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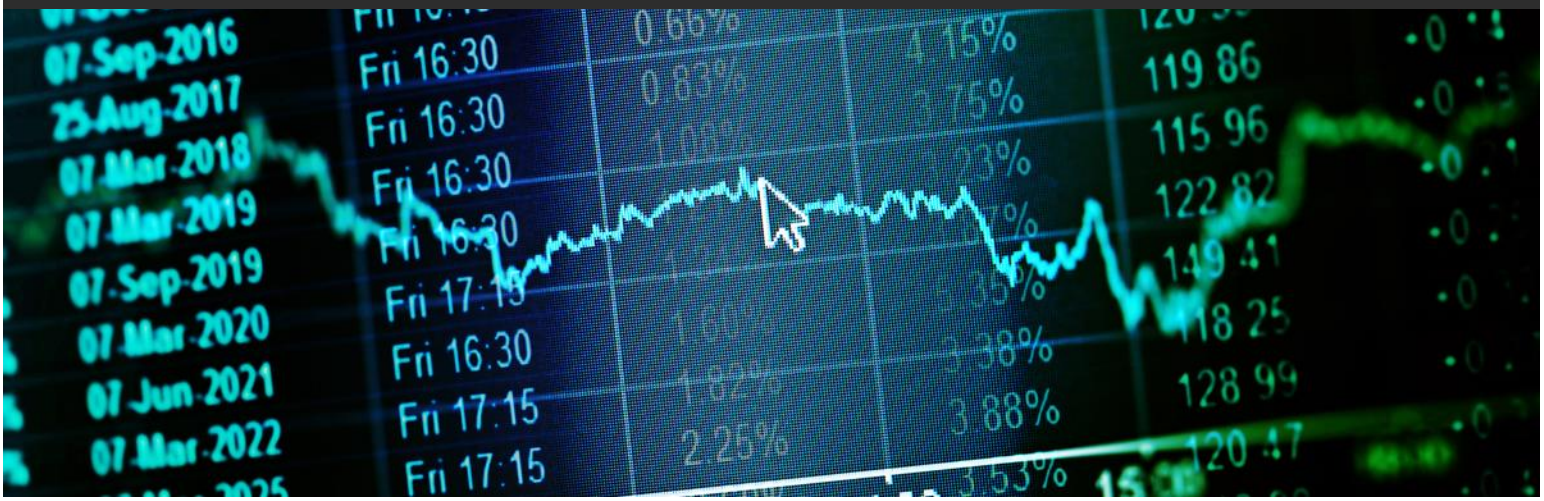

April 2020

Welcome to Greenberg Traurig's LIBOR Transition Newsletter, where we provide updates, analysis, and occasional commentary on the latest developments relating to the highly anticipated phasing-out of LIBOR at the end of 2021 – less than two years from now.

Litigation Risks – Outstanding Residential Mortgage Loans

LIBOR has been widely used as the index for adjustable rate, residential mortgage loans (ARMs). Indeed, by some estimates, approximately $1 trillion in ARMs in the United States are tied to LIBOR. This consists of some 2.8 million loans and more than half of the currently outstanding ARMs. There are many types of ARMs, but they typically feature an initial, fixed rate for a specified number of years, based on an index plus a margin, and then annual or monthly rate changes, with a rate cap (and sometimes a floor).

As explained in our prior LIBOR Transition Newsletters, the Alternative Reference Rates Committee (ARRC) has recommended a newly created rate, the Secured Overnight Financing Rate (SOFR), to replace LIBOR. In developing the SOFR, the ARRC described several benefits: the SOFR is based on an active and well-defined market, and using observable transactions, rather than estimates. In ARRC's view, SOFR should be a reliable alternative, and not susceptible to manipulation, as was LIBOR.[1] However, notwithstanding these benefits, the plaintiffs' bar will be looking for opportunities, particularly on a class-action basis, to argue that the use of SOFR disadvantages mortgage loan borrowers.[2] Plaintiffs may pursue

