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LIBOR PHASEOUT: LITIGATION IS COMING

*John Michael Neubert**

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* J.D. Candidate, Notre Dame Law School, May 2021; B.B.A. in Finance, Texas Christian University, 2018. I would like to thank Dr. David McIlroy for his valuable guidance throughout the research and drafting process. I would like to thank Professor Matthew J. Barrett for introducing me to the issues surrounding LIBOR Phaseout and providing thoughtful discussion. I would also like to thank the editors of the *Michigan Business & Entrepreneurial Law Review* for their thorough edits. Finally, thank you to my family, especially my parents, for their constant love and encouragement. All mistakes are my own.

INTRODUCTION**

In July 2017, the Chief Executive of the Financial Conduct Authority (FCA) announced that LIBOR, the London Interbank Offer Rate, will not be supported after the end of 2021.[1] The severity of this decision is expressed through the fact that LIBOR was once hailed as the "world's most important number" and justifiably so as it served as a reference rate in an estimated total of $400 trillion assets globally in 2019.[2] Market participants were told they had to find a replacement for LIBOR within four years, but they were not given any specificity on how the amendment process should work or what rate it should be replaced with. There is no exact substitute rate for LIBOR, so any contract amendment for a replacement rate must be accompanied by losses; the decision to determine who compensates for this change in value has been delegated to the market participants to figure out themselves.[3] Most contracts referencing LIBOR did not consider that the phaseout of the world's most important number would be a possibility, and as a result most of the fallback language in these contracts are ambiguous and largely ineffective for parties to rely on when making decisions for a new rate term.[4] A mandated path for how parties must replace LIBOR in legacy contracts has yet to be enacted with a little over a year left until the phaseout deadline, and Michael Held, executive vice president and general counsel of the Federal Reserve Bank of New York, characterizes this reality as

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** On Monday, November 30, 2020, U.S. and U.K. regulators and LIBOR's administrator made a collection of announcements that proposed the possibility of a new endgame for USD LIBOR. Specifically, the ICE Benchmark Administration (IBA) announced that it will open a consultation on its intention to cease the publication of LIBOR settings. In its new proposed plan, the IBA would extend posting the USD overnight, 1M, 3M, 6M, and 12M LIBOR until June 30, 2023. Despite the IBA in its announcement stating that "[t]his consultation is not, and must not be taken to be, an announcement that IBA will cease or continue the provision of any LIBOR setting after December 31, 2021," the market is treating the extension as close to a near certainty given the endorsement the extension has received from the Alternative Reference Rate Committee (ARRC), the US regulators, and the Financial Conduct Authority (FCA). The consultation is open for feedback until January 25, 2021. The author of Note would like to express that if the extension is confirmed and finalized, all contracts that end prior to June 30, 2023 would not need to be amended or renegotiated. Only legacy contracts that extend beyond June 30, 2023 would need to be amended and parties need to determine a new rate accordingly. However, the exact timeline for the reference date will not be finalized until after this Note is published. *See* ALT. REFERENCE RATES COMM., GUIDE ON THE ENDGAME FOR USD LIBOR, https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_Endgame_USD_LIBOR.pdf.

1. *See* Andrew Bailey, The Future of LIBOR, Speech, 27 July 2017, https://www.fca.org.uk/news/speeches/the-future-of-LIBOR.

2. *Replacing LIBOR – the World's Most Important Number*, J.P. MORGAN (May 2020), https://privatebank.jpmorgan.com/gl/en/insights/investing/replacing-LIBOR-the-worlds-most-important-number.

3. *See* Hanif Virji et al., *Facing the End of LIBOR: The Financial and Legal Implications*, BUTTERWORTHS J. OF INT'L. BANKING AND FIN. L. (2019).

4. ALT. REFERENCE RATES COMM., SECOND REPORT (2018) [hereinafter SECOND ARRC REPORT], https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Second-report.

a "DEFCON 1 litigation event if I've ever seen one."[5]

This paper will explore the different steps market participants should take to make sure they are prepared when LIBOR is phased out in December 2021. Part I will focus on the actions market participants should do before going into negotiations that can increase their potential to reach a consensual agreement. Part II will explore what financial firms should be prepared for during the negotiation process and what claims may arise when no agreement is reached. The decision for how to handle any LIBOR-linked financial instrument in their portfolio should be left to the discretion of market participants themselves. This paper does not set out to make that decision, but it will communicate the urgency with which firms should act to either reach a consensual agreement or prepare for the legal risk and litigation costs of DEFCON 1.

