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Loan servicers and lenders are under increasing pressure to modify loans that are in danger

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With increasing demand from borrowers and the public and the implementation of the Obama Administration's Home Affordable Modification Program, loan servicers and lenders are under increasing pressure to modify loans that are now in default or in danger of default. Whether or not such efforts will be effective in curbing the crisis in the housing market remains to be seen. Many in the industry remain skeptical. One thing we do know, however, is that many more loans than ever before will be modified. This leads to an issue that will certainly be more prevalent in the years to come; the lien priority of mortgages that have been modified.

One question that servicers should be keeping in the back of their minds as they complete loan workouts with distressed borrowers is this: Will the modification of this loan affect the priority of my lien and to what extent? The Restatement (Third) of Property establishes the basic common law rule that a senior lienholder may modify a loan agreement so long as it is not substantially prejudicial to junior lienholders. Restatement of Mortgages Section 7.3(a). Furthermore, "absent an increase in the principal amount or the interest rate of the mortgage, such modifications normally do not jeopardize the mortgagee's priority as against intervening interests...Extensions of maturity generally reduce the likelihood of foreclosure of the senior mortgage, and are thus beneficial, rather than prejudicial, to the interest of junior lienors.". Restatement of Mortgages Section 7.3 comment c. When there is a prejudice the remedy is to reverse priority only to the extent that the modification is in excess of the claim that existed under the original terms of the mortgage and note.

This question of whether or not a modification is "substantially prejudicial" is not always an easy one to answer and will certainly depend on the laws of your jurisdiction and the opinion of a trier of fact. The problem can best be illustrated by an example. Let's say that Lender 1 holds a thirty year first lien position mortgage on Blackacre with a remaining principal balance of $200,000 and a fixed rate of 7.00%. Lender 2 holds a second lien position mortgage on Blackacre in the amount of $20,000. Mortgagor falls into arrears and asks Lender 1 for a loan modification. Lender 1 capitalizes the present arrearage of $20,000, lowers the interest rate to 5.00%, and extends the life of the loan by ten years. As a result the principal balance on the first lien on Blackacre increases to $220,000 and the life of the loan is extended. Furthermore, although the modification has lowered Mortgagor's monthly payments it will increase the total payments that Mortgagor will have to pay in order to discharge the mortgage. Certainly, Lender 2 has not been prejudiced in the present because a foreclosure has been prevented. But what if Mortgagor defaults a second time and Lender 1 is forced to foreclose sometime in the future? For the sake of argument let's pretend the value of Blackacre is $240,000. If Lender 1 had foreclosed as a result of the first default then it would have been entitled to approximately $220,000 (principal balance plus arrears) and Lender 2 would have been entitled to the remaining $20,000. If, in the second default, Mortgagor again fell into arrears of

$20,000, then the total payoff for Lender 1 would be approximately $240,000. As a result of the foreclosure Lender 2 would receive little to nothing on its secured claim. One can certainly see the argument that Lender 2 has been substantially prejudiced. If Lender 1 had conducted a foreclosure as a result of the first default (which it was contractually and legally entitled to do) then Lender 2 would have received satisfaction or reasonably close to the satisfaction of its lien. Instead, Lender 1 modified the loan thereby increasing the debt obligation. When Lender 1 foreclosed due to the second default, Lender 2 received nothing.

Whether or not a judge would be persuaded by such an argument is a separate topic and this author tends to think that the answer is no. The point is that the argument is out there and it may be in the best interests of lenders to avoid litigation over this issue. Lenders and loan servicers should always consider junior lienholders and seek subordination agreements where appropriate. When negotiating a loan modification the better safe than sorry rule should always apply. No one wants to get into a battle over priority after incurring the expense and loss of a foreclosure.

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