

Pre-Existing Mortgages in Easement Transactions



Using Non-Disturbance and Subordination Agreements to Prevent Extinguishment and Comply with Tax Law

When a mortgage predates an easement on a property, the easement could be extinguished in a foreclosure if the owners default on their mortgage payments. And if the easement is to be donated and the donors wish to obtain tax benefits, additional complications arise. These problems can be avoided by obtaining an agreement from the mortgage holder appropriate to the circumstances.

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ENSURING THE EASEMENT'S PERMANENCE

Pre-Existing Mortgages Present Challenges

When a property owner mortgages their property, this doesn't present a problem for the holder of a conservation or trail easement on the property. However, when an easement is placed on a property that is subject to a pre-existing mortgage *and* this mortgage isn't addressed during the easement planning, serious risks arise:

- If the property owner later defaults on mortgage payments (or otherwise fails to comply with the mortgage terms), the mortgage holder may foreclose and the easement may be extinguished.
- If a donation of an easement is to be used as a charitable deduction for federal tax purposes, tax law requires that the permanence of the easement must not be threatened by possible foreclosure on a pre-existing mortgage.

There are two ways to eliminate these risks:

- The property owners could pay off the mortgage and refinance with a new mortgage after the easement is put in place. This would put the easement

holder's interest ahead of the mortgage holder's interest. This is the simpler solution but not always practical from the owners' financial standpoint.

- The property owners could request and the mortgage holder could agree to allow the easement to survive a potential foreclosure and to resolve other potential sources of conflict between the two interests so as to satisfy the easement holder's need for permanence.

What Is Needed from the Mortgage Holder?

For the latter alternative, the agreement by the mortgage holder may, depending on the circumstances, require some or all of the following provisions to effectively protect the easement holder:

1. Consent
2. Non-Disturbance
3. Subordination

Consent

The mortgage holder consents to the recording of the grant of easement. Mortgage documents sometimes prohibit the property owners from further encumbering the mortgaged property. This provision guards against an inadvertent default under the mortgage due to the recording of the easement in violation of such a prohibition.

Non-Disturbance

The mortgage holder agrees that in the event of a sale of the property due to default on the mortgage (or bankruptcy), the easement will not be disturbed. Anyone who purchases the land will take title under and subject to the terms of the easement. Any agreement sought from a mortgage holder will need this provision for the protection of the easement. Consents are almost always included with non-disturbance agreements; thus, we will refer to an agreement containing both (but not a subordination as described below) as a non-disturbance agreement.

Subordination

The mortgage holder agrees that the rights of the easement holder under the easement take precedence in all respects over the rights of the mortgage holder under the mortgage. Such an agreement may be impossible to obtain, which results in a major problem when subordination is mandatory. Some transactions do not require subordination; others do. For example, if the property owners are donating the easement in whole or in part and wish to obtain a federal tax deduction for a qualified conservation contribution, federal tax law requires subordination of the mortgage to the easement to qualify for the deduction. Subordination may also be necessary to meet the requirements of a grant or incentive program that requires issuance of a title policy insuring the conservation easement free and clear of liens.

Model Consent, Non-Disturbance, and Subordination Agreement

Model non-disturbance agreements and subordinations for other real estate and real estate finance uses do not address the needs of conservation easement transactions. To fill this gap, WeConservePA offers a flexible document aimed at conservation easement protection issues—the [*Model Consent, Non-Disturbance, and Subordination Agreement with Commentary*](#). The model illustrates the protections an easement holder may want to obtain and provides a form that mortgage holders can consider using if they have no particular boilerplate preference. The model can be easily customized to remove the subordination provision if subordination is unnecessary.

BACKGROUND

First in Time, First in Right

Land ownership is sometimes described as a bundle of sticks, due to the number of interests that, bundled together, equate to fee-simple ownership. These interests can be separated and vested in different people or entities all at the same time. The right to use a portion of the

property to transport power (a utility easement) may be held by one entity. The power to constrain the use and development of the property (a conservation easement) may be held by a conservation organization. The right to take ownership of a property for failure to pay a debt obligation (a mortgage) may be held by a third entity. The right to exclusively possess a portion of the property (a lease) may be held by a fourth entity, and so on. Because disputes can arise when these interests compete or collide with one another, courts have developed rules to sort out which interests will prevail. The basic rule is *first in time, first in right*.

