Financing Construction on Long Term Leasehold Estates

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INTRODUCTION

Construction of buildings on leasehold estates encompasses all the usual questions arising from the landlord-tenant relationship, with the additional complexities present because a building is to be erected on the premises. This article discusses some of the problems involved, with special attention directed to the case in which funds must be raised by the lessee to finance the construction. Emphasis is placed on lease provisions which will render financing attractive to a potential investor.

The construction of buildings on leasehold estates is not a recent development. Around 1860 the long term lease began to be used as a financing device in urban areas of the United States, and during the late nineteenth and early twentieth centuries played an important part in the development and expansion of American cities. A later variant, which became particularly popular in the rental of retail sales outlets, was the percentage lease, under which the rent was based on a percentage of gross or net sales, or on some other measurement derived from the property involved.

Today the long term lease continues to increase in popularity. This is due both to the pressure of business expansion and an increased supply of investment funds. A business concern today may be constantly expanding, in an effort to retain its share of the market by rendering better service or extending service and sales into a potential market. Since the end of the Second World War there has been a greatly

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1. There is no definite length for a long term lease. It is here considered to be twenty-five or more years in length.

2. Cohen, Long Term Leases, Problems Of Taxation, Finance, And Accounting 18 (1954). Information on some of the earlier history of long term leases and in general on their development will be found in McMichael, Leases; Percentage, Short And Long Term Chapters 1 and 17 (1947).

3. Cohen, op. cit. supra note 2, at 19. Where a percentage lease is involved the lessor may construct a building to the lessee's specifications and then lease both the land and the building to him. Such an arrangement is not within the scope of this article.
increased consumer demand for goods, which has resulted in an increased demand for buildings, machinery, and other capital goods and installations.\textsuperscript{4}

Management has thus been faced with the decision as to how this expansion is to be financed. When plant facilities must be enlarged, many reasons can be given for the use of construction on long term leasehold estates rather than on property owned outright. Some of these are: reduction of debt and simplification of capital structure, keeping investment in fixed assets low, tax advantages, and elimination of heavy real estate ownership.\textsuperscript{5} It has been suggested, however, that underlying all these reasons is the basic premise that the use of a long term lease will release funds which may be used more effectively for another purpose.\textsuperscript{6} Management must make two decisions: the optimum amount of capital, and its best alternative uses.

The other important factor today is the pressure of an increased amount of investment funds, which forces the holders of capital to go further afield in a search for investment opportunities. Insurance companies, which comprise a large proportion of the institutional investors in this country, have exerted continual pressure to liberalize state laws so that investment may be made in a greater variety of assets.\textsuperscript{7} Less conventional investments are being sought both because there is a shortage of other investment opportunities and because those which

\textsuperscript{4} Id. at 22.
\textsuperscript{5} Id. at 73, 74. A further factor influencing the use of a lease may be what is termed "management flexibility." Consider the possibility of acquiring use of a parcel of land either by a long term lease or by purchase, the price being raised by debt financing as in the case of a corporate mortgage bond issue. If the lease is used there are none of the restrictions on the lessee's future working capital position, borrowing activity and dividend policy which might be required for a bond issue. Id. at 82-83.
\textsuperscript{6} Id. at 73. Another device aimed at accomplishing much the same result is the sale and leaseback. See EITEMAN, THE LEASE AS A FINANCING AND SELLING DEVICE, Chapter 2 (1951).
\textsuperscript{7} "... over the past several decades life insurance investments ... have been growing at the rate much faster than the supply of those types of investments which have been traditional for such funds ..." Bell and Fraine, Legal Framework, Trends and Developments in Investment Practices of Life Insurance Companies, 17 LAW AND CONTEMPORARY PROBLEMS 45, 67 (1952).

Apparently, prior to 1942, no insurance company in the United States was permitted to make direct investments in real estate. In that year Virginia amended its law to permit this, and in 1946 New York State followed suit by adopting Sec. 81(7)(h) of the Insurance Law. Such investments are now permitted in about 40 States. RODGERS, SOME LEGAL PHASES OF LIFE INSURANCE INVESTMENT 4 (1954).

It is significant that not until an amendment of the Insurance Law in 1951 was a leasehold proper security for a loan by an insurance company. Therefore, investment in this field is a recent development. See N. Y. INSURANCE LAW §81(6)(a), as amended by L. 1951, c. 400, effective March 31, 1951. Evidently savings banks have not been interested in this type of investment, or have not been able to exert enough pressure on the legislature, since a leasehold is still not adequate security for a loan under section 235 of the New York Banking Law. OPS. ATT'Y. GEN. 275 (1899).
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are available do not provide a satisfactory return. The current investment situation is such that financing of leasehold construction may be more readily obtained. Admittedly a first mortgage on a fee interest is more attractive than a similar mortgage on a leasehold interest, but the potential lender cannot be as selective as he may wish. The increase in funds available for investment forces him to go further afield in his search for use of these funds, and he is then forced to consider the possibility of financing leasehold construction.

The construction of a building on the leasehold is of primary importance to both the lessor and lessee. The building, directly or indirectly, will provide income from which the lessee can meet his rent obligations. For the lessor it serves as security that the lessee will meet his lease obligations, since default on any of these obligations will result in forfeiture of the building.

During the period of construction there is little or no security for the lessor, as the building will not have substantial value until completion. In fact, there is need for additional security during this period merely to insure completion. At the other extreme, as the lease expiration date approaches there will be decreasing incentive for the lessee to maintain the building in good condition, thus impairing its value as security.

Since the building is to serve as security, the lessor should insist that it be of a certain minimum valuation and be completed within a specific period of time. The valuation will vary widely with the financial background of the lessee and his business and the value of the reality involved. It has been suggested that the minimum value of the building be from five to ten times the amount of the annual rental, or from ten to one hundred per cent of the value of the fee.

In many cases the prospective lessee may not have sufficient funds to finance the construction and thus will have to seek assistance. This will be available only if the lessee can offer adequate security, as by executing a mortgage of his lease-

8. COHEN, op. cit. supra note 2, at 15. See note 7 supra.
9. Where a particular piece of property is involved, the person wishing to use it may find that it is not for sale but only for lease. If the owner's basis is low he may wish to avoid the potential capital gains tax and the problem of reinvestment of the proceeds of sale.
10. The value of the building which reverts to the lessor, either upon default by the lessee or at the expiration of the lease, is not taxable income to the lessor, INT. REV. CODE OF 1954, §109.
11. See Part III, infra.
12. See Part IV, infra.
14. A leasehold mortgage will be used as the basis of discussion, but many other and varied financing arrangements are possible; see Part II infra.
hold interest. It would be wise for the lessee to obtain a commitment for financial assistance prior to entering into a lease, rather than gambling on obtaining this afterward. Once the lease is signed the borrower's position is weaker, since the prospective lender knows that obtaining financial aid is imperative, and stricter terms may be imposed. The best approach is to have the prospective lessee, lessor, and person rendering financial assistance confer and establish the terms of all agreements between the parties before any binding commitments are made.

If a leasehold mortgage is used, the lease will define not only the rights of the lessee but also those of the mortgagee, since his lien will be only upon the estate granted by the lessor. Furthermore, any prospective mortgagee must also consider his position as a lessee, since if any default on the lease obligations occurs, the mortgagee may find it necessary to assume these obligations in order to protect his security.

At the same time, a careful lessor will want to know how his lessee intends to finance construction. He would like to be fairly sure that the needed financial aid will be forthcoming, since inability to raise the needed funds may mean default on the lease obligations and the lessor will then be faced with the necessity of securing a new tenant.

