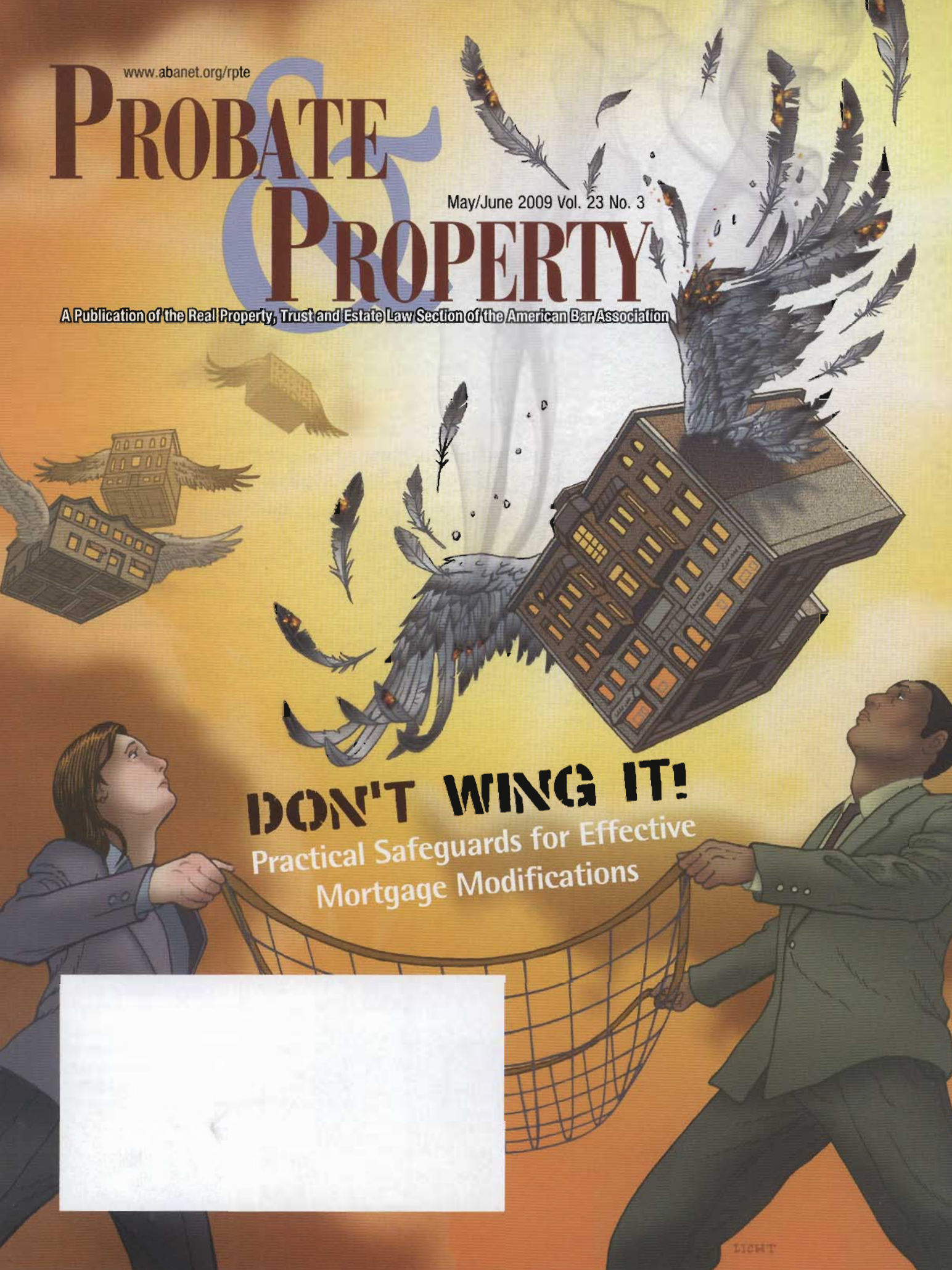


www.abanet.org/rpte

PROBATE & PROPERTY

May/June 2009 Vol. 23 No. 3

A Publication of the Real Property, Trust and Estate Law Section of the American Bar Association



DON'T WING IT!

Practical Safeguards for Effective
Mortgage Modifications



DON'T WING IT!