[1] There are several variations of the SOFR. For purposes of mortgage servicing, the substitute rate likely will be SOFR Compounded in Advance – e.g., for a 30-day SOFR beginning on April 1, SOFR would be compounded from March 1-30 to determine the rate.
[2] Michael Held, executive vice president and general counsel of the Federal Reserve Bank of New York, characterized the LIBOR transition as a "DEFCON 1 litigation event," a "situation that invites litigation . . . on a massive scale." Speech, "SOFR and the Transition from LIBOR" (Feb. 26, 2019).

various theories of liability, and noteholders and servicers may wish to act now to minimize the risk of litigation.

Contract-Based Claims

On contract theories, plaintiffs may focus on the specific language in the underlying mortgage agreements. For example, on Fannie Mae/Freddie Mac mortgage loans, the uniform note provides the right to substitute a new index, if the agreed index is "no longer available," based on "comparable information," but without guidance as to how these phrases should be interpreted or applied. This language therefore would be open to interpretation by the courts, potentially generating diverging results. Meanwhile, some mortgage agreements are silent as to the unavailability of the original rate and/or use of a substitute rate.

Depending on the language at issue, plaintiffs may assert claims for: (1) anticipatory breach or repudiation before LIBOR is extinguished; (2) breach of the note, asserting that the rate term is or became ambiguous, and that the note should be interpreted against the drafter to include the most favorable rate; (3) frustration of purpose or impossibility of performance, arguing that the noteholder/servicer was required to negotiate a new rate, and seek to discharge the duty to pay; or (4) specific performance, arguing for the use of LIBOR as it existed at a particular point in time. In defense of such claims, noteholders and servicers may consider various defenses, generally framed around the lack of knowledge at the time of origination of a future change in the rate, such as: (1) acts of government/change in law; (2) mutual or unilateral mistake (assuming that LIBOR would remain in place for the life of the loan); and (3) the necessity and fairness of reformation (the parties agreed to a variable rate tied to a third party/unbiased, longstanding, industry-accepted benchmark and, therefore, SOFR is appropriate).

Along with contract theories, plaintiffs may also assert claims for unjust enrichment, promissory estoppel, or breach of the covenant of good faith and fair dealing, arguing, in essence, the "inequity" of the rate substitution.[3]

Statutory Claims

Plaintiffs may take advantage of the liability standards and multiple remedies available under the various states' unfair and deceptive acts and practices statutes (UDAPS). For instance, California's Unfair Competition Law, Cal. Bus. & Prof. Code § 17200, *et seq*. (UCL), prohibits any "unlawful, unfair or fraudulent business act or practice."[4] The law's scope is "intentionally framed in broad, sweeping language," and interpretation and application of the UCL heavily favor consumers.[5] Plaintiffs can seek restitution and injunctive relief under the UCL.[6] The UDAPS of other states also provide strong protections to consumers, and generally permit the recovery of damages (sometimes trebled/punitive) and injunctive relief, and often attorneys' fees (e.g., Mass. Gen. Laws ch. 93A §§ 4 & 9, N.Y. Gen. Bus. Law § 349).

[3] Plaintiffs also may attempt negligence claims, although courts generally hold that lenders/servicers do not owe a legal duty. Moreover, plaintiffs could assert fraud-based claims, but these are often difficult to pursue in a proposed class action given individualized issues of reliance, causation, and harm.
[4] Cal. Bus. & Prof. Code § 17200.
[5] *Cel-Tech Commc'ns, Inc. v. L.A. Cellular Tel. Co.*, 20 Cal. 4th 163, 181 (1999).
[6] In a future Newsletter, we will discuss the regulatory risks related to the LIBOR transition. For example, state and local authorities can bring enforcement actions under the UCL, which carry the potential for civil penalties up to $2,500 on a per-violation basis. Further, there is the potential for enforcement at the federal level, including from the Consumer Financial Protection Bureau.

