

Mortgage Modification Agreements in Difficult Economic Times

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Introduction

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 lenders and borrowers should be cautious when entering into these agreements, in order to avoid any “traps for the unwary.” This article will examine the various factors that mortgage lenders should consider when determining whether to modify an existing delinquent loan rather than exercise the legal rights and remedies provided in the loan documents. Mortgage modification issues include the necessity (or lack of necessity) of obtaining a title datedown endorsement and title insurance, the issues posed by the existence of subordinate lienholders, and possible bankruptcy concerns. 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). The Restatement position on mortgage modifications is discussed later in this article. *See Exhibit A* attached hereto for a summary of various modification structures and lender guidelines, and *Exhibit B* attached hereto for an outline of business and legal items for lenders to consider in connection with mortgage modification agreements.

Mortgage Modifications that Prejudice Subordinate Lienholders

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. 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. *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 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”).

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. 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*, 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”).

Rights of Subordinated Lienholders

Courts often are especially solicitous of the rights of subordinated purchase-money mortgagees. 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).

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

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. *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 ("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. Amenias 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. 4th 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.

Future Advance Loans

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.*, 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 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." *Id.* at 419.

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 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. *See generally* Restatement § 2.1 (Future Advances) and § 2.3 (Priority of Future Advances).

Requirement of Additional Security

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. 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”).

Bankruptcy Issues

1) 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. 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.

2) “Lien stripping” in Chapter 11 cases is not universally accepted, with the argument against lien stripping based on Supreme Court precedent. The Supreme Court, in *Dewsnup v. Timm*, 502 U.S. 410 (1992), a Chapter 7 case, addressed the issue of whether a debtor may “strip down” a creditor's lien on real property to the value of the collateral, as judicially determined, when that value is less than the amount of the claim

secured by the lien. The Court began with the premise that because the parties disagreed about the meaning of § 506 of the Bankruptcy Code, the statute was ambiguous. The Court reasoned that the term "allowed secured claim" as it is used in § 506(d) need not be defined in accordance with § 506(a) (which provides that an undersecured creditor's allowed claim is bifurcated into secured and unsecured portions). The Court identified the pre-Bankruptcy Code rule that a "creditor's lien stays with the real property until the foreclosure." *Id.* at 417. According to the majority opinion, "[a]part from reorganization proceedings [citation omitted], no provision of the pre-Code statute permitted involuntary reduction of the amount of a creditor's lien for any reason other than payment on the debt." *Id.* at 419. The Court went on to state that since Congress made no explicit statement that it intended to revise pre-Bankruptcy Code law, the Court would interpret § 506 in light of such previous law. The Court therefore concluded that a debtors in a Chapter 7 liquidation case cannot strip down a creditor's lien pursuant to § 506 of the Bankruptcy Code.

The *Dewsnup* case stands for the proposition that there can be no lien stripping without payment of the debt which is secured by the lien. The *Dewsnup* problem was that the debtor attempted to strip the creditor's lien without either making payments on the debt or allowing the creditor to purchase the property by credit bid and enjoy the appreciation.

It is important to note that *Dewsnup v. Timm* was a Chapter 7 case. The Court limited its holding and, arguably, its rationale, to the application of § 506 to those cases under Chapter 7. The methodology and analytical premises that led to the Court's conclusion have been questioned and thoroughly analyzed in the dissenting opinion filed by Justice Scalia as well as by subsequent courts interpreting the seemingly unambiguous statutory language of § 506.

In Chapter 11 reorganization cases, the lien stripping is coupled with payments under a plan. In reorganization cases, ownership of the property will vest in the debtor. There is no right to credit-bid, which is lost to a lender. Unlike the creditor in *Dewsnup*, creditors in reorganization cases receive something in exchange for the voiding of their liens: payment obligations under a plan of reorganization. If a creditor receives the value of its interest in the property under a plan of reorganization, the principles of *Dewsnup* are not violated and the lien may be stripped.

