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Priority Issues with Mortgage Loan Modifications


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Borrowers and lenders may modify the terms of a loan for a variety of reasons, whether to provide additional funding for capital improvements or other cash needs, or to modify the interest rate or defer the maturity date when the borrower is in distress. Corporate loan facilities may be subject to frequent modifications to implement provisions in the credit agreement which contemplate additional fundings or other changes to loan terms. As a condition to modifying a loan secured by a mortgage, lenders often require assurances from counsel or a title company as to whether a corresponding mortgage modification (or junior lienholder consent) is needed to maintain the lender's lien priority on the real estate collateral.

Senior lienholders face a potential loss of priority in favor of two types of junior lienholders—those lienholders with liens at the time of the loan modification and those lienholders whose interests arise subsequent to the loan modification. With respect to existing junior lienholders, the senior lienholder may need to obtain consent to the modification to preserve its priority; with respect to future lienholders, the senior lienholder may need to provide notice by recording a mortgage modification.

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Obtaining Junior Lienholder's Consent

When a senior lienholder modifies its loan, an existing junior lienholder may be adversely affected by the loan modification. As protection for junior lienholders, courts have held that failure to obtain an existing junior lienholder's consent to a loan modification may cause the first lien mortgage to lose priority if the modification materially impairs or prejudices the existing junior lienholder.

When determining whether an existing junior lienholder has been or could be prejudiced, courts typically assess whether the modification makes it easier or more difficult for the borrower to pay the senior loan. If the senior loan modification increases the borrower's chances of satisfying the senior loan, then the existing junior lienholder is generally deemed not harmed and there is less risk of a loss of priority. If the modification imposes more onerous conditions on the borrower, the existing junior lienholder generally is deemed harmed because the senior lender is more likely to foreclose and extinguish the junior lender's mortgage or reduce its recovery. Assessing whether an existing junior lienholder is adversely affected does not necessarily yield easy answers, and courts will make the distinction based on a variety of factors.

In *Shultis v. Woodstock*, the borrower purchased a tract of land from the plaintiffs for a purchase price of $1million, which was paid in part by a $500,000 purchase money note, secured by a first lien mortgage, in favor of the plaintiffs at a 9 percent interest rate.[1] The borrower then granted a second lien mortgage to G&G Mortgage Investors (G&G) securing a junior loan of $300,000.

The borrower defaulted in making principal payments under the senior loan. To avoid foreclosure, the plaintiffs and borrower modified the senior loan to extend the maturity date and raise the interest rate to 16 percent. The borrower defaulted at the extended maturity date, and the plaintiffs commenced a foreclosure action. G&G sought dismissal, arguing that because the senior loan modification prejudiced its rights as junior lienholder, consent to the loan modification was necessary, and the failure to obtain its consent resulted in the senior lienholder forfeiting its priority to the junior lienholder.

The court denied G&G's request for a reversal of priorities with respect to the entire senior loan amount, but did grant G&G priority over the senior loan to the extent of the increase in the outstanding balance resulting from capitalized interest computed at a higher rate than before the amendment. While the increase in interest was relatively minor, the court found that there was sufficient equity cushion to protect G&G's interest, and any harm to G&G could be abated by granting G&G priority over the incremental interest from the loan modification. However, the court stated that a modification that more severely impaired the junior lienholder's interest could have resulted in a wholesale reversal of priorities.

Courts generally agree that extending the maturity date does not by itself require an existing junior lienholder's consent or notice to future lienholders. Extending the due date of the senior loan is generally deemed beneficial to junior lienholders by providing the borrower additional time to pay the senior loan and thereby reducing the default risk. Similarly, reductions in the interest rate or in the amount of the senior loan are not considered prejudicial to junior lienholders.

Administrative changes, such as changing the amounts held in lockboxes, are likewise generally not considered to require a mortgage modification.[2]. In contrast, any increase in the interest rate, principal amount or other charges payable under the senior lien generally will be subordinated to junior liens, if such increase is effective after the date such junior liens are placed of record.

In *In re White*, the borrower and the senior mortgagee entered into a loan modification that (i) extended the maturity date by one month, (ii) capitalized arrears owed on the note and deferred, interest free, $65,000 of the principal balance until a balloon payment at maturity, at which time the deferred principal amount plus all other amounts due under the note would be due and (iii) reduced the interest rate for the remaining term.[3] No new funds were advanced under the senior loan modification.

The junior mortgagee claimed that the deferral of principal to the maturity date (rather than providing for amortization during the term) made the loan more susceptible to default at maturity. In addition, the junior mortgagee argued that the deferred balloon payment would result in a higher amount due on the senior mortgage in the event of foreclosure, reducing the proceeds of the foreclosure available to satisfy the junior note.

The court held that the senior loan modification did not impair the junior mortgagee's position, but actually improved the borrower's ability to repay the junior loan. First the interest rate was substantially lowered, reducing the senior debt service. Second, given the borrower's default under the senior mortgage, the senior lender's determination not to foreclose allowed the borrower to make ongoing payments under the junior mortgage. Finally, the junior mortgage matured 14 years before the senior mortgage, when the balloon payment would become due.

The need for junior lienor consent at the time of modification can be eliminated — as it is in most corporate financings — by a subordination agreement between the senior and junior lienors at the time the junior lien is granted. The junior lienor will typically agree in the subordination agreement that its lien will remain junior to the senior lien notwithstanding the modification of the senior obligations, although the senior lienor may agree to certain exceptions (for example, the increase in the senior loan over a certain amount).

