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CHAPTER 2

The Instruments of Real Estate Finance

In beginning our discussion of the various legal instruments used in assembling funds for the purchase of rights in land and improvements, it will be well to note that, in the case of a fee, the estate purchased is in perpetuity. This affects the price, which is customarily paid in advance for the perpetual term, and contrasts sharply with transactions involving short-term estates, such as apartment or office leases. It is also the reason why most real estate financing problems arise out of transactions involving fees.

The difficulties accompanying payment in advance are multiplied by the infinite term of the rights conveyed and by the fact that funds for advance payment cannot be accumulated from accruing benefits. If the purchaser of a fee cannot provide the price from his own resources, he has to borrow and pledge the rights he acquires as security for the debt assumed. Thus, in effect, he is enabled to place himself in a position comparable to that of the tenant on a short-term lease, at least so far as paying for his rights out of funds accruing during their terms is concerned.

One other consideration is important. The probabilities of fluctuations of major size in the price of the services rendered by land and improvements increase with the length of the term of an agreement. The result is that, when funds are borrowed, the lender will ordinarily require some form of security to guarantee future payments.

The methods, instruments, and practices used in acquiring title to land and improvements are simplest when all of the purchase price can be provided at the time of transfer in cash or its equivalent from the purchaser's resources, that is, with "equity funds." [1]

On the other hand, when the purchaser's resources are inadequate, or in such a form that he thinks it inadvisable to concentrate

[1] The expression "cash or its equivalent" is used to indicate all forms of wealth that the seller is willing to accept as a part of the "consideration." Frequently, transfers are made in which little or no actual cash or liquid securities are employed.

them in one enterprise, he has these alternatives: he may seek others willing to join their resources with his; he may supplement his funds by borrowing; or he may use both procedures.

We may turn first, then, to a discussion of the methods, instruments, and practices commonly used in raising equity funds.

Assembly of Equity Funds

Traditionally, the purchaser of the single-family home in fee supplies equity funds from his own resources. Since the individual home is most frequently purchased for use and occupancy, it is unusual to find more than one individual (or family) contributing equity funds. In practice, the purchaser, however, does not always provide these funds from his own resources. In recent years, it has become fairly common for him to obtain a personal loan and to use the proceeds as equity funds. This practice is in sharp contrast to that which prevailed prior to 1930, when the funds supplied by the purchaser commonly comprised from a third to half of the purchase price and personal loans were unobtainable. At that time, in some areas, it was possible to borrow more than two-thirds of the purchase price by the use of instruments and practices to be described, which to a considerable extent have now disappeared from the market.

In transactions involving the purchase, for investment, of long-term interests in land and improvements, the purchase price is usually so large that equity funds assume considerable proportions. Since the required amount may be beyond the resources of most individuals, a number of ways have been devised to pool individual resources. The most common is the organization of a corporation and the sale of stock. Where building operations are involved, the stock is frequently taken by architects, real estate brokers, contractors, and, in some instances, by those who supply part of the borrowed funds.[2]

Other forms of association such as partnerships, syndicates, and trusts are also employed. A syndicate has been frequently used in sub-

[2] Two special applications of the stock device were used during the twenties: the "French Plan" and the "Indiana Plan." For a contemporary description of these and other stock plans, see Robert F. Bingham, "New Methods of Financing Real Estate," *Annals of Real Estate Practice* (National Association of Real Estate Boards, 1930) p. 541; Elmore L. Andrews, "Stock Issues as a Means of Financing Real Estate Developments," *idem*, Vol. 4 (1926) p. 98; and George C. Forrey, "Real Estate Preferred Stocks," *idem*, Vol. 5 (1927) p. 157.

division or allotment operations, as well as in dealings in acreage or accommodation land.[3] The advantages of the informal types of organization are commonly supposed to be flexibility and freedom from prescribed procedures and legal requirements, though they involve delicate problems of title, tax consideration, and the like, which have led to much litigation.

A special corporate form, the *cooperative* or *mutual* undertaking, has been most commonly used in housing developments, and is discussed here in its application to apartment houses, known as cooperative or mutual projects. Several types of legal organization may be used in a cooperative development.

One type is represented by the organization of a trust, similar to the Massachusetts Common Law Trust. Title, in fee, to the land and improvements is taken by a trustee in accordance with the terms of a trust agreement. The trustee issues certificates of beneficial interest to participants, each of which carries rights to the occupancy and use of a specified apartment. The certificates of interest and the trust agreement also contain provision for payments by the holders to meet operating costs, taxes, and debt service and to cover other contingencies. Ordinarily, provision is made for a board of advisers, selected from the certificate holders, to advise the trustee, although final authority usually rests in him. Among the contingencies provided for are dissolution of the trust, and transfer of the certificate and its privileges. Operating rules are also included. This organization is complex and is used less than the more familiar corporate form, which has tax advantages in a number of states.

When the corporate form is employed, the corporation (instead of a trustee as in the Common Law plan) holds title to the land and improvements in fee. Stock, in an agreed amount, is issued and made transferable only in blocks, each block representing a part of the equity proportionate to the value of the use of a particular apartment. Each block of stock carries with it the right to a proprietary lease of an assigned apartment. The conditions of the lease and the charter and by-laws of the corporation govern its operation and stip-

[3] See Robert F. Bingham and Elmore L. Andrews, *Financing Real Estate* (Cleveland, 1924) Chapters 9 and 23; L. H. Roseberry, "Syndicate Financing of Real Estate Projects," *Annals of Real Estate Practice*, Vol. 5 (National Association of Real Estate Boards, 1927) p. 73; C. C. C. Tatum, "Syndicate Financing and Subdivision Work," *idem*, Vol. 3 (1926) p. 91; Rupert C. Herzog, "Charting the Financial Plan in Subdivision Projects," *idem*, Vol. 3 (1926) p. 113.

ulate the rights and privileges of proprietary leaseholders as well as of stockholders. Assessments are made against lease-stockholders to meet the cost of operation, taxes, and debt service, and the stock stands as security for the payment of these assessments. Other provisions in the lease and by-laws cover the same contingencies as does the trust form of organization.

