

# Federal Circuit's Economic Failings Undo the Penn Central Test

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## Editors' Summary

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Faulty understanding of standard economic and financial analysis within regulatory takings cases continues to set this jurisprudence apart from standard tort cases, where state of the art economic methods typically are applied within both liability and damages phases of the trial. Clear examples of economic nonsense can be found in three recent decisions by the U.S. Court of Appeals for the Federal Circuit that ignored competent economic evidence within the *Penn Central* test to overturn temporary takings decisions. The Federal Circuit's flip-flop between its 2003 decision in *Cienega Garden VIII* and its more recent decisions in *Cienega Gardens X*, *Rose Acre Farms*, and *CCA* reveals both misapplication of "parcel as a temporal whole" from *Tahoe Sierra*, a *Lucas* case, to *Penn Central* cases and faulty use of valuation methods appropriate for real property to evaluate the severity of economic impact of temporary business income losses. Confused legal theories cannot be shoehorned into standard economic methods essential to evaluate the *Penn Central* test.

## I. Progeny of *Cienega X* Supplant Standard Economic Methods With Confused Legal Theories

Thirty years after Justice William J. Brennan's decision in *Penn Central*,<sup>1</sup> the federal circuit created an economic *tsemisht* of the *Penn Central* test in its *Cienega X* decision.<sup>2</sup> Progeny of *Cienega X* demonstrate that faulty legal theories of economics developed in *Cienega X* should not displace well-established economic theories of measuring and benchmarking financial losses. This Article takes a meta-look at recent federal circuit and federal claims court decisions to reveal that confused legal theories cannot be shoehorned into standard economic methods essential to evaluate the *Penn Central* test.<sup>3</sup>

Progeny of *Cienega X* at issue are:

- *Rose Acre Farms, Inc. v. United States (Rose Acre Farms VI)*<sup>4</sup>;
- *CCA Associates v. United States (Fed. Cl.)*<sup>5</sup>; and
- *CCA Associates v. United States (Fed. Cir.)*<sup>6</sup>

An earlier Article by the author details the economic failings of *Cienega X*<sup>7</sup>; a recent Article explains the deficiencies of *Rose Acre Farms*' analytic approaches to *Cienega X*'s *Penn Central* test.<sup>8</sup> Reliance on diminution in value of property in lieu of loss of income led each of the federal circuit decisions astray.

Not surprisingly, *CCA Associates*' post-trial memorandum put the court on notice that they were playing under protest of the *Cienega X Penn Central* rules.

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*Author's Note: The author served as expert financial economist and testified for the plaintiff in the Palazzolo remand trial at Wakefield, Rhode Island, June 2004. He has testified on economic elements of the Penn Central test and estimated economic losses in takings cases at the Court of Federal Claims. He can be reached at [wade@energyandwatereconomics.com](mailto:wade@energyandwatereconomics.com). The author acknowledges helpful comments from an anonymous legal reviewer; remaining errors are the author's.*

1. *Penn Cent. Transp. Co. v. New York City*, 438 U.S. 104, 8 ELR 20528 (1978).
2. *Cienega Gardens v. United States (Cienega X)*, 503 F.3d 1266 (Fed. Cir. 2007). "Tsemisht," or "simist," is Yiddish for confused, befuddled, mixed up.
3. *Penn Cent.*, 438 U.S. at 124. To establish a regulatory taking, a plaintiff must provide evidence regarding: (1) the regulation's economic impact on the claimant; (2) the extent to which the regulation has interfered with distinct investment-backed expectations (DIBE); and (3) the character of the government's actions. The court must then balance these factors in some manner. *Id.*
4. 559 F.3d 1260, 39 ELR 20058 (Fed. Cir. 2009), *cert. denied*, 130 S. Ct. 1501 (2010).
5. 91 Fed. Cl. 580 (2010), *appeal docketed* (Fed. Cir. July 19, 2010).
6. 284 Fed. Appx. 810, 811 (Fed. Cir. 2008).
7. William W. Wade, *Confusion About "Change in Value" and "Return on Equity" Approaches to the Penn Central Test in Temporary Takings*, 38 ELR 10486 (July 2008).
8. See William W. Wade, *A Tale of Two Circuits: Penn Central's Ad Hocery Yields Inconsistent Takings Decisions*, 42 URB. LAW. (forthcoming 2010).

CCA acknowledges that this Court generally must apply the *Cienega X* analysis, notwithstanding the fact that this analysis directly conflicts with the Federal Circuit's decision in *Cienega VIII*. However, CCA preserves herein its argument that *Cienega X*'s "lifetime value" approach to measuring economic impact is contrary to United States Supreme Court precedents, contrary to Federal Circuit precedents, and contrary to sound policy.<sup>9</sup>

## II. Measuring Business Income Losses With Property Values Is Flat Wrong

The essential economic fact to understand in the *Cienega Gardens*, *CCA*, and *Rose Acre Farms* cases is that unanticipated regulatory proscriptions interrupted their plans of business operations causing substantial loss of income for a period of two to five years. *CCA Associates* and *Cienega Gardens* owned rental properties, which were prohibited from exiting a government low-income housing program and increasing rents to market; *Rose Acre Farms* suffered a 25-month loss of table egg sales due to government restrictions.

