

## MORTGAGE MODIFICATION: VOLUNTARY AND INVOLUNTARY

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**' 3A: 1. Introduction [level 1]**

A staggering number of residential and commercial foreclosures may result from the credit crunch and devaluation of real estate that began in 2006 and 2007.<sup>3</sup> It is estimated that over two million subprime borrowers are in danger of losing their homes because of impending interest rate jumps as introductory rates expire and their mortgages become subject to adjustable rates. Borrowers, lenders, governmental agencies and the general public are acutely interested in and working to reduce the number of foreclosures and potential foreclosures.<sup>4</sup> As a result of the current troubled economic times and declining values of real estate, loan workouts have increased and mortgage modification agreements are becoming more common. But the parties should be cautious when entering into these agreements, in order to avoid any “traps for the unwary.”

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<sup>3</sup> For more detail on the mortgage crisis, see *infra* §§ 55A:1 through 55A:6 in Chapter 55A “Mortgage-Backed Securitization Litigation”.

<sup>4</sup> Louise Story, *Lawmakers Debate Pitfalls of Loan Modification*, 2008 WLNR 21651125, 11/13/08 N.Y. Times B3; Damian Paletta & Deborah Solomon, *Homeowners Wait as Relief Plan Drags*, 11/4/08 L.A. Times A3; E. Scott Reckard, *Mortgage plan may cut costs for 395,000 -Interest rates on some Countrywide subprime and 'option ARM' loans will temporarily go as low as 2.5%*, 2008 WLNR 20267305, 10/24/08 L.A. Times 1 ; Robin Sidel, *Massive Effort to Save Mortgages*, 11/1/08, WSJ 1(J.P. Morgan’s plans); Michael M. Phillips and Ruth Simon, *FDIC Plan Tests Limits of Leniency*, 11/1/08, WSJ 1 (FDIC plan with IndyMac mortgages); E. Scott Reckard, *Countrywide clients to get mortgage aid 125,000 Californians stand to benefit from a loan-abuse settlement. Borrowers nationally could save \$8.7 billion.*, 10/6/08 LATIMES 1 2008 WLNR 18977021.

At the heart of the problem are mortgage-backed securities (MBS),<sup>5</sup> and especially securities where the collateral is partially or wholly subprime residential mortgages.<sup>6</sup> However, this chapter is also applicable to the modification of mortgages on commercial real property through a “workout” or bankruptcy. This chapter will examine the various factors that mortgage lenders, borrowers and also other parties in mortgage-backed securities should consider when determining whether to modify an existing delinquent loan rather than exercise the legal rights and remedies provided in the loan documents. This chapter will encompass both voluntary or consensual modification of mortgages through workouts as well as involuntary modification of mortgages through bankruptcy such as through reorganization with or without cram down.<sup>7</sup>

Mortgage modification issues include the necessity (or lack of necessity) of obtaining a title datedown endorsement and title insurance,<sup>8</sup> the issues posed by the existence of subordinate lienholders in Part II. EFFECT OF MODIFICATION OF SENIOR MORTGAGE ON JUNIOR LIENHOLDERS (beginning with § 3A:2), and possible bankruptcy concerns in Part III. BANKRUPTCY ISSUES (beginning with § 3A:10 Lien stripping in Chapter 11. Section 7.3 of the Restatement of the Law (Third) – Property (Mortgages) (1997) (“RESTATEMENT”) deals specifically with the effect of mortgage modifications on intervening interests (keeping in mind that the RESTATEMENT is more aspirational than an actual statement of the current law).<sup>9</sup> The RESTATEMENT position on mortgage modifications is discussed later in this chapter.<sup>10</sup>

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<sup>5</sup> The process of securitization of mortgages is covered infra in Chapter 56 “Asset Securitization and Commercial Mortgage-Backed Securities”.

<sup>6</sup> Securitization of residential home mortgages is discussed in § 56:11.

<sup>7</sup> See §§ 3A:10 through 3A:18 in Part III. Bankruptcy Issues.

<sup>8</sup> See § 3A:32 Title insurance for mortgage modifications.

<sup>9</sup> See § 3A:5. Mortgage modifications that prejudice subordinate lienholders -The Restatement approach to modification of senior mortgage.

<sup>10</sup> See § 3A:5. Mortgage modifications that prejudice subordinate lienholders -The Restatement approach to modification of senior mortgage.

See Appendix 3AA MODIFICATION STRUCTURES AND GUIDELINES attached hereto for a summary of various modification structures and lender guidelines, and Appendix 3AB MODIFICATION AGREEMENTS (OUTLINE) attached hereto for an outline of business and legal items for lenders and other parties to consider in connection with mortgage modification agreements.

## **II. EFFECT OF MODIFICATION OF SENIOR MORTGAGE ON JUNIOR LIENHOLDERS**

### **' 3A: 2. Mortgage modifications that prejudice subordinate lienholders [level 1]**

In general, any modification that increases the interest rate 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 or encumbrance on the property.<sup>11</sup> Most cases (and commentators) agree that post-lien *additions* to the original principal of the senior loan or *increases* in the interest rate of the loan should lose their priority as to a junior lien if entered into without the consent of the junior lienholder, because they place an additional burden on the junior lienholder’s security.<sup>12</sup>

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<sup>11</sup> See generally *infra* Chapter 26 “Special Considerations for Junior Lenders and Lienholders” and particularly §§ 26:41 through 26:44 in Part IX. “PRIORITY AFTER MODIFICATION OR REPLACEMENT OF SENIOR MORTGAGE”; Grant S. Nelson, Dale A. Whitman, § 9.4 “Replacement and modification of senior mortgages- Effect on intervening lienors, Real Estate Finance Law (Practitioner Treatise 5<sup>th</sup> ed. 2007 & Westlaw database REALFNLAW); Corpus Juris Secundum, XIV. Lien and Priority G. Transactions Subsequent to Mortgage Affecting Priority, 59 C.J.S. Mortgages § 253 (includes state citations).

<sup>12</sup> See, e.g., *Shane v. Winter Hill Fed. Sav. & Loan Assoc.*, 397 Mass. 479, 485-87 (1986) (ruling that where 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 therefore unenforceable to the extent it exceeded the 1% increased agreed to, because the second mortgagee would have to pay more to cure any default); *East Boston Sav. Bank v. Ogan*, 428 Mass. 327, 331 (1998) (“we have recognized that a first mortgage holder may not unduly prejudice the junior mortgagee when modifying a first mortgage”); *Sackdorf v. JLM Group Ltd. Partnership*, 250 Va. 321, 332 (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

There is more of a “gray area” with respect to other modifications, such as an extension (or reduction) of the maturity date, deferral of interest, or a reduction in the interest rate or the amount of the loan. Some lenders use a rule of thumb that if the only modification is that the loan is extended for a period of six months or less, and a title datedown is obtained showing no intervening liens, they will not require a title endorsement for the modification (and may just use a letter agreement to effect the modification). An extension of time to repay a loan generally is presumed *beneficial* to junior lienors, not prejudicial, and modifications that merely alter 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.<sup>13</sup>

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consent”); *Gluskin v. Atlantic Savings & Loan Association*, 32 Cal. App. 3d 307, 322 (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”); *Shultis v. Woodstock Land Development Associates*, 594 N.Y.S.2d 890, 893 (N.Y.A.D. 3 Dept., 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”). See also 3 Powell, *Real Property* (1996) § 458, pp. 37-258--37-259 (“[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”).

<sup>13</sup> See, e.g., *Lennar N.E. Partners v. Buice*, 49 Cal. App. 4th 1585 (1996) (“An extension of a senior debt that merely alters the date of payments generally does not adversely affect the junior lienholders. However, when 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”); *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 (Fla. Dist. Ct. App. 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 (Cal. Ct. App. 1998) (ruling that modification of mortgage would not be deemed material because only maturity date of loan was affected; both principal amount and interest rate of note remained unchanged); *Gulesarian v. Fields*, 351 Mass. 238, 242-43 (1966) (holding that postponement to maturity of monthly payments of principal due next 24 months did not affect or diminish priority of first mortgage and would not result in any loss of priority over junior mortgage); *East Boston Sav. Bank v. Ogan*, *supra*, 428 Mass. at 331 (“A second mortgagee . . . accepts risks inherent in that security. These include, for instance, a renewal or an extension of time for payment on the original mortgage (citation omitted). Actions like these cannot be considered prejudicial to the junior mortgagee and, in fact, do not require the approval of the junior mortgagee”); *Shultis v. Woodstock Land Development Associates*, *supra*,

**' 3A: 3. Mortgage modifications that prejudice subordinate lienholders - Rights of subordinated lienholders [level 2]**

Courts often are especially solicitous of the rights of subordinated purchase-money mortgagees.<sup>14</sup> See, e.g., *Citizens & S. Nat'l Bank of S.C. v. Smith*, 277 S.C. 162 (1981), in which the South Carolina Supreme Court stated that priority under a subordination agreement is strictly limited by the express terms of the agreement. The court ruled that in this case, where the second mortgagee (to whose mortgage the purchase-money first mortgagee had agreed to be subordinated) extended the time for payment for one year without the subordinated first mortgagee's knowledge and consent, the second mortgagee lost its priority because the first mortgagee had agreed to be subordinated on the assumption that the second mortgage would be fully satisfied on the initial due date. The court reversed the priorities of the parties because of the prejudice to the subordinated purchase-money lender but acknowledged that its holding was limited to the particular facts of the case; i.e., the subordination of a purchase-money mortgage (of which, as noted above, many courts are very protective), and a written subordination agreement that stated the second mortgagee (to whose mortgage the purchase-money mortgagee subordinated its first lien) would not make any modifications to its loan without first obtaining the subordinating purchase-money mortgagee's consent. See also *Gluskin v. Atlantic Savings & Loan Association*, *supra*, 32 Cal. App. 3d at 314 (stating that "strong policy reasons" exist to protect seller in mortgage-subordination situations).

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594 N.Y.S. 2d at 893 ("The net effect of the . . . modification was to extend [the mortgagor's] time to make the final principal payment by a period of six months and to increase the interest payable thereon . . . [E]xtending the time of payment does not, in and of itself, work prejudice upon junior lienors so as to require their consent"); *State Life Ins. Co. v. Freeman*, 308 Ill. App. 127, 31 N.E.2d 375,381 (1st Dist. 1941) ("The extension of the time of payment of a mortgage in no way impairs the mortgage lien as against subsequent incumbrancers or as against any other parties subsequently dealing with the title).

<sup>14</sup> See *infra*, Change in Priority Through Subordination § 40:61. Generally; § 26:6. Reordered priority through subordination—Enforceability of subordination agreements—Subordination; Priority of Purchase Money Mortgages § 40:27. Generally; Chapter 64. California Practice IV. Deficiency Judgments § 64:118. Purchase money mortgages: CCP § 580b—Exceptions for nonstandard transactions—Subordination to construction or other loans; § 26:8. Reordered priority through subordination—Enforceability of consensual subordination agreements (junior mortgages).

In *MCB Ltd. v. McGowan*, 359 S.E. 2d 50 (N.C. App. 1987), the seller sold property to a developer and took back a purchase-money deed of trust, which provided that its lien would be subordinated to construction financing and permanent financing in such amount as the purchaser might "reasonably request." The seller-landowner subordinated its mortgage to interim financing but refused to subordinate to the permanent loan. The court held that the subordination language was too vague to be held enforceable, because it: 1) failed to state any maximum amount for subordination; 2) contained no formula to determine the maximum amount; and 3) failed to describe the terms of the permanent mortgage that would be acceptable. The court also refused to consider an estoppel argument by the purchaser-developer on appeal because it was not raised at the trial level. *See also Remodeling & Construction Corp. v. Melker*, 65 N.Y.S. 2d 738, 740-41 (N.Y. Sup. 1946) (suggesting that shortening maturity date by two years might result in prejudice to junior lender; court reversed priorities but modification agreement also increased interest rate and amortization of loan; court stated that "[i]f this modification of the first mortgage were not done for the sole purpose of wiping out the second mortgage, it is impossible to ascribe any reason for it").<sup>15</sup>

**' 3A: 4. Mortgage modifications that prejudice subordinate lienholders -Effect of well-drafted and comprehensive subordination agreements [level 2]**

Although the rights of subordinated purchase-money mortgage lenders generally are protected by the courts, subordinated purchase-money mortgagees will not necessarily be protected from the enforcement of well-drafted and comprehensive subordination agreements.<sup>16</sup> *See, e.g., Community Title v. Crow*, 728 S.W. 2d 652, 654-55 (Mo. App. E.D. 1987). In this case the purchase-money borrower obtained another mortgage from a savings and loan association

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<sup>15</sup> *See generally* Note, *Subordination Clauses: North Carolina Subordinates Substance to Form; MCB Ltd. V. McGowan*, 23 WAKE FOREST L. REV. 575 (1988).

<sup>16</sup> *See* Chapter 40. Priorities Among Lien Claimants XIV. Change in Priority Through Subordination § 40:61. Generally; Chapter 40. Priorities Among Lien Claimants III. Priority of Purchase Money Mortgages § 40:27. Generally; § 26:6. Reordered priority through subordination—Enforceability of subordination agreements—Subordination.

("S&L") to build a house. Although the purchase-money lender had agreed to subordinate its mortgage to the S&L mortgage for such a purpose, the S&L mortgage did not mention the prior purchase-money mortgage. But the court affirmed the priority of the S&L mortgage over the purchase-money mortgage, because the purchase-money lender had agreed to subordinate its mortgage and had communicated this agreement to the S&L). *See also Poyzer v. Amenia Seed and Grain Company*, 409 N.W. 2d 107, 110-111 (ND 1987) (court held that oral agreement of mortgage lender, which did not record its mortgage, to subordinate its mortgage to a subsequent mortgage, which subsequent mortgage was recorded, was enforceable based on doctrine of part performance; subsequent mortgagee had performed title search showing no prior mortgage of record and had advanced \$90,000 to borrower); *Southern Floridabanc Federal Savings v. Buscemi*, 529 So. 2d 303, 304-305 (Fla. App. 4<sup>th</sup> Dist. 1988) (court held that subordination provision in purchase-money mortgage was effective despite junior mortgagee's failure to obtain a specific confirmation from the purchase-money lender; court stated that foreclosure is an equitable action and equity will not allow a purchase-money lender to evade its obligations); *Pose v. Quali-Built, Inc.*, 88 Daily Journal D.A.R. 8608 (U.S. Ct. of Appeals 9th Cir., 1988) (court held that bank had no duty to advise plaintiff of the legal consequences of her unlimited subordination agreement, which would constitute the unauthorized practice of law by bank; bank would not have made the construction loan without holding the first lien on the entire development and plaintiff was aware of this).

In order to be enforceable, agreements to subordinate should be set forth with specificity and must not be waived by the parties' conduct or actions. *See, e.g., Life Savings and Loan Association of America v. Bryant*, 125 Ill. App. 3d 1012, 1017 (1984) (court held that failure of contract-for-deed vendor to satisfy conditions to which subordination provisions of contract were made subject to, restored purchaser's contract to its priority over subsequently executed mortgage by vendor because of mutual negation or waiver of subordination provision); *Jurado v. Simos*, 125 Ill.App.3d 1012, 1018 (1988) (subordination provision contained in purchase-money deed of trust contained provision that purchase-money lender would subordinate its position "in such amount as may be reasonably requested" by purchase-money borrower; court held that this requirement of future agreement in the material terms concerning application of the subordination provision rendered the clause void for indefiniteness as a matter of law).

To avoid problems, lenders (usually construction lenders) who wish their loans to secure priority ahead of existing purchase-money mortgages should obtain the written consent of the purchase-money mortgage lender to the Modification Agreement, or add language in the subordination agreement that the purchase-money mortgage holder is subordinated to the construction mortgage "and any extensions, renewals or modifications thereof." Construction lenders still should be careful not to prejudice the subordinated lienholder in a purchase-money mortgage situation, because purchase-money mortgage lienholders are generally favored by the courts. Consent is preferred, and the subordinated lienholder may willingly do so to avoid default under a construction mortgage. Construction lenders, as well as subordinating purchase-money lenders, should carefully review subordination agreements to make certain that all terms are clearly and comprehensively stated.

**' 3A: 5. Mortgage modifications that prejudice subordinate lienholders -The Restatement approach to modification of senior mortgage [level 2]**

The RESTATEMENT<sup>17</sup> provides, at § 7.3(c), that:

If the mortgagor and 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 interests in the real estate . . .

The RESTATEMENT further provides, at § 7.3 cmt. c., that:

A modification of a mortgage will ordinarily cause it to lose priority to junior interests to the extent that the modification is materially prejudicial to those interests . . . Even when material prejudice exists, however, no loss of priority will occur if the

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<sup>17</sup> Restatement of the Law (Third) – Property (Mortgages) (1997).

mortgage contains a clause reserving the right to modify, the modification is within the scope of the clause, and the clause's operation has not been terminated by notice from the mortgagor.

For a decision that appears to support the RESTATEMENT position, see *100 Eighth Ave. Corp. v. Morgenstern*, 150 N.Y.S. 471 (1957). In this case the purchase-money lienholder ("subordinated lender") subordinated its mortgage to another lender pursuant to a subordination clause in the purchase-money mortgage "provided in all such events (a) that the interest rate thereof shall not be greater than 4 ½ per annum and provided (b) the amortization shall be no different as presently is payable under the said mortgage." Subsequently, the lender whose loan was in first position as the result of the subordination ("first lender") modified its mortgage by reducing the quarterly interest payments and increasing the interest rate on the loan from 4 ½ percent to 5 percent; all other terms of the mortgage remained as before. As a result of these modifications (which were made without the consent of the subordinated lender), the subordinated lender accelerated its loan and commenced a foreclosure action, arguing that the modification agreement was not binding on it and that the subordinated loan was in default as the result of such modifications. But the court rejected this argument, stating that "[t]he consent of a second mortgage is not required in order to validate a modification of the terms of a first mortgage." *Id.* at 476. The court acknowledged that although the evidence indicated an impairment "of a sort," the proof offered failed to establish the extent of such impairment. *Id.* at 477. See also *Strong v. Stoneham*, 2 Mass. App. Ct. 828, 829 (Mass. Ct. of Appeals, 1974) (holding that priorities were not affected by an agreement to increase the interest rate entered into by mortgagor and first mortgagee; subordinate mortgages were recorded but court reasoned that this was not constructive notice to first mortgagee of their existence, and first mortgagee had no actual notice).

*But see Nature's Sunshine Products, Inc. v. Watson*, 174 P.3d 647 (Ut. App. Ct. 2007). This case held that an advance that otherwise would be beyond the scope of the dragnet clause in a senior mortgage (limiting advances to \$75,000), would not be permitted to prime a junior mortgage lien even if the senior mortgage contained broad

terms permitting modification of the senior lien (the mortgage was modified from a \$75,000 loan to a \$1,320,000 loan; an amount 16 times greater than the original loan). This case includes an analysis of a “dragnet clause”<sup>18</sup> and future modification rights, both of which occur in a single loan document. The dragnet clause in the mortgage stated as follows:

FOR THE PURPOSE OF SECURING (1) payment of all obligations now or hereafter arising pursuant to or otherwise related or connected to that certain "First Security Home Equity Line Agreement, Note, and Disclosure Statement" of even date herewith executed by the Trustor (the "Agreement"), which Agreement evidences a revolving credit line in the maximum principal sum of SEVENTY FIVE THOUSAND AND 00/100 Dollars (\$75,000.00) together with interest, costs, and expenses, as therein provided, payable to the order of Beneficiary at the times, and in the manner and with interest as therein set forth, together with any extensions, renewals, modifications, and future advances thereof or thereunder; (2) the performance of each agreement of Trustor herein contained; (3) the payment of all sums expended or advanced by Beneficiary under or pursuant to the terms of this Trust Deed and/or the Agreement, together with interest thereon as provided therein.

The modification clause, contained in paragraph 10 of the mortgage, provided in pertinent part as follows:

At any time, and from time to time upon written request of Beneficiary, ... Trustee may ... grant any extension or modifications of the terms of the Agreement[.]

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<sup>18</sup> See generally, 3 A.L.R.4th 690, Debts included in provision of mortgage purporting to cover all future and existing debts (Dragnet Clause)—modern status.

