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Creditor's Rights: Ground Lease Mortgages--Endorser Beware!

Christopher Detzel

CREDITOR'S RIGHTS: GROUND LEASE MORTGAGES – ENDORSER BEWARE! *Mandell v. Fortenberry,* 290 So. 2d 3 (Fla. 1974)

Plaintiffs, lessors of a ninety-nine year ground lease,[1] joined their corporate tenant in executing a mortgage encumbering both the leasehold and the reversionary interests.[2] The mortgage secured a note signed by both the tenant and the defendants as accommodation endorsers.[3] When the tenant defaulted on both the lease and note, lessors retook possession of the premises[4] and paid off the note to prevent foreclosure by the mortgagee. As equitable subrogees of the mortgagee,[5] lessors subsequently sued the endorsers on the mortgage note. Endorsers acknowledged liability but sought to set-off against the note indebtedness the value of the improvements erected by the tenant.[6] Finding that the lessors had failed to establish damages the circuit court entered judgment for the defendant-endorsers.[7] The district court of appeal reversed, granting the lessors both lease default and mortgage subrogation rights, while denying the endorsers any rights as deficiency judgment debtors,[8] on the ground that the tenant's default on the lease eliminated the land and improvements as a source of possible credit to the endorsers.[9] The Florida supreme court affirmed and HELD, where a tenant-mortgagor breaks a valid contract his accommoda-

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1. The lease provided that any permanent improvements erected by the tenant would become the property of the lessors. Furthermore, if the tenants desired to mortgage the premises the lessors agreed to join in the mortgage execution without assuming any personal liability for repayment of the debt. 290 So. 2d at 5.

2. The purpose of the financing was to pay for erection of improvements costing in excess of $86,000 on the land by the tenants. As provided in the lease and at the request of the defendant-endorsers, the lessors executed the mortgage lien encumbering their interest in the property as security for payment of the tenants' promissory note. Respondents' Brief for Certiorari at 2, 3, 290 So. 2d 3 (Fla. 1974) [hereinafter cited as Brief]. For a discussion of the mortgage in the ground lease situation, see Anderson, *The Mortgagee Looks at the Ground Lease,* 10 U. FLA. L. REV. 1, 7 (1957).

3. Lessors required the endorsement by the defendants, who were stockholders of the corporate tenant, as a condition precedent to lessors' execution of the mortgage. Brief, *supra* note 2, at 3.

4. Lessors were awarded possession of the leased premises and the improvements by order of the County Judge's Court in Brevard County after the tenant's default on the lease. Brief, *supra* note 2, at 4.

5. "'Legal subrogation' is a remedy developed in equity to provide relief 'where one having a liability or right of a fiduciary relation in the premises pays a debt due by another under such circumstances that he is, in equity, entitled to the security or obligation held by the creditor whom he has paid.' The remedy is not available indiscriminately. The person paying the debt of another must have some obligation or other rational justification for intervening in the relationship between debtor and creditor." Fortenberry v. Mandell, 271 So. 2d 170, 172 (4th D.C.A. Fla. 1972) (citations omitted).

6. The defendant-endorsers contended that lessors' position was analogous to that of a mortgagee who, having acquired title to the mortgaged realty by foreclosure, sought a deficiency judgment and therefore they were entitled to credit for the value of the improvements. *Id.*

7. *Id.*

8. *Id.* at 173.

9. *Id.* at 172.

tion endorser is not entitled to relief, absent a specific showing of unjust enrichment.[10]

A ninety-nine year ground lease is more in the nature of a security device than an ordinary lease.[11] The lessor relinquishes possession of his property for an extended period of time in exchange for an annual ground rent, which is secured by the land and any improvements added by the tenant.[12] Default by the tenant causes little distress to the lessor because he can repossess both the property and the improvements. The lessor's security is diminished, however, if he joins the tenant in the execution of a mortgage, for the tenant's default on the note might result in loss of the entire property interest through a mortgage foreclosure.[13] Recognizing this risk the lessor generally demands a higher rent in consideration for his joining in the mortgage.[14] Should default occur he can still protect his interests by purchasing the note, as did the plaintiff-lessors in the instant case.[15]