Ideally the lessor, lessee and mortgagee would draft all the relevant agreements together, and no binding commitments would be made until all parties were satisfied with the terms of the transaction. It may be argued that admitting the mortgagee into lease negotiations would make final agreement harder to reach.

15. Generally, the lessor will lease an unencumbered piece of property. But suppose there is a prior mortgage on the fee. Foreclosure of this mortgage will terminate the lease; *Metropolitan Life Ins. Co. v. Childs Co.*, 230 N. Y. 285, 130 N. E. 295 (1921). However, a tenant not joined in a foreclosure proceeding cannot be evicted. *Stellar Holding Co. v. Burns*, 143 Misc. 781, 257 N. Y. Supp. 369 (1932). In effect, the fee mortgage is allowed to affirm or disaffirm the lease. The same problem is presented when the lease contains a provision which allows subordination of it to a subsequent mortgage.

The lessee in this case is placed in a precarious position. He cannot be expected to accept such a lease when he is planning to make a sizeable investment in the property. No financial aid will be forthcoming, and if there already is a mortgage on the fee the lessee should secure from the mortgagee a subordination of the mortgage to the lease, or an agreement that foreclosure will not terminate the lease. See *Friedman, Preparation of Leases* 27-30 (1953), Note, 47 Mich. L. Rev. 993 (1949).

16. Leases often contain a covenant by the lessee that he will not assign his estate without the lessor's permission. In this case such leases should further provide that permission will not be required if the leasehold estate is sold upon foreclosure of a leasehold mortgage or conveyed to a mortgagee in satisfaction of the mortgage.

17. Ostensibly, any security deposit is to compensate the lessor for loss occasioned by default. However, it may not always satisfy this purpose; it is wiser not to rely to any extent on the deposit, and instead do all that is possible to avoid the default.
since a third party's views would have to be taken into account. However, any objections raised in conference would have been encountered later when a leasehold mortgage was sought, and it seems wiser to face them at the earliest possible moment. This is particularly true in regard to a lease provision which the mortgagee would consider either absolutely necessary or entirely unacceptable.

If it is not possible to confer with the mortgagee while the lease is being prepared, it should be drawn with the idea that it will have to be in a form acceptable to some mortgagee. The lessor and lessee will have to foresee the provisions which a mortgagee would consider essential or objectionable, a task much more difficult than it would be if the mortgagee were present. Against these considerations must be balanced the adequate protection of the lessor, who must also remember that some day he may wish to sell his reversion. The terms of the lease will have an extremely important effect on the price which the reversion may command.

One serious problem is that construction may be financed with little or no capital investment by the lessee. Such financing could lead to overexpansion of the lessee's business operations, in which case one poor year might mean default on rent and other lease obligations. To prevent this possibility both the lessor and mortgagee should carefully examine the business operations, present and prospective, of the lessee, with special regard for this problem. The lessor might suggest a lease covenant that the lessee himself furnish a certain percentage of the necessary capital. The effectiveness of this is questionable, since it will not control the activity of the lessee with regard to construction on other property. If the lessor should try to impose any further restrictions on the lessee's business activity, such as limiting the power to borrow funds, he will meet with strong opposition, and if the lessee is well advised he will not accept any such restrictions. If it is necessary to impose detailed and specific restrictions of this type, then a collateral agreement covering these matters would be more appropriate than inclusion of such terms in the lease.

Actually, when the lessee seek financial assistance the lessor may benefit greatly. He has a tenant who is going to fulfill his lease obligations if at all possible. Standing behind this tenant is a mortgagee who is ready to take over.

18. The lack of restrictions may be one of the reasons why a lease is sought. See note 5 supra.
the lease obligations, because he has a lien only on the estate granted to the tenant and will lose his security if the lease is terminated.19

II

METHODS OF LEASEHOLD FINANCE

The discussion which follows assumes that a leasehold mortgage has been selected as the appropriate means for financing construction. Where a mortgage is used the funds may be advanced in a lump sum or in installments as needed during the various stages of construction. As in the case of an ordinary building loan, it is likely that the installment method will be employed. This is much wiser since it allows the mortgagee to exercise control over the funds during the course of construction. The building provides most of the security for the loan, and the entire amount of the loan should not be advanced at a time when the security does not exist.

Accompanying the building loan mortgage is a building loan contract. The latter is mainly an administrative document governing the disposition of any mortgage advances and aimed at protecting the integrity of the security. It will contain covenants by the lessee-mortgagor to accomplish this result; e.g., that the mortgagee may deduct certain amounts, such as any taxes due on the property, from any advances to be made under the contract, which deductions shall be deemed secured by the contract and mortgage; that advances are to be made in accordance with a schedule set forth in the contract; that the building is to be completed within a certain period of time and is to be of a certain minimum

19. When the lessee seeks capital to finance construction he must furnish security, which will be a personal obligation as well as a lien on the leasehold estate. Where a lease has been in existence for some time and the rent is a fixed sum, then a rise in property value will create a lease which is advantageous to the lessee in that he is paying rent which is less than the current fair rental for the property. In such a case financing will be easier to obtain, since the lender's security is enhanced by the increase in value. The lessee will be under increased pressure to meet his lease obligations, and even if the mortgage must be foreclosed the leasehold will be readily marketable.

However, any potential lender should not rely too heavily on the existence of such an “equity”. While the property has increased in value, this may be diminished while the building is being constructed. Even when the building is completed the value of the property will depend in a large part upon the type of structure is erected thereon. Thus the lender should not advance money simply because the lease has become advantageous to the lessee; an equally if not more important consideration is the extent of the lessee's financial responsibility and the use proposed for the property. A conservative plan of use where there is no equity may often be better than a speculative plan where there is an advantageous lease.

Any chance for appreciation accruing to the lessee's advantage will not be present where the lease provides for reappraisals at various stages during the term of the lease. See Part V infra.
valuation; that no advances shall be made unless construction is proceeding in an adequate and satisfactory manner, and if the progress is at any time unsatisfactory the mortgagee shall have the option of assuming responsibility for completion of the building; that all advances will be used to pay mechanics and materialmen and discharge their liens; and that insurance, satisfactory to the mortgagee, will be carried on the building at all times.\textsuperscript{20} One of the most important provisions is that which allows the mortgagee to take over construction of the building if it is not progressing satisfactorily. Such a stipulation is essential where there is a lease clause requiring the lessee to complete the building by a certain date, and the required completion date in the building loan contract should be well in advance of that required in the lease.

In the situation described above the necessary funds are raised solely by a mortgage of the leasehold. The mortgage is subject to all the terms of the lease, and the reversionary interest of the lessor is not subject to the lien of the mortgage. A variation of this arrangement occurs when the lessor makes his reversionary interest subject to the mortgage; this could also be coupled with the personal obligation of the lessor. It would seem that such an arrangement would be necessary only when the lessee does not exhibit sufficient financial responsibility, or when the proposed use of the property is especially speculative. The wisdom of such action from the lessor's point of view is seriously questioned. First, the lessor admittedly has a poor financial risk in his lessee, which is already undesirable from the viewpoint that possible default on the lease obligations can be foreseen. Second, in effect a partnership is formed between the lessor and lessee, with the lessor liable for a large partnership debt and having only a limited, although prior, claim on the partnership profits.\textsuperscript{21}

Although a mortgage is the basis of discussion, it may be profitable to make a limited survey of other available financing methods, chiefly leasehold security issues, since they may involve many problems in common with a mortgage. In place of a single mortgagee, many individuals may provide the necessary funds through the purchase of leasehold bonds. A corporate or individual fiduciary is selected as the indenture trustee and a leasehold mortgage then acts to secure

\textsuperscript{20} Of primary importance is the function of the building loan contract with regard to mechanic's liens. See Part III \textit{infra}.

