

# New York Law Journal

## Real Estate Trends

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WEDNESDAY, JANUARY 20, 2010

### FINANCING

# Maintaining Lien Priority With Mortgage Modification



By  
**Jeffrey B.  
Steiner**



And  
**Zachary  
Samton**

In this difficult economic climate, many lenders and borrowers seeking to avoid foreclosure or other severe remedies have elected to negotiate amendments or modifications to existing mortgage loans. The method in which lenders choose to effect these amendments varies widely, often depending on the manner in which the original loan was documented. In the case of many commercial real estate loans, the key business terms are often contained in a stand-alone, unrecorded credit agreement that relies upon a largely boilerplate mortgage form to create its lien on the collateral property. As such, the modification of loan terms may not seem to require a recorded amendment, the consent of a junior lienholder or an endorsement to the existing title insurance policy, when, in fact, the material terms being amended were never in the public record in the first place. However, as we discuss in this article, the process of amending or modifying an existing mortgage loan may be more complex than anticipated and even technical details must be carefully considered to avoid unintended consequences.

When amending or modifying a mortgage loan, a lender must consider issues of enforceability against both the borrower and subordinate lenders. Whether an amendment or modification of a mortgage loan is recorded, or consented to by an existing junior lien holder, should not affect its enforceability against the borrower, but may have significant implications with respect to the priority of the liens encumbering the mortgaged property. In a period of declining real estate values, lien priority may have a considerable effect on a lender's ability to realize on its collateral.

As New York is a so-called "race/notice" state,<sup>1</sup> the failure of mortgagee to record an amendment or modification of an existing mortgage and the subsequent recording of a lien that is thought to be subordinate in priority may cause the first mortgage to lose its priority, either as to the entirety of the outstanding balance of the previously superior debt or as to only that portion of the loan affected by



the unrecorded, or subsequently recorded, mortgage amendment. Additionally, an amendment or modification of a first mortgage will not automatically prime an intervening lien if such intervening lien

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has been properly recorded. In the event a junior lien has encumbered the subject property between the recording of the first mortgage and the date of the desired amendment or modification, consent of the junior lienor may be required to maintain the lien priority of the first mortgage.

Not every mortgage loan modification is recorded or requires the consent of a junior lienor, however. It would be impractical to require a recordation or consent every time a borrower and senior lender agree on something outside the four corners of the existing loan documents. If, for example, a mortgage requires the borrower to remit payment of its monthly debt service to a specific account, the lender can change its payment instructions without recording an amendment or obtaining the consent

of the junior lien holders without jeopardizing the priority of its lien. The courts have held that an unrecorded mortgage amendment (in the instance of a subsequently recorded junior lien) or an amendment to a first mortgage without the consent of an existing junior lienor will only cause the first mortgage to lose priority if the modification materially impairs or prejudices the junior lienor.<sup>2</sup>

In *Shultis v. Woodstock Land Development Associates*,<sup>3</sup> the borrower and the first mortgage lender, without obtaining the consent of the subordinate mortgage holder, entered into a modification of the first mortgage loan extending the maturity date and increasing the interest rate. When the borrower was unable to repay the outstanding principal balance of the first mortgage loan by the extended maturity date the first mortgagee commenced a foreclosure action. The borrower did not oppose the first mortgagee's motion for summary judgment, but the subordinate mortgage holder sought dismissal, claiming that the failure to obtain its consent to the modification of the first mortgage prejudiced its position. The court, citing *Schwartz v. Smith*,<sup>4</sup> found that simply extending the maturity date of the first mortgage did not prejudice the junior mortgage holder, since such an extension is typically thought to benefit a subordinate lien holder. The logic supporting the court's holding is that by granting a borrower more time to pay off a superior loan, the junior lien holder has an increased chance of seeing its lien paid. Reductions in interest rate or in the amount of a senior loan are likewise not considered materially prejudicial to junior lienholders; similar to an extension of the maturity date of the senior debt, such modifications are considered benign at worst, and beneficial at best.<sup>5</sup>

The court in *Shultis* did, however, find that the subordinate mortgage holder was prejudiced by the increased interest rate contained in the first mortgage modification. As such, the court confirmed the lower court's holding that the subordinate mortgage was entitled to priority over an amount equal to the increased interest on the first mortgage, but not as to the entire outstanding balance of the first mortgage loan.

