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The Commercial Loan Ranger

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NEW YEAR REVELATIONS: WHAT IS TRENDING IN 2018 FOR COMMERCIAL LENDERS AND BORROWERS?

Commercial lenders and borrowers witnessed a lot of changes in 2017. Rather than providing a list of important cases and legislation in 2017, I thought it might be more useful to discuss recent events occurring at the end of 2017 that may signal important trends for both commercial lenders and borrowers to keep an eye on as we start 2018.

Litigation – The Evolving Duty of Care for a Lender

As evidenced by the case of *Rossetta v. CitiMortgage* decided by the California Court of Appeal just last month, the duty of care for a lender continues to expand following the most recent recession. The general rule regarding the liability of a lender is that a lender owes no duty of care to a borrower when the lender's involvement in the loan transaction does not exceed the "scope of its traditional role as a mere lender of money." Although this general rule still remains, what is changing to the detriment of lenders is the limitation of what constitutes the lender's "traditional role as a mere lender of money." In particular, it seems that since the recent recession, courts are expanding the lender's duty of care to its borrowers in order to more closely scrutinize the lender's actions (and inactions) in each case.

For example, in a 2013 decision involving a dispute about the lender's performance of a construction loan agreement, the Court, in the case of the *Jolley v. Chase Home Finance,* reversed a judgment entered into by the trial court in favor of the lender on the borrower's negligence claim, and allowed the borrower to apply general tort principles to broaden the lender's duty of care. The impact of the recession on the *Jolley* court's reasoning can hardly be disputed. As reasoned by the Court:

> Due to the ongoing financial crisis, the federal government has adopted a voluntary incentive-based program designed to encourage lenders and borrowers to work together in the event of the borrower's default, by establishing a home loan modification program. [Citations omitted]. Similarly, the California Legislature has expressed a strong preference for fostering more cooperative relations between lenders and borrowers who are at risk of foreclosure, so that homes will not be lost. [Citations omitted]. These provisions, enacted in 2008, require lenders to negotiate with borrowers in default to seek loss mitigation solutions. As discussed hereafter, existing law will soon be supplemented by amendments enacted as part of the "California Homeowner Bill of Rights." [Citations omitted].
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> Granted, these ameliorative efforts have been directed primarily at aiding resident homeowners at risk of losing their homes. [Citations omitted]. We also understand there is no express duty on a lender's part to grant a modification under state or federal loan modification statutes. And until the new legislation takes effect, no private right of action for damages is granted under the statutes. [Citations omitted]. *We do not cite any of these legislative measures in reliance upon their provisions, nor do we suggest their provisions were violated in the present case. Rather, we refer to the existence—and recent strengthening—of these legislative measures because they demonstrate a rising trend to require lenders to deal reasonably with borrowers in default to try to effectuate a workable loan modification. In short, these measures indicate that courts should not rely mechanically on the "general rule" that lenders owe no duty of care to their borrowers*. [Emphasis Added].

The recent *Rossetta* decision is so important because it expands a lender's exposure beyond that set forth in the *Jolley* decision and well demonstrates that, despite the fact that many consider the recent recession to have ended, the reasoning underlying the expansion the duty of care found in the *Jolley* decision will most likely continue well beyond 2018. The *Rossetta* case involved the reversal of a dismissal by the trial court of a negligence claim against a lender, where the lender alleged mishandled the borrower's loan modification application. What makes this decision so distinctive is that, after noting the absence of direction from the California Supreme Court, the *Rossetta* court appears to have ruled that the mere fact the a lender received or reviewed a loan modification application was sufficient, in and of itself, to justify an expanded duty of care owed by the lender. In other words, the mere fact that a lender received an application to modify a loan, may justify a court, without limitation except as to what the court may deem reasonable, the opportunity to second guess the processes and criteria adopted by the lender regarding the acceptance or rejection of a borrower's loan modification application. Further, combining the holdings of the *Jolley* and *Rossetta* decisions, it will now be extremely difficult, if not impossible, for lenders to obtain summary judgment in the context of a loan work-out. Although the *Rossetta* decision involved a residential loan, I believe it is foolish for any commercial lender to ignore this ruling and not train its special assets department of the necessity of creating detailed "paper trails" evidencing all communication with its borrowers.

HVCRE Regulations - There will be changes.

Last quarter, the *Clarifying Commercial Real Estate Loans Act, as amended* (H.R. 2148) which is designed to amend the Federal Deposit Insurance Act to clarify capital requirements for HVCRE loan passed the U.S. House of Representatives on a voice vote. About the same time as the passage of H.R. 2148 by the House, the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC), who jointly issued the current HVCRE rule, proposed a replacement of the HVCRE rule with a new rule being billed as HVADC (high volatility, acquisition, development and construction).

