

Real Estate Lenders Beware: Merger May Destroy or Diminish the Value of a Lender's Security

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May 2013

A recent decision of the California Court of Appeal provides the means for real estate lenders to avoid the potential loss or diminishment of their security through merger.

Real estate lenders and their counsel may overlook the merger risk to their security. The doctrine of merger, which is codified in California as Civil Code sections 805 and 811, holds that easements benefitting one property and burdening another merge out of existence when the ownership of both properties becomes the same. The rationale is that an easement becomes unnecessary when the one benefitting from the easement owns the entire legal estate.

This may be problematic, however, when an easement constitutes all or an important part of the security of a deed of trust. If such an easement is merged out of existence when the dominant and subservient tenements come under common ownership, the secured lender will lose a valuable part of its security. For example, an easement may provide essential access to a landlocked property.

For merger to occur, the ownership of the two properties must be equal and coextensive. The legal question thus arises whether a deed of trust, by which the property owner conveys title to the property to a trustee to be held for a beneficiary – typically a lender – prevents merger.

The question is unsettled in California. One line of thinking holds that deeds of trust are conveyances of title in form only, that the substance of such a deed is to create a lien, and that a deed of trust should therefore not prevent merger because a lien would not do so. The other approach is to respect the form of a deed of trust as a transfer of the fee interest, thus creating different owners of the two properties and preventing merger. This latter approach would create the equivalent of a “mortgage exception” to merger, which other states have done.

In *Hamilton Court, LLC v. East Olympic, L.P.*, 2013 WL 1613269 (2nd Dist., April 16, 2013), the California Court of Appeal provides lenders and other beneficiaries of deeds of trust with the means to protect themselves against merger and its unintended consequences, although it leaves open the question of a mortgage exception in California. In *Hamilton Court*, the seller of commercial property benefited by an easement (the dominant tenement) sold the property for cash and a purchase-money promissory note secured by the property, including the easement. The seller included language in the deed of trust permitting a transfer of the property on the condition that any transfer of the property would be “subject to this Deed of Trust and would not affect its priority in any manner whatsoever.” The buyer later transferred the property to the owner of the property burdened by the easement (the servient tenement). Several years later, the seller foreclosed on the purchase money note and reacquired the property at the foreclosure sale. The owner of the servient tenement then claimed the easement had been extinguished by merger, and sued to quiet title to the servient tenement free of the easement. The trial court agreed that merger had extinguished the easement, and issued judgment against the seller.

The Court of Appeal reversed, holding that the language quoted above in the deed of trust was in effect a stipulation that merger would not occur so long as the deed of trust remained in effect. In a concurring opinion, Justice Richard Mosk argued for a broader ruling; one that would create a mortgage exception in California to protect the beneficiaries of deeds of trust from the inequitable result of losing easements constituting all or a portion of their security when transactions over which they have no control extinguish those easements by reason of merger.

Because the “mortgage exception” remains unrecognized in California, lenders remain at risk to the merger doctrine, which has the potential to extinguish easements upon a transfer of the dominant tenement to the owner of the servient tenement even though the easements have been pledged as security to a third-party lender. *Hamilton Court*, however, gives lenders the means to protect themselves from this surprising and damaging result by including protective language in their deeds of trust. Such language should unambiguously include the borrower’s agreement, to be binding on any transferee, that the merger doctrine will have no application to the secured property so long as the deed of trust remains in effect.

TroyGould PC was counsel for the prevailing party in this case. If you have questions regarding this decision or its impact on real estate and lending transactions, please contact Jeffrey W. Kramer.