\textsuperscript{21} It is also possible that the owner of an unimproved piece of property may not have sufficient funds to improve it and a mortgage may not provide enough additional capital. In this case, a sale and leaseback coupled with a leasehold mortgage may be used to obtain the required funds. The sale and leaseback today is by itself a widely used financing device. It is not limited to the financing of construction on leasehold estates but may be used to finance the use of both real and personal property. For a general discussion of the subject, see Cary, \textit{Corporate Financing through the Sale and Leaseback of Property}, 62 \textit{Harv. L. Rev.} 1 (1949); Cohen, \textit{op. cit. supra note 2, at 23; Eiteman, op. cit. supra note 6.}

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the bonds which will be issued under the indenture. One of the main advantages of leasehold bonds or other securities is that they facilitate the tapping of many sources of funds.\textsuperscript{22} The lessee may market the bonds himself or may allow an underwriter to handle the marketing.\textsuperscript{23} On the other hand, the cost of bond financing will often be higher than that involved in the use of a mortgage. If an underwriter is used there will be his commission to consider. Unless the amount of the loan desired is quite high, bond financing may not be justified due to the costs of underwriting and, in some cases, registration with the Securities Exchange Commission.

When bonds are used it will be necessary to provide for redemption at maturity. This may be done by establishing a sinking fund into which the lessee is required to pay a certain amount each year, which can be used to redeem some of the outstanding bonds. The remaining bonds will then be protected by increased security, as the total value of the mortgaged property will still be subject to the lien of the outstanding bonds. Repayment of part of the principal each year will also protect the bondholders in case the value of the leasehold or improvements thereon diminishes. The same amortization of the loan can be accomplished by providing that the bonds issued have staggered maturities over the period of the loan. In either case, default on redemption at any time would be considered as a default on the obligation running to the remaining bondholders.\textsuperscript{24}

Unfortunately, it may be that leasehold bonds are often used as a means for financing speculative projects for which money would not otherwise be available. It is interesting to note that leasehold securities have been widely employed in the highly speculative field of financing gas and oil extraction.\textsuperscript{25} The reason that such securities are popular in speculative fields is probably that individual and relatively uninformed investors may be "sold" more easily than a single mortgagee, particularly if the latter is a conservative institutional investor. During the 1920's the real estate bond was extremely popular, being secured either by fee or leasehold

\textsuperscript{22} The discussion of real estate bonds is based on BINGHAM & ANDREWS, FINANCING REAL ESTATE, chapter 17 (1924).
\textsuperscript{23} It is likely that the bonds will be taken on a "best efforts" basis, the underwriter making no guaranty as to the amount that will be sold and taking a commission only on the amount actually sold. For a full discussion of underwriting techniques, see Loss, SECURITIES REGULATION 106-120 (1951).
\textsuperscript{24} The problem of protecting leasehold bondholders is very much the same as that of protecting a single mortgagee. The indenture trustee must be given as much, if not more, power to act to protect the interests of the bondholders as a single mortgagee would have.
\textsuperscript{25} Loss, op. cit. supra note 23, 306-316.
It has been estimated that in the early 1930's there were more than $10,000,000 worth of these bonds outstanding and of these about eighty per cent were in default. Many of the defaults which occurred can be traced to the fact that proper care was not taken to protect the investors when the bonds were issued. This is not meant to suggest that the use of such bonds as a method of financing leasehold construction is in any way improper; when adequate safeguards are taken such bonds may be perfectly acceptable, and a properly secured leasehold bond can be just as sound an investment as a leasehold first mortgage. However, in view of past experience a potential investor in such securities would be well advised to examine the situation carefully before investing.

The use of securities to finance leasehold construction need not be confined to real estate bonds. It is possible to use common and preferred stock to represent different claims. The lessee could organize a corporation and convey to it the leasehold interest in return for common stock. The corporation could then issue bonds to a person or persons who would advance money for the contemplated construction. If further financing were necessary it might be possible to persuade suppliers of materials and labor to take preferred stock as compensation. The only limitation on such action is the ingenuity of the lessee and the willingness of creditors to accept stock in place of immediate payment.

26. "Over a long period of time the investor had been led to believe that there could not be a loss under a real estate bond. Houses of issue constantly bombarded the investor with the idea that no loss had ever been sustained by an investor, intending that the investor should believe that no loss would ever be sustained, and investors bought in reliance on the integrity and financial standing of the underwriter. But the very factors that led to defaults in the real estate bonds caused the failure of many of the houses of issue so that the investor was deprived of his chief reliance just at the time when he needed it most."

Rothschild, Some Legal Aspects of Real Estate Finance 1-2 (1937).


28. Ibid.; H. R. REP. No. 35 (part 2), 2-3, places the blame for losses suffered by the investor in the main on improprieties in the original financing. In particular, leasehold bonds were sold under representations that a fee interest was the security. The indenture trustee was often not able to or did not wish to, protect the interests of the bond holders. See Rothschild, op. cit. supra note 26, at 2-14.

Suggestions as to elimination of abuses in this field can be found in Saperstein, Real Estate Bond Issues of the Future 4-8 (1935).

29. A practical solution to a problem in financing construction on a fee interest is found in National Real Estate and Building Journal, Jan. 1949, p. 30: The owner wished to erect an apartment building in the suburbs of Cleveland. A mortgage loan could be obtained for only fifty to sixty percent of the value of the property, which was not sufficient to give the owner adequate working capital. Therefore, the owner of the fee conveyed the property to an Ohio corporation organized to hold the land, in return for common stock. Prospective tenants were obtained who bought six percent cumulative preferred stock in proportion to the floor space of the apartments that they would occupy. The annual net income of the property is $100,000, and this is used to pay the dividends on the preferred stock and to retire a certain amount of this stock, pro rata, each year. It is estimated that all of the preferred will have been retired approximately fifteen years after the date of issuance.
COMPLETION OF THE BUILDING: MECHANICS' LIENS

The focal point of many of the problems which will be discussed here is the building which has been constructed or which is to be constructed upon the leasehold estate. This building represents a guaranty of rent payments to the lessor, and to the mortgagee it is property on which he has a lien, a valuable right even though this lien is junior to the rights of the lessor. Thus the value of the building must be preserved at all times during its life. Care must be taken that it is completed free of liens, that it is protected against loss due to fire or other casualty, and that it is always maintained in good condition. Failure to comply with these requirements will impair or eliminate the building's function as security and jeopardize the rights of both the lessor and the mortgagee.

It follows from this that the first concern of the parties is that the building be constructed free of any incumbrances other than the lien of the mortgage. During the course of construction liens may arise in favor of all persons furnishing labor or materials who are not paid for their services. These liens will attach to the property interest of the person or persons who consent to the work. Since the lessee will be contracting for the work, his leasehold interest will be subject to lien. In addition, in almost every case the lease will require construction of a building, and such a lease condition amounts to consent by the lessor so that the lien will also attach to his reversionary interest. In New York the courts have found the requisite consent on the part of the lessor where there has been such a requirement in the lease, or a requirement that certain alterations be made on already existing structures. However, the lessor is not liable in personam for costs of such construction or alteration unless he has expressly agreed to contribute thereto.