The accommodation endorser of a leasehold mortgage loan[16] similarly seeks to protect his own interests and prevent loss in the ground lease situation. Although he is secondarily liable[17] to the mortgagee for payment of the note in event of a default,[18] the extent of his liability is measured solely by the instrument and is limited to persons and subjects expressed or implied therein.[19] His rights are those of the mortgagor (whose note he has endorsed) including any corresponding defenses available to the mortgagor in a suit for recovery of

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10. 290 So. 2d 3 (Fla. 1974). The supreme court did not directly agree with the district court's finding that plaintiff held both lessor rights and subrogation rights, but rather dismissed the writ of certiorari on procedural grounds because of the defendants' failure to plead and prove the collateral issue of unjust enrichment. *Id.* at 9 (Ervin & Dekle, JJ., dissenting).

11. Anderson, *supra* note 2, at 3. Although more secure than most investments, the ground lease still carries with it certain minimal risks. *See* Hecht, *Variable Rental Provisions in Long-Term Ground Leases*, 72 COLUM. L. REV. 625 (1972).

12. The lessor's primary objective is to maintain his underlying investment in land while drawing from it a secure long-term rental income, and his main concern is that his annuity be continually secured. Hecht, *supra* note 11, at 627.

13. Anderson, *supra* note 2, at 6.

14. The transaction is similar to a contractual investment in which the lessor has encumbered his interests in the land in return for increased rental annuity and greater security through the tenant's erection of improvements, which enhance the land's value. *See generally* Anderson, *supra* note 2; Hecht, *supra* note 11.

15. Brief, *supra* note 2, at 4.

16. Although the term "leasehold mortgage loan" is used, the mortgage actually encumbers the entire security interest. See text accompanying notes 11-15 *supra.*

17. FLA. STAT. §§673.102(1)(d), .414(1) (1973).

18. Younghusband v. Ft. Pierce Bank & Trust Co., 100 Fla. 1088, 130 So. 725 (1930); Bemis v. McKenzie, 13 Fla. 553 (1870). The endorser generally signs the instrument without consideration, for the purpose of lending his name and credit for the benefit of another party. He then assumes the position of a surety, with attendant rights and liabilities. FLA. STAT. §673.418 (1973). *See generally* UNIFORM COMMERCIAL CODE §3-415, comments 1-5.

19. Standard Accident Ins. Co. v. Bear, 134 Fla. 523, 184 So. 97 (1938); Parrish v. Board of Pub. Instruction, 82 Fla. 11, 89 So. 317 (1921); Gate v. Warrington, 37 Fla. 542, 19 So. 883 (1896).

the debt.[20] Thus, where the mortgagee (or his subrogee) seeks a judgment on the note the endorser normally expects to have the mortgagor's right of recourse to the collateral for satisfaction of the indebtedness.[21]

These expectations remain unchanged by the presence of a ground lease so long as the lessor has encumbered the fee as security for the mortgage loan,[22] because the endorser's interests are in no way subject to the lease.[23] His liability is on the note; consequently he is primarily concerned with the collateral securing its payment. He relies on the lessor's actions to make the collateral available as a set-off against any judgment on the note, or at least not to preclude its use in this manner. Confusion often arises where, as in the instant case, the lessors seek a judgment against the endorsers on the mortgage note as equitable subrogees of the mortgagee[24] independent from their status as legal owners of the collateral.[25] It is crucial for proper analysis to avoid the confusion created by the lessor's dual legal role and concentrate instead on determining what rights, if any, the accommodation endorsers succeed to in this situation.[26]

Because the problem involved rights under both the lease and the mortgage it should have been necessary for the court in the instant case to analyze the interests of all the parties in the context of both transactions to obtain an equitable solution. The majority, however, chose to focus almost exclusively on the lease transaction, while silently acquiescing in the district court's holding that the lessors were entitled to lease default rights separate from their rights as subrogees of the mortgagee.[27] The court digressed from the important

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20. Bear v. Duval Lumber Co., 112 Fla. 240, 150 So. 614 (1933).