I. Preparing for Negotiations: Identification/Drafting

Market participants need to identify and implement a plan for how they will deal with the risk presented from the phaseout of LIBOR.[6] Although there was early speculation about dialogue between the ICE Benchmark Administration (IBA) and panel banks to see if a significant number would continue to provide LIBOR estimates after December 2021, the notion of a LIBOR extension has been publicly dismissed by the Federal Reserve Board and the FCA.[7] The FCA has intervened to preserve LIBOR's stability only through the end of 2021, and Vice Chair for Supervision of the Federal Reserve Board Randal Quarles addressed this point warning financial institutions that "it is [now] a matter of *how* LIBOR will end rather than *if* it will end."[8] Quarles expanded on this point to make financial institutions aware that the Federal Reserve fully expects to see an appropriate level of preparedness at the banks they supervise, and that as the end of 2021 grows closer so will the Fed's expectations in regards to firm preparedness to handle this issue.[9] As to questions of whether COVID-19 will delay the phaseout deadline, the FCA announced that, together with the Bank of England and members of the Working Group on Sterling Risk-Free Reference Rates, it continues "to monitor and assess the impact on transition timelines, and will update the market as soon as possible" while confirming that "[t]he central assumption that firms cannot rely on LIBOR being published after the

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5. *See* Michael Held, *SOFR and the Transition from LIBOR,* BIS (Feb. 2019), https://www.bis.org/review/r190318f.htm.

6. *See generally* DELOITTE U.K., LIBOR TRANSITION: SETTING YOUR FIRM UP FOR SUCCESS (2015), https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/financial-services/deloitte-uk-LIBOR-transition-ibor-benchmark-report-digital.pdf.

7. *See generally LIBOR Litigation Risks: Securitization and Market Legacy Vehicles and Instruments,* SFA, 12 (Dec. 2019), https://structuredfinance.org/wp-content/uploads/2019/12/SFA-Libor-Litigation-Risks.pdf.

8. Randal K. Quarles, *The Next Stage in the LIBOR Transition, Speech,* Federal Reserve Board (June 3, 2019), https://www.federalreserve.gov/newsevents/speech/quarles20190603a.htm.

9. *Id*.

end of 2021 has not changed and should remain the target date for all firms to meet."[10] LIBOR is ending, and firms should be actively working to make sure that they are putting together a plan to deal with repercussions of the LIBOR phaseout if they have not already done so.[11]

The expected discontinuation of LIBOR presents an active risk to public companies, investment advisers, investment companies, and broker-dealers.[12] As such, the SEC released a statement on LIBOR transition in July 2019 explaining that the risks associated with the discontinuation of LIBOR will be exacerbated if the work necessary to effect an orderly transition to an alternative rate is not completed in a timely manner.[13] The Commission encouraged market participants back in 2019 to begin the process of identifying any legacy contract that contains interest rate provisions referenced to LIBOR that did not contemplate the permanent discontinuation of LIBOR when drafted.[14] When a firm takes inventory, it is important to not limit the inquiry to third-party debt instruments; intercompany loans, long-term leases, and procurement contracts may also have a LIBOR component that needs to be adjusted.[15] The Commission has laid out a template of questions to help guide firms on where they should focus their attention in their determination for the risks they face during this transitionary period.[16] The list of questions does not purport to cover all potential risks, but it does highlight some key areas to focus on. As a minimum standard, investigations should yield results that determine precisely: the specific language used for fallback provisions, the type of financial instrument being used in the legacy contract, and the alternative rate necessary to satisfy the parties involved in the contract.

A. *What Specific Language is Used for Fallback Provisions?*

Due to liquidity, LIBOR became the dominant USD reference rate used in a wide array of cash instruments beyond syndicated loans, including corporate loans, floating rate notes, securitizations, and consumer mortgages.[17] Transitioning away from LIBOR in legacy contracts involving these financial instru-

10. *Impact of the Coronavirus on firms' LIBOR transition plans,* FCA (Mar. 25, 2020), https://www.fca.org.uk/news/statements/impact-coronavirus-firms-libor-transition-plans.

