THE PHASE-OUT OF LIBOR: Timeline, State of Play and the Path Forward

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The LIBOR Phaseout – How We Got Here

- The London Interbank Offered Rate ("LIBOR") is a benchmark interest rate index used in setting the interest rate for many variable-rate loans and other financial obligations.
- Questions around LIBOR's validity as a credible benchmark rate arose following examples of manipulation of LIBOR's rate-setting process.
- In 2013, the Financial Stability Board (the "FSB"), an international body that monitors and makes recommendations about the global financial system, convened global regulators, central banks and market participants to review major interest rate benchmarks and plans for reform.
- In the U.S., the Financial Stability Oversight Council (the "FSOC"), which is responsible for monitoring any risks to the U.S. financial sector, recommended the identification of alternative interest rate benchmarks to LIBOR and the development of a transition plan.
- In 2014, the Board of Governors of the Federal Reserve System (the "Federal Reserve") convened the Alternative Reference Rates Committee (the "ARRC"), a group of private-market participants tasked with ensuring a successful transition from U.S. dollar (USD) LIBOR to a more robust reference rate.
- The ARRC has recommended the Secured Overnight Financing Rate ("SOFR"), published by the Federal Reserve Bank of New York (the "FRBNY"), as the successor to LIBOR.

LIBOR Timeline for the LIBOR Phase-out

- The phase-out of LIBOR is scheduled to occur in stages, with the first stage scheduled to begin at the end of this year.
- Specifically, on November 30, 2020, the International Exchange (ICE) Benchmark Administration (the "IBA"), the administrator of LIBOR, announced its intention to cease publishing:
    - One-week and two-month LIBOR immediately after December 31, 2021 and
    - The remaining LIBOR tenors (overnight, one-month, three-month, six-month and 12-month) immediately after June 30, 2023.

March 5, 2021 – The Clock (Officially) Starts Ticking

- On March 5, 2021, the IBA issued an announcement confirming that it would cease publishing the applicable LIBOR tenors after the dates set forth above.
- On the same date, the UK's Financial Conduct Authority (the "FCA") issued a separate announcement confirming that LIBOR would either end or no longer be representative after the dates set forth above.
- Since that time, the Commodities Futures Trading Commission has recommended, as a market best practice, switching interdealer trading conventions from LIBOR to SOFR for USD linear interest rate swaps by July 26, 2021. (more on this later).
- Additionally, the Federal Reserve, the Office of the Controller of the Currency (the "OCC") and the Federal Deposit Insurance Corporation (the "FDIC") jointly recommended that banks cease entering into new contracts using LIBOR as a reference rate as soon as practicable and in any event by December 31, 2021.

Overview of Key Dates

LIBOR Tenors	End/Last Representative Date
1-week **2-month**	December 31, 2021
Overnight, 1-month, 3-month, 6-month and 12-month	June 30, 2023

And We're Off – March 5th as a Benchmark Transition Event

- The March 5th announcements from the IBA and FCA constitute a "Benchmark Transition Event" under the ARRC's recommended fallback language for transitioning away from LIBOR.
- The occurrence of a Benchmark Transition Event does not trigger an immediate transition from LIBOR to an alternate benchmark rate, such as a SOFR-based rate. Rather, the Benchmark Transition Event sets the deadline by which such transition must take place.
- Depending on what type of fallback language is used in the applicable credit agreement, the Benchmark Transition Event either:
    - Allows the relevant parties to begin the process of negotiating amendments to reflect the transition from LIBOR to an alternate benchmark rate, or
    - Puts the relevant parties on notice of the date by which a hardwired transition from LIBOR to an alternate benchmark rate will take place.

- In 2019, the ARRC published two approaches for fallback language:
    - A form of amendment language (the “Amendment Approach”) that would allow the lender in a bilateral loan (but subject to objection by the borrower) or the borrower and administrative agent in a syndicated loan (but subject to objection by the required lenders) to amend the applicable credit agreement at a later date to replace LIBOR with an alternate benchmark rate (which may be a SOFR-based rate) upon the occurrence of a trigger event.
        - Amendments should be based on recommendations of relevant government authorities or prevailing market conditions.
    - A form of hardwired language (the “Hardwired Approach”) that would allow the lender in a bilateral loan (but subject to objection by the borrower) or the administrative agent in a syndicated loan (but subject to objection by the required lenders) to automatically replace LIBOR with an alternate benchmark rate upon the occurrence of a trigger event. The replacement rate is determined based on a predetermined waterfall of alternative rate options (more on this later).