Practical Considerations

As noted above, the central premise of any litigation will be that the use of SOFR causes harm to borrowers. Accordingly, in transitioning away from LIBOR, noteholders and servicers could consider taking a conservative approach, and particularly when analyzing the results of the implementation of SOFR in the context of the applicable margins and rate caps. Having said that, tension then would exist with investors, who would object to lower returns. These competing interests should be considered and balanced, and some of ARRC's recommendations for newly originated ARMs may assist, including:

- Using either a 30- or 90-day SOFR average to set rates, which may mitigate the risks of single day fluctuations. The Federal Reserve Bank of New York is set to begin publishing SOFR averages in the first half of 2020.
- Setting the rate by reference to an average of SOFR, calculated over a given span of time.
- Restructuring rate caps to contain a one percent periodic adjustment to offset potential monthly payment increases to borrowers.

Further pursuant to ARRC recommendations, servicers must provide clear disclosures to borrowers about the LIBOR transition, and what it will mean for them. In preparing these disclosures, servicers should take into account the content of the underlying notes, and all applicable banking, securities and consumer protection laws. Servicers should also add LIBOR issues to their complaint tracking systems, monitor complaints for repeated topics, and address borrower concerns on a reasonable basis.

Finally, noteholders and servicers should continue to look for guidance from ARRC and state and federal regulators.

LIBOR Transition and the Massachusetts Attorney General's Perspective

Many adjustable-rate promissory notes use LIBOR as the index on which interest rates change while the loan is amortized and paid. These debt instruments, which typically are used in residential loan transactions, allow the noteholder to choose a new index if LIBOR is no longer available and typically are based on notice and without consent from the borrower. The following is language commonly found in these debt instruments:

> Beginning with the first Change Date, my adjustable interest rate will be based on an Index. The "Index" is the average of interbank offered rates for six-month U.S. dollar-denominated deposits in the London market ("LIBOR"), as published in The Wall Street Journal. The most recent Index figure available as of the date 45 days before each Change Date is called the "Current Index."
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> If the Index is no longer available, the Note Holder will choose a new index that is based upon comparable information. The Note Holder will give me notice of this choice.

Choosing a new index is a bargained-for right that would appear to be the noteholder's right to exercise (without consent of a borrower). Beyond any covenant of good faith and fair dealing that may be implied in such instruments, noteholders (typically banks and other financial institutions) may place themselves in the most defensible position when making that choice by ensuring that any alternative index chosen to replace LIBOR does not place the borrower in a less advantageous position and potentially run afoul of state laws protecting borrowers.

For example, in Massachusetts, the Massachusetts Attorney General (MA AG) has promulgated a series of regulations concerning mortgage brokers and mortgage lenders, including, in particular, 940 C.M.R.

8.06(15), which may implicate a note holder's exercise of its contractual right to choose another index. Specifically, Section 8.06(15) provides, in relevant part:

> It is an unfair or deceptive act or practice [under Mass. Gen. Laws c. 93A (Chapter 93A)] for a mortgage broker to arrange or mortgage lender to make a mortgage loan unless the mortgage broker or lender, based on information known at the time the loan is made, reasonably believes at the time the loan is expected to be made that the borrower will be able to repay the loan based upon a consideration of the borrower's income, assets, obligations, employment status, credit history, and financial resources, not limited to the borrower's equity in the dwelling which secures repayment of the loan based upon a consideration of the borrower's income, assets, obligations, employment status, credit history, and financial resources, not limited to the borrower's equity in the dwelling which secures repayment of the loan.
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> The determination under 940 CMR 8.06(15) of a borrower's ability to repay a loan shall take into account, without limitation: (a) the borrower's ability to repay at the fully indexed rate, assuming a fully amortizing repayment schedule, and the resulting scheduled payments that may be charged under the loan accounting for interest rates, financial terms or scheduled payments that may adjust upward; and (b) the property taxes that are required on the subject property at the time the loan is expected to be made and the reasonably anticipated insurance costs if the loan requires that insurance be maintained on the property, regardless whether the broker or lender will collect an escrow for such taxes or insurance in connection with loan payments. For purposes of 940 CMR 8.06(15)(a), the "fully indexed rate," with respect to loan rates that may adjust upward, shall mean the index rate prevailing at the date of loan origination plus the margin to be added to it after the expiration of an introductory interest rate.

