A leasehold mortgage is an encumbrance or lien on a tenant’s interest in a lease conveyed to a lender as collateral for a loan to the tenant. Often a leasehold mortgage is used by a tenant under a long-term ground lease in order to secure financing for construction or major renovations to the leased premises. The most obvious benefit of a leasehold mortgage arrangement is that it allows a tenant to proceed to develop the leased premises without spending some or all of its on-hand assets. Once the improved leased premises begins generating income, the tenant may pay both the rent under the lease and the debt service on the loan secured by the leasehold mortgage.

The use of a leasehold mortgage for financing creates unique relationships among the tenant, the tenant’s lender or leasehold mortgagee, the landlord and the landlord’s lender or fee mortgagee. The obligations of the tenant to the leasehold mortgagee are governed by the leasehold mortgage and related loan documents, and, likewise, the obligations of the landlord to the fee mortgagee are governed by the fee mortgage and related loan documents. The relationships among all four parties, however, are controlled generally by the lease, which may have been negotiated and executed by the tenant and the landlord prior to

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obtaining the prior written consent of the landlord. This section of the lease will probably also state that any leasehold mortgage granted by a tenant is subject and subordinate to all rights and interests of the landlord, and the leasehold mortgage shall be an encumbrance or lien only on the tenant’s interest in the lease and leasehold estate and not on the landlord’s fee interest in the property. The landlord will want to be certain that the leasehold mortgage is subject to the terms of the lease and that the leasehold mortgagee does not acquire any rights greater than those of the tenant. Many commercial leases other than ground leases will specifically prohibit a tenant from entering into a leasehold mortgage, so if a tenant wants the option to do so, it should make this known early in the negotiating process (preferably when negotiating the term sheet or letter of intent).

The above-mentioned lease provisions permit a tenant to grant a leasehold mortgage so long as the landlord’s interest in the leased premises is not compromised. The financiability of a leasehold interest, which is the real issue for the tenant and the leasehold mortgagee, may depend on the provisions dealing with the tenant’s default and the landlord’s obligation to provide the leasehold mortgagee with notice of such default and adequate opportunities to cure. For example, if the landlord may immediately terminate the lease due to the tenant’s default, and in turn the tenant’s leasehold estate, and without notice to the leasehold mortgagee, the leasehold mortgage is rendered valueless. Instead, if the lease requires the landlord to provide the leasehold mortgagee with notice of the tenant’s default and an opportunity to cure the default on behalf of the tenant, the leasehold mortgagee’s interest in the leasehold may survive. Similarly, a leasehold mortgagee will want the lease to provide the tenant with the ability to assign its leasehold interest freely. That way, should the leasehold mortgagee take possession of the leased premises following foreclosure, it may market and sell the leasehold interest in order to recoup the unpaid amount of the underlying loan.

As mentioned above, if a leasehold mortgage is permitted under a lease, the lease will often require a separate written consent of the landlord prior to the tenant’s conveyance of a leasehold mortgage to its lender. The consent of the landlord will often include a subordination of the landlord’s rights to the tenant’s personal property kept on the leased premises such as equipment, machinery, tools and inventory. The underlying loan from the leasehold mortgagee to the tenant most likely names these items of personal property as collateral, with the security interest being perfected by the filing of a UCC-1 with the state in which the tenant entity was formed. Since many states provide a landlord with statutory remedies against a defaulting tenant that include the right to possess and sell the tenant’s personal property located at the leased premises (such as the rights of levy and distraint for rent), it is important to a leasehold mortgagee that the landlord’s statutory rights are subordinate to the leasehold mortgagee’s rights to the tenant’s personal property.

The relationship between the tenant, leasehold mortgagee and fee mortgagee is often controlled by a SNDA. The tenant must have a right to non-disturbance of the lease following foreclosure and sale of the fee interest by the fee mortgagee, which would be set forth in a SNDA. Without such a right, the value of the leasehold interest is greatly impaired because the fee mortgagee may be able to terminate the lease in the event of foreclosure after the landlord defaults on its obligations to the fee mortgagee. If the SNDA has been executed by the tenant, landlord and fee mortgagee prior to the grant of the leasehold mortgage, the leasehold mortgagee may wish to amend the SNDA to name the leasehold mortgagee as a party to the SNDA and provide for greater non-disturbance rights.

In sum, a leasehold mortgage is a very useful financing tool for a tenant. Nonetheless, due to the complicated relationships they create, care must be taken in the review of the lease and related documents to assure that the leasehold mortgage has value to secure a loan.

ENDNOTES

The Pennsylvania Superior Court recently created uncertainty for the burgeoning Marcellus Shale industry in Pennsylvania when it held that whether the Dunham Rule applies to Marcellus Shale gas is an open question. Pennsylvania has long followed a presumption, known as the Dunham Rule, that when a reservation or exception for “minerals” does not mention natural gas or oil, there is a rebuttable presumption that the word “minerals” does not include natural gas or oil.