Courts have split in the wake of *Dewsnup v. Timm* on the issue of whether lien stripping is permissible in a case under Chapter 11. The split is largely the result of the apparent willingness of some courts to accept the Supreme Court's invitation to limit *Dewsnup* to cases under Chapter 7. Several courts have refused the invitation. After all, § 506 applies equally to all chapters of the Bankruptcy Code. *See, e.g.* In *In re Dever*, 164 B.R. 132, 135 (Bankr. C.D. Cal. 1994), the court analyzed the *Dewsnup* problem as follows:

This holding [*Dewsnup*] appears to have been driven by two factors: (1) as a voluntary lien, the bargained-for result under state law would have been that, if the debtor failed to repay the loan, the lender was entitled to foreclose; and (2) there was no benefit whatever realized for the estate or other creditors from this post-

abandonment voiding of the lien. Under the circumstances, the Supreme Court considered unfair an outcome that appeared to place all the risk of a decline in property value on a mortgage lender, and none on the debtor, who would retain the upside potential *if* the property later appreciates in value. A ‘windfall,’ the Court called such a result.... If an undersecured creditor forecloses, one of two things happens: either the creditor is paid in cash the fair market value of the property by a third party purchaser, which in theory should be the equivalent of the collateral value determined by the bankruptcy court; or the creditor buys the property itself by credit-bid if other bids at the sale are not sufficiently attractive to the creditor. The creditor thus has the choice of whether to forego the immediate cash in favor of betting on the property's future appreciation. What disturbed the Court in *Dewsnup* was the debtor's attempt to create a third alternative in which the creditor neither received the cash value of the property nor the appreciation potential of ownership. The true effect of lien-stripping in Chapter 7 cases is to allow debtors to redeem their property at a discounted value by installment payments over a protracted period--without giving the creditor any choice whatsoever in the matter. The issue, therefore, is not really how much of the claim is protected by the lien, but rather who has the right to ownership of the asset when it leaves bankruptcy. Under what conditions does the undersecured creditor have the right to bid for ownership of the property? Framed in this manner, the unfairness of Chapter 7 lien stripping lies in its failure to require that the creditor receive the cash value of its collateral as the price for being deprived of its opportunity to credit-bid at a foreclosure sale. But this is not a Section 506 failing. Other provisions of the Code are responsible for providing the checks and balances on lien-stripping.

3) If all of the legal requirements of a Chapter 11 reorganization plan are met, with the exception of a successful confirmation vote by creditors, the plan may still be confirmed over the objection of a dissenting class. If the plan does not discriminate unfairly and is fair and equitable to the dissenting class, it can be “crammed down” on the impaired class that votes against the plan. In a cram down, the debtor may (1) reduce the principal amount of the secured claim to the value of the collateral; (2) reduce the interest rate; (3) extend the maturity date; or (4) alter the repayment schedule. The debtor may also make a minimal payment on the unsecured claim. Under the Bankruptcy Code a cram down is permissible when the plan provides a dissenting secured class with consideration equal to the amount of its claim or when no class below the dissenting unsecured class participates under the plan.

Chapter 13 debtors also 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* (emphasis added.) 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.

A cram down is the single biggest workout and bankruptcy threat to a lender. 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. 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 scrutinize plans proposing this form of payment on a case-by-case basis.

A class of secured creditors can also be crammed down if each secured creditor receives the indubitable equivalent of the claim. A secured creditor receives the indubitable equivalent of the claim when the secured creditor receives a return of part of its collateral while the remainder of its secured claim continues to be secured by the remaining collateral, and when the debtor proposes to pay the present value of the remaining secured claim over a period of time. 11 U.S.C.A. § 1129(b)(1). *See, e.g., Matter of Woodbrook Associates*, 19 F.3d 312, 317-20 (7th Cir. 1994) (finding that a plan that provided a 5 percent distribution to the mortgagee's unsecured deficiency claim while paying debtor insiders in full constituted unfair discrimination); *In re Creekside Landing, Ltd.*, 140 B.R. 713, 716 (Bankr. M.D. Tenn. 1992) (finding that extreme disproportionality between payments to insiders and to the mortgagee's deficiency claim contributed to finding of unfair discrimination). *Cf. In re Aztec Co.*, 107 B.R. 585, 588 (Bankr. M.D. Tenn. 1989) (holding that the language of "[s]ection 1129(b)(1) prohibits only unfair discrimination, not all discrimination, and, therefore, some discrimination between classes of unsecured claims must be permissible").

4) 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. 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 (assuming, as is customary in single-asset

bankruptcy cases, that the mortgagee's claim is placed in a separate class by itself). 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. 11 U.S.C. §§ 1123(a)(2), (3), (b)(1), 1126(c). See, 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 party], even without a due-on restriction, changes obligors and therefore alters rights under the instruments memorializing the loan." *Id.* at 956.

