GGP: Single Purpose Entity or All in the Corporate Family?

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On August 11, 2009, in a long-awaited ruling in the chapter 11 case of General Growth Properties, Inc. ("GGP"), the Court denied the motions to dismiss that had been brought on behalf of several of the property-level lenders.[1] Few if any observers anticipated that the Court would grant these motions and actually dismiss some of the individual SPE borrowers from the larger GGP bankruptcy. But while the result itself may not be surprising, the Court delivered a lengthy (nearly fifty page) detailed opinion supporting its ruling. This opinion provides a sobering insight into how a long-tenured and well-respected bankruptcy judge views the role of single purpose entities ("SPEs"). And, given that the primary function of single purpose entities in structured finance is to mitigate bankruptcy risk, one could argue that the only perspective that really matters on this topic is that of the bankruptcy judge.

Among secured lenders, the concern at the outset of the case focused on the likelihood of substantive consolidation.[2] As the case has unfolded, the risk of substantive consolidation has receded, but it appears that the Court has found an alternative path in the direction, but stopping short, of substantive consolidation. Loosely formulated as the

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[1] Memorandum of Opinion, In re: General Growth Properties, Inc., No. 09-11977 (Bank. S.D.N.Y. Aug. 11, 2009) (hereinafter, the "Opinion"). The motions to dismiss were filed after the Court issued its final order with regard to debtor-in-possession ("DIP") financing and the use of cash collateral. As the Court summarizes, its final cash collateral order "had various forms of adequate protection for the project-level lenders, such as the payment of interest at the non-default rate, continued maintenance of the properties, a replacement lien on the cash being upstreamed from the project-level Debtors and a second priority lien on certain other properties. DIP financing was arranged, but the DIP lender did not obtain liens on the properties of the project-level Debtors that could arguably adversely affect the lien interests of the existing mortgage lenders." Opinion at 17.

[2] *See* Daniel B. Rubock, *GGP Warns of Possible Substantive Consolidation Motions for the First Time in Its Bankruptcy Case*, Moody's Structured Finance, August, 2009.

"corporate family" view, this path is less draconian (from the standpoint of secured lenders) than substantive consolidation, but it still unsettles certain assumptions upon which lenders, especially in the commercial mortgage-backed securities ("CMBS") market, have relied. While the end is not "nigh," adjustments in terms of lender expectations, as well as modifications to structuring and underwriting criteria, tailored in response to the case, will be a part of the landscape going forward.

The Corporate Family vs The SPE

At its most general, the issue is: how should an SPE borrower that is part of a larger corporate-level bankruptcy be viewed in bankruptcy? Is there a basis for treating the SPE in bankruptcy the same way it is viewed in structuring a transaction, namely on a stand-alone basis, or, alternatively, does the SPE structure merely provide a guideline for a bankruptcy court to decide the appropriate adequate protection for a secured lender, while treating the SPE as part of the parent company's bankruptcy case? The Court's response to this question may be guessed from its view of the good faith filing issue (discussed below): "[t]he Court is not required in these cases to examine the issue of good faith as if each Debtor were wholly independent. We turn to the interests of the Group as a whole."[3]

One of the overarching themes to which the Court returns several times in the Opinion is the near impossibility of raising capital in the frozen credit markets. There is no ground to dispute this contention, but the critical point is that the Court looks at this obstacle from the perspective of the GGP group as a whole—the parent and the SPE subs—rather than at the individual entity level. In describing the capital structure of the GGP debtors, the Court speaks of the "consolidated outstanding indebtedness" of GGP

[3] Opinion at 27. The "Group" refers to the GGP parent-level debtors together with the SPEs.

and its SPE subsidiaries.[4] The court does not collapse the interests of parent and subsidiary, as would be the case in a substantive consolidation, but does view the problems facing the various GGP entities through the same lens. A key factor for the Court is GGP's perceived inability to successfully reorganize at the parent company level without the certainty of cash flow from the SPE assets beyond the amounts required to be paid to the secured lenders as adequate protection.[5]

The response of a secured creditor (of an SPE) might be to wonder why it suddenly must bear the burden of the parent's financial difficulties. The Court, however, sees an alignment of interests between the parent and the SPEs, asserting, wrongly perhaps, that the inability of the parent to restructure would inevitably impair the financial situation of the SPEs.[6]

The Court's reasoning suggests that it is applying a "corporate family" doctrine to the GGP entities, an approach that treats affiliated companies as a collective whole engaged in a common enterprise. While it stops short of substantive consolidation, this approach stands well adrift from, if not antithetical to, viewing an SPE as a stand-alone entity.

To support its position, the Court first takes note of the lack of direct precedent and then looks to a handful of cases following In re: U.I.P.,[7] a 1987 decision involving

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[4] Opinion at 6.

[5] *See* Final Order Authorizing Debtors to (A) Obtain Postpetition Secured Financing Pursuant to Bankruptcy Code Sections 105(a), 362, and 364, (B) Use Cash Collateral and Grant Adequate Protection Pursuant to Bankruptcy Code Sections 361 and 363 and (C) Repay in Full Amounts Owed Under Certain Prepetition Secured Loan Agreement, In re: General Growth Properties, Inc., No. 09-11977 (Bank. S.D.N.Y. May 14, 2009).

[6] Opinion at 28. The Court declines to consider the contrary and hardly unreasonable position that a solvent SPE borrower with a moderately leveraged loan on a cash flowing property would have access to refinancing capital regardless of the difficulties facing the parent.