**The Butler Case**

In *Butler v. Powers*, No. 1795 MDA 2010 (Pa. Super. Ct. Sept. 7, 2011), the trial court found that a reservation in a deed that reserved “one half the minerals and Petroleum Oils” did not include Marcellus Shale gas based on the application of the Dunham Rule. The Superior Court disagreed and held that it is not clear whether the Dunham Rule applies to Marcellus Shale gas. The Superior Court did not decide whether the Dunham Rule applies but instead remanded the case to the trial court for a determination of (1) whether Marcellus Shale constitutes a “mineral”; (2) whether Marcellus Shale gas constitutes the type of conventional natural gas contemplated by the Dunham Rule line of cases; and (3) whether Marcellus Shale is similar to coal as to which the Pennsylvania Supreme Court has determined that whoever owns the coal owns the coal bed methane gas contained therein, in which case it would logically follow that whoever owns the Marcellus Shale owns the shale gas.

**What Does This Mean?**

Depending on the ultimate outcome of *Butler*, which will go back to the trial court in Susquehanna County, and then potentially on appeal to the Pennsylvania Superior and Supreme Courts, landowners who did not believe that their “mineral” reservation included Marcellus Shale gas may find that they own more than they anticipated. Potentially more troubling is the fact that although the dispute between the parties in *Butler* does not directly involve a deed that explicitly conveys or reserves natural gas rights (since the deed in question used only the terms “minerals” and “petroleum oils,”), the outcome of the case could establish precedent regarding whether a conveyance or lease of oil and gas rights, reserving all other minerals, reserves the unconventional gas trapped in the Marcellus Shale to the mineral title holder.

We will continue to monitor this case and provide updates as it develops.
ENERGY STAR® Expands Its Reach

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Despite the economic slowdown, the U.S. Environmental Protection Agency (EPA) reports continued significant growth in the number of commercial buildings achieving ENERGY STAR status. In 2010, more than 6,200 commercial buildings earned ENERGY STAR status, which is 60 percent more ENERGY STAR awards than in 2009. The cities with the most ENERGY STAR buildings are located through the United States, and include Los Angeles, San Francisco, Chicago, Detroit, Houston, Dallas-Fort Worth, Atlanta, New York, and Washington, D.C. Commercial buildings that earn this distinction must achieve energy efficiency performance in the top 25 percent of buildings nationwide in their class, and are estimated by EPA to use 25 percent less energy than average buildings.

Buildings in a number of categories may achieve ENERGY STAR recognition including, among others, schools from kindergarten through 12th grade, retail stores, financial institutions, data centers, medical offices, houses of worship, low-rise units in low-rise multi-family buildings, and single-family homes. As of the end of August, EPA has expanded this list to include, for the first time, new and substantially rehabilitated multifamily high-rise residence buildings. To earn the ENERGY STAR, multifamily high-rises must have an independent engineer or architect conduct testing and inspection during construction and certify that the building meets energy-efficiency guidelines set by EPA, and is designed to exceed by at least 15 percent the energy-efficiency standards set by the American Society of Heating, Refrigerating and Air-Conditioning Engineers (ASHRAE).

Upcoming Events

REAL ESTATE SEMINAR ON TITLE DEFECTS
November 14, 2011 | Harrisburg, PA

David J. Tshudy will be a presenter at the National Business Institute seminar, “Top 10 Title Defects - Cured.” The course will cover the most common title defects that attorneys are encountering today and best practices for curing each one. David will discuss “Break in Chain of Title.” He will address missing documents, name variances of the grantor/grantee, and inclusion of all proper parties on documents. For more information, visit www.nbi-sems.com.

REAL ESTATE LEASING SYMPOSIUM: GETTING MORE VALUE FROM YOUR REAL ESTATE LEASES - LEASE PROVISIONS THAT AFFECT A BUSINESS’S OPERATIONS AND ITS BOTTOM LINE

November 17, 2011 | Pepper’s Harrisburg Office
11:30 a.m. | Registration and Lunch
Noon - 1:30 p.m. | Presentation
1.5 Substantive PA CLE Credits

In this time of recovery from an economic downturn, businesses continue to look for ways to save. The real estate that a company or organization owns or rents is often one of its biggest expenses and, in particular, there are ways to get more value from your leases. Join us for this informative seminar, designed for tenants, landlords, investors, brokers, agents, developers and property managers, as Pepper Hamilton LLP real estate practitioners discuss important lease provisions that impact your business and benefit your company’s bottom line.