Cooperative housing projects were developed in considerable number during the late twenties, principally in New York, Chicago, and Washington. In the late twenties, the Amalgamated Clothing Workers Union built some notable projects in New York City and has since operated them very successfully.[4] In the early forties, this form of organization was used for housing projects developed by the Federal Works Agency, and it aroused the interest of certain labor organizations.

During World War II, there was a further revival of this type of operation in several larger cities, partly as a result of rent control. Under the regulations of the Office of Price Administration, landlords were forbidden to raise their rents above those existing on the "freeze date." The provisions of the Emergency Price Control Act of 1942 [5] did not restrict the sale of residential land and improvements. The landlord who could not raise his rents was not prohibited from organizing a cooperative corporation, thereby placing his tenants in the position of subscribing to stock in the corporation or of being threatened with eviction. If tenants were unwilling, it was not difficult to find substitute purchasers who, by giving due notice, could obtain possession. Furthermore, the rent restrictions of the Veterans' Emergency Housing Program could be avoided largely by building for sale as a cooperative enterprise.[6]

The purpose of these several types of organization is to provide equity funds and to spread the risk of loss and the opportunity for

[4] See *infra*, Chapter 6.

[5] January 30, 1942, c. 26, 56 Stat. 23.

[6] For discussion of the questions involved in the organization and operation of cooperative housing projects, see Bureau of Labor Statistics, *Nonprofit Housing Projects in the United States*, Bulletin No. 896 (1947); Bureau of Labor Statistics, *Organization and Management of Cooperative and Mutual Housing Associations*, Bulletin No. 858 (1946); National Housing Agency, *Mutual Housing, A Veterans' Guide* (1946); Edwin Yourmann, "Some Legal Aspects of Cooperative Housing," *Law and Contemporary Problems*, Vol. 12, No. 1 (Duke University, Winter 1947) p. 126. See also "Cooperative Housing Societies in 1929," *Monthly Labor Review*, Bureau of Labor Statistics, Vol. 32, No. 1 (January 1931) pp. 47-51.

profit. Their effect is to widen the sources for equity funds. No data exist, however, for estimating how extensively different types of organization have been utilized.[7]

ASSEMBLY OF BORROWED FUNDS: THE MORTGAGE

The practice of pledging property as security, essential in the acquisition of rights in land and improvements through borrowing, is as old and as ubiquitous as property itself.[8] In its simplest form a pledge is signified by the pawn ticket; in real estate financing it has become elaborate, formal, and rigid.

The most common instrument to pledge an interest in land and improvements is known as a "mortgage." In its earliest form in Anglo-Saxon communities, the mortgage was a deed, that is, it transferred to the creditor both title and possession or occupancy. This deed, however, contained a defeasance clause which provided that if the debtor faithfully and punctually performed his obligations, the title, possession, and occupancy pledged would revert to him and the entire transfer would be null and void. If the pledge was redeemed, the transaction was dead, and the debtor recovered his rights.

Today, the mortgage is essentially unchanged in form, but its content and effect have been radically modified. Now, as a result of legislation and court decision, any instrument the purpose of which, either expressed or reasonably implied, is to pledge rights in land and improvements as security for the performance of obligations, is a mortgage; and "once a mortgage, always a mortgage." Even though the defeasance clause be purposely omitted, if the intent of the parties can reasonably be interpreted as that of pledging rights as se-

7 In the assembly of land for public housing developments subsidized by the Federal Public Housing Authority, funds to equity holders were distributed as follows: to individuals, 48.0 percent; two or more persons, 11.1 percent, or a total of 59.1 percent to private persons; 8.4 percent to financial institutions; balance in small amounts to estates, nonprofit organizations, and so forth. (National Housing Agency, *Who Owns the Slums?*, Bulletin No. 6, 1946.)

8 A considerable, though unmeasured, portion of the loans made by banks is supported by a pledge of rights in land and improvements, taken as "additional collateral" after the advances have been made and at a time when some doubt has arisen about their repayment. In most cases, the relationship of the parties as debtor and creditor is essentially the same as though the funds had been advanced to assist in acquisition of rights in the land and improvements pledged. It would lead too far afield, however, to explore this type of case further.

curity, the instrument and its effect are as though the defeasance clause were included.[9]

In addition, the transaction no longer transfers use and occupancy. In effect, after the transaction, the debtor remains in possession the same as before; and the rights of the creditor become enforceable only upon the debtor's default in meeting the obligations. In other words, the mortgage gives the creditor a lien against the rights of the debtor, enforceable only after default.[10]

Through the years, the rights of the creditor have become further modified. He no longer comes into full possession of the rights of the debtor, even after default. Instead, he has only the right to demand that the pledged property be offered for sale to satisfy the obligation.[11] If at the sale the obligation is satisfied, the creditor has no further interest. Unless he becomes the purchaser at the foreclosure sale, the interest of the creditor in the pledged property becomes extinguished with foreclosure and sale. He may have other recourse on a bond or note which the mortgage secures, but his rights under the mortgage are exhausted.

It must be emphasized that the interest of the creditor in the property pledged by the mortgage can be enforced only in the future; so long as the obligations of the debtor, under the terms of the agreement, are discharged, the latter has possession and use of the pledged property, free of any interference by the creditor, unless the agreement provides otherwise. Because of his interest, however, the creditor does have an equitable right which enables him to prevent dissipation of the pledged property; otherwise, its management remains in the hands of the debtor until he has defaulted.

Within the framework of such general rules of law or equity, so firmly established as accompaniments of the relationship of mortgagor and mortgagee that they cannot be waived even by agreement, the provisions of the mortgage instrument establish and determine

9 This is true in most jurisdictions, but there is considerable variation among states, and such generalizations should not be taken as a literal interpretation of the law in every state. See Miles L. Colean, *The Impact of Government on Real Estate Finance in the United States* (National Bureau of Economic Research, Financial Research Program, 1950) Chapter 5.

10 Technically, in "title theory" states, title passes to the mortgagee when the transaction is consummated; in "lien theory" states, the mortgage creates only a lien and title remains in the mortgagor until foreclosure; and in a few states a combination theory prevails, in accordance with which a lien is created until default, when title passes.