- The transition from LIBOR to the alternate benchmark rate will occur on the earlier of:
  - The Benchmark Replacement Date, which is immediately after December 31, 2021 (for 1-week and 2-month LIBOR) or June 30, 2023 (for Overnight, 1-month, 3-month, 6-month and 12-month LIBOR), and
  - For loans with an "early opt-in election," the date specified in that option, if exercised by the parties.

Getting a Head Start – The Early Opt-in Election

- The Amendment Approach and the Hardwired Approach also incorporate an "Early Opt-in Election," permitting the transition to an alternate benchmark rate before the Benchmark Replacement Date.
- Objective criteria is used to trigger the Early Opt-in Election:
  - First, a determination that at least five (or other agreed-upon number) currently outstanding U.S. dollar-denominated syndicated or bilateral credit facilities at such time contain (as a result of amendment or as originally executed) as a benchmark interest rate, in lieu of LIBOR,
    - A new benchmark interest rate to replace LIBOR (Amendment Approach); or
    - A SOFR-based rate (including the possibility of a forward-looking "Term SOFR" rate as a benchmark rate (Hardwired Approach); and
  - Second, the election to declare that an Early Opt-in Election has occurred (with written notice).

- For syndicated loans, the determination is made by the administrative agent (under the Hardwired Approach), or the administrative agent or the required lenders (under the Amendment Approach), but the election is made jointly by the administrative agent and the borrower. Under the Amendment Approach, the required lenders must consent to the election. Under the Hardwired Approach, the required lenders may object to the election.
- For bilateral loans, the determination and election are made by the lender, but the borrower may object to the election.

Countdown to 2023 – New Loans

- As noted above, the Federal Reserve, the OCC and the FDIC have jointly recommended that banks cease entering into new contracts using LIBOR as a reference rate as soon as practicable and in any event by December 31, 2021.
- Continued LIBOR originations after that date may pose safety and soundness concerns.
- Although the ARRC has recommended SOFR as the successor to LIBOR, they are not analogous indexes. Unless you are using a Term SOFR rate or a compounded SOFR average in advance (more on these variations of SOFR later), you cannot simply replace LIBOR with SOFR in your pricing models and loan documents.
- Even if you are using a SOFR average in advance, for example, a 90-day SOFR average to replace 3-month LIBOR, simply importing a corresponding SOFR quantity for LIBOR would be insufficient, and a number of adjustments (i.e., a spread adjustment and other conforming changes) will be necessary.

Countdown to 2023
Existing or “Legacy” Loans

- Borrowers and lenders should immediately begin the process of identifying their outstanding LIBOR-based legacy loans with maturity dates that extend beyond 2021, including the particular LIBOR tenor (overnight, one-week, one-month, two-month, three-month, six-month or 12-month) that is used.
- Such obligations may include, but are not limited to, bank loans and lines of credit, derivatives, leases, installment sales agreements, municipal bonds, promissory notes, reimbursement agreements governing letters of credit, standby bond purchase agreements governing the purchase of bonds upon an optional or mandatory tender, other credit facilities and certain investments.
- Once the outstanding LIBOR-based legacy loans have been identified, borrowers and lenders should review the underlying credit agreements to determine whether they already include effective fallback language.
- Beginning in 2019, the ARRC recommended the Amendment Approach and the Hardwired Approach for incorporating effective fallback language into loan transactions (incorporated as part of the original credit agreement or an amendment to an existing agreement).
- The ARRC has since recommended that the Amendment Approach be discontinued in favor of the Hardwired Approach.

Countdown to 2023

Older Legacy Loans with Pre-ARRC Replacement Language

- Credit agreements entered into prior to 2017 may contain fallback language designed for only a temporary, rather than permanent, discontinuance of LIBOR as a reference rate. It is therefore unlikely that such language would effectively address the LIBOR transition:
  - Designed only for temporary disruptions;
  - May create a fixed rate fallback; or
  - May fall back to "prime" or "base," which are not equivalent to LIBOR.
- First, check to see if your credit agreements incorporate one of the two approaches recommended by the ARRC, a variation of the approaches, or perhaps a different approach.

