

2009 CLE – Complex Closing Stories

II. Leasehold Interests & Improvements, Options, Rights of First Refusal

Story – ABC, LLC owns fee interest in a vacant lot. XYZ, LLC (related entity) plans to enter a long term ground lease with an option to purchase the fee interest in the property. XYZ plans to build an office building and lease same to a third party. The goal is to eventually sell the fee and lease, including the building to the tenant.

Issues:

1. How much Title insurance coverage should ABC and XYZ purchase?
2. What if ABC and XYZ decide to collapse the lease before selling? Is ABC fully covered upon the sale (with warranties) to the third party?
3. Can the option to purchase in the lease be insured?

Discussion-

A. **How are Leasehold Interests Insured?** – Both owners and loan policies can be endorsed by an ALTA 13-06 (Owners - Exhibit A) and 13.1-06 (Loan – Exhibit B) endorsement. These endorsements offer specially tailored coverages for lessees and their lenders. The endorsements replace the former ALTA Leasehold Owners and Loan policies. The old Leasehold policies were designed to provide protection for a tenant leasing space in an office building with minimal improvement expense. They were criticized for not taking into account tenant improvements and the value of a unique location for retail purposes. The losses under these policies were calculated by determining the difference between the fair market value of the remaining lease term less the remaining rent to be paid under the lease terms. The ALTA Leasehold endorsements are designed for leases involving significant tenant improvements. The special coverages include the following matters:

1. **Tenant Leasehold Improvements** – Leasehold improvements are defined and included in the Valuation provision.
2. **Valuation of Estate or Interest Insured** – Includes the remaining lease term and any tenant leasehold improvements existing on the date of eviction. The value of any remaining rent no longer required to be paid under the Lease agreement is taken into account.
3. **Additional Items of Loss** – Subject to the conditions of the policy and endorsement, the following matters are included in the computing loss or damage:

- i. Cost of removing and relocating personal property;
- ii. Rent or damages the Insured may be obligated to pay to someone other than the lessor in the lease;
- iii. Amount of rent that must be paid to the lessor after the eviction, pursuant to the terms of the lease;
- iv. Fair market value, at the time eviction, of the Insured in any lease or sublease made by the tenant as lessor;
- v. Reasonable costs incurred to secure a replacement leasehold; and,
- vi. Cost incurred for leasehold improvements, less salvage value, if said leasehold improvements are not substantially complete at time of eviction.

4. Lawful Deprivation – Under the Leasehold endorsements “Evicted” and “Eviction” are defined to include the lawful deprivation of the tenant’s right of possession contrary to the terms of the lease, or the lawful prevention of the tenant’s use of the land or improvements for the purposes set forth in the lease. If the tenant cannot use the insured property for a specific purpose described in the lease, then, subject to the terms and conditions of the policy, the tenant can recover for covered damages. In addition, if the tenant cannot fully possess the property, the policy recognizes the insured will incur damages. For example, damages caused by a loss of parking spaces or specifically insured access. Note that loss of business income is not covered as a loss by reason of eviction. Loss of business income damages are viewed as too speculative.

B. How much title insurance coverage should be obtained? – As with all title policies, the amount of coverage should match the amount of potential damages an insured may suffer as a result of a total failure of title. Since Leasehold endorsements cover both the leasehold estate and any leasehold improvements, both must be considered. Valuation of a leasehold estate is a difficult matter. So much so that the coinsurance provision of the ALTA 1992 Owners policy did not apply to the valuation of the leasehold estate. The 2006 ALTA Owners policy does not contain a coinsurance provision. Leasehold improvements are easier as a construction budget is often available. In addition, any potential losses covered by the Additional Items of Loss (discussed above) should be included.

Several methods of valuation exist. Most focus on the length of the lease and then add in the value of the improvements. For example, a lease term of 25 years or less could be valued at 10 times the annual gross rentals. A lease term of 25 to 49 years could be valued at 20 times the annual gross rentals. A long term lease, more than 50 years, could be valued at the full value of the land plus improvements. The endorsements do not require a

specific method of valuation for determining the amount of coverage, so the Insured should consider all factors in determining the amount of coverage to purchase.

