STRUCTURED FINANCE
SPECTRUM

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Editor's Note

We are two months into the new year, and so far 2023 is proving to be as elusive to predict as its predecessors. The structured finance markets are in flux, both bringing new regulations (Article 12 of the UCC) and saying final farewell to others (LIBOR). This edition highlights some of the issues we're facing right now, with a bit of prognosticating about what might come.

I hope you enjoy the issue—and look forward to seeing many of you in Vegas!

Katrina Llanes
Partner, Finance

Introducing...

In January, we welcomed Steve Blevit, Solmaz Kraus, and Chris Juarez to the Structured & Warehouse Finance Team in Los Angeles. Over the last decade, this team has handled more than $100 billion of transactions involving single-family residential homes, including term and warehouse financings and securitizations, the first institutional warehouse facility for single-family rental in 2012, the first securitization of single-family rental debt in 2013, and the first securitization of iBuyer debt in 2021. Steve also developed the financing and securitization documentation widely used at all levels of single-family rental finance today.

New Year, New Article 12 of the Uniform Commercial Code

In 2022, the American Law Institute (ALI) and the Uniform Law Commission (ULC) approved the Uniform Commercial Code Amendments (2022) that propose changes to the Uniform Commercial Code (UCC) to address transactions in digital assets and other emerging technologies, including virtual currencies and ledger technologies. The 2022 amendments include a new article—Article 12—that expressly governs the transfer of property rights in certain digital assets or "controllable electronic records" that have been created or may be created in the future. Article 12 also leverages the use of new technologies, including virtual (non-fiat) currencies and nonfungible tokens (NFTs). The 2022 amendments include revisions to other articles of the UCC, including most notably Article 9, to facilitate incorporation of market changes arising from these new technologies.

Amending the UCC Framework to Address Certain Digital Assets and Other Emerging Technologies

Work on the 2022 amendments began in 2019, when ALI and ULC formed a joint drafting committee to examine the UCC and propose revisions to address emerged and emerging technological developments. For 30 months, before preparing the 2022 amendments, the committee held 18 meetings with industry stakeholders, the UCC, and digital asset experts from law schools, law firms, government agencies, and private technology companies. The committee focused on the UCC's coverage of digital assets, including controllable electronic records (CERs), chattel paper, hybrid transactions combining the sale or lease of goods with a transaction in other property outside the UCC's scope, payment systems, and consumer issues.

New Article 12

The drafting committee adopted Article 12 specifically to clarify rights in CERs, which are records stored in an electronic medium that are susceptible to control under Section 12-105. The 2022 amendments take a broad, technologically flexible approach to defining CERs but obviously contemplate CERs that arise under electronic ledger technology, such as blockchain. This electronic ledger technology assigns economic value to electronic records without intrinsic value (such as virtual currency or NFTs), and the creation or transfer of electronic records facilitates the transfer of the rights to

payment, personal/real property, and the performance of services or other obligations.

Before the 2022 amendments, the rights to, and perfection and priority of, certain new classes of digital assets were not clearly or optimally reflected under commercial law. Article 12 is designed to address this lack of clarity for electronic records that are "controllable" and to specify the rights acquired by a purchaser. To be controllable under Article 12-105, the following must be true of the electronic record:

- The electronic record must have some value or benefit (for example, a virtual currency's "value"), and the controlling person must have the right to enjoy "substantially all the benefit."
- The controlling person must have the exclusive power to prevent others from enjoying any rights or benefits of the electronic record.
- The controlling person must have the exclusive power to transfer control of the electronic record.
- The electronic record must contain some marking or other identification that a controlling person can use to readily identify themselves as having the powers listed in the three points above.

The exclusivity noted in the second and third points is not voided by a party sharing the rights with another party because the electronic record is subject to certain system terms or protocols limiting the use of the record or relating to the transfer or loss of control.

CERs often have rights connected, or "tethered," to other assets, and it is the underlying asset tethered in the record, not the record itself, that provides value. Legal rights related to this underlying asset (that is, laws other than the UCC) will govern the rights to the asset and the related CER. For example, if the asset tethered to the CER relates to real property, then laws governing real property would determine the transfer of the CER tethered to that interest. An exception exists for controllable payment intangibles and controllable accounts when a person obtains control of the controllable account or controllable payment intangible and control of the tethered CER.

Article 12 expressly excludes certain electronic records from the CER definition, including deposit accounts, investment property, and an electronic copy of a record evidencing chattel paper.

In addition, Article 12 provides purchasers of CERs with certain benefits of the "take-free" rule if the purchaser is a "qualifying purchaser." "Take-free" rules permit the purchaser to acquire an interest in the transferred CER free from any competing property claims. To be a "qualifying purchaser," the purchaser must obtain control of the CER for value in good faith and without notice of a property claim to the CER. The filing of a financing statement is not notice of a claim of property right to the CER. By applying this concept to a controllable account or controllable payment intangible, Article 12 effectively creates an electronic instrument. And so far as the terms of the controllable account or controllable payment intangible provide that the account debtor will not assert claims or defenses against the transferee of the CER, the controllable account or controllable payment intangible is effectively an electronic negotiable instrument.

Article 12 expressly excludes certain electronic records from the CER definition, including deposit accounts, investment property, and an electronic copy of a record evidencing chattel paper. Generally, the drafting committee wanted to retain the outstanding law related to these assets (including rights under other articles of the UCC) and revise them to meet the challenges of the emerging market technology. The amendments on security interest, including its relation to chattel paper, are found in the 2022 amendments' sections on Article 9.

Now that the 2022 amendments have been finalized, states can facilitate their adoption. The state legislatures' legal staff and the state and local bar associations' legislative committees can work together to review the proposed 2022 amendments and make revisions deemed necessary to deal with state and local issues. As of February 2023, 20 states and the District of Columbia have introduced bills to adopt the 2022 amendments. It is important to note that finance market participants that do not participate in commercial transactions that involve digital assets may be impacted by the 2022 amendments due to the extensive revisions to Article 9, including the sections on paper and electronic chattel paper. ■

The Coin of the Realm-less: Who Owns the FTX Coin?

When FTX filed for bankruptcy on November 11, 2022, some compared the event to the collapse of Lehman. Among the issues in the FTX case is who owns the cryptocurrency held at—or absconded from or absconded and returned to—the FTX entities now in bankruptcy. What is property of the estate under Section 541 of the United States Bankruptcy Code is a matter of state or other applicable law, not federal bankruptcy law. This, it turns out, is a surprisingly complex question.

Crypto Generally

Historically, money was specie coin and fiat currency, and its value derived from its inherent substance (e.g., gold, silver, etc.), its convertibility (e.g., a gold standard), and what you could purchase with it (e.g., dollars are legal tender for purchases where dollars are accepted, which is mandated by fiat in the United States). Monetary systems rely on multipliers such as banking systems, which manage most payment processing.

Cryptocurrency arrived in 2008 with a paper, *Bitcoin: A Peer-to-Peer Electronic Cash System* by Satoshi Nakamoto. The blockchain-enabled decentralized "distributed ledger," Nakamoto said, would delink currency from a "trust based model" of regulated financial institutions and offer a transaction scheme with no intervening third parties to reverse transactions. Realm-less money, with no intrinsic substance, convertibility, or fiat, was born. Cryptocurrency value would be based on its designed scarcity, independence from the trust based model, and the irreversibility of its transactions. Cryptocurrency also became valued based on speculative opinions. Bubbles are as indifferent to asset class as tulip bulbs in the mid-1600s.

Cryptocurrency is controlled by numeric keys. To acquire cryptocurrency a person obtains a private key, a random number, reduced to an alphanumeric representation of the number in a high base, like radix 58 (in the case of Bitcoin). The private key is encrypted through a one-way process into a public key and a public address for the distributed ledger. "One-way process" means it is impossible to decrypt the private key from the public key or public ledger address.

Whoever knows the private key controls the transfer of the coin under the related public address to another public address on the distributed ledger. To transact in the cryptocurrency, a person who knows the private key for a public address may deliver the coin under that public address to any public address controlled by a transferee. The transaction is then verified by the blockchain through a process commonly referred to as "mining."

The Revenge of the Trust Model

Black's Law Dictionary defines "property" as "[t]hat which is peculiar or proper to any person; that which belongs exclusively to one." The term is said to "extend to every species of valuable right or interest." A key component of ownership is possession. While the law is unsettled, we can say with tolerable confidence that cryptocurrency is "possessed" by direct or indirect and, broadly speaking, exclusive control of an alphanumeric private key through which a public address on the distributed ledger can be manipulated to transmit coin to another public address on the distributed ledger. If a private key is lost, all cryptocurrency recorded on the distributed ledger under the public address corresponding to a private key is effectively lost forever. It can never be transacted with again, as there is no way to discover or reconstruct the private key. Thus, ownership of cryptocurrency orbits about or is always in some way derivative of control over—by agreement or otherwise—the custody of private keys.

This is as unsimple as it is unsettled. A private key can be held in personal custody. This is known as "cold storage." Cold storage can be achieved in a large number of imaginable ways. A person might store the private key on a thumb drive. A person might write the private key on a piece of paper. One could even tattoo a private key, or an encrypted private key for safekeeping, on one's body like a treasure map.

Cold storage has issues too obvious to recount. You could lose the piece of paper, lose the thumb drive, or lose the password to access the thumb drive. To address this, the practice of establishing custody wallets arose.

In a rudimentary custody wallet arrangement, a third-party custodian is given the alphanumeric private key, for safekeeping, under rules established by the terms of a custody account agreement. In a more complex custody wallet arrangement, one or more private keys known only to the custodian might be used to hold custodial cryptocurrency on a commingled basis; i.e., the cryptocurrency is held under one or more public addresses controlled by a custodian for the benefit of multiple owners. For the rudimentary and more complex arrangements to be secure, several things are needed. The custody account terms must be clear and unambiguous. Compliance by the custodian with the terms of the custody agreement is essential. The custodian must not make unauthorized transactions with the private key. The nature of cryptocurrency, particularly the inability to discover the private key, and thus a private key holder, heightens the need for integrity. Often custody accounts are insured to indemnify against the loss of the private keys. For an insurer to insure, its underwriting will require integrity of compliance and risk management. You can see here that even with a custody wallet the "trust based model" creeps back in.

There is another wrinkle. The Nakamoto paper stated that "[t]he cost of mediation [in the trust based model] increases transaction costs." But because of the means of its transmission on the distributed ledger, cryptocurrency comes with a high transaction cost; two transaction parties having control over a private key and related public keys and addresses have to be matched. This is where exchanges, like FTX, come in.

If a private key is lost, all cryptocurrency recorded on the distributed ledger under the public address corresponding to a private key is effectively lost forever.