11 Again it must be pointed out that there are exceptions in states where by statute the creditor is given the right of entry upon default and after a given time his possession becomes indefeasible.

the obligations of the debtor. They may also limit or enlarge the powers and privileges of the mortgagee. In general, any provision may be included by agreement which does not forfeit in advance basic rights of the mortgagor. These are protected as a matter of public policy because the debtor is sometimes a necessitous borrower. As such, he is protected against forfeiture in advance of the right to reclaim his pledge and, in most jurisdictions, against the extortion of an unconscionable rate of interest. The term of the loan (the time or times, place, and manner of its repayment), the rate of interest within the maximum, with reasonable penalties for not meeting payments on the due date, or allowances for payments made in advance of their due date, and readjustments or changes in the scheduled payments which may come into effect in certain specified contingencies, these and many other details may be provided for in an agreement embodied in the mortgage instrument.

Within the limitations of law, then, there is ample opportunity for adapting the mortgage instrument to the circumstances peculiar to each transaction. Once executed, its provisions can be changed only by mutual consent, but in its preparation the mortgage instrument is susceptible of great adaptability. Much of its rigidity is the unnecessary result of custom or the routine use of standardized provisions.

STRAIGHT-TERM MORTGAGES

Provisions covering the term of the loan and the manner of repayment illustrate both the potential flexibility of the mortgage instrument and the persistence of customary practice. Traditionally, a term is fixed by agreement, at the end of which the whole loan falls due; accrued interest is payable at stated intervals during the term or *in toto* at the end. A mortgage containing these provisions is called a "straight-term" or a "straight" mortgage and is well adapted for a debtor who expects to pay the debt on or before its due date and for a lender who wishes to lend for a period approximately equal to the term agreed upon and to recover the whole sum at the end of that period.

Yet the straight-term mortgage is frequently used in transactions in which both the borrower and the lender recognize that the borrower is not likely to be able to pay the debt at the end of the term. Sometimes an agreement to extend the mortgage is part of such a straight-term mortgage. This agreement, however, is commonly tacit or verbal and is not enforceable at law. Thus, its use leaves some uncertainty or creates an advantage for one of the parties. Notwithstanding its inappropriateness, the use of the straight-term mortgage persists.

PARTIAL-PAYMENT MORTGAGES

The partial-payment mortgage, which is a variation of the straight-term mortgage, provides that at specified intervals during the term a partial payment shall be made to reduce the debt. These payments usually fall due on annual, semi-annual, or quarterly dates, when interest is also due. Under the partial payment play, the sum of the payments on principal is less than the original debt, and a balance, called a "balloon payment," becomes due at the end of the term.

This arrangement is appropriate when the borrower anticipates receipt of income corresponding to payments scheduled during the term and of a sum sufficient to meet the balloon payment at the end of the term, and where the lender, instead of keeping the original amount of funds outstanding for the entire term, prefers to recover a portion of them at stated intervals and the remainder at the end of the term. In practice, these conditions are seldom found. The balloon payment is usually considered by both parties to represent a sum which the borrower will not have provided and which the lender will not demand, or does not expect to receive, when the term expires. Both parties usually anticipate that this sum will be "refinanced." Many lenders cling to the practice because it gives them the right at the end of the term to negotiate a different form of agreement for repayment of the balance or to demand its entire liquidation. Borrowers, on the other hand, may use this type of mortgage to borrow funds for other purposes and to have the use of a sizable proportion of the funds for the whole period of the loan.

FULLY AMORTIZED MORTGAGES

Another type of agreement, the amortized mortgage, is used more and more frequently in mortgage loans on homes. The most common terms embodied in this type of home mortgage provide for full reduction of the debt at maturity by fixed monthly payments. Payments are credited first to interest accumulated for the month at the agreed rate and the balance toward reduction of principal. Other terms provide for the payment of a fixed amount per month on principal and in addition the interest accrued for the month. There are also variations of these two basic types of full amortization agreements.

The monthly amortized mortgage is appropriate where the borrower receives his principal income monthly and where the repayment of the principal in small monthly sums will not result in dispersion of the lender's principal or cause a loss because of waiting to recapture sufficient principal for further investment. Although not appropriate, therefore, for many individual lenders, it is especially suited to institutional lending. It gives a calculable liquidity expectation to the investment and some turnover of investment which facilitates adjustments of the portfolio to changes in the money market; it also maintains contact between borrower and lender, providing prompt notice of default or other stresses affecting the quality of the investment.

From the debtor's viewpoint, the scheduling of repayment in monthly amounts within the borrower's income approximates a rental arrangement, with payments comparable to the "use value" of the home.

This kind of provision also has a particular appropriateness in financing income-producing land and improvements, inasmuch as the funds for repayment of such a loan and for the payment of interest charges are usually received from the revenue flowing from net rents. This income is generally received monthly and is seldom sufficient to pay any considerable portion of the indebtedness in a short time. The gradual reduction to extinguishment of the debt out of month-to-month revenue would appear to be a realistic arrangement, but it is seldom used. Instead, the mortgage agreements entered into in financing income-producing land and improvements much more frequently provide partial amortization by quarterly, semi-annual, or annual payments of principal and interest. Furthermore, the total of these periodic payments, exclusive of the last payment, never equals the amount of the original loan.

The mortgage on income-producing land and improvements seldom confers special privileges upon the creditor. His role is usually passive while the obligations are not in default. Thus, he never exercises direct control of the management of the land and improvements, of the income received from their operation, nor even of the disposition of the debtor's equity. So long as management does not cause or permit open and notorious waste of the collateral, and the sums due at specified dates are paid, so long as tax payments are met when due, and fire and casualty insurance premiums are paid, the creditor ordinarily has no right to any control. Though the value of the collateral may decline until it becomes obvious that there is no margin to protect the creditor, and though the debtor may experience periods of swollen net earnings and may have an opportunity to dispose of his equity at a large profit, the creditor still receives only the payments provided for in the original agreement. He cannot call for additional collateral; he cannot intervene in a transaction which transfers the equity. At most, under the usual mortgage agreements, he can only ask, after default, that a court of competent jurisdiction appoint a receiver to collect the rents and otherwise protect his deteriorating position.

