LAW360

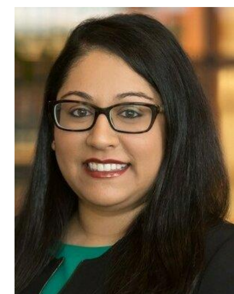
Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

How Lenders And Borrowers Can Prepare For Libor's End

By **Kelly Gelfand Egers, Christopher Clement and Daksha Bhatia**
(March 16, 2023, 1:05 PM EDT)

Kelly Gelfand Egers

Christopher Clement


Daksha Bhatia

Publication of the U.S. dollar London Inter-Bank Offered Rate, also known as Libor, is currently scheduled to end on June 30.

For over 50 years,[1] Libor has served as a benchmark for setting interest rates for floating rate loans and debt instruments around the world. Scandals involving Libor manipulation, however, created calls for a new benchmark.[2]

In response, the Alternative Reference Rates Committee, a group of private debt market participants, was convened by the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York in 2014 to assist in the transition to a new benchmark.

In 2017, the ARRC recommended the Secured Overnight Financing Rate, or SOFR, as an alternative to Libor, advising that SOFR is a "much more resilient rate than Libor because of how it is produced and the depth and liquidity of the markets that underlie it."[3]

While some debt agreements have been amended to provide for a replacement benchmark, it is estimated that, as of early February 2023, about 75% of the U.S. leveraged loan market still needed to transition to a new rate.[4]

To help guide the move away from Libor, on Dec. 16, 2022, the board announced that it had adopted a final rule[5] to implement the Adjustable Interest Rate (Libor) Act, or the Libor Act.[6] The final rule was published in the Federal Register on Jan. 26 and became effective on Feb. 27.

The Libor Act is intended to, among other things, establish a nationwide, uniform process for replacing references to USD Libor in certain existing contracts, such as credit agreements and other loan documents, and preclude certain litigation relating to contracts that reference USD Libor.

The Libor Act also contains a safe harbor that, if applicable, protects certain parties against claims, actions, and damages arising from the use of a board-selected benchmark replacement and the implementation of benchmark conforming changes.[7]

Notably, the Libor Act only applies in specific circumstances, as further described below. Given that most syndicated credit agreements include language addressing the situation where Libor is no longer published, so-called fallback language — including a switch to the Alternate Base Rate based on the prime or federal funds rate — it is anticipated that the Libor Act will not affect such deals unless the fallback language fails to ensure a transition away from Libor, as described below.

The final rule establishes a benchmark replacement for U.S. law-governed contracts that reference overnight, one-, three-, six- or 12-month USD Libor and that do not provide for a clearly defined replacement benchmark.

Under the final rule, the applicable board-selected benchmark replacement, set out below, will replace the corresponding Libor tenor in the following scenarios[8]:

1. Where a contract references Libor and contains no fallback provisions;

2. Where a contract references Libor and contains fallback provisions that do not identify a specific benchmark replacement or a determining person, defined in the final rule as any person with the sole authority, right or obligation, including on a temporary basis, to determine a benchmark replacement, whether or not such person's authority, right or obligation is subject to any contingencies specified in the Libor contract or by governing law; and

3. Where a contract references Libor and contains fallback provisions that identify a determining person, but the determining person has not selected a replacement.

In addition, the Libor Act and the final rule require the following references in any fallback provisions to be disregarded and deemed null and void: a benchmark replacement that is in any way based on any Libor value, except to account for the difference between Libor and the benchmark replacement; and any requirement that a person who is not the benchmark administrator, defined in the final rule as a person who publishes a benchmark for use by third parties, conduct a poll, survey or inquiries for quotes or information concerning interbank lending or deposit rates.[9]

Under the final rule, if a determining person selects the applicable board-selected benchmark replacement, such selection is irrevocable and shall be used in any determination of the benchmark under the applicable contract occurring on and after the "Libor replacement date," defined in the final rule as the first London banking day after June 30, unless the board determines that any Libor tenor will cease to be published or representative on a different date.[10]

The board-selected benchmark replacement shall be made by the earlier of the Libor replacement dates and the latest date for selecting a benchmark replacement according to the terms of the applicable contract.[11]

If an agreement includes a fallback to a specific rate, for example an alternate base rate based on the prime or federal funds rate, then the agreement does not fall into Category 1 above.

Many borrowers under syndicated credit agreements that predate the inclusion of reference rate replacement provisions will likely be disappointed by this outcome, given that the borrowing costs under an Alternate Base Rate are typically much higher than those under Libor or Term SOFR.

Under Category 2 above, generally, the fallback provisions are defective because they either do not actually identify a replacement or do not establish a person as having sole authority to select a replacement.

