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COMMENTS

THE EFFECT OF A MORTGAGE FORECLOSURE ON A LEASE EXECUTED SUBSEQUENT TO THE MORTGAGE

A owns Blackacre in fee. *B* loans money to *A* and takes a mortgage on Blackacre as security for the debt. Subsequent to the execution of the mortgage *A* leases the land to *C*. *A* then defaults on his debt and *B* takes steps to realize on his security. What are the rights and obligations of *B*, the mortgagee, *C*, the lessee, and *A*, the mortgagor-lessor?

The last business depression brought a great many of these transactions into litigation. Defaults on mortgage debts were common and

foreclosures numerous. Lessees who had entered into long term leases at high rentals before the "crash" were anxious to be relieved of their obligations. Foreclosing mortgagees were just as anxious to maintain the rental income. This was the typical case, although at times the situation was reversed—the lessee desiring to retain the lease and the mortgagee wishing to terminate it.

Lease Prior to the Mortgage

As a background for this discussion a short analysis of the relationship between a lessee holding a lease executed prior to the mortgage and the mortgagee seems desirable. The lessor's mortgagable interest consists of the reversion and a right to the rent. At common law a mortgage subsequent to the lease would, without any specific mention in the instrument, cover both of these interests.[1]

In title theory states the mortgagee under such a mortgage is entitled to the rent, even before default. A statute or a special agreement may postpone that right until the mortgagor defaults. In either situation, the requisite privity is found in the mortgagee's succession to the mortgagor's estate.[2]

In lien theory states the mortgagee has no right to rent before default unless the mortgage so provides. The mortgagor, as owner entitled to possession until foreclosure, is entitled to collect rents from his tenants, subject to the right of the mortgagee in connection with foreclosure to have a receiver of rents appointed to protect him in cases in which his security is precarious.[3] In foreclosure a mortgagee who took with actual or constructive notice of the prior lease can sell only the lessor's interest and the tenant's rights under the lease cannot be extinguished.[4]

Lease Subsequent to the Mortgage

Where the lease is executed subsequent to the mortgage the relationship of the parties is not so well defined.

(a) *Historical.* At common law a mortgage of land conveyed the fee interest, which included the right to immediate possession. Early cases from title theory states, that is, those jurisdictions adhering to the common law concept of mortgage, held, in the absence of a clause permitting

[1]TIFFANY, LANDLORD AND TENANT (1912) § 146 (e); WALSH, MORTGAGES (1934) 94.

[2]Otis v. McMillan, 70 Ala. 46 (1881); Noble v. Brooks, 224 Mass. 288, 112 N. E. 649 (1916); F. Groos & Co. v. Chittim (Tex. Civ. App. 1907), 100 S. W. 1006.

[3]WALSH, MORTGAGES (1934) 94, In State *ex rel.* Gwinn v. Superior Court, 170 Wash. 463, 16 P. (2d) 831 (1932), it was held that REM. REV. STAT. § 804, which provides that the mortgagee is not entitled to possession until foreclosure, prevents the mortgagee from taking advantage of a clause in the mortgage covering rents and profits because it amounts to a taking of possession prior to foreclosure in violation of the statute. *Cf.* Debentures, Inc. v. Zech, 192 Wash. 339, 73 P. (2d) 1314 (1937), which held that where the assignment of rents was not provided for in the mortgage or in a separate instrument executed coincident with the execution of the mortgage, but was made three years after the mortgage was executed, it constituted a new and entirely valid contract.

[4]Recording of the lease, or the tenant's possession, are held to constitute notice of the lease. Taylor v. Bell, 129 Ala. 464, 29 S. W. 572 (1900) (Lessee's landlord could not impair rights of lessee by giving a mortgage subsequent to the execution of the lease.); Tropical Inv. Co. v. Brown, 45 Cal. App. 205, 187 Pac. 133 (1920); Heaton v. Grand Lodge, 55 Ind. App. 100, 103 N. E. 488 (1913).

the mortgagor to retain possession, that the mortgagee could assert his possessory right before as well as after default. The execution of a lease subsequent to the mortgage did not deprive him of this right. Since the mortgagor had neither "title" nor right to possession he had no interest which he could lease.[5] Consequently any person who took possession under a purported lease had no more right to possession of the land than one who had derived his possession from a stranger to the title. As against the prior mortgagee the tenant was merely a trespasser and could be evicted as he might by any holder of a paramount title.[6]

Modernly, in both title and lien theory states, the mortgagor is usually allowed to retain possession of the mortgaged premises until condition broken,[7] or until judicial sale ordered by the decree of foreclosure,[8] and in many instances until the expiration of the statutory period of redemption.[9] The mortgagor's possessory interest is sufficient to constitute the subject matter of a lease.[10] As the lessee's right to possession stems from a similar right in the mortgagor-lessor it is apparent that the mortgagee is not entitled to possession as against the lessee unless he has that right against the mortgagor. The effect upon the lessee of the mortgagee's assertion of his possessory rights against the mortgagor is a matter on which there is a lack of uniformity in judicial decisions, as is shown by the following analysis of the cases.

(b) *Common law rule.* One line of authority adheres to the rule that the mortgagee's assertion of possessory rights and "absolute title" as against the mortgagor is an eviction of the lessee by title paramount and that such an eviction terminates the lease and the lessee's liabilities thereunder.[11] As the tenant's right to possession depends upon that

[5]Keech *ex dem.* Warne v. Hall, 1 Doug. 21, 99 Eng. Rep. 17 (1778); Rogers v. Humphreys, 4 Adol. & El. 299, 111 Eng. Rep. 799 (1835): "If the lease be subsequent to the mortgage then the mortgagee may treat the lessee and all those who may be in possession as wrongdoers." *Cf.* Moss v. Gallimore, 1 Doug. 279, 99 Eng. Rep. 182 (1779) (mortgagor not really a tenant at will, but only like such a tenant). *Cf.* Birch v. Wright, 1 T. R. 378, 99 Eng. Rep. 1148 (1786) (mortgagor's possession is that of the mortgagee). *Cf.* Litchfield v. Ready, 20 L. J. (N. S.) Ex. 51 (1850).

