RPC

LIBOR: Litigation risks in the endgame?

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LIBOR and SONIA – the back story

"*LIBOR: Entering the Endgame*" was the aptly named speech given by Andrew Bailey, Governor of the Bank of England, in July 2020. COVID-19 has caused mass disruption across the world but LIBOR as we know it nevertheless remains scheduled to cease at the end of 2021. However, despite the Financial Conduct Authority (FCA) first announcing the move away from LIBOR in July 2017, the transition is proving difficult.

The Working Group on Sterling Risk-Free Reference Rates (Working Group) recommended the Sterling Overnight Index Average (SONIA) benchmark as their preferred Risk-Free Rate (RFR) to replace LIBOR in sterling markets. However, as most UK lenders transition to SONIA, it is increasingly clear that this transition is complex since LIBOR and SONIA are fundamentally different. LIBOR is a forward-looking rate that gives borrowers certainty about the amount of their interest payments at the start of the interest period, whilst SONIA is a backward-looking rate where the amount of the interest payable can only be determined at the end of the interest period. SONIA is also an RFR so, unlike LIBOR, does not incorporate any credit risk.

In this bulletin, as we approach the LIBOR "endgame", we explore how the transition could lead to disputes and litigation from three different sources:

1. contractual interpretation claims
2. claims arising out of renegotiations, and
3. mis-selling claims.

How might contractual interpretation claims be framed?

There will be many contracts linked to LIBOR that will remain outstanding and unamended after the 2021 deadline; these "legacy" contracts will include both contracts where no agreement could be reached ahead of the deadline and contracts that were not practicable to convert before the deadline. Examples of such contracts include securitisation bonds and older syndicated and bilateral loans. Parties to such contracts will need to determine how their contracts will operate once LIBOR is no longer being published.

Applicability of existing fallback provisions

In the first instance, parties will need to identify whether and how the existing fallback provisions in their legacy contracts apply. The main difficulty parties will face here is that most fallback provisions were not drafted with the complete discontinuance of LIBOR in mind.

Instead, those provisions are aimed at dealing with events where LIBOR is temporarily unavailable, such as if there is a market disruption event which causes LIBOR temporarily not to appear on the designated rate screen. For example, in 2018, the Loan Market Association, the trade association for the primary and secondary syndicated loan markets in EMEA, acknowledged that its previously existing fallbacks were not designed to be used long term and produced revised wording to allow for a replacement benchmark to be selected in various scenarios. Meanwhile, in acknowledgement of the need to amend its standard terms to account for the LIBOR transition, on 23 October 2020, ISDA launched the IBOR Fallbacks Supplement and IBOR Fallbacks Protocol. This supplement '*amends ISDA's standard definitions for interest rate derivatives to incorporate robust fallbacks for derivatives linked to certain IBORs*' (including LIBOR).

Therefore, in many cases, existing fallback provisions will change the economics of a contract in an unintended manner. For example, interest rates could differ substantially from what had been intended or a floating rate product may become a fixed rate product if the fallback provision refers to the last published LIBOR rate, which would not change in the future and therefore would be applied in perpetuity. As such, counterparties might find themselves in situations where they disagree about whether and how the fallback provisions apply as their interests will necessarily diverge in what is a zero-sum game.

A legislative fix

Recognising that there will be "tough legacy" LIBOR contracts – contracts which cannot realistically be amended or renegotiated and which do not have appropriate fallback provisions - the UK Government announced in June 2020 that it intends to grant the FCA additional regulatory powers that will allow it, amongst other things, to amend the methodology used to calculate critical benchmarks.

In essence, this could result in the production of a "synthetic LIBOR" (possibly tied to SONIA) that is used in legacy contracts in place of LIBOR, thereby avoiding the need to rely on impractical fallback provisions. However, there remains great uncertainty as to how the methodology will be amended and to what asset classes the synthetic rate would apply. Unsurprisingly therefore, the FCA has cautioned against parties relying on a legislative fix instead of transitioning their contracts away from LIBOR. In particular, the FCA has warned that it may not be possible to generate a synthetic LIBOR in all circumstances or for all LIBOR currencies.

Irrespective of how exactly the legislative fix is implemented and how the synthetic LIBOR is calculated, inevitably there will be the potential for disputes between parties. Notably, parties may disagree about whether their legacy contract falls within the scope of the legislative fix; the parties' interests in this regard may not align, with one party likely benefiting more from the application of the legislative fix than the other(s). If there is ambiguity or room for interpretation, therefore, there is scope for disputes.