[7] Heisley v. U.I.P. Engineered Prods. Corp. (In re: U.I.P. Engineered Prods. Corp.) 831 F.2d 54 (4th Cir. 1987).

the bankruptcy of a steel company with multiple operating company subsidiaries. The Court takes these cases together to stand for the principle as stated in In re: U.I.P. that "the nature of a corporate family created an ''identity of interest'…that justified the protection of the subsidiaries as well as the parent corporation.'"[8] In reaching this conclusion, the Court stops short of the full discussion one would expect in applying, and arguably expanding, the "corporate family" doctrine to the GGP case. On their facts, In re: U.I.P. and its related cases appear to stand for the principle that the corporate family doctrine should apply when the parts are worth far less than the whole, or, put another way, when the unity of interest protects not just the entities, but more importantly the underlying asset value.

It is not clear that this logic is sound as applied by GGP. The GGP SPEs, while part of a large, complicated corporate structure in one sense, were operationally (or at least could be) distinct, in that the malls could have been operated or managed independently from one another and the parent, either by GGP or another shopping center company or a sophisticated institutional investor.[9] As such, the parts were not worth less than the whole—many healthy performing shopping centers could continue to operate successfully without the corporate parent.

While citing the cases on the "corporate family" doctrine as legal support for its conclusion, the Court is clearly focused on what it perceives to be the equities of the case in front of it. An example of this perspective is the Court's implicit approval of GGP's attempt early in 2009 to convene a "special servicer summit" to discuss loan

[8] Opinion at 29 (quoting *In re: U.I.P. Engineered Prods. Corp.* at 56).
[9] *See* Brief of Commercial Mortgage Securities Association and Mortgage Bankers Association as Amici Curiae, In re: General Growth Properties, Inc., No. 09-11977 (Bank. S.D.N.Y. Aug. 11, 2009) (distinguishing the relationship between the GGP parent and SPE subsidiaries from a parent corporation with more operationally interconnected, less free-standing subsidiaries).

modifications *en masse* for the securitized loans to the SPEs. Missing, however, from the Court's analysis is an acknowledgement that the CMBS structure is itself a whole. The distinction in roles between master servicer and special servicer, the limitations on modifying loans not in default,[10] and the separate treatment of separate loans[11]—these are part of the basic architecture of CMBS, not contrivances to prejudice a borrower or honest debtor. In the Court's words, quoting the debtors' brief, "the CMBS structure caused additional roadblocks to the Company's attempts to refinance its debt or even talk with its lenders."[12] While the emphasis on preserving value for the collective enterprise is clearly the Court's focus, it seems unduly dismissive not even to discuss the contrary position, namely that separate loans to separate entities by separate lenders on separate properties should be treated separately.

Bad Faith

One of the contentions raised in the motions to dismiss is that the bankruptcy petitions were filed in bad faith. The Court's analysis and rejection of this argument is detailed and grounded in case law and looks at the concept of bad faith against both objective and subjective tests, all of which can be distilled into three elements.[13] First, insolvency is not a requirement to a voluntary bankruptcy. The appropriate test is whether the entity is in some measure of financial distress. Second, as a condition to

[10] In GGP, most of the project-level loans were not in default and regardless of whether the loans were a CMBS loan or a traditional portfolio loan, lenders usually do not discuss, or entertain requests for, extensions or modification if a loan is performing. Moreover, the US Tax Code limits the ability of master and/or special servicers to agree to "significant modifications" to a CMBS loan until it (not its current family group) is in imminent default.

[11] GGP interpreted hyper-amortization (with its Anticipated Repayment Dates) in certain loans, which imposed steep interest rate increases, cash traps at the property level and application of excess cash to principal, "as equivalent to maturity and the consequences of a loan becoming hyper-amortized as equivalent to default." Opinion at 9.

[12] Opinion at 15.

[13] Opinion at 18–42.

bankruptcy, financial distress appears to be a fluid enough concept to fit almost any fact pattern. In the Court's reasoning, a solvent SPE borrower with a moderately leveraged mortgage loan and no other debt could find itself to be in financial distress based solely on the prospect of having difficulty refinancing its mortgage in two or three years. Third, even though a borrower has no obligation to negotiate with its lender prior to filing for bankruptcy, the difficulty perceived by GGP in attempting to negotiate with the master servicers and special servicers of the individual CMBS loans seems to have informed the Court's view that the filings, while inconvenient for the secured lenders, were not in bad faith.[14]

The Court's overall handling of the bad faith analysis points to a settled precept: the standard for dismissal on such grounds is and shall remain a very high bar to clear. This is not inconsistent with the favored *raison d' etre* of Chapter 11, to facilitate the rehabilitation of the honest debtor.

Independent Directors

"Where were the independent directors" has been one of the persistent questions in the GGP bankruptcy. Unfortunately, the answer may be that "they don't appear to matter."

Admittedly, this may overstate things, but this case will at least lead to a thorough reexamination on the role, utility and value of independent directors in CMBS transactions. While few in the marketplace believed that bankruptcy-remote meant bankruptcy-proof, most did not think it was quite so proximate. One reason for this

[14] It is interesting to note that in another high profile case being heard down the hall from GGP, In re Extended Stay Inc., the Court appears to be less troubled with the role of loan servicers. No. 09-13764 (Bank. S.D.N.Y.). Rejecting a proposed deal between the debtors in that case and several certificate holders, the Court makes clear that it is the special servicer that acts as the voice of the CMBS lender in default scenarios and that this aspect is part of the CMBS structure. *Id.*

belief was the requirement typically contained in both the loan documents and the organizational documents of the SPE Property Owners that any voluntary bankruptcy filing needed the affirmative vote of the independent directors.

