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CLIENT MEMORANDUM

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LIBOR Transition Update: An Overview of Federal LIBOR Legislation

Signed into law on March 15, 2022, the Adjustable Interest Rate (LIBOR) Act (the "LIBOR Act") [1] establishes a nationwide framework for the replacement of LIBOR as a benchmark interest rate in contracts lacking effective fallback provisions that are either impossible or practically impossible to amend before the tenor cessation date. By operation of law, the LIBOR Act replaces remaining references to the most common LIBOR tenors in these so-called "tough legacy" contracts with a benchmark interest rate to be set by the Board of Governors of the Federal Reserve System (the "Federal Reserve"),[2] which is to be based on the Secured Overnight Funding Rate ("SOFR").[3]

In this alert, we provide an overview of the LIBOR Act and explain why its passage may resolve issues with a patchwork system of state legislation.

Background

For several years, market participants have been in the process of amending contracts in anticipation of LIBOR's discontinuance. One particularly common dilemma market participants have encountered in their amendment efforts relates to so-called tough legacy contracts, which make up a significant proportion of the more than two hundred trillion dollars-worth of financial instruments referencing LIBOR.[4] While there is no formal definition, tough legacy contracts are understood as existing LIBOR-referencing contracts that cannot, before the cessation of LIBOR, either convert to a replacement benchmark rate or be amended to include a fallback provision.

On March 6, 2020, the Alternative Reference Rates Committee ("ARRC") published draft New York State legislation, in part to address issues arising from contracts lacking effective fallback provisions.[5] Among other provisions, the proposed legislation provided for the replacement of LIBOR with fallbacks and spread adjustments based on SOFR.[6]

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1 H.R. 2471, Div. U.

2 *See* LIBOR Act, § 104(a), (b).

3 LIBOR Act, § 103(6).

4 *See* LIBOR Act, § 102(a).

5 *See Progress Report: The Transition from U.S. Dollar LIBOR*, ARRC, at 12 (Mar. 31, 2021), available here (last visited Apr. 7, 2022).

6 See id.

On April 6, 2021, New York became the first state to enact LIBOR Transition legislation.[7] As we previously reported, this legislation largely mirrored the ARRC recommendations and proposed provisions.[8] Shortly thereafter, the State of Alabama enacted a nearly identical statute.[9] Several other states have since proposed similar legislation.[10]

The state-by-state legislative solutions had several drawbacks. For example, questions remained regarding whether the mandatory replacement provisions of the state legislation would violate the Contracts Clause of the U.S. Constitution, which prohibits states from passing laws which would impair the right to contract.[11] In particular, the New York mandatory provision requiring the use of the recommended benchmark (SOFR) was seen by some observers to be a potential impairment of contractual rights.

Other observers questioned whether mandatory replacement provisions would violate Section 316(b) of the Trust Indenture Act of 1939 ("TIA"), which broadly provides that the rights of security holders to receive payment of principal and interest when due may not be impaired without consent.[12] Previously, courts had assumed that any amendment to an instrument's "core payment terms," including principal and interest owed, would fall within the ambit of Section 316(b) of the TIA.[13] Thus, for example, if the LIBOR setting for a legacy contract exceeded the sum of the replacement benchmark rate and the applicable spread, a security holder could claim that its right to receive full payment of interest was impaired without consent, in violation of the TIA.

Given these legal uncertainties, the need for a nationwide approach became increasingly apparent. On December 8, 2021, the House of Representatives passed the initial version of the LIBOR Act (H.R. 4616), which sought to provide a national LIBOR Transition framework.[14] The proposed legislation was received with widespread support by multiple constituents.[15] The ARRC also endorsed the legislation, noting that the bill would "ensure the stability of nationwide markets [and] help to effect a fair transition for financial contracts which do not consider the permanent cessation of LIBOR and have no workable fallbacks."[16] After passing the U.S. Senate by a vote of 68 to 31,[17] President Biden signed the bill into law on March 15, 2022.[18]

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7 *See* N.Y. Gen. Oblig. Law Art. 18-C.

8 *See Governor Cuomo Introduces Proposed New York Legislation on LIBOR Replacement*, Paul Weiss (Jan. 28, 2021), available here (last visited Mar. 31, 2022).

9 *See* Ala. Code § 5-28-1 *et seq.*

10 To date, five other states have proposed LIBOR transition legislation: Florida, Georgia, Indiana, Nebraska, and Tennessee.

11 U.S. Const. art. 1, § 10, cl. 1.

12 *See* 15 U.S.C. § 77ppp(b).

13 *See, e.g.*, BOKF*, N.A.* v. *Caesars Entm't Corp*., 144 F. Supp. 3d 459, 472 (S.D.N.Y. 2015) (stating that it is "indisputable that if [the issuer] had unilaterally adjusted the amount of principal or interest it would pay on a note that would be an impairment under section 316(b).").

14 *See* Adjustable Interest Rate (LIBOR) Act of 2021, H.R. 4616, 117th Cong. (2021), available here.