[6]Anderson v. Robbins, 82 Me. 422, 19 Atl. 910 (1890).

[7]Burke v. Willard, 243 Mass. 547, 137 N. E. 744 (1923); Smith v. Shephard, 15 Pick. (Mass.) 147 (1833); Kimball v. Lockwood, 6 R. I. 138 (1859).

[8]McDermott v. Burke, 16 Cal. 580 (1860) (right of mortgagor to possession ends with transfer of deed, by which sale is consummated); Jones v. Thomas, 8 Blackf. (Ind.) 428 (1847).

[9]Dolese v. Bellows-Claude Neon Co., 261 Mich. 57, 245 N. W. 569 (1932), (1933) 32 MICH. L. REV. 119; Benz & Sons v. Willar, 198 Minn. 311, 269 N. W. 840 (1936), (1937) 21 MINN. L. REV. 610.

[10]Rohrer v. Deatherage, 336 Ill. 450, 168 N. E. 266 (1929).

[11]*Fed.*: Tyler v. Hamilton, 62 Fed. 187 (C. C. D. Ore. 1894); Moran v. Pittsburgh C. & St. L. R. Co., 32 Fed. 878 (C. C. D. Ohio 1887), *appeal dismissed* 154 U. S. 110 (1893).

Ala.: American Freehold Land Mortgage Co. v. Turner, 95 Ala. 272, 11 So. 211 (1892) (foreclosure by power of sale).

Cal.: Mercantile Trust Co. v. Union Oil Co., 176 Cal. 461, 168 Pac. 1037 (1917); McDermott v. Burke, 16 Cal. 580 (1860); *Cf.* Title Ins. & Trust Co. v. Pfenninghausen, 57 Cal. App. 655, 207 Pac. 927 (1922).

Del.: Merchant's Union Trust Co. v. New Philadelphia Graphite Co., 10 Del. Ch. 18, 83 Atl. 520 (1912).

Ill.: Gartside v. Outley, 58 Ill. 210 (1871); *Cf.* Reichert v. Bankson, 199 Ill. App. 95 (1916).

Ind.: Jones v. Thomas, 8 Blackf. (Ind.) 428 (1847).

of the mortgagor-lessor, when the latter's right falls the tenant's right falls with it.[12]

In supporting this rule, some cases employ the irrelevant rationale that if the lease is not terminated the mortgagor thus may defeat entirely the security of the mortgagee by executing a long-term lease for an inadequate consideration.[13] This assumes that the only alternative is preservation of the lease in every instance. It fails to recognize the possibility of giving the mortgagee an option to preserve or terminate the lease. The argument also assumes the unlikely possibility that the mortgagor will be foolish enough to enter into such an unfavorable lease for the purpose of depriving the mortgagee of his security. The mortgagor would be paving the way for a larger deficiency judgment against himself because of the lower price the land would bring at the foreclosure sale.

Another argument that has been advanced in behalf of the common law rule is that the mortgagor cannot make a lease giving a greater right than he had or which will interfere with the right of the mortgagee to enter for condition broken.[14] This involves the same faulty analysis that is found in the cases dealing with disputes between the lessee and

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Iowa.: The Iowa court holds that failure to join the lessee in the foreclosure action does not deprive the purchaser at foreclosure of his right to possession, but possession cannot be delivered to him under the process of that judgment. The purchaser cannot obtain that remedy except by some other action. Downard v. Groff, 40 Iowa 597 (1875); Dolese v. Bellows-Claude Neon Co., 261 Mich. 57, 245 N. W. 569 (1932), (1933) 32 MICH. L. REV. 119 (The fact that lessee was not made a party only affects the remedy the purchaser must pursue against the lessee to recover possession.); Johns v. Wilson, 6 Ariz. 125, 53 Pac. 583 (1898). The cases are not clear as to whether the lease is preserved if the lessee is never made a party to any action.

La.: Thompson v. Flathers, 45 La. Ann. 120, 12 So. 245 (1893); Barelli v. Szymanski, 14 La. App. 47 (1859).

Me.: Anderson v. Robbins, 82 Me. 422, 19 Atl. 910 (1890) (title theory).

Mass.: Burke v. Willard, 243 Mass. 547, 137 N. E. 744 (1923) (title theory); Smith v. Shephard, 15 Pick. (Mass.) 147 (1883) (Entry on condition broken allowed by statute.).

Mich.: Dolese v. Bellows-Claude Neon Co. 261 Mich. 57, 245 N. W. 569 (1932), (1933) 32 MICH. L. REV. 119.

Minn.: Benz & Sons v. Willar, 198 Minn. 311, 269 N. W. 840 (1936), (1937) 21 MINN. L. REV. 610 (lien theory).

Mo.: McFarland Real Estate Co. v. J. Gerardi Hotel Co., 202 Mo. 597, 100 S. W. 577 (1907) (power of sale in instrument).

N. H.: Hale v. Nashua R. Co., 60 N. H. 333 (1880).

R. I.: Kimball v. Lockwood, 6 R. I. 138 (1859) (title theory).

Eng.: Rogers v. Humphreys, 4 Adol. & El. 299, 111 Eng. Rep. 799 (1835); Keech *ex dem.* Warne v. Hall, 1 Doug. 21, 99 Eng. Rep. 17 (1778) (title theory).

[12]McDermott v. Burke, 16 Cal. 580 (1860). Some of the actions available to the mortgagee against the lessee after assertion of his paramount title are indicated in Castleman v. Belt, 2 B. Mon. (Ky) 157 (1841). The mortgagee can bring ejectment, or maintain trespass for mesne profits after the date of the deed, or waive trespass and sue in assumpsit for use and occupation from the date of the mortgagee's demise. But he cannot distrain and bring an action for rent on the lease. Rogers v. Humphreys, 4 Adol. & El. 299, 111 Eng. Rep. 799 (1835).

