



Don't 'Fall Back' on LIBOR

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LIBOR Remediation Raises Lien Priority and Title Insurance Questions

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The mandate to remediate existing loans that are indexed to LIBOR prior to LIBOR's cessation to incorporate robust LIBOR "fallback" provisions poses unique challenges for commercial mortgage lenders. Not only must they adopt a consistent approach for the modification of a potentially large volume of loans over a relatively short period of time, obtain the cooperation of borrowers and transition to a new benchmark rate, they must consider issues affecting the lien priority of the mortgages and deeds of trust securing those loans and the title coverage afforded by their loan policies, in order to avoid potentially impairing each.

What is LIBOR Remediation?

The UK's Financial Conduct Authority, which is responsible for regulating LIBOR, initially announced in 2017 that LIBOR's publication would not be guaranteed beyond the end of 2021. LIBOR's administrator, the ICE Benchmark Administration, subsequently announced on November 30, 2020 a consultation on its proposal to cease publication of 1-week and 2-month LIBOR on December 31, 2021, and to cease publication of overnight, 1-, 3-, 6- and 12-month LIBOR on June 30, 2023. The consequence of these announcements is that lenders must transition to alternate benchmarks for the origination of new floating rate loans and to modify (or "remediate") certain existing loans that reference LIBOR. The remediation process entails amending the loan documents for any existing loan with a maturity date occurring on or after the date that the applicable LIBOR term (or "tenor") will cease (which, for most loans that reference LIBOR, will be June 30, 2023) to incorporate provisions for the replacement of the floating rate benchmark (or "fallback" provisions) in cases where either no contractual alternative to LIBOR exists or the existing provisions have been determined to be inadequate or would produce an undesirable result (*i.e.*, a reversion to the prime rate, for example).

To date, the Alternative Reference Rates Committee ("ARRC") has recommended three separate approaches for the remediation of existing bilateral loans that reference LIBOR, each with its own model fallback provisions. They are: (i) the "hardwired" approach, which establishes a benchmark replacement (or "waterfall" of potential benchmark replacements) to automatically replace LIBOR when LIBOR (or the applicable LIBOR tenor) ceases to be provided or is no longer representative; (ii) the "amendment" approach, which permits lenders to select a benchmark replacement (potentially subject to the affirmative or negative consent of borrowers) upon the occurrence of such a transition event; and (iii) the "hedged loan" approach, which ties the benchmark replacement to the derivative used to hedge floating rate exposure under the loan. While the "amendment" approach is no longer recommended by the ARRC as a best practice, we note it here because it was a previously-recommended approach employed by lenders and continues to be used.

Along with the adoption of a benchmark replacement, the ARRC-recommended model fallback provisions also contemplate: (1) a spread adjustment (which may be a positive or negative value or zero) as a mechanism to make the benchmark replacement more closely approximate LIBOR following its replacement; (2) the unilateral adoption by the lender of technical, administrative or operational modifications to loan documents (called "benchmark replacement conforming changes") to reflect the adoption and implementation of the benchmark replacement; and (3) an "early opt-in" feature permitting the lender (or, in some cases, both parties) to agree to replace LIBOR prior to the occurrence of a transition event.

In addition to the foregoing three approaches, loan parties may also choose to amend the loan documents for an existing loan to presently adopt a benchmark replacement for LIBOR, rather than waiting for the applicable LIBOR tenor to cease to be provided or to no longer be representative.

LIBOR Remediation and Lien Priority

For commercial mortgage lenders, any amendment to a loan document (or any change in loan terms) should raise questions about whether the lien created by the mortgage or deed of trust may be affected – and loan modifications associated with LIBOR remediation are no different. Therefore, a lender may want to consider obtaining title searches in connection with its LIBOR remediation efforts to determine whether junior liens encumber the mortgaged property. If a title search discloses any junior liens, then the lender must consider whether the loan modification would materially

prejudice or impair the rights of the junior lien-holder; if so, the junior lien-holder's consent to the loan modification will be necessary to prevent a loss of lien priority. Further, in the event that a lender adopts a remediation approach that does not specifically identify a benchmark replacement, it may need to consider searching title twice – both at the time the amendment is entered into, as well as when a benchmark replacement is finally established.