This case was somewhat of a “close call” (the court appearing to stretch to reach an “equitable” result) and would be very difficult to underwrite from a title-insurance standpoint; i.e., at what point does a modification of the amount due under the mortgage become so large (or, as the court says, “so extreme, so out of the ordinary and so unlike the other ministerial actions which Paragraph 10 [the mortgage modification clause of the mortgage] authorizes [the mortgagee to make]”) as to constitute a “new loan” and therefore not be subject to the modification provision? To what extent does a dragnet clause limit the scope of a right to modify contained elsewhere in the mortgage (this case involved a home equity line of credit)? The court’s reasoning in this case is a little shaky. For example, it argues that a pertinent consideration is that because the instant mortgage was (by assignments) “two places removed from the original mortgagee,” that fact should have a negative impact on the enforceability of the modification. Why? This should have no effect at all, since loans are assigned all the time (and the title insurance follows such assignments of a mortgage loan). The court acknowledged that a provision in the original recorded mortgage permitting modifications *does* permit a senior lender to modify its loan, *even if it significantly prejudices the junior lender* (this position is supported by the RESTATEMENT, as noted above). But the ruling in this case should be distinguished from cases where 1) the senior loan documents do not contain a provision that permits future extensions and modifications; 2) a subordination agreement, setting forth the respective rights and obligations of the first lender and the junior lender if a future extension or modification occurs, has been entered into; and 3) the mortgage does not contain a dragnet clause or a future-advances provision.

It is uncertain whether a title-insurance underwriter would be willing to rely solely on the fact that the original mortgage permitted future modifications and extensions, notwithstanding the degree of prejudice to the subordinate lienholder or impairment of the security. If the first mortgage provides that the lender may modify the mortgage in the future in any manner it deems appropriate, or if the first and second lender 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 changing the maturity date, the junior lender will have a more difficult time

challenging a subsequent modification of the first mortgage. But some courts 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. The expense and delay of defending claims of prejudice by a subordinate lienholder in such situations may not be worth it to the title company (which is obligated to pay all defense costs as well as any loss), or else may necessitate special risk premiums.

' 3A: 6. **Mortgage modifications that prejudice subordinate lienholders - Remedies where prejudice occurs to junior lienholder** [level 2]

Even where a court finds that there is "prejudice" to a junior lienholder as the result of a modification, the remedy generally is limited to only the extent of the prejudicial modification; e.g., if the interest rate on the first mortgage is increased by three percent, that is the extent of the modification that is prejudicial and the priority of the first mortgage will only be affected to that extent, and the priorities of the mortgages will not be reversed (although this may occur in some states with respect to purchase-money mortgages).

The feasibility of a "partial reversal" of lien priority was presented squarely to the court in the case of *Lennar N.E. Partners v. Buice, supra*, 49 Cal. App. 4th 1576 (1996). In *Lennar*, the trustor executed a promissory note in favor of Bank of America in 1983 for \$600,000 and gave a second note to an S&L for \$ 700,000, which became the junior lien. In 1988 both notes were renegotiated and the junior lienholders executed subordination agreements. In 1993 the senior note was renegotiated without the participation or consent of the junior lienholder. The interest rate was changed from a variable prime plus three percent (nine percent at that time) to a fixed 12 percent rate, the maturity date was extended one year, and the principal was increased, thereby diminishing the return on the property and adversely affecting the value of the junior lender's security. On summary adjudication, the trial court found that by substantially modifying the terms of the note, the senior lender forfeited the priority of its entire lien to the lien of the junior lender. *Id.* at 1584-1585. The California appellate court reversed and directed the trial court to enter a new judgment declaring that only the modifications to the senior loan lost priority. While agreeing with the trial court that the changes to the senior loan were material as a matter of law, the court held that equitable relief under the circumstances could be fully

accomplished by denying priority only to the modifications, thereby restoring to the junior lender the same position it enjoyed when it first agreed to subordinate. *See also Burney v. McLaughlin*, 63 S.W.3d 223, 231 (Mo. App. S.D., 2001) (“It is this Court's observation, on reviewing the case law in this area, that only in a rare number of cases . . . where the paramount mortgage has substantially impaired the security interest of the junior mortgage, are the priorities reversed”).<sup>19</sup>

**' 3A: 7. Modification: Retaining liability of parties [level 1]**

The lender should make certain all guarantors, endorsers, etc., execute the modification agreement or else reaffirm their obligation at time of execution of the modification agreement. It would also be prudent to see that a waiver notice (as to modifications) is inserted in the guaranty agreement, or provide in the guaranty agreement that the guarantors are directly and primarily liable along with the borrowers. At the very least, the lender should reserve all rights against the guarantor(s) in the modification Agreement; otherwise the guarantor(s) may be released from personal liability.

Where a party who has received a conveyance from the original mortgagor, and has assumed the debt, subsequently enters into a modification agreement without the consent of (or execution of the modification agreement) by the original mortgagor, the general rule is that (assuming the lender had knowledge of the loan assumption) the original mortgagor is released from the debt obligation, based on suretyship principles, at least to the extent that damage to the transferor would otherwise result. *See* RESTATEMENT § 5.3(d) cmt. d. (“While many cases give a total discharge, Restatement, Third, Suretyship and Guaranty § 41, which is followed here, recognizes a discharge only to the extent of the transferor’s actual damage”). The RESTATEMENT also provides, at § 5.3(d) cmt. e., that “[w]hether an extension of time to the transferee causes loss to the transferor depends on the facts.”

If the original mortgagor consents to or executes the modification agreement, the original mortgagor remains liable. It may be useful to insert a clause in the original loan documents that

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<sup>19</sup> *See generally* Patrick A. Randolph, Jr., *Mortgage Modification and Alteration of Priorities Between Junior and Senior Lienholders*, August 19, 2008, available at <http://dirt.umkc.edu/alterationofpriorities.htm>.

future modification agreements entered into with *any* party, including the original borrower or the transferee, will still result in the original mortgagor being liable, as well as all other parties who may be secondarily liable (such as guarantors).<sup>20</sup>

If a transferee from the original mortgagor takes subject to the mortgage, the minority rule releases the original mortgagor if the original mortgagor doesn't consent to the modification agreement executed by transferee. The majority rule is that since the new grantee never assumed liability, the original mortgagor is only released to extent of the value of the property at time of the extension or modification. This is because the original mortgagor is not a surety in this situation, as would be the case if the loan had been assumed.<sup>21</sup>

If the original mortgagor enters into a modification agreement after a conveyance of the property, the grantee still is bound, even though the grantee didn't consent. This is true whether or not grantee took subject to or assumed mortgage, unless entered into after statute of limitations has run.<sup>22</sup>

### ' 3A: 8.      **Future advance loans** [level 1]

At the outset it is important to recognize different types of mortgages to cover future advances. Although terminology differs depending on the locale, these fall roughly into three types, which are treated differently: (1) the "construction" or "improvement" loan, (2) the "open end" "credit line" or "home equity" loan, and (3) the "dragnet" clause. For comparison, two mortgages (or mortgage clauses) which do not cover future advances, but rather cover additional security, are discussed in § 40:30.<sup>23</sup> These are the "after acquired property" clause, and the "cross collateral" clause. Normally the issue with future advances clauses is whether the lender

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<sup>20</sup> See Kratovil and Werner, *Modern Mortgage Law and Practice*, Second Ed. (1981), Ch. 39.

<sup>21</sup> See Kratovil and Werner, *Extensions and Modifications*, 8 Creighton L. Rev. 1974-75.

<sup>22</sup> See Kratovil and Werner, *Modern Mortgage Law and Practice*, Second Ed. (1981), Ch. 39.

<sup>23</sup> Chapter 40. Priorities Among Lien Claimants VI. "Future Advances" Clauses § 40:30. In general.

has priority over third party junior mortgages, mechanics' liens, judgment liens or liens that may attach to the land before the lender advances the money under the original commitment.<sup>24</sup>

With respect to revolving or “credit line” loans, where the balance could reach zero and then increase, most states have statutes that protect the priority of such advances *if* the mortgage contains certain statutory “magic” language (such as “this is a revolving credit loan”) and states the maximum loan amount that can be outstanding. *See, e.g.*, Illinois, 205 ILCS 5/5d (Revolving Credit Loans Secured by Real Property):

Any mortgage or deed of trust given to secure a revolving credit loan may, and when so expressed therein shall, secure not only the existing indebtedness, but also such future advances, whether such advances are obligatory or to be made at the option of the lender, or otherwise . . . The total amount of indebtedness that may be so secured may increase or decrease from time to time, but the total unpaid balance so secured at any one time shall not exceed a maximum principal amount which must be specified in such mortgage or deed of trust.

For a case that deals with both future-advance and modification issues, *see Cottingham v. Citizens Bank*, 859 So.2d 414 (Ala. 2003). In this case, the court drew an important distinction between a general modification right and a “future advance” provision. In this case, the borrower executed a mortgage in 1988 containing a general right to modify or replace the mortgage in the future. In 1992 the balance secured by this mortgage was paid down to zero, but the mortgage was never cancelled of record. In 1998 the borrower executed a guarantee of certain debts related to the original purposes

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<sup>24</sup> See *infra* Chapter 40. Priorities Among Lien Claimants VI. “Future Advances” Clauses § 40:30. In general. Future advance considerations are also discussed *infra* in [§ 40:31 “Optional and Obligatory Advances.”](#) [§ 40:32 “Notice Required to Defeat a Lender’s Claim to Priority for an Optional Advance,”](#) [§ 40:33 “Special Problems of Construction Lenders”](#) and §§ [40:34 to 40:44 “Mechanics’ and Materialmen Liens.”](#) The jurisdictional treatment of future advances is covered *infra* in [Appendix 40C of Chapter 40](#). See also, *Restatement of the Law (Third) – Property (Mortgages) § 2.1 Future Advances (1997) (includes statutory citations)*.

of the loan and agreed that the 1988 mortgage, among other things, would secure that guarantee. Shortly thereafter, the loan went into default and the mortgagee foreclosed privately on the mortgage. In a suit for wrongful foreclosure, the borrower alleged that when the secured balance was paid down to zero in 1992, the underlying mortgage was cancelled automatically as a matter of common law, and that therefore it did not exist when the 1998 guarantee was executed; consequently, the reference to the mortgage in that guarantee was meaningless. The Alabama Supreme Court agreed and held that the mortgage, which contained a provision stating that it secured a certain note "and all renewals, extensions and modifications," could not be construed as a note securing future advances, and therefore when the loan balance was paid down to zero the mortgage was deemed cancelled. According to the court, "[t]he law in Alabama is clear that a mortgage for a specific debt cannot be used to secure any subsequent advances in the absence of an express provision securing future indebtedness" (internal quotations and citations omitted) and "[b]ecause of the 'absence of an express provision securing future indebtedness,' i.e., a future-advance clause, within the mortgage, even if the . . . notes were renewed, an issue we need not address, no new indebtedness could be added to the debt specifically secured by the mortgage."<sup>25</sup>

The point of this case is that a provision indicating that notes can be extended, modified and renewed does not mean that the notes are future-advance notes and that as a consequence the mortgage is cancelled when the balance on such "non-future-advance notes" reaches zero. Such a result would prevent the securing of future advances even when the mortgagor has agreed in a later note (after the mortgage has been cancelled as described) that the debt represented in that note constitutes an advance secured by the earlier mortgage. This is a trap for the unwary and an important lesson for the cautious. (The RESTATEMENT requires a specific agreement for future advances. RESTATEMENT at § 2.1.) The court's ruling in *Cottingham* is generally consistent with the common law that when a mortgage is fully paid it is deemed cancelled. Therefore, in order to avoid inadvertent cancellation of a debt where the parties really intend that the terms might

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<sup>25</sup> *Cottingham v. Citizens Bank*, 859 So.2d 414, 419 (Ala. 2003).

subsequently be amended to add to the principal, even after the original debt is repaid, the parties cannot rely upon a general right to modify the instruments but must include a specific future-advance clause.<sup>26</sup>

' 3A: 9. **Requirement of additional security for modification [level 1]**

If the lender requires additional security (such as additional property, a personal guarantee of the debt by the debtor or a third party, etc.) in connection with a mortgage modification without advancing additional funds (or if the funds advanced are worth less than the additional security granted), the receipt of such additional security by the lender (or a portion thereof) may be deemed a preferential transfer under § 547 of the Bankruptcy Code, if a bankruptcy proceeding is filed by or against the borrower within 90 days thereafter.<sup>27</sup> This would enable the bankruptcy trustee to set aside the transfer. Bankruptcy courts have ruled that there may be a partial preference if the value of the transferred property exceeds the new value given by the previously undersecured lender. *See, e.g., In re Spada*, 903 F.2d 971, 976 (3d Cir. 1990) (holding “that a *determination* [by the bankruptcy court] of how much ‘new value’ was involved in the exchange is mandated” by the statute [§ 547].” *Id.* at 976 (emphasis added); the court noted that such a determination is necessary because it must compare how much new value is given to the amount of the preferential transfer with the creditor); *In re F&S Cent. Mfg. Corp.* 53 Bankr. 842, 850 (“To the extent that a creditor can demonstrate that its agreement to modify the terms of the debtor's obligation gave the debtor money or money's worth in new credit, goods, services or property, there is no reason to avoid the transfer”) (emphasis added) (citing AM. JUR 2D Bankruptcy § 551 (1980)); *In re Jet Florida Systems, Inc.*, 861 F.2d 1555, 1558 (11th Cir.1988) (stating “that Congress was clear in requiring that a party seeking the shelter of section 547(c)(1) must prove the specific measure of the new value given to the debtor in the exchange”).

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<sup>26</sup> *See generally* RESTATEMENT § 2.1 (FUTURE ADVANCES) AND § 2.3 (PRIORITY OF FUTURE ADVANCES).

<sup>27</sup> For avoidance as a preference, see generally, §§ 34:51 to 34:76 *infra*.

### III. BANKRUPTCY ISSUES

#### ' 3A: 10. Lien stripping in Chapter 11 [level 1]

In the bankruptcy setting, the phrase “lien stripping” refers to the process of reducing a secured claim to reflect the value of the underlying collateral. For lien stripping in Chapter 11 bankruptcy in general, see *infra* Chapter 29, § 29:71 “Altering secured claims-In general” and § 29:72 “Lien stripping”.

#### ' 3A: 11. Lien stripping in Chapter 11- Claim secured only by a security interest in the debtor's principal residence: Section 1123(b)(5) [level 2]

Section 1123(b)(5) of the Bankruptcy Code conforms the treatment of residential mortgages in Chapter 11 to that in Chapter 13, preventing the modification of the rights of a holder of a claim secured only by a security interest in the debtor's principal residence.<sup>28</sup> Since it is intended to apply only to home mortgages, it applies only when the debtor is an individual. It does not apply to a commercial property, or to any transaction in which the creditor acquired a lien on property other than real property used as the debtor's residence. Section 1123(b)(5) therefore represents an explicit Congressional approval of “lien stripping” in Chapter 11 cases, subject only to the home-mortgage exception. “Lien stripping” in Chapter 11 cases is not universally accepted, with the argument against lien stripping based on Supreme Court precedent in *Dewsnup v. Timm*, 502 U.S. 410 (1992), a Chapter 7 case, which addressed the issue of whether a debtor may “strip down” a creditor's lien on real property to the value of the collateral, as

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<sup>28</sup> See *infra* § 29:72. Effect of confirmation—Effect of confirmation on liens—Altering secured claims—Lien stripping. For Chapter 13 bankruptcies, see §§ [30:117](#) to [30:131](#), “ ‘Strip down’ and other issues for home mortgages.”.

judicially determined, when that value is less than the amount of the claim secured by the lien.<sup>29</sup>

' 3A: 12.        **Lien stripping in Chapter 13 [Level 1]**

Chapter 13 debtors can, under 11 U.S.C.A. § 1322(b)(2), cram down (i.e., modify the rights of) holders of secured claims, *other than a claim secured only by a security interest in real property that is the debtor's principal residence*.<sup>30</sup> See, e.g., *In re Ives*, 289 B.R. 726, 729 (Bankr. D. Az. 2003) (ruling that provision in debtor's Chapter 13 proposed plan that would "strip down" creditor's secured claim to amount of equity in property was not binding on creditor, even though time for objection to plan had passed). But as noted above, § 1322(b)(2) prohibits modification of a mortgage "that is secured *only* by a security interest in real property that is the debtor's principal residence" (emphasis added); therefore, if the mortgagee takes additional security the mortgagee will lose the statutory prohibition against modification.<sup>31</sup> Also, if the mortgagee's lien is totally unsecured, a Chapter 13 debtor may strip off the lien. See *Zimmer v. PSB Lending Corp. (In re Zimmer)*, 313 F.3d 1220, 1227 (9th Cir., 2002) ("In order to give effect to the definitions of secured and unsecured claims under § 506(a), we must conclude that the rights of a creditor holding only an unsecured claim may be modified under § 1322(b)(2)"); *In re Millspaugh*, 302 B.R. 90 (Bankr. D. Idaho, 2003) (ruling that Chapter 13 debtors may "strip off" creditor's wholly unsecured lien, notwithstanding language of Bankruptcy Code's anti-modification provision that prohibits modifying rights of holders of security interests in debtors' principal residence, provided that no procedural infirmities exist).<sup>32</sup> Query: Because the stripped lien in a Chapter 13 case is not discharged until the

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<sup>29</sup> See *infra* § 29:72. Effect of confirmation—Effect of confirmation on liens—Altering secured claims—Lien stripping.

<sup>30</sup> See *infra* §§ 30:117 to 30:139, beginning with § 30:117 " 'Strip down' and other issues for home mortgages-Introduction".

<sup>31</sup> See §§ 30:119 to 30:127, beginning with § 30:119 "When is mortgage secured only by debtor's residence".

<sup>32</sup> See *infra* § 26:40. "Modifying junior home liens in Chapter 13 bankruptcy", which cites *In re McDonald*, the first court of appeals decision on whether a wholly unsecured junior mortgage on the debtor's residence is protected

end of the plan, if the value of the residence goes up between the commencement of the case and the 60<sup>th</sup> payment, could the mortgagee bring a proceeding before the court before discharge to reinstate the lien as the creditor is now an undersecured creditor as opposed to unsecured creditor?<sup>33</sup>

**' 3A: 13. Cram down issues in Chapter 11 [level 1]**

A cram down is the single biggest workout and bankruptcy threat to a lender in Chapter 11. However, the confirmation and other requirements that a debtor must satisfy in order to cram down both a secured and an unsecured claim, particularly in the case of a single-asset real estate bankruptcy, impose such burdens on a debtor that relatively few Chapter 11 debtors who propose cram down plans successfully achieve reorganization by cramming down the lender.<sup>34</sup> Although a mortgagee may be entitled to retain all of its rights under the mortgage, the mortgagee will not necessarily receive an obligation with level periodic payments. Also, the present-value requirement necessitates the use of an interest rate. This rate varies in each jurisdiction and can be either the contract rate or a market rate based on treasury-bill rates plus a court-determined upward adjustment for risk factors. The debtor's plan may also propose negative amortization of the lender's secured claim. Negative amortization occurs when part or all of the interest on the claim is deferred, allowed to accrue, and added to the principal periodically to be paid at a later date when the income from the property has increased or its value has appreciated. Bankruptcy courts have held that negative amortization is not per se impermissible, but courts will closely

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by the antimodification [section 1322\(b\)\(2\)](#). In re McDonald ( [In re McDonald, 205 F.3d 606 \(3d Cir. 2000\)](#), cert. denied, [531 U.S. 822, 121 S. Ct. 66, 148 L. Ed. 2d 31 \(2000\)](#)) held that a wholly unsecured claim is not protected from modification.

<sup>33</sup> Note also, [In re Cruz](#), 253 B.R. 638,(Bankr. D.N.J. Oct 13, 2000) in which Chapter 13 debtors who had obtained confirmation of plan that classified junior mortgagee's claim as secured, and that provided for its payment in full, could not retroactively apply Third Circuit (?) McDonald, [205 F.3d 606 \(3d Cir. 2000\)](#), decision providing for strip off of wholly unsecured junior mortgage liens to escape res judicata effect of their confirmed plan after time for appealing confirmation order had passed.

<sup>34</sup> See cases analyzed in Chapter 23 "Bankruptcy– Cram Down in Chapter 11".

scrutinize plans proposing this form of payment on a case-by-case basis.<sup>35</sup> A class of secured creditors can be crammed down if each secured creditor receives the indubitable equivalent of the claim.<sup>36</sup>

**' 3A: 14. Cram down issues in Chapter 11- Modification  
of non-monetary provisions of the loan documents [level 2]**

A bankrupt debtor (including an individual) may file a Chapter 11 bankruptcy plan that seeks, pursuant to § 1123(a)(5) of the Bankruptcy Code to modify or delete certain provisions of the mortgage documents.<sup>37</sup> Section 1123(a)(5) lists several means available to a debtor for plan implementation, including curing or waiving of any default, extension of the maturity date or a change in the interest rate. But § 1123(a)(5) does not provide for the modification of non-monetary terms of a secured creditor's loan documents, such as the due-on-sale clause. Because the deletion of such a non-monetary provision alters the legal, equitable and contractual rights to which the mortgagee is entitled under the mortgage, such deletion most likely renders the mortgagee's class impaired under the Bankruptcy Code<sup>38</sup> (assuming, as is customary in single-asset bankruptcy cases, that the mortgagee's claim is placed in a separate class by itself).<sup>39</sup> The primary consequence of such a determination is that the mortgagee will be entitled to vote on behalf of such class to accept or reject the plan.<sup>40</sup>

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<sup>35</sup> See infra § 29:73 “Cram down”.