A Rule Not to Be Ignored

If an easement is recorded on a property that is subject to a previously existing mortgage, the rights of the holder of the mortgage come before the rights of the easement holder. That is, unless the mortgage holder agrees to change the *first in time, first in right* rule.

The consequences of not securing such agreement can be severe: If the owner fails to make mortgage payments, the mortgage holder has the power to order the county sheriff to sell the property at a public sale to recoup the debt owing to it. If the mortgage holder has not agreed to allow the conservation easement to survive such action, the sale will be ordered free and clear of the conservation easement.

Tax Deduction Issue

If the property owners will claim a donation of the conservation easement as a charitable deduction for federal tax purposes, it is necessary for the mortgage holder to give up certain rights in favor of the easement holder. Otherwise, the Internal Revenue Service can disallow the deduction and subject the owners to interest and penalties. Treasury Regulations Section 1.170A-14(g) states that:

[N]o deduction will be permitted under this section 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.

APPROACHING THE MORTGAGE HOLDER

Identifying the Mortgage Holder

The first step to obtain an agreement from the mortgage holder is to find a person who has the capacity to review and approve the request. That may be an easy task if the mortgage is held by a bank or other lender with whom the owners have an ongoing relationship. Direct the request to a senior-level officer or another person who regularly services the owners.

If the mortgage has been sold to FNMA (Fannie Mae), FHLMC (Freddie Mac), or a conduit for investment, the decision of whether to honor the request is made by the company servicing the mortgage. (The lack of guidance as to how to handle requests regarding conservation easements has sometimes led these servicers to reject them out of hand.)

In cases where the mortgage has been sold, especially when the assignee of the mortgage identified on the public record is MERS (Mortgage Electronic Registration Systems, Inc.), direct the request to the mortgage servicing company that collects monthly payments from the owners. Try to find out which department handles requests for protection of later-recorded property interests and direct the communication to the head of that department.

Evaluating Likelihood of Agreement

Before investing time and expense in a prospective grant of easement, the owners and prospective easement holder may want to consider what the chances are that the mortgage holder will agree to provide the requested protections to the pending conservation easement.

Level of Protection Requested

Is a full subordination needed or will an agreement assuring survival of the easement in the event of fore-closure suffice? A consent and non-disturbance agreement, which is often furnished for protection of leasehold and easement interests, is more likely to be granted than full subordination. However, if an easement donation is intended to qualify as a charitable contribution for federal tax purposes, a subordination will be needed.

Local Mortgage Holder

Is the mortgage held by a local bank or other lending institution? Do the owners have a good relationship with the mortgage holder; for example, are they customers who have maintained deposit accounts with the mortgage holder and have reduced the outstanding balance of the mortgage debt? The likelihood of obtaining an agreement increases when a direct appeal can be made to a mortgage holder who is familiar with the owners and the property and can take into account a variety of factors when making a decision.

Remote Mortgage Holder

Is the mortgage held by some remote entity such that the owners have contact only with a servicing agency? That's a sign that the mortgage has probably become securitized—part of a pool of the collateral securing bonds sold to investors. In that case, subordination is unlikely although foreclosure protection via a non-disturbance may be possible.

Property Value as Collateral for Loan

How restrictive is the easement? Does the appraised value of the property after the easement is granted indicate that the property will continue to provide sufficient collateral for the mortgage debt (so that the bank is unlikely to take a loss if there is a foreclosure)? Will the mortgage loan continue to conform to the required loan to value ratio? Typically, there is a requirement that the value of the loan collateral (in this case the value of the property) must exceed the loan balance by at least 20%. Will the easement negatively affect marketability of the property? These are

all factors that the mortgage lender will want to consider in connection with its decision to accommodate a request for easement protection.