By establishing a common pool of cryptocurrency and fiat cash, it is possible to transact efficiently in cryptocurrencies. Cryptocurrency is maintained at the exchange through one or more private keys known only to the exchange, and cash is maintained through various bank accounts. The customer transmits cash or cryptocurrency to the exchange and receives a customer account, which is essentially an internal ledger entry at the exchange. This is similar to a bank account.

Account holders may then exchange their cryptocurrency and cash using the internal ledger of the exchange. The only actual transfers recorded in the distributed ledger, as opposed to the internal ledger of the exchange, are done periodically after netting all the internal transactions and withdrawals of cryptocurrency and cash from the exchange. This dramatically reduces the cost of the cryptocurrency transactions.

It also resurrects the "trust based model" that Nakamoto had sought to kill. A traditional "trust based model" works through internal controls, extensive and redundant risk management layering, regulation, fear of law enforcement, and in the case of unregulated capital, by limiting investment to a small number of investors who are not accredited investors. For everyone else, there are banks and insurance companies, highly regulated entities.

FTX Meltdown: Who Owns What of What's Left

When close to all of the FTX entities filed for bankruptcy in early November, the filing entities had approximately 330 employees, of which approximately 127 were located in the United States. These employees were responsible for the risk management and internal controls of over 90 entities, tens of billions of assets and liabilities, and more than 1 million individual accounts. This is farcically inadequate to provide appropriate risk management. According to the first-day declaration of John Ray III, chief restructuring officer and CEO of FTX, "Never in my career have I seen such a complete failure of corporate controls." Sam Bankman-Fried's "effective altruism" model gave way to a "trust based model" meltdown.

Now FTX account holders are waiting to discover what they own of whatever is left. There are several things to know about the process of determining ownership.

- One, these will be cases of first impression. There is no substantial body of precedent law to address and provide certainty to the questions of ownership.
- Two, the precise terms of the account agreements will be very important to the determination.
- Three, the law governing these agreements and the jurisdiction of the "location" of the alphanumeric keys and accounts will also be very important to the determination, because it is this local law that will determine what is or is not property of the estate under Section 541 of the Bankruptcy Code. For example, Idaho has a developed statutory scheme (House Bill 583) for the purchase and sale of digital assets and for perfection of security interests in virtual currency.

Voyager and Celsius Opinions and Account Terms

We have one opinion to look to in *In re Voyager Digital Holdings Inc.*, No. 1:22-bk-10943 (Bankr. S.D.N.Y. 2022), and one to look to in *In re Celsius Network*, No. 1:22-bk-10964 (Bankr. S.D.N.Y. 2023).

In *In re Voyager Digital Holdings*, Judge Michael Wiles ruled that fiat currency funds (i.e., cash) held for the benefit of (FBO) account holders at Metropolitan Commercial Bank were not property of the estate under Section 541 of the Bankruptcy Code because (1) the bank accounts were designated FBO

accounts and (2) the terms of the customer agreements of Voyager with certain Voyager account holders explicitly stated that "each Customer is a customer of the [Metropolitan Commercial Bank]." Of note is that, in addition to the clarity of the terms, no party contested the matter. Also, the ruling did not extend to cryptocurrencies held by Voyager, for which the customer agreements were unfavorable to account holders who might claim ownership of the cryptocurrency:

> Customer grants Voyager the right … to pledge, repledge, hypothecate, rehypothecate, sell, lend, stake, arrange for staking, or otherwise transfer or use any amount of such Cryptocurrency, separately or together with other property, with all attendant rights of ownership….

In *In re Celsius Network*, Judge Martin Glenn ruled on whether account holders in that case who held "earn accounts" actually owned the cryptocurrency in those accounts. The *Celsius* case was decided based on the unambiguous language in the customer agreement. The customer agreements stated: "you grant Celsius … all right and title to such Eligible Digital Assets [cryptocurrency], including ownership rights …." Celsius had, among other things, the right to rehypothecate, pledge, or transfer all cryptocurrency in the "earn accounts." *Quod erat datum*: The cryptocurrency is not the customers' property.

But *In re Celsius Network*'s value as a precedent is limited because it is based on the specific language of the account agreements governing the "earn accounts." FTX accounts are maintained under account agreements that were written by FTX lawyers and the specific language is different. However, rights to transfer, rights to rehypothecate, rights to commingle, express rights of ownership, and admonitory language that account holders may not be able to exercise rights of ownership will all be indicative of a lack of ownership, although a final determination of ownership will be based on the whole of the agreement and to the extent there is ambiguity, possibly the practices related to the account.

Custody Accounts and Commingling

When it comes to custody accounts when a private key is transmitted to a custodian, what rights that creates will be determined by the terms of the custody account under the governing law of that custody account agreement. If the custody account agreement terms are unambiguous that the custodian will only hold the private key and will not transact in the cryptocurrency controlled by the private key, except at the instruction of the custody account holder, then it is likely that the cryptocurrency controlled on the distributed ledger by the private key held by the custodian will be found to be the property of the custody account holder and not the property of the estate.

Today there are few definitive answers, but the FTX case and other crypto exchange cases will start to shape a body of law that will add certainty and regulatory overlay to the world of cryptocurrency.

If a custodian has agreed to aggregate custody of cryptocurrency under a public address or public addresses corresponding to a private key or private keys known only to the custodian, but has also agreed that no rehypothecation or transfers are permitted apart from the instructions of the account holders, then what? Despite commingling, this might be sufficient to establish ownership. If managed in accordance with the terms of the agreement, there would always be sufficient cryptocurrency in the custody account to return the exact number of coins deposited by each custody account holder. In addition, there are many arrangements in state law for commingled goods to create an undivided whole property

interest in a commingled mass. "Commingling fungible goods is not categorically antithetical to a bailment," according to *In re Enron Corp.*, No. 01-16034 (Bankr. S.D.N.Y. Jan. 22, 2003). In cases of commingled fungible assets such as steel pellets, oil, and gas, often several owners will have an ownership interest in the form of a bailment that can be divided into lots of exclusive ownership. They create an undivided interest in a fungible mass analogous to a tenancy in common. The law generally favors flexible partition, so there is a thread of reason that would permit withdrawal and partition by one bailee or tenant, as it were, of its interest in the fungible coin under a commingled custody arrangement.

Note also that the concept is embodied in the Uniform Commercial Code to address continuing liens in even irretrievably commingled collateral. See, for example, comment 4 to Section 9-336 of the New York Uniform Commercial Code:

> SP-1 has a perfected security interest in Debtor's eggs, which have a value of $300 and secure a debt of $400, and SP-2 has a perfected security interest in Debtor's flour, which has a value of $500 and secures a debt of $600. Debtor uses the flour and eggs to make cakes, which have a value of $1,000. The two security interests rank equally and share in the ratio of 3:5. Applying this value to the entire value of the product, SP-1 would be entitled to $375 and SP2 would be entitled to $625.

Arguably, similar rules should apply to commingled but traceable cryptocurrency custody arrangements. Hypothetically, then, if 10 custody account customers transmit equal amounts of a cryptocurrency to a single custody account managed by a single custodian with one or more private keys and corresponding public keys and addresses, under appropriate and unambiguous account terms establishing a bailment, a tenancy in common or a trust arrangement, then each account holder could, and a strong case can be made they should, own one tenth of whatever remains, and whatever is recovered to, the public addresses used for the custodial arrangement. Similar reasoning might be used to establish that a trust arrangement between the custodian and the customers has been established. In that instance, the estate under Section 541 would own the legal title to the cryptocurrency in the custody account, but not the beneficial title, the right to the value of the trust estate, which would be the property of the customers.

Conclusion

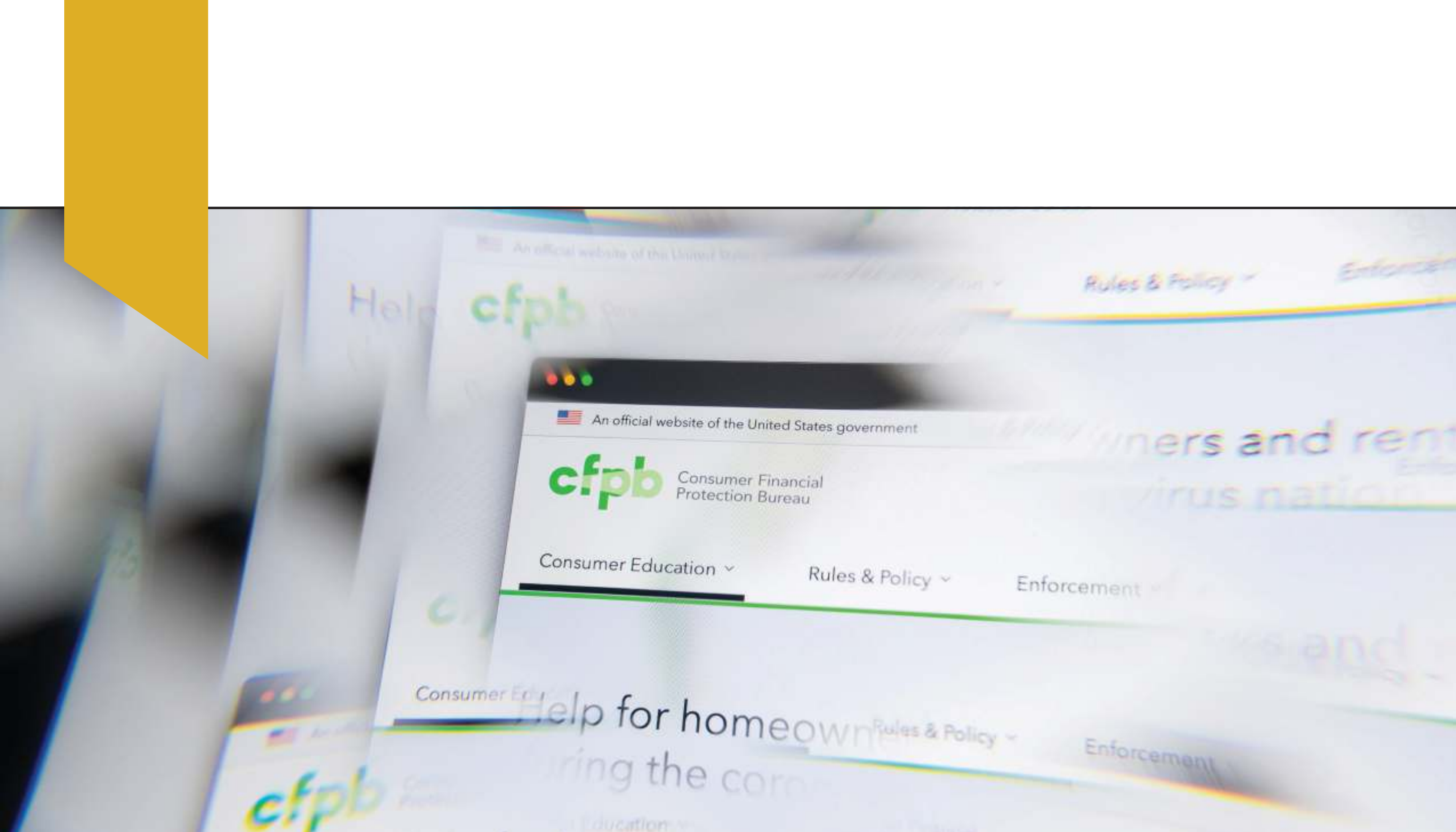
This leaves FTX account holders—and account holders at other distressed exchanges—with a great deal to think about.