<sup>36</sup> See infra § 29:73 “Cram down”.

<sup>37</sup> See infra § 29:73 “Cram down”. See also infra § 30:128. “ ‘Strip down’ and other issues for home mortgages—Curing home mortgages/mortgage secured only by debtor's residence—Debtor optional filing under Chapter 11 to circumvent Section 1322(b)(2)”.

<sup>38</sup> See infra § 29:56 “Unimpaired classes and their treatment”.

<sup>39</sup> See § 33:11 “Generally”, in Part IV. “SEPARATE CLASSIFICATION OF MORTGAGEE’S UNDERSECURED DEFICIENCY CLAIM”.

<sup>40</sup> See 11 U.S.C. §§ 1123(a)(2), (3), (b)(1), 1126(c) and, e.g., *In re Barrington Oaks General Partnership*, 15 B.R. 952 (Bankr. D. Utah 1981). Pursuant to the debtor's Chapter 11 bankruptcy plan in this case, the property was to be sold to a third party in violation of the due-on-sale clause. The bankruptcy court concluded that the mortgagee bank was impaired under § 1124 of the Bankruptcy Code, stating “The bank is impaired because the sale to [the third

Although the mortgagee's class may be impaired for purposes of cramdown under the Bankruptcy Code, some bankruptcy courts nonetheless have allowed the modification of non-monetary provisions of the loan documents, including the deletion of due-on-sale clauses. For example, in *In re Real Pro Financial Services, Inc.*, 120 B.R. 216, 219 (Bankr. M.D. Fla. 1990) the mortgagee filed a motion for relief from stay to foreclose on a Chapter 11 debtor's real property. The court found the secured creditor's argument that the bankruptcy court had no power to modify or alter a mortgage with a due-on-sale clause to be "wholly without merit."<sup>41</sup>

**' 3A: 15. Cram down issues in Chapter 11- Modification  
and section 1111(b)(2) election [level 2]**

Under section 1111(b)(2) of the Bankruptcy Code, an undercollateralized secured creditor is permitted to continue to be treated as a fully secured creditor under a plan that provides for the debtor's retention of the collateral.<sup>42</sup> The election is advantageous in those situations where a creditor does not wish to incur an immediate loss and has confidence in the success of the debtor's reorganization or believes that its collateral will increase in value with the passage of time. A creditor making the election should attempt to assure that the restructured note and loan documents contain a due-on-sale clause (and other crucial loan provisions, such as a prepayment-premium provision) providing for accelerated payment of the claim if the collateral is subsequently sold. The right to include a due-on-sale clause (or prepayment-premium provision) in the restructured agreement is enhanced if such a clause was contained in the original note and mortgage. Alternatively, the mortgagee can argue that a due-on-sale clause (or a prepayment-

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party], even without a due-on restriction, changes obligors and therefore alters rights under the instruments memorializing the loan." *Id.* at 956.

<sup>41</sup> See also *In re Coastal Equities, Inc.*, 33 B.R. 898, 905 (Bankr. S.D. Cal. 1983) ("a due-on-sale clause is not something so sacrosanct that it is immune from modification in a bankruptcy setting"). See also Jerald I. Ancel, Marlene Reich, and Gregory J. Seketa, *Are the Secured Creditor's Loan Documents Inviolable?* 13-AUG AM. BANKR. INST. J. 22 (1994).

<sup>42</sup> See Chapter 29. Bankruptcy—Reorganization Under Chapter 11, XV. Cram Down Plans, Variations, and Alternatives § 29:82. Section 1111(b)(2) election.

premium provision) is a customary provision in a mortgage and is intended to promote the liquidity of institutional lenders.

For a cautionary bankruptcy lesson on this modification issue, see *In re Carr Mill Mall Ltd. Partnership*, 201 B.R. 415 (Bankr. M.D.N.C. 1996). In this case of first impression, the bankruptcy court held that a yield-maintenance prepayment provision contained in a mortgage note was unenforceable *en toto* where the loan matured prior to bankruptcy but was extended as part of a confirmed Chapter 11 plan agreed to by the creditor, and no specific mention of the prepayment provision contained in the original loan documents was made in the plan or in the amended loan documents memorializing and implementing the plan. Under the terms of the plan, the maturity dates of the three debt obligations of the borrower were extended for a period of seven years after the effective date of the plan. All three of the notes had matured prior to the borrower's bankruptcy filing. The plan contained a provision stating that "[e]xcept as expressly modified by the terms and conditions of this Plan or any other order of the Bankruptcy Court, all terms and conditions of the [lender's] loan documents shall remain unaltered and in full force and effect." In order to implement the plan, the lender and the borrower entered into three modification agreements to memorialize the modifications made to the respective loans as the result of the confirmed plan. However, the modification agreements made no mention of the prepayment-premium provisions contained in the original notes, although the modification agreements each contained a provision stating that, except as expressly modified, "all other terms and conditions of the original loan documents remain unaltered and in full force and effect" Subsequently, the borrower located an entity willing to refinance the loans and requested payoff statements from the lender, which the lender provided. The payoff letters included a prepayment calculation for each note. The court found that the plan and the modification agreements were ambiguous as to the post-confirmation effect of the prepayment provisions in the notes, because although all unaltered terms of the loan documents were retained, the parties would be required, under the approved bankruptcy plan, to be returned to their post-maturity/pre-bankruptcy status, a period when the prepayment provisions could not possibly have been enforced. The court found, on the basis of its own factual determination, that the parties did not actually intend to require the borrower to pay a prepayment premium in the event that the loan was prepaid prior to the extended maturity date. The court reasoned that once the original maturity dates of the notes had passed, prepayment was no longer an option for the

borrower; therefore, the rights created by the original prepayment provisions had disappeared and the borrower could pay the debt obligations free of any prepayment premium. The court stated that the lender could have “revived” the prepayment-premium provisions by insisting that the plan specifically so provide, but had failed to do so. The court’s decision was also influenced by the fact that the prepayment-premium provision contained in the original notes could not be accurately calculated during the extended term, i.e., the provisions in the notes referenced a Treasury Note due on February 15, 1993, which Treasury Note had already matured prior to the plan confirmation and the execution of the modification agreements.

But the holding in the *Carr Mill Mall* case, *supra*, may be limited to its specific facts and to cases in bankruptcy proceedings. *See, e.g., Great Plains Real Estate Development, L.L.C. v. Union Central Life Insurance Co.*, 536 F.3d 939 (8<sup>th</sup> Cir. 2008). In this case the Eighth Circuit Court of Appeals upheld the ruling of the federal district court that a liquidated damages analysis did not apply to the prepayment premium provision because there was no breach of contract in the context of a voluntary prepayment; the lender's execution of a written loan modification and extension agreement with the borrower, modifying the interest rate, reducing the loan principal, and extending the maturity date for the promissory note secured by the mortgage did not waive the prepayment premium provision in the promissory note under Iowa law where the parties never specifically negotiated a waiver of the prepayment premium, which was not mentioned in the refinancing offer, counteroffer, or ultimate written executed modification and extension agreement that explicitly provided, “Except as expressly modified herein, all of the terms of the Note, the Mortgage and the other Loan Documents remain in full force and effect.”

In any event, the lesson of *Carr Mall Mills* case, *supra*, is clear for lenders: Take nothing for granted and specifically address the prepayment rights (and perhaps other specific non-monetary rights such as the right to enforce a due-on-sale clause) in any modification, supplemental or restated documents intended to acknowledge and implement the terms of the plan, and make certain that the maturity date or dates of any Treasury Note (or Notes) or other instruments utilized in the calculation of the prepayment premium are accurate and applicable with respect to any extension of the maturity date of the loan as authorized by the plan and set forth in the documents (including any modification agreement) memorializing the terms of the plan.

' 3A: 16. Strip down of tax liens [level 1]

On strip down of tax liens, see *In re Dever*,<sup>43</sup> 164 B.R. at 143:

The issue before this Court on cross-motions for summary judgment is whether consumer debtors can use Section 506 of the Bankruptcy Code to “strip down” tax liens on their house in a Chapter 11 case. The Internal Revenue Service (IRS) argues that the holding in *Dewsnup v. Timm*, 502 U.S. 410, 112 S. Ct. 773, 116 L.Ed.2d 903 (1992), should be extended to Chapter 11 cases to preclude “lien stripping” because *Dewsnup* held that Chapter 7 debtors cannot use Section 506 for that purpose. The Supreme Court, however, expressly reserved the question as to the applicability of its ruling to cases under the reorganization chapters. *Id.* 502 U.S. at ----, 112 S. Ct. at 778. No case at the circuit level has directly addressed the question in the Chapter 11 context since *Dewsnup*. The few lower court decisions on the subject have split. The issue of lien stripping in Chapter 11 is presented here in particularly stark terms, because the debtors converted their Chapter 7 case to Chapter 11 specifically to avoid the *Dewsnup* result. Thus, the question is whether they can accomplish in a converted Chapter 11 what the Supreme Court has prohibited in the original Chapter 7 case. For the reasons set forth below, this Court concludes that *Dewsnup*'s holding cannot be imported into Chapter 11 cases without eviscerating other key provisions and principles of that reorganization chapter. Being loath to undermine the Chapter 11 statutory framework without compelling cause, this Court holds that Section 506 permits Chapter 11 debtors to strip down liens on real property under a plan.

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<sup>43</sup> 164 B.R. 132 (Bankr. C.D. Cal. 1994).

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Modifying the rights and interests of secured creditors is at the heart of most reorganizations. Many Chapter 11 cases would be pointless and unreorganizable, if debtors could not reduce secured debt on property that had declined in value. This would particularly apply to single asset real estate cases, where the sole purpose of the case is usually to relieve the burden of a secured debt load that the property can no longer support. At least under current business conditions, very few Chapter 11 plans seek merely to stretch out or reduce payments to unsecured creditors. Most debtors are currently entering Chapter 11 with their assets fully encumbered, which means that their plans must restructure the secured debt in order to make a meaningful difference in their financial well-being.

On strip down of tax liens, *see also In re Johnson*, 386 B.R. 171, 173-179 (Bankr. W.D. Pa. 2008):

In the bankruptcy setting, the phrase “lien stripping” refers to the process of reducing a secured claim to reflect the value of the underlying collateral. Variants of this phrase are a “strip-down” wherein an undersecured creditor's lien is reduced to the equity value held by the Debtor in the collateral (after the amount of any superior lien is deducted from the fair market value of the collateral), and, a “strip-off” wherein a wholly-unsecured creditor's lien is removed from collateral in which there is no equity value.

In this case, the Debtor was originally seeking a combination of both forms of lien-stripping relief. He asked that the IRS tax lien be stripped off the Real Property because there is no equity in that

property, and, that the IRS tax lien be stripped down on the Personal Property to the level of available equity in that property, i.e., \$41,374.88. As indicated, the IRS has conceded that its secured claim is reduced to \$41,374.88 and therefore the latter request is no longer at issue.

The statutory basis for “stripping off” a lien arises from the combination of 11 U.S.C. §§ 506(a) and (d). First, by operation of Section 506(a) an undersecured creditor's allowed claim is bifurcated into secured and unsecured portions. Then, with certain exceptions not applicable here, pursuant to Section 506(d) the lien securing the claim is voided to the extent that it is not an allowed secured claim, effectively stripping the lien “off” to that extent. Although the lien stripping process seems straightforward based on the statutory language, there are two issues that must be considered in making the determination whether the Debtor should be granted relief. First, does *Dewsnup v. Timm*, 502 U.S. 410, 112 S. Ct. 773, 116 L.Ed.2d 903 (1992), preclude the Court from granting the requested relief in this Chapter 11 case? Second, if that hurdle is cleared, is there some reason why an IRS tax lien should be treated any differently than other liens?

The Court must first consider whether the decision in *Dewsnup*, the foremost Supreme Court decision on lien stripping, dictates the outcome in this case. In *Dewsnup* the Court held that a lien on real property could not be stripped-down in a Chapter 7 case. The *Dewsnup* Court construed the statutory language of Sections 506(a) and (d) in such a manner as to give effect to the pre-Bankruptcy Code rule in liquidation cases that liens pass through a bankruptcy unaffected. The Court did so because it was not convinced that Congress had intended to depart from that rule when it adopted the Bankruptcy Code. *See* 502 U.S. at 417, 112 S.

Ct. 773. Importantly, however, the *Dewsnup* Court was careful to limit the holding of the case to the situation squarely before it, *i.e.*, an attempt to strip a lien in a Chapter 7 liquidation case.

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As a result of this limiting language, it is clear that the *Dewsnup* Court left open the question as to whether the same result would be reached in different circumstances, for instance, in a case under a different chapter of the Bankruptcy Code. Based on this “opening,” courts and commentators have examined whether *Dewsnup* also establishes the rule on the availability of lien stripping in Chapter 11 and 13 cases. A great majority of the courts that have considered the issue in reorganization cases have concluded that the holding in *Dewsnup* should be limited to Chapter 7 cases and should not prevent lien stripping in reorganization cases.

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It is also instructive to consider the particular feature of liquidations that seemed to cause the Court in *Dewsnup* to have concerns about whether lien stripping should be permitted in Chapter 7 cases. The Court noted that the “practical effect” of finding that lien stripping was allowed in Chapter 7 would be that a creditor's interest would be frozen at the judicially determined property valuation, leaving the creditor to lose the benefit of any increase in the value of the property that might occur between then and the time of a foreclosure sale. Instead, the debtor would enjoy the benefit of any such increase -- a result some might view as a windfall. *See* 502 U.S. at 417, 112 S. Ct. 773. The *Dewsnup* case can thus be interpreted to stand for the proposition that there can be no lien stripping without payment of the debt secured by

the lien, and upon failure to so provide, allowing the creditor to purchase the property by credit bid and enjoy any appreciation in value. *See In re Dever*, 164 B.R. 132, 135 (Bankr. C.D. Cal. 1994). By contrast, in reorganization cases any lien stripping is coupled with payments under the plan and ownership of the property being vested in the debtor. This has led courts and commentators to note that creditors in reorganization cases thus receive something in exchange for the voiding of their liens, *i.e.*, payment obligations under a plan of reorganization, so that principle of *Dewsnup* is not violated. *See In re Bowen*, 174 B.R. 840, 855 (Bankr. S.D. Ga. 1994); Baxter Dunaway, *Law of Distressed Real Estate* § 29.72 (2007). To sum up, lien stripping is a fundamental aspect of reorganization proceedings. To bar lien stripping in cases under the reorganization chapters would: ... [I]n essence, gut the sum and substance of the reorganization and rehabilitation of debt concept under the Bankruptcy Code. In such cases, the Debtor would propose a plan for repayment of creditors to the extent of the value of the property securing the creditor's claim, but would still owe the unsecured portion of the claim, post-confirmation, in order to obtain a release of the lien on said property. This would require all plans filed under Chapters 11, 12 and 13 to pay all creditors one hundred percent of their claims in order for the debtor to emerge from bankruptcy with a true “fresh start.” Clearly, this has never been the purpose contemplated for Section 506(d). *In re Butler*, 139 B.R. 258, 259 (Bankr.E.D.Okl.1992). The Court therefore concludes that, in general, lien stripping is permitted in Chapter 11 cases, notwithstanding the decision in *Dewsnup*.”

' 3A: 17.      **Modification of junior home liens in Chapter 13** [level 1]

With respect to the modification of junior home liens in Chapter 13 bankruptcy, see Ch. 26, *Special Considerations for Junior Lenders and Lienholders* § 26:40 *Modifying junior home liens in Chapter 13 bankruptcy*. See also infra, Ch. 30, *Bankruptcy: Chapter 13 Adjustment of Debts by Individuals*, §§ 100-139; Adam Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, September 24, 2008 (available at <http://www.creditslips.org/creditslips/2008/09/mortgage-modifi.html>) (arguing that permitting modification of mortgages in bankruptcy presents the best solution to the foreclosure crisis and that empirical data suggest that permitting modification would have little or no impact on mortgage credit cost or availability); Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1575-76 (2008) (arguing that securitization conflicts with and undermines bankruptcy practice).

**' 3A: 18. Mortgagor waiving right to automatic stay [level 1]**

In an attempt to negate the effects of a subsequent borrower bankruptcy, many mortgage modification and forbearance agreements executed during loan-workout negotiations contain provisions whereby, among other things, the mortgagor agrees to waive the automatic stay under § 362 of the Bankruptcy Code, whether such bankruptcy proceeding is voluntary or involuntary. The purpose of the automatic stay is to stop all collection efforts against the debtor and its assets, including actions to realize the value of collateral securing an obligation of the debtor, and give the debtor “breathing room” to attempt to develop a repayment plan that will satisfy the debtor’s outstanding obligations.

Lenders typically seek to include such a provision in order to implement and effectuate the timely enforcement of state law remedies, such as receivership, foreclosure, or assignments of rents, irrespective of the bankruptcy. These provisions provide that the borrower will not object to or oppose the lender’s motion for relief from the automatic stay

in consideration of the lender's willingness to forbear from exercising its rights and remedies.

The Bankruptcy Code does not expressly prohibit *pre-petition* waivers of the automatic stay. Section 558 of the Bankruptcy Code, however, provides that waivers of defenses *subsequent* to the filing of the petition are not binding on the estate. Supporters of pre-petition waivers maintain that enforcement of such provisions is necessary in order to facilitate and effectuate pre-bankruptcy consensual workout arrangements. They also argue that such agreements are supported by new and valuable consideration in the form of forbearance in the exercise of the lender's legal rights and remedies, as well as other lender concessions and accommodations.

Opponents of these provisions, however, assert that they should not be enforced because they are contrary to the rehabilitative goals of Chapter 11, usurp the authority of bankruptcy judges, and are burdensome to the estate. They argue that enforcement of such provisions means that the debtor is usually unable to reorganize and must liquidate, thereby leaving little, if any, available assets for distribution to unsecured creditors of the bankruptcy estate.

Emerging case law generally holds that a pre-petition waiver of the automatic relief from stay may at least be considered as a circumstance in determining whether to grant relief from stay. For example, in *In re Shady Grove Tech Center Associates Ltd. Partnership*, 227 B.R. 422 (D. Md. 1998), the Maryland bankruptcy court held that a pre-bankruptcy waiver was enforceable because all of the following conditions had been satisfied: (1) the lender granted substantial concessions and incurred risks as part of the workout agreement and in exchange for the waiver; (2) there was material, significant, substantial consideration given by the lender for the waiver provision, in the context of a restructuring agreement

(including a reduced interest rate, an advance of new money, an extension of the maturity date of the loan, and capitalized interest payments); (3) the debtor and its counsel acknowledged that the waiver was voluntarily given after negotiations; (4) the rights of third parties were not materially affected by the waiver because there was no equity in the property and the case was essentially a two-party dispute between the debtor-borrower's equity holders and the lender; (5) there had been no substantial change in circumstances and the property was not and never would be necessary to any type of plan of reorganization, because there was no reasonable prospect of a successful reorganization within a reasonable time period, and; (6) the waiver was negotiated between financially sophisticated parties and experienced counsel. The court acknowledged that waivers of bankruptcy rights are "inherently suspect," and noted that the party seeking to enforce such an agreement "must demonstrate that under the specific facts of the case, the public policy encouraging workouts overcomes the policy in favor of affording the debtor the respite accorded by their automatic stay in bankruptcy." *Id.* at 425. But the court found that in this case the lender had met this burden of proof.

