Litigation risk makes for a bumpy ride from LIBOR to risk free rates

Financial institutions continue to prepare for the anticipated cessation of the publication of the London Interbank Offered Rate (LIBOR) benchmark after the end of 2021 and its replacement with "risk-free" overnight rates, including reformed SONIA (for sterling) and the new SOFR rate (for U.S. dollars). Transitioning affected financial products to the new rates and amending legacy books is a massive project for any sizable institution. And despite even diligent efforts to meet that challenge, there is growing recognition that the transition will not be perfect, so that legacy instruments will pose significant litigation risk for the financial industry.

Although industry organizations, including the UK's Loan Market Association (LMA), the U.S. Federal Reserve's alternative reference rates committee (ARRC), the International Swaps and Derivatives Association (ISDA) and the Association for Financial Markets in Europe (AFME), are developing various forms of model wording to guide parties' efforts to revise documentation, some legacy agreements will not be amended easily (or at all). This is particularly likely where consents to amendment are difficult to obtain – e.g., for those syndicated loans that require unanimous lender consent to implement the relevant changes and for many bond issuances. The transition will also be more complicated for multi-currency financial products.

Much of the potential litigation risk revolves around fallback mechanisms in unamended legacy financial instruments that survive beyond the anticipated December 2021 LIBOR cessation date. Many fallbacks, particularly in agreements that predated the July 2017 "Future of LIBOR" speech by the CEO of the UK Financial Conduct Authority (FCA), are designed only for a temporary unavailability of the benchmark rate and do not anticipate a cessation of LIBOR at all. For instance, legacy floating rate notes and bonds as well as syndicated loan documents often provide for the polling of "reference banks" for their cost of funds as a fallback. As a practical matter, "polling" provisions may prove difficult or impossible to implement. Some legacy floating rate instruments provide for the last published LIBOR to be a backstop (and in other cases, no fallback is provided); in these scenarios, a floating rate instrument could be effectively converted to a fixed rate instrument based on the last applicable LIBOR to be published pre-cessation. In the case of European syndicated loans, ultimate fall back is often to the actual cost of funds of the lenders. In addition to being difficult for lenders and agents to administer, concerns have been raised about exactly how those quotations should be treated for the purposes of calculating the rate to be charged to the borrower, not least because non-bank lenders do not fund themselves on the interbank market. All of these uncertainties are fertile ground for litigation.

Nor is litigation risk limited to commercial loans and securities. Particularly in the U.S., LIBOR is often used as a benchmark for consumer finance. In the U.S. mortgage market alone, it is estimated that over 2.8 million outstanding adjustable-rate mortgages (ARMs) (worth more than $1 trillion) require interest payments based on LIBOR. In addition, a significant number of student loans and reverse mortgages are also linked to LIBOR. Most ARMs allow for the substitution of a new index based on comparable information if the original index is no longer available. But such mortgages typically do not specify how to define an acceptable substitute or what it means for LIBOR to be unavailable. If a shift away from LIBOR-based interest calculation increases the interest required to be paid by consumers, lenders could not only face lawsuits brought by consumers but may also face regulatory and enforcement scrutiny by agencies tasked with protecting consumers (e.g., the U.S. Consumer Financial Protection Bureau and state Attorneys General and banking departments).

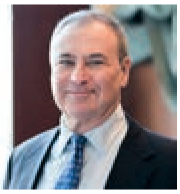
Efforts to modify ARM mortgage agreements are complicated by the fact that many of these loans have been securitized and are now owned by a web of investors. This problem is mirrored in

other securitizations including collateralized loan obligations (CLOs), which often have complex structures with multiple classes of debt, whose respective holders have differing entitlements to payment and priority; trustees and servicers and other agents also typically play important roles. Amendments may thus be difficult to implement.

Other litigation risks, unrelated to the challenge of amending instruments to include workable fallback provisions, include:

- The risk of interest rate mis-matches which could arise where a mandatory interest rate hedge, and its related loan, transition at different times or to different rates, or where a securitized investment agreement (i.e. CLO or mortgage-backed security) transitions at a different time or to a different interest rate than the underlying interest obligations.
- Risks related to implementing credit spread adjustments to reflect the difference between the LIBOR and the new "risk free" rates and in the methodology of calculating compounded risk free rates.

In addition to the work already taking place to transition to the new "risk-free" rates, financial institutions aiming to minimize litigation risks related to LIBOR cessation should inventory their LIBOR-linked products with a view to identifying potential "problem areas" and implement a robust process to address such areas and engage with affected borrowers. If not already underway, institutions should certainly commence this process as soon as possible.



Marc Gottridge
Partner, New York
T +1 212 909 0643
marc.gottridge@hoganlovells.com

Arwen Handley
Partner, London
T +44 20 7296 2810
arwen.handley@hoganlovells.com