21. If the mortgage holder then releases or voluntarily destroys the collateral security for the instrument, the endorser is discharged to the extent that such specific security would have contributed to payment of the debt. Goodman v. Goodman, 127 Ohio St. 223, 197 N.E. 777 (1933). If the endorser offers to pay the note upon the condition that the collateral for the note be turned over to him, he is discharged if the holder of the note refuses to turn over the collateral. Liverpool & London & Globe Ins. Co. v. Orrell, 140 Fla. 563, 190 So. 552 (1939).

22. In Florida this is called "subordinating the fee." It has become widespread practice to insert such clauses in ground leases so that the lessor's interest as well as that of the tenant is encumbered. Anderson, *supra* note 2, at 6.

23. Since his liability is solely on the note and measured by its limits, the endorser is not insuring the lease and has no duty or obligation to prevent its default. 290 So. 2d at 8 (dissenting opinion); see text accompanying note 17 *supra*. The situation appears to be a normal mortgage transaction to the endorser, affording him the right to receive whatever credits or benefits might accrue from a final disposition of the mortgage security if he is charged with liability for the note indebtedness.

24. In such a case the endorsers can expect that the new holder of the lien will stand in the mortgagee's shoes, acquiring all the rights of the mortgagee but no greater rights than he had. Furlong v. Leybourne, 171 So. 2d 1 (Fla. 1964); Cuesta, Rey & Co. v. Newsom, 102 Fla. 853, 136 So. 551 (1931); Bradford v. Marvin & Martin, 2 Fla. 463 (1849).

25. In the instant case, however, the endorsers knew the mortgage they endorsed was secured by the specific mortgaged premises, which could be subjected to foreclosure or other action in discharge of the debt. "It was immaterial to them whether the [lessors'] in their subrogation status foreclosed the mortgage, received a deed to the land in lieu of foreclosure, or retook it by virtue of the default of the lease." 290 So. 2d at 8 (dissenting opinion).

26. 290 So. 2d at 8 (Ervin, J., dissenting).

27. The district court stated that the lessors were owners of the security at the time of

issue of the concomitant equitable rights of the endorsers in this situation and instead spoke in terms of the collateral issue of unjust enrichment.[28] In some instances the lease provision granting lessors title to all erected improvements might be a source of substantial unjust enrichment. It could then be considered by the court and the lessors' damages reduced accordingly.[29] This is, however, an affirmative defense that must be pleaded and proved in order for the court to take cognizance of it. As courts grant relief only where unjust enrichment is substantial and obviously inequitable, and the endorsers in this case failed to demonstrate any such enrichment by the lessors, the majority refused to disturb the lower court's decision.[30]

The dissent, on the other hand, focused on the true issue of whether the endorsers were entitled to any equitable rights under the circumstances. Because the mortgage encumbered the entire fee, not merely the leasehold interest, the endorsers were entitled to the same reciprocal rights under Florida law as any accommodation endorsers held responsible for a mortgage debt.[31] The most important of these rights, in this situation, is the right to receive credit or consideration for the enhanced value of the mortgaged premises as a result of the improvements erected by the tenants.[32] Agreeing with the endorsers' contention that the lessors' position was analogous to that of a mortgagee who seeks a deficiency judgment after acquiring title to the mortgaged realty by foreclosure,[33] the dissenters sought to apply this principle of equity in determining the extent of the deficiency to be allowed. In so doing the rights sought to be enforced by the lessors would be limited to those of a mortgagee's subrogee;[34] that is, to sue on the note or to apply the security received to the amount of the debt. The case then could be decided fairly only if tried anew under equitable principles applicable in cases where a deficiency decree is sought.[35]

On balance, although the minority reached the better result in the instant case, it seems that both sides improperly treated the issue by failing to evaluate

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the mortgage and thereby acquired possession not by foreclosure but by termination of the lease. 290 So. 2d at 6, *quoting* Fortenberry v. Mandell, 271 So. 2d 170, 171-72 (4th D.C.A. Fla. 1972).

28. *Id.* at 5-6.

29. *Id.* at 7. The majority explained this by pointing out that some improvements would add to, and others would diminish, the actual value of the real property. Those that are not easily converted into other uses fall into the latter category while those buildings easily converted to a wide variety of uses fall in the former. Thus, if the endorsers could demonstrate that the lessors were able to sell their property for a greater price *because* of the improvements, then the court could consider it in determining the lessors' damages. *Id.* Unfortunately, in such an analysis the court ignored the presence of the ground lease, which seriously affected the nature of the interests involved. See text accompanying notes 59, 60 *infra.*

30. 290 So. 2d at 7.