Plaintiffs filed temporary takings complaints. The Court of Federal Claims ruled a taking had occurred to *Cienega Gardens* owners,<sup>10</sup> *CCA Associates*,<sup>11</sup> and *Rose Acre Farms*<sup>12</sup> based on the economic impact of lost earnings within the framework of the *Penn Central* test. The federal circuit's *Cienega X* decision vacated and remanded, criticizing the heretofore acceptable calculation of economic impact. *CCA (Fed. Cir.)* and *Rose Acre Farms VI* followed *Cienega X*.

The error of the federal circuit's view of economic methods is bolstered by the U.S. Supreme Court's recognition of standard economic approaches.<sup>13</sup> Two cases confirm what economists and financial analysts consider bedrock: lost earnings are what matter when an income-producing business operation is interrupted. Justice Stanley Foreman Reed contrasted returns with the change in market value in the 1951 *United States v. Pewee Coal*<sup>14</sup> case: "Market value, despite its difficulties, provides a fairly acceptable test for just compensation when the property is taken absolutely. But in the temporary

taking of operating properties, market value is too uncertain a measure to have any practical significance."<sup>15</sup> In 1949, *Kimball Laundry* reached the same conclusion:

[I]f the difference between the market value of the fee on the date of taking and that on the date of return were taken to be the measure, there might frequently be situations in which the owner would receive no compensation whatever because the market value of the property had not decreased during the period of the taker's occupancy.<sup>16</sup>

Citing to these cases, Judge Charles F. Lettow concluded in the 2007 case: "The better measure [for temporary possession of a business enterprise is] the operating losses suffered during the temporary period of government control."<sup>17</sup>

## III. *Cienega X* Distraction With "Parcel as a Whole" Misguides Progeny

In spite of these Supreme Court cases and the fact that the federal circuit had measured and relied on rental income losses in *Cienega VIII*,<sup>18</sup> the 2007 court of appeals reversed itself and concluded that, in a temporary regulatory takings *Penn Central* analysis, the economic impact of the loss of income had to be evaluated in context with the value of the business as a whole "just as it is in the context of a permanent regulatory taking."<sup>19</sup> The court proposed two possible ways "to compare the value of the restriction to the value of the property as a whole."<sup>20</sup>

The court of appeals considered:

First, a comparison could be made between the market value of the property with and without the restrictions on the date that the restriction began (the change in value approach). The other approach is to compare the lost net income due to the restriction (discounted to present value at the date the restriction was imposed) with the *total net income without the restriction over the entire useful life of the property* (again discounted to present value).<sup>21</sup>

The federal circuit has unraveled logical economic frameworks that make sense in the *Penn Central* test. Decisions in *Cienega X* and *Rose Acre Farms VI* reinterpreted and misconstrued economic testimony presented at the Court of Federal

9. *CCA Associates v. United States*, 91 Fed. Cl. 580 (2010). "Plaintiff CCA Associates' Post-Trial Memorandum," Aug. 26, 2009, n.15 at 23. (The lengthy footnote is referred to interested readers.)

10. *Cienega Gardens v. United States (Cienega IX)*, 67 Fed. Cl. 434 (2005).

11. *CCA Assocs. v. United States*, 75 Fed. Cl. 170 (2007).

12. *Rose Acre Farms, Inc. v. United States (Rose Acre V)*, 75 Fed. Cl. 527 (2007).

13. *Cienega X* disavowed reliance upon income approaches to measure economic impact. Expert opinion in a taking case is guided by the correct theories from the expert's discipline. *Cienega Gardens v. United States (Cienega X)*, 503 F.3d 1266, 1281-82 (Fed. Cir. 2007). Where income losses are the issue, permanently or temporarily, due to a take, cash flows must be measured with and without the lost-causing disruption. *Daubert* standards expect no less than that the expert demonstrates that her analytic technique has been tested in actual situations and peer reviewed. *Daubert v. Merrell Dow Pharms., Inc.*, 509 U.S. 579, 23 ELR 20979 (1993).

14. 341 U.S. 114 (1951).

15. *Id.* at 119-20 (Reed, J., concurring) (emphasis added) (citations omitted). The brief discussion of the three Supreme Court cases is an abridgement of and no substitute for the extensive explication in *CCA Associates v. United States*, 75 Fed. Cl. 170, 200-04 (2007).

16. *Kimball Laundry v. United States*, 338 U.S. 1, 7 (1949).

17. *CCA Associates v. United States*, 75 Fed. Cl. 170, 2004 (2007).

18. *Cienega Gardens v. United States (Cienega VIII)*, 331 F.3d 1319, 1342-45 (Fed. Cir. 2003).

19. *Cienega Gardens v. United States (Cienega X)*, 503 F.3d 1281 (Fed. Cir. 2007).

20. *Id.* at 1282.

21. *Id.* (emphasis added to call attention to the *entire useful life* phrase discussed in Section 6.3.)

Claims trials without a glimmer of understanding fundamental concepts of economics and finance. *Rose Acre Farms VI* extended and further confounded *Cienega X*'s reversal of *Cienega VIII*'s carefully developed analytic approach to the *Penn Central* test.<sup>22</sup>

#### IV. CCA's Taking Decision Under *Cienega X*

After the federal circuit threw out Judge Lettow's 2007 *CCA* finding of a taking based on five years of lost income,<sup>23</sup> he carefully replaced the government expert's assumptions with empirical data in the record to again find a taking in the 2010 remand decision.

