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Legislative Fix For Post-Libor Issues Seems Improbable

By **Anne Beaumont** (March 27, 2019, 1:26 PM EDT)


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In 2014, the Federal Reserve Board of Governors and the Federal Reserve Bank of New York convened the U.S. Alternative Reference Rates Committee "in order to identify best practices for alternative reference rates, identify best practices for contract robustness, develop an adoption plan, and create an implementation plan with metrics of success and a timeline." After completing that work, the ARRC was dormant until it was reconstituted in 2018 to carry out the plan it had developed to develop a replacement for the London Interbank Offered Rate.

In July 2017, the U.K.'s Financial Conduct Authority announced that it would no longer compel Libor panel banks to make submissions after the end of 2021, and it and other regulators have since made clear that market participants need to find alternatives to Libor. As a result, the ARRC has kicked into high gear, and now meets several times a year to address the numerous, significant challenges the transition away from Libor presents.

It now appears that the ARRC is considering asking the New York State Legislature to pass a statute that would apply to certain types of existing or "legacy" contracts referencing Libor.

Minutes of ARRC meetings are published on a dedicated ARRC website hosted by the New York Fed, and several recent minutes, including those for the December 2018 and January 2019 meetings, indicate that a legal working group (constituted from the ARRC, which is comprised of a variety of market participants and regulators) has been tasked with looking into seeking "legislative relief in order to mitigate risks related to legacy contracts for certain cash products in the event of a Libor cessation." The topic also has come up repeatedly in questions submitted to the ARRC's Friday afternoon "open office hours" conference calls.

The January 2019 ARRC minutes indicate that the purpose of the legislation would be to address an expected backlog of potentially thousands of contracts that cannot practicably be amended prior to the end of 2021. The contemplated legislation currently is focused on floating rate notes and securitizations because, to change a term such as the interest rate, they generally require unanimous noteholder consent.

That will be nearly impossible to obtain, both because it will be difficult to identify and track down all of the holders, and because some holders may refuse to consent. An inability to amend such contracts would mean that either they would have no fallback language at all, leaving holders and issuers alike in a quandary as to the applicable interest rate, or they would convert to a fixed rate, such as the last-quoted Libor.

As I understand it, the contemplated statute would declare certain types of contracts to have been "substantially performed" (i.e., not breached) if, when Libor ceases to be available, fallback language that has been adopted or endorsed by the ARRC or International Swaps and Derivatives Association is followed and a similarly officially endorsed "spread adjustment" is applied.

A scenario in which such a statute might apply would be where Libor ceases permanently to be quoted, and the trustee for a securitization ceases calculating and paying interest to noteholders based on Libor as provided in the applicable indenture and instead calculates and pays interest using the Secured Overnight Financing Rate, plus an ARRC-approved spread, and following ARRC-approved contractual fallback language.

If, under those circumstances, a noteholder were to sue (putting aside procedural barriers such as a no-action clause) on the basis that the interest payments were insufficient and had been calculated in breach of the indenture, the contemplated New York statute would supply a defense to the trustee. It would, it appears, be irrelevant that the noteholder might be able to establish substantial damages due to the change in calculation — the claim would be defeated by application of the statute. Absent the statute, the trustee would face a situation in which it is compelled to pay interest based on Libor but there is no Libor, or in which the formerly floating rate of interest that is due becomes fixed at the level of the last-quoted Libor.

I see at least two potential obstacles to the use of legislation to address this type of issue. For one, there is a serious question whether there is the political interest or will on the part of lawmakers to pass such a statute given that it will result in an economic advantage to some counterparties at the expense of others. Moreover, even if the interest and will are there, such a statute could run afoul of the United States Constitution or the New York State Constitution.

New York state, of course, has a history of enacting business-friendly statutes to address market-wide legal challenges. Among the most prominent are General Obligations Law Sections 5-1401 and 5-1402, which declare the enforceability of New York choice-of-law and forum-selection clauses in respect of transactions that, broadly speaking, involve at least $250,000.

These statutes ease the way for the application of New York law and the exercise of jurisdiction by New York courts where the parties wish to take advantage of them. Critically, they do not purport to alter substantive rights, nor do they favor or cause economic harm to any particular party.

In contrast, the ARRC's contemplated statute would directly affect substantive rights. By definition, SOFR is not equal to Libor. Thus, to use SOFR in place of Libor, a "spread adjustment" is necessary to account for the differences between the rates.[1] There are various views as to both how to calculate such an adjustment and how to apply it. What is clear, though, is that there is no single "correct" adjustment, and since each transaction is a zero-sum situation, any conversion will benefit one side of the transaction at the direct expense of the other.

Indeed, market participants and experts now generally seem to accept that some level of "value transfer" is inevitable when Libor is discontinued, because the conversion will be inexact. Interestingly, no single category of market participants stands to benefit. The benefits and detriments will be allocated differently both among institutions and even within large institutions, and, indeed, it cannot be said in advance who will be winners and who will be losers. So it cannot be said that overall the contemplated statute will help the buy side at the expense of the sell side or vice versa, much less that it could even be designed to do so if that were thought desirable.

One thing, however, is sure: Some parties will be helped, and others harmed. While the ARRC and others are working hard to minimize such harm, it cannot be eliminated altogether, and any nonvoluntary approach that is imposed through legislation necessarily means the state government would end up favoring some market participants and disadvantaging others. In addition, because of the ubiquity of New York choice-of-law provisions in complex financial transactions, such legislation would have effects far beyond the boundaries of the New York state.

It is one thing for parties to agree (I hope, knowingly) to such results, but it would be unprecedented for the New York State Legislature — or any other governmental entity — to impose them. In the current political climate, I question seriously whether the ARRC's contemplated legislation is likely to be a priority item for either the Legislature or Governor Andrew Cuomo. Simply put, it seems an unlikely place for either branch of the New York state government to spend political capital.

Even if this political obstacle is surmountable, there is an equally serious legal one presented by the United States and New York State Constitutions. Article I, Section 10, Clause 1 of the U.S. Constitution states that "No State shall…pass any…Law impairing the Obligation of Contracts." As interpreted by the United States Supreme Court, this provision prohibits "State legislation which seeks to change the obligation of such contracts in any particular."[2]

It most recently surfaced as a concern that had to be carefully navigated during the financial crisis, when Congress considered legislative measures to tax or nullify what were viewed as excessive bonuses and other compensation in the financial industry.[3] In addition to this federal constitutional limitation, both the U.S. and New York State Constitutions contain "takings" clauses, which, broadly speaking, prohibit the taking of private property — including through legislation — without just compensation. These constitutional parameters would have to be considered and navigated in developing effective legislation that purports to affect contractual obligations and relations among parties to Libor-based transactions.

Although the ARRC's desire to address the significant operational challenges presented by the need to amend thousands of contracts is understandable, doing so by amending contracts wholesale through legislation, and without the knowledge or consent of at least some of the parties to those contracts, seems likely to be unworkable.

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[1] Libor is an unsecured rate that reflects the credit quality of the contributing panel banks. SOFR, by contrast, is a secured rate based on overnight repo that has no bank-credit component.

[2] In re State Tax on Foreign-Held Bonds, 82 U.S. 300, 326 (1872)

[3] See Ashby Jones, Would an AIG-Bonus Tax Pass Constitutional Muster? (A Tribe Calls 'Yes!'), WSJ Law Blog (Mar. 18, 2009) (discussing constitutional issues raised by proposed 91% tax on bonuses paid to AIG employees); see generally Robert Meltz, When Congressional Legislation Interferes with Existing Contracts: Legal Issues, Congressional Research Service R42635 (Aug. 20, 2012),