Where The Post-Libor Litigation Tsunami Will Hit

By **Marc Gottridge** (May 13, 2019)

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It is rare for a banking regulator to warn the industry of a "DEFCON 1 litigation event," a "situation that invites litigation" that "would be on a massive scale."[1] But that's precisely what Michael Held, executive vice president and general counsel of the Federal Reserve Bank of New York, recently did. Held sounded a litigation tsunami warning over the "trillions of dollars of existing contracts" that incorporate the Libor rate and extend beyond Libor's anticipated permanent cessation at the end of 2021, but lack "effective fallbacks" to replace Libor.[2]

After briefly considering the state of responses to regulators' calls for the development of workable Libor fallbacks in legacy instruments, this article addresses: (1) which products are subject to the greatest post-Libor litigation risk and (2) what kinds of claims we can expect. (Although Libor is also widely used in various types of consumer debt in the U.S., particularly mortgage loans, this article focuses on commercial and investment instruments.)

Background: The Demise of Libor and the Search for Workable Fallbacks

In July 2017, Andrew Bailey, chief executive of the U.K. Financial Conduct Authority, Libor's regulator, announced that the FCA would cease requiring panel banks to make Libor submissions after 2021. The FCA's rationale was that the underlying market that Libor sought to measure — for unsecured wholesale term lending among banks — was no longer sufficiently active to "ensure the rate is genuinely representative of market conditions."[3]

Since then, regulators have promoted the use of "risk-free rates," such as the Federal Reserve's newly developed Secured Overnight Financing Rate, or SOFR, to replace Libor, although it would be an understatement to say there are significant differences between Libor (a forward looking rate incorporating bank credit risk) and RFRs. As Held conceded, "The solution is not a simple substitution."[4]

Regulators have also urged market participants to review their legacy agreements to scrutinize the viability of the fallback mechanisms used to calculate contractual interest rates in the absence of Libor. In his recent speech, Held expressed concern that many contracts "seem to have been drafted assuming the gap" in Libor availability would be "temporary, not permanent," but if Libor permanently ceases to exist, "the fallback solutions in existing contracts become impractical or materially change the economics. That's a situation that invites litigation."[5]

The types of fallback provisions most likely to give rise to disputes include those:

- Requiring that a certain number of "reference banks" be polled as to their estimated cost of funding. The Libor panel banks have been subjected to years of class action and other litigation over alleged manipulation of Libor. It is difficult to imagine that any banks would voluntarily assume the risk of providing informal "Libor-like" quotes for the benefit of third parties. As a result, this fallback is likely to fail — effectively leaving the parties without any backstop (unless an additional fallback is contractually provided, as is sometimes the case).

- Reverting to the last available Libor rate — i.e., essentially converting a floating-rate obligation to fixed — or to a bank's prime rate. As Held observed, turning the last published Libor into a permanent term of a floating-rate agreement "is not a very satisfactory solution to either the issuers or the borrowers who thought they had an instrument that protected them against interest rate risk."[6] And replacing Libor with a prime (or similar) rate is likely to disadvantage borrowers.

- Granting discretion to the lender, calculation agent or trustee. Such discretion can be either unfettered or limited in some way — e.g., "the agent may choose a reasonably comparable index." But the exercise of discretion, particularly by an interested party such as a lender, can be second-guessed, and disputes may arise over what is "reasonably comparable" to today's Libor. Moreover, where discretion is granted to an agent or trustee, it is doubtful that they will be compensated for taking on such litigation risk.

Questions also abound as to what will trigger the fallback mechanism in a particular instrument, and how clearly the trigger event is defined. For example, a provision that the fallback mechanism applies when Libor is "unavailable" is likely to invite litigation. Should that be interpreted as requiring an FCA announcement that Libor no longer exists? If not, does "unavailability" require some regulatory action (e.g., the FCA declaring Libor unrepresentative of the underlying market), or does it depend on the conduct of the Libor panel banks (e.g., a certain number of them ceasing to contribute submissions)? And what happens if Libor's administrator continues to publish some form of Libor beyond 2021, even without many current panel banks' participation or the FCA's imprimatur?

Industry organizations, the Federal Reserve's alternative reference rates committee and market participants working on the planned transition from Libor have all devoted considerable thought to fallback issues, with the goal of reducing uncertainty. ARRC working groups, following detailed consultations, have started to publish, in Held's words, "specific actionable language to react to and start to use in contracts across different products"[7] including bilateral business loans, floating rate notes, securitizations and syndicated business loans. In the derivatives markets, the International Swaps and Derivatives Association is working on amendments to its standard 2006 definitions in order to facilitate the widespread adoption of effective fallbacks.

However, each market participant must decide whether and to what extent to try to adopt particular fallback language. As a practical matter, it may be difficult to obtain counterparties' agreements to amend existing documentation, at least in certain markets and situations. So significant litigation risk relating to legacy instruments is likely to persist.