11. *LIBOR – Act now on replacement*, PWC (Dec. 3, 2019), https://www.pwc.com/us/en/cfodirect/publications/in-the-loop/LIBOR-replacement.html ("All companies – regardless of the size of their LIBOR exposure or industry – need to act now").

12. *See Staff Statement on LIBOR Transition,* U.S. SEC. & EXCH. COMM'N (July 12, 2019), https://www.sec.gov/news/public-statement/LIBOR-transition.

13. *Id.*

14. *Id.*

15. *See* Chalyse Robinson & Nathan J. Moore, *Prepare Your Business for the End of LIBOR,* WILMERHALE (Aug. 20, 2019), https://www.wilmerhale.com/en/insights/client-alerts/20190820-prepare-your-business-for-the-end-of-LIBOR.

16. *See* U.S. SEC. & EXCH. COMM'N, *supra* note 12.

17. *Id.*

ments presents itself as a challenge as most contracts for these cash products did not envision the possibility that LIBOR would be phased out.[18] The fallback language in these contracts is often absent, ambiguous, or fails to contemplate the permanent cessation of LIBOR.[19] Determining what the fallback provision is (if any) for the scenario where LIBOR becomes available is necessary for strategy formation as different terms can be used in fallback language to replace rates such as: to utilize another index, to poll London or NYC banks, to obtain at least one LIBOR rate from a defined bank, obtain the vote of 100% of noteholders, or to fix the transaction at the LIBOR rate at the time of deal closing instituting the last posted LIBOR as a new fixed rate.[20] Firms should look to the exact language of the trigger, fallback, and any margin or spread contemplated for in fallback provisions of legacy contracts to determine whether the replacement rate contracted for is appropriate.

B. *What Type of Financial Product is Being Used?*

LIBOR is most often associated with the derivates market and the current estimated volume of derivates based on US Dollar LIBOR is $199 trillion.[21] However, USD LIBOR is also referenced in several trillion dollars of corporate loans, floating-rate mortgages, floating rate notes, and securitized products.[22] The use of LIBOR across asset classes increases the complexity for financial institutions as the process for negotiations of a new term differs depending on whether the underlying financial instrument is a consumer, commercial, or interbank loan. It is certain that the gains and costs from investing in these different financial instruments will shift as firms negotiate a replacement rate.[23] How the risk is adjusted and what is expected from regulators during this transition process is not certain and differs depending on the specific instrument used.

C. *What Process Can be Taken to Facilitate the Transition?*

As a response to the LIBOR scandal in 2012, the Federal Reserve Bank of New York established the Alternative Reference Rate Committee (ARRC) to consider the range of potential reference interest rates and identify a risk-free rate or rates to replace LIBOR that would represent best practices for use in new derivates and other contracts.[24] The ARRC identified the Secured Overnight

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18. ALT. REFERENCE RATES COMM., SUMMARY OF ARRC'S LIBOR FALLBACK LANGUAGE 1 (2019) [hereinafter ARRC'S LIBOR FALLBACK LANGUAGE], https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/LIBOR_Fallback_Language_Summary.

19. *See* SECOND ARRC REPORT, *supra* note 4, at 27.

20. *SFA*, *supra* note 7, at 5.

21. SECOND ARRC REPORT, *supra* note 4, at 2.

22. *Id* at 1.

23. Virji et al., *supra* note 3, at 719.

24. *See generally* SECOND ARRC REPORT, *supra* note 4.

Financing Rate (SOFR) as the preferred alternative benchmark rate.[25] On September 24, 2018, the ARRC released a report outlining its LIBOR fallback consultation which laid out two alternative approaches for how institutions could best transition to an alternative reference rate: the "hardwired approach" and the "amendment" approach.[26] Under the hardwired approach, the administrative agent on its own or by request of the borrower notifies all parties to a loan agreement that a specific number of "currently outstanding U.S. dollar-denominated syndicated credit facilities" have identified SOFR plus a spread risk adjustment as the replacement benchmark interest rate for contracts with LIBOR.[27] After the parties have been notified, the borrowers and required lenders may elect by affirmative vote to replace LIBOR with the change going into effect on the first business day the administrative agent provides written notice to loan agreement parties that the Early Opt-in election has been made.[28] Alternatively, under the amendment approach the language included in the loan documents provides a "triggering event" that the lender may amend the loan document to substitute a replacement index, and will become effective on a specified date.[29] The amendment approach is offered for loan products specifically as most loan agreements typically involve a known set of parties and can often be amended facilitating a streamlined amendment process to select a replacement rate and spread adjustment.[30]