The mortgagee is also vitally interested in this problem. If he wished, he could advance the total amount due under the mortgage and then assert a

30. See Part IV, infra.
31. N. Y. LIEN LAW §3.
32. Ibid.
33. Otis v. Dodd, 90 N. Y. 336 (1882), affirming 24 Hun. 538 (1881) (Covenant to erect buildings which immediately were to become lessor's property and which could not be removed without lessor's consent during the term of the lease or at the expiration thereof); Jones v. Menke, 168 N. Y. 61, 60 N. E. 1053 (1901), reversing 36 App. Div. 636, 56 N. Y. Supp. 1109 (1st Dep't 1889) (Covenant by lessee to improve premises for restaurant and liquor trade within three months); McNulty Bros. v. Offerman, 152 App. Div. 181, 137 N. Y. Supp. 27 (2d Dep't 1912); Note, 8 FORHAM L. REV. 384 (1939).
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superior lien over any subsequent lienors. However, in so doing he would lose that great measure of control which is achieved by making installment advances only so long as the construction is proceeding in a satisfactory manner. The building will not be adequate security for the loan until it is properly completed, and immediate advancement of the whole sum is not wise even if the mortgagor appears to be completely reliable. The statutory law of New York affects a compromise between the conflicting interests of mortgagee and lienors; the building loan contract and mortgage must be recorded, and the schedule of advances contained therein will inform potential lienors of the mortgage lien, the terms of the mortgage and, most important, the time at which advances are to be made so that they may secure payment of their debts. The mortgagee is given only partial priority; he will come ahead of the lienors only as to advances made before he is given notice of any liens by the recording system. Any advances made after notice of lien is filed will be subject to the lien. It is therefore necessary for the mortgagee to make a title search for such liens immediately prior to making any advances. In addition, if the advances made before the filing of notice of lien are to be protected, both the building loan contract and the building loan mortgage must contain a covenant by the mortgagor that he will hold in trust for the potential lienors all advances made and the right to receive all future advances. Prior to the filing of notice of lien, the lienors must look to the trust res created by the covenant in the mortgage and contract that all advances will be held for the benefit of lienors.

The mortgagee is not required to make sure that the mortgagor is properly applying the advances. However, the statute imposes certain sanctions to prevent misuse of the advances. They must be segregated in a special bank account and the mortgagor must keep a record of all disbursements made from this account, the records being available for inspection by the lienors. Diversion of these funds for an improper use is punishable as larceny, and a civil remedy is provided for enforcement of the trust created.

36. The money advanced under the building loan contract may be raised by sale of securities issued under the mortgage, such as the real estate bonds discussed in Part II, supra; N. Y. LIEN LAW §2(13).
38. N. Y. LIEN LAW §13(2).
39. Id. §13(3).
40. This compromise is approved and contrasted with the views taken by other jurisdictions in 4 AMERICAN LAW OF PROPERTY §16.1061 (1952).
41. N. Y. LIEN LAW §13(3).
42. Id. §36(d).
43. Id. §36(b).
As soon as any notices of lien are filed, no further advances can safely be made by the mortgagee. Thus, such liens can have the effect of stopping construction until they have been discharged. Therefore it is wise to take further precautions to prevent the imposition of liens. Where construction is done under a contract with a general contractor, the construction contract may contain a covenant that the contractor will not file or permit to be filed any such liens. Care should be taken in drafting this provision, since an agreement not to permit liens to attach to a building does not prevent the contractor from filing his own lien when the owner defaults. The desired protection can be obtained only by an express waiver of lien in the construction contract. It is also advisable to get waivers of lien from all subcontractors involved, if possible. However, payment in full to the general contractor is also satisfactory in this respect, since the subcontractor may not file a lien if the general contractor has been paid in accordance with his contract. The New York Lien Law does not place an obligation upon the owner or lessee to see that the contractor makes proper payments to the subcontractor.

Another solution would be to have the lessee post a bond to insure completion of the building free of liens. This is a common long term lease provision, since the lessor has no other effective means of insuring that the building will be completed properly within the time stipulated in the lease. The objection to requiring such a bond is that it will involve considerable expense for a lessee who may already need financial assistance. The security should be in the form of cash or readily marketable securities, such as government obligations or the bond of a professional surety company. The amount

48. The use of a security deposit in the form of cash or securities adds further complications to the transaction. The parties must consider who is to receive the interest on the deposit; who is to vote any proxies; when repayment will be made to the lessee; who shall hold the deposit; if the lessor holds the deposit, what duties of management, care and investment are imposed on him; what effect a sale of either the lessor's or lessee's estate will have upon the deposit. For a discussion of these and other problems, see Note, 34 Col. L. Rev. 426 (1934).

Note in connection with these problems that N. Y. REAL PROPERTY LAW §233 provides that any such security deposit is to be considered a trust fund and must be kept segregated. Neither the lessor nor the lessee may waive this requirement.
required, to be effective, must be sizeable, and where the lessee is short of capital funds and is also investing in the building himself the burden of providing security is quite severe. A surety’s bond is also unsatisfactory from the lessee’s point of view, since he will have to put up security to get the bond and will also have to pay a fee to the bonding company. Depending on the financial integrity of the lessee involved, it may be possible to do away with the requirement of a bond, especially where the lessee is investing some of his own capital in the building. This would be accomplished by having all the lessee’s available funds used before resort to any mortgage advances, and these could be held as security during construction, being released as progress is made; thus the cash deposit would be converted into an investment in the building which would still serve as a security deposit.

It is apparent that construction financed through a building loan contract will be more attractive to the lessor, since it imposes stricter regulation upon the lessee. It is possible that the lessor will be willing to forego a security deposit if such a financing arrangement is used. There should not be any provision in the lease governing the type of financing to be used, especially where the lease is to be for a very long term; during the term of the lease there may be a change in thinking about acceptable leasehold financing practice, and it is wiser not to make specific stipulations of this type which may later necessitate changes in the lease. However, the fact that one type of financing rather than another may be desirable shows the advantage in having all the interested parties confer prior to the execution of the lease. Here the lessor might prevail upon the mortgagee to exact some terms not suitable for inclusion in the lease, or to make some other arrangement which will benefit the lessor. In Chicago a substantial reduction in the security required to insure completion free of liens has been allowed when a construction loan has been made by a reputable financial institution and the loan has been conditioned upon expenditure of the proceeds of the loan on the building.

Waivers of lien, bonds, and building loan contracts can help insure satisfactory completion of the building, but the most important factor is careful appraisal of the lessee and his plans. In this regard the mortgagee has much more at stake than the lessor; the latter may find himself with a defaulting tenant, but the former must also contend with the possible loss of security.

50. Another possibility is that the lessor offer the lessee a lower rental if an acceptable means of financing is chosen. In regard to the reduction of rent to facilitate mortgage financing, see Part V infra.
PROBLEMS OF DEPRECIATION: INSURANCE, AND PURCHASE AND RENEWAL OPTIONS

Once the building has been completed in a satisfactory manner the lessor and mortgagee must face further problems, the most important being maintenance of the value of the building. During the lifetime of the building its value may be lessened by depreciation of three types: contingent depreciation due to casualty loss, functional depreciation or obsolescence, and normal physical depreciation due to the ravages of time.\textsuperscript{52}

Contingent depreciation is the most easily solved problem, since protection against it may be secured by adequate insurance coverage.\textsuperscript{53} It is not, however, satisfactory to provide that the proceeds of casualty insurance be used to pay off the mortgage debt outstanding at the time of loss. First, the lessee would be deprived, to the extent of the mortgage debt, of funds with which to construct a new building, and would be forced to seek new financing elsewhere. Second, the lessor looks to the building as security for the performance of the lease obligations, and this security should not be impaired by any reduction in amount. Thus the lease and mortgage might both provide that the proceeds of insurance be used to repair the damage to the building, or if the loss is total, to finance new construction.\textsuperscript{54}

Functional depreciation presents greater difficulties because its occurrence is based on many factors outside the control of any of the parties. Change of neigh-

\textsuperscript{52} WEIMER \& HOYT, PRINCIPLES OF URBAN REAL ESTATE 20 (1948).
\textsuperscript{53} Both the lease and mortgage will require that the lessor maintain satisfactory insurance coverage on the building at all times. However, reliance should not be placed solely on the lessee. The mortgage should require the lessee to turn over the insurance policies at the time the building loan mortgage is executed. All subsequent mortgage payments should include not only principal and interest but also a pro rata amount of the renewal premium of the policies. These funds would be held in escrow by the lender and used to pay for renewal premiums when due.
\textsuperscript{54} 1 AMERICAN LAW OF PROPERTY §3.75 (1952). This need not necessarily involve an extension of the mortgage, although the mortgagee may be willing to grant one. The mortgage might be extended by the amount of time necessary to restore the building. If no extension can be obtained then the lessee is, at least, in no more disadvantageous position than if the mortgage were discharged by use of the insurance proceeds.

