

## LEASEHOLD OWNER'S POLICIES: CURING INSOMNIA, OR HOW MUCH TITLE INSURANCE WILL ALLOW THE LESSEE TO SLEEP AT NIGHT

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The Jan./Feb. 1995 *Title Issues*, titled "Title Insurance For Leasehold Estates," outlined the basic coverages of the American Land Title Association (ALTA) Leasehold Title Policies. This article will discuss the most frequently asked question regarding the leasehold owner's policy: How much title insurance should the lessee obtain?

Please note that the discussion below is limited to property in Illinois. Insurance regulations in some other states require predetermined amounts of leasehold coverage. Also, regulators in states which require approval of title endorsements may not have approved the endorsement shown below.

### A. Language Differences Between Fee and Leasehold Policies

The ALTA Leasehold Owner's Policy – 1992, is identical to the ALTA Owner's Policy – 1992, except in the following respects: (1) The leasehold policy insures a leasehold estate rather than a fee estate; and (2) the Conditions and Stipulations of the leasehold policy contain the following three additional paragraphs:

#### 1. Definition of Terms

(h) "leasehold estate": 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.

#### 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 25 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 damages 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 lessee-insured will want to be sure that the amount of insurance on its policy is sufficient to cover any anticipated loss as measured by the provisions above. How does the lessee make this calculation?

#### **B. Loss Under Paragraph 14 of the Conditions and Stipulations—Value**

If a party is purchasing fee title to a parcel of land, the amount of insurance on the owner's policy is fairly simple to determine. Normally, it is the purchase price. If improvements are to be constructed, and coverage is desired at the time of closing for the potential increase in value of the land, additional insurance may be purchased.

If a party is a lessee under a new lease or is purchasing an existing leasehold, determining the amount of insurance is more difficult. By virtue of the definition of leasehold estate noted above, the leasehold policy only insures the right of possession. If the insured is forced to vacate the land because of a covered title defect, how will its loss be determined?

Before addressing this question, it is important to remember that it is very rare for a title defect to cause the lessee to lose title to their estate. Most claims for which an insurer is liable under a leasehold policy involve payment to third parties: e.g., a mechanic's lien claimant is paid to settle his lien claim or an outstanding tax item is paid. In these instances, as long as the insured loss does not exceed the value of the lease estate as discussed below, it is not necessary to determine the value of the estate.

Occasionally, however, the title defect is so severe that the leasehold estate fails. The classic example of this occurs when the lessor does not have title to the land. Obviously, the lessee's title is only as good as the lessor's, and the failure of the lessor's title will result in failure of the lessee's title. It then becomes necessary to address the question of how the lessee's loss is determined.

I shall address the issue under various fact scenarios.

- 1. Insurance of a new lease or of the assignment of an existing lease—no improvements to be built by the lessee and no separate payment by lessee for existing improvements*

The initial inquiry as to loss begins at paragraph 14 (P14)

of the Conditions and Stipulations noted above. (I will discuss loss under paragraph 15 (P15) of the Conditions and Stipulations later in the article.)

The thrust of P14 is to attempt to determine what it would cost the insured to replace the lost leasehold estate. I shall use some examples to try to divine the meaning of this clause.

Assume that the leasehold estate commences on the date of policy and has a 25-year term. The total rent to be paid over the life of the lease is \$1,000,000.

#### Example 1

A title defect which causes the lease to be invalid is discovered immediately after closing and the insured must vacate. The title insurer applies P14 first by comparing the cost of the fair market rental of the estate (undiminished by the title defect) or similar "replacement" premises to the cost of the actual rent under the insured lease.

If the fair market rental of the estate (or of a replacement estate) is equal to or less than such rental payments, the insured has suffered no loss under P14. (Note that he might still have a compensable loss under P15.)

#### Example 2

A title defect which causes the lease to be invalid is discovered 15 years after the commencement of the lease and the insured must vacate. Using the approach in example 1, the insurer determines that the current fair market rental for the 10 years remaining in the lease term is \$250,000. The actual remaining rent, however, is \$300,000. Again, the insured has not suffered a loss under P14.

#### Example 3

Assume the same facts as example 2 except that because of high occupancy rates in the area or other market forces the fair market rental of the leasehold estate for the 10 years remaining in the lease term is now \$400,000. Since the actual rent remaining to be paid is \$300,000, the insured has suffered a loss under P14. The insurer then calculates the amount of the loss.

Note that under P14 the insurer will not pay the \$100,000 difference. This is because the paragraph provides that the insurer will pay "... the then present worth of the excess ..." of the market value of the lease over the remaining rent. The insured is entitled to payment of the \$100,000 over the remaining 10 years of the lease. Rather than paying over time, however, the insurer will make a lump sum payment equal to the discounted value of the right to receive \$100,000 over 10 years.