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." 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).

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. 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-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 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.

As noted above, the lesson of this case 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.

5) *See also In re Dever, supra*, 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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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.”

6) *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*.”

7) With respect to the modification of junior home liens in Chapter 13 bankruptcy, see *The Law of Distressed Real Estate*, by Prof. Baxter Dunaway, Ch. 26, *Special Considerations for Junior Lenders and Lienholders* (updated through June 2008) § 26:40 *Modifying junior home liens in Chapter 13 bankruptcy*:

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."

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Is the § 1322(b)(2) prohibition against modification limited to the protection of first mortgagees? The legislative history of the statute indicates that it was designed to protect and promote "the increased production of homes and to encourage private individual ownership of homes as a traditional and important value in American life." *In re Glenn*, 760 F.2d 1428, 1434 (6th Cir. 1985). In *In re Harris*, 147 B.R. 17 (Bankr. N.D. Ohio 1992), the court rejected the argument that junior mortgages per se should not receive the antimodification protection of § 1322(b)(2) because the intent of Congress was to protect first mortgage lenders.

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Assuming the value of the security is inadequate even to cover the first mortgage, are junior mortgages or other liens also protected from modification? ... [T]he courts have given a mixed response to this question.

See also Dunaway, *supra*, 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); 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).

The Restatement Approach to Mortgage Modifications

The Restatement 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 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" 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[.]

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.

Remedies Where Prejudice Occurs to Junior Lienholder

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"). *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>.

Retaining Liability of Parties

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 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). *See* Kratovil and Werner, *Modern Mortgage Law and Practice*, Second Ed. (1981), Ch. 39.

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. *See* Kratovil and Werner, *Extensions and Modifications*, 8 Creighton L. Rev. 1974-75.

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. *See* Kratovil and Werner, *Modern Mortgage Law and Practice*, *supra*.

Tax Effect of Modification

A deemed "sale or exchange" of the old note for the modified one may occur under the Internal Revenue Code ("IRC") if there is a significant modification. This should not apply to a change occurring as of the date of maturity. This issue is discussed in the regulations under Sec. 1001 of the IRC. 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. 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 Internal Revenue Service ("IRS") as a taxable disposition of "property" for new cash or property.

If the contract rate is lowered to or below the Applicable Federal Rate ("AFR"), a taxable event will occur for both the borrower and the lender. In this case, the total number of payments made during the modification period, as well as the repayment of principal at the end of the period, are discounted back to present value at the current AFR rate. To the extent that the sum of this discounted series of payments is less than the current outstanding principal balance, the IRS views the difference as forgiveness of debt and this amount becomes taxable.

Also, if principal forgiveness is negotiated as part of the modification agreement, the principal forgiven is taxable to the borrower. Thus, even if principal forgiveness has some appeal in a specific modification, it may also have a significant negative effect on the borrower. This tax effect will vary for each transaction.

Effect of Loan Securitization and Assignments

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.

The Modification Announcement is attached hereto, in its entirety, as **Exhibit C**.

On October 3, 2008, President Bush signed into law the Emergency Economic Stabilization Act of 2008 (the "Act"). The revised legislation includes provisions that, among other things (i) authorize the Secretary of the Treasury (the "Secretary") to

establish a program to purchase up to \$700 billion of troubled assets, and (ii) require the establishment of a program for the sale of insurance on troubled assets. The Chicago-based law firm of Jenner & Block, LLC, has stated the following in a Client Advisory summarizing the Act, 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.

Adam J. Levitin, *Purchasing Mortgage-Backed Securities Does Not Give the Government the Ability to Modify Mortgages Backing the Securities* (2008), p.1. (Prof. Levitin's article is attached hereto, in its entirety, as **Exhibit D.**) See also Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 263 (1987); Mark Adelson, *ABS/MBS Investors Lose in Treasury Dept.-ASF Plan for Loan Modifications*, Dec. 10, available at: www.adelsonandjacob.com/pubs/Loan_Modification_Problems.pdf; Kenneth C. Kettering,

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 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.”

.....

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.”

Title Insurance for Mortgage Modifications

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). This endorsement is attached hereto as **Exhibit E**. The ALTA Form 11 Endorsement is similar to the California Land Title Association (“CLTA”) Form 110.5 Endorsement (attached hereto as **Exhibit F** and 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 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.