31. *Id.* at 8 (Ervin, J., dissenting).

32. *Id.* at 9.

33. The dissenters found sufficient similarity in the lessors' right, in the event of default to retake the mortgaged premises and improvements thereon. *Id.*

34. See text accompanying note 22 *supra.*

35. 290 So. 2d at 9 (Ervin, J., dissenting).

the nature of the problems involved in the context of the ninety-nine year ground lease.[36] It was necessary for the court to analyze the interests of all the parties in the context of the entire transaction and then apply the most clearly analogous legal rationale to obtain an equitable solution. Such an analogy appears in the case of *Liverpool & London & Globe Insurance Co. v. Orrell*[37] where an insurance policy was an integral part of the collateral held by the mortgagee upon which the defendant relied in endorsing the note.[38] The insurance company paid off the note, was assigned the policy, and then sued the endorser on the note.[39] Recovery was denied on the ground that the debt had been extinguished.[40] Because the endorser had relied on the collateral securing the note he was entitled to delivery upon payment of the debt.[41] Thus, when the insurer refused to surrender the policy the endorsers' liability was terminated.[42]

In the instant case the endorsers sought similar equitable treatment. Like the defendant-endorser in *Liverpool,* they were sued by a transferee of the mortgagee's interest who was also the holder of the security. It would seem to follow that the lessors' refusal to allow the endorsers to deduct the value of the security as a credit against the note ought to have discharged the debt. The determination of whether the situation presented a transfer to the lessors that preserved the mortgage and kept it alive, so as to operate as payment and discharge of the debt, depended upon the duties and interests that the lessors sought to protect.[43] Such a determination in the instant case, in view of the endorsers' interest, would best have been explained by application of the doctrine of merger.[44]

Generally merger takes place when the ownership of the mortgage on the

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36. The precise situation here appears to have seldom arisen in any jurisdiction. The minority reached essentially the correct result, but for the wrong reason. See text accompanying notes 40, 42, 49-52 *infra.*

37. 140 Fla. 563, 190 So. 552 (1939) (suit against an accommodation endorser involving a chattel mortgage in which the mortgagor was required to insure the chattel against destruction in order to secure the note).

38. *Id.*

39. *Id.* at 554.

40. *Id.* at 557.

41. Northern Bank & Trust Co. v. Slater, Watt & Co., 123 Wash. 528, 212 P. 1063 (1923).

42. *Id.* at 530, 212 P. at 1064.

43. Sumner v. Osborne, 101 Fla. 742, 135 So. 512 (1931).

44. Strictly speaking, there are some problems in applying the doctrine of merger to this case because some of the specific requirement may not be met. Generally merger is thought of as the union of legal title and equitable title to the land in the same person; but in a lien theory state such as Florida this union does not exactly occur. Jackson v. Relf, 26 Fla. 405, 8 So. 184, 185 (1890). Additionally, here there was no strict merger of estates in the same person, with the same right, at the same time. Morrow v. Commonwealth Life Ins. Co., 118 Fla. 371, 159 So. 525, 526 (1935). The difficulty is that the instant case simply cannot be categorized under an existing legal theory. Solution can be had only by carefully applying closely analogous rationales so as to obtain the most equitable result. The rationale underlying the doctrine of merger seems the best suited for assessing the interests of the parties in the instant case.

land and the equity of redemption[45] of the mortgage become united in the same person, causing the mortgage to cease to be an encumbrance. Extinguishment of the debt is the normal result, but a contrary intention expressed by the party acquiring the interests will control.[46] This intention may be declared expressly or it may appear from the conduct of the parties or from the circumstances and equities of the transaction.[47] In this regard, the party is aided by the usual presumption that one intends that effect that is most beneficial to him[48] so that no merger will result if there is nothing to rebut the presumption.[49]

