "demoralization costs," which he defined as the costs associated


with any government action that causes property owners to experience uncompensated losses. Such costs, he maintained, include not only the psychological pain incurred by losers and their sympathizers from uncompensated losses, but also the foregone investment caused by fear of such losses on the part of property owners more generally.\footnote{Id. at 1214.}

Michelman recognized that demoralization costs should not be reduced to zero by compensating for all losses. Instead, he argued, the government should compensate only when demoralization costs exceed what he called "settlement costs"—the costs of paying compensation and of administering a compensation system. Both demoralization costs and settlement costs are real costs to society—they represent foregone resources that could be used for other purposes. Michelman suggested that the objective should be to minimize the costs associated with government action that impairs property values by incurring either settlement costs or demoralization costs, whichever is lower.\footnote{Id. at 1215.}

As applied to the rules of just compensation, Michelman's standard suggests that legal rules that lower the valuation costs of fixing awards of compensation may be desirable because they allow the legal system to be more generous in identifying the circumstances in which compensation is appropriate. In other words, if fewer resources are spent squabbling over the size of compensation awards, settlement costs are reduced. The lower the settlement costs, the larger the set of cases in which it makes sense, on social utility grounds, to alleviate demoralization costs by paying compensation.

From this perspective, it is not implausible that property owners as a class would agree \textit{ex ante} to give up a more finely-tuned measure of compensation in return for a broader or more certain guarantee of compensation. In other words, before they know whether or not their property will be taken, owners would prefer a broad but incomplete promise of compensation to a promise of full compensation that applies more selectively. This intuition is consistent with what we observe in programs like worker's compensation, which typically provide for caps on damages in return for greater coverage against workplace injury. It is also consistent with what we observe in the practices of the
INCOMPLETE COMPENSATION FOR TAKINGS

insurance industry in areas such as disability insurance, where policies typically pay benefits that fall short of full indemnity but also do not require absolute proof of disability.

B. Maintaining Efficient Incentives

The theory that compensation is required in order to force the government to internalize the costs of takings of property may also justify incomplete compensation.\(^6\) Takings entail not only demoralization costs, but also opportunity costs, in that once the government takes property, it cannot be put to any alternative private use. By requiring the government to pay compensation for assets taken, the argument goes, government officials are forced to compare the value of the resource in government hands to its value in private hands. In theory, officials will go forward with the taking only if they anticipate that the resource will produce greater value as part of the government project than the compensation the government must pay to obtain it. If the government is not required to pay compensation for takings, government officials may suffer from the "fiscal illusion" that the resources it takes have no opportunity cost. As a result, they may engage in excessive takings of property, resulting in a misallocation of resources.\(^6\)

Standing alone, the fiscal illusion argument suggests the need for a rule of complete compensation, such as full indemnification. Otherwise, the government will have imperfect incentives to compare the opportunity costs of a taking with the value of the property in the hands of the government. But the fiscal illusion theory is vulnerable to the objection that the cost-internalization story operates in two directions.\(^6\) Not only do we want government officials to have efficient incentives to regulate, we also want private parties to have efficient incentives to desist from activity that warrants regulation. If all declines in property values


associated with government regulation result in compensation, then the deterrent effect to engaging in activity subject to government regulation will be eliminated. For example, if the government must compensate the owner of a factory shut down for polluting, this obviously undermines the incentive effects of rules prohibiting pollution. Assuming that much, if not most, regulated activity has a negative net social value, compensating for regulatory losses would create perverse incentives to engage in antisocial behavior.

As this objection reveals, the concern about fiscal illusion is simply a species of a more general concern about limiting behavior that imposes external costs on others. Once we see that this is the case, the fiscal illusion argument becomes vastly more complicated. It is desirable to create incentives for the government to behave efficiently, but it is also desirable to create incentives for private parties to behave efficiently. Adopting a regime of cost-internalization for the government will undermine cost-internalization by private parties; conversely, adopting a regime of cost-internalization for private parties sacrifices cost-internalization by the government. These two objectives tend to conflict: requiring the government fully to internalize all costs of takings would provide no incentives to property owners, but requiring property owners fully to internalize the costs of using their property in ways inconsistent with future government takings (that is, denying all compensation) would provide no incentive to the government.

One possible solution to this dilemma is to require the government to pay incomplete compensation when it takes property and to leave the balance of the costs on the owner. This provides an incentive, albeit an imperfect one, for the government to consider the costs of taking property. It also provides some incentive for property owners to avoid improvident investments that increase the costs of takings and to minimize the consequential damages associated with takings. Incomplete compensation, in this sense, works something like a rule of comparative negligence in tort or like deductibles and co-payment requirements in

64 See Kaplow, supra note 63, at 531.
65 Many consequential damages associated with condemnation, such as moving expenses, are subject to the control of the owner, at least in part. A rule of full indemnification would almost certainly increase these costs.
insurance contracts. These rules, like the market value standard of just compensation, provide incentives for the claimant to take precautions to minimize the costs of events that give rise to monetary liability for someone else.