D. *What Substitute Language is Recommended for Commercial Products?*

In November of 2019, the ARRC released a summary report of LIBOR fallback language that lays out its recommendations for triggers, benchmark replacement rates and relevant spread adjustment for the following commercial cash products: floating rate notes, bilateral business loans, syndicated loans, and securitizations.[31]

1. Triggers

In regard to triggers, the ARRC recommends that it would be appropriate for any of these products to use either permanent cessation triggers or pre-

25. *Id.* at 6.

26. ALT. REFERENCE RATES COMM., ARRC RECOMMENDATIONS REGARDING MORE ROBUST FALLBACK LANGUAGE FOR NEW ORIGINATIONS OF LIBOR SYNDICATED LOANS (2020) [hereinafter ARRC RECOMMENDATIONS REGARDING ROBUST FALLBACK LANGUAGE], https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/Updated-Final-Recommended-Language-June-30-2020.pdf.

27. *Id.* at 2.

28. ARRC'S LIBOR FALLBACK LANGUAGE, *supra* note 18, at 5–6.

29. ARRC RECOMMENDATIONS REGARDING ROBUST FALLBACK LANGUAGE, *supra* note 26, at 9–12.

30. *Id.*

31. ARRC'S LIBOR FALLBACK LANGUAGE, *supra* note 18.

cessation triggers.[32] A permanent cessation trigger causes LIBOR to be replaced with the alternative benchmark rate when either the administrator or a regulator with authority over the administrator of the benchmark issues a statement announcing that LIBOR will cease to be provided.[33] A pre-cessation trigger activates the switch from LIBOR to the alternative rate when a regulator with authority over the administrator announces that the benchmark is "no longer representative."[34] For securitizations, the ARRC approves of a specific pre-cessation trigger, the asset replacement percentage trigger, which designates that a percentage of underlying assets have been converted to the benchmark or replaced by assets bearing interest based on the benchmark replacement.[35] As mentioned earlier, the ARRC has offered an alternative amendment approach for bilateral and syndicated business loans that would allow for an "early opt in" pre-cessation trigger to be implemented which offers flexibility for the parties to decide which conditions would represent a triggering event.[36]

2. Benchmark and Spread Adjustment

On April 8, 2020 the ARRC agreed on a recommended spread adjustment methodology for cash products referencing LIBOR.[37] It recommends that the replacement benchmark rate for legacy contracts be SOFR plus a spread adjustment methodology based on a historical median over a five-year lookback period calculating the difference between USD LIBOR and SOFR.[38] Lastly, the ARRC recommends that the selected spread adjustment be selected by the issuer or designee for floating rate notes, by the lender for bilateral business loans, by the borrower and admin agent for syndicated loans, and by designated transactional representative for securitizations.[39]

E. *What Substitute Language is Recommended for Consumer Cash Products?*

Consumer products often involve a more sophisticated lender so there is a stronger need for plain contract language. Thus, for consumer cash products such as a closed-end adjustable rate mortgage, the ARRC recommends that the language uses either a permanent cessation or a non-representativeness pre-cessation trigger, and that the replacement rate be SOFR plus a spread adjust-

32. *Id.* at 4.

33. *Id.*

34. *Id.*

35. *Id.*

36. *Id.*

37. ALT. REFERENCE RATES COMM., ARRC ANNOUNCES RECOMMENDATION OF A SPREAD ADJUSTMENT METHODOLOGY FOR CASH PRODUCTS (2020) [hereinafter ARRC's RECOMMENDATION OF A SPREAD ADJUSTMENT METHODOLOGY], https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_Spread_Adjustment_Methodology.pdf.

38. *Id.* at 1.

