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Negotiating and Drafting Leases for the Landlord

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NEGOTIATING AND DRAFTING LEASES FOR THE LANDLORD

SENeca B. ANDERSON*

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I. INTRODUCTION

The landlord who leases his property enters the transaction with the not unreasonable expectation that the tenant will live up to his part of the bargain and pay his rent. In addition, he expects that any long-term lease will be free of “escape hatches” which the tenant can use as an excuse for terminating the lease when the real motive is that the lease has proven less profitable than the tenant expected. Similarly, the landlord does not knowingly consent to “booby traps,” i.e., provisions allowing the tenant to continue in occupancy at a lower rental or no rent at all, or subjecting the landlord to unexpected expenses or penalties. Further, the landlord hopes the rent will provide an income which inflation will not unduly erode and which will be subject to minimum federal income taxation.

The purpose of this article is to consider those steps which counsel for the landlord should take to protect the rent check and also to suggest other means whereby he can better serve his client. The problems which confront the landlord when he leases improved property or property

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which he proposes to improve himself will be considered first. The difficulties present when the property is unimproved and the landlord is unwilling to improve it himself, will be discussed later since ground leases vary materially from ordinary leases, and ground leasing is one of the major techniques employed for obtaining revenue from land presently undeveloped.

II. PROPERTY ALREADY DEVELOPED OR WHICH LANDLORD IS WILLING TO DEVELOP

A. Protection Against Unwillingness or Inability of Tenant To Pay

The first and most elementary step a landlord should take to assure himself that a prospective tenant will not default in his rent is to investigate the tenant’s credit. In the case of an individual tenant, the least the landlord should do is to inform himself as to the tenant’s employment, his record for paying his debts, where he banks, and with whom he does business. The landlord should know what property the tenant owns, whether there are judgments against him, whether he has been adjudged a bankrupt or convicted of a crime, and whether he is involved in marital or tax difficulties. The extent of the investigation will naturally depend upon the length of the term, the amount of the rent, the nature of the premises to be demised, and whether the lease contemplates new construction or expensive alterations by the landlord.

Where the tenant is a corporation, the landlord should examine its balance sheet and operating statements and find out all he can about its officers, directors and, in the case of a small corporation, its principal stockholders. Such information, if not obtainable directly from the prospective tenant, can usually be acquired for a small fee from a credit agency. In the case of a publicly held corporation, much useful information can be obtained at any stockbroker’s office.

Landlords frequently overlook the importance of an investigation; thus, the first item on the attorney’s agenda should be to ascertain whether an investigation has been made and, if so, what it discloses. The information elicited will have a great effect on what steps should be taken to protect the landlord against the tenant’s inability or unwillingness to observe his rent covenant.

There are at least four means whereby payment of rent may be secured to some degree. First, there are the landlord’s right of distress and the statutory landlord’s lien, some form of which may be found in almost every American jurisdiction.¹ These may, and in many cases should, be strengthened by a contractual lien. The second means is prepayment of rent or prepayment of a security deposit. The third is requiring the tenant to make improvements or repairs to the premises which

¹ The Florida statutes on distress are Fla. Stat. § 83.11 through § 83.19 (1969). Those creating the statutory landlord’s liens are Fla. Stat. § 83.08 and § 83.10 (1969).
will revert to the landlord upon termination of the lease. The fourth is the guaranty agreement. No one of these measures is a panacea. Rather, in each lease, the attorney representing the landlord must weigh carefully the weakness as well as the strength of each available tool. He must keep in mind that the landlord, except in most unusual circumstances, cannot unilaterally dictate the terms of the lease. The bargain must also be acceptable to the tenant, and the landlord’s counsel who forgets this and drives away the prospective tenant by unreasonable demands or unnecessary quibbling is not likely to endear himself to his client.

Furthermore, the attorney must remember that in the case of many tenants, the most notable being the United States Government, the landlord needs no security to support the covenant to pay rent. In leases to major chain stores or to large well-known corporations it is not customary to require security deposits, prepaid rents or guarantees, although the latter are required where the lease is to a subsidiary corporation. Frequently, such leases contain waivers of statutory liens and distress. While such tenants are not immune to financial disaster or subsequent bankruptcy, the risk is sufficiently minimal to be acceptable to both prudent landlords and the institutional mortgagees which finance them.

1. LANDLORD’S LIENS AND THE REMEDY OF DISTRESS

The common law of England provided the landlord with one of the most potent of all remedies, that of distress. Under this remedy, when rent was in arrears the landlord could enter the demised premises without process of law, seize—with very few exceptions—whatever he could find, and hold it as security until the delinquent rent was paid. Even a third party’s goods found on the premises were subject to distrain. Despite the obvious injustice to the stranger, Blackstone vigorously defended this right of the landlord. A Canadian court held that the landlord who seized both the chattels of his tenant and those of a stranger were not required to sell the tenant’s goods before the stranger’s.

As part of their inherited common law, nearly all American states adopted the English law of distress as it existed when the original thirteen colonies gained their independence. An early South Carolina court, considering an attempt to distrain goods of a stranger, expressed the view that:

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3. Generally speaking, whatever goods and chattels the Landlord finds upon the premises, whether they in fact belong to the tenant or a stranger, are distrainable by him for rent; for otherwise a door would be open for infinite frauds upon the landlord; and the stranger has his remedy over by action on the case against the tenant. . . .
5. Pegg v. Starr, 23 Ont. 83 (1892).
his whole system of distress for rent was inapplicable to the circumstances originally of the British colonies, where the ancient feudal system was utterly unknown, and nothing but colonial dependence could ever have permitted it to gain a footing in America in subservience to British policy.

In a later case,\(^6\) however, the South Carolina court recognized the common law right of distress and permitted the landlord to exercise it against the property of a stranger which had been seized on the demised premises. The view proclaimed in the earlier South Carolina decision has occasionally been followed elsewhere, and a few states have held that common law distress, even when restricted to the tenant's own goods and chattels, is foreign to their law.\(^7\) In most jurisdictions, the common law remedy of distress has been modified by statute.\(^8\)

In Florida, common law distress, if it existed at all, has long since been superseded by a statute\(^9\) which limits the landlord's remedy in several particulars while expanding it in others. The landlord may no longer exercise self-help; instead he must file an affidavit "in the court in the county where the land lies, having jurisdiction of the amount claimed." The court then issues a writ to its executive officer commanding him to levy "on the property liable to be distrained for rent" and collect the amount claimed in the affidavit. The officer must summon the defendant if he can be found, to appear in court. Before the writ (or warrant as it is also called) can issue, the plaintiff must post a surety bond for at least double the amount claimed. The defendant may replevy the property if he so elects. Third parties claiming distrained property may intervene, and the property may not be sold until after a trial and judgment for the plaintiff.\(^10\) This procedure has been held to be "a statutory summary proceeding in rem" requiring no personal service upon the defendant.\(^11\)

Distress is still one of the most powerful weapons in the landlord's arsenal and one with which attorneys are too frequently unfamiliar. In Florida, the property of the tenant may be seized regardless of whether it has ever been on the leased premises. It is not necessary to provide for distress in the lease, since the remedy is one afforded the landlord by law.\(^12\) It has been held, however, that an assignee of the rent who does

\(^{6}\) Simpson v. McDonald, 79 S.C. 277, 60 S.E. 674 (1908), wherein the goods seized were leased to the tenant under an unrecorded lease of which the landlord had no notice. The case appears to have turned on this point.

\(^{7}\) Jones v. Ford, 254 F. 645 (8th Cir. 1918) (held that common law distress has never been countenanced in Missouri); Deaver v. Rice, 20 N.C. 567 (4 Dev. & Bl. 431) (1839).

\(^{8}\) "It [the remedy of distress] appears to have been abolished in a few of the states, and in most of them its exercise has been regulated by statute." In re West Side Paper Co., 162 F. 110, 111 (3d Cir. 1908).


\(^{10}\) Fla. Stat. § 83.15 and § 83.19 (1969).

\(^{11}\) Over 30 Ass'n, Inc. v. Blatt, 118 So.2d 71 (Fla. 3d Dist. 1960).

\(^{12}\) Blanchard & Burrus v. Raines' Executrix, 20 Fla. 467 (1884).
not own the reversion has no right of distress.\textsuperscript{13} It follows, therefore, that a mortgagee who takes an assignment of rents cannot distrain prior to foreclosure.

The only true landlord's lien is a creature of statute; the term "common law lien" is a misnomer. What the common law gave the landlord was only a remedy, a right to seize goods found on the leased premises. Only when he reduced these goods to physical possession did the landlord acquire any interest in them. Thus, in \textit{Morgan v. Campbell},\textsuperscript{14} a controversy between a landlord and the tenant's assignee in bankruptcy, the United States Supreme Court acknowledged that an Illinois statute, which provided that "every landlord shall have a lien upon the crops— for rent which shall accrue for such year," gave the landlord a lien which took precedence over a subsequent assignment in bankruptcy. However, at the same time, the Court held that another section of the statute, which gave the landlord the right to distrain on the tenant's property found on the leased premises, created no lien, so that a seizure of chattels other than crops occurring after the filing of the bankruptcy petition was not effective against the assignee in bankruptcy. The Court, in speaking of the right to distrain, said:

\begin{quote}
It is difficult to see why the tenant, subject to this dormant right of the landlord, is not as much the owner of his effects as any other person would be who owned property and owed debts.\textsuperscript{15}
\end{quote}

Most agricultural states, including Florida, have enacted statutes similar to the Illinois statute, giving the landlord a lien on the agricultural produce of the leased farm for the current year's rent.\textsuperscript{16} Some states, especially in the South where share-cropping is prevalent, have extended the lien to include, in addition to rent, advances to the tenant both for the preparation of the crop and the support of the tenant and his family.\textsuperscript{17}

The Florida landlord lien statute\textsuperscript{18} is an interesting one because it purports to create three different classes of lien. The statute provides:

\begin{quote}
\textit{Landlord's lien for rent.}—Every person to whom rent may be due, his heirs, executors, administrators or assigns, shall have a lien for such rent upon the property found upon or off the premises leased or rented, and in the possession of any person, as follows:

(1) Upon agricultural products raised on the land leased or rented for the current year. This lien shall be superior to all other liens, though of older date.
\end{quote}

\textsuperscript{13} Hutsell v. Deposit Bank, 102 Ky. 410, 43 S.W. 469 (1897).
\textsuperscript{14} 89 U.S. (22 Wall) 381 (1874).
\textsuperscript{15} Id. at 391.
\textsuperscript{16} Fl. Stat. § 83.08(1) (1969).
\textsuperscript{17} Fl. Stat. § 83.10 (1969).
\textsuperscript{18} Fl. Stat. § 83.08 (1969).
(2) Upon all other property of the lessee or his sub-lessee or assigns, usually kept on the premises. This lien shall be superior to any liens acquired subsequent to the bringing of such property on the premises leased.