C. Simultaneous Leasehold and Fee Interests - In the story above, what is the most flexible method for providing both the fee owner and the leasehold owner coverage? Can the fee owner and leasehold owner be covered by the same policy? The parties' goal is to eventually sell the fee, ground lease and improvements to a third party. At this point in the project, they are not sure whether the fee owner or the leasehold owner will sell the property. The entity that does sell will want to be sure they have coverage. Assume the fee is valued at \$2 million, while the improvements – once completed – will be valued at \$8 million. If the lease is collapsed/terminated into the fee and the owner sells for \$10 million, will the owner be protected if the buyer makes a claim on the warranties? While the definition of Insured under the policy offers protection for certain successors to Insured, it is not clear that a lessor could make a claim on a former lessee's policy. One solution is to issue one policy for both the fee and the leasehold interests. The amount of coverage would be the combined value (\$10 million in our example). The Insureds would include both the fee owner and the leasehold owner. Any claim would be paid to by the title insurer to both Insureds. As a result, the Insureds would need to have an agreement as to how the claims funds would be divided among them. The policy would not indicate any value allocation for the fee or leasehold interests.

D. Can Option to Purchase contained in the lease be insured?

Yes, subject to requirements establishing the priority, an option to purchase is an insurable interest in real property. The policy insures the holder of the option that the option to purchase is valid and enforceable and that the rights of the holder are vested, all subject to the terms of the option agreement and the holder's compliance with the terms thereof. A recorded option creates a priority right in the subject property over later recorded instruments pursuant to NCGS § 47-18. However, if the option is exercised, as a practical matter, the proceeds of the sale must be used to pay all liens on the property in order of their priority, even if subsequent to the option when it is exercised. The policy covers expenses necessary in a judicial determination or defense of the validity and enforceability of the option, but does not cover any expenses required to enforce the option and obtain a transfer of title.

For an owner, the policy will be a normal owner's policy with an endorsement (Exhibit C)) regarding the option. The optionee will be shown as the insured. The insured instrument would be the option agreement. The insured interest is fee simple; however, the policy would

show that title to the fee estate is still in the current owner. Exceptions for the terms and conditions of the option agreement will be taken. In addition, in any type of sale/leaseback or synthetic lease scenario a recharacterization exception will also be included.

The option agreement, or a memorandum thereof, must be recorded in order to establish its priority. NCGS § 47-119 requires that a memorandum contain the following information:

1. The names of the parties thereto;
2. A description of the property which is the subject of the option;
3. The expiration date of the option; and,
4. Reference sufficient to identify the complete agreement between the parties.

Note regarding Options in Gross – An Option in Gross is an option in which the holder of the option does not own any leasehold or other interest in the land which is the subject of the option. NCGS § 41-28(1). This option becomes invalid if it is not exercised within 30 years of its creation. NCGS § 41-29. If the grantee has an interest in the land, such as the lease in our case, then the option is not in gross and this limitation would not apply. Any title insurance policy insuring an option in gross would take exception to the option becoming invalid if not exercised within the statutory time frame.

E. What is the effect of a Right of First Refusal?

While rarely insured, rights of first refusal are treated the same as options to purchase. The same requirements and exceptions would apply. In fact, a preemptive right in the nature of a right of first refusal in gross is subject to the same 30 year limitation to exercise as an option in gross. NCGS § 41-29. A right of first refusal is normally excepted to in title insurance policies, unless subordinated to the insured interest.

- F. Installment Land Contracts** - Installment land contracts are treated very much like options to purchase. They must be recorded in order to be affective against third parties. Once recorded, a contract is “accorded the same protection as a grantee in a recorded deed.” Quinn v. Thigpen, 266 N.C. 720 at 723, 147 S.E. 2d 191 at 193 (1966). Again, as a practical matter, a title insurer will likely require any intervening title matters between the recordation of the contract and the deed to be eliminated prior to insuring.

