

D R A F T
FOR DISCUSSION ONLY

Mortgage Modifications Act

Uniform Law Commission

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Mortgage Modifications Act

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Mortgage Modifications Act

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Mortgage Modifications Act

Reporter's Prefatory Note

~~The parties to a mortgage loan often agree to modify the terms of the secured indebtedness or obligations. Typical modifications include extending the maturity date of the loan, increasing or decreasing the interest rate or changing the method by which interest is calculated, and increasing the principal of the loan by agreeing to new advances or by capitalizing unpaid interest. The parties often agree to modifications in response to a mortgagor's default in payment or the mortgagor's financial distress. Some commercial credit facilities are modified on a periodic basis to reflect changing conditions in debt markets or to substitute debt tranches. In addition, a lender will sometimes consent to the sale of mortgaged property, leaving existing financing in place, upon an increase in the interest rate of the loan.~~

~~When the terms of a mortgage loan are modified, the common law is not clear as to whether the parties must execute and record a modification of the mortgage instrument. Nor is~~

the common law clear as to whether a modification affects the priority of the mortgage with respect to junior lienholders. The recordation issue affects parties who acquire interests in the mortgaged property after a modification. The question is what types of modifications should be placed of record to give notice to parties who acquire an interest after the modification. The priority issue, on the other hand, affects parties who acquired their interests in the mortgaged property after recordation of the mortgage but before the modification. The question is what types of modifications are prejudicial to their preexisting junior interests. A third issue is whether a loan modification is a novation, which could cause the loan to be unsecured.

Recordation of a modification agreement

—— Relevant to the first issue — whether a recorded modification agreement is required — is that most jurisdictions do not have requirements as to which loan terms that must be included in a mortgage. Restatement (Third) of Property: Mortgages § 1.5, reporter's note (1997). Some states do have statutory requirements that a mortgage state the maximum principal that the mortgage can secure. To the extent that a loan term must be included in a mortgage, recordation of a modification of that term is likely required in those states.

—— The maturity date of a loan, while not generally required to be included in a mortgage, is usually stated in a mortgage because the omission of the maturity date in the mortgage may have consequences as to the application of the statute of limitations. Thus, failure to record a modification of the maturity date could have similar consequences as to the application of the statute of limitations. Furthermore, certain changes to the mortgage itself, such as adding or

~~releasing collateral would require recordation of a document to perfect the lien and set the priority of the mortgage as to new collateral or to clear title in case of a partial release.~~

~~—— Because cases provide little guidance as to the first issue, borrowers are required to suffer the delays and incur the expense of the preparation and recordation of an amendment to the mortgage even when the modification is of loan terms that are not created by or disclosed in the mortgage. The act is intended to provide clarity by creating a safe harbor for certain types of modifications to the terms of a loan that do not require recordation of a modification agreement. Modifications that are not within the safe harbor will continue to be governed by other law.~~

Priority

~~—— With regard to the second issue — whether a loan modification affects the priority of a mortgage — a large number of reported cases exist, but they do not provide sufficient guidance in resolving the issue. The Restatement view, which is the prevailing view and often cited by courts, is:~~

~~If a senior mortgage or the obligation it secures is modified by the parties, the mortgage as modified retains priority against junior interest in the real estate, except to the extent that the modification is materially prejudicial to the holders of such interests~~

~~Restatement (Third) of Property: Mortgages § 7.3(b) (1997). What is not clear from the case law is which modifications are materially prejudicial to junior interests and which are not.~~

~~—— The priority cases consider various types of modifications such as extensions of the maturity of a loan, increases in the principal of a loan, and changes in the interest rate, and determine based on the particular facts of the case whether the modification materially prejudices a junior interest holder. A number of cases find that an increase in the principal of a loan causes a~~

~~loss of priority, usually only to the extent of the increase. Restatement § 7.3 cmt. c. Most of the cases addressing an extension of the maturity of a loan find that a junior lienholder is not materially prejudiced and is in fact benefitted because the senior lender is extending the loan rather than foreclosing and cutting off the junior lien. *Id.* Some cases, however, hold otherwise, finding that an extension is materially prejudicial. Thus, the cases do not provide sufficient guidance and require litigation to resolve the issue.~~