Value of Mortgage as Asset of Lender

Is the mortgage loan a profitable investment for the mortgage lender? A mortgage holder may be more willing to accommodate the request for protection if the loan is a profitable investment; for example, it bears a higher interest rate than can be obtained if the owners elected to refinance the existing loan with a new loan to accommodate the grant of easement.

Request Is for Protection of Easement from Foreclosure, Not Full Subordination

Mortgage holders (including servicing agencies for entities holding mortgages as security for bonds) are familiar with and have procedures for issuing (or approving) consent and non-disturbance agreements (for example, when requested for the protection of tenants investing in leasehold improvements or for easement holders investing in infrastructure improvements). A request for non-disturbance of an easement may be more familiar and less threatening to the mortgage holder.

Initial Communication

The initial communication should come from the owners. Regarding a specific loan, most if not all mortgage servicing companies have a policy of not communicating with anyone other than the borrowers.

Identifying Persons Authorized to Speak for Owners

If agreeable to the owners, the initial communication should authorize one or more representatives of the future easement holder to discuss the arrangements with the mortgage holder. The representatives of the easement holder authorized to contact the mortgage holder will need both the loan number and social security numbers of the borrowers.

Framing the Request

Assume that the person receiving the initial communication knows nothing about conservation easements. How can the request be framed in the best light? Here is an example:

The purpose of the conservation easement is to protect natural and scenic resources without preventing productive private use of the property. Except for ____ acres designated Highest Protection Area, the remainder of the property (____ acres) can continue to be used for farming, timbering, and other open space uses. One or more areas totaling ____ acres are available for residential use. Existing uses and improvements are not impaired.

Highlighting Reasons for a Favorable Response

Owners may want to consider including in the initial information a brief summary of any factors that may incline the mortgage holder to respond favorably to the owners' request. Examples:

- The mortgage holder's security for the loan—the value of the land even subject to the easement—will still be quite sufficient to protect the mortgage holder's financial interest.
- The owners have an excellent record of making regular payments.
- There is a robust market for lands protected by conservation easement in the vicinity, thus the marketability of the mortgage property won't be impaired by the easement.
- If the mortgage holder has no objections, the easement holder will publicly acknowledge the mortgage holder's cooperative role in advancing protecting important natural resources for the public's benefit.

If available, supporting documentation (as discussed in the next section) may also be included, but, since the

mortgage holder may need a lot of time to agree to a request, it is important to reach out as soon as the owners and easement holder have reached agreement on the basic terms of the easement grant.

Supporting Documentation

Items that the mortgage holder will typically need when addressing a request for easement protection include the following:

- Draft easement document (including exhibits, if any)
- Appraisal evidencing the impact of the easement on the property's value—a “before and after appraisal”
- Information on the outstanding principal balance of the debt secured by the mortgage
- Document requested for mortgage holder approval, such as the [*Model Consent, Non-Disturbance, and Subordination Agreement*](#)
- If Fannie Mae owns the mortgage, [*FNMA Form 236*](#) “Application for Release of Security”

NON-DISTURBANCE VERSUS SUBORDINATION

Both subordination and non-disturbance agreements provide protection for later in time property interests. They both assure the survival of an easement from the risk of being divested by a prior interest, but there are differences as discussed below.

Non-Disturbance

Requests for Non-Disturbance Are Common

It is common for utility companies and other prospective holders of easements to request non-disturbance agreements from mortgage holders in order to ensure that their later recorded interests are protected in the event of a foreclosure. Similarly, holders of long-term leasehold interests

looking to make major leasehold improvements will request non-disturbance agreements to protect their investments should the owners default on their mortgage. If the mortgage holder is satisfied that the easement or lease is a benefit to the property or, at least, does not diminish the marketability or value of the collateral below an acceptable level, the mortgage holder will likely agree to record a document consenting to the creation of the interest and promising not to divest the interest upon a foreclosure.

No Change in Lien Priority

The non-disturbance agreement does not change the priority of the mortgage holder's lien. It does not give the easement holder the right to challenge the exercise by the mortgage holder of its rights under its mortgage documents.

