CADWALADER

The LIBOR Transition Challenge and More

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Some Thoughts on Lockouts and Default Prepayment

By **Steven M. Herman**
Partner | Real Estate

Many loan transactions contain what is known as a "lockout" period – that is, a period subsequent to closing where the prepayment of a loan is prohibited. This provision is a "bargained-for" economic term upon which a lender is relying in pricing its loan. A lockout period may be a strict lockout with no right of prepayment or it may allow prepayment with the payment of a prepayment fee or provision of some form of "yield maintenance." In all events, this fee, premium or yield maintenance is an agreed-upon economic term upon which a lender is relying should it not receive the economic "deal" it bargained for in the form of contracted-for interest payable over the complete term of the lockout period.

In securitized, fixed rate financings, the loan is not prepayable at all and is, in effect, "locked out" from prepayment until the last few months of the loan to allow for a refinancing. In this context, a borrower is given the ability to defease its loan but not prepay the loan. A defeasance is a mechanism whereby a borrower replaces the collateral of the mortgaged property and its cash flow with a package of treasury securities tailored to create a cash flow which will yield the interest payments which are required under the mortgage loan for the remainder of the term of the mortgage loan *and* to provide for the principal repayment upon maturity of the mortgage loan.

As a result of these restrictions, a borrower would not have any right to prepay its loan during any such lockout period. If the lockout period is a complete restriction, then any attempt to prepay the loan could be rejected by the lender, and the lender would not have any obligation to accept such tender of prepayment. Notwithstanding the foregoing, one inalienable right a borrower always has is what is known as its right of redemption. Since when a borrower enters into a mortgage financing it is either (a) granting a mortgage on its property whereby the lender has a lien on the property as collateral security for repayment of the loan (these jurisdictions are commonly referred to as lien "theory" states since there is a lien on the property) or (b) granting a deed of trust whereby the borrower's property is technically conveyed to a trustee in trust for the benefit of a beneficiary (the lender) as collateral security for repayment of the loan (these jurisdictions are commonly referred to as "title theory" states since the title to the property is technically conveyed), when the loan is repaid, the borrower is exercising its right to redeem its property. This right allows the borrower to "redeem" its property (that is, obtain the release of the mortgage lien upon its property or "reconveyance" of its property) upon payment to the lender of all outstanding amounts. Since real property is "unique" in the eyes of the law, courts are reluctant to allow a lender to potentially reap a windfall when a borrower defaults a mortgage loan by taking the borrower's property. Courts will protect a borrower's right to redeem its property and will endeavor to allow a borrower in all events to pay back its lender in full and obtain a release of the lien on the mortgage on its property. Courts allow this after a default, after the commencement of a foreclosure, after months or years of litigation and in most jurisdictions at any time

prior to the *completion* of the foreclosure auction. So the risk to a lender is that, simply put, if a borrower were to default its loan, it then can “prepay” the loan by tendering all amounts due under the loan to the lender and receive a discharge or satisfaction of its mortgage lien. A borrower always has the right to pay off its loan by paying the lender all amounts owed prior to the completion of the foreclosure auction. Consequently, a borrower could circumvent a prepayment prohibition by defaulting its loan and then tendering full payment.

In order to prevent or deter this “default prepayment,” many loan documents contain a provision that in this circumstance there is a significant premium of, say, 5% or even 10% of the principal amount of the loan that is payable in connection with any payoff of the loan tendered subsequent to a default. While these provisions are negotiated, in the limited circumstance described, they are generally agreed upon and do function as a deterrent. As long as these amounts are not viewed as a penalty, a court should uphold these provisions as permissible and, in such a circumstance, a borrower’s tender of payment to redeem would be required to include this additional sum in order for a lender to be required to accept such payment in satisfaction of the outstanding debt. At a minimum, these provisions should give any borrower pause to try to circumvent its agreed-upon economic transaction.

Don't Lose It over a Lost Promissory Note

By **Susan Vuernick**
Associate | Real Estate

A promissory note, in simplest terms, is the acknowledgment of a debt. It is a written promise to repay an amount owed by one party to another and contains the terms of such repayment. While a promissory note is not typically a "negotiable instrument" as defined in the UCC, it is intended to be and is codified as an instrument that can be easily transferred by the lender to a third party. Because of this easy transferability, losing a promissory note can have serious consequences for a lender since the possessor of the document is likely the only party who can enforce it.

