The Rise and Rise of "Investment-Backed Expectations"

Steven J. Eagle*
Professor of Law, George Mason University
School of Law, Fairfax, Virginia.

"INVESTMENT-BACKED EXPECTATIONS" was fashioned in 1967 as an academic concept reacting in part to the morality of land speculation. In 1978 it was transformed into one of three principal factors used in determining whether land-use regulations work a taking of property. In more recent years, a determination that there were investment-backed expectations is becoming necessary for a takings plaintiff to prevail. Beyond the takings inquiry, however, the notion of investment-backed expectations is undergoing a second transformation. It is increasingly being regarded as a prime determinant of what constitutes "property" itself. Like the domain of the administrative state,[1] the sway of investment-backed expectations expands without limit.

Yet at no point has the concept of "investment-backed expectations" been defined or its implications fully explored. Its proponents have not demonstrated why the term "investment-backed expectations" is superior to the term "property rights" that it threatens to displace.[2]

I. Michelman's Vision and Its Implementation in *Penn Central*

The takings-determination phase of investment-backed expectations spans the period from its origination in a seminal 1967 article by Harvard law professor Frank Michelman,[3] through its incorporation into constitutional jurisprudence by Justice Brennan in *Penn Central Trans-*

* An earlier version of this article was presented at the Rocky Mountain Land Use Institute's Ninth Annual Land Use Conference on March 10, 2000.

1. *See* Gary Lawson, *The Rise and Rise of the Administrative State*, 107 HARV. L. REV. 1231 (1994).

2. *See* Richard A. Epstein, Lucas v. South Carolina Coastal Council: *A Tangled Web of Expectations*, 45 STAN. L. REV. 1369, 1370 (1993) ("Neither [Justice Brennan] nor anyone else offers any telling explanation of why this tantalizing notion of expectations is preferable to the words 'private property'. . . .").

3. Frank I. Michelman, *Property, Utility, and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law*, 80 HARV. L. REV. 1165 (1967).

portation Co. v. City of New York,[4] until Justice Scalia's opinion in *Lucas v. South Carolina Coastal Council*.[5]

Investment-backed expectations incorporates Professor Michelman's utilitarian theory of property rights, patterned on that of Jeremy Bentham. Its premise is that "property" consists of an individual's entitlement under a currently accepted and institutionalized system of rules designed to achieve adequate productivity and some redistribution of wealth.[6] "Property" thus is instrumental and has no intrinsic meaning.

Michelman's notion differs substantially from that of the Founders. Supreme Court Justice William Patterson declared in 1795 that

> [I]t is evident . . . that the right of acquiring and possessing property, and having it protected, is one of the natural, inherent, and unalienable rights of man. Men have a natural sense of property: Property is necessary to their subsistence, and correspondent to their natural wants and desires; its security was one of the objects, that induced them to unite in society.[7]

Likewise, James Madison declared that "[g]overnment is instituted to protect property of every sort; . . . . This being the end of government, that alone is a *just* government, which *impartially* secures to every man, whatever is his *own*."[8] In fact, protection of property rights was the "great focus" of the Framers.[9] Furthermore, many settlers were attracted to the colonies precisely because they could own land in fee simple, whereas in England land was held by only by elites, through tenurial grants from the crown as opposed to fee title.[10]

In part, Michelman's concept was responsive to Justice Holmes' opinion in *Pennsylvania Coal Co. v. Mahon*.[11] There, the coal company had sold the surface rights to land upon which a house was built. The company had reserved both mining rights and the right of support of the surface. This permitted it to mine without legal liability for any subsidence of the buyer's lot. After homeowners demanded protection, the Pennsylvania legislature enacted the Kohler Act, which forbade subsidence within 150 feet of a residence. Justice Holmes held that the Act deprived the company of its right of support and effectively took

4. 438 U.S. 104 (1978).
5. 505 U.S. 1003 (1992).
6. *See* Michelman, *supra* note 3, at 1211–12.
7. Vanhorne's Lessee v. Dorrance, 2 U.S. (2 Dall.) 304, 310 (C.C.D. Pa. 1795) (quoted in WALTER BERNS, TAKING THE CONSTITUTION SERIOUSLY 225–26 (1987)).
8. *Id.* at 266–68 (emphasis in original).
9. JENNIFER NEDELSKY, PRIVATE PROPERTY AND THE LIMITS OF AMERICAN CONSTITUTIONALISM 92 (1990) ("The great focus of the Framers was the security of basic rights, property in particular, not the implementation of political liberty.").
10. *See* JAMES W. ELY, JR., THE GUARDIAN OF EVERY OTHER RIGHT: A CONSTITUTIONAL HISTORY OF PROPERTY RIGHTS 13 (1992).
11. 260 U.S. 393 (1922).

the pillars of coal that it required be left in place to avoid subsidence. He famously declared: "The general rule at least is that while property may be regulated to a certain extent, if regulation goes too far it will be recognized as a taking."[12] Naturally, judges and scholars have asked ever since: "How far is too far?"