Conclusion

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 article 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.

EXHIBIT A

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 this paper), 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. 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 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*, 2nd 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*, 2nd 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.

EXHIBIT B

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 release (or not release) borrower from liability.
- G. Provide for additional principal disbursements.
- H. Partially release property.
- I. 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.
- J. When modifying mortgage, opportunity exists to add other provisions, e.g., due-on-sale clause; cross default; guaranty; or to correct defects, e.g., drafting defects; incorrect legal description.

II. General Legal Considerations

- A. Modification Agreements are useful prior to acceleration of loan and foreclosure.
- B. Obtain title search to determine if there are any other liens on the property.
- C. 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.
- D. Some courts may hold that entire priority will be lost and the priority of the original loan will be entirely subordinated as a result of a modification without consent of subordinate lienholder (usually in connection with subordinated purchase-money loans, or where not right to subsequently modify is contained in the first mortgage), as a result of inability to determine exact extent of prejudice to subordinate lienholder.
- E. Some courts may hold that virtually any change in the terms of a mortgage (other than a decrease in the interest rate), e.g., even an extension of maturity date, may prejudice subordinate lienholders. Any change that makes an increased demand on a 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 the borrower (e.g., large balloon payment and therefore increased risk of default). Under some circumstances, and in some jurisdictions, any change whatsoever in the original terms, even a decrease in the interest rate, may not be permissible without the consent of junior lienholders (may depend on state law).
- F. Always conduct a title search before modification of mortgage (including federal tax liens and UCC filings), and determine what modification endorsements are available from the title company based on the type of modification and the regulatory and statutory permissibility of the issuance of such endorsements in the particular jurisdiction.

- G. It may be a good idea to send the borrower a letter, prior to execution of Modification Agreement, stating clearly the conditions under which the modification will occur.
- H. Always prepare a written Modification Agreement containing all terms of workout, and record it, unless only change is decrease in interest rate or simple extension (and relatively short) of principal payments to maturity.
- I. If intervening lien claimants exist, endeavor to obtain their consent and subordination as part of the Modification Agreement.
- J. 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.
- K. Obtain consent of any guarantors of original loan prior to modification; otherwise they may be released.
- L. If present owner of property is not original mortgagor, original mortgagor must also sign Modification Agreement to preserve such mortgagor's personal liability to lender.
- M. Provide in original loan documents for right to subsequently amend and modify note and mortgage in any respect. If subordinate lienholder requests estoppel agreement, preserve right to modify first mortgage as part of agreement. 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.
- N. If mortgage loan is securitized and has been transferred, make certain that proper parties execute Modification Agreement.
- O. Where possible, have subordinate lienholders execute Intercreditor Agreement to establish rights and obligations of the respective parties, including future modification rights and limitations.

EXHIBIT C

(FANNINE MAE ANNOUNCEMENT)

Announcement 06-18 October 4, 2006

Amends these Guides: Servicing

Conventional Mortgage Modifications

This Announcement describes an additional option now available to servicers for modifying delinquent adjustable-rate conventional mortgages and introduces new and enhanced forms for documenting modifications of both adjustable-rate and fixed-rate conventional mortgages.

In order to avoid foreclosures of delinquent mortgages, we allow servicers to modify the terms of delinquent conventional mortgages with our prior approval and that of the mortgage insurer, if any. Currently, servicers may recommend to us modifications that extend the term of the mortgage, provide for reamortization of the outstanding debt, change adjustable-rate mortgages to fixed-rate mortgages (using the current market interest rate for the remaining term of the mortgage), capitalize delinquent interest and escrow items or advances (and costs, if allowed by state law), and/or reduce the existing interest rate to the current market rate or to a below-market interest rate. We do not, however, expect a servicer to recommend a mortgage modification to us unless the servicer has concluded, after appropriate investigation and analysis, that the modification will result in bringing the mortgage current and keeping it that way.

Servicers are reminded that while a mortgage is in an MBS pool they must not agree to any modification that would affect the mortgage term, interest rate, unpaid principal balance, or other major characteristic of the mortgage. An MBS pool mortgage can be modified if it has been removed from the MBS pool because it has four or more payments past due.