These examples illustrate that the decision as to how



much title insurance to purchase, and perhaps whether to purchase title insurance at all, depends on whether the insured lessee has negotiated a favorable lease. While appraisals may be used to determine whether the lease, viewed from today's perspective, is sufficiently advantageous (e.g., having lower than market rental payments) to justify purchasing insurance, determining whether the value of the lease at some point in the future, when a loss occurs, will result in a payment under the policy is more problematic.

*II. Insurance of a new lease or of the assignment of an existing lease—improvements to be built by the lessee or separate payment by lessee for existing improvements*

Now assume that underlying facts regarding the lease are the same as above except that the lessee is required to or plans to construct leasehold improvements on the land or has paid a separate consideration for the improvements. Is the insurer required under P14 to reimburse the lessee for the cost of these improvements in the event the lease fails?

The answer, unfortunately, is no. While the *value* of the improvements may increase the value of the leasehold estate, which latter value is used in determining loss under P14, there is no direct compensation for the *value* or *cost* of the improvements.

To address this problem, the insured may be able to obtain an endorsement to the leasehold title policy for an additional premium. A copy of such an endorsement is shown on Exhibit A.

It is not necessary that the improvements be shown as an insured estate in Schedule A (see B.III. immediately below) for this endorsement to issue. To recover under this endorsement, however, the lessee would have to furnish to the insurer sufficient proof of payment of the cost of the improvements.

*III. Insurance of leasehold estate in the land (except the buildings and improvements) and ownership of the buildings and improvements*

Some transactions are structured such that the insured has a leasehold estate in the land (except the buildings and improvements) and the "ownership" of the buildings and improvements on the land. The "how and why" of such a transaction is beyond the scope of this article. The focus of this article will be on how the "lessee-owner's" loss is determined under the title policy issued in such a case.

When insuring these two estates in one policy, the title insurer has a choice. A fee owner's policy can be issued

with an endorsement adding paragraphs 1(h) and P14 and P15 to the policy, but limiting such paragraphs to the insurance of the leasehold estate only. Alternatively, a leasehold owner's policy can be issued with an endorsement limiting paragraphs 1(h) and P14 and P15 to the leasehold estate.

In the event of total failure of the lessee's title, how is loss or damage determined under the policy? As to the leasehold estate in the land, the analysis under B.I. and B.II. above would apply.

As to the improvements, the following provisions of the Conditions and Stipulations, which appear in both the fee and leasehold policies, would be relevant:

7. ... (a) The liability of the Company under this policy shall not exceed the least of:
  - (i) the amount of insurance stated in Schedule A; or
  - (ii) the difference between the value of the insured estate or interest as insured and the value of the insured estate or interest subject to the defect, lien or encumbrance insured against by this policy...

Thus, the value of the improvements would have to be determined and appropriate compensation paid. If the endorsement shown on Exhibit A has been issued, proof of payment of costs of the improvements would have to be furnished.

**C. Loss under Paragraph 15 of the Conditions and Stipulations**

The lessee should also consider the provisions of P15 in calculating the amount of insurance requested. These provisions relate to relocation expenses, temporary rents, and damages related to any subleases. The lessee should study the provisions of P15 and decide how they would influence his choice of policy amount. Obviously, the importance of the coverages under P15 will vary depending on the lessee's business and the type of lease involved.

Note that one potential item of loss which may be important to certain lessees is not covered: the cost of obtaining a new leasehold site and building improvements thereon. If such coverage is desired, the title insurer should be approached as to the availability and cost of same. This would also apply to other special coverages which a lessee's special circumstances would require.

*The Coinsurance Provisions of the Policy*

In the event that the lessee intends to place improvements

on the land after the date of policy, he should be aware of the following provisions of the Conditions and Stipulations of both the fee and leasehold owner's policies:

7(b) In the event the Amount of Insurance stated in Schedule A at the Date of Policy is less than 80 percent of the value of the insured estate or interest or if subsequent to the Date of Policy an improvement is erected on the land which increases the value of the insured estate or interest by at least 20 percent over the Amount of Insurance stated in Schedule A, then this policy is subject to the following:

- (i) where no subsequent improvement has been made, as to any partial loss, the Company shall only pay the loss pro rata in the proportion that the amount of insurance at Date of Policy bears to the total value of the insured estate or interest at Date of Policy; or
- (ii) where a subsequent improvement has been made, as to any partial loss, the Company shall only pay the loss pro rata in the proportion that 120 percent of the Amount of Insurance stated in Schedule A bears to the sum of the Amount of Insurance stated in Schedule A and the amount expended for the improvement.

