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Roger Bernhardt
Golden Gate University School of Law, rbernhardt@ggu.edu

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Solomonic Priority

ROGER BERNHARDT

A lender seeking to help its borrower in distress has more to worry about than simply whether its loan security is good enough to permit such generosity. If there are junior lenders in the background (underground?), the senior lender's indulgences can lead to changed priorities, punishing rather than rewarding the senior lender's intended altruism.

Lennar Northeast Partners v Buice (1996) 49 CA4th 1576, 57 CR2d 435, reported at 20 CEB RPLR 45 (Jan. 1997), is a good illustration. Buice Trust purchased a $935,000 loan secured by an existing first deed of trust that was currently in default. Buice agreed to extend the note's due date for another year and to increase the note amount by $140,000 (to cover some past and future interest) in return for an increase in the interest rate from 9 percent to 12 percent. (I am oversimplifying the transaction, and ignoring a good many other facts.) Lennar Partners, holders of a subordinated note and deed of trust on the same property, took the view that as a result of this transaction they were now first rather than second in seniority, because they never consented to the changes. Lennar relied on the general rule that a senior lender's agreement to "material" loan modifications without a junior lienholder's consent may result in a loss of the senior lender's priority over the junior, based on the rationale that the unconsented-to modification might increase the risk of the borrower's default or impair the junior's security (*e.g.*, by substantially increasing the borrower's burdens under the modified loan). 2 California Real Property Financing §1.21 (Cal CEB 1989). (Except in the case of a nonconsenting subordinating seller, until *Lennar*, the case law was unclear about whether the senior's entire original loan or just the unconsented-to modified portion would lose priority.)

Two trial court judges agreed with Lennar and elevated Lennar's lien entirely over Buice's lien. The court of appeal, however, held that Buice's modifications cost it only partial, not total, loss of priority: the $140,000 modifications dropped to third place, but the original $935,000 was still first. Although, technically, Buice was the prevailing party, this was a meager victory: that final $140,000 is not likely to get paid. (Why fight unless there is not enough security to go around?)

So future Buices have to be careful if they want to stay senior. No one else is going to watch out for them. The debtor doesn't care, because she's going to owe the money regardless of who wins. And junior lenders would just love to see the senior lender foul up, because it can only improve their relative positions (unless the juniors themselves are unwitting seniors, *i.e.,* they know they are junior to *A,* but do not realize they are also senior to *C,* and therefore in need of the same cautionary advice). So here is advice for lenders to follow when asked to change the terms of a loan.

Double-Check the Future Advance Clause

Most deeds of trust contain some kind of future advance clause—a clause providing that any future extension of credit by the lender will also be secured by the existing deed of trust. California Mortgage and Deed of Trust Practice §8.38 (2d ed Cal CEB 1990). With the future

advance clause, the lender has the advantage that the priority of the future credit extension will relate back to the date of the original deed of trust.

When a modification is requested, you cannot go back and rewrite the original deed of trust, but you can review it to see what kind of future advance clause it contains. Some old clauses (called "dragnet" or "anaconda" clauses) are worded so broadly that any new transaction can fit under it; lenders don't commonly use these types of clauses anymore because they are difficult to enforce. See Mortgage and Deed of Trust §8.34. Newer clauses generally have some limitations on what new loans come under the old deed of trust, often requiring at a minimum some paperwork linkage between the transactions. If the new advance doesn't comply with the conditions in the future advance clause, the lender loses the advantage of having priority relate back to the date of the original deed of trust. The result is that, despite any language in the new note stating that it is secured by the old deed of trust, the lender must conduct a new title search to look for juniors, because any new money lent will take priority only as of the date the new loan was made.

Alternatively, if the new advance does fit within the parameters of the future advance clause in the old deed of trust, a title search is unnecessary because California law protects the priority of future advances made by the advancing lienholder unless that lienholder has received *actual notice* of intervening liens. Mortgage and Deed of Trust §8.38. The burden is on the junior lienholder to notify the senior of her existence, rather than on the senior to search for juniors each time the borrower requests another advance.