Do their account terms and the related practices suggest that a court will find that they have a property right—clear title to a defined unique alphanumeric private key, a tenancy in common in or beneficial title to one or more custodial private keys—to the underlying cryptocurrency falling outside the property of the estate under Section 541 of the Bankruptcy Code? A careful read of the account terms should tell a good part of the story.

A question that follows is if indeed account holders of any particular class held a right to property in cryptocurrency and that right was converted to someone else's use—was transacted without in violation of agreements—will the converted cryptocurrency be recovered and ultimately returned to them as the true owner? Or will good faith recipients of such cryptocurrency, to the extent they can be discovered, be sheltered from recovery.

There may also be competing actions by law enforcement to pursue asset forfeitures. Will law enforcement asset forfeitures be returned to the bankruptcy estate of the FTX entities for distribution to unsecured creditors? If they are traceable to valid custody arrangements, will they be returned to the true owner?

Today there are few definitive answers, but the FTX case and other crypto exchange cases will start to shape a body of law that will add certainty and regulatory overlay to the world of cryptocurrency. These cases will likely dovetail with the emergence of new regulatory schemes developed by legislatures and regulators. Despite there being no definitive answer, competent analysis can already begin to answer the questions and define risk. ■



CFPB Issues Proposed Rule to Establish Public Registry of Supervised Nonbank Form Contract Provisions That Waive or Limit Consumers' Legal Protections

On January 11, 2023, the Consumer Financial Protection Bureau (CFPB) announced a Proposed Rule to establish a public registry and require nonbanks supervised by the agency to register their use of certain terms and conditions contained in "take it or leave it" form contracts for consumer financial products or services that "attempt to waive consumers' legal protections, to limit how consumers enforce their rights, or to restrict consumers' ability to file complaints or post reviews." The purpose of Proposed Rule's registration system is to allow the CFPB to prioritize oversight of nonbanks that use the covered terms and conditions based on the agency's perception these provisions pose risks for consumers.

The CFPB seeks public comment on the practical utility of collecting and publishing this information and ways to minimize the burden of the information collection on respondents. The comment period closes on April 3, 2023.

The Proposed Rule

The Proposed Rule would require annual registration by most nonbanks subject to the CFPB's jurisdiction, with limited exceptions. Specifically, a "supervised nonbank" would be defined to mean a "nonbank covered person" that is subject to supervision and examination by the CFPB, except to the extent that the person engages in conduct or functions that are excluded from the CFPB's supervisory authority pursuant to 12 U.S.C. 5517 or 5519. A supervised nonbank would include any nonbank covered person that (1) offers or provides a residential-mortgage-related product or service, any private educational consumer loan, or any consumer payday loan;

(2) is a larger participant engaged in consumer reporting, consumer debt collection, student loan servicing, international money transfers, and auto financing; or (3) is subject to a CFPB order issued pursuant to 12 U.S.C. 5514(a)(1)(C).

Those excluded from the scope of the Proposed Rule would include persons subject to CFPB supervision and examination solely in the capacity of a service provider, natural persons, and persons with less than $1 million in annual receipts resulting from offering or providing all consumer financial products and services relevant to the activities noted above. Also exempt from the rule would be a person that has not, together with its affiliates, engaged in more than de minimis use of covered terms and conditions (i.e., fewer than 1,000 times in the previous calendar year) and a person that used covered terms or conditions in covered form contracts in the previous calendar year solely by entering into contracts for residential mortgages on a form made publicly available on the internet required for insurance or guarantee by a federal agency or purchase by Fannie Mae, Freddie Mac, or Ginnie Mae.

The Proposed Rule would require annual registration by most nonbanks subject to the CFPB's jurisdiction, with limited exceptions.

Under the Proposed Rule, a "covered term or condition" would be subject to the rule's reporting requirements. A "covered term or condition" would be defined as "any clause, term, or condition that expressly purports to establish a covered limitation on consumer legal protections applicable to the offering or provision of any consumer financial product or service." In turn, "covered limitation on consumer legal protections" would be defined to mean any covered term or condition in a covered form contract:

1. Precluding the consumer from bringing a legal action after a certain period of time;
2. Specifying a forum or venue where a consumer must bring a legal action in court;
3. Limiting the ability of the consumer to file a legal action seeking relief for other consumers or to seek to participate in a legal action filed by others;
4. Limiting liability to the consumer in a legal action including by capping the amount of recovery or type of remedy;
5. Waiving a cause of legal action by the consumer, including by stating a person is not responsible to the consumer for a harm or violation of law;
6. Limiting the ability of the consumer to make any written, oral, or pictorial review, assessment, complaint, or other similar analysis or statement concerning the offering or provision of consumer financial products or services by the supervised registrant;
7. Waiving, whether by extinguishing or causing the consumer to relinquish or agree not to assert, any other identified consumer legal protection, including any specified right, defense, or protection afforded to the consumer under Constitutional law, a statute or regulation, or common law; or
8. Requiring that a consumer bring any type of legal action in arbitration.

In the Proposed Rule, the CFPB acknowledges that there may be overlap in the types of covered terms and conditions, so some contract provisions may fall into more than one category. The Proposed Rule currently proposes to limit the collection of terms and conditions that *expressly* attempt to establish the covered limitation. Any contract containing a covered term would be considered a "form contract" provided it (1) was included in the original contract draft presented to the consumer; (2) was not negotiated between the parties; (3) is intended for repeated use in transactions between the company and consumers and contains a covered term or condition.

Supervised nonbanks covered by the Proposed Rule would be required to collect and submit this information through the CFPB's registration system. Under the Proposed Rule, the registry of terms and conditions would be publicly available, rather than limited to government regulators or CFPB staff. The CFPB supports the public availably of this data on the grounds that it will lead to more informed consumers and provide other regulators the opportunity to identify covered terms and conditions that are explicitly prohibited by the laws they enforce or supervise. The proposed format for the registry is similar to another recent CFPB proposed rule that proposes to establish a public registry of regulatory actions involving certain nonbanks subject to CFPB supervision. We discussed this proposed rule in a blog post, "CFPB Proposes Nonbank Registry to Focus on Compliance 'Recidivism.'"

CFPB's Request for Comment on the Proposed Rule

The CFPB is seeking comment on a range of issues related to the Proposed Rule, including:

- The prevalence of the covered terms and conditions.
- Potential impacts of collecting and publishing this information.
- Reasons why the information should not be publicly disclosed.
- The burden of collecting and filing these provisions.
- The use of form contracts purchased from third parties.
- Other entities that may be affected by the proposed rule.

The period for public comment ends on April 3, 2023.

Is the Establishment of a Public Registry Likely?

The CFPB currently has 37 rules that have been proposed but not implemented, five of them since the start of the Biden Administration. Most notably, neither the CFPB's proposed rule for small business lending data collection from September 1, 2021 or its proposed rule for credit card late fees and late payments from June 22, 2022 have been finalized. Since the substance of this rule is limited to the collection and publication of contract terms, rather than the prohibition of any behavior, enactment might be more likely. The recent Fifth Circuit decision in *Community Financial Services* found the CFPB's funding structure unconstitutional and vacated the agency's Payday Lending Rule on those grounds. Now any rule promulgated by the CFPB would likely be susceptible to legal challenges.

Under the Proposed Rule, the registry of terms and conditions would be publicly available, rather than limited to government regulators or CFPB staff.

Takeaway

The CFPB's focus on seeking public disclosure of covered terms and conditions reflects a continued focus on the content of form contracts used in nonbanks' consumer finance products and services. The public nature of the registry could lead to increased scrutiny of contract provisions by the CFPB, other regulators, and the public, increasing reputational risk to covered entities and the likelihood of heightened enforcement activity by federal and state regulators. Entities that would be subject to the Proposed Rule's requirements should carefully review the Proposed Rule and consider commenting.

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Moving to Address Appraisal Bias, Agencies, and the Appraisal Foundation Issue Updates

A year and a half after President Biden's announcement of the Interagency Task Force on Property Appraisal and Valuation Equity (PAVE), the past weeks have seen a flurry of activity from federal agencies and the Appraisal Foundation to address issues of bias in residential property appraisal. What should lenders, servicers, and appraisers know?

Background

In June 2021, President Biden announced the formation of the PAVE Task Force, comprising 13 federal agencies, including the White House Domestic Policy Council. He tasked the group with identifying and evaluating "the causes, extent, and consequences of appraisal bias and to establish a transformative set of recommendations to root out racial and ethnic bias in home valuations."

In March 2022, the member agencies of the PAVE Task Force published an action plan, announcing a series of concrete commitments to address appraisal bias in five broad categories:

1. Strengthening guardrails against discrimination in all stages of residential valuation.
2. Enhancing fair housing and fair lending enforcement, and driving accountability in the appraisal industry.
3. Building a diverse, well-trained, and accessible appraiser workforce.
4. Empowering consumers to take action against bias.
5. Giving researchers and enforcement agencies better data to study and monitor valuation bias.

While the task force's activity is ongoing, federal agencies in the past few weeks have announced a series of steps that are in line with the PAVE goal of addressing real property appraisal bias.

FHA: Draft Mortgagee Letter on Reconsiderations of Value and Appraisal Review

On January 3, 2023, the Federal Housing Administration (FHA) published for public comment a draft mortgagee letter, Borrower Request for Review of Appraisal Results, that would permit a second appraisal to be ordered if a direct endorsement

underwriter determines that an original appraisal contains a material deficiency. The letter would expressly identify as a material deficiency—one that would directly impact value and marketability of the underlying property—indications of either unlawful bias in the appraisal or a violation of applicable federal, state, or local fair housing and nondiscrimination laws.

Further, the draft mortgagee letter would require the underwriter in a transaction involving an FHA-insured loan to "review the appraisal and ensure that it is complete, accurate, and provides a credible analysis of the marketability and value of the Property." Among other criteria, this would require the underwriter to make a determination of whether the appraisal is materially deficient—that is, whether the appraisal contains indications of unlawful bias or a violation of applicable fair housing and nondiscrimination laws. Providing a "credible analysis" exceeds the scope of a quality control review. If included in a finalized mortgagee letter, it would require lenders to determine whether underwriters must be state-licensed or state-certified appraisers.

The draft mortgagee letter also sets forth standards for the submission and consideration of a borrower's request for a review of appraisal results, including the submission of a reconsideration of value request to the appraiser.