The illustrative example provided for determining a borrower's ability to repay the loan uses a six-month LIBOR of 5.5% at the day of origination, plus a margin of 6%.

Considering Section 8.06(15), any new index chosen to replace LIBOR likely should not put the borrower in a worse position than under LIBOR such that it might run afoul of Chapter 93A, which is one of the most widely used statutes for policing deception and unfairness in business transactions or dealings with consumers (borrowers).

Under Chapter 93A, the MA AG may seek injunctive relief if the MA AG has "reason to believe" a defendant is violating or is about to violate Chapter 93A and such action would be in the public interest. In addition, the MA may seek restitution for all Massachusetts residents who suffered an "ascertainable loss" of money or property arising from an unfair act or practice. Furthermore, a court may impose a $5,000 civil penalty for each violation and require reimbursement of attorneys' fees and costs if a defendant "knew or should have known" that the act violated Chapter 93A. Moreover, a borrower may bring his or her own action under Chapter 93A and seek recovery of actual damages, double or treble damages, and reimbursement of attorney's fees and costs on behalf of himself or herself and all other similarly situated.

At the federal level, noteholders may wish to verify that disclosure of a change in payment as a result of a rate adjustment and of the new index, as required by the Truth in Lending Act and Regulation Z, are provided when applicable and within the established timeframes. *See* 12 C.F.R. § 1026.20(c).

Accordingly, noteholders may consider auditing their residential loan portfolios in particular to understand what debt instruments used LIBOR as an index. Concomitantly, noteholders may wish to ensure that any change to that index — contractually bargained for or otherwise — does not implicate any

state laws protecting borrowers, particularly for those types of loans that state regulators deem as potentially predatory.

Recent Developments

- *ARRC Releases Consultation on Fallback Language for New Variable Rate Private Student Loans for Public Feedback* – On March 27, 2020, the Alternative Rates Reference Committee (ARRC) released a consultation on U.S. Dollar (USD) LIBOR fallback contract language for new variable rate private student loans. The consultation on fallbacks for new variable rate private student loans proposes two different steps in a successor rate waterfall: an "ARRC Replacement Index" and a "Note Holder-Determined Replacement Index." *See* a copy of the consultation here.
- *English regulators address impact of the coronavirus on firms' LIBOR transition plans* - As analyzed in our most recent client alert on LIBOR transition, questions abound whether market participants will be in position to transition away from LIBOR to an alternative reference rate given the current disruption caused by COVID-19. On March 25, the Financial Conduct Authority (FCA) announced that, together with the Bank of England and members of the Working Group on Sterling Risk-Free Reference Rates, it continues "to monitor and assess the impact on transition timelines, and will update the market as soon as possible" while confirming that "[t]he central assumption that firms cannot rely on LIBOR being published after the end of 2021 has not changed and should remain the target date for all firms to meet." *See* the FCA statement here.
- *ARRC releases a proposed legislative solution to Minimize Legal Uncertainty and Adverse Economic Impact Associated with LIBOR Transition* – On March 6, the ARRC released a legislative proposal aimed at addressing LIBOR cessation in financial instruments and contracts governed by New York law, which intends to minimize the risk of frustration in the performance of a party's contract obligations when a LIBOR fallback provision is not sufficient, is ambiguous or is silent as to what reference rate would apply when LIBOR is no longer quoted. There is not, at the moment, any indication that progress has been made with the New York state legislative body to enact this (or any similar bill or proposal) into law. *See* the ARRC legislative proposal here.

Read previous editions of GT's LIBOR Transition Newsletter.

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