



### Modification of Mortgage Terms

- During loan term, mortgagor/mortgagee can modify the terms of the mortgage debt
- Modification is effective between mortgagor and mortgagee; but what effect will modification have upon third parties?
  - Junior lienholders
  - Prior mortgagor (if modification is being entered into by successor of prior mortgagor)



### Modification of Mortgage Terms

- 1990: O buys Redacre, grants \$100,000 mortgage to Bank
- 2000: O sells Redacre to X, who assumes the mortgage (w/Bank's consent)
- 2007: X borrows \$100,000 more from Bank, mortgage is increased from \$50,000 (then-remaining balance) to \$150,000
- Effect of modification on O's liability?



### Modification of Mortgage Terms

- When X purchased Redacre from O, O became a **surety**
  - O is still liable to Bank in contract, but as between O and X, it is understood X is now primarily liable, and O will be secondarily liable
  - The law of suretyship protects surety against modification of debt without surety's consent (partial or complete discharge)



### Modification/Suretyship

- Modification of mortgage by Bank and X will result in a discharge of O
  - Traditional rule: O is completely discharged (no liability on debt, period)
  - Recent trend (Restatement of Suretyship): O is discharged to extent its interest is impaired (e.g., no liability for increased amount of the debt), still liable for \$50K



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- 2000: X buys apartment building, grants mortgage to Bank1 (principal = \$1 million, interest-only payments @ 10%, balloon payment due in 7 years)
- 2005: X obtains mortgage from Bank2 (principal amount = \$500,000)
- 2007: X defaults to Bank1
  - Balance = \$1.1MM (\$1MM principal + \$100,000 accrued but unpaid interest)
  - X and Bank1 modify mortgage terms: "rewriting" debt to \$1.1MM, increasing interest rate to 12%, extending maturity date to 2012
  - Bank2 did not know of or consent to modification
- To what extent is modified Bank1 mortgage enforceable vs. Bank 2?



## Modification of Senior Mortgage

- Modification of Bank1 mortgage is effective vs. Bank2, except to the extent it is "materially prejudicial" to Bank2 [Restatement § 7.3(a)]
- Bank2: modification prejudiced us because
  - Principal increased by \$100K (capitalized interest)
  - Interest rate increased by 2%
  - Maturity extended by 5 additional years
- Which changes create material prejudice?

## Modification of Senior Mortgage: Material Prejudice

- Is increased principal balance prejudicial to Bank2?
  - Arguably, not in this case; if Bank1 had foreclosed, it would've had priority to full extent of \$1.1 million (principal + accrued interest)
- But, interest is now accruing at 12% on a larger balance; Bank1 would not have priority w/respect to increased interest amount
  - Before: annual interest = \$100,000 (\$1MM x .10)
  - Now: annual interest = \$132,000 (\$1.1MM x .12)



## Modification of Senior Mortgage

- Restatement § 7.3(c): if senior mortgage provides that modification of senior mortgage is enforceable vs. third parties claiming through mortgagor (e.g., junior lienors), that provision is enforceable against junior lienors [Note 3, page 840]



## Replacement of Mortgage

- Often, rather than modify the terms of a mortgage, the parties may simply "refinance" the mortgage
  - E.g., X has 10% mortgage, wants to lower interest rate to now-prevailing 7%
  - X simply borrows enough to pay off mortgage loan, grants new mortgage (at 7%) to secure repayment of new loan

## *Houston Lumber v. Skaggs*

- June 1977: Sandia Savings loaned Skaggs \$37K, secured by recorded construction mortgage
  - Skaggs hired contractor to build home, but contractor "stiffed" several subs, including Houston Lumber, which got a mechanics' lien
- November 1977: Skaggs granted Sandia a permanent mortgage once construction was complete; Sandia released/cancelled the construction mortgage
- Should Sandia's mortgage have priority over Houston Lumber's mechanics' lien?



## Replacing Construction Mortgage

- Held [p. 834]: replacement permanent mortgage is entitled to same priority as original construction mortgage (even though original had been cancelled of record!)
- No harm to Houston Lumber here
  - It knew it was junior when it began working
  - No evidence it relied upon the cancellation
  - Modification wouldn't have caused material harm

## Refinancing Hypothetical

- 1990: X borrows \$100K from Bank1 (at 10%), Bank1 takes/records mortgage
- 2000: X borrows \$50K from Bank2, which takes/records mortgage
- 2007: X borrows \$100K from Bank3 (to refinance Bank1 mortgage)
  - Bank3 takes/records mortgage, and Bank1's mortgage is cancelled of record
- Priority: Bank2 vs. Bank3?



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## Equitable Subrogation

- Restatement § 7.6: Bank3 gets priority
  - Mortgagee that pays off a prior mortgage will be subrogated to priority of that mortgage, so long as mortgagee “was promised repayment and reasonably expected to receive a [lien on the land] with the priority of the mortgage being discharged,” as long as subrogation “will not materially prejudice the holders of intervening interests” in the land



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## Equitable Subrogation

- Does this result make sense?
  - Priorities usually governed by recording act
  - Bank3 could've easily discovered Bank2's recorded mortgage
  - Bank3 could've taken an assignment of Bank1's mortgage (and thus gotten its priority)
  - If Bank3 didn't bother to do that, why should Bank3 get Bank1's priority?



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## Equitable Subrogation

- Courts in several states have rejected the Restatement's subrogation rule
  - In these states, Bank3 would probably not be subrogated to the priority of Bank1's mortgage [MO case authority is not sympathetic to equitable subordination]
  - Bank2's mortgage would thus have priority over Bank3's mortgage



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## *Countrywide v. First Nat'l Bank* (Wyoming Supreme Ct. 2006)

- Countrywide (*i.e.*, Bank3) should've known of the prior recorded mortgage lien, so “the countervailing public policy interest in clarity and certainty in matters of land title ... outweighs the interests of private lending institutions which can be protected by simple due diligence.”