In terms of background, the Basel Committee on Banking Supervision (Basel Committee), in response to the 2008 financial crisis, agreed to modify internationally negotiated bank regulatory standards known as the Basel Accords, to increase bank capital requirements. On July 9, 2013, the federal banking regulators, including the Federal Reserve, the FDIC, and the OCC, issued a final rule to implement most of the Basel III recommendations, including modifications to capital requirements.

The Basel III final rule applies to all banks and bank holding companies domiciled in the United States, with some exceptions, and went into effect on January 1, 2015 for most banks. Basel III imposes new rules for high volatility commercial real estate (HVCRE), which the regulations characterize as loans that finance the acquisition, development or construction (ADC) of real property, subject to certain exemptions, such as for the financing of the acquisition, development and construction of one to four family residential properties. All loans that meet the definition of HVCRE are reported separately from other commercial real estate (CRE) loans and are also assigned a risk weighting of 150% for risk-based capital purposes (prior to January 1, 2015, a CRE loan would have typically been assigned a significantly lower risk weight, which, in turn, would lower the capital required to be held by the Bank for such loans). However, if the loan transaction is structured to meet certain requirements under the current HVCRE rules, such as a 15% capital contribution and restrictions on withdrawal of the capital during the life of the project, the Bank gets the benefit of a lower capital requirement.

Based on what I have read to date, most banks and banking groups favor H.R. 2148 which amends the HVCRE requirements, as opposed to the new HVADC which is designed to replace the HVCRE requirements. The original HVCRE rules have been criticized as being ambiguous and not very advantageous for borrowers, since, in some cases, it has forced banks to categorize more loans as being subject to the HVCRE rules that originally intended due to the uncertainty in the law. I understand that one of the key components of H.R. 2148 is that it is designed to more clearly define what constitutes a high volatility ADC loan. Further, the HVADC rule, as presently proposed, eliminates the capital contribution exemption, unlike HR 2148, which seeks to retain and clarify this exemption.

At this time, Congress has not passed H.R. 2148 or the new, proposed HVADC replacement. It will be interesting to see, what if anything, Congress does in 2018 to revise or replace the HVCRE requirements.

Is LIBOR In The Process Of Being Replaced?

As we start 2018, the issues surrounding the future of LIBOR raise more questions than answers for commercial lenders and borrowers.

LIBOR, or the London Interbank Offered Rate, is a benchmark interest rate that banks charge each other for one month, three month, six month and one year loans. LIBOR is calculated from submissions received from individual contributing banking based on the question of what rate would the contributing banks borrow funds were it able to do so by accepting inter-bank offers. Thus, the contributing banks need not base their response from solely existing transactions and the response can be based on subjective interpretation and analysis.

In 2012, investigations began as to whether multiple banks that contributed to the determination of LIBOR were manipulating the LIBOR rates in order to, among other things, better demonstrate the financial stability of the contributing banks, especially during the recession that began in 2008. Based in part on eroding public trust in LIBOR, in 2014, the Federal Reserve Bank convened the Alternative Reference Rate Committee (ARRC) to identify a new alternative to the LIBOR rate used in the United States (USD LIBOR) that would be solely based on actual transactions. Although the ARRC selected a possible alternative to replace LIBOR, the anticipated replacement to LIBOR will not be made available to financial institutions until the end of 2021. Further, although there has been much discussion as to whether LIBOR is in the process of being "phased out" by the end of 2021, at present, to my knowledge, there is no prohibition by any federal authority to the use of LIBOR after 2021 and it is unclear whether any such prohibition to the use of LIBOR will be instituted in the future.

It is critical for financial institutions to now review their loan portfolio, especially those loans based on LIBOR and that have a term extending beyond 2021, because of the possibility of LIBOR "going away", or at least not being a desirable benchmark after 2021. However, in light of the possibility that LIBOR may continue to exist after 2021, it would appear that lenders should insure that for their LIBOR based loans, their loan documents contain "fall back" language regarding the use of an alternative index or indices to protect lenders against not merely the elimination of LIBOR but also for the creation and widespread use of better and more commercially accepted alternative indexes should LIBOR fall into disfavor. Such fall back language should be carefully negotiated and drafted, as unfortunately, I do not believe that there exists "one size fits all" replacement language that would be applicable to all LIBOR based loans.

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