Where mechanics' liens have attached to the property prior to the casualty loss, and the insurance thereon is payable to the lessee or his representative, then the insurance proceeds are subject to such liens after deduction of the premiums paid by the lessee. Diversion of the proceeds to other purposes, such as reconstruction, without discharging the liens, is larceny. N. Y. LIEN LAW §4-a.

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borhood, highway facilities, population shifts and market factors, all of which are extremely difficult to forecast, play an important part in changes in the value of a building. It is hard to take steps to prevent this type of depreciation. Perhaps the best protection is proper analysis of the adaptability of the building to several types of business activity, and a proper choice of location after due consideration of such activity. Every prospective mortgagee, and to a lesser extent every prospective lessor, should consider not only the practicality of the use proposed for the building at the time of its initial construction, but should also attempt to evaluate the same matter for a considerable time in the future. The mortgagee's task may be a little bit easier, since he must consider only the period over which the mortgage will extend.

Normal physical depreciation may be fairly easily countered and eliminated. Such depreciation will be of increasingly serious concern to both the mortgagee, if there is one, and the lessor toward the end of the lease, since the lessee will feel that there is no reason for expending a great deal of money on a building which is soon to revert to the lessor. As the end of the lease approaches the mortgagee runs the risk of a decrease in the value of his security due to the lessee's failure to properly maintain the property.55

Two approaches can be used here. First, sanctions may be applied to the lessee who does not keep the property in good repair. Second, the prospect of keeping the property in good condition can be made to appear attractive and profitable to the lessee apart from any sanctions contained in the lease. The first step is to include covenants in the lease and the mortgage requiring adequate maintenance by the lessee, including the making at his expense of all repairs that may become necessary. Failure to do this can lead to termination of the lease; such a provision is common in long term leases.56

It has also been suggested that the lease might provide for a sinking fund maintained by the lessee.57 The idea is that even should the lessee default, the lessor would be able to repair the old building or finance new construction. Presumably the payments required under this arrangement would be increased as the building aged, recognizing that maintenance charges increase toward the end of a building's economic life. The lessee should accept such an arrangement only if he is allowed a credit against sinking fund deposits for all actual repairs done on the building; if this is not done, it will hamper the conscientious lessee who wishes

55. Furthermore, as the end of the lease approaches, the value of the lessee's estate will diminish and the value of the reversion will increase.
56. This will not protect the lessor or mortgagee against obsolescence. A covenant to keep the property in good repair will not call for replacement of an obsolescent building. NIEHUSS & FISHER, op. cit. supra note 49, at 28.
57. Id. at 29.
to keep the property in good condition. He would have to bear both the repair expenses and the sinking fund requirements, which would defeat the purpose of the fund by actually diminishing the funds available for repair.

Another objection to the use of such an arrangement is the difficulty of making an accurate estimate of the actual repair costs. In practice, the adoption of a fair standard may be impossible, since the cost of repairs over the expected life of the building may not be susceptible of accurate estimate. If the approximation is not accurate, then either the lessee will have put too much in the fund or else it will be too low to accomplish its purpose.

Primary reliance on a lease covenant to keep the property in good condition will not be satisfactory either. The lease cannot accurately specify what is to constitute "good condition," since the circumstances will vary in each case. Final resort might have to be had to the courts to determine whether the lessee is fulfilling his obligations. The lessor may find that by the time the lease is terminated for breach of this condition, the property has suffered considerable harm. Finally, this lease covenant in itself provides only a bare minimum; the lessee may have a good deal of latitude in what he does, and the value of the property may be diminished even though he does conform to the minimum requirements of the lease.

There are, however, other means by which the lessee can be encouraged to maintain the property in a satisfactory manner. These methods provide an incentive rather than a sanction. Reversion of the building to the lessor at the end of the lease is hard to justify. During the existence of the lease, the investment of the lessee in the building serves as an inducement to prevent default, especially default on rental payments. When the end of the lease is reached there is no longer need for this security, assuming no previous violations, and there appears to be no reason why the lessor should get the building without compensating the lessee therefor. It may be argued that the building is to be considered as part of the rent paid to the lessor under the terms of the lease. In other words, the rent might be reduced because of the value of the building which is to revert to the lessor. This argument assumes that the building will have a value at the end of the lease, which involves a further assumption that the building will be kept in reasonably good condition and will not suffer from obsolescence. It would seem quite speculative to predict a valuation of this type, and usually the rental is fixed with, at most, no more than fleeting consideration of this matter.

If the lessee retains an interest in the building he will be encouraged to keep it in good condition and perhaps make certain valuable additions to it. If it is
required that the lessor give the lessee some measure of compensation for the improvements erected, the lessee will be anxious to keep the improvements in good condition, assuming the compensation approximates the fair market value of the building at the termination of the lease.

However, requiring compensation in this manner alone goes to the other extreme and puts a burden upon the lessor. Suppose that the building is not satisfactory to the lessor, since he wishes to put the property to a different use upon expiration of the lease. He must then bear any costs of removing the building and, in addition, compensate the lessee. Assuming that the lessor contemplates new construction he should not have to bear more than the demolition cost.

Either extreme of no compensation or forced compensation is not fair or practical. A suggestion has been made to resolve this impasse, which is to give the lessor and lessee options to buy out each others' interest when the lease is terminated. The lessor would have the first option, which would be to buy the building and thus compensate the lessee for the value that he has added to the property. If the lessor did not wish to exercise his option then the lessee would have the option to purchase the lessor's reversion and acquire a fee interest in the property. It has been further suggested that if neither party chose to exercise their options, then they would become tenants in common with their interests being in proportion to the value of their respective contributions to the property.

The suggestion of double purchase options is good, but the creation of a tenancy in common does not seem to be wise. The lessor could refuse to purchase because he felt that the building was not suitable for the use he desired for the property. At the same time, the lessee could refuse to purchase because the value of the building was not sufficient to justify the cost of acquiring the fee interest. In such a case any gain to the lessor and loss to the lessee due to reversion of the building would not seem to be objectionable. Moreover, the result of a tenancy could be eventually to force the lessor to buy out the lessee's interest in order to effectively use the property.

However, the double option by itself is fair and effects an equitable adjustment of the parties' interests. Moreover, it can act an aid to leasehold finance. Its first effect is to encourage the lessee to maintain the building in good condition, which means that the value of the mortgagee's security is maintained. More important is the fact that it makes the financing of construction more readily obtainable during the latter part of the lease. Suppose

58. Id. at 31-5.
59. However, insofar as the improved condition of the building may also enhance the value of the reversion, the lessee is increasing the option cost of the property to himself by improving it.