In *In re Frye*, 320 B.R. 786, 789 (Bankr. E.D. Vt. 2005), the bankruptcy court noted that no case in the Second Circuit had ruled on this issue, and thus the case was one of first impression in the District of Vermont. After reviewing the case law in other jurisdictions, the court found it significant that the pre-petition waiver was agreed upon in the context of a prior bankruptcy case and had not been inserted in the original loan documents; i.e., it was entered into after commencement of the debtor's first bankruptcy case and the debtor had received valuable consideration in the form of an extension of time to cure the loan defaults as well as a 19-month extension of the first redemption date. The court held that although pre-petition waivers of the automatic stay are enforceable in certain circumstances, they are neither *per se* enforceable nor self-executing, and that the following factors must be considered:

1. the sophistication of the party making the waiver;
2. the consideration for the waiver, including the creditor's risk and the length of time the waiver covers;
3. whether other parties are affected, including unsecured creditors and junior lienholders;
4. the feasibility of the debtor's plan;
5. whether there is evidence that the waiver was obtained by coercion, fraud or mutual mistake of material facts;
6. whether enforcing the agreement will further the legitimate public policy of encouraging out of court restructurings and settlements;
7. whether there appears to be a likelihood of reorganization;
8. the extent to which the creditor would be otherwise prejudiced if the waiver is not enforced;
9. the proximity in time between the date of the waiver and the date of the bankruptcy filing and whether there was a compelling change in circumstances during that time; and;
10. whether the debtor has equity in the property and the creditor is otherwise entitled to relief from stay under § 362(d) of the Code.

*Id.* at 791.

The court noted that it “agree[d] with the great weight of authority that has developed in this area of the law and will enforce pre-petition stay waivers even if the bankruptcy filing was not in bad faith and even if the debtor has some equity in the property which would typically negate the availability of relief under § 362(d), if other compelling factors are present.” *Id.* (citation omitted). The court further noted that the burden is on the party opposing the enforcement of an executed pre-petition waiver agreement to demonstrate that it should not be enforced. After applying the foregoing factors to the facts of the present case, the court reasoned

that the equities heavily favored enforcement of the pre-petition waiver agreement in the forbearance agreement, but stated that it would not make a final ruling in this case until additional evidence was presented on the following relevant factors: whether other creditors would be adversely affected; the feasibility of the debtor's plan; whether the debtor was capable of filing a reorganization plan with a reasonable likelihood of confirmation and consummation; and whether the debtor had equity in the property.

*See also In re Bryan Road, LLC*, 382 B.R. 844 (Bankr. S.D. Fla. 2008) (ruling that where debtor and lender entered into court-approved forbearance and extension agreement during foreclosure proceeding, which agreement provided for waiver from automatic stay if debtor filed subsequent bankruptcy proceeding, and debtor filed Chapter 11 bankruptcy petition on day before scheduled foreclosure sale, forbearance agreement with waiver-of-stay provision was enforceable and therefore cause existed for granting lender's motion for relief from automatic stay).

However, some courts have refused, for a variety of reasons, to enforce waivers of the automatic bankruptcy. *See* Judith Greenstone Miller and John C. Murray, "Waivers of Automatic Stay: Are They Enforceable" (and Does the New Bankruptcy Act Make a Difference?) 41 REAL PROP. PROB. & TR. J. 357, 370-72 (2006), which discusses the case law in this area, contains forms of waivers of the automatic bankruptcy stay, and suggests the following with respect to drafting strategies for lenders:

As evidenced by the various cases that have dealt with this issue, it is unclear whether, and under what conditions, bankruptcy courts may uphold relief-from-stay provisions in the future. Real estate lenders should certainly be judicious in their use of relief-from-stay provisions in loan workout documents, and may wish to restrict their use and attempted

enforcement to true workout situations where the following factors are present:

1. Consideration (in the form of forbearance, loan concessions or modifications by the lender, *etc.*) is clearly established;
2. Few, if any, other creditors (secured or unsecured) have or may assert significant claims against the borrowing entity (or such other creditors specifically consent in writing to the relief-from-stay provision or execute the document containing the relief-from-stay provision);
3. The borrower has been represented and advised by competent counsel;
4. The agreement clearly states the specific facts and circumstances that support a finding of cause for relief from the stay (i.e., the lack of need for, or appropriateness of, bankruptcy reorganization, as well as lender reliance thereon as evidenced by recitals that indicate that the borrower has no realistic chance for reorganization, has few or no employees, has few or no unsecured creditors, has no equity in the property, and has no assets other than the property); and
5. The lender can conclusively demonstrate that the outstanding loan balance exceeds the value of the property.

To sustain the enforceability of a waiver of the automatic bankruptcy stay, it is generally a good idea to set forth, in the workout or restructuring agreement, the factual circumstances surrounding the transaction at the time the documents are executed. Also, although it is possible that a pre-petition waiver of stay entered into by an individual debtor-borrower will be enforced under the proper circumstances, the vast majority of existing case law upholding such waivers involves business entities and deals primarily with single-asset real estate. Furthermore, when drafting a relief-from-stay provision, lenders would be well advised to specifically state that the enforcement of the provision is expressly subject to the approval of the bankruptcy court, in order to avoid the implication that the lender is attempting to oust the bankruptcy court of its jurisdiction and its authority to decide the enforceability of such a provision.

*See generally* Jeffrey W. Warren and Adam Lawton Alpert, In the bankruptcy setting, the phrase “lien stripping” refers to the process of reducing a secured claim to reflect the value of the underlying collateral. “The Enforceability of a Pre-Petition Waiver of the Automatic Stay”, 27-APR AM. BANKR. INST. J. 24 (2008) (discussing and analyzing the *In re Bryan Road* case, *supra*, as well as other recent cases in this area).

#### **IV. STATUTES REQUIRING WRITTEN AGREEMENTS TO LEND**

##### **' 3A: 19. Credit agreement statutes [level 1]**

In response to the surge in lender liability claims against lenders commencing in the mid-1980s (especially in connection with affirmative claims or defenses of borrowers based on breach of an alleged oral agreement to lend, to extend, modify or refinance an existing loan, or to forbear from exercising contractual remedies), many states have enacted laws specifically requiring a written agreement between the lender and borrower as a prerequisite for any legal action against the lender. See *infra* Chapter 7, Appendix 7B “Statutes Requiring Written Agreements to Lend or Continue Loan”.

These statutes typically apply to any “credit agreement,” which (for example) the Illinois Credit Agreement Act (“ICAA”) defines as “an agreement or commitment by a creditor to lend money or extend credit or delay or forbear repayment of money not primarily for personal, family or household purposes, and not in connection with the issuance of credit cards.” 815 ILCS 160/1(1). Section 2 of the ICAA states as follows:

A debtor may not maintain an action on or in any way related to a credit agreement unless the credit agreement is in writing, expresses an agreement or commitment to lend money or extend credit or delay or forbear repayment of money, sets forth the relevant terms and conditions, and is signed by the creditor and the debtor.

[815 ILCS 160/2.](#)

Some state credit agreement statutes go even further by including within their scope agreements covering any other financial accommodation, while other state statutes apply only to a loan of money or the loan of money and an extension of credit. Minnesota was the first state to enact such a statute, and at least 40 states now have such laws.

These statutes were intended to prevent misunderstandings between parties to credit agreements and to introduce certainty into what, at least in the past, was often an informal process. However, there is no “uniform” credit agreement statute, and the provisions of these laws vary from state to state. These statutes either expressly incorporate and include credit and loan agreements within the respective existing statutes of frauds of the state, or else they contain separate provisions requiring those agreements to be in writing.

Some credit agreement statutes provide further protection to the lender by expressly prohibiting the use by borrowers of alternative theories of recovery, including actions based on torts such as breach of fiduciary duty, fraud, and misrepresentation (which actions would normally constitute exceptions to statutes of fraud), if those other theories would require proof of the same facts necessary to prove the oral agreement. *See, e.g., Household Commercial Financial Services Inc. v. Suddarth*, 2002 WL 31017608, (N.D. Ill., 2002), at \*5 (“The ICAA bars all actions that are in any way related to an alleged credit agreement, whether those actions sound in contract or tort [citations omitted]. It also bars traditional exceptions to the statute of frauds, such as fraud, part performance, and equitable estoppel”); *McAloon v. Northwest Bancorp, Inc.*, 274 Ill. App. 3d 758, 763-764 (1995) (finding that ICAA barred plaintiff’s actions for breach of contract, common law fraud and misrepresentation; action was based on defendant’s breach of an oral agreement to lend funds and court held that the ICAA barred traditional exceptions to the Illinois Frauds Act). Thus, equitable defenses are unavailable to a borrower under the ICAA because, although such defenses constitute an exception to the statute of frauds, the Illinois legislature, by enacting an entirely separate credit agreement statute rather than amending the existing statute of frauds, intended for the credit

agreement statute to extend beyond the statute of frauds and the traditional defenses to that statute.

Other state statutes (and courts interpreting such statutes) are more solicitous of the borrower's interests, particularly for non-commercial transactions. For example, Nebraska's credit agreement statute, NEB. ST. § 45-1 *et seq.*, requires the lender to give express notice to the borrower of the existence of the statute, either by bold writing on the note or by a separate signed writing. *Id.*, § 45-1, 112 and 113. Arizona's credit agreement statute, A.R.S. § 44-101, only applies if the amount involved equals or exceeds \$250,000. *Id.*, at § 44-101(9). Delaware's credit agreement statute, DEL. CODE ANN. tit. 6, §2714 states as follows at subsection (b):

A contract, promise, undertaking or commitment to loan money or to grant or extend credit, or any modification thereof, in an amount greater than \$100,000, not primarily for personal, family, or household purposes, made by a person engaged in the business of lending or arranging for the lending of money or the extending of credit shall be invalid unless it or some note or memorandum thereof is in writing and subscribed by the party to be charged or by the party's agent. For purposes of this section, a contract, promise, undertaking or commitment to loan money secured solely by residential property consisting of 1 to 4 dwelling units shall be deemed to be for personal, family or household purposes.

In those states having statutes that do not expressly prohibit the borrower from raising traditional equitable defenses, courts interpreting those statutes have not been uniform in their decisions on whether defenses such as equitable estoppel, waiver, partial performance, or bad faith, which have traditionally constituted valid defenses to state statutes of frauds, are still available to borrowers. *See, e.g., Maynard v. Central National Bank*, 640 So. 2d 1212, 1213 (Fla. 5<sup>th</sup> DCA 1994) (“Section 687.0304 [of Florida’s credit-agreement statute] prevents a debtor from bringing a claim based on an oral credit

agreement but does not prevent a debtor from asserting affirmative defenses based on an oral credit agreement”).

## V. INCOME TAX EFFECT OF MODIFICATIONS

### ' 3A: 20. Tax effect of modification agreements [level 1]

Where the change (or changes) in the existing debt obligation (whether by modification, forbearance, disbursement of funds not provided for in the original debt instrument, etc.) is so substantial as to amount virtually to the issuance of a new security, the same income tax consequences will follow as if a new security were actually issued, i.e., the modified debt instrument will be treated as a new debt instrument given in consideration for the old, unmodified debt instrument. See *infra* Chapter 47A “Taxation and Tax Consequences of Real Estate Workouts.” Most modifications to existing debt other than de minimis changes constitute a sale or exchange of an “old” obligation for a “new” obligation and a deemed reduction of principal. Also, cancellation of debt (“COD”) generally results in taxable income – although special rules may apply to avoid or defer income in certain situations, e.g., no taxable income is currently recognized where COD occurs as part of a bankruptcy proceeding or where a debtor is insolvent.

The old debt instrument will be treated as “property” for purposes of sec. 1274 of the Internal Revenue Code (the “Code”), and under Treas. Reg. Sec. 1.1001-1(a), the gain or loss from the conversion of such property into cash, or from the exchange of such property for other property differing materially either in kind or in extent, will be treated as income or as loss sustained, depending on the taxpayer's adjusted basis in the debt instrument and the amount realized from the “disposition” of the property. See *infra* §§ 47A:20 to 47A:45 in Chapter 47A, Part C. HAS THE DEBT BEEN MODIFIED?– FINAL REGULATIONS UNDER SECTION 1001.

Even a debt modification that does not appear to reduce principal or the effective interest rate may nevertheless result in adverse tax consequences. It is unclear exactly what changes in a debt instrument would be so material as to amount virtually to the issuance of a new security under the Code, and each case will be decided on its facts.

Under Treas. Reg. Sec. 1.1001-1(a), a debt instrument has been modified so as to cause the aforementioned tax consequences if the terms of the new debt instrument differ "materially either in kind or in extent" from the terms of the old debt instrument. It appears that, in any event, a reduction in the interest rate of the original debt instrument, or any payment from the lender not provided for in the original debt instrument, would be deemed to be material modifications under the Code.

The Internal Revenue Service's interpretation of "material change" in the terms of a security affects an entire range of transactions. Thus, routine loan renegotiations and modifications may result in a deemed taxable exchange of the debt instrument.

Lenders and borrowers should certainly be aware of and address the aforementioned tax implications of negotiating modifications of real estate loans, especially when the borrower is requesting that the lender agree to waive or forbear from the collection of all or a portion of the existing interest payments.

Lenders must also be aware that if they foreclose but fail to notify the Internal Revenue Service, a federal tax lien may be raised to first priority. *See Title Guar. Co. of WY v. Internal Revenue Service*, 667 F.Supp. 767, 771 (D. Wyo. 1987) (court held that federal law is controlling, once a lien has attached, in determining priority of competing liens on the taxpayer's property; Government's federal tax lien was raised to first priority when mortgagee foreclosed on its mortgage but failed to notify Internal Revenue Service; notice of federal tax lien does not need to be refiled after filing of lien foreclosure suit in order to foreclose lien, because assessment lien remains attached to property). *Cf. U.S. v. State of Colo.* 872 F.2d 338, 341 (C.A.10 (Colo.) 1989) (failure to comply with federal notice provisions does not automatically elevate junior tax liens to priority status).

*See* the following excerpt from BNA TAX MANAGEMENT PORTFOLIOS (Real Estate Series) No. 592 § III G. 4 (2008):

The assumption rules under the 1986 proposed regulations . . . provided that a modification occurred only where the terms of the new debt instrument differed "materially either in kind or in extent," within the meaning of the 1986 Regs. § 1.1001-1(a), from

the terms of the old debt. Many commentators objected to this provision because the law was far from clear as to what the language quoted above actually meant.

The meaning of the Reg. § 1.1001-1(a) “materially either in kind or extent” language has substantial significance in determining the tax consequences of a number of transactions involving mortgage debt in addition to assumptions, because it can be interpreted to require a deemed exchange where, for any reason, the rights of the parties to a debt instrument are altered. This may occur, for example, where a mortgage is refinanced to take advantage of lower interest rates or where the terms of the note are changed in the course of a workout involving a financially troubled debtor.

The Supreme Court's 1991 holding in *Cottage Savings Assoc. v. Comr.*, 111 S.Ct. 1503 (1991), involved the exchange by a savings and loan company of a pool of mortgages held by it for another pool of mortgages that were held by another such entity. Due to an increase in market interest rates, the values of all the mortgages involved in the exchange had depreciated substantially. The purpose of the exchange was to permit each of the exchanging entities to claim a loss reflecting the depreciation in the values of their respective portfolios without altering, in economic substance, their loan portfolios. The mortgages in each of the pools were closely similar in terms of the type of property securing their loans, their terms to maturity, their interest rate, and the creditworthiness of their mortgagors.

The only real differences between the pools were that the mortgages in each pool were secured by different parcels of real property, and the mortgagors were different. The Court, interpreting Reg. § 1.1001-1(a), which provides that any gain or loss from the exchange of property for other property “differing

materially either in kind or in extent” is treated as income or loss sustained, held that the portfolio exchanges between the two entities came within this language. The court held that the losses claimed must, therefore, be allowed.

The IRS viewed this decision, while its holding related to an actual exchange of debt instruments, as permitting Regs. § 1.1001-1(a) to be applied to any modification of a debt instrument if the modified debt instrument is considered to differ materially, either in kind or in extent, from the unmodified debt instrument.

Consequently, Treasury published, in December 1992, Prop. Regs. § 1.1001-3 (the so-called “Cottage Savings regulations”), which set forth the factors to be considered in determining (i) what constitutes the modification of a debt instrument and (ii) if a modification has occurred, whether it is sufficiently significant (“a significant modification”) to support the conclusion that the modified debt instrument differs materially either in kind or in extent from the unmodified debt instrument (i.e., whether the modification should be deemed an exchange of the unmodified debt instrument for the modified debt instrument with the attendant tax consequences).

**Note :** Thus, there will be no tax consequences in the case of the typical refinancing of a residential mortgage, where the issue price of the modified (new) debt instrument is equal to the unpaid principal balance of the unmodified (old) debt instrument and the lower interest rate provided by the new debt instrument is at least equal to the AFR. This is so, even though the refinancing is a significant modification.

*See also* BNA TAX MANAGEMENT PORTFOLIOS (Real Estate Series) No. 592 § III K. (2008) (Cancellation of Indebtedness):

The Bankruptcy Tax Act of 1980, P.L. 96-589, codified a substantial portion of prior case law and IRS administrative positions with respect to income from cancellation of indebtedness and also provides certainty and predictability in areas where such attributes were lacking. Under the Act, all income arising from cancellation of indebtedness is taxed unless specifically excluded from § 108.

However, under the Mortgage Forgiveness Debt Relief Act of 2007, P.L. 110-142 (applicable to discharges of indebtedness on or after January 1, 2007), up to \$2 million (\$1 million for married individuals filing separately) of cancellation of indebtedness income is not taxed if the indebtedness is qualified principal residence indebtedness discharged (cancelled) in 2007, 2008, or 2009. § 108(a) (1) (E) (added by P.L. 110-142, § 2).

*See also* Albert J. Cardinali and David C. Miller, “Tax Aspects of Non-Corporate Single Asset Bankruptcies and Workouts”, 1 AM. BANKR. INST. L. REV. 87, 90-91 (1993) (noting that “for income tax purposes, a material change in the terms of a debt instrument (a “Modification”) is treated as an exchange of the debt instrument for a new obligation and can result in the realization of COD [cancellation of indebtedness] income,” and providing examples of the treatment of some changes – and noting that “generally, the mere extension of the maturity date will not constitute a Modification.

## **VI. Fannie Mae LOAN MODIFICATION PROGRAMS**

' 3A: 21.       **Fannie Mae loan modification programs [level 1]**

The securitization of mortgages was the triggering event causing the worldwide financial crisis beginning about 2006.<sup>44</sup> The securitization process is described infra in Chapter 56 “Asset Securitization and Commercial Mortgage-Backed Securities”. Relevant Fannie Mae publications regarding modifications of securitized mortgages are listed below in this section,<sup>45</sup> Fannie Mae information is available at [http://www.Fannie Mae.com/index.jhtml](http://www.FannieMae.com/index.jhtml). See the following:

1. Streamlined Modification Program: MBS Pools  
Frequently Asked Questions  
Streamlined Modification Program: MBS Pools  
Frequently Asked Questions  
[http://www.Fannie Mae.com / mbs / pdf / smpfq.pdf](http://www.FannieMae.com/mbs/pdf/smpfq.pdf)  
File Size: 28.5KB updated: 17 Dec 08
  
2. Media: News Releases > Fannie Mae To Suspend  
Foreclosures Until January 2009. November 20, 2008  
[http://www.Fannie Mae.com / newsreleases / 2008 / 4531.jhtml?p=Media & s=News+Releases](http://www.FannieMae.com/newsreleases/2008/4531.jhtml?p=Media&s=News+Releases)  
File Size: 49.5KB updated: 20 Nov 08
  
3. Media: News Releases > Fannie Mae Provides New  
Servicer Flexibility to Help December 8, 2008  
[http://www.Fannie Mae.com / newsreleases / 2008 / 4547.jhtml](http://www.FannieMae.com/newsreleases/2008/4547.jhtml) File Size: 49.1KB. updated: 08 Dec 08
  
4. 2009 Single-Family Master Trust  
Execution Copy Federal National Mortgage  
Association ( Fannie Mae) as Issuer, Master

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<sup>44</sup> See infra § 55A:1 Introduction.

<sup>45</sup> These also can be found by searching [www.Fannie Mae.com](http://www.FannieMae.com).