C. Subsidizing Public Goods

A third reason for providing incomplete compensation is to subsidize takings of property. There is a tendency to think of takings as bad things, like suppressions of free speech or unreasonable searches and seizures. But the United States Constitution does not prohibit takings; it only prohibits takings without just compensation.\footnote{U.S. CONST. amend. V.} The Constitution also assumes that takings will occur in the pursuit of "public uses."\footnote{Id.} Most public uses—such as the construction of highways and other infrastructure investments, the development of parks and recreation areas, and the protection of the environment—provide important benefits to the public. Subsidies are good when they produce public benefits that exceed their costs. This describes many, if not most, of the public uses associated with the takings power—enough that including a measure of subsidy in the computation of just compensation may be warranted.

The point here is really just the inverse of the analysis in the previous subsection about the internalization of external costs. All else being equal, the government should internalize the negative externalities that it imposes on regulated firms, and regulated firms should internalize the negative externalities that they impose on the government (or on society at large). By the same token, however, both the government and regulated firms should be encouraged to create and impose positive externalities on others. The classic way to do this is by subsidizing activity that generates positive externalities or public goods.

Limiting awards of compensation to fair market value, in effect, confers a subsidy on those who exercise the power of eminent domain or who exercise the power to impose regulations designed to protect the public interest. If awards of just compensation were enhanced to reflect a restitution standard or an indemnification standard, the subsidy element would be reduced or would disappear altogether. This would reduce the incentive of

\footnote{U.S. CONST. amend. V.} \footnote{Id.}
the state to use these powers to achieve ends in the public interest.

D. Implications for International Regulatory Takings

Do the rationales for incomplete compensation, developed in the context of domestic takings in the United States, apply to international takings? In a broad sense, it seems that they surely do. This is especially true if the inquiry is confined to international regulatory takings. If one were considering only outright expropriation of property owned by foreign nationals, as occurred, for example, in Cuba after the communist takeover in the late 1950s, then the case for something closer to a rule of full indemnification or restitution would be plausible. This kind of confiscation of property from political outsiders seems little different than theft and presumably deserves strong condemnation and deterrence. If one assumes, however, that the typical international regulatory taking claim is more like an American regulatory takings case, in which a foreign-owned facility complains about regulations adopted, at least ostensibly, to protect the public interest, then the various rationales for incomplete compensation would seem to be fully applicable.68

Consider, first, the loss spreading rationale. Foreign investors considering the risks of regulatory takings would almost certainly prefer a rule of broad coverage with incomplete compensation to a rule of spotty coverage and full compensation. This is the kind of tradeoff they get with foreign overseas investment insurance,69 and the same balance of considerations presumably applies under a legal regime enforced by international arbitration.

Cost-internalization considerations also support incomplete compensation in this context. Regulatory takings may come about because of overzealous governments or even covert attempts to sabotage foreign investments, and these sorts of behaviors should be discouraged. It is surely the case, however, that most

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68 For an analysis of NAFTA’s expropriation provisions in the broader context of environmental protection concerns, see Patricia Isela Hansen, The Interplay Between Trade and the Environment Within the NAFTA Framework, in ENVIRONMENT, HUMAN RIGHTS AND INTERNATIONAL TRADE 313 (Francesco Francioni ed., 2001).

69 For a discussion of the United States program for providing governmentally-sponsored foreign investment insurance, see Cecil Hunt, Valuation Experience of Government Investment Insurance Operations, in VALUATION VOL. 3, supra note 21, at 69.
government regulations are motivated, at least in part, by a desire to protect the public against a variety of environmental and other types of harms. Foreign firms should also be discouraged from engaging in behaviors that harm the public, and incomplete compensation provides a degree of incentive for such firms to avoid engaging in conduct that is likely to trigger a regulatory response.

Finally, the subsidy rationale is applicable here. Governments should take measures to protect public health and welfare. The provision of this type of public good is one of the primary responsibilities of government. Thus, even if international obligations like NAFTA require governments to pay compensation to firms in the event that they are subjected to regulatory takings, it is important not to remove all incentives to regulate in the interest of the public welfare. Just compensation in this context therefore should be interpreted to mean incomplete compensation, that is to say, fair market value but nothing more, in part out of a desire to encourage governments to keep on regulating in the future.