The significant difference between installment land contracts and options to purchase involve the right of the buyer to redemption of equity. Under the installment land contract, a buyer generally makes monthly payments

until the purchase price is satisfied. Many such contracts contain a clause which states that upon default by the buyer, the amounts paid are treated as rent and not subject to the equity of redemption. In Lambreth v. McDaniel, the Court of Appeals held such a clause did not extinguish the buyer's equity of redemption, even though the buyer had defaulted on monthly payments. Lambreth v. McDaniel, 131 N.C. 319, 506 S.E. 295 (1998). The Court noted that

“It has been held repeatedly that the relationship between vendor and vendee in an executory agreement for the sale and purchase of land is substantially that subsisting between mortgagee and mortgager, and governed by the same general rules.” Id at 321, 297 citing Brannock v. Fletcher, 271 N.C. 65 at 73, 155 S.E. 2d 532 at 540-541 (1967).

As a result, the seller would be required to convey the property by deed to the buyer upon payment of the balance of the purchase price, interest and ad valorem taxes pursuant to the contract.

The above case law on the redemption of equity creates a common problem when a buyer stops making payments under the contract and relinquishes possession of the property. At what point are the buyer's rights under the contract extinguished? Does the seller have to foreclose to extinguish the buyer interest in the real property? Is establishing some form of Notice of Default of record sufficient? The Brannock case states the buyer must tender the unpaid balance “within a reasonable time”, but does not define what is reasonable. Brannock at 73, 540-41. Title companies are likely to address this issue on a case by case basis.

- G. Obtaining Releases/Uncanceled Leases** - There are several methods in which a lease agreement terminates, such as expiration of term, agreement between parties, default, and surrender or rejection in bankruptcy. Unfortunately, none of the methods of termination require that a document canceling the lease be placed of record. In addition, leases often contain multiple extension clauses, which do not necessarily require anything to be recorded when an extension is exercised. These matters make it difficult to determine whether a recorded lease or memorandum thereof is still active or otherwise still creates an interest in a lessee. Title insurers may rely upon off record information to help determine whether or not a lease still affects title to the property.
- H. Relationship to Loans on Fee or Leasehold Interest** - When a fee owner grants a lease on their property, the leasehold interest and the fee coexist. Any lien or encumbrance on either interest must be considered for its effect on the other interest. Competing interests on the fee interest and the leasehold interest normally arise in three situations:

1. Pre-existing liens or encumbrances on the fee interest when the leasehold interest is granted.
2. Liens or encumbrances granted by the leasehold owner.
3. Post lease liens or encumbrances by the fee owner.

Any pre-existing lien against the fee interest will affect the leasehold interest of a tenant and their lender. For example, the foreclosure of a prior deed of trust on the fee interest will cut off the leasehold interest. This is unacceptable to most tenants and their lenders. On the other hand, a fee lien holder may not wish to subordinate their interest to that of the tenant and the lease lien holder. An alternative solution is to enter a Non-Disturbance and Attornment Agreement (“NDA”). Under the NDA, the fee lien holder agrees not to disturb the tenant’s possession of the property, so long as the tenant is not in default under the terms of the lease. In return, the tenant agrees to attorn to and recognize the fee lien holder as the landlord under the lease in the event the fee lien holder takes possession of the fee interest as a result of foreclosure or other default by the landlord under the fee deed of trust.

In some cases a Subordination Non-Disturbance and Attornment agreement (“SNDA”) is needed from the tenant, subordinating the leasehold interest to that of a new lender on the fee interest. In addition to subordinating the leasehold interest, the SNDA contains non-disturbance provisions as in an NDA. The SNDA allows the leasehold interest to be shown as a subordinate matter on the loan policy for the new deed of trust. However, the title insurer will take exception to the terms and conditions of the SNDA as it contains obligations on the part of the lender.

The SNDA may also be used to subordinate the lien of the fee lender to the leasehold interest. This occurs when required by the leasehold owner or their lender. The fee lender obviously must agree to the subordination. They may be willing to do so, because the property is more valuable with a tenant under a long term lease agreement. Again the title insurer will take exception to the terms and conditions of the SNDA.

