Insurance & Reinsurance - Canada

A tale of two tenants: why due diligence is critical

Contributed by **Lang Michener LLP**

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When it comes to purchasing real property, buying title insurance is not a cure for all potential problems. A recent case in Ontario demonstrates the perils of relying on title insurance as a safety net against problems with tenants. Failure to carry out sufficient diligence left a property owner without tenants and seeking coverage from the title insurer.

In May 2008 1764139 Ontario Inc purchased a commercial strip mall. It also purchased a policy of title insurance from Stewart Title Guaranty Company. At the time of purchase, the purchaser understood that the lower part of the building, which contained a number of storage units, was occupied by a single tenant, Kennedy Storage. Kennedy had a five-year lease which expired on December 31 2009, with a renewal option. For a time, the rent due was delivered by the former owner of the property 'as agent' for Kennedy. In June 2009 Kennedy defaulted, the locks were changed and the purchaser posted a sign indicating to those with goods in the units that it was the owner of the property in question.

After seeing the sign, Maria Berardinetti contacted the purchaser. She claimed to have been leasing two units in the lower part of the building. This would overlap with the property leased by Kennedy. The written Berardinetti lease was not disclosed to the purchaser at or before the purchase transaction. Berardinetti had continued to pay her rent to the previous owner of the property after closing.

The policy insured for loss or damage due to, among other things, defect in title or unmarketability of title. The purchaser claimed that the Kennedy and Berardinetti leases were conflicting, and that this conflict constituted a defect in title at the time of purchase (the competing lease argument). The purchaser sought coverage for this defect under the policy. The purchaser also claimed that as the Kennedy lease appeared to be bogus, the apparent fraudulent misrepresentation of this lease rendered unmarketable the title that he had purchased (the bogus lease argument). Both defects in title and unmarketability of title were covered risks under the policy.

Under the competing lease argument, the purchaser contended that two tenants leasing the same space gave rise to a reasonable probability of litigation, and that this risk was sufficient to make title to the property doubtful, which therefore made title to the property unmarketable. The court rejected the competing lease argument and found that in order to make this claim under the terms of the policy, the purchaser had to have incurred a loss or damage. The state of title at the time of making the claim was irrelevant. Even if two leases (ie, the Kennedy lease and the Berardinetti lease) relating to the same space were in place at the time of closing, any conflict which may have existed between the tenants was resolved by the time that the purchaser learned of the conflict. As Kennedy had already defaulted and been locked out of the premises, there was no longer a conflict and no potential for litigation between the purchaser and the two tenants. There was also no evidence of any loss experienced by the purchaser as a result of any defect. Even if the leases were competing leases and even if this constituted a title defect at the time of closing in May 2008, the defect no longer existed at the time that the claim was made. Therefore, title to the property was not unmarketable at the time that the claim was made.

Under the bogus lease argument, the purchaser contended that the Kennedy lease was fraudulent, since the purchaser had been unable to locate anyone from Kennedy and the vendor of the property paid rent for Kennedy as agent. The court rejected the bogus lease argument, ruling that the potential claim against the vendor did not constitute a matter of title. The risk of litigation that would be a matter of title would be litigation with a third party over the property and the vendor's title to the property (eg, whether the property was allegedly owned by someone else or was subject to an unregistered easement). A claim against the vendor for a fraudulent misrepresentation is surely a serious matter, but is not transformed into a matter of title simply because

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the misrepresentation relates to real property.

Insureds are advised to:

- review their insurance policies with brokers and insurers to ensure that they understand the scope of the policy;
- consider the risks that they want covered and whether premiums for this coverage are justified by the likelihood of the risk or the damage that would be caused;
- carry out extensive diligence when making an acquisition of property, including reviewing leases, meeting with tenants and making site visits to see which units are accessed and by whom; and
- consult with a lawyer if in doubt about any of the above or about their rights under their insurance policy.

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