Smith v. Martin and its Logical Extension?

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On December 3, 1996, the court of appeals of North Carolina rendered its opinion in the case of *Smith v Martin*, 124 N.C.App. 592, 478 S.E.2d. 228 (1996). Although this action was brought to recover damages for the wrongful cancellation of a deed of trust, the opinion discusses subordination agreements in response to the defendant's argument that his cancellation of the deed of trust was not a proximate cause of the Smiths' damages. In summary, the facts are as follows. In 1988, the Smiths sold a commercial piece of property to the Lattas. The Smiths provided purchase money financing in the amount of $35,000 and secured repayment with a second position deed of trust on the property. A few days later, the Smiths agreed to loan the Lattas an additional $20,000 for renovations on the property. They agreed that the $35,000 note would be replaced by a $55,000 note and deed of trust. The trustee named on both deeds of trust was the closing attorney, Mr. Martin. Unfortunately, Martin forgot to cancel the $35,000 deed of trust at the time the $55,000 replacement deed of trust was recorded. This ultimately created the confusion.

Almost two years later, the Lattas obtained five additional loans from United Carolina Bank ("UCB"). Only the third loan was secured by the subject property. It was at this time that the uncancelled $35,000 deed of trust was discovered and the Smiths signed a document entitled "Deed of Subordination." The appellate brief for the plaintiff indicates that the deed of subordination was never used because an affidavit of payment regarding the $35,000 deed of trust was obtained from the Smiths and recorded in the Orange County Registry. Thus, the UCB deed of trust securing one of its five loans to the Lattas (this particular loan was for $58,064.00) became a third lien on the property behind the original acquisition loan from Hillsborough Savings & Loan and the Smiths' $55,000 loan.

A few weeks after making all five loans to the Lattas, UCB and the Lattas agreed to enter into a consolidation loan in the amount of $245,334. As security for the loan, the Lattas were required to provide a first lien deed of trust on the property. The title examiner found the $35,000 deed of trust that had been cancelled and also found the $55,000 deed of trust in favor of the Smiths. Through various misunderstandings, the closing attorney instructed the trustee, Martin, to cancel the $55,000 deed of trust for the benefit of the Smiths. Martin never contacted the Smiths but he did cancel the deed of trust. Because the Lattas continued to make payments on the $55,000 note to the Smiths, the Smiths remained unaware of the cancellation until after the Lattas filed their Chapter 13 petition almost a year and a half later.

After submitting a secured proof of claim, the standing trustee objected to the secured status and allowed the Smiths' claim only on an unsecured basis. The Smiths filed this lawsuit against the trustee for wrongful cancellation of the deed of trust. The Defendant claimed that his cancellation of the $55,000 deed of trust was not the proximate cause of plaintiff's loss and contended that the Smiths' execution and delivery of the "Deed of Subordination" was sufficient to subordinate the $55,000 deed of trust to UCB's entire

$245,000 deed of trust. The court disagreed and held that "regardless of the intentions of the parties, …the deed of subordination is unenforceable as a matter of law." *Id.* at 597, 478 S.E.2d at 231. The court went on to state that a typical subordination agreement involves a purchase money mortgage and cited several California cases. It held that subordination agreements and clauses that <u>subordinate loan obligations</u> secured by a deed of trust to future loans, must include, at a minimum, terms which state the maximum amount of the future loans and the maximum rate of interest permitted on the loan. (emphasis added *Id.* at 599, 478 S.E.2d at 232).

One might conclude that a logical extension of the holding in *Smith v Martin* is that <u>any</u> subordination agreement wherein a party subordinates its <u>interest</u> to a <u>future</u> loan, must contain, at a minimum, these specific details of the new loan. With respect to subordination agreements signed by mechanics and materialmen lien claimants in favor of the owner's lender, such an extension of the holding seems logical, at first. In its reasoning, the *Smith* court stated there is a need to specify at a minimum the maximum amount of principal and rate of interest earned thereon, so that the lender subordinating its interest can minimize the risk of its interest being impaired or ultimately destroyed. *Id.* at 599, 478 S.E.2d at 232, [citing *MCB Limited v McGowan*, 86 N.C.App. at 610, 359 S.E.2d at 52 (1987), quoting *Handy v. Gordon*, 65 Cal.2d 578, 55 Cal.Rptr. 769, 770-71, 422 P.2d 329 (1967).]

