

New Security for Tenants and Their Lenders: ALTA Introduces Expanded Leasehold Coverages

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After weeks of protracted negotiations, you call your client and tell her that the lease for her business's new space is ready to sign. You have both spent many hours (and dollars) hammering out issues crucial to her business such as use provisions, remedies, maintenance obligations and renewal terms. You are confident that every danger has been diminished and every pitfall protected against.

Notwithstanding diligent efforts, leasehold transactions present unique problems for practitioners, and chief among them is the inadequacy of protection for tenants in the event of title problems that detrimentally affect the leasehold estate.

For many years real estate practitioners and their clients have chosen to forego the protections afforded by the leasehold policy. Many felt protected by the lessor's due diligence (including title searches and title insurance) and the terms of the lease. This sense of security, no doubt was a relative one based on the limited protections offered by the title insurance industry and its 1975 ALTA Leasehold Policies. Now may be the time to rethink whether or not title insurance should be obtained to protect owners of leasehold interests.

For one thing, the protections afforded by your lease may be wholly inadequate due to the financial situation of the Landlord. For another, there are new products offered by the title industry

With the introduction of the ALTA 13 Leasehold Owner's Endorsement and the corresponding ALTA 13.1 Leasehold Loan Endorsement, the title industry has responded to the demands of its customers by offering significantly expanded leasehold coverages. Now, the product being offered more accurately addresses developments in the leasing market. Retail, office and industrial tenants investing thousands of dollars in leasehold improvements were not adequately protected. The 1975 Policy also failed to protect the holder of a leasehold that was valuable due to its particular location.

This article will undertake to set forth, with simplicity, the differences between the new endorsements and the 1975 Leasehold policy, and to point out the practical benefit of these new products. The following comparison sets forth the text of the ALTA 13 Leasehold Owner's Endorsement with commentary inserted discussing the differences with the 1975 Leasehold Owner's policy. The uninterrupted text of the ALTA 13 and ALTA 13.1 Endorsements follow these materials as Exhibit A, and Exhibit B, respectively.

I. A Comparison of Protection

American Land Title Association Endorsement 13 (Leasehold-Owners)
Adopted 10-13-01
Section IV-20

ENDORSEMENT

Attached to Policy No.

Issued by

INVESTORS 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 which, 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.

1975 Comparison:

Evicted: The Endorsement contains a definition of the terms "evicted" and "eviction" that was lacking from the predecessor policy. This definition is important in that it provides the insured with protection against the inability to utilize the premises for a

particular use specified in the lease.

Leasehold Estate: The 2001 Endorsement deleted from the definition of "Leasehold Estate" language that subjected the coverage to lease provisions limiting the Tenant's right to possession. This eliminates an area for conflict in the 1975 Policy. The ALTA committee also decided not to create a specific exception for the Tenant's duties under the lease.

Tenant Leasehold Improvements: One of the most frequent complaints about the 1975 Leasehold Policy was that it excluded from coverage the tenant's leasehold improvements. Due to changes in the nature of today's leasing market, these improvements may represent a significant part of the value of the lease. The new endorsement specifically includes these improvements, provided the tenant has more than a mere possessory interest in the improvements.

2. The provisions of subsection (b) of Section 7 of the Conditions and Stipulations shall not apply to any Leasehold Estate covered by this policy.

1975 Comparison:

The new owner's endorsement states that Section 7 (b) ("coinsurance") of the conditions and stipulations do not apply to the valuation of the Leasehold Estate. The thought was that this is a difficult valuation to begin with and would likely present fertile ground for argument. The provision means that the Tenant will not have to procure an appraisal at the front end of the Lease. The exclusion does not apply to the value of Leasehold Improvements, since valuing these is imminently less complicated. The Tenant (or its counsel) is advised to obtain insurance in an amount based on a tenant improvement construction budget. The prudent practitioner will advise his client to be certain to obtain sufficient coverage based on a reasonable estimate of the value of the leasehold.

3. Valuation of Estate of Interest Insured

If, in computing loss or damage, it becomes necessary to value the estates or interests of the insured as the result of a covered matter that results in an Eviction, 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.

1975 Comparison:

Perhaps the most valuable expansion of coverage in the new endorsement is found in the reformulation of the method for determining loss. After all this is where the money is, so to speak. Whereas, under the 1975 Leasehold Policy, the Leasehold Estate value was determined by subtracting the rent to be paid under the lease for the remainder of the term (including any options or renewals) from the fair market rental value for the same term (as determined by appraisal). This difference, if any, would be the limit for the insured's recovery. Thus, if there were a dip in the local rental market, the insured may be barred from any recovery. Additionally, there was no provision for any recovery for amounts spent on tenant upfit and improvements. Clearly, such a result would not be acceptable in today's market where Tenants routinely spend thousands to "customize" space based on the unique needs of their business.

Since the endorsements valuation system will generally be based on an appraisal, there is also the flexibility to add value based on the worth of a particular location to the Tenant's business. Such a valuation was not contemplated under the 1975 policy definitions. This added protection should prove extremely valuable in the retail leasing market, where everyone knows the old adage about "location".

4. 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 estates or interests insured by this policy.

- 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 which the insured as owner of the Leasehold Estate is 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 the insured 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 insured 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, landscaping costs and fees, costs and interest on loans for the acquisition and construction.

This endorsement is made a part of the policy and is subject to all of 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 and any prior endorsements, nor does it extend the effective date of the policy and any prior endorsements, nor does it increase the face amount thereof.

1975 Comparison:

Again, the 2001 endorsement greatly expands the scope of coverage for leasehold owners and lenders. While the 1975 policy offered some coverage for additional items of damages (e.g. moving costs for personal property; sublease damages; damages payable to the owner of paramount title), the new endorsement contains significant new coverages. Reimbursement for transportation costs for relocating the insured's personal property is now covered for a 100 mile radius (an increase from the 25 miles allowed under the 1975 policy).

Additionally, the new endorsement now covers certain hard and soft costs incurred in the construction of the Leasehold Tenant Improvements. These costs include costs to obtain permits and zoning, architectural and engineering fees, and costs and interest associated

with financing. Obviously, the ability to recapture these costs is of great interest to the insured.

II. Conclusion

Reacting to longstanding complaints from various interested parties, the ALTA has crafted new coverage for leasehold interest owners and lenders. This protection more accurately reflects current realities in the leasing market and offers Tenants and their lenders a new security for their transactions involving leaseholds. These parties can now rest assured that there is comprehensive coverage available to address title issues affecting the leasehold.