Whatever the ultimate outcome of the GGP case, one positive result will definitely be a better understanding of how the independent director concept works (or doesn't work) in CMBS finance.[15] In particular, what duty does an independent director have to consider the interests of creditors of the borrower and shareholders (and perhaps creditors) of the borrower's parent company? And what if independent directors in place at the closing of a loan are dismissed—possibly in contravention of the organizational documents, an *ultra vires* act—and replaced with compliant directors who could be counted on to vote in favor of the bankruptcy?[16]

At one of the hearings on the motions to dismiss, GGP offered testimony that (i) the initial independent directors put in place at the closing of the mortgage loans were really just place-holders pursuant to the requirements of the secured lenders[17] and (ii) the SPEs had undertaken a lengthy, deliberative process in deciding to replace the initial independent directors.[18] The replacement independent directors were described as "seasoned individuals" who both satisfied the standard of "independence" required by the

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[15] Even some of the special servicers, in testimony at the hearing, seemed to have inflated views of the role of independent directors, a position that drew rebuke from the Court. Opinion at 33.

[16] If in fact the independent directors were inappropriately fired and replaced, this could and support a motion to dismiss the bankruptcy case. Generally speaking, on the facts in GGP, there is no basis for sustaining a motion to dismiss on these grounds. *But see* In re Kingston Square Associates, 214 B.R. 713, 735 (Bankr. S.D.N.Y. 1997) (noting that "when a corporation approaches insolvency or actually becomes insolvent, directors' fiduciary duties expand to include general creditors.").

[17] In describing these place-holder directors, the Court noted that "[i]t does not appear that these managers had any expertise in the real estate business and as mentioned above, some of the lenders thought the independent managers were obligated to protect their interests alone." Opinion at 38-39.

[18] The Court seemed impressed with the extent of GGP's pre-filing deliberation, noting that the extensive discussions lasted for six weeks and included a "total of seven Board meetings and three informational sessions" in the months before its filing. Opinion at 22.

organizational and loan documents and, in contrast to the directors being replaced, had significant restructuring experience and qualifications to assist the SPE debtors in their analysis and decision.[19] The problem with the *ultra vires* argument is that the loan documents and the organizational documents governing the role of independent directors did not expressly prohibit their replacement. In most instances, the relevant loan document and organizational document provisions required that the borrower maintain two (2) independent directors at all times and that any decision to file bankruptcy required the unanimous consent of all directors, including the independent directors. With respect to the termination or removal of independent directors, the documents only provided that termination would not be effective until a successor had been appointed. There is no provision for notice to or consent by the secured lender for the removal or replacement of the independent directors, so long as the SPE Property Owner appoints a replacement that satisfies the standard of independence set forth in the organizational documents. With regard to removal or replacement of independent directors, the organizational documents governing the GGP loans mirrored the comparable provisions in typical capital-market compliant organizational documents.

In terms of the scope of duty for an independent director, the Court states the position clearly, that the independent managers had the same duties as the non-independent directors of a Delaware corporation, specifically a "prima facie duty to act in the interests of the corporation *and its shareholders*."[20] The Court cites Gheewalla, the

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[19] The prior independent directors had been provided by Corporation Service Company, which "supplie[d] these directors in the same fashion as it provides filing and other ministerial services for corporations." Opinion at 38.

[20] Opinion at 40 (emphasis added). As the Court noted, "beyond the unsecured debt of the parent companies were thousands of equity holders who depended, in large part, on the net cash flow of and the equity in the project-level Debtors as a principal source of protection for their investment." *Id.* at 30.

controlling Delaware Supreme Court case that states the proposition that directors have duties to the corporation and its shareholders when operating in a "zone of insolvency."[21] This is an accurate statement as to present Delaware law, but not necessarily one that has been accepted by the CMBS market with respect to its assumptions about the mitigating role independent directors should play in the decision to file for bankruptcy. Most CMBS lenders did not expect an independent director to act as a shill for the lender,[22] but they probably did not underwrite the probability that the independent director would also be focused on the interests of the parent entity.[23] Commenting on the confusion about the role of the independent directors, the Court states, "the record at bar does not explain exactly what the Independent Managers were supposed to do."[24] At the outset of the case, concern seemed to focus on the termination of the independent directors that were in place and their replacement with individuals hand-picked by GGP. The real question is whether this even mattered, given the standard of duty to all independent directors are held under Delaware law. [25]

As the GGP case moves forward, CMBS lenders will focus on ways to "fix" the independent director issue, namely whether there are structural or documentary changes that will result in a legally sound basis for continuing to rely on this mechanism as a

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[21] North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007). Gheewalla does acknowledge that creditors may bring a derivative action against directors on behalf of the corporation, a useless remedy in the context of an independent director whose sole function is to vote on insolvency matters.

[22] As the Court noted, "if [Secured Lenders] believed that an 'independent' manager can serve on a board solely for the purpose of voting 'no' to a bankruptcy filing because of the desires of a secured creditor, they were mistaken." Opinion at 33.

[23] As one commentator noted, "the brand new law the judge made was this: in determining whether SPEs may file for Chapter 11 bankruptcy, independent directors perhaps must take into account the interests of the parent corporation." Daniel Rubock, *GGP Judge: Bankruptcy-Remote Entities Remain in Bankruptcy, but Don't Worry About Substantive Consolidation*, Moody's Structured Finance, August, 2009.

[24] Opinion at 33.

