

**New Jersey
N2K Hour:**

**Need To Know
Insuring a
Leasehold
Interest**

**Webex Presentation:
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Leasehold Interest Defined

- A leasehold interest may be defined as a non-freehold possessory estate for a term of years.
- There is no limit to the term. There is no limitation to 99 years, which some people seem to think is the maximum term. A leasehold for 200 years or more is still a leasehold.
- After the term specified, the leasehold interest is normally followed by an automatic reversion of possession to the fee owner.
- The lessor is the landlord or fee title owner and the lessee is the tenant.

Leasehold Interest Defined (cont'd)

- A leasehold estate may be further defined as the right to possession for a fixed term, subject to any limiting provisions described in the lease. A leasehold estate is similar to an estate for years.
- Upon expiration of the lease term, fixtures will typically belong to the landlord unless there is an agreement to the contrary.
- Under a net lease, which is given in a commercial setting, the tenant is responsible for costs (such as taxes) normally borne by the fee owner. These costs are in addition to the agreed upon rental.

Why Title Insurance for Insuring Leasehold Interest

- A leasehold was treated as personalty at common law but it is now generally treated as realty and constitutes an estate in land.
- Leases for a term of two years or longer are eligible for recording and enjoy protection under the recording act. Since 2012 Title 46 expressly permits the recording of memoranda of leases.
- Leasehold Owner's Title insurance for a leasehold estate includes coverage upon eviction for the value of the lease for the remaining lease term and any tenant leasehold improvements less the value of rent which no longer must be paid.

Why Title Insurance for Insuring Leasehold Interest (cont'd)

- Relocation cost and cost associated with obtaining a reasonably equivalent leasehold may also be covered.
- Leasehold Loan Insurance will be desired by lender for essentially the same reasons as when providing a mortgage covering a fee interest, including of course, priority.
- Leasehold mortgages constitute an insurable interest and the courts have recognized their validity.

Mechanics of Insuring a Leasehold Interest

- A standard title search must be made including all the components that would normally be done in connection with insuring a fee interest.
- Note that all liens and matters affecting the fee interest must be set up as exceptions in the commitment.
- In the past leasehold estates and interests were insured utilizing the ALTA Leasehold Owners Policy (1992) and the ALTA Leasehold Loan Policy (1992).

Mechanics of Insuring a Leasehold Interest (cont'd)

- In 2001 ALTA Endorsements 13 (Leasehold – Owners) and 13.1 (Leasehold – Loan) were adopted. They were designed to be annexed to the ALTA 1992 Owner's and Loan Policies. Thus, superseding the Leasehold Policies.
- The 1992 policies were withdrawn in favor of the ALTA 2006 policies. ALTA did not create, in 2006, new versions of the 1992 Leasehold policies.
- Hence, leasehold coverage is now given solely by the use of the 13 and 13.1 endorsement in conjunction with the 2006 ALTA Owner and ALTA Loan Policies.

Mechanics of Insuring a Leasehold Interest (cont'd)

- There are several acceptable methods for determining the amount of insurance for a leasehold owner's policy as set forth in the rate manual.
- One method is to insure for an amount equal to the aggregate amount of the total rent contemplated under the lease.
- A second method is to insure for an amount equal to the total rent for the first six years of the lease following settlement. (For percentage leases the usage of a statement of estimated rent is acceptable).
- Lastly, the approved fair market value established by an acceptable appraiser may also be used.

Mechanics of Insuring a Leasehold Interest (cont'd)

- If insuring an assignment of a leasehold estate the amount of insurance is calculated by adding the full consideration to the amount of any assumed obligations.
- In the event that a leasehold owner's policy is to be issued simultaneously with a fee owner's policy, the rate manual provides that the premium for the leasehold policy will be a percentage of the amount charged for the fee policy.
- It is required to include an exception in the Leasehold Owner's policy for the terms and conditions of the leases including, without limitation, the lessor's right of reversion.