The continued use of this type of agreement is all the more notable when one considers that the debtor in most instances is, by design, a corporation organized for the specific purpose of holding the equity and borrowing on mortgage collateral; its only asset in most cases is the equity; its only obligation is that secured by the mortgage. It is thus in a position of having everything to gain and little to lose. If the equity threatens to vanish, it can economize on operating expenditures, particularly upon repairs and replacements; it can collect rents as far in advance as persuasion, supported by liberal discounts, can induce tenants to pay; it can default in payment of taxes and seek to delay court action until the largest possible sum has been realized; it can distribute this sum to stockholders, leaving the creditor to exercise all the rights he has demanded in his agreement, namely, that of asking the court to foreclose, to appoint a receiver to collect rents, and finally to sell the collateral at public sale. On the other hand, if circumstances provide an opportunity for sale of the equity at a profit, the corporation need have no concern about its obligation. The sale can be made subject to the mortgage and the profits distributed to stockholders. In neither situation can the creditor exercise any control.

The prevalence of this anomalous situation probably reflects in some measure a transference to mortgages of practices common in connection with other collateral loans; but in these loans the creditor's position is protected by his being able to call for additional collateral or to effect a prompt sale in case the obligation is affected by changes in the value of the collateral. On all such loans, income from the collateral traditionally belongs to the debtor. There is no reason in law, however, why this tradition should be perpetuated in connection with mortgages on income-producing land and improvements. Mortgage agreements could be made, and have been made, in which the creditor was given a measure of control over income and the right to demand repayment of his loan or to make any other adjustment he might wish when the debtor disposed of his equity.[12]

Many such agreements have provided for complete amortization by periodic payments on principal, but have neglected to protect the mortgagee against the sale of the equity or against complete repayment by refinancing at periods not specified in the agreement. There has, in brief, been little progress toward adjustment of the mortgage agreement to real estate market behavior. The mortgage instrument remains potentially flexible but in practice almost completely rigid.

"PAST DUE" MORTGAGES [13]

There is one other arrangement frequently entered into in connection with home mortgages, namely, where the mortgage is payable on demand or after a very short term. After execution of the agreement or upon expiration of the term, the obligation is carried as an "open" or "past due" mortgage. In some instances the borrower keeps his obligation in good standing merely by paying interest at agreed intervals; in others he also pays something toward amortization. In both cases both parties assume that the loan will not be called and it seldom is. During periods of stress, however, it may be necessary for the lender to request payment; in other circumstances, he may wish to insist upon curtails, that is, on reduction of principal.

Some lenders contend that the open or demand mortgage gives greater control over the loan, enabling the enforcement of curtails or other adjustments when needed. At the same time, however, they

12 Particularly those insured by the Federal Housing Administration under the provisions of Section 207 of the National Housing Act, as amended (February 3, 1938, c. 13, 52 Stat. 8, 16). The technical legal problems involved are numerous but not beyond the possibility of solution given proper legal counsel.

13 There are virtually no data on the extent of the use of this and other types of mortgage instruments. See, however, Bureau of the Census, 16th Census: 1940, *Housing*, Vol. 4, Part 1, Table A-5, p. 10, which contains some data on the prevalence of provision for amortization of home mortgage debt. These data indicate that principal payment was required on 79 percent of the first mortgages on single-family, owner-occupied homes.

argue that the borrower is justified in accepting these unilateral features on the ground that unfair advantage is never taken of a mortgagor; the borrower, strangely enough, is generally satisfied with the arrangement.

PROTECTION OF COLLATERAL MARGIN

The mortgage has another feature that is unique, for it contains no provision for maintenance of a "margin of safety." In other collateral loans the contract usually provides that the borrower must maintain during the term of the loan an agreed "margin" by increasing the collateral if its value declines. Part of the collateral may be released if it increases in value, provided that at least the original margin is preserved. Failure of the borrower to maintain this margin constitutes default and automatically authorizes the sale of the collateral to pay the obligation. This kind of provision obviously can be made only if there is some criterion, acceptable to both parties to the agreement, by which the fluctuations in the value of the collateral can be objectively determined. The mortgage, however, seldom if ever contains a "safety margin" provision. The collateral is appraised when the loan is made, and throughout the term of the loan it stands as the only collateral, subject neither to increase nor to release.[14]

PRIORITY OF MORTGAGES

Another anomalous situation exists in connection with the use of mortgages. Since possession and occupancy of the land and improvements remain with the debtor, he may pledge his rights as collateral for more than one obligation or loan. Thus, he may build up a series of contingent claims against his rights, each of which ostensibly pledges the same collateral. In such a case, however, the borrower is actually pledging only the rights he has left. In effect, he establishes a hierarchy of interests determined by facts pertinent to each transaction. Most important are the date of execution and the recording of the pledge instrument. The general rule is that an instrument executed and recorded creates a claim prior to all subsequently executed

[14] Provision is frequently made for release of parts of the premises mortgaged if they can be divided and sold as separate units, or if a portion is taken by public authority. The usual agreement is that the proceeds from the sale or disposition of a portion must be used to reduce the outstanding balance of the loan proportionately. This is an equitable arrangement, but it makes provision only for changes in the physical volume or amount of land and improvements hypothecated.

and recorded. In accordance with the order in which they are executed and recorded, these claims are known as first mortgages, second mortgages, third mortgages, and so on.

Since recordation constitutes notice to the public, it is assumed that creditors accepting the collateral pledged to them by subsequent instruments recognize this priority. So long as all prior claims are, to the satisfaction of the creditor, sufficiently less than the value which he places on the collateral, he may be willing to accept his inferior position and make further advances. The use of inferior or junior mortgages was formerly common in real estate financing, and still persists though there is no basis for estimating its extent.[15]

So long as there is no default on any obligation for which a mortgage has been given as collateral, the rights of all the creditors remain dormant. When there is a default, the creditor upon whose obligation the default occurs may take action to enforce his claim.[16] Such action does not technically affect the rights of creditors who hold a prior claim, though they may be made parties to the action. The creditor whose obligation is in default can ask only for sale of the rights pledged to secure his funds; that is, he can ask only for the sale of the collateral subject to all prior claims. In effect, the holder of a junior mortgage recognizes that, in case of default on prior obligations, he may be obliged to advance the funds to cure the default and maintain these in good standing while he forecloses. This he may do in order to get possession and obtain the income from the land and improvements until he in turn is foreclosed by the prior lien holder.