[13]American Freehold Land Mtg. Co. v. Turner, 95 Ala. 272, 11 So. 211 (1892); Reichert v. Bankson, 199 Ill. App. 95 (1916); Barelli v. Szymanski, 14 La. App. 47 (1859).

[14]Westside Trust & Sav. Bank v. Lopoten, 358 Ill. 631, 193 N. E. 462 (1934).

the purchaser upon foreclosure, next to be discussed.

The argument chiefly relied upon in these cases is that the rights of the mortgagee and the purchaser at the foreclosure sale are not fixed by the status at the date of the sale but relate back to the date of the mortgage. Thus, it is said, that since the lease was not in existence when the mortgage was made, there were no rights against a tenant which could be transferred upon the foreclosure sale; the reversion created later by the execution of the lease is subject to the prior mortgage and when such reversion is destroyed by foreclosure the leasehold falls with it.[15] The weakness in this argument is that it employs a fiction—relation back—as a substitute for an analysis of the relations actually existing between the parties with respect to the mortgaged subject matter. In the normal case one who mortgages land has a fee simple interest. Designating the owner's interest as "M", when the owner mortgages he divides his interest, "M", into two parts: "M_1", the fee simple subject to be entirely divested if the mortgage conditions are not fulfilled, and "M_2", the interest of the mortgagee, which consists of a power to acquire or create in a purchaser at foreclosure sale a fee simple absolute in the land if there is a default upon the mortgage. When the mortgagor subsequently leases the land he again divides his interest at that time, "M_1", in two parts: "M_1a", a possessory leasehold, and "M_1b", a reversion expectant upon the leasehold. The mortgagee's interest, "M_2", remains the same, except that it now applies to the two parts into which "M_1" has been divided; his power now exists with respect to both parts. There is no need to talk about "relation back." Upon breach of the conditions in the mortgage the power can be exercised with respect to the interests as they then appear. The only question to be considered is whether the mortgagee has taken the steps necessary to exercise his power of foreclosure and sale as to both interests. If he has, the sale operates upon the interests as they are at the time of the sale, not upon the interests as they were when the mortgage was made.

Another feature of the decisions in this line of authority is the rule that the leasehold is terminated without the joining of the mortgagor's lessee in the foreclosure action. It is usually said that he need not be joined because he is not beneficially interested in the claim secured or in the estate mortgaged.[16] It is submitted that this holding is based upon a rationale which is valid today in but a small number of states[17] because of the change in theory as to the effect of a mortgage upon the possessory rights of the parties. In a jurisdiction which adheres to the original common law theory of mortgages, the mortgagee being entitled to possession of the land from the time of the execution of the mortgage the proposition that the lessee's rights are extinguished without joining him as a party defendant in the foreclosure action is valid. As the mortgagor's possession—if he was in possession when the lease was made—is merely by sufferance of the mortgagee the mortgagor's lessee is not more than a tenant at sufferance, or more likely he is but

[15]Reed v. Bartlett, 9 Ill. App. 267 (1881); Kimball v. Lockwood, 6 R. I. 138 (1859); 1 TIFFANY, LANDLORD AND TENANT (1912) § 73; S. A. Gard, *Lessee's Status after Foreclosure of a Prior Mortgage* (1933) 1 KAN. CITY L. REV. 11; see *infra*, p. 44.

[16]McDermott v. Burke, 16 Cal. 580 (1860).

[17]*See* 2 JONES, MORTGAGEES (8th ed. 1928) 225, *n.* 62.

a trespasser, as to the mortgagee.[18] As such he is subject to summary eviction by the mortgagee, even before default upon the mortgage; *a priori,* after default either with or without foreclosure proceedings against him. It follows, then, that there is no need to join the mortgagor's lessee under the original common law theory. But if the mortgagor is entitled to possession, the situation is entirely different, and modernly the mortgagee is entitled to such possession at least until default. The mortgagor then has an interest which he can transfer to another or out of which he can carve lesser interests in favor of another. The lessee acquires from his lessor possessory rights which, although subject to defeasance, must, nevertheless, be foreclosed if they are to be defeated. The reason underlying the result under the strict common law theory thus fails in most of the American states. The cases, therefore, which simply follow the earlier authorities without taking into consideration what the rule of the jurisdiction is as to possession before default or foreclosure are not well reasoned, and it may be suggested that the rule permitting the leasehold to be extinguished without the joindure of the tenant deprives the tenant of his property without due process in a state which follows the more modern theory of mortgages.

In the states generally adhering to this view the termination of the lessee's interest is avoided, however, if "authority" is contained in the mortgage,[19] or if the lease is executed by both the mortgagor and the mortgagee,[20] or where by prior conduct the purchaser at the foreclosure sale is estopped to claim that the leasehold is extinguished.[21] Moreover, while the rule normally forbids the adoption by the mortgagee or the purchaser at the foreclosure sale of the benefits of the lease without the consent of the lessee[22] it is recognized that the mortgagee or the purchaser, by conduct indicating an intent to recognize the lessee as his tenant and by the tenant's recognition of the mortgagee or the purchaser as his landlord, may create a new lease.[23] If no new lease is made the tenant by mere acknowledgment of the mortgagee or purchaser as his landlord, that is by attorning to him,[24] may become a tenant at will,

[18]Even if the mortgagor were in possession as tenant at will of the mortgagee, the possessory rights of both the mortgagor and his lessee would be terminable merely by notice. *See* Public Service Co. v. Voudomas, 84 N. H. 387, 151 Atl. 81 (1930). Moreover, the transfer of the mortgagor's interest upon foreclosure sale would terminate the possessory rights of both. *See* 1 TIFFANY, REAL PROPERTY (3rd ed. 1939) 261.

