Mortgage Subordination

Accepting an easement on a property subject to a pre-existing mortgage is a special problem. If the lender ever forecloses on the mortgage and takes title to the property, the easement may be extinguished. The only solution is to have the lender subordinate its rights in the property to the rights of the easement holder. That means that in the event of a foreclosure, the easement will not be extinguished. Most land trusts will not accept an easement on mortgaged property unless the holder of the mortgage agrees to subordinate (from Practice 9H of the Land Trust Standards and Practices).

What is mortgage subordination?

When a mortgage holder subordinates a mortgage to a conservation easement they agree to allow the easement to be first in the chain of title, so that in the event of a foreclosure, the integrity of the easement remains intact. In determining interests in a parcel of land, the general legal rule is "first in time, first in right." Thus, where a mortgage is recorded prior to a conservation easement, the interests of the lender will be given priority over the interest of the easement holder in the event of foreclosure. As such, the easement will be extinguished and the lender will take title to the land free and clear of the easement encumbrance.

The lender's "first in time" priority interest may be altered by a contractual agreement called a mortgage subordination. In this agreement, the lender consents to subordinate its mortgage to the conservation easement, even though the mortgage was recorded prior to the conservation easement in the public land records. Thus, in the event of foreclosure, the lender would take title subject to the easement, thereby giving the easement holder the continued legal right to monitor, enforce and defend its conservation easement. Although the actual form of the mortgage subordination may vary from state to state, the subordination agreement will typically be a short document which simply provides that the lender "hereby subordinates the lien" of its mortgage to the conservation easement.

Why is mortgage subordination necessary?

In addition to preventing problems associated with foreclosure, a mortgage subordination is a requirement in order for the donor of a conservation easement to receive a charitable deduction for their donation. Treasury Regulation Section 1.170A-14(g)(2) states that "no deduction will be permitted...for an interest in property which is subject to a mortgage unless the mortgagee subordinates its rights in the property to the right of the qualified organization to enforce the conservation purposes of the gift in perpetuity." Thus, in order for the donor of the easement to claim any federal income, gift, or estate tax benefits, mortgage subordination is necessary.

Mortgage subordination is also critical in that it allows the land trust to meet its perpetual obligation to steward and enforce its conservation easements.

Why can obtaining a mortgage subordination be a challenge?

The lending institution generally has no legal or financial incentive to yield its position and allow the easement to take priority over the mortgage. Most lenders are conservative and believe that the safest position is to safeguard their existing rank in the title and to take the property free and clear of all other encumbrances in the event of foreclosure.

Here are some suggestions to make the process go smoothly: With large institutional lenders and governmental agencies, be prepared to spend some time locating the appropriate person to address the mortgage subordination request.

- Explain the purpose of the easement to the lender and describe how it benefits the community at large. If it is a donation, emphasize the charitable aspect of the grant.
- Explain to the lender the IRS requirements for deductibility and why a mortgage subordination is essential.
- If appropriate, convince the lender (with an appraisal or otherwise) that the easement-restricted property continues to have a value in excess of its outstanding mortgage and/or that the permitted uses of the property will not unduly limit marketability of the property should the lender have to foreclose.
- Cite local subordination precedents whenever possible. Be prepared to negotiate and address the lender's concerns contractually. A lender may be concerned about its liability, arising upon foreclosure, for previous violations of the easement (by the mortgagee or others), or the land trust's superior right to obtain reimbursement of restoration costs from the property owner. These concerns can be expressly addressed in the mortgage subordination agreement.
- Be prepared to pay a processing fee (or prepare the donor for the payment of a fee).
- It may be beneficial to spend some time building relationships with local lenders prior to the need for a subordination agreement. This may pave the way for an easier process in the future. Even utilizing the above approaches, a lender may simply refuse to agree to a mortgage subordination. In that event it may be necessary to seek refinancing with an agreeable lender, or the landowner may need to pay down or pay off the loan.

Information Resources

The Learning Center resources are available to volunteers and staff of Land Trust Alliance member land trusts and partners and to individual members donating $250 and above.

Practice 9H: Title Investigation and Subordination, Land Trust Standards and Practices - learningcenter.lta.org/objects/view.acs?object_id=15147

"Mortgage Subordination: Why and When it's Necessary", *Exchange* Spring 2002 - learningcenter.lta.org/objects/view.acs?object_id=875

"Negotiating with Lenders on Mortgage Subordination", *Exchange* Spring 2002 - learningcenter.lta.org/objects/view.acs?object_id=874

Sample Mortgage Subordination Procedures/Checklist, Peconic Land Trust - learningcenter.lta.org/objects/view.acs?object_id=16310

Sample Mortgage Subordination Agreement - learningcenter.lta.org/objects/view.acs?object_id=16311

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