Professional Perspective

Global LIBOR Legislative Solutions

Contributed by Lisa Fried, Marc Gottridge, Rupert Lewis, Ceri Morgan & Jenny Stainsby, Herbert Smith Freehills

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The London Inter-Bank Offered Rate (LIBOR), long the preeminent global interest-rate benchmark, ended as of Dec. 31, 2021, in nearly all currencies and tenors (maturities)—and although regulators granted U.S. dollar LIBOR in several tenors a temporary reprieve, it too is scheduled to end after June 30, 2023. The transition from LIBOR to rates such as the Secured Overnight Financing Rate (SOFR) for U.S. dollars and the Sterling Overnight Interbank Average (SONIA) for Sterling has largely been successful.

Legislators and regulators, however, are understandably concerned about the potential disruption of contractual continuity and litigation risk posed by so-called "tough legacy" contracts. These are financial instruments that incorporated LIBOR as a term for the payment of interest but lacked a workable (or in some cases, any) "fallback" rate to replace LIBOR in the event of its unavailability or cessation. We summarize below the legislative and/or regulatory solutions that several jurisdictions have adopted to mitigate the risks raised by tough legacy contracts, all aimed at ensuring contractual continuity and reducing litigation risk. We also identify coverage gaps and potentially inconsistent approaches.

In April 2021, the New York legislature amended the state's General Obligations Law specifically to address the end of U.S. dollar LIBOR, and on March 15, 2022, President Joe Biden signed federal legislation which is substantively nearly identical to the New York law. The new federal statute pre-empts New York and other state laws on the subject.

In the U.K., the Financial Services Act 2021 granted new and enhanced powers to the Financial Conduct Authority (FCA) to manage the wind-down of LIBOR in various currencies, and in December 2021, the Critical Benchmarks (References and Administrators' Liability) Act became effective. Meanwhile, in the EU, amendments to the Benchmark Regulation 2016/1011 came into force in February 2021.

These developments are welcome and should go far to promote contractual continuity and reduce litigation risk. Nevertheless, gaps in the coverage of the legislation enacted to date remain. For example, the recently enacted U.S. legislation does not reach contracts incorporating LIBOR in currencies other than US dollars. The U.K. legislation applies only to English (or other U.K.) law agreements.

Although the FCA's statutory authority to decree a "synthetic LIBOR" solution at LIBOR's source extends to U.S. dollar LIBOR, thus far it has only taken that step in respect to sterling and Japanese yen LIBOR. Moreover, because these legislative fixes necessarily change the interest rates payable under legacy contracts incorporating LIBOR, parties disadvantaged by the transition will be motivated to bring claims—and may seek to exploit perceived gaps in, or inconsistencies between, different jurisdictions' legislation.

The Problem

Many contracts and financial instruments, mainly entered into years before LIBOR's termination was contemplated, incorporate LIBOR as a term but lack provisions to replace LIBOR with a different rate in the event of LIBOR's unavailability or permanent cessation. Some contain no fallback in the event that LIBOR is no longer published, while others contain fallbacks that are not workable, such as a provision for a LIBOR-like polling of reference banks for their cost of funds.

Still others contain "fallbacks" that on their face could dramatically alter the economics of a transaction—e.g., by requiring reversion to the last available LIBOR screen rate or last published LIBOR. And although many "legacy" contracts lacking practical fallbacks have been or may yet be amended through negotiations between the parties, that is not always possible. In some cases, parties may be unwilling or unable to negotiate an amendment. For instance, a negotiated amendment is unlikely for issuances of floating rate debt securities whose terms require the unanimous consent of widely dispersed classes of holders.

The persistence of such tough legacy contracts after LIBOR's discontinuance creates the potential for litigation and market disruption. Parties to such contracts may advance in court arguments based on frustration of purpose, force majeure, impossibility or impracticability of performance and the like.

