

Effects of Modifications on Loan Policies

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During a recent series of seminars for commercial loan officers, I discussed some of the fundamental coverage provided by the standard ALTA 1992 Loan Policy of Title Insurance. Throughout the seminars, lenders asked a number of questions pertaining to coverage for modifications, renewals and advances. Because of the frequency of these questions, I felt it might be helpful to provide a brief discussion of those issues again.

One of the fundamental misunderstandings that many lenders have regarding coverage provided by title insurance deals with the enforceability of the underlying note secured by a mortgage. Title insurance does not guarantee the enforceability of the note nor the lender's ability to collect on the debt. Title insurance is designed to insure, as of the date of policy, the validity and priority of the mortgage given as security for the repayment of the note. It is also important to remember that an insurer's duty to defend is often broader than its liability under a claim. The process used by a bank to facilitate renewals and modifications should be discussed with bank counsel. When a lender modifies a note, and I use that term loosely, it is possible for them to extinguish the security for the note and to void their title insurance coverage. This possibility is best explained with a couple of examples most commonly encountered.

First is a situation where a lender, after the date of policy, makes modifications to an existing note. These modifications could come in the form of an extension of payment terms, modifications to the interest rate, or a renewal of the note. The renewal is often encountered when dealing with a balloon mortgage. What happens to the coverage under the policy if there is an intervening lien between the date of the original note and the modification? Under the terms of the policy, the insurance company would defend any attacks on the validity or priority of the original mortgage where only a renewal has occurred, because the original policy will remain in effect and the insurance company would be liable subject to the conditions and stipulations contained in the policy. If, as a result of the modification, additional funds are advanced or accrued interest is financed into the note, the duty to defend would still be applicable, but any losses suffered due to the advance or financing of interest are not covered because these are post policy events, created, suffered or assumed by the insured. This situation would most likely occur in bankruptcy where the judge could find that the changes did not attach to the mortgage.

The second situation is where the lender modifies an existing note and those modifications result in a novation. Black's Law Dictionary defines a novation as: "Substitution of a new contract, debt or obligation for an existing one, between the same or different parties." What happens to the coverage under the policy if there is an intervening lien between the date of the original note and the modification? If this event occurs, the title insurance company will have a duty to defend a challenge to the validity or priority of the mortgage. If, in the resulting litigation, it is determined that a novation has occurred, then the title insurance policy will no longer be in effect. Why? When a novation occurs, the original debt has been replaced and the judge rules that a new,

unsecured note exists. As a result, the note is satisfied and the mortgage is no longer a valid lien on the property. Under the conditions and stipulations of the policy, when the underlying debt is paid, the policy terminates. Additionally, the unenforceability of the original note is not a risk covered by the policy.

The final situation is where the lender advances additional funds after the date of the policy, to be secured by the original mortgage. This is typically in the form of a construction loan, future advance note or a credit line mortgage. What happens to the coverage under the policy if there is an intervening lien between the date of the original note and the subsequent advance? The title insurance company will still have a duty to defend but the ultimate liability under the policy may be reduced or eliminated. As the principal of the indebtedness decreases, the amount of insurance is reduced pro tanto. Furthermore, the company is not liable for any indebtedness created subsequent to the date of policy except for advances made to protect the lien or to prevent deterioration of improvements.

Now that the situations have been laid out, the question becomes how to avoid these situations and what the lender needs to do to insure full coverage under the policy. First of all, it is imperative that the lender requests the appropriate endorsement from their title agent. In most cases, the issuance of the appropriate endorsement at the time of the policy will provide the lender with full protection.

When making a balloon mortgage, it is appropriate to request a Balloon Mortgage Endorsement. This endorsement will protect the lender against the unenforceability of the lien due to the exercise of a conditional right to refinance, an extension of the loan term, or a change in the rate of interest. It is still possible to obtain protection when the endorsement is not issued at the time of policy. The Balloon Mortgage Endorsement can be issued at the time of the modification.

Where the lender is replacing an existing note with a new note to be secured by the existing mortgage, it is appropriate to request an update endorsement. The update endorsement will reconfirm the coverage amount and advance the date of the policy to the date of the replacement note. In order to issue this endorsement, it is necessary to obtain an update on title and any intervening matters will have to be dealt with to the underwriter's satisfaction.

If a lender is contemplating future advances at the time of the original loan, a future advances endorsement should be requested. There are a number of various future advances endorsements available ranging from endorsements for credit line loans to endorsements for obligatory and nonobligatory advances. Special construction loan endorsements are available in most states, and in most cases, additional requirements will be made and title updates will be necessary prior to each disbursement. Generally, these endorsements insure that future advances will relate back and have the same priority as the original mortgage. The endorsements do have exclusions for certain intervening liens such as state and federal tax liens and do not insure priority when the mortgagor has filed for bankruptcy.

We advise banks to discuss procedures with counsel for all renewals, modifications and extensions. Also, it is in the lender's best interest to discuss what coverage is needed with bank counsel and to determine which endorsements should be requested to provide that coverage. As always, the agency personnel and Investors Title Insurance Company's Underwriting Support Department are available to provide guidance and direction.