Both the *Smith v. Martin* and *McGowan* decisions involved facts where one lender subordinated its interest to another lender and both decisions defined subordination agreements very narrowly. In *McGowan*, the court defined a subordination clause as "one in which a seller of land, after retaining a security interest in the property sold, permits his interest to become secondary in priority to an encumbrance placed upon the property by the purchaser." *Id*. at 609, 359 S.E. 2d at 52.

If an owner engages the services of a general contractor to improve the property before he obtains financing, the lender will require the contractor to subordinate its interest to the lender's deed of trust. Since the funds from the loan will ultimately pay the contractor, the contractor is usually willing to do so. Although a lien claimant is not a purchase money lender, much less a lender, subordinating its interest to a lender puts its lien in peril similar to a purchase money lender that subordinates its interest – save one important distinction. Unlike a purchase money lender, the lien claimant can still sue the owner if he defaults on his payment obligation. In contrast, it is well-established law in North Carolina that the holder of a purchase money note and deed of trust may look only to the property he sold for repayment. Accordingly, the lien claimant is not in as bad a position as a purchase money noteholder who subordinates his lien interests. In fact, the lien claimant's chance of being paid is probably enhanced by virtue of the loan to which it subordinates its interest. Given the narrow definition of a "subordination agreement" in the *Smith v. Martin* and *McGowan* decisions coupled with the inherent difference in the risk associated with subordinating a purchase money deed of trust versus a monetary lien to a third party's deed of trust, it is not clear whether the courts will extend the minimum requirements of a subordination agreement expressed in the *Smith v. Martin* holding to a subordination agreement signed by a lien claimant.

From a practical standpoint, the holding in *McGowan* is also noteworthy. The subordination provision contained within the purchase money deed of trust that was the subject of this case required the beneficiary to subordinate its interest to a construction loan and to the permanent financing loan. The court held that the requirement in the subordination agreement which stated that the defendants would subordinate their position upon the plaintiff's request "in such amount as may be reasonably requested by" was void for indefiniteness as a matter of law. *Id.* at 608, 359 S.E. 2d at 51. Practitioners should take heed of this decision when drafting construction contracts for their owners to avoid a similar result. Fortunately, the *McGowan* court offered some advice when it recognized the specific details of future loans are not always known and authorized the use of some outside standard to define the unknown terms of the future loan.

Given the Court's expressed concern to quantify the risk and given the language regarding subordinating one's interest to an unknown <u>future</u> loan, it also seems reasonable that a North Carolina court would find a subordination agreement referring to a specific loan already in existence, (i.e. by the book and page in the county registry where the deed of trust is recorded) is specific enough and therefor valid even though it does not contain a statement regarding the maximum principal amount and interest rate to be charged thereon. Until these questions are resolved definitively, however, most title insurance underwriters have revised their standard subordination agreements to include such language and it is advised that the practicing bar observe and follow the requirements of a valid subordination agreement as expressed by the *Smith* Court. (A sample subordination agreement form is attached at the end of this article.)

To extend the *Smith* Court's minimum requirements to a subordination provision found in a lease, however, seems illogical for two reasons. First, a tenant has a possessory interest in the land, not a financial lien on the property. Fundamentally, this is a different kind of interest. Second, a sophisticated tenant will not agree to subordinate its interest to a future or even known lender without conditioning such subordination upon the lender's agreements to allow the tenant to remain in possession and "not disturb" the tenant provided the tenant is not in default under the lease. Instead of being competing interests, the interests of a tenant and lender are interdependent. The lender's money enables the landlord to acquire, improve or refurbish the property to a prospective tenant's specifications. The lender's primary assurance that the loan will be repaid is the anticipated income stream generated by that tenant. Thus, the effect of subordinating its leasehold interest to the lien of a future lender is relatively small when coupled with the non-disturbance provision. Consequently, this author believes that the cases upon which *Smith v. Martin* relies and the practical risk, or lack thereof, that a tenant incurs by subordinating its interest dictates that the holding in *Smith v. Martin* should not be extended to subordination agreements relative to leasehold or any other non-lien type interests.