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that a mortgage is desired with only 15 years to run on the lease, or the lessee wants an extremely long term mortgage which would not be completely repaid until a date which from the mortgagee's point of view is dangerously close to the termination date.

The double purchase option insures that the lessee will either have the money to discharge the mortgage debt,\(^6\) being compensated for the value of the building, or he will have fee ownership of the property, which is better security for the mortgage than a leasehold interest. The exercise of the option by the lessee will turn a first leasehold mortgage into a first mortgage on the fee.\(^6\) With such protection there ordinarily should be no impediment to obtaining a mortgage any time during the lease.

A related provision would allow the lessee to purchase the fee at any time during the term of the lease, or at any time after a certain number of years have elapsed. Here there is no opportunity for the mortgagee to be paid off from the proceeds of a sale of the building, but the lessee's interest is always convertible into fee ownership, which should be satisfactory to the mortgagee.\(^6\)

Given the fact that either one of these two option arrangements is included in the lease, it is necessary to decide how the price of the option is to be determined. The wisest procedure is to provide for appraisal of the property at the time the option is to be exercised. If a fixed price is set and the value of the property changes, then one party will not wish to exercise his option and the result may be just as inequitable as when no option of any kind is included in the lease. This is especially relevant where the option is included so that mortgage financing may be more readily obtained.\(^6\) If appraisal is used, adequate safeguards are available to insure that a fair price will be fixed.\(^6\)

It is possible that the lessor will not accept a lease which gives the lessee a chance to purchase the property, or which imposes an obligation upon the lessor

\(^6\) The mortgage should stipulate that any proceeds available to the lessee because of such an option be applied to discharge the mortgage obligation.


\(^6\) The single purchase option will allow the lessee to escape from a lease which is disadvantageous to him, as in the case where the rental value has fallen since the execution of the lease.

\(^6\) If the lessee does not want to exercise the option, then the mortgagee should be allowed to do so in order to protect his security.

\(^6\) If no agreement can be reached, the courts will fix a fair price for the exercise of the option. William D. Rae Co. v. Courtney, 250 N. Y. 271, 165 N. E. 289 (1929). The courts will also review the decision of any appraisers to make sure that the price fixed is fair. Moore v. Eadie, 245 N. Y. 166, 156 N. E. 653 (1927). Ice Service Co. v. Phipps Estates, 245 N. Y. 393, 157 N. E. 506 (1927); see note 67 infra.
FINANCING CONSTRUCTION ON LONG TERM LEASEHOLD ESTATES

to compensate the lessee for improvements. Therefore a compromise may be necessary, and a renewal lease may be the means of accomplishing this.

A renewal clause makes possible extension of the lease for a specified period or periods of time, and may provide for one or several renewals of the lease. In New York, long term leases are often for an initial term of 21 years with renewal options of similar duration.65

Near the date at which the original lease is to come to an end, the lessee may notify the lessor that he wishes to remain in occupancy. The lease for the renewal period is the same as the original, except that a reappraisal is customary to ascertain the rent to be paid for the term of the new lease. The renewal option presents a less favorable picture to the mortgagee then the purchase option.66 Suppose the property has appreciated in value since the lease was executed. At the time the mortgage was given, the fair rental value was twice the rent reserved by the lease, and the mortgagee took the resultant leasehold "equity" into consideration when making the loan. The renewal option, while maintaining the lease in force, will remove this equity as the rent reserved will be adjusted upward to coincide with the fair rental value of the property. Thus the mortgagee's margin of security will be diminished. Such a situation should be contrasted with the more favorable double purchase option which will either provide cash for the discharge of the mortgage or convert the mortgage into a first lien on the fee.

In spite of a possible mortgagee preference for a purchase option, the financing of leasehold construction may be greatly facilitated by the inclusion of a renewal option. It will encourage the lessee to maintain the property in good condition since, like the purchase options, it gives him a continuing interest in the property. Either type of option will be valuable and should be included in the

65. Comment, 48 YALE L. J. 1400, 1402 (1939). This practice is due to the facts that (1) leases for longer than 21 years were once subject to a special tax, and (2) owners hesitate to lease for long periods when there is a continued rapid rise in land values.

66. The renewal option can greatly aid in getting financial assistance, especially where a mortgage loan is sought from an insurance company. Section 81(6)(a) of the New York Insurance Law provides that an insurance company may invest in a mortgage on leasehold property having an unexpired term of not less than twenty-one years including the additional term which may be obtained through an enforceable option of renewal. In addition, such loan may not extend for more than four-fifths of the unexpired term including the renewal option, and in no case longer than thirty-five years. Thus, even though the renewal option may result in increased rent, it enhances the opportunity to get a mortgage from an insurance company. Actually, it is in this respect more favorable than a purchase option, since no special advantage accrues from a purchase option under the law at present.

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lease; without one or the other, the lessee may find that leasehold financing is a difficult matter when a substantial part of the lease term is over. 67

V

RENTAL PAYMENTS

A lease with reappraisal provisions is somewhat similar to the lease with a renewal option; it provides that at certain stated intervals the property will be reappraised and a new rental determined. 68 The function of this type of lease is to adjust the rent so as to reach a predetermined rate of return, say six per cent, on the fair market value of the property. Where the rental is the same for the whole term of the lease, there being no reappraisal, the impact of any rise or fall in the value of the property will fall on the lessee. The reappraisal lease shifts the effect of any fluctuation in property values to the lessor, except as to the extent that such a change may fall on the lessee in the period between reappraisals.

Such a lease has both advantages and disadvantages as far as the lessee is concerned. While there will not be much chance for him to obtain a substantial equity in the property, he will also not have the risk of holding the property for a long period of time under a lease by which the rent reserved is higher than the current rental rate.

A variation of the reappraisal lease is one which provides for reappraisals with a minimum payment below which the rental may never fall, even though the property decreases in value. Such a lease is extremely disadvantageous to the

67. Both the lessee's right to renew the lease and his right to compensation for improvements constructed on the property have been the subject of legislation in England. See The Landlord and Tenant Act, 1927, 17 & 18 Geo. 5, c. 36 §§1-5, 17, 21; The Landlord and Tenant Act, 1954, 2 & 3 Eliz. 2, c. 56, §§24-26, 30, 33, 34, 37, 43. The statutes apply to renewal of most business tenancies of more than one year's duration. The lessee may ask the lessor for renewal, and if the request is denied may petition the courts to grant a renewal of up to 14 years in length. Renewal will not be granted if it can be shown that the lessee has failed to observe the covenants in the former lease or if the lessor needs the property for his own use, but not if the lessor merely wants to rent to another person.

Where renewal is not granted because the lessor wishes to use the property for another purpose, then the lessee is entitled to compensation for improvements he has constructed. To be entitled to claim such an award, the lessee must notify the lessor prior to the commencement of improving the property of his intent to do so. Then the lessor has time to object that the improvements are not suitable for the property, or to make any other objection he wishes. If he fails to make such objection before a court prior to the construction of improvements, or if the court finds his contention to be without merit, the lessee is then entitled to compensation which is fixed by the court at the end of the lease, but only when the lessee has asked for and been unable to obtain a renewal of that lease.

lessee, as he will bear any loss in the value of the property while the lessor will benefit from any increase.

The reappraisal lease makes it more difficult for the lessee to obtain financial aid. He will obtain little or no equity in the property; it may not appear to be an attractive risk to potential investors; and frequent reappraisal will make it hard to estimate the actual return which may be expected from an improvement. It is possible that a particularly well-planned improvement will eventually lead to increased rent. The only attractive aspect of a reappraisal lease is that it will relieve the lessee from burdensome rent obligations when the value of the property has fallen, but it is questioned whether the reappraisal feature will be included if there appears to be much chance that there will be a decrease in the property value.