If a change to the benchmark rate may ultimately increase the amount of interest charged to a borrower, thereby making the loan more costly to repay, seeking the junior lien-holder's consent may be advisable unless an agreement has been recorded that unconditionally subordinates the junior lien to the indebtedness secured by the mortgage or deed of trust and all related modifications and increases. However, if no such subordination agreement exists and the junior lien-holder refuses to grant its consent, the lender may be required to prove in a lien priority dispute that the junior lien-holder is not harmed by the change from LIBOR to the benchmark replacement. Several factors may be influential in this determination but cannot be presumed to be dispositive, including that the benchmark replacement is the ARRC-recommended Secured Overnight Financing Rate ("SOFR"), that the benchmark replacement is formulated to be comparable to LIBOR through the spread adjustment (as described above), that the benchmark replacement would not constitute a "significant modification" for tax purposes or falls within a statutory or other "safe harbor" for REMIC or other purposes, or that it has become impossible to accurately calculate the interest that would be charged to a borrower based on the applicable LIBOR tenor following its cessation.

Additionally, if the existing mortgage or deed of trust expressly identifies LIBOR as the benchmark rate applicable to the mortgage loan or, under applicable state law, the change in benchmark rate must be identified in a recorded loan modification to ensure the continued priority of the mortgage or deed of trust relative to subsequent liens, then the lender must record a loan modification to provide actual (or, if suitable, constructive or inquiry) notice to third parties of LIBOR's replacement with a successor benchmark. It should be noted, however, that certain liens, such as tax and, in some states, mechanic's liens, will still "prime" a recorded mortgage or deed of trust, even if a loan modification has been recorded.

LIBOR Remediation and Title Insurance

With respect to a lender's title insurance coverage, acts of the insured (*i.e.*, the lender), which include LIBOR remediation efforts (both the loan modification itself and, in the event that the remediation approach does not specifically identify the benchmark replacement, the subsequent establishment of the benchmark replacement) may also become the basis for a defense against coverage under a loan policy if the insured's acts will affect the priority of the insured mortgage. For this reason, it may be advisable for a lender to obtain a modification endorsement, insuring the continued priority of the lien of its mortgage or deed of trust as of the date of any loan modification in connection with the lender's LIBOR remediation efforts. Note, however, that modification endorsements are not available in every jurisdiction and, if available, may be costly to obtain or only available with the recordation of an amendment to the mortgage or deed of trust or upon satisfaction of other requirements (such as the consent of junior lien-holders, if any).

As an alternative and if available, a "date-down" endorsement may be purchased. The "date-down" endorsement will not add any loan modification to the policy's description of the insured mortgage, but will insure that there are no intervening liens or encumbrances against the mortgaged property or, if there are, add them as exceptions to coverage. If a lender is updating title coverage in connection with its LIBOR remediation efforts, it may also want to confirm that the benchmark replacement will not impair coverage under any variable rate and usury endorsements to the title policy or to obtain new endorsements, if available.

No Simple Answers

Unfortunately, there is no "one-size-fits-all" solution to assure that LIBOR remediation will not jeopardize a mortgage lender's lien priority or impair coverage under a loan policy of title insurance. Each state has its own laws governing lien priority. Likewise, each state has its own regulatory regime for title insurance, and there is no comprehensive endorsement covering LIBOR transition that is currently available. Therefore, a lender and its attorneys may need to analyze each loan (and each state's laws and title insurance requirements) individually, while also taking into consideration its borrower's willingness to cooperate and pay for costs associated with LIBOR remediation, in order to determine its optimal LIBOR remediation strategy.

(This article has been updated to reflect recent market developments.)

LawWise Podcast: A Closer Look at Real Estate Workouts and Restructurings, Part 2

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In this second part of our LawWise podcast on real estate workouts and restructurings, real estate finance partner Steve Herman and special counsel Loren Taub examine the goals of borrowers and lenders in workouts and restructurings, potential remedies, and prenegotiation and forbearance agreements.

If you cannot access the podcast below, please [click here](#) to listen.



Hotel Financing Series, Part 5: Hotel Management Arrangements and Related Issues

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In the previous installment of our hotel financing series, we examined some of the key issues regarding franchise agreements and non-disturbance agreements. In this Part 5 of the series, we look at hotel management agreements and related issues.