[Servicing Guide Part VII: Delinquent Mortgages; Chapter 5, Loss Mitigation Alternatives; Section 502.02: Modifying Conventional Mortgages](#)

We have recently enhanced the *Home Saver Solutions Network* to facilitate modifications of adjustable-rate mortgages that provide for the modified mortgages to remain adjustable-rate

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mortgages, as opposed to changing to fixed-rate mortgages. We do not modify fixed-rate mortgages to adjustable-rate mortgages. Effective immediately, servicers may recommend to us modifications of adjustable-rate mortgages that capitalize delinquent amounts and/or extend the term of the mortgage and that provide for the mortgages to remain adjustable-rate mortgages with the same pre-modification adjustable-rate features, such as the index, change dates and limits on interest rate change, as are provided in the original mortgage documents. This enhancement will give servicers additional flexibility in tailoring mortgage modifications to help borrowers cure delinquencies. To facilitate the documentation of modifications of adjustable-rate mortgages that provide for the mortgages to retain their adjustable-rate features, we have created the *Loan Modification Agreement (Adjustable Interest Rate)* Form 3161.

We also permit servicers to recommend to us mortgage modifications that either (a) temporarily reduce the interest rates of fixed-rate mortgages, in which the reduced interest rate increases in a series of steps to a fixed, current market interest rate; or (b) increase the interest rate of adjustable-rate mortgages in a series of steps to a fixed, current market interest rate. To facilitate the documentation of such modifications, we have created the *Loan Modification Agreement (Step Interest Rate)* Form 3162.

Finally, we have enhanced our existing *Loan Modification Agreement (Fixed Interest Rate)* Form 3179, which can be used to modify either a fixed-rate mortgage or an adjustable-rate mortgage that the borrower has agreed to change to a fixed-rate mortgage. In early October 2006, the new Forms 3161 and 3162 and the enhanced Form 3179 will be available for download from our Web site at www.efanniemae.com.

Servicers should contact their Servicing Consultant, Portfolio Manager, or our National Servicing Organization's Customer Care Center at 1-888-326-6438 if they have any questions about this Announcement.

Pamela S. Johnson
Senior Vice President

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EXHIBIT D

PURCHASING MORTGAGE-BACKED SECURITIES DOES NOT GIVE THE GOVERNMENT THE ABILITY TO MODIFY MORTGAGES BACKING THE SECURITIES

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The residential mortgage-related assets that the government is proposing to purchase in the bailout plan 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. The SPV will purchase large pool of mortgages from a financial institution. The SPV pays for the mortgages by issuing securities. These securities are collateralized by the mortgages owned by the SPV, hence they are “mortgage-backed” securities. These MBS are typically referred to as “certificates,” and most are debt securities that entitle the holder to a series of regularly scheduled payments, as with a corporate bond.

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. Just as corporate bond holders have no right to control the bond issuer’s management decisions, so too do MBS holders have no right to control how the SPV’s management of the mortgages.

The decision to modify mortgages held by an SPV rests with the SPV’s agent, call the servicer. The servicer performs the day-to-day tasks related to the mortgages owned by the SPV, such as collecting payments, handling paperwork, foreclosing, and selling foreclosed properties. These servicers, including many “mortgage companies” like Countrywide and Wells Fargo owned by bank holding companies, are the entities that actually consider loan modification requests. Confusingly, the servicer is often, but not always, the originator.

Servicers carry out their duties according to what is specified in their contract with the SPV. This contract is known as a “pooling and servicing agreement” or PSA. PSAs frequently place restrictions on servicers’ ability to modify mortgages. Sometimes the modification is forbidden outright, sometimes only certain types of modifications are permitted, and sometimes the total number of loans that can be modified is capped (typically at 5% of the pool). Additionally, servicers are frequently required to purchase any loans they modify at par (100 cents on the dollar). This functions as an anti-modification provision. Moreover, all PSAs prohibit the servicer from undertaking any action, including many modifications, that would threaten the MBS’s pass-thru tax status.

In order to direct servicers to engage in large scale loan modification, it is necessary to amend the PSA; a servicer that does not comply with a PSA risks being sued by the SPV and by the MBS holders. PSAs, however, cannot easily be modified. This is to preserve pass-thru tax status for the trust in order to avoid double taxation; to preserve the bankruptcy remoteness of the trust, so that the trust’s assets cannot be seized by creditors of the mortgages’ originators; and to protect the MBS holders from liability for the trust’s actions.