Michelman rejected the "fraction of value destroyed" approach of *Pennsylvania Coal*, advocating instead that courts not ask "how much," but rather "whether or not the measure in question can easily be seen to have practically deprived the claimant of some distinctly perceived, sharply crystallized, investment-backed expectation."[13] In accord with his utilitarian approach, Michelman posited that compensation is owed only if it minimizes the cost of a beneficial governmental action to the society as a whole.[14]

Justice Brennan utilized the Michelman approach in *Penn Central*.[15] There, the company's plan to construct an office tower on top of Grand Central Terminal was stymied by city's historic preservation law. In the course of his opinion upholding the ordinance, Justice Brennan held that the regulation would be judged considering the parcel as a whole.[16] He professed that the Court was unable to devise a "set formula" for regulatory takings cases and that judges must decide each case based on "essentially ad hoc, factual inquiries."[17] Finally, Brennan stated that three factors were of "particular significance." These are the "the character of the governmental action," the "economic impact of the regulation on the claimant and, particularly, the extent to which the regulation has interfered with distinct investment-backed expectations."[18]

Brennan declared that Penn Central could not establish a compensable loss since it had conceded that it could obtain a fair rate of return from its continuing terminal operations.[19] That "appellants may estab-

12. *Id.* at 415.

13. *See* Michelman, *supra* note 3, at 1233.

14. *Id.* at 1412. Michelman's scheme for determining whether government should act and whether compensation then should be paid utilizes three concepts: efficiency gains (the excess of benefits produced by the governmental action over the costs it imposes), demoralization costs (the dollar value of the adverse effects upon losers and their sympathizers who observe the failure to compensate), and settlement costs (the dollar value of the time, effort, and resources necessary to reach a settlement that will prevent demoralization costs). For a lucid explanation of how the parts fit together, *see* WILLIAM A. FISCHEL, REGULATORY TAKINGS: LAW, ECONOMICS, AND POLITICS 141–58 (1995).

15. Penn Central Transp. Co. v. City of New York, 438 U.S. 104 (1978).

16. *Id.* at 130–131.

17. *Id.* at 124.

18. *Id.*

19. *Id.* at 129 n.26. The concession was ill advised. Penn Central was in bankruptcy and failed to emphasize the importance of its lost rental income from the office building. "No competent showing of Penn Central's 'reasonable return' with and without the

lish a 'taking' simply by showing that they have been denied the ability to exploit a property interest that they heretofore had believed was available for development" was a concept he found "quite simply untenable."[20]

This assertion seems to contradict the fact that the right to develop land is one of the "standard incidents" of ownership.[21] Justice Brennan's attempted reconciliation is firmly rooted in Professor Michelman's "speculator exception." Michelman had contrasted the owner of an apartment building in land now rezoned for single family residences, who "no longer has the apartment investment he depended on," with "the nearby land speculator who is unable to show that he has yet formed any specific plans for his vacant land still has a package of possibilities with its value, though lessened, still unspecified—which is what he had before."[22]

While speculators perform the valuable service of guiding society to a more efficient use of resources, Professor Mandelker accurately perceived that Michelman's view was based on antipathy, on "an argument that society may censure morally unacceptable behavior, and an argument that the taking clause need not recognize property losses discounted in land markets."[23] "Investment," as such, clearly is not the issue. No one has suggested, for instance, that a person unexpectedly inheriting an apartment building from a distant relative can be deprived of it without compensation.[24] The devisee inherits the decedent's expectations, not because of dessert but because of lack of antipathy.

Real estate development typically entails the subdivision of parcels so as to create new rights in land with the spatial boundaries and coordinated use rights that maximize aggregate value.[25] Thus, it was the

building project was proffered." William A. Wade, Penn Central's *Economic Failings Confounded Takings Jurisprudence*, 31 URB. LAW. 277, 287 (1999).

20. *Penn Central*, 483 U.S. at 130.

21. RICHARD A. EPSTEIN, TAKINGS: PRIVATE PROPERTY AND THE POWER OF EMINENT DOMAIN 123 (1985).

22. *See* Michelman, *supra* note 3, at 1233–34. This seems patently incorrect. The reduction in value merely reflects the fact that some components of the "package of possibilities" have been removed by the new regulation.