Practical Safeguards for Effective Mortgage Modifications

By Michael J. Zerman

As in previous real estate downturns, many mortgage lenders will elect to modify certain delinquent loans in their portfolios rather than exercise foreclosure remedies. By doing so, these lenders may avoid holding large amounts of real property that they cannot sell quickly without incurring significant losses. Loan modifications can result in "win-win" situations when distressed borrowers are able to continue making mortgage payments with the help of lender concessions (which may be of a temporary nature), and some lenders may be willing to grant such concessions in anticipation of the eventual recovery of the real estate market and the rise of property values.

But both borrowers and lenders must exercise caution when negotiating modification agreements. Especially for loans secured by commercial property, many legal issues must be carefully considered and factored into the decision of whether and under what conditions to modify a loan or instead to exercise other remedies, such as foreclosure or appointment of a receiver. This article will examine several important factors that mortgage lenders should consider when determining whether to modify a delinquent loan.

The Central Concern: Loss of Priority

Generally, any modification that increases the interest rate of the loan, shortens the maturity date of the loan, or increases the amount of the debt is considered a "material modification" that would adversely affect or "prejudice" the holder of a subordinate lien on the property. Many cases agree that mortgage liens, to the extent they secure non-obligatory advances above the original loan amount or increases in the interest rate of the loan, should lose their priority over a junior mortgage lien if entered into without the consent of the junior lienholder, because they impair the junior lienholder's ability to collect on its lien. See, e.g., *Gluskin v. Atl. Sav. & Loan Ass'n*, 108 Cal. Rptr. 318, 323 (Ct. App. 1973) ("a lender and a borrower may not bilaterally make a material modification in the loan to which the seller has subordinated, without the knowledge and consent of the seller to that modification, if the modification materially affects the seller's rights"); *Shane v. Winter Hill Fed. Sav. & Loan Ass'n*, 492 N.E.2d 92, 95-97

(Mass. 1986) (when first mortgage provided right of mortgagee to raise interest rate by 1%, but mortgagee raised rate by 1.25% without notice to second mortgagee, increase was prejudicial and unenforceable); *Shultis v. Woodstock Land Dev. Assocs.*, 594 N.Y.S.2d 890, 893 (App. Div. 1993) ("changing the interest rate on the loan and bringing the additional interest charges within the lien of the mortgage does work prejudice inasmuch as the change increases the total amount of indebtedness placed prior to the subordinate lien"); *Sackdorff v. JLM Group Ltd. P'ship*, 462 S.E.2d 64, 70 (Va. 1995) ("We agree with the principle that a senior lienor may not modify the terms of its agreement with the borrower so as materially to prejudice the rights or impair the security of junior lienors, without their consent."). This result may be different in some jurisdictions, depending on the specific wording of a state's applicable future advances statute or possibly the wording of the mortgage itself. Nevertheless, to avoid problems, lenders that desire to maintain mortgage lien priority ahead of junior liens should obtain the written consent of the junior lienholders to the modification agreement, which should be duly recorded so that future lien claimants will have notice of the modification.

The law is generally more lenient for other types of modifications, such as an extension of the maturity date, deferral of interest, or a reduction in the interest rate or the amount of the loan. An extension of time to repay a loan generally is presumed beneficial to junior lienors, not prejudicial. Modifications that extend the time period in which to pay off the senior loan, or reduce the interest rate or the amount of the loan, should not result in a loss of priority. See, e.g., *Resolution Trust Corp. v. BVS Dev. Inc.*, 42 F.3d 1206, 1215 (9th Cir. 1994) (lienholder's subordination not nullified by extension of term of superior loan without subordinate lienholder's consent because extension did not materially increase risk of default); *Lennar N.E. Partners v. Buice*, 57 Cal. Rptr. 2d 435, 440 (Ct. App. 1996) ("An extension of a senior debt that merely alters the date of payments generally does not adversely affect the junior lienholders. . . . [W]hen the obligation is increased, by an increase in the principal amount or an increase in the interest rate, the junior lienholder's position is worsened."). Nevertheless, even in these benign situations, lenders and their attorneys should be cautious about entering into an unrecorded loan modification agreement without obtaining title insurance, as discussed below.

Michael J. Zerman is counsel with the Los Angeles, California, office of Manatt, Phelps & Phillips, LLP.