~~——— This act is intended to provide clarity by creating a safe harbor for modifications that do not affect the priority of a mortgage. Those modifications that do not fit within the safe harbor will continue to be governed by other applicable law. Many loan modifications only affect the obligations that are secured by a mortgage rather than modifying the terms of the mortgage itself. Some types of modifications, such as increasing the principal of a loan, clearly prejudice junior lienholders. Other types of modifications, such as decreasing the interest rate on a loan, clearly do not prejudice junior lienholders. The intent of the act is to exclude from the safe harbors of the act those types of modifications to the secured obligations that materially prejudice junior lienholders, leaving other modifications of the secured obligations within the safe harbors.~~

Novation

~~——— The act will make clear that if a mortgage provides that it secures an obligation as modified, the mortgage will secure the obligation as modified even if the modification might otherwise be treated as a novation. [Should there be exceptions or should the act make the language of the mortgage effective regardless of the type of modification?]~~

Purpose

~~——— The act will save time and money for parties who wish to modify the terms of their loans in ways that fit within the safe harbors by avoiding the need to obtain title updates to determine whether there is a junior lien and by avoiding the need to prepare and record a mortgage amendment. If mortgaged property is encumbered with a junior lien, the parties can avoid the necessity of obtaining consent from the lienholder and may avoid later litigation over priority if no consent is given.~~

~~——— When a mortgagor is in default in payment or otherwise in financial distress, a modification can be an alternative to foreclosure that benefits both parties. The lender hopes that a modification will result in a performing loan, and the borrower hopes to retain ownership of the mortgaged property. In the case of a residential mortgage loan, the borrower hopes to avoid foreclosure and loss of the home.~~

~~——— The act is intended to remove some roadblocks to modification by making the law more certain and by protecting the priority of a mortgage for certain common modifications that would not typically cause a material prejudice to a junior interest holder. The act seeks to adopt the appropriate balance between the rights of the parties to a senior mortgage to modify loan terms and the rights of a junior interest holder to avoid material prejudice to its lien position.~~

[Residential and non-residential loan modifications]

~~———The act distinguishes residential and commercial mortgage loans because of some important differences between them. Commercial mortgages typically contain a “due on encumbrance” clause, which allows a lender to accelerate the loan if the borrower allows a second mortgage or other subordinate lien on the property without the consent of the superior lienholder. Thus, second liens are rare, and when the senior lender does consent, the lenders may enter into an inter-creditor agreement that governs the issue of priority in case of a modification. When senior lenders do agree to additional financing, it is often mezzanine financing secured by ownership interests in the borrowing entity rather than by the real property, and an inter-creditor agreement is typical. As a result, junior consensual lienholders are not often affected by the modification of a senior mortgage loan. However, commercial properties may be encumbered by judgment liens or mechanic’s liens.~~

~~———With respect to residential mortgage loans, a lender may not accelerate based on “the creation of a lien or other encumbrance subordinate to the lender’s security instrument which does not relate to a transfer of rights of occupancy in the property.” 12 U.S.C. §1701j-3(d)(1). Thus, residential borrowers can and often do have subordinate financing in the form of a home improvement loan, a home equity loan, or a home equity line of credit.~~

~~———Commercial loans are also much more diverse in their terms as compared to residential mortgage loans, most of which use standardized Fannie Mae/Freddie Mac form documents. Thus, the types of modifications that the parties may wish to make also vary more for commercial loans. Reasons for modification are also more diverse for commercial loans. Residential mortgage loans are rarely modified except to address a default by the borrower or the borrower’s financial distress. For residential loans, competing policies exist favoring the availability of secondary financing and modification of distressed loans in order to prevent foreclosure of a home.]~~

~~———{The Prefatory Note will continue with a description of the act.}~~

~~Mortgage Modifications Act~~

Section 1. Title

This [act] may be cited as the Mortgage Modifications Act.

Section 2. Definitions

In this [act]:

(1) “Common-interest community” means real property with respect to which a person, by virtue of ownership of a unit, is obligated to pay real-property taxes or insurance premiums or for maintenance, improvement of other real property, or services described in a declaration or other governing record, however denominated. The term includes properties held by a cooperative-housing corporation. In this paragraph, “ownership” includes a leasehold interest if the lease term is at least [20] years, including renewal options.

_____ (2) “Loan document” means a promissory note, credit agreement, loan agreement, indenture, or other ~~agreement~~record creating ~~indebtedness~~debt or other obligations secured by a mortgage. The term does not include a mortgage.

