Transitioning Away from LIBOR: A Constantly Shifting Landscape

I. What's the issue?

The London Interbank Offered Rate ("LIBOR") is the most widely used interest rate benchmark in the world, referenced in some $373 trillion notional value of financial transactions of all types. But in light of the various price-fixing scandals surrounding LIBOR and the limited activity in the London interbank market, the U.K. Financial Conduct Authority ("FCA") announced in 2017 that it will no longer sustain the publication of LIBOR as a reference rate by the end of 2021. LIBOR's administrator now plans to retire 3-, 6-, and 12-month U.S. dollar LIBOR in late June 2023, while leaving in place the end-of-2021 retirement date for 1-week and 2-month U.S. dollar LIBOR and for all LIBOR settings in British pounds, euros, Swiss francs, and yen. U.S. regulators have encouraged banks to transition away from LIBOR "as soon as practicable."

LIBOR's discontinuation poses risks to parties to all financial instruments—derivatives, bonds, loans, mortgage-backed securities, collateralized loan obligations, and more—that are linked to LIBOR or similar regional benchmark rates. Most market participants did not anticipate that LIBOR would be discontinued. Accordingly, many financial transactions provide no contractual fallbacks, or the fallback provisions in place may not effectively cover LIBOR's discontinuation. Michael Held, General Counsel at the Federal Reserve Bank of New York, summarized this as "a DEFCON 1 litigation event if I've ever seen one." Given the high stakes and risks to the financial system, the State of New York and the European Union have recently adopted measures to address the problems facing "tough legacy" contracts—that is, pre-existing contracts that reference LIBOR but do not provide for a viable fallback reference rate in the event of LIBOR's cessation. These measures seek to migrate certain contracts to their respective regulators' recommended replacement benchmark, and thus to reduce the uncertainty and litigation risk surrounding LIBOR's cessation. Other jurisdictions are following hot on their heels in taking the same approach. The LIBOR transition nonetheless faces potentially contentious disputes and litigation.

II. Haven't regulatory actions resolved this already?

Since LIBOR's discontinuation was first announced, growing alarm bells have been sounded in the halls of many industry groups, regulatory bodies, and legislative chambers. This has resulted in various off-the-shelf solutions—some voluntary, some by operation of law.

For instance, New York Senate Bill 297B/Assembly Bill 164B, signed into law April 6, 2021, attempts to provide a "safe harbor" fallback provision for certain "tough legacy" contracts. This law tracks the model transition law championed by the Alternative Reference Rates Committee, a group convened by the Federal Reserve Board and the New York Fed to work on LIBOR transition issues. The New York law generally provides that contracts that reference USD LIBOR with no viable express fallback provision will be deemed, by operation of law, to instead reference the "recommended benchmark replacement." The New York law adopts the Secured Overnight Financing Rate ("SOFR") as the replacement benchmark. A "safe harbor" is created for those that implement the recommended benchmark replacement in qualifying contracts—meaning, parties to a relevant contract are barred from declaring a breach or refusing to perform as a result of a qualifying contract being transitioned to SOFR.

Other efforts are ongoing to force a single solution onto the marketplace. In the United States, lobbying has shifted to Congress, for a federal law to cover contracts that are outside the reach of New York law. Efforts are ongoing to similarly create safe-harbor types of solutions pointing to other alternative rates, such as the Sterling Overnight Index Average ("SONIA") in the United Kingdom. On February 13, 2021, the European Union, by way of an amendment to its Benchmark Regulation ((EU) 2016/1011, the "BMR") empowered the European Commission to select alternative benchmarks for tough legacy contracts governed by EU member state law and which do not already contain fallback provisions. This ensures contractual continuity, though notably the legislation falls short of expressly providing a safe harbor from civil claims as seen in the New York law. These alternative benchmarks will come into force on the occurrence of certain pre-defined trigger events, and the precise rate(s) used will be the subject of consultation with various industry bodies and other stakeholders. The European regime has extraterritorial effect, in that it will also be relevant to contracts which are not governed by EU member state law, but where the contracting parties are based in the EU and the governing law of the contract does not provide for an equivalent fallback mechanism to that now provided by the BMR. In the United Kingdom, a legislative solution with many features similar to the New York approach is progressing through the legislative process and is expected to be brought into U.K. law later in 2021.

