TESTIMONY BEFORE THE HOUSE JUDICIARY COMMITTEE REGARDING OPEN-END MORTGAGES AND LIEN PRIORITY -- PUBLIC HEARING, SEPTEMBER 8, 1989

Good morning, Mr. Chairman Caltagirone and Members of the Committee. My name is Melvin C. Breaux. I am a member of the Philadelphia law firm of Drinker Biddle & Reath. Our firm represents the Pennsylvania Association of Savings Institutions, and I am here today, with James H. Stoup, Vice President-Government Affairs of the Association, to testify on behalf of the Association with respect to the lien priority of advances made under open-end mortgages. We wish to thank you for the opportunity to appear and offer testimony regarding House Bills 942 and 983.

Need for the Legislation. The purpose of House Bills 942 and 983, as we understand them, is to enhance the ability of lenders in Pennsylvania to make available to Pennsylvania consumers lines of revolving credit secured by mortgages on the consumers' real estate. With such lines, consumers can borrow as much as they desire from time to time up to the specified maximum amount of the line. As I'm sure you know, these lines of credit have become increasingly popular with consumers because it is a fairly convenient way for them to be able to access from time to time the equity that they have in their homes in accordance with their needs. Also, of course, this form of consumer credit is one of the few remaining as to which the interest paid is fully tax deductible. The two bills under consideration today would assure that lenders have the agreed-upon lien priority on the mortgaged property in the full amount of the line of credit even though the consumer might not take the full amount of the loan in one advance and even though a period of time passes before the initial or any subsequent takedowns by the consumer.

Background. As has been discussed here today, under present law a lender who makes a loan secured by a mortgage on real estate in Pennsylvania generally must have advanced funds at or prior to the recording of the mortgage and have advanced the full amount of the loan in order for the full loan amount to have lien priority dating from the date the mortgage is left for recording. For example, if a mortgage lender takes a mortgage and disburses the loan amount in two advances, one prior to recording and the second some time subsequent to recording, it is likely that the lien of the second advance would date only from the making of that advance, not from the date of recording the mortgage. Consequently, if another creditor were to file a mortgage or other lien of record between the recording of the first lender's mortgage and the first lender's second advance, the lien of the intervening creditor likely would have priority over the original lender's

second advance. A possible exception would be if at the time of making the second advance the first lender were contractually obligated to make it; in other words, if the second advance were "obligatory". This exception is sometimes referred to as the "obligatory future advance doctrine." This doctrine derives not from legislation, but from judicial decisions.

Under the obligatory future advance doctrine, a future advance made under a previously recorded mortgage will have lien priority from the date of the recording of the mortgage only if the mortgage lender was contractually obligated to make the advance at the time it was made and the mortgage specifically states that it covers future advances.

While some lenders have been offering open-end home equity mortgage loans in Pennsylvania, (with, as previously stated, considerable consumer acceptance), it seems that others have refrained from doing so because of the uncertainty as to the lien priority. It also is possible that some lenders that are offering this product are doing so on a smaller scale than would be the case otherwise because of the lien priority problem. I also assume that many of the lenders that are offering the product must be relying on the obligatory advance doctrine. Unfortunately, however, since that doctrine derives from court decisions, it could be vitiated or drastically limited - without any advance warning - in future decisions.

More importantly, however, the obligatory advance doctrine does not provide reasonable and sufficient comfort or assurance with respect to the lien priority of open-end home equity mortgage loan contracts because there can be serious disagreement as to whether any given advance made under those agreements would be considered obligatory. For example, typically, the contract provides that the lender can terminate the contract at any time upon appropriate notice to the customer. With the presence of such a clause, one might argue that the advance cannot be obligatory since the lender can terminate the contract at will. Another illustration of this problem can be found in the area of construction lending. In a typical loan agreement for construction credit that provides for the lender to make periodic advances, such advances are conditioned on a number of things, including the borrower's not being in default under the agreement at the time of the advance. Frequently, however, a borrower will in fact be in default for a technical non-compliance with the agreement. In other cases the default may be serious; but the lender will want to make the advance anyway because the lender still believes in the borrower and the project, notwithstanding the default. Since the borrower may be in default, the advance, if made, could be challenged successfully by an intervening lien creditor on the grounds that the advance was not obligatory when made. Consequently, the intervening creditor's

lien would have priority over the construction lender's advance. This result does not seem fair or equitable to us: it gives the intervening creditor an advantage for a purely technical reason. One additional example: a home equity revolving credit agreement may provide that the borrower will be in default if the borrower is late making his monthly payment or if the borrower exceeds his credit line limit. Yet, lenders usually do not cease permitting advances because of such infractions when they are minor, even though under the contract they could.

