SENATE COMMITTEE ON NATURAL RESOURCES

FILE # ML-45400-07
I.D. # 45400

October 16, 2007

RQ-0639-GA

The Honorable Greg Abbot
Attorney General of Texas
P.O. Box 12548
Austin, TX 78711-2548

Re: Request for an Opinion

Dear General Abbott:

The Brazos River Authority (the "BRA") owns substantial property surrounding Possum Kingdom Lake, and much of that property is subject to long-term residential leases to private individuals. A majority of the existing leases reflect a below-market rate, and many of the below-market leases have a number years remaining in their terms. Legislation proposed in the last session would have required the BRA to sell the leased property to the lessees. In response to that proposed legislation, the BRA is in the process of formulating policies and procedures to offer to sell the leased property to the lessees, and one substantial question presented is the legal requirements governing valuation of the property as part of any sale to the lessees.

Certain lessees contend that the property should be valued as though encumbered by the remaining term of the existing leases. This method of valuation would result in a substantial discount from fair market value of the fee simple interest, because of the below-market lease rates. Outside counsel for the BRA, however, has advised the BRA that any sale of leased property to a lessee for a price that reflects the existing lease would result in a windfall to the lessee, who would acquire the full fee simple interest in the property for a price discounted by a below-market lease that would cease to exist the moment the property is sold. Counsel advises that such a windfall is prohibited by article III, section 52 of the Texas Constitution, which prohibits grants of public funds or things of value to individuals. Enclosed is an opinion letter to the BRA from its outside counsel containing their legal analysis of this issue.

Because this is a matter of vital interest to the BRA and to other constituents of mine, I respectfully request the Attorney General to issue an opinion as to whether leased property at Possum Kingdom Lake should be valued as though unencumbered by existing leases where the sale is to the lessee, or

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whether the sales price should be discounted to reflect the remaining term of the existing leases, although the lease would cease to exist the moment the property is sold. In particular, I request that the opinion address whether using the discounted sales price would violate the prohibitions of article III, section 52 of the Texas Constitution. The Attorney General has previously addressed this issue in a Letter Opinion. Tex. Att'y Gen. L.O. 98-082 (Sept. 28, 1998).

Sincerely,

Kip Averitt

cc: The Honorable David Dewhurst, Lt. Governor of Texas
Mr. Phil Ford, General Manager/CEO, Brazos River Authority

Enclosure

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TEXAS BOARD OF LEGAL SPECIALIZATION

August 16, 2007

Mr. Steve Pena, Presiding Officer
Board of Directors
Brazos River Authority
P.O. Box 7555
Waco, TX 77614-7555

Re: Opinion Letter Regarding Sales of Property to Lessees at Possum Kingdom Lake.

Dear Chairman Pena and Members of the Board:

We have been asked to provide our legal opinion regarding the legal requirements governing the valuation of property owned by the Brazos River Authority ("Authority") in the area of Possum Kingdom Lake for the Authority's contemplated sale of the property to the Authority's current residential lessees.

I. DISCLOSURE OF THIS OPINION LETTER

In this matter, this firm, Scott, Douglass & McConnico, L.L.P. ("SD&M"), only represents the Authority. Concerning this letter and the matters discussed in this letter, SD&M does not have an attorney-client relationship with any other person or entity. SD&M understands that the Authority intends to share this letter with certain third parties. Despite this, concerning this letter, SD&M is not undertaking any attorney-client duties of any kind to those third parties.

Because the Authority plans to share this letter with certain third parties, both the Authority and SD&M understand and intend that this letter is not protected by the attorney-client privilege found in Tex. R. Ev. 503. By disclosing this letter to third

parties, we understand that the Authority in no way waives any privilege or discovery exemption that may apply:

(1) to this firm's underlying work performed to produce this letter; or

(2) to any other communication between SD&M and the Authority concerning this letter or the matters discussed in this letter.

The matters discussed in this letter are complicated legal issues. This letter reflects the result of our careful analysis of these issues. Despite this, this letter in no way promises or guarantees that a court or other adjudicating body will agree with the opinions SD&M asserts in this letter. Instead, anyone reading this letter must understand that it is entirely possible that a court or other adjudicating body could ultimately decide the issues addressed in this letter in a different manner than the manner SD&M asserts in this letter as being correct. In other words, this letter in no way guarantees what the ultimate outcome will be in any litigation addressing the issues discussed in this letter.

II. QUESTIONS PRESENTED

The specific questions we have addressed are: (1) whether Texas law requires the Authority to sell the property for fair market value; and (2) if so, whether such fair market value should be determined with or without consideration of the existing leases. We address these two issues in this letter, and conclude that:

(1) Texas law requires the Authority to sell its property for fair market value; and

(2) When Authority property subject to a lease is sold to the lessee, the fair market value determination should be made as though the property were unencumbered by the lease.