[25] Notwithstanding the expectations of the secured lenders, at least two of the place-holder directors voted in favor of the Chapter 11 filings of those debtors on whose boards they still served. Opinion at 40.

bankruptcy mitigant in future transactions.[26] In formulating any such proposals, one of the key questions is the linkage between the "corporate family" doctrine and the expanded scope of duty for independent directors under the *Gheewalla* case.

Substantive Consolidation

The initial concern over substantive consolidation has abated, thankfully. On multiple occasions, in writing and from the bench, the Court has swatted away the possibility, most recently stating, "nothing in this Opinion implies that the assets and liabilities of any of the Subject Debtors could properly be substantively consolidated with those of any other entity."[27] Some commenting on the case remain focused on substantive consolidation, but as discussed above, the real concern may be the slow creep via judicial expansion of the "corporate family" doctrine.[28]

With all the anticipation surrounding GGP, there may be a tendency, of which we are no doubt at least guilty in part, of reading too much into the various interlocutory statements by the Court as the case grinds forward. In the Opinion before us now, the narrow issue is really just to decide the grounds for sustaining or denying a motion to dismiss. In dealing with this issue, the Court expressly favors a case-by-case approach, but one that takes into account "the interests of the group as well as the interests of the individual debtor."[29] This does not mean the end for CMBS lending or for the use of

[26] One of the structural "fixes" under discussion in the CMBS industry is the prospect of requiring SPE borrowers to hold their assets in a business trust, with Delaware being the oft-spoken venue of choice. However, given the Court's treatment of an Illinois business trust in the GGP case, a similar use of Delaware business trusts would likely be ineffective. Focusing on the actions of the business trust rather than organizational formalities, the Court dismisses the idea that a business trust is not a bankruptcy eligible debtor. Opinion at 43.
[27] Opinion at 42.
[28] *See* Rubock *supra* note 2.
[29] Opinion at 30.

single purpose entity structures. It does mean that lenders need to adjust their expectations to fit this – to some degree, new – reality.

Conclusion

In assessing the ramifications of the Court's treatment of GGP and its SPEs under the "corporate family" doctrine, the unanswerable question is the extent to which the Court's decision is a reaction to the collapse in the markets for real estate credit. From a secured lender's perspective, the real test of the SPE structure is whether it can withstand the pressure of bankruptcy. Given the market conditions of the last 18 months, the Court appears to be saying that the state of the markets is a crucial fact by itself in the case, and that these market conditions merit a balancing of the genuine expectations of the secured creditors as to the durability of the SPE structure against the reasonable expectation of GGP and the SPE borrowers that a refinancing market would exist.[30] Put another way, the dire market conditions that provide the context for this case may act to limit its precedential impact, at least in market climates more hospitable to raising capital.

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[30] As the Court noted, "[f]aced with the unprecedented collapse of the real estate markets, and serious uncertainty as to when or if they would be able to the refinance the project-level debt, the Debtors' management had to reorganize the Group's capital structure. [Secured Lenders] do not explain how the billions of dollars of unsecured debt at the parent levels could be restructured responsibly if the cash flow of the parent companies continued to be based on the earnings of subsidiaries that had debt coming due in a period of years without any known means of providing for repayment or refinance." Opinion at 30.

ENFORCEABILITY OF PREPAYMENT PREMIUMS – LANGUAGE DOES MATTER!

By John C. Murray

Introduction

The Circuit Court of Cook County, Illinois recently entered an interesting ruling on the enforceability of a commercial-loan prepayment provision. *See Cornerstone Leased Drugstores LLC v. Wells Fargo Bank Northwest, NA*, Circuit Court of Cook County, Illinois, No. 07 CH 04352 (June 19, 2009). The case was decided solely on the basis of the meaning of the contractual language regarding prepayment contained in the (identical) mortgage notes executed by Cornerstone Leased Drug Stores LLC ("Cornerstone") in connection with forty-two 25-year mortgages on properties located in 16 states. The Court agreed with the defendant, Wells Fargo Bank Northwest ("Wells Fargo," which served as trustee for the five institutional lenders who actually loaned the money and were designated as trust-beneficiaries) with respect to its calculation, under each of the notes, of the Reinvestment Yield under the prepayment provision and the conversion to a monthly yield as provided by the provision. This article will summarize and analyze the court's decision and discuss its relevance for commercial mortgage lenders.

Analysis of Decision

The court summarized the issues as follows:

> There are two portions of [the prepayment provision] that are critical to the resolution of the dispute between the parties. The first is part (i) of the definition of "Reinvestment Yield," and in particular the parenthetical statement: "(or such other display as may replace such displays on the Bloomberg service or any other generally available service)." The second is contained within the definition of "Prepayment Consideration" providing the method of calculating the total amount of the remaining payments due under the note: "such sum to be determined by discounting (monthly on the basis of a 360-day year composed of twelve 30-day months).

Id. at p.3.

The prepayment premium was to be calculated (pursuant to the applicable provision) by reference to the "Reinvestment Yield," which, as stated in the provision,

> means the yield to maturity of either (i) the yield reported as of 11:00 A.M. (New York City time) on the date of calculation on the display designated USD on the Bloomberg Financial Markets Screen (or such other display as may replace such displays on the Bloomberg service or any other generally available service) for actively traded U.S. Treasury securities having a constant maturity equal to the remaining average life of the Note, or (ii) if such yields shall not be reported as of such time or the yields reported as of such time shall not be ascertainable (including by way of interpolation), the Treasury Constant Maturity Series yields reported for the latest day for which such yields shall have been so reported as of

> the Business Day next preceding the Determination Date in Federal Reserve Statistical Release H-15 (519) (or any comparable successor publication) for U.S. Treasury securities having a constant maturity equal to the remaining average life of the Note as of the Determination Date: provided however, if no maturity exactly corresponding to the remaining average life of the Note shall appear therein, yields for the two most closely corresponding reported maturities (with one being shorter and the other longer) shall be calculated pursuant to the foregoing sentence and the Reinvestment Yield shall be interpolated from such yields on a straight-line basis (rounding in each of such relevant periods, to the nearest month). All such prepayments must occur on a Business Day.