Servicer, Guarantor and Trustee 2009 Single-family Master Trust Agreement for Guaranteed mortgage Pass-through Certificates [http://www.FannieMae.com/mbs/pdf/singlefamilytrustagreement\\_January2009.pdf](http://www.FannieMae.com/mbs/pdf/singlefamilytrustagreement_January2009.pdf)  
File Size: 454.4KB , updated: 07 Dec 08

5. Amended and Restated 2007 Single-Family Master Trust Agreement  
Execution Copy Federal National Mortgage Association ( Fannie Mae) as Issuer, Master Servicer, Guarantor and Trustee Amended and Restated 2007 Single-family Master Trust Agreement for Guaranteed Mortgage Pass-through Certificates  
[http://www.FannieMae.com/mbs/pdf/singlefamilytrustagreement\\_amended2007.pdf](http://www.FannieMae.com/mbs/pdf/singlefamilytrustagreement_amended2007.pdf). File Size: 450.5KB updated: 07 Dec 08

6. HomePath: Resources: Questions and Answers  
Whether you're a prospective home buyer thinking this might be the time to purchase a home or a homeowner worried about foreclosure, Fannie Mae's HomePath has information that can help you.  
[http://www.FannieMae.com/homepath/resources/questions\\_answers.jhtml](http://www.FannieMae.com/homepath/resources/questions_answers.jhtml) File Size: 27.8KB, updated: 25 Aug 08

7. Media: News Releases > Fannie Mae to Increase Cash Incentives Paid to Servicers to Avoid Foreclosure. July 31, 2008.  
<http://www.FannieMae.com/newsreleases/2008/4439.jhtml?p=Media&s=News+Releases>, File Size: 47.5KB, updated: 31 Jul 08

The parties to a loan modification agreement, as well as title insurers, should be careful that, as a result of mortgage securitizations and the sale of many loans into the secondary market, the proper lender party is executing the modification agreement and that the “trail” of any assignments is set forth with specificity in the modification agreement. For example, Fannie Mae issued Announcement 06-18 (“Modification Announcement”), on October 4, 2006, with respect to documenting modifications of both adjustable-rate and fixed-rate conventional mortgages in a mortgage pool. According to the Modification Announcement:

In order to avoid foreclosures of delinquent mortgages, we [Fannie Mae] allow servicers to modify the terms of delinquent conventional mortgages with our prior approval and that of the mortgage insurer, if any.

## **VII. EMERGENCY ECONOMIC STABILIZATION ACT AND TROUBLED ASSET RELIEF PROGRAM (“TARP”)**

### **' 3A: 22. Emergency Economic Stabilization Act of 2008 (“Act”) and the Troubled Asset Relief Program (“TARP”) [level 1]**

On October 3, 2008, President Bush signed into law the Emergency Economic Stabilization Act of 2008 (“Act”). The Act includes the creation of the Troubled Asset Relief Program (“TARP”), which (i) authorizes the Secretary of the Treasury (“Secretary”) to establish a program to purchase up to \$700 billion of troubled assets from financial institutions, and (ii) requires the establishment of a program for the sale of insurance on troubled assets. The Treasury can purchase assets from any “financial institution,” as defined in § 3(5) of the Act. The definition is broad enough to cover virtually any entity holding qualifying assets and having significant operations in the United States. “Troubled Assets,” as defined in § 3(9) of the Act, are “any residential or commercial mortgages, and any securities that are based on or related to such mortgages, that in each case was originated or issued on or before March 14, 2008, the purchase of which the

Secretary determines promotes financial market stability." The Secretary can expand this definition, however, by certifying to Congress that he or she has determined that the purchase of "any other financial instrument . . . is necessary to promote financial market stability." (*Id.*)

The Chicago-based law firm of Jenner & Block, LLC, has stated the following in a Client Advisory entitled "Summary of the Emergency Economic Stabilization Act of 2008", received via email message by the lead author of this chapter and dated October 3, 2008:

### **The Troubled Asset Relief Program and Troubled Asset Insurance**

The Act authorizes the Secretary to establish the Troubled Asset Relief Program ("TARP") to purchase troubled assets from financial institutions. The mandate given to the Secretary is very broad and includes the authority to set guidelines for identifying troubled assets, to price and value troubled assets, to purchase troubled assets and to sell troubled assets. The total purchase authority under TARP is capped at \$700 billion and is available in installments. \$250 billion are immediately available under TARP for the purchase of troubled assets with an additional \$100 billion accessible upon the President's request. The balance of \$350 billion may become available after the President gives Congress a written report requesting the Secretary to have such access. However, Congress can block the final \$350 billion request through a joint resolution of disapproval. Additionally, the Act raises the statutory public debt ceiling from \$10 trillion to \$11.3 trillion.

Key factors in implementing TARP will be the identification of troubled assets and the purchase price paid for them. The Act gives the Secretary broad discretion in determining both what types of assets will be purchased and the price paid for such assets. If the

purchase price is set too low, banks may be unwilling to participate in the program. If the purchase price is set too high, the assets may eventually be sold at a loss to the taxpayers.

The Act also requires the Secretary to establish a program to insure troubled assets originated or issued prior to March 14, 2008. Financial institutions participating in the insurance portion of TARP will pay premiums for such insurance. The premium rates will be set by the Secretary, and must be at a level that will create reserves sufficient to cover anticipated claims. The premium payments will be placed in a fund to be used to pay claims on the TARP insurance. If the insured obligations exceed the amount in such fund, the purchase authority under TARP would be reduced by such excess. Therefore, the participation in and effectiveness of this insurance program will depend in large part on the amount of the insurance premiums.

With respect to securitized mortgage loans, one commentator has stated that:

The residential mortgage-related assets that the government is proposing to purchase in the bailout plans are for the most part not mortgages themselves. Rather, the assets are mortgage-backed securities (MBS). An MBS is a security issued by a trust (SPV) that has been specially created for a securitization transaction.

.....

By purchasing MBS, the government will not become the direct owner of the mortgages. Instead, it will simply hold securities of an entity that owns mortgages. This is

insufficient to give the government the ability to modify the mortgages.<sup>46</sup>

*See also* Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 263 (1987) (arguing that the Section 316(b) of the Trust Indenture Act, which prohibits a binding vote by bondholders to change any core term-principal amount, interest rate, or maturity date of a bond issue, inhibits a troubled company's ability to reorganize outside of bankruptcy); Mark Adelson, *ABS/MBS Investors Lose in Treasury Dept.-ASF Plan for Loan Modifications*, Dec. 10, 2007, available at: [www.adelsonandjacob.com/pubs/Loan\\_Modification\\_Problems.pdf](http://www.adelsonandjacob.com/pubs/Loan_Modification_Problems.pdf) (arguing against federal proposals that call for “fast-track” modifications of loans because the legislation would obligate servicers to modify certain loans without determining whether the modifications would be in the best interests of investors); Kenneth C. Kettering, *Securitization and its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1661-1664 (2008) (critiquing the legal foundations and vast growth of securitization, and the neglect of the courts to apply certain applicable provisions of fraudulent transfer law to securitizations, e.g., that the transfer of a securitized asset from the Originator to the SPE could be challenged as a fraudulent transfer).

## **VIII. MODIFICATION OF MORTGAGES ON OWNER-OCCUPIED RESIDENCES**

**' 3A: 23. Modification of mortgages on owner-occupied residences [level 1]**

**' 3A: 24. Modification of mortgages on owner-occupied residences- Workouts of residential mortgage backed securities to avoid foreclosures [level 2]**

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<sup>46</sup> Adam J. Levitin, *Purchasing Mortgage-Backed Securities Does Not Give the Government the Ability to Modify Mortgages Backing the Securities* (2008), p.1. [available from author Levitin at Georgetown Law Center]

A massive number of foreclosures of residential mortgages may result from the credit crunch and devaluation of real estate that began in 2006 and 2007.<sup>47</sup> It is estimated that over two million subprime borrowers are in danger of losing their homes because of impending interest rate jumps as introductory rates expire and their mortgages become subject to adjustable rates. At the center of the problem are residential subprime and Alt-A mortgages which have been pooled/secured into mortgage-backed securities (MBS).<sup>48</sup> Eighty percent of subprime and Alt-A loans have been securitized.<sup>49</sup> When the mortgages are on residential property the securities are referred to as residential mortgage-backed securities (RMBS), which are then transferred to investors. Due to the devaluation of the properties securing the mortgages, the downturn in the economy, the reduction of the mortgagor's income and the potential number of foreclosures, there has been intense pressure by the government and the parties involved to modify the RMBS mortgages to reflect the current value of the properties and to make the payments more affordable and thereby reduce the number of foreclosures.<sup>50</sup> Further, there are efforts to use taxpayer funds to accomplish this reduction in foreclosures.<sup>51</sup> In the preceding

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<sup>47</sup> For more detail on the mortgage crisis, see *infra* §§ 55A:1 through 55A:6 in Chapter 55A “Mortgage-Backed Securitization Litigation”.

<sup>48</sup> The process of securitization of mortgages is covered *infra* in Chapter 56 “Asset Securitization and Commercial Mortgage-Backed Securities”.

<sup>49</sup> Eric Stein, *Relieving Wall Street of Debt Does Not Translate into the Right to Stop Foreclosures*, Center For Responsible Lending (9/24/2008), <http://www.responsiblelending.org/pdfs/gov-ltd-power-to-modify-final.pdf>. Securitization of residential home mortgages in general is discussed in § 56:11.

<sup>50</sup> Testimony of Martin D. Eakes, Self-Help and Center for Responsible Lending

Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, *Oversight of the Emergency Economic Stabilization Act: Examining Financial Institution Use of Funding Under the Capital Purchase Program*, (Nov. 13, 2008), available at <http://www.responsiblelending.org/pdfs/martin-testimony-11-13-08-final.pdf>.

<sup>51</sup> *Id.*, Testimony of Martin D. Eakes, Self-Help and Center for Responsible Lending

sections of this chapter the focus was primarily on the legal and tactical implications of modification of mortgages. In this Part, the emphasis is on the contractual and other limitations on the government and other parties to workout by modification of the mortgages. We will consider the obstacles to modifications of securitized mortgages by workout through modification of the mortgages.

**' 3A: 25.      Modification of mortgages on owner-occupied residences to avoid foreclosures- Securitization and mortgage backed securities [level 2]**

The most significant obstacles to modification of mortgages exist for the mortgages that have been pooled into mortgage-backed securities (MBS) where the securities are owned by multiple investors. First, consider the nature of securitization. The objective of mortgage securitization or structured financing is to turn income-producing mortgages into a product that can be sold to Wall Street or other investors who wish a reliable source of steady payments, equivalent to bond payments. The original holder of the mortgages is the financial institution generating or pooling the mortgages.<sup>52</sup> This institution is known as the transferor or originator.

The mortgages are pooled and sold by the institution to an entity that is bankruptcy remote and structured so that it is unlikely to fail. This bankruptcy-remote entity is created for each securitization and is normally in the form of a trust, which is alternatively referred to as a special purpose entity (SPE), special purpose vehicle (SPV),

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Before the U.S. Senate Committee on Banking, Housing and Urban Affairs , Oversight of the Emergency Economic Stabilization Act: Examining Financial Institution Use of Funding Under the Capital Purchase Program, (Nov. 13, 2008), available at <http://www.responsiblelending.org/pdfs/martin-testimony-11-13-08-final.pdf>.

<sup>52</sup> For a description of the process and the participants, see *infra* Part II. Types of Assets Securitized § 56:16. Securitization of real estate interests other than home mortgages—Pooled transactions: Commercial mortgage-backed securities (CMBS)—Commercial mortgage-backed securities (CMBS) process—Detailed CMBS process and participants. See also, § 56:15 and Figure 3 in § 56:15.

or special purpose corporation (SPC). These are equivalent terms. In this chapter, the entity will be referred to as a SPE or SPE/SPV. Generally the SPE either directly or indirectly issues debt interests, which are transferred by the SPE trust to investors. These debt interests are securities, which are either publicly or privately placed. These securities have as collateral the mortgages which have been purchased by the SPE, therefore they are referred to as “mortgage-backed” securities (MBS).<sup>53</sup> These MBS securities are typically referred to as “certificates,” and most are debt securities that entitle the holder/investor to a series of regularly scheduled payments, similar to a corporate bond. The process is known as securitization.

There is only one SPE trustee for each securitization.<sup>54</sup> The trustee represents the trust that holds the legal title to the mortgages/collateral for the benefit of all class holders (tranches) of the certificates.<sup>55</sup> Funds and accounts should be designated for a specific transaction and should be held in trust, for the benefit of the investors in the securities. Funds should not be commingled.

**' 3A: 26. Modification of mortgages on owner-occupied residences to avoid foreclosures- Servicing and Pooling and Servicing Agreement (PSA) [level 2]**

In securitization, the trustee may have no employees or facilities and therefore must retain and pay a third party, the “servicer”, to administer the day-to-day operations of the transaction.<sup>56</sup> Master servicers agree to service the collateral, such as mortgage pools, in

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<sup>53</sup> The process is designed to separate the investors from the risk of failure of the transferor/originator.

<sup>54</sup> See *infra* § 56:57 “Trustee”.

<sup>55</sup> See [§ 56:84](#), “Subordination and Tranches.”

<sup>56</sup> See Hambly, “Master Servicer, Special Servicer, and the Trustee,” (Chapter 3 in Fabozzi, *Trends in Commercial Mortgage-Backed Securities* (McGraw Hill 1999)).

accordance with the negotiated pooling and servicing agreement. The “Pooling and Servicing Agreement” (PSA)<sup>57</sup> is a legal contract defining the responsibilities and the obligations of the master servicer and the special servicer for managing a securitization<sup>58</sup>. This agreement covers the relationship among the servicers, the trustee, underwriter, special servicer, sub-servicers, rating agencies, certificateholders, and the other parties to the transaction. It is typical to separate servicer functions and include provisions for a “special servicer” to handle workouts and foreclosures.<sup>59</sup> Generally, the originators of loans retain the right to service the loans after the loans are sold to the SPE. It is important to note that the master servicer retains all liability to the trust for the servicing activities. These servicing agreements can be hundreds of pages long. In the agreement reference is typically made to a defined “servicing standard,” which requires the servicer to administer the collateral in the same manner in which it administers comparable loans or collateral in the same manner in which it administers comparable collateral in its own portfolio or in portfolios placed with institutional investors.

When a loan becomes delinquent, the special servicer is responsible for returning it to performing status—via modification, restructure, or serious collection efforts—or else foreclosing the property and selling it. The special servicer must always consider the returns to the certificateholders when deciding which course of action to take. An analysis prior to any action determines the net amount the certificateholders would receive if the property were foreclosed. A similar analysis is performed when the loan is modified.<sup>60</sup> A special servicer is appointed at the onset of a transaction. There is only one

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<sup>57</sup> Sometimes abbreviated as PSA, not to be confused with the Public Securities Association, which is also known as PSA.

<sup>58</sup> § 56:58. Servicer/master servicer—In general.

<sup>59</sup> See § 56:63. Special servicer—Loan modifications and workouts.

<sup>60</sup> Hambly, “Master Servicer, Special Servicer, and the Trustee” (Chapter 3 in Fabozzi, *Trends in Commercial Mortgage-Backed Securities* (McGraw Hill 1999)).

special servicer in each securitization. It is not uncommon for the special servicer to hold some or all of the subordinated residual interest or tranches<sup>61</sup> and to enjoy special incentive compensation tied to successful completion of its responsibilities.<sup>62</sup> The special servicer is responsible for maximizing the returns (or, in some cases, minimizing the losses) to the certificate holders. A special servicer cannot give undue consideration to any class of certificateholders; all classes, or tranches, must be treated equally. If the special servicer holds a subordinated interest, there is a potential conflict of interest.<sup>63</sup> The special servicer may receive a predetermined amount of basis points per annum of specially serviced loans in addition to asset disposition fees. The documentation should provide whether parties other than the special servicer can foreclose on the collateral and should provide for a successor to the special servicer. For example, can the trustee also foreclose on collateral?<sup>64</sup>

**' 3A: 27. Modification of mortgages on owner-occupied residences to avoid foreclosures- Emergency Economic Stabilization Act residential mortgage modification provisions [level ]**

With respect to the provisions of the EESA Act that pertain to the modification of

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<sup>61</sup> See [§ 56:84](#), "Subordination and Tranches." One main reason is that the rating agencies gain more comfort that a special servicer will perform properly if it has an up-front investment that it must recoup during the transaction. This is a classic case of "putting your money where your mouth is."

<sup>62</sup> Seneker II, Documentation of Securitized Commercial Real Estate Mortgage Loans—The Basic Elements, SD16 ALI-ABA 195, 199 (1998).

<sup>63</sup> Duff and Phelps, Silverberg, [Structural Issues for Multiborrower Transactions](#), 432 PLI/Real 897, 903 (1998) (if the special servicer is also the first-loss buyer, objective standards for the workout/disposition of assets are necessary. For example, an offer to buy a nonperforming loan may be significantly below the loan balance, which would result in a loss to the lowest designated class of certificates. The special servicer may be the first-loss holder).

<sup>64</sup> [Bankers Trust \(Delaware\) v. 236 Beltway Inv.](#), 865 F. Supp. 1186, 26 U.C.C. Rep. Serv. 2d 776 (E.D. Va. 1994) (trustee could foreclose).

residential mortgages, the Minneapolis-based law firm of Faegre & Benson has stated the following in *Financial Markets Rescue Package Q&A: Asset Eligibility*, dated October 13, 2008, available at <http://www.faegre.com/showarticle.aspx?Show=8503>:

What are the provisions for altering homeowners' mortgages?

Q: When the government buys an asset, how does it impact residential homeowners and tenants? A: The purchase by the government does not affect the legal rights of either homeowners or mortgage holders under the mortgages acquired. (§ 119(b)(1).)

Q: What duties does the government have to mitigate foreclosures and to encourage servicers to modify loans? A: The Treasury Secretary must implement a plan to maximize assistance for homeowners and use his authority to encourage servicers to take advantage of the HOPE for Homeowners Program under section 257 of the National Housing Act or other available programs to minimize foreclosures. (§ 109(a).) The Secretary may also use loan guarantees and credit enhancement to facilitate loan modifications to prevent avoidable foreclosures. (*Id.*) The Secretary is required to consent to "reasonable requests for loss mitigation measures" where it has the authority to do so. (§ 109(c).) The Secretary is also required to coordinate with the Federal Reserve Board, the Federal Housing Finance Agency, the Secretary of HUD, and other federal government entities that hold troubled assets to "attempt to identify opportunities for the acquisition of classes of troubled assets that will improve the ability of the Secretary to improve the loan modification and restructuring process, and, where permissible, to permit bona fide tenants who are current on their rent to remain in their homes under the terms of the lease." (§ 109(b).) Other federal government property managers, i.e. the Federal Housing Finance Agency, the FDIC, and the Federal Reserve Board, are given similar obligations. (§ 110(b).) Q: How might the government mitigate foreclosures and encourage servicers to modify loans? A:

The EESA does not provide specific guidance on how the government may mitigate foreclosures or encourage servicers to modify loans that it acquires under the TARP. The sections which address the actions of "Federal housing managers"—i.e. the Federal Reserve Board, the Federal Housing Finance Agency, and the FDIC—require those entities to "encourage implementation by the loan servicers" of loan modifications if the "Federal housing manager" does not own the loan itself and to "assist in facilitating any such modifications." (§ 110(c).)

Q: What can the government do with servicing contracts?

A: The EESA does not contain specific provisions addressing servicing contracts. The EESA states that the Secretary "shall have authority to manage troubled assets purchased under this Act, including revenues and portfolio risks therefrom." (§ 106(b).) If the government purchases mortgages directly, it may be able to force changes to the servicer contracts. If the government purchases interests in securitizations, the contractual documents that govern those securitizations and the servicing of the underlying mortgages will control. In any event, the EESA does not specify what the management of servicing contracts may entail.

Note: on November 12, 2008, the Secretary of the Treasury secretary admitted the U.S. Treasury has no plans to begin buying troubled assets, "gutting the program's purpose completely." See John Kemp, *TARP and Fed Facilities Unravel*, Reuters, November 13, 2008 (available at <http://blogs.reuters.com/great-debate/2008/11/13/tarp-and-fed-facilities-unravel/>).

Recently, institutional investors in securitized mortgages have vastly increased their rate of loan modifications. See Paul Jackson, *Ocwen Steps Up Loan Mods, Confounds MBS Investors*, HousingWire, June 20, 2008 (available at <http://www.housingwire.com/2008/06/20/ocwen-steps-up-loan-mods-confounds-mbs-investors/>):

It looks like the rubber is finally beginning to meet the road when it comes to massive loan modification activity and its effect on RMBS and derivative investors. Case in point: Ocwen Financial Corp., a large subprime servicer, has left MBS investors both angry and nervous after several deals serviced by the company experienced significant interest shortfalls on senior ABS securities in the month of May.

An interest shortfall occurs when bondholders do not receive the full interest they are due for reasons that include delinquencies, defaults and prepayments. In this case, driving the shortfalls were both a dramatic increase in loan modification activity at the West Palm Beach, Florida-based servicer, as well as the judgment of the trustee involved in accounting for the surge in modifications.