(3) Upon all other property of the defendant. This lien shall date from the levy of the distress warrant hereinafter provided.

The above quoted Florida Statute leaves many questions unanswered. The question of whether a landlord's lien takes precedence over a federal income tax lien is a matter of federal law. Thus, even though the above quoted statute provides that the lien created by the second paragraph is superior to all the liens acquired subsequent to the date the property is brought onto the leased premises, a Florida court was constrained to give priority to federal tax liens neither assessed nor recorded prior to that date, but recorded prior to the first default in payment of rent. 19

However, if the lease had contained a contractual lien and had been recorded, the landlord would appear to have fallen within the exceptions contained in the federal statute, which give priority to recorded mortgages and pledges prior in time to the perfection of the federal tax lien. The Supreme Court of Florida has ruled that such contractual liens, if the lease is recorded, have the effect of recorded chattel mortgages. 20

Similarly, the Bankruptcy Act drastically affects the landlord's rights. 21 While a statutory lien will be recognized for delinquent rents, the Bankruptcy Act limits the lien to three months' rent. 22 Perhaps here too, a recorded lease with a contractual lien would be beneficial to the landlord. 23

The Florida landlord lien statute also leaves unanswered the question of what the lien on "agricultural products raised on the land" includes. Does it include animals? If so, what of animals purchased when young and kept on the land, and what of seedlings and small plants brought to a nursery where they are permitted to grow? Would the landlord have a lien on these, superior to that of a conditional vendor? Do

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20. Weed v. Standley, 12 Fla. 166 (1868); Richardson v. Myers, 106 Fla. 136, 143 So. 157 (1932). These cases were decided before the enactment in Florida of the Uniform Commercial Code. However, Fla. Stat. § 679.104 (2) (1969) excludes landlord's liens from the operation of the Code and hence it is not necessary to file a financing statement with the Secretary of State to give constructive notice of their existence. The writer believes the exclusion in Fla. Stat. § 679.104 (2) (1969) is broad enough to cover contractual as well as statutory landlord's liens. Therefore, recording the lease or a memorandum thereof containing the lien with the Clerk of the Circuit Court is sufficient to have it operate as a recorded chattel mortgage. However, any doubt would be removed if a financing statement accompanied by the lease or a memorandum containing the lien were filed with the Secretary of State.
21. For a discussion see Friedman, Secured Creditors In Bankruptcy Under Florida Law, 10 U. Fla. L. Rev. 473, 475 (1957).
23. In some situations even a recorded chattel mortgage would be subject to cost of administration in the Bankruptcy Court. In re Quaker City Uniform Co., 238 F.2d 155 (3d Cir. 1956), cert. denied, 352 U.S. 1030 (1957).
milk and wool qualify as agricultural products? The landlord’s lien for advances, which is restricted to “crops grown on rented land” is seemingly not as broad and would probably not apply to these last two items despite the tendency to speak of “wool crops” and “milk crops.”

Further, does the statutory language “all other property of the lessee or his sublessee, or assigns, usually kept on the premises” have any exceptions? What of motor vehicles? Would a mortgagee or bona fide purchaser for value who relies on a motor vehicle certificate of title prevail over the landlord where the vehicle is usually garaged on the leased premises? What of the cash surrender value of a life insurance policy usually kept on the premises?

Florida Statute section 83.09 defines “all other property of the defendant,” as used in the third paragraph of section 83.08, as everything but “beds, bed-clothes and wearing apparel.” However, what of homestead, which Florida Statute section 222.02 exempts from levy; what of the cash surrender value of life insurance policies, which is exempted by section 222.14; and what of wages, which are exempted from “garnishment or attachment” by section 222.11? The answers to these questions are beyond the scope of this article.

In City Building Corp. v. Farish, it was stated that Florida Statute section 83.08 must be construed in conjunction with the statutes providing for distress warrants. And, in In re J.E. De Belle Co., it was held that a distress warrant cannot issue for unaccrued rent. Therefore, the landlord’s lien, efficacious as it may be in collecting delinquent rent, affords no security for future rents. Two means of improving the landlord’s position are immediately apparent. One method is to provide in the lease that, in the event of a failure to pay the rent within a limited period of time after it falls due, or where the tenant threatens to or does vacate the premises, the rent for the balance of the term will be accelerated. Such a clause would be unlikely to meet with much resistance from the tenant, since, when he enters into the lease, he expects that he will be able to meet his obligations. The acceleration clause is offered as a possible means of circumventing the rule that a distress warrant will not issue for rent not yet due. The second method is to insert in the lease a contractual lien on all the goods kept on the premises—or at least on trade fixtures and equipment and machinery where there is a commercial lease. If the lease, or a short form reciting this, is recorded, it will have the effect, under state law, of a recorded chattel mortgage. This will permit the landlord to distrain for delinquent rent or go into equity and foreclose his contractual lien. Whether it will enable him to sustain his priority for more than three months’ delinquent rent, if the tenant becomes bankrupt, is another question.

24. 292 F.2d 620 (5th Cir. 1961).
25. 286 F. 699 (S.D. Fla. 1923).
26. See note 20 supra and accompanying text.
If the lawyer who prepared the lease for the landlord has had the foresight to obtain a thorough credit report and a list of the tenant's assets, and has kept it in his file, he will find himself in an advantageous position if the tenant is later in arrears and the landlord wishes to invoke the remedy of distress.

2. PREPAID RENT AND SECURITY DEPOSITS

Except where the tenant's financial standing is such that the landlord is willing to rely on his unsecured promise to pay rent, some security, usually in the form of prepaid rent or a security deposit, is normally required. Occasionally, in short-term leases, the tenant may prepay his rent in full, as where he rents a summer cottage for two or three months. The more usual practice, however, especially in apartment and residential leases, is to prepay the first and last months' rent and to provide in the lease that the balance of the rent is payable monthly in advance. The difficulty with this practice is that if the tenant damages the property, or fails to return all the items of personal property where the demised premises are furnished, there is no security deposit for the landlord to retain upon the expiration of the lease. The end of the lease is usually the time when the landlord first learns of the missing or damaged furnishings. He may not distraint the tenant's property since his claim is not for rent but for damages. This leaves him completely unsecured, with only a personal action against the erstwhile tenant.

Furthermore, the practice of collecting prepaid rent, if the amount is substantial, as is frequently the case with commercial leases, may have unfortunate income tax consequences for the landlord who reports his income on a cash basis, since the prepaid rent has to be reported as income during the year received.27

Prepayment of rent has its disadvantages from the tenant's viewpoint as well. If the tenant prepays the rent, it is possible that he may lose his money and be evicted as well. For example, if a senior lien-holder, such as a mortgagee, forecloses on the landlord's property, the tenant who has prepaid his rent may be evicted by the purchaser at the foreclosure sale. Also, if the lease contains a subordination clause and a subsequent mortgage is foreclosed, the tenant's prepaid rent is subordinated. The principal advantage of prepaid rent to the landlord is that it may be kept in the event of default.29 This is not true of security deposits unless they comply with strict legal requirements.

The security deposit is usually more desirable to the landlord than prepaid rent. It is not income to the landlord until such time as it is forfeited or applied to delinquent rent or other breaches of covenant.28

27. Renwick v. United States, 87 F.2d 123 (7th Cir. 1936).
29. Warren Serv. Corp. v. Comm'r of Internal Revenue, 110 F.2d 723 (2d Cir. 1940); Wagner v. Rice, 97 So.2d 267 (Fla. 1957).
If the lease is properly drawn, the tenant has no right to demand that the security deposit be applied toward the rent, and the landlord does not have to return it until the demised premises and chattels are surrendered in the condition prescribed by the lease. If the deposit is in the amount of the last month's rent but is given to secure both rent and other lease covenants, as the landlord shall elect, and if the tenant fails to pay the last month's rent and leaves the premises damaged, the landlord can apply the deposit to the damages and distrain for the delinquent rent.

If the lease simply requires the landlord to repay the deposit provided the tenant has performed his agreement, it is not a covenant running with the land nor does it give the tenant a lien on the property. It is only a personal covenant of the landlord not binding on subsequent purchasers. Even where it is drawn so as to bind the landlord's successors in title and is a covenant running with the land which creates a lien, the lease will not protect the tenant if a prior lien is foreclosed. A covenant running with the land resulting in a lien on the premises will cause the landlord to encounter difficulties in refinancing, since most institutional mortgagees are required to obtain a first lien on the premises as a prerequisite to lending money on real estate.

None but the most naive of tenants will deposit a meaningful sum with the landlord unless he has substantial assurance that it will be repaid. Thus, in most cases the landlord will have to consent to escrow the deposit. Frequently, the landlord insists that he should have the personal use of the security deposit until such time as it has to be returned to the tenant. If the tenant objects to depositing the funds unless they are kept in trust, the landlord's counsel should point out to his client the reasonableness of the tenant's position. With the security deposit held in a proper trust or escrow account, both parties are afforded a reasonable measure of protection.

Security deposits are of three types: those indemnifying the landlord against losses; those providing for liquidated damages; and hybrid deposits which for certain breaches are indemnity funds and for others provide liquidated damages.

Landlords usually find indemnification agreements unsatisfactory because such agreements leave them with the burden of proving their losses. While proof may be simple to provide in the case of some breaches, such as an undertaking to repair damages to a building, it is extremely difficult to assess the landlord's loss when a solvent tenant prematurely quits the premises. The courts, however, appear to favor the indemnity agreement since liquidated damage covenants may inflict unwarranted

30. To be a covenant running with the land in Florida, the word "assignee" or some similar expression must be used. Armstrong v. Seaboard Air Line R. Co., 85 Fla. 126, 95 So. 506 (1923); Burdine v. Sewell, 92 Fla. 375, 109 So. 648 (1926).

31. Fla. Stat. § 83.39, enacted by the 1969 Legislature, imposes upon the landlord, who rents more than five individual housing units, the duty of holding security deposits of $100 or more in an escrow account or of posting a bond to secure the deposit. This requirement may not be waived, but, unfortunately, the statute contains no penalty for failure to comply. See also N. Y. Gen. Obligation Law § 7-103 (McKinney 1964).
penalties, although at least one Florida case professes just the opposite. Therefore, the landlord's attorney must be thoroughly familiar with decisions of his own jurisdiction which involve liquidated damage agreements. The Florida attorney is fortunate because precise rules have been enunciated by the Florida Supreme Court for determining whether an attempted liquidated damage covenant will receive judicial sanction.

