

Introduction to Leases:

Essential Fundamentals for Searching and Examining Leasehold Estates

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Helpful Definitions:

“Leasehold” is an estate in real property held under a rental agreement by which the owner gives another the right to occupy or use land for a period of time (West's Encyclopedia of American Law, edition 2). A leasehold estate can be bought and sold on the open market. It is a ‘less than freehold’ estate.

“Freehold” is a right of title to land with two necessary elements: *immobility*, meaning the land and that which is affixed to the land, and *indeterminate duration*, that is, no fixed duration of ownership.

“Estate for years” is an estate which must expire at a period certain, fixed in advance. It is an interest arising from an agreement or contract for the possession of lands or tenements for some definite period (i.e., a lease). Such estate is regarded at common law as a chattel.

“Chattel” refers to all personal property (things you own other than real estate).

“Chattels real” is an interest in real estate less than freehold, such as estates for years, at will and by sufferance. Chattel real passes a present interest in real property.

“Reversionary Interest or Estate” is held by the fee owner, who has the right to regain possession of the property after the lease has expired.

Arizona Revised Statutes

33-201. Duration of interest; fee tail prohibited

A. Estates in lands, as respects the extent of the interest of the holder, are divided into:

1. Estates of inheritance. An estate of inheritance shall be termed a fee simple or fee, and when not defeasible or conditional shall be a fee simple absolute.
2. Estates for life.
3. Estates for years.
4. Estates at will.
5. Estates by sufferance.

B. No lands of this state shall be held as an estate in fee tail.

33-202. Estates as property interest; freeholds; chattels real; chattel interests

A. Estates of inheritance and for life are freehold estates, except that an estate for the life of a third person, whether limited to heirs or otherwise, is a freehold only during the life of the grantee or devisee, and after his death is a chattel real.

B. Estates for years are chattels real.

C. Estates at will or by sufferance are chattel interests, but are not liable as such to sale on execution.

33-233. Life estate in term of years

An estate for life may be created in an estate for a term of years and a remainder may be limited thereon.

Characteristics of Leases

- Gives exclusive possession with a reversionary right to the lessor
- Bilateral contract - must contain mutual agreement, consideration, capable parties and a lawful purpose
- A lease gives the tenant the right of quiet enjoyment and possession, although the lease may contain restrictions on the use of the property, among other things
- Death usually does not terminate the lease. Lease obligations could pass on to the heirs.
- Generally, a new fee owner takes title subject to the lease, but not always. Leases are thus personal property (chattel).

What are we insuring?

Leasehold title policies insure against loss or damage to the **right of possession** arising out of defects, liens or encumbrances insured against for the term or terms of the lease, subject to any provisions in the lease which limit such right of possession.

Components of an Insurable Lease

- Name of lessor and lessee
- Granting clause, e.g. “hereby lets, leases and demises”
- Date lease term begins and ends (a “habendum clause”)
- Lessor’s signature (title companies prefer to have lessee sign, also)
- Description of demised premises

Additional requirements if Memorandum of Lease is recorded

- Title companies prefer that the Memorandum of Lease is dated and executed equal to the lease
- Granting clause in the present tense is also preferred.
- Reference to the actual lease

Searching Leasehold Titles

1. Examine the fee title prior to the date of the lease.
2. From the date the lease or memorandum of lease is recorded, search the title for matters affecting both the fee and the leasehold.
3. Run the GI for both the lessor and the lessee. For the lessor, look for bankruptcies. A debtor in bankruptcy can reject a lease, for example. For the lessee, look for matters as usual, such as judgments and tax liens.

Examining Leasehold Titles

1. Once all documents affecting both the fee and the leasehold are compiled, determine which matters can prime, affect or jeopardize the leasehold.
2. ALWAYS obtain a copy of the original lease and amendments.
3. Look for trust deeds recorded prior to the lease.
4. Look for documents signed by the lessee affecting the leasehold, such as subordination agreements.
5. Examine the lease very carefully for any lessor consents needed, such as a consent to encumber, assign or sublease the leasehold.
6. Examine the lease carefully for rights given to the lessee, such as ingress and egress rights. Read the description of the demised premises. It is not always just the land and improvements that are demised.