In *Shultis*, the court distinguished between a junior lien holder's two possible remedies following a modification of the senior mortgage without

JEFFREY B. STEINER is a member of and ZACHARY SAMTON is counsel to DLA Piper LLP (US). MARCUS WANG, an associate at the firm, assisted in the preparation of this article.

obtaining its prior consent. If the senior mortgagee enters into an agreement with the borrower without obtaining consent of the junior lienor, and such agreement substantially impairs the security interest of, or materially effects the equity securing, the junior instrument, courts have elevated junior lienors to superior positions and divested the first mortgagee of its first priority lien. On the other hand, where a junior lien holder is prejudiced by the senior mortgagee's agreement, but not to such an extent that its security, or a substantial portion of the equity secured thereby, is threatened, the senior mortgagor should lose its priority only with respect to the modified terms of the first mortgage.<sup>6</sup> The reasoning of the *Shultis* holding extends beyond the borders of New York and has been followed by courts across the country.<sup>7</sup>

Whether substantial impairment and/or material prejudice has in fact been inflicted upon the junior lienor is generally a question of fact to be determined by a trial court.<sup>8</sup> Upon a finding that, as a result of a modification of a senior mortgage, substantial impairment of the junior lienor's security interest has occurred or the equity securing such junior lien has been effectively destroyed, courts may "prime the senior lien by the junior lienor."<sup>9</sup>

Not all modifications, however, will result in the complete priming of the junior lien over the formerly senior mortgage. Courts have found in certain circumstances that material modifications to a mortgage substantially impairing a junior lienholder would result in penalties only to the extent of the modification. In *Shane v. Winter Hill Federal Savings and Loan Association*,<sup>10</sup> the terms of the senior mortgage permitted the lender to raise the interest rate by 1 percent, but ultimately, in a modification, the interest rate was raised instead by 1.25 percent, without the consent of the second mortgagee. The court found that the "subsequent increase in the interest rate [by 1.25 percent]...plainly exceed[ed] the increase permitted [which allowed an increase in the rate by 1 percent]," causing material prejudice to the second mortgagee. The court held, however, that in this case, the reasonable remedy was not to subordinate the entire first mortgage to the junior mortgage, but instead to subordinate only the extra 0.25 percent.<sup>11</sup>

As case law dictates that the loss of priority is a question of fact and today's economic environment often demands significant debt restructuring, a prudent lender must avoid the trap of hastily modifying a troubled mortgage loan without the proper due diligence or attention paid to the issue of priority. If, for example, without consent of a junior lien holder, the first mortgage is modified such that inter alia the casualty and condemnation provisions are re-written to require that any award received by the borrower be automatically applied to pay-down the outstanding principal balance of the loan or additional events of default are added (or the cure periods for certain defaults are shortened), a subordinate lienor would have a good argument that the first mortgage loan (or a portion of the debt thereof) should be subordinated to the existing junior lien. The application of a casualty or condemnation award to the payment of the first loan rather than to the repair of the collateral property, as was initially provided for in the first mortgage, would materially affect the equity securing the subordinate debt and therefore fall directly under the holding in *Shultis*. The junior

lienor would also have grounds to assert that adding additional events of default or shortening a cure period would prejudice its security by allowing the senior mortgagee to foreclose in a situation not contemplated when the junior lien was recorded.

Notwithstanding the fact that during the loan origination process, lenders and their counsel are typically focused on obtaining title insurance to guaranty the priority of their lien, the lender's initial diligence and original title insurance policy will not necessarily serve to protect against subsequent modifications that may cause the subject mortgage to lose its priority in respect of liens filed after the original first mortgage. Even a simple unrecorded or un-consented to modification of the terms of a mortgage loan may cause a loss of priority, which in the circumstance of a collateral property encumbered by significant junior liens (whether junior mortgages or mechanics' liens) could prove very costly to the lender in the long run. When negotiating the modification of an existing mortgage loan, lenders should carefully consider the effects of such agreement on the priority of its mortgage. Even if a lender decides to forgo additional title insurance on a loan modification, it would be best served to obtain a title continuation and, in the event any work had been performed at the subject property, the relevant lien waivers.