In Stenor, Inc. v. Lester, the lease gave the landlord the option of treating the deposit money as liquidated damages or of crediting it toward the landlord's loss. The court refused to enforce the agreement as a liquidated damage contract and required the landlord to prove his actual damages. The court said that in determining whether an agreement would be enforced as a liquidated damage contract or construed as a penalty agreement enforceable only to the extent that damages were proven, the following principles govern:

1. Whether there is a penalty or bona fide liquidated damages is a question of law.
2. The denomination of a sum as "liquidated damages" is inconclusive. It still may be a penalty.
3. When the damages are susceptible of determination by some known rule or pecuniary standard, the liquidated damages must not be disproportionate.
4. When the agreement is to pay the same sum for a partial breach as for a total breach, or is to secure the performance of covenants of widely varying importance in respect to any of which the sum would be excessive, it will be regarded as a penalty.
5. Giving the landlord the option of applying the deposit against the amount of actual damages or of treating it as liquidated damages shows a lack of mutuality that indicates a penal intention.

In Hyman v. Cohen, as in Stenor, Inc. v. Lester, the security deposit equalled a year's rent. The term of the lease was five years. There was a provision that the lease could be terminated for any of several breaches, some of a more serious nature than others. However, the deposit could be retained as liquidated damages only if the lease were actually terminated. The provision was found to be an enforceable liquidated damages covenant and not a penalty since the damages were for the loss sustained by premature termination, not for the particular default which occurred. The court considered the damages not susceptible of exact determination and found that the liquidated damages were not disproportionate to the possible losses incurred.

32. Stenor, Inc. v. Lester, 58 So.2d 673 (Fla. 1952); Glynn v. Roberson, 58 So.2d 676 (Fla. 1952).
33. Stuco Corp. v. Gates, 145 So.2d 527 (Fla. 2d Dist. 1962).
34. 58 So.2d 673 (Fla. 1952).
35. 73 So.2d 393 (Fla. 1954).
The following guidelines should serve to assist the lease draftsman in preparing a security deposit clause which will withstand the scrutiny of the Florida courts:

1. Where the term of the lease is for five or more years, a deposit equal to one year's rent is not excessive in case of the premature termination of the lease. Where the term is shorter, the draftsman would be wise to fix liquidated damages at not more than twenty percent of the total rent or one month's rent, whichever is greater.  

2. The landlord should not attempt to have the deposit treated as liquidated damages where the breach does not result in lease termination but rather should specifically provide that for such breaches the deposit is to be treated as an indemnity fund. While *Stenor, Inc. v. Lester* will not sanction a security deposit agreement which permits the landlord to elect to treat the deposit as either liquidated damages or an indemnity, it does not indicate judicial disapproval of an agreement providing that the deposit is to be treated as one type of agreement for certain breaches and as another type of agreement for other breaches.

3. **TENANT'S IMPROVEMENTS AS SECURITY**

Ground leases frequently require the tenant to provide a security deposit which is to be returned when he completes improvements of a specified nature or value. Thereafter, the improvements themselves serve as the landlord's security.

Frequently, tenants of improved property are also required to add improvements or to make extensive repairs. Shopping center developers have favored the so-called "shell lease" where they erect the foundations, floors, walls and roof but require the tenant to complete the building in accordance with agreed-upon plans or established minimum standards. In office and apartment leases it is not unusual for the lease to place on the tenant the burden and expense of partitioning and decorating his office or apartment. This can easily run into thousands of dollars. If the tenant is later evicted, the landlord inherits these improvements.

In agricultural leases, tenants generally are required to cultivate the land, plant crops, construct or repair fences and farm buildings, and fertilize the soil. These improvements, if made, will revert to the landlord in the event the lease is prematurely terminated.

In Florida, if a lease requires or even "contemplates" that the tenant is to make improvements, the landlord's interest may be subject to the liens of materialmen, architects, contractors, sub-contractors, mechanics and laborers who furnish the tenant with materials or services for the im-

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36. In Hyman v. Cohen, note 35 *supra*, the court enforced liquidated damages of one year's rent where the term was five years; hence, it is concluded that twenty percent of the rent on a short term lease is acceptable. The practice of requiring a deposit equal to one month's rent is so widespread in short term leases that it is not believed that a court would upset it.
Improvement of the demised property. Formerly, the landlord could not avoid this liability by simply inserting a lease provision stating that he would not be responsible for improvement costs. However, in 1963 the Florida Legislature enacted a new mechanic's lien statute which changed this, and now the lessor's attorney is remiss in his duties if he fails to insert such an exculpatory clause and record the lease. However, the question remains as to whether a recorded memorandum of a lease or a short-form lease including this provision would be effective to insulate against a mechanic's lien. In states other than Florida, the draftsman of the lease should examine the local statutes and decisions relating to priority of claims on leased property.

At one time it was held that the value of improvements made by the tenant was income to the landlord in the year the lease terminated, but this holding has been superseded by section 109 of the Internal Revenue Code, which expressly excludes such improvements from taxation. One of the inconsistencies of income tax law is that the landlord who accepts a cash security deposit must pay income tax on it if the lease is forfeited, whereas he may receive, in a like manner, valuable improvements, on a tax-free basis. However, the landlord should be warned that if the term of the lease is clearly less than the reasonable useful life of the improvements, so that the courts can find that the improvements were intended as a substitute, or partial substitute, for rent, he may find the section 109 exclusion to be illusory. Similarly, where the lease is terminable at the landlord's will, the exclusion may not apply.

If a landlord permits a tenant to occupy a building in return for the tenant's promise to repair it, the value of the repairs is income to the landlord; but, because repairs can be deducted against income, such an arrangement is normally tax-free.

If the landlord's title is unencumbered, the tenant is safer in improving the property than in delivering a security deposit which is not properly escrowed. However, if a prior mortgage is foreclosed, the tenant stands to lose his lease and forfeit the improvements. Bankruptcy or insolvency of the landlord will not affect the tenant's right to continued possession under the lease, but the instances are legion where insolvent landlords have failed to return security deposits entrusted to them.

4. GUARANTY AGREEMENTS

A vehicle frequently employed to secure the landlord's rent is the guaranty agreement. The student who seeks to lease an apartment may

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38. Fla. Stat. § 713.01 through § 713.36 (1969). Fla. Stat. § 713.10 (1969) provides: In the absence of fraud on the part of the lessor, the interest of the lessor shall not be subject to liens for improvements made by the lessee where the lease is recorded in the clerk's office and the terms of the lease expressly prohibit such liability.
find that the landlord insists that his parents guarantee payment of the rent; the small corporation which leases a place of business may find the landlord reluctant to sign without the guarantee of corporate stockholders, officers or directors.

Where buildings are to be erected, or extensively altered by the landlord, he is especially insistent that the parent corporation guarantees the leases of its subsidiaries. Mortgagees are willing to lend greater sums on property leased to national tenants with strong credit than to local tenants with lower credit standing. Lenders tend to treat a lease to a subsidiary, guaranteed by the parent corporation, as tantamount to a lease to the parent corporation, although, as will presently be pointed out, such treatment may not be warranted.

The individual who is *sui juris* may validly guarantee the debts of any tenant, be it an individual, a partnership, or a corporation. This is not necessarily true of the corporation, whose charter or by-laws, if not the laws of the state of its incorporation, may severely limit or even prohibit it from guaranteeing the debts of another corporation, especially the debts of a non-subsidiary.

Florida Statute section 608.13(9)(a) empowers a Florida corporation to guarantee the "evidences of indebtedness" of another corporation, whether or not organized under Florida law, "unless otherwise provided by its certificate of incorporation or by law." Thus, unless limited by its certificate of incorporation, the corporation has statutory authority to guarantee a mortgage note of another corporation. However, it is unlikely that a lease qualifies as an "evidence of indebtedness."\(^{41}\)

Florida Statute section 608.13(10) (Supp. 1970) authorizes a Florida corporation to:

> do all and everything necessary and proper for the accomplishment of the objects enumerated in its certificate of incorporation or necessary or incidental to the benefit and protection of the corporation, and to carry on any lawful business necessary or incidental to the attainment of the objects of the corporation....

While this provision permits a corporation to guarantee the lease of a subsidiary, it is doubtful that it authorizes the corporation to act as an accommodation guarantor for a stranger.

A situation which frequently arises involves the officers of one corporation offering to guarantee a lease of another corporation which they own, but which is not owned by the guarantor corporation. Minority stockholders of the guarantor corporation who have no interest in the lessee corporation have every right to complain, as do creditors or the trustee in bankruptcy of the guarantor corporation in case it later becomes insolvent. The Florida statute,\(^{42}\) denying a corporation the defense of *ultra*

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42. Fla. STAT. § 608.30 (1969).
vires, does not apply to stockholders, creditors, or the trustee in bankruptcy of the guarantor corporation.\textsuperscript{43}

Therefore, an accommodation guarantee by a corporation which does not occupy a parent-subsidiary relationship to the lessee may prove worthless. It is a good practice in such cases to require unanimous consent of the stockholders, thus eliminating any future objection.\textsuperscript{44} There is also a possibility that the guarantor may be a foreign corporation, not qualified to do business in Florida. In such a case, the corporation may not be amenable to suit in Florida.\textsuperscript{45} While the law of most states may not require that the tenant be sued first\textsuperscript{46} or that he be made a party to any suit against the guarantor, it is advisable to recite in the guaranty agreement that, in case of default, the obligee may proceed directly against the guarantor without either joining or first suing the tenant. Also, since a material modification of the lease not consented to by the guarantor will serve to release him,\textsuperscript{47} the guaranty agreement should contain a provision consenting in advance to lease amendments.

 Guarantees by executors or trustees will not bind the estate unless the will or trust instrument expressly confers such power.\textsuperscript{48} A will or trust indenture granting a power to guarantee debts would be highly unusual. It is difficult to imagine a set of facts which would warrant a probate court granting such a power to the guardian of a minor or incompetent.

 Most landlords probably believe that a guaranty of the lease, if properly authorized, will protect them against the insolvency or bankruptcy of the tenant and that with such a guaranty the only concern is that the guarantor remain solvent. This is not the case according to

\textsuperscript{43} Knowles v. Magic City Grocery, Inc., 197 So. 843 (Fla. 1940), holds that while ordinarily only the state may challenge the act of a corporation as \textit{ultra vires}, there is an exception in favor of a creditor where fraud is alleged. Apparently there is also an exception in favor of stockholders under like circumstances. Sommers v. Apalachicola Northern R. Co., 85 Fla. 9, 96 So. 151 (1923).

\textsuperscript{44} In Sommers v. Apalachicola Northern R. Co., note \textsuperscript{43} supra, the court said at page 155: "The rule generally is that stockholders who participate in and assent to acts of corporations will not afterwards be heard to complain, but will be held estopped to question the validity of the proceedings." \textit{See also} Perkins v. Trinity Realty Co., 69 N.J. Eq. 723, 61 A. 167 (1905); Santos v. National Bank of Glenn Falls, 130 Misc. 348, 223 N.Y. Supp. 817 (1927).

