

TITLE ISSUES

TITLE INSURANCE FOR LEASEHOLD ESTATES

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Title insurance is usually associated with insuring the purchasers or the mortgagees of a parcel of real estate. A prospective tenant, however, often has concerns which are similar to those of such parties: "Am I dealing with the proper owner?" "What liens, easements and other encumbrances affect the property?" "Are there any recorded covenants which may prohibit or affect my intended use of the site?"

The answers to these questions, of course, may have significant repercussions. An invalid lease, for example, may result in eviction from the premises. Conflicting tenancies and undisclosed easements may severely impact the incoming tenant's anticipated use of a site. Such concerns are of particular importance in the commercial arena, where unanticipated delays may be costly and the funds necessary for building, renovating or relocating to new space are often substantial.

Leasehold title commitments and policies are intended to address these and similar concerns. Unlike the typical title insurance policies which relate to the fee simple interest in land, leasehold title insurance insures the right of possession under a specified lease. The lease itself - as well as the lease's commencement and termination dates - are identified in Schedule A of the commitment or policy.

THE ALTA LEASEHOLD OWNER'S POLICY (1992)

Leases typically contain both real property aspects and contractual rights and obligations. Leasehold title insurance policies insure only the possessory rights conferred by a lease. Specifically, the ALTA leasehold

owner's and loan policies define the leasehold estate being insured as "the right of possession for the term or terms described in Schedule A hereof subject to any provisions contained in the Lease which limit the right of possession."

Given the unique nature of leasehold title insurance, the jackets of the ALTA leasehold policies contain two provisions which are not included in the standard policy jackets. These paragraphs provide a method for computing the amount of an insured's loss under a leasehold policy and detail the damages for which an insured may seek recovery. In the ALTA Leasehold Owner's Policy (1992), these paragraphs are enumerated Conditions and Stipulations 14 and 15, respectively, and read as follows:

14. Valuation Of Estate Or Interest Insured

If, in computing loss or damage incurred by the insured, it becomes necessary to determine the value of the estate or interest insured by this policy, the value shall consist of the then present worth of the excess, if any, of the fair market rental value of the estate or interest, undiminished by any matters for which claim is made, for that part of the term stated in Schedule A then remaining plus any renewal or extended term for which a valid option to renew or extend is contained in the Lease, over the value of the rent and other consideration required to be paid under the Lease for the same period.

15. Miscellaneous Items Of Loss

In the event the insured is evicted from possession of all or a part of the land by reason of any matters insured

against by this policy, the following, if applicable, shall be included in computing loss or damage incurred by the insured, but not to the extent that the same are included in the valuation of the estate or interest insured by this policy.

- (a) The reasonable cost of removing and relocating any personal property which the insured has the right to remove and relocate, situated on the land at the time of eviction, the cost of transportation of that personal property for the initial twenty-five miles incurred in connection with the relocation, and the reasonable cost of repairing the personal property damaged by reason of the removal and relocation. The costs referred to above shall not exceed in the aggregate the value of the personal property prior to its removal and relocation.

“Personal property,” above referred to, shall mean chattels and property which because of its character and manner of affixation to the land, can be severed therefrom without causing appreciable damage to the property severed or to the land to which the property is affixed.

- (b) Rent or damage for use and occupancy of the land prior to the eviction which the insured as owner of the leasehold estate may be obligated to pay to any person having paramount title to that of the lessor in the Lease.
- (c) The amount of rent which, by the terms of the Lease, the insured must continue to pay to the lessor after eviction for the land, or part thereof, from which the insured has been evicted.
- (d) The fair market value, at the time of the eviction, of the estate or interest of the insured in any sublease of all or part of the land existing at the date of the eviction.
- (e) Damages which the insured may be obligated to pay to any sublessee on account of the breach of any sublease of all or part of the land caused by the eviction.

The ALTA Leasehold Loan Policy (1992), designed to insure the mortgagee of a leasehold estate, contains similar provisions which correspond with a mortgage transaction.

INSURING LEASEHOLDS IN ILLINOIS

Leasehold title insurance normally is requested only for leases which relate to commercial or industrial properties and which are of relatively long duration. Franchisees, the anchor tenants of shopping centers, and their lenders are typical examples of parties who request leasehold title insurance. In the residential arena, occasionally the prospective tenant of a co-operative will request title insurance.

Before a leasehold estate may be insured, a number of factors usually will need to be addressed. The following discussion is intended to provide the reader with a brief overview of the factors and issues which are of particular importance to the title insurer insuring a leasehold estate in Illinois.