- If your credit agreement already includes effective fallback language (either in the original agreement or through an amendment), then:
  - Borrowers and lenders should work with their counsel and financial advisors to consider any fundamental differences between LIBOR and the alternate benchmark rate that would replace LIBOR. Such differences might include:
    - Potential changes in interest rate levels, profitability or costs;
    - Responses to changing market conditions;
    - State lending law constraints; and
    - Possible impact on financial ratios, reporting and other covenants, or accounting practices.
  - If it is determined that the alternate benchmark rate could introduce unanticipated risks to, or reduce the anticipated economic return of, the financial obligation, the borrower or lender may wish to approach the other party to explore a possible renegotiation of the terms.

- If your credit agreement lacks fallback language, or the fallback language is inadequate or otherwise exposes the borrower or lender to the unintended or disadvantageous risks described above, then:
  - The parties should consider the steps necessary to amend the agreements within the timeframe anticipated for the LIBOR transition.
  - Such amendments may extend beyond simply swapping out LIBOR for an alternate benchmark rate. For example, the amendments could include:
    - Appropriate adjustments to the spread above the reference rate to account for anticipated differences between the alternate benchmark rate and LIBOR and/or
    - A one time, lump-sum payment in lieu of a spread adjustment.
- If amendments are impracticable, legislative solutions at the state and federal level may be needed (more on this later).

ARRC's Recommended Alternative Benchmark Rate - SOFR

- The ARRC-recommended alternate benchmark rate for each LIBOR tenor will be some form of SOFR plus a spread adjustment for such tenor (and possibly other conforming changes).
- SOFR is based on the cost of transactions in the overnight repo market, where large banks and hedge funds borrow or lend to one another using U.S. Treasuries as collateral.
- In other words, SOFR is "backward-looking," based on historical rates for actual transactions.
- SOFR is considered a "risk free" rate because it is based on collateralized (secured) borrowing costs.
- Drawbacks to SOFR:
  - Does not reflect the cost of unsecured borrowing (known as a credit sensitive rate), which more closely approximates the funding costs of lenders.
  - Does not expedite the creation of a term structure enabling the calculation of forward-looking rates. Currently, the ARRC has not recommended any forward-looking Term SOFR rates (more on this later).

SOFR – Is There Anything Else on the Menu?

- ***Contrasting Alternative Risk-Free Rates by Currency***
- Like the ARRC, national working groups in other currency jurisdictions have chosen either an unsecured or secured overnight rate as their alternate benchmark rate, depending on the characteristics of their national markets:

U.S. Dollar	**SOFR**	**Overnight secured repo rate**
Sterling	SONIA	Overnight unsecured rate
Japanese Yen	TONA	Overnight unsecured rate
Euro	ESTER	Overnight unsecured rate
Swiss Franc	SARON	Overnight secured repo rate

- ***Alternatives to SOFR***
- **Bloomberg Short Term Bank Yield Index (BSBY)**
  - Based on commercial paper, certificate of deposit, U.S. dollar bank deposit and short-term bank bond transactions.
  - Includes both a term structure and systemic credit-sensitive spread.
  - Compliant with the IOSCO Principles for Financial Benchmarks.
  - No built-in floor or spread adjustment.
  - Available in overnight, one-, three-, six- and 12-month tenors.
  - Earlier this year, (i) Bank of America issued a $1 billion six-month floating rate bank note referencing the one-month tenor of BSBY and (ii) Bank of America and JPMorgan traded the first complex derivative using BSBY, exchanging $250 million worth of an interest-rate swap.

- **Ameribor**
  - Calculated as a weighted average of the daily transactions in the overnight unsecured loan market on the American Financial Exchange, where banks lend to each other through mutual lines of credit.
  - Uses short-term funding data collected by the Depository Trust and Clearing Corporation, which processes trades for Wall Street.
  - Calculated based on unsecured transactions (i.e., a “credit-sensitive” benchmark rate).
  - Popular with small- and medium-sized lenders because it is sensitive to funding cost increases.
  - Compliant with the IOSCO Principles for Financial Benchmarks.
  - No built-in floor; Ameribor futures can reflect zero or negative rates.
  - Available in one-, three- and term rate tenors.

- **ICE Bank Yield Index**
  - Provided by the ICE Benchmark Association.
  - Forward-looking credit-sensitive interest index based on executed transaction data representing short-term, unsecured bank investment yields.
  - IBA is still seeking external assurance regarding compliance with IOSCO Principles for Financial Benchmarks.
  - ICE does not appear to set a floor for the Bank Yield Index.
  - Available in one-, three-, six- and 12-month tenors.