Beyond these legislative and regulatory solutions are efforts to organize a voluntary transition. The FCA has issued guidance to regulated firms on the planned transition from LIBOR to SONIA, while the Bank of England has published considerations regarding "the conduct of consent solicitations to transition English law legacy bond contracts from LIBOR to SONIA." In Switzerland, the Financial Markets Authority has been urging market participants to address the risks arising from the discontinuation of LIBOR and warned banks about litigation risks arising from legacy contracts. The International Swaps and Derivatives Association ("ISDA") published its IBOR Supplement and Protocol in October 2020. These documents, which have been the subject of extensive consultation, allow market participants to adhere to the terms of the Supplement *in toto*. If counterparties take that route—reportedly some 14,000 have signed on with ISDA as "adhering parties"—they will be subject to the hard-wired fallback regime provided for therein, including the prospect of a credit spread adjustment to help ensure that the replacement reference rates exhibit similar features to the IBORs they replace at longer-dated tenors. Those spread adjustments were set following announcements in March 2021 as to the projected cessation date for various reference rates. ISDA has also provided *pro forma* documentation allowing parties to agree to bespoke bilateral arrangements with their counterparties in relation to LIBOR issues. It is inevitable, given the diversity of products in the derivative market, that some counterparties will want to take a bespoke approach. But in any event, the ISDA approach is purely *voluntary*—if one side or the other does not assent to the amendments, they do not take effect, unless required to by an applicable legislative or regulatory mechanism.

III. So what's left to worry about?

Plenty. It is true that legislative and regulatory efforts—past, ongoing, and anticipated—suggest that the situation will not be as chaotic as many initially feared. The additional lease on life given to certain tenors of U.S. dollar LIBOR, specifically, will also help. Still, as some questions get answered, others get raised. Until *all* contracts have actually been migrated away from LIBOR, vigilance in this constantly shifting landscape is necessary to ensure parties do not get taken advantage of—or find themselves on the wrong end of a lawsuit.

Do I have contracts that are not "saved" by an applicable safe-harbor type of legislation? Most fundamentally, owing in part to just how widely used LIBOR was (and is) worldwide, there is no single legislative solution that will apply to everyone's contracts. Some types of contract will likely fall through the cracks, intentionally or unintentionally, of various "solutions." And while legislatures appear to be cognizant of the other actors moving in this space, one can readily imagine situations arising where the parties dispute *which* legislative solution actually governs the situation.

An examination of the New York legislation confirms that most large investors will not be able to simply presume that everything they have will be taken care of in one fell swoop. Most obviously, this is because the law only applies to contracts governed by New York law. While many financial contracts expressly adopt New York law, many do not. Just as importantly, the recent New York legislation covers only contracts that reference *USD* LIBOR. So contracts that instead rely on LIBOR for other currencies are not covered by that law. Those with LIBOR contracts thus will need to ascertain both what law governs the contracts *and* what rates those contracts reference, before even knowing if the New York legislation is even possibly applicable. Disputes may arise as to choice-of-law issues, as well as how to apply "safe harbor" laws in complex financial arrangements, such as where the contracts use both USD and other currency LIBORs in the same relationship.

By way of another example, the New York legislation limits the substitution of SOFR only where the contract at issue contains no fallback provisions, or if the fallback provisions themselves are "based in any way on any LIBOR value." Investors thus cannot presume that their USD LIBOR-referencing New York contracts will, in fact, transition to SOFR. They need to analyze whether their contracts have instead already provided for something else. Disputes may arise as to whether a given contract already provides its own fallback so as to avoid the imposition of SOFR onto the parties.

Do I want the replacement rates? Even presuming every contract is going to be eventually covered by a solution chosen by someone else, investors need to ask if that is their desired outcome. The LIBOR alternatives are, of course, not LIBOR. They are measured differently, and thus behave differently, from LIBOR. SOFR, for example, is based on actual prices for collateralized funding through the U.S. repo market, rather than borrowing rates (often estimates) in the London interbank market. As a result, SOFR is generally lower than LIBOR, and more volatile. (For instance, during the COVID-19 pandemic SOFR fell to just 0.01% in late March and early April 2020.) There will naturally therefore be winners and losers from the move to these new rates. If the legislative solutions that exist, or are in the works, do not fit the investor's financial needs, then as an economic matter the investor should be looking to restructure or get out of contracts that are going to force it into those sub-optimal "solutions."

Do I have accounting, tax, or other obligations? There are also other considerations related to financial preparations for rates forced into a party's contracts by legislative action. Disclosure or other accounting-related issues might come into play if the financial side of a business is expected to operate or perform differently due to the transition. Tax or other accounting issues might also arise if one financial instrument no longer is a viable "hedge" to another after the transition than it was before it.

IV. I have a contract not governed by any legislative "fix." What's the worst that can happen?

There are many situations, ranging from the simple to the complex, where the cessation of LIBOR could create thorny legal questions about the enforceability of "legacy" contracts. We give some examples below. In practice, certain people's contracts involved in scenarios like these will fall into legislative fixes like those discussed above. But it is still important to understand the underlying problems those legislative acts are trying to solve, both to analyze whether deferring to those solutions is in each party's interest, but also to help issue-spot problems for contracts that end up falling through the cracks of the various legislative efforts.