Lenders Requirements for Lease Agreements – Commercial leases are not only used as a means of obtaining space to operate a business, but also as means to finance a business. The security given for a loan by a lender to a tenant is a deed of trust on the leasehold interest. This security only extends to the leasehold interest in the real property and is limited by the terms and conditions of the lease agreement. If for any reason the lease is terminated, the security for the loan will be lost. As a result, lenders will require that certain terms and conditions be included in the lease agreement. Some such terms address permission (allows the leasehold interest to be mortgaged), ability to cure (allows the lender to cure defaults

by the tenant), and term of lease (lease term must be in excess of the maturity of the loan).

- I. **Recording Matters** – A memorandum of lease may be recorded to avoid recording the entire lease agreement and placing all terms and conditions on the public record. Under NCGS § 47-120, a properly executed acknowledged and recorded memorandum shall have the same effect as if the entire lease agreement had been recorded. NCGS § 47-118(a) requires that a memorandum contain the following information:
1. The names of the parties thereto;
 2. A description of the property leased;
 3. The term of the lease, including extensions, renewals, and options to purchase, if any; and,
 4. Reference sufficient to identify the complete agreement between the parties.
- J. **Mechanic's Liens on Leasehold Interests** – Claims of lien only extend to the interest of the obligor. If a leasehold owner contracts with a provider of materials or labor to the property, then that contractor's lien rights only extend the leasehold interest. As long as the fee owner has not contracted with the provider, then the lien rights do not extend to the fee interest. The contractor cannot claim a lien against the fee interest in the property. Title companies are not likely to require lien waivers or affidavits from the tenant or their contractors when insuring a fee interest in the property. When insuring a leasehold interest, these waivers or affidavits would be required.

**EXHIBIT A
ENDORSEMENT**

Attached to Policy No.

Issued by

CHICAGO TITLE INSURANCE COMPANY

1. As used in this endorsement, the following terms shall mean:

- a. "Evicted" or "Eviction": (a) the lawful deprivation, in whole or in part, of the right of possession insured by this policy, contrary to the terms of the Lease or (b) the lawful prevention of the use of the Land or the Tenant Leasehold Improvements for the purposes permitted by the Lease, in either case as a result of a matter covered by this policy.
- b. "Lease": the lease agreement described in Schedule A.
- c. "Leasehold Estate": the right of possession for the Lease Term.
- d. "Lease Term": the duration of the Leasehold Estate, including any renewal or extended term if a valid option to renew or extend is contained in the Lease.
- e. "Personal Property": chattels located on the Land and property that, because of their character and manner of affixation to the Land, can be severed from the Land without causing appreciable damage to themselves or to the Land to which they are affixed.
- f. "Remaining Lease Term": the portion of the Lease Term remaining after the Insured has been Evicted as a result of a matter covered by this policy.
- g. "Tenant Leasehold Improvements": Those improvements, including landscaping, required or permitted to be built on the Land by the Lease that have been built at the Insured's expense or in which the Insured has an interest greater than the right to possession during the Lease Term.

2. Valuation of Estate or Interest Insured:

If in computing loss or damage it becomes necessary to value the Title as the result of a covered matter that results in an Eviction of the Tenant, then that value shall consist of the value for the Remaining Lease Term of the Leasehold Estate and any Tenant Leasehold Improvements existing on the date of the Eviction. The Insured Claimant shall have the right to have the Leasehold Estate and the Tenant Leasehold Improvements valued either as a whole or separately. In either event, this determination of value shall take into account rent no longer required to be paid for the Remaining Lease Term.

3. Additional items of loss covered by this endorsement:

If the Insured is Evicted, the following items of loss, 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 Title.

- a. The reasonable cost of removing and relocating any Personal Property that 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 one hundred miles incurred in connection with the relocation, and the reasonable cost of repairing the Personal Property damaged by reason of the removal and relocation.

- b. Rent or damages for use and occupancy of the Land prior to the Eviction that 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 that, by the terms of the Lease, the Insured must continue to pay to the lessor after Eviction with respect to the portion of the Leasehold Estate and Tenant Leasehold Improvements 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 lease or sublease made by Tenant as lessor of all or part of the Leasehold Estate or the Tenant Leasehold Improvements.
- e. Damages that the Insured is obligated to pay to lessees or sublessees on account of the breach of any lease or sublease made by the Tenant as lessor of all or part of the Leasehold Estate or the Tenant Leasehold Improvements caused by the Eviction.
- f. Reasonable costs incurred by the Insured to secure a replacement leasehold equivalent to the Leasehold Estate.
- g. If Tenant Leasehold Improvements are not substantially completed at the time of Eviction, the actual cost incurred by the Insured, less the salvage value, for the Tenant Leasehold Improvements up to the time of Eviction. Those costs include costs incurred to obtain land use, zoning, building and occupancy permits, architectural and engineering fees, construction management fees, costs of environmental testing and reviews, and landscaping costs.

