LIBOR TRANSITION: WHAT IS A "SAFE HARBOUR" AND WHY DOES THE UK’S LEGISLATIVE TOOLKIT NEED ONE?

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Legal Briefings

In the context of the UK’s legislative solution for the transition of so-called "tough legacy" LIBOR contracts, contained within the Financial Services Bill (**FS Bill**), HM Treasury (**HMT**) has recently published a consultation paper: Supporting the wind-down of critical benchmarks.

The consultation considers the case for incorporating a legal “safe harbour” in the legislation, to reduce the potential risk of contractual uncertainty and disputes in respect of legacy LIBOR contracts that are automatically transitioned by the statute. In essence, the proposed safe harbour may include one or both of the following features in order to reduce such risks: (1) express wording as to the continuity of contracts that are automatically transitioned by the FS Bill; and/or (2) protection from claims relying on the effect of automatic transition under the FS Bill (e.g. a change in interest rate payable under the contract) as a cause of action, liability or grounds for litigation between parties to contracts. The consultation was published in response to approaches made to HMT by a number of stakeholders, articulating the need for such a provision.

The significance of the legal safe harbour will depend ultimately on the all-important question as to which legacy LIBOR contracts will be able to take advantage of the legislative fix, on which the market does not yet have clarity, nor is it likely to in the near future. The breadth of the definition of “tough legacy” LIBOR contracts will be considered as part of the FCA’s forthcoming consultation on its enhanced powers under the FS Bill (specifically its powers under Article 23C), which has not yet been published. If “tough legacy” is defined broadly, it could contradict the regulator’s policy for parties to proactively transition. If the definition is too narrow, it will limit the impact of the legislative fix on the problematic cliff-edge scenario when publication of LIBOR ceases. Equally, greater clarity on the definition of “tough legacy” at an earlier stage may impact negatively on proactive transition efforts; but if the regulators wait too long, then the legislative solution may cause more disruption than it is trying to fix.

The dynamic between the scope of the safe harbour vs the scope of the definition of “tough legacy” is important and illustrates the difficult balance the regulators are trying to achieve. The wider the definition of “tough legacy”, the greater the volume of legacy LIBOR contracts caught by the legislative fix, increasing the potential risk of contractual uncertainty and disputes in respect of legacy LIBOR contracts that are automatically transitioned by the statute, and emphasising the need for a robust safe harbour in the legislation.

“Safe harbour” is not a term of art and the precise effect of a safe harbour in the context of the FS Bill will be defined following the receipt of responses from stakeholders to the consultation, which closes on 15 March 2021. However, the wording of the consultation itself provides some insight as to the operation and parameters of the safe harbour that HMT is considering, as discussed below. We also give an overview of how the UK proposal compares with other jurisdictions and the likely impact of the safe harbour provision on the risks of LIBOR transition.

BACKGROUND TO THE FS BILL

The FS Bill provides an overarching legal framework which gives the FCA new and enhanced powers to manage the wind-down of a critical benchmark (i.e. LIBOR), as discussed in our previous blog post: LIBOR transition measures in the new Financial Services Bill: the legal framework, market impact and risks. The FS Bill amends the Benchmarks Regulation 2016/1011 (**EU BMR**), as amended by The Benchmarks (Amendment and Transitional Provision) (EU Exit) Regulations 2019 (**UK BMR**). While the legislation is drafted by reference to the wind-down of any “critical benchmark”, for ease of reference in this blog post we refer only to the impact on LIBOR transition.

The FS Bill seeks to reduce the risk of litigation arising from disputes about the continuity of so-called “tough legacy” LIBOR contracts. In simple terms, it does this by providing new and enhanced powers for the FCA where it has determined that a critical benchmark is at risk of becoming unrepresentative, or has become unrepresentative, and that its representativeness cannot reasonably be maintained or restored. In such circumstances, the FCA will have the power to designate a change to the methodology by which LIBOR is set so that references in “tough legacy” contracts to LIBOR will effectively be treated as a reference to the new methodology (the synthetic LIBOR rate), rather than a rate which no longer exists.

The FCA’s powers of designation arise under Article 23A and its powers to change the methodology are provided for at Article 23D of the UK BMR.

PURPOSE OF THE SAFE HARBOUR

The overarching purpose for the safe harbour is set out at Chapter 1 of the consultation paper. In summary, while firms should continue to prioritise active transition away from LIBOR, HMT recognises that legislation is necessary to support orderly cessation and wishes to minimise (as far as is reasonably possible) the potential for litigation and/or market disruption arising as a direct result of the powers provided for under the legislation.