Title Insurance for Mortgage Modifications

The lender's original American Land Title Association (ALTA) Loan Policy will not provide coverage for a subsequent loan modification. That policy insures the lender's lien on the insured land only as of the date set forth in Schedule A of the original policy. It does not insure the terms of a later modification unless an express endorsement is obtained to that effect, because the subsequent modification of the loan is a "post-policy" event that is otherwise excluded from coverage.

Most title insurance companies offer several alternative endorsement forms for loan modifications. Lenders may obtain coverage for mortgage modification agreements under ALTA Endorsement Form 11 (see Exhibit A on page 16). The ALTA Form 11 Endorsement is similar to the California Land Title Association (CLTA) Form 110.5 Endorsement (see Exhibit B on page 17 and discussed below), modified to include a credi-

Before issuing the ALTA Form 11 Endorsement or the CLTA 110.5 Endorsement, the title insurer will review the modification agreement and conduct a complete title and tax lien search to ascertain that nothing would render the modification agreement unenforceable or affect the priority of the insured mortgage after recording of the modification agreement. The title company's review usually includes the following matters:

- assurance that the parties to the modification agreement appear of record as the owner of the land (mortgagor) and as the mortgagee, respectively;
- the power and authority of the parties to execute the modification agreement;
- a determination that there are no encumbrances subsequent to the insured mortgage—if any such encumbrances are found, they will be set forth as exceptions in the endorsement unless the parties holding the encumbrances subject their interests to the insured mortgage as modified by appropriate subordination language in a recorded agreement;
- a determination that the holder of the note is a party to the modification agreement (by an inspection of the note if necessary);
- a determination that no work is in progress or recently completed (to avoid the superiority of mechanics' liens) by a site inspection or by requiring an affidavit from a creditworthy party for such work;
- a determination of the rights of any parties in possession, which may require additional exceptions to coverage; and
- a determination that no additional property is being added as security for the loan as part of the modification.

The lender should be equally concerned with all of these matters, and the modification agreement should contain borrower representations and warranties for many of these issues. The borrower, however, should cooperate


directly with the title company in requests for information. The title insurer is usually in a better position than the lender to evaluate and assume the risks presented by any defects revealed by its title search or any inaccuracies in the documents provided by the borrower.

Both the CLTA 110.5 Endorsement and the ALTA Form 11 Endorsement require that the modification agreement be recorded. Most title companies also offer custom endorsements (see Exhibit C on page 17), which insure against any loss of priority or impairment of the lien of the insured mortgage as a result of the execution of an unrecorded modification agreement, provided that it contains only certain "minor" modifications (for example, a short extension of the maturity date). Such custom endorsements are typically much less expensive than the CLTA 110.5 Endorsement or the ALTA Form 11 but are not applicable to modification agreements that contain material modifications that might be prejudicial to junior lienholders. In addition, even though a custom endorsement may be issued in some states without recording the modification agreement, the lender should consider recording the modification, anyway, in anticipation of further modifications, because their sequence may become confusing if some modifications are recorded and others are not.

More Traps for the Unwary: Disclaimers in Existing Loan Documents

Some lenders may rely mistakenly on language contained in the original loan documents or recorded subordination agreements that purports to allow the lender and borrower to modify the loan without the consent of junior lienholders. The *Restatement (Third) Property: Mortgages* (1997) appears to lend some credence to this position. Section 7.3(c) of the *Restatement* provides that:

If the mortgagor and the mortgagee reserve the right in a mortgage to modify the mortgage or the obligation it secures, the mortgage as modified retains priority even if the modification is materially prejudicial to the holders of junior interest in the real estate



Most title insurance companies offer several alternative endorsement forms for loan modifications.

tors' rights exclusion. The CLTA 110.5 Endorsement assures the lender that the modification agreement modifies the insured mortgage and does not result in priority of any junior lien over the insured mortgage, except as disclosed in the endorsement. The ALTA Form 11 Endorsement gives additional coverage beyond that of the CLTA 110.5 Endorsement in that it also insures the continuing validity and enforceability of the insured mortgage. Unless the title company agrees to remove the creditors' rights exclusion, however, the CLTA 110.5 Endorsement would be preferable, where available.