VA: Enhanced Oversight Procedures to Combat Appraisal Bias

On January 18, the Department of Veterans Affairs (VA) issued Circular 26-23-05, detailing the enhanced oversight procedures that the VA has adopted "to identify discriminatory bias in home loan appraisals and act against participants who illegally discriminate based on race, color, national origin, religion, sex (including gender identity and sexual orientation), age, familial status, or disability."

In the circular, the VA indicated that it will review all appraisal reports submitted in connection with VA-guaranteed home loans to identify any potential discriminatory bias. The VA will: (1) conduct an escalated review of any suspected incidents of bias; and (2) remove from its panel of approved appraisers any individual who is confirmed to have provided a biased appraisal.

The VA also reminded panel appraisers that in submitting a Fannie Mae Form 1004 (Uniform Residential Appraisal Report), they certify that they have not based the opinion in an appraisal report on discriminatory factors (e.g., race) of either the property applicants or the residents of the area where the property is located.

Appraisal Foundation: Proposed Revision of Appraisal Standards

In mid-December, the Appraisal Standards Board (ASB) of the Appraisal Foundation released its fourth exposure draft of proposed changes to the Uniform Standards of Professional Appraisal Practice (USPAP), the operational standards that govern real property appraisal practice.

In response to comments received in response to the last draft, the ASB proposes to add to the USPAP Ethics Rule a section expressly discussing nondiscrimination. The proposed section would prohibit appraisers from engaging in both unethical discrimination and illegal discrimination and would provide guidance on the type of conduct constituting each form.

Unethical discrimination

First, the ASB proposes to include an express statement that an appraiser must not engage in unethical discrimination. That prohibition would preclude an appraiser from developing or reporting an opinion or value that is based on the actual or perceived protected characteristics of any person.

Second, the rule would prohibit an appraiser from performing an assignment with bias against the actual or perceived protected characteristics of any person—meaning that the appraiser may not engage in any discriminatory conduct (regardless of whether it arises in the course of developing or reporting an opinion of value). For purposes of this prohibition, the rule would utilize the USPAP definition of bias: "a preference or inclination that precludes an appraiser's impartiality, independence, or objectivity in an assignment."

The rule would make a limited exception for activity that qualifies with "limited permissive language," permitting an appraiser to use or rely on a protected characteristic in an assignment only if:

- Laws and regulations expressly permit or otherwise allow the consideration of a protected characteristic.
- Use of or reliance on that characteristic is essential to the assignment and necessary for credible assignment results.
- Consideration of the characteristic is not based on bias, prejudice, or stereotype.

The exposure draft provides as an example of activity that might qualify for the exception the completion of an appraisal review in order to determine whether the initial appraisal was discriminatory.

The ASB proposes to include an express statement that an appraiser must not engage in unethical discrimination.

The ASB proposal makes clear that because "an appraiser's ethical duties are broader than the law's prohibitions," an appraiser may commit unethical discrimination without violating any applicable law; however, an act that "constitutes illegal discrimination … will also constitute unethical discrimination."

Illegal discrimination

Complementing the prohibitions on unethical discrimination, the ASB proposes to include an express statement that an appraiser must not engage in illegal discrimination—conduct that violates the minimum standards of antidiscrimination set forth in the Fair Housing Act, the Equal Credit Opportunity Act (ECOA), and Section 1981 of the Civil Rights Act of 1866. The rule would impose on appraisers a duty to understand and comply with such laws as they apply to the appraiser and the appraiser's assignments, including the concepts of disparate treatment and disparate impact. Further, the rule would prohibit an appraiser from using or relying on a nonprotected characteristic as a pretext to conceal the use of or reliance on protected characteristics when performing an assignment.

Further guidance

The exposure draft indicates that the ASB would follow the adoption of the new nondiscrimination section of the ethics rule with detailed guidance on the scope of these prohibitions, including:

- Background on federal, state, and local antidiscrimination laws.
- Guidance on the application of the Fair Housing Act, ECOA, and Section 1981 to appraisals of residential real property.
- Explanation of the disparate treatment and disparate impact theories of discrimination, including examples relating to appraisal practice.
- Guidance on neighborhood discrimination in real property appraisals.
- Clarification on acceptable uses of protected characteristics, in connection with the "limited permissive language" exception for the prohibition against unethical discrimination.

OMB: AVM Rule on Regulatory Agenda

Automated valuation models (AVMs) are considered a useful tool to help mitigate appraisal discrimination. On January 4, 2023, the Office of Management and Budget (OMB) released its Fall 2022 Regulatory Agenda. Among other topics, the OMB indicated that an interagency proposed rule addressing quality control standards for AVMs is expected in March 2023. The Dodd–Frank Act's amendments to the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) require the federal banking regulatory agencies to undertake this rulemaking.

ASC: Hearing on Appraisal Bias

On January 24, 2023, the Appraisal Subcommittee (ASC) of the Federal Financial Institutions Examination Council held a hearing on appraisal bias. Of note, Consumer Financial Protection Bureau Director Rohit Chopra ended the hearing by articulating the objective that the "lodestar" of appraisals is an appraisal that is neither too high nor too low, but rather is accurate. Chopra then questioned the regulatory structure governing appraisals, calling it "byzantine." His remarks focused on the funding mechanism between the Appraisal Institute and the Appraisal Foundation, implying that there may be a conflict of interest.

Understanding Chopra's comment requires knowledge of the current regulatory framework, which Title XI of FIRREA established in 1989. It includes three principal parties: the ASC, the Appraisal Foundation, and the Appraisal Institute:

- The ASC is a federal agency with oversight of the state appraisal regulatory structure for real property appraisers and monitoring activities of the Appraisal Foundation.
- The Appraisal Foundation is a private nonprofit educational organization. Through the ASB and the Appraiser Qualifications Board, the Appraisal Foundation sets the ethical and performance standards of appraisers in the USPAP. The board establishes the minimum education, experience, and examination requirements for real property appraisers, which are then enforced by state regulatory agencies. The Appraisal Foundation is funded through sales of publications and services, as well as by its sponsoring organizations.
- The Appraisal Institute is a private professional organization of appraisal professionals and is one of the sponsoring organizations of the Appraisal Foundation.

Takeaway

Viewed through the lens of the overall PAVE Task Force efforts, actions by the FHA and the VA show early and concrete action to address residential appraisal bias. Because they implicate government insurance and guarantee programs, the focus is particularly important for lenders and appraisers to heed so that documentation submitted to the agencies is accurate.

Viewed through the lens of the overall PAVE Task Force efforts, actions by the FHA and the VA show early and concrete action to address residential appraisal bias.

Appraisers should also take note of the updated USPAP exposure draft as it moves toward final adoption so that they are aware of their responsibilities to avoid bias in appraisal reports. Finally, with regulators scrutinizing the appraisal framework—as seen in the OMB and ASC announcements—more significant changes are expected.

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New York Foreclosure Abuse Prevention Act Curtails Servicers' Options

New York Assembly Bill 7737B, the Foreclosure Abuse Prevention Act, became law on December 30, 2022. The Act is significant because it reverses judicial precedent that permitted a lender, after default, to undo the acceleration of a mortgage and stop the running of the statute of limitations in a foreclosure action through voluntary dismissal, discontinuance of foreclosure actions, or deacceleration letters. Notably, the Act applies both prospectively and to any foreclosure action filed before its effective date that had not been resolved through a final judgment and order of sale. Further, unlike other provisions of New York law, the Act applies to all properties (and not only those that are owner-occupied). Public reaction has been mixed whether the measure will benefit consumers—but regardless, it changes the rules of the game for lenders and servicers in New York State.

Background

Existing New York law establishes a six-year statute of limitations for the commencement of a mortgage foreclosure action, triggered when the borrower defaults on the obligation and the lender accelerates the obligation to pay the secured debt. In 2021, the New York Court of Appeals considered whether a lender can deaccelerate a loan and reset the statute of limitations.

The court decided four cases (with the opinion rendered in *Freedom Mortgage Corp. v. Engel*, 37 N.Y.3d 1 (2021)), "each turning on the timeliness of a mortgage foreclosure claim." The court held that the lender's voluntary dismissal of a foreclosure suit constituted a revocation of the lender's election to accelerate. The revocation returned the parties to their pre-acceleration rights, reinstated the borrower's right to repay via installments, and established a new statute of limitations period for any future default payments. According to the court, "where the maturity of the debt has been validly accelerated by commencement of a foreclosure action, the noteholder's voluntary withdrawal of that action revokes the election to accelerate, absent the noteholder's contemporaneous statement to the contrary."

The court also considered what constituted an "unequivocal overt act" sufficient to trigger a valid acceleration of debt and the six-year statute of limitations. The court held that neither

the issuance of a default letter nor the filing of complaints in prior discontinued foreclosure actions that failed to reference the pertinent modified loan were sufficient methods to validly accelerate debt.

The Act

Since the *Engel* decision, mortgagees in New York State have relied on their ability to voluntarily discontinue a foreclosure action—and effectively reset the statute of limitations—to engage distressed borrowers in loss mitigation efforts. However, the Act appears to eliminate a mortgagee's ability to unilaterally reset the limitations period by voluntarily discontinuing a foreclosure action and deaccelerating the loan.

With the express intent of overturning the *Engel* decision, the Act amends provisions of New York's Real Property Actions and Proceedings Law (RPAPL), General Obligations Law (GOL), and Civil Practice Law and Rules (CPLR) relating to the rights of parties involved in foreclosure actions.

Real Property Actions and Proceedings Law

Under previous law, Section 1301 of the RPAPL prohibited the commencement or maintenance of any action to recover any part of a mortgage debt while another action to recover part of the mortgage debt is already pending or after final judgment has been made for the plaintiff without leave of the court in which the first action was brought. Beyond clarifying that a foreclosure action falls within the scope of that prohibition, the Act provides that procurement of leave from the first court must be a condition precedent to commencing or maintaining the new action. Thus, failure to comply with the leave-of-court-condition precedent may no longer be excused by finding that the prior action was "de facto discontin(ued)" or "effectively abandoned" or that the defendant was not prejudiced nor by deeming the pre-action failure a mistake, omission, defect, or irregularity that could be overlooked or disregarded.

Moreover, failure to obtain leave is a defense to the new action. If a party brings a new action without leave of the court, the section declares that the previous action is deemed discontinued unless before the entry of final judgment in the original action, the defendant: (1) raises the failure to comply with the condition precedent; or (2) seeks dismissal of the action based on one of the grounds set forth in Section 3211(a)(4) of the CPLR.

Section 1301 of the RPAPL is further amended to provide that if the mortgage securing the bond or note representing the debt so secured by the mortgage is adjudicated as time-barred by a court of competent jurisdiction, any other action to recover any part of the same mortgage debt is equally time-barred. As a result, if the statute of limitations acts to bar a foreclosure action or any other action to recover on mortgage debt, an investor or servicer cannot bring any other action to recover the same part of the mortgage debt, including another foreclosure action or an action to recover a personal judgment against the borrower on the note.