As a result of the temporary taking, and considering the entire, whole, useful life of [its apartment complex], *CCA* suffered an 18% economic loss in its total market value. In determining how far is too far, there is "no magic number," and "no set formula." Here, an 18% economic loss concentrated over approximately five years constitutes a "serious financial loss." The duration of the deprivation, five years and ten days, is significant in this regard. . . . The economic loss suffered here, when combined with the character of the government's actions and *CCA*'s reasonable investment-backed expectations, which both factor heavily in *CCA*'s favor, is sufficient to establish that *CCA* suffered a temporary regulatory taking.<sup>24</sup>

##### A. Takings Fraction Is Benchmarked to Equity, Not Fair Market Values

One wonders how the federal circuit will deal with the 18% diminution in property value as the basis for a taking decision following the government's appeal filed July 20, 2010.<sup>25</sup> This value, in fact, does not measure the all-important *Penn Central* test prong: frustration of distinct investment-backed expectation. The 18% diminution is the difference in fair market values of the building stipulated by the parties assuming that the building converted to market-rate operations immediately and assuming that the property remained in the regulated state for five more years, at which point it would convert to market-rate operation.<sup>26</sup>

22. See Wade, *supra* note 7.

23. *CCA Assocs. v. United States*, 75 Fed. Cl. 170 (2007).

24. *CCA Assocs. v. United States*, 91 Fed. Cl. 580, 618-19 (2010) (internal citations omitted).

25. *CCA Assocs. v. United States*, U.S. Court of Appeals for the Federal Circuit, Case #2010-5100, -5101, "Brief of Defendant-Appellant, The United States," July 19, 2010. (The brief never mentions lost income during the five year taking period, dealing only with Fair Market Values of the real property, the Chateau Cleary housing project in New Orleans. The real property, of course, was not taken and not at issue. Neither does the brief identify the all-critical denominator value, against which to measure the severity of economic impact. The brief argues that the Federal Claims Court erred in applying the *Penn Central* test, while not evaluating the two economic prongs of the test with competent measures of the lost income or the investment basis that should serve as the denominator of takings fraction. Until such time that the Federal Circuit or the Supreme Court corrects the specious analysis of severity of economic impact made by the government in this case and *Rose Acre Farms*, takings jurisprudence is unlikely to have any predictability.)

26. *Id.* at 619.

The *CCA* decision's 18% diminution in building market value had to ignore the point of the Fla. Rock Indus., Inc. v. United States (*Florida Rock V*)<sup>27</sup> seminal decision that diminution in value of the property is not dispositive of the severity of the economic impact; diminution alone is not sufficient to reveal whether economic viability has been destroyed.

*Florida Rock V* recognized that the investment basis in the property is the correct denominator of the takings fraction and compared values before and after the change in regulation to that investment basis to determine if any "reasonable return" was possible after the change.<sup>28</sup> This ruling clarified the all important takings fraction to require measurement of the investment in the property as the "value . . . to furnish the denominator of the fraction," correcting *Keystone's* misfocus on comparing "after" values to "before" values,<sup>29</sup> a ratio that reveals nothing about the effect of regulatory change on economic viability of the investment. Only by comparing income before and after to the investment basis in the property can courts evaluate frustration of *Penn Central's* "distinct investment-backed expectations" (DIBE)<sup>30</sup> with standard financial methods and performance benchmarks.

The original *CCA* decision had found an 81.25% diminution of return on equity over the five-year period based on lost rental income.<sup>31</sup> The 2010 decision shortened the period of the taking and reported loss of income of \$714,430 to award compensation.<sup>32</sup> While the decision did not benchmark losses to equity, the owner's equity in the property at the time of the taking, \$811,700, is in the record.<sup>33</sup>

The denominator of the taking fraction against which the loss is measured is \$811,700, not the market value of the property. The point missed by the 18% calculation is that the market value of the property is comprised of two parts: the owners' equity, plus debt owed to the lender. The amount of *CCA Associates'* debt is not found in the case filings. Nonetheless, the correct financial measure of the denominator value is owners' equity against which to benchmark the owners' losses, which are captured in the numerator of the takings fraction. The reported rental losses represent the present value of lost rental income at the *end* of the taking period. Converting these to match the valuation date of the equity, the losses are 56.25% of owners' equity.<sup>34</sup>

27. Fla. Rock Indus., Inc. v. United States (*Florida Rock V*), 45 Fed. Cl. 21 (1999). On March 28, 2000, the Court of Federal Claims entered final judgment on the partial taking of the 98-acre parcel for \$752,444, plus interest, plus attorney and expert costs and urged the parties to negotiate an award related to the remaining 1,462 acres. Fla. Rock Indus., Inc. v. United States, 2000 WL 331830 (Fed. Cl. Mar. 28, 2000). The federal government paid Florida Rock \$21 million in the fall of 2001 to settle the pending case and dispose of the claim with respect to the remaining 1,462 acres.

28. Fla. Rock V, 45 Fed. Cl. at 38. This decision has not been overturned by the Federal Circuit, although *Cienega X* ignores it.

29. *Keystone Bituminous Coals Ass'n v. DeBenedictis*, 480 U.S. 470, 497, 17 ELR 20440 (1987).

30. *Penn Cent. Transp. Co. v. New York City*, 438 U.S. 104, 124, 8 ELR 20528 (1978).

31. *CCA Assocs. v. United States*, 75 Fed. Cl. 170, 199 (2007).

32. *CCA Assocs. v. United States*, 91 Fed. Cl. 580, 620 (2010).

33. *Id.* at 611 n.35.