Cornerstone subsequently refinanced the loan and exercised its right to prepay in the summer of 2006. However, on the stipulated date for calculation of the prepayment premium (August 16, 2006), a "matched" Treasury security that would mature on the maturity date of the loan (March 3, 2019) did not appear on the Bloomberg USD screen. The parties then agreed, as per the language in the prepayment provision, to interpolate the prepayment consideration using the two most closely corresponding reported U.S. securities, one shorter than March 3, 2019 and one longer. But the parties disagreed on whether they could only look to the Bloomberg USD screen to ascertain such interpolation based on the U.S. Treasury securities most closely corresponding to March 2019 (as argued by Wells Fargo), or whether the parties could look to different screens for such purpose (as argued by Cornerstone). The court ruled in favor of Wells Fargo, noting that "Paragraph 6 [the prepayment provision] of the Notes, while admittedly complex, is not ambiguous." *Id*. at p. 5. The court further noted that: "The plain language of the note anticipates the possibility that changes might occur over the course of those 25 years, but does not provide the parties with an alternate financial markets screen from which to obtain information on the interest rate borne by U.S. Treasury securities." *Id*. at p. 7.

Cornerstone also argued that the Reinvestment Yield should have been calculated on a semi-annual, rather than a monthly basis. But after carefully reviewing the language in the prepayment provision, the court agreed with Wells Fargo that in order to be consistent with the terms of the Notes the Reinvestment Yield had to be calculated on a monthly basis. According to the court:

> Since the discount factor is comprised of the "Reinvestment Yield plus 50 basis points," the Notes direct the parties to apply the Reinvestment Yield as if it accrued monthly, and then to add 50 basis points to that number. The word monthly in this section of the note provides the clear and unambiguous direction for that calculation. As such, there is no issue of material fact . . . and Wells Fargo's Motion for Summary Judgment is granted.

Id. at p. 7.

The basic purpose of a yield-maintenance prepayment provision in a commercial real-estate loan document is to provide a fee to the lender that will compensate it for the difference between the original interest on the loan and the yield available from U. S. Treasury instruments at the time of prepayment. The prepayment clause in the *Cornerstone* case provided that "the Notes direct the parties to apply the Reinvestment Yield as if it accrued monthly, and then to add 50 basis points to that number." This adding of basis points, which is not all that common any more in connection with prepayment premium provisions in commercial mortgage-loan documents, was probably done by the lender to blunt any argument that prepayment based on U.S. Treasury instruments without the addition of such basis points would constitute a “windfall” for the lender. But this specific language (certainly not a bad idea) had no bearing on the court’s ruling, which was based strictly on contractual interpretation. This was not a true “yield maintenance” case where the validity or enforceability of such a clause in general was questioned. For years, institutional lenders such as insurance companies have used "yield maintenance" clauses to calculate prepayment premiums, and such clauses are considered the industry norm.

See Richard F. Casher, *Prepayment Premiums: Hidden Lake is a Gem*, 19-9 ABI J. 1 (Nov. 1, 2000):

> A yield-maintenance clause typically assumes that the prepayment premium and the prepaid principal will be invested in U.S. Treasury securities (Treasuries) that will mature at the same time as the prepaid loan and that the dollars so invested will return the same yield that the insurance company would have realized had its loan not been prepaid. Treasuries are used as the reinvestment norm because there exists no standard commercial mortgage loan rate, given the uniqueness of each commercial loan and the inherent difficulty (if not impossibility) of identifying an identical or similar loan; in contrast, the market for treasuries is deep and highly liquid.

See also Restatement (Third) of Property: Mortgages § 6.2 comment a (1997):

> The primary purpose of [prepayment] clauses is to protect the mortgagee against the loss of a favorable interest yield . . . . Prepayment may also result in further losses, such as the administrative and legal costs of making a new loan . . . and in some cases additional tax liability.

Conclusion

The *Cornerstone* case (at least at the trial level) once again clearly illustrates the importance of clarity in the drafting of a mortgage prepayment provision, and in this case it would appear the lenders (and their counsel) did it right. The borrower had contended that it was overcharged by $2,260,000 based on the defendant’s calculation (the total prepayment amount paid to Cornerstone, pursuant to Wells Fargo’s calculation, was $20,621,812). The court noted in its ruling that there was no ambiguity and therefore no need to examine parol evidence. (*See also Friedman v. LaSalle Nat’l Bank*, 2004 Ohio 2205 (Ohio App. 2004), at P21 (“[t]he prepayment provision is clear on its face and unambiguous. Therefore we will not consider the parol evidence [the borrower] advances”)). The court’s ruling in *Cornerstone* highlights the fact that a mortgage prepayment provision should be carefully, clearly, and comprehensively drafted so that its meaning is clear and there is no ambiguity that may open the door to a challenge by a clever borrower. The general rule is that any ambiguity will be construed by a court in the borrower’s favor when the lender has drafted the loan documents. *See, e.g., Littlejohn v. Parrish*, 163 Ohio App. 3d 456, PP 27-28 (2005) (holding that mortgage, which provided that there was no prepayment penalty but that any prepayment was subject to the mortgagee’s approval, imposed duty of good faith and fair dealing “when one party has discretionary authority to determine certain terms of the contract"; court refused summary judgment for mortgagee and remanded case for further proceedings). The moral of the *Cornerstone* case: Language does matter! [Note: The judgment entered in favor of Wells Fargo in the *Cornerstone* case was fully dispositive of the case, and Cornerstone had 30 days in which to file a Notice of Appeal (unless a post-trial motion was filed within that time, in which event the notice of appeal would be due 30 days after disposition of the post-trial motion). The author is uncertain, as of the date of this article, whether either such event has occurred or will occur.]