First, the lease itself - or a memorandum thereof - must be recorded in the county recorder's office. This recording provides third parties with constructive notice of the leasehold interest. Second, a copy of the lease must be reviewed. Because a lease transfers an interest in real estate, it must contain many of the same elements as that of a formal deed of conveyance - such as words of actual demise (e.g., “I hereby let” or “I hereby lease”), proper execution, with waiver of homestead rights, if appropriate, and notarization. Among other matters, the lease will be examined for:

- The identity of the lessor. The lessor, of course, should be the record fee titleholder(s) of the land. The lessor's authority to enter into the lease also will be considered. If, for example, the lessor is a corporation or a partnership, corporate resolutions or a certified copy of the partnership agreement will be requested in order to verify that the signatories had the actual authority to enter into the lease;
- The term of the lease. It must, of course, be verified that the leasehold estate has commenced and that it has not expired or otherwise terminated. If, for example, the leasehold to be insured was created several years prior to the examination, the chain of title must be reviewed to eliminate the possibility of a merger of the fee and leasehold estates;
- The legal description of the land demised by the lease. Normally, the lease will demise the entire premises that is owned by the lessor. This, however, is not always the case. Insuring the leaseholds of shopping center tenants, for example, often involve

important peripheral issues, such as the tenant's right of access. In addition, such examinations frequently necessitate a review of various parking, ingress, egress and other easement agreements, which also may need to be insured. In such instances, it is important that the lease and the other documents be drafted so as to specifically grant to the tenant the rights which have been negotiated; and

- Limitations placed upon the lessee, such as provisions requiring the lessor's consent prior to an assignment, sublease, mortgage or other encumbrance of the leasehold estate.

A third factor arises in relation to pre-existing leaseholds. If, for example, a thirty-year lease was executed in 1980 and the current tenant is seeking to assign its interest under the lease, an application may be placed for a leasehold owner's policy insuring the proposed assignee. In such an instance, a letter from the owner of the fee normally will be required in addition to the other standard clearance items. The purpose of this letter is to obtain the owner's assurance that there have been no defaults under the terms of the lease and that all amounts due under the lease have been duly paid. This letter frequently is referred to as an "estoppel letter."

In addition, if the leasehold is already in existence and has previously been assigned, it must be verified that a correct "leasehold chain of title" exists for the leasehold estate."

Finally, it should be noted that the current tenant, if any, and the proposed lessee will be included in the title company's name search. This search is intended to identify the judgments, liens or other matters which may affect the leasehold estate being insured.

ISSUES IN INSURING LEASEHOLD ESTATES

As alluded to previously, performing a leasehold title examination often involves complex issues, such as access and easement rights. Special concerns or issues often arise in various situations, such as the following:

- Occasionally, leases provide that they will commence upon the completion of the construction of certain contemplated improvements. In addition to the mechanics lien issues which invariably will arise whenever a building is being erected or renovated, proof that the construction has been completed and

that the leasehold estate has, in fact, commenced usually will be required;

- Leases in which the demised premises encompass only designated floors or less than the entire building or lot. In such situations, obtaining coverage over matters of survey must be addressed on a case by case basis.
- "Sale and Leaseback" transactions, in which title to the buildings and improvements is severed from the land, with the owner of the improvements obtaining a lease for the land upon which the improvements are situated;
- Properties in which the leasehold estate may be taxed by the county assessor under a separate tax parcel number. Such a situation may occur if the fee estate is exempt from real estate taxation or is being taxed as a railroad parcel;
- Insuring subleasehold interests, which often necessitate additional clearance and documentation;
- Insuring combinations of fee and leasehold interests as part of a single transaction. For example, a retailer may be purchasing the site for its store and simultaneously may be entering into a lease for a parking lot adjoining the structure. The resulting title policy will describe and insure two distinct interests: the fee simple to the land underlying the store and a leasehold interest for the parking lot; and
- The potential for the imposition of a real estate transfer tax upon the assignment of a leasehold interest. The City of Chicago transfer tax ordinance, for example, was amended in 1993 to encompass assignments of "ground" leases which are for a term of thirty or more years when all options to renew or extend are included, whether or not any portion of the term has expired.

CONCLUSION

Leasehold title insurance commitments and policies are intended to address the title concerns faced by a prospective tenant or leasehold mortgagee. As of the policy's effective date, leasehold policies insure the right of possession for the term of the lease, subject to the terms of the lease itself. As such, leasehold owner's and loan policies serve a valuable function. The use of title insurance should be considered prior to entering into any lease negotiation, particularly when valuable and long-term interests are concerned.