Where Is the Greatest Litigation Risk?

Prudent financial institutions are taking stock of their portfolios to ascertain where their highest litigation risks may lie. Although that will necessarily vary from institution to institution, it is possible to identify certain types of products that, in general, may be more susceptible to become the subject of disputes.

Floating Rate Bonds and Notes

Investors' dispersed (and often indirect) ownership of these securities makes it difficult, if not impossible, to amend these securities. Where they contain a fallback, it usually provides for polling "reference banks" for their cost of funds as a fallback, sometimes with last published Libor as an additional backstop. Issuers may face litigation raising contractual and/or securities laws claims, discussed below.

Syndicated Loans

The multilateral nature of these loans, together with provisions requiring (in some cases) a 100% lender vote, may make it complicated in practice to agree on amendments that incorporate a robust fallback mechanism. Historically, many syndicated credit agreements have provided for the use of a defined base rate as a fallback; in practice, this has generally been higher then Libor.

Securitizations

Libor is widely used in securitizations, particularly collateralized loan obligations. These products often have complex structures with multiple classes of debt, whose respective holders have differing entitlements to payment and priority; trustees and agents also typically play important roles. Amendments may thus be difficult to implement. The fallbacks in legacy securities in this market have generally based on the polling/"reference bank" model, often with a further fall back to the last published Libor. In some cases, a trustee may be given broad authority to designate a replacement benchmark rate.

In general, the OTC derivatives governed by standard form documentation based on ISDA master agreements are less likely to pose significant litigation risk, because: these are typically bilateral arrangements this market already has experience with uniform modifications in the context of regulatory changes; and ISDA will shortly propose a protocol enabling parties to existing agreements to readily incorporate amendments to the 2006 ISDA definitions, including robust standardized fallback wording. Nevertheless, in particular cases parties may not adopt the amendments, particularly for transactions that are bespoke and/or are connected to structured lending transactions, leaving uncertainty and litigation risk.

What Claims Are Likely to Arise?

It is not too early to consider the kinds of claims that are likely to be filed. While not exhaustive, the discussion below highlights some issues that will probably be litigated in the Libor transition.

Contractual Interpretation

Numerous questions of contractual interpretation will certainly arise. For example, as previewed above, the application of triggers to convert the applicable rate from Libor to something else may well generate litigation, particularly if the contract is less than clear about the event causing or permitting the conversion to take place.

For example, a borrower paying interest under a promissory note at Libor plus "x" basis points, aggrieved by a move from Libor that increases the effective interest rate it is paying, may argue that Libor actually remained available so that the lender's conversion to the fallback rate was a breach of the note's terms.

Where discretion is granted to a party to select a Libor replacement that is "reasonably comparable" to Libor, there is ample scope to debate just how comparable the new rate is. And in the event that some Libor substitute (such as SOFR plus some accepted spread) later gains (arguably) sufficiently widespread acceptance in a particular market, parties may advocate that a contractual reference to "Libor" should be read liberally — i.e., as not limited to Libor itself but also incorporating a rate that could be characterized as the "new Libor."

Some instruments executed after Bailey's July 2017 announcement provide for Libor to be replaced by whatever reference rate is recognized as the industry standard. Disputes may arise as to whether the new rate has achieved the requisite degree of recognition. Given the variety of contractual provisions and factual scenarios that may exist, it is impossible to compile a complete list of potential issues of contractual interpretation that may arise.

Although the adjudication of such cases is likely to be fact-specific, it is reasonable to expect courts deciding these issues to attempt to give effect to commercial parties' expressed intentions and "not by construction add or excise in interpreting commercial contracts add or excise terms, nor distort the meaning of those used and thereby make a new contract for the parties under the guise of interpreting the agreement."[8]

Covenant of Good Faith and Fair Dealing

The covenant of good faith and fair dealing, which is generally implied in every contract, may be invoked to challenge the exercise of a party's discretion in setting a rate or price if it acts "arbitrarily, unreasonably, or capriciously, with the objective of preventing the other party from receiving its reasonable expected fruits under the contract."[9] It is not difficult to imagine lenders facing claims of this sort if they exercise contractual discretion to replace Libor with another rate that arguably advantages them over their borrowers; agents or trustees exercising similar discretion may also face such claims. In the commercial (as opposed to consumer) context, however, such claims can be difficult to establish.[10]

Mutual Mistake

A party may seek judicial reformation of a contract or a judgment voiding or rescinding a contract, on the ground that the parties mutually operated under "a material mistake" that "vitally affects a fact or facts on the basis of which the parties contracted."[11] Borrowers may claim that they and a lender operated on the basis of such a mistake when entering into a loan agreement, believing that Libor would continue through the term of the contract and never be permanently discontinued.