(~~23~~) “Modify” means change, amend, ~~or revise. The term includes supplement and restate, correct, supplement, or restate. The term does not include a transfer or assignment of the ownership of or right to enforce an obligation secured by a mortgage.~~ The term “modification” has a correlative meaning.

(~~34~~) “Mortgage” means a ~~security instrument~~record that creates a consensual interest in real property to secure payment or performance of an obligation. ~~The term includes a deed of trust [but does not include a security instrument that creates a consensual interest to secure an obligation owed to a homeowners’ association in a common-interest community].~~

_____ (5) “Mortgaged property” means real property or fixtures subject to a mortgage.

(~~46~~) “Non-residential mortgage ~~loan~~” means a ~~loan secured by a~~ mortgage that is

not a residential mortgage ~~loan~~.

(~~5~~7) “Obligation” means a debt or other duty or liability of an obligor secured by a mortgage.

(~~6~~8) “Obligor” means a person that:

(A) owes payment or performance of an obligation;

(B) has signed a mortgage with respect to mortgaged property; or

(C) is otherwise accountable in whole or in part for payment of the obligation.

(9) “Person” means an individual, estate, business or nonprofit entity, public corporation, government or governmental subdivision, agency or instrumentality, or other legal entity.

(~~7~~10) “Record”, used as a noun, means information:

(A) inscribed on a tangible medium; or

(B) stored in an electronic or other medium and retrievable in perceivable form.

(11) “Record,” used as a verb, means to submit a document complying with applicable legal standards, with required fees and taxes paid, to the appropriate governmental office under [~~the~~the cite to state recording act ~~of this State~~].

(~~8~~12) “Residential mortgage ~~loan~~” means a ~~loan secured by a~~ mortgage on residential real property.

(~~9~~13) “Residential real property” means real property that, when a mortgage is entered into with respect to the property, is used or ~~is~~ intended by its owner to be used primarily for the personal, family, or household purposes of its owner and is improved, or intended by its

owner to be improved, by one to four dwelling units. ~~The term includes:~~

- ~~_____ (i) an attached single family unit;~~
- ~~_____ (ii) a single family manufactured housing unit or a time share in a dwelling unit if either is treated as real property under law of this state other than this [act]; and~~
- ~~_____ (iii) a single family unit in a common interest community.~~

(1014) “State” means a state of the United States, the District of Columbia, Puerto Rico, the United States Virgin Islands, or any other territory or possession subject to the jurisdiction of the United States. The term includes a federally recognized Indian tribe.

Reporter’s Notes

1. **Common-interest community.** The term “common-interest community” comes from the Uniform Home Foreclosure Procedures Act and the Model Negotiated Alternative to Home Foreclosure Act. Note that the definition will be moved to section 3 if that is ultimately the only place that it is used.

Questions: Do we need this definition? Would it be better to reference each state’s definition of a common interest community?

2. Loan document. The term “loan ~~agreement~~document” is intended to encompass any type of ~~agreement~~record that creates an obligation secured by a mortgage. It is intended to include a promissory note, a credit agreement, a loan agreement, an indenture, a construction loan agreement, a consumer credit agreement, or any other type of agreement secured by a mortgage. However, it does not include the mortgage itself.

2.3. Modify. The term “modify” is intended to be very broad and thus to encompass any type of modification or change that parties might make to a loan document, including a correction, supplement to or a restatement of a loan document. The term does not include an assignment or transfer. “Modification”, as the corresponding noun, has a corresponding meaning.

~~3. The term “mortgage” is intended to include not only mortgages but also deeds of trust and other consensual real property security interests. It is based upon the definition~~4. Mortgage. The definition of “mortgage” comes from the definition of “mortgage agreement” in the Model Negotiated Alternative to Home Foreclosure Act; however, in this act, the term refers to the instrument rather than to the interest in property. The Model Act excludes. Depending upon local usage and custom, a mortgage may be denominated as a mortgage, deed of trust, trustee deed, security deed, deed to secure debt, or the like. The definition does not contain an exclusion of homeowners’ association liens, and we need to consider whether our act should also exclude them. If we do exclude homeowners’ association liens, do we need to define common interest community, as does the Model Act, or is the term sufficiently self-explanatory in the context of

~~this act?~~ because they are excluded in the Section 3.

Question: Do we need to include in the definition of mortgage a consensual interest in fixtures?