By “dramatic increase,” we’re talking about monthly loan modification activity that rose more than six fold between the end of last year and April of this year — in fact, Ocwen modified nearly 900 loans in April, after modifying less than 200 in January and well below 25 loans in December 2007, according to a review of available data by Housing Wire. The company has modified more loans in the first four months of this year than it modified during all of 2007; in fact, Ocwen modified more loans *in April alone* than it modified during all of last year.

Analysts at Credit Suisse this week noted the interest shortfall in a research report, and said that Ocwen had significantly stepped up both interest reductions as well as principal reductions in modifying troubled loans. The company also reduced its so-called required trial mod period to three months from a prior six month

trial, as part of a strategy to reduce its advance cost, Credit Suisse said.

“Ocwen had materially increased its modification program activity and many modifications involved principal reductions in addition to interest rate reduction and/or forgiveness of other payment and cost amounts,” said Diane Pendley, a managing director at Fitch Ratings.

#### *Trustees “blindfolded”*

At least part of the shock investors felt this month on Ocwen-serviced deals was because the trustee, Wells Fargo & Co., was forced to determine how to account for the flood of modifications. Fitch Ratings, in a press statement Friday, noted that Wells didn’t have sufficient information to determine the proper allocation of funds and/or losses, due to limitations in the reporting format used to obtain data from servicers.

In plain English, HW’s sources said this means that Wells didn’t really know what was principal reduction, what was interest forgiveness, and what funds (or lack thereof) needed to be allocated where. So it had to guess, and allocated losses to interest rather than principal — the result is that senior bondholders took a hit rather than junior holders. That sort of has a way of ticking off senior bondholders rather inordinately.

Trustee confusion over loan modification activity underscores the pains the securitization market is undergoing as it develops policies and procedures for handling a flood of bad loans; it also underscores how a lack of data standardization across servicers in reporting loan data can lead to problems upstream. The OCC’s

John Dugan underscored the severity of this problem in remarks earlier this month, noting that wide variations in reporting standards across servicers made it difficult for the agency to get a read on actual loss mitigation efforts.

April [2008] was the first month in which a sizable number of mods were reported through to the trustee for the May distribution, Fitch's Pendley noted.

Fitch also noted that Wells "had recently developed an enhanced reporting format, based on the trustee's participation on an industry task force on the issue." For its part, Wells Fargo said it has since circulated the new format among servicers; the new format is designed to give it enough information to determine the proper allocation of funds and/or losses.

*See also* Paul Jackson, *BofA Rolls Out \$8.4 Billion Loan Mod Program*, HousingWire, October 6, 2008 (available at <http://www.housingwire.com/2008/10/06/bofa-rolls-out-84-billion-loan-mod-program/>):

The mortgage bailout for Main Street has officially begun, in the shadow of a \$700+ billion bailout of Wall Street signed into law on Friday afternoon by President Bush.

A slew of lawsuits against Countrywide Financial Corp. led Bank of America Corp. to announce late Sunday evening what will likely end up being the single largest predatory-lending settlement in American history, with the bank unveiling an \$8.4 billion program to modify 400,000 Countrywide-originated mortgages nationwide. Bank of America purchased Countrywide earlier this year.

North Carolina-based BofA said the program, which will involve heavy interest rate and principal reductions for hundreds of thousands of borrowers — more than a quarter of them in California — was “designed to achieve affordable and sustainable mortgage payments for borrowers who financed their homes with subprime loans or pay option adjustable rate mortgages serviced by Countrywide.”

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BofA said that all subprime and option ARM loans originated prior to the end of 2007 will be eligible for relief under the program, and that the massive modification program will be implemented by December of this year. Until then, the bank said it cease all foreclosures for borrowers it deems likely to qualify for a modification under the program — which pretty much means all subprime and option ARM borrowers that still have a mortgage, sources told HW.

Bank of America has already been halting most of its foreclosures in the state of California; HousingWire reported on Aug. 12 that July notices of default in the Golden State had fallen dramatically, and that 91 percent of the drop was due to files serviced by BofA/Countrywide.

The bank will target a 34 percent ration of PITI to income in restructuring loans, at least for the first year, according to a press statement; while full details weren't in the statement, BofA alluded to “limited step-rate interest rate adjustments” in subsequent years. It will also waive late fees and prepayment fees for affected borrowers.

Joe Price, BofA CFO, said that while the program would extend to all qualifying mortgages serviced by Countrywide, only 12 percent of eligible loans are currently owned by BofA. As a result, the majority of modifications that BofA will look to do will be subject to compliance with servicing contracts and will require investor approval — officials at BofA did not comment on the likelihood of investors approving specific forms of loan modifications, but early reaction from our sources suggests that reaction may not be positive.

A similar loan modification campaign was put into place by the Federal Deposit Insurance Corp. in late August at IndyMac Federal Bank after the government took control of the bank and servicing operation on July 11th from Indymac Bancorp; the status of the government's efforts to initiate wide-scale modification generated significant recoil among investors and ABS/MBS analysts at the time.

“The implications of these modifications on the securitized MBS market are significant,” wrote Deutsche Bank’s director of RMBS trading Christopher Helwig at the time, in a note to clients. “Rate reductions lead to potential interest shortfalls causing deals to miss their overcollateralization targets and fundamentally weakening credit enhancement to senior note holders. While this may have the net effect of flattening the CDR curve, this will in all likelihood not improve deal performance.”

' 3A: 28.           **Mortgage modification: Statutory bills and enactments** [level 1]

**Westlaw.com**

Proposed and enacted statutory changes related to or impacting modification of mortgages are listed below. For the current status, search Westlaw database “FC-BILLTRK”.

1. 2007 CONG US HR 7326 110th CONGRESS, 2d Session HR 7326 Introduced in House December 10, 2008. To establish a systematic mortgage modification program at the Federal Deposit Insurance Corporation, and for other purposes.

[2.](#) 2007 CONG US HR 7328 110th CONGRESS, 2d Session HR 7328 Introduced in House December 10, 2008. To amend title 11 of the United States Code with respect to modification of certain mortgages on principal residences, and for other purposes.

[3.](#) 2007 CONG US S 3738 110th CONGRESS, 2d Session S 3738 Introduced in Senate December 11 (legislative day, December 10, 2008). To amend the Truth in Lending Act to permit deferrals on certain home mortgage foreclosures for a limited period to allow homeowners to take remedial action, to require home mortgage servicers to provide advance notice of any upcoming reset of the mortgage interest rate, and for other purposes.

[4.](#) 2007 CONG US HR 7307 110th CONGRESS, 2d Session HR 7307 Introduced in House November 20, 2008. To help struggling families stay in their homes and to ensure that taxpayers are protected when the Secretary of the Treasury purchases equity shares in financial institutions.

[8.](#) 2007 CONG US HR 1424 110th CONGRESS, 2d Session Enrolled Bill October 03, 2008 HR 1424 SEC. 101.

PURCHASES OF TROUBLED ASSETS. SEC. 102.  
INSURANCE OF TROUBLED ASSETS. SEC. 103.  
CONSIDERATIONS. SEC. 104. FINANCIAL STABILITY  
OVERSIGHT BOARD. SEC. 105. REPORTS. SEC. 106.  
RIGHTS; MANAGEMENT; SALE OF TROUBLED ASSETS;  
REVENUES AND SALE PROCEEDS. SEC. 109.  
FORECLOSURE MITIGATION EFFORTS. (a) Residential  
Mortgage Loan Servicing Standards. To the extent that the  
Secretary acquires mortgages, mortgage backed securities, and  
other assets secured by residential real estate, including  
multifamily housing, the Secretary shall implement a plan that  
seeks to maximize assistance for homeowners and use the authority  
of the Secretary to encourage the servicers of the underlying  
mortgages, considering net present value to the taxpayer, to take  
advantage of the HOPE for Homeowners Program under section  
257 of the National Housing Act or other available programs to  
minimize foreclosures. In addition, the Secretary may use loan  
guarantees and credit enhancements to facilitate loan modifications  
to prevent avoidable foreclosures.

[16.](#) 2007 CONG US HR 7126 110th CONGRESS, 2d  
Session HR 7126 Introduced in House September 26, 2008. To  
provide stability to the housing market in the United States by  
providing diligent notice and options to homeowners facing the  
risk of foreclosure, providing alternatives to the homeowner and  
mortgagee that can assist in the retention of the home while  
meeting the financial obligations to ensure that the mortgagee will  
be made whole, and providing protections to renters of properties  
subject to mortgages in foreclosure, and for other purposes.

[17.](#) 2007 CONG US HR 7094 110th CONGRESS, 2d  
Session HR 7094 Introduced in House September 25, 2008. To

establish a term certain for the conservatorships of Fannie Mae and Freddie Mac, to provide conditions for continued operation of such enterprises, and to provide for the wind down of such operations and the dissolution of such enterprises.

[26.](#) 2007 CONG US S 3686 110th CONGRESS, 2d Session S 3686 Introduced in Senate November 17 (legislative day, September 17, 2008. To establish an Office of Foreclosure Evaluation to coordinate the responsibilities of the Department of the Treasury, the Department of Housing and Urban Development, the Federal Housing Administration, the Federal Housing Finance Agency, the Neighborhood Reinvestment Corporation, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and other Federal Government entities regarding foreclosure prevention, and for other purposes.

[27.](#) 2007 CONG US S 3690 110th CONGRESS, 2d Session S 3690 Introduced in Senate November 17 (legislative day, September 17, 2008. To help struggling families stay in their homes and to ensure that taxpayers are protected when the Secretary of the Treasury purchases equity shares in financial institutions. Proposal to allow federal bankruptcy judges to alter mortgage terms.

[29.](#) 2007 CONG US HR 3221 110th CONGRESS, 2d Session HR 3221 Enrolled Bill July 28, 2008. (a) Short Title. This Act may be cited as the 'Housing and Economic Recovery Act of 2008'.

[30.](#) 2007 CONG US S 2136 110th CONGRESS, 2d Session S 2136 Reported in Senate July 29 (legislative day,

July 28, 2008. To address the treatment of primary mortgages in bankruptcy, and for other purposes.

[42.](#) 2007 CONG US HR 6116 110th CONGRESS, 2d Session HR 6116 Introduced in House May 21, 2008. To allow homeowners of moderate-value homes who are subject to mortgage foreclosure proceedings to remain in their homes as renters.

[43.](#) 2007 CONG US HR 6076 110th CONGRESS, 2d Session HR 6076 Introduced in House May 15, 2008. To amend the Truth in Lending Act to permit deferrals on certain home mortgage foreclosures for a limited period to allow homeowners to take remedial action, to require home mortgage servicers to provide advance notice of any upcoming reset of the mortgage interest rate, and for other purposes.

[47.](#) 2007 CONG US S 2992 110th CONGRESS, 2d Session S 2992 Introduced in Senate May 7, 2008. To amend title 38, United States Code, to enhance housing loan authorities for veterans and to otherwise assist veterans and members of the Armed Forces in avoiding the foreclosure of their homes, and for other purposes.

[48.](#) 2007 CONG US HR 5830 110th CONGRESS, 2d Session HR 5830 Reported in House May 5, 2008. H. R. 5830 Report No. 110-619. To create a voluntary FHA program that provides mortgage refinancing assistance to allow families to stay in their homes, protect neighborhoods, and help stabilize the housing market.

[49.](#) 2007 CONG US HR 5579 110th CONGRESS, 2d Session HR 5579 Reported in House May 1, 2008. H. R. 5579, Report No. 110-615. To remove an impediment to troubled debt restructuring on the part of holders of residential mortgage loans, and for other purposes. For text of introduced bill, see copy of bill as introduced on March 11, 2008. This Act may be cited as the 'Emergency Mortgage Loan Modification Act of 2008'.

[50.](#) 2007 CONG US HR 5720 110th CONGRESS, 2d Session HR 5720 Reported in House April 24, 2008. H. R. 5720 Report No. 110-606. To amend the Internal Revenue Code of 1986 to provide assistance for housing. April 24, 2008. Reported with an amendment, committed to the Committee of the Whole House on the State of the Union, and ordered to be printed. For text of introduced bill, see copy of bill as introduced on April 8, 2008. (a) Short Title. This Act may be cited as the 'Housing Assistance Tax Act of 2008'.

### **Lexis.com**

Lexis.com, FILE-NAME: EIC218 Emerging Issues Commentary, examines pending subprime-related legislation including: the Mortgage Reform and Anti-Predatory Lending Act of 2007, the Home Ownership Emergency Act, the Expanding American Homeownership Act of 2007, the Emergency Home Ownership and Mortgage Equity Protection Act of 2007, the Helping Families Save Their Homes in the Bankruptcy Act of 2007, the Home Owners' Mortgage and Equity Savings Act, the Mortgage Forgiveness Debt Relief Act of 2007, the Promoting Refinancing Opportunities for Mortgages Impacted by the Subprime Emergency Act of 2007, the Protecting Access to Safe Mortgages Act, the Home Ownership Preservation and Protection

Act of 2007, the Community Foreclosure Assistance Act of 2007, and the Predatory Mortgage Lending Practices Reduction Act. Included are links to Bill tracking.

**' 3A: 29.'**      **Obstacles and limitations on the ability of the servicer of mortgage backed securities to modify mortgages** [level 1]

Some argue that if the government acquires mortgage-backed securities (MBS)<sup>65</sup> that include distressed loans, the government will have the right to modify those loans to prevent foreclosures. This isn't accurate.<sup>66</sup> Just as corporate bond holders have no right to control the bond issuer's management decisions, also MBS holders have no right to control how the trust manages the mortgages.<sup>67</sup>

Below is an example of PSA trust language clarifying that the trust agreement cannot be changed by a security holder if it reduces cash flows to other security holders:

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<sup>65</sup> For example using the Emergency Economic Stabilization Act, the \$700 billion bailout passed by Congress.

<sup>66</sup> Prof. Adam J. Levitin, Purchasing Mortgage-backed Securities Does Not Give The Government The Ability To Modify Mortgages Backing The Securities, Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy, September 24, 2008 (available from Prof. Levitin, Georgetown University Law Center); see also <http://www.creditslips.org/creditslips/2008/09/mortgage-modifi.html>); Eric Stein, Relieving Wall Street of Debt Does Not Translate into the Right to Stop Foreclosures, Center For Responsible Lending (9/24/2008), <http://www.responsiblelending.org/pdfs/gov-ltd-power-to-modify-final.pdf>.

<sup>67</sup> Eric Stein, Relieving Wall Street of Debt Does Not Translate into the Right to Stop Foreclosures, Center For Responsible Lending (9/24/2008), <http://www.responsiblelending.org/pdfs/gov-ltd-power-to-modify-final.pdf>.

This Agreement or any Custodial Agreement may also be amended from time to time by the Depositor, the Master Servicer, the NIMS<sup>68</sup> Insurer, the Trustee and, if applicable, the Custodian, with the consent of the NIMS Insurer and the Holders of Certificates entitled to at least 66% of the Voting Rights for the purpose of adding any provisions to or changing in any manner or eliminating any of the provisions of this Agreement or any Custodial Agreement or of modifying in any manner the rights of the Swap Provider or Holders of Certificates; *provided, however, that no such amendment shall (i) reduce in any manner the amount of, or delay the timing of, payments received on Mortgage Loans which are required to be distributed on any Certificate without the consent of the Holder of such Certificate, (ii) adversely affect in any material respect the interests of the Swap Provider or Holders of any Class of Certificates (as evidenced by either (i) an Opinion of Counsel delivered to the Trustee or (ii) written notice to the Depositor, the Master Servicer and the Trustee from the Rating Agencies that such action shall not result in the reduction or withdrawal of the rating of any outstanding Class of Certificates with respect to which it is a Rating Agency) in a manner other than as described in (i), or (iii) modify the*

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<sup>68</sup> NIMS are structured finance products collateralized by the residual cash flows from one or more securitizations (underlying deals). Alvin L. Arnold, 1 Real Estate Transactions: Structure and Analysis with Forms § 8:4 (RETSAs § 8:4).

consents required by the immediately preceding clauses (i) and (ii) without the consent of the Holders of all Certificates then outstanding.<sup>69</sup> [emphasis added, footnotes added]

Numerous other legal and structural obstacles stand in the way of modifications: 1) Servicers may avoid modifications for fear of investor lawsuits.<sup>70</sup> 2) modifications may cause disproportionate harm to certain tranches of securities over other classes, 3) some PSAs limit the number or percentage of loans in a pool that can be modified,<sup>71</sup> 4) second liens on the property create a negative incentive to modification by the first lien holder.<sup>72</sup> As Credit Suisse reports, “it is often difficult, if not impossible, to force a second-lien holder to take the pain prior to a first-lien holder when it comes to modifications,” thereby undermining the effort;<sup>73</sup> Credit Suisse reports that between one-third and one-half

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<sup>69</sup> PSA for Park Place Securities, Inc., Series 2005-WHQ4, serviced by Homeq and with Wells Fargo as Trustee.

<sup>70</sup> See Bajaj, Vikas and Meier, Barry, *Some Hedge Funds Argue Against Proposals to Modify Mortgages*, New York Times, October 23, 2008.

<sup>71</sup> See Credit Suisse, *The Day After Tomorrow: Payment Shock and Loan Modifications*, Apr. 5, 2007 (noting specific examples of PSAs with various modification restrictions, including 5% by balance, 5% by loan count, limits on frequency, and limits on interest rate).

<sup>72</sup> Testimony of Martin D. Eakes, Self-Help and Center for Responsible Lending

Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, Oversight of the Emergency Economic Stabilization Act: Examining Financial Institution Use of Funding Under the Capital Purchase Program, (Nov. 13, 2008), available at <http://www.responsiblelending.org/pdfs/martin-testimony-11-13-08-final.pdf>.

<sup>73</sup> Credit Suisse, *Subprime Loan Modifications Update*, Oct. 1, 2008, at p. 8.

of the homes purchased in 2006 with subprime mortgages have second mortgages,<sup>74</sup> and many more homeowners have open home equity lines of credit secured by their home; 5) a REMIC may suffer significant adverse tax consequences (including penalties and the loss of its status as a REMIC) as the result of significant modifications that do not fall within the enumerated exceptions,<sup>75</sup> 6) PSA agreements with servicers create an economic incentive for servicers to foreclose rather than modify - because of the time required to modify; 7) if the special servicer also owns the junior tranche of the securitized debt (often referred to as the “first loss” tranche) it will be motivated to avoid a foreclosure and find a successful workout, since after the equity it is in a first loss position; however if the special servicer has no economic interest in the project, then its safest course of action will always be the most conservative course (usually foreclosure), any affirmative efforts on the part of the special servicer can only open it up to criticism by the bondholders; and 8) for limitations, imposed by FASB 140, on the discretion of servicers, see *infra* footnote 5 in § 56:65, “Special servicer—Workouts by servicers compared to workouts by traditional lenders—Late-stage workouts” and Mountain, Deloitte & Touche LLP Article: Securitization Accounting, the Ins and Outs (And Some Do's and Don'ts) of FASB 140, FIN 46R, IAS 39 and More, 882 PLI/Comm 741, 760 (July 2005). See also, § 56:135, “FASB Statement No. 140: Securitization transfers after March 31, 2001—Summary of FASB Statement No. 140.”

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<sup>74</sup> Credit Suisse, *Mortgage Liquidity du Jour: Underestimated No More*, March 12, 2007 at 5.

<sup>75</sup> See § 47A:31. The stakes—Consequences to creditor—Impact on special taxpayers, and § 56:105. REMIC (Real estate mortgage investment company)—Qualification as REMIC—Asset test—Qualified mortgages—Assumption or mortgage modifications.

Notwithstanding all of the obstacles to modification of securitized mortgages, it is generally understood that even in states with a rapid nonjudicial foreclosure procedure it is usually less net cost to the parties involved to modify than to foreclose.<sup>76</sup> When considering the impact of foreclosure, it is important that the conversation includes parties who bear the ultimate risk in mortgage loans--the private mortgage insurers and the bond insurers and the major pension plans and mutual funds that hold MBS.<sup>77</sup>

' 3A: 30.           **Possible change in bankruptcy code to allow modification of home mortgages**

The process in bankruptcy by which a Chapter 13 debtor attempts to reduce the mortgagee's claim/debt to the value of the underlying property/security under Code section 506(a) and discharge the balance as an unsecured claim under the Chapter 13 plan is known by the euphemisms of "strip down," "cram down" or "bifurcation."<sup>78</sup> The Supreme Court in *Nobelman* has held that a debtor is not entitled to strip down/modify a home mortgage.<sup>79</sup> Thus, Chapter 13 debtors can, under 11 U.S.C.A. § 1322(b)(2), cram down (i.e., modify the rights of) holders of secured claims,

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<sup>76</sup> Of course the risk of redefault must be factored in.