It is likely that the junior will in fact notify you of the existence of her lien, because it is both imperative, as suggested above, and simple to do so. (After all, a junior learns about a senior when she gets a title search incidental to making her own loan; because she also usually records a request for notice of default of the senior loan, it isn't much more effort for her to send a letter notifying the senior of her existence). Thus, your client likely will know about the junior. Once your client actually knows about the junior, the effectiveness of an optional future advance clause is markedly reduced. Any such advance is secured, but as a third, not a first. All the future advance clause does in this case is to avoid the need for executing another deed of trust; it does not help on priority. Your client should not make such an advance unless the client would have been willing to take a third deed of trust on the property at the outset. (Attorneys should also admonish their clients to save the notification letters they get from juniors so that the client can negotiate with the junior when modifications are contemplated.)

Is There a Subordination Agreement?

A future advance made without a junior's consent gets third priority after the junior's second lien, but at least the old first stays first. The situation can be even worse when the original priorities resulted from a subordination agreement rather than by time and order of recording. A junior who agrees to subordinate to a senior on certain conditions subordinates only if those conditions are met: a party who has agreed to subordinate her deed of trust to a $1 million loan may not be subordinate to a loan of $1.1 million instead. This straightforward contract logic can generate harsh results—total rather than partial reversal of priorities. That's understandable when the subordinating loan never complied; but what if the subordinating loan failed to comply because, while the senior's deed of trust permitted a future advance, the junior's subordination agreement did not (*e.g.,* the senior loan was for the permitted $1 million and was later enlarged because of a $100,000 further advance)? If the extra $100,000 given to help out the borrower will reduce the priority of the entire $1 million previously advanced, you can be sure that a lender won't agree to advance the new money.

Lennar's Contribution

Lennar's contribution to this issue is to apply future advance principles rather than subordination logic to loan workouts, and to preserve the senior's original loan priority, even when the lender who modifies the loan knows there is a subordinated junior. Under *Lennar,* total reversal of priorities occurs only in special cases (*e.g.*, when, according to the *Lennar* court, the subordinated party is a seller; I think, however, a better case can be made for applying the total priority reversal in transactions involving a "hard money" lender like Lennar if its note is subject to CCP §580b (antideficiency prohibition for purchase money loans), because the lender would lose real money if a senior's foreclosure extinguished its lien). In summary, it's still somewhat risky to bail out your borrower, but it's not catastrophic.

Safer Alternatives

Lennar suggests less risky ways to aid distressed borrowers. Regardless of whether your senior lienholder client knows about a junior, or whether the junior subordinated or just appeared later, the client can simply agree to postpone payment of the loan. Postponement is not regarded as a material modification harmful to a junior, and therefore can be done without junior consent. 49 CA4th at 1584. Your client can agree to give the debtor breathing room without endangering his or her priority.

In a tantalizing but little-examined aspect of *Lennar*, the senior claimed (unsuccessfully) that it was doing just that for its debtor. Buice asserted that most of the additional $140,000 advanced represented delinquent back interest and prepaid future interest, rather than a transfer of funds to the debtor. The court didn't buy it, but suppose it were true?

If a senior can safely permit the borrower not to pay on time, it can also safely permit the interest to accrue, surely with the same priority as the unpaid principal. Buice got in trouble not for letting the interest accrue, but for *capitalizing* the interest, which made it look like a future advance or modification, with an attendant loss of priority. It may be legitimate to forego interest payments, but not to take a new note for them!

Does that mean that your client must give up the opportunity to compound the back interest and to charge a higher interest on the entire loan? Yes, but not entirely. Why not make the foregone compounding and foregone interest rate increase the principal of a new note—admittedly in third position, but nevertheless secured—thereby leaving the original note and original interest intact and in first position (just as a lender holding a first deed of trust can make a subsequent loan secured by a third deed of trust on the property without the consent of the holder of the second deed of trust)? It's not perfect, but it doesn't make things worse and it may be better than foreclosure. (Of course, whether you can sue as a sold out junior on your third note after you have foreclosed yourself out through a senior sale is an entirely separate question; see discussion of cases in Mortgage and Deed of Trust §4.32.)