General Obligations Law

Under Section 17-105 of the GOL, an agreement to waive the statute of limitations to foreclose on a mortgage is effective if expressly set forth in writing and signed by the party to be charged.

The Act amends Section 17-105 by: (1) clarifying that the GOL is the exclusive means by which parties are enabled to postpone, cancel, reset, toll, revive, or otherwise effectuate an extension of the limitations period for the commencement of an action or proceeding upon a mortgage instrument; (2) clarifying that unless effectuated in strict accordance with Section 17-105,

the discontinuance of an action upon a mortgage instrument, by any means, shall not function as a waiver, postponement, cancellation, resetting, tolling, or extension of the statute of limitations; and (3) codifying certain judicial rulings holding as much.

> Under Section 17-105 of the GOL, an agreement to waive the statute of limitations to foreclose on a mortgage is effective if expressly set forth in writing and signed by the party to be charged.

While not included or otherwise referenced in the Act, it is also worth noting that Part 419 of the New York State Department of Financial Services' mortgage loan servicer business conduct rules prohibit a mortgage servicer from requiring a homeowner to waive legal claims and defenses as a condition of a loan modification, reinstatement, forbearance, or repayment plan. It is unclear whether Part 419 would be interpreted to prohibit servicers from seeking a waiver of the limitations period pursuant to Section 17-105, especially loans whose limitations period has already run. To further complicate matters, the New York legislature is currently considering a bill that would (1) create an express private right of action for violations of Part 419; (2) make compliance with Part 419's requirements a condition for commencing a foreclosure action; and (3) render failure to materially comply with Part 419 to be a defense to a foreclosure action or an action on the note, even if servicing of the loan has been transferred to a different servicer when a foreclosure action or action on the note is commenced.

Civil Practice Law and Rules

The Act amends and adds several provisions of the CPLR relating to the application of the statute of limitations in actions relating to mortgage debt.

First, the Act adds Section 203(h) to the CPLR, which terminates the ability of a lender or servicer to extend the statute of limitations on a foreclosure action by any form of unilateral action. No voluntary discontinuation of an action to enforce a mortgage may "in form or effect, waive, postpone, cancel, toll, extend, revive or reset the limitations period to commence an action and to interpose a claim, unless expressly prescribed by statute." In other words, the amended section appears to prohibit a mortgagee from "de-accruing" a cause of action or otherwise effectuating a unilateral extension of the limitations period by suspending a foreclosure action—and providing loss mitigation opportunities to the borrower—once the six-year statute of limitations has begun to run after the loan is accelerated.

The methods by which the statute of limitations in a mortgage foreclosure action can be waived or extended are exclusively set forth in Article 17 of the GOL (17-105, express written agreement to extend, waive, or not plead as a defense the statute of limitations; 17-107, unqualified payment on account

of mortgage indebtedness effective to revive the statute of limitations). A bare stipulation of discontinuance or a lender's unilateral decision to revoke its demand for full payment is no longer a permissible method for waiving, extending, or modifying the statute of limitations.

Second, the Act adds Section 205-a to the CPLR, limiting reliance on the savings statute for time-barred claims. After termination of an action, the new section permits the original named plaintiff to commence a new action upon the same transaction or occurrence or series of transactions only if: (1) the plaintiff brings the new action within six months of the termination; and (2) the termination of the prior action occurred in any manner other than a voluntary discontinuance, "a failure to obtain personal jurisdiction over the defendant," dismissal for any "form of neglect," a "violation of any court rules or individual part rules," "failure to comply with any court scheduling orders," failure to appear for a conference or at a calendar call, failure to "timely submit any order or judgment," or a "final judgment upon the merits." Further, only one six-month extension will be available to the plaintiff.

Under new Section 205-a, a successor-in-interest or an assignee of the original plaintiff can only commence a new action if that party pleads and proves that the "assignee is acting on behalf of the original plaintiff." Further, if the defendant has served an answer and the action has been terminated, in a new action based on the same transaction or occurrence or series of transactions (whether brought by the original plaintiff or a successor-in-interest or assignee thereof) any cause of action or defense that the defendant asserts will be considered timely "if such cause of action or defense was timely asserted in the prior action." Section 205-a also provides that the original plaintiff (or a successor-in-interest acting on behalf of the original plaintiff) may only receive one six-month extension, and no court shall allow the original plaintiff to receive more than one six-month extension.

Third, the Act amends Section 213(4) of the CPLR to clarify that in any action where the statute of limitations is raised as a defense—and if that defense is based on a claim that the indebtedness was accelerated before or through commencement of a prior action—a plaintiff will be estopped from asserting that a mortgage instrument was not validly accelerated before "or by way of commencement of a prior action." An exception exists if the prior action "was dismissed based on an expressed judicial determination, made upon a timely interposed defense, that the instrument was not validly accelerated."

Further, in any quiet title action seeking cancellation and discharge of record of a mortgage instrument, a defendant will be estopped from asserting that the applicable statute of limitations period for commencement of an action has not expired because the instrument was not validly accelerated before or by way of commencement of a prior action, "unless the prior action was dismissed based on an expressed judicial determination, made upon a timely interposed defense, that the instrument was not validly accelerated."

Finally, the Act amends Section 3217 of the CPLR by adding a new subsection (e), which clarifies that if the statute of limitations is raised as a defense in an action, and if the defense rests on a claim that the instrument was accelerated before or by virtue of the commencement of a prior action, the plaintiff cannot stop the tolling of the statute of limitations by asserting that the instrument was not validly accelerated unless the prior action was dismissed based on an express judicial determination of invalid acceleration.

Takeaway

In light of the Act's curtailment of a servicer's or investor's ability to unilaterally suspend a foreclosure action, we recommend that mortgagees carefully review their pending mortgage foreclosure actions in New York State. At a minimum, the Act removes the ability of a holder or servicer in New York State to voluntarily discontinue a foreclosure action after acceleration of the indebtedness triggers the running of the statute of limitations.

Whether this will interfere with servicers' contractual rights and ability—and obligations under the CFPB rules and Part 419—to offer meaningful loss mitigation opportunities to borrowers remains to be seen. At least one judge thinks so. In a recent order to show cause, a New York Supreme Court judge concluded that the Act violates the Contracts Clause of the U.S. Constitution and included an invitation for the New York attorney general to weigh in.

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The Last Days of **LIBOR**

On December 16, 2022 the Board of Governors of the Federal Reserve adopted a final rule identifying the benchmarks that will replace LIBOR in various types of financial instruments after LIBOR (at least in its current form) ceases to exist on June 30, 2023. This marked a significant milestone in the U.S. financial system's transition away from LIBOR, and it followed on the heels of a consultation commenced by the UK's Financial Conduct Authority (FCA) in November 2022 regarding the potential publication of synthetic LIBOR though September 2024.

LIBOR and Its Demise

The London Interbank Offered Rate (LIBOR) was created in the 1980s as a proxy for the rate at which banks could borrow from one another on an unsecured basis. Over the next four decades it morphed into the world's most important benchmark, used as the base interest rate in an ever-increasing variety of financial instruments. At its peak, more than $200 trillion of financial contracts were tied to LIBOR, and it was published in five different currencies and seven different maturities each business day.

Over the years, however, the interbank unsecured lending market that it sought to reflect grew illiquid as it was replaced by other forms of financing. As a result, LIBOR panel banks often had to rely on trader judgment rather than actual transactions to submit the rate quotations used to calculate the benchmark. Collectively, these conditions made LIBOR very susceptible to manipulation. Over the past decade, the panel banks have faced a myriad of fraud-based claims from both regulators and private litigants and have paid out billions of dollars in settlements.

Efforts to reform or replace LIBOR began in earnest in 2012, when the regulator for the benchmark's administrator, the FCA, published a report recommending comprehensive reforms to LIBOR. In 2013, the International Organization of Securities Commissions (IOSCO) published principles for financial benchmarks to promote the quality and integrity of benchmarks by ensuring that they would be based on arm's-length transactions in robust markets. In 2014, the Financial Stability Board endorsed the IOSCO principles and recommended reforms to strengthen LIBOR and the development of risk-free rates that could provide alternatives to LIBOR. That same year, the Fed board and Federal Reserve Bank of New York (FRBNY) convened a group of private-sector financial institutions known as the Alternative Reference Rates Committee (ARRC) to spearhead those efforts in the United States. Finally, in 2017 the FCA announced that it would no longer compel or persuade banks to provide LIBOR submissions after 2021, effectively commencing the countdown to LIBOR's cessation. The process would be neither quick nor easy.

SOFR and Its Adoption

In 2017, the ARRC identified the Secured Overnight Financing Rate (SOFR) as the (nearly) risk-free rate best suited to eventually replace USD LIBOR. Unlike LIBOR, SOFR has the benefit of being based on a robust underlying market (the roughly $750 billion market for U.S. Treasuries repurchase agreements). But SOFR also bears other significant differences from LIBOR that have complicated the transition process. First, SOFR itself is an overnight rate and does not have a term structure like LIBOR. Second, SOFR is a secured financing rate, while LIBOR is based on unsecured financing; so SOFR rates do not reflect the bank credit risk embedded in the LIBOR rates they would replace.

Following the ARRC's identification of SOFR as the preferred LIBOR replacement benchmark in 2017, various industry groups sprang to action to assist their members in effecting the transition. The primary industry association for derivatives, the International Swaps and Derivatives Association (ISDA), was probably the most active and coordinated of these groups, conducting multiple market consultations to build industry-wide consensus on all aspects of the transition. One of ISDA's first accomplishments in this regard was coordinating the derivatives market's coalescence around Fallback Rate (SOFR) as its preferred replacement benchmark. Since January 2021, all standard LIBOR-based derivative transactions have provided this version of SOFR, which is compounded in arrears and published by Bloomberg Index Services Limited, as the primary fallback to USD LIBOR.

Coordination within the cash markets with LIBOR exposure has proved more challenging, and these markets have generally been less keen to adopt Fallback Rate (SOFR) as a fallback rate. Market participants have worried that a rate compounded in arrears would be problematic for borrowers that value the cash flow certainty of a forward-looking rate (like LIBOR) that can be calculated well before a payment became due.

In a series of consultations conducted by the ARRC, cash market participants generally expressed a preference for term rates based on SOFR. However, whether such rates could be developed before LIBOR ceased to be published remained an open question during the early years of the transition; both regulators and the ARRC expressed concerns that SOFR-based term rates might suffer from some of the very same issues (e.g., a thin underlying market) that plagued LIBOR.

