Chapter 10
Legal Issues re. CLT Ownership

The CLT lease creates a distinctive legal framework within which the ownership interests of the CLT and the CLT homeowner are defined and the rights of the two parties are sorted out with regard to a particular piece of property. The structure involves a "fee interest" in the leased land held by the CLT, and a "leasehold interest" (or "leasehold estate") held by the homeowner. In most cases the homeowner's leasehold interest is accompanied by or includes deeded ownership of the house and other improvements on the leased land. This chapter addresses some legal and practical questions that may arise regarding the CLT ownership structure and that are likely to be of concern to CLTs and their attorneys. Also, regarding the nature of the restrictions normally imposed on the ownership rights of the CLT homeowner, see Chapter 8, "Implementing Restrictions on Ownership." Regarding the enforceability of these restrictions, see Chapter 9, "Enforceability of the CLT's Preemptive Right."

Legality of Separation of Interests in Land and Buildings

With few exceptions, CLT leases provide for separate ownership of land and improvements. In a few jurisdictions, CLTs have been advised against using leases that provide for deeded ownership of the improvements by the ground lessee (see discussion below under "Leases that Do Not Separate Title to Improvements"). When it is possible, however, the preferred approach is for the ground lessee to have fee ownership of the improvements, which is usually conveyed with a deed. This approach is rooted in the philosophy that gave rise to the CLT model – a philosophy that views land as a finite resource in which all members of a community have a necessary interest, while viewing improvements as human products in which the particular individuals who produced or subsequently purchased them have a particular interest. And, for most CLT homebuyers, having a deed to a building conveys a stronger sense of ownership than is conveyed by having a leasehold interest in a building – even when the rights and monetary value conveyed by the two are more or less the same.

Though leases and deeds represent generally familiar concepts, the CLT's separation of title to land and buildings is not a familiar practice for many people. Some may even argue that it is "legally impossible," in spite of the fact that the practice is not unique to the CLT model and is relatively common in many other situations. As a general rule, there is no legal prohibition against the creation of separate ownership interests in a building and the underlying land. In fact, the horizontal division of what was once a single unit of real estate is no more difficult and causes no more confusion than the more common vertical division of a cornfield into the separate lots of a subdivision. In both situations, the owner of an estate in real property is simply selling a portion of her interest in that real property. She may divide her property along a horizontal, vertical, or inclined plane or in any manner according to her desire.[1]

More specifically, it is clear that ownership interests in improvements can be transferred independently of the land on which they are located. Even parts of buildings, as in the case of a condominium, may be considered to be independent units of real estate and as such may be alienable. It is well established that ownership interests in improvements as between buyers and sellers of realty are determined by reference to the intentions of the parties, as might be

expressed in or inferred from a written agreement such as a purchase agreement or deed.[2]

Separation of ownership of land and buildings as between lessor and lessee is also a long-standing practice that modern-day courts have little trouble in upholding. In two tax cases where ownership of buildings separate from the underlying realty was disputed, the New York Court of Appeals has said: "...no doubt there is power by agreement to separate title,"[3] and "...nor is there any reason in law or policy why there may not be a separate ownership of buildings apart from lands on which they rest .... nor is there any ground in the natural order which makes unworkable such a concept of separate ownership."[4]

In fact such separate ownership is quite common. Long-term commercial ground leases, for instance, are usually transactions in which the landlord leases unimproved real property which the tenant develops. Such leases frequently provide for the demolition of existing structures on the land and the erection of new ones, with title to the new buildings vesting in either the landlord or the tenant as provided by their agreement.[5] Mobile homes located on leased mobile home park lots, where not considered to be personalty, provide another common example of separate ownership. Also, in many jurisdictions, condominiums may be built and owned on leased land.