Both the renewal and reappraisal lease have the disadvantage to the lessee that they will not let him benefit for long periods of time from a rise in the property value. However, the former is less objectionable since it does not involve any obligation to continue under the lease. The lessee may ascertain the increased rental which he is to pay, and then determine if he wishes to stay on. The reappraisal lease denies him any choice in this matter.

Finally, there is the graded rental lease, in which there are several different periods with varying rental payments during each of these periods. The rental may be stepped up or stepped down during these periods. It is possible that the rent may start at a low rate, increase, and then decrease as the end of the lease approaches.

The graded rental lease may be used to aid financing and also to help the lessee maintain the property in adequate condition as the end of the lease approaches. Assume that the land is held under a forty year lease and that a mortgage with a term of fifteen years is possible to finance the construction. If the parties confer in advance, it may be possible to arrange for low rentals during the first fifteen years and the last ten years, with a proportionate increase in the middle fifteen years to compensate for these reductions. The effect of this would be to allow the lessee to devote more funds to the payment of the mortgage and encourage the extension of financial assistance during this initial period. The reduced rental during the last ten year period would allow the lessee to devote more funds to the maintenance of the building during a time when these costs can be expected to be highest.

Such an arrangement means that until the fifteen year mark has been

70. See Part IV, supra.
reached the lessor will in effect be subordinating part of his rental claim of the mortgagee. During the middle period of the lease, the rental payments will in part represent forced saving on the part of the lessee similar to that involved in a sinking fund arrangement. However, the graded rental does not guarantee that any funds will be available to pay for maintenance; it merely means that the lessee may apply more available funds to repair if he so desires. The lessor is receiving a prepayment of rent which conceivably could be used to repair the building if it reverted to the lessor upon the lessee’s default.

A graded rental arrangement is something to be seriously considered by the parties interested in leasehold construction. Its main advantage is that it lessens the financial commitments of the lessee during the first part of the lease. In this respect it may make financial assistance more readily available during this period.

VI

TERMINATION OF THE LEASE

The last point of inquiry will be to consider the aspects of termination of the lease which are of importance to the mortgagee. The termination here discussed will be limited to that occurring upon condemnation of the demised premises, bankruptcy of the lessee, and default by the lessee.

A. Condemnation

In the first instance, the property may be taken for public use by either the federal, state or local government, and this condemnation may be either total or partial. New York cases generally have held that the lessee is entitled to compensation for the taking of his leasehold estate. However, by the terms of the lease the lessee may waive, or be deemed to have waived, any rights to share in the award, as when it is provided that the leasehold is to terminate upon vesting of title in the condemnor or when the lease contains an express waiver.


73. Musanti v. New York, 73 Misc. 534, 131 N. Y. Supp. 20 (1911), where lessee waived the right to claim an award as to the land but retained the right as to the building. In re Harlem River Drive, 202 Misc. 540, 113 N. Y. S. 2d 292 (1952).
present value of the property is below that on which the rental was based, the lessee may not be allowed to share in the award in the absence of a provision in the lease covering this situation, on the theory that there is no value assignable to his estate. 74

The mortgagee has a lien on the mortgagor's interest in the condemnation award in the amount necessary to satisfy the mortgage debt. 75 This lien extends not only to the property interest which the lessee may have, but also to any rights which he may exercise with respect to the mortgaged property. 76 Therefore, the mortgagee can be expected to require that the lease in no way prejudice the rights of the lessee in the award. It is also preferable that the parties spell out in the lease the basis on which the award is to be allocated, instead of leaving the subject for litigation and judicial determination. 77

There are many ways in which the award could be allocated, but it has been suggested that there are three which are most commonly used. 78 First, under the

76. Application of Lafayette Nat. Bank of Brooklyn, supra note 75. A case decided by the Court of Appeals shows the extent to which a leasehold mortgage is protected and allowed to share in the condemnation award. United States v. 53½ Acres of Land, supra note 75. In this case the lessee had defaulted in the payment of rent for several successive rental periods. The lessor instituted summary proceedings to remove the lessee from the property, and a court order was obtained to that effect and carried out. The property was then condemned. By statute in New York a creditor or mortgagee of the lessee has a right of redemption for a certain period of time following eviction in summary proceedings. N. Y. Civ. Prac. Act §1438.

Here the mortgagee was allowed, upon the payment of the rent due with interest, to exercise this right of redemption and receive the share of the condemnation award which would have gone to the lessee if there had been no default.

However, not all such rights survive the vesting of title in the condemnor. In In re Waterfront on Upper New York Bay, 246 N. Y. 1, 157 N. E. 911 (1927), the lessee had an option to purchase the property at a fixed price, but did not have any other right under the lease which would entitle him to share in the condemnation award. The lessee waited until after the amount of the award was ascertained and then, the award being more than the option price, attempted to exercise the option and claim the award. Held: the option was terminated by vesting of title in the condemnor. But cf. In re Triborough Bridge Approach, 249 App. Div. 579, 293 N. Y. Supp. 223 (1st Dep't 1937), aff'd without opinion, 274 N. Y. 581, 10 N. E. 2d 561 (1937) (Lease for five years; renewal options for four successive five-year periods were considered in allocating part of condemnation award to lessee in absence of lease provision covering allocation).

77. Where there is no such provision in the lease, judicial determination of allocation will be available. In re Delancy St. in City of N. Y., 120 App. Div. 700, 105 N. Y. Supp. 779 (1st Dep't 1907).
78. MIEHUIS & FISHER, op. cit. supra note 49 at 36-37.
"present value" clause the lessor receives the present value of the remaining rentals for the term of the lease, plus the present value of the reversion. The total award is taken as the value of the property at the end of the term for computing the present value of the reversion. Such an assumption is preferable to a second separate determination of the value of the property, which may vary from the amount of the original award.

A second type of clause gives the value of the land to the lessor and the value of the building to the lessee. The objection to this arrangement is that it gives to the lessor all the changes in the value of the land. Under the "present value" theory such changes accrue to the lessor only through the change in the value of his reversion. At the inception of the lease the value of the reversion is slight and would be little affected by such changes; as the end of the lease approaches, any fluctuations in value will have more effect on the value of the reversion.

From the financing aspect this second clause can be harmful to the lessee. Its effect is to leave the leasehold mortgagee without the chance of benefiting in any manner from an increase in the value of the property, his only security being a steadily depreciating building. While it is not suggested that the mortgagee will make a loan strictly on the value of a leasehold equity, such an equity may influence the mortgagee to grant a larger loan for building construction than would have been granted on the security of the building alone. The presence of a clause giving the entire value of the land to the lessor may decrease the amount of money which the mortgagee is willing to advance.

The third type of clause gives the lessor an amount equal to the capitalized value of his rents. If the rate of interest is constant then the lessor will get the same amount, no matter when the condemnation takes place. Fluctuations in the value of the land will not be reflected in the lessor's award, and this may result in a substantial injustice to either the lessor or lessee. If property values go up the lessor will not receive an amount equal to his estate since the value of his reversion is not considered. If property values fall drastically, then the amount paid to the lessor may substantially exhaust the award.

It is the latter result which makes this third clause objectionable to the mortgagee. A drastic decline in land values would mean that the lessee might not receive adequate compensation for the building, and the mortgagee would be deprived of the proceeds realized upon the forced sale of his security. Like the second clause, this will discourage an adequate loan.