34. Calculations available from the author.

## B. Back to Basics to Provide Context for Measuring Severity of Economic Impact

Judge Lettow's careful benchmarking of income losses to CCA's equity in the 2007 *Penn Central* test is usefully compared to the 18% change in building value to reveal *Cienega X*'s lack of understanding of measurement of economic impact. Plaintiffs in a regulatory takings case must surmount the *Penn Central* test to support payment of just compensation. *Penn Central*'s two economic concepts, "economic impact"<sup>35</sup> and DIBE,<sup>36</sup> are measurable with established benchmarks by which to gauge the severity of an economic injury.

While the Justice Brennan majority never defined the terms, their meaning is no mystery to financial and economic theorists and practitioners. Nor are they a mystery to Judge Lettow; within the Economic Impact section of the 2007 decision,<sup>37</sup> he cites the Supreme Court and prior Claims Court and Federal Circuit Court decisions that explain exactly how a claimant must measure and benchmark the two economic prongs of the *Penn Central* test.

While not dispositive of the severity of economic impact, the economic losses are the first economic fact to examine in a temporary taking. Claimant must demonstrate that regulatory-imposed income losses undermine distinct investment-backed expectations. Whether *some* return on investment remains after the change in regulatory regime is not at issue; rather, the determinative fact is whether economically viable returns remain as measured by standard economic methods.<sup>38</sup>

Severity of economic impact must be benchmarked by investment-backed expectations, the essential prong of a regulatory taking. Investment-backed expectations, whether "distinct" in *Penn Central*<sup>39</sup> or "reasonable" in *Cienega VIII*,<sup>40</sup> must be shown to be frustrated as one condition to decide a regulatory taking; i.e., the change in returns must demonstrate erosion of economic viability of the investment in the whole property after imposition of the unanticipated change in regulations.

## C. Reasonable or Distinct IBE Refer to Profitability in Penn Central

*Cienega X*'s reliance on "reasonable" expectations to the exclusion of the original meaning in *Penn Central* can be seen as the logical outcome of repeated decisions' failure to grasp the significance of *Florida Rock V*'s dispositive reliance

on the DIBE prong of the *Penn Central* test.<sup>41</sup> For no discernable legal or linguistic purpose, *Kaiser Aetna v. United States*,<sup>42</sup> changed "distinct" to "reasonable" the year following *Penn Central*. Subsequently, this change has confounded courts' views of reasonable expectations vis-à-vis plaintiffs' notice of regulatory prohibitions<sup>43</sup> with reasonably expected return on investments.

To satisfy the federal circuit's myopic focus on "reasonable" expectations, Judge Lettow creates arguably two new tests of reasonable expectations within the 2010 decision to respond the *Cienega X*'s emphasis on jurists' second-guessing of investors expectations:

The Court of Appeals identified two possible standards to apply in this analysis: (1) there is no taking unless the expectation was the "primary" investment-backed expectation, or (2) the expectation is "investment-backed" if an investor would not have invested "but for" the expectation, even if it is not the primary expectation.<sup>44</sup>

Not surprisingly, this distracted the decision from the evaluation of severity of economic impact, which seems to have been lost from the original intent of the *Penn Central* test. Justice Brennan relied on Prof. Frank Michelman's 1967 *Harvard Law Review* article,<sup>45</sup> cited in the opinion,<sup>46</sup> as the basis for the two economic prongs of the *Penn Central* test. Professor Michelman argued that the test for whether compensation should be paid depends, not on how much value has been destroyed, but "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."<sup>47</sup> Thereby, Professor Michelman created the language adopted in *Penn Central*.

*Cienega X* is the progeny of subsequent conversion of distinct profit expectations to reasonable notice of rules. Prior to *Cienega X*, Federal Claims Court cases followed the logic of *Cienega VIII*, applying reasonable investment-backed expectations (RIBE) in context with both notice *and* frustration of investment-backed expectations under the economic impact prong. The original *Penn Central* language intended to measure the severity of economic impact on the claimant by the interference with investment-backed expectations—which is exactly what *Cienega VIII* did. "Reasonable" as the touchstone of IBE must be returned to "distinct" to avoid random takings decisions in the future.

35. *Penn Cent.*, 438 U.S. at 124.

36. *Id.* at 105.

37. *CCA Assocs.*, 75 Fed. Cl. at 195.

38. Standard finance theory defines economic viability as a return on investment greater than the investor's opportunity cost of the next best alternative. Practitioners typically benchmark the plaintiff's actual returns to comparable risk-weighted industry returns. Abundant literature exists to support these methods of analysis.

39. *Penn Cent.*, 438 U.S. at 124.

40. *Cienega Gardens v. United States (Cienega VIII)*, 331 F.3d 1319, 1345-46 (Fed. Cir. 2003).

41. *Fla. Rock Indus., Inc. v. United States (Florida Rock V)*, 45 Fed. Cl. 21 (1999).

42. 444 U.S. 164, 175, 10 ELR 20042 (1979).

43. *Cienega Gardens v. United States (Cienega X)*, 503 F.3d 1266, 1289 (Fed. Cir. 2007) ("the plaintiffs could not reasonably have expected the change in regulatory approach").

44. *CCA Assocs. v. United States*, 91 Fed. Cl. 580, 603 (2010) (citing *Cienega X*, 503 F.3d at 1290).

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

46. *Penn Cent.*, 438 U.S. at 128.