- **IHS Markit**
  - Prepares the USD Credit Inclusive Term Rate ("CRITR") and the USD Credit Inclusive Term Spread ("CRITS").
  - CRITR and CRITS are forward-looking term rates that measure the daily USD cost of funding in institutional markets.
  - According to IHS Markit, CRITR and CRITS are the first credit-sensitive rates based on extensive constituent bases - tracking most USD institutional certificate of deposit, commercial paper and short-term corporate bond transactions using a publicly disclosed, rules-based methodology and compliance framework.
  - Designed to give banking institutions a broad measure of USD funding costs on a senior unsecured basis.
  - Compliant with the UK Benchmark Regulation and the IOSCO Principles for Financial Benchmarks.
  - No set floor (i.e. a minimum limit) for either CRITR or CRITS.
  - Available in one-day and one-, three-, six- and 12-month tenors.

- **LSTA Rider**
  - The Loan Syndications & Trading Association (the "LSTA") has developed a slot-in rider that can be incorporated into the ARRC's Hardwired Approach for fallback language. The rider would allow loans to transition to a preferred credit sensitive rate ahead of, in lieu of, or behind adjusted Term SOFR once the dominant LIBOR tenors cease after June 30, 2023.
  - The rider fits into the larger LIBOR fallback framework published by the ARRC.
  - The rider offers two formulations: (i) the selection of a specific credit-sensitive rate and (ii) the following preferred hierarchy of credit sensitive rate alternatives.
    - Ameribor;
    - Bank Yield Index (provided by ICE Benchmark Association);
    - BSBY and
    - IHS Markit Credit Rate (provided by IHS Markit).

LIBOR vs SOFR

LIBOR	SOFR
Considered a "Forward-looking" rate.	Considered a "backward-looking" rate.
Designed to produce an average rate representative of the rates at which large, international banks with access to the wholesale unsecured funding market could obtain funding.	Based on historical rates for actual transactions secured by US Treasuries over a certain period of time.
Considered an unsecured rate reflecting the credit risk of lending to banks.	Considered a secured and therefore "risk-free" rate.
Currently calculated for a number of tenors, ranging from overnight to one year.	Overnight rate.

Where Is SOFR?

- SOFR is published on a daily basis by the FRBNY.
- The SOFR rates are available on the FRBNY's website: www.newyorkfed.org.
- The ARRC's announcements regarding the LIBOR phase-out are also available on the FRBNY's website: www.newyorkfed.org/arrc/sofr-transition

In a Perfect World – The Ideal SOFR Based Alternate Benchmark Rate

- Ideally, the fallback rate for a LIBOR-based instrument might be:
  - Term SOFR of the same tenor as the LIBOR it replaces:
    - For instance, 90-day SOFR replaces 3-month LIBOR.
    - Problem - unlike LIBOR, currently there are no ARRC-recommended Term SOFR rates.
    - Possible solution – the ARRC may be in a position to recommend Term SOFR rates for business loans in the near term (more on this later).
    - Possible solution - in addition to producing SOFR, the FRBNY also publishes 30-, 90- and 180-day historical averages of SOFR and a SOFR Index (allowing users to calculate a compound SOFR over any start and ending date) on a daily basis.

- Plus a spread adjustment:
  - To minimize the differences between LIBOR and SOFR, the ARRC has incorporated a spread adjustment into its fallback language. For example, a rate of LIBOR + 2.0% would equate to SOFR + 2.0% + X%, with X% being the "spread adjustment."
  - The ARRC's recommended spread adjustment methodology is based on a historical median of the difference between LIBOR and SOFR over a five-year lookback period, set by the occurrence of a Benchmark Transition Event.
  - For non-consumer cash products, the ARRC has recommended following the spread adjustments published by ISDA. The occurrence of the Benchmark Transition Event on March 5, 2021 fixed the lookback period for this calculation, allowing for the publication of spread adjustments. The list of spread adjustments can be found here: https://assets.bbhub.io/professional/sites/10/IBOR-Fallbacks-LIBOR-Cessation_Announcement_20210305.pdf
  - Consequently, market participants can now refer to definitive numerical spread adjustments in their fallback language, as opposed to general concepts such as "Benchmark Replacement Adjustment" as set forth in earlier iterations of the ARRC fallback language.
  - The ARRC's recommended spread adjustments in consumer products will incorporate a 1-year transition period.