Providing Notice to Future Junior Lienholders

Shultis involved a dispute between two lienholders with existing liens at the time of the senior loan modification. The senior lienholder could have preserved its priority with respect to its entire loan amount by obtaining the existing junior lienholder's consent to the modification—or by having the junior lienholder agree that its lien would remain subordinate to the modified senior mortgage—pursuant to a subordination agreement or a separate instrument. Consent or subordination is not an option with respect to liens that arise after the date of the loan modification. The senior lienholder may be required to provide record notice to preserve its priority as to such subsequent liens.

As New York follows a "race/notice" statutory scheme, the failure to record an amendment may cause the first mortgage to lose priority (either as to the entirety of the outstanding balance or only that portion of the loan affected by the unrecorded mortgage amendment) to a subsequent lienholder without notice of the modification.[4]

In *Yuzary v. WCP* Wireless, the senior lienholder held a note and mortgage that appeared to have a maturity date in February 1992.[5] In 2006, a junior lienholder placed a mortgage on the same property, believing that the senior loan had reached its maturity in 1992 and therefore any foreclosure action would have been time-barred as of 1998. The senior lienholder claimed that the term of the mortgage was extended in a private letter agreement.

The court found this argument unavailing—the letter was never recorded and therefore was not effective against the junior lienholder.[6] Accordingly, because the senior lienholder failed to record a mortgage modification that was prejudicial to the subsequent lienor and the subsequent lienor had no notice of the modification, the junior lienholder had priority over the earlier lien.

Often (especially in corporate financings), a mortgage will purport to secure the loan as it may be modified after recordation of the mortgage. It is not clear whether this clause purporting to secure future modifications would be effective to prime an intervening lien in the event a subsequent modification is prejudicial to the intervening lienor, and there is little or no case law on point. The concept of inquiry notice may impute knowledge to an intervening lienor of any modifications that exist as of the date the intervening lien arises, but an intervening lienor would not be able to inquire as to the substance of a future amendment.

Moreover, the principles of the case law discussed above suggest that such expansive language securing future amendments may not inoculate the senior lienholder from a loss of priority if the modification is prejudicial to junior lienholders. Given the lack of a significant body of case law on this topic, a prudent lender would not rely solely on such protective language if the modification is prejudicial to junior lienholders and would be well advised to record a modification to the mortgage and to obtain consent of any then-existing intervening lienholder.

Note that many mortgages do not recite all of the economic terms of the underlying loan (such as the maturity date and interest rate). While the mortgage may not give actual notice of such economic terms, a junior lienholder is nevertheless deemed on notice of the terms of the underlying loan. The rationale behind this principle is that junior lienholders would not lend to the borrower based solely on the terms of the recorded documents. The junior lienholder would typically discover through its due diligence the material terms of the senior loan before deciding to advance its loan. Therefore, regardless of whether a particular term is expressly stated in the mortgage, the potential for a loss in priority exists if that term is modified.

Title Insurance Considerations

A title policy obtained by a lender only insures title as it exists on the effective date. The protection offered by the original title policy does not extend to subsequent loan modifications that may cause the subject mortgage to lose its priority with respect to intervening liens. Furthermore, if a claim is made by a junior or intervening lienholder based even in part on alleged prejudice from such a loan modification, title companies now generally refuse to defend the insured against such a claim on the basis that the loan modification is an "act of the insured" and therefore not covered by the title policy.[7]

Given the limitations of the original title policy, it is customary practice for lenders to request the protection of an updated title policy, typically at the borrower's expense, and the title insurer will typically insist on the recordation of a mortgage modification. However, in the event of simple extensions or other minor modifications, a lender may waive the requirement for an updated title policy or modification endorsement if it believes there is no risk of prejudice to junior lienholders and that therefore the cost of the updated title policy is not justified. As a less costly alternative to obtaining updated title insurance, lenders may order an updated title search to perform due diligence on any intervening liens, and may require the borrower to clear such intervening liens.

New York does not have a "modification endorsement" or "date-down endorsement." The state's equivalent is to obtain a "modification policy"—a new lender's policy with an effective date as of the recordation of the mortgage modification. This modification policy confirms that the loan modification agreement does not discharge the title insurer, insures the lender's lien as amended by the amendments to the loan documents, and updates the lender's title insurance. Assuming the amount insured by the title policy remains the same, the new premium would be 50 percent of the original premium. As New York is a filed rate state, the premium cannot be negotiated.

Because of the expense associated with title insurance in New York, the issue of whether a mortgage modification and corresponding title insurance are needed to maintain the senior lender's lien priority may warrant more discussion than in other states. In states where a mortgage modification endorsement or its equivalent is less costly (and often in New York as well, notwithstanding the higher cost of title insurance), the parties and their respective counsel may not devote much attention to the issue of whether the loan modification is prejudicial to junior lienholders, and instead may decide to bypass the issue by simply obtaining the relevant title insurance product. As a result, many practitioners do not need to confront the issue as the risk to their client is passed on to the title company.

Endnotes:

[1] *Shultis v. Woodstock Land Dev. Assocs.*, 188 A.D.2d 234, 234, 594 N.Y.S.2d 890, 891 (1993).

[2] Jeffrey B. Steiner and Zachary Samton, "Maintaining Lien Priority with Mortgage Modifications," N.Y.L.J., (Jan. 20, 2010)

[3] *In re White*, 514 B.R. 365, 367 (Bankr. E.D.N.Y. 2014)

[4] NY Real Prop 291.

[5] **Yuzary v. WCP Wireless Lease Subsidiary LLC**, 943 N.Y.S.2d 466, 2012 N.Y. Slip Op. 03285 (2012).

[6] Note that this case is an exception to the general rule that extending the senior loan's maturity date does not require giving notice to junior lienholders.

[7] Warren's Weed at §95.43(g).