Mechanics of Insuring a Leasehold Interest (cont'd)

- Assignments of Leases can also be insured by issuing a new policy or endorsing an existing policy.
- When insuring an assignment of lease, the commitment should contain a requirement calling for an estoppel certificate.
- The estoppel certificate is to be signed by the lessor and states that the lease has not been assigned to a different party and that the assignor is not in default under the terms of the lease and the lease is in full force and effect.
- In fact, an estoppel certificate should also be obtained when insuring a leasehold mortgage or sublease.

Insuring a Leasehold Mortgage - Further Considerations

- The appropriate exceptions must be taken for items affecting the fee interest, e.g. mortgage liens, easements, restrictions, etc.
- Many leases contain automatic subordination clauses, meaning that the lease will be subordinate to any mortgage placed against the fee interest in the future.
- If there is no automatic subordination clause a new lender on the fee interest may require the lessee to execute a subordination, attornment and non-disturbance agreement (SNDA).
- The SNDA subordinates the lease to the new mortgage and recognizes the new lender as the landlord in the event of foreclosure.

Energy Projects – ALTA 36 Endorsements

- ALTA has developed the ALTA 36 series of endorsements for use when insuring energy projects.
- Several of the ALTA 36 endorsements are to be used with leasehold estates.
- These endorsements are designed specifically for energy projects, such as wind farms, solar farms, traditional electricity generating facilities, etc. Such projects may involve leasehold interests.
- The specific endorsements applicable to leasehold estates are 36.2-06 for an owner's policy and 36.3-06 for a loan policy. Coverage is afforded for loss in the event of an eviction or ejection.

Energy Projects – ALTA 36 Endorsements (cont'd)

- The endorsement provides that the loss calculation shall include diminution in value of insured's interest in any existing or future “severable improvements.”
- If the project is over more than one parcel, the endorsement contains a definition of “constituent parcel” that becomes applicable.
- The computation of loss due to the eviction or ejection caused by a covered matter affecting any constituent parcel shall include loss or damage to the integrated project.
- The ALTA 36 series should only be issued after Underwriter consultation.

Sale Leaseback and Synthetic Lease Transactions

- A sale-leaseback is a transaction wherein the owner of the fee (A) conveys the property to B who then leases the property to A.
- A sale-leaseback may be viewed as an irregular security transaction in which the parties have actually entered into a mortgagor-mortgagee relationship.
- For insurance purposes such transactions should be carefully reviewed in consultation with your underwriter.
- A synthetic lease is a form of the sale-leaseback which presents additional risks in insuring.

Sale Leaseback and Synthetic Lease Transactions (cont'd)

- In a synthetic lease transaction the lessor takes out a purchase money mortgage loan from a lender in order to acquire property.
- The lessor then leases the acquired property to the lessee and the rental payments made under the lease are applied to the debt of the mortgage.
- The loan documents may reference the transaction as a lease for accounting purposes but will likely contain wording creating a mortgage as well.

Sale Leaseback and Synthetic Lease Transactions (cont'd)

- In the event of a bankruptcy petition filing, and the re-characterization of the transaction, the mortgage wording is designed to protect the interest of the lessor as a mortgagee.
- In insuring such transactions for the lessor, one may be asked to provide additional coverage protecting the lessor as a mortgagee in the event of re-characterization.
- A method of providing the requested coverage would be the issuance of both an owner and loan policy, with wording setting forth the circumstances under which the loan policy would become effective.

Sale Leaseback and Synthetic Lease Transactions (cont'd)

- A request may also be made by the lessee for coverage protecting its fee interest in the event of re-characterization.
- Synthetic lease transactions are very complex, so please contact your underwriter if asked to insure such a transaction.

