The Condominium as a Mortgage Investment

Russell R. Pike
THE CONDOMINIUM AS A MORTGAGE INVESTMENT

By Russell R. Pike*

Lord Coke once said, "The earth hath in law a great extent upward, . . . of ayre and all other things even up to heaven, for cujus est solem usque ad coelum".1 While maxims are not the law, and this particular one has received some harsh treatment from writers,2 California builders are currently putting the maxim to work. Not only are they subdividing the airspace above land, they are currently asking California lenders to take mortgages on the resulting "lots" of California air.3

The object of this "air splitting" is the Condominium, a new type of community living currently being touted as the "New Frontier" in housing.4

Variously described as the individual ownership of a cubicle of air space,5 or of a single unit in a multiunit structure,6 the condominium is basically the ownership of part of a building.7 It is designed to combine the elements of apartment house living with the "pride of home ownership."8 One of the major advantages claimed for the condominium is that there will be a separate mortgage for each unit. In this vital area, financing, the individual will purportedly be free to act as any home owner is.

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1 Coke, Commentaries on Littleton, 4a (1670); "He who possesses land possesses also that which is above it," Broom, Legal Maxims, 4th ed. 382 (1864).
3 Panel Discussion: "How We Closed the Sale on Our First Condominium," Condominium Conference held at the Claremont Hotel, Berkeley, California on Nov. 28, 1961, sponsored by Associated Home Builders of the Greater East Bay [hereinafter cited as Condominium Conference].
5 Remarks of Earl M. Ripley, Condominium Conference.
6 Ibid.
7 As to the possibility of such partial ownership see Thompson v. McKay, 41 Cal. 221 (1871); Galland v. Jackman, 26 Cal. 79 (1861); Madison v. Madison, 206 Ill. 534 (1904); McConnel v. Kibbe, 33 Ill. 175 (1864); see also, Lashbrook, The "Ad Coelum" Maxim as Applied to Aviation, 21 Notre Dame Law. 143 (1946).
8 Remarks of William Mason, Condominium Conference.
Mortgages in California

Under California law, a mortgage is merely a lien on real property, security for a debt or obligation. On default of payment, the mortgagor may force a sale and recover the amount due from the proceeds. Since the property itself is the basic security for the debt, prospective mortgagees will be primarily concerned with the property interest of the prospective mortgagor and the physical elements of the property.

Title to be Conveyed

The type of title to be conveyed to the individual owners of condominium units will bear directly on the availability of mortgage money. So also will the question of disposal of the property in the event of destruction of the multi-unit structure, or a partial destruction and a decision not to rebuild. Two suggested legal structures will suffice here to point out some of the problems involved. As more experience is acquired there will undoubtedly be other methods suggested and used.

One method would combine a fee simple absolute in the unit with an undivided interest in the common elements, (halls, stairs, elevators, lobbies, driveways, swimming pool, etc.). On destruction, or partial destruction and a decision not to rebuild, a power of attorney contained in the declaration of covenants would give the management body power to dispose of all the owners' interests and distribute the proceeds. While this method provides an absolute fee which would appeal to mortgagees, there is a possibility that obtaining title insurance on a title conveyed under such power of attorney would be difficult. In California it is virtually impossible to transfer land or obtain realty loans without title insurance. Even a possibility of such a result would likely discourage lenders from entering this field.

A second method would employ a conveyance of a fee simple determinable with an undivided interest in the common elements. In addition, each owner would receive an undivided interest (equal to

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Footnotes:

10 Williams v. S. C. Mining Association, 66 Cal. 193, 201, 5 Pac. 85 (1884).
13 Panel Discussion, Condominium Conference.
14 Borgwardt, supra note 11.
17 Remarks of Jess Long, Condominium Conference.
his interest as a tenant in common) in the possibility of reverter. The determining event would be destruction or partial destruction and a decision not to rebuild. On the happening of the determining event, each owner would be left with an undivided interest in the remains. There is in this method no problem of disposal since an incident of a tenancy in common is the right to partition. The corresponding difficulty, however, is the determinable fee.

**Mortgages and Determinable Fees**

While any interest in real property capable of being transferred may be mortgaged, many lenders, especially institutional lenders, have firm policies against lending on determinable fees. The reason is obvious; a mortgage, as a lien, gives the mortgagee a right to have the debt paid out of the proceeds of a sale of the property unless otherwise paid. If the property is held by the mortgagor in determinable fee, on the happening of the determining event the mortgagor no longer has an interest in the property and the mortgagee's security is dissolved.

**Second Interest in the Condominium**

The very nature of the condominium contemplates that each unit owner will have an undivided interest in the common elements in addition to the interest in the unit itself. This interest could be used to secure the mortgage given on the unit and will protect the mortgage from dissolution of all security even in the event of destruction. It is quite clear, however, that the value of this second interest could easily fall far short of the value of an individual unit before destruction. In a high rise condominium there could easily be 100 units. The effect of destruction would be to leave each unit owner with a 1/100th undivided interest, or some such fractional share in the remains. In such a case, outstanding mortgages could far exceed the value of the

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18 Fear has been expressed that since the same person will hold the determinable fee and the right of reverter, the doctrine of merger of title will apply thus eliminating the safety provided by separate interests; panel discussion, Condominium Conference. This fear is unfounded as equity is not bound by the rule of merger and may preserve the identity of each interest when they would be merged at law. Anglo-Californian Bank v. Field, 146 Cal. 644, 80 Pac. 1080 (1905); Rump v. Gerkens, 59 Cal. 496 (1881); 33 Cal. Jur. 2d Mortgages § 284 (1957).