In the commercial mortgage-backed securities market, promissory notes are often transferred from originating lenders to secondary buyers, as lenders bundle mortgages together and then sell them as income-producing investments to institutional buyers. In the balance sheet loan market, lenders commonly sell off portions of their loans to co-lenders or participants in order to reduce their risk or exposure. Since it is an industry standard practice to maintain promissory notes separately from the rest of the mortgage loan documents, when a mortgage loan is sold or its servicing is transferred to another mortgage loan servicer, the mortgage loan file and the note are both shipped to the new owner or servicer and may result in misplaced or lost promissory notes.

Even if a promissory note is lost, the legal obligation to repay the loan remains. The lender has a right to "re-establish" the note legally as long as it has not sold or transferred the note to another party.

States have different requirements for what is necessary to enforce payment under a note that has been lost, depending on whether the state has adopted the 2002 amendment to U.C.C. § 3-309. The prior version of the section requires a lender seeking enforcement to be "in possession of the instrument and entitled to enforce it when loss of possession occurred." (U.C.C. § 3-309(a)(i)). An assignee seeking recovery under a lost note in states that have not adopted the amendment may need to furnish additional information or involve the original holder of the note in the enforcement proceedings. New York allows recovery if a party can prove: (i) ownership of the debt; (ii) the facts which prevent production of the note; and (iii) the terms of the note. However, the party will be required to deliver security in twice the amount of the alleged obligation, as determined by a court. (N.Y. U.C.C. § 3-804).

U.C.C. Section 3-804 was recently discussed in *Bank of New York Mellon v. Hardt* (2nd Dep't June 26, 2019). The plaintiff in *Hardt* was a lender foreclosing on a mortgage made by Hardt as borrower. Plaintiff's summons and complaint contained a lost note affidavit and a copy of the original note. In support of Hardt's motion to vacate her default, Hardt called plaintiff's standing into question. The Supreme Court of the State of New York appointed a special referee to determine whether the plaintiff had standing and, in conjunction with the hearing, the parties

stipulated that the only issue in contention was "whether, in the absence of physical possession of the original note or valid assignment thereof, the plaintiff, as a matter of law, lacks standing." After reviewing the facts, the special referee concluded that the lender had standing to pursue the foreclosure action. The Supreme Court agreed.

On Hardt's appeal, the Appellate Division, Second Department, found that in denying Hardt's motion to vacate her default, the Supreme Court "in effect, found that the defendant lacked a meritorious defense…" The Second Department agreed with the referee and rejected Hardt's contention that "a mortgagee cannot, as a matter of law, establish standing where, as here, the original note was lost and there is no valid assignment of the note to the plaintiff." In its ruling, the Court recognized that U.C.C. 3-804 is an appropriate vehicle to prove ownership of a lost, destroyed or stolen note if the "holder" "prove[s] ownership of the notes, the circumstances of the loss and their terms" (quoting *Marazzo v. Piccolo*, 163 A.D.2d 369, 370 (2nd Dep't 1990)). The Court also noted that it recently applied U.C.C. Section 3-804 to a foreclosure action "reiterating that '[p]ursuant to U.C.C. 3-804, the owner of a lost note may maintain an action upon due proof of [1] his [or her] ownership, [2] the facts which prevent his [or her] production of the instrument, and [3] its terms'" (quoting *U.S. Bank N.A. v. Cope*, 167 A.D.3d 965, 967 (2nd Dep't 2018)) (brackets in original).

In contrast, the Second Department, in *Deutsche Bank Nat. Trust Co. v. Anderson*, 161 A.D.3d 1043 (2018), did not find lost note affidavits persuasive and denied summary judgment to the foreclosing lender. While the *Anderson* Court found that the copy of the note produced by lender was "sufficient evidence of its terms," it also found that the lost note affidavits submitted by the lender were "inconsistent with each other and contain[ed] vague and conclusory statements." *Anderson*, 161 A.D.3d at 1044. Therefore, it was not clear when the loan servicer or its agent acquired possession of the note or which party (*i.e.*, the loan servicer or its agent) acquired the note. Moreover, plaintiff's affidavit failed to provide sufficient facts as to when the search for the note occurred, who conducted the search, the steps taken in the search for the note, and when or how the note was lost. Thus, the affidavits failed to sufficiently establish the plaintiff's ownership of the note. *Anderson*, 161 A.D.3d at 1044-45 (citations omitted).

Additionally, the court in *U.S. Bank N.A. v. Cope* found that a lost note affidavit was insufficient because in it the party claimed without providing more information that "she conducted a diligent search of 'all of our files,' consisting of 'a thorough audit of the customary filing locations, inclusive of the original credit file.'" *U.S. Bank N.A. v. Cope*, 97 U.C.C. Rep. Serv. 2d 593, 2018 WL 6626497 (New York Supreme Court, Appellate Division, December 19, 2018)).

