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The Adjustable Interest Rate (LIBOR) Act

Federal LIBOR Legislation in Five Quick Bites

#1 - Contracts Covered by the Legislation

The legislation nullifies references in the fallback provisions of a contract:

- That require a party to poll for LIBOR or where the replacement rate is based on LIBOR (e.g., "last LIBOR").

The legislation automatically imposes the statutory replacement rate on:

- Contracts with no fallback provisions.
- Contracts that identify neither a specific non-LIBOR replacement rate nor a person to determine the replacement rate.

For contracts with discretion to choose a replacement for LIBOR, the legislation provides a safe harbor for parties who select the statutory replacement rate.

- For example: "If LIBOR is no longer available, lender may <u>choose a rate based on comparable information</u>."

If discretion to choose a replacement rate under a contract is not exercised by the time LIBOR ceases, the legislation will automatically impose the statutory replacement rate.

Contracts NOT within scope of the Legislation:

- Contracts that fall back to a specific non-LIBOR fallback, *e.g.*, Base Rate, Prime Rate, or Fed Funds.

#2 - Safe Harbor under the Legislation

The legislation provides certain protections against disputes or liability arising out of the transition from LIBOR to the replacement rate. The legislation:

- Immunizes parties from suit or liability if the legislation's statutory replacement rate is selected as the replacement for LIBOR.
- Precludes a counterparty from contending that the replacement of LIBOR discharged or excused its performance or otherwise allowed it to cancel the contract.

The safe harbor applies to all parties to a transaction that is subject to automatic transition to the statutory replacement rate. It also applies to a contract that gives a party discretion to choose a replacement for LIBOR, if that party:

- Chooses the statutory replacement rate identified by the Federal Reserve for that category of contract.
  - The statutory replacement rate will be set forth in rules issued by the Federal Reserve no later than 180 days after enactment of the law (*e.g.,* September 2022).
- Complies with certain terms of the contract not affected by the legislation.
  - For example, some fallbacks may require LIBOR to be replaced before the June 30, 2023 cessation date:
    - "If lender determines LIBOR is <u>no longer a widely used benchmark rate in new loans</u>, then LIBOR shall be replaced with a comparable benchmark."

#3 - The Statutory Replacement Rate

The Federal Reserve is required to identify the replacement rate that will apply to contracts subject to the legislation, called the "Board-Selected Benchmark Replacement."

- The Board-Selected Benchmark Replacement must be based on the Secured Overnight Financing Rate or "SOFR," published by the Federal Reserve Bank of New York.
  - Different versions of SOFR exist, such as Term SOFR, compounded SOFR, etc.
- The Federal Reserve will identify which version of SOFR will apply to each category of contracts.
  - The Federal Reserve has discretion to choose how to divide contracts into categories. Categories could include, for example, asset-backed securities, business loans, consumer products, financial market transactions (*e.g.*, derivatives), floating rate notes, and all other contracts.
- The Board-Selected Benchmark Replacement will add a "spread adjustment" to SOFR, accounting for LIBOR's credit-risk component.
  - The spread adjustment for each tenor of LIBOR is based on the five-year historical gap between overnight secured financing transactions and LIBOR, determined as of March 5, 2021.
  - For consumer loans, the spread adjustment will transition linearly over a one-year period starting on June 30, 2023.

#4 - Benchmark Replacement Conforming Changes

The transition from LIBOR to SOFR will likely require certain **technical**, **administrative** or **operational** changes in a contract to facilitate the **implementation**, **administration**, and **calculation** of the new benchmark.

- The legislation authorizes the Federal Reserve to determine the scope of such changes, known as "Benchmark Replacement Conforming Changes."
  - However, the Federal Reserve will not likely address all implementation issues that may arise under all contracts.
  - So, the legislation grants certain contract parties the right to unilaterally adopt certain additional changes, known as the "Calculating Person."
- Under the legislation, "Benchmark Replacement Conforming Changes" become an integral part of the contract.

#5 - The Trust Indenture Act and Similar Contract Provisions

- The Trust Indenture Act of 1939 (“TIA”) effectively imposes a unanimous-consent requirement for changes that affect an investor’s right to receive principal or interest on a security.
- Securities that are exempt from the TIA are governed by indentures that often have provisions similar to the TIA’s restrictions.
- To address the potential impact of these restrictions on LIBOR transition, the legislation:
  - Amends the TIA’s restrictions to add an exception for changes made under the legislation.
  - Provides that indentures that contain similar restrictions may be changed to implement the Board-Selected Benchmark Replacement or Benchmark Replacement Conforming Changes and not be deemed to “impair or affect” any right to receive payment.

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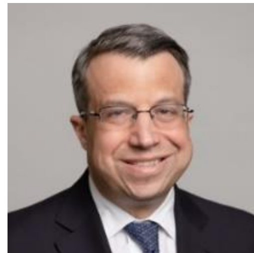

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