\textsuperscript{45} FLA. STAT. § 48.181 (1969), the so-called "long-arm" statute, will permit substituted service on the Secretary of State if the defendant conducted business or a "business venture" in the state. However, where an out-of-state corporation, not qualified to do business in Florida, executes a guaranty agreement outside of this state, this statute does not seem to apply. However, it would permit substituted service on an individual guarantor who was a resident at the time the guaranty was executed but who has subsequently moved to another jurisdiction.

\textsuperscript{46} If the guaranty is absolute and unconditional, the creditor may sue the guarantor directly in Florida without seeking a remedy against the debtor. Fegley v. Jennings, 44 Fla. 203, 32 So. 873 (1902).

\textsuperscript{47} Fridenberg v. Robinson, 14 Fla. 130 (1872); Kelsey Lumber Co. v. Rotsky, 178 S.W. 837 (Tex. Civ. App. 1915); Insley v. Webb, 122 Wash. 98, 209 P. 1093 (1922).

\textsuperscript{48} Shiff v. Shiff, 20 La. Ann. 269 (1868); Johnston v. Union Bank, 33 Miss. 526 (1859); International Store Co. v. Barnes, 3 S.W.2d 1039 (Mo. 1928).
two landmark decisions of the Court of Appeals for the Second Circuit. In *Hippodrome Building Co. v. Irving Trust Co.* and *In re Schulte Retail Stores, Corp.*, the first being an involuntary bankruptcy case and the second a Chapter X reorganization, a guarantor who was neither in bankruptcy nor in reorganization was relieved of liability for more than the three years' rent limitation imposed on the bankrupt.

Since the Florida court is unlikely to permit the forfeiture of a security deposit amounting to more than three years' rent, the *Hippodrome* and *Schulte* decisions do not render a guaranty agreement less valuable than a security deposit in Florida. However, the *Hippodrome* and *Schulte* cases do come as a shock to the landlord or his attorney who supposes that the function of the guaranty agreement is to have the guarantor underwrite the lease and assume it in the event of the tenant's insolvency or bankruptcy. Perhaps if the guaranty agreement states that the guarantor shall become the tenant under such circumstances, the effect of these decisions may be avoided.

**B. "Escape Hatches" and "Booby Traps"**

A tenant should be permitted to terminate his lease in the event of certain contingencies. For example, any lease will come to an end if the sovereign takes the demised premises under the power of eminent domain. The same holds true where a leased building is completely destroyed by fire, unless the parties agree that the lease is to resume should the landlord immediately rebuild the leased premises.

Other instances wherein the tenant should be able to terminate come readily to mind. The "military clause" in war-time leases, whereby tenants of residences and apartments may cancel if ordered away on military duty, is an example which finds its peace-time counterpart in many leases to employees of airlines and other national corporations which frequently transfer their personnel. A lawyer or doctor who practices alone

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49. 91 F.2d 753 (2d Cir.), cert. denied, 302 U.S. 748 (1937).
50. 105 F.2d 986 (2d Cir. 1939).
51. A somewhat similar suggestion was made by the Committee on Mortgage Law and Practice of the American Bar Association in a report entitled: "Effect of Operation of the Bankruptcy Act on Rights and Remedies of Mortgage Holders." The Committee has attached to its report a suggested form. A modified version, prepared by the author, appears in 1 *FLORIDA REAL PROPERTY PRACTICE* Sec. 16.76 (1965).
52. The draftsman should be warned that insertion of the innocent sounding statement that the lease shall terminate in the event of a total taking of the demised premises is highly explosive and will exclude the lessee from any part of the award unless it is qualified by a statement that he shall be entitled to share in it.
53. The lessee of premises destroyed by unavoidable casualty is not relieved from an express covenant to pay rent, unless he protects himself by a stipulation that rent shall cease in such event, or unless the destruction is of the entire subject matter of the lease, so that nothing remains capable of being held or enjoyed. Joiner v. Brightwell, 252 Ala. 112, 39 So.2d 414 (1949); Coy v. Downie, 14 Fla. 544 (1874); Nashville C. & St. L.R. Co. v. Heikens, 112 Tenn. 378, 79 S.W. 1038 (1903). And absent a covenant to repair, the landlord is under no duty to restore the premises. Fischer v. Collier, 143 So.2d 710 (Fla. 2d Dist. 1962); Roell v. Brooks, 205 Miss. 255, 38 So.2d 716 (1949).
may insist that his office lease terminate with his death. Also many leases provide that if the premises cannot be used for the purpose for which they were leased the tenant has the option to cancel. Such provisions are normally the subject of bargaining between the parties, and if the landlord is willing to lease on these conditions, his attorney ought not to interfere. Nevertheless, the attorney must avoid lease clauses which may give the tenant an excuse to break the lease under circumstances not contemplated by the landlord. While it is not possible to catalogue all such “escape hatches,” a discussion of a few of the more frequently encountered ones may serve to make the attorney not specializing in lease law more aware of the nature of the problem.

Many leases contain a long list of landlord's covenants, some of relative insignificance. Under such circumstances, a provision that the tenant may terminate upon the breach of any of landlord's covenants is unreasonable and should always be suspect.

Leases of gasoline service stations sometimes contain language to the effect that if access to the station is ever suspended, the tenant may cancel. Thus, if access is temporarily denied while a road is under repair, the tenant may break his lease. To avoid this possibility, the lease should provide for partial abatement of rent during the period of inaccessibility rather than total cancellation of the lease.

Fire and condemnation clauses frequently conceal “escape hatches.” Many leases provide that if the premises are damaged by fire, the tenant may cancel. The landlord should insist that the damage be such that it cannot be repaired within a specified time before the tenant can abandon the premises. Similarly, an option to cancel upon the occurrence of any taking can provide an excuse rather than a legitimate reason to terminate. Thus, in shopping centers where the buildings are set back from the streets, a fair provision would allow cancellation for a taking of any part of the building or more than 15% of the parking area. In other cases a generally acceptable limitation on cancellation is to restrict the right to takings which after restoration of the improvements would materially impair the tenant's use of the premises.

Particularly troublesome to mortgagees and, therefore, to landlords who hope to obtain mortgages, are covenants which allow the tenant to cancel for events which a mortgagee cannot control or cure. In this category are violations of a landlord's covenant not to lease to a competitor

54. When a lease limits the use of premises to a single purpose, as “for a saloon and no other purpose,” and a subsequent change of law prohibits its use for that purpose, the tenant may cancel. Halloran v. Jacob Schmidt Brewing Co., 137 Minn. 141, 162 N.W. 1082 (1917). Accord, Jones Shutter Products, Inc. v. Edmanuel, Inc., 168 So.2d 682 (Fla. 3d Dist. 1964).

55. The author has previously discussed escape hatches in somewhat greater detail in The Mortgagee Looks at the Commercial Lease, 10 U. FLA. L. REV. 484, 499 (1957).

56. The general rule is that the breach of a covenant by the lessee gives the lessor an action for damages rather than a right to terminate the lease, except where the lease expressly provides for termination. Salley v. Michael, 151 Ark. 172, 235 S.W. 785 (1921); Wilson v. Watt, 327 S.W.2d 841 (Mo. 1959).
within a certain radius of the leased premises. If the covenant is not to lease specific property, the tenant can be protected by a restriction on the specific property and he would not have to have the right to cancel. If, however, the covenant is a radius one, the landlord should restrict the tenant's remedy to an injunction or a suit for damages, and the tenant should not be given the option to cancel or the right to withhold rents. If he fails to so limit the tenant's rights, the landlord may encounter resistance from prospective mortgagees.57

"Booby traps," as the name indicates, are innocent in appearance but lethal in results. To detect them requires a careful study of the lease. Any provision allowing the tenant to withhold rents is always suspect. A provision in a service station lease to the effect that rent shall be abated for as long as any entrance to the station is blocked could enable a tenant to occupy the premises rent-free for months or years.

A provision for a division of the award in case of a taking, but imposing the entire burden of restoration on the landlord, works an injustice to the landlord.

A covenant providing that additions are to be erected in the future at the landlord's expense, when coupled with an agreement fixing rent at a definite dollar figure can be ruinous for the landlord if construction costs increase. To avoid this problem, the increase in rent should be a percentage of cost.

A major chain store offers a percentage lease which excludes from gross sales items sold in vending machines. This is meant to cover sales of stamps, soft drinks and the like. However, there is nothing to prevent the store from selling items in vending machines which are customarily sold over the counter. A solution to this problem might be to limit such exempted sales to a small percentage of gross sales.

The landlord should be very cautious about granting options since they are binding upon him, but are not binding upon the tenant. Options to extend the lease are often demanded by tenants. There is justification for this, in that tenants ordinarily do not wish to leave an established business locale. At the same time, they should be able to leave at the end of the agreed term if their venture proves unsuccessful. If rent is tied to a price index, or if the landlord receives additional percentage rent based on sales, the landlord is warranted in granting a renewal option. However, if rent is fixed and there is no provision protecting the landlord from tax and other cost increases, options to renew on the same terms can be disastrous to the landlord. If a renewal option is given, the landlord should require that it be exercised substantially before the end of the term so that he will have ample time to find a new tenant if the option is not exercised. It is wise to spell out in the lease the exact man-

57. In view of the rule discussed in the preceding note, violation of such a covenant would only give a right to damages in most jurisdictions, unless the lease provided for termination in event of its breach. Nevertheless, most mortgagees insist on an express waiver of the right to terminate or withhold rent.
ner in which the option must be exercised. Provision may be made so that
the lease will automatically renew itself on the option terms unless the
landlord receives notice by registered mail to the contrary by a date
well in advance of the end of the term.

Options to purchase are not beneficial to the landlord since they
bind only him. If the sale price is fixed, it may prove inadequate in the
future, and the tenant may exercise it at a time when, for tax reasons,
the landlord would find it undesirable to sell. For instance, if there is a
substantial gain and the owner is very old or seriously ill, he might sub-
stantially deplete his estate by selling and paying a capital gains tax
instead of holding it and letting his executor sell it. Furthermore, such
an option can prevent an advantageous sale to another buyer or impede,
if not prohibit, mortgaging the property. Even an option of first refusal
can cost the owner an advantageous sale since the prospective purchaser
may not be willing to hold his offer open while the tenant decides whether
to exercise the option.

In any lease, a landlord is wise to insist upon the right to enter the
premises during the last few months of the term in order to show it to
prospective tenants and, at any time, to show it to prospective purchasers
or mortgagees. If such rights are not expressly retained, a tenant with
whom the landlord has had a falling-out can refuse admission to the
premises.