To digress for a moment to a related issue involving priority of interests in title, remember that any tenant who has an unrecorded lease with a term of three years or less continues to have priority over any subsequently recorded interest. Of course, the converse is true. If a tenant is in possession pursuant to a lease with a term that is greater than three years, its interest may be terminated by a successor to the fee owner who first records his interest. Thus, title insurers will take exception to rights of tenants pursuant to unrecorded leases with a term of three years or less as well as to the rights of tenants pursuant to recorded leases or memorandums thereof.

To the extent a tenant does subordinate its interest to a lender either by provisions in the lease itself or by way of a subordination agreement, the title insurance company will want this evidenced in the public record before insuring the lender's interest is thereby superior. While this may not appear necessary, remember that the title insurance company wants the subordination agreement to be effective against the successors and assigns of the tenant and this can be ensured only if the subordination agreement is properly recorded.

Similarly, since most subordination agreements do contain a non-disturbance provision and may contain additional affirmative obligations on the lender, a title insurance underwriter may show the tenant's interest as a subordinate matter and also take exception on the lender's policy for "loss or damage resulting from the lender's failure to comply with terms and provisions of the subordination agreement." Arguably this exception is not necessary for two reasons. First, the failure of the lender to comply with the terms of the subordination agreement would be a post policy event and second, it would be an act of the insured agreed to and/or assumed by the insured. Both matters are specifically excluded from coverage under the policy pursuant to paragraph number three in the pre-printed Exclusions from Coverage.

Now let's return to the primary discussion and explore the possibility of a dispute between a tenant and a lender in possession that arises out of the effectiveness of a subordination agreement. If a tenant's lease provisions require that casualty or condemnation proceeds be used to rebuild the improvements, but the lender's deed of trust requires those proceeds to pay down it's loan, the real dispute will occur between the tenant and the landlord. If the lender is now the landlord via foreclosure or otherwise, minor tenants typically will have no right to force the landlord to rebuild the premises. If one does exist, it is usually subject to the landlord's (and hopefully the lender in possession would not fall under the umbrella of this definition) receipt of the proceeds or is subject to the loan provisions (which usually grant the lender the right to determine whether the condemnation or casualty can be used for rebuilding the premises.) If the tenant is a desirable tenant, the lender will probably want to keep the tenant happy and will rebuild in order to continue receiving the income stream that will allow it to recoup it's loan (unless the lender is in a position to be made whole by the proceeds from the condemnation or casualty and the value of the land.)

In order to avoid the remote possibility of a dispute over the validity of a lease's subordination provision, one might consider drafting the subordination provision to specifically state that the lease will be subordinate to any loan or combination of loans that together have a maximum amount of no more than [90%] of the total fair market value of the property as determined by an independent appraiser at the time the last loan is made and will have a maximum rate of interest of no more than [4%] above [the then prevailing rate, or prime or some other index as is negotiated and is readily ascertainable in the future]. This should protect both parties by having a commercially reasonable standard upon which to ascertain whether or not the present leasehold interest will be subordinate to the future interest of the lender. As both the *McGowan* and *Smith v. Martin* holdings state, other jurisdictions require subordination clauses to contain terms that will define and minimize the risk that the subordinating liens will be impaired or destroyed. *Smith* at 599, 478 S.E.2d at 232, (citing *McGowan*, 86 N.C.App at 610, 359 S.E.2d at 52 as quoting *Handy v. Gordon*, 65 Cal.2d 578, 55 Cal.Rptr. 769, 770-71, 422 P.2d 329 (1967).

While this author feels strongly that it is illogical to extend the holding in *Smith v. Martin* to subordination agreements given by tenants, practitioners should remember its requirements when obtaining subordination agreements from parties with a monetary lien interest in property.