III. ANALYSIS

A. The Authority must sell its property for fair market value.

Section 49.226 of the Texas Water Code and article III, section 52, of the Texas Constitution require the Authority to obtain fair market value for any property it may sell.

1. Section 49.226 of the Texas Water Code

Section 49.226 of the Texas Water Code provides the statutory basis for the Authority to conduct private sales of Authority land. This section also provides the safeguard that all Authority land "must be exchanged for like fair market value" and also provides that such fair market value "may be determined by the [Authority]":

> Any personal property valued at more than $300 or any land or interest in land owned by the district which is found by the board to be surplus and is not needed by the district may be sold under order of the board either by public or private sale, *or* the land, interest in land, or personal property may be exchanged for other land, interest in land, or personal property needed by the district. *Except as provided in Subsection (b), land, interest in land, or personal property must be exchanged for like fair market value, which value may be determined by the district.*

Tex. Water Code Ann. § 49.226(a) (Vernon Supp. 2006) (emphasis added).

2. Article III, Section 52, of the Texas Constitution

Sales at fair market value are also required to satisfy article III, section 52 of the Texas Constitution, which prohibits a governmental entity such as the Authority from granting public funds or any "thing of value" to an individual. The provision reads:

> Except as otherwise provided by this section, the Legislature shall have no power to authorize any ... subdivision of the State to lend its credit or to grant public money or thing of value in aid of, or to any individual, association or corporation whatsoever, or to become a stockholder in such corporation, association or company.

Tex. Const. art. III, § 52. That provision prohibits grants to individuals of public funds or "things of value" unless the grant: (1) serves a legitimate public purpose; and (2) affords a clear public benefit received in return. *Tex. Mun. League Intergovernmental Risk Pool v. Tex. Workers' Comp. Comm'n*, 74 S.W.3d 377, 383 (Tex. 2002).

Though article III, section 52, has most often been applied when actual funds are granted to individuals, it is also applicable to challenge an inadequate sales or lease price

of public land to individuals. In other words, if a public entity sells land to an individual at a below-market price, the discount can constitute a "thing of value" to the individual and thus be prohibited under section 52 unless there were a corresponding "clear public benefit." *See Davis v. City of Lubbock*, 326 S.W.2d 699, 652-653 (Tex. 1959); Tex. Att'y Gen. Op. JC-0582 (Nov. 26, 2002) (holding that lease for $1.00 rental did not violate section 52, because lessee was required to run art museum, and lease thus "serves a public purpose of the county and the transfer is subject to adequate controls, contractual or otherwise, to ensure that the public purpose is accomplished").

B. When property subject to a lease is sold to the lessee, the fair market value determination should not consider the terms of the lease.

When leased property is sold to the lessee, the leases will cease to exist, title to the leasehold estate and the leased fee estate will merge, and the lessee will acquire fee simple title to the property. The fair market value for such a sale should thus be calculated as though unencumbered by the lease's remaining term. Calculating the sales price as though encumbered by the Authority's below-market leases would give an unconstitutional discount to the lessee, who will actually own the property free of the lease after the sale. If the property is valued as though still encumbered by the lease, then the lessee will receive an unconstitutional windfall.

1. When leased property is sold to lessee, the estates merge, the lease ceases to exist, and lessee owns the property free and clear.

"Merger of estates is the absorption of a lesser estate in land into the greater." *Steger v. Muenster Drilling Co., Inc.*, 134 S.W.3d 359, 376 (Tex. App.—Fort Worth 2003, pet. denied). *Franz v. Katy Indep. Sch. Dist.*, 35 S.W.3d 749, 754 (Tex. App.—Houston [1st Dist.] 2000, no pet.). Under the merger of title doctrine, lesser estates such as leases and easements are merged into the remaining estate, by automatic operation of law, when the holder of one estate acquires the rest of the real property interest. *See, e.g., Franz*, 35 S.W.3d at 754 (holding that after lessor terminated lease and acquired improvements, pre-existing tax lien on improvements attached to the land itself "because the two estates [the improvements and the land] merged when Franz terminated the lease and assumed ownership of the improvements"); *Cecola v. Ruley*, 12 S.W.3d 848, 852 (Tex. App.—Texarkana 2000, no pet.) ("Under the merger doctrine, if an easement exists and then the owner of that easement acquires a greater estate, the two estates merge into

the greater of the two and the lesser is extinguished.... [A]ny easement that might have existed over what became the Cecola strip before the purchase by the Cecolas was extinguished by the merger doctrine when it was purchased."); *Hall v. Prof'l Leasing Assocs.*, 550 S.W.2d 392, 394 (Tex. Civ. App.—Dallas 1977, no writ) ("For example, the obligation to pay rent under a real estate lease is discharged when the lessee acquires title to the reversion, because the lease is terminated by merger of the leasehold with the reversion.").

