

# Transitioning from LIBOR—Some Key Considerations

November 14, 2019

Regulators have made clear that LIBOR—the benchmark rate that underpins trillions of dollars of loans and other contracts—will not be available beyond 2021. However, recent volatility in markets relating to the secured overnight benchmark rate (“SOFR”), the benchmark rate that has been identified as the potential replacement for LIBOR, has heightened concerns about market readiness around LIBOR replacement. While many details around the transition are unclear, we discuss in this client update some legal considerations that are relevant for companies at this time.

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## Financing Agreement Considerations

For borrowers that have debt maturing past 2021, it is critical that the relevant agreement include contractual fallbacks for LIBOR discontinuation.

- **Legacy contracts.** If the relevant agreement was entered into before newer fallbacks discussed below became prevalent, then fallbacks that were intended to be temporary will become permanent.
- **Syndicated loans.** Loans traditionally provided for interest based on the prime rate or ABR if LIBOR was temporarily unavailable. This will result in borrowers having to make substantially higher interest payments once LIBOR is permanently discontinued.
- **FRNs.** Floating-rate bonds (“FRNs”) provide for calculating interest based on the last available LIBOR rate if LIBOR is temporarily available. As a result, a bond that was intended to be a floating-rate instrument will become a fixed-rate instrument.
- **Newer contracts.** For the last several years, borrowers have been including a variety of contractual fallbacks to address LIBOR replacement. However, earlier this year, the Alternative Reference Rates Committee (the “ARRC”), a group of private-market participants convened by the Federal Reserve Board and the New York Fed to

facilitate LIBOR transition, released recommended contractual [fallback language](#) for various cash products. The main components of this fallback language are as follows:

- **Trigger events.** The fallback is triggered when there is a public statement that the relevant administrator will cease to provide LIBOR permanently or that it is no longer representative.
- **Successor rate.** The successor rate is proposed to be either term SOFR (which is to be a forward-looking rate similar to LIBOR endorsed by a government body) or compounded SOFR (which is the compounded average of daily SOFR rates in arrears with a lookback and/or suspension period to determine the interest amount payable), plus a spread adjustment to minimize the difference with LIBOR. The ARRC published various methods for calculating the spread adjustment in the [minutes](#) of its September meeting, and this work is ongoing.
- **Hardwired approach.** Under this approach, the interest rate will automatically convert based on a waterfall of preferred successor rates with spread adjustments without any party's consent.
- **Amendment approach.** Given the uncertainties around the replacement rate, the ARRC has also provided for a streamlined amendment approach with negative consent rights for majority lenders. In this case, the administrative agent and the borrower determine the successor rate taking into account regulatory pronouncements and market convention.
- **Early opt-in.** Majority lenders and the administrative agent are permitted to opt in early to the successor rate even before LIBOR ceases to exist if dollar-denominated syndicated loans are being issued with that new reference rate. No borrower consent is required.

Broadly speaking, market participants have started to adopt the ARRC amendment approach in syndicated loans and the hardwired approach in floating-rate notes, with minor variations. Borrowers should focus on the details relating to the fallback language, including whether it provides for provisions to maintain pricing and whether it affords borrowers consent rights over early opt-in and certain other changes.

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## Hedging Considerations

As many borrowers enter into interest-rate hedges to manage LIBOR exposure on their loans, they need to also review their hedging contracts to assess the impact of LIBOR

discontinuation on their business. Unlike loans or FRNs, swaps are generally documented under master agreements and definitions published by the International Swaps and Derivatives Association, Inc. (“ISDA”). ISDA has been working on documentation to be used for LIBOR transition with respect to derivatives transactions.