15 *See*, *e.g.*, *Oversight of the Treasury Department's and Federal Reserve's Pandemic Response*, Virtual Hearing Before the H. Comm. on Financial Services, 117th Cong. 15 (2021) (statement of Treasury Secretary Yellen), available here (last visited Apr. 7, 2022); *Monetary Policy and the State of the Economy*, Virtual Hearing Before the H. Comm. on Financial Services, 117th Cong. 13 (2021) (statement of Federal Reserve Chair Powell), available here (last visited Apr. 7, 2022).

16 ARRC Welcomes Passage of LIBOR Transition Bill by U.S. House of Representatives, ARRC, at 1 (Dec. 9, 2021), available here (last visited Apr. 7, 2021).

17 Mark Mauer, *Congress Passes Legislation on Libor Fix as Part of $1.5 Trillion Spending Package*, WALL ST. J. (Mar. 11, 2022), available here.

18 H.R. 2471, Div. U.

The LIBOR Act

Overview

The LIBOR Act's stated purpose is to "preclude litigation" related to the LIBOR transition by establishing "a clear and uniform process, on a nationwide basis, for replacing LIBOR."[19] The Act broadly defines LIBOR contracts to include, without limitation, agreements of any type that, by their terms, continue to use LIBOR as a benchmark rate as of the applicable replacement date.[20] It strictly applies to the most common tenors—the overnight, one-month, three-month, six-month, and 12-month USD tenors—and explicitly excludes the less common one-week and two-month tenors.[21]

Substantively, the legislation provides for the mandatory and automatic replacement of LIBOR with an alternative benchmark rate to be set by the Federal Reserve on the LIBOR replacement date.[22] It establishes a safe harbor from litigation for claims arising out of selecting or using the Federal Reserve identified benchmark.[23] The statute also provides that federally supervised banks are not required to use SOFR for non-LIBOR related loans, and limits the ability of regulators to initiate enforcement action against any bank solely for electing a non-SOFR benchmark interest rate.[24] Further, through its safe-harbor provision, the LIBOR Act reassures market participants of the benefits of electing SOFR as a replacement rate by providing that no person may be subject to any claim or liability arising out of selecting or using the Federal Reserve identified-benchmark or implementing conforming changes permitted under the LIBOR Act.[25]

Advantages of the LIBOR Act

The LIBOR Act establishes a national framework for resolving tough legacy contracts. In many respects, the statute parallels the New York legislation, which largely incorporated the ARRC recommended provisions. However, the federal legislation provides some important advantages over state-based solutions.

Uniformity

The LIBOR Act contains two express preemption provisions. First, it preempts other replacement benchmark legislation for the most common tenors—the overnight, one-month, three-month, six-month, and 12-month USD tenors.[26] Second, it preempts state and local laws that limit the manner interest is calculated with respect to the replacement benchmark rate.[27] The national framework provided by the federal legislation therefore prevents conflict of law issues arising between states with competing legislation.

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19 LIBOR Act, § 102(b).

20 LIBOR Act, § 103(16).

21 LIBOR Act, § 103(15). The two less common one-week and two-month tenors were discontinued on December 31, 2021. *ICE LIBOR Feedback Statement on Consultation on Potential Cessation*, ICE Benchmark Administration Limited, at 17 (Mar. 5, 2021), available here (last visited Mar. 18, 2022). As the ARRC has observed, these two tenors "are uncommon," and there are only a "narrow set" of LIBOR referencing contracts of this type that contain no fallback provisions. *See ARRC Releases Statutory Fallback Recommendations for 1-Week and 2-Month USD LIBOR Contracts* (Dec. 3, 2021), available here (last visited Mar. 18, 2022).

22 *See* LIBOR Act, § 104(a).

23 LIBOR Act, § 105(c).

24 LIBOR Act, § 106(a), (b).

25 LIBOR Act, § 105 (c).

26 *See* LIBOR Act, § 107 (1).

27 *See* LIBOR Act, § 107 (2).

Certainty

As noted above, state legislation faced potential legal challenges on Contract Clause and TIA grounds. The LIBOR Act, however, peremptorily resolves these two issues.

First, unlike state legislation, federal legislation is not subject to the Contract Clause because the clause explicitly and strictly applies to state governments. It does not, in and of itself, restrain the federal government from limiting the right to contract.[28]

Second, the LIBOR Act forestalls challenges predicated on the TIA by expressly amending Section 316(b).[29] Indeed, the amendment makes clear that "the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security shall not be deemed to be impaired or affected" by the automatic replacement of LIBOR with a replacement benchmark rate.[30]

Conclusion

The LIBOR Act should help mitigate market risks and reduce potential litigation arising from tough legacy contracts. This should allow industry participants to focus on other operational, regulatory, and market risks associated with the upcoming cessation of the more common LIBOR tenors.

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28 *See* U.S. CONST. art. 1, § 10, cl. 1.

29 LIBOR Act, § 108 (adding 15 U.S.C. § 77ppp(b)(3)).

30 See id.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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