The precariousness of this position obviously increases with the number and amount of prior obligations. It is not surprising, therefore, to find that interest rates and discounts on junior obligations are higher than on prior mortgages, and that funds advanced against junior mortgages are of a speculative or high risk category. Thus, the use of a multiplicity of mortgages is expensive to the borrower

[15] In an analysis of mortgage interest rates in the Hartford-New Britain Metropolitan District, the Federal Home Loan Bank Administration found that 10 percent of all nonfarm mortgages under $20,000, recorded during May and June 1942, were junior liens. (Federal Home Loan Bank Administration, *An Analysis of Mortgage Interest Rates in the Hartford-New Britain Metropolitan District,* unpublished study, March 1944, p. 3.)

[16] Many prior liens contain a provision which permits the holder to declare his own obligation in default in case of default on any junior lien. This provision is necessitated to prevent holders of junior liens from obtaining possession and "milking the property" while senior lien holders are foreclosing.

and risky to at least some of the creditors. The Federal Housing Administration is commonly thought to have had a strong influence in the direction of eliminating use of junior mortgages in financing homes. The availability of higher loan-value ratios on insured home mortgages has, in many instances, obviated the use of junior liens.

TRUST DEEDS IN THE NATURE OF MORTGAGES

A trust deed in the nature of a mortgage is sometimes used in financing transactions. This instrument places title in the hands of a trustee—a "stranger" to the transaction—and indicates to him the rights and obligations of each party and what action he must take to preserve or enforce those rights and obligations. The trustee's instructions provide for reconveyance of the collateral to the debtor when the obligations are discharged and for sale of the collateral in case of default. He thus becomes a "stakeholder," holding title in trust for the benefit of both parties as long as they both have an interest in it.

In some jurisdictions the trust deed in the nature of a mortgage has practically supplanted the mortgage, and it is common to speak of "first trusts" rather than of "first mortgages." In certain instances, legal provisions are more flexible when the trust deed is used. Abstractly, it can be assumed that when a disinterested person holds the stakes, there is less likelihood of fraud and less need for careful protection of the rights of the borrower. This distinction, however, is more apparent than real because the trustee's actions, like those of a mortgagee, are controlled by the legal provisions of the trust agreement. And as long as collateral secures the repayment of a debt, the equitable principles governing the case are those which apply to mortgages.

There is one situation, however, in which the use of a trustee to hold the collateral is almost a necessity, namely, when the parties at interest, particularly the creditors, are numerous and widely scattered, and when their interests in the collateral are proportionate to the amount of the indebtedness due to each. It is not feasible for each creditor to hold a proportionate share of the collateral, or for the group to act as promptly as can a trustee.

The trust deed in the nature of a mortgage is nearly always used in connection with a mortgage bond issue, a land trust certificate and, in some instances, a cooperative enterprise.

LAND CONTRACTS OR CONTRACTS FOR DEED

The land contract came into common use toward the end of the nineteenth century in connection with sale of lots in subdivisions or allotments. It is an agreement by a seller to give possession and occupancy to a buyer upon payment of a cash sum, usually nominal, with an agreement of the buyer to pay the balance of the agreed price, with interest, in instalments over a period of time, usually several years. It is commonly provided that, when these periodic payments have accumulated to a considerable portion of the purchase price (usually half), the seller will give a deed, or transfer title, and take the usual mortgage as security for payment of the balance. Meanwhile, the purchaser is a sort of tenant at sufferance. His interest is an equitable one, subject to extinction upon default by resort to legal procedures more akin to those available to a landlord than to those governing the relationship of mortgagor and mortgagee, and therefore simpler, quicker, and less expensive.[17]

In using a land contract, the creditor in effect retains all rights and title as collateral, except those of use and occupancy. The debtor acquires these rights but on a rather tenuous basis. For upon default, he may lose not only the use and occupancy but also his equitable interest in the contingent right to complete title. It has happened that before the buyer was in a position to demand title the seller had lost, through foreclosures of prior liens, the power to give title. There is usually nothing in the land contract to prevent the seller from placing such prior liens, and, in many instances, prior liens exist when the contract is executed. Furthermore, most of these contracts contain an agreement between the parties that they will not be recorded. The purchaser, therefore, lacks the protection of a recordation of his interest.

The usual terms provided by the land contract are 10 percent of the purchase price, in cash, and payment of a sum equal to 1 percent of the purchase price per month. These terms vary, however, and are determined by negotiation; and, although the down payment and the percentage of total price to be paid before transfer of

[17] In some jurisdictions, however, the courts have gone a long way to relieve the harshness of the provisions contained in some of these contracts. This mitigation takes the form of refusal to forfeit the contract if payments have been made in other than strict accordance with the provisions except after notice and warning and of requiring formal foreclosure if the purchaser has acquired what appears to be a genuine equity.

title may vary, there is almost no flexibility in scheduled payments. Since in most jurisdictions there are fewer limitations on use of the land contract than on use of the mortgage, it, like the trust deed in the nature of a mortgage, is an instrument susceptible of great flexibility, though it is seldom employed in practice.

LAND TRUST CERTIFICATES

Land trust certificates were often used in the twenties to finance the purchase or construction of improvements on centrally located land —particularly in Canton, Chicago, Cleveland, Dayton, and Pittsburgh. They are not an evidence of indebtedness but of beneficial ownership of an interest in the *fee*. Inasmuch as their use has been confined mostly to instances in which the interest in the fee was limited in time and provision was made for its liquidation, they may be more properly classified as instruments securing debt than as a means of assembling equity funds.

Land trust certificates have usually been issued in the following circumstances. The owner of a centrally located fee found it desirable to construct a large building to replace an existing structure.[18] He transferred the fee to a trustee, taking back simultaneously a long-term ground lease and a number of certificates of beneficial interest in the fee. He thus changed his own status from owner of the fee to owner of a leasehold estate and, through the certificates, to an equitable owner of the fee. The certificates were then sold by the owner to an investment dealer or in the open market to raise the funds for construction.