Under operation of the merger doctrine, if the lessees acquire the leased fee estate from the Authority, the leasehold estate will merge with the leased fee estate, and the lease will cease to exist. *See Pitman v. Sanditen*, 626 S.W.2d 496, 498 (Tex. 1981) (holding that when a tenant under a lease containing an option to purchase exercises the option, "[t]he relation of landlord and tenant ceases and that of vendor and purchaser arises"). Through such a sale, therefore, the lessee will acquire the fee simple title to the property, unencumbered by the lease.[1] Because the lessee will in fact own that entire interest after the sale, the constitution requires that the lessee must pay for that interest.

2. Valuing the property as though encumbered by the leases violates the constitutional prohibition against granting public funds.

Independent of the merger doctrine, the constitutional prohibition against granting public benefit to individuals would prohibit valuing the property as though encumbered by the leases, because such a valuation would essentially give the lessee the fee title to the property at a discounted price. The constitution prohibits granting such a windfall to the lessees, and it acts as an absolute bottom-line check on the Authority's ability to sell the lease property to the lessee for anything less than its full unencumbered value. Irrespective of technical application of the merger doctrine or any other equitable concept, it would be unconstitutional for the lessee to acquire the entire property interest from the Authority without paying the Authority for the entire property interest.

[1] Here, there is no purpose to a sale of Possum Kingdom property to the lessees *except* to merge the two estates, terminate the lease, and allow the lessee to own the property free and clear. Indeed, proposed legislation sought by lessees that would have mandated such sales provided that the leases would be terminated upon sale to the lessee. *See* C.S.S.B 3, proposed amendment to Tex. Water Code § 221.020(f) (80th R.S.) ("A lease in effect on the date an application of intent to purchase a lot is submitted under Subsection (c) remains in effect until the sale of the lot is completed or terminated. *A lease of the lot expires on the date the sale of the lot is completed.*") (emphasis added).

One federal court analyzed the same issue, and held that a lessee-shipper's purchase of leased property from a railroad, valued as though encumbered by the lease, was a sufficient windfall to the shipper as to violate a federal statute prohibiting kickbacks by railroads to shippers. *United States v. Schaivone*, 430 F.2d 231, 234 (1st Cir. 1970). The court focused not on the terms of the option to purchase in the parties' lease, but on the bottom-line fact of whether the shipper-lessee received a benefit by acquiring an unencumbered interest in the property but paying only for an encumbered interest. The court noted that "since [lessee's] purchase of the encumbered property automatically extinguishes the encumbrance, [lessee] is immediately in a position to resell the property without the encumbrance." Given that the federal statute was designed to prevent railroads giving a benefit to one shipper over another, "only by requiring the lessee-shipper to pay the fair market value of the property without the lease encumbrance can we be certain that the aforementioned advantages do not accrue to the lessee-shipper." *Id.*

Here, independent of whether there is a *per se* application of the merger doctrine, if the lessees in fact acquire the entire fee interest in the property, they will have acquired a substantial benefit through the transaction that they can immediately resell. Only by requiring that the lessees pay the fair market value of that unencumbered interest can the Authority ensure that the lessees do not receive a public windfall.

The issue is even more stark because the Authority's below-market leases are still in place. The *Schaivone* court expressly condemned the potential double windfall that could result if a lessee were able to acquire full fee title by paying as though the property were encumbered by a below-market lease: "a shipper would negotiate a lease which would make the fee as encumbered valueless or unmarketable for a period of years, then purchase the property for a small amount, thereby extinguishing the encumbering lease. The result would be that the shipper would have obtained valuable land for a pittance." 430 F.2d at 234.

The Texas Constitution prohibits governmental bodies like the Authority from selling public property for a "pittance." The sale of the Authority's property at Possum Kingdom to the lessees for less than the full price of the fee simple unencumbered by the leases would be a grant of a public benefit to the lessees in violation of Article III, Section 52. As such, the leases should not be considered when determining value of leased property sold to the lessee.

3. The burden of the lease should not be factored into the fair market value of the property when it is sold to the lessee.

Because of the merger doctrine and the prohibition against granting public funds or benefits to individuals, the valuation of property to be sold to lessees should reflect the fact that the lease will terminate at the time of the sale, and should not give any credit or discount to the lessee for any portion of lease burden that will no longer exist. In other words, the lessee will own fee simple title, unencumbered by the lease, after the closing, so the purchase price must reflect that benefit acquired. The only Texas authority directly on point holds that the lessee would receive an unconstitutional windfall if the property were valued as though still encumbered by the lease.

