

LEASEHOLD TITLE INSURANCE: A PATHWAY TO CLOSING*

Law school teaches that real property consists of a bundle of rights associated with certain estates or interests, foremost of which is the fee simple absolute. Much has been written about the insurability of fee estates. This article will discuss title insurance products for leasehold estates and their practical value in consummating significant commercial lease transactions.

Just like fee owners and fee mortgagees, certain prospective tenants, tenants' assignees and leasehold lenders can benefit from the information furnished in a title report and the subsequent protections of a leasehold title insurance policy. Nonetheless, only a few long term lessors of high value real property with costly leasehold improvements purchase leasehold title insurance unless their lenders simultaneously purchase it, thus affording such lessors a discounted premium rate. This is counter-intuitive, given that the impairment or loss of a long term leasehold estate due to a title claim or failure of title can be every bit as devastating to the tenant as such a loss or claim might be to a fee owner. In addition, the leasehold endorsement to the 2006 ALTA owner's policy expands the policy as to the computation of loss or damage and identifies compensable items of loss for a policy insuring a leasehold.

The value question of whether or not to purchase a Leasehold Owner's title insurance policy is a secondary consideration. First, let us focus on what information can be derived from a leasehold title report:

(1) Who is the fee owner of the premises (and thus the party with the authority to execute the lease as landlord)? Is there an overlandlord? Does this raise consent/recognition/ estoppel issues?

(2) What judgments and liens have been recorded against the fee estate? Does this raise creditworthiness concerns about the landlord?

(3) If there is a mortgage(s) recorded against the fee estate, is it current or in foreclosure? If current, does this raise consent/non-disturbance/estoppel issues?

(4) Are there any covenants or restrictions in deeds or easements of record that might limit the tenant's intended use of the premises? A covenant prohibiting the sale of alcoholic beverages could be disastrous to a tenant who intends to open a restaurant.

(5) Are there any purchase options or reversionary rights? Changing landlords in the middle of the term of a lease can be problematic.

The answers to these questions can provide valuable negotiating leverage (or at least a reality check) to a prospective tenant or assignee. A leasehold title report is inexpensive, can provide possibly critical due diligence, and, just as in a fee transaction, will establish a pathway to closing, identifying issues to be resolved prior to lease execution.

But what about paying the premium to turn that title report into a leasehold owner's policy?

What does a Leasehold Owner's Policy insure?

Leasehold title insurance has evolved since the first ALTA forms were introduced in 1975, tracking the growing complexity of leasehold transactions. In addition to insuring the possessory rights conferred by the lease, the Leasehold Endorsement to the 2006 Revised ALTA Owner's Policy addresses a host of collateral concerns:

1. Increase in market rent rates when rent is payable to a person having paramount title to the lessor under the lease;
2. If the tenant's leasehold improvements are not substantially completed at the time of eviction, the cost, less the salvage value, for the leasehold improvements up to the time of eviction (including costs of: land use, zoning, building and occupancy permits; architectural, engineering and construction management fees; environmental testing and reviews; landscaping; and fees, costs and interest on acquisition and construction loans);
3. Cost of relocating and repairing movable equipment and personalty to a new site within 100 miles;
4. The cost to secure a replacement leasehold equivalent to the lost leasehold;
5. Rent the tenant must continue to pay its landlord if the tenant is evicted from part of the leasehold estate;
6. The fair market value of the insured's interest as lessor in any lease or sublease of all or part of the leasehold estate or the tenant's leasehold improvements;
7. Damages the tenant may be obliged to pay its subtenant; and
8. Defense of title claims adverse to the tenant's leasehold estate.

Coverages 1 through 7 above have no corresponding provisions in fee title insurance policies. These unique coverages have been expressly crafted to protect leasehold owners and lenders and address critical financial risks. Practitioners should discuss the value of these protections with their tenant clients before electing not to purchase a leasehold owner's policy.

How is the value of a leasehold estate determined?