Under the terms of the lease, the original owner undertook to pay a stipulated annual rental and to construct a specified improvement involving a minimum stated expenditure. The rent reserved was based upon the appraised value of the land, which fixed the *amount* for which land trust certificates were issued. Reserved rentals were also an amount sufficient to pay a calculated rate of return on the total amount for which certificates were issued. An additional sum, paid annually, was to be used by the trustee to repurchase the certificates or the option to purchase or call the certificates within a

[18] For further discussion, see Robert F. Bingham, "Types of Property Which May Be Financed by Land Trust Certificates," *Annals of Real Estate Practice,* Vol. 5 (National Association of Real Estate Boards, 1927) p. 141, and Robert F. Bingham, "Developments in the Use of Land and Leasehold Trust Certificates," *ibid.,* Vol. 4 (1926) p. 78; also, Robert F. Bingham and Elmore L. Andrews, *op. cit.,* Chapter 20.

specified number of years, at a stated premium, was reserved for the original owner. The certificates when so repurchased were to be held in trust for the original owner; and, when all were repurchased, title was returned to the original owner as the sole beneficiary of the trust.

Thus, in effect, the original owner of the fee pledged his interest as security for payment of the rent reserved and for performance of his other obligations; upon faithful performance he reacquired his interest. As security, he constructed the improvements specified in the trust agreement. In doing so, he frequently borrowed a part of the necessary funds and again pledged his leasehold estate as security by executing a leasehold mortgage. He thus built up a hierarchy of claims prior to his own interest, at the base of which were the land trust certificates. All other interests were junior to this one, and default in performance of the covenants of the lease could jeopardize the interests of the mortgagee as well as those of the original owner of the fee. Owing to the secure position of certificate holders, it was generally assumed that the funds could be raised at a lower cost than is usually involved in mortgage procedure.[19]

MORTGAGE BOND ISSUES

The use of the mortgage bond provides one of the most dramatic episodes in the history of real estate finance. The first issue appears to have been made in 1893 by the Peabody Houghteling Company, in Chicago, and was secured by the Mallers Wholesale Store Building. A few issues appeared prior to World War I,[20] and afterward they became a common form of investment, issued by national and local companies.

Estimates of the volume issued from 1919 to 1930 vary considerably, and the exact amount may never be known. Fairly accurate

[19] In some instances, more funds could be obtained by the sale of both land trust certificates and leasehold mortgage bonds than by use of the usual first mortgage, partly because of the complicated character and unfamiliarity of the procedure. It was difficult to analyze and appraise the various interests on their true merits. The procedure was limited to those states in which the law was not unfavorable. It was never used in New York apparently because of the doubtful status of several of the interests involved. For a discussion of some of the legal questions connected with this type of security, see John S. Miller, "Land Trust Certificates," and Herbert J. Friedman, "Land Trust Certificates," *Annals of Real Estate Practice*, Vol. 5 (National Association of Real Estate Boards, 1927) pp. 114 and 124.

[20] Evans Clark, editor, *The Internal Debts of the United States* (New York, 1933) p. 74, estimates that $150 million were outstanding in 1913, and quotes W. C. Clarke's estimate of $300 million for 1919.

records of large issues are available, but about 1925 a large number of banks and their affiliates and real estate concerns and mortgage bankers began to float small issues. No compilation of these exists. Two estimates of amounts outstanding have been made—$5 billion for 1931 [21] and $10 billion for 1935 [22]—but they are inconsistent with one another in view of the fact that the 1931 oustandings were doubtless higher than those of 1935. Unfortunately, there is no way of knowing whether the 1931 estimate is too low or the 1935 estimate too high. The number of persons directly affected has been placed as high as four million.[23] The largest volume issued in any one year appears to have been floated in 1927, one year after the failure of one of the larger issuing houses,[24] when the total reached nearly $1 billion.

In connection with a mortgage bond issue, a deed of trust was executed by a borrower pledging with a trustee his interest in land and improvements as security or collateral for payment of the obligation.[25] Simultaneously, a series of bonds was executed, each certified by the trustee as representing a portion of an original obligation secured by the trust deed. Usually these units were in denominations of $1,000, $500, and $100, and interest coupons were attached. The bonds matured serially, or provision was made for their gradual retirement by lot. The borrower agreed to pay interest at stated intervals to the trustee or a fiscal agent and provide sufficient funds to retire maturing bonds or a similar amount to be selected by lot.

By splitting the obligation into a number of small units, the bonds could be widely distributed. Large and small investors could secure the advantages of relatively high interest rates, suitable de-

21 *Ibid.*, p. 74.

22 This estimate, made by the Sabath Committee (U. S. Congress, House, Select Committee to Investigate Real Estate Bondholders' Reorganizations, Report No. 35, 74th Congress, 1st Session, 1935), quoted and endorsed by Robert A. Halliburton (*The Real Estate Bond House,* Indiana, 1939, p. 1).

23 *Idem.*

24 The table compiled by Ernest A. Johnson ("The Record of Long-Term Real Estate Securities," *Journal of Land and Public Utility Economics,* Vol. 12, No. 1, February 1936, p. 44) indicates that the largest volume occurred in 1925, with approximately $696 million. Nelson, Hunt and Company, Chicago, issued monthly reports, up to 1930, purporting to give currently the total of both real estate stocks and bonds issued. During the years 1919-30, their total of bonds was $4,797 million. Nelson, Hunt and Company estimates are more complete because they include unlisted securities.

25 Many of the land issues were secured by a mortgage on a leasehold estate, and the descriptive literature was not very explicit in pointing out the precise nature of the estate pledged. There may have been unintentional irony in the use of the expression "first mortgage gold bonds" in practically all of the literature.

nominations, and a wide selection of maturity dates. The widespread buying of government bonds during World War I had created a market for this type of investment, probably by diverting savings which otherwise would have gone into more familiar forms of investment.

For the most part, the companies issuing mortgage bonds were not under public supervision and the instrument was seriously abused, a development not anticipated, apparently, even by experienced investment analysts.[26] The widespread distribution of interests in a single obligation created unprecedented difficulties when there was default. The duties and obligations of the trustee were not clearly defined and trustees were not always disinterested. In many cases, the trustee was an officer of the issuing company. In most instances, proceeds from the sale of bonds became part of the commingled funds of the issuing house. In some instances they were also used to meet maturing obligations or to make margin loans in the stock market rather than to develop the improvements pledged as security.

