Penn Central’s Ad Hocery Yields Inconsistent Takings Decisions

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I. Introduction

The courts’ understanding and application of the Penn Central test in the regulatory takings context remains in disarray. Last year, for example, in applying the severity of economic impact prong of the test, the Ninth Circuit in Guggenheim and the Federal Circuit in Rose Acre Farms reached opposite conclusions on comparable reported percentage losses. Neither decision relied on or cited Florida Rock V’s “logical framework based upon well-established rules and principles” to undertake the balancing called for in Penn Central. Each overlooked the point of Florida Rock V’s 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. Until the analysis applied by the courts conforms to the economic underpinnings explicit in the distinct investment-backed expectations (DIBE) language of the Penn Central decision, the lack

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1. See Penn Cent. Transp. Co. v. New York City, 438 U.S. 104, 124 (1978). “[T]he Court’s decisions have identified several factors that have particular significance. The economic impact of the regulation on the claimant and, particularly, the extent to which the regulation has interfered with distinct investment-backed expectations are, of course, relevant considerations.” Id. The third factor is the character of the governmental action. Id.

2. Guggenheim v. City of Goleta, 582 F.3d 996 (9th Cir. 2009).


4. See Fla. Rock Indus., Inc. v. United States, 45 Fed. Cl. 21, 23 (Fed. Cl. 1999) [hereinafter Florida Rock V].

5. See Penn Central, 438 U.S. at 124.

6. See Florida Rock V, 45 Fed. Cl. at 23.

7. See id.

of clarity and predictability will remain a challenge for parties and lawyers.

The Supreme Court has avoided articulating a coherent theoretical framework to replace the “ad hoc, factual inquiries” of *Penn Central* in spite of several relevant petitions for *certiorari* in recent years, most recently in *Rose Acre Farms*. Economic shortcomings have allowed courts to confuse ad hoc considerations of case facts with economic methods, which are not ad hoc. Conflicting results from similar evaluations of severe economic impact in the two cases mentioned above are the progeny of pushing *Penn Central*’s ad hocery “too far.”

This article examines the economic confusion in the *Rose Acre Farms* cases to demonstrate the unpredictable nature of takings jurisprudence and to urge the Court to correct faulty understandings of economics within the *Penn Central* test if, indeed, that test is to be its polestar. As further developed in Part II of this article, the *Rose Acre VI* decision emphasizes the need for courts to distinguish the economic differences between real property takings cases and temporary takings of earnings from business operations. The *Rose Acre VI* decision applies a uniquely ad hoc, confused approach that transubstantiated eggs into the relevant parcel and evaluated loss of gross revenues as a mistaken measure of decline in value. Lost income was the property right at stake and diminution in rate of return was the correct economic metric.

Conversion of *Penn Central*’s distinct profit expectations to what is essentially a “reasonable notice of rules” test has confounded judges and litigators. Without doubt, the *Penn Central* “frustration of distinct investment-backed expectations” (DIBE) prong was intended to get at measurement of lost economic viability. Subsequent conversion of

11. The Court in *Penn Central* stated:

   [T]his Court, quite simply, has been unable to develop any “set formula” for determining when “justice and fairness” require that economic injuries caused by public action be compensated by the government, rather than remain disproportionately concentrated on a few persons. . . . In engaging in these essentially ad hoc, factual inquiries, the Court’s decisions have identified several factors that have particular significance. *Penn Cent.*, 438 U.S. at 124.
12. See Pa. Coal Co. v. Mahon, 260 U.S. 393, 415 (1922). “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.” *Id.* (emphasis added). Financial economic decision rules play an obvious role in determining when a regulation undermines investment-backed expectations sufficiently to award compensation; *i.e.*, when the regulation “goes [so] far” that it crosses a relevant analytic threshold abundantly defined in economic and financial textbooks.
DIBE to reasonable notice has stripped this prong of its objective ability to reveal severity of economic impact. *Penn Central* itself is left without a polestar.