C. Some Customary Lease Clauses

There are three types of leases of developed property or property
which the landlord agrees to develop: net leases\(^58\) in which the tenant
assumes all expenses, those in which certain expenses are borne by both
the landlord and tenant, and those in which the landlord assumes all ex-
penses. The latter type is most frequently encountered in short-term
leases.

Long-term leases which do not impose taxes, repairs, and mainte-
nance on the tenant, are usually accompanied by percentage rentals or
some other type of variable rent designed to protect the landlord from
rises in taxes and operating costs. Frequently, such leases specifically pro-
vide that the rent is to be increased by the amount of any tax in-
creases.\(^59\) Counsel for the landlord should be careful that the lease pro-

\(^58\) The term "net rental" when used with reference to real property, means a rental
over and above all expenses. Perkins v. Kirby, 39 R.I. 343, 97 A. 884 (1916). Hence, a net
lease is one providing a net rental.

\(^59\) Where the lease provides for additional rent in the form of a percentage of gross
sales above a certain base, it has been customary to increase the base if the tenant is required
to pay additional taxes. Thus, if tenant paid 5% of sales over $1,000,000 and he was there-
after called upon to pay an additional $1,000 in taxes, the base from which percentage rental
is calculated increased by $20,000. The author has been informed that several years ago the
larger landlords began to eliminate from their leases this right of the tenant to deduct in-
creases in taxes from percentage rent, and the practice has spread. This, of course, is a
negotiable item, and the landlord's attorney must not assume that the tenant is entitled to
have his base increased unless so instructed by his client.
vides that such increases will operate retroactively so as to cover the tax year for which the increase is payable, and not merely subsequent years. Where certain repairs are to be borne by each party to the lease, it is not sufficient, from the landlord's standpoint, merely to designate which are to be the responsibility of each. For example, if interior repairs and maintenance are the responsibility of the tenant, and the landlord wants assurance that they will be carried out, there should be an affirmative covenant binding the tenant to make the repairs and surrender the property in its original condition except for reasonable wear and tear. Those damages to the property which the tenant is not obligated to repair should also be specifically set out.

Which of the above three types of lease will be selected will depend not only on the length of the term but on the nature of the property and the bargaining position of the parties. In a net lease, the landlord should expect a smaller net return than in a gross lease, since the former frees him of the risk of increased operating costs whereas the latter does not. The assumption of risk invariably carries a premium in the market place.

Except in unsubordinated ground leases, it is customary to insert a clause permitting the landlord to terminate the lease in case of the tenant's bankruptcy.60 Usually there is no objection to this on the part of the tenant. Absent such a clause, the bankruptcy of the tenant can subject the landlord to interminable court hearings, delays in receipt of rent, and considerable legal expense.

Without a provision restricting or limiting the tenant’s right to sub-

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60. It has long been held that a clause providing for lease termination in the event the tenant becomes insolvent or bankrupt is ordinarily enforceable even though the courts view such clauses with disfavor and regard them as penalties. Model Dairy Co. v. Foltis-Fischer, 67 F.2d 704 (2d Cir. 1933). The cases so holding, however, appear to involve ordinary commercial leases, not unsubordinated ground leases where the tenant has erected improvements whose value equals or exceeds the value of the leased land. Cf. Finn v. Meighan, 325 U.S. 300 (1945).

The Bankruptcy Act, § 70(b), 11 U.S.C. § 107(c) (1964) which the Supreme Court in Finn v. Meighan, supra, said was merely declaratory of existing law, provides, inter alia:

A general covenant or condition in a lease that it shall not be assigned shall not be construed to prevent the trustee from assuming the same at his election and subsequently assigning the same; but an express covenant that an assignment by operation of law or the bankruptcy of a specified party thereto or of either party shall terminate the lease or give the other party an election to terminate the same shall be enforceable.

The United States Supreme Court in Smith v. Hoboken R.W. & S.S. Connecting Co., 328 U.S. 123 (1946), while indicating that the lease provision would ordinarily be enforceable because of this statute, refused to forfeit it until the Interstate Commerce Commission had determined whether the public interest required that the line be operated by the lessee rather than the lessor, a determination required by the Interstate Commerce Act.

It would appear that the above quoted statute would not apply to a lease forfeiture for bankruptcy if it were unenforceable under state law, and the author does not believe that such a clause has to be treated as inviolate if the equities in favor of the tenant are sufficiently strong. Cf. In re Larkey, 214 F. 867 (D.C. N. J. 1914). Nevertheless, until such time as the question is finally resolved, mortgagees cannot safely make leasehold loans where the ground lease contains an insolvency or bankruptcy clause, and therefore tenants of unsubordinated ground leases cannot tolerate such a clause.
lease or assign his lease, he is free to do so, although the original tenant remains liable to his landlord for observation of his covenants. There are many reasons why a landlord may wish to deny to his tenant the right to assign or sub-let. In the case of the lease of a private residence, the landlord may be unwilling to have the property occupied by someone he has not personally approved. Where he leases a part of a shopping center to an important tenant, such as a department store, the drawing power of the tenant may be such that its replacement by a less favorably regarded tenant could adversely affect the rents from other stores in the center. Leases to tenants of this character usually forbid sub-leasing or assignment except to subsidiary corporations or to corporations with which there has been a merger. Many commercial leases also contain an affirmative covenant requiring the operation of the store under the tenant’s trade name. Such clauses frequently specify the days and hours that the store must be kept open. This can be important to the landlord where there is percentage rent.

Several years ago the author negotiated a lease of a factory building for a tenant. The landlord failed to prohibit the tenant from sub-leasing or assigning. Later, the business outgrew the premises. In the meantime rents had risen substantially and the tenant was able to assign the lease at a considerable premium in which the landlord did not share. Had the landlord, in the lease agreement, denied the tenant the right to assign or sub-let he, rather than the tenant, would have reaped the benefit of the increase of rental value.

Depending on the nature of the demised premises, the landlord may find it advantageous or necessary to limit the purposes for which the premises may be used. Absent such a limitation, the tenant may use the premises for any lawful purpose. Such use restrictions are especially essential in shopping center leases where many tenants are given exclusive rights of one kind or another.

At common law, the remedy of forfeiture is available to the landlord for a disclaimer by the tenant of the landlord’s title, but not for failure to pay rent or breach of other vital covenants, except where the lease expressly grants such a remedy. There are statutes in Florida which permit forfeiture for breach of the rent covenant and where the tenant is

61. Frisell v. Nichols, 94 Fla. 403, 114 So. 431 (1927); Dolph v. Lennon, 109 Or. 336, 220 P. 161 (1923). But see Foreman Auto Co. v. Morris, 198 Ky. 1, 248 S.W. 486 (1922) and Shaughnessy v. Davis, 254 S.W. 713 (Mo. App. 1923), where statutes denied the right of assignment without the landlord’s consent or waiver.


66. Fla. STAT. § 83.05 (1969).
convicted of using the demised premises for purposes of prostitution or lewdness or as a house of ill-fame, but not for other causes.

Thus, it is important to the landlord that the lease contain a default clause which will permit him to terminate the lease by forfeiture for the tenant's breach of covenants which the landlord considers vital. However, this provision alone in the default clause is insufficient. Where the lease is forfeited, the tenant is not relieved from liabilities accrued at the time of forfeiture and, as has previously been pointed out, he also forfeits prepaid rent. However, unless the landlord expressly reserves the right in the lease, he cannot collect rent which is not due at the date of forfeiture nor can he collect damages for loss of future rent. Therefore, the lease should contain a default clause which not only permits forfeiture of the lease, but one which also gives the landlord the right to hold the tenant liable for accruing rents and for any deficiency in rents resulting from reletting. A well-drafted default clause will go one step further and give the landlord the option of renting in the tenant's behalf or in his own behalf. This frees the landlord from any possible obligation to pay to the evicted tenant rent collected in excess of the amount called for by the defaulted lease, while preserving the landlord's right to collect a deficiency from his original tenant.

It is also important in many leases to give the landlord a right to enter the demised premises to effect repairs either to the demised premises or to other property of the landlord. Without such a provision, an entry by the landlord into one apartment or office for the purpose of repairing a defective water pipe causing a leak in another might constitute a constructive eviction.

D. Hedging Against Inflation

Real estate, like common stocks, is a traditional shelter for those seeking to preserve their wealth from diminution by inflation. Today,

67. FLA. STAT. § 796.02 (1969).
68. Bohning v. Caldwell, 36 F.2d 222 (5th Cir. 1929); Casino Amusement Co. v. Ocean Beach Amusement Co., 101 Fla. 59, 133 So. 559 (1931).
69. See note 28 supra.
70. See Casino Amusement Co. v. Ocean Beach Amusement Co., note 68 supra.
71. This is the holding of the United States Supreme Court in Gardiner v. Butler & Co., Inc., 245 U.S. 603 (1918). However, the New York Court of Appeals, in Hermitage Co. v. Levine, 248 N.Y. 333, 162 N.E. 97 (1928), held that a right to damages survived where the lease provided that landlord might relet as the tenant's agent after eviction. In Liggett Co. v. Wilson, 224 Mass. 456, 113 N.E. 124 (1916), the Supreme Judicial Court of Massachusetts refused to permit any recovery for future rents or damages by the landlord where he reentered pursuant to a clause permitting reentry in case of an assignment for the benefit of creditors, even though the lease provided he could then rent as agent for the tenant. Such provisions have been upheld subject to landlord's duty to minimize damages. International Trust Co. v. Weeks, 203 U.S. 364 (1906).
72. See Harperley Hall Co. v. Joseph, 187 N.Y.S. 120 (Sup. Ct. 1921), where such a claim was made. The tenant's claim of constructive eviction was not sustained because he did not abandon the premises and because the lease gave the landlord the right to enter and make repairs. The court indicated that the acts of the landlord, were it not for these facts, constituted a partial eviction. For a definition of a constructive eviction, see Hankins v. Smith, 103 Fla. 892, 893, 138 So. 494, 495 (1931).
most landlords are reluctant to enter into anything but short-term leases unless some type of anti-inflation protection is built into the lease.

As already indicated, a landlord would be foolish to lease for a long term and agree to pay taxes, make repairs, and furnish services without protecting himself against the likelihood that these expenses will increase over the years. Most landlords consider themselves equally unwise if they agree to accept a fixed dollar income after expenses since they are convinced the dollar will continue to diminish in purchasing power as it has in the past. Hence, from the landlord's point of view, the ideal lease is a net one where the net rent will constantly increase as the dollar erodes. Tenants understandably resist such leases. In the traditional net lease of ten years ago, the tenant assumed all expenses while obligating himself to pay the landlord a fixed return on his investment. Only the purchasing power, not the dollar amount, of the landlord's net yield before income taxes could decrease. The tenant assumed the rising costs of operating the property but went no further. Today, some tenants will agree to tie the net rent to a price index or, as is frequently the case where retail stores occupy the demised premises, to pay a percentage of sales over a certain minimum. Percentage rents, however, are not readily adaptable to many types of property. In the case of leases of banking premises, tenants have been known to obligate themselves to pay, as additional rent, a small percentage of their deposits over a minimum amount. Tenants generally are less resistant to such increases than to those relating to cost indices because if their receipts increase they feel they can afford the greater rent, whereas an increase in the cost of living, while it will surely add to their expenses, may not enhance income. From the landlord's standpoint, increases based on sales volume or bank deposits will reflect the marketing or banking abilities of his tenant but not necessarily the erosive effects of money depreciation. Most leases in which percentage rentals are payable are not net ones. They are leases where the landlord assumes at least some of the expenses of maintenance.