Under Category 3 above, although there is a fallback provision, the determining person has not completed its task of selecting a replacement. In such events, the Libor Act would apply to replace Libor, despite there being a fallback provision in the agreement. However, note that parties to a contract may agree in writing that the contract is not subject to the Libor Act.[12]

With respect to Libor contracts that are not derivative transactions, consumer loans, Federal Housing Finance Agency-regulated entity contracts, or Federal Family Education Loan Program Asset-Backed Securitizations, benchmark replacements under the final rule will become effective on the Libor replacement date, include the one-, three- and six-month credit spread adjustments, or CSAs, recommended by the ARRC, and are as follows[13]:

LIBOR Tenor	Replacement + CSA
Overnight	Secured Overnight Financing Rate ("SOFR") + 0.00644%
One month	One-month CME Term SOFR[14] + 0.11448%
Three month	Three-month CME Term SOFR + 0.26161%
Six month	Six-month CME Term SOFR + 0.42826%
Twelve month	Twelve-month CME Term SOFR + 0.71513%

It is expected that the benchmark replacement provisions of the Libor Act will have little impact on the syndicated loan market, given that even loans that predate the inclusion of reference rate replacement provisions typically include a fallback to an Alternate Base Rate, which would be an acceptable fallback under the Libor Act.

However, even if the Libor Act applies to a particular contract, the borrower may seek to amend its agreement now in advance of the Libor replacement date. Borrowers may be interested in switching away from Libor to the extent they can achieve an overall interest cost that is lower than they would incur if their agreement becomes subject to the Libor Act.

While SOFR has historically been lower than Libor, at least during the five-year lookback period that the ARRC used to determine the recommended CSAs, in a floating rate loan, the benchmark is only one component of the borrower's overall interest cost.

When a replacement reference rate is lower, the overall interest paid by the borrower would be reduced unless some other mechanism makes up for the difference between the two benchmarks.

The ARRC-recommended CSAs are intended to do just that and were computed based on historical five-year median spreads between USD Libor and compounded averages of SOFR.[15]

As noted above, the Libor Act locks borrowers into the CSAs recommended by the ARRC. Therefore, borrowers looking to negotiate a lower CSA, and thereby achieve a lower cost compared to the outcome under the Libor Act, would need to amend their agreements soon, before the Libor Act — if applicable — ties them to the ARRC-recommended CSAs.

At times, the U.S. leveraged loan market has adopted alternatives to the ARRC-recommended CSAs when shifting to Term SOFR in so-called amendment approach contracts that do not include

"hardwired" CSAs, with some Libor transition amendments including lower CSAs or even in some instances no adjustment.

However, more recently, lenders have become more resistant to amendments that do not include a CSA or that include a CSA that they believe is too low, which may make it more difficult for borrowers to achieve their desired result.[16]

The U.K.'s Financial Conduct Authority has announced that, subject to consultation, it intends to publish a synthetic version of USD Libor on a nonrepresentative basis,[17] meaning that synthetic USD Libor will not represent what the rate otherwise would have been if it had continued to be published.

If synthetic USD Libor is published, it is anticipated to be available for one-, three- and six-month tenors after June 30 and through the end of September 2024.

Although neither the decision to publish synthetic USD Libor nor its format are final, it is expected to be the same as the one-, three- and six-month tenor replacements noted in the table above, including the applicable CSAs, i.e., CME Term SOFR plus the applicable ARRC-recommended CSAs.

Whether synthetic USD Libor may be used by borrowers will vary depending on the Libor transition language in the applicable contract, as well as the drafting around the Libor provisions in the applicable contract, and should be closely reviewed with counsel.

With just over three months until the deadline, time pressure is increasing on borrowers and lenders to ensure their loans will continue to function smoothly. All debt agreements that reference Libor should be reviewed with counsel, and prompt action should be taken to provide for a replacement benchmark rate and a road map for dealing with the impending cessation of Libor.

Kelly Gelfand Egers is counsel, Christopher Clement is a partner and Daksha Bhatia is knowledge management specialist at Cahill Gordon & Reindel LLP.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of their employer, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] See https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr667.pdf.

[2] See https://www.forbes.com/advisor/investing/what-is-libor/.

[3] See https://www.newyorkfed.org/arrc/sofr-transition.

[4] See https://news.bloomberglaw.com/bankruptcy-law/scuffle-in-us-leveraged-loan-market-slows-down-libor-transition.

[5] Final Rule: https://www.federalregister.gov/documents/2023/01/26/2023-00213/regulations-implementing-the-adjustable-interest-rate-libor-act#:~:text=Overview%20of%20the%20Final%20Rule,clear%20and%20practicable%20benchmark%20replacements.

[6] Libor Act: https://uscode.house.gov/view.xhtml?path=/prelim@title12/chapter55&edition=prelim.

[7] See Libor Act Section 5804 and Final Rule Section 253.7.

[8] See Final Rule Section 253.3.

[9] See Libor Act Section 5803(b) and Final Rule Section 253.3(a)(2).

[10] See Final Rule Section 253.2. The adopting release for the Final Rule states that the "Board has not determined, and does not expect to determine, a Libor replacement date earlier than the first London banking day after June 30, 2023"; see footnote 21 in Supplementary Information section of Final Rule.

[11] See Final Rule Section 253.3(c).

[12] See Final Rule Section 253.1(c) and Libor Act Section 5803(f).

[13] See Final Rule Section 253.4 and Libor Act Section 5802(20).

[14] "CME Term SOFR" refers to Term SOFR as published by the Chicago Mercantile Exchange.

[15]
See https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_Spread_Adjustment_Consultation_Follow_Up.pdf.

[16] See https://www.bloomberg.com/professional/blog/debt-investors-losing-millions-on-libor-switch-start-to-fight-back/.

[17] See https://www.fca.org.uk/publications/consultation-papers/cp22-21-synthetic-us-dollar-libor#revisions.