The success of the initial issues led to careless and opportunistic appraisal practices which often allowed the appraisal to be determined by the amount of the bond issue. As a result, the traditional margin appeared to have been preserved between the indebtedness and the value of the collateral. Distribution of bonds among an uninformed public avoided the kind of analysis and safeguards that would have been demanded by an experienced investor. The public relied upon the representations of the issuing company; they were unable to make, and were largely oblivious to the necessity for making, any analysis of a particular issue. The issuing houses failed to justify this confidence; they were more desirous of profits from the issuance and distribution of securities than of preserving the securities in good condition.[27]

The first spectacular failure among the issuing houses was that

[26] See, however, the series of four articles by Irving Allen in *The Annalist* (May 21, June 4 and 18, and July 16, 1926) in which many of the contemporary practices were criticized and their dangers pointed out.

[27] The prevalence of these practices was amply demonstrated in hearings held before the Select Committee to Investigate Real Estate Bondholders' Reorganizations, House of Representatives, 73rd Congress, and by contemporary investigations of the Securities and Exchange Commission. They are summarized and documented in Securities and Exchange Commission, *Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees,* Part 3 (June 3, 1936).

of G. I. Miller & Company, Inc., of New York, in 1926. At the time, they had outstanding some $56 million in bonds, widely distributed.[28] This failure caused consternation, but had little effect on the practices of issuing houses. New issues ceased, however, in the early thirties when wholesale distress, defaults, and difficulties began.

Defaults and foreclosures were followed by reorganizations.[29] In these operations the issuing houses again played a major role. For the most part, they had sole access to the lists of bondholders. The bondholders were generally unknown to one another, and so it was easy for the issuing house to take the initiative in organizing bondholders' protective committees,[30] nominating persons who would act on such committees, drawing the bondholders' agreement, and taking such other steps as are necessary for unified action by a widely distributed group of interested parties. In many instances, advantage was taken of uninformed bondholders in drafting bondholders' agreements, in appointment of members of the protective committee, in naming attorneys for the bondholders' protective committee, and in the selection and remuneration of trustees to receive the deposit of bonds from those who agreed. As a result, fees, costs, and negligence often absorbed a large portion of the funds collected, and bondholders suffered proportionate losses.

In the meantime, it was difficult if not impossible for bondholders to obtain authentic and adequate information about their holdings; it was a common practice for bond houses to advance interest due to bondholders and thus keep them in ignorance of defaults that had occurred. Furthermore, there was no market for mortgage bonds except over the counter; and, in most cases, this market was maintained only by the willingness of the issuing company to repurchase its bonds. Many of the larger companies sustained this market while they had funds. When these companies went into receivership, all semblance of an organized market disappeared. This situation offered an excellent opportunity for individuals who had information about the position of an issue to purchase the bonds at

[28] Robert A. Halliburton, *op. cit.,* Table 2, p. 135.

[29] For a contemporary description of reorganization methods in Chicago, see Carrie Maude Jones, "Apartment House Bonds: Some Plans for Reorganizing Defaulted Issues," *Journal of Land and Public Utility Economics,* Vol. 9, No. 4 (November 1933) pp. 358 ff.

[30] Securities and Exchange Commission, *op. cit.,* pp. 48 ff.

whatever price they wanted to offer. Some were none too scrupulous, and they bought up large blocks of bonds at a price which reflected the bondholders' predicament more than the probability of future recovery on the asset.

Extensive investigations by Congress eventuated in enactment and revision of the Securities Exchange Act of 1934, which placed companies under much stricter supervision and limitations. Thus, the spectacular incident ran its course and mortgage bonds at least temporarily disappeared from the real estate market.[31]

GUARANTEED MORTGAGES AND PARTICIPATION CERTIFICATES

One special development connected with mortgage bonds occurred early in the twentieth century, when the title guarantee companies in New York began to guarantee not only title but also payment of interest and principal on the mortgage.[32] Originating without specific authority in the law, legislation was obtained which authorized this practice.[33] Supervision of title guarantee companies in New York was exercised by the Superintendent of Insurance, but was more nominal than real. The insurance, or guaranteeing of title, was a relatively small activity compared with life, fire, and casualty insurance, and the guarantee of mortgages, at least from 1900 to 1920, was likewise a small item in the business of title guarantee companies. The law itself, even as amended during these two decades, was loosely drawn and left the business of guaranteeing mortgages largely to the discretion of the officers of the title guarantee companies.[34] This activity grew with the same spectacular rapidity as mortgage bond

[31] Literature on this episode, prior to the deluge of defaults and through the process of organization of bondholders' protective committees, is relatively abundant and is listed in Robert A. Halliburton, *op. cit.*, pp. 127 ff. Likewise, proposals for remedies are numerous, including those which have been enacted into law, especially in the Securities Exchange Act of 1934 and regulations thereunder. See N. W. MacChesney and Elmer M. Leesman, "Mortgages, Foreclosure and Reorganization," *Illinois Law Review*, Vol. 31, No. 3 (November 1936) pp. 287-319; Elmer M. Leesman, "Corporate Trusteeship and Receivership," *Illinois Law Review*, Vol. 28, No. 2 (June 1933) pp. 238-64. For a review of the behavior of the market for these bonds, including an indication of losses to bondholders, up to 1936, see Ernest A. Johnson, *op. cit.*, pp. 46 and 306; and Genevieve Koester, "Chicago Real Estate Bonds, 1919-1938," *Journal of Land and Public Utility Economics*, Vol. 15, No. 1 (February 1939) p. 49, and No. 2 (May 1939) p. 201.

[32] The history of this development is given in the report of George W. Alger, Moreland Commissioner to Governor Herbert H. Lehman in 1934 (*Moreland Commissioner Report*, New York State, 1934).

[33] N. Y. Laws, 1904, c. 543.