Removal of Improvements from Leased Land

When the ownership of land and improvements is separated between ground lessor and ground lessee, the question of the lessee's right to remove the improvements from the leased premises is an important consideration for both parties. Community land trusts generally have a strong interest in seeing that improvements are not removed. A CLT that has developed affordable housing or otherwise improved land for the long-term benefit of the local community has a clear interest in seeing that the improvements are not removed from the CLT's land and that the benefits provided by the improvements on that land are not lost to the community. To protect this interest, a CLT can, as a condition of the ground lease, prohibit the removal of improvements. The Model CLT Ground Lease contains such a prohibition (Section 7.1). Nonetheless, there may be situations in which a CLT has reason to allow the removal of at least certain improvements, and some CLTs have in fact entered into lease arrangements that allow removal. It is therefore relevant to review some of the consequences of a lessee's right of removal when such a right is allowed under a ground lease.

One of the consequences of separation of ownership of land and improvements is that the two ownership interests can interfere with each other at the end of the lease term, making the timing of any removal an important consideration in the drafting of the lease agreement. Where the right of removal is provided but with no agreement as to time of removal, a number of states have adhered to the original common law rule that improvements must be removed before the expiration of the term or be forfeited.[6] However, most states have evolved some exceptions in the face of the potential harshness of the rule. For example, if the length of the term is uncertain or if the lease is terminated prematurely (say, as the result of a default by the lessee), then a majority of the courts have allowed the lessee a "reasonable time" after termination to remove her improvements. Reasonable time is held to vary with the facts and circumstances of the case.[7]

It should be noted that the Model Lease not only prohibits removal of the improvements but provides that title to the improvements shall revert to the CLT upon the termination of the lease (Section 7.7). In the event of such reversion, however, the Model provides for compensation to the lessee in the amount of the purchase option price as determined by the

formula set forth in the lease. Given this provision for compensation and given the difficulty and expense of moving and re-establishing a major structure on a new site, it is unlikely that a CLT lessee would want, or be able, to remove such a structure even if her lease permitted removal. Greater economic advantage would normally lie in selling rather than removing the structure.

Questions regarding removal are more likely to come up in connection with smaller improvements that are more readily movable and that may be moved independently of any major structures on the premises. If a CLT wishes to allow the removal of any such items, it should be careful to specify in the lease exactly what may be removed, under what conditions, during what period of time. In drafting these terms the CLT will of course be concerned with the effect of the removal of the improvement on the value and usefulness of the premises and remaining improvements.

Definition of Improvements

When titles to land and improvements are separated, it is obviously important that the exact nature of each party's ownership interest and the exact division of interests intended by the CLT be carefully defined. Two types of distinctions are important for the CLT in this regard.

First, it is important to distinguish between those things that are included as parts of the house and other permanent improvements owned by the lessee (collectively termed the "Home" in the Model Lease) and those things that remain a part of the premises owned by the CLT (the "Leased Land" in the Model Lease). Is the basement of a building included in the improvements? Are the pipes leading from the building to the street a part of the improvements or of the premises? Answers to questions such as these may affect various issues relating to liability and responsibility for repairs – though the Model Lease assigns to the homeowner (lessee) *all* liability and responsibility for repairs relating to *both* the Home (the improvements) and the Leased Land.

A second distinction must be made between those things owned by the lessee as improvements to the realty and other items owned by the lessee as personalty (personal property, as opposed to real estate). As noted above, a CLT ground lease normally prohibits or restricts the removal of improvements. It does not restrict the removal of personalty. Nor does the CLT have a preemptive option to purchase items owned by the lessee as personalty. Obviously it is important to distinguish clearly between the two types of lessee property. (This distinction can be blurred, however, in jurisdictions where the practice is to give the ground lessee a bill of sale, rather than a deed, for the improvements. Since a bill of sale is normally used to document the sale of personalty, and since personalty is normally assumed to be removable, it becomes especially important to define the improvements as specifically as possible and to explicitly prohibit their removal.)

CLTs may also be concerned with yet another distinction, involving a different, though closely related, definition of the term "improvement." This is the distinction between "improvements" to an existing structure (which add value to the structure) and "repairs" (which renew or restore pre-existing value) – a distinction that has a bearing on some tax questions and that figures in some CLT resale formulas. An item classified as a repair in this sense (say, new siding replacing damaged siding) may still be classified as an improvement (or a part of an improvement) in the sense discussed above (it is neither removable personalty nor a part of the underlying land). The distinction between improvements and repairs is

discussed in Chapter 12 in connection with "resale formula design." The discussion below is limited to the definition of improvements as distinct from the leased premises on the one hand and from the lessee's personalty on the other hand.