The consultation identifies two distinct features of a potential safe harbour aimed at minimising litigation/market disruption:

1. **Contractual continuity**

   This feature of the proposed safe harbour would provide express legal certainty that references to LIBOR in “tough legacy” contracts caught by the FS Bill should continue to be read as such following transition to the synthetic LIBOR rate (i.e. after designation of LIBOR as an Article 23A benchmark and any changes made to its methodology under Article 23D).

   The purpose of this feature is to prevent parties to legacy contracts from refusing to perform contractual obligations, frustrating the contract or triggering a force majeure clause on the basis that LIBOR no longer exists after designation and the change in methodology. The mechanism contained in the existing FS Bill ought to be effective in providing parties with the legal basis to resist such arguments, through the operation of synthetic LIBOR as the applicable contract rate. However, this express safe harbour would nevertheless be valuable.

2. **Protection from claims**

   This feature of the safe harbour would prevent parties from relying on the automatic switch from existing LIBOR to synthetic LIBOR under the FS Bill as a cause of action, liability or grounds for litigation between parties to contracts. This has the potential to provide parties with a broader protection from litigation, not only from claims relating to frustration and force majeure, but extending to claims for breach of contract or mis-selling claims for losses suffered as a result of the change in interest rate.

As explained in the introduction, the precise scope of the safe harbour will be influenced by stakeholder responses to the consultation. HMT has indicated that the legislation may include both or only one of the features identified above.

COMPARISON WITH EU/US POSITION ON SAFE HARBOUR

The EU's legislative solution for the transition of legacy LIBOR contracts is now in force (see our blog post: [Final EU legislative fix for legacy LIBOR: impact on transition risk for UK entities]). The safe harbour provided by the EU legislation is limited to providing contractual continuity, with no express protection from civil claims. The wording of the initial proposal from the EU suggested that the legislation might provide for a broader form of safe harbour (for example to provide immunity from counterparty claims brought as a result of the automatic change in the interest rate when the legislative fall-back is imposed). However, the European Commission ultimately opted for a narrow safe harbour. It is also important to note that the final EU legislative fix clarifies that it will only apply to contracts governed by Member State laws (or third country laws where that jurisdiction has not introduced a legislative fix).

A broader form of safe harbour has, however, been proposed by the ARRC in the legislative solution for contracts governed by New York law (and largely tracked in a Senate Bill introduced in the New York State legislature on 28 October 2020). Progress in the US has stalled since the expected extension to end-June 2023 of the continued publication of certain USD LIBOR tenors (following the ICE Benchmark Administration Consultation on Potential Cessation published in December 2020). However, the wording of ARRC's proposed safe harbour is broad and includes the following:

> "…no person shall have any liability for damage to any person or be subject to any claim or request for equitable relief arising out of or relating to the use of [the recommended benchmark replacement to which legacy LIBOR contracts will automatically transition]…and the use of such [recommended benchmark] shall not give rise to any claim or cause of action by any person in law or in equity."

Given the drafting of HMT's consultation, the scope of the UK's safe harbour could be as broad as that of the ARRC. Even if the UK adopts the same approach, there is clearly going to be variation in the comparative protection from claims offered by the regimes of different jurisdictions (in particular the EU), and forum shopping remains a possibility, as discussed below.

IMPACT ON LIBOR TRANSITION RISK

We consider below the likely impact of the proposed safe harbour on LIBOR transition.

1. Rationale for a safe harbour

The legislative solution is a blunt tool, which will change automatically the interest rate payable under the contract when the relevant trigger is activated and LIBOR switches to synthetic LIBOR. For those parties who lose out financially, there will be a real economic incentive to bring claims, and this will provide fertile ground for litigation. This will lead to inevitable market disruption, not only because of uncertainty for individual contracts as to the effect of arguments that there has been an event of frustration, a breach of contract or breach of duty etc., but also in terms of the time and cost for financial services institutions in dealing with such litigation on a potentially very large scale.

To the extent the safe harbour can reduce these risks, then it will be welcomed by the financial services sector, but it will ultimately benefit end users of financial services as well.

2. Scope of the safe harbour

The scope of the safe harbour will have a clear impact on the extent to which the risk of LIBOR transition is reduced.