47. Michelman, *supra* note 45, at 1233.

## V. *Cienega X* Set the Stage for *Rose Acre VI* and *CCA Associates*

In view of CCA's protest of the *Cienega X* version of the *Penn Central* test, and its misapplication in *Rose Acre Farms VI*,<sup>48</sup> I turn now to a discussion of how the federal circuit detoured from received law and economics.<sup>49</sup>

### A. *Wrong Evaluation Approach Valued Wrong Property Right*

The federal circuit's confusion about how to measure and benchmark the economic impact prong of the *Penn Central* test for a temporary taking originated in its reversal of a taking in *Cienega X*.<sup>50</sup> That decision addressed the question of whether valuation of the lost income from use of the plaintiff's apartment buildings or valuation of the change in real property value appraised before and after the taking period is the more appropriate measure of the *Penn Central* test for a temporary taking of income. In *Cienega X*, the court decided that temporary income losses from the plaintiff's rental properties should be measured in context with the buildings' real property values, which the government's expert testified were little diminished after the temporary taking ended.

The *Cienega X* decision failed to understand what the Supreme Court had known for decades; i.e., that appraisal approaches may measure a change in market value for real property—tangible assets—but they cannot accurately measure income losses for income-producing properties. The change in market value approach will produce incorrect estimates of economic losses because the before and after appraisal of market value is aimed at the wrong stick in the bundle of property rights—the tangible asset in lieu of the income stream from the use of the property lost during the period of regulatory imposition.

### B. *Government Persistently Ignored Standard Economic Methods*

The confusion arose from the government's persistent misapplication of valuation approaches suitable for real property to the lost rental earnings caused by government intervention in the low-income housing program. The government had argued the change-in-value position for some years before the *Cienega X* decision despite repeated opposition expert testi-

mony and admonishment in the Court of Federal Claims that change in cash flows is what matters to an income-producing property.

Rejecting the government's argument, the 2005 *Cienega IX* decision of the Court of Federal Claims concluded that "the return on equity approach best measures the impact of [lost income during the taking] on the plaintiffs. Measuring an owner's return on equity better demonstrates the economic impact [of] temporary takings of income-generating property than a measurement of the change in fair market value."<sup>51</sup> *CCA Associates* (2007) reiterated the appropriateness of the return on equity approach.<sup>52</sup> Both of these Federal Claims Court decisions followed the analytic approach thought settled in 2003 by the Federal Circuit in *Cienega Gardens v. United States (Cienega VIII)*.<sup>53</sup>

In its *Cienega IX* post-trial brief, the government argued: "The change-in-cash flow model has numerous flaws. First, because plaintiffs' model only seeks to measure the change in cash flow, it examines only one stick in the bundle of rights. Second, the model fails to consider the properties' overall value."<sup>54</sup> The government fails to acknowledge that the cash flow from an investment in an income-producing asset is the essential stick in the bundle of rights.

Part of the confusion over when to rely on change in property value or change in income from use of the property stems from failure of the courts to differentiate between the property interest taken by the regulation at issue—the tangible assets or the intangible assets. In regulatory takings cases, economic losses arise from diminution of value of the tangible assets (real property) or from the proscribed economic use of the property (intangible assets).

An unforeseen regulatory prohibition of a planned business use of property could change its economic value due to a change in the value of the tangible assets and/or due to a change in the value of the intangible assets. If the tangible assets are not affected by the regulation, then the effect of the regulation would be ascribed to the foregone uses of the property, the intangible assets. In *Nollan v. Cal. Coastal Comm'n*<sup>55</sup> and *Dolan v. City of Tigard*,<sup>56</sup> the tangible assets were devalued by the governments' land dedication requirements. In the *Cienega Gardens* and *CCA Associates* line of cases, the use of the property, not the property, was diminished.

John Maynard Keynes, arguably the godfather of modern economics, defined investment as the right to obtain a series of prospective returns during the life of the asset.<sup>57</sup>

48. *Rose Acre Farms, Inc. v. United States (Rose Acre VI)*, 559 F.3d 1260, 39 ELR 20058 (Fed. Cir. 2009).

The totality of the economic loss, for purposes of a takings analysis, is generally captured by the diminution in value metric, when the 'taken' property is food or another commodity . . . . [W]e are convinced that it was clear error to place sole reliance on the diminution in return metric.

*Id.* at 1274-75.

49. An earlier article shows how decisions prior to *Cienega X* conformed the *Penn Central* test to standard economic methods. William W. Wade, "Sophisticated and Abstruse Formulas" Made Simple: Advances in Measurement of *Penn Central's* Economic Prongs and Estimation of Economic Damages in Federal Claims and Federal Circuit Courts, 38 URB. LAW. 337 (2006).

50. 503 F.3d 1266.

51. *Cienega Gardens v. United States (Cienega IX)*, 67 Fed. Cl. 434, 475 (2005).

52. 75 Fed. Cl. 170, 195-96 (2007) ("[Return on equity] best measures the impact . . . on the owners' . . . properties because the alleged taking involves lost streams of income at an operating property, not the physical transfer of a piece of undeveloped property to the government and subsequent return of that property to the owner.").

53. *Cienega Gardens v. United States (Cienega VIII)*, 331 F.3d 1319 (Fed. Cir. 2003).

54. Brief for Defendant-Appellant at 40, *Chancellor Manor v. United States*, 331 F.3d 891, 33 ELR 20222 (Fed. Cir. 2003) (No. 02-5066).

55. 483 U.S. 825, 17 ELR 20918 (1987).

56. 512 U.S. 374, 24 ELR 21083 (1994).