4.5. Mortgaged property. This term now appears in the act in several places.

6. Non-residential mortgage. A “non-residential mortgage ~~loan~~” is a mortgage that secures a commercial ~~mortgage~~ loan or any other mortgage loan that is secured by property that is not a residential mortgage loan real property as that term is defined.

5.7. Obligation. The definition of the term “obligation” comes from the Model Negotiated Alternative to Foreclosure Act. ~~As in the Model Act, the~~ and the Uniform Home Foreclosure Procedures Act. The term includes a non-recourse debt. ~~Should that be stated in the definition itself? Also, to consider is whether we need a separate definition for debt to be used when the act refers to monetary obligations as in section 3(b)(1-3) and 4(b)(1-3), whether the debt is non-recourse due to the application of anti-deficiency judgment legislation, agreement of the parties, or for other reasons.~~

8. Obligor. This definition comes from the Uniform Home Foreclosure Procedures Act.

6.9. Person. The definition of “person” comes from the ULC Drafting Rules and Style Manual.

7.10. Record. The definition of “record”, used as a noun, comes from the ULC Drafting Rules and Style Manual.

11. Record. The definition of “record”, used as a verb, comes from the Uniform Nonjudicial Foreclosure Act ~~and the Uniform Assignment of Rents Act. The term primarily used in the act is “recorded” which is a passive participle functioning as an adjective.~~

Question: Would it be better to define “recorded”?

8.12. Residential mortgage. A “residential mortgage ~~loan~~” is one that is secured by a mortgage on residential real property as that term is defined in the act. ~~By using that defined term, the definition includes the requirement that the loan be for personal, family, or household purposes.~~

9.13. Residential real property. The definition of “residential real property” comes from the definition of that term in the Uniform Nonjudicial Foreclosure Act ~~and includes examples from the definition of mortgaged property in the Model Negotiated Alternative to Foreclosure Act. In the Model Act, the character of property as residential is determined at the time of foreclosure, which is not applicable in this act. This definition (and the one in the Uniform Act) determines the residential character of the property at the time the loan is made. As described in that Act, there are two elements in the definition, one relating to the use of the property and the other to the improvements on it. “Residential real property” must be used or intended to be used primarily for personal, family, or household purposes of its owner. This definition is similar to that of the Uniform Consumer Credit Code, the Federal Trade Commission’s Holder in Due~~

Course Rule, and various other consumer protection statutes. Some commercial or other nonresidential use is permitted within this definition, so long as the primary use is residential.

~~10.~~14. State. The definition of “state” comes from the ULC Drafting Rules and Style Manual.

Section 3. Scope; Exclusions

(a) Except as provided in subsection (b), this [act] applies to mortgages whether denominated as a mortgage, a deed of trust, or another name.

(b) This [act] does not apply to a record creating a consensual interest to secure an obligation owed to a condominium association or homeowners’ association in a common-interest community.

(c) This [act] does not affect any law of this state that governs:

(1) the required content of a mortgage; or

(2) future advances. “Future advances” are advances of funds made after the initial advance of funds pursuant to the terms of a loan document before its modification.

Reporter’s Notes

1. **Scope.** The act applies to modifications of obligations secured by mortgages, which are defined as consensual interests in real property to secure payment or performance of an obligation.

2. **Exclusion for homeowners’ association lien.** The act is not intended to apply to the modification of a declaration of covenants, conditions, and restrictions or other record that creates an obligation to a condominium association or homeowners’ association.

3. **Laws Governing Contents of a Mortgage.** The act is not intended to affect any state law that requires a mortgage to include certain terms such as a law that requires that a mortgage state the maximum principal of a loan.

4. **Laws Governing Future Advances.** The [act] is not intended to affect state law governing future advances. The definition of “future advances” will be moved to the definitions section if the term is ultimately used elsewhere in the act; otherwise, it will be collapsed into the language of the subsection. The definition of future advances needs some thought.

See also see reporter’s note 8 after Section 4 for a discussion of the issue of a modification that provides for new future advances or turns a fixed loan into a revolving credit

loan.

