A Look Ahead: Potential Constitutional Challenges to the Proposed New York Legislation for U.S. Dollar LIBOR Contracts

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By Marc Gottridge and Charles Barrera Moore | May 26, 2020

The London Inter-Bank Offered Rate (LIBOR) is slated for extinction by Dec. 31, 2021, when LIBOR's regulator will cease requiring panel banks to contribute to "the world's most important number." Gelboim v. Bank of Am., 823 F.3d 759, 765 (2d Cir. 2016) (quotation marks and footnote omitted). Hundreds of thousands of financial contracts (including floating rate securities, bilateral and syndicated loans, interest rate swaps and home mortgages), with an estimated $200 trillion notional value, incorporate U.S. Dollar LIBOR. Many will remain in effect beyond 2021, yet lack robust fallbacks to automatically replace LIBOR after it no longer exists. Some "legacy" instruments have no fallback provisions whatsoever. Others contain impractical fallbacks: for example, reverting to last-quoted LIBOR may transform floating-rate into fixed-rate securities. Amending such "legacy" agreements to replace or backstop LIBOR with another rate, such as the Secured Overnight Financing Rate (SOFR) published by the Federal Reserve Bank of New York (FRBNY), may be impractical, particularly where notes and bonds require all holders' consents to amend.

The likely results, barely 18 months away, are substantial uncertainty and ultimately what FRBNY's General Counsel has called "a DEFCON 1 litigation event," with lawsuits "on a massive scale." Michael Held, "SOFR and the Transition from LIBOR" (Feb. 26, 2019). Because many U.S. Dollar LIBOR contracts are governed by New York law, New York will be the center of the litigation storm.

ARRC Steps Into the Breach, Proposing New Legislation

To reduce uncertainty and minimize litigation risk, the Alternative Reference Rates Committee (ARRC)—a group of private market participants convened by the Federal Reserve Board and FRBNY to promote the transition from U.S. Dollar LIBOR—recently proposed New York state legislation. (For the proposed bill's text, see ARRC, Proposed Legislative Solution to Minimize Legal Uncertainty and Adverse Economic Impact Associated with LIBOR Transition 13-20 (March 6, 2020) (ARRC proposal). Under ARRC's proposal, if either ARRC, the Federal Reserve Board or FRBNY selects a "Recommended Benchmark Replacement"—presumably SOFR plus a still-undetermined spread adjustment—that new rate would, "by operation of law," replace U.S. Dollar LIBOR (as of the "LIBOR Replacement Date") in any "contract, security or instrument" using LIBOR as a benchmark but either lacking any fallback provision or containing a fallback that includes LIBOR or requires polling or surveying lenders for rates. ARRC's proposal would nullify and replace such unworkable fallback provisions, while providing a "safe harbor" from litigation for using the Recommended Benchmark Replacement. The proposal would not, however, affect existing contract language specifying a non-LIBOR fallback (e.g., prime rate), and contracting parties could agree to opt out of the legislation's mandatory application.

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Enacting ARRC's proposal should reduce the levels of future economic disruption and litigation over uncertain contractual language. But if enacted, the legislation will almost certainly face constitutional challenges. We preview below issues that may arise under the U.S Constitution's Contract Clause and the non-delegation doctrine under the New York Constitution.

Contract Clause

The Contract Clause provides that "[n]o state shall … pass any … Law impairing the Obligation of Contracts … ." U.S. Const. art. I, §10, cl. 1. Although phrased absolutely, the clause is interpreted flexibly, using a two-step inquiry: (1) whether the state law "operated as a substantial impairment of a contractual relationship"; and if so (2) whether that impairment was "reasonable" and in pursuit of "a significant and legitimate public purpose." Energy Reserves Group v. Kansas Power & Light Co., 459 U.S. 400, 411-12 (1983) (quotation marks omitted).

To the extent legacy LIBOR-linked contracts lack any fallback, ARRC's proposal would not displace a contractual term, but merely fill a void. There would be no impairment at all. But where legacy contracts contain either a LIBOR-linked or "polling"-based fallback, ARRC's proposal concededly "overrides" their express terms. ARRC proposal at 5. Some parties disadvantaged when a statutorily-mandated, SOFR-based "Recommended Replacement Rate" displaces a contractual fallback provision can be expected to contend that an unconstitutional impairment has occurred.

Such parties would likely argue that the fallback provision is an important contractual term, because the interest rate is the "primary inducement" to enter into financial instruments—indeed, the "central provision" on which borrowers and lenders rely. Buffalo Teachers Fed'n v. Tobe, 464 F.3d 362, 368 (2d Cir. 2006) (discussing wage term of employment contracts). Challengers might try to demonstrate, through historical statistical analyses and/or projections, that the new, legislated fallback rate results in substantially higher (or lower) interest payments than under their contracts as written. In response, the legislation's defenders would surely contest both the economic significance of the change and parties' actual reliance on obscure fallback provisions. Taking a broader view, they would also argue that replacing an unworkable rate with a more robust one designed to continue to honor, after LIBOR's demise, the parties' intention to pay or receive a market-based floating rate does not "interfere[] with a party's reasonable expectations." Sveen v. Melin, 138 S. Ct. 1815, 1822 (2018).