<sup>77</sup> Adam Levitin, Credit Slips: Who Speaks for Mortgage "Lenders"? Available at <http://www.creditslips.org/creditslips/2008/04/who-speaks-for.html>. Again, the risk of redefault must be factored in.

<sup>78</sup> See § 30:118. "Strip down" and other issues for home mortgages—Curing home mortgages/mortgage secured only by debtor's residence—"Strip down," "cram down" or "bifurcation": *Nobelman* case.

<sup>79</sup> *Nobelman v. American Sav. Bank*, 508 U.S. 324, 113 S. Ct. 2106, 124 L. Ed. 2d 228 (1993).

*other than a claim secured only by a security interest in real property that is the debtor's principal residence.*<sup>80</sup> But as noted, § 1322(b)(2) prohibits modification of a mortgage “that is secured only by a security interest in real property that is the debtor’s principal residence”. By enacting § 1322(b)(2), Congress thought that it would lead to greater credit availability and lower credit costs for homeowner mortgages.<sup>81</sup> However, this assumption is being challenged:<sup>82</sup>

A proposal to amend the Bankruptcy Code to allow modification of home mortgages was deleted from the \$ 700 billion

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<sup>80</sup> Emphasis added. See *infra* §§ 30:117 to 30:139, beginning with § 30:117 “ ‘Strip down’ and other issues for home mortgages-Introduction”.

<sup>81</sup> See references in footnote 1 in § 30:118.

<sup>82</sup> Adam Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, Georgetown University - Law Center, [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1071931](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1071931), September 24, 2008. This article empirically tests the economic assumption underlying the policy against bankruptcy modification of home mortgage debt - namely that protecting lenders from losses in bankruptcy encourages them to lend more and at lower rates, and thus encourages homeownership. According to the article, the data show that this assumption is mistaken; permitting modification would have little or no impact on mortgage credit cost or availability. The article argues that because lenders face smaller losses from bankruptcy modification than from foreclosure, the market is unlikely to price against bankruptcy modification. In light of market neutrality, the article asserts that permitting modification of home mortgages in bankruptcy presents the best solution to the foreclosure crisis because, unlike any other proposed response, bankruptcy modification offers immediate relief, solves the market problems created by securitization, addresses both problems of payment reset shock and negative equity, screens out speculators, spreads burdens between borrowers and lenders, and avoids both the costs and moral hazard of a government bailout. Therefore, the author of the article concludes that, as the foreclosure crisis deepens, bankruptcy modification presents the best and least invasive method of stabilizing the housing market.

bailout bill in September, 2008 when the National Association of Home Builders, along with the Mortgage Bankers Association and other industry groups opposed it. The Mortgage Bankers group argued that allowing judges to force mortgage write-downs would lead to higher interest rates -- as much as 2 percentage points -- for all mortgages.<sup>83</sup> The proposal to amend the Bankruptcy Code was considered dead at that time. However, in view of the continuing home foreclosures and the economic recession, the National Association of Home Builders on December 9, 2008 announced it was open to previously off-limits ideas. Rep. John Conyers D-Mich., introduced HR 7328<sup>84</sup> a new version of the bankruptcy expansion proposal in the House of Representatives, just a day after the Home Builder's lobbying group withdrew its opposition. Rep. Brad Miller D-N.C., sponsor of an earlier bankruptcy reform bill, said the shift by home builders is significant. "They matter economically and politically in every (congressional) district, much more so than Wall Street. Morgan Stanley is not in my district, home builders are," he said.<sup>85</sup> Such reform is also supported by key advisers to President-elect Barack Obama, including former Treasury secretary Lawrence H. Summers, who will chair the National Economic Council under the new administration.<sup>86</sup>

A key amendment in HR 7328 is the amendment to 11 U.S.C.A. 1322(b):

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<sup>83</sup> Peter Y. Hong, Homeowner Relief May Be on the Way for Troubled Mortgages, 12/11/08 LAT-BUS (No Page).

<sup>84</sup> See Westlaw, 2007 CONG HR 7328, 110<sup>th</sup> CONGRESS, 2d Sesssion.

<sup>85</sup> Peter Y. Hong, Homeowner Relief May Be on the Way for Troubled Mortgages, 12/11/08 LAT-BUS (No Page).

<sup>86</sup> Peter Y. Hong, Homeowner Relief May Be on the Way for Troubled Mortgages, 12/11/08 LAT-BUS (No Page).

### SEC. 3. AUTHORITY TO MODIFY CERTAIN MORTGAGES.

Section 1322(b) of title 11, United States Code, is amended-

- (1) by redesignating paragraph (11) as paragraph (12),
- (2) in paragraph (10) by striking 'and' at the end, and
- (3) by inserting after paragraph (10) the following:

'(11) notwithstanding paragraph (2) and otherwise applicable nonbankruptcy law, with respect to a claim for a debt for a loan secured by a security interest in the debtor's principal residence that is the subject of a notice that a foreclosure may be commenced, modify the rights of the holder of such claim-

'(A) by reducing such claim to equal the value of the interest of the debtor in such residence securing such claim;

'(B) by waiving any otherwise applicable early repayment or prepayment penalties;

'(C) if any applicable rate of interest is adjustable under the terms of such security interest by prohibiting, reducing, or delaying adjustments to such rate of interest applicable on and after the date of filing of the plan; and

'(D) by modifying the terms and conditions of such loan-

'(i) to extend the repayment period for a period that is the longer of 40 years (reduced by the period for which such loan has been outstanding) or the remaining term of such loan, beginning on the date of the order for relief under this chapter; and

'(ii) to provide for the payment of interest accruing after the date of the order for relief under this chapter at an annual percentage rate calculated at a fixed annual percentage rate, in an amount equal to the then most recently published annual yield on conventional mortgages published by the Board of Governors of the Federal Reserve System, as of the applicable time set forth in the rules of the Board, plus a reasonable premium for risk; and'.

**' 3A: 31. Preserving tax status  
of REMICS [level 1]**

In general, a REMIC is a mortgage pool for which a REMIC election is filed and which satisfies certain requirements concerning the composition of its assets and the nature of its investors' interests. It must also make arrangements to prevent entities not subject to tax from holding certain of its interests.<sup>87</sup>

*See* IRS Rev. Proc. 2008-28,<sup>88</sup> which states its “purpose” as:

This revenue procedure describes conditions under which modifications of certain mortgage loans will not cause the Internal Revenue Service (the Service) either to challenge the tax status of certain securitization vehicles that hold the

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<sup>87</sup> See §§ 56:101 through 56:126.

<sup>88</sup> See Rev. Proc. 2008-28, 2008-23 I.R.B. 1054, 2008 WL 2066293 (IRS RPR)(2008).

loans or to assert that those modifications create a liability for tax on a prohibited transaction.

Under this Revenue Procedure, the Service will not, based on loan modifications, challenge the qualifications of real estate mortgage investment conduits ("REMICs") or investment trusts to hold loans, or assert that the modifications create an additional tax liability on a prohibited transaction, if certain conditions are met.

This revenue procedure applies to a modification of a mortgage loan that is held by a REMIC, or by an investment trust, if all of the following conditions are satisfied: .01 the real property securing the mortgage loan is a residence that contains fewer than five dwelling units, .02 The real property securing the mortgage loan is owner-occupied, .03 (1) If a REMIC holds the mortgage loan, then as of either the startup day or the end of the 3-month period beginning on the startup day, no more than ten percent of the stated principal of the total assets of the REMIC was represented by loans the payments on which were then overdue by 30 days or more; or (2) If an investment trust holds the mortgage loan, then as of all dates when assets were contributed to the trust, no more than ten percent of the stated principal of all the debt instruments then held by the trust was represented by instruments the payments on which were then overdue by 30 days or more, .04 the holder or servicer reasonably believes that there is a significant risk of foreclosure of the original loan. This reasonable belief may be based on guidelines developed as part of a foreclosure prevention program similar to that described in Section 2 of this revenue procedure or may be based on any other credible systematic determination, .05 the terms of the modified loan are less favorable to the holder than were the unmodified terms of the original mortgage loan, .06 the holder or servicer reasonably believes that the modified loan presents a

substantially reduced risk of foreclosure, as compared with the original loan.<sup>89</sup>

This revenue procedure governs determinations made by the Service on or after May 16, 2008, with respect to loan modifications that are effected on or before December 31, 2010.<sup>90</sup>

' 3A: 32.           **Title insurance for mortgage modifications [level 1]**

The lender's original ALTA Loan Policy provides insufficient protection for a subsequent mortgage modification, because it insures only the lender's lien on the real property as of the date set forth on Schedule A of the Loan 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.

The American Land Title Association ("ALTA") provides lenders' mortgage-modification-agreement coverage pursuant to ALTA Endorsement Form 11 (Modification of Mortgage). For this endorsement, see *infra* Chapter 42, Appendix 42F "ALTA Mortgage Modification Endorsement Form (Adopted 10-19-96)". The ALTA Form 11 Endorsement is similar to the California Land Title Association ("CLTA") Form 110.5 Endorsement (discussed below), modified to include a creditors' rights exclusion (where the facts of the transaction indicate that such an exclusion is necessary). The ALTA Endorsement Form 11 gives additional coverage beyond that of the CLTA Form 110.5 Endorsement, in that it also insures the continuing validity and enforceability

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<sup>89</sup> See Rev. Proc. 2008-28, 2008-23 I.R.B. 1054, 2008 WL 2066293 (IRS RPR)(2008).

<sup>90</sup> See Rev. Proc. 2008-28, 2008-23 I.R.B. 1054, 2008 WL 2066293 (IRS RPR)(2008).

of the insured mortgage as a result of the modification agreement (which document must be recorded).

Before agreeing to issue the ALTA Endorsement Form 11 (or the other forms of endorsement discussed herein), the title-insurance company must review the modification agreement and conduct a complete title and tax-lien search, to ascertain that nothing would render the insured mortgage invalid or unenforceable after recording of the modification agreement. The title company's review usually will include (without limitation) the following matters:

- a. Assurance that the parties to the modification agreement appear of record as the owner of the land (mortgagor) and as the mortgagee, respectively.
- b. The status and capacity of the parties to the modification agreement.
- c. A determination that there are no liens or encumbrances subsequent to the subject mortgage. If any such liens or encumbrances are found, they must be set forth as exceptions in the endorsement unless the parties holding the liens or encumbrances subject their interest to the mortgage, as modified, by appropriate recorded subordination agreements.
- d. A determination that the holder of the note is a party to the modification agreement (by an inspection of the note if necessary).
- e. A determination of the necessity for an inspection and the extent thereof, governed, in each instance, by information disclosed in the search, inquiry of the lender, and the equities involved. In many instances, the most important consideration should be given to work in progress, or recently completed, and to the rights of parties in possession.
- f. No additional property is being added as security for the loan as part of the modification.

See the following excerpt from William C. Hart, *Debt Restructuring Problems in the Workout of Troubled Real Estate Assets – Part II*, Title Law Associates (2002), available at <http://www.titlelawannotated.com/>:

In most jurisdictions the priority of a mortgage or trust deed depends upon the order of recordation. A modification of an existing mortgage – be it in the interest rate, the term of the mortgage, the principal amount, or some other change – may be found not to have the priority of the original mortgage but to be junior to interests in the real property of the original mortgage recorded after the original mortgage and before the modification. If, for example, the interest rate in an existing mortgage were increased from 8 percent to 13 percent, the additional 5 percent interest might not have priority over liens or encumbrances recorded after the mortgage but prior to the modification.

If a lender who has been involved in a workout of indebtedness wants its title insurer to insure the priority of both the mortgage and the modification, the lender must first record the settlement documents in the record office where the original mortgage is recorded. An insured lender may then work with the title insurance company to draft an endorsement that will provide the necessary coverage, or purchase one of the CLTA standard form endorsements that apply. CLTA Endorsement Form 110.5 provides coverage when a workout extends the maturity date of the loan and mortgage, reduces the interest rate, or defers interest. The endorsement insures that the settlement documents have modified the insured mortgage or trust deed as the parties intended, and that the insured mortgage is still prior to any other liens or encumbrances on the real property. A modified version of Endorsement Form 110.5 insures that the settlement agreement has resulted in additional collateral of the borrower being made

subject to the lender's insured mortgage or trust deed and that both the original mortgage and the new obligations have priority over any other liens or encumbrances on the property.

A third CLTA endorsement, Form 108.8, is available to protect a lender when further advances are to be made to the defaulting borrower as a part of a workout. Form 108.8 insures against loss by reason of title to the insured estate or interest being vested in anyone other than the borrowers at the time of the additional advance, and by reason of priority of any interest over the lender's mortgage insofar as it secures the additional advance.

The parties to a loan modification agreement, as well as title insurers, should be careful that, as a result of mortgage securitizations and the sale of many loans into the secondary market, the proper lender party is executing the modification agreement and that the "trail" of any assignments is set forth with specificity in the modification agreement.

**' 3A: 33.      Modification litigation [level 1]**

In New York state Supreme Court on December 1, 2008, in a proposed class action by bond investors Greenwich Financial Services Distressed Mortgage Fund 3, sued Countrywide Financial Corporation, the home lender acquired by Bank of America Corp., claiming that Countrywide cannot modify terms of securitized mortgages<sup>91</sup> without the investor's permission.<sup>92</sup> The suit was filed by William Frey, a private investor in mortgage-backed securities.

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<sup>91</sup> For the process of securitization, see *infra* Ch 56 "Asset Securitization and Commercial Mortgage-Backed Securities".

<sup>92</sup> See *Greenwich Financial Services Distressed Mortgage Fund 3 LLC v. Countrywide Financial Corp. et al.*, No. 650474/2008, *complaint filed* (N.Y. County Dec. 1, 2008); 2008 WL 5070657 (Complaint), Trial Pleading (Dec. 1, 2008); *Hedge Fund Sues to Enforce Countrywide Mortgage Securities*, Briefs and Other Related Documents, ANDREWS CLASS ACTION LITIGATION REPORTER, 15 No. 11 ANCALR 20, Dec. 18, 2008;

The complaint alleges that to settle allegations of widespread predatory lending made against it by the Attorneys General of at least 15 States, Countrywide Financial Corporation has agreed to reduce payments due on hundreds of thousands of mortgage loans by a total of up to \$8.4 billion. Most of these loans are owned not by Countrywide, but rather by trusts to which Countrywide sold the loans in the process of securitization. To pay Countrywide for the loans, those trusts in turn sold securities (often called “certificates” and sold in different classes or “tranches”) to investors. Countrywide plans not to absorb the \$8.4 billion reduction in mortgage payments itself (even though it was Countrywide’s own conduct of which the Attorneys General complained in the proceedings that Countrywide has now settled), but rather to pass most or all of that reduction on to the trusts that purchased mortgage loans from Countrywide. If the trusts are forced to absorb the reduction in payments occasioned by Countrywide’s settlement of the allegations against it, then the value of the securities that those trusts sold to investors will decline.

By this action, plaintiffs seek a declaratory judgment that, under the agreements that govern the administration of the loans that Countrywide sold to trusts in these series of securitizations (including the trust that issued the securities that plaintiffs own), Countrywide is required to purchase every mortgage loan on which it agrees to reduce the payments.

In response to the complaint, Bank of America stated it was disappointed in this attempt to halt a program intended to keep as many as 400,000 at-risk families in their homes and stabilize the nation's housing market. Bank of America is confident that together with the attorneys general they have built a program that benefits both consumers and investors, whose interests they carefully considered in developing the program of modifying mortgages.<sup>93</sup>

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[http://www.businessweek.com/pdfs/2008/1201\\_complaint.pdf](http://www.businessweek.com/pdfs/2008/1201_complaint.pdf)

<sup>93</sup> Mara Der Hovanesian, *Investor Sues to Block Mortgage Modifications*, Top News December 1, 2008, 9:49AM EST.

### ' 3A: 34. Information sources and websites [level 1]

#### **Westlaw**

Westlaw has segregated cases, articles, administrative items and other materials related to the subprime and financial crisis. To access this material, type “FC” (for financial crisis) in the box reserved for selection of database. This brings up a selection of ten databases covering the financial crisis. For example, “FC-CS” is the database for financial crisis cases.

#### **Lexis.com**

To find databases in Lexis.com related to the subprime mortgage crisis, select “find a source” and search “subprime”.

#### **Center for Responsible Lending**

The Center for Responsible Lending (CRL) is a nonprofit, nonpartisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. Information is available at: <http://www.responsiblelending.org/about/>. CRL's staff includes attorneys, researchers, and policy analysts in North Carolina, Washington DC, and California who study and report on predatory lending matters and monitor legislative and regulatory activity in state capitols and in the US Congress. Center for Responsible Lending | 302 West Main Street | Durham, NC 27701 | (919) 313-8500.

#### **Credit Slips**

A blog on things about credit and bankruptcy. “We are seven academics who will use this space to do what we like to do when we get together--discussing and debating what does

happen and what should happen when consumers and businesses borrow money.” Available at <http://www.creditslips.org/>.

## **Fannie Mae**

Fannie Mae information is available at <http://www.FannieMae.com/index.jhtml>. See also supra § 3A:21 “Fannie Mae loan modification programs”.

## **National Consumer Law Center**

National Consumer Law Center (NCLC), 7 Winthrop Square, Boston, MA 02110 website available at [http://www.consumerlaw.org/issues/financial\\_distress/index.shtml](http://www.consumerlaw.org/issues/financial_distress/index.shtml) with links to:

### *Failed Banks*

National consumer Law Center (NCLC) created this failed bank site to assist attorneys and advocates with the issues that arise when a bank, which makes or holds a mortgage, has failed. Includes links to: 1) List of Failed Banks along with their claim bar dates, 2) Q&A Regarding the IndyMac Bank Failure, 3) Other Relevant Documents, 4) Wamu Purchase and Assumption Agreement.

### *Lender Bankruptcy*

This site focuses mainly on Chapter 11 bankruptcies and was designed to inform attorneys of the recent rulings in lender bankruptcy cases. Provided on this webpage will be Judges orders pertaining to claim bar dates, transfer of assets, confirmation of plan, as well as voluntary petitions and chapter 11 plans.

### *Loan Modification Programs*

Programs have emerged in an effort to minimize the number of foreclosures. This site was implemented to provide a more comprehensive understanding of what the industry is doing to combat the foreclosure issue. NCLU notes that as of November 11, 2008 the program under Freddie Mac and Fannie Mae have been considered to be the standard for the industry. However, there are different variations. This site provides a chart that summarizes the industry and government sponsored loan modification programs.

#### **' 3A: 35. Conclusion [level 1]**

In these troubled economic times, with real-estate values (both residential and commercial) plummeting and borrowers unable to pay their mortgages, many lenders will make the decision to modify at least some of the loans in their portfolio in lieu of exercising legal remedies. By doing so, these lenders may avoid the consequences of foreclosing and becoming the owners of vast amounts of real estate that they are unable to dispose of within any reasonable time for amounts that are anywhere near the outstanding loan balances. For tax and/or economic reasons (or statutory and/or regulatory reasons), lenders may be amenable to entering into modification agreements with distressed borrowers (who are cooperative and willing to work with their lenders) under certain circumstances, in the hope that the present unsettled economic situation will improve and land values will eventually rise. This may be wishful thinking, but the real-estate market historically has operated in cycles, and many borrowers may be able to continue to make mortgage payments if certain -- even if only temporary -- monetary concessions are granted by lenders. But as this chapter illustrates, caution must be exercised by both borrowers and lenders when negotiating the terms and conditions of modification agreements. Especially in connection with commercial loans, there are many business and legal aspects that 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 and assignments of rent. Each situation is unique, and there is no “one size fits

all” for loan modification agreements; each party may need to make some concessions in order to obtain a satisfactory result.

**' 3A: 36. APPENDIX 3AA**

**MODIFICATION STRUCTURES AND GUIDELINES**

1) Choice of Structure

Once it has been determined that a modification is feasible, there are a number of possible structures to consider. Take into account the analysis and input that had previously been done and the value of the property and the trend of this value as they relate to the principal balance and the anticipated accrual amounts. Also, choose the particular structure in light of anticipated trends, both long- and short-term, within the property itself, the market, and with respect to the lender's current policies, procedures, and position for modifications.

2) Basic Modification Structure. The most basic modification structure is a simple accrual and compound-interest rate modification that reduces the pay rate to an amount lower than the contract rate, and the difference continues to accrue and compound monthly at the contract rate. This structure tends to work best when the value of the property indicates that there will be an excess value relative to the total accruals and principal balance. If the trends are less positive, the pay rate may be lowered with the difference between the coupon and pay rates accruing, but not compounding.