Section 4. Non-Residential Loan Modification

(a) Except as provided in subsection (b), if a recorded ~~mortgage securing a~~ non-residential mortgage ~~loan~~ provides that the mortgage secures obligations under a loan document as it may be amended, modified, supplemented, or restated, or words of similar effect, the mortgage secures the obligations under the loan document as modified without ~~the necessity of recording an amendment to~~ regard to whether a modification of the mortgage is recorded and without regard to whether the modification may otherwise constitute a novation of the obligations under the loan document and ~~has the same~~ retains its priority ~~as the priority of the original recorded mortgage.~~

(b) Subsection (a) does not apply to a modification that:

(1) increases ~~the amount of~~ the principal of the obligation ~~[except if the increase is a capitalization of unpaid interest or other unpaid obligations]~~ stated in the recorded mortgage,

~~[(2) extends~~ or accelerates the maturity date of the obligation if the maturity date is stated in the ~~original~~ recorded mortgage,]

~~[(3) increases the interest rate of the obligation if the interest rate is stated in the original~~ recorded mortgage,] or

~~[(4) occurs at the time of~~ contemporaneously with a transfer of ~~[the ownership or right to enforce]~~ of a loan document.]

(c) A modification described in subsection (b) is governed by ~~the law that would apply without regard to this [act]~~ other law.

Reporter's Notes

1. ~~Section 3 applies to non-residential loans.~~ **Another Option.** In our December meeting there was support for language suggested by Dale Whitman which is shown as subsection (b) below. In addition, Pat Fry suggested separating the concepts of priority and continued security for the modified obligation. Below is possible language that incorporates those comments:

(a) If a non-residential mortgage provides that it secures obligations under a loan document as the obligations may be amended, modified, supplemented, or restated, or words of similar effect, the mortgage secures the obligations under the loan document as modified without regard to whether a modification of the mortgage is executed and recorded and without regard to whether the modification may otherwise constitute a novation of the obligations under the loan document.

(b) Except as provided in subsection (c), modification of an obligation secured by a non-residential mortgage does not affect the priority of the mortgage as against junior interests in the mortgaged property.

Note that subsection (a) does not need exceptions. As between the parties, the mortgage is still enforceable to secure the modified obligation. With modification language in the mortgage, the mortgage itself need not be modified. Subsection (b) is based on the language of Restatement §7.3(b). The safe harbor applies even without modification language in the mortgage, and the exceptions to the safe harbor would be those modifications that are materially prejudicial. The provisions are not limited to recorded mortgages.

~~2. Subject to exceptions in subsection (b), subsection (a) is intended to create a safe harbor for modifications of a loan document if a mortgage provides that it secures loan documents as modified. Most mortgages do in fact have a provision to this effect. If modifications are within the safe harbor, no need exists for the recordation of a modification agreement, and the mortgage retains its original priority.~~ **Applicability.** Section 4 applies to non-residential mortgage loans. The section applies to modifications of obligations secured by a mortgage. It does not apply to releases of or additions to the mortgaged property.

3. Continued security for modified obligation. The first part of subsection (a) makes clear that a provision in a mortgage to the effect that the mortgage secures obligations in loan documents as modified is effective. The mortgage will secure the loan document obligations as modified without regard to whether the parties **execute and record a modification of the mortgage** itself and without regard to whether the modification may otherwise constitute a novation of the obligations under the loan document.

Execution and recordation of a mortgage modification may be desirable for other reasons. If a loan document term that is stated in the mortgage is modified, a recorded modification agreement will give notice of that modification pursuant to a state's recording act.

Some states require that a mortgage must state the maximum principal amount that the mortgage may secure. In those states, an increase in the stated principal amount would appear to require a modification of the mortgage. Section 3(c)(1) makes clear that this act does not supersede any such requirements.

If a modification is so substantial as to constitute a novation of the loan, some cases hold that the mortgage may no longer secure the modified loan. See, e.g. *In re Fair Finance Co.*, 834 F.3d 651 (2016). Subsection (a) is intended to clarify that language in the mortgage stating that it continues to secure the loan is effective even if the modification is so substantial as to be a

novation.

4. **Priority.** Under common law and the Restatement, if an obligation secured by a mortgage is modified, the mortgage “retains priority as against junior interests in the real estate, except to the extent that the modifications is materially prejudicial to the holders of such interests.” Restatement §7.3(b). The purpose of second part of subsection (a) of the act is to create a safe harbor for certain modifications that will not be treated as materially prejudicial with exceptions to the safe harbor listed in subsection (b).

5. **Increase in principal.** Cases hold that an advance of new funds does materially prejudice a junior lienholder. This provision would change that rule if the new advance does not increase the principal beyond the principal stated in the mortgage.

Question: Does this implicate some state’s statutes regarding future advances or revolving credit loans? See note 8 below.