In terms of the first feature of the proposed safe harbour, an express provision for legal certainty and contractual continuity will provide welcome incremental certainty, notwithstanding the fact that the mechanism contained in the FS Bill ought to be effective in providing parties with the legal basis to resist attempts to refuse to perform contractual obligations, frustrate contracts or trigger force majeure clauses as a result of the operation of synthetic LIBOR.

The second feature of the proposed safe harbour may have the greatest impact on the potential for litigation and market disruption because it raises the possibility of a broad immunity from the sorts of mis-selling claims which we have long flagged as one of the key risks of LIBOR transition (at least for the sub-set of "tough legacy" contracts). However, it is not clear how comprehensive that immunity will be because although tortious claims, for example, certainly fall within HMT's broad description of the second feature of the safe harbour, the categories of claim specifically listed in the examples at paragraph 1.9 of the consultation is far from comprehensive. Whether or not the ultimate form of the safe harbour is sufficiently broad to include the typical causes of action for mis-selling claims (including tortious claims and breaches of statutory duty) will have an enormous impact on the potential for mis-selling claims as a result of the legislative fix.

3. Effect on active transition efforts

The regulatory authorities continue to emphasise that the legislative fix is not intended to divert attention from active transition efforts. Indeed it is possible to characterise a safe harbour as entirely consistent with the continued encouragement of transition. There will be some parties to legacy LIBOR contracts who have not engaged with outreach communications from the banks, in the hope that they will be able to take advantage of uncertainties at the time of LIBOR cessation to negotiate a better contractual bargain.

Removal of the theoretical opportunity to bring claims simply as a result of the rate changing under the legislation may remove one obstacle to proactive transition. There will be no upside to a "wait and see" approach; and by contrast there will remain a clear downside to having no control over privately negotiating the future rate. This may bring parties to the negotiating table who have, to date, been hesitant.

4. Risk of forum shopping

The first iteration of the various legislative fixes of the UK, EU and US all sought to have extraterritorial effect, regardless of the law applicable to the legacy contract.

Since then, the European Commission has confirmed that the EU solution will only apply to EU law contracts, unless the law of the third country does not have its own legislative fix (and the parties to the contract are established in the EU). The FS Bill is not limited to contracts governed by UK law and applies to all UK supervised entities (this is tempered by express requirements on the FCA to have regard to the likely effect outside of the UK when exercising its powers). However, the consultation states that the UK can only provide a possible legal safe harbour for contracts governed by UK law. The US legislative solution (including its broad form of safe harbour) seeks to have wide extraterritorial effect and is not limited to contracts governed by US law.

The matrix described above has the potential for some very complicated issues of conflicts of laws, in relation to which it is too early to provide proper commentary. However, if a party stands to lose out financially as a result of transition (regardless of which regime applies), then there is a clear risk of forum shopping by that party to bring its claim in a jurisdiction where there is no (or a more narrow form of) safe harbour (e.g. the EU). The EU solution would not apply if the contract in question was subject to English law and the UK's legislative fix applied to the contract. However, this could lead to a dispute as to whether or not the contract was a "tough legacy" contract within the scope of the exemption at Article 23C of the UK BMR. We do not yet know how broad the Article 23C exemption will be (the FCA's consultation on this aspect of its powers is awaited), but anything short of a blanket exemption for all legacy contracts referencing LIBOR is likely to lead to technical statutory interpretation arguments as to whether the UK legislative solution applies.

By contrast, the UK and US legislative solutions are more likely to be relied upon by parties who have financially benefitted as a result of transition and wish to have protection from civil claims, or who wish to avoid the time and cost of such claims, regardless of the economic outcome, such as financial institutions.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

JENNY STAINSBY
GLOBAL HEAD – FINANCIAL SERVICES REGULATORY

RUPERT LEWIS
PARTNER, HEAD OF BANKING LITIGATION, LONDON

HARRY EDWARDS
PARTNER, MELBOURNE
+61 3 9288 1821
Harry.Edwards@hsf.com

NICK MAY
PARTNER, LONDON

+44 20 7466 2617
Nick.May@hsf.com

REGIONAL HEAD OF PRACTICE – DISPUTES, EMEA, LONDON
+44 20 7466 2995
Jenny.Stainsby@hsf.com

+44 20 7466 2517
Rupert.Lewis@hsf.com

CERI MORGAN
PROFESSIONAL SUPPORT CONSULTANT, LONDON
+44 20 7466 2948
Ceri.Morgan@hsf.com

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