3) Other Modification Structures. If the market situation is extremely difficult (as it is as of the date of writing this Chapter), with the property's value dropping below the current principal balance, or market trends appear to be adverse, a reduction in the coupon rate for the term of the modification with no accrual or compounding could be considered. (The potential tax ramifications of this action are discussed below.)

4) Anticipating Improved Performance. If there is a reduction in the coupon rate for the term of the modification with no accrual or compounding, the modification structure should include some protection for the lender in the event that the property may perform well at a future date.

There are several conditions that can mitigate the loss to the lender in the event the property trends show improvement. The most common is to include a contingent-interest or shared-appreciation feature in the modification. When the lender is giving up its rights to future yields through a reduced interest rate modification, such features should be incorporated.

5) Standard Features. Standard features in a modification structure should include the lender's right to any excess cash flow, a shortened maturity date on the loan if deemed desirable, a tax escrow, and other safeguards that would reduce the probability of future default and lower the lender's exposure on the loan.

6) Special Arrangements. In properties requiring capital improvements, or significant tenant improvements and leasing commissions, the estimated expenditures for such items should be set forth in a budget prepared by the borrower for the lender's review on an annual basis, if not more often.

Another alternative in lieu of a longer-term modification would be to allow for a payoff of the loan at par or at a discount. Payoffs at par should be encouraged when the lender sees a deteriorating situation and can get its principal back at 100 cents on the dollar and not risk future exposure to deteriorating conditions. If the lender provides for a future date payoff at par or discount in conjunction with a modification, it may also wish to include a contingent-interest or shared-appreciation feature.

#### 7) Cash Management Agreements

A cash management agreement can provide the lender with perfection and activation of its rent assignment (through acknowledgment by the borrower that the lender is perfected, or by requiring tenants to send rents directly to a lockbox, or by appointment of a receiver) and will become a stipulated cash collateral order should the borrower file for bankruptcy. The cash management agreement can contain other bankruptcy protections, including an agreement by the borrower not to challenge a motion to obtain relief from the automatic stay by the lender and an agreement not to seek any extension of the period during which the borrower has the exclusive right to file a bankruptcy plan.

## 8) Management Safeguards

Cash management agreements often require that the lender remit cash for operating expenses back to the borrower. If the borrower has a hard time sticking to a budget, or if its reporting abilities are weak, it may help to have a third-party management company or accounting firm represent to the lender that the funds are being spent in accordance with the cash management agreement, if the lender is not in a position to replace the managing agent.

## 9) Release from Lender Liability Claims

The borrower should, where possible, also release the lender from any claims the borrower may have or allege concerning lender liability. Both parties should explicitly agree in any modification or cash management agreement that all future agreements must be in writing and that neither party is bound by any oral statements or representations. During this time, the lender should not give up any rights to commence or proceed with foreclosure upon a default under the cash management agreement, the modification agreement, or any of the original loan documents.

## 10) Expanded Default Provisions

If possible, the lender should shorten existing notice and cure periods and obtain personal recourse for post-default rents. These may be alternatives, if not belts and suspenders, for deeds in escrow (a discussion of which is beyond the scope of this outline).

## 11) Expanded Indemnities

If environmental indemnities in the original loan documentation are insufficient, an expansion of these indemnities should be inserted in the modification documentation. In addition, this is an ideal time to obtain additional protective provisions, or strengthen or update clauses in older loan documents, such as due-on-sale clauses, prepayment-premium clauses, tax-escrow clauses, anti-forfeiture provisions, carveouts in non-recourse provisions, and ERISA and RICO provisions.

## 12) Tax Effect of Modifying an Existing Loan (Including Contract Rate Reductions)

A modification of an existing loan may constitute a taxable event if the modification is so substantial that it amounts to the issuance of a new security.<sup>94</sup> Gain or loss will be realized depending on the borrower's adjusted basis in the debt instrument and the amount realized from the "disposition" of the "old" debt instrument. A modification will be deemed "material" if there is a reduction in the interest rate or an advance of additional funds by the lender. Such a transaction is treated by the IRS as a taxable disposition of "property" for new cash or property.

## 13) Book Value Enhancement

Another tax concern relates to the borrower's book value for the property versus the loan amount. In the event of a foreclosure, the borrower would recognize a gain on the difference between these amounts for income tax purposes. If the difference is significant, this tax liability may provide a strong incentive for the borrower to proceed with a modification. On the other hand, the borrower may have suspended (passive) operating losses that can be used to offset any taxable gain produced by foreclosure. In some instances, accumulated losses can more than cancel any gain, actually improving the borrower's balance sheet.

## 14) Be Prepared to Make Adjustments

If it appears that a modification is going to require a reduction in the contract rate or a principal reduction, the lender's tax or finance department should be kept informed so they can assist with any necessary adjustments.

## 15) Subordinate Liens

In connection with all loan modifications, written consents and subordinations of lien must be obtained from all junior lienholders (and holders of any other encumbrances against the mortgaged property). If those consents and subordinations are not obtained, junior lienholders (or

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<sup>94</sup> See infra §§ 47A:20 through 47A:45.

encumbrancers) may argue that they have been prejudiced or that their security has been impaired as a result of the modification, and that the first lienholder's priority should therefore be voided or subordinated to the extent of that prejudice or impairment. Courts have been generally sympathetic to such claims by subordinate lienholders.

#### 16) Courts Likely To Interpret Some Changes Unfavorably

Some courts have held that virtually any change in the terms of a mortgage, even an extension of the maturity date or the postponement or accrual of interest payments, may prejudice junior lienholders. Any change that makes an increased demand on the borrower's cash flow, increases the likelihood of default or encourages a lack of financial responsibility by the borrower (for example, a large balloon payment or payment of a significant amount of accrued interest at maturity) could be interpreted by a court as prejudicing intervening lien claimants.

#### 17) Retaining Liability of Parties

The lender should make certain, in connection with all loan modifications, that all guarantors, endorsers, and the like, either execute the modification agreement or else reaffirm their obligations in a separate (or attached) written document at the time of execution of the modification agreement, and that the modification agreement expressly reserves all rights against guarantors; otherwise, that guarantors may be released from personal liability.

#### 18) Suretyship Model.

When the property has been previously conveyed from the original owner/borrower to a party who has assumed the debt, and such party enters into a modification agreement without the consent of the original borrower, the general rule (based on suretyship principles) is that the original borrower is released from the debt obligation (assuming the lender had knowledge of the loan assumption). Of course, if the original borrower consents to or executes the modification agreement, the original borrower remains liable for the debt and other loan obligations.

#### 19) Extent of Release.

It depends on the jurisdiction. If the transferee from the original borrower took title subject to the mortgage and did not expressly assume it, the "minority rule" releases the original borrower if he

or she doesn't consent to the modification agreement executed by the transferee. However, the "majority rule" is that since the grantee never assumed any liability under the mortgage, the original borrower is only released to the extent of the value of the property at the time of the modification, because the original borrower is not a surety here, as he or she would be if assumption occurred. *See* Kratovil and Werner, *Extensions and Modifications*, 8 CREIGHTON L. REV. 595 (1974-1975); Kratovil and Werner, *MODERN MORTGAGE LAW AND PRACTICE*, 2<sup>nd</sup> ed., ch. 39 (1981).

If the original borrower enters into a loan modification agreement with the lender after a conveyance of the property to a third party, the transferee is still bound by the modification, even though he or she did not consent. This is true whether or not the transferee took subject to or assumed the mortgage. *See* Kratovil and Werner, *supra*, *MODERN MORTGAGE LAW AND PRACTICE*, 2<sup>nd</sup> ed., ch. 39.

## 20) Title Policy Endorsements

In addition to the usual title endorsements sought by lenders in connection with modification agreements (such as the ALTA Form 11 Endorsement -- Mortgage Modification) or the CLTA Form 110.5 Endorsement -- Mortgage Modification), additional specific title-policy endorsements should be requested in connection with mortgage modifications providing for the periodic addition of contingent interest or shared appreciation payments to principal, which endorsements should cover (where applicable and available) such issues as usury, non-imputation, shared appreciation, interest-on-interest and compounding of interest, variable rates, negative amortization and (if available), and recharacterization.

## 21) Attorney-Client Privilege

During any workout phase, it is important to maintain the attorney-client privilege for any sensitive written correspondence or work product. These materials should flow through either the lender's in-house counsel or to outside counsel. Any memos that are sent to counsel with copies to other people (especially email messages) may not fall into the realm of attorney-client

privilege and may be subject to a claim that such actions on the part of the lender actually caused some of the problems that resulted in the loan default.

#### 22) Record a Chronology

The lender should consider recording a personal chronology of factual events during negotiations, including any requests the lender may have made of the borrower. This can assist outside counsel if they have not been involved in the case or for clarification purposes if negotiations deteriorate into litigation.

#### 23) Formalize Meetings

Additionally, to avoid potential lender liability actions or misrepresentations on matters discussed, it is useful to have at least one other person present during negotiation sessions, including telephone conversations. Until the negotiations turn hostile or litigation has commenced, it may be better to have a business person present at the negotiations rather than an attorney. If either party intends to bring counsel, advance notice should be given to allow the other party to also arrange for legal representation at the meeting. If the borrower appears at a meeting with counsel and this has not been previously arranged, the lender's representative should excuse himself or herself from the meeting.

#### 24) Cost and Timing Issues

The lender should establish a preliminary timeline and a budget for legal counsel, services, consultants, and other outside sources before beginning the modification negotiations. Although the preliminary budget will frequently be exceeded and the timelines extended, having an initial plan will help contain costs and highlight time requirements. In negotiating a modification, fees can vary substantially, depending on the complexity of the modification and the willingness of the borrower to cooperate in the negotiations. These fees, along with any closing costs, should be passed on to the borrower since the modification results in a major benefit to the borrower. If possible, a pre-negotiation agreement should be executed by the borrower before modification discussions commence, and should expressly provide that all such costs will be borne by the

borrower. *See Travelers Ins. Co. v. Corporex Properties, Inc.*, 798 F. Supp. 423 (E.D. Ky. 1992), where the court expressly upheld a pre-negotiation agreement entered into between the institutional lender and the borrower in connection with a proposed negotiated workout of a \$6.4 million nonrecourse commercial mortgage loan on an office building in Covington, Kentucky.

## 25) The Importance of Drop-Dead Dates

At all points during the modification negotiations, through and including execution of the modification agreement, drop-dead dates should be established with the borrower. Although these dates can be extended during the process, they put pressure on the borrower to reduce the amount of time spent during the entire procedure. This will often result in a faster closing. Without such dates, the borrower may attempt to stall and delay every discussion, sometimes with no intention of closing the modification, simply to gain a tax advantage by pushing a potential bankruptcy or foreclosure action into the next tax year.

This illustrates how important it is to know the borrower's true goals in the negotiations. For example, if the lender knows up front that the borrower is simply seeking tax advantages, a stipulated foreclosure to occur not earlier than an agreed upon date could be considered as a possible alternative to fruitless negotiations toward loan modification. This would result in a lower cost of foreclosure to the lender and yet give the borrower some of the desired tax advantages. Although such a stipulated foreclosure is probably not the most desirable alternative for the lender, it could be acceptable if the time periods involved are not extensive, and the risk of a bankruptcy filing or other litigation cropping up along the way is mitigated.

## 26) When Do These Considerations Matter?

Whether or not the original borrower executes the modification agreement may be unimportant to the lender if the loan is nonrecourse and the property constitutes the lender's sole security. However, if the original borrower has any personal liability on the loan, or if there are "carveouts" from the exculpatory provisions in a nonrecourse loan, such considerations become especially important to the lender.

## **APPENDIX 3AB**

### **MODIFICATION AGREEMENTS (OUTLINE)**

#### **I. Business Reasons for Modification of Loan Documents**

- A. Extend (or shorten) maturity date.
- B. Capitalize delinquent interest.
- C. Raise (or lower) interest rate.
- D. Increase default rate.
- E. Change or postpone payment dates, or amount of payment.
- F. Permit assumption and/or release borrower from liability.
- G. Provide for additional principal disbursements.
- H. Partially release property.
- I. Postpone foreclosure to avoid taking property back at deflated value on books of lender.
- J. Require additional security for loan (additional property, personal guarantee of borrower or third parties, etc.). Note: The receipt of additional security by the lender for an antecedent debt may constitute a preferential transfer under sec. 547 of Bankruptcy Code if borrower files bankruptcy within 90 days thereafter.
- K. Opportunity exists to add or update mortgage provisions, e.g., due-on-sale clause; cross-default; guaranty(ies); environmental indemnities; or to correct defects, e.g., drafting defects; incorrect legal description; or to add clauses providing lender right to share in potential upside, e.g., shared-appreciation or contingent-interest features.

- L. Whether or not original borrower executes modification agreement may be unimportant to lender if loan is nonrecourse and property constitutes lender's sole security. However, if original borrower has any personal liability on the loan, or if there are "carveouts" from exculpatory provisions in nonrecourse loan, such considerations become especially important to the lender.

## II. General Legal Considerations

- A. Modification Agreements are useful prior to acceleration of loan and foreclosure, and may give borrower "breathing room" to bring loan current (especially if borrower is cooperative and property may increase in value).
- B. Make certain language in original loan documents contains right to modify or extend loan at any time for any reason without notice to third parties – and not subject to "reasonableness" standard.
- C. Restatement position – if mortgagor specifically reserves right to modify in original mortgage, priority is retained even if modification is materially prejudicial to subordinate lienholders (not majority case-law position).
- D. Obtain title search to determine if there are any other liens or encumbrances on the property.
- E. Law is that, normally, priority of lien will be lost to extent that subordinate lienholders are prejudiced, or security is impaired, unless subordinate lienholders consent and formally subordinate to the modification (or enter intercreditor or subordination agreement).
- F. Some courts may hold that entire priority will be lost and priority of original loan will be entirely subordinated as result of modification without consent of subordinate lienholder (usually in connection with subordinated purchase-money loans; loans where modification is so drastic as to amount to new loan; where no right to subsequently

modify is contained in first mortgage: or as a result of inability to determine exact extent of prejudice to subordinate lienholder).

- G. Some courts may hold that virtually any change in terms of mortgage (other than decrease in the interest rate), e.g., even an extension of maturity date, may prejudice subordinate lienholders (because loan will not be paid off at time originally anticipated). Any change that makes an increased demand on borrower's cash flow could be interpreted as prejudicing intervening lien claimants, or any change that increases likelihood of default or encourages lack of financial responsibility by borrower (e.g., large balloon payment at maturity and therefore increased risk of default). Under some circumstances, and in some jurisdictions (which are in distinct minority), any change whatsoever in the original terms, even a decrease in the interest rate, may not be permissible without consent of junior lienholders.
- H. Always conduct title search before modification of mortgage (including federal tax liens and UCC filings), and determine what modification endorsements are available from title company based on nature and scope of modification and regulatory and statutory permissibility of issuance of such endorsements in particular jurisdiction.
- I. It may be good idea to send borrower a letter prior to agreeing to enter into Modification Agreement, stating clearly the conditions (including “drop dead” dates) under which modification will be considered and a Modification Agreement prepared – or consider execution of “pre-negotiation agreement,” to be executed by both parties.
- J. Always prepare written Modification Agreement containing all terms of workout, and record it, unless (depending on jurisdiction) only change is decrease in interest rate or simple (and relatively short – six months or less) extension, or extension of limited number of monthly payments to maturity date.
- K. If the title report shows that intervening lien claimants exist, obtain their consent and subordination as part of the Modification Agreement, or have parties enter into intercreditor or subordination agreement.

- L. Obtain appropriate title insurance endorsement, to be paid for by borrower, insuring continuing priority, validity, and enforceability of first mortgage lien after recording of Modification Agreement.
- M. Obtain consent of any guarantors of original loan prior to modification; otherwise they may be released.
- N. If present owner of property is not original mortgagor, original mortgagor must also sign Modification Agreement to preserve such mortgagor's personal liability (if any) to lender.
- O. Provide in original loan documents (and Modification Agreement) for right of lender to subsequently amend and modify note and mortgage in any respect. If subsequent encumbrances are permitted in loan documents, make them conditional upon execution of subordination agreement by subordinate lienholder at time of each such encumbrance, with subordinate lienholder agreeing to subordinate to lien of first mortgage as same may be subsequently amended. If original mortgage contemplates future disbursement, modification or assumption, insert clause in mortgage requiring title endorsement to original policy insuring such future modification.
- P. Where possible, have subordinate lienholders execute intercreditor agreement to establish rights and obligations of respective parties, including future modification rights and limitations.
- Q. Determine if mortgage loan has been securitized, and if it is securitized, and has been transferred to another entity (or entities), make certain that both proper lender party(ies) and borrower party(ies) execute Modification Agreement.
- R. Keep abreast of current developments (including state and federal statutes and regulations) regarding ability and authorization of lender, loan servicer, etc., to modify securitized loan. Treasury secretary has urged loan modifications, but no force of law presently exists. Lenders (or servicers) are still modifying securitized loans, and lawsuits have been filed on behalf of trustees and investors challenging such modifications. Loan

modifications of securitized loans are expected to grow 15-20% in 2009 from virtually none.

- S. Standard features in a modification structure could include lender's right to any excess cash flow, shortened maturity date on loan if deemed desirable, tax escrow, cash-management agreement with "waterfall" provision, and other safeguards that would reduce the probability of future default and lower lender's exposure on loan.
- T. In properties requiring capital improvements, or significant tenant improvements and leasing commissions, estimated expenditures for such items should be set forth in budget prepared by borrower for lender's review on an annual basis, if not more often. If possible, lender should shorten existing notice and cure periods and obtain personal recourse for post-default rents.
- U. Credit Agreement statutes – Most states have passed laws protecting lenders from alleged oral agreements to lend, modify, extend or refinance existing loan, or forbear from contractual remedies, unless specific written agreement exists between lender and borrower.
- V. Where change (or changes) in the existing debt obligation by modification is so substantial as to amount virtually to issuance of new security, same income tax consequences will follow as if a new security were actually issued, i.e., modified debt instrument will be treated as a new debt instrument given in consideration for the old, unmodified debt instrument.
- W. Modification of an existing loan may constitute taxable event if modification is so substantial that it amounts to issuance of new security. Gain or loss will be realized depending on borrower's adjusted basis in debt instrument and amount realized from "disposition" of "old" debt instrument. Modification will be deemed "material" if there is reduction in interest rate or an advance of additional funds by lender. Such a transaction is treated by the IRS as taxable disposition of "property" for new cash or property.

- X. If possible, lender should shorten existing notice and cure periods and obtain personal recourse for diversion post-default rents and other “bad boy” acts.
  - Y. With respect to future-advance and revolving-credit loans, make certain that “magic language” required by state statutes is contained in loan documents. Also, make certain that future-advance clause in mortgage does not conflict with clause granting modification rights.
  - Z. Bankruptcy issues:
    - 1. Chapters 7 (liquidation), 11 (reorganization), and 13 (wage-earners) of Bankruptcy Code currently prevent modification of rights of holder of claim secured only by security interest in an individual debtor’s principal residence and prevent “lien stripping” (although there is still some uncertainty regarding Chapter 11).
    - 2. With respect to Chapter 11, in commercial bankruptcy case plan can, under certain circumstances, be “crammed down” on impaired class (usually mortgage lender who votes to reject plan) and debtor may (a) reduce principal amount of secured claim to value of collateral, (b) reduce interest rate; (c) extend maturity date, (d) cure or waive any defaults, and (d) alter repayment schedule.
    - 3. Can non-monetary terms of mortgage (due-on-sale, prepayment, etc.) be modified? Courts are split.
    - 4. Waiver of automatic stay clause in Modification Agreement – is it enforceable? Courts are split; depends on facts.
- III. Summation.
- A. For tax and/or economic reasons (or statutory and/or regulatory reasons), lenders may be amenable to entering into modification agreements with distressed borrowers (who are cooperative and willing to work with their lenders) under certain circumstances, in hope that present unsettled economic situation will improve and land values will eventually rise.

B. Many borrowers may be able to continue to make mortgage payments if certain -- even if only temporary -- monetary concessions are granted by lenders.

C. Caution must be exercised by both borrowers and lenders when negotiating terms and conditions of modification agreements. Especially in connection with commercial loans, there are many business and legal aspects that must be carefully considered.

D. Each situation is unique, and there is no “one size fits all” for loan modification agreements; each party may need to make some concessions in order to obtain satisfactory result.

E. Securitization of mortgage loans has made modifications more difficult and time-consuming. Federal legislation and/or modification of the Bankruptcy Code may change this dynamic, and should be closely monitored.