To date, servicers have granted few significant modifications for several reasons: contractual limitations (discussed above); understaffing for the volume of modification demand; lack of proper trained personnel; fear of suit by MBS holders who believe that modifications hurt their investments; and misaligned incentives. Foreclosure is frequently more profitable to servicers than loan modification. Therefore servicers are incentivized to foreclose rather than modify loans, even if modification is in the best interest of the MBS holders and the homeowners.

Six major problems prevent the government from modifying mortgages simply by purchasing hundreds of billions of dollars of MBS. Some of these problems prevent modification outright; others would result in a significant loss to taxpayers due to the modifications.

Problem 1. Treasury Will Typically Need to Hold At Least Two-Thirds of All MBS in a Pool to Modify the Underlying Mortgages

The typical PSA provides that it may only be modified with the consent of two-thirds of all of the MBS holders, as well as the insurer for the Net Interest Margin Securities—the resecuritization of the residual claims on the SPV.¹ Further, PSAs prohibit modification of the underlying mortgages that would change the scheduled

¹ See, e.g., Pooling and Servicing Agreement, Park Place Securities, Inc., Series 2005-WHQ4:

cashflow to a MBS holder, absent the holder's consent. PSAs contain this provision to comply with the Trust Indenture Act of 1939.² Thus, Treasury would have to incur all of the losses itself if it wished to engage in modifications. In so doing, the Treasury would be bailing out not just the financial institutions that chose to sell their MBS holdings to Treasury, but also the ones that did not sell, as their positions would be protected by the losses absorbed by Treasury.

Even if Treasury were willing to absorb all the modification losses itself, there is still the question of whether the government will be able to purchase the necessary two-thirds of MBS issued by any particular pool in order to have the authority to alter the PSA. This alone will be a tall order, as there might be thousands of IVIES from a single pool and these MBS might be dispersed world-wide. Some may be held by entities from which the Treasury Department will not be authorized to make purchases. And others will be held by entities that choose not to sell to the Treasury Department. The Treasury would need to put a Humpty-Dumpty of MBS back together again in order to modify the PSA to direct the servicer to engage in large-scale loan modification.

Problem 2. Collateralized Mortgage Obligations Make It Exceedingly Difficult for Treasury to Purchase a Sufficient Number of MBS to Modify Mortgages

The Treasury's Humpty-Dumpty problem is exacerbated by collateralized mortgage obligations, second mortgages, and mortgage insurance. Collateralized mortgage obligations or resecuritization seriously impedes the government's ability to purchase a sufficient number of MBS for any particular pool in order to ultimately engage in modification of the underlying mortgages. MBS issued by an SPV are typically tranced—divided into different payment priority tiers, each of which will have a different dividend rate and a different credit rating. Because the riskier tranches are not investment grade, they cannot be sold to entities like pension plans and mutual funds. Therefore, they are often resecuritized into what are known as collateralized mortgage obligations (CMOs). A CMO is a securitization in which the assets backing the securities are themselves mortgage-backed securities rather than the underlying mortgages. CMOs are themselves then tranced, and the senior tranches can receive investment grade ratings, making it possible to sell them to major institutional investors. The non-investment grade components of CMOs can themselves be resecuritized once again into what are known as CMO2s. This process can be repeated, of course, an endless number of times.

The upshot of this financial alchemy is that to control a sufficient share of MBS to alter a PSA, the government will frequently also have to own a sufficient share of CMOs to alter the CMOs' PSA and of CMO2s to alter the CMOs PSA in order to alter the MBS PSA. As a result it will be incredibly difficult for the government to purchase a sufficient amount of MBS to ultimately be able to modify the underlying mortgages.

This Agreement or any Custodial Agreement may also be amended from time to time by the Depositor, the Master Servicer, the NIMS 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 consents required by the immediately preceding clauses (i) and (ii) without the consent of the Holders of all Certificates then outstanding.

² 15 U.S.C. § 77ppp(b). ("Notwithstanding any other provision of the indenture. . .the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security, or to institute suit for the enforcement of any such payment on or after such respective dates, shall not be impaired or affected without the consent of such holder).

