CLEARY GOTTLIEB

ALERT MEMORANDUM

The Adjustable Interest Rate (LIBOR) Act: A Closer Look at How It Interacts with State Law and What It Means for Potential Litigation Risks

April 11, 2022

On March 15, 2022, President Biden signed into law the Adjustable Interest Rate (LIBOR) Act (the "LIBOR Law").[1] The objectives of the legislation are to facilitate the transition of legacy LIBOR contracts that either (a) lack LIBOR fallback provisions entirely or (b) contain inadequate LIBOR fallback provisions and to avoid related "disruptive litigation".[2]

When Does the LIBOR Law Apply?

The LIBOR Law applies to contracts that use, as a Benchmark rate, the one-month, three-month, six-month and twelve-month tenors of U.S. Dollar LIBOR as of the applicable LIBOR Replacement Date (each, a "LIBOR Contract").[3] The definition of covered contracts is broad and includes indentures, organizational documents, guarantees, mortgages, deeds of trust, leases, securities (whether representing debt or equity, and including any interest in a corporation, a partnership, or a limited liability company), and other instruments. As discussed in more detail below, the LIBOR Law preempts state LIBOR laws, and applies to contracts regardless of the governing state law. As a result, the LIBOR Law covers instruments created under Delaware corporate law, such as LIBOR floating rate preferred stock, to which the LIBOR law enacted by New York state in 2021 is inapplicable.

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[1] H.R. 2471, Div. U.

[2] H.R. 2471, Div. U., Section 102(a)(3); 102(b). Capitalized terms used but not defined herein have the meanings ascribed to them in the LIBOR Law.

[3] LIBOR Law, § 103(15)-(16). Contracts that reference one-week or two-month tenors or non-USD LIBOR rates are not included within the definition.

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The LIBOR Law does not apply to (1) LIBOR Contracts that expressly state they are not subject to the LIBOR Law; (2) LIBOR Contracts that contain workable fallback language that is not LIBOR-linked; (3) LIBOR Contracts as to which a Determining Person does not elect to use a Board-Selected Benchmark Replacement; (4) the application to a Board-Selected Benchmark Replacement of any cap, floor, modifier, or spread adjustment to which LIBOR had been subject pursuant to the terms of a LIBOR Contract, and (5) any provisions of Federal consumer financial law that require creditors to notify borrowers of a change in terms or that govern the reevaluation of rate increases on credit card accounts under open-end (not home-secured) consumer credit plans.[4]

How Does the LIBOR Law Work?

The LIBOR Law includes two different sets of provisions that may apply to LIBOR Contracts, depending on what kind of fallback provisions are included in the contract. The "Automatic Provision" automatically replaces LIBOR with a Board-Selected Benchmark Replacement by operation of law in certain circumstances. The "Discretionary Provision" applies to contracts that allow a Determining Person (a person with the authority to determine a Benchmark Replacement) to select a benchmark replacement rate and provides a safe harbor should that individual select the Board-Selected Benchmark Replacement.

In addition, under the LIBOR Law, by September 11, 2022, the Board of Governors of the Federal Reserve System (the "Board") must issue regulations to give effect to the law, including (1) the selection of a Board-Selected Benchmark Replacement that is based on SOFR and incorporates the applicable Tenor Spread Adjustment[5] and (2) the identification of any related "conforming changes".

Automatic Provision – Section 104(a)-(b) of the LIBOR Law

The Automatic Provision applies to LIBOR Contracts that (1) contain no Fallback Provisions, (2) contain Fallback Provisions that identify neither (a) a specific Benchmark Replacement nor (b) a Determining Person, (3) include Fallback Provisions that are themselves based on LIBOR or (4) include Fallback Provisions requiring that a person other than a benchmark administrator conduct a poll of interbank lending rates to determine a replacement rate.[6]

The LIBOR Law defines the "LIBOR Replacement Date" as the first London banking day after June 30, 2023, unless the Board determines that any LIBOR tenor will cease to be published or cease to be representative on a different date. For LIBOR Contracts subject to the Automatic Provision, on the LIBOR Replacement Date, the Board-Selected Benchmark Replacement will automatically override the language in the relevant contract and become the applicable benchmark rate going forward, even if the parties take no steps to modify the documentation.[7]

Any conforming changes made under Board regulations ("Benchmark Replacement Conforming Changes") will also become a part of any LIBOR Contracts subject to the Automatic Provision. Such Benchmark Replacement Conforming Changes may include (1) any technical, administrative, or operational changes that affect the implementation of the Board-Selected Benchmark Replacement or (2) modifications that a "Calculating Person" determines are otherwise necessary or appropriate for the implementation of the same with respect to LIBOR Contracts that are not consumer loans.[8] The LIBOR Law defines "Calculating Person" as any person responsible for calculating or determining any valuation, payment, or other measurement based on a