**II. Rose Acre Farms**

Rose Acre Farms complained about its loss of table egg sales due to government restrictions. For health concerns, the USDA had required Rose Acre to send 57.75 million dozen eggs to the breaker market, where they were pasteurized and sold as breaker eggs, rather than to the more lucrative table egg market. Three of nine Rose Acre Farm properties were at issue, producing 135.5 million dozen eggs during the two-year period of the alleged temporary taking. This lowered gross revenues for Rose Acre Farms and caused undisputed net losses from these three farms during the period.

The case was heard by the Federal Claims and Federal Circuit Courts twice; both times the lower court found a taking and the Federal Circuit reversed. Most recently, the Federal Circuit held that Rose Acre did not suffer a regulatory taking under the *Penn Central* test. The Federal Circuit concluded that diminution in value, rather than diminution in return, is the appropriate metric when assessing the economic impact prong of the *Penn Central* test. Further, the Federal Circuit determined that the relevant parcel, the denominator of the economic impact prong, was the 135 million diverted eggs and not the three farms at issue. The court held that a 10% diminution in value for diverting 135 million eggs to the breaker market was not a severe enough economic impact to be considered a regulatory taking.

The Federal Circuit held that the trial court’s reliance on the diminution in return as the economic impact metric to be in error. The court declared that reliance on diminution in return is a “profits-based approach . . . [which] provides limited guidance and constrains a fact

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14. *Id*. at 1263–64.
15. *Id*. at 1268.
16. *Id*. at 1265.
17. See infra Parts II. A & B.
18. *Rose Acre VI*, 559 F.3d at 1283.
19. *Id*. at 1275.
20. *Id*.
21. *Id*.
22. *Id*. 

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finder’s ability to provide a complete and fair assessment of the economic impact prong.” 23 Additionally, the Federal Circuit held that the trial court erred by merely declaring the 219% diminution in return to be a severe economic impact without comparing it to any standard on the ground that diminution in return is “an inherently relative number.” 24

The primary thrust of the trial in the Federal Claims Court concerned economics. 25 The economic record of Rose Acre V and VI is hopelessly muddled, particularly in the discussions of elements of the Penn Central test. 26 Whether the denominator was the diverted eggs or the three farms—or neither; whether gross revenues or net profits, lost income or lost value, average marginal costs or average total costs governed the numerator apparently eluded the judges, the parties, and even the experts. To sort through the economics, this section discusses the opposing positions reported in both decisions related first to the numerator and then the denominator of the Penn Central takings fraction.

A. Numerator, or Revenue Measurement

Rose Acre V initiates the discussion of severity of economic impact as follows: “[h]istorically, two different methods have been used to evaluate the severity of the economic impact of a regulatory taking, diminution in value and diminution in return.” 27 The decision then amplifies this language with a footnote: “[d]iminution in value is sometimes referred to as ‘diminution in revenue’ and diminution in return is interchangeable with ‘diminution in profit.’ ” 28

While lost returns may be equated to lost profits, diminution in revenues is not equivalent to diminution in value. 29 Fundamentally,
revenues stem from the use of property; diminution in revenues is not akin to diminution in value of the property.30

This confusion between valuation of real property and the diminution of the sales revenues from the use of property reflects language introduced by the government expert—not valuation practice.31 The following exchange occurred between government counsel and the government expert.

What is your opinion with respect to the economic impact of the regulations in terms of diminution in value?

My opinion is that the diminution in value is 10.6 percent.

Now, you’ve been using diminution in revenue, diminution in value. Can you explain why you’re using those terms interchangeably?