57. JOHN MAYNARD KEYNES, GENERAL THEORY OF EMPLOYMENT, INTEREST, AND MONEY 135, 225 (Harcourt, Brace & World 1965) (1936). See also APPRAISAL INSTITUTE, THE APPRAISAL OF REAL ESTATE 471 (12th ed. 2001)

Keynes emphasized the expected cash flow or profitability of investments as the key motivating determinant for investment. Any discussion of whether a temporary regulatory taking has occurred is pure sophistry without measurement of the change in cash flows of an income-producing property.<sup>58</sup> After all, the use of the land, not the land, is the property right at stake.

## VI. Cienega VIII's Precedential Economic Insights Lost in Cienega X

Government counsel and the Federal Circuit, other than Circuit Judge Pauline Newman,<sup>59</sup> appear to be unaware of the importance of Professor Keynes, or abundant information from the Appraisal Institute and a host of finance textbooks and journal articles that convey long received and settled economic theory that underpins modern finance—and the seminal *Cienega VIII* decision.

### A. Federal Circuit's Flip-Flop Misconstrued Tahoe-Sierra

The Federal Circuit's *Rose Acre VI* decision<sup>60</sup> earlier this year extends that court's misconstruction of the economic significance of the Supreme Court's *Tahoe-Sierra Pres. Council, Inc. v. Tahoe Reg'l Planning Agency* "parcel as a whole" language<sup>61</sup> between *Cienega VIII* and *Cienega X*. The Federal Circuit revisited the question of whether the economic impact should be calculated by a diminution in value analysis or a

diminution in return analysis in *Rose Acre Farms VI*.<sup>62</sup> Conjoining this question with *Tahoe Sierra's* parcel as a temporal whole concept, government counsel argued in their brief that "[t]he exclusive focus upon Rose Acre's lost profitability during the temporary period [of the restrictions] is an erroneous assessment of the economic impact of a temporary regulatory restriction upon the property as a whole." They conclude that "[t]he obvious purpose of this [*Tahoe-Sierra*] requirement is to assess the economic impact of the temporary regulatory action in relation to the entire life of the property."<sup>63</sup>

*Cienega X* relied on *Tahoe-Sierra* to invoke "the impact on the value of the property as a whole [a]s an important consideration [in a temporary taking], just as it is in the context of a permanent regulatory taking."<sup>64</sup> The decision then addressed the question of whether valuation of the lost income from use of the plaintiff's property or valuation of the change in real property value measured before and after the taking period is the more appropriate measure of the *Penn Central* test in view of considerations of the parcel as a temporal whole.

Government counsel first brought up *Tahoe-Sierra* in *Cienega VIII*. That decision disavowed the government's reliance on *Tahoe-Sierra* for the principle that "a fee simple estate cannot be rendered valueless by a temporary prohibition on economic use, because the property will recover value as soon as the prohibition is lifted." Judge Paul Michel concluded that *Tahoe-Sierra*

is inapt because . . . the Owners' theory of recovery is *not* that their fee simple estates were taken or their land rendered "valueless." The Owners' entitlement to compensation is based on the taking of the . . . property interests reflected in the mortgage loan notes and the Regulatory Agreements. The difference is that the Owners' loss of the contractual prepayment rights was both total and immediate. They were barred from the unregulated rental market and other more lucrative property uses.<sup>65</sup>

*Cienega VIII* correctly identified the lost use of the fee simple property as the relevant property interest and measured the economic impact prong of the *Penn Central* test by the diminution in income caused by the temporary loss of market-rate rental income. "The loss of 96% of the possible rate of return on the investment is, even under the most conservative view, a 'serious financial loss.'"<sup>66</sup> The recovery of value of the tangible assets of *Tahoe-Sierra's* plaintiffs' undeveloped residential lots is not a competent comparison to a business' ability to resume operations after the end of the regulatory prohibition. Earnings lost in time are lost forever.<sup>67</sup>

("Income-producing real estate is typically purchased as an investment and from an investor's point of view earning power is the critical element affecting property value.")

58. See, e.g., Prof. John Echeverria, Remarks at the 20th Judicial Conference of the U.S. Court of Federal Claims (Oct. 11, 2007), [http://www.law.georgetown.edu/gelpi/current\\_research/documents/RT\\_Pubs\\_Pres\\_CtFedClsConf07.pdf](http://www.law.georgetown.edu/gelpi/current_research/documents/RT_Pubs_Pres_CtFedClsConf07.pdf)

The use of the profitability measure raises several issues of concern, including . . . (2) whether this approach has the unintended effect of undermining or circumventing the property as a whole rule by providing an alternate pathway to recovery for claimants who might otherwise not be able to demonstrate significant adverse economic effects.

On September 25, 2007, the Federal Circuit, in the latest round in the *Cienega Gardens* litigation, . . . issued a new decision pointing in a different direction . . . In this latest decision the Federal Circuit reversed a finding of a taking, primarily on the ground that the profitability or so-called "return on equity" approach failed to account for the property as a whole.