Although the New York courts have reviewed Lost Note Affidavits differently, counsel requesting a Lost Note Affidavit from an existing lender that cannot locate its promissory note to be assigned to the future lender should try to obtain the following: (i) a signed and notarized statement that the physical note has been lost, (ii) a clear statement of the amount, interest rate and repayment terms of the loan, the date the original note was signed, and the proper legal names of all parties involved, and (iii) a description of the circumstances surrounding the loss using as much detail as possible. It should be noted that lenders providing a lost note affidavit will rarely provide the foregoing item (iii) and will only provide the bare

minimum affidavit. Details describing the lengths taken to look for the document as well as any other details about its disappearance should be included. The lender must represent to the borrower that it has full rights and title to the note which it cannot now produce. In preparing a Lost Note Affidavit, a review of the loan agreement should be conducted (and a copy of the note itself, if available, produced) to determine whether there are any specific requirements to which the lender must adhere in the event of a lost note in the subject transaction.

An indemnification provision may also be requested in the Lost Note Affidavit so that the future lender and the borrower can be assured that they will not be liable for any additional claims arising from (i) the original note, (ii) any prior or subsequent transfer of the original note or any right or interest therein, or (iii) any matter arising out of the Lost Note Affidavit. Many lenders refuse to provide this indemnity.

The marketplace has evolved to a standard where Lost Note Affidavits are typically proffered and accepted, and most contain bare minimum requirements. These include a limited set of representations that the lender owns the note, has not pledged or assigned it and has the authority to transfer the note. While many borrowers request an indemnification, it is rarely given.

LIBOR Transition Study by Cadwalader and Sia Partners

Cadwalader and Sia Partners recently conducted a benchmarking study on the LIBOR transition efforts of over 75 organizations.

The study concluded that the largest, best-resourced organizations are farthest ahead in their LIBOR transition efforts, while mid-size and smaller firms are lagging behind and need to focus on transition efforts immediately. In addition, the results also indicated that substantial legal, operational and risk issues still need to be addressed. As the market is yet to be regularized and therefore the full costs of implementing the transition remain to be seen, borrowers in real estate financing may consider fixed rate loans as a preferable option to avoid the uncertainty of such transitional costs, as well as avoiding the need to navigate any cost indemnity discussions with the lenders (with respect to ascertaining and apportioning LIBOR transition costs amongst the parties) and any associated process of negotiating and amending the terms of existing loans.

Read more about the Cadwalader/Sia Partners study here.

LIBOR Transition to Alternative Rates – Tax Treatment under Proposed Regulations

On October 8, 2019, the U.S. Treasury Department and IRS issued proposed regulations confirming that transitions from LIBOR and other interbank offered rates (IBORs) to alternative reference rates in debt instruments and derivatives will not be taxable events, provided that the fair market value of the modified contract is substantially equivalent to the fair market value of the unmodified contract (fair market value test). Further discussion and analysis of the proposed regulations and the fair market value test can be found here.

Recent Matters

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

- Represented the lenders in the $800 million financing of 650 Madison Avenue in New York.
- Represented the lenders in the $1.975 billion acquisition financing of Blackstone's joint venture interest in the Great Wolf Resorts portfolio.
- Represented the lender in the $185 million loan secured by The Essex Crossing, a mixed-used development in the Lower East Side neighborhood of New York.
- Represented the lenders in the $300 million financing of 560 Mission Street in San Francisco, California.
- Represented the lender with respect to a $304 million mortgage loan secured by an office building located in Bellevue, Washington.
- Represented the lenders in a $373 million transaction comprised of a $327.7 million mortgage loan and $45.3 million mezzanine loan for Wells Fargo Center, a distinctive office tower in Denver, Colorado.
- Represented the lender in a $112 million mortgage loan to finance the acquisition of KPMG Plaza at Hall Arts in Dallas, Texas.
- Represented the agent and initial lender in a $135 million mortgage loan secured by the Westinghouse headquarters in Cranberry Township, Pennsylvania.
- Represented a pan-European fund managed by Invesco Real Estate, the global real estate investment manager, on its EUR31 million refinancing with Aareal Bank of two of its properties located in Milan, Italy.

Real Estate Events

Feb. 9-12, 2020

CREF/Multifamily Housing Convention & Expo

Location: San Diego
Organizer: MBA

March 25, 2020

CREFC 5th Annual Women's Network Symposium

Location: Cadwalader's New York Office
Organizer: CREFC

June 8-10, 2020

CREFC Annual Conference 2020

Location: New York
Organizer: CREFC