The best result will be obtained by adopting the "present value" clause
mentioned first. This means that as the lease progresses the lessee will be entitled to an ever decreasing proportion of the award. It still allows the lessee to share in the appreciation or depreciation of the value of the property to some extent. Thus the mortgagee can consider the value of any existing leasehold equity in determining the amount of the loan. If there is such an equity, the lessee's share in it will diminish as the lease progresses. However, this is not objectionable and it parallels the valuation of the lessee's interest in the lease hold where no condemnation occurs.

B. Bankruptcy

It is common for leases, both short and long term, to provide that bankruptcy or insolvency of the lessee or an assignment for the benefit of creditors shall automatically terminate the lease. At one time the lessor was not in a very favorable position when the lessee was declared bankrupt, since it was held that rent accruing after the date of the petition in bankruptcy was not provable, as the liability thereon was contingent. This doctrine favored the interests of other creditors since the claim for default on a long term lease might amount to more than the claims of all the other creditors.

The reaction to this treatment was a search by lessors for some device which would allow them to terminate the lease prior to the bankruptcy, so as to give them a provable claim for damages encompassing the whole lease term. The desired solution was reached by the use of an “ipso facto” clause in the lease, which provided that bankruptcy should be considered a breach and termination of the lease without any action on the part of either the lessor or lessee. Such a clause was held to give the lessor a claim provable in bankruptcy, the claim being for the amount of the rent reserved for the rest of the term of the lease, less the fair rental value of the property for such term.

The amendments to the Bankruptcy Act in 1934 made an “ipso facto” clause no longer necessary; the Act now provides that claims for such damages are specifically provable. The right to recover is limited, however, to the amount of rent accruing within one year from the termination of the lease. Similarly,

80. In one case the general claims against a bankrupt chain store company were $9,000,000 in the aggregate, while claims of lessors for future rent amounted to $43,000,000. 1 U. S. L. Week 404 (1934).
82. Ibid. The New York Debtor and Creditor Law, section 13(a), adopts the one-year bankruptcy provision and applies it to assignments for the benefit of creditors.
in corporate reorganizations the lessor is limited in his right to recover, being able to prove a claim for no more than three years rent.\textsuperscript{83}

Thus the main historical justification for such treatment of bankruptcy has vanished; but leases continue to provide for "ipso facto" termination. It is suggested however, that if mortgage financing is to be available, the lessor must be willing to forego such a forfeiture provision. It would jeopardize the position of any person advancing money upon leasehold security. The mortgagee in the case where the lessee is declared bankrupt would have only an unsecured claim against his estate. The security for the loan would be gone at the moment when the petition in bankruptcy was filed, since the lessee's interest would terminate at that time. Such a clause would tend to discourage loans to even the most reliable lessees. The dangers inherent in the possibility of the lessee's business being a failure would be greatly magnified.

C. Default by the Lessee

Successful leasehold finance will arise from the careful selection of the business activity to be conducted on the property. The lease should be drawn so as to afford adequate protection to the lessor without imposing unduly restrictive conditions upon the lessee. Neither the lease nor the mortgage obligations should be so one-sided or oppressive from the lessee's point of view that the success of a business venture which is basically sound will be imperiled. The discussion which has preceded this section has attempted to show in what manner the lease and mortgage may best function to protect the lessor and mortgagee without imposing unreasonable restriction on the lessee.

However, in the background of all such discussion is the thought that the lessee may, due to mismanagement or generally bad business conditions, be unable to maintain payment on the lease or mortgage or both. If there is default on lease obligations the mortgagee should have the right to declare the principal of the mortgage due, and foreclose if the lessee cannot or will not cure the default.

Default on the lease obligations represents perhaps the most dangerous problem to the mortgagee. It is common practice to include in the lease that the breach of any of the covenants shall expressly authorize the lessor to terminate the tenancy. The termination may be by notice to the lessee and subsequent initiation of summary proceedings.\textsuperscript{84}

\textsuperscript{83} It is also necessary to consider leases drawn before the amendment to the Bankruptcy Act which contain an "ipso facto" clause. The mortgagee should insist upon a modification of the lease to remove this before agreeing to advance any money upon a leasehold interest.
In New York a distinction is drawn between a condition in a lease, violation of which will not automatically terminate the estate, and a conditional limitation, the latter causing the estate to terminate without any action on the part of the lessor when there is a breach of lease covenants. Where a conditional limitation is involved the lessor may bring summary proceedings to evict the tenant; otherwise the proper action is ejectment.  

No matter whether the lease is drawn to provide for a condition subsequent or a conditional limitation, the lessor should not be allowed to proceed without first giving the mortgagee a chance to cure the default. It has been established that the mortgagee has a right to cure the lessee's default in rental payments, and may do this by tendering the amount due directly to the lessor. This right is, of course, dependent on the knowledge of the mortgagee that a default has occurred. On the other hand it has been held that when summary proceedings are justified by the terms of the lease, then the lessor is under no obligation to inform the mortgagee of a default in rent payments.

Where the lessee has been removed from the property by an action of ejectment, the mortgagee may redeem the lease by paying the amount of rent due plus interest and costs within six months after the lessor has regained possession on an execution issued on judgment. If summary proceedings are used, the mortgagee may redeem within a year after the warrant to remove the tenant is issued, but this right exists only if the unexpired term of the lease at the time the warrant is issued is more than five years.

Reliance on such procedure is unsatisfactory from the mortgagee's point of view and his interests may be badly prejudiced. The section granting a right of redemption where summary proceedings were used applies only when the default has been in rental payments. The same is true for ejectment. Thus default on a different lease covenant, such as the covenant to complete the building free and clear of liens, will not come within the statutory rights of redemption. Apart

88. N. Y. Civ. PRAC. ACT §§1001, 1002.
89. *Id.*, §1438. Under section 1437 the lessee himself has such a right to redeem.
90. *Id.*, §1439.
91. *Id.*, §§1001, 1002.
from the statute there is a possibility that a right of redemption exists in equity, but the mortgagee should not rely on the existence of such a right.

Full protection can be given the mortgagee only if he must be notified of the tenant's default prior to the commencement of any action to recover the premises. He should also be given a reasonable period in which to cure the default. Failure to pay rent will probably be the most common default, and one which can be cured fairly quickly by the mortgagee. Therefore, the period of grace could be made shorter here than in other cases.

It is suggested that the lease provide that the lessor will give both the lessee and the mortgagee notice of default and intention to commence proceedings to remove the tenant after a stated period of grace. An additional safeguard is obtained when the mortgagee gets from the lessor a written consent to the mortgage, a term of that consent being that notice of any default will be given by the lessor to the mortgagee by registered mail at a specified address, and that the mortgagee shall have the period of grace stipulated in the lease to make good any defaults.

Such a procedure will eliminate the need for resorting to the statutory method of redemption. While a right may exist under the statute or in equity, reliance on it can prove to be troublesome and no doubt will be costly. While the mortgage will not be originally entered into if there is foreseeable chance of default, the mortgagee should be pessimistic and provide for it. Such pessimism may eventually prove very wise.

CONCLUSION

Only a few of the problems and considerations in leasehold finance have been mentioned here; each situation will involve problems of its own, and the leases and mortgages negotiated will vary widely from case to case, and from year to year. In many areas today real estate expansion has been extremely rapid, and there are signs that some areas are overdeveloped in regard to certain types of business enterprises. For example, the number of shopping centers in urban areas is increasing to the point where soon the financing of such centers may no longer be wise investment policy. On the other hand, many of the factors will

94. National Real Estate and Building Journal, April 1954, p. 44.
remain constant; none of the parties can insist on everything he wants unless he is in an overwhelmingly strong bargaining position. There is usually plenty of room for compromise, and it is thus preferable that all the parties concerned confer before any agreements are entered into.