The Future of Term SOFR

- The ARRC is considering the formulation of a Term SOFR rate, but it is not currently in a position to recommend such a rate.
- To have a Term SOFR rate, you must have robust SOFR markets and SOFR futures, which do not exist at this stage.
- The CME Group ("CME"), which operates an exchange for the interest rate derivative transactions that would provide the pricing inputs for the development of Term SOFR, announced the launch of forward-looking SOFR term rates for 1-, 3- and 6-month tenors.
- Drawback - CME has previously stated that it will not license Term SOFR for derivatives until 2023, which for many, calls into question the utility of a rate for cash products now that cannot be match-hedged until a later date.

- The ARRC wants to see a sufficient volume of underlying transactions before endorsing CME's Term SOFR rates, or any future Term SOFR rates published by other providers.
- On June 8, 2021, the ARRC announced that the final market indicator for Term SOFR becoming robust and stable enough to be formally recommended is expected to be satisfied following the adoption of the recommended change to USD linear swap trading conventions from LIBOR to SOFR on July 26, 2021.
- On July 21, 2021, the ARRC announced loan conventions and best practice recommendations for the use of forward-looking SOFR Term rates in syndicated and bilateral business loans in order to expedite the transition away from LIBOR.
- The July 21st announcement was made in anticipation of the ARRC's formal recommendation of the SOFR Term rates produced by the CME.

- According to its July 21st best practice recommendations, the ARRC:
  - Supports the use of Term SOFR (in addition to other forms of SOFR) in business loans, particularly multi-lender facilities, middle market loans and trade finance loans.
  - Recommends the continued use of overnight SOFR and SOFR averages for floating rate notes, consumer products (including adjustable rate mortgages and student loans) and most securitizations (the exception being certain securitizations with underlying assets that reference SOFR Term rates).
  - Does not support the use of Term SOFR for the vast majority of the derivatives markets, as these markets already reference SOFR compounded in arrears (the exception being end-user facing derivatives that hedge cash instruments linked to SOFR Term rates).
- The ARRC's formal recommendation of the SOFR Term rates is expected to follow very shortly after the anticipated move of interdealer swap trading conventions from LIBOR to SOFR on July 26, 2021 (according to ARRC Chair Tom Wipf, the recommendation may come within days, not weeks).
- In any event, the ARRC does not view Term SOFR as necessary for all products and continues to encourage market participants to proceed with the transition from LIBOR to SOFR.

The SOFR 30-, 90- and 180-Day Averages

- SOFR averages for a given publication date are an average of the daily overnight SOFR rate over certain periods of time (i.e., commencing exactly 30-, 90- and 180 calendar days **before** the publication date and extending through SOFR published that day), calculated on a compounded basis.
- Unlike the various LIBOR tenors, which are forward-looking rates, the SOFR averages are based on historical rates.
- Nevertheless, the SOFR averages are useful for those market participants that are looking for:
    - A rate that applies for a 30-, 90- and/or 180-day term product;
    - A rate that is known in advance and can be applied to the relevant product up front; and
    - A rate produced by the official sector and publicly available and transparent to all market participants.

- The SOFR averages offer the convenience of having a published rate of the relevant tenor known and established upfront. Although the averages reflect the overnight SOFR rates for the prior period, they can be transparently applied in advance of the upcoming payment period.
- Market participants can use simple or compounded SOFR averages, which can be calculated either in advance or in arrears, depending on whether the averages are applied at the start or end of an interest period.
- SOFR averages are intended to accurately reflect movements in interest rates over a given period of time and smooth out any idiosyncratic, day-to-day fluctuations in market rates.

SOFR in Advance vs SOFR in Arrears?

- Users of the SOFR averages must determine the period of time over which the daily SOFRs will be observed and averaged.
- An "in advance" structure would reference an average of SOFR observed before the current interest rate begins:
    - Operationally easy to implement.
    - Offers the convenience of having a published rate of the relevant tenor known and established up front, notwithstanding that the averages reflect the overnight SOFR rates from the prior interest period.