Problem 3. Junior Mortgages Are Securitized Separately and Must Also Be Modified for Any Modification of Senior Mortgages to Be Effective

The impossibility of modifying PSAs to permit modification on a wide scale is further complicated because many homeowners have more than one mortgage. Even if the mortgages are from the same lender, they are often securitized separately. If a homeowner is in default on two or three mortgages it is not enough to reassemble the MBS pieces to permit a modification of one of the mortgages. Modification of the senior mortgage alone only helps the junior mortgage holders, not the homeowner. For homeowners with multiple mortgages, the obstacle to providing effective mortgage modification through government purchase of loans is even higher.

Problem 4. Net Interest Margin Securities Insurers Must Agree to Modifications of PSAs and Mortgages

An SPV's income can exceed the dividends it must pay certificate holders. The residual value of the SPV after the certificate holders are paid is called the Net Interest Margin (NIM). The NIM is typically resecuritized separately into an NIMS, and the NIMS is insured by a financial institution. This NIMS insurer holds a position similar to an equity holder for the SPV. The NIMS insurer's consent is thus typically required both for modifications to PSAs and modifications to the underlying mortgages beyond limited thresholds. NIMS insurers financial positions are very similar to out of the money junior mortgagees—they are unlikely to cooperate absent a payout because they have nothing to lose. This will complicate mortgage modification by the Treasury and add to its expense.

Problem 5. Loss of Private Mortgage Insurance Coverage Upon Modification Would Destroy MBS Resale Value and Cost Taxpayers Money

On top of all this, many mortgages are insured by private mortgage insurance. This can be purchased either by the borrower or by the lender. Private mortgage insurance protects MBS investors from losses and greatly enhances the value of MBS. Private mortgage insurance policies typically provide for the termination of the insurance upon a loan modification.³ The termination of private mortgage insurance would greatly reduce the resale value of loans for the government.

Problem 6. REMIC Tax Problems from Modification Would Destroy MBS Resale Value and Cost Taxpayers Money

Even if the government could somehow modify the underlying mortgages by purchasing MBS in spite of all the obstacles mentioned thus far, modification would result in serious negative tax consequences for the MBS that would make them hard for the government to resell and would penalize MBS holders who could not or did not participate in the bailout.

The value of MBS depends heavily on their tax treatment. MBS are structured to enjoy REMIC (Real Estate Mortgage Investment Conduit) status under the Internal Revenue Code, which enables the MBS to avoid double taxation of income. Absent REMIC status, federal income tax would apply to the SPV as well as to the dividends paid to the MBS holders. REMIC status gives an SPV pass-thru status, so federal income tax only applies to the MBS holders on the dividends received from the trust. In order to qualify for tax-advantaged REMIC status, the pool of loans securitized in a REMIC must generally be treated as a static pool.⁴ This usually precludes large

³ Radian Guaranty Master Policy, Condition 4.C, at <http://www.radianbiz!pdffMaster Policy 2008.pdf>:

Notwithstanding any other provision of this Policy, the coverage extended to any Loan by a Certificate of Insurance may be terminated at the Company's sole discretion, immediately and without notice, if, with respect to such Loan, the Insured shall permit or agree to any of the following without prior written consent of the Company: (1) Any material change or modification of the terms of the Loan including, but not limited to, the borrowed amount, interest rate, term or amortization schedule, excepting such modifications as may be specifically provided for in the Loan documents, and permitted without further approval or consent of the Insured.

⁴ Treasury Reg. Subchapter F, § 301.7701-4, provides in part:

Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

scale modification of loans in the pool.⁵ Thus, significant mortgage modification by servicers could cost an SPV its REMIC status and result in double taxation of the MBS.

Because of this concern, many PSAs place significant constraints on modification of mortgage loans as well as modification of the PSA itself.⁶ Once REMIC status is lost, it cannot be regained, so any government action that would cost an MBS its REMIC status would seriously impair its resale value.

The Government Will Be Unable to Modify Mortgages Simply By Purchasing Billions of Dollars of Mortgage-Backed Securities. Bankruptcy Modification Provides the Only Guaranteed Method of Widescale Mortgage Modification for Distressed Homeowners

Only bankruptcy law changes can require the trust to go along with a loan modification and deal with the junior lien problem. Already Chapter 11 bankruptcy is used for the same effect. Because of the Trust Indenture Act, it is very difficult to engage in a consensual modification of corporate bonds. As a result businesses that need to restructure their bonds often find it necessary to do in bankruptcy. Amending the Bankruptcy Code to permit modification of all mortgages would also make voluntary modifications more likely, because a trust could defend any lawsuit by asserting that the borrower could have gotten the same deal (or one less favorable to the trust) in bankruptcy. Thus, permitting bankruptcy relief may well cause it to be unnecessary in many cases.