While the liability amount of a lender's leasehold policy is based on the amount of the mortgage (just as in insuring a mortgage on a fee estate), the various states use a formula similar to New York's to determine the amount of insurance to purchase for a leasehold owner's policy.

In New York, Section 7(A) of the Title Insurance Rate Manual of the Title Insurance Rate Service Association, Inc., approved by the New York State Department of Insurance (now a part of the State's Department of Financial Services), provides in pertinent part:

"(1) For leases having a term of six (6) years or less, an amount equal to the aggregate of the total rents payable under the lease; or

(2) For leases having a term of more than six (6) years, an amount not less than the aggregate of the total rentals for the six (6) years immediately following the closing of the lease transaction...; or

(3) Not less than the fair market value of the land and improvements at the time of closing of the leasehold transaction; or

(4) Not less than the appraised value of the land and improvements at the time of the closing of the leasehold transaction."

Note that, in (A) (1) above, whereas the six years or less term is regardless of whether part of the term has elapsed, it is unclear whether "total rents payable" includes only the base rents (thus excluding so-called additional rent comprised of real estate taxes, insurance premiums and other charges). (A)(2), specifies that "on percentage leases, a statement of estimated rent may be used."

Section 7(A) also includes methodology for calculating the amounts of insurance applicable for (i) proposed construction ("the projected cost of improvements may, at the option of the insured, be added to the amount specified in (1 through 4, above)"; and (ii) an assignment of a leasehold estate ("the minimum amount of insurance is calculated by the greater of:

(a) The full consideration for the leasehold estate, including all mortgages assumed or taken subject to; or

(b) The value of the leasehold estate calculated by the method outlined in Section 7(A)(1) or Section 7(A)(2), above").

Certain other states, such as California, use the same formula to calculate the liability insurance amount, but use a different number of years in the lease term periods set forth in 1 and 2 above.

Recorded Interest

Absent a recorded interest, a lease will not be financeable and it may not be title insurable. Typically, the landlord and the tenant may enter into a lease memorandum or, in some jurisdictions, a short form lease in recordable form, which sets forth certain of the lease provisions (the parties; the lease term; the description of the leased premises at a minimum). It is unusual (but not unheard of) to record the entire lease. Where evidence of a leasehold interest is not already on record, even where the lease requires the landlord to enter into a lease memorandum or short form lease, it can be a long

negotiation to get the landlord to cooperate. The need for and status of a recorded leasehold interest should be addressed early on in any leasehold finance transaction or other leasehold transaction where title insurance may be required.

Landlord Estoppel Certificate

The certificate, executed by the landlord, should reference the lease together with all modifications, amendments, extensions and/or agreements pertaining thereto. It should state that the lease "remains in full force and effect and that no event has occurred, or failed to occur, which, with notice or the passage of time, or both, shall become a default or Event of Default thereunder." In the case of a leasehold mortgage and/or lease assignment, the certificate should set forth the landlord's consent to the mortgage and/or assignment, unless such consent is expressly not required by the terms of the lease. Where a new lease is being executed at closing, the landlord's estoppel is usually not necessary (unless it is an overlandlord who must consent).

Approval Rights of the Fee Mortgagee

Where there is fee mortgage financing in place, any lease transactions will exist in the shadow of the mortgage loan documents. Leaseholds will likely be subordinate to the fee mortgage, unless and to the extent a subordination, non-disturbance and attornment agreement ("SNDA") is negotiated. If the title report turns out a fee mortgage, the tenant's attorney may want to inquire whether the lender's consent is required for the lease transaction and, if the size of the lease transaction warrants it, whether an SNDA can be obtained.

Conclusion

When negotiating a significant commercial lease or ground lease, a savvy tenant's attorney, as part of his or her due diligence process, should consider mining the information contained in a leasehold title insurance report. Whether or not to turn that title report into a leasehold insurance policy by the payment of a premium can be decided as the transaction approaches closing.

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