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Published by Financier Worldwide Ltd

SPECIAL REPORT ARTICLE June 2021

The end of LIBOR: near-term litigation over historical LIBOR 'fallback' rates

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The London Interbank Offered Rate (LIBOR) has been referred to as "the world's most important number". However, it is now common knowledge that LIBOR will be phased out in the coming years.

In many instances, legislation, industry group momentum, and other market forces may resolve issues regarding replacement of contractual interest rates once LIBOR is no longer available. For example, the State of New York recently passed legislation directed at resolving the replacement interest rate for New York law-governed financial contracts that do not specify a rate when LIBOR is unavailable. In other instances, parties entering into contracts after the UK Financial Conduct Authority (FCA) announced LIBOR's impending cessation have agreed upon terms to replace the benchmark.

But what is to become of contracts where the parties agreed on a fallback interest rate if LIBOR cannot be ascertained, particularly in instances where the parties did not know that LIBOR would become permanently unavailable? Recent legislative solutions have not addressed these contractual provisions. Moreover, in some instances, the agreed fallback interest rates in these contracts – which may be tied to a bank's 'base rate' – are hundreds of basis points higher than recent historical LIBOR. Will those fallback rates apply, and in what circumstances? How will this be resolved?

Counterparties to those contracts should anticipate disputes ahead. Below, we discuss the fights that may loom and how counterparties might prepare for the same.

What is a 'fallback' interest rate?

A fallback provision resolves the replacement interest rate in case a benchmark, like LIBOR, is not available. As the market has prepared for the permanent unavailability of LIBOR, many parties have included detailed provisions to resolve the interest rate when LIBOR is no longer available.

But many older contracts included fallback rates before the FCA contemplated, or in some instances a counterpart recognised, LIBOR's impending permanent unavailability. Some examples of these types of contracts are outlined below.

Converting to alternate base rate advance. In this scenario, a temporary inability to ascertain LIBOR would lead to an automatic conversion to an alternate base rate advance (which is often times significantly higher than the previously agreed rate). Such contract language could look like: "If Lender notifies [the borrower] that due to circumstances affecting the London interbank market for US dollar deposits there are no adequate and reasonable means to ascertain the LIBOR Rate, then, on such day, the LIBOR Rate Advance will automatically convert to an alternate base rate Advance (and [the borrower] will accept such conversion) until Lender notifies [the borrower] that the circumstances causing such suspension no longer exist".

Another instance of this language would look like: "[If] the LIBOR Rate cannot be determined … any pending request for a borrowing of, … conversion to or continuation of LIBOR Rate Loans … will be deemed to have converted … into a request for [an Alternate Base Rate] Loan".

In other types of agreements, the fallback rate would be determined not just by looking to a specified, different rate, but rather though a multistep process which sometimes requires the consent of all parties. On some occasions, a lender would have to run the process in a 'commercially reasonable' manner.

Regardless of the form the fallback provision takes, in almost all cases the market participants' reading thereof will generally align with their economic interests.

Anticipated disputes

Where the fallback rate shifts the financial terms of an agreement, market participants are likely to clash over the fallback rate's meaning.

On one hand, contractual counterparties benefitting from the higher fallback interest rate will say that sophisticated parties, represented by counsel, agreed to the fallback rate and this unambiguous term applies no matter what causes LIBOR to be unavailable.

On the other hand, parties adversely affected by the contract's higher fallback rate will say exactly the opposite: they will claim that that the provision, on its face, unambiguously shows that the parties included this provision solely to address the temporary unavailability of LIBOR – for example due to technical issues or natural disasters – rather than the complete end thereof.

These parties might argue, alternatively, that the contract is ambiguous, necessitating consideration of evidence outside the contract. These parties would likely try to point to evidence regarding the parties' expectations at the time the contract was drafted or seek to introduce expert evidence as to market understanding of temporary fallback rates.

What steps should market participants take?

Parties to contracts tied to LIBOR should analyse such contract now to determine whether the contract includes a fallback provision and its financial impact.

Parties that benefit from such fallback rates may wish not to take any action and, instead, simply apply the higher rate when LIBOR concludes. To take things one step further: if the contractual language is strong enough, some parties may even consider increasing their investments in debt where the interest rate might shift favourably when LIBOR ends. If there is a multistep process to set the replacement rate, such parties will want to ensure that they meticulously comply with all requirements – procedural or otherwise – to protect themselves as much as possible from the risk of litigation.

Parties that stand to lose from such fallback rates, on the other hand, should assess their options should they be unable to agree with their counterparty regarding the replacement rate in the near term or obtain the necessary consents in multiparty contracts. Further, to the extent that third parties or industry groups are required to be consulted, parties should ensure that those entities are consulted as early as possible to avoid further delays.

If no satisfactory resolution can be reached through negotiations, these parties may wish to consider bringing a suit well before LIBOR's end to seek to confirm that their fallback rate applies only where LIBOR is temporarily, rather than permanently, unavailable. As LIBOR's final end approaches, lenders will have more leverage. Once LIBOR ends, borrowers should expect lenders to: (i) threaten to declare the borrower in default should it refuse to pay the higher fallback rate; and (ii) claim that, upon such a declaration, the lender is entitled to exercise various default remedies (including the right to apply a higher 'default' interest rate or accelerate the debt).

A declaration of default could yield severely negative collateral effects. For one, a borrower's options often become severely limited once a lender declaration of default is imminent. Borrowers often have multiple financing facilities, and a default in one facility may yield cross-defaults in others, which can be catastrophic. Consequently, if the borrower waits until LIBOR is unavailable, it may be forced to pay the higher rate while in the process of challenging it. Particularly if the borrower is facing financial strains, even temporarily paying the higher rate while litigation progresses can present significant cash flow challenges.

Moreover, borrowers in some instances may find it procedurally difficult to challenge, on an urgent basis, the imminent application of a higher rate. Under the law applicable in many US jurisdictions, such as New York, a party seeking injunctive relief generally needs to demonstrate that it would be irreparably harmed absent such relief (typically this means harm beyond monetary damages). This means the plaintiff often has to clear a higher bar than merely proving that the fallback rate does not apply if LIBOR is permanently unavailable. And as anyone working under a tight deadline has experienced, exigent applications create additional pressures for business teams and legal departments.

Where the fallback rate is to be determined through a process, invoking that process early or seeking to obtain confirmation about how the process will run could provide borrowers with better negotiating positions. In the case of negotiations failing, borrowers would then be better positioned to show a dispute requiring judicial intervention.

Conclusion

The approaching end of LIBOR will create significant bumps in the road for involved parties. Legacy contracts with fallback provisions that alter the current contract's economic terms represent one such bump. Parties are well-served to prepare now to protect their financial interests. ■

This article first appeared in the June 2021 issue of Financier Worldwide magazine.

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