39. ARRC'S LIBOR FALLBACK LANGUAGE, *supra* note 18, at 6.

ment risk using the same five-year lookback period methodology as the commercial cash products.[40] The ARRC also recommends a one-year transition period to this five-year median spread adjustment in consumer products in response to comments and concerns from consumer advocacy groups.[41]

F. *What Other Alternative Rates Might be Used Besides SOFR?*

Although SOFR has been selected by the ARRC as LIBOR's replacement, the use of SOFR as the alternative rate is not yet backed by any legal or regulatory mandate. Leaders of ten larger regional banks voiced their concerns about adopting SOFR through a letter written in September 2019.[42] These leaders pointed to concerns that using SOFR as the rate during periods of significant economic stress would push borrowers' rates lowers while banks' cost of funds are rising as the SOFR will likely decrease when investors seek the safe haven of U.S. Treasury securities.[43] This concern is playing out currently as COVID-19 has caused extreme financial market turbulence and as a result the SOFR has moved sharply in the opposite direction of LIBOR.[44] SOFR is still positioned to become the primary replacement rate benchmark for financial contracts in lieu of LIBOR, but the problems posed by the difference between SOFR and LIBOR, especially during an economic crisis, leave room for other potential interest rates to be brought to negotiation.

Now, there is no longer a question as to whether LIBOR is being phased out. Firms and financial institutions should already be preparing to implement an effective transition plan. These project plans will be unique to each institution's needs but a basic structure for any institution should: (1) identify any contracts with language referenced to LIBOR; (2) categorize the contracts by type of financial instrument used; (3) analyze the contracts' language to determine if it is a legacy contract with inadequate fallback provisions; (4) draft desired substitution language for any upcoming contract renegotiations using agency recommendations and industry standards as guides to facilitate smoother transition.

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40. *Id.* at 7.

41. ARRC's RECOMMENDATION OF A SPREAD ADJUSTMENT METHODOLOGY, *supra* note 37.

42. Letter from R. Christopher Marshall Exec. Vice President & Treasurer, BBVA USA Bancshares, Inc.,et. al., to the Hon. Randal K. Quarles, Vice Chairman of Supervision, Bd. Of Governors of the Fed. Rsrv. Sys. et al. (Sept. 23, 2019), https://www.politico.com/f/?id=0000016d-d15d-d0d8-af6d-f77d6c5f0001.

43. *Id.*

44. *See* Jeffrey Armstrong, *Covid-19 Crisis Exposes LIBOR Replacement's Weaknesses,* LAW 360 (Mar. 27, 2020, 5:45 PM), https://www.law360.com/articles/1256813/covid-19-crisis-exposes-LIBOR-replacement-s-weaknesses ("From March 12 through March 20, USD 3-month LIBOR rose a total of 46 basis points – nearly one-half a percent. Over that same time, 3-month SOFR declined by roughly 7.7 basis points.").

II. Preparing for Battle: Negotiations and Potential Litigation Claims

Part I of this paper illustrated some of the significant input provided by financial regulators on procedures and alternative rates that could be chosen to help ensure market-participants successfully transition from LIBOR. However, no mandatory governmental regulation currently exists that would require borrowers or lenders to use a specific replacement rate for LIBOR in legacy contracts. Parties themselves must proactively and bilaterally agree to amend their existing contracts before December 2021, but the absence of direct regulatory pressure to renegotiate LIBOR-linked contracts may cause counterparties to drag their feet and be slow or reluctant to engage.[45] COVID-19 also adds another cause for parties, both in their ability to renegotiate and their willingness to focus on the issue of LIBOR-phaseout prioritizing other concerns. However, COVID-19 can actually be an actor that speeds up this process as many market participants are already analyzing and reviewing contracts for *force majeure* clause and doing client outreach.[46] Firms and financial institutions should also take this as an opportunity to review for and discuss any LIBOR related issues when doing client outreach about COVID-19 concerns.

For institutions that have taken the steps to identify legacy contracts linked to LIBOR and created a plan of action with potential substitute language drafted, the next step will be to begin the renegotiations. The process of renegotiations will likely be spearheaded by the financial institutions making offers, so it is important that counterparties be ready with their own calculations. The next section of this note will attempt to use the implications of LIBOR risk identification in Part I. It will also create a general overview of different ways this renegotiation process will unfold over the next two years highlighting the resulting legal battles and litigation costs that will likely arise from the different scenarios. Until any legislation is passed, this process can likely only end in two ways: consensual agreements or litigation.

A. *The Contract Types*

1. The Good – A Legacy Contract with Clear Fallback Language

Although unlikely, there is the possibility that the legacy contracts identified by firms contain robust fallback language that offers an unambiguous and actionable path to the replacement rate of LIBOR. Historically, fallback language for the replacement of LIBOR did not contemplate the permanent discontinuation of LIBOR, and as a result, there is uncertainty over contract interpreta-

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45. DELOITTE U.K., *supra* note 6, at 7.

