The Real Estate Finance Journal Vol. 36 No. 4 SPRING 2021

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The Real Estate Finance Journal

A THOMSON REUTERS PUBLICATION

SPRING 2021

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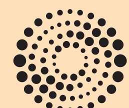

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THE REAL ESTATE FINANCE JOURNAL
(ISSN 0898-0209) is published quarterly by Thomson Reuters, 610 Opperman Drive, Eagan, MN 55123-1396.

Editorial Offices: Thomson Reuters, 50 Broad Street East, Rochester, NY 14694. All editorial correspondence, manuscripts, etc., should be sent to this address. Although the utmost care will be given material submitted, we cannot accept responsibility for unsolicited manuscripts.

Subscription: For subscription information or for customer service, call 1-800-328-4880. Periodicals postage paid at St. Paul, MN.

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LIBOR Remediation Raises Lien Priority and Title Insurance Questions

*Emanuel Tsourounis II and Alan W. Lawrence**

Commercial mortgage lenders face unique challenges due to LIBOR remediation. The authors of this article explain the challenges, various remediation approaches, and note that there are no simple answers.

The mandate to remediate existing loans that are indexed to LIBOR prior to LIBOR's cessation to incorporate robust LIBOR "fall-back" 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

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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:

- 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;
- 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
- 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:

- 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;
- 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
- 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 lienholder; if so,

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the junior lienholder'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 lienholder'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 lienholder refuses to grant its consent, the lender may be required to prove in a lien priority dispute that the junior lienholder 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,

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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 lienholders, 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.

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