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Mortgage Modification: Is Consent Of Juniors Required?

Can a servicer commence a modification without fear that inferior encumbrances can somehow claim to be superior?

by Bruce J. Bergman

This is not a purely scholarly excursion. Rather, with mortgage modifications both prior to and during the foreclosure process becoming evermore prevalent, lenders and servicers are increasingly wondering whether they need the consent of subordinate lien holders (particularly junior mortgagees) to pursue a modification.


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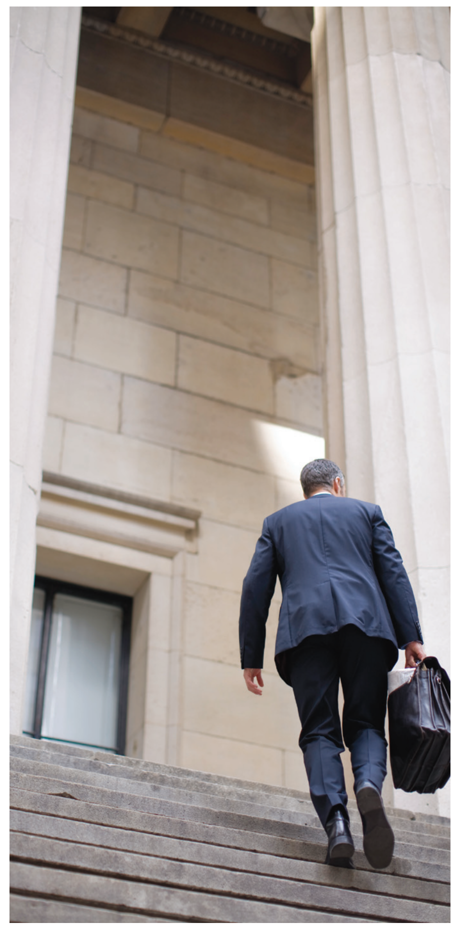
Many are concerned that a mortgage modification might somehow prejudice a junior party and lead to a reversal of priorities - that is, render the once-senior modified mortgage as inferior.

To translate this affirmatively into day-to-day events encountered by servicers, assume there is a mortgage default. Mortgage modification is the best (and maybe the only) path to pursue, short of prosecuting a foreclosure action to sale. For many reasons, most of which are obvious, the mortgage holder would prefer to endeavor rather than to modify. But, as is not so unusual, the borrower has obtained subsequent junior mortgages and has suffered liens and judgments that attach to the mortgaged premises. A mortgage modification will alter the nature of the debt (on that first mortgage) ahead of the later mortgage holders, lienors and judgment creditors. Thus, the question arises: Can a servicer pursue a modification without fear that these otherwise inferior encumbrances can somehow claim to be superior?

A recent case in bankruptcy court rather neatly sums up what can be confusing and obscure law and examines an enlightening example. The case reaches the succinct and understandable conclusion that there is no basis to subordinate a senior mortgage where the modification neither increased the principal amount nor the interest rate. [Sperry Associates Federal Credit Union v. U.S. Bank. NA, 514 B.R.365 (E.D.N.Y. 2014).]

What follows are the key principles presented in the case:



- A senior lender is free to enter into a modification agreement with a borrower without obtaining the consent of any junior lienors;
- But, if the modification prejudices the rights of a junior lien holder, or impairs its security, and has been made without that junior lien holder's consent, the senior lien holder can lose its priority, whereby the junior lien holder is elevated to a position of superiority;
- When the modification prejudices the junior lien holder but does not substantially impair the junior's security interest or destroy the equity, then the senior lien holder will be required to relinquish its priority as to the modified terms only;

• The main factors considered are whether the modification increased the interest rate and if it increased the principal;

• Extension of the time of payment does not, in and of itself, prejudice a junior lienor to require their consent; and

• Changing the interest rate on the loan and securing that with the lien of the mortgage is prejudicial to a junior lienor because the change increases the total amount of indebtedness placed prior to the subordinate lien.

In that particular case, the senior mortgage holder modified the loan pursuant to the Home Affordable Modification Act, and the agreement lowered the borrower's monthly payments due per the note. What follows is precisely what the modification did, as it relates to the actual world in which lenders and servicers function:

• Extended the maturity date of the note by one month;

• Capitalized arrears on the note;

• Deferred, without interest, any payment on account of a portion of the modified principal balance to the end of the term of the note;

• Allowed the deferred principal amount plus all other sums due under the note to be due and payable at the end of the term; and

• Reduced the interest rate for five years, with periodic increases over the balance of the term but never exceeding the original interest rate.

The argument from the junior mortgagee claiming prejudice (and demanding that it be declared superior) was that by deferring principal to the maturity date, instead of providing for the amount to be amortized during the term of the note, the obligation became more susceptible to defaults at maturity. In addition, it claimed that the modification adversely affected the junior mortgage prior to maturity. Had there been a default and a foreclosure sale, the deferred balloon payment and reduced monthly payments under the senior mortgage would have resulted in a higher amount due at the time of the foreclosure, thus reducing the proceeds of the foreclosure sale to satisfy the junior obligation.

The court disagreed with these claims of prejudice, finding that the interest rate of the senior mortgage was substantially lowered and observing that the deferred principal amount due at maturity did not bear interest. Accordingly, the total amount payable by the borrower on the senior mortgage was reduced by the modification. Although the maturity of that mortgage was extended for a month, the accrual of additional interest for that short period did not offset the savings resulting from the reductions in the interest rate over the long term of the mortgage.

Next, the junior's argument ignored that the borrower was in default under the senior mortgage at the time of the modification. So, rather than foreclosing that mortgage at the time, the borrower's payments were reduced, thus improving the borrower's ability to make payments due under the junior mortgage.

Finally, the argument that deferral of principal under the senior mortgage until maturity increased the chance that the borrower would be unable to pay the junior mortgage at maturity did not take into account the actuality that the junior mortgage matured many years before the senior. Thus, from the viewpoint of the borrower's ability to pay the junior mortgage during its term and at maturity, the deferral of principal improved the junior's position.

With these guidelines in mind, and knowing the principles of the law, lenders and servicers now have something akin to a road map to help them confidently proceed with modifications without the consent of junior lienors. Of course, if the nature of the modification is prejudicial to junior encumbrancers for some reason, then their consent would be required. SM

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