46. *See* Paul Rosen, *What Happens with Contracts Amid the Covid-19 Pandemic*, FORBES (Mar. 26, 2020, 6:03 PM), https://www.forbes.com/sites/paulrosen/2020/03/26/what-happens-with-contracts-amid-the-covid-19-pandemic/#1ad0b7e142af.

tion.[47] Yet, there are some existing contracts that do fit this category. In the event that the fallback language included in the agreement contains: (1) a trigger akin to "if the index no longer fits the agreed upon definition of being available," (2) a benchmark replacement that reads similar to "the Note holder will use X replacement rate,"[48] or (3) a benchmark replacement adjustment similar to "the Note holder will calculate the new interest by adding X percentage points to the index," there is likely no room for the parties to renegotiate or reasonably claim that the change of index contracted for use is a term that can or should be negotiated. The clearly-defined trigger, the specified alternative rate, and the spread (if necessary) are all important factors for a firm to consider when evaluating a contract on its likelihood of attracting litigation.

2. The Likely – Ambiguous or Silent Fallback Provisions

The ARRC's second report stated that most legacy contracts referencing LIBOR do not have robust fallback language. "Large numbers of legacy contracts provide for alternatives to LIBOR, but they were drafted in anticipation of the possibility of only a temporary, short-term interruption in LIBOR's availability."[49] These provisions do not fully and precisely address issues that could be contentious. Competing contract interpretation arguments will be made to claim that the contractual provisions do not effectively address a permanent cessation of LIBOR. Challenges as to the trigger ("What does 'no longer available' mean?"), challenges as to the fairness ("rate to be chosen by lender at a later date"), and challenges to the rate term itself ("Last-posted LIBOR") all have defects that can give rise to arguments.[50] These arguments can either be answered in meeting rooms during negotiation talks or in courts during litigation, and it is up to the parties to decide how they plan to address any contract ambiguity.

B. *The Contract "Solutions"*

1. Client Follow-up (Clear Fallback Language)

Arguments could possibly be made about the fairness of the new rate. However, principles of contract autonomy will likely override as long as the

47. U.S. SEC. & EXCH. COMM'N, *supra* note 12.

48. This rate should be a fully alternative rate not mentioning or referencing LIBOR, such as "last-posted LIBOR," as this specified rate can also lead to contract interpretation of the parties' intention about a fixed or floating rate change. *See* SFA, *supra* note 7, at 5.

49. Howard Altarescu & Andrew Morris, *LIBOR . . . Coming to an End?,* JD SUPRA (Dec. 20, 2018), https://www.jdsupra.com/legalnews/LIBOR-coming-to-an-end-74602/.

50. *See generally id.*

language contains clear and specified replacement rates.[51] Client outreach should still be done to confirm that all relevant parties are aware of the upcoming change in rate firstly to maintain good client relations and secondly to add an extra layer of mitigation against any potential future claims.[52] Furthermore, this is a good time for firms to double-check that they are in compliance with any applicable banking, securities, and consumer protection laws that might be potential sources for other claims depending on the alternative rates fairness.

2. Consensual Resolution (Battle in the Boardroom)

"The only way to avoid disputes under agreements that are long-term and fail to address the cessation of LIBOR as a possible eventuality is for parties to agree to a change in index and agree to compensation for losses that result from such a change."[53] Amendments to bi-lateral contracts will be a function of leverage of each party, and firms and financial institutions should factor in the risk and cost of litigation when making any demands or concessions for the replacement rate. Parties could potentially streamline amending a silent contract by agreeing to adopt the ARRC recommendations for the financial product underlying the contract in dispute. Whether parties choose to apply the hardwired approach, immediately replacing LIBOR with another rate, the amendment approach, altering the instruments to replace a fallback rate with another fallback rate that will come into effect with the trigger, the waterfall language provided by the ARRC will reduce the amount of outside research parties need to expend to come to this agreement. Consensual agreements from all necessary parties result in successful contract amendment and continuation with the new agreed upon terms.[54] The ARRC recommendations are not required for parties to reach a consensual resolution, but they do provide a readily available template for parties that can save transactional costs spent on drafting and negotiating different terms.