Diminution in value is the value of the asset. In this case it’s the price of the eggs. When we’re talking about just a reduction in the price, that’s the same thing as a diminution in revenue. So those terms are used interchangeably.32

In this exchange, the government economist equated eggs, a farm product, with the value of the farm tangible assets, and substituted the 10.6% loss in gross sales value of the eggs for the loss in value of the three farms.33 The government expert equated diminution in price of eggs (diminution in revenues) to a diminution in value of the property.34 A change in the price of eggs can be considered a change in the gross revenues.35 But, this is not interchangeably used to measure a change in value of property.36

Value of property is based on the present value of the stream of profits.37 Two critical steps are skipped by the government expert in relating the change in price to change in value of the property: costs and calculation of profits. In a high volume, low profit-margin business, like farm products, costs may be quite high compared to competitive prices in the industry.38 The diminution in value of the property is not measured by the

30. See id. at 35–50.
32. Id.
33. See id.
34. See id.
35. See Pratt et al., supra note 29, at 35–50. R = P*Q, where R = gross revenues; P = price; and Q = quantity of eggs.
36. See infra notes 12–16.
37. See Pratt et al., supra note 29, at 35–50.
38. The facts of the Rose Acre Farm case strongly suggest that egg farming is a slim profit margin business; i.e., a 10% reduction in gross revenues eliminated profit and changed the operation to a losing situation. See Rose Acre V amended, No. 92–710C, 2007 WL 5177409, at *1–10, *10 (Fed. Cl. July 11, 2007).
change in gross revenues; the diminution in value of the property hinges on the change in profitability of the business. The trial court’s reference to the expert’s error was mere dicta in footnote ten.\(^{39}\) The Federal Circuit promoted the error to the core of its decision to overturn *Rose Acre V*.\(^{40}\)

Calculations made using the government expert’s data reveal a 16.4% decline in net operating income;\(^{41}\) but the profit margin on the operation was only 2.04%—typical for high volume farm products.\(^{42}\) Hence, operating the business of the three farms with eggs mandated to the breaker market does, indeed, shift the operation from profitable to money-losing, as shown by the plaintiff’s expert. Plaintiff’s expert demonstrated that plaintiff suffered a loss of $6,638,446, rather than making a $3,028,936 profit, at the three farms affected by the regulations.\(^{44}\) Dividing the after value by the before value, plaintiff expert claimed a 219% decline in profits.\(^{45}\)

The 219% calculation created a problem to be discussed with the denominator. Plaintiff’s expert adequately demonstrated serious economic impact with the showing that the mandated shift of eggs to the breaker market extinguished 100% of reasonably expected profits.\(^{46}\)

The *Rose Acre V* court concluded “based on the Federal Circuit decision [*Rose Acre IV*] alongside the evidence presented at trial that diminution in return approach provides the best understanding of the regulations’ impact on plaintiff.”\(^{47}\) The testimony of plaintiff’s expert clearly demonstrated that using the diminution in return is appropriate “where, as here, the issue concerns the economic impact, albeit temporary, of government regulations on a going business concern.”\(^{48}\)

In *Rose Acre Farms VI*\(^{49}\) the government revisited the question of whether the economic impact should be calculated by a diminution in

\(^{39}\) *Rose Acre V amended*, 2007 WL 5177409, at *5 n.10.

\(^{40}\) See *Rose Acre VI*, 559 F.3d 1260, 1268–69 (Fed. Cir. 2009), cert. denied, 130 S. Ct. 1501 (2010).

\(^{41}\) The author calculated net operating income (NOI) “but for” the shifting of eggs to the breaker market and the actual NOI and then calculated that there was a 16.4% decline in NOI.

\(^{42}\) *Rose Acre VI*, 559 F.3d at 1269.

\(^{43}\) Common sense confirms that margins on crops and farm products are measured in the pennies with farmers selling millions of units of bushels of wheat, gallons of milk or eggs. Profits come from high volumes with low margins.


\(^{45}\) See id.

\(^{46}\) See id.

\(^{47}\) Id.

\(^{48}\) Id. at *9* (quoting *Rose Acre IV*, 373 F.3d 1177, 1188–89 (Fed. Cir. 2004).

\(^{49}\) *Rose Acre VI*, 559 F.3d 1260, 1268–69 (Fed. Cir. 2009), cert. denied, 130 S. Ct. 1501 (2010).
value analysis or a diminution in return analysis. Conjoining this question with Tahoe Sierra’s parcel as a temporal whole concept, the government argued in its 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.” The government argued that “[t]he obvious purpose for this [Tahoe-Sierra] requirement is to assess the economic impact of the temporary regulatory action in relation to the entire life of the property.”