22 William v. S. C. Mining Association, 66 Cal. 193, 5 Pac. 85 (1884); 33 Cal. Jur. 2d Mortgages § 3 (1957).
combined interests in the remains. The question then arises, can this gap be closed?

**Insurance**

Both the mortgagor and mortgagee of real property have an insurable interest in the mortgaged property. Normally there is an agreement in the mortgage that only one policy shall be taken out but that it shall insure both the mortgagor's and mortgagee's interests. In addition to the insurance of the individual condominium unit, under such a mortgage insurance agreement, the common elements could be insured by the management body. Contributions by individual owners toward the cost of such insurance and distribution of proceeds on the happening of the insured event could easily be handled in the management agreement.

**Management Agreement**

The relation of mortgagor and mortgagee requires the mortgagor to preserve the property for the purpose of the security for which it was originally pledged. In the case of condominiums, the unit owners will generally be average homeowners. It is not to be expected that they will have experience in the care and maintenance of a large, modern apartment building. Since all owners will be dependent on the common areas the management agreement must provide for upkeep and repairs through the years.

Mortgagees will be especially interested in the method arrived at for maintaining the property since the marketability of the individual units is a test of the value of the mortgage as an investment security. A covenant in the management agreement requiring the retention of professional managers has been suggested as a solution.

**Expenses of Maintenance**

To enforce collection of the unit owner's proportionate share of expenses, probably put on a monthly assessment basis, a clause in the declaration of covenants provides for a lien for any payments which the grantee fails to make as required in the management agreement.

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24 Osborne, Mortgages § 138 (1951).
25 Remarks of John E. Koster, Condominium Conference.
28 Remarks of Lloyd D. Hanford, Condominium Conference.
29 See note 7 supra.
The lien will be in favor of the management body and should be subordinate to any prior recorded encumbrance made in good faith and for value. This subordination is to insure the availability of first mortgages on the units since institutional lenders and other investors either prefer or are restricted by law to such mortgages.

**Effect of Foreclosure**

The object of a suit to foreclose a mortgage is the sale of the estate which the mortgagor held at the time he executed the mortgage. In this respect, foreclosure on one unit in a condominium would have no effect on the other owners' interests in their units. The interest held as tenants in common is somewhat different. Cases are numerous to the effect that a mortgage or encumbrance executed by one tenant in common affects only his interest and is a mere nullity insofar as the other co-tenants are concerned. Under execution on a judgment the sale can only be of the undivided interest of the co-tenant and the purchaser becomes a tenant in common with the other co-tenants.

**Tax Liens Distinguished**

In many states a tax lien, unlike a voluntarily executed encumbrance, is on the property itself, not on the interest of the person assessed. The lien on the real estate is a lien established by statute of which the tax collector may avail himself in default of payment. In a condominium project, should the tax collector foreclose a lien on a unit owner's share of the property held in common the resulting sale would result in conveyance of not merely the title of the person assessed but a new and complete title to the property.

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31 CAL. FIN. CODE §§ 1413, 1416.


34 Helvey v. Sax, 38 Cal. 2d 21, 237 P.2d 269 (1951); CAL. REV. & T. CODE §§ 2187, 3518; for co-tenants right to pay tax and prevent sale of property, see 14 AM. JUR. Cotenancy § 43 (1958).
This problem of tax assessment is also important in conjunction with mortgage insurance. The Housing Act of 1961 added section 234 to the National Housing Act providing for mortgage insurance on condominium style housing. While there are many requirements for eligibility the most important to prospective mortgagees is that of tax assessment. The act provides that real estate taxes must be assessed and be lienable only against the individual units and not against the multi-unit structure. Common sense tells us that were it otherwise a tax lien could easily amount to more than the value of any particular unit, thus presenting an impossible situation from the mortgagee's standpoint.

Two compelling reasons—the nature of a tax lien and the availability of mortgage insurance under the National Housing Act—require separate tax assessment of each unit owner's interest in the unit itself and of his interest in the common elements.

**Tax Assessment in California**

In a recent opinion the Attorney General of California said that assessors in California were not required, under present law, separately to assess each individual undivided interest of a tenancy in common in real property, but that if they did it would not be invalid. The opinion also stated that such an owner has no right to compel separate assessment and is not entitled to pay his proportionate share of the current taxes assessed against the entire parcel.

Tax assessors who have considered the problem have said that such assessment as is required under section 234 of the National Housing Act is completely feasible and practical. They also stated that they were willing to comply as nearly as possible with the needs of the condominium. It would seem unwise, however, to leave this important item to the individual willingness of each assessor.

**Conclusion**

As has been stated, determinable fees in general are not the most attractive investments to prospective mortgagees. It will be noted however, that the Condominium is unique in one respect. The determining event is destruction, or partial destruction and a decision not to rebuild. Therefore, the event which will determine the fee is also

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40 Comment, 50 CALIF. L. REV. 299 (1962).
42 37 CAL. OPFS. ATT'Y GEN. 223 (1961).
43 Remarks of Forrest Simoni, Condominium Conference.
the very event which is insured against under the normal mortgage agreement. The mortgagee should not be without adequate security because the insurance proceeds will take the place of the salable unit on destruction. The determinable character of the fee, then, need not be a deterrent to financing.

There remains one aspect of the condominium which, while workable, is far from satisfactory. Compliance with section 234 of the National Housing Act is necessary to insure the availability of F.H.A. mortgage insurance, which is needed to attract widespread mortgage financing. This of course will require enabling legislation in view of the opinion given by the Attorney General of California.\(^4^5\)