6. **Change in maturity date.** Most of the cases find that a junior lienholder is not materially prejudiced by the extension of the maturity date of a loan because it makes a foreclosure less likely. In a few circumstances, a junior lienholder could be prejudiced if the value of the property falls during the extended term of the loan or because principal is not reduced as quickly with a modified amortization schedule. The Restatement position is that an extension of the maturity of a senior mortgage loan is beneficial to junior lienholders and should not cause a loss of priority.

Question: Do we want to keep this exception?

Question: What if the maturity date is shortened? Why would that ever happen except perhaps in conjunction with a reduction in interest rate and payments?

6. **Increase in interest rate.** Cases hold that an increase in interest rate does materially prejudice a junior interest holder and results in loss of priority to the extent of the increase. Taking this exception out would change that rule.

Question: Do we want to keep this exception?

7. **Modification contemporaneously with transfer.** The Restatement and cases on subrogation give a lender who pays off another lender and takes a new note and mortgage the same priority as the mortgage that is repaid to the extent that junior lienholders are not materially prejudiced. Examples of material prejudice are the same as those relating to a modification. It does not matter that the lender has changed. The same is true where a loan is assigned and modified rather than paid off with a new loan.

Concerns about modification at the time of transfer may relate to whether a mortgage tax is due. Whether a tax is due is governed by other law. This act is not intended to create a method for avoiding payment of such a tax.

~~3. Subsection (b) lists exceptions to the safe harbor—those types of modifications that the act does not alleviate the necessity for recording or protect the priority of the mortgage, in which case those issues are determined by other law as provided in subsection (c). If the committee determines that the exceptions as related to the recordation issue and the priority issue are different, section 3 may need to be divided into two sections—one for each issue—or the exceptions may need to be listed in separate subsections for the two issues.~~

Question: Do we want to keep this exception?

~~4. The exceptions and possible exceptions to the safe harbor are discussed in an issues memo.~~
8. Future advances. Michael O’Neal has raised a concern about a modification that provides for new future advances or turns a fixed loan into a revolving credit loan. We have added language in Section 3 as a possible way to address the issue. Michael describes the issue as follows:

I believe we need an exception for future advances. Without one, this act could be used to avoid (1) existing statutes that govern the required *contents* and *effect* of future advance mortgages and (2) existing laws that govern *priority of mechanics’ liens* and other similar liens.

The recommendation of the Study Committee expressly stated that the Drafting Committee should not consider the question of future advances. It is true that that recommendation defined “future advances” as “advances of funds made . . . *without* modification of the loan documents.” Study Committee Report, at 5 n. 12. But the question is sufficiently complicated and the political interests at stake are so strongly vested that we should consider whether future advances made *pursuant to a modification* of the loan documents should be expressly excluded.

The following example demonstrates the potential conflicts with state mechanic’s lien priority laws.

Example 1: On January 1, B acquires Blackacre, located in State X, in the amount of \$150,000 and obtains a loan in the amount of \$100,000 from L for that purpose. B executes and L records a mortgage encumbering Blackacre and securing the loan obligation. The entire \$100,000 is advanced by L to B and used by B to pay the purchase price.

On February 1, B contracts with GC to furnish materials and labor for improvements to Blackacre and GC commences work at the property. Because the loan by L was fully disbursed prior to commencement of work, under the laws of State X any lien rights in favor of GC for work performed or material furnished but unpaid by B are completely subordinate to the recorded mortgage securing the \$100,000 for the benefit of L.

On March 1, B pays down the loan from L to a balance of \$10,000. B and L agree to supplement the original loan with a revolving line of credit in the amount of \$90,000, which B may use in part to pay for the ongoing construction. They agree that the original mortgage will also secure the supplemental revolving credit loan facility. Under the existing “broken priority” laws of State X, the lien of the mortgage will continue to have

priority over the lien rights of GC to the extent of \$10,000. However, because GC has already commenced work at Blackacre, GC's lien rights will now have priority over the mortgage in favor of L to the extent of any future advance of the \$90,000 revolving credit line secured by the mortgage.

As drafted, the proposed act will overturn this result. Because there is no increase to the original principal amount of \$100,000 secured by the mortgage, the supplemental line of credit transaction is a "modification" that does not fall into any of the exceptions to the safe harbor. Therefore, the mortgage will secure the \$90,000 line of credit with the "same priority" as the original mortgage.