Downside for Mortgage Holder

The only downside for the mortgage holder is that, if there is a sheriff's sale of the property upon a default of the mortgage loan, the mortgage holder is prohibited by the non-disturbance agreement from listing the lease or easement (including a conservation easement) as an interest to be divested by the sale (which could increase the sale proceeds for the mortgage holder). The sheriff's deed to the purchaser at the sale will be under and subject to the lease or easement; they don't go away.

Subordination

Prioritizing Rights vis-à-vis Other Liens

The non-disturbance agreement is not technically a subordination, because it does not change the priority of the mortgage vis-a-vis the other interest; subordination does change the priority. Subordination is ordinarily not needed unless a re-ordering of the priority of the same type of interest (for example, the first mortgage is put behind the later recorded mortgage) is necessary.

Problems for Mortgage Holder

A subordination of the mortgage can present many problems for the mortgage holder including: a decision by a

servicing agent to subordinate may violate the servicing agreement; a mortgage no longer in first position will no longer qualify as collateral for bonds; and the title policy insuring the mortgage as a first-priority lien may no longer be effective.

Federal Tax Deduction Issue

Typical forms of non-disturbance agreement do not address proceeds of condemnation because, in most cases, the holders of various types of easement are free to assert a separate claim for the taking of their easement interests. However, conservation easements drafted to meet the requirements of a qualified conservation contribution adopt the single claim procedure mandated by the federal tax code: the interest of the conservation easement holder is treated as if it were terminated by the taking and, instead of a separate claim, the easement holder has the right to a percentage of the proceeds (the "proportionate value") of the taking otherwise payable to the landowners. Thus, to meet the requirements of a qualified conservation contribution, a typical non-disturbance document used for other easements is not sufficient unless it is adapted to provide for payment to easement holder of its proportionate value of the proceeds of a condemnation.

Nuanced Approaches to Subordination

Relationships among various property interests can be organized in ways that go beyond the basic first-second-third ordering of priority. Sometimes, for example, the holders of mortgages on a particular property cooperate with another by agreeing to put one in first position but further agree to share the proceeds of sale, condemnation, and the like proportionately. WeConservePA's [*Model Consent, Non-Disturbance, and Subordination Agreement*](#) adopts a similar nuanced approach. It has the holder of the existing mortgage place the easement holder's interest first for purposes of assuring survival in a foreclosure and, as to condemnation proceeds, establishes a proportionate sharing arrangement; otherwise, the mortgage holder's exercise of its rights and remedies under its mortgage documents is unaffected.

IS FORECLOSURE PROTECTION ALWAYS NECESSARY?

Protecting an easement from foreclosure is obviously desirable if not crucial but may not be strictly necessary in all circumstances.

Intransigent Mortgage Holder

If the mortgage holder is intransigent and neither subordination nor a non-disturbance agreement to provide foreclosure protection are available, the prospective easement holder may—for a highly desirable easement and one not intended as a qualified conservation contribution—evaluate the risk that landowners will default on the existing mortgage, consider approaches to minimize that risk, and proceed as appropriate in the holder's best judgment. (That there might be a path forward assumes that the property owners won't go into default simply by granting an easement.)

Risk Evaluation

To evaluate the risk of default, the prospective easement holder must examine the creditworthiness of the owners and the value of the property as collateral for the outstanding loan using much the same analysis that the mortgage lender performs in determining whether to issue a non-disturbance or subordination agreement. With an understanding of the risk, the prospective easement holder can then make a reasonably prudent business decision about whether or not to move forward.

Additional Assurances

If the prospective easement holder decides to move forward with the easement, it may want the landowners to furnish additional assurances to minimize the adverse consequences of a default on the mortgage. These assurances may include the personal guaranty of landowners secured by a mortgage on the property or other real estate interests; a security interest in bank, securities, or other investment accounts; proceeds of policies of life insurance; or any other assets. The purpose of the guaranty and

collateral is to be sure that, if the easement holder has to invest funds to preserve its conservation easement in the property, it has recourse to other assets of the landowners to recoup that investment.