However, it seems unlikely that such litigants could establish a basis for reformation because the law requires that their "proof of mistake must be of the highest order," and they "must show with equal clarity and certainty the exact and precise form and import that the instrument ought to be made to assume, in order that it may express and effectuate what was really intended by the parties."[12]

Even if the parties mistakenly assumed that Libor would exist forever, they will have no basis to establish that they really intended something else to replace it, much less precisely what they intended as its replacement.

Impracticability of Performance

This common law doctrine applies when, after a contract is made, a party's performance is rendered impracticable without that party's fault by the occurrence of an event, the nonoccurrence of which was a basic assumption on which the contract was made.[13] If the existence of a specific thing is necessary for performance of a duty, its "destruction" qualifies as such an event.[14]

It is therefore arguable that if Libor ceases to exist and the only fallback in a contract (e.g., polling "reference banks") fails, it may be impracticable to perform the contract as written. When this little-used doctrine has been invoked, it has usually been as an equitable defense that excuses nonperformance.[15]

Cases in which courts have used this doctrine to reform a contract, relying on expert evidence essentially to rewrite the price term,[16] are rare and have been criticized, but following the cessation of Libor, some litigants may seek such relief. (It would also be unsurprising for parties also to invoke related doctrines, such as impossibility of performance or frustration of purpose.)

Securities Law Claims

Although disclosures in recent bond prospectuses generally disclose risks relating to the discontinuance of Libor, such disclosures were — unsurprisingly — all but nonexistent before Bailey's July 2017 speech. Purchasers of securities may attempt to bring claims for rescission or damages under the Securities Act of 1933, arguing that prospectuses by which Libor-linked securities were sold that did not disclose the risks of Libor being discontinued were materially misleading.[17]

However, such claims are subject to a strict three-year statute of repose, measured from the date the securities were sold, closing this avenue to most prospective plaintiffs (even apart from any substantive difficulties).[18] For registered securities, U.S. Securities and Exchange Commission Rule 10b-5 and Section 10(b) of the Securities Exchange Act provide an alternative path to a damages action.[19]

A plaintiff would have to show that the defendant's omission to disclose the risk that Libor would be discontinued was "a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading"[20] and, among other requirements,[21] scienter — i.e., that the defendants acted at least recklessly, if not intentionally.[22] Given the level of surprise that generally greeted Bailey's July 2017 announcement about Libor's demise, it should be difficult for plaintiffs to establish scienter as to earlier disclosures.

Conclusion

Although financial institutions are understandably now engaged in the process of amending their Libor-linked instruments, Michael Held's speech has appropriately focused attention on the litigation risk that will be exacerbated if sufficiently robust fallbacks are not implemented. Watch this space as 2021 approaches.

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[1] Speech, “SOFR and the Transition from Libor” (Feb. 26, 2019) (“Held Speech”), available at https://www.newyorkfed.org/newsevents/speeches/2019/hel190226.

[2] Id.

[3] Speech by Andrew Bailey, Chief Executive of the FCA, “The Future of Libor,” (July 27, 2017), available at https://www.fca.org.uk/news/speeches/the-future-of-Libor

[4] Held Speech.

[5] Id.

[6] Id.

[7] Id.

[8] Morlee Sales Corp. v. Manufacturers Hanover Trust Co., 9 N.Y.2d 16, 19 (1961).

[9] Wilson v. Amerada Hess Corp., 773 A.2d 1121, 1130 (N.J. 2001); see also Dalton v. Educational Testing Service, 87 N.Y.2d 384, 389 (1995).

[10] See, e.g., R&G Properties, Inc. v. Column Financial, Inc., 968 A.2d 286, 300-03 (Vt. 2008).

[11] Asset Management & Capital Co. v. Nugent, 85 A.D.3d 947, 948 (2d Dep’t 2011) (quotations and citations omitted).

[12] Id. (citations and quotations omitted; emphasis in original).

[13] Restatement (Second), Contracts § 261.

[14] Id. § 263.

[15] See, e.g., Asphalt Intern, v. Enterprise Shipping Corp., 667 F.2d 261, 263 (2d Cir. 1981).

[16] See, e.g. Aluminum Co. of America v. Essex Group, Inc., 499 F. Supp. 53 (W.D. Pa. 1980).

[17] See 15 U.S.C. § 77l(a)(2); see also SEC Regulation S-K, Item 503, 17 C.F.R. § 229.503 (“Prospectus summary and risk factors”).

[18] See 15 U.S.C. § 77m; California Public Employees’ Retirement System v. ANZ Securities, Inc., 137 S. Ct. 2042 (2017).

[19] See 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.

[20] 17 C.F.R. § 240.10b-5(b).

[21] The elements of a 10b-5 claim are typically: "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation." Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 157 (2008).

[22] "Every Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly, though the Circuits differ on the degree of recklessness required." Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 319 n.3 (2007)