[34] *Moreland Commissioner Report*, New York State, 1934, pp. 13 ff.

financing, the obligations guaranteed by New York State companies totaling nearly $3 billion by 1930.[35]

Guarantees covered two types of obligations, namely, (1) the single mortgage held exclusively by a single investor, and (2) the "participation," which covered certificates of interest issued by a trustee who held the original obligation(s) and issued the certificates of proportionate interest. In many participations the trustee was either the issuing house itself or appointed by it, worked closely with it, and had the power to substitute collateral. It appears from the record that this power of substitution was frequently abused and resulted in deterioration of collateral. It also became evident that there was considerable carelessness, if not intentional dishonesty, in selling both guaranteed mortgages and participation certificates in connection with obligations which were in default at the time of sale. In some instances, banks and trust companies became so closely involved with issuing houses that the public was confused as to the identity of the obligor.[36]

Another type of mortgage guarantee was also provided during the twenties by some of the national surety or casualty insurance companies incorporated outside New York. Generally speaking, these companies, for a consideration or premium, became the surety or guarantor of obligations originated by others. Their contract of indemnity provided for payment of interest and principal after default of the original obligor.[37]

[35] *Ibid.*, p. 9 gives the following summary of the growth of this business:

Year	*Number of Companies*	*Combined Capital and Surplus (millions)*	*Total Guarantees Outstanding (millions)*
1921	12	$64	$548
1922	14	71	652
1923	15	55	781
1924	20	64	981
1925	26	93	1,214
1926	28	121	1,522
1927	37	141	1,837
1928	45	183	2,169
1929	47	200	2,407
1930	50	204	2,867
1931	50	200	2,851
1932	47	184	2,823

[36] *Ibid.*, pp. 103 ff.

[37] For a contemporary description of their methods, see P. W. Kniskern, "Methods of Issuing Guaranteed Mortgages," *Annals of Real Estate Practice*, Vol. 4 (National Association of Real Estate Boards, 1926) p. 67.

The mortgage guarantee appears to have arisen because of a demand on the part of investors for a type of assurance either independent of the original issuing house or supported by the assets and representations of an organization in which they had confidence. In New York it may have been a consequence of this fact that guaranteed mortgage bonds were eligible for the investments of trust funds. At any rate, the experience with guaranteed mortgages and participation certificates was little, if any, happier than that with unguaranteed mortgage bonds. After the crisis of October 1929, defaults and difficulties multiplied. Under the supervision of the Superintendent of Insurance, efforts to reorganize, rehabilitate, and improve the situation made little progress. A series of legislative enactments resulted in the appointment of a Mortgage Commission to deal with certificated issues. There was some recovery for holders of guaranteed mortgages and participation certificates; and a mortgage moratorium slackened the rate of foreclosures. Throughout the thirties, however, there was much distress and heavy losses.[38]

Long-Term Leaseholds

The long-term lease is not essentially an instrument of real estate finance, but it is frequently used in lieu of financing instruments or in conjunction with them, as in land trust certificates. Its effect is to divide the interest of the owner of the fee into two parts: (1) the right to receive rent for a stipulated period and of reversion at the end of that period, and (2) the right of use and occupancy of land and improvements during the lease term. The rent reserved represents the price paid for the right to the benefits from use and occupancy and is customarily paid on a fixed annual basis. The annual

[38] The Insurance Department was neither equipped to carry out the multitudinous details of reorganization and salvage nor in a position to rehabilitate the title guarantee companies, and, at the same time, represent the creditors of these companies. This anomaly led to the passage of the Schackno Act (N. Y. Laws, 1933, c. 745), to the subsequent Moreland Act, and, in accordance with the recommendations of the Moreland Commissioner, George W. Alger, to the Mortgage Commission Act (N. Y. Laws, 1935, c. 19). The Mortgage Commission became responsible for administering and reorganizing 7,805 series representing certificated participations and 15,503 guaranteed whole mortgages, or properties, foreclosed as a result of default, in the total amount of over $688 million. On April 1, 1939, the Commission had effected settlement or reorganized all but 535 series and 607 individual mortgages amounting to a little less than $25 million; in that year the Commission was discharged. During the years of its operation, it paid annually to certificate holders on the average about 3.5 percent of the amount of their certificates. No estimate of the final losses incurred by original investors is available. See *Annual Report of the Mortgage Commission* (1939); also Ralph E. Cramp, "Guaranteed Mortgage Companies in Review," *Contemporary Law Pamphlets,* Series 4, No. 6 (New York University, 1941).

rent reserved may vary, for example, on a graduated basis, increasing at specified intervals during the term of the lease. Occasionally, the rent reserved is specified for only a portion of the term of the lease and is fixed for the rest of the term by negotiation.

When the owner of a fee grants a leasehold estate for a period of years at a specified rent, he forfeits his own right to participate in any enhancement that may come during that period in the value of the rights of use and occupancy. Conversely, for the term of the lease for which a specified rental is reserved, the lessor presumably escapes the risk that the value of use and occupancy may decline. In avoiding this risk, however, he depends upon the promise of the lessee to pay the stipulated rental for the period. In forfeiting the right to participate in any enhancement of value, the lessor is likely to require some assurance other than the promise of the lessee to pay the rental; in other words, he usually requires "security." This is taken as a deposit of collateral, as the purchase of improvements for an agreed price paid at the time the lease is executed, or as a covenant by the lessee to erect new improvements, and as some form of guarantee that the covenant will be performed. Since permanent improvements attached to the land become part of it, they stand as security for the payment of the rent reserved.

From the point of view of financing, then, the long-term lease is usually a ground lease only and provides a convenient way by which the owner of the fee may, in effect, lend the use and occupancy of his land to a lessee. Instead of paying the specified rental in advance for the whole term, the lessee agrees to pay it at periodic intervals and guarantees such payment by giving what the lessor considers to be adequate security. The lessor, instead of getting a large lump sum payment at the beginning of the term, receives more modest annual payments. The lessee borrows the use of the land instead of borrowing funds.

If the security provided requires expensive improvements, or the purchase of improvements already existing, the lessee may mortgage his leasehold estate to obtain part of these funds. In many cases, the amount which can be borrowed on the leasehold mortgage, plus the amount of the present value of the annual rental reserved, is larger than that which could be obtained by purchasing the fee outright and securing a first mortgage loan. In other cases, the long-term lease is suggested because the owner of the fee prefers an annual income to a lump sum payment and wishes to retain the right to the future use and occupancy of the premises.

The long-term lease, particularly the ground lease, plays an important part in the development of the use of parcels of land whose values are high, whose use is intensive, and whose future is usually well assured but not accurately predictable. The financing of long-term leaseholds is complicated and often considered more hazardous than the financing of fees. Use of long-term leaseholds in America is less widespread than in England and is generally confined to land improved with commercial structures.