Absent Protection, What Happens in the Event of Default?

Sheriff's Sale

If a mortgage becomes in default, the mortgage holder is required, prior to public sale of the mortgaged property by the county sheriff, to identify all interests to be divested by the sale, which would include a conservation easement accepted under and subject to the mortgage. The sale may occur as soon as 30 days after notices are issued. Terms of sale are usually cash or bank check equal to 10% of the bid on the sale date and the balance within 30 days after. Upon payment of the bid price, the sheriff deeds the property to the successful bidder free and clear of all the interests identified in the notice of sale.

Easement Holder as Bidder

If the easement holder has the means (via financial guarantees previously provided by the landowners or other resources) to bid at sheriff's sale and is the successful bidder, the easement holder becomes the owner of the property free and clear of all interests identified as to be divested in the sale. The easement holder is then in a position to resell the property under and subject to a conservation easement crafted to achieve the conservation objectives of the original easement.

(The easement holder could request the sheriff to issue the deed under and subject to the conservation easement existing prior to the sale, but in addition to adding complexity to the matter, this precludes an opportunity to update the easement document to the holder's latest form.)

Risks of Bidding at Sale

The minimum bid by the easement holder at the sale must be sufficient to pay the prior mortgage plus unpaid property taxes, transfer tax on the recording of the deed, and the sheriff's costs of sale, which typically include a percentage of the bid price as a commission. The short timeframes for notice of the sale and delivery of the bid price may be difficult to meet unless the holder has the ability to use its own resources or draw on a line of credit to fund the acquisition. The feasibility of quick action in case of a default is an important factor when evaluating the risk of accepting a conservation easement under and subject to an existing mortgage.

Another risk is that other bidders may continue bidding over the easement holder's minimum bid. If the conservation easement were a mortgage or other lien, the holder would continue to bid up to the amount secured by its lien because each dollar bid over the minimum is distributed by the sheriff after the sale to holders of other liens on the property in order of priority. But the conservation easement is not a mortgage lien; thus, it is not entitled to payment from proceeds of sale above the minimum bid but it is nevertheless subject to divestment from the sale if anyone other than the easement holder is the successful bidder. A discussion of strategies to avoid or mitigate undesirable outcomes of competitive bidding at the sheriff sale is beyond the scope of this guide; however, one protection that can be obtained prior to easement acceptance is an assignment to the easement holder of any rights landowners may otherwise have to receive proceeds of a sale of the property due to a default on the prior mortgage.

Land Trust Standards and Practices

Practice 9.F.2. of [Land Trust Standards and Practices](#) addresses mortgage subordination. It provides as follows:

Evaluate the title exceptions and document how the land trust addressed mortgages, liens, severed mineral rights and other encumbrances prior to closing so that they will not result in extinguishment of the conservation easement or significantly

undermine the property's important conservation values.

The information on foreclosure protection furnished in this guide is consistent with Practice 9.F.2. The course of action offered for consideration *when foreclosure protection is not available* may not strictly comply with the practice but is presented as a potential path to be considered when a highly desirable conservation easement is thwarted by an intransigent mortgage holder.

EASEMENT AMENDMENT

If a mortgage exists on a property at the time of a proposed amendment to the easement document, the easement holder will want to evaluate whether it needs to protect the amendment from the risk of challenge by the mortgage holder. The risk arises if the amendment results in a decrease in the value of the property, for example, an amendment that changes owners' rights to subdivide from three permitted lots to two. The problem is that, if the mortgage goes into default, a court may find that the mortgage holder was prejudiced by the change in the easement and did not consent to it. That ruling would allow the property to be sold in a foreclosure subject only to the easement as it was when the mortgage was recorded (for three lots, not two per the above example). A discussion of the factors to consider when amending an easement on a mortgaged property and the range of approaches that may be used to provide sufficient protection for the amendment are beyond the scope of this guide; easement holders are advised to consult with counsel.



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