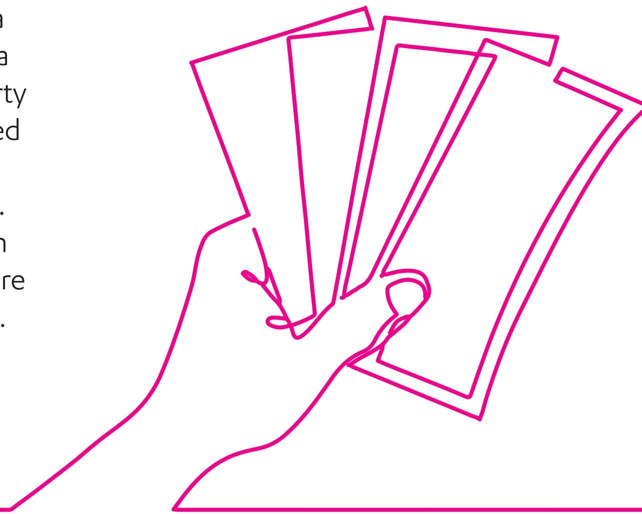
Force majeure and frustration

Force majeure and frustration are notoriously difficult to establish, but where they are, they can relieve the parties from their obligations under a contract. Not all contracts have force majeure clauses, but where they do, such a clause will amend the obligations of a party (or parties) to a contract when triggered by an extraordinary event or circumstances. On the other hand, frustration is a common law principle that applies where something occurs after the formation of a contract that renders the contract impossible to fulfil or transforms the performance obligation to something completely different from the obligation that existed when the contract was formed. Where a contract is frustrated, all the parties' obligations are discharged.

In the context of the LIBOR transition, where parties cannot rely on fallback provisions (whether because they do not exist or they do not work) or the legislative fix, or cannot agree an amendment, a party may seek to enforce a force majeure clause and/or claim that the contract has been frustrated. The consequences could be severe for counterparties: they could, for example, be left with immediately repayable loans or unhedged positions.

In this respect, it is interesting to note the position taken by the Alternative Reference Rates Committee (ARRC), a group of private-market participants convened by the Federal Reserve Bank of New York and the Federal Reserve Board to manage the transition from US dollar LIBOR to a new reference rate.

The ARRC has announced that their own legislative fix proposal will seek to prevent such disputes by, among other things: a) prohibiting a party from citing the discontinuance of LIBOR or the use of the statute-recommended replacement benchmark rate as justification for refusing to perform its contractual obligations or declaring a breach of contract; and b) providing a "safe harbour" from litigation to a party that selects the statute-recommended replacement benchmark rate as the replacement rate in a LIBOR contract. To date, the Working Group has given no indication that similar provisions are intended in respect of Sterling LIBOR.



Could claims arise out of renegotiations?

As identified above, many LIBOR contracts will be renegotiated ahead of the transition deadline and it will be very difficult, if not impossible, to amend existing agreements in a value neutral manner. Parties will be in a better or worse position under an amended contract depending on what reference rate they choose to replace LIBOR. Parties may look to counterbalance this by way of offering the worse-off party some form of benefit through spread-adjustment, a financial payment or otherwise. However, these negotiations may not take place against the same background as the original negotiations of the LIBOR contract. Borrowers may find themselves in a weaker bargaining position if, for example, market conditions are worse than they were at the time of entering into the contract or if the borrower is closer to its covenant limits. This could mean that lenders take advantage of their strengthened bargaining position to impose additional covenants on borrowers, require them to pay additional fees or simply increase the interest rate payable. Such actions may give rise to common law claims and may also engage FCA rules.

Are mis-selling claims a possibility?

It has already been over three years since the FCA first announced the intention to discontinue LIBOR at the end of 2021. As such, where a party (such as a borrower or a party to a derivatives contract) suffers loss under LIBOR contracts that were entered into post-July 2017, there may be scope for bringing a mis-selling claim against their counterparty. For example, a borrower may claim that the lender failed adequately to explain relevant information related to the LIBOR transition, or made misrepresentations in respect of it, such as how it would work or even its existence.

Additionally, claims could arise from representations made by lenders to borrowers in the context of agreeing potential amendments to their legacy LIBOR contracts. For example, a lender may have represented that an amendment was cost-neutral when that was not in fact the case. There is also the scope for misrepresentations to have been made in relation to the legislative fix. For example, a borrower could argue that it would have been better off under the legislative fix than under the amendments it agreed and that their lender represented otherwise in order to convince them to agree the amendments. Conversely, representations made by lenders that amendments were unnecessary in light of the legislative fix could also give rise to claims where the borrower is ultimately worse off under the fix.

Conclusion

Since the FCA's announcement of the cessation of LIBOR, understandably parties have focused on the transactional implications of the transition. Yet, with the transition deadline fast approaching, attention will need to be paid to the sizeable litigation risks that exist; pre-emptively considering these risks could prevent them being realised. However, the intrinsic difficulties with the transition, including the divergence in the interests of counterparties, points towards a view that contractual, renegotiation and mis-selling disputes will arise. How widespread these claims will be remains to be seen but given the prevalence of LIBOR as a reference rate across a wide range of financial markets and products, the scope is clearly significant.

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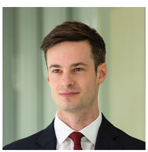

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