Who Owns the "Fixtures" When the Lease Expires?

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Here, the author offers a few practical measures that landlords and tenants, and their advisors, can take to minimize the risk of protracted, and expensive, disputes over who owns what fixtures at critical stages of the landlord-tenant relationship.

When a lease expires, it is not uncommon for landlords and tenants to dispute what constitutes the landlord's property and what constitutes the tenant's property, even when sophisticated parties and equally sophisticated leases are involved. Ownership disputes also can arise when the tenant defaults and the landlord sues to terminate the lease and recover possession of the premises. What constitutes the "premises" is not always as clear as one might think, however. Finally, ownership disputes can arise in the context of a bankruptcy when creditors, including the landlord, the tenant, and the trustee, contest ownership of the tenant's assets.

Some Basic Principles

Land and buildings are quintessentially "real property" and revert to the landlord when a lease expires or is terminated. Except in rare instances, there is no dispute over who owns the land and the building. The ownership issue is less clear when it concerns tenant improvements and installations that are substantially integrated into the premises, such as complex refrigeration systems, extensive boiler systems (and related distribution lines, pumps, and water-softening tanks), wall-mounted forklift charging stations, pallet racking, and similar equipment in an industrial facility. Are these items the tenant's personal property that the tenant is entitled to remove, or are they so integrated into the building that they constitute a part of the landlord's reversionary interest in the premises?

State law generally provides definitions and basic principles that eliminate simple cases. Property is either "real property" or "personal property." Real property is "immovable" and includes land and buildings. Personal property is "movable" and includes furniture, fixtures, and equipment the tenant uses in its trade or business and is entitled to remove at lease expiration. Such personal property usually is defined as a "trade fixture." Unfortunately—and the source of almost all ownership disputes in this area—real property also includes property that in fact can be removed but is "affixed" to or "imbedded" in the land or a building to such an extent that it cannot be removed without "injury" or "damage" to

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the land or building. Such hybrid property commonly is defined as a "fixture."

Leases sometimes embellish these definitions and basic principles. For example, injury or damage upon removal often must be "material" for an item to be characterized as a real property fixture rather than a trade fixture. However, "materiality" is of limited assistance when each side is motivated to leverage any lack of objective certainty to its advantage. The party that paid for the item does not necessarily prevail in these disputes.

Most state laws and sophisticated leases provide that even an item that otherwise might be a trade fixture before it is installed becomes the landlord's property at lease expiration or termination if it is sufficiently attached to or incorporated into the premises.

One Landlord's Unfortunate Experience

The author is familiar with an unfortunate case in which a private equity fund subsidiary purchased a very large, FDA-certified refrigerated food-processing facility. The tenant, also a private equity fund subsidiary, had purchased the food-processing business from the original founders of the enterprise. A long-term lease between the founders' land-holding entity and their operating entity was in place at the time of all the purchase and sale transactions. Accordingly, neither party to the lease was an original participant in the creation of the landlord-tenant relationship. Within a relatively short time, the tenant went into bankruptcy.

The landlord obviously was distressed to lose its tenant, but became even more distressed when the trustee in bankruptcy claimed that all the boilers, refrigeration coils and compressors, water-softening equipment, and many other items the landlord considered necessary to operate the facility as an FDA-certified refrigerated food-processing facility, were removable trade fixtures and not owned by the landlord. In theory, all these items could be removed, though in some instances it would be a major endeavor and significant repairs would be required.

Moreover, without these items, the facility could not be operated as a food-processing facility, which had been the facility's intended purpose since construction. The bankruptcy trustee elected to litigate ownership. Knowledge of who had paid for and installed the contested property might have helped the tenant, but neither the tenant nor the landlord was an original party to the lease. Documentary evidence, such as purchase invoices and depreciation schedules, was sketchy. In any event, the lease provided that "fixtures" became the landlord's property at lease expiration or termination.