Another Nail in the MERS Coffin:
Arkansas Court Rules That MERS Was Not A Necessary Party To A Foreclosure Action In Which MERS Served As Lender's Nominee On The Senior Deed Of Trust

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On March 19, 2009, the Supreme Court of Arkansas determined that Mortgage Electronic Registration Systems, Inc. ("MERS") was not a necessary party to a foreclosure action involving the foreclosure of a junior mortgage, where MERS was not the true beneficiary of the senior deed of trust nor was specifically authorized by the lender to act on the lender's behalf in the foreclosure proceedings. *Mortgage Electronic Registration Systems, Inc. v. Southwest Homes of Arkansas*, -- S.W.3d --, 2009 Ark. 152, 2009 WL 723182 (Mar. 19, 2009). Coming in on the heels of *Landmark National Bank v. Kesler*, 40 Kan. App. 2d 325, 192 P.3d 177 (2008) (also finding that MERS was not a necessary party to a foreclosure action), *Mortgage Electronic Registration Systems, Inc. v. Southwest Homes of Arkansas* places MERS on unstable ground in mortgage foreclosure actions.

In 2003, Jason Lindsey and Julie Lindsey entered into a deed of trust on a one-acre lot in Benton County, Arkansas, to secure a promissory note from Pulaski Mortgage. The deed of trust listed Pulaski Mortgage as the lender, Jason and Julie Lindsey as the borrowers, James C. Ernst as the trustee, and MERS as the beneficiary "acting 'solely as nominee for Lender,' and 'Lender's successors and assigns.'" In 2006, Jason and Julie Lindsey granted a mortgage on the same property to secure a second promissory note from Southwest Homes of Arkansas ("Southwest Homes"). In 2007, Southwest Homes filed a Petition for Foreclosure in Rem against the Lindseys under the mortgage and listed the Lindseys, the Benton County Tax Collector and "Mortgage Electronic Registration System, Inc. (Pulaski Mortgage Company)" as respondents. Southwest Homes served Pulaski Mortgage, but did not serve MERS. A decree of foreclosure was entered in April 2007, and the property was auctioned to Southwest Homes. The sale was approved in May 2007. In 2008, MERS learned of the foreclosure and moved for relief. The circuit court denied MERS's motion, and MERS appealed.

MERS argued that it held legal title to the property and therefore was a necessary party to any action regarding title to the property. Although the deed of trust indicated that MERS held legal title and was the beneficiary and nominee of the lender, it also provided that all payments were to be made to the lender, that the lender would make decisions on late payments, and that the lender

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held all rights to foreclosure. The borrowers never made payments to MERS and MERS did not service the loan in any way. MERS simply provided electronic tracking of ownership interests in residential real property security interests. Still, MERS asserted that it held bare legal title because it held the authority, as an agent of the lender, to exercise the rights of the lender, regardless of who the lender may be under the MERS electronic registration.[2]

The court found that MERS did not hold legal title under the deed of trust and therefore was not a necessary party to the foreclosure action initiated by Southwest Homes. In its decision, the court described the relationship between parties to a deed of trust – the borrower, who conveys legal title to the trustee; the lender, who is the beneficiary of the deed of trust and holds the indebtedness secured by the deed of trust; and the trustee, who takes legal title and whose duties are limited to undertaking foreclosure upon default and reconveying the deed of trust upon satisfaction of the underlying debt. Because MERS was not the trustee under the deed of trust, the deed of trust did not convey legal title to MERS. Also, MERS was not the beneficiary of the deed of trust, although so designated in the deed of trust, because it did not receive the payments on the underlying debt.

Chief Justice Jim Hannah authored the opinion. Justice Danielson authored a concurring opinion, in which Justices Imber and Wills joined. Justice Danielson's concurring opinion discusses the Kansas Appellate Court opinion in *Landmark National Bank v. Kesler*.

[2] The court specifically rejected this argument, stating "We specifically reject the notion that MERS may act on its own, independent of the direction of the specific lender who holds the repayment interest in the security instrument at the time MERS purports to act."

LIBOR UNDER ATTACK:
UNDERSTANDING THE CURRENT CONTROVERSIES

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The London InterBank Offered Rate (commonly known as "LIBOR") is the most commonly used benchmark for short-term interest rates both in the international and domestic markets. According to the British Banking Association (the "BBA"), which oversees the calculation and publication of LIBOR quotes, at least $350 trillion of retail and wholesale financial instruments are linked to LIBOR. Over the past three decades, LIBOR has replaced the Prime Rate as the most common index used to determine the interest due under floating rate, short-term commercial loans (such as construction loans and land loans) and most home mortgages. The rate has historically been fairly stable and not subject to sudden, wide swings. That began to change last fall with the collapse of Lehman Brothers and the worldwide credit crunch. The global financial crisis and resulting governmental interventions in the financial sector have raised a number of questions regarding the immediate and long-term viability of LIBOR as a reliable indicator of the interbank lending market and a useful index for banks involved in real estate lending. This article will provide a short refresher on the basics of LIBOR and discuss the current controversies.