Rose Acre VI misapplied Tahoe-Sierra’s parcel as a temporal whole language. 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. Rose Acre VI 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 economic prospects of the plaintiff for all time to come. This would eliminate presumptively black-letter law that the effects of temporary takings are measured between a “start” date and an “end” date. Otherwise, a temporary taking of income must be shown to be equivalent to a permanent taking to justify compensation.

The government’s expert opined that diminution in gross revenues is “superior to the diminution in profit measure” because the diminution in profit measure includes the fixed costs. Supplanting standard

50. See Tahoe-Sierra Pres. Council v. Tahoe Reg’l Planning Agency, 535 U.S. 302, 327 (2002). “[E]ven though multiple factors are relevant in the analysis of regulatory takings claims, in such cases we must focus on ‘the parcel as a whole.’” Id.
52. Id. at 40–41.
54. See Rose Acre VI, 559 F.3d at 1274.
55. The Federal Circuit and the Court of Federal Claims have consistently restricted measurement of economic data governing the Penn Central test and damages to the period of the temporary takings. See Wyatt v. United States, 271 F.3d 1090, 1097 (Fed. Cir. 2001). “The essential element of a temporary taking is a finite start and end to the taking.” Id. at 1097 n.6; see also Cienea Gardens v. United States, 67 Fed. Cl. 434, 483 (Fed. Cl. 2005). “[The] ‘essential element’ of a temporary taking is ‘a finite start and end to the taking.’” Id. at 483 (citing Wyatt, 271 F.3d at 1097).
57. Id. His novel concept of valuation is at odds with standard agricultural economics and financial valuation. What matters to most decision makers—and damage calculations in court cases—is the profitability of an enterprise, not the gross revenues. Only rarely does an enterprise seek to maximize gross revenues rather than net profits.
economics with the government’s legal theory, he equated the decline in gross revenues to a decline in value;\textsuperscript{58} he applied his 10.6% diminution in gross revenues by the diversion of the breaker eggs to a measure of diminution in value of the property.\textsuperscript{59} The government expert’s leap from gross revenues to value of the parcel defined as the 135 million dozen eggs is specious. Equating the eggs with the denominator parcel was the fatal error articulated by the government expert and adopted by the court in \textit{Rose Acre VI}.\textsuperscript{60}

The government expert swayed the Federal Circuit, which was looking for a way to deal with a “value” metric,\textsuperscript{61} by calculating the ratio of gross sales “with” the take to gross sales “without,” 89.4%, and claimed that the diminution in value—only 10.6%—was not sufficient to qualify as a severe economic impact.\textsuperscript{62} This conclusion from the arithmetic is wrong and misleading.\textsuperscript{63} Rose Acre’s profit margin on gross revenues was only 2% “without” the take.\textsuperscript{64} Hence, a 10.6% decline in revenues changed a profitable operation to a money-losing operation, just as plaintiff’s expert testified.\textsuperscript{65}

B. The Denominator as the Basis for Investment-Backed Expectations

The \textit{Rose Acre V} court adopted the Rose Acre expert’s calculation that Rose Acre sustained a 219% diminution in profit at the three farms,\textsuperscript{66} concluding that the severity of economic impact element of the \textit{Penn Central} test “weighs heavily in favor of the plaintiff.”\textsuperscript{67}

Rose Acre’s expert compared the 219% diminution to the 96% diminution in the rate of return reported from \textit{Cienega IX}.\textsuperscript{68} Rose Acre expert’s comparison is an analytic mistake because the \textit{Cienega IX}...
calculation measures the decline in rate of return (e.g., the ratio of change in income to owners’ equity).\textsuperscript{69} Rose Acre’s expert’s ratio simply shows that the loss, $6.6 million, is a little more than twice as large as the profit without the USDA prohibition.\textsuperscript{70} This has no analytic significance in law or economics and led to pages of confounding testimony in \textit{Rose Acre VI} by the government expert about equally non-illuminating hypotheticals.\textsuperscript{71}