- An “in arrears” structure would reference an average of SOFR over the current interest period:
  - Reflects what actually happens to interest rates over the given period.
  - The eventual rate becomes increasingly certain as the end of each period approaches and most of the SOFR observations are known.
  - Provides very little notice before payment is due.
  - A number of conventions have been designed to allow for a longer notice of payment within the “in arrears” framework, including payment delays, lookbacks and lockouts.

The ARRC Hardwired Approach

- The Federal Reserve, OCC and FDIC have advised that new contracts entered into prior to December 31, 2021 should either use a reference rate other than LIBOR or include effective fallback language with a clearly-defined alternate benchmark rate effective upon the discontinuation of LIBOR.
- Under the ARRC's Amendment Approach, the Benchmark Transition Event triggers permissive language allowing the parties to amend the applicable credit agreement at a later date to reflect the transition from LIBOR to an alternate benchmark rate, based on recommendations of relevant government authorities or prevailing market conditions.
- Under the ARRC's Hardwired Approach, the Benchmark Transition Event does not trigger an immediate transition away from LIBOR to the relevant hardwired waterfall rate. Rather, the Benchmark Transition Event sets the date upon which such trigger will take place immediately after December 31, 2021 or June 30, 2023, depending on the applicable LIBOR tenor, subject to the use of the Early Opt-in Election).

- The ARRC has recommended that the Amendment Approach be discontinued in favor of the Hardwired Approach, noting that the Hardwired Approach is operationally easier to implement at the time of a transition and offers certainty as to the successor rate (i.e., a version of SOFR).
- Although the Hardwired Approach has become increasingly common, a number of market participants continue to use the Amendment Approach, citing reasons such as:
  - Desire to retain flexibility and/or
  - Potential issues with the Hardwired Approach, such as:
    - Lack of a flip-forward to Term SOFR (more on this later) and
    - Market conventions for the administration of SOFR loans have yet to be developed.

The Benchmark Replacement Waterfall in the ARRC's Hardwired Approach

- The ARRC's Hardwired Approach includes a list or "waterfall" of recommended alternate benchmark rates for LIBOR.
- In all cases, however, the ARRC's recommended alternate benchmark rate is some form of SOFR plus a spread adjustment.
- If the first choice is unavailable, you proceed to the second choice.

Step One of the Waterfall

- The first recommendation in the waterfall is always Term SOFR plus the applicable spread adjustment.

Step Two of the Waterfall

- The second recommendation in the waterfall is Daily Simple SOFR or Compounded SOFR (depending on product type) plus the applicable spread adjustment.

The Waterfall in Review

- The actual benchmark replacement rate will depend on what is available as of the applicable Benchmark Replacement Date (or the effective date of an Early Opt-in Election):
  - First alternative is always Term SOFR.
    - Term SOFR is a forward-looking term rate based on SOFR, currently under development by the FRBNY.
    - As of today, it is unknown when an ARRC-recommended Term SOFR rate will be available for any of the tenors.

- Second alternative is Daily Simple SOFR or Compounded SOFR.
- If the second alternative were to become unavailable, then an alternate benchmark rate plus a spread adjustment would be selected by the lender (bilateral loans) or the borrower and the administrative agent (syndicated loans), giving due consideration to:
  - Any selection or recommendation by the Relevant Governmental Body (i.e., the Federal Reserve or the FRBNY) or
  - Any evolving or then-prevailing market convention.

- Currently, the Hardwired Approach does not include a mechanism to subsequently "flip forward" to Term SOFR if it subsequently becomes available (some market participants have independently added this mechanism).

Decision-making in Bilateral versus Syndicated Loans

- Alternate Benchmark Rate:
  - Bilateral loans – decisions made by the lender (but the borrower may object).
  - Syndicated loans – decisions made by the borrower and/or the administrative agent (but the required lenders may object).
- Early Opt-in Election:

  Determination

  - Bilateral loans - the lender that loan facilities exist referencing an alternate benchmark rate.
  - Syndicated loans – the administrative agent or the required lenders determine(s) that loan facilities exist referencing an alternative benchmark rate.

  Election

  - Bilateral loans – the lender elects to exercise the early opt-in (but the borrower may object).
  - Syndicated loans – the administrative agent and the borrower jointly elect to exercise the early opt-in (but the required lenders must consent/may object).

What About Interest Rate Swaps?