If the general term "improvements" (or the term "Home" as in the Model Lease) is used in a lease agreement instead of an itemization of particular improvements, then in certain circumstances a court may have to decide whether certain items are in fact improvements. A body of law has evolved defining what items are or are not improvements, but courts will first look to the context and contents of the lease in making their determination. If there is any question about whether certain items are or are not improvements, then the drafters of the lease should itemize.

The courts reveal virtually no disagreement as to whether buildings on permanent foundations should be classified as improvements. However, there are many other items that are less easily classified. Generally, the term "improvement" is not considered to include everything placed on land that is leased. Only those items of a permanent nature (excluding business trade fixtures) that are somehow annexed to the realty with an intention to make them part of the premises will be found to be improvements where the lease does not indicate otherwise. The ease or difficulty of removal of a disputed improvement is not necessarily the decisive test.[8]

Items within buildings that have been held to comprise improvements include (to name a range of examples) structural alterations, stages, doors, locks, awnings, and (more generally) anything that renders the premises more available, profitable, or useful but that is not akin to personalty.[9] Heating and air conditioning systems and their components have been held to constitute improvements. However, where these or similar items are not substantially attached to the premises (e.g., a window air conditioner) or where they are considered to be trade fixtures, they have not been classified as improvements.[10]

Outside of buildings, drains and ditches are counted as improvements if they comprise lasting systems for carrying off surface water or for irrigating land. The preparation of land for agriculture and the preparation of land for building sites are generally considered to be improvements to the land, as are fences and sidewalks or driveways. Orchards have been held to be improvements,[11] but most agricultural plantings of annual species would be viewed as impermanent personalty. The general rule is that improvements do not include those changes made merely for the temporary enjoyment of the present tenant. Accordingly, short-term fertilization of land is normally not considered to be an improvement,[12] but lasting improvements of the soil may qualify.[13]

Again, whenever questions can be raised as to whether certain items should be classified as improvements, the CLT ground lease should itemize and/or define improvements so as to answer the possible questions clearly. The particular items in question will vary depending on local circumstances and the goals of the particular CLT.

Leases that Do Not Separate Title to Improvements

In a few jurisdictions, attorneys have found reason to question the practicality, if not the legality, of separating title to improvements on land leased from a CLT. The obstacles in these cases have not been a matter of outright prohibition of separation. Rather, people who regularly deal with real estate transactions in these jurisdictions have found that applicable law and practice either do not clearly support the separation of title or may give rise to practical problems when it comes to recording title to, mortgaging, or taxing property where

land and buildings are separately owned.

In a few instances, attorneys in such jurisdictions have advised CLTs to use a lease that does not recognize separate, deeded ownership of the improvements, but does provide for the purchase of a long-term leasehold interest in the entire property (both land and improvements). The price paid for such a leasehold interest (or "leasehold estate") need not differ from the price that a CLT homebuyer would otherwise pay for a fee interest in the improvements and a leasehold interest in the land. Nor do restrictions on the resale of such a leasehold interest need to differ from other CLT resale restrictions (though the language in which appraisal-based resale formulas are described may need to be modified). In fact, almost all of the rights, restrictions and obligations that the more common type of CLT lease establishes for lessee and lessor can also be established by a lease that does not provide for separate ownership of the improvements. CLTs taking this approach have had little trouble adapting the Model Lease to their circumstances.

It should also be noted that the mortgageable value of a leasehold estate is not affected, one way or the other, by separate ownership of the improvements – as evidenced by the following statement in FHA handbook 4150.1 (Chapter 6, Section 5, Leaseholds):

> "The Leasehold Estate may consist of both the improvement and the land, although in most cases the improvement is purchased in fee simple, subject to ground rent."

The methods by which leasehold estates are to be appraised, as prescribed by Fannie Mae and Rural Housing Services, as well as FHA, among others, do not treat the value of improvements separately from the value of the overall leasehold estate (see Chapter 20, "Financing CLT Homes."