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That could leave counterparties uncertain as to whether they are still subject to binding obligations and if so, on what terms—and saddle them with significant litigation expense. Although the extension of the end-date for U.S. dollar LIBOR in the most frequently used tenors, until after June 30, 2023, undoubtedly has reduced the scope of the problem, significant risks remain.

Accordingly, legislators and regulators in several jurisdictions have proposed – and in some cases enacted—legislative and regulatory fixes aimed at closing the contractual gaps created by LIBOR cessation reducing uncertainty and minimizing litigation risk.

The Fixes

Legislators in the U.S., U.K. and EU have enacted or proposed statutory fixes that vary in scope and effect. The differences include the scope of the new laws and how and to what extent they promote contractual continuity and protect parties from litigation risk.

The U.S.

The recently enacted federal statute—the Adjustable Interest Rate (LIBOR) Act—and previous state laws were strongly supported by the Alternative Reference Rates Committee (ARRC), convened by the Federal Reserve Bank of New York, which proposed SOFR. The U.S. legislation promotes contractual continuity and creates a litigation safe harbor in certain circumstances—i.e., where SOFR-based replacement benchmark rates replaced LIBOR, either by operation of the new law, through amendments agreed by the parties, or by decision of a "determining person"—e.g., a trustee or calculation agent having contractual authority to determine a replacement rate.

Where LIBOR is thus replaced by the "[Federal Reserve] Board-selected benchmark replacement" rate—i.e., SOFR plus an applicable spread—that replacement is deemed a "commercially reasonable replacement for and a commercially substantial equivalent to LIBOR," and a "reasonable, comparable, or analogous rate, index, or term for LIBOR" in respect of the affected contract, security, or instrument. These provisions go far to guarantee continuity of contract.

The new federal law also expressly creates a safe harbor against litigation. Replacing LIBOR with the "Board-selected benchmark replacement" rate in the circumstances specified in the statute does not: discharge or excuse performance "for any reason, claim, or defense"; justify the termination or suspension of a party's performance; constitute a breach of contract; or void or nullify any contract, security, or instrument.

The federal legislation automatically invalidates contractual fallback provisions that are based on U.S. dollar LIBOR, or involved polls, surveys, and inquiries. Where such a provision is thus invalidated, or where a contract subject to the law contained no fallback provision at all, SOFR plus a spread adjustment—the "Board-selected benchmark replacement" – automatically becomes the fallback.

These changes are effective on the "LIBOR Replacement Date"—i.e., they took effect after Dec. 31, 2021, for 1-week and 2-month U.S. dollar LIBOR, and will apply after June 30, 2023, for U.S. dollar LIBOR in all other tenors. The legislation does not affect contracts with fallback provisions not based on either LIBOR or on polling or similar methods—e.g., contracts reverting to a base or prime rate.

The Adjustable Interest Rate (LIBOR) Act authorizes "determining persons" to select the recommended benchmark replacement and encourages such trustees and agents to use that authority. If a determining person adopts the "Board-selected benchmark replacement," the statute provides for continuity of contract and a safe harbor from litigation; that provision was triggered by the FCA's 2021 declaration that USD LIBOR was unrepresentative.

To be clear, the "determining person" is not required to use the "Board-selected benchmark replacement" and is free to choose another benchmark instead – but in that event, the "safe harbor" terms would not apply. Furthermore, if a determining person fails to select a benchmark replacement by a certain date, "the Board-selected benchmark replacement on and after the LIBOR replacement date, shall be the benchmark replacement for the LIBOR contract."

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The EU

For ease of reference, we will compare the EU (and below, the U.K.) legislative solution with U.S. federal law. It is worth noting that the EU and the U.K. frameworks are drafted in general terms to cater for any benchmark in cessation (meeting certain criteria), but we focus here on their application to LIBOR.

The EU legislative fix operates in a similar fashion to the U.S. legislation, although it does not offer any safe harbor and so provides less protection to contracting parties from potential litigation.