The *Restatement*, however, is not always an actual statement of current law. See *Restatement* § 7.3, Reporters' Note, recognizing that little judicial authority exists concerning the enforceability of terms in senior mortgages reserving the right to modify; that scholarly commentary is divided; and suggesting that the issue is best addressed by analogy to future advances made under the mortgage terms authorizing them. It is unlikely that a title insurer would be willing to rely solely on the fact that the original mortgage permitted future loan modifications, notwithstanding the degree of prejudice to a subordinate lienholder or impairment of its security. The junior lender will have a more difficult time arguing that the first lender lost priority because of a subsequent modification of the first mortgage if the first mortgage provides that the lender may modify the mortgage in the future and increase the amount of indebtedness secured in any manner it deems appropriate; or if the holders of the first and second mortgage liens have entered into a subordination or intercreditor agreement that provides that the senior lender may modify the mortgage at any time, including increasing the interest rate or amount of indebtedness or changing the maturity date. Some courts, however, still may question the enforceability of such an open-ended subordination agreement when the modification materially changes the junior lender's rights or ability to collect on its lien. Lenders should be especially careful not to prejudice a subordinated purchase-money mortgage because such lienholders are generally favored by the courts. See, e.g., *Gluskin*, 108 Cal. Rptr. at 322 (stating that "strong public policy reasons" exist to protect subordinated sellers).

The risk of defending against claims by other lienholders in such situations without obtaining their consent and subordination to the modifications may not be worth it to the title company, which is obligated to pay all defense costs as well as any loss. A subordinated purchase-money lender may be willing to consent to a modification to avoid a default under the senior loan. Mechanics' lien claimants, however,

often require that their liens be satisfied rather than subordinated to a modified mortgage. In such instances, the borrower or lender may be required to escrow additional funds to satisfy such liens concurrently with recording the modification agreement.

Preserving Guarantor Liability

The lender should make certain that all guarantors, indemnitors, endorsers, and the like execute the modification agreement or reaffirm their obligations at the time of execution of the modification agreement. Most state laws provide that a guarantor will be exonerated if the principal obligation is modified without the guarantor's consent. Ideally, the guaranty agreement should include a waiver of notice for modifications. Such a waiver, however, may be deemed ineffective. In California, a guaranty will also be unenforceable if a guarantor is already primarily liable for the repayment of the debt, such as when the borrower is a partnership and the guarantor is the general partner of such partnership. See, e.g., *Valinda Builders v. Bissner*, 40 Cal. Rptr. 735 (Ct. App. 1964); *Riddle v. Lushing*, 21 Cal. Rptr. 902 (Ct. App. 1962). This situation can arise inadvertently in the course of a loan modification if, for example, the borrower changes its entity status from a limited liability company to a partnership and the existing guarantor is a general partner of the new borrower. In such instances, the guarantor will be released from personal liability on the guaranty, notwithstanding its written consent to the modification. To flush out such issues in advance, lenders and their counsel should request an opinion letter from the borrower's counsel stating that each of the original loan documents, as modified, remains a binding and enforceable obligation of the parties thereto.

Bankruptcy Factors

If the lender requires additional security (such as additional property, a personal guarantee of the debt by the debtor or a third party) without advancing additional funds (or if the funds advanced are worth less than the additional security granted), the receipt of such

additional security may be deemed a preferential transfer under Bankruptcy Code § 547. If a bankruptcy proceeding is filed by or against the borrower within 90 days, the bankruptcy trustee could set aside the transfer of the additional collateral to the lender on this basis. See, e.g., *In re Spada*, 903 F.2d 971, 976 (3d Cir. 1990). A variety of other issues can arise in a bankruptcy, which are outside the scope of this article. Therefore, a lender



The lender should make certain that all guarantors, indemnitors, endorsers, and the like execute the modification agreement or reaffirm their obligations at the time of execution of the modification agreement.

should review carefully the borrower's financial statements before any modification to assure itself that bankruptcy is not imminent. In addition, the modification agreement should contain the borrower's representation and warranty that no bankruptcy or insolvency proceedings are pending or contemplated by the borrower.