The Pennsylvania Association of Savings Institutions, therefore, strongly supports the attempt to bring clarity and certainty to the area by way of legislation.

House Bill 942. House Bill 942 would make it clear that, provided the restrictions and requirements of that bill are complied with, the lien of such future advances, obligatory or otherwise, would relate back to the initial recording of the mortgage, as agreed by the lender and the borrower.

House Bill 942 would provide that a mortgage can secure future advances up to the maximum dollar amount of indebtedness as stated in the mortgage. The mortgage must state the intention of the lender and the customer to have the mortgage secure future advances; it must state the maximum amount of the indebtedness, exclusive of interest; and it must state at its beginning that it is an "open-end mortgage". House Bill 942 also would make it clear that the first advance can be made after recordation and the balance can be repaid to zero and then increased again without affecting the lien priority.

Besides protecting the lender,the Bill contains several protections for the borrower and for other potential creditors of the borrower. Other lien creditors or prospective lien creditors need only review the public mortgage records - which they do anyway in processing a mortgage loan application - to learn that an open-end mortgage has been recorded against the property and the maximum amount of principal indebtedness secured by that mortgage. That prospective creditor would be expected to use that information in his determination as to whether to extend the credit. One beneficial aspect of 942 from the standpoint of the borrower is that the borrower or a subsequent lien creditor may, by giving notice to the original lender, limit the amount of that lender's indebtedness that can enjoy the superior lien priority. The borrower can achieve this at any time simply by providing the open-end lender with written notice that he intends to limit his loan and then delivering that notice to the appropriate government office for recording.

The Bill strikes a careful balance between protecting the rights of the home equity lender and protecting the rights of other creditors of the borrower. The relation back of lien priority would not apply to future advances which a lender makes more than five business days after the lender receives notice of a lien or other encumbrance against the property or notice of work done or materials provided for the mortgaged premises. These notices (by borrower or subsequent lien creditors) are effective unless subsequent advances are (a) obligatory or (b) made to complete construction or repair of the mortgaged premises, if the mortgage loan was made for such purposes.

The borrower's ability to terminate the original lender's right to superior lien position as to advances made after that termination will enable the borrower to obtain secured credit elsewhere if he chooses to do so because he will be able to offer the new creditor a lien that would have priority over any advances that the first lender might make thereafter. This feature successfully balances the lender's need for lien priority assurance and the borrower's need for flexibility in choosing a lender. Additionally, this flexibility will foster and enhance competition among lenders, since the borrower will not be "locked in" to the first creditor.

House Bill 983. As we read H.B. 983, it would simply codify the obligatory advance doctrine as it would permit the lien of a future advance to relate back to recording only if the advance is obligatory. Quite significantly, however, H.B. 983 goes on to provide that an advance will be considered obligatory even though at the time the advance is made events may have occurred or failed to occur that would, under the mortgage, permit the lender to withhold the advance, so long as the lender has not terminated the open-end contract. This provision of 983 should aid considerably in answering the difficult question of: "when is an advance obligatory?"

A disadvantage of 983, however, is that it does not give the borrower or other lien creditor of the borrower the opportunity, pursuant to a mechanism set forth in the bill, to terminate the ability of the lender -- upon notice -- to make future advances that will relate back to recording. As I discussed earlier, we believe that these termination-upon-notice provisions are an important benefit for the borrowers and for competition in the lending industry. It is for these reasons that the Pennsylvania Association of Savings Institutions supports H.B. 942.

That concludes my testimony, Mr. Chairman. Once again, for the Association and myself I wish to express our appreciation for being allowed to testify today.