Property Taxation

Important questions relating to property taxes include (a) the question of whether separately owned land and improvements can be assessed and taxed separately, and (b) the question of whether the lessee (whether owning the improvements or not) can be required to pay the taxes on the CLT's fee interest in the property. The answer to the first question is that separately owned land and improvements can be and are assessed and taxed separately in most states. The answer to the second question is that CLT lessees are, as a practical matter, obligated to pay the taxes on both their own and the CLT's property – but not always in the same way. The current version of the Model Lease specifically assigns direct liability for taxes and assessments on *both* land and improvements to the lessee (Section 6.1). The earliest version of the Model Lease did not assign liability for taxes on the land to the lessee but, instead, added the cost of these taxes to the lease fee. (See Chapter 13, "Establishing and Collecting Fees," for a discussion of the pros and cons of the two approaches.) Tenants have not traditionally been liable for property taxes due on leased land, so it is important that the CLT lease explicitly assign the obligation to pay this tax – directly or as a component of the lease fee – to the lessee. Tenants *are* customarily liable for taxes due on improvements that they make to, or own on, leased land; Nonetheless, the ground lease should explicitly assign responsibility for taxes on improvements as well as land to the lessee, as the Model Lease does.

Special assessments to cover the cost of public improvements such as streets and sidewalks have been held not to be included in the term "taxes," so the lease should specify that the lessee is responsible for paying assessments as well as taxes. The Model Lease does so specify (Section 6.1).

Local practice varies greatly on what assessors are willing to do as a matter of administrative practice. In some tax jurisdictions it may be difficult, if not impossible, to get separate tax bills for land and improvements (or for leased fee and leasehold estate). The lack of separate bills need not be a problem, however, as long as responsibility for paying all taxes is assigned to the lessee. (The more important question of whether local assessors will recognize the effect of the lease on the assessed value of the property is discussed in Chapter 17, "Property Tax Assessments.")

The interplay between assessment and due dates for taxes and lease term can be dealt with in the lease. Payment of taxes on a pro rata basis for the time covered by a lease is the usual resolution, and is the judicial rule in some jurisdictions.

If taxes are not paid by the responsible party, then the other party may wish to pay the tax to protect its interest in the property and hold the defaulting party indebted to it. The CLT may treat delinquent taxes owed by the lessee as delinquent rent and add them to the lease payments.[14] Such a provision is contained in Section 6.4 of the Model Ground Lease.

Owner Liability

In the typical CLT arrangement (regardless of whether improvements are deeded to the lessee or not), the lessee-homeowner is subject to the same liabilities as any other homeowner. For purposes of determining liability, property law has traditionally regarded a long-term lease as it would a sale of the premises for the term of the lease.[15] It is true that modern landlord-tenant law has made the landlord in a typical residential situation much more responsible for the condition of the premises and, in some situations and jurisdictions, has prohibited the landlord from shifting some risks to the tenant. Nevertheless, the 99-year lease arrangement that is typical of the CLT model should be viewed more in terms of traditional property law than in terms of modern, residential, consumer-oriented landlord-tenant law. Therefore, generally, the CLT as lessor probably should not be under any obligation to anyone for conditions that develop on the premises after the tenant is in possession.[16]

However, the CLT would be obligated to disclose to the resident any concealed dangerous conditions in existence when possession is transferred of which it has knowledge.[17] Also, the CLT may not be able to shift to the resident its liability to the public and adjoining landowners for certain dangerous defects, hazardous waste, and possibly other conditions that are the subject of specific statutes in a particular jurisdiction.[18]

The Model Lease assigns "sole responsibility and liability" to the lessee/homeowner (Section 9.1) and requires the lessee to carry liability insurance and name the CLT as additional insured (Section 9.4). Given this fact and the approach to liability taken by traditional property law as described above, it is highly unlikely that a situation would arise in which the CLT could be held liable in a way not covered by the lessee's insurance. Nonetheless, most CLTs have wanted to carry their own liability insurance covering whatever residual liability they might still bear with regard to their fee interest in the property. Many CLTs, however – especially those with smaller holdings – have not been able to find reasonably priced insurance to cover just this residual liability and have therefore been forced to choose between going without such insurance and purchasing expensive policies developed for conventional landlords. CLTs with larger holdings have been more successful in negotiating policies appropriately priced for their circumstances. (CLTs should be reminded that they will need to arrange full insurance coverage for any periods of time when they have exercised a purchase option and reacquired fee simple ownership of a property.)