Background

In a nutshell:

> [LIBOR] is a benchmark; giving an indication of the average rate a leading bank, for a given currency, can obtain unsecured funding for a

> given period in a given currency. It therefore represents the lowest real-world cost of unsecured funding in the London market.[1]

The first LIBOR rates were published by the BBA for three currencies in 1986. Today, LIBOR is quoted each business day for ten currencies with 15 maturities quoted for each, ranging from overnight to 12 months. Current rate quotes are widely available from a variety of print and on-line sources– interested parties can even sign up for daily updates via Twitter.[2]

Each currency has a panel of eight to 16 banks which are asked the following question:

> At what rate could you borrow funds, were you to do so by asking for and then accepting inter-bank offers in a reasonable market size just prior to 11 a.m.?

Between 11:00 and 11:20 a.m. BST each business day, each panel bank forwards its answers to that question for the appropriate currencies and maturities to Thomson Reuters, the BBA's designated number-cruncher. None of the banks can see the others' information until the final rates are issued. Thomson Reuters uses a "trimmed arithmetic mean process" to determine LIBOR. In other words, it ranks panel submissions in descending order and then drops the top and bottom quartiles. The middle 50% of the quotes are then averaged to create the LIBOR quote. An example from the BBA website:

[1] British Banking Association, "bbalibor Explained: The Basics," (http://www.bbalibor.com/bba/jsp/polopoly.jsp?d=1627).
[2] Visit http://twitter.com/BBALIBOR to sign up. Currently, only the 3 month British Pound Sterling rate is quoted via Twitter.

~~Barclays Bank plc~~	~~2.15~~	
~~Bank of Tokyo-Mitsubishi UFJ Ltd~~	~~2.15~~	
~~HSBC~~	~~2.12~~	
~~Royal Bank of Scotland~~	~~2.11~~	
UBS AG	2.105	
Abbey National	2.1	
Bank of America	2.1	
Citibank NA	2.1	LIBOR Rate =
Mizuho Corporate Bank	2.1	2.10063
Rabobank	2.1	
Royal Bank of Canada	2.1	
WestLB AG	2.1	
~~BNP Paribas~~	~~2.05~~	
~~Lloyds Banking Group~~	~~2~~	
~~Deutsche Bank AG~~	~~1.95~~	
~~JP Morgan Chase~~	~~1.95~~	

It is important to note that LIBOR is based on the panel banks' best guess of the offered rate, not actual transactions. As the BBA explains, "[s]ubmissions are based upon the lowest perceived rate that a bank on a certain currency panel could go into the inter-bank money market and obtain sizable funding, for a given maturity." Obviously, there is a significant amount of subjectivity in that determination.

Not surprisingly, given the "London" bit of "London InterBank Offered Rate," the panel banks are chosen only among those banks active in the London money market. They are chosen based on: (1) the scale of market activity; (2) credit rating; and (3) perceived expertise in the currency concerned. The panels are re-evaluated each year and adjusted as necessary. The panel for the U.S. Dollar was most recently established as of June 1, 2009. It was not changed from last year and currently consists of the following banks:

Bank of America	Lloyds TSB Bank plc
Bank of Tokyo-Mitsubishi UFJ	Rabobank
Barclays Bank plc	Royal Bank of Canada
Citibank NA	Société Générale
Credit Suisse	The Norinchukin Bank
Deutsche Bank AG	The Royal Bank of Scotland
HSBC	UBS AG
JP Morgan Chase	West LB AG

After the panels were last established on June 1, 2009 the BBA issued a press release entitled "Defining the L in BBA LIBOR."[3] Prior to June 19, 2009, quoted rates included the following note: "Contributions [to the rate fixing process] must represent rates formed in London and not elsewhere." The BBA determined that the phrase "formed in London" could be confusing and outdated because many major participants in the London money markets are not physically located in London or do not book trades there. Therefore, the BBA changed the note to read: "Contributions must represent rates at which a bank would be offered funds in the London Money Market." This change has no immediate impact on LIBOR but is seen as a potential liberalization of the panel determination method which will allow banks which had not previously been qualified to join a currency panel to apply to do so. It is also designed to prevent the disqualification of banks that currently participate in the panels because of the closure of London operations by non-British banks.[4] The BBA will next re-evaluate the panels in May 2010, so any impact of this change will not be seen until that time.

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[3] The press release can be found at:
http://www.bba.org.uk/bba/jsp/polopoly.jsp?d=145&a=16133

[4] Adam Bradbery, "Libor No Longer Just London," Wall Street Journal (June 19, 2009).

The LIBOR system described above has been subject to serious criticism over the past year because of the impact of several aspects of the global financial crisis and governmental responses to it. Each of these criticisms essentially questions whether LIBOR, as currently formulated, is an accurate measure of the true cost of borrowing in the interbank money market and, ultimately, whether it is a reasonable index to use in consumer lending, particularly commercial and residential real estate loans.