[19]Merchant's Union Trust Co. v. New Philadelphia Granite Co., 10 Del. Ch. 18, 83 Atl. 520 (1912). What constitutes such an authority is not made clear by the decision. It might mean that if the mortgage contained a pledge or assignment of rents it would be regarded as a contract to assign the reversion when it comes into existence, when it would operate somewhat like a mortgage on after-acquired property.

[20]Flynn v. Lowrance, 110 Okla. 150, 236 Pac. 594 (1924).

[21]McDermott v. Burke, 16 Cal. 580 (1860); Mercantile Trust Co. v. Union Oil Co., 176 Cal. 461, 168 Pac. 1037 (1917).

[22]Moran v. Pittsburgh C. & St. L. R. Co., 32 Fed. 878 (C. C. S. D. Ohio 1887), *appeal dismissed,* 154 U. S. 110 (1893).

[23]McDermott v. Burke, 16 Cal. 580 (1860); Reichert v. Bankson, 199 Ill. App. 95 (1916); Gartside v. Outley, 58 Ill. 210 (1871). *See* 1 TIFFANY, LANDLORD AND TENANT (1912) §§ 73 (3), 73 (6).

[24]It has been urged that the mortgagee or purchaser is precluded from asserting his rights against the tenant or from obtaining an acknowledgment of tenancy from him by reason of an English statute—11 GEO. II,

and this may be converted into a periodic tenancy by payment and acceptance of rent.[25]

(c) *New York Rule.* Recent cases indicate a growing trend toward what is referred to as the New York rule. These jurisdictions give the mortgagee the option of preserving or terminating the lease. By making the tenant a party defendant to the foreclosure proceedings the mortgagee may terminate the lease. By omitting him from the proceedings, the mortgagee may preserve the lease.[26] If the lease is preserved the lessee pays the rent reserved in the original lease.[27]

The cases supporting this rule are not in harmony in their reasons for so doing. The leading case of *Metropolitan Life Ins. Co. v. Childs*[28] relied on a statute[29] which provides that:

"The grantee of leased real property, or a reversion thereof,

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c. 19, § 11—, adopted in many states—*see, e. g.*, IOWA CODE (1935) § 2013—, which makes void all attornments to "strangers," excepting an attornment to a mortgagee "after the mortgage has been forfeited." Reichert v. Bankson, 199 Ill. App. 95 (1916), where the court said of the mortgagee, "he is an absolute stranger to such tenant." But these statutes cannot prevent the mortgagee who is entitled to possession from asserting his possessory rights by an eviction of the tenant and they do not seem intended to preclude an attornment by a tenant to one, who by reason of paramount title, has a right to evict him and is threatening to do so. Westside Trust and Sav. Bank v. Lopoten, 358 Ill. 631, 193 N. E. 462 (1934). As eviction by paramount title is always a defense to a claim for rent, acquisition of possession by the mortgagee relieves the tenant from the duty to pay rent to the mortgagor-lessor. Smith v. Shephard, 15 Pick (Mass.) 147 (1833). The same is true when, to avoid an actual eviction, the tenant attorns to the mortgagee or purchaser, since an attornment is properly regarded as "constructive" eviction by paramount title. Kimball v. Lockwood, 6 R. I. 138 (1859). *See* 1 TIFFANY, LANDLORD AND TENANT (1912) §§ 73 (4), 182 (2) a.

[25]Gartside v. Outlay, 58 Ill. 210 (1871); Kimball v. Lockwood, 6 R. I. 138 (1859). Dicta in some cases have also indicated that if the tenant is permitted to make extensive improvements under the terms of the lease, the mortgagee or purchaser will be held to have consented to an extension of the lease. McDermott v. Burke, 16 Cal. 580 (1860); Gartside v. Outlay, *supra;* but *cf.* Anderson v. Robbins, 82 Me. 422, 19 Atl. 910 (1890).

[26]*Fla.:* Dundee Naval Stores Co. v. McDowell, 65 Fla. 15, 61 So. 108 (1913).

Ga.: Western Union Tel. Co. v. Brown & Randolph Co., 154 Ga. 229, 114 S. E. 36 (1922).

Ill.: Gale v. Carter, 154 Ill. App. 478 (1910); Richardson v. Hadsall, 106 Ill. 476 (1883); *Cf.* Westside Trust & Sav. Bank v. Lopoten, 358 Ill. 631, 193 N. E. 462 (1934) (joinder not mentioned); *Cf.* Rohrer v. Deatherage, 336 Ill. 450, 168 N. E. 266 (1929).

Mont.: Blodgett Loan Co. v. Hansen, 86 Mont. 406, 284 Pac. 140 (1930) *semble;* Dolin v. Wachter, 87 Mont. 466, 288 Pac. 616 (1930) *semble.*

Neb.: Munday v. O'Neil, 44 Neb. 724, 63 N. W. 32 (1895).

N. J.: Walgreen Co. v. Moore, 116 N. J. Eq. 348, 173 Atl. 587 (1934); Ellveeay Newspaper Workers' B. & L. Ass'n v. Wagner Market Co., 110 N. J. L. 577, 166 Atl. 332 (1933); Union Inv. Co. of N. J. v. McDonough, 94 N. J. L. 130, 109 Atl. 301 (1920).

N. Y.: Metropolitan Life Ins. Co. v. Childs, 230 N. Y. 285, 130 N. E. 295 (1921); Commonwealth Mortgage Co. v. DeWaltoff, 135 App. Div. 33, 119 N. Y. Supp. 781 (1909); Hirsch v. Livingstone, 3 Hun. (N. Y.) 9 (1874).

[27]Western Union Tel. Co. v. Brown & Randolph Co., 154 Ga. 229, 114 S. E. 36 (1922); Commonwealth Mortgage Co. v. DeWaltoff, 135 App. Div. 33, 119 N. Y. Supp. 781 (1908).

[28]230 N. Y. 285, 130 N. E. 295 (1921).

[29]McKINNEY'S CONS. LAWS OF N. Y. (1917) § 223.