This endorsement is issued as part of the policy. Except as it expressly states, it does not (i) modify any of the terms and provisions of the policy, (ii) modify any prior endorsements, (iii) extend the Date of Policy, or (iv) increase the Amount of Insurance. To the extent a provision of the policy or a previous endorsement is inconsistent with an express provision of this endorsement, this endorsement controls. Otherwise, this endorsement is subject to all of the terms and provisions of the policy and of any prior endorsements to it.

[Witness clause optional]

CHICAGO TITLE INSURANCE COMPANY

By: _____
Authorized Signatory

ALTA Endorsement - Form 13-06
 (Leasehold-Owner's) (6/17/06)

**EXHIBIT B
 ENDORSEMENT**

Attached to Policy No.
Issued by
CHICAGO TITLE INSURANCE COMPANY

1. As used in this endorsement, the following terms shall mean:

- a. "Evicted" or "Eviction": (a) the lawful deprivation, in whole or in part, of the right of possession insured by this policy, contrary to the terms of the Lease or (b) the lawful prevention of the use of the Land or the Tenant Leasehold Improvements for the purposes permitted by the Lease, in either case, as a result of a matter covered by this policy.
- b. "Lease": the lease agreement described in Schedule A.
- c. "Leasehold Estate": the right of possession for the Lease Term.
- d. "Lease Term": the duration of the Leasehold Estate, including any renewal or extended term if a valid option to renew or extend is contained in the Lease.
- e. "Personal Property": chattels located on the Land and property that, because of their character and manner of affixation to the Land, can be severed from the Land without causing appreciable damage to themselves or to the Land to which they are affixed.
- f. "Remaining Lease Term": the portion of the Lease Term remaining after the Insured has been Evicted as a result of a matter covered by this policy.
- g. "Tenant": the tenant under the Lease and, after acquisition of all or any part of the Title in accordance with the provisions of Section 2 of the Conditions of this policy, the Insured Claimant.
- h. "Tenant Leasehold Improvements": Those improvements, including landscaping, required or permitted to be built on the Land by the Lease that have been built at the Insured's expense or in which the Insured has an interest greater than the right to possession during the Lease Term.

2. Valuation of Estate or Interest Insured:

If in computing loss or damage it becomes necessary to value the Title as the result of a covered matter that results in an Eviction of the Tenant, then that value shall consist of the value for the Remaining Lease Term of the Leasehold Estate and any Tenant Leasehold Improvements existing on the date of the Eviction. The Insured Claimant shall have the right to have the Leasehold Estate and the Tenant Leasehold Improvements valued either as a whole or separately. In either event, this determination of value shall take into account rent no longer required to be paid for the Remaining Lease Term.

3. Additional items of loss covered by this endorsement:

If the Insured acquires all or any part of the Title in accordance with the provisions of Section 2 of the Conditions of this policy and thereafter is Evicted, the following items of loss, 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 Title.

- a. The reasonable cost of removing and relocating any Personal Property that 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 one hundred miles incurred in connection with the relocation, and the reasonable cost of repairing the Personal Property damaged by reason of the removal and relocation.

