Leases As Security Devices

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ABSTRACT

Leases have priority over mortgages and other security devices if they were entered into prior to the security devices and if the leases were duly recorded, or in the alternative, the lessee can prove that the holder of the security device had actual notice of the lease's existence. Which means, that should the creditor seek to foreclose on the premises, the lessee has a protected right to remain on the premises pursuant to the terms of the lease. This holds true for a subsequent purchaser of the property either at the foreclosure sale or thereafter.

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When we think of the word, "leases", we often are limited in out perception of the word. Typically, we think of a possessory arrangement of goods or real property for a price.

Quite often, owners of multiple dwelling properties or commercial properties seek financing in purchasing the property, or in refinancing the property at a later occasion. At the closing with the lending institution, besides the typical documents being executed, to wit: the mortgage and promissory note, the lending institution requires an "assignment of leases and rents" to be signed.

Simply put, this document transfers the rights as lesser to the lending institution upon a default of the loan by the owner of the property. This means that the owner can no longer execute new leases with the tenants, and further, cannot collect the rent from the tenants. Instead, the rental monies are collected by the lending institution to satisfy the loan obligation and to mitigate its damages. Hence, the leases become a security device.

The location of the property determines the state law to the applied. For the purpose of this article, we will use New York State law.

The significance of the "assignment of the leases and rents" as a security device becomes extremely important when the owner of the property obtains financing on the property from more than one lending institution.

New York State's Real Property Law, Section 290, at relevant part provides at subsection "3":

The term "conveyance" includes every written instrument, by which any estate or interest in real property is created, transferred, mortgaged or assigned, or by which the title to any real property may be affected, including an instrument in execution of a power, although the power be one of revocation only, and an instrument postponing or subordinating a mortgage lien; except a will, a lease, for a term not exceeding three years, an executory contract for the sale or purchase of lands, and an instrument containing a power to convey real property as the agent or attorney for the owner of such property.

This means that all leases, for three (3) or more years, must comply with this recording statute.

New York State's Real Property Law, Section 291 provides:

A conveyance of real property, within the state, on being duly acknowledged by the person executing the same, or proved as required by this chapter, and such acknowledgement or proof duly certified when required by this chapter, may be recorded in the office of the clerk of the county where such real property is situated, and such

county clerk shall, upon the request of any party, on tender of the lawful fees therefor, record the same in his said office. Every such conveyance not so recorded is void as against any person who subsequently purchases or acquires by exchange or contracts to purchase or acquire by exchange, the same real property or any portion thereof, or acquires by assignment the rent to accrue therefrom as provided in section two hundred ninety-four-a of the real property law, in good faith and for a valuable consideration, from the same vendor or assignor, his distributees or devisees, whose conveyance, contract or assignment is first duly recorded, and is void as against the lien upon the same real property or any portion thereof arising from payments made upon the execution of or pursuant to the terms of a contract with the same vendor, his distributees or devisees, if such contract is made in good faith and is first duly recorded. Notwithstanding the foregoing, any increase in the principal balance of a mortgage lien by virtue of the addition thereto of unpaid interest in accordance with the terms of the mortgage shall retain the priority of the original mortgage lien as so increased provided that any such mortgage instrument sets forth its terms of repayment.

This means that should you fail to record the leases on the property, (commercial leases generally being in duration of at least five (5) years or longer), then in that event, you will lose your priority based upon the subsequent proper recordings of security devices by good faith parties for consideration.

An exception, as referred to above, would be the lessor being able to illustrate that subsequent parties recording security devices had actual knowledge of the lesser at time of, or before they recorded their instruments. Sam & Mary Housing Corp. v Jo/Sal Market Corp., 1983, 121 Misc. 2d 434, 468 N.Y.S. 2d 294, modified on other grounds 100 A.D. 2d 901, 474 N.Y.S. 2d 185, 479 N.E. 2d.821.affirmed 64 N.Y. 2d 1107, 490 N.Y.S. 2d 185, 479 N.E. 2d.821.

The purpose of this, as well as, many other recording security statutes is to give notice to the world of the event and to protect the rights of good faith purchasers who have no knowledge of prior liens, encumbrances, conveyances which were not recorded. This obviously will also protect against fraud.

Failure to comply with the recording statute can prove fatal. An unrecorded deed is a nullity as concerns a subsequent deed duly recorded. People v. Waring, 1897, 76 N.Y. 463.

What constitutes "Actual Notice", so as not to be effected by failing to comply with the recording statute. It appears that if a subsequent purchaser or prospective lienholder has knowledge of any fact that could conflict with his or her ownership, or interest in the property, then he or she is presumed to have "inquired" into the facts to determine any type of interest which would have priority over the subsequent purchasers rights. It should be noted, however, that should a diligent search not discover any prior right, then the "inquiry" burden has been met and satisfied Williamson v. Brown, 1857, 15 N.Y. 354

In the City Bank of Bayone v. Julius G. Hocke action, 168 A.D. 83, 153 N.Y.S. 731, the Court reaffirmed the principle that a lease for a term exceeding three (3) years must be recorded as against subsequent good faith purchases, but held, that where the tenant is open, visible, obvious and in continuous possession, a subsequent lienholders is charged with constructive notice.