> or of any rent, the devisee or assignee of the lessor of such lease . . . has the same remedies . . . for the non-performance of any agreement contained in the assigned lease . . . as his grantor or lessor had, or would have had, if the reversion had remained in him."

The court felt that the purchaser at the foreclosure sale was a "grantee of the reversion" within the meaning of the statute,[30] saying: "It is precisely the same so far the estate granted was concerned as if the lease had been prior to the mortgage."[31]

The *Childs* case has been criticized by one writer[32] on the basis that the statute cited by the New York court is inapplicable to the situation under consideration. Granting that this is true[33] the writer's conclusion that the leasehold interest is necessarily terminated upon foreclosure of the mortgage without the tenant being joined as a party defendant is based upon wholly erroneous conceptions as to the nature of the relationships created by a mortgage and subsequent lease in any case in which the mortgagor is entitled to possession, either by statute or agreement, until default upon the conditions of the mortgage.[34]

[30]*Accord:* Blodgett Loan Co. v. Hansen, 86 Mont. 406, 284 Pac. 140 (1930); Ellveeay Newspaper Workers' B. & L. Ass'n v. Wagner Market Co., 110 N. J. L. 577, 166 Atl. 332 (1933); Commonwealth Mortgage Co. v. DeWaltoff, 135 App. Div. 33, 119 N. Y. Supp. 781 (1909).

[31]The court then adds the meaningless sentence, "Therefore it is necessary to join the lessee before his interest is cut off." If the language of the court is to be literally construed in that this transaction is to be given the same status as a lease made prior to the mortgage, the mortgage would be subject to the lease and joinder of the lessee will not terminate the lease. See cases cited note 2, *supra.* The assignee of the reversion has no right to terminate the lease except for the lessee's failure to perform the conditions of the lease.

[32]S. A. Gard, *Lessee's Status After Foreclosure of a Prior Mortgage* (1933) 1 KAN. CITY L. REV. 11.

[33]The English prototype of this statute was 32 HENRY VIII, c. 34 (1540). This statute was an aftermath of the dissolution of the monastaries and was designed to permit the lords, to whom Henry VIII had given the confiscated lands, to take advantage of covenants and conditions in leases of the forfeited lands, a transferee of a reversion being unable, by reason of the normal common law rule against alienation of rights of re-entry, to insist upon such rights. *See* Co. LITT. 215a; 7 HOLDSWORTH, HISTORY OF ENGLISH LAW (1926) 288; 1 TIFFANY, REAL PROPERTY (3d ed. 1939) 355. There never was any doubt as to the transferability of the reversion expectant upon a leasehold or as to the transferee's right to rent. *See* HOLDSWORTH, *loc. cit. supra,* at 264-265. As the latter question only is involved here, the common law rule covers the case and resort to the statute is unnecessary.

[34]See pages 41-42, *supra,* for discussion of the nature of the interests resulting from a mortgage and subsequent lease, and as to the necessity for joining the tenant as a party defendant in the foreclosure proceeding. The writer of the article mentioned fails, as have some courts, to realize the significance of the change in theory as to possessory rights of the mortgagor upon the relationships created by mortgage and lease. The writer also falls into the additional error of stating that the leasehold interest falls because there is no privity of contract between the mortgagee or purchaser at foreclosure sale and the mortgagor's lessee. This has no support whatever in common law theory. From earliest times it has been recognized that only privity of estate is necessary to continue the relationship. There is privity of estate between the assignee of the reversion and the original lessee by reason of the succession of the mortgagee or purchaser at foreclosure sale to the mortgagor-lessor's interest. *See* 1 TIFFANY, REAL PROPERTY (3rd ed. 1939) 174; also *see* WALSH, LAW OF REAL

Although the reasoning set forth in the *Childs* case may leave something to be desired, the result is the only proper one in a jurisdiction which gives the mortgagor the right to possession until foreclosure upon default or some time thereafter.

In other cases reaching the same result as the *Childs* case the courts have been equally inept in stating reasons for the conclusion reached. In supporting the rule that the lessee must be joined in the foreclosure proceedings before his interest can be terminated, one court advanced the unconvincing argument that failure to cut off the outstanding lease will cause the property to be sold at a price below what it would bring if that interest is not attached.[35] This is not a reason why the lessee must be joined, but is an assumption that he must be joined before his interest is extinguished. The court also relied on the apparent fallacy that the lease in every instance is disadvantageous to the owners of the reversion. In the majority of cases the land with the lease attached is worth more than it would be if it had no rental income.[36]

One court advanced the reason that if the lessee had prepaid the rent for the full term, he should be made a party so he could protect himself by being allowed to claim a recoupment from the surplus arising from the sale which had been turned over to the mortgagor.[37] This

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PROPERTY (2d ed. 1927) 462, *n.* 7, for citation of early English commentators.

[35]Gale v. Carter, 154 Ill. App. 478 (1910) (mortgagor objecting to nonjoinder of lessee).