The following example demonstrates the potential conflicts with existing state laws governing revolving credit lines. For example, Virginia has a statute that governs the priority of credit line deeds of trust. See VA. CODE § 55.1-318. This provision establishes certain formalities for the *contents* of credit line deeds of trust (e.g., a required legend declaring "THIS IS A CREDIT LINE DEED OF TRUST", beneficiary's address, stated maximum aggregate principal amount secured). It then establishes *priority rules* that provide for future advances to have priority that "relates back" to the recording of the deed of trust. There are exceptions to this priority rule; for example, a subsequent judgment creditor may obtain partial priority over a future advance by giving notice to the beneficiary. These priority rules conflict with Virginia's recent loan modification statute. VA. CODE § 55.1-318.1.

Virginia is not alone. Florida law also requires a mortgage to expressly state that it secures future advances and state the maximum principal amount secured; and it provides a special statute of limitations (20 years) as to effectiveness. FLA. STAT. § 697.04. Many other examples could be found. Without an exclusion for future advances, the act could be used to evade these formal contents requirements and override these priority rules.

Example 2: On January 1, B acquires Blackacre, located in State X, in the amount of \$150,000 and obtains a loan in the amount of \$100,000 from L for that purpose. B executes and L records a mortgage encumbering Blackacre and securing the loan obligation. The entire \$100,000 is advanced by L to B and used by B to pay the purchase price.

On February 1, B pays down the loan from L to a balance of \$10,000. B and L agree to supplement the original loan with a revolving line of credit in the amount of \$90,000. They agree that the original mortgage will also secure the supplemental revolving credit loan facility. State X has rules similar to Virginia or Florida (*supra*) that govern the contents the priority of credit line mortgages. However, B and L do not amend the recorded mortgage to comply with those rules. Because the recorded mortgage does not comply with the content requirements of the credit line statute, the mortgage may not be entitled to the benefit of the priority rules of that statute.

As drafted, the proposed act will overturn this result. Because there is no increase to the original principal amount of \$100,000 secured by the mortgage, the supplemental line of credit transaction is a "modification" that does not fall into any of the exceptions to the safe harbor. Therefore, the mortgage will secure the \$90,000 line of credit with the "same

priority” as the original mortgage. That the mortgage fails to comply with the credit line statute appears to be immaterial.

The simplest way to prevent these kinds of conflicts with existing state priority rules as to future advances is to include an exception to the safe harbor for a modification that “provides for a future advance.” By expressly excluding future advances, this act would appropriately deal with the narrow issue raised by the Virginia statute—providing clarity of what does and does not constitute “material prejudice” to a potential junior creditor.

You will note that I have also included as part of the exception the phrase that the modification “provides that the collateral secures future advances.” Normally, of course, such a provision would be found in the mortgage itself. However, according to the Restatement, the agreement for a future advance “need not be in the mortgage” and is binding on third parties provided “the mortgage states a monetary amount to be secured.” RESTATEMENT § 2.1(b), (c). Although I have not examined the supporting case law in detail, the Reporter’s Note indicates that “[t]his principle is widely accepted.”

Section 4.5. Residential Loan Modification

(a) Except as provided in subsection (b), if a recorded ~~mortgage-securing a~~ residential mortgage-~~loan~~ provides that the mortgage secures obligations under a loan document as it may be amended, modified, supplemented, or restated, or words of similar effect, the mortgage secures the obligations under the loan document as modified without ~~the necessity of recording an amendment to~~ regard to whether a modification of the mortgage is recorded and without regard to whether the modification may otherwise constitute a novation of the obligations under the loan document and ~~has the same~~ retains its priority ~~as the priority of the original recorded mortgage.~~

(b) Subsection (a) does not apply to a modification that:

(1) increases the amount of the principal of the obligation [except if the increase is a capitalization of unpaid interest or other unpaid obligations],;

~~[(2) extends the maturity date of the obligation if the maturity date is stated in the original mortgage,];~~ or

~~[(3) increases the interest rate of the obligation if the interest rate is stated in the original mortgage,] or~~ _____

~~_____ [(4) occurs at the time of a transfer of [the ownership or right to enforce] a loan document.]~~

(c) A modification described in subsection (b) is governed by the law that would apply without regard to this [act].