Like the U.S. law, the EU legislation enables the relevant body (here, the European Commission) to select a statutory replacement rate for LIBOR following a trigger event—including a statement of non-representativeness by the regulator with responsibility for the benchmark administrator.

But under the EU solution, the European Commission can make such a designation for any currency or tenor of LIBOR in cessation, including U.S. dollar LIBOR). To date, statutory replacements have been designated for Swiss franc LIBOR and EONIA—the interest rate for one-day loans between European banks—with the European Commission confirming its intention to designate for sterling and yen LIBOR in due course. It is understood that the statutory replacement rates for sterling and yen LIBOR will mirror the "synthetic" methodology imposed by the FCA (discussed in the U.K. section below). The European Commission has not yet confirmed any intention to offer a replacement for U.S. dollar LIBOR, which is unsurprising given the extended publication of the main tenors of U.S. dollar LIBOR to end of June 2023.

Similar to the U.S. fix, the EU legislative fallback will apply to a broad spectrum of contracts: it is not limited to financial instruments. And, also like the federal law, the threshold requirement to engage the EU solution is based on the type of existing fallback in the legacy LIBOR-referencing contract. It will be engaged in contracts only where there is no, or "no suitable" fall-back provision, although those categories are less clearly defined than in the U.S. legislation.

"Unsuitable" fallbacks are defined in the EU legislation as those that do not provide for a permanent replacement for LIBOR; require third-party consent, which has been denied; or involve a replacement that diverges from the underlying market/economic reality and could adversely impact financial stability. The EU solution has the potential to be interpreted more broadly than U.S. law, which is more prescriptive as to the types of fallbacks that are subject to the legislation; the EU legislation may apply to a wider range of fallbacks.

Some market participants expecting a form of safe harbor provision within the EU solution were disappointed when the final version of the EU text was published. The EU fix lacks any express contractual continuity protections, other than the fact of naming a replacement rate, and does not provide any immunity from counterparty claims brought as a result of the automatic change in the rate of interest payable when the statutory replacement rate takes effect. This is the most significant difference between the EU legislation and the U.S. and U.K. solutions.

The U.K.

The U.K., as the home jurisdiction of LIBOR's administrator, has taken a different approach to its legislative framework. The FCA has made clear that the U.K. has a distinct role to play in minimising global financial stability risks and disruption to financial systems from the wind-down of LIBOR. And it has adopted a mechanism with the stated intention of allowing the U.K.'s statutory solution to "flow through" to global users of existing LIBOR contracts continuing to reference the rate (subject to other jurisdictions' legislative frameworks).

By using its powers under the U.K.'s statutory fix, the FCA can alter the methodology for calculating LIBOR, rather than nominating a replacement rate (as the U.S. and EU solutions do). From Jan. 4, 2022, the FCA has used these powers to command publication of so-called "synthetic" LIBOR for 1-month, 3-month and 6-month sterling LIBOR and all yen LIBOR. Synthetic sterling LIBOR is not calculated using panel bank submissions. Rather, it is based on a term Sterling Over Night Indexed Average (SONIA) plus a credit adjustment spread. Similarly, synthetic yen LIBOR is based on the Tokyo Term Risk Free Rate plus a credit adjustment spread.

Publication of the synthetic rates will be time limited. It has been stressed by the regulators that this is a "bridging solution" only: the relevant currencies and tenors of LIBOR have been designated as unrepresentative, and their representativeness will never be restored. But the FCA will continue to direct ICE Benchmark Administration to publish the synthetic rates to stabilize the rate for a time limited wind-down period. The FCA has confirmed that publication of synthetic yen LIBOR will

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be limited to one year, and while sterling LIBOR could conceivably continue for a maximum period of 10 years, the FCA must conduct an annual review to consider whether continued publication is appropriate.