This uncertainty led some market participants to adopt SOFR-based rates that are calculated in advance by averaging SOFR rates over an earlier observation period, such as the Average SOFR benchmark published by the FRBNY. Eventually, however, the initial concerns that regulators and the ARRC had with term SOFR rates were assuaged as a robust derivatives markets for trading SOFR on a term basis developed. In July 2021, the ARRC formally recommended the use of term SOFR rates (as published by CME Group, "Term SOFR") for most cash products.

Spread Adjustments

These SOFR-based rates and calculation methodologies helped address SOFR's lack of a term structure, but they did not solve for the value transfer that could arise from replacing an unsecured financing rate with a secured rate in existing contracts. ISDA took the lead on this subject. Following a series of market consultations, in March 2021 it published standardized spread adjustments that could be added to SOFR-based replacement benchmarks to account for this difference. These recommended spread adjustments were based on the five-year historical median difference between USD LIBOR and SOFR. In June 2021, these same spread adjustments were endorsed by the ARRC for use in cash products.

LIBOR tenor being replaced	Spread applied to SOFR-based rate (bps)
1-week USD LIBOR	3.839
1-month USD LIBOR	11.448
2-month USD LIBOR	18.456
3-month USD LIBOR	26.161
6-month USD LIBOR	42.826
1-year USD LIBOR	71.513

Documentation

Perhaps the most significant effort in the process of moving away from LIBOR has been establishing contractual language to effect the transition across product types. For some types of contracts, market participants have preferred a "hardwired" approach, calling for an automatic transition to a replacement benchmark upon LIBOR's cessation or the occurrence of certain other pre-cessation events. Other markets been more prone to delegating the responsibility of selecting a replacement benchmark (usually subject to certain predetermined limitations) to one or more deal parties.

Regardless of the product type or preferred approach, defining clearly delineated events that would trigger the automatic conversion to a replacement benchmark or the right to designate a replacement benchmark has been a critical component of the document remediation process. Over time, the language setting forth cessation-based triggers has become more and more standardized across products, but pre-cessation triggers have continued to vary across contract types. The one pre-cessation trigger that has become fairly standard across product types is a statement by the regulator for LIBOR's administrator (the FCA) announcing that LIBOR is no longer representative of the underlying market it is meant to represent (the "representativeness trigger").

The market that has been most coordinated in its documentation approach is the market with (by far) the largest exposure to LIBOR, the derivatives market. In addition to standardizing the replacement benchmark provisions, ISDA has published standardized hardwired triggers that have made their way into the bulk of legacy LIBOR-based derivative transactions. All the major derivatives clearing houses have incorporated such language into their legacy transactions, and over 15,000 market participants have signed on to the ISDA 2020 IBOR Fallbacks Protocol to incorporate such fallback provisions into their legacy uncleared transactions.

Documentation within the cash markets is more varied across products, and even from deal to deal. For its part, the ARRC (in coordination with relevant industry groups) conducted several product-specific market consultations and published product-specific recommended benchmark replacement language, which has helped bring some consistency. Still, ARRC's suggested provisions have been frequently modified and negotiated, and many cash instruments include bespoke fallback provisions that predate the publication of the ARRC's recommended language.

Perhaps the most significant effort in the process of moving away from LIBOR has been establishing contractual language to effect the transition across product types.

The LIBOR Act and the Fed Rule

Industry transition efforts received a bit of relief in March 2021, when the FCA announced that LIBOR's administrator, the ICE Benchmark Administration (IBA), with the cooperation of the panel banks, had agreed to continue publishing certain tenors of LIBOR beyond the end of that year. The IBA committed to publishing overnight, 1-month, 3-month, 6-month, and 12-month USD LIBOR through June 30, 2023. Two other two USD LIBOR tenors (1-week and 2-month), as well as all EUR and CHF LIBOR tenors and most GBP and JPY LIBOR tenors, would still cease to be published at the end of 2021.

Despite the continuing publication of these USD LIBOR tenors, in October 2021 the Fed board and its fellow U.S. prudential regulators issued a joint statement encouraging the institutions they oversee to cease entering into new LIBOR contracts by the end of that year. Even with this mandate (and the massive transition efforts to date), many contracts that reference LIBOR and have no workable fallbacks remain outstanding.

In March 2022, the U.S. government enacted legislation to provide a backstop aimed at ensuring a smooth transition for these transactions. The Adjustable Interest Rate (LIBOR) Act (the "LIBOR Act") provides that LIBOR-based contracts that lack practicable replacement benchmarks (i.e., benchmarks that are untethered to LIBOR and do not involve a poll) will automatically transition (by operation of law) to the applicable reference rates recommended by the Fed board, each as adjusted by the relevant recommended spread adjustments. For in-scope non-consumer products, that transition will occur on the first business day following June 30, 2023 (the "LIBOR replacement date"). In-scope consumer loans will also switch over to the recommended replacement benchmark on the LIBOR replacement date, but the recommended spread adjustments will be phased in (linearly) over a one-year period.

The LIBOR Act also provides legal safe harbors insulating (1) any "determining party" with the contractual right to choose a replacement benchmark that selects the applicable benchmarks recommended by the Fed board; and (2) any "calculating party" that needs to make technical, administrative, or operational conforming changes to a contract in order to perform calculations using the applicable benchmark recommended by the Fed board. The LIBOR Act applies to all in-scope contracts governed by U.S. law and expressly preempts the earlier state laws (including New York's) purporting to address benchmark replacement.

On December 16, 2022, the Fed board published a final rule (the "Fed Rule") setting forth the replacement benchmarks that will replace LIBOR on the LIBOR replacement date pursuant to the LIBOR Act. Under the Fed Rule, SOFR (plus a 0.644 basis point spread adjustment) will replace overnight LIBOR in all in-scope contracts that reference that rate, but term LIBOR rates will be replaced by different replacement benchmarks in different types of products.

Unsurprisingly (given the consensus within that market), the Fed board recommended Fallback Rate SOFR as the replacement benchmark for derivatives transactions. For cash transactions, the Fed board generally recommended the applicable tenor of Term SOFR to replace 1-month, 3-month, 6-month, and 12-month LIBOR, but it selected alternative replacement benchmarks for Federal Family Education Loan Program (FFELP) asset-backed securitizations (ABS) and transactions involving entities regulated by the Federal Housing Finance Agency (FHFA).

The LIBOR Act applies to all in-scope contracts governed by U.S. law and expressly preempts the earlier state laws (including New York's) purporting to address benchmark replacement.

Consistent with current practice in the FFELP ABS market, legacy transactions linked to 3-month LIBOR will transition to 90-day Average SOFR, and all other LIBOR tenors will transition to 30-day Average SOFR, each as modified by the related recommended spread adjustments.

The 30-day Average SOFR will also serve as the replacement benchmark for all tenors of LIBOR in all transactions involving FHFA-regulated entities except for Federal Home Loan Bank (FHLB) advances. Government-sponsored entities like the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) have been utilizing 30-day Average SOFR in newly issued multifamily loans and other structured products since 2020, and both Fannie Mae and Freddie Mac have recently identified it as the replacement benchmark for transactions in which they serve as determining parties. Unlike other transactions involving FHFA-regulated entities but consistent with the

current practices of the FHLB, the Fed board has selected Fallback Rate (SOFR) as the replacement benchmark for FHLB advances.

Like most cash products, in-scope consumer loans will transition to Term SOFR; but (as mandated by the LIBOR Act) the recommended spread adjustments for such products will be phased in over a one-year period.

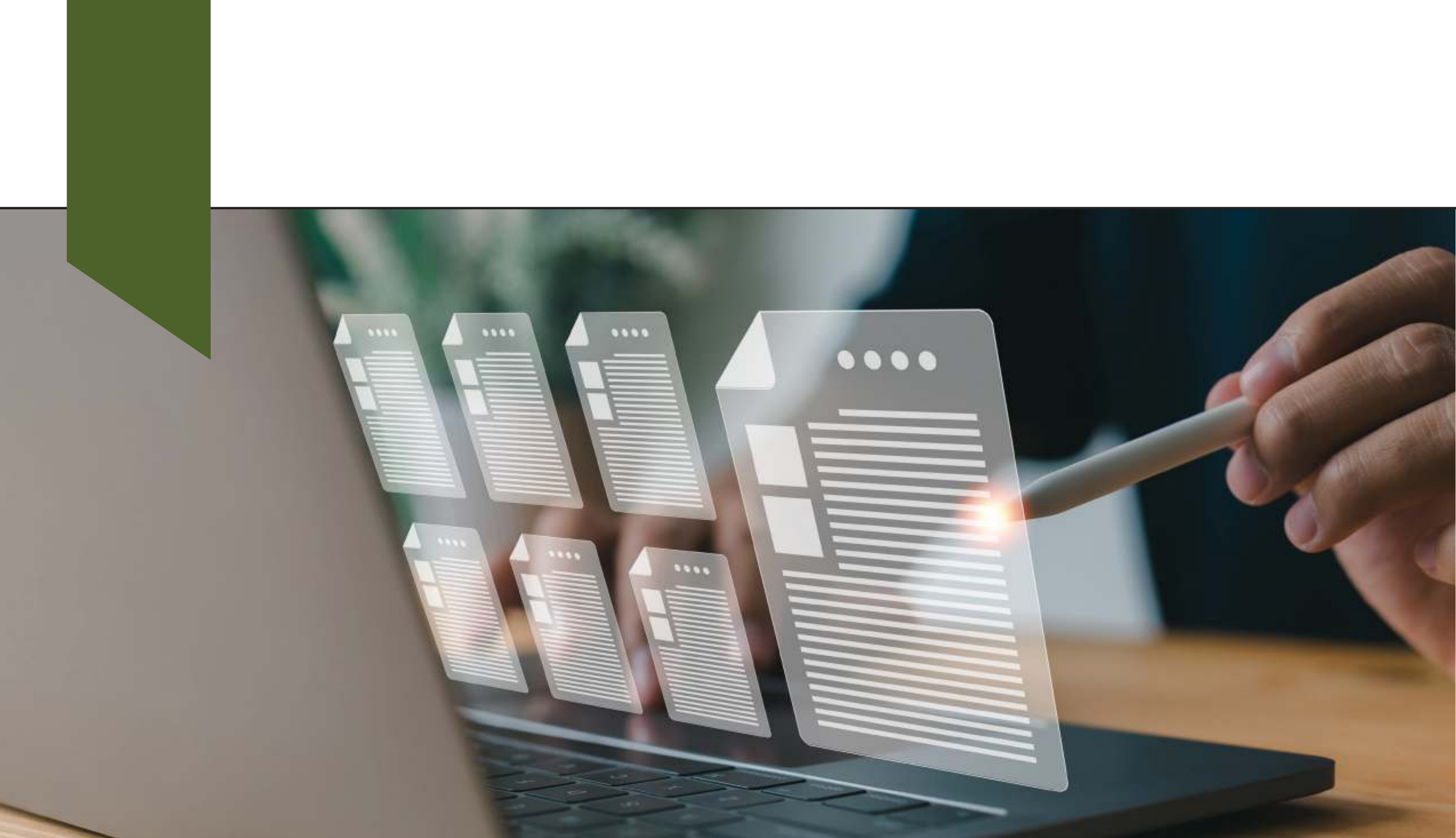
Synthetic LIBOR

The LIBOR Act and Fed Rule should provide a solution for most U.S.-law-governed LIBOR-based transactions that do not contain clear and practicable fallback provisions, but many legacy cash instruments (including most U.S. syndicated loans) are expected to fall outside their scope. Most U.S. credit agreements (and various types of indentures) call for interest to be calculated based on the Prime rate when LIBOR (or the applicable benchmark) is unavailable or otherwise unsuitable for use. Prime has traditionally yielded much higher rates than LIBOR, so borrowers will likely find its use to be highly objectionable. However, this benchmark is expected to remain viable beyond the LIBOR replacement date, and it is not linked to LIBOR or polling, so contracts that have (temporary or permanent) fallback provisions referencing prime will typically fall outside the scope of the LIBOR Act and the Fed Rule.