Local Legal Counsel

The legal questions that arise from the creation of very long term leasehold estates and from the separation of ownership interests in buildings and land are not unique to the CLT. In fact, carefully drafted agreements, such as leases based on the Model CLT Lease, will usually be controlling whenever a question arises. Nonetheless, CLTs should consult with an experienced local real estate attorney in adapting the Model Lease for its own CLT homeownership program.

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[1] Piper v. Taylor, 48 N.D. 96 Y, 188 N.W. 171, 172 (1922) (real estate may be divided upon perpendicular or lateral lines); Griffin v. Fairmont Coal Co., 59 W. Va. 480, 53 S.E. (1905) (person who owns entire estate may sell and convey any part of it).

[2] Madison v. Madison, 206 nl. 534, 69 N.E. 625, 627 (1903) (ownership of land is not confined to surface but extends indefinitely downwards and upwards); Thorn v. Wilson, 110 Ind. 325, 11 N.E. 230, 231 (1887) (intention of parties and subject matter of agreement define nature of interest); Hahn v. Baker Lodge, A.F. & A.M., 21 Or. 30, 27 p. 166,166-67 (1891) (grant of freehold interest in part of building construed according to intention of parties). See generally, 23 Am. Jur.2d., Deeds 810.

[3] U.S. v. Tax Commissioner of City of New York, 254 N.Y.S. 2d. 785, 788 (N.Y. App. Div. 1964).

[4] National Cold Storage v. Boyland, 227 N.Y.S. 2nd. 147, 150, aff'd 236 N.Y.S. 2d. 62, 187 N.E.2d. 129 (N.Y. App. Div. 1962).

[5] 2 Powell on Real Property (MB), section 242 [1]b[ii].

[6] Annot., 6 A.L.R.2d. 322 (1949).

[7] Ibid.

[8] 51C C.J.S. Landlord and Tenant, section 394(3) 1968).

[9] Wright v. LeMay, 118 N.W. 964 (Mich. 1908); French v. N.Y., 29 Barb. 363, 16 How. Pr. 220 (N.Y. App. Div. 1859); Sanders v. Lefkovitz, 292 S.W. 596 (Texas 1927); Smusch v. Kohn, 22 Misc. 344, 49 N.Y.S. 176 (N.Y. App. Div. 1898); United Booking Offices v. Pittsburgh Life and Trust Co., 65 Misc. 31, 119 N.Y.S. 216 (N.Y. App. Div. 1909).

[10] Matz v. Miami Club, 127 S.W.2d. 738 (Mo. App. 1939).

[11] 19. Ferrell v. Ormond Mining, 176 N.C. 475, 97 S.E. 886 (1918); Root v. McFerrin, 87 Miss. 17 (1859).

[12] Tollefson, supra.

[13] 22. Pritchard v. Williams, 181 N.C. 46, 106 S.E. 144 (1921); Dunham v. Davis, 101 S.E.2d. 278 (S.C. 1957).

[14] Rich v. Don-Ron Trousers Corp., 343 N.Y.S.2d. 684 (1973).

[15] Thomas v. Barnes, 634 S.W.2d. 554 (Mo. App. 1982); Shackett v. Schwartz, 77 Mich. App. 518, 258 N.W.2d. 543 (1977).

[16] Powell v. United Oil Corp., 160 Ga. App. 810, 287 S.E.2d. 667 (1982i (lessor of gas station not liable for plaintiff's emotional distress when she was observed while using facilities through peephole in restroom mirror); SpinelIi v. Golda, 6 N,I. 68, 77 A. 233 (1950).

[17] Second Restatement of Torts, 358; Property, 17.1.
[18] Whalen v. Shivek, 326 Mass. 142, 93 N.E.2d. 393 (1950).