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Litigation Risks in Transitioning out of LIBOR

What would you do if one day the essence of your financial agreement, the price of your contract, was suddenly changed into something ambiguous which requires interpretation or negotiation? Will you try to negotiate all of your agreements again or will you resort to litigation? It is possible that the decision is out of your hands.

In this article, we will look into the imminent discontinuation of LIBOR and the potential litigation risks it carries for market participants.

While it took some time to alter the 50-year-old tradition, in July 2017 the Financial Conduct Authority ("**FCA**") announced that as of January 2022, the FCA would no longer compel panel banks to submit contributions for LIBOR.[1]

"You can imagine the litigation risk when the reference rate for a 20-year contract disappears and there's no clear path to replace it. Now imagine 190 trillion dollars' worth of those contracts. This is a DEFCON 1 litigation event if I've ever seen one."[2]

LIBOR, the London Interbank Offered Rate, is a prominent and internationally accepted interest rate benchmark based on unsecured interbank short-term lending and borrowing. LIBOR has been commonly used as the basis for calculating interest and other payments of financial products for more than 50 years and it is commonly used in correlation with almost all financial products, including derivatives, bonds, loans and mortgages.

LIBOR originated in the late 1960s when a syndication of the major London banks submitted to the Intercontinental Exchange the interest rate at which they were prepared to lend money to one another. A representative rate was then published daily to allow market participants a simple method of calculation funding costs; the rate also indicated how the panel banks viewed the stability of their competitors. This great power made LIBOR prone to manipulation.

In 2012, the LIBOR scandal shocked the banking community, as it was discovered that a number of the major panel banks were artificially manipulating LIBOR to benefit their trading positions. The scandal was the beginning of LIBOR demise and its replacement by (near) risk-free rates ("**RFRs**") such as the Sterling Overnight Index Average ("**SONIA**").

While it is still possible that the usage of LIBOR continues into 2022, market participants should not rely on the availability LIBOR for legacy contracts.[3] Instead, they should seek to mitigate their dependency and exposure to LIBOR as the transition into less easily manipulated, more transparent and more robust alternative rates will not be stopped. Lingering financial actors risk finding themselves behind the curve, with LIBOR-linked obligations that are no longer fit for purpose.[4]

In the background, an alternative(s) to LIBOR is vigorously sought after; the Bank of England Sterling Working Group officially recommended a move to SONIA;[5] the ARRC selected SOFR as its preferred alternative; SARON has been named the preferred alternative for Swiss Franc markets; TONAR as the preferred alternative for Japanese Yen markets and ESTER as the preferred alternative for Euro markets.[6]

It is critical for market participants to understand their LIBOR exposures, including for legacy contracts, which are meant to mature after 2021, and we encourage our clients to assess their interaction with LIBOR across their business and create a plan to move away from LIBOR and into alternative rates ahead of 2022

In terms of possible fixes, there are several, none of which provides the ultimate solution.

The market's preferred solution would probably be for the legislator to announce a legislative fix, replacing LIBOR with something else, unfortunately the FCA implied that while legislators might redefine LIBOR as "*RFRs plus fixed spreads*", until that happens market participants should not count on this alternative and take required actions to evaluate their exposure and eliminate it.[7]

The International Swaps and Derivatives Association, is working to develop a fallback arrangement for LIBOR which can possibly be seamlessly implemented by changing the association's definitions for interest rate derivatives, which will allow a more streamline solution in legacy agreements.[8]

Nevertheless, until these solutions mature, parties to LIBOR legacy contracts will need to negotiate and agree a way forward. The discontinuance of LIBOR is sure to have an effect on international litigation. Unsurprisingly, most market participants did not anticipate that LIBOR would ever discontinue, so while some contracts may revert to fallback rates[9] others may be silent on what happens in the absence of LIBOR or they might include a provision meant for a temporary unavailability of LIBOR, not its ultimate discontinuation. In these cases, parties will need to negotiate a new acceptable rate (ideally) before the triggering of LIBOR provisions; if they fail, litigation is inevitable.

Litigation may bloom even if the panel banks (or some of them) continue to submit their LIBOR quotes, a lander may assert that LIBOR is no longer a representative benchmark once the number of submissions has reduced dramatically or in fact once the value of LIBOR transactions in the market has done the same. Another potential claim a lander may raise is that the agreement to pay has been frustrated as LIBOR is no longer available.

We encourage our clients to review their exposure, negotiate and amend their positions to the best of their abilities and prepare for litigation if they are unable to do so effectively.

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[1] See speech given by Andrew Bailey, FCA Chief Executive (July 27th, 2017), available at: https://www.fca.org.uk/news/speeches/the-future-of-libor. On the backdrop of the COVID-19 epidemic, the UK's Working Group on Sterling RFRs delayed the deadline by which it recommended lenders to stop issuing LIBOR linked loans to the end of Q1 2021 but did not postpone the date on which firms can no longer rely on LIBOR being published. See RFRWG Further statement on the impact of Coronavirus on the timeline for firms' LIBOR transition plans, (Apr. 2020), https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/rfrwg-further-statement-on-the-impact-of-coronavirus-on-timeline-for-firms-libor-transition-plans.pdf?la=en&hash=68299592AF83B04E3BF60BA3209AA9A73522E9D4

[2] See speech given by Michael Held, NY Fed Exec VP and General Counsel (Feb. 26th, 2019), available at: https://www.newyorkfed.org/newsevents/speeches/2019/hel190226

[3] See speech given by Edwin Schooling Latter, Director of Markets and Wholesale Policy at the FCA (Jan 28th, 2020), available at: https://www.fca.org.uk/news/speeches/libor-transition-and-contractual-fallbacks

[4] See speech given by Andrew Hauser, BoE Markets' Executive Director (June 27th, 2020), available at: https://www.bankofengland.co.uk/-/media/boe/files/speech/2019/join-the-revolution-why-it-makes-business-sense-to-move-on-from-libor-speech-by-andrew-hauser.pdf?la=en&hash=300FC737B7BD085F8BC09E14F63C2C68EE7011E9

[5] New Legacy loan transactions referring Sterling LIBOR, THE BANK OF ENGLAND https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/new-and-legacy-loan-transactions-referencing-sterling-libor.pdf (last visited, May 13th, 2020); earlier this year it was announced that the BOE will also publish a compounded SONIA index to complement the existing overnight SONIA: see speech given by Andrew Hauser, Executive Director for Markets, THE BANK of England (February 26th, 2020), available at: https://www.bankofengland.co.uk/speech/2020/andrew-hauser-isda-sifma-amg-benchmark-strategies-forum-2020

[6] The ARRC Selects a Broad Repo Rate as its Preferred Alternative Reference Rate, FEDERAL RESERVE BANK OF NEW YORK (June 22, 2017), https://www.newyorkfed.org/medialibrary/microsites/arrc/files/2017/ARRC-press-release-Jun-22-2017.pdf

[7] See speech given by Andrew Bailey, FCA Chief Executive (July 15th, 2019), available at: https://www.fca.org.uk/news/speeches/libor-preparing-end

[8] Interbank Offered Rate (IBOR) Fallbacks for 2006 ISDA Definitions: *Supplemental Consultation on Spread and Term Adjustments for Fallbacks in Derivatives Referencing USD LIBOR, CDOR and HIBOR and Certain Aspects of Fallbacks for Derivatives Referencing SOR* (May 16th, 2019), https://www.isda.org/a/n6tME/Supplemental-Consultation-on-USD-LIBOR-CDOR-HIBOR-and-SOR.pdf

[9] e.g. "*if the index I no longer available the note holder will choose a new index which is based upon comparable information*".