Rose Acre’s expert considered as the denominator the business operations of the three farms.\textsuperscript{72} But, he never measured that concept with investment values. The investment basis in the three farms is not in the record.\textsuperscript{73} Had he followed \textit{Florida Rock V}, the appropriate value would have been the owners’ equity in the three farms. This value is nowhere in the record or experts’ reports. \textit{Rose Acre VI} ultimately rejected the trial court’s reliance on the 219\% diminution in return as indicative of severe economic impact “because it does not set any baseline or standard to which to compare an inherently relative number.”\textsuperscript{74}

While the Rose Acre expert does not provide an estimate of return on equity for the three farms “but for” the taking, the $6.6 million loss after the taking revealed that distinct investment-backed expectations—\textsuperscript{75} the second prong of the \textit{Penn Central} test—were indeed frustrated.

The \textit{Rose Acre VI} decision initiated the discussion of the relevant denominator as the three farms agreed upon in \textit{Rose Acre IV}.\textsuperscript{76} The court, perhaps beguiled by the government expert’s discussion of change in gross revenues/value\textsuperscript{77} and troubled by the plaintiff’s unbenchmarked 219\% number,\textsuperscript{78} decided that “the proper framing of the issue requires us to refocus on the approximately 135 million dozen eggs produced at

\textsuperscript{69} See \textit{Cienega IX}, 331 F.3d at 1340–41.
\textsuperscript{70} See \textit{Rose Acre VI}, 559 F.3d 1260, 1270 (Fed. Cir. 2009).
\textsuperscript{71} See \textit{id.} at 1270–1271.
\textsuperscript{72} Id. at 1272–73.
\textsuperscript{73} See \textit{Rose Acre VI}, 559 F.3d at 1274. Rose Acre owned six other farms, unaffected by the problems at the three farms. See \textit{id}. Arguably, the parcel as a whole investigation might have investigated the point made late in the decision that “if the proper parcel were the business of the enterprise, we would have to understand how the 219\% diminution in return compared to the profits from the six unaffected farms.” \textit{Id.} at 1275. This would open a different kettle of fish ignored by the record. The government did not raise the issue in trial; I will not raise it in this article.
\textsuperscript{74} Id. at 1269. This reiterates the same deficiency with the measure reported in \textit{Rose Acre IV}. See \textit{Rose Acre IV}, 373 F.3d 1177, 1187 (Fed. Cir. 2004).
\textsuperscript{76} See \textit{Rose Acre VI}, 559 F.3d at 1267–68.
\textsuperscript{78} See \textit{Rose Acre VI}, 559 F.3d at 1269.
the three farms, and not the three farms as a business.”79 Plaintiff expert lost the reasonable argument that the “business as a whole was the [relevant] parcel;”780 the court concluded that:

[the importance of properly defining the parcel likely explains why [Plaintiff’s expert] testimony misses the mark with respect to his choice of methodology. . . . When we review [his] testimony in light of our holding that the correct parcel is the eggs, it obliterates [his] opinion that the diminution in return is the proper metric.81

C. Confounded Numerator and Denominator
Measurement Led to No Definitive Penn Central Test

The Federal Circuit adopted the government’s “parcel as a whole” logic and went on to transubstantiate Cienega X’s change-in-value-of-tangible-real-property82 into Rose Acre Farms’ gross-revenues-from-egg-production as the way to measure “parcel as a whole.” “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.”83 The court concluded: “we are convinced that it was clear error to place sole reliance on the diminution in return metric.”84

The Federal Circuit concluded that Rose Acre Farms did not suffer a compensable taking because diversion of the 57 million dozen eggs to the breaker market only lowered revenues by about 10%.85 The decision is so analytically confused that it yields no useful economic guidance for future litigation. Diminution of value as applied in Cienega X relates to tangible assets and does not measure lost income in a temporary taking.86 The Rose Acre VI court’s conclusion is clear economic error.