Options to Renew or Purchase

- The definition of “lease term” contained in ALTA Endorsements 13-06 and 13.1-06 includes the wording “any renewal or extended term if a valid option to renew or extend is contained in the Lease.”
- Accordingly, when the endorsements are issued, the policy remains in effect throughout the renewal or extended term period.
- If there is a dispute between the parties as to the right to renew or extend, the use of the word “valid” in the endorsement is limiting.

Options to Renew or Purchase (cont'd)

- If, therefore, the lessor denies the lessee's right to extend or renew, the dispute is not within the scope of coverage.
- Because of this some insureds may request an endorsement, or affirmative insurance, covering the right to renew or extend the lease.
- If it is determined that such coverage should be provided it should perhaps be accomplished by insuring against loss or damage arising from the entry of a final – non appealable judgment determining that the lease may not be renewed or extended.
- However, whether to issue such affirmative insurance, and the precise language, should be a matter on which your underwriter is consulted.

Options to Renew or Purchase (cont'd)

- Some leases contain options to purchase, giving the lessee the right to purchase the fee estate from the lessor under certain conditions.
- A lease may also have a provision, a right of first refusal, which requires the lessor to offer to sell the property to the lessee prior to selling to a 3rd party.
- The decision as to whether to provide coverage for an option or right of first refusal must again be made in consultation with your underwriter.
- The N.J. option endorsement is an approved form and may be issued under appropriate circumstances. The endorsement supersedes the previous non-standardized forms that were utilized in the past.

Residential Leases

- When insuring commercial leases it is not normally necessary to consider spousal interest because the interest is normally held by a business entity such as a corporation, LLC or partnership.
- However, when insuring a residential leasehold interest, such as co-ops or Camp Meeting Associations, spousal rights and the manner in which title is held can become important.
- It had been held in New Jersey that a husband and wife could not hold a leasehold interest as Tenants By The Entirety because a leasehold was considered personalty at common law and Tenancies By The Entirety were not recognized at common law in personalty.

Residential Leases (cont'd)

- A statute was enacted subsequent to the case law, N.J.S.A. 46-3-17.2, which now permits personalty to be held by the Entirety.
- Normally, when called upon to issue leasehold policies, it will be in a commercial setting. However, requests do happen in a residential setting as well. As previously alluded to, this is most often in connection with co-ops and Camp Meeting Associations.
- Camp Meeting Associations, (such as Ocean Grove in Monmouth County and Mt. Tabor in Morris County) are communities where the fee title remains in the association and the homes are occupied pursuant to 99 year renewable leasehold estates.

Residential Leases (cont'd)

- In a co-operative regime the lessee or unit owner holds a long term leasehold interest under a proprietary lease and becomes a shareholder in the co-operative housing corporation.
- More often than not neither the buyer nor lender will desire title insurance. The lender will file the appropriate UCCs to secure its interest.
- Occasionally, however, title insurance will be requested. It is always important to call for the recording of the documents creating the interests to be insured.
- If the appropriate documents are not to be recorded an exception must be taken.

Wrap Up and Review

- A leasehold interest is a non-freehold possessory estate for a term of years which is an insurable interest for purposes of title insurance.
- The parties to the transaction, particularly in connection with a commercial transaction, will be desirous of obtaining title insurance to protect their interests.
- The issuance of leasehold policies is effectuated through the use of the ALTA 2006 policies together with the ALTA 13-06 (owner's) and 13.1-06 (leasehold loan) endorsements.
- Methods for calculating the appropriate premiums for the policies are set forth in the rate manual.

Wrap Up and Review (cont'd)

- The ALTA 36 series of endorsements (energy projects) may be issued in conjunction with leasehold policies but your underwriter must be consulted.
- Sale-leasebacks and synthetic leases may also be insurable but present some unique risks which require consultation with your underwriter.
- Residential leases are also insurable although requests for insurance will be much rarer than in a commercial setting.
- Insurance will not often be requested in conjunction with a co-operative transaction. However, when insurance is requested care must be taken to insure that the appropriate documents are recorded or an appropriate exception is taken.

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