The Attorney General analyzed a proposed sale by the City of San Angelo of certain lands to the lessees of those lands. Tex. Att'y Gen. L.O. 98-082 (Sept. 28, 1998). The parties agreed that "fair market value" as determined by an appraisal was required, but they disputed the definition of "fair market value" and whether the "appraisal should consider the fact that the land is burdened for some period of time by the lease."

The opinion first held that the merger doctrine would apply to extinguish the lease, because it was a sale to the lessee:

> We conclude that, unless there is evidence that the parties do not intend the leased fee estate and the leasehold estate to merge upon the lessee's purchase, the two estates merge and the leasehold estate is extinguished. Significantly, the situation about which you ask involves a lessee purchasing the lot he or she currently leases; consequently, it is distinguishable from a situation in which a third party purchases real property that is subject to a lease.

Id. at 2. What the lessee acquired, therefore, was the full fee title to the land, unencumbered by a lease.

The opinion therefore concluded that "we believe that a lessee who purchases the whole of the city's estate, which include the right to receive rents for the term of the lease and the reversionary interest, *must pay for the whole of the estate*." *Id.* (emphasis added). The opinion went on to note that, if the purchase price were discounted "by subtracting the value of future rents," which was the lessee's argument, that would run afoul of the

constitutional prohibition against granting public funds or things of value to individuals. *Id.* at 2-3 (citing Tex. Const. art. III, § 52(a)). The only Texas authority directly on point thus holds that the fair market value of leased property sold to a lessee must be calculated as though unencumbered by the lease.[2]

4. Appraisal treatises are consistent with our legal analysis.

Our review of various appraisal treatises has not revealed any reference to the precise question presented here—how to value leased property that is being sold to the lessee. However, application of the appraisal guidelines, when considered in light of the fact that the lessee will own the entire fee simple estate as a result of the sale, also results in a valuation that does not consider the terms of the existing lease.

For example, one treatise reviewed sets forth certain conditions that must be met before any particular lease can affect the value of a leased fee estate, including the condition that "the *remaining term* of the lease must be long enough so that, if the property were placed on the market, a potential purchaser would recognize the lease and be willing to pay more or less for the property because of its existence." J.D. Eaton, Real Estate Valuation in Litigation, 389 (2d ed.). Of course, where property is being sold to a lessee, there is no "remaining term" at all, because the lease will be extinguished once the lessee acquires it. In another treatise, appraisers are guided to ask various questions in valuing leased fee interests, including questions about the remaining term of a lease, as well as various factors that might affect the parties' performance of the lease terms into the future, such as: *"What is the likelihood that the tenant will be able to meet all of the rental payments on time?"* and *"Is the lease written in a manner that will accommodate reasonable change over time, or will it eventually become cumbersome to the parties?"* Appraisal Institute, The Appraisal of Real Estate, 82 (12th ed.). In the context of a sale to a lessee, where the lease will be extinguished, these inquiries have no application. An appraiser would have to conclude, under these guidelines, that the existing lease cannot have any effect on the value of the leased fee estate when it is sold to the lessee. This conclusion is fully consistent with the mandate of the Uniform Standards of Professional

[2] Another Attorney General opinion concluded that the Sabine River Authority could sell surplus property, but noted that any such sale must "comport with the Texas Constitution." Tex. Att'y Gen. Op. GA-0371 (2005). Specifically, the opinion noted that art. III, section 52, limits a governmental body's "authority to aid individuals and private entities" and cautioning that any such sale not be "a gratuitous transaction." *Id.* at n.4.

Appraisal Practice, which provides that "[w]hen developing an opinion of the value of a leased fee estate...an appraiser must analyze the effect on value, *if any*, of the terms and conditions of the leases." Stds. Rule 1-4(d) (emphasis added). The emphasized phrase "if any," gives an appraiser the ability and discretion to conclude, as he should in the case of a sale of the leased fee to the lessee, that the lease terms and conditions may not have any effect at all on the value of the fee simple interest.

IV. CONCLUSION

Under both the merger doctrine and the prohibition against granting public funds to individuals, the valuation of property to be sold to the lessees should reflect the fact that the lease will terminate upon closing and the lessee will acquire the entire fee title to the property. The sales price therefore should not give any discount to the lessee for any portion of lease burden, because that burden will no longer exist after the sale. The only Texas authority directly on point so provides, and the constitutional prohibition against the grant of public funds operates here to prohibit any windfall to lessees by allowing them to acquire the full fee title in the property without paying for the full fee title.

Sincerely yours,

Jennifer Knauth

JK:ew