The clearest remarks in Rose Acre VI about the lost return or lost revenues approach to measurement of economic impact appear in a footnote:

This is not to say that, in other circumstances, a fact finder may never rely solely on diminution in return to assess the economic impact of the regulation. In this case, however, we need not decide whether the trial court should have looked only at

79. Id. at 1271–1272; see also id. at 1272 n.5 (summarizing the confusion among the litigants and the court). Reliance upon either insights from Cienega VIII or Florida Rock V would have rendered moot this confusion and waste of court time.
80. Id. at 1273.
81. Id. at 1273.
82. See Cienega X, 503 F.3d 1266, 1284 (Fed. Cir. 2007).
83. Rose Acre VI, 559 F.3d at 1275.
84. Id.
85. See id. at 1283.
86. See Cienega X, 503 F.3d at 1284.
diminution in value without consideration of diminution in return. Thus, we do not hold that it is never proper to consider diminution in return as one proper metric in assessing a takings claim even when the property subject to regulatory action is a discrete asset, such as some commodity. Certain circumstances not presented to us here may support a more balanced examination of multiple economic indicators. Other mathematical formulations or certain normalization algorithms could perhaps render moot our concerns stated above about the diminution in profit metric. Conversely, upon a more searching analysis of the analytical methods, a court might conclude that diminution in return is never appropriate when analyzing certain classes of non-categorical takings claims. None of this need we decide today. Therefore, we leave those issues for future cases.87

III. Conclusion

Regardless of the confused economics throughout *Rose Acre VI*, both approaches survive the scrutiny of the Federal Circuit for another day. *Rose Acre’s Petition for Writ of Certiorari*, which presented the Supreme Court with questions dealing with the correct measurement of the severity of economic impact and the confusion about *Penn Central*’s denominator in the takings fraction, was denied.88 Although *Cienega VIII* previously resolved this issue,89 future courts must discern the difference between the economic analysis of cases with diminution in value of tangible assets from cases with lost income due to interrupted business operations at stake.

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 discriminate between the property interest taken by the regulation at issue—the tangible assets or the intangible assets. In temporary takings, the use of the property, not the tangible assets, is the property right at stake. Confusion between attributes of the tangible real property and the intangible use of the property has led government presentations away from standard valuation estimates of lost income. Lost use of property is measured by lost earnings or lost income, not a change in real property value.

*Florida Rock V* established the investment basis in the property as the denominator of the takings fraction and compares returns before and after the change in regulation to that investment basis to determine that no “reasonable return” was possible.90 This ruling clarified the all important takings fraction to require measurement of returns before and

87. *Rose Acre IV*, at 1275 n.7.
89. See *Cienega IX*, 331 F.3d at 1340.
after to the investment basis in the property to benchmark severity of economic impact. *Rose Acre* failed to define the relevant denominator and analyze returns in relation to a denominator. The court there failed to appreciate the important way that *Florida Rock V* conformed the *Penn Central* test to standard financial economics.

Had *Florida Rock V* been followed, the appropriate benchmark value to reveal severity of economic impact would have been the owners’ equity in the three farms. This value is nowhere in the record or experts’ reports. In view of the $6.6 million loss caused by the government regulation, the rate of return would have been shown to be negative, thus confirming that the result of the health restrictions eliminated economically viable use of the three farms during the time it was in effect.

The *Rose Acre VI* decision emphasizes the need for courts to discriminate economic differences between real property takings cases and 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 a mistaken measure of *decline in value*. Lost income was the property right at stake and diminution in rate of return was the correct economic metric.

Until the Supreme Court puts an end to faulty understanding of economics within the *Penn Central* test (if, indeed, it is to be its polestar) conversion of *Penn Central*’s distinct investment-backed expectations to reasonable notice of rules will continue to confound judges and litigants. 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 its objective ability to reveal severity of economic impact. *Penn Central* itself is left without a polestar.

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92. See id. at 1272–73.