Where an impasse is reached between a landlord who demands both a net lease and protection against inflation, and a tenant willing to enter a net lease but who refuses to guarantee the purchasing power of the rent, the landlord's attorney is afforded a real test of his ingenuity. Before turning away the prospective tenant, he should point out to his client other means of combatting inflation. For instance, the landlord may be able to obtain a mortgage at a fixed rate of interest, although such mortgages on commercial or business properties, as contrasted to single family homes, are admittedly difficult to find in today's money market. 74 If the

74. The investment of funds in fixed interest obligations has, of course, become increasingly unattractive with the accelerated inflation of the last decade and with limitations on permissible interest imposed by usury statutes. Numerous devices, including some flagrant gimmicky, have resulted from the endeavor to find more attractive investment yields. . . .

Quoted from Another Hat for the Insurance Companies—An Interim Look, a paper delivered by Albert E. Saunders, Jr., Associate Counsel, Phoenix Mutual Life Insurance Company,
purchasing power of the rent diminishes, so too will that of the dollars used to repay the mortgage. Money borrowed on the mortgage, if not used to improve the property, can be invested in common stocks or convertible debentures. If a satisfactory mortgage cannot be negotiated, an inflation-conscious landlord can be reminded of the value of having at least a part of his estate in fixed obligations, since he, in turn, will undoubtedly have obligations of a like nature. The attorney should also analyze any tax benefits which his client can derive from the lease. The tax benefits, if any, should be weighed against the disadvantage of a fixed dollar net income. If the landlord still insists on protection from inflation, a careful appraisal should be made to determine if the proposed lease will enable him to sell the property at a better price. If so, the landlord might accomplish his purpose by entering the lease, selling the property, and re-investing the proceeds.

The share-cropping lease and the farm lease calling for payment in agricultural produce, partially solve the inflation problem. In the cotton-producing states of the South, long-term farm leases frequently require payment in cotton rather than money. They do not, however, necessarily measure inflation with any degree of accuracy since cotton or other produce can diminish in price because of over-production, lack of demand and similar causes, while the cost of living rises. The landlord can ask for the option of demanding his rent in cash or produce, but most tenants will refuse unless the rent is sufficiently below the prevailing rates to warrant assuming the risk.

Many service station leases provide additional rent in the form of a payment of a cent or more per gallon of gasoline sold on the leased premises. A moment's reflection will show that such payments will in no way compensate for inflation. Increases in rental can come only through increases in the number of gallons of gasoline sold and will not accrue from increases in the price per gallon. The author has pleaded with oil companies for additional rent in the form of a percentage of receipts from gasoline sales rather than a flat gallonage rental, but so far to no avail.

E. Minimizing Income Taxes

The key to minimizing the landlord's income tax is to make maximum utilization of the accelerated depreciation provisions of the Internal Revenue Code and to convert ordinary income into long-term capital gains.

Land cannot be depreciated; improvements can be. In most in-
75. See Section E infra.
76. Where land and improvements are purchased for a lump sum the basis for deprec-
stances, it is the landlord who receives this depreciation. However, the tenant receives the depreciation where improvements are erected and paid for by him. Therefore, unless there are compelling reasons to the contrary, counsel for the landlord should be alert to preserve this right to depreciation for his client. Many professional real estate operators are not interested in holding property subject to long-term ground leases because the entire income is taxable to them. However, such operators may be willing to enter into such leases as landlords if leasing will increase the sale value of unimproved property and enable them to sell it at a substantial gain, or if they have surplus depreciation from other properties which they can use to offset their ground rents.\footnote{77}

The landlord, if properly advised, will stay away from a straight-line depreciation and, instead, will elect an accelerated method which will provide him with the greatest permissible depreciation during the first few years. Accelerated depreciation should exceed principal payments during the earlier years of a mortgage obtained to finance construction costs.\footnote{78} It frequently happens that all or nearly all of the rent received during the first few years of the lease can be offset by operating expenses, interest charges and depreciation. Sometimes the landlord, despite a cash flow which substantially exceeds out-of-pocket expense, can show, as a result of accelerated depreciation, a loss which may be offset against other income.

Later, after he has consumed most of his depreciation, and his mortgage payments are no longer largely applied to interest, the landlord may be able to sell the property at a price considerably in excess of its depreciated value for tax purposes. While he will pay a tax on this excess, if he complies with the requirement of the Internal Revenue Code, the major part of the gain will be characterized not as ordinary income, but as a long-term capital gain.\footnote{79} The new purchaser acquires the property at a new basis and his depreciation is computed on the price paid for the building, not on the depreciated basis of his seller.\footnote{80}

\footnote{77. In determining who is entitled to depreciation, the courts will look to substance and not to form. Thus, where the taxpayer erected a building, sold it, and leased it back, with an option to repurchase, the tenant taxpayer, not the landlord, was held entitled to the depreciation, because the court found the sale and leaseback was no more than a disguised mortgage. Helvering v. F & R Lazarus & Co., 308 U.S. 252 (1939).}

\footnote{78. On a 20-year, 8% amortizing mortgage, the monthly payment is $8.37 per $1,000. During the first year the principal is reduced $19.17. Thus, even straight-line depreciation will exceed loan amortization during the early years of most of today's mortgages. Figures taken from \textit{MONTHLY PAYMENT DIRECT REDUCTION LOAN AMORTIZATION SCHEDULES,} Ninth Edition, published by Financial Publishing Company.}

\footnote{79. \textit{INT. REV. CODE of 1954} § 1250. For an explanation, see \textit{Anderson, Tax Planning of Real Estate,} in \textit{J\textsc{o}INT COMMITTEE ON CONTINUING EDUCATION OF AMERICAN LAW INSTITUTE AND THE AMERICAN BAR ASSOCIATION,} 87 (6th Ed. 1970).}

\footnote{80. The cost basis is fixed by statute, Sec. 111(a) of the Revenue Acts of 1934 and 1936, 26 U.S.C.A. \textit{INT. REV. CODE,} Sec. 111(a), provides that the gain from the sale of property shall be the excess of the amount realized therefrom over the basis. This means cost to the petitioner, which may be entirely different from the "cost history of the property bought." (Emphasis added.) Reis v. Comm'r of Int. Rev., 142 F.2d 900, 903 (6th Cir. 1944). \textit{See also Civic Center Fin. Co.}}
Both the Internal Revenue Code and the regulations made pursuant to it are subject to frequent change and hence should be reviewed each time a lease requiring new construction is to be negotiated. For the purposes of this article, it is sufficient to state that preservation of the right to depreciation in the landlord will minimize his income taxes and his attorney should never surrender this right unless the landlord knowingly consents.

III. UNDEVELOPED PROPERTY WHICH THE LANDLORD IS NOT WILLING TO IMPROVE HIMSELF

Vacant and unimproved land is not necessarily unproductive of revenue. In the case of wild land, hunting rights and fishing rights may be valuable. In most instances, persons to whom these rights are granted are licensees rather than tenants, and the instruments conferring them are licenses, not leases. Grazing rights fall in the same category, although it is possible to lease land for any of these purposes.

The writer recently examined a lease in which the landlord demised raw land which the tenant agreed to convert into a golf course. This lease, however, is not a ground lease. A "ground lease" is a term of art applying to a special type of lease which gives the tenant an estate which he can convey freely and mortgage readily.

Frequently, the owner of vacant property is willing to lease it for a long term if the tenant will improve it. The reason for such a lease may be that the owner considers himself not qualified or too busy to undertake the work of construction; or, the owner may have doubts about the tenant's solvency.

Where the tenant is financially strong, such as a major oil company, it is sometimes possible to negotiate a net lease whereby the landlord causes the improvements to be erected at his own expense by a contractor recommended by the tenant. If the estimated price is exceeded, the tenant agrees to increase the net rent proportionately. Such a net lease may be more advantageous to both landlord and tenant than requiring the tenant to erect the improvements at its cost. If the landlord builds, he probably will have to mortgage the property for the cost of the improvements. In such a case, the landlord will be able to deduct both interest and depreciation. The net rent which the landlord would have received for the land alone will be increased by the mortgage amortization costs. The landlord can benefit from the tax shelter provided by depreciation. At the same time, the tenant can charge all the rent as an

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81. Tips v. United States, 70 F.2d 525 (5th Cir. 1934); Saxman v. Christman, 52 Ariz. 149, 79 P.2d 520 (1938); De Rinzo v. Cavalier, 165 Ohio St. 386, 135 N.E.2d 394 (1956); Strandholm v. Barbey, 145 Or. 427, 26 P.2d 46 (1933).

expense on its income tax and does not have to tie up its capital in the improvements. Therefore, counsel for the landowner should be prepared, under proper circumstances, to advise his client to build despite the client's preconceived prejudice against building. Before doing so, however, the credit of the tenant should be investigated and the lease should be carefully scrutinized for "escape hatches." As previously discussed, "escape hatches" are prevalent in most service station leases tendered by oil companies.

In many cases, however, the landowner's best opportunity for making his property productive will be to ground lease it. The unsubordinated ground lease is no newcomer to the common law, the subordinated ground lease, on the other hand, appears to have sprung up since World War II. The writer is under the impression, although he cannot verify it, that the first subordinated ground leases were written on Miami Beach properties. In any event, they have spread throughout the country and have become popular with developers of hotels, apartments, shopping centers, and other commercial properties who prefer acquiring property by subordinated ground leases to any other method. Therefore, the advantages and disadvantages to the landlord of both types of ground lease will be considered.

Fourteen years ago, the author examined the ground lease from the viewpoint of the leasehold mortgagee. At that time it was pointed out that its similarity to the ordinary commercial lease is only superficial. The commercial lease is, in most instances, issued to an occupancy tenant. The ground lease, on the other hand, is issued, more often than not, to a developer who proposes to mortgage his leasehold and erect improvements to be occupied by subtenants. It is essential to a ground lease that the tenant's estate be freely alienable, that it may be mortgaged apart from the fee, and that the liability of the tenant for future observation of his covenants terminates when he assigns his interest. In order to be mortgageable, the landlord must not reserve a right to terminate for breaches which the mortgagee cannot readily cure. The technical requirements of the unsubordinated ground lease have been too often discussed to merit further treatment here. Since the subordinated ground lease possesses characteristics quite different from true ground lease, it will be separately discussed after the unsubordinated ground lease.