At the second step, the governing principle is that "[l]egislation adjusting the rights and responsibilities of contracting parties must be upon reasonable conditions and of a character appropriate to the public purpose justifying its adoption." U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 22 (1977). Courts generally defer to the judgments of a legislature "remedying [] a broad and general social or economic problem" and "exercising its police power, rather than providing a benefit to special interests," Energy Reserves, 459 U.S. at 412, as long as no "evident and more moderate course would serve [the state's] purposes equally well." U.S. Trust, 431 U.S. at 31. At this step of the analysis, parties defending the legislation would probably have the stronger argument. ARRC's proposed legislation promotes the public interests in ensuring continuity in contractual relationships, reducing commercial and legal risk and minimizing litigation and burden on the courts; there is no obvious "more moderate course" that

would accomplish these goals as effectively. (Similarly, a challenge based on a "due process" theory under the federal or state constitutions is unlikely to succeed given the prevailing rational basis standard of review. USA Baseball v. City of New York, 509 F. Supp. 2d 285, 296-97 (S.D.N.Y. 2007).)

Non-Delegation

ARRC's proposed legislation may also be attacked as an improper delegation of the State's "legislative power," which "shall be vested in the Senate and the Assembly." N.Y. Const. art. III, §1. "[T]he Legislature cannot pass on its law-making functions to other bodies," although "there is no constitutional prohibition against the delegation of power, with reasonable safeguards and standards, to an agency or commission to administer the law as enacted by the Legislature." Levine v. Whalen, 39 N.Y.2d 510, 515 (1976).

ARRC's proposal would impose on thousands of contracts a fallback rate not specified by the Legislature, but instead to be "selected or recommended by a Relevant Recommending Body"—i.e., ARRC, the Federal Reserve Board or FRBNY. This provision is unusual in at least two ways. First, the New York Legislature would grant authority to federal, rather than state, agencies. The Legislature cannot control, oversee or supervise the Federal Reserve Board or FRBNY, and the proposed legislation does not even purport to guide or limit any Relevant Recommending Body's work. New York case law on the constitutionality of delegations to a federal entity is scant, but a few reported New Deal-era cases condemned the practice. See, e.g., Cline v. Consumers' Co-op. Gas & Oil Co., 152 Misc. 653, 669-70 (Sup. Ct. Jefferson Cnty. 1934). Second, authority would also be granted to ARRC, a group of private entities including "banks, asset managers, insurers, and industry trade organizations," augmented by ex-officio public sector members. (ARRC's members are listed at https://www.newyorkfed.org/arrc/about.) Delegation of legislative powers to private parties that "are neither chosen by, nor responsible to the State government" has been held invalid, Fink v. Cole, 302 N.Y. 216, 225 (1951), at least where the private actors are not subject to "official supervision," 8200 Realty v. Lindsay, 27 N.Y.2d 124, 133 (1970).

Defenders of the proposed legislation would respond that the Legislature did not "yield[] any real sovereign power" by incorporating a reference rate to be chosen by one of the Relevant Recommending Bodies. Id. at 132. ARRC's proposal arguably does not cede "fundamental legislative or policymaking authority, which remains at all times with the Legislature," Medical Soc'y of State of N.Y. v. Serio, 100 N.Y.2d 854, 864-65 (2003), and the parsimonious approach to delegation reflected in decades-old lower court decisions has "fallen into disrepute," Boreali v. Axelrod, 71 N.Y.2d 1, 10 n.1 (1987). In recent decades, New York courts have upheld "legislative delegations of authority that are circumscribed in only the most general of terms." Id. at 10. As for private entities' involvement, the Court of Appeals has held that authorizing real estate industry representatives to participate in New York City's rent stabilization process was not an improper delegation of "legislative power," although the private parties' role in that case was "closely circumscribed and regulated" by the statute. 8200 Realty, 27 N.Y.2d at 132. Finally, choosing the Benchmark Replacement Rate might be analogized to incorporating by reference professional standards promulgated by expert private organizations, and New York courts have held that is not an improper delegation of legislative power. See, e.g., USA Baseball v. City of New York, 509 F. Supp. 2d 285, 299 (S.D.N.Y. 2007) (collecting cases). On balance, such arguments seem likely to prevail.

Conclusion

Enacting ARRC's proposal should, as intended, significantly reduce the anticipated post-LIBOR wave of lawsuits, while sparking new litigation over its constitutionality. At this early stage, the proposed legislation appears likely to survive Contract Clause and non-delegation challenges, albeit not without a fight.

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