How *Not* To Purchase An Outparcel

A case study of how an outparcel can give developers and retailers a real headache.

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Although most shopping center professionals and their lawyers are very familiar with outparcel development, a recent sale that encountered some serious pitfalls is worth recounting to provide a guide for some issues that can cause both heartache and heartburn. This article will cover, in some detail, several issues that arose in the sale.

A suburban Chicago shopping center with both a grocery store and a home improvement store as anchors had leased the end cap space to Retailer X. During the course of the negotiations, Retailer X obtained a "no build" restrictive covenant over an area that covered a portion of the proposed outparcel that was to-be-developed in order to preserve Retailer X's visibility from the road in front of the center. The site plan that delineated the no-build area was attached to both the lease itself and the memorandum of lease that was subsequently recorded against the shopping center property that included the outparcel.

Several years later, Retailer X filed for Chapter 11, and subsequently was liquidated to provide the maximum recovery for all of the company's stakeholders. During the Chapter 11 proceedings, several of Retailer X's leases were assumed and assigned for value to Retailer M. Retailer M opened its business, a nearly identical use, in the leased premises as the assignee of Retailer X.

Prior to the assignment, Bank A purchased the outparcel in question with full knowledge of the no-build restriction and its area. Its plans for construction did not encroach into the no-build area. Nevertheless, Bank A obtained the consent of Retailer X for its construction plans and also required the shopping center owner to indemnify Bank A from any claims by Retailer X in the event any issue arose out of the construction of Bank A's facility.

A change in strategy at Bank A led its management to sell the outparcel to Bank F. In the contract for the sale, Bank A provided representations and warranties to Bank F that Bank A was conveying marketable title free and clear of all defects and Bank A's warranty of title survived closing for a period of 1 year. Notably, however, Bank A did not disclose to Bank F the existence of the no-build restriction encumbering the outparcel. Concurrent with the purchase, Bank F obtained a policy of title insurance for only the purchase price of the outparcel, which insured good and marketable title. The title insurance company's title commitment did not disclose the existence of the no-build restriction. Also, the shopping center owner, under an amendment to a reciprocal easement agreement, reviewed and approved Bank F's construction plans, which plans did encroach into the no-build restriction. Like Bank A, the shopping center owner knew about the no-build restriction, but did not provide notice to Bank F when it reviewed Bank F's construction plans.

After the commencement of construction of Bank F's facility (excavation, concrete foundation, steel beams and roof trusses having already been erected), Retailer M filed suit to enforce the restrictive covenant, enjoin Bank F's construction and positively enjoin Bank F to relocate its branch bank outside of the no-build restriction. Bank F, through its real estate counsel, tendered the claim to the title company and the title company hired counsel to defend the lawsuit. Initially the trial court ruled for Bank F finding that it did not have notice of the restrictive covenant and therefore, it was a bona fide purchaser with clear title. But Retailer M appealed and the appellate court reversed finding that Bank F had inquiry notice of the covenant. The basis for the finding of inquiry notice was a recital contained in the amendment to the reciprocal easement agreement, which Bank F signed, and which referenced a deed that separated ownership of the outparcel from the shopping center when Bank A purchased the outparcel. The deed, which Bank F had not seen, identified Retailer X's lease and the memorandum of lease. During the appeal, Bank F's rights to proceed against Bank A on the warranty of title had lapsed.

After the appeal, the client contacted new counsel for advice. New counsel replaced the lawyers that had been retained by the title company, defended the main claim on the covenant, presented and preserved claims against the title company, Bank F's former professional advisors, and presented different third-party claims against Bank A, Bank A's professional advisors and the shopping center owner.

A settlement was reached, with Bank F only funding 5 percent of the settlement payment to Retailer M for the breach of the no-build covenant. Bank F also obtained title insurance covering the full cost of the land and construction.

The situation described above encountered many issues to be addressed in the purchase of a shopping center outparcel. They are:

1. When buying an outparcel for subsequent development, be sure that the title company provides a commitment to increase the amount of title insurance to cover later construction and development costs.

2. When buying an outparcel, extreme care must be devoted to reviewing the title commitment, and all of the underlying documents. The appellate court ruled that Bank F had inquiry notice, i.e., it was aware of facts that should have raised a red flag causing Bank F to inquire further into the nature of all easement agreements AND lease agreements. The appellate court thought it an easy task to determine if lease agreements may potentially affect title to an outparcel and should be reviewed as a matter of course in a transaction such as this.

3. In the contract for the purchase of an outparcel directly from the shopping center owner, either from the original developer of any subsequent purchaser, be sure to obtain representations and warranties regarding any restrictive covenants and providing that there are no such covenants that would prevent development of a building on the parcel in accordance with plans approved by the parties to the contract. Also, if construction plans for the outparcel are to be reviewed by the shopping center owner under an REA, state the reasons why approval is being sought, i.e., "to ensure that construction will be in conformance with all shopping center owner's lease obligations.

4. In the contract for the purchase of an outparcel from a party other than the original developer, such as the subsequent owner of the outparcel, in addition to the representations and warranties described in number 3 above, try to have the present owner join the contract solely for the purpose of providing an estoppel regarding any restrictive covenants that may affect the parcel in question. **SCB**

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