84. In employing the term "subordinated ground lease" the author recognizes its legal inaccuracy but bows to convenience and universal usage. It is used to describe a ground lease in which the landlord covenants to join, without personal liability, in a leasehold mortgage for the purpose of also encumbering his own interest in the demised premises. It would also include a ground lease in which the landlord actually joins in such a mortgage, though the requirement is not imposed by the lease.
86. Id.; Hyde, Leasehold Mortgages, 12 ASS. OF LIFE INSURANCE COUNSEL PROCEEDINGS 659 (1955); Kelly, Some Aspects of Leasehold Financing, 33 NOTRE DAME LAWYER 34 (1957).
A. The Unsubordinated Ground Lease

It is the opinion of this writer that, in the vast majority of cases, an unsubordinated ground lease is more beneficial to most landowners than a cash sale, even though it may not prove to be as profitable as other leases. Generally, the rent will exceed the yield on high-grade bonds of a face amount equal to the value of the land, and the security is as great, if not greater. Also, the unsubordinated ground lease exempts the owner from the burden of developing the property himself.

Today, the threat of inflation is such that institutional lenders are reluctant to lend on long-term mortgages unless they are provided with some type of hedge against inflation. For this reason, the argument that the ground lessor is entitled only to a fixed rent based on land value at the time the lease is negotiated because his position is similar to that of the holder of a long-term first mortgage, while valid in the past, is no longer tenable today. Thus, the landlord can now usually demand and receive a rent escalation clause based on a cost-of-living index. The customary clause provides for adjustments from the base rent, but the rent may never be lower than the base. Since ground rent represents a far lesser expense than rent of a property with extensive improvements erected by the landlord, tenants of ground leases are less prone to refuse increases tied to a cost of living index than tenants of other leases.

If the tenant is astute, he will insist that increases in rental after an institutional first mortgage is negotiated shall be payable only out of income after fixed expenses, including real estate taxes, operating costs and the debt service on the first mortgage. The reason for this is that leasehold mortgagees look with greater favor on leasehold loans when they know the portion of the ground rent senior to these expenses will not increase during the term of the mortgage or after foreclosure.87


88. A lease which does not contain the suggested limitation will not necessarily preclude a leasehold loan, but it will affect the size of the loan. In a letter to the author dated November 24, 1970, Mr. Albert E. Saunders, Jr., Associate Counsel of Phoenix Mutual Life Insurance Company, in reply to an inquiry as to his company's position, stated:

The question is essentially one of appraisal and the impact of one or more variables upon valuation. . . . The problem you posit of a rent escalation provision tied to a cost of living index may be simpler than some of the escalation provisions that are written rather commonly. It may also pose its own peculiar problem because of question as to its validity; i.e., is the Consumer Price Index the appropriate measuring device for establishing changes in the rental value of a piece of real estate.

Be that as it may, from the point of view of valuing a leasehold such as you describe I am sure that we would penalize it by reason of the cost of living index adjustment. How much is a judgment factor taking into account the length of the term, the interval at which adjustments are required, and a judgment determination of whether or not the particular real estate should be expected to retain its present relative position in the economy. An agreement subordinating the escalation provision to the rights of the leasehold mortgagee and permitting the escalation provision to be cut off by foreclosure would of course permit a valuation which would disregard the escalation provision. In this sense it is somewhat comparable to the provision in some
erally, the landlord should accede to this partial subordination provided the base rent represents a fair return on the value of the land at the time the lease is executed, and operating expenses are adequately defined and, perhaps, also limited to a percentage of gross rent collected. It is in the landlord's interest, as well as his tenant's, that the land be improved; if valuable improvements are erected, the landlord can be assured that the mortgagee will see that the base rent is paid, and if the project is a success, he will receive the additional rent. Therefore, the landlord should not take a position which will place a roadblock in the path of the tenant seeking a leasehold loan without which he cannot erect the contemplated improvements. Perhaps the landlord's consent to subordinate the increases in the rent may justify some concession in return, such as more frequent adjustments.

When the original mortgage is satisfied, usually fifteen or more years after it is made, the cost-of-living index may well have increased to the point where the tenant is required to pay a rent substantially in excess of the base rent. In such event, if a new leasehold first mortgage is obtained, only rent in excess of the current rate at the date of the new mortgage application should be subordinated to taxes, operating expenses and the servicing costs of the new first mortgage.

Unsubordinated ground leases are sometimes encountered in which the tenant either additionally or alternately covenants to increase the rent based on periodic reappraisals of the land as if it were unimproved. Such leases are disfavored by tenants, since the rent increase is not only

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chain store leases designed to fix a minimum in lieu of percentage rent in the event of acquisition of the property by a mortgagee. Your suggestion that the increase be payable out of income remaining after payment of operating expenses and debt service accomplishes a somewhat similar result but requires a meticulous definition of operating expenses and also provision for a return to equity in lieu of debt service in the event of acquisition of the property by the mortgagee.

A result different in degree, and perhaps a result having greater validity, is produced if the escalation provision is tied to either periodic reappraisal and reestablishment of rental value or to a value produced by periodic capitalization of net income. An approach of that character should keep more closely in step with the actual value of the particular security without assuming any correlation between the property and the general purchasing power of the dollar. Presumably to be totally fair any evaluation should disregard existing financing and leases to operating tenants and should tie capitalization rates to some indicator expected to keep pace with the money market, as for example prime rate, discount rate, or a wholesale or consumer price index keyed to an agreed base year. This too holds the obvious administrative problem of establishing objectivity where there are so many unknowns and assumptions based on subjective judgment.

Another type of rent provision becoming common in the purchase-leaseback, leasehold financing situation is that containing the typical kicker expressed either as a percentage of gross revenue produced by the property or as a substantially larger percentage of net in excess of a defined operating cost including some pre-agreed allowance for debt service or return to equity in lieu of debt service. This last again raises the not inconsequential practical problem of arriving at a satisfactory definition of net or of operating cost. The question however has very practical application because many of the deals being negotiated today which involve a purchase and lease-back and leasehold financing do contemplate a lease with some sort of kicker arrangement and the insurance company more times than not finds itself interested in both sides of the deal.

Understandably you would prefer a rather more categorical answer but I don't know where to find it.
geared to inflation, but also to rises in land value attributable to other causes, such as increased population density. A ninety-nine year lease calling for such reappraisal after forty or fifty years may not be too difficult to obtain, since most tenants would settle for a term of such length in the first place. However, unsubordinated ground leases with reappraisals in the earlier years of the lease are usually resisted by knowledgable tenants. If the landlord is willing to provide that such increases are payable only out of income in excess of expenses and mortgage amortization, obtaining this type of increase may be less difficult.

The ground lease will prove especially attractive to the landowner whose cost basis is substantially below the present value of the land. Assume a value of $50,000 and a cost basis of only $10,000. In the event of sale, the federal capital gains tax would normally consume $10,000 of the purchase price, leaving the owner only $40,000 to reinvest. On the other hand, if he ground-leases, the landowner should get a return on the full value of $50,000. If the owner is a dealer for tax purposes and has to treat the gain as ordinary income, a ground lease may prove the only feasible method of doing business unless he wishes to develop the property himself.

The landlord of a true ground lease, as contrasted to a subordinated one, retains an asset on which he can readily borrow, at least after improvements are completed. He can obtain a first mortgage loan on the fee even though the tenant has mortgaged the leasehold. The partial subordination advocated above may limit the amount the landowner can borrow through a first mortgage on the fee, but it will not preclude him from obtaining such a loan. In the subordinated lease the landlord is required to join in the leasehold mortgage, thereby encumbering his estate as security, and thus cannot obtain a separate first mortgage on the fee.

Especially where interest rates decrease between the time the owner enters into the ground lease and the date he seeks a fee mortgage, it is conceivable that he may be able to borrow even more than he would have received, after taxes, from a sale and the rent may amortize the mortgage within a period of fifteen or twenty years. If he can obtain such a mortgage loan, the landlord can have his cake and eat it too.

Unsubordinated ground leases providing not only for rent increases tied to a cost-of-living index but also for participation in gross sales or net profits are relatively rare. They are probably the result of compromise whereby the landlord has sought, but not obtained, a higher base rent. If the rent represents the full fair return on the value of the land at the inception of the lease, and there are also provisions for increases tied to a cost-of-living index, it is difficult to justify additional increases in

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89. Situations where there are separate first mortgages on the estates of landlord and tenant in the same property are common. However, the first mortgage on the landlord's estate must be subject to the lease if the tenant is to obtain a mortgage on the leasehold. Under such circumstances, foreclosure of either mortgage will not impair the validity of the other.
rent since all of the risks are shouldered by the tenant and none by the landlord. The landlord retains his secured position and does not risk his land as does the landlord of the *subordinated* lease who joins in the leasehold mortgage.

Although the entrepreneur who proposes to acquire a leasehold estate would prefer a *subordinated* to an unsubordinated lease, the latter may prove more advantageous to him than a land purchase. This is true because as a tenant, he does not have to tie up large sums of capital to buy the land. It is true that a *subordinated* lease will enable him to obtain a larger mortgage, perhaps for the whole cost of the improvements. However, since the land costs him nothing but rent and taxes, the leasehold loan, in which the owner is not required to join, should still provide the tenant as much, or almost as much, cash for construction costs as would a fee loan where a part of the proceeds must be used to purchase the fee. Furthermore, the tenant can charge off the ground rent as an expense on his federal income tax return, whereas, if he purchased the land, he would have no such deduction nor could he depreciate the land. In both cases, the tenant can take a deduction for real estate taxes actually paid.

To summarize: The unsubordinated ground lease is highly advantageous to the landowner and, from his standpoint, frequently preferable to a sale. It provides him a maximum degree of security of investment, a yield somewhat higher than is offered by corporate bonds of good quality, and, in many instances, an inflation hedge of considerably greater efficacy than is afforded by convertible bonds or debentures. Additionally, the unsubordinated ground lease is not subject to capital gains taxation. At the same time, an unsubordinated ground lease has its advantages for the tenant which are not available should he purchase the land, although these benefits are far less than those inherent in a *subordinated* lease. Hence the landlord cannot expect the return on an unsubordinated ground lease which a *subordinated* one will yield him. One is a minimum risk investment, the other a speculation whose higher yield is compensation for the risks incurred.

The principal disadvantages of the unsubordinated ground lease to the fee owner are: first, the rent he receives is fully taxable; and, second, he does not receive the leverage available upon property which he develops himself with borrowed funds. Many landowners believe that the security of their investment and the exemption from the risk and responsibility of developing the property themselves offset these drawbacks.