59. Judge Pauline Newman was on the *Cienega VIII* and *Cienega X* courts and had reasonably harsh words for her *Cienega X* colleagues: "This panel has no authority to revoke our prior decision in *Cienega VIII*. . . . The creative theories propounded by my colleagues for redetermining whether a taking occurred ignore the law of this case. . . . I must, respectfully, dissent." *Cienega Gardens v. United States (Cienega X)*, 503 F.3d 1266, 1291-92, 1295 (Fed. Cir. 2007) (Newman, J., dissenting). Judge Newman served as an adjunct professor of law at George Mason University at the time, teaching Legal and Economic Theory of Intellectual Property. She received a B.A. from Vassar College in 1947, an M.A. from Columbia University in 1948, a Ph.D. from Yale University in 1952, and an LL.B. from New York University School of Law in 1958. Chances are good that she knows who Professor Keynes was.

60. *Rose Acre Farms, Inc. v. United States (Rose Acre VI)*, 559 F.3d 1260, 39 ELR 20058 (Fed. Cir. 2009).

61. 535 U.S. 302, 331, 32 ELR 20627 (2002) ("[T]he District Court erred when it disaggregated petitioners' property into temporal segments corresponding to the regulations at issue and then analyzed whether petitioners were deprived of all economically viable use during each period.")

62. 559 F.3d 1260.

63. Corrected Brief for Defendant-Appellant at 40-41, *Rose Acre Farms v. United States*, 559 F.3d 1260, 39 ELR 20058 (Fed. Cir. 2009) (No. 2007-5169).

64. *Cienega X*, 503 F.3d at 1281. When evaluating the economic impact of a regulation, the court explained that a court cannot "disaggregate[] [the owner's] property into temporal segments corresponding to the regulations at issue and then analyze[] whether [the owners] were deprived of all economically viable use during each period." *Id.* (internal quotation omitted).

65. *Cienega Gardens v. United States (Cienega VIII)*, 331 F.3d 1319, 1344 (Fed. Cir. 2003).

66. *Id.* at 1343.

67. *Bass Enters. Prod. Co. v. United States*, 48 Fed. Cl. 621, 624 (2001). ("This case involves the taking of a right to develop and drill for natural resources . . .

## B. Tahoe-Sierra Provides No Economic Guidance for Penn Central

Invoking *Tahoe-Sierra* is misguided for two reasons. First, that decision dealt with the very narrow question of whether a temporary moratorium on residential land development constitutes a taking of property under the *Lucas* theory. In *Lucas v. South Carolina Coastal Council*,<sup>68</sup> the Court decided that the property owner had been permanently denied “all economically beneficial or productive use of land.”<sup>69</sup> The court in *Tahoe-Sierra*, in fact, denied the *Lucas* taking and concluded that the facts of Tahoe property owners would be “best analyzed within the *Penn Central* framework.”<sup>70</sup> The *Tahoe-Sierra* decision, relied upon in *Cienega X*, provides no guidance on how the *Penn Central* test should be applied for income-producing properties.

Second, in contrast to *Lucas*, where economic wipeout was adopted as a given, the *Cienega Gardens* cases key on measurement of the economic impact prong of the *Penn Central* test where the alleged taking causes income losses from income-producing properties. No income losses are in the *Tahoe-Sierra* record. Consequently, *Tahoe-Sierra* provides no instruction about how to measure and benchmark losses from income-producing properties or what might constitute the parcel as a whole where other than fee-simple raw land is at stake.

The *Cienega X* panel at the Federal Circuit tossed out significant economic insights from the *Cienega VIII* panel. *Cienega X* readdressed the question of whether valuation of the lost income from use of the plaintiff’s property or valuation of the change in real property value is the more appropriate measure of the *Penn Central* test. Although inconsistent with the received canon of finance and economics,<sup>71</sup> the government argued and won the point in *Cienega X* that the change in real property values of the buildings should govern the *Penn Central* test because the buildings would recover value after the period of the taking.<sup>72</sup>

## C. Cienega X Analytic Methods Eliminate Temporary Takings

The recovery of value of the tangible assets of *Tahoe-Sierra*’s plaintiffs’ undeveloped lots is not a competent comparison to

a business’ ability to resume operations after the end of the regulatory prohibition. *Cienega X* offered a second approach that investigates business recovery but still invokes *Tahoe-Sierra*’s parcel as a temporal whole. The approach eliminated the thought-to-be black-letter law that the effects of temporary takings are measured between a “start” date and an “end” date. Instead, *Cienega X* redefined the lost income approach as “compar[ing] the lost net income due to the restriction (discounted to present value at the date the restriction was imposed) with the total net income without the restriction over the *entire useful life of the property* (again discounted to present value).”<sup>73</sup>

R.S. Radford argued in a PLF amicus brief filed in support of CCA petitioners: “This remarkable error . . . would erase this Court’s jurisprudence of temporary takings, rendering *Penn Central* a mere curiosity, and reducing the class of compensable takings to those that can . . . fit within the narrow categorical rules of *Lucas* or *Loretto*.”<sup>74</sup>

The decision’s language would require experts to evaluate the economic impact of a temporary loss of income during the taking period with data beyond the end of the taking to prove that the loss *during* the temporary taking period eviscerates the plaintiff’s economic prospects for all time to come. In other words, losses during the period of take must overcome subsequent returns after the end of the taking to justify compensation. Yet, the circuit court decided and the Court of Federal Claims cases have consistently restricted measurement of economic data governing the *Penn Central* test and damages to the period of the temporary takings.<sup>75</sup>

Time values of money are important to this determination. Depending on the length of the taking period and discount rate, plaintiff may or may not recover from the economic loss. From the point of view of economic theory, however, if it were true that a temporary taking must prove loss “in relation to *the entire life of the property*,” then temporary takings actually must be shown to be equivalent to a permanent taking to justify compensation. If so, Mr. Radford is correct: temporary takings do not exist.