In the instant case the lessors' intent to retain control of the property was evident from the circumstances.[50] The note had been bought to prevent loss of the land[51] so that they might continue to reap the benefits of ownership. With the mortgage lien outstanding, lessors' title was subject to divestment by foreclosure. In order to secure title it was necessary to purchase the note, thus freeing the land from the encumbrance. But at the same time this action must have also extinguished the debt. If the lessors' intent in the subsequent suit on the note was not to extinguish the debt, then the mortgage was revived for both parties; upon the endorsers' payment of the debt they were entitled to a lien on the property. Other jurisdictions have reached a similar equitable result by treating the debt as discharged by the mortgagee's (or his subrogee's) acquisition of the fee.[52]

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45. Redemption is the right of any person having an interest in the mortgaged premises who would be a loser by foreclosure to satisfy the mortgage indebtedness, prior to being foreclosed from that right, and thus clear the property from encumbrance. Quinn Plumbing Co. v. New Miami Shores Corp., 100 Fla. 413, 129 So. 690, 692 (1930). Certainly the lessors in the instant case fall into this category. Payment was made for the purpose of preserving their interest in the property. The result ought to have been extinguishment of the debt.

46. Walter J. Dolan Properties, Inc. v. Vonnegut, 133 Fla. 854, 184 So. 757 (1938); Jackson v. Relf, 26 Fla. 465, 8 So. 184 (1890).

47. *See* Jensen v. Burton, 117 Cal. App. 66, 3 P.2d 324 (Cal. 1931) (derived from conduct of the parties); Gimbel v. Venino, 135 N.J. Eq. 574, 39 A.2d 489 (N.J. Ch. 1944) (equities determined); Philadelphia Sav. Fund Soc'y v. Stern, 343 Pa. 534, 23 A.2d 413 (1942) (circumstances determined intention).

48. That is, most beneficial within the allowances made by the doctrine of merger. Although merger will allow the lessors to choose the best of two possible choices, it will not permit them the luxury of retaining the property unencumbered while at the same time suing for full recovery on the note.

49. *Cf.* Florida Land Holding Corp. v. McMillen, 135 Fla. 431, 186 So. 188 (1938).

50. This also was the most beneficial course open to the lessors. By retaining the property and improvements, the lessors were able later to sell them for substantially more than was required to pay off the note (which they had to do in order to retain unencumbered title to the property) even though the amount received from sale of the land and improvements might not have equalled the actual value of the land plus the amount spent in purchasing the note. But the difference, if any, was of the nature of a "loss" on the ground lease investment and must rightly fall on the investor who took this risk. See text accompanying notes 59, 60 *infra*.

51. Brief, *supra* note 2, at 4.

52. *See, e.g.*, Desiderio v. Iadonisi, 115 Conn. 652, 163 A. 254 (1932); Franklin Mortgage Co. v. McDuffie, 43 Ga. App. 604, 159 S.E. 599 (1931); Central Hanover Bank & Trust Co. v. Roslyn Estates, Inc., 293 N.Y. 680, 266 App. Div. 244, 42 N.Y.S.2d 130 (2d Dep't 1943).

These jurisdictions treat the mortgage debt as paid when the mortgagee has appropriated the mortgaged property, and the value of the property exceeds the mortgage debt.[53] Similarly, where the lessor owning the fee acquires the note secured by the mortgaged fee, he may not recover the entire indebtedness.[54] When the courts determine the amount due the lessors, the acquisition of the lien by purchase of the note constitutes not only satisfaction of the mortgage but also of the accompanying note if the property is equal in value to the mortgage debt; it constitutes partial payment of the total due on the note if the property is worth less.[55] Under this theory the circuit court was correct in denying the lessors recovery for failure to establish damages, as without such proof the debt was extinguished.

On the basis of the foregoing equitable considerations it seems clear that the court in the instant case erred in granting the lessors unencumbered title to the premises on the basis of the lease default alone. The mortgage encumbered the entire fee,[56] causing the endorsers to understand that it was executed to secure payment of the entire indebtedness. As mortgagees are entitled to no more than payment in full[57] the endorsers justifiably expected that the mortgagee would make himself whole, if necessary, out of the land and improvements, but not that he would be enriched at the expense of the endorser.[58] Where the endorser has entered the transaction in justifiable reliance on the collateral in case of default, the same equitable principles apply to the assessment of liability whether it is the mortgagee or his transferee who seeks to enforce the debt.[59]

