



Counselors at Law

UNPARALLELED RESPONSE, UNPARALLELED SOLUTIONS

What you know may hurt you

March 2007

I hope that this issue of the Cooley, Shrair P.C. Bank Alert Notice finds you busy during this first quarter of 2007. It does appear that there is more activity than just line renewals and paperwork. This brings me to an interesting topic.

A 2005 case decided in Massachusetts, *QUEENO, et al v. COLONIAL CO-OPERATIVE BANK* held that where a lender had knowledge of a borrower's existing, but unrecorded Purchase and Sale Agreement to a third party buyer, that the lender could not simply foreclose when the borrower stopped making payments. In this case, the court held that the lender's knowledge of the existing Purchase and Sale Agreement, required the lender to foreclose subject to the Purchase and Sale Agreement even though the contract was not of record at the Registry of Deeds. The facts of this case are somewhat simple. The borrower owned a lot of land. It approached the lender for a construction loan where it had an existing contract to build a home for a buyer for a specified price. The borrower and the buyer began to dicker over some of the terms of the sale. The borrower would not make changes that the buyer demanded. The borrower stopped paying the mortgage loan thinking that the lender would foreclose. The lender did just that and began foreclosure proceedings. The buyer, however, was able to obtain an injunction from the court holding that the lender could not foreclose as it had actual knowledge of the outstanding Purchase and Sale Agreement despite the fact that the contract had never been recorded. As such, lenders must be careful where they have prior knowledge of unrecordable interests in their real estate collateral.

The problem also exists when lenders are going to finance commercial investment property whereby one or more tenancies exist. It is always an issue as to whether subordination agreements must be obtained for the leases. Lenders typically require in their due diligence package copies of all leases which exist at the premises to be mortgaged, together with rent rolls. If the leases contain subordination clauses, such that the tenancies are at all times subordinate to a mortgage placed on the premises, there is no problem. Where the leases are not automatically subordinate and are not of record, but the lender has actual notice of them, a different result occurs. Many lenders believe that based upon the fact that a lease is not of record, that their mortgage has priority and that they are protected. They are not; this is because of the actual

notice the lender has of the outstanding interest in the real estate.

It would be prudent for lenders to protect themselves, where they do not have knowledge of such contracts, e.g., obtain a warranty or representation from the borrower in the commitment letter and subsequent loan documents that no outstanding purchase and sale agreements or leases are in existence.

Furthermore, if the lender knows there are tenants operating in the premises to be mortgaged and no subordination language is contained in the applicable leases, then the lender will have knowledge of such tenancies and to foreclose out the tenancy, it would likely need a Subordination Agreement. As such, we typically advise that to protect the lender, a Subordination Agreement or a Subordination and Non-Disturbance Agreement be obtained and recorded at the Registry of Deeds.

Sincerely,

A handwritten signature in black ink, appearing to be 'P. Shrair', with a long horizontal line extending to the right.

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