A Single Revolving Credit Facility and Other "Simple" Scenarios: A borrower has a revolving credit facility that references LIBOR plus a spread. Similar to Loan Market Association terms, the facility contains language that, if three-month LIBOR is not published, the rate reverts to "the cost to the relevant Lender of funding its participation in that Loan from whatever source it may reasonably select." None of the relevant contracts fit into any legislative solution.

Initially, there may be a question whether the fallback provision is even capable of practical application on a permanent basis. Even if it is, in certain jurisdictions the parties may ask the more fundamental question of whether the express mechanism was truly intended to govern where LIBOR has permanently ceased, rather than to govern only where LIBOR's publication is temporarily interrupted. Parties in certain jurisdictions may even argue that LIBOR's unexpected failure means the parties' obligations to each other should cease entirely, due to such doctrines as mutual mistake, frustration of purpose, or other legal excuses to performance.

Counterparties will often have opposing financial interests in determining which arguments to advance. If the lender uses customer deposits to fund its lending activities, the "cost of funds" alternative could be consistently below LIBOR. The lender may argue that adopting the fallback mechanism on a permanent basis would thus create an unjustified windfall to the borrower.

The parties' behavior in negotiating and navigating these issues could also give rise to disputes. For instance, if a group of similarly situated, powerful parties try to coordinate a response or otherwise strong-arm clients into their preferred solution, such acts could give rise to antitrust or other concerns. How these issues are resolved (or litigated) will depend on the particular lending market in question. For example, the players and interests involved in the leveraged loan market are markedly different from those at play in the residential mortgage market.

Derivatives, Hedges, and Basis Trades: Assume a plain vanilla 15-year fixed-for-floating interest rate swap referencing LIBOR. The swap is governed by the 2006 ISDA Definitions, which, generally speaking, require the floating rate index to be gleaned from a poll of certain banks in the event LIBOR is not published. The swap is a hedge for interest obligations under a bilateral loan, which also references LIBOR. The loan provides fallback language based on the lender's "cost of funds" as per the loan agreement example above. None of the relevant contracts fit into any legislative solution.

As in the prior example, the parties may disagree as to whether the contractual fallback provisions should govern after LIBOR ceases to be published. As to the swap, the parties could agree to be bound by the IBOR Supplement and Protocol which would, at least, ensure the smooth passage to a new reference rate at a given date. However, that is a *voluntary* solution. One party or the other may find it advantageous to refuse to adhere to the Supplement and Protocol (in whole or in part), particularly if the swap is deeply out-of-the-money. If refused, the courts will be faced with resolving the relevance of an industry standard created in 2020 for the purpose of interpreting contracts formed years earlier.

This scenario is also complicated by the existence of two related transactions. A divergence between how interest is calculated on an obligation (the loan) versus how interest is calculated on the instrument intended to hedge the obligation (the swap) will impact the effectiveness of the intended hedge. That will be so even if ISDA's proposed solution is adopted by the parties. This could not just create unintended economic risk; it could cause larger tax, accounting, and other issues. Coverage ratio issues could arise, and parties may inadvertently be deemed to run afoul of their own investment guidelines if the swap is no longer an effective hedge. A party attempting to remain hedged may want to ensure any amendments to one transaction are mirrored in the other. It may be more likely to succeed, either by negotiation or in litigation, where the related instruments were done as a package with a common counterparty.

The potential challenges of the LIBOR transaction increase as structured transactions grow more complex, such as: when a party's actions have downstream effects through a total return swap; when option features give rise to valuation uncertainties that are highly sensitive to LIBOR and its successor rates; or when less liquid products must be marked to market.

Secondary-Market Transactions: A portfolio of 30-year debt instruments is acquired from a financial institution. The debt instruments bear interest rates referencing 12-month LIBOR plus 300 basis points. The purchase agreement contains provisions that the acquirer "has relied solely on information disclosed to it by the Seller in the Data Room [which included all the debt instruments]" and that, "[s]ave for fraud, the Acquirer releases the Seller from any and all liability arising from the Transaction." None of the relevant contracts fit into any legislative solution.

This scenario adds issues arising from the involvement of another actor—the seller of the loans. The purchase agreement in this scenario is on "seller friendly" terms, but that may not prevent accusations that the seller failed to disclose the risks associated with LIBOR cessation, including what it knew about whether borrowers were expecting their obligations to be governed by some fallback language, by an industry-standard alternative rate, or something else. Similar issues may arise when loan servicing rights change hands, as servicers are responsible for the collection and payment of interest.