[36]New Jersey has developed a unique rule stemming from the application of a statute (N. J. REV. STAT. [1937] 2:65-1 *et seq.*) which provides that complete exhaustion of the property and all interests therein is a condition precedent to an action on the bond for a deficiency arising out of a sale of the mortgaged premises. It was first held that failure to make a tenant of the mortgaged premises a party defendant to the foreclosure and thus to bar his interest was a failure completely to exhaust the property and "all interests therein." Ellveeay Newspaper Workers' B. & L. Ass'n v. Wagner Market Co., 110 N. J. L. 577, 166 Atl. 332 (1933). The theory is that a failure to make a tenant a party may prevent the property from bringing the best possible price at the sale. In American & Italian B. & L. Co. v. Liotta, 117 N. J. L. 467, 189 Atl. 118 (1936), it was said that the mortgagee is under a duty to join all persons having an interest in the property, on the theory that both advantageous and disadvantageous leases may deter a certain class of bidders. "There may be those who are interested in the property for some particular or special purpose requiring immediate possession." Subsequent cases realized that the strict application of this rule in cases where the lease is advantageous would result in a sale of the land at a lower value than if the lease were preserved, thereby defeating the purpose of the statute. The cases now hold that if the mortgagee can prove that failure to join the lessee has not lessened the vendible value of the mortgaged premises he has exhausted his security in compliance with the statute. Guaranty Trust Co. v. Hoffman, 116 N. J. Misc. 340, 199 Atl. 781 (1938); Harvester B. & L. v. Elbaum, 119 N. J. L. 437, 196 Atl. 709 (1937); *see* also Fidelity Union Trust Co. v. Chausmer, 120 N. J. L. 208, 198 Atl. 828 (1938); Strafford B. & L. Ass'n v. Wagner, 122 N. J. Eq. 452, 194 Atl. 440 (1937). The application of the statute to these cases has put the mortgagee between Scylla and Charybdis. He is compelled either to cut off all advantageous leaseholds, thereby decreasing the value of his security, or to subject himself to further litigation, wherein the jury must determine as an issue of fact that the failure to join the tenant did or did not deter public bidding. Note (1939) 4 U. NEWARK L. REV. 206 *passim*.

[37]Dundee Naval Stores Co. v. McDowell, 65 Fla. 15, 61 So. 108 (1913) (In the absence of statute, rent is not normally apportionable as to time.);

argument does not indicate a necessity for joinder. Although it might be desirable to prevent a multiplicity of actions in any jurisdiction that might regard rent apportionable as to time, the lessee could clearly maintain a separate action at law to recover his prepaid rent from the mortgagor-lessor.

A better reason for the requirement of joinder recognizes the principle that the purchaser at the foreclosure sale takes the mortgagor's title as it existed when the mortgage was made, but subject to all junior interests if the owners of such interests are not joined as defendants in the foreclosure action.[38] As the holders of these interests have the right to redeem from the mortgage, it follows that they must be joined to cut off this right on the foreclosure of a prior mortgage.[39] Due process would seem to require a "day in court" before this right could be extinguished.[40] Failure to join them would make it impossible to transfer a clear title to the purchaser at the foreclosure sale.

Another group of cases, recognizing that the subsequent lessee should have the same rights as other junior interests in foreclosure, requires the joinder of the lessee so that he may take advantage of the doctrine of marshalling of assets; that is, that he may require the reversionary interest to be first subjected to the payment of the mortgage debt.[41] Reasoning along the same line, the New Jersey court[42] has required the joinder of the lessee so that he might request a sale in the inverse order of alienation. The court said the mortgage covered three separate interests, the leasehold and two parcels in fee which had been conveyed by the mortgagor subsequent to the execution of the lease. The decree impliedly directed that the leasehold should be sold only in case the other parcels do not produce a sufficient sum to pay the debt. This right would exist in every case where the value of the land subject to the lease would be sufficient to discharge the obligation, and there is no reason why the lessee, the same as any junior encumbrancer, should not be able to take advantage of these principles of mortgage foreclosure when the rest of the circumstances permit.

The New York rule is the most desirable from the standpoint of policy. There is no reason why the lessee should be allowed to escape the terms of a lease voluntarily entered into by him because of a change of ownership in the fee. If the mortgagee preserves the lease, the rights and obligations of the lessee are the same as they would be following

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see Porter v. Tull, 6 Wash. 408, 33 Pac. 965 (1893) (Where building occupied by tenant destroyed by fire, *held*, that tenant could recover rent paid in advance for portion of month remaining after destruction of premises.).

[38]WALSH, MORTGAGES (1934) §§ 74, 76.

[39]Foster v. Trowbridge, 44 Minn. 290, 46 N. W. 350 (1890) (second mortgagee not made a party to foreclosure did not lose right of redemption); Cram v. Cottrell, 48 Neb. 646, 67 N. W. 452 (1896); WALSH, MORTGAGES (1934) § 68.

[40]Dundee Naval Stores Co. v. McDowell, 65 Fla. 15, 61 So. 108 (1913); Note (1937) 21 MINN. L. REV. 610.

[41]Dundee Naval Stores Co. v. McDowell, 65 Fla. 15, 61 So. 108 (1913); Western Union Tel. Co. v. Brown & Randolph Co. 154 Ga. 229, 114 S. E. 36 (1922): "Where the lessee has equities, the mortgagee should be required to sell the property in the first instance subject to the lease when such sale will fully pay off and discharge his demand, and when to permit a sale otherwise would destroy and wipe out the lease."

[42]Union Inv. Co. of N. J. v. McDonough, 74 N. J. L. 130, 109 Atl. 301 (1920).

an assignment of the reversion, or a retention of the reversion by the mortgagor. His position is in no way jeopardized or made more burdensome by the mortgagee's election to preserve the lease. The mortgagee's election to terminate the lease is a contingency which the lessee should anticipate. He knows when he enters into the lease that he is getting an interest subordinate to that of the prior mortgagee and which is subject to divestment by default on the mortgage debt and exercise of the mortgagee's option.

The mortgagee would terminate the lease only if it detracts from the value of the security and the sale of the land cleared of the lease would bring a better price than a sale subject to the lease. Conversely, he will preserve the lease when it enhances the value of the security. Whatever the election of the mortgagee may be his interests are so tied in with those of the mortgagor that the benefits resulting from his choice will inure to the latter.

The lessee is not defenseless. At the time he enters the lease he may request the mortgagee to agree, as part of the consideration for the lease, not to evict him in the event of a foreclosure, or he may request that the mortgagee become a party to the lease,[43] or he may even get a subordination agreement. If the lease is advantageous the mortgagee should be only too willing to consent to such an arrangement. If he does not consent the lessee can refuse to execute the lease.