- b. Rent or damages for use and occupancy of the Land prior to the Eviction that 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 that, by the terms of the Lease, the Insured must continue to pay to the lessor after Eviction with respect to the portion of the Leasehold Estate and Tenant Leasehold Improvements 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 lease or sublease made by Tenant as lessor of all or part of the Leasehold Estate or the Tenant Leasehold Improvements.
- e. Damages that the Insured is obligated to pay to lessees or sublessees on account of the breach of any lease or sublease made by the Tenant as lessor of all or part of the Leasehold Estate or the Tenant Leasehold Improvements caused by the Eviction.
- f. Reasonable costs incurred by the Insured to secure a replacement leasehold equivalent to the Leasehold Estate.
- g. If Tenant Leasehold Improvements are not substantially completed at the time of Eviction, the actual cost incurred by the Insured, less the salvage value, for the Tenant Leasehold Improvements up to the time of Eviction. Those costs include costs incurred to obtain land use, zoning, building and occupancy permits, architectural and engineering fees, construction management fees, costs of environmental testing and reviews, and landscaping costs.

This endorsement is issued as part of the policy. Except as it expressly states, it does not (i) modify any of the terms and provisions of the policy, (ii) modify any prior endorsements, (iii) extend the Date of Policy, or (iv) increase the Amount of Insurance. To the extent a provision of the policy or a previous endorsement is inconsistent with an express provision of this endorsement, this endorsement controls. Otherwise, this endorsement is subject to all of the terms and provisions of the policy and of any prior endorsements .

[Witness clause optional]

CHICAGO TITLE INSURANCE COMPANY

By: _____
Authorized Signatory

ALTA Endorsement - Form 13.1-06
(Leasehold-Loan) (6/17/06)

EXHIBIT C

OPTION TO PURCHASE ENDORSEMENT

Attached to Owner's Policy No.

SAMPLE ENDORSEMENT

Issued by
CHICAGO TITLE INSURANCE COMPANY

The Company hereby insures that the rights of the Insured under the Option described in Paragraph *[INSERT SCHEDULE B PARAGRAPH NUMBER DESCRIBING THE OPTION]* of Schedule B ("Option") are vested in the Insured subject to the terms and provisions of the option.

The Company further insures against loss or damage which the Insured may sustain resulting from:

1. The unenforceability of the right to exercise the Option except to the extent that such unenforceability or claim thereof is based on the failure of the Insured to have fulfilled the terms and conditions of the Option.
2. The priority over the Option of any conveyance made of the fee simple estate in the land or of any liens or encumbrances created thereon after the date of policy, excepting such liens or encumbrances that would affect the Insured had the Insured been the owner of the fee simple title instead of an Option as of date of policy, including, without limitation, real estate taxes, special assessments, demolition liens, drainage liens and water liens.
3. The entry of any court order or judgment which constitutes a final determination and requires the Insured, as condition to receiving specific performance of the Option, to pay a sum in excess of the Option price, other than attorney's fees and costs of litigation.

Nothing contained in this endorsement shall be construed as insuring the Insured against loss or damage sustained or incurred by reason of:

- (a) Rejection of the Option under the provisions of the Federal Bankruptcy Code or state insolvency laws.
- (b) The failure of the Insured to receive all or part of an award entered in a condemnation proceeding unless failure to share in said award stems solely from a court order or judgment which constitutes a final determination and adjudges option invalid or incapable of specific performance.
- (c) The failure of the Insured at the time of payment of the Option price either to have obtained proper conveyances and releases from all person then having an interest in said land or a lien or encumbrance thereon (the determination as to the identity of such persons and the nature of the interest, lien or encumbrance owned or claimed to be at the expense of the Insured) or to have obtained a court order or judgment which constitutes a final determination and determines those persons and interests entitled to receive the option price.
- (d) Attorney's fees and costs in connection with the proceedings mentioned in subparagraph (c) immediately above, or in connection with an action to enforce the Option, excluding attorney's fees incurred to defend an attack on the validity or enforceability of said Option.
- (e) Any lien, or right to a lien, for services, labor or material heretofore or hereafter furnished and imposed by law.

This endorsement is issued as part of the policy. Except as it expressly states, it does not (i) modify any of the terms and provisions of the policy, (ii) modify any prior endorsements, (iii) extend the Date of Policy, or (iv) increase the Amount of Insurance. To the extent a provision of the policy or a previous endorsement is inconsistent with an express provision of this endorsement, this endorsement controls. Otherwise, this endorsement is subject to all of the terms and provisions of the policy and of any prior endorsements to it.

CHICAGO TITLE INSURANCE COMPANY

By: _____

Authorized Signatory