23. Daniel R. Mandelker, *Investment-Backed Expectations: Is There a Taking?*, 31 WASH. U. J. URB. & CONTEMP. L. 3, 12–13 (1987).

24. *See* Daniel R. Mandelker, *Investment-Backed Expectations in Taking Law*, 27 URB. LAW. 215, 226 (1995) ("All expectations in privately held property are investment-backed by purchase or acquisition.").

25. This process is both as old as the practice by which medieval fields were owned in common for grazing purposes yet divided into private strips for agriculture, and as modern as the division of commercial real estate projects into intricate fee, leasehold, and mortgage ownership rights. *See, e.g.*, Henry E. Smith, *Semicommon Property Rights and Scattering in the Open Fields*, 29 J. LEG. STUD. 131–69 (2000); David Alan Richards, *"Gradable and Tradable": The Securitization of Commercial Real Estate Mortgages*, 16 REAL EST. L.J. 99 (1987).

prospect of rental income from the contemplated office tower that led to the severance in *Penn Central* of the air rights that previously were inchoate in the undivided fee. Ironically, the developers of Grand Central Terminal had reinforced its structure precisely in the anticipation that an office building would be constructed above it.[26] One might think this created some sort of protected expectations. However, Justice Brennan would have none of this. He asserted that " 'taking' jurisprudence does not divide a single parcel into discrete segments and attempt to determine whether right in a particular segment have been entirely abrogated."[27] Perhaps another reason for Brennan's rigidity about severance of development rights was that this might inevitably lead to a degradation of his neat division of owner motivations into the "primary expectation concerning the use of the parcel" (the railroad terminal) and secondary expectations.[28] The acceptance of multiple parcels would force the Court to confront multiple uses and multiple motivations.

In subsequent cases the Supreme Court quickly reaffirmed the *Penn Central* three-factor test.[29] While some cases indicate that courts must review and take into the balance all three factors,[30] the recent trend has been to treat the need for investment-backed expectations as an absolute requirement.[31]

In an early article reviewing the history of investment-backed expectations, Professor Mandelker asked: "What does a consideration of investment-backed expectations add to takings theory?"[32] He noted:

> Curiously, Justice Brennan did not mention either the estoppel or vested rights doctrines in *Penn Central*. This omission may be an oversight, or may indicate that investment-backed expectations must be considered even though they do not create an estoppel or a vested right. If this interpretation is correct, the expectations taking factor introduces a landowner tilt in taking theory that did not exist before.[33]

26. 438 U.S. at 115, n.15 ("The Terminal's present foundation includes columns, which were built into it for the express purpose of supporting the proposed 20-story tower.").

27. *Id.* at 130.

28. *Id.* at 136. Indeed, Justice Brennan's adoption of the "tax block" as the appropriate unit of property in Penn Central was arbitrary and unexplained. 438 U.S. at 130–31. The New York Court of Appeals had deemed that the relevant denominator included all of the railroad's considerable other holdings in the vicinity of Grand Central Terminal, a view that Justice Scalia subsequently termed in dicta as "extreme" and "unsupportable." Lucas v. South Carolina Coastal Council, 505 U.S. 1003, 1016 n.7 (1992).

29. *See, e.g.*, Kaiser Aetna v. United States, 444 U.S. 164, 175 (1979); PruneYard Shopping Center v. Robins, 447 U.S. 74, 83 (1980).

30. *See, e.g.*, Ciampetti v. United States, 18 Cl. Ct. 548, 558 (1989).

31. *See, e.g.*, Loveladies Harbor, Inc. v. United States, 28 F.3d 1171, 1179 (Fed. Cir. 1994) (demanding "distinct investment-backed expectations"); Creppel v. United States, 41 F.3d 627, 632 (Fed. Cir. 1994) ("One who buys with knowledge of a restraint assumes the risk of economic loss.").

32. Mandelker, *supra* note 23, at 5.

33. *Id.* at 5–6

In hindsight, Mandelker asked the right question but ventured the wrong answer. The courts never were wont to discern expectations freely and *Penn Central* has come to epitomize judicial deference to regulation. Even as courts and commentators were trying to explicate "investment backed expectations" within the context of the *Penn Central* three-factor test, however, the Supreme Court was quietly changing the doctrine.