2. **Grant of Lease.** Landlord leases to Tenant and Tenant leases from Landlord the Premises and all easements, rights and privileges appurtenant thereto, in accordance with the provisions of that certain unrecorded Lease dated March 15, 2007 between Landlord and Tenant ("Lease"), including all rights of ingress and egress through and over the common areas of the Shopping Center (referred to in Section 16 of the Lease as "Common Area") designated for such purpose. A full and complete copy of the Lease is available at the offices of Tenant specified above.

Always read the description of the demised premises for additional interests or property to be searched. Here the searcher must search title to the Common Area for any encumbrances that could prime the lease, primarily trust deeds.

Examining continued

7. The Commitment must contain the legal description used in the lease. Do not use the fee legal description. Therefore, you must determine that the demised premises lie within the fee property.
8. Carefully review all amendments and supplements for changes in the legal description or other terms that impact the lessee's interest.
9. Determine the remaining term of the lease, especially if insuring a leasehold loan. The loan maturity date cannot extend beyond the lease term.

Sample of "Schedule A" Leasehold Description (Your Underwriter May Vary)

A LEASEHOLD created by that certain unrecorded "(title of underlying lease document)" dated _____, _____, executed by _____, as lessor, and _____, as lessee, as referenced in the document entitled "(Memorandum of Lease, Short Form Lease)" which recorded _____, _____, as Document No. _____, for the term or terms and upon and subject to all the provisions contained in said document and in said lease[, and contained in the (list amendments, if any)].

Requirements

(Your Underwriter may vary)

1. Always require a copy of the lease and all amendments, supplements and assignments.
2. Require an estoppel statement signed by both the lessor and the lessee stating that there are no unrecorded amendments, assignments or defaults on either side.
3. If lease requires, make a requirement for necessary lessor consents.

7.2 Mortgage.

(a) Lessee may not mortgage, hypothecate or otherwise encumber the Leased Premises or his interest in this Lease, or in the improvements situate thereon, without obtaining the prior written approval of Lessor. Notwithstanding the foregoing, Lessor agrees that its title in and to the Leased Premises shall be subject and subordinate to the lien of any first lien real property mortgage or deed of trust, and any subsequent renewal, increase, modification, replacement or extension thereof (hereinafter collectively referred to as the "mortgage"), which may be placed by Lessee, from time to time, upon Lessee's interest in this Lease, the Leased Premises and the improvements thereon; subject, however, to the following terms and conditions:

Note the requirement for landlord's approval to mortgage the property.

Sidebar

Also note the lessor agrees to subordinate its title to the premises to the lien of a leasehold mortgage. That is impossible. The lessor can join in the mortgage and encumber his title, but since fee title is the highest form of ownership, it can never be "wiped out," only conveyed. Hence, it cannot be subordinated to anything, only encumbered.

Severed Improvements - Residential

In some areas of the Valley, homebuyers actually lease the land and get a deed to the house. The landlord has severed the improvements, such that the land and the house are owned by different parties.

First Rule - Never insure title to the house by itself. You must insure a leasehold in the ground, also. Otherwise, how does the homeowner get to the front door? An easement is not sufficient for title insurance.

Second Rule - Always search the chain of title to both the ground and the house and determine that both chains match. To sever improvements, the first deed must come from the landlord, not the lessee.

Third Rule - Always convey title by an Assignment of Lease for the ground and a Deed to the house. Do not attempt to accomplish such a conveyance in a single instrument.

The Legal Description

Underwriters in Arizona use the “two-parcel” method shown below for describing the insured parcel. Then vest ‘fee as to Parcel 1 and leasehold as to Parcel 2.’