The lessee is further protected by his right to an action against the mortgagor for breach of the covenant of quiet enjoyment if he is evicted by paramount title prior to the expiration of the term.[44]

When formal joinder is not necessary: In jurisdictions subscribing to the New York rule formal joinder of the lessee is not always necessary to terminate his leasehold interest. It has been held that a person who takes a lease subject to the mortgage and fails to record it before the commencement of the foreclosure action, whose possession is not sufficient to impute notice to the mortgagee, and whose interest is not actually known to the mortgagee, will be bound by the decree. He will be regarded as a party defendant joined in the action.[45] A New Jersey case held that a lessee who had full knowledge of the foreclosure proceedings and concealed his interest therein could be taken out of possession by a writ of assistance issued at the instance of the purchaser at the foreclosure sale.[46] Such conduct bound him to the decree as much as if he had been formally joined.[47]

When the lease is terminated: Although all of the jurisdictions following the New York rule uniformly hold that joinder of the lessee as

[43]Flynn v. Lowrance, 110 Okla. 150, 236 Pac. 594 (1924).

[44]See *infra*, p. 48.

[45]Virges v. Gregory, 97 Wash. 333, 166 Pac. 610 (1917) *semble*; Hager v. Astorg, 145 Cal. 548, 79 Pac. 68 (1904) ("assuming grantee" bound by decree).

[46]Strong v. Smith, 68 N. J. Eq. 686, 60 Atl. 66 (1905).

[47]Welsh v. Schoen, 59 Hun. (N. Y.) 356, 13 N. Y. Supp. 71 (1891) (Failure of lessee to record lease before filing of foreclosure complaint did not bar him from defending his possession on the ground that he was not made a party when he was in possession of the premises when the action was begun.); Strong v. Smith, 68 N. J. Eq. 686, 60 Atl. 66 (1905) (If mortgagee, at the commencement of the suit, had notice of lessee's possession or of existence of lease, he would be bound to inquire as to lessee's interest in the premises and make him a party to the foreclosure suit.).

a party defendant in the foreclosure action is necessary to terminate his leasehold interest, the further question arises as to the stage in the proceedings at which the lessee's interest is extinguished. The Washington court in *Virges v. Gregory*[48] held that even though the lessee is joined in the foreclosure action, his duty to pay rent continues until the purchaser at the foreclosure sale gets absolute title at the end of the period of redemption. If the mortgagor redeems, the lessee's liability under the lease is not cut off. "If this were not so, and the tenancy was terminated by the mere sale at the commencement of the period, and should the mortgagor redeem within that period, he would find the tenancy terminated years before the expiration of the lease, though the title to the property had never passed out of him."[49] This same reasoning could be applied to cases adhering to the common law rule, where a right of redemption exists in the mortgagor.

In the *Childs* case[50] the lessee, who was joined in the foreclosure action, moved out of the premises after the entry of the judgment but before the sale. Prior to the sale the judgment against him was vacated. In an action brought by the purchaser at the foreclosure sale for rent, the court said that neither the beginning of an action to foreclose nor an entry of a judgment of foreclosure and sale constitutes an eviction. "The sale may never occur. The amount due may be paid. The mortgagee may repent. Until the sale actually takes place the tenant remains liable to his landlord on the contract." A further reason the court might have added is that the mortgagor might have a substantial defense to the debt and mortgage.[51]

By holding that entry of judgment does not amount to an eviction, the court has placed the lessee in a dilemma. If he remains in possession until the sale it may take him weeks or even months to find other suitable premises. If he moves out and enters into another lease he may find himself still bound on the first lease. Although it is true that the mere existence of a paramount title does not amount to an actual eviction, courts would remove the lessee's present uncertainty without materially injuring the mortgagee by holding that the mortgagee has made an irrevocable election by joining the lessee and carrying the foreclosure proceedings to judgment; and that such conduct constitutes an eviction as a matter of law. This problem does not exist in jurisdictions, such as Washington, which have statutes allowing the lessee to remain in possession for the determined period of redemption.[52]

Failure to join the lessor-mortgagor: The rule has been stated that if the mortgagor-lessor is not made a party defendant to the foreclosure, the lease is not terminated and the lessee cannot refuse to pay rent to the mortgagor-lessor on the ground of constructive eviction.[53] His

[48]97 Wash. 333, 166 Pac. 610 (1917).

[49]REM. REV. STAT. § 602 allows a tenant under an unexpired lease to retain possession during the period of redemption. Walgreen Co. v. Moore, 116 N. J. Eq. 348, 173 Atl. 587 (1934) (filing of bill to foreclose does not constitute an eviction); Blodgett Loan Co. v. Hansen, 86 Mont. 406, 284 Pac. 140 (1930) *semble;* Dolin v. Wachter, 87 Mont. 466, 288 Pac. 616 (1930) *semble;* Sullivan v. Superior Court, 185 Cal. 133, 195 Pac. 1061 (1921).

[50]230 N. Y. 285, 130 N. E. 295 (1921).

[51]Thompson v. Flathers, 45 La. Ann. 120, 12 So. 245 (1893).

[52]*Supra* n. 49.

[53]Alford v. Carver, 3 Tex. Civ. App. 607, 72 S. W. 869 (1903).

lessor's title being unaffected by the decree, the tenant cannot question it or attorn to another. An interesting suggestion has been made that if the purchaser has a right of possession against the lessee, by reason of the latter having been made a party to the foreclosure proceeding, he has title paramount to that of the lessee and eviction might be asserted as a defense to a claim for rent irrespective of whether the mortgagor was a party or not.[54] The difficulty with this suggestion is that it fails to recognize that the lessee's right to possession stems from the mortgagor's right to possession and if the mortgagor still has that right it is difficult to understand how it can be taken from him by joining his lessee in the foreclosure action. If the mortgagee is not entitled to possession against the mortgagor, how can he be against the mortgagor's lessee?