In Phelan v. Brady, 119 N.Y. 587, it was held that actual possession of real estate is notice to the world of the existence of any right which the party in possession is able to establish.

The subsequent lienholder argued in this case the point that the premises was occupied by many tenants and it would be burdensome to ascertain all of their rights and interests. However, the Court stood firm in stating that actual possession of real property is sufficient notice.

A sublease of a store in a shopping center is subject to the Recording Act. 478 Elmwood, Inc. v. Hassett, 1981, 83 A.D.2d.409, 445 N.Y.S.2d 336.

In the 478 Elmwood action, a McDonald's restaurant was erected in an area of a Buffalo shopping plaza reserved for automobile parking. 478 Elmwood has a sublease whereby it occupied a large store in the plaza and with it, had the right to use the parking area for the "automotive vehicles of its customers and/or employees" (pg. 410), with the plaza's other tenants, for which it agreed to pay 90% of the parking area's maintenance and related expenses. Afterwards, a portion of the plaza was leased to McDonalds, whereat it built its restaurant.

Although, the plaintiff, 478 Elmwood did in fact have a sublease in effect prior to the arrangement with McDonalds, McDonalds claims that since Elmwood failed to record its sublease, it was not bound by such agreement.

The Court held that had 478 Elmwood duly recorded the sublease, then McDonalds would have been on constructive notice of its terms and liable for its breach. Since this was not the case, 478 Elmwood had to prove to the Court that McDonalds had actual notice of its sublease. The Court found that the jury had to determine whether actual notice existed. The Court added, that a visual examination of the premises would have disclosed that the paved parking area was for customers, so that this would constitute notice to McDonalds that it could be infringing on 478 Elmwood's rights.

CASE PROBLEM

Facts

John, the owner of a mix-used building known as Heaven Gardens obtained a mortgage on the premises in October of 2001. A mortgage was recorded, as well as, an assignment of leases and rents.

In October of 2003, John was in default on the mortgage loan and so a foreclosure proceeding was ready for commencement, with pre-foreclosure letters being sent to John.

Heaven Gardens was a mix-used building consisting of 12 residential apartments and 2 commercial units.

John, at this time, also owed his brother, Paul, money. In an attempt to payoff his brother off for monies he owed to him, he entered into subleases with his brother in February of 2003. The agreement was that he would rent both commercial units to his brother for $200.00 a month each, for a duration of twenty (20) years, and his brother could collect the rent from the actual tenants, $3,000.00 each. The subleases were never recorded and the brother obviously never took possession, but only had an interest in the rental collections.

In May of 2003, John attempted to save his building from foreclosure by obtaining a new lender, whereby he could borrow enough money to satisfy the initial loan.

A new lender did in fact lend the money to John in June of 2003, but did not satisfy the 1st loan, but instead took it by assignment. At this time, John never disclosed the sub-leases to the new lender, but instead only furnished the underlying leases for all residential and commercial units.

Discussion

John's sub-leases were legal. He gave them to his brother, not in the true context of possession agreements, but instead as collateral (security device) to pay off his debt owed to his brother. The sub-leases were for twenty year terms, which meant that they had to be recorded to preserve their priority. They were not recorded.

The new lender, had it satisfied the first loan, would have recorded its mortgage in or around June of 2003, after the subleases. The new lender would have then also recorded an assignment of rents and leases.

With this scenario, the brother could claim that although he failed to record the sub-leases, they would still have a priority, because they were executed first, and equally important, the new lender should have made "inquiry" into the commercial leases of the building, since commercial leases are typically for more then three (3) years.

This argument would fail for a combination of reasons. The new lender was cleaver enough to have the first loan assigned to it, thus preserving the recording of the assignment of rents and leases from October of 2001, prior to the subleases.

Further, the reason for the assignment of rents and leases would have kicked-in October of 2002, upon the default of the loan by John. Which means, that the lender upon such a default could then collect all rents and John would be forbidden to create new leases – hence, the subleases.

Lastly, an "inquiry" would not have proven fruitful, in that John submitted only the underlying leases in obtaining funds from the new lender, so was in effect hiding the subleases from being discovered, and by not recording the same, a search of the County Clerk's records too would have failed to discover any prior liens. Further, the fact that the brother never took possession defeats the claim of "constructive notice".

CONCLUSION

That had the subleases been properly recorded and the new lender satisfied the old debt, the subleases would have had priority over the new lender's rights and the new lender would have been burdened by two sweetheart leases for twenty years. This would be burdensome should it attempt to collect the rents, or in the alternative, in the event of a foreclosure proceedings attempt to sell the premises. Thus, if a State has a race-notice type recording statute, failure to comply could prove costly.

REFERENCES

1. City Bank of Bayonne v. Julius G Hocke, 168 A.D.83, 153 N.Y.S. 731
2. 478 Elmwood, Inc. v. Hasset, 1981, 83 A.D.2d.409, 445 N.Y.S.2d 336
3. New York State Real Property Law, Sections 290 & 291
4. People v. Waring, 1987, 76 N.Y. 463
5. Phelan v. Brady, 119 N.Y. 587
6. Sam & Mary Housing Corp. v. Jo/Sal Market Corp., 1983, 121 Misc.2d 434, N.Y.S.2d 294
7. Williamson v. Brown, 1857, 15 N.Y. 354