Exhibit A

PARCEL NO. 1:

ALL IMPROVEMENTS LOCATED ON THE FOLLOWING DESCRIBED PROPERTY

LOT 52, BRIARWOOD IV, ACCORDING TO BOOK 202 OF MAPS, PAGE 34, RECORDS OF MARICOPA COUNTY, ARIZONA.

PARCEL NO. 2:

LOT 52, BRIARWOOD IV, ACCORDING TO BOOK 202 OF MAPS, PAGE 34, RECORDS OF MARICOPA COUNTY, ARIZONA.

EXCEPT ALL THE IMPROVEMENTS LOCATED THEREON.

Note that the sum of Parcel 1 and Parcel 2 is merely Lot 52. Additionally, who is the actual owner of Parcel 2?

Mel's Method of Setting Up A Severed Improvements Commitment

- 1) Show the legal description as one parcel: Lot 52, Briarwood IV
- 2) Vest title in the homeowner
- 3) Describe the estate or interest being insured as follows:

Mel's method of describing the insured estate in Schedule "A" with severed improvements

LEASEHOLD in the ground only created by that certain unrecorded "(title of underlying lease document)" dated _____, _____, executed by _____, as lessor, and _____, as lessee, as referenced in the document entitled "(Memorandum of Lease, Short Form Lease)" which recorded _____, _____, for the term or terms and upon and subject to all the provisions contained in said document and in said lease[, and contained in the (list amendments, if any)], together with title to the improvements situated on the ground until termination of said lease.

Nearly every lease states that title to the improvements revert to the lessor upon termination of the lease. Examine the lease for how title to improvements is handled.

Therefore, avoid insuring "fee simple" title to the building.

8.3 Title to Improvements.

Upon the expiration of the term hereof, or upon the earlier termination of this Lease, Lessee's right, title and interest in and to any improvements comprising a part of the Leased Premises, as they then exist shall automatically be vested in Lessor without any liability or obligation on the part of Lessor, express or implied, to pay or compensate Lessee therefor. Lessee may not demolish the improvements upon the Leased Premises without obtaining the prior written approval of Lessor.

Note that title to the improvements reverts to the lessor upon termination of the lease. Therefore, it is not an estate in perpetuity or inheritance. In reality, it is a freehold estate for life measured by a term of years. As a freehold estate, it can be encumbered and conveyed during the term of years. It is because the freehold estate terminates on a date certain that we cannot insure "fee title to the improvements."

33-233. [Life estate in term of years](#)

An estate for life may be created in an estate for a term of years and a remainder may be limited thereon.

Schedule B Exceptions for Severed Improvements

At the end of Schedule B, show:

“Lessor’s title to the improvements upon termination of the leasehold estate as provided in the lease set forth in Schedule A.”

In loan policies, add to Schedule B:

“The effect of any failure to comply with the terms, covenants, conditions and provisions of the lease referred to in Schedule A.”

Your underwriter may also require:

“Any rights, interests or claims which are not shown by the Public Records but which could be ascertained by making inquiry of the lessors in the lease referred to in Schedule A.”

Sublease with Severed Improvements

MEMORANDUM OF SUBLEASE

This Memorandum of Sublease, made and entered into this 5th day of May, 2000, ~~19~~, by and between BRIARWOOD TWO HOMEOWNERS ASSOCIATION, INC. referred to hereinafter as "Lessor", and ~~_____~~ referred to hereinafter as "Lessee."

WITNESSETH:

For and in consideration of the sum of One Dollar, and other valuable consideration paid and to be paid by Lessee to Lessor, the Lessor does demise and ~~rent unto Lessee, and the Lessee does lease and take from the Lessor, upon the terms~~ and conditions and subject to the limitations more particularly set forth in that certain Lease Agreement between Lessor and Lessee bearing even date herewith, the following described property:

Lot 76 of Briarwood Two, according to the plat of record in the office of the County Recorder of Maricopa County, Arizona, in Book 172, page 17.

TO HAVE AND TO HOLD the same for a term commencing on the date hereof and ending April 30, 2070.

What should you be looking for?