⁵ Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation on Possible Responses to Rising Mortgage Foreclosures before the Committee on Financial Services, U.S. House of Representatives; 2128 Rayburn House Office Building, April 17, 2007, at <http://www.fdic.gov/news/news/spceches/archives/2007/chairnanlspapr1707.html>.

⁶ Pooling and Servicing Agreement, ABFC 2005-OPT 1 Trust, at <http://www.sec.gov/Archives/edgar/data/11343316/000091412105002222/as871211-ex4.txt>.

Notwithstanding any provision of this Agreement to the contrary, neither the Trustee nor the NIMS Insurer shall consent to any amendment to this Agreement unless it shall have first received an Opinion of Counsel, delivered by (and at the expense of) the Person seeking such Amendment, to the effect that such amendment will not result in the imposition of a tax on any REMIC constituting part of the Trust Fund pursuant to the REMIC Provisions or cause any REMIC constituting part of the Trust Fund to fail to qualify as a REMIC at any time that any Certificates (other than the Class P Certificates) are outstanding and that the amendment is being made in accordance with the terms hereof.

EXHIBIT E

ALTA Form 11 - Modification of Mortgage

ENDORSEMENT

Attached to Policy No. _____

Issued By

_____ *Title Insurance Company*

The Company insures against loss or damage sustained or incurred by the insured by reason of:

1. The invalidity or unenforceability of the lien of the insured mortgage upon the title at Date of Endorsement as a result of the agreement dated _____, recorded _____ ("Modification"); and
2. The lack of priority of the lien of the insured mortgage, at Date of Endorsement, over defects in, or liens or encumbrances on the title, except for those shown in the policy or any prior endorsement and except: [Specify exceptions, if any]

This endorsement does not insure against loss or damage, and the Company will not pay costs, attorneys' fees or expenses, by reason of any claim which arises out of the transaction creating the Modification, by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws, that is based on:

- a. the Modification being deemed a fraudulent conveyance or fraudulent transfer; or
- b. the subordination of the interest of the insured mortgagee as a result of the application of the doctrine of equitable subordination because of the Modification; or
- c. the Modification being deemed a preferential transfer except where the preferential transfer results from the failure:
 - i. to timely record the instrument of transfer; or
 - ii. of such recordation to impart notice to a purchaser for value or a judgment or lien creditor.

This endorsement is issued as part of the policy. Except as it expressly states, it does not (i) modify any of the terms and provisions of the policy, (ii) modify any prior endorsements, (iii) extend the Date of Policy or (iv) increase the Amount of Insurance. To the extent a provision of the policy or a previous endorsement is inconsistent with an express provision of this endorsement, this endorsement controls. Otherwise, this endorsement is subject to all of the terms and provisions of the policy and of any prior endorsements.

[Witness clause optional]

Date of Endorsement: _____

[Witness clause optional]

Date: _____

_____ *Title Insurance Company*

By: _____

Authorized Signatory

ALTA Form 11

EXHIBIT F

CLTA Form 110.5 - Modification of Mortgage

ENDORSEMENT

Attached to Policy No. _____

Issued By

_____ *Title Insurance Company*

The Company hereby insures the owner of the indebtedness secured by the insured mortgage against loss or damage which the insured shall sustain by reason of:

1. The failure of that certain agreement executed by _____ and recorded _____ to modify the insured mortgage or the obligation secured thereby;
2. The priority of any lien or encumbrance over the lien of the insured mortgage as modified by the above mentioned agreement, except for those matters shown in Schedule B as prior to the insured mortgage, and the following matters:

This endorsement is made a part of the policy and is subject to all of the terms and provisions thereof and of any prior endorsements thereto. Except to the extent expressly stated, it neither modifies any of the terms and provisions of the policy and any prior endorsements, nor does it extend the effective date of the policy and any prior endorsements, nor does it increase the face amount thereof.

Date: _____

_____ *Title Insurance Company*

By: _____

Authorized Signatory

CLTA Form 110.5 (Rev. 6-14-96)

ALTA - Lender