Reporter's Notes

1. Another option. John Valdivielso and Lisa Caffrey provided comments with respect to what they believe would be useful for residential mortgages. Based on their comments, another option for the language of the residential section is as follows:

_____ (a) Except as provided in subsection (b):
_____ (1) modification of an obligation secured by a residential mortgage does not affect the priority of the mortgage; and
_____ (2) recordation of a modification agreement is not necessary to retain mortgage priority.

_____ (b) Subsection (a) does not apply to a modification that:
_____ (1) provides for the advance of new funds not contemplated under the loan documents and mortgage; or
_____ (2) increases the interest rate in excess of that provided in the loan documents.

Note that Lisa and John do not have the same concerns with residential mortgages about continued security of the modified obligation or about novation. Also, we can add a definition of modification agreement if this subsection (a) is selected.

_____ **2. Applicability.** Section 5 applies to residential mortgage loans. The section applies to modifications of obligations secured by a mortgage. It does not apply to releases of or additions to the mortgaged property.

_____ **3. Priority.** Under common law and the Restatement, if an obligation secured by a mortgage is modified, the mortgage “retains priority as against junior interests in the real estate, except to the extent that the modifications is materially prejudicial to the holders of such interests.” Restatement §7.3(b). The purpose of subsection (a) of the [act] is to create a safe harbor for certain modifications that will not be treated as materially prejudicial with exceptions to the safe harbor listed in subsection (b).

_____ Recordation of modification agreement is not necessary to retain the priority of the mortgage if the modification is not materially prejudicial to junior interest holders. However, recordation of a modification agreement may be desirable for other reasons.

_____ **4. Increase in amount owed.** Cases hold that an advance of new funds does materially prejudice a junior lienholder and results in loss of priority at least to the extent of the increase.

Question: What should this exception cover and how should it be worded?

5. **Change in maturity date.** Most of the cases find that a junior lienholder is not materially prejudiced by the extension of the maturity date of a loan because it makes a foreclosure less likely. In a few circumstances, a junior lienholder could be prejudiced if the value of the property falls during the extended term of the loan or because principal is not reduced as quickly with a modified amortization schedule. The Restatement position is that an extension of the maturity of a senior mortgage loan is beneficial to junior lienholders and should not cause a loss of priority.

Question: Do we want this as an exception?

Question: What if the maturity date is shortened? Why would that ever happen except perhaps in conjunction with a reduction in interest rate and payments?

6. **Increase in interest rate.** Cases hold that an increase in interest rate does materially prejudice a junior interest holder and results in loss of priority to the extent of the increase. Consistent with case law, this exception removes increases in the amount owed from the safe harbor.

Section ~~6~~. Uniformity of Application and Construction

In applying and construing this uniform act, a court shall consider the promotion of uniformity of the law among jurisdictions that enact it.†

†Section ~~7~~. Relation to Electronic Signatures in Global and National Commerce

Act {Insert if necessary.}

This [act] modifies, limits, or supersedes the Electronic Signatures in Global and National Commerce Act, 15 U.S.C. Section 7001 et seq.[, as amended], but does not modify, limit, or supersede 15 U.S.C. Section 7001(c), or authorize electronic delivery of any of the notices described in 15 U.S.C. Section 7003(b).

Legislative Note: *It is the intent of this act to incorporate future amendments to the cited federal law. A state in which the constitution or other law does not permit incorporation of future amendments when a federal statute is incorporated into state law should omit the phrase “, as amended”. A state in which, in the absence of a legislative declaration, future amendments are incorporated into state law also should omit the phrase.†*

†Section ~~8~~. {Saving Provision

~~—— If a saving provision is necessary, include appropriate language. See Rule 403.}† Section~~

8. Transitional Provision

(a) This [act] applies to a mortgage modification made on or after [the effective date of this [act]].

(b) This [act] applies to a mortgage created on, after, or before [the effective date of this [act]].

Reporter's Note

†Should subsection (a) refer to modification of an obligation rather than to a mortgage modification?

9. Severability

If a provision of this [act] or its application to a person or circumstance is held invalid, the invalidity does not affect another provision or application that can be given effect without the invalid provision.†

Legislative Note: Include this section only if the state lacks a general severability statute or a decision by the highest court of the state stating a general rule of severability.

10. Repeals; Conforming Amendments

(a) . . .

(b) . . . †

Legislative Note: A state should examine its statutes to determine whether conforming revisions are required by provisions of this act relating to { }. See Section { }.

11. Effective Date

This [act] takes effect . . .

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