Without explanation or any apparent attempt at distinction, a year after *Penn Central* was decided Justice Rehnquist restated its holding using the term "reasonable investment-backed expectations,"[34] a practice followed by the Court in subsequent cases. While on its face innocuous, the addition has had a fundamental impact on the way that American courts view property rights. While "expectations" seem personal and subjective, "reasonableness" seems rooted in the context of societal interaction and objective. In short, reasonable expectations are shaped by law—or shape the law. This set the stage for the fundamental reassessment of the role of investment-backed expectations following the Supreme Court's decision in *Lucas*.

II. *Lucas* Opens the Floodgates

While Justice Scalia's opinion in *Lucas v. South Carolina Coastal Council*[35] generally is deemed a spirited (if narrow) defense of property rights, its ultimate impact might be quite different. This stems primarily from two passages in which Scalia attempts to explicate the case's holding, which is that a regulation depriving an owner of all economically viable use generally is the functional equivalent of a taking. The first passage links common law traditions with popular understandings:

> Where the State seeks to sustain regulation that deprives land of all economically beneficial use, we think it may resist compensation only if the logically antecedent inquiry into the nature of the owner's estate shows that the proscribed use interests were not part of his title to begin with. This accords, we think, with our "takings" jurisprudence, which has traditionally been guided by the *understandings of our citizens* regarding the content of, and the State's power over, the "bundle of rights" that they acquire when they obtain title to property.[36]

This passage risks conflation of the understandings of the law that individual citizens develop with the law itself and leaves unanswered the role of "reasonable expectations."

34. *Kaiser Aetna*, 444 U.S. at 175.
35. 505 U.S. 1003 (1992).
36. *Id.* at 1027 (internal citation omitted) (emphasis added).

Chief Judge Loren Smith of the U. S. Court of Federal Claims strove to maintain the distinction between property rights and expectations in *Store Safe Redlands Associates v. United States*:[37]

> The initial inquiry by the court—whether plaintiff has a property interest—is not determined by examining whether plaintiff has "reasonable investment backed expectations." Such an inquiry is only relevant when assessing whether government regulation has effected a taking by regulation of an acknowledged and existing property interest. At this point it is not relevant to the antecedent inquiry which the court must address: does plaintiff possess a property interest and, if so, what is the proper scope of that interest? Before plaintiff can argue whether the government has taken its property, it must first prove what it owns. The presence of "reasonable backed expectations" does not aid in establishing the existence of the property interest. If the plaintiff proves that it has property rights in the water and if the court finds that defendant took the property, then it may be appropriate to address "expectations."[38]

However, *Store Safe* has not been cited in subsequent judicial opinions, nor, apparently has the point been discussed by other courts.

The second important passage in Justice Scalia's *Lucas* opinion links common law traditions with legislative powers:

> Any limitation [that prohibits all economically beneficial use of land] cannot be newly legislated or decreed (without compensation), but must inhere in the title itself, in the restrictions that background principles of the State's law of property and nuisance already place upon land ownership.[39]

Some courts have utilized this passage to assert that any statute or local ordinance adopted prior to a landowners purchase inheres in the buyer's title, so that the owner never possessed the right allegedly taken by the regulation.[40] I have argued elsewhere that this is a misreading of Scalia's intent to limit the "background principles" exception to restrictions established within the common law accretion of precedent.[41]

Another power influence on the expectations doctrine has been the parallel flowering of the broad reading of "background principles" into the "notice rule" developed by the Supreme Court in 1984, in *Ruckelshaus v. Monsanto Co.*[42] There the Court found that the government could release a pesticide manufacturer's trade secrets to the public without incurring takings liability. The statute mandating revelation of the secrets in the application for approval of the pesticide's lawful sale also provided for the disclosure to the public. "Monsanto could not have

37. 35 Fed. Cl. 726 (1996). Unfortunately, the case has not been cited in a subsequent published opinion.

38. *Id.* at 734 (citation omitted).

39. *Lucas*, 505 U.S. at 1029.

40. *See, e.g.*, Kim v. City of New York, 681 N.E.2d 312 (N.Y. 1997).

41. *See* Steven J. Eagle, *The 1997 Regulatory Takings Quartet: Retreating From the "Rule of Law,"* 42 N.Y.L. SCH. L. REV. 345 (1998) ("New York Court of Appeals Year in Review" issue).