The court appeared eager to do equity to the lessor so that he would recover his due. But it failed to analyze correctly the nature of the transaction, which was essentially an investment with all the attendant risks for the lessors. There was no rational basis, legal or equitable, for reimbursing the lessor for the loss resulting from his bad investment. Because the lessors stood to make a profit from the ground lease investment it is they who must justifiably bear the corresponding risk of loss. Although generally a secure investment, the ground lease transaction can go sour, as it did in the instant case. In this event, the owner's only recourse is to minimize his losses.[60] There is no reason why courts

53. Central Hanover Bank & Trust Co. v. Roslyn Estates, Inc., 293 N.Y. 680, 266 App. Div. 244, 42 N.Y.S.2d 130 (2d Dep't 1943). The debt is generally considered extinguished unless the actual value of the security is ascertained by foreclosure and sale under the lien and a proper deficiency sought. Franklin Mortgage Co. v. McDuffie, 43 Ga. App. 604, 159 S.E. 599 (1931).

54. Central Hanover Bank & Trust Co. v. Roslyn Estates, Inc., 293 N.Y. 680, 266 App. Div. 244, 42 N.Y.S.2d 134 (2d Dep't 1943).

55. *Id.*

56. 290 So. 2d at 8 (Ervin, J., dissenting).

57. Honeyman v. Jacobs, 306 U.S. 539, 542 (1939).

58. Gelfert, Ex'r v. National City Bank, 313 U.S. 221, 233 (1941).

59. If it had been the mortgagee, the endorsers would certainly have received credit for the security; but because it was the lessors (who actually had no greater rights) the court allowed greater recovery.

60. This is the attendant risk in any investment situation. Although the opportunity for

should make the lessors whole at the expense of mortgage note endorsers where it was the lessors who entered into a profit or loss proposition. To allow the lessors to appropriate the security and then enforce the debt without regard to the value of that security clearly sanctions double recovery and constitutes unjust enrichment in any sense of the term.[61]

The instant case must certainly sound a warning to future endorsers of leasehold mortgage notes. Because the endorser in future ground lease mortgage transactions cannot automatically rely on the collateral being available to him for credit against the note, it is his counsel's responsibility to take affirmative action in the bargaining process to secure a contractual foundation for his reliance. Protection can best be afforded by incorporating terms into the lease or endorsed mortgage note that spell out the endorser's obligations in case of default by the tenant and explicitly provide for resort to the security as a setoff in the event the endorser is called upon to satisfy the debt. To allow otherwise will certainly undermine the security and availability of the leasehold mortgage by creating an atmosphere of "endorser beware" in which the prospective stockholder-endorser is inhibited from utilizing what is otherwise an attractive method of financing his enterprise.

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gain is always attractive, every investor must be aware of the possibility of loss and be prepared in that event to minimize his losses.

61. The district court speaks of unjust enrichment as receipt of more than one is due, but said it failed to see how lessors would be unjustly enriched because they had a legal right to the improvements by virtue of their lease and a separate right to enforce the note by virtue of their payment to the mortgagee. Fortenberry v. Mandell, 271 So. 2d 170, 172-73 (4th D.C.A. Fla. 1972). This position fails to take into acount that upon joining in execution of the mortgage, the lessors encumbered their "legal right" to the improvements with a mortgage lien, which, in the event of default by the tenant mortgagor, might "legally" be satisfied by foreclosure and sale of the land, passing lessors' previous rights under the lease. The lessors' "separate" rights then were unmistakably bound together, for only by paying off the note could lessors prevent loss of the land. It was certainly granting them more than they were due to allow them to keep the land (which they might have lost) and also to reimburse them for the money spent to prevent this loss.

The supreme court spoke of possible unjust enrichment, but only if the defendants could prove that the improvements were of a type that enhanced the value of the land. 290 So. 2d at 6, 7. This was a totally superfluous analysis because the court failed to recognize the true nature of the transaction involved. Because the lessors were "investing" in the security created by erection of these improvements, there was no reason for the court to insure them against possible loss suffered as a result of diminished security (where the lessor carelessly allowed erection of improvements that *decreased* rather than enhanced the value of the land) by reimbursing them at the expense of the endorsers.