The provisions of this paragraph shall not apply to costs, attorneys' fees and expenses for which the company is liable under this policy, and shall only apply to that portion of any loss which exceeds, in the aggregate, 10 percent of the Amount of Insurance state in Schedule A.

First, the insured must be sure that the amount of insurance is 80 percent or more of the value of the leasehold estate (as defined under P14) at the time the policy is issued in order to prevent the insurer from applying the coinsurance provisions in case of a claim.

However, even if the amount of insurance meets the 80 percent or more test at the time the policy is issued, if a *subsequent* improvement causes an increase in the value of the estate so that such value at the time of the completion of the improvement is 20 percent or more above the amount of insurance, the insured becomes a coinsurer with the title company for any partial loss which exceeds 10 percent of the amount of insurance.

Again, an example should help clarify this provision. Assume that the lessee insures a leasehold estate on unimproved land for \$500,000. Assume further that this amount equals the value of the leasehold estate as such value is defined under the leasehold owner's policy.

The tenant then builds an improvement on the land which

costs \$250,000 and increases the value of the estate by \$200,000. Twenty percent of the amount of the policy (\$500,000) is \$100,000. Since the increase in value of the estate (\$200,000) is equal to or greater than said 20 percent, the coinsurance provisions of the policy become applicable.

A title defect is then discovered, e.g., \$100,000 in unpaid taxes. Under the provisions noted above, the title insurer's liability for the loss is calculated as follows: First, since Paragraph 7(b) only applies to the portion of the loss which exceeds 10 percent of the amount of insurance, or in this case \$50,000 ( $\$500,000 \times 10\%$ ), subtract that \$50,000 from the \$100,000 loss, which leaves \$50,000 to which the ratio outlined above is applied.

The ratio is \$600,000 (\$500,000 amount of insurance x 120%) to \$750,000 (\$500,000 amount of insurance plus \$250,000 amount *expended* for the improvement). This ratio simplifies to 4:5. The insurer would then pay 4/5 of the \$50,000 of the loss subject to the coinsurance provisions, namely \$40,000. The insurer would also pay the \$50,000 of the loss not subject to the coinsurance provisions. Thus, the total paid by the insurer is \$90,000. The insured must pay the remaining \$10,000 of the \$100,000 loss.

Obviously, the percentage paid by the insurer in any particular case will vary depending on the facts. The important point for the insured is to make sure that enough insurance is purchased at the time the policy is issued, or at least prior to commencement of construction of the improvement, to prevent the insured from having to pay part of a covered loss. The insured may even request that if sufficient insurance is purchased, that the insurer issue an endorsement to the policy deleting the coinsurance provision with respect to the contemplated improvement.

Finally, if an improvement is contemplated sometime in the future, determining the amount of insurance becomes even more problematic. This is because the value of an improvement built in the future is difficult to predict. Also, the value of the leasehold estate declines over time. Thus, the composite of the value of the leasehold and the improvement is a challenge for the insured to calculate.

## Conclusion

The above discussion and examples demonstrate the importance of a lessee and its counsel analyzing the leasehold estate with respect to the particular factors which determine how the title insurance amounts should be calculated. Although the insurer can be helpful, only the lessee and its legal and financial advisors know the transaction well enough to make a sound judgment as to the amount of insurance which will allow them to sleep soundly after the close of the transaction.



# Exhibit "A"

Endorsement Attached to and forming a part of

\_\_\_\_\_ No. \_\_\_\_\_

Issued by  
CHICAGO TITLE INSURANCE COMPANY

## **Leasehold Policy Endorsement—Cost of Improvements**

The Company hereby agrees that monetary loss or damage sustained or incurred by the insured shall include the amount expended by or on behalf of the insured for the erection of improvements on the land. Such loss or damage shall be in addition to any loss or damage determined under paragraph 14 of the Conditions and Stipulations, but in no event shall the Company be responsible for loss or damage in excess of the Amount of Insurance stated in Schedule A.

Such amount expended shall include all funds paid by or on behalf of the insured for such improvements and for related costs, both "hard" and "soft", which costs may include, without limitation, materials, labor, and/or fees, as evidenced by a sworn statement substantiated by receipts for costs incurred in connection with the improvements as shown on the attached [schedule, exhibit, etc. which shows proposed items for expenditure].

This endorsement is made a part of the policy or commitment and is subject to all the terms and provisions thereof and of any prior endorsements thereto. Except to the extent expressly stated, it neither modifies any of the terms and provisions of the policy or commitment and prior endorsements, if any, nor does it extend the effective date of the policy or commitment and prior endorsements or increase the face amount thereof.