Hotel management comes in two scenarios. In the first scenario, a hotel operates under a franchise model, with the hotel owner employing a professional hotel manager to manage the day-to-day operations of the hotel, as discussed in the previous installment. In the second scenario, which we will examine more closely below, some hotels are run under a hotel management model under which the owner of the brand runs the hotel for the owner. This is slightly less common, but some of the international hotel chains continue to run some hotels under their own management. In the latter scenario, because the hotel manager is also the person who owns the brand, the responsibility to adhere to brand standards rests with the hotel manager.

Hotel management agreements

The hotel management agreement (“HMA”) sets out the duties undertaken by the hotel manager, as well as the obligations and rights of the hotel owner. As the hotel manager runs the day-to-day operations of the hotel, it is of prime importance that the hotel manager has the requisite experience and capability to run the particular hotel, and, if there is a separate franchise agreement in place, be able to adhere to any requirements prescribed by the franchisor.

The arrangements with the hotel manager and the HMA are key elements of a lender's due diligence. In conducting its analysis, some of the questions the lender may want to ask may include:

1. What is the experience and track record of the hotel manager?
2. With regard to termination rights of the hotel owner if the hotel manager is not capable, is there a long period of notice or are there issues with fees upon termination?
3. Does the hotel manager provide frequent and detailed updates on key hotel information, such as vacancy rates, guest rating, operating plans, marketing plans, expenditure, hiring staff, etc.? And does the hotel owner have a say in these matters?
4. What are the key performance indicators set on the hotel manager?
5. What is the remuneration structure? Is there a performance incentive?
6. In terms of cashflow structure, whereas usually the hotel manager would have access to the hotel operating accounts, does the hotel owner also have access? Or does the hotel manager run the accounts and then make distributions to the owner? And at which stage does the hotel management fee get deducted?
7. How competent is the hotel manager in dealing with the franchisor's requirements? And does the hotel manager provide reports which adhere to the reporting requirements under the franchise agreement?

Duty of care agreement

It is common for the lender to enter into a duty of care agreement with the hotel manager. The agreement covers a number of key areas, including:

1. Acknowledgement of lender's security. The hotel manager acknowledges that the hotel owner has obtained finance and grant security over its assets (including the rights to the HMA) to the lender. To the extent that there are competing interests over owner's assets (for example, any collateral provided with respect to hotel manager's fees), the priority is agreed in this document.
2. Termination. This document may alter the termination procedure in the HMA. For example, if the hotel owner is in breach and the lender wants to keep the HMA in place, the duty of care may provide that the hotel manager must first notify the lender, and the lender may wish to cure the default. Separately, if the hotel owner is in breach under the facility, the lender may terminate the HMA in exercising its enforcement rights.
3. Amendments. Material amendments to the HMA will generally require lender's prior consent.
4. Access to documents. Where the lender takes enforcement action and appoints a new hotel manager, the hotel manager agrees to assist with the transfer of documents and information.
5. Direction upon enforcement. When the HMA has mechanics which prescribe how the cash profit is to be deposited, the lender may direct the hotel manager to send the cash profit of the hotel to an account specified by the lender where the lender exercises its enforcement rights.

In the next – and final – part of our hotel financing series, we will look at cash controls that are typical for hotel financing.

Recent Transactions

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Here is a rundown of some of Cadwalader's recent work on behalf of our clients.

Recent transactions include:

- Representation of the administrative agent and lender in an initial \$415 million mortgage and mezzanine financing secured by 37 self-storage facilities in connection with the acquisition of a public REIT that provides debt and equity capital to private developers, owners and operators of self-storage facilities. The facility provides for additional add-on capacity at a later date.
- Representation of the co-lenders in a \$742 million mortgage loan to refinance a 9.9 million-square-foot portfolio of 80 primarily multi- and single-tenanted industrial properties, three data center properties, one office property and two vacant land parcels, located in eight states, owned by subsidiaries of Link Industrial Properties, LLC, the U.S. warehouse platform of Blackstone Real Estate Advisors L.P.
- Representation of the lender with respect to a \$280 million loan to finance a corporate headquarters building located in Chicago.