The landlord made the business-driven decision to settle, paying $2.5 million for equipment affixed to and, in many cases, imbedded in the premises that was integral to its operation for its intended purpose. Now, the landlord had no tenant and, in its mind, had paid $2.5 million to "purchase" its own property!

Some Practical Suggestions to Manage Uncertainty

Can situations like this be avoided, or at least mitigated? In the example above, neither party could do much about the lease itself since it already was in place when they came upon the scene, but the lease negotiation stage usually presents the best opportunity to address the personal property

"trade fixture" vs. real property "fixture" challenge.

The following are some suggestions for landlords and tenants:

- It is extremely difficult to craft definitions of key terms sufficiently well to eliminate disputes, but the likelihood of disputes can be reduced with thoughtful drafting. For example, the landlord in our illustration would have had a stronger case if the lease had provided that fixtures that are necessary to the operation of the building for its intended purpose constitute landlord's property regardless of when they were installed or by whom. Alternatively, a tenant would want fixtures to remain its property unless removal caused damage that could not (reasonably) be repaired.

- When possible, it is useful to list and categorize existing or to-be-installed items that are highly susceptible to controversy in a schedule to the lease. The landlord burned in the example above insisted on extensive scheduling of "landlord's property" and "tenant's property" when it finally found a replacement tenant. The landlord also took advantage of the opportunity to include extensive provisions relating to the maintenance, repair, and replacement of scheduled items, including detailed language regarding the tenant's right to abandon items that no longer were of productive use and who owned "landlord's property" that the tenant replaced during the lease term. These precautions benefited both parties by providing some clarity.

- The landlord in the illustration above had the facility carefully inspected at the time of purchase, but it did not incorporate the information in the inspection report into the purchase agreement in any effective way.

  For example, the landlord did not include a schedule of "landlord's property" adequately supported by one or more seller representations and warranties. The survival period of the representations and warranties and related indemnity provisions may not have been sufficient to provide a remedy against the seller when the actual dispute with the tenant arose but, if nothing else, scheduling with supporting representations and warranties would have compelled the parties to pay attention to these issues, thereby reducing the likelihood of them arising unexpectedly in the future. A buyer of a business operated from leased premises can make similar good use of inspections, scheduling, and representations and warranties to protect its position.

- The landlord also obtained an estoppel certificate from the tenant, but the certificate addressed "customary" matters such as term expiration date, rental rate, rent adjustments, options to extend the term, and whether any defaults existed. Although a buyer cannot abuse a tenant by demanding confirmation of information well beyond custom and practice, some lease provisions on the subject of the tenant's obligation to provide estoppel certificates contain omnibus language that may afford the opportunity to include at least some useful information on the subject of landlord's property and tenant's property. From the buyer-tenant perspective, the document evidencing the landlord's consent to the lease assignment or sublease of the

premises can be crafted to include confirmation of the status of fixtures that may become the subject of lease-end disputes.

- Typical lease provisions regarding the landlord's prior consent to the tenant's installation of fixtures and trade fixtures also can be helpful to both landlords and tenants. In industrial facilities, tenants often negotiate for broad authorization to alter and improve the premises but, even if the landlord agrees to this, requiring prior written notice to the landlord at least establishes a paper trail of who installed what and when and gives the parties the opportunity to discuss whether, at lease expiration, a particular installation may trigger an ownership controversy.
- Though it may be too little, too late in some instances, a landlord and tenant walk-through of the premises before the tenant moves out affords the parties the opportunity to discuss their expectations and avoid last-minute surprises. It is more difficult to find common ground after the tenant moves out than before.

This short discussion omits other parties that can become engaged in ownership disputes, such as the landlord's lender and the tenant's lender, but the discussion hopefully offers a few practical measures that landlords and tenants, and their advisors, can take to minimize the risk of protracted, and expensive, disputes over who owns what at critical stages of the landlord-tenant relationship.