Some contracts may have clauses, such as an amendment for bond issues, that require consent from many investors, causing difficulty for market participants amending legacy contracts. The battle in this scenario contains the transactional risk of getting all the different parties to agree as well as an administrative risk of needing a strong document review or IT system capable of identifying and tracking down all parties involved.[55] Furthermore, there is the potential that when parties meet to discuss the change in the reference rate, one of the parties will use this as an opportunity to renegotiate a loan contract and

51. *See* Mark L. Movsesian, *Two Cheers for Freedom of Contract*, 23 CARDOZO L. REV. 1529, 1530 (2002) ("Courts again refrain from challenging the substance of parties' agreements, and interpretation again emphasizes the written language.").

52. *See* Deloitte *U.K.*, *supra* note 6, at. 7.

53. Virji et al., *supra* note 3, at 720.

54. *Id.*

55. *See* DELOITTE U.K., *supra* note 6, at 12–16.

look to amend provisions that extend beyond just changing the reference rate.[56] Market participants on both ends should be aware of the relevant accounting standards that could be compromised by this amendment because the contractual change would be deemed a "substantial modification."[57] All parties should be aware that negotiations should be done with leverage, but both sides hold the leverage of not agreeing on amendments and threatening litigation.

3. No Consensual Resolution (Battle in the Courts)

Although the templates and SOFR rate should be reliable alternatives that parties could agree on for consensual amendments, the plaintiffs' bar will be looking for opportunities, particularly on a class-action basis, to argue that any coerced or non-consensual change disadvantages borrowers.[58] Some of the claims that are expected from plaintiff's will be an anticipatory breach or repudiation before LIBOR is extinguished.[59] As a general rule, rescission of a contract is permitted for such a breach which substantially defeats its purpose.[60] Financial institutions should be on the lookout for developed case law that addresses whether courts find that an agreed upon reference rate is the ultimate reason that consumers choose to bind themselves to one contract over another. Thus, the intended change in rate is grounds for anticipatorily pulling out of the financial instrument. Plaintiffs that do not like the rates offered to them by financial institutions will likely seek the courts to find a more favorable rate and argue that the term *rate* is, or became, ambiguous. If the plaintiff did not draft the original contract, they could argue that ambiguous rate terms should be interpreted against the drafter and a rate most favorable to the plaintiff should be inserted as the replacement rate.

Other legal claims that plaintiffs might bring would be to seek to enforce that the contract be terminated under the implied covenant of good faith and fair dealing.[61] This doctrine prevents one party from denying the other the benefit of the contract, and an unfair rate that leads to no consensual agreement would be looked at to see if one party would be seizing an unanticipated windfall.[62] Plaintiffs will likely also try to bring claims under *force majeure* clauses found within the contracts arguing that the change in the LIBOR rate represents an engagement of this clause which triggers termination of the contract.[63] Claims

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56. *Id.* at 7.

57. *Id.*

58. *LIBOR Transition Newsletter – Issue 4: Litigation Risks – Outstanding Residential Mortgage Loans*, GREENBERG TRAURIG: INSIGHTS (Apr. 1, 2020), https://www.gtlaw.com/en/insights/2020/4/LIBOR-transition-newsletter-issue-4.

59. *See id.*

60. Wiljeff, LLC v. United Realty Mgmt. Corp., 920 N.Y.S.2d 495 (N.Y. App. Div. 2011) (quoting Lenel Sys. Int'l, Inc. v. Smith, 824 N.Y.S.2d 553 (N.Y. App. Div. 2006)).

61. *See* Altarescu & Morris, *supra* note 49.

62. *See id.*

63. Virji et al., *supra* note 3, at 719.

could also be brought under unexpected-circumstances doctrines such as impossibility, frustration of purpose, or mutual mistake of fact.[64] Arguments could be brought that performance is impossible because LIBOR's cessations represent an event that the "parties did not anticipate and is beyond their control," or that the value of performance for the borrower has been destroyed and the allocated-risk of the event of LIBOR's cessation was not present at the time the contract was made.[65] Financial institutions should pay attention to the court decisions on these claims and any respective risk this would have on the portfolio if it is found that plaintiffs are able to discharge their duty to pay. Lastly, some parties may seek specific performance to use LIBOR as it existed at a particular point or an alternative rate that is not SOFR.[66]