42. 467 U.S. 986 (1984).

had a reasonable, investment-backed expectation that EPA would keep the data confidential."[43] Likewise, in *Connolly v. Pension Benefit Guaranty Corp.*, the Court held that employers had to expect that statutes might be amended in the highly regulated pension field.[44]

In *Nollan v. California Coastal Commission*,[45] Justice Scalia attempted in limit the *Monsanto* notice rule to cases in which an owner's burden was voluntarily exchanged for a valuable government benefit. "But the right to build on one's own property—even though its exercise can be subjected to legitimate permitting requirements—cannot remotely be described as a 'governmental benefit.' "[46] However, Scalia's distinction has not fared well in the lower courts.[47]

III. "Expectations" Redefining "Property": *Good v. United States*

Good v. United States,[48] decided by the U. S. Court of Appeals for the Federal Circuit in 1999, is important and may represent the culmination of the doctrine of investment-backed expectations. The plaintiff was not a person engendering much sympathy, since he had clear advice from the outset that he would have considerable difficulty in obtaining approvals for his development in the fragile Florida Keys. Good obtained a permit for his development from the U.S. Army Corps of Engineers and then encountered numerous delays and court battles in his quest for state authorization. By then his Corps of Engineers permit had expired.

The Corps ultimately denied Good's renewal application predicated on the Endangered Species Act, which was enacted only *after* Good had acquired his land. Unsurprisingly, Good argued that at the time of purchase he could not have expected a denial based on the Act. The court said: "Appellant's position is not entirely unreasonable, but we must ultimately reject it. In view of the *regulatory climate* that existed when Appellant acquired the subject property, Appellant could not have had a reasonable expectation that he would obtain approval to fill ten acres of wetlands in order to develop the land."[49]

43. *Id.* at 1006.
44. 475 U.S. 211, 227 (1986).
45. 483 U.S. 825 (1987).
46. *Id* at 833 n.2.
47. *See, e.g.*, Kim v. City of New York, 681 N.E.2d 312 (N.Y. 1997); Grant v. South Carolina Coastal Council, 461 S.E.2d 388 (S.C. 1995); Hunziker v. State, 519 N.W.2d 367 (Iowa 1994). *Cf.* K & K Constr., Inc., 551 N.W.2d 413 (Mich. Ct. App. 1996), *rev'd on other grounds*, 575 N.W.2d 531 (Mich. 1998).
48. 189 F.3d 1355 (Fed. Cir. 1999).
49. *Id.* at 1361–62 (emphasis added).

The court also declared that "[r]easonable, investment-backed expectations are an element of every regulatory takings case" and that *Lucas* "did not hold that the denial of all economically beneficial or productive use of land eliminates the requirement that the landowner have reasonable, investment-backed expectations of developing his land."[50]

Thus, "expectations" is deemed not only to reflect changes in law but also to anticipate them. Justice Kennedy noted in his concurring opinion in *Lucas* that "[t]here is an inherent tendency towards circularity . . . for if the owner's reasonable expectations are shaped by what courts allow as a proper exercise of governmental authority, property tends to become what courts say it is. Some circularity must be tolerated in these matters, however, as it is in other spheres."[51] The gloss given expectations in *Good*, however, together with the notice rule and a loose construction of "background principles," hasten an obliteration of any distinction between statements of law contained in the Constitution, in statutes and ordinances, in the climate of regulatory and public opinion, and in the perceptions of landowners and those who would assert preferred versions of the public interest.

The Federal Circuit's opinion in *Good* brings us full circle. "Investment-backed expectations" was an expression of Professor Michelman's utilitarian instincts. When *Good* grounds reasonable expectations in "climate," it merely restates what the avatar of American legal utilitarianism, Oliver Wendell Holmes, wrote over a century ago: law is prophecy.[52] But if Holmes was the public skeptic, he was the private cynic, viewing regulatory takings law simply as "determining a line between grabber and grabbee that turns on the feeling of the community."[53] The lack of a clear demarcation between ownership rights as protected by the Constitution and the range of expectations that a landowner or regulator or judge might glean about the future is an aspect of our jurisprudence that makes it more likely that the law of grabber and grabbee will prevail.

50. *Id.* at 1361.

51. *Lucas*, 505 U.S. at 1034 (Kennedy, J., concurring).

52. Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 458 (1897) "The prophecies of what the courts will do in fact, and nothing more pretentious, are what I mean by the law." *Id.* at 461.

53. MARK L. POLLOT, GRAND THEFT AND PETTY LARCENY: PROPERTY RIGHTS IN AMERICA 78 (1993) (quoting letter to Harold J. Laski, October 23, 1926, *reprinted in* THE HOLMES-LASKI LETTERS 888 (1953)).

What I deem the fusion of the "notice rule" and "reasonable investment-backed expectations" doctrines would have the effect of obliterating the distinction between property and the state's police power. Unless we can understand and apply them separately, the Constitution and those subject to it will be the worse off.