[4] *Id.* § 104(f)(1)-(5).
[5] "Tenor Spread Adjustment" shall mean— (A) 0.00644 percent for overnight LIBOR; (B) 0.11448 percent for 1-month LIBOR; (C) 0.26161 percent for 3-month LIBOR; (D) 0.42826 percent for 6-month LIBOR; and (E) 0.71513 percent for 12-month LIBOR.
[6] *Id.* § 104(a)-(b).
[7] *Id.* § 104(a)-(b).
[8] *Id.* § 104(d).

Benchmark. The Calculating Person may be, but is not required to be, the same as the Determining Person.

The LIBOR Law clarifies that the automatic replacement of LIBOR with the Board-Selected Benchmark Replacement on the LIBOR Replacement Date will not be deemed to impair or affect contractual rights and will not have the effect of discharging or excusing performance under any LIBOR Contract.[9]

Discretionary Provision – Section 104(c)

The Discretionary Provision applies only to LIBOR Contracts that grant a Determining Person the authority to choose a replacement benchmark for LIBOR. The Discretionary Provision creates a safe harbor for the selection by the Determining Person of the Board-Selected Replacement Benchmark. Specifically, the LIBOR Law provides that no person may be subject to liability arising from (1) selecting or using the Board-Selected Benchmark Replacement, (2) implementing Benchmark Replacement Conforming Changes or (3) determining Benchmark Replacement Conforming Changes (outside of the consumer loan context).[10]

If a Determining Person fails to select any Benchmark Replacement, the Board-Selected Benchmark Replacement will become the benchmark replacement automatically.[11] If the Board-Selected Benchmark Replacement becomes the benchmark replacement for LIBOR Contracts subject to the Discretionary Provision, "all Benchmark Replacement Conforming Changes shall become an integral part of the LIBOR contract."[12]

The LIBOR Law Supersedes State Law and Mitigates Potential Litigation Risks

New York previously enacted legislation that, like the LIBOR Law, is intended to facilitate a more orderly transition following the cessation of LIBOR.[13] There are, however, questions about whether the New York LIBOR law and similar laws passed by other states could be subject to challenge based on two distinct federal law theories: (1) that the preemption doctrine bars such laws from being applied to contracts governed by the federal Trust Indenture Act of 1939 ("TIA")[14]; and (2) that the laws may be challenged as unconstitutional under the Contract Clause of the U.S. Constitution.[15]

The LIBOR Law expressly supersedes any state or local law relating to the selection or use of a Benchmark Replacement or related conforming changes. Further, the LIBOR Law provides that no state or local law that expressly limits the manner of calculating interest will apply to the selection or use of a Board-Selected Benchmark Replacement or Benchmark Replacement Conforming Changes.[16] As a result, the LIBOR Law preempts and supersedes the New York LIBOR law.

In addition, the LIBOR Law specifically addresses the potential for conflicts between remedial legislation addressing the cessation of LIBOR and the TIA. By way of background, the TIA is a New Deal-era piece of legislation that aims to protect minority bondholders from being forced into accepting out-of-court debt reorganizations by powerful majority holders.

The LIBOR Law explicitly amends the TIA to clarify that "that the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security shall not be deemed to be impaired or affected" by the operation of the LIBOR Law.[17] As a result, no consent is required for changes to TIA-covered contracts arising under the LIBOR Law, and there is no conflict between the statutes.

Finally, it bears noting that the prohibitions in the Contract Clause of the U.S. Constitution apply only to state law and not to federal legislation, such as the LIBOR Law. Given that the LIBOR Law supersedes

9 *Id.* § 105(b).
10 *Id.* § 105(c).
11 *Id.* § 104(c)(3).
12 *Id.* § 104(d).
13 Article 18-C of the New York General Obligations Law.
14 15 U.S.C. § 77ppp(b).
15 U.S. Const. Art. I, § 10, cl. 1.
16 LIBOR Law, § 107.
17 *Id.* § 108.

similar state law remedial measures, the question of whether those state laws pass constitutional muster is now largely academic.

In light of the above, the LIBOR Law is substantially less vulnerable to challenge in the courts than prior state legislation addressing the LIBOR transition. The risk of litigation is more significant in areas where uncertainty remains: for example, in connection with contracts that are not covered by the LIBOR Law, including so-called "tough" legacy contracts (i.e., contracts that lack LIBOR fallback language and cannot easily be amended) that are not governed by U.S. law.

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