Market participants likely to be on the defense of these claims, such as noteholders and servicers, should consider the strength of any legal defenses they can make framed around lack of knowledge at the time of origination.[67] Courts are hesitant to terminate contracts,[68] and defendants could make arguments based on mutual or unilateral mistake.[69] They could also argue that the parties agreed to a variable rate tied to a third party, longstanding, industry-accepted benchmark; therefore, it is more reasonable for the parties to adopt the new industry standard of SOFR plus a market spread adjustment laid out by the ARRC than it would be to terminate the contract altogether.[70] Lastly, there is current New York legislation pending that could allow for defendants to argue that any pending litigation on the appropriateness of an anticipatory breach should be stayed until the legislature has had an opportunity to decide on the proposal.

4. Government Regulation? (Wait and See Approach)

Lastly, firms and financial institutions that have the majority of their financial products governed under New York law could hold off on negotiations and wait until legislation is implemented to address LIBOR cessation in financial instruments and contracts. On March 6, 2020 the ARRC released its New York State legislative proposal for amending legacy contract that lack adequate fallback language.[71] A substantial number of financial contracts referencing

64. Altarescu & Morris, *supra* note 49.

65. *Id.*

66. *See id.*

67. GREENBERG TRAURIG, *supra* note 58.

68. *See* Mariana Pargendler, *The Role of the State in Contract Law: The Common-Civil Law Divide,* 43 YALE J. INT'L L. 143, 162 (2016) ("U.S. courts have been similarly reluctant in applying the doctrines of impracticability and frustration of purpose").

69. *Id.*

70. *Id.*

71. *See* Donna Parisi et. al, *ARRC Releases NY Law Proposal to Amend Transactions Referencing UDS LIBOR*, SHEARMEN & STERLING PERSPECTIVES (Apr. 2020),

USD LIBOR are governed by New York law, and as exhibited by the prior two paragraphs the lack of legislative action will lead to an onslaught of litigation and increased risk from inconsistency in the financial instruments continuity.[72] The legislation would set a market-wide standard for different contractual circumstances. It has a mandatory and permissive application depending on the fallback language found in the original agreement.[73] Initially, this proposed bill was intended to be folded into the New York State budget bill incorporated in the budget on April 1, but COVID-19 has delayed the timeline.[74] However, I would not recommend this option because even this legislation will likely be challenged under U.S. constitutional law.[75] Delaying the process to wait on a legislative fix instead of working to amend the contract now could put firms in a difficult position if any impending constitutional challenge is not resolved before 2021.

Conclusion

There is not a clear path for any financial institution save for the ones that had really good lawyers who perceived the threat of a reference rate phaseout and drafted the original agreements with clear fallback language. It is known that LIBOR is ending by 2021, but what is unknown is how firms and financial institutions will choose to handle the necessary work that needs to be done by the end of next year. A change in rate necessarily involves a change in valuation, and market participants should factor in litigation risk and costs before making any decisions about how to handle the process. The end of LIBOR brings about the potential beginnings of DEFCON 1 for financial contracts, so it is imperative that firms know now what they are going to choose: mutual agreement or a battle in the courts.

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https://www.shearman.com/perspectives/2020/04/arrc-releases-summary-of-proposed-new-york-law-aimed-at-amending-legacy-transactions-usd-LIBOR.

72. *See id.*

73. *See id.*

74. *See id.* On October 28, 2020, New York State Senator Kevin Thomas introduced legislation substantially similar to the proposed legislation from the ARRC related to LIBOR's transition. Although introduced, the bill (S.9070) is not likely to be taken up until sometime in 2021 after the new legislative session begins in New York in January. *LIBOR Update – New York Legislation*, SEWARD & KISSEL LLP (Nov. 4, 2020), https://www.sewkis.com/publications/libor-update-new-york-legislation/.

75. Howard S. Altarescu, et al., *The LIBOR Transition – What a Legacy!: Legislative Solutions/Constitutional Law Considerations,* ORRICK: INSIGHTS (Feb. 5, 2020), https://www.orrick.com/en/Insights/2020/02/The-LIBOR-Transition-What-a-Legacy-Legislative-Solutions-Constitutional-Law-Considerations? ("Any state legislation that purports to effect a change in an outstanding contract could possibly be subject to challenge under the "Contracts Clause" of the United States Constitution.").