## VII. Conclusions

The *Rose Acre VI* decision emphasizes the problem of shoe-horning economic methods for real property takings cases to measure temporary takings of earnings from business operations. The decision applied a uniquely ad hoc confused approach that transubstantiated eggs into the relevant parcel and evaluated loss of gross revenues as some supposed way to measure *decline in value*. Lost income was the property right at stake, and diminution in rate of return was the correct economic metric. In what must be judged very understated, Prof.

The resources will remain in the ground until plaintiffs are permitted to develop them. Bass has not lost any of the oil and gas. *Bass has lost time*.” (emphasis added)). The decision struggles with an appropriate “rental rate” to compensate plaintiff for his lost time during the temporary taking. What became of the Federal Circuit’s understanding revealed in *Yuba Natural Res. Inc. v. United States (Yuba V)*, which held that even though “the property is returned to the owner when the taking ends, the just compensation . . . is the value of the use of the property . . . which the owner lost as a result of the taking.” 904 F.2d 1577, 1580-81 (Fed. Cir. 1990).

68. 505 U.S. 1003 (1992).

69. *Id.* at 1015.

70. *Tahoe-Sierra Pres. Council, Inc. v. Tahoe Reg’l Planning Agency*, 535 U.S. 302, 321, 32 ELR 20627 (2002).

71. See *supra* note 38.

72. *Cienega Gardens v. United States (Cienega X)*, 503 F.3d 1266, 1280 (Fed. Cir. 2007) (“In *Tahoe-Sierra*, the necessity of considering the overall value of the property was explicitly confirmed in the temporary regulatory takings context.”) (citing *Tahoe Sierra*, 535 U.S. at 331).

73. *Id.* at 1282 (emphasis added).

74. Brief Amicus Curiae of Pacific Legal Foundation in Support of Petitioner at 26, *CCA Assocs. v. United States*, No. 08-505, *cert. denied*, 129 S. Ct. 1313 (2009).

75. *Wyatt v. United States*, 271 F.3d 1090, 1097 n.6, 32 ELR 20345 (Fed. Cir. 2001) (“The essential element of a temporary taking is a finite start and end to the taking.”). See also *Cienega Gardens v. United States (Cienega IX)*, 67 Fed. Cl. 434, 479 (2005) (“The “essential element” of a temporary taking is “a finite start and end to the taking.””) (citing *Wyatt*, 271 F.3d at 1097 n.6).

Steven Eagle wrote of the *Rose Acre VI* outcome in his recent fourth edition: “Discerning the correct measure of economic impact has been the subject of some dispute.”<sup>76</sup> Counsel for plaintiff is closer to the mark in his Petition for Rehearing en banc: “The [2009 decision] will . . . create widespread confusion in this Court’s takings jurisprudence.”<sup>77</sup>

The *CCA Associates* 2010 decision’s analysis of severity of economic impact to satisfy *Cienega X*’s view of *Penn Central* reveals that standard economic methods have been discarded, even though the decision once again found a taking for the claimant. Economic impact is not measured or benchmarked to the investment basis. Diminution in building value is not a sufficient measure of severity of reduction of economic viability.

The original intent of *Penn Central*’s parcel as a whole language has been lost by the Federal Circuit’s commingling of tangible property values with intangible use values of the property. The correct measure of damages for a claim about partial taking of land is the difference in the value of the property before and after the taking. To surmount the *Penn Central* test, the analyst, following *Florida Rock V*, must evaluate the ability of returns to the land after the taking to recoup owners’ investment and provide a competitive rate of return on investment. Owners’ invested capital is the denominator.

The correct measure of damages for a temporary taking of business income from an income-producing property is the present value of lost income during the taking period. To surmount the *Penn Central* test, the analyst must evaluate the ability of income to the property for the entire duration of the taking to earn a competitive rate of return on invested capital for that period. Owners’ invested capital is the denominator. Income earned after the end of the temporary taking is irrelevant, unless the Supreme Court intends to put an end to the notion of temporary takings.

Notice that 100% of owners’ invested capital is the denominator in both cases. Owners’ equity is tantamount to the *Tahoe Sierra* concept of “parcel as a whole” where lost earnings are the issue. The relevant time period to measure economic losses is governed by temporary takings case law, which has been clear since *Wyatt*.

Conversion of *Penn Central*’s distinct profit expectations to reasonable notice of rules has confounded jurists, litigators, and the *Penn Central* test. Without doubt, the *Penn Central* prong, “frustration of distinct investment-backed expectations,” intended to get at measurement of lost economic viability. Subsequent conversion of DIBE to reasonable notice has stripped this prong of the *Penn Central* test of its objective ability to reveal severity of economic impact. *Penn Central* itself is left without a *polestar*.<sup>78</sup>

76. STEVEN J. EAGLE, REGULATORY TAKINGS 342 (4th ed. 2009).

77. Petition of Rose Acre Farms, Inc. for Rehearing En Banc at 2, Rose Acre Farms, Inc. v. United States (*Rose Acre VI*), 559 F.3d 1260, 39 ELR 20058 (Fed. Cir. 2009) (No. 2007-5169).

78. *Palazzolo v. Rhode Island*, 533 U.S. 606, 633, 32 ELR 20516 (2001) (O’Connor, J., concurring) (“Our polestar instead remains the principles set forth in *Penn Central* itself and our other cases that govern partial regulatory takings.”).