- **Legacy and newer contracts.** ISDA expects to publish a standard protocol to amend existing transactions. Any adoption of the protocol by derivatives counterparties would be voluntary. In addition, ISDA expects to publish amendments to the 2006 definitions that parties can use to document new derivatives contracts.
- **Successor rate.** ISDA has also published the results of a consultation to determine the successor rate, which is proposed to be an overnight risk-free rate subject to certain adjustments to incorporate various factors, including a bank-credit-risk premium and different tenors. ISDA has selected Bloomberg Index Services Limited to calculate and publish these successor rates to be implemented in derivative contracts.
- **Divergence between the ARRC and ISDA.** A few key differences remain between the fallbacks proposed by the ARRC for cash products and those proposed by ISDA for swaps.
  - **Triggers/early opt-in.** ISDA’s consultation published in October indicates that there is no consensus as to converting to a successor rate upon a statement by the regulator that LIBOR is no longer representative or other pre-cessation triggers. This could potentially result in divergence between trigger events in cash products and in derivatives.
  - **Primary successor rate/spread adjustment.** Unlike the ARRC, ISDA has not proposed a forward-looking rate similar to term SOFR as the primary successor rate for the derivatives market. Further, the methods for calculating the spread adjustment discussed by ISDA differ somewhat from those recently discussed by the ARRC.

If LIBOR is discontinued and the market is required to transition to risk-free rates, a borrower may face a situation where the reference rate used in its loans does not match the reference rate used in its interest-rate hedges. Clients should monitor this space to make sure that the changes to be implemented in the derivatives industry will continue to allow them to effectively hedge their borrowings.

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## Tax Considerations

Borrowers need to be mindful of whether implementing contractual fallbacks in connection with LIBOR transition could trigger a taxable event for the parties.

- **Occurrence of taxable event.** If LIBOR transition triggers a taxable event, among various adverse tax consequences:
  - the parties may under certain circumstances be required to recognize gain, but not loss, on the debt instrument;
  - the debt will be deemed re-issued, and its issue price will be redetermined, which may affect the amount of original-issue discount, if any; and
  - the successor rate may result in the debt instrument being treated as a contingent payment debt instrument instead of a variable rate debt instrument.
- **Proposed regulations.** Last month, in order to mitigate the impact of LIBOR transition, the U.S. Internal Revenue Service (the “IRS”) issued proposed regulations, which generally can be relied on by the taxpayers at this time. Under these proposed regulations, an alteration of terms of a debt instrument to replace a rate referencing an interbank offered rate and any associated alteration generally will not trigger a taxable event if the replacement or successor rate is a qualified rate. To be a qualified rate, among other requirements, the replacement or successor rate needs to be a rate listed in these proposed regulations or other future guidance issued by the IRS.

Borrowers should be careful to ensure that the fallback language in their contracts does not provide for successor rates that will not qualify under the new IRS-proposed regulations.

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## SEC Considerations

SEC staff has advised companies to actively manage risk and anticipate exposure relating to LIBOR transition.

- **Contractual review.** The staff recommends a general review of existing and new contracts, including in light of whether they, individually or in the aggregate, arise to a material risk to the company’s operations.

- **Disclosure obligations.** Companies should keep investors informed about efforts to identify exposure to LIBOR cessation as well as any risk mitigation efforts. Existing SEC rules and regulations may require disclosure relating to LIBOR cessation in risk factors or management's discussion and analysis, among other sections of documents filed with the SEC. Companies should also share material information being used by management or the board in monitoring the company's transition efforts, which may include qualitative disclosures and, when material, quantitative disclosures, such as the notional value of contracts referencing LIBOR and extending past 2021.

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## Final Thoughts

Although many aspects of LIBOR replacement remain unclear, some key practical takeaways for companies are as follows:

- Borrowers should review legacy contracts and seek to opportunistically amend those contracts if they do not have adequate fallback language.
- Borrowers should focus on the details relating to the fallback language for new contracts, including whether it affords borrowers consent rights over early opt-in and the successor rate qualifying under the new IRS-proposed regulations.
- Borrowers should keep in mind the possibility of divergence in the successor rate for cash products and related interest rate swaps when entering into long-dated swaps.
- For public companies, adequate disclosure around risks and mitigation efforts that spans reporting periods is key.

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Please do not hesitate to contact us with any questions.

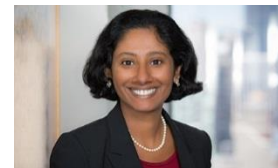
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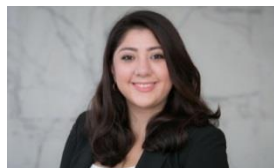


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