Attorneys and bankers looking to effect "quick and dirty" modifications that avoid excess transaction expenses will undoubtedly

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seek to avoid the time and expense of requiring counsel opinion letters that address corporate authority, enforceability and may otherwise expose the concerns we outline here. Even if opinions are dispensed with, prior to entering into the modification, lender's counsel should review the corporate resolutions that authorized the initial loan transaction. Some broadly drafted resolutions executed at the initial closing may have anticipated the need for subsequent modifications while others may bear the mark of a powerful minority investor that requires consultation prior to any loan modification.

Some unique enforceability concerns are raised by modifications of mortgages secured by properties located in New York state. Mortgage tax issues may be raised, for instance, when a modification

serves to capitalize interest that went unpaid during some period of default. The applicable tax would need to be paid before the supplementary mortgage lien for such capitalized interest could be enforced. In addition, New York's arcane lien law would necessitate modifications to the mortgage instruments as well as any related building loan contract and lien law affidavit. Given mechanics' unique right to have their liens relate back to that commencement of work, even a thorough title search offers little comfort. Lenders that modify construction loans (or any loan for property undergoing material renovation) must be sure to obtain lien waivers as a condition to any modification.

As the failure to maintain first lien priority may prevent a mortgagee from cleanly foreclosing on its collateral and recovering the full amount of the relevant debt, or conversely, to prevent another lienor from foreclosing out such mortgagee's interest in the subject property, attention to such issues is critical when modifying the terms of an existing first mortgage loan.

1. NY REAL PROP §291.

2. *Sackdorff v. JLM Group Ltd. Partnership*, 462 S.E.2d 64 (1995) ("...a senior lender 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").

3. *Shultis v. Woodstock Land Development Associates*, 594 N.Y.S.2d 890 (App. Div. 1993).

4. *Schwartz v. Smith*, 143 A.D. 297 (App. Div. 1911).

5. *Lennar Northeast 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 lien holders. However, when the obligation is increased, by an increase in the principal amount or an increase in the interest rate, the junior lien holder's position is worsened"); *Crutchfield v. Johnson & Latimer*, 243 Ala. 73, 75 (1942) ("The extension of time of payment of the installments...by an agreement between [the borrower] and [the lender] did not impair the security of appellees as subsequent encumbrancers"); *Eurovest Ltd. v. 13290 Biscayne Island Terrace Corp.*, 559 So.2d 1198, 1199 (1990) ("The granting of an extension of time does not result in a loss of priority merely on the ground of such extension"); *Friery v. Sutter Buttes Sav. Bank*, 61 Cal. App. 4th 869, 875 (3rd Dist. 1998) [modification of the mortgage was not considered material where only the maturity date of loan was affected while the principal amount and the interest rate of the note remained unchanged]; *Guleserian v. Fields*, 351 Mass. 238, 242-243 (1966) [postponement to maturity of monthly payments of principal did not affect or diminish priority of first mortgage and resulted in no loss of priority over junior mortgage]; *East Boston Sav. Bank v. Ogan*, 428 Mass. 327, 331 (1998) ("A second mortgagee accepts risks...[that] include...a renewal or an extension of time for payment on the original mortgage...actions like these cannot be considered prejudicial to the junior mortgagee and, in fact, do not require the approval of the junior mortgagee"); *State Life Ins. Co. v. Freeman*, 31 N.E.2d 375, 381 (1st Dist. 1941) ("The extension of time of payment of a mortgage in no way impairs the mortgage lien as against subsequent encumbrancers or as against any other parties subsequently dealing with the title").

6. *Fleet Bank v. County of Monroe Industrial Development Agency*, 124 A.D.2d 964 (App. Div. 1996).

7. *Lennar Northeast Partners v. Buice*, 57 Cal. Rptr. 2d. 435 (Ct. App. 1996); *In Re Lunan Family Restaurants*, 194 B.R. 429.

8. *Empire Trust Co. v. Park-Lexington Corp.*, 276 N.Y.S. 586 (1st Dep. 1934).

9. Melvyn Mitzner, "Lenders Consider the Problem of Mortgage Modifications: When Must a Consent or Subordination Be Obtained?," *New York Law Journal* Volume 210, Number 42, Aug. 30, 1993.

10. *Shane v. Winter Hill Federal Sav. and Loan Ass'n*, 492 N.E.2d 92 (1986).

11. *Id.*