The U.K. legislation casts a wide net in terms of the type of contract to which it applies, extending to all contracts governed by U.K. law (including non-financial contracts), save for cleared derivatives. In a major contrast to U.S. and EU laws, there is no further filter depending on the type of fall-back used, save for ensuring that the legislation does not inadvertently override any fallbacks or replacement rates agreed between contractual counterparties through active transition.

The U.K. solution has the potential to apply to any currency or tenor of LIBOR, provided the FCA mandates the publication of a synthetic rate. At least in theory, the FCA could in the future require the publication of synthetic U.S. dollar LIBOR, although we discuss further below some comments made by the FCA to manage the market's expectations in this regard.

The protections offered by the U.K. solution fall somewhere in the middle, between the more generous offering of the U.S. law and the light-touch approach of the EU. The U.K. legislation contains express contractual continuity provisions, which should help to deter arguments based on refusal to perform contractual obligations, alleged frustration or force majeure. However, it provides limited protection from claims, which seek to preserve the status quo in terms of claims and causes of action that exist prior to the date on which LIBOR is converted to synthetic LIBOR (in the relevant currency/tenor).

Overlapping Solutions & Open Questions

The differing scopes of the various jurisdictions' legislative fixes have created some actual and potential overlap and have left certain questions unanswered.

The FCA expects that the change of methodology imposed through LIBOR's administrator in the U.K. should "flow through" to global users of LIBOR, but has expressed no view as to the legal basis for adopting synthetic LIBOR in contracts that are not governed by U.K. law. In Q&As it published on Oct. 15, 2021, the FCA confirmed that EU, U.S., and U.K. authorities agree that contractual governing law clauses should prevail, and that the FCA would not seek to override legislative solutions applying in respect of the contractual governing law.

The impact of synthetic sterling/yen LIBOR on non-U.K. law contracts is likely to be a question of contractual construction according to the governing law of the contract. However, the potential extraterritorial effect of the U.K. solution may give rise to a very real risk of conflicts of laws.

And this risk may be heightened where more than one jurisdictional fix provides a replacement for the same currency/tenor of LIBOR, but where there is a divergence in the protections offered by the legislation. For example, the U.K. and the EU solutions both intend to cater for sterling/yen LIBOR legacy contracts, but differ in the protections offered.

The U.S. legislation is by its terms limited to U.S. dollar LIBOR contracts and does not purport to affect sterling or yen LIBOR. Would a U.S. court nevertheless treat synthetic LIBOR as "LIBOR" for the purposes of a U.S. law-governed sterling or yen LIBOR contract? Based on the usual principles of contractual interpretation, it appears more likely than not that a court applying U.S. law to a contract that provided for the governing rate to be "LIBOR" (with or without a spread or margin) in a currency other than US Dollars, and did not further define or qualify what was meant by "LIBOR," would conclude that "LIBOR" means whatever its regulator, the FCA, states that it means, even if the methodology for determining LIBOR changes.

That conclusion could be bolstered by resort to the Act of State doctrine, under which US courts generally refrain from sitting in judgment on acts by foreign government taken in their sovereign territory; such acts (in this case, the U.K. enactments and FCA regulatory acts regarding synthetic LIBOR) are generally given the same legal effect they purport to have where made.

Complications may arise if the FCA exercises its authority to promulgate synthetic U.S. dollar LIBOR – and its plans to do so remain uncertain. If the FCA does publish synthetic U.S. dollar LIBOR, it can be expected to ensure that it will be equivalent to the ARRC/Fed SOFR-based replacement benchmark rate (including spread adjustments). In that event, U.S. and U.K. law should be entirely consistent. Even so, it is not clear how courts outside the U.S. or the U.K. would construe non-U.S./U.K. contracts based on U.S. dollar LIBOR.

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Conclusion

The U.S., EU, and U.K. have made substantial progress in promoting contractual continuity and reducing litigation risk in relation to tough legacy contracts. However, legislators, regulators, and market participants still have work to do to minimize inconsistency and the emergence of gaps between different jurisdictions' approaches.

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