Moderator
Brian P. Downey, Partner

Presenters
Matthew J. Swett, Partner
Hannah Dowd McPhelin, Associate


There is no fee to attend this event.
The ability of a homeowners association to impose a blanket prohibition preventing homeowners in the association from leasing their homes was recently upheld by the New Jersey Appellate Division in *Cape May Harbor Village and Yacht Club Association v. Sbraga.* Although this landmark decision sustains the authority of homeowners associations to materially restrain the alienability of homes within their communities, the court’s decision weighed heavily on the facts of the particular case, which should be taken into account prior to taking any action based on the decision.

Even more fundamental to association governance than the specific holding in the case, however, the Appellate Division also clarified factors that will determine when actions of homeowners associations will be subject to judicial scrutiny of the “reasonableness” of their actions, rather than the lower standard offered under the “business judgment rule.”

The plaintiff community involved in this case is a small, exclusive community, comprised of 24 houses and a marina with 42 boat slips. At the time of the defendant’s purchase of her property in 2000, the community’s developer had already recorded a Declaration of Covenants and Restrictions, which specifically contemplated the right of homeowners to lease their homes and boat slips. Following a divorce, and because of the depressed real estate market, the defendant sought to lease her home for summer vacation rentals and asked the association president if this was permitted. Upon realizing that the Declaration did permit leasing, the members of the association, by a vote of 20-3 (or 87 percent), adopted an amendment to the Declaration restricting the ability of homeowners to lease their homes.

In determining the legitimacy of the association’s action, the Appellate Division first addressed whether the association’s decision should be reviewed using a test of reasonableness or by the more lenient business judgment rule. The business judgment rule is a much lower standard of review than the reasonableness test. Overturning a decision under the business judgment rule requires “a showing … of fraud, self-dealing or unconscionable conduct.” The court did not make a blanket rule on which standard should be applied to all community association decisions, but following an earlier Appellate Division case, found that, given the facts of the case, the reasonableness standard was more appropriate “because the amendment was enacted after appellant’s acquisition of the property and because the amendment affect[ed] a fundamental property right.”

The Appellate Division then scrutinized the reasonableness of the association’s decision applying the following “positive” factors:

1. the one imposing the restraint has some interest in land which he is seeking to protect by the enforcement of the restraint
2. the restraint is limited in duration
3. the enforcement of the restraint accomplishes a worthwhile purpose
4. the type of conveyances prohibited are ones not likely to be employed to any substantial degree by the one restrained
5. the number of persons to whom alienation is prohibited is small
6. the one upon whom the restraint is imposed is a charity.

## The Application of the Reasonable Test

**Means That Boards and Associations Must Have a Rational Basis for Their Actions and Should Keep Good Records of Those Reasons.**
And the following negative factors:

1. the restraint is capricious
2. the restraint is imposed for spite or malice
3. the one imposing the restraint has no interest in land that is benefited by the enforcement of the restraint
4. the restraint is unlimited in duration
5. the number of persons to whom alienation is prohibited is large.

The court held that homeowners in the community clearly possess an interest in the land and stressed that the association’s action was directed at “preserving the stable residential character of the community.” The character of the neighborhood had never before been marked by weekly rentals to vacationers and the association had a rational basis for believing that the peace and tranquility of the community would be disrupted if rentals were permitted. The lack of previous leasing activity also evidenced that the restriction would not substantially affect the alienation of property, as leasing was not an anticipated use by the homeowners when purchasing their homes. The only factor the court found lacking, the element of limited duration, was given little weight due to the overwhelming majority of the members who favored the restraint and the fact that the amendment could be undone in the future by the association. Finally, because the amendment applied to all of the homeowners, there was no spite or malice shown to the defendant by the adoption of the amendment.

Although the court followed the reasonableness test used in Mulligan, the outcome in this case was specifically distinguished from the decision in that case. In Mulligan the homeowners association’s restriction on leasing was found to be unreasonable and the homeowner was granted some relief from the enforcement of the restrictions because the community was much larger and had a variety of housing styles and because the amendments were adopted by only a simple majority of the homeowners. Here, the size, homogeneity and support of the community all weighed in favor of upholding the restriction.

**Conclusion**

The Appellate Division decision in Cape May Harbor Village grants community associations broad power to sustain the character of their communities through amendments to their master declarations. However, the application of the reasonable test means that boards and associations must have a rational basis for their actions and should keep good records of those reasons. Community associations may be guided by this case to determine whether their decisions will be reviewed by the business judgment rule or scrutinized under the higher reasonableness standard and the factors that a court will employ to determine the extent to which the alienability of property may be constrained by an association.

**Endnotes**

4 *Cape May Harbor Village*, slip op. at page 15.
5 *Cape May Harbor Village*, slip op. at pages 18-19. These factors were taken by the court from the Restatement of Property § 406, comment i (1944) (citation omitted); accord Restatement (Third) of Property: Servitudes § 3.4, comment c (2000).
6 *Mulligan*, 337 N.J. Super. at 301.