(d) *Pennsylvania rule.* The Pennsylvania court has gone even farther than the New York court in allowing the mortgagee to preserve the lease. The legislature adopted a statute[55] which provides that an execution purchaser of lands, which at the time of the sale were in possession of a tenant, is deemed the landlord of such tenant and is given the same rights against him "as the owner might have had if no such sale had been made." The court has held that such purchaser under the act succeeds to the benefit of the contract if he chooses to have it. If he disaffirms the lease, he severs the relationship and extinguishes the tenancy and he is no longer entitled to the statutory remedies.[56] The mortgagee is not required to join the tenant to extinguish the lease. What constitutes an affirmance or disaffirmance is not entirely clear, but it has been held that suing on the contract for rent would be a confirmation of the lease.[57]

(e) *Washington.* Whether Washington will follow the New York or the common law rule when the court is confronted with this type of case is a question which cannot be answered until the decision is rendered. In *Virges v. Gregory*[58] a lessee, who had failed to record his lease prior to the commencement of the foreclosure action, asserted as a defense to an action for rent brought by the purchaser at foreclosure that as he was in effect a party to the action the foreclosure decree terminated his tenancy and relieved him from the obligation to pay rent. The court said that in any event the statute allows the lessee to retain possession until the expiration of the period of redemption[59] and that until that time he is liable to the purchaser for rent. It was unnecessary to decide whether or not the joinder or non-joinder of the lessee would have any effect in terminating the lease. It is suggested that the Washington court's respect for decisions of the New York court, augmented by the fact that the lessee has the right to redeem[60] from the foreclosure sale, will lead it to adopt the New

[54]1 TIFFANY, LANDLORD AND TENANT (1912) 420.

[55]PURDON'S PENN. STAT. (1936) 12:2611.

[56]Hemphill v. Tevis, 4 W. & S. (Pa.) 535 (1842).

[57]Hemphill v. Tevis, 4 W. & S. (Pa.) 535 (1842); W. H. Lloyd, *The Mortgagee and the Tenants of the Mortgagor* (1931) 10 PENN. B. A. Q.; *see* also, Roush v. Herbick, 269 Pa. 145, 112 Atl. 136 (1920); Westside Trust & Sav. Bank v. Lopoten, 358 Ill. 631, 193 N. E. 462 (1934) (Mortgagee, on condition broken, may treat tenant as trespasser or he may "elect" to recognize lessee as his tenant.).

[58]97 Wash. 333, 166 Pac. 610 (1917).

[59]REM. REV. STAT. §§ 600, 602. [60]REM. REV. STAT. § 594.

York rule when the occasion arises.

(f) *General rules applicable to all jurisdictions. Lessee's right to pay the mortgage debt.* The tenant has the right at common law and independent of the provisions of the lease to protect his lease by paying the mortgage on the leased property and taking an assignment of it.[61]

Prepayment of rent: Where the subsequent lessee has paid the rent in advance the courts hold that it is no defense to the mortgagee's right to have the property free of the lease.[62] The lessee is charged with notice of the prior mortgage and anticipates the payment of rent thereon at his peril.[63] To hold that prepayment of rent would preserve the lease until the expiration of the term would enable the mortgagor to defeat the security of the mortgagee and would open the door for fraud in every case of rent productive property where the security is inadequate for the payment of the mortgaged debt.[64]

Lessee's right to sue for breach of covenant of quiet enjoyment: The mortgagor-lessor is liable to the tenant for a breach of the covenant of quiet enjoyment when the tenant is evicted by a prior mortgagee.[65] The tenant is entitled to recover substantial damages measured by the value of the unexpired term less rents reserved and to look for reimbursement to the surplus money which may be realized on a foreclosure sale.[66] This action will not be available to the tenant if the lease contains express provisions negativing or limiting the covenant of quiet enjoyment. For example, if the lease provides that it is "subject to the mortgage" it would exclude any warranty on behalf of the mortgagor-lessor against eviction by the mortgagee's paramount title.[67] The tenant's right to maintain this action may be valueless as it is very likely that a mortgagor who could not make payments on the mortgage debt would not have property which could satisfy a judgment.

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[61]Averill v. Taylor, 8 N. Y. 44 (1853); C. M. Lewis, *Effect of Foreclosure of Mortgage on a Lease* (1932) 25 LAW & BANK. 78.

[62]Rohrer v. Deatherage, 336 Ill. 450, 168 N. E. 266 (1929).

[63]State *ex rel.* Coker v. Dist. Ct., 159 Okla. 10, 11 P. (2d) 495 (1932).

[64]Fletcher v. McKeon, 71 App. Div. 278, 75 N. Y. Supp. 817 (1902); *Cf.* Smith v. Cushatt, 199 Iowa 690, 202 N. W. 548 (1925) (Where subsequent lease was to expire prior to expiration of period of redemption, a tenant who in good faith paid rent to the mortgagor before the mortgagee had any rights to the rent, could not be dispossessed or compelled to account for the rental value of the land.); Offman v. Cheney, 204 Wis. 56, 234 N. W. 325 (1931); Grether v. Nick, 193 Wis. 503, 213 N. W. 304 (1927). There would have been no eviction of the lessee until the expiration of the period of redemption regardless of prepayment of rent.

[65]Ganz v. Clark, 252 N. Y. 92, 169 N. E. 100 (1929); 2 UNDERHILL, LANDLORD AND TENANT (1909) § 427; 1 TIFFANY, LANDLORD AND TENANT (1912) § 79 (a): "A lease ordinarily contains an express covenant of quiet enjoyment by the lessee, but even though such a covenant is not expressed it will be implied." Duncklee v. Webber, 151 Mass. 408, 24 N. E. 1082 (1890) (Foreclosure sale under a mortgage prior to lease is breach of covenant, express or implied.).

[66]Title Guarantee & Trust Co. v. 21st & 5th Ave. Corp., 110 Misc. 126, 180 N. Y. Supp. 358 (1920).

[67]"If there is an express covenant against disturbance by the lessor or those claiming under him, this limits the effect of the implied covenant so that there is in such case no covenant against disturbance by one having paramount title, and yet such disturbance, if it amounts to an eviction will suspend the right to rent." 1 TIFFANY, LANDLORD AND TENANT (1912) § 79 (a).