To potentially address this issue, the FCA commenced a consultation on November 23, 2022 seeking industry consideration of whether the FCA should compel the IBA to publish 1-month, 3-month and 6-month synthetic USD LIBOR for a 15-month period from the LIBOR replacement date (through September 30, 2024). Under this approach, which is similar to the one employed for certain tenors of GBP LIBOR and JPY LIBOR, synthetic LIBOR for these tenors would equal the applicable Term SOFR rate plus the recommended spread adjustment rather than being based on panel bank rate submissions.

Additionally, synthetic LIBOR would be declared permanently non-representative. As such, synthetic LIBOR would not affect any transactions documented with ARRC-recommended benchmark replacement provisions because the contractually prescribed replacement benchmarks would take effect when LIBOR is deemed unrepresentative on the LIBOR replacement date. However, any transactions calling for fallback to the prime rate that either lack permanent transition provisions or include bespoke provisions that do not include a representativeness trigger would instead revert to synthetic LIBOR on the LIBOR replacement date (if the FCA does indeed compel its publication).

In any case, reliance on either synthetic LIBOR or the LIBOR Act and Fed Rule is highly unlikely to be the preferred course of action for most major market participants. We should expect large financial institutions (and their regulators) to be pushing contractual remediation at a frenzied pace over these last six months of USD LIBOR's existence to mitigate the wave of litigation that is sure to follow. ■



State Commercial Loan Disclosure Requirements

As part of what may be an emerging trend, state regulators have started to focus on commercial lending, leading to the adoption of consumer-like disclosure requirements that impact certain commercial loan origination platforms, including merchant cash advances, small business loans, and factoring.

California, New York, Utah, and Virginia have each recently passed new laws and regulations requiring higher levels of disclosure for commercial loans, similar to those found in the Truth in Lending Act (TILA). Similar laws have been proposed in Connecticut, Maryland, Mississippi, Missouri, North Carolina, New Jersey (in both the Senate and the General Assembly), and Pennsylvania and are pending, have failed, or been withdrawn. High-level summaries of the new California and New York regulations are provided below, but we note these are not exhaustive and there can be material differences among certain state law requirements. These regulatory trends heighten the importance of ongoing state regulatory monitoring and compliance for "providers" of certain commercial financing transactions.

California

Persons providing commercial financing to borrowers "whose business is principally directed or managed from California" are now required to provide borrowers with consumer-like disclosures under the California Commercial Financing Disclosure Law (CCFDL). Commercial financing providers will be required to disclose to the recipient at the time of extending a specific offer of commercial financing specified information on the transaction and to obtain the recipient's signature on that disclosure before consummating the commercial financing transaction.

While the CCFDL contains certain exemptions (including transactions greater than $500,000 and real estate secured commercial financings), the California law applies to, among other things, commercial loans, certain commercial open-end plans, factoring, merchant cash advances, and commercial asset-based lending. Unlike the New York law, which applies to brokers as well as lenders, under the California law, "provider" is primarily limited to entities extending credit, such as lenders/originators, but it also includes a nonbank partner

in a marketplace lending arrangement that facilitates the arrangement of financing through a financial institution.

The CCFDL outlines express requirements for the disclosures, including specific formatting requirements and required information about the policies and procedures for lending and servicing. When disclosures are provided by a third party, the lender must have policies to ensure that the third party has copies of the compliant disclosure and the disclosure is provided to the relevant debtors. Noncompliance is subject to criminal and civil penalties, necessitating detailed oversight of California commercial financing programs.

New York

In New York, lenders and brokers in a commercial financing transaction of $2.5 million or less must make certain consumer-style disclosures, similar to those in TILA, to recipients. The New York law provides a de minimis exemption for "any person or provider who makes no more than five commercial financing transactions in New York in a twelve-month period." New York issued final regulations on February 1, 2023, with an effective date of August 1, 2023. The specific disclosures vary by the type of financing, but for closed-end financing they generally require information such as the total amount of the commercial financing, financing terms, the annual percentage rate (calculated largely in accordance with TILA), rate-related fees and charges, repayment amount totals, payment frequency, prepayment terms, and collateral descriptions.

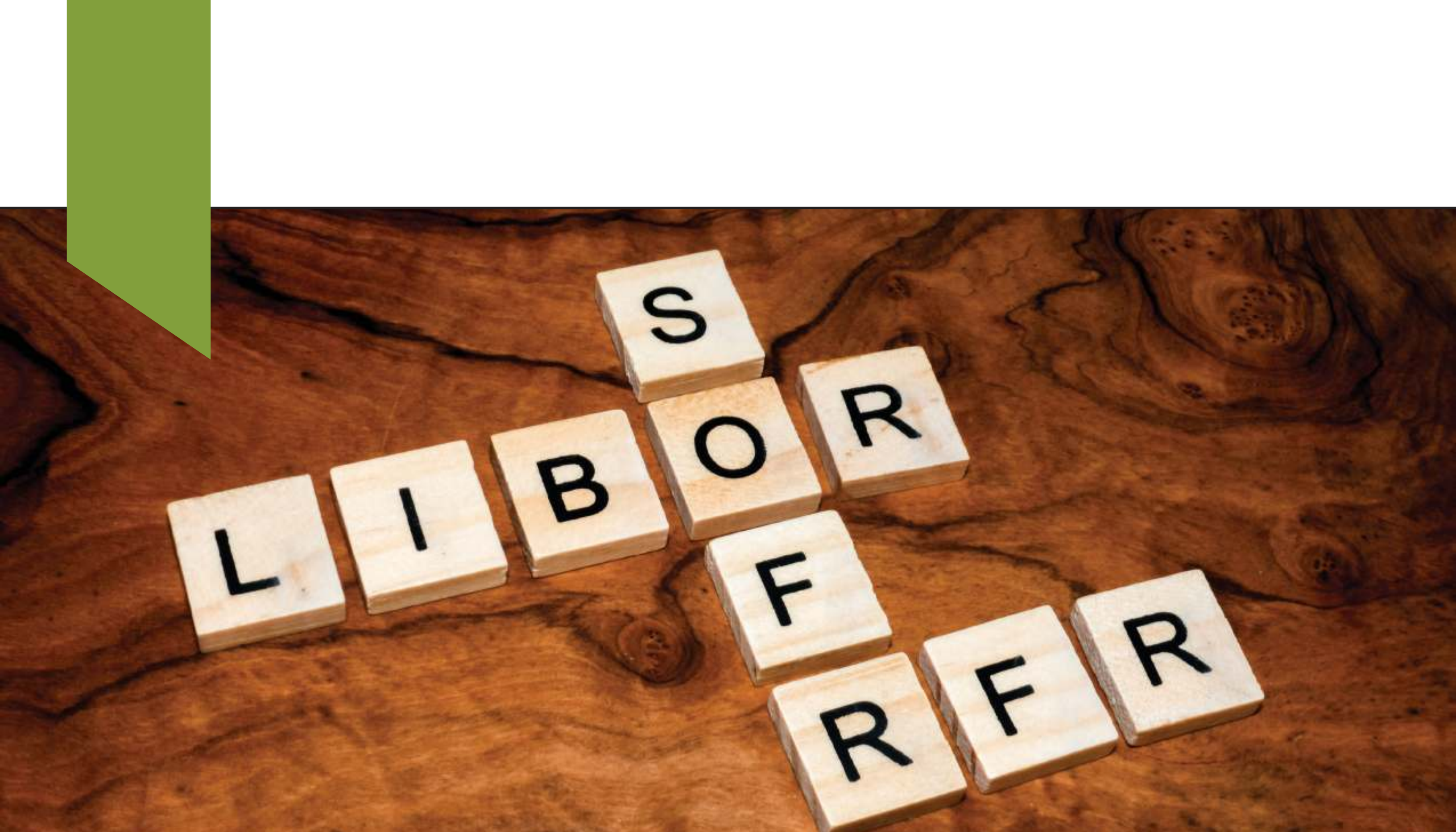
While the format mirrors California's in many respects, it contains additional requirements. As in California, to the extent that the disclosures are provided by a third party, the lender must have policies in place to ensure that the third party has copies of compliant disclosures and that the disclosures are provided to customers. The third party must provide evidence that the disclosure was provided, and the lender must maintain related records. Also, as in California, oversight will be important as noncompliance may result in civil penalties and other non-monetary relief.

TILA Preemption?

While the state law disclosure requirements are very similar to those of TILA, the Consumer Financial Protection Bureau (CFPB) has made an initial determination that, at least for the New York law, TILA does not preempt state action. In response to an industry request for a preemption determination, the CFPB reasoned that TILA only applies to consumer credit and does not create preemption for commercial financing. Accordingly, the CFPB's preliminary determination is that TILA does not preempt New York law. The CFPB is also considering making determinations regarding the California, Utah, and Virginia laws, and noted in its preliminary determination that these laws are very similar to New York's and TILA would not preempt these laws. The determination is subject to a comment period, after which a final determination will be published.

Conclusion

California, New York, Utah, and Virginia are the only states with commercial finance disclosure laws currently in effect or soon (within the next few months) to become operative. However, these laws may be indicative of a new legislative trend, and industry participants should continue to monitor federal and state requirements to avoid any potential liability down the road. ■



CLOs and the SOFR Transition

The beginning of 2023 marks the last days of the London Inter-Bank Offered Rate (LIBOR). Most market participants are aware that by the end of June, LIBOR, the long-standing global interest rate benchmark, will be fully replaced by the Secured Overnight Financing Rate (SOFR). Commercial real estate (CRE) lenders have been preparing for this transition for several years, weighing the upcoming changes for outstanding variable-rate financial loans benchmarked to LIBOR. There are various options for these "legacy contracts." Many have specific fallback provisions in their governing documents for a replacement benchmark, to which the loan will automatically transition after June 30. Those legacy contracts without any fallback provisions will transition to the benchmark rate selected by the Federal Reserve Board, which will be one of the multiple different SOFR-based rates (depending on the nature of the legacy contract) and include a stipulated spread adjustment set forth in the Adjustable Interest Rate (LIBOR) Act of 2021.