- Existing LIBOR provisions included in legacy derivatives transactions (e.g., interest rate swaps) do not anticipate a permanent cessation of LIBOR.
- To address this problem, in 2020, the ISDA introduced the IBOR Fallbacks Supplement (the "Supplement") and the IBOR Fallback Protocol (the "Protocol").
- The Supplement amends the 2006 ISDA Definitions to incorporate fallback language into new swap transactions, providing for the transition from LIBOR to SOFR once LIBOR is either discontinued or considered non-representative.
- Under the Supplement, the LIBOR replacement will be SOFR compounded in arrears over a given interest period plus a spread adjustment.
- The fallback language will automatically apply to new swap transactions incorporating the 2006 ISDA Definitions executed on or after January 25, 2021.

- The Protocol, also effective as of January 25, 2021, allows swap counterparties to amend the terms of their legacy swap transactions in order to incorporate the Supplement's fallback language.
- On March 5, 2021, the ISDA released a statement confirming that the FCA's March 5th announcement constituted an "Index Cessation Event" under the Supplement and the Protocol for all LIBOR settings.
- The occurrence of the Index Cessation Event:
    - Establishes the "Index Cessation Effective Date" for each LIBOR setting (i.e., immediately after December 31, 2021 for one-week and two-month LIBOR and June 30, 2023 for the remaining LIBOR tenors) and
    - Fixes the date for determining the spread adjustments to be added to the fallback rate in order to approximate LIBOR (i.e., March 5, 2021).
- In tandem with its own fallback approach, the ARRC has encouraged broad market uptake of the Protocol.

- This transition is not without its risks:
    - Borrowers typically execute swap transactions in order to hedge the interest rate risk associated with a floating rate, LIBOR-based loan.
    - Although linked by the swap transaction, the interest rate swap and the underlying loan are governed by separate agreements.
    - The fact that an interest rate swap transitions to SOFR under the Protocol does not mean that the underlying loan agreement would also automatically transition to SOFR.
    - As a result, borrowers could be left with a mismatch in floating rates under the interest rate swap versus the loan transaction, resulting in a less effective hedge.
    - Even if both the interest rate swap and the underlying loan transition to SOFR, additional mismatches could also occur if the transition occurs at different times or under a different methodology.
- Borrowers, lenders and swap counterparties should review and, if necessary, conform the interest rate mechanics in their linked/hedged transactions, to ensure that the interest rate swap and underlying loan fall back to the same replacement rate in a consistent manner.

State and Federal Legislation

- In April 2021, the New York State Legislature adopted new Section 18-C of the General Obligations Law ("Section 18-C"):
  - Intended to address the problem of tough legacy contracts that are LIBOR-based but are difficult to amend and predate discussions of the LIBOR phase-out.
  - Provides an interest rate backstop to automatically replace LIBOR "by operation of law" on the Benchmark Replacement Date.
  - Modeled on the ARRC's Hardwired Approach, Section 18-C uses as its "recommended benchmark replacement" the SOFR-based benchmark replacement recommended by the Federal Reserve, FRBNY or the ARRC.
  - Retains flexibility to opt out and select an alternative to LIBOR in lieu of the predetermined SOFR-based benchmark replacement.
  - Only applies to contracts that:
    - Are governed by New York law;
    - Employ LIBOR as the benchmark interest rate index; and
    - Contain no fallback provisions or fallback provisions based in any way on LIBOR (e.g., provisions that fall back to the prime rate or the federal funds rate would not be affected).
  - Provides a safe harbor from litigation.

- It remains to be seen whether the enforcement of Section 18-C will encounter legal challenges. For example:
  - The "sacred rights" problem: the alteration of certain economic provisions in a credit agreement, including maturity date, interest rate, amortization, and other repayment terms, typically require unanimous consent of the holder(s) of the debt.
  - Section 18-C may run afoul of indentures governed by the Trust Indenture Act of 1939 (the "TIA"):
    - TIA is a federal statute.
    - Section 316(b) of the TIA provides that the right of a holder of an indenture security to receive a debt service payment on the applicable due day cannot be impaired.
  - Section 18-C appears to anticipate these potential legal challenges, by declaring that the selection or use of a recommended benchmark replacement will not constitute an amendment or modification of any contract, or prejudice, impair or affect any person's rights thereunder.
  - No Ex Post Facto Laws – nevertheless, a New York statute purporting to override the terms of a previously-executed contract may be problematic from a federal and state law perspective, including under the Contracts Clause and Takings Clause of the U.S. Constitution. However, without amendments, such contracts will be unworkable by their terms after the LIBOR phase-out.