Conclusion

Modification agreements can result in a "win-win" situation for both borrowers and lenders. Lenders, however, should take appropriate precautions to reduce inherent risks by following certain formalities, such as obtaining appropriate title insurance, recording the modification agreement, obtaining the written consent of all guarantors and junior lienholders, and receiving a clean opinion letter from borrower's counsel. ■

EXHIBIT A

ALTA Form 11—Modification of Mortgage'

ENDORSEMENT

Attached to Policy No. _____

Issued By _____

_____ Title Insurance Company

The Company insures against loss or damage sustained or incurred by the insured by reason of:

1. The invalidity or unenforceability of the lien of the insured mortgage upon the title at Date of Endorsement as a result of the agreement dated _____, recorded _____ ("Modification"); and
2. The lack of priority of the lien of the insured mortgage, at Date of Endorsement, over defects in, or liens or encumbrances on the title, except for those shown in the policy or any prior endorsement and except: [Specify exceptions, if any]

This endorsement does not insure against loss or damage, and the Company will not pay costs, attorneys' fees or expenses, by reason of any claim which arises out of the transaction creating the Modification, by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws, that is based on:

- a. the Modification being deemed a fraudulent conveyance or fraudulent transfer; or
- b. the subordination of the interest of the insured mortgagee as a result of the application of the doctrine of equitable subordination because of the Modification; or
- c. the Modification being deemed a preferential transfer except where the preferential transfer results from the failure:
 - i. to timely record the instrument of transfer; or
 - ii. of such recordation to impart notice to a purchaser for value or a judgment or lien creditor.

This endorsement is issued as part of the policy. Except as it expressly states, it does not (i) modify any of the terms and provisions of the policy, (ii) modify any prior endorsements, (iii) extend the Date of Policy or (iv) increase the Amount of Insurance. To the extent a provision of the policy or a previous endorsement is inconsistent with an express provision of this endorsement, this endorsement controls. Otherwise, this endorsement is subject to all of the terms and provisions of the policy and of any prior endorsements.

[Witness clause optional]

Date of Endorsement: _____

[Witness clause optional]

Date: _____

_____ Title Insurance Company

By: _____
Authorized Signatory

ALTA Form 11

*© 2006 American Land Title Association. Reprinted with permission.

EXHIBIT B

CLTA Form 110.5—Modification of Mortgage*

ENDORSEMENT

Attached to Policy No. _____

Issued By _____

_____ Title Insurance Company

The Company hereby insures the owner of the indebtedness secured by the insured mortgage against loss or damage which the insured shall sustain by reason of:

1. The failure of that certain agreement executed by _____ and recorded _____ to modify the insured mortgage or the obligation secured thereby;
2. The priority of any lien or encumbrance over the lien of the insured mortgage as modified by the above mentioned agreement, except for those matters shown in Schedule B as prior to the insured mortgage, and the following matters:

This endorsement is made a part of the policy and is subject to all of the terms and provisions thereof and of any prior endorsements thereto. Except to the extent expressly stated, it neither modifies any of the terms and provisions of the policy and any prior endorsements, nor does it extend the effective date of the policy and any prior endorsements, nor does it increase the face amount thereof.

Date: _____

_____ Title Insurance Company

By: _____

Authorized Signatory

CLTA Form 110.5 (Rev. 6-14-96)

ALTA—Lender

* Reprinted with the permission of the California Land Title Association.

EXHIBIT C

ENDORSEMENT

Attached to Policy No. _____

Issued By _____

_____ Title Insurance Company

This Company hereby insures the owner of the indebtedness secured by the mortgage referred to in Schedule A against loss or damage sustained by the Insured by reason of the extension of the maturity date of the obligation secured by the Mortgage from _____ to _____ and including _____ by agreement dated _____ impairing the lien of the insured mortgage on the land or its priority.

This endorsement is made a part of the Policy and is subject to all the terms and provisions thereof and of any prior endorsement thereto. Except to the extent expressly stated, it neither modifies any of the terms and provisions of the policy and prior endorsements, if any, nor does it extend the effective date of the Policy and prior endorsements or increase the face amount thereof.

Date: _____

_____ Title Insurance Company

By: _____

Authorized Signatory

First American Form 47 (Rev. 3/99). Reprinted with Permission.

Extension of Maturity Date

Reprinted with permission from Probate & Property
May/June 2009 (American Bar Association)
Copyright © 2009 American Bar Association