**B. The Subordinated Ground Lease**

The landowner who enters into a *subordinated* ground lease not only surrenders control of the property to his tenant (except as the lease limits that control), but he also convenants to subject the property to a mortgage, the proceeds of which go to the tenant. The mortgage or mortgages
to which the landlord subordinates are fee mortgages, since they not only-encumber his interest in the land, but his tenant's as well. Therefore, such leases are not subject to the rigid limitations and restrictions imposed by leasehold mortgagees whose liens encumber only the interest of the tenant and will be extinguished if the lease is terminated. As long as there exists an enforceable agreement between the landlord and subtenants on whose subleases the mortgagee is relying, whereby these subleases may not be terminated in the event the ground lease is cut off, the terms, provisions or conditions of the subordinated ground lease are of no interest to the mortgagee. Thus, the parties are free to insert or omit from such a lease whatever they please. In effect, all of its terms are negotiable. Since a subordinated ground lease carries a risk to the landlord not found in the unsubordinated lease, he has every right to demand and expect a substantially greater return than where he ground leases without subjecting his interest to a mortgage given to finance improvements. If he is knowledgeable, the landlord will bargain, and bargain hard, for high rent, participation in profits or gross receipts, acceleration clauses, re-appraisals at frequent intervals, and any other means available to assure himself maximum participation in the income generated by the demised premises. The landlord should never forget that he has, in effect, entered into a limited partnership in which he is the limited partner supplying the money, i.e., the property. The tenant is the general partner who contributes his entrepreneurial skills but little, if any, hard cash; yet, he manages the business and takes the bulk of the profit. Therefore, the landlord must insist that the proceeds of the loan to which he subordinates be spent on improving the demised premises, rather than allowing the tenant to pocket the money or divert it to other uses. The lease must spell this out in detail.

Next to the rent clause, the lease provision subject to the severest bargaining is the subordination clause itself. In the ground leases along Collins Avenue in Miami Beach, which were negotiated in the twenty-year period following World War II, landlords customarily agreed to subordinate to only one construction mortgage and one so-called “permanent” mortgage which refinanced it. These “permanent” mortgages usually were required to amortize within 15 or 20 years. The leases limited the size of the mortgages in which the landlord covenanted to join and provided for a maximum interest rate and a minimum term for which they were required to run, so as to keep mortgage payments within bounds. Because of the high interest rates prevalent in recent months, tenants are resisting

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90. Without some such agreement the subtenant can abandon the premises upon termination of his landlord's lease. East Coast Stores, Inc. v. Cuthbert, 101 Fla. 25, 133 So. 863 (1931); Williams v. Michigan Central R.R., 133 Mich. 448, 95 N.W. 708 (1903); Leckie v. Dunbar, 177 Okla. 355, 59 P.2d 275 (1936). But see C.N.H.F., Inc. v. Eagle Crest Dev. Co., 99 Fla. 1238, 128 So. 844 (1930). Contra, McConnell v. East Coast Land Co., 100 Ga. 129, 28 S.E. 80 (1897), where it was held that a subtenant with knowledge of his landlord's tenancy becomes a subtenant of the owner, who, at his option, may proceed directly against the subtenant.
interest limitation provisions, their argument being that they can be expected to seek the lowest possible interest rate since lower rates are to their advantage. There is merit in this position. Landlords, however, insist that the tenant obtain its mortgage from institutional lenders rather than individuals. However, the definition of the term institutional lender has been expanded to include real estate mortgage trusts and other institutions besides the conventional sources of funds such as banks and life insurance companies.

Tenants are increasingly demanding the right to have the landlord join in mortgages refinancing the initial mortgage and even increasing it to cover future improvements or expansions. Such future subordinations prolong and perpetuate the dangers inherent in subordinated ground leases and should not be granted readily by landlords. However, it is beneficial for the landlord to agree that the lease be drafted so that once the original "permanent" mortgage is satisfied, the tenant will be able to obtain a leasehold mortgage. Many of the earlier subordinated leases were not so drafted and tenants have found themselves in a position where they cannot obtain leasehold financing without a lease amendment. Tenants who seek an amendment are at the mercy of the landlord who can, and usually does, demand a heavy price for even the slightest lease modification.

A bankruptcy clause has no place in an unsubordinated ground lease, but it does in a subordinated one, provided it ceases to be operative when all mortgages in which the landlord can be required to join are satisfied. If the tenant becomes insolvent, the only way the landlord can protect himself is to step in and make the mortgage payments himself or, if the mortgage is in default and cannot be reinstated, to refinance. To protect himself, the landlord should insist on the right to terminate the lease when the tenant defaults on the mortgage, becomes bankrupt, becomes insolvent, abandons the premises, or otherwise subjects the landlord to any unreasonable risk of losing his estate.

An unsubordinated ground lease must be freely alienable if it is to be

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91. The reason landlords refuse to subordinate to mortgages where the mortgagee is an individual is fear of a collusive foreclosure. Also, it is believed that institutional mortgagees are less prone to foreclose without giving the landlord every opportunity to cure a tenant's default.

92. Once all mortgages in which the landlord is required to join have been satisfied, the ground lease ceases to be a subordinated one. Since a fee subject to an unsubordinated ground lease is a far safer and more conservative investment than one subject, or potentially subject, to a mortgage, the landlord can sell it at a much higher price than he can where his interest is or can be mortgaged by the tenant.

93. It is the author's opinion that the landlord of an unsubordinated ground lease would not be allowed to terminate the estate of a tenant who has erected valuable improvements because his position is not threatened by the bankruptcy and to permit such a termination would result in an unconscionable forfeiture. See note 60 supra. However, where he has joined in the mortgage, his estate is threatened by insolvency or bankruptcy of the tenant and he is in substantially the same position as any other landlord with an insolvent or bankrupt tenant. For this reason, such a landlord ought to be able to terminate the lease if the lease so provides.
acceptable to mortgagees. The tenants of subordinated ground leases will also seek free alienability, but the landlord whose estate has been subjected to a heavy mortgage needs to be sure that the property does not fall into the hands of an incompetent or dishonest person who will mismanage it and perhaps permit a default under the mortgage. Therefore, the alienability clause is one to be negotiated. However, once the mortgage is satisfied and the landowner is no longer obligated to subordinate again, free alienability should be permitted so that the tenant may obtain a leasehold loan.94

The writer does not consider the subordinated lease a desirable vehicle for the unsophisticated landlord who is financially unable to protect his interests in the event of a default under the mortgage. Furthermore, if the landowner does not own his land free and clear, he cannot give the tenant an acceptable subordinated ground lease without first satisfying any existing mortgage since the landlord's mortgagee cannot be expected to subordinate to the fee mortgage with which the tenant will finance new construction. From the tenant's standpoint, subordinated ground leases are actually not as attractive as some tenants think. A recalcitrant or legally incompetent landlord, whose joinder in a future mortgage cannot be obtained promptly, can cause delay and expense out of all proportion to the advantages supposedly conferred by the subordinated ground lease. In this writer's opinion, landowners, in most cases, should sell the premises rather than enter a subordinated ground lease, and the developer should seek his financing from an institutional lender which will purchase the land, lease it back to the developer on a long-term lease, and simultaneously give him a leasehold loan.95

94. Free alienability of the leasehold estate is essential if the tenant is to obtain a leasehold loan. See articles cited in footnote 86 supra.

95. Of late, however, a new type [i.e., of sale-leaseback], which for convenience may be called a "mortgaged leaseback," has been developed as a vehicle for equity participation by life insurance companies and similar institutions for financing not the ultimate occupants of the project but rather the developer who builds, leases, and manages it. The transaction is in the nature of a joint venture in which the developer contributes his services and skill but little if any money, and the financial institution contributes all or almost all the money required to purchase the land and erect the improvements. In return for financing the venture, which may be an apartment house, shopping center, industrial park, or other commercial development, the financing institution requires not only that the developer contribute his expertise and services but that he occupy a position subordinate to the institution.

The mortgaged leaseback, which is only one of a number of methods employed for achieving this objective, works as follows: The developer either purchases or obtains an option on a parcel of land. He agrees to sell the fee to the institution, which, in turn, leases the land back to him for a term of thirty to forty years. The purchase price is the value of the land as determined by appraisers selected by the institution. In fixing the value of the land, they presumably do not take into account the effect of the leaseback on its value. The rent provided in the leaseback is partly fixed and partly a percentage of profits. The total yield is expected to exceed 15 percent per annum on the price paid by the institution for the land. The institution then makes the developer a leasehold mortgage loan amortizable over the maximum possible length of time permitted by the investment statute applicable to it. The interest rate may be fixed or tied to the prime rate but there is a proviso in the note that in no event shall it exceed 10 per cent or 15 percent per annum, depending on whether or not the leasehold borrower is a corporation. Any income after the pay-
IV. Conclusion

Landlords and tenants are no different from the rest of mankind. They may strive for "all this and heaven, too," but they are unlikely to obtain it. A lease is a bargain and, as such, it involves give and take. It is the role of counsel, whether representing the landlord or the tenant, to see that the bargain is properly reduced to writing and that his client understands it. In many instances, the attorney can be of assistance either in negotiating the terms or in advising his client where he can make concessions and where he cannot, what he can legitimately demand and where he should graciously give in.

Representing the landlord in a major lease requires more than mere access to a form book and a basic knowledge of the law of landlord and tenant. While the skills of the lawyer are essential, those of the real estate appraiser, mortgage banker, economist, accountant, architect and others may be just as vital. The attorney representing a client whose experience as a developer of real estate is limited, should not hesitate to call in experts from other fields. While the lawyer should be aware of his own limitations and should not usurp the functions of other specialists, he nonetheless, must be sufficiently familiar with the business problems presented to know when and from whom to seek help. The landowner who leases to department stores, chain stores, or professional developers of expensive projects such as regional shopping center is doing business with skilled and experienced professionals assisted by experts from many fields. To meet them on terms of equality, he needs advice and assistance that the lawyer alone cannot provide.

ment of taxes, operating expenses, including a management fee to the developer, and the principal and interest payments on the leasehold mortgage, is divided according to the agreement of the parties, with the institution's share constituting the contingent rent in the leaseback.

By the end of the term, if all goes according to plan, the leasehold mortgage has been repaid, the financial institution has received a high rent under the lease, and it then owns free and clear an obsolescent building on a piece of land which, because of inflation, will probably be worth more than the original price which the institution paid. The developer has pocketed the management fee and his share of the profits during the term of the lease, but upon its termination his interest in the venture ceases.

This is the basic plan of the mortgaged leaseback, but variations are possible. For instance, when the development is in the planning stage, the institution may issue its commitment but not advance any money until the improvements are completed, thereby necessitating construction financing by the developer prior to closing with the permanent investor.