- Congress is considering federal legislation that would address the LIBOR phase-out:
  - In contrast to a patchwork of state legislation, uniform federal legislation could address all contracts governed by state or federal law, providing certainty and consistency.
  - Federal legislation could preempt a state law like Section 18-C, avoiding conflict of laws issues.
  - Unlike a state law, federal legislation could override the TIA.
  - Federal legislation could address any potential federal tax or securities law implications relative to the LIBOR phase-out.

Tax Risks for Non-profit Corporations

- The LIBOR phase-out poses unique tax risks to borrowers that are 501(c)(3) corporations.
- Under certain circumstances, 501(c)(3) corporations may borrow the proceeds of tax-exempt municipal bonds issued by a quasi-public corporation.
- If the bonds bear interest at a LIBOR-based rate, then the LIBOR phase-out and resulting amendments to the applicable credit agreements may subject the borrower to reissuance risk and the possible termination of a qualified hedge.
- On October 9, 2019, the Internal Revenue Service ("IRS") published proposed regulations (which may be relied upon prior to the release of the final regulations) that would allow 501(c)(3) corporations to amend their outstanding tax-exempt financial obligations in order to replace LIBOR with an alternate reference rate without triggering such tax issues; provided, that the amendments satisfy certain conditions.

- Proposed Treasury Regulation Section 1.1001-6 generally provides that if the terms of a debt instrument or non-debt contract are altered or modified to replace, or provide or alter a fallback to, an IBOR-referencing rate with a "qualified rate," such alteration or modification (and any "associated" alternations or modifications, such as the addition of an obligation for a party to make a one-time payment to offset the change in value of a debt instrument resulting from the replacement of the IBOR-referencing rate) will not result in recognition of income, gain, deduction or loss to any party thereto under Section 1001 of the Internal Revenue Code.
- A "qualified rate" generally includes, but is not limited to, a rate based on SOFR, provided the fair market value of the debt instrument or non-debt contract after the alteration or modification is substantially equivalent to its fair market value prior thereto.
- In determining "fair market value" for this purpose, the parties may use any reasonable, consistently applied method, taking into account the value of any one-time payment as described above.
- Pending release of the final regulations, the IRS also issued Revenue Procedure 2020-44 ("Rev. Proc. 2020-44") on October 9, 2020.
- Under Rev. Proc. 2020-44, the IRS has endorsed certain amendments to financial obligations that incorporate fallback language recommended by the ARRC and ISDA.

Disclosure Risks for Non-profit Corporations

- Borrowers that are 501(c)(3) corporations should confirm their disclosure obligations with respect to the LIBOR transition.
- Pursuant to the Securities and Exchange Commission's Rule 15c2-12, an underwriter may not sell municipal bonds without determining that the issuer or the "obligated person" (i.e., the 501(c)(3) corporation that borrows the proceeds of the bonds) has entered into a written continuing disclosure agreement to disclose certain matters to the bondholders on an ongoing basis.
- Pursuant to continuing disclosure agreements entered into after February 27, 2019, such borrowers are required to file a notice with the MSRB's EMMA system of:
  - The incurrence of material financial obligations or
  - Material amendments to outstanding financial obligations, if such amendments are determined to affect existing bondholders.

- The borrower would be required to file the notice within ten business days of the effective date of the financial obligation or amendment.
- Amending the credit agreements underlying the borrower’s financial obligations to add or change interest rate fallback language could trigger this filing requirement.
- As a preliminary matter, such borrowers should review their continuing disclosure policies and procedures, particularly the standard for assessing materiality of a financial obligation or related amendment.
- Then, the borrower should work with its counsel and financial advisor to confirm the specific process for:
    - Evaluating LIBOR-related amendments to its financing agreements against this standard and
    - Ensuring the filing of any required notices within the necessary timeframe.
- For outstanding financial obligations that already contain effective fallback language, such that no amendment to the underlying agreements is necessary, borrowers may consider whether a voluntary disclosure regarding the change in the benchmark rate is appropriate.
- As a general matter, the SEC encourages borrowers to provide bondholders with forward-looking information regarding the impact of the LIBOR phase-out on their outstanding municipal securities, derivatives positions, hedging strategies, investments and other contracts, as well as their overall financial and operating conditions.

Please contact me for more information on the LIBOR Phase-out

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