Similar disclosure issues may arise in mergers and acquisitions, where the entity being acquired has a significant portfolio of LIBOR-linked instruments. The parties may dispute whether or not standard form warranties and indemnities are sufficient to cover all LIBOR-transition related issues. In an extreme scenario, a party may assert that the LIBOR transition, or a botched attempted transition, could trigger a right to revisit the deal's terms under a "material adverse change" or similar provision.

Generalizing this point more fully, *anybody* involved in LIBOR-linked transactions should be assessing whether they have exposure to, or themselves hold claims arising out of, misrepresentation or omission allegations. For example, a publicly traded company that holds a material amount of LIBOR-referencing investments should consider not just the accounting, tax, financial, legal, or other risks of the LIBOR transition, but also whether those risks have all been adequately disclosed.

Bonds, CLOs, RMBS, and Other "Deadlocked" Scenarios Involving Multiple Parties: A company buys a 15-year investment-grade bond from an infrastructure company that refers to 6-month LIBOR. The issuer is seeking to amend the terms of the bond so that it refers to SOFR plus an additional spread. In many situations like this, a change would require the consent of at least a majority of the bondholders. The terms also include a "sweeper" clause which binds the minority of bondholders who do not consent to the change. None of the relevant contracts fit into any legislative solution.

Practically speaking, an issuer seeking to amend the terms of its bond indenture will need to offer bondholders terms that are attractive enough to get them to agree to an amendment—presumably, something that is expected to track the investor's LIBOR-based expectations. But an issuer may find it difficult to reach the required minimum level of support even when offering what it sees as fair terms, particularly in situations where the impacted parties do not share equally in the risks of the amendment.

Even if the issuer is able to reach an agreement with the required number of stakeholders, those who disagree may still consider whether they have a legal right to challenge the amendment, either on substantive grounds (the terms are unreasonably oppressive to a minority) or on procedural grounds (whether sufficient notice given, whether the disclosures adequate, etc.). If no amendment can be worked out voluntarily, debates along the lines discussed above would be carried out, circling around the parties' reasonable intent. What may be different here is that it may not be that everyone who feels aggrieved will have privity of contract with all of the other relevant actors. Breach of duty claims, fraud/securities fraud claims, and unjust enrichment claims may here be the focus of any disputes that turn into litigation.

A similar deadlocking scenario could arise with respect to **Collateralized Loan Obligations ("CLOs")**, given the large number of stakeholders in such instruments, and the differential impact an alternative rate might have on different CLO tranches.

Residential Mortgage-Backed Securities ("RMBS") and **Commercial Mortgage-Backed Securities ("CMBS")** are debt instruments under which the noteholder is often entitled to payments linked to LIBOR, backed by a pool of underlying mortgages whose borrowers must make payments linked to LIBOR. Borrowers, master servicers, investors, government-sponsored enterprises, and other parties involved may have diverging interests with respect to what the replacement rate should be used, either at the loan or the note level. As in the examples above, contractual rights here are more likely to mix with tort-like analyses. RMBS may present a particularly messy scenario, given that the security may be backed by loans from many different underlying lenders, making it all the more difficult to get agreement in a cost-effective way. Loan servicers may find themselves caught in the middle, facing restrictions on their ability to modify loans, as well as an ongoing obligation to collect and remit interest payments. These issues could heighten the risk of large middlemen colluding or otherwise strong-arming other actors.

V. What Should You Be Doing, and How Can Quinn Emanuel Assist?

The impact of the LIBOR discontinuation and transition to alternative reference rates can hardly be overstated. There are still many moving parts, and significant uncertainty as to the passage of legislative solutions which in any event will be of varying degrees of relevance to different market participants, have the capacity to conflict with each other, and are not straightforward to implement in practice. In light of the significant potential for economic loss and disputes over the proper interpretation of LIBOR linked contracts, the time to manage litigation risk in preparation for the post-LIBOR world is **now**. There are likely to be significant financial rewards for those who do their homework and can thus act decisively, and potentially grave consequences for those who choose to ignore the impending change.

Quinn Emanuel can assist in (i) **identifying** any transactions referencing LIBOR, (ii) **considering** the practical and legal ramifications of the transition for those transactions, (iii) **advising** on the current state of legislative solutions in various jurisdictions and how those will apply to any given situation, (iv) **moving** your counterparties to come up with solutions to avert or ameliorate any negative implications, and also (v) achieving the best solution for you in **negotiations** with your counterparties and **in the courtroom**.

With our expertise in the most complex, high-stakes disputes in the banking sector on both sides of the Atlantic and in Asia, we are perfectly placed to assist clients in developing a global strategy to address the upcoming LIBOR discontinuation.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to reach out to:

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