Impact of TARP

James Bianco of Arbor Research recently wrote a piece that observed the behavior of LIBOR panel banks which accepted TARP funds versus those which did not. Analyzing the rates submitted by three TARP banks (Bank of America, Citibank, and JP Morgan Chase) and two Japanese banks (Bank of Tokyo and Norinchukin), Bianco noted that from 2004 to 2007, there was little difference in the rates submitted by the five banks. Since the three U.S. banks accepted TARP funds, however, the difference between the two groups has broadened, with the U.S. banks submitting LIBOR rate quotes significantly below the Japanese banks. To Bianco, this suggests that the TARP program has had an important and skewing impact on LIBOR.[5] The Federal Reserve Bank of San Francisco has recently voiced similar concerns, which Bianco interprets as suggesting that LIBOR no longer reflects real risk in the system because of the guarantees by the U.S. government.[6]

[5] "The Uselessness of LIBOR," Seeking Alpha (June 22, 2009) (http://seekingalpha.com/article/144506-the-uselessness-of-libor?)

[6] Jens H. E Christensen, Jose A. Lopez, and Glenn D. Rudebusch, "Do Central Bank Liquidity Facilities Affect Interbank Lending Rates?" FRBSF Working Paper 2009-13 (June 2009).

Two-Tiered System

Another criticism of LIBOR which has gained significance since the September 2008 collapse of Lehman Brothers is that it is based on the fiction that there is a single money market in London. There are actually at least two distinct tiers of money markets – banks with low credit ratings have to pay more to borrow cash than do higher-rated ones. That has always been true to a limited extent, but the gap has widened since the advent of the current global economic crisis. In the middle of 2008, according to the BBA, the average difference between the highest and lowest quote submissions from panelists for the one-month euro was 6.9 basis points. By the end of the year, the difference had exploded to 43.9 basis points. For the first quarter of 2009, it had receded a bit to 26.4 basis points. The same trend is generally true for other currencies, especially the dollar, where the impact of TARP may be felt more sharply. One commentator recently observed that "the biggest institutions are able to fund themselves at around Libor levels while smaller institutions have to pay, in some cases, more than 100 basis points above Libor."[7]

The impact of this disparity could be significant for smaller institutions. If a smaller institution made a commercial construction loan at LIBOR plus 250 basis points a year ago, when it could actually borrow funds at LIBOR, but now it is forced to pay LIBOR plus 100 bp to borrow, its modest spread has taken a big hit while, in all likelihood, its risk on the loan has risen.

[7] David Oakley and Michael Mackenzie, "Fall in Libor fails to paint a true picture," Financial Times (June 3, 2009).

The BBA's decision to expand the "L" in LIBOR may permit smaller banks to participate in the currency panels, which should theoretically have the impact of raising LIBOR to reflect the true borrowing cost for the middle tier of banks.[8] However, some commentators point out that this will further distort LIBOR by raising the average rates above the "true" cost of borrowing for the top tier of banks, which will raise the cost to borrowers (including, ultimately, consumers) and potentially increasing the profit spread for banks that can borrow money more cheaply.[9] So long as there is a great disparity between the borrowing power of large and small institutions, but a single index which attempts to capture both ends of the spectrum, this problem will persist.

Oversight of Panels

A final criticism levied against LIBOR is that the process allows panel banks the potential to understate their true costs of borrowing in order to avoid the appearance that they are experiencing funding difficulties. In December 2008 the BBA took steps to address this concern by establishing a three-step disciplinary procedure to punish banks that inaccurately report rates. Of course, given that the banks are supposed to quote the rates that they perceive are correct, rather than reporting rates used in recent transactions,

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[8] Id.

[9] Lucy Tobin, "Revealed: How the Banks are Profiteering from Lending," Evening Standard (August 10, 2009) ("Banks were thrown into fresh controversy over excess profits today after it emerged that the spread between their cost of borrowing and the interest rates they levy on businesses and homeowners has rocketed to new highs. Figures compiled by the Evening Standard reveal the difference between the three-month Libor, the London inter-bank offered rate, and the average interest rate charged on mortgages has shot up to 3.7%, almost seven times higher than the difference recorded this time last year. . . . The picture is even worse for business customers, where the spread can commonly be as high as 7.12%. Critics said the staggeringly large number shows how easy it is in the current environment for banks to make huge profits at the expense of customers.")

it is unclear whether the BBA's actions will have the intended impact. The optimal solution, according to Jan Misch, a money market trader at Germany's biggest state-owned bank, is to require the panel banks to "prove they can transact at the rates they submit to the BBA."[10] There is no indication that the BBA is moving to adopt such a change to the LIBOR determination process.

The Future of LIBOR

It has been suggested by a number of analysts that LIBOR's inadequacies, brought to light by the current financial crisis, mean that it should be replaced by another index. That seems unlikely in the near term, as there is currently no consensus on an alternative index. Instead, it is more likely that the BBA will attempt to preserve the viability of LIBOR by continuing to tweak the system to respond to criticisms by analysts and banks.

The current controversies surrounding LIBOR may have no immediate impact on how real estate attorneys draft loan documents, but they may help illuminate changing term sheets. Lenders, particularly smaller institutions, are much more likely to design a floating rate based on LIBOR to include a floor. For example, the rate for a loan may be 30 day LIBOR plus 250 basis points, provided that 30 day LIBOR shall not be less than 1.5%.

In light of recent changes to LIBOR by the BBA, it may also be a useful exercise for attorneys to revisit the definitions of LIBOR used in form loan documents to ensure

[10] Ben Livesey and Gavin Finch, "Libor to Be Set by More Banks as BBA Boosts Scrutiny," Bloomberg.com (June 10, 2008) (www.bloomberg.com/apps/news?pid=20601087&sid=alj8baVXsFA8&refer=home)

that any future changes made by BBA to the methods of calculation will not have unintended consequences.