CLOs and Special Tax Benefits

Collateralized loan obligations (CLOs) are a relatively new trend in the world of CRE debt securitization. A CLO (like a traditional commercial mortgage-backed securities (CMBS) securitization) is a portfolio of interests in CRE loans held by a special-purpose vehicle. However, unlike traditional CMBS conduit transactions, CRE CLO lending allows for floating interest rates, shorter loan terms, loan extensions, significant construction, and future funding obligations. Many of the special-purpose vehicles behind CLOs are domiciled in offshore tax havens, such as the Cayman Islands, or in a special-purpose Delaware statutory trust, and are therefore not subject to separate U.S. income tax. However, this tax benefit also makes CLOs difficult to service, as applicable tax rules limit a servicer's ability to actively engage in workouts and restructurings. Significant modification of the loans can be seen as "re-originations" and can cause the CRE CLO issuer to be deemed as engaging in a U.S. trade or business, thus subjecting the entity to net income taxation in the United States. However, there is a useful exception: modifications to a particular loan can be permitted if the modification is being made to protect the CRE CLO investors in the vehicle.

CLOs, Modifications, and Prime

Over the past few years, in anticipation of the SOFR transition, many lenders have been modifying their legacy contracts to

either provide for an efficient transition to a SOFR benchmark on June 30, 2023 or even to get ahead of the curve and transition now (whether by adding SOFR fallback provisions or amending previous fallback provisions accordingly). However, as noted above, modifications of loans in CLOs, even in the context of LIBOR going away, are still subject to the limitations of the tax rules. Luckily, for those CLO loans that don't have fallback provisions in place, the tax regulators have permitted the modification of the loans to accommodate the SOFR transition without triggering any tax-related consequences. But, for some CLO issuers, particularly more vintage deals, the SOFR transition can present a unique issue. For CLO loans that identify the prime rate as its replacement benchmark, a nearly automatic transition to the SOFR is not a foregone conclusion, as the loan will have to be modified to change the fallback interest rate from prime to a new SOFR benchmark—and the loan can only be modified if the modification is deemed to be required to protect the investors of the vehicle. If the servicer can attest that a transition to prime would reasonably be expected to cause a default under the loan (as of January 30, 2023, the prime rate was 7.50% and the 30-day average SOFR rate was 4.310%), then the servicer will be permitted under the tax rules (as well as most CLO's governing documents) to modify the loan to another benchmark as not doing so would be an abrogation of the servicer's duty to protect the CRE CLO investors. However, if the servicer cannot make that assertion, the borrower will need to keep their current fallback benchmark of prime no matter how dismaying the rate hike may be. One pathway out of this conundrum is for the issuers to purchase these loans out of their CLOs to transition them to a SOFR benchmark instead of the prime rate. A buyout gives the issuer (the new lender and servicer) total flexibility to modify the loan but does come with inherent costs as well. Barring an eleventh-hour promulgation, it appears some difficult decisions will need to be made soon for any CLO loans featuring prime or other unpopular fallback benchmark provisions. ■

Looking Ahead: Delaware Statutory Trusts and Finding Flexibility in Workout Situations

The Delaware Statutory Trust (DST) has become a popular option for commercial real estate investors seeking to engage in tax-deferred 1031 exchanges. As its name indicates, the DST is a type of passive trust created under Delaware law, and provided the DST is properly structured and operated, it enables trust beneficiaries to avail themselves of tax-deferred 1031 exchanges. While advantageous to borrowers with 1031 exchange investors, the trust is limited in what actions it can take without endangering the 1031 benefits. In particular, what makes these DSTs unique is that neither the trustee nor the trust beneficiaries can contribute additional capital to the DST once the initial offering has closed. Any lender seeking to lend to a DST borrower should structure around these issues at loan *origination* to ensure they will have the flexibility to resolve issues that arise during the loan term. With capital markets in flux and uncertainty abounding these days, it's time to explore new ways for lenders to build in flexibility in DST structures at origination to make a possible future loan workout not just feasible but fruitful.

Why the DST?

Under current IRS guidance, each DST beneficiary is treated as owning an undivided fractional interest in the real property directly, enabling them to qualify for 1031 exchanges as long as the DST follows certain guidelines. Often referred to as the "Seven Deadly Sins," these include the following restrictions:

1. No future equity contributions after the initial DST offering has closed.
2. No new borrowings or renegotiation of loan terms.
3. No new leases or renegotiation of current leases (unless the tenant faces insolvency or bankruptcy).
4. No reinvestment of sale proceeds.
5. No capital expenditures beyond what is necessary to maintain property value.
6. Reserves can only be invested in short-term debt obligations.
7. Trustees can only keep a minimal amount of cash at the DST to cover emergency maintenance and repair issues—the DST must distribute all other cash proceeds to trust beneficiaries.

Despite these limitations, the DST does offer one significant advantage over other 1031-eligible structures (e.g., a tenancy in common)—control. In a DST, control is consolidated in a single trustee managed by the deal sponsor—the trust beneficiaries have no control rights over the trust or the real property. Because lenders will only have to deal with a single control party, they can avoid coordination issues endemic

to other 1031 structures, provided adequate provisions are included within the trust governing documents from the outset.

What Is a Loan Workout?

Put simply, a loan workout generally involves lenders agreeing to forgo remedies after a loan default (or in anticipation of a potential loan default) for a certain amount of time, if borrowers provide additional consideration. This commonly includes additional cash—often a principal paydown of the loan balance or the deposit of additional cash reserves—and can include supplementary protections such as guaranties or cash flow sweeps to a lender-controlled account. Regardless, a workout will require two items: (1) a negotiating partner with the authority to bind the borrower; and (2) capital. Given the DST's limitations, workouts may not be possible if lenders don't account for their possibility before originating the loan.

Avoiding Pitfalls from the Beginning—DST Operating Documents

It is important for lenders to ensure that their DST borrowers have certain provisions in their organizational documents to allow for possible workouts during the loan term. As the DST is a passive entity and has limited ability to act in capacities not specifically delineated in the trust agreement, there are two major components that lenders should require—a master lease structure and a springing LLC provision. A master lease avoids some of the issues that accompany 1031-eligible DSTs—primarily the trustee's limited operational abilities. A springing LLC provides for greater flexibility under certain conditions, but it is only as good as the pre-approved LLC agreement (and comes at the expense of future 1031 eligibility for the DST's beneficial owners).

Master Lease Structure

A master lease structure helps overcome a 1031-eligible DST's limitations by having a master lessee exert day-to-day control over the property. In such an arrangement, a master lessee under the control of the DST sponsorship would lease the property from the DST pursuant to a master lease and would then execute standard commercial leases with third-party tenants. The master lease would also be collapsible upon a loan default, so lenders would be able to directly underwrite the third-party tenant rents. Such a master lease structure is beneficial given that a 1031-eligible DST is generally unable to negotiate leases during the term of the loan. The master lessee can fulfill these duties during this period on behalf of the DST in exchange for receiving fees carved out of the third-party rents. While a master lessee is not necessarily required with a long-term triple-net commercial lease in place, having one can provide lenders additional comfort. If any commercial

tenant issues arise (such as closure and capacity issues during COVID), the master lessee will be in a position to resolve them. While not a panacea, a master lease structure may allow the loan parties to prevent routine issues from snowballing into significant ones.

Springing Limited Liability Company

To avoid fatal issues, however, the inclusion of a "conversion" provision in the DST's trust agreement is necessary. This would allow for the lender to compel the trustee to convert the DST into an LLC once certain conditions are met—generally including (1) the default of the loan; (2) imminent risk of a default of the loan; or (3) upon a certain date before loan maturity. Once the conversion is effectuated, the LLC will be able to negotiate a workout with the lender. Absent a conversion mechanism, the DST would be unable to negotiate with the lender due to its passive status, leaving the lender few options outside of enforcing remedies. Upon a conversion, all the trust beneficiaries would receive a membership interest in the LLC equivalent to their pro-rata interest in the DST. Generally, to facilitate the conversion, a pre-approved form of the LLC operating agreement is included in the trust documents as an exhibit. One thing to note, however, is that upon a conversion, the multimember LLC will be treated as a partnership for tax purposes and preclude investors from qualifying for future 1031 exchanges for their ownership interests in the LLC. Sometimes, the operating agreements will enable the LLC to "spring back" to a 1031-eligible DST, but these arrangements introduce risk for 1031 investors.

Additional Capital

Before addressing the master lease or the springing LLC, lenders should look ahead to what a workout for their specific loan might look like. Do major tenants roll during the loan term? Is the sponsor reputable (particularly in the DST and 1031 spaces)? Are there property-specific concerns? Even with the belts and suspenders of a master lease and a springing LLC, lenders should think hard about potential issues that could ripen during the loan term because these provisions do not by themselves address all constraints in organizing and operating a 1031-eligible DST—namely, the inability to raise additional capital from investors after the initial offering.

While this can be mitigated (to some extent) at the loan level with hefty reserves and conservative underwriting, it cannot be avoided. A master lease might provide an avenue for a good sponsor to invest capital into the property outside the DST in order to avoid impairing the DST's 1031 eligibility for beneficiaries, but it does not necessarily make for a good investment. The springing LLC can raise capital, but is subject to its own limitations. Providers of additional capital (following an LLC conversion) will likely be unwilling to invest in the new LLC pro-rata alongside the former trust beneficiaries, and such capital providers may demand preferential distributions. Likewise, seeking out additional mezzanine debt will require the creation of new entities and additional structuring around the newly formed LLC.

Given these drawbacks, lenders may want to consider requiring the sponsor, as manager of the new LLC, to maintain a wide range of discretion to raise additional capital in post-default or near-default scenarios. Without this latitude, the consent of all or some of the investors may be required, which could stop a workout in its tracks. Avoiding coordination issues is one of the reasons for selecting a DST over a syndicated tenancy-in-common or other 1031-eligible structure in the first place. The decision-making process should be outlined in the form LLC agreement attached to the trust agreement and be approved by the lender with an eye toward a workout.

Conclusion

Two important components for lenders as they structure a 1031-eligible DST loan transaction are the master lease structure and the springing LLC. The master lease structure allows for flexibility in dealing with everyday issues. The springing LLC can provide a mechanism for the borrower and lender to work out a distressed loan and avoid foreclosure. However, when considering these structures at loan origination, lenders should also be mindful of the common issues that lead to a workout—namely, a lack of adequate capital. In addition to a well-crafted master lease, trust agreement, and springing LLC agreement, lenders and borrowers should consider, particularly in an uncertain economic environment, giving the DST sponsor the flexibility to raise the capital necessary to meet the demands of their particular loan following an LLC conversion. ■

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