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Impact of LIBOR reform on contractual continuity

Contracts with an estimated notional value of more than $300 trillion use LIBOR as their benchmark – for this reason Warren Buffet described LIBOR as the base rate for the whole world. With regulators across the world shining a light on LIBOR's viability, this briefing considers what changes to LIBOR might mean for English law governed contracts that use LIBOR as a benchmark.

General approach of the English courts

For this purpose we shall consider four LIBOR scenarios in the context of the LMA Facility Agreement and the 2006 ISDA Definitions – including the scheduled replacement of the British Bankers' Association ("BBA") as LIBOR administrator, the discontinuance of LIBOR for certain currencies and maturities and the possible replacement of LIBOR as a benchmark.

Before looking at each scenario it is worth noting that it can be expected that the English courts will strive to ensure as little disruption to business as possible, being fully aware of the importance to the financial markets of their decisions. For the purposes of our four LIBOR scenarios, English judges will make use of two important legal tools to aid them in this process.

Tool 1 – Contractual interpretation – here the courts will consider the LIBOR language used in the contract to determine what a reasonable person would have understood the parties to have meant at the time having regard to all the surrounding circumstances.

Tool 2 – Implication of terms – more ambitiously the courts could decide to imply new words into a contract. In order to do so the courts must determine (a) that there is a gap in the contract, (b) that it is objectively necessary to fill that gap, (c) that had the parties thought of the point they would have filled the gap and (d) that it can be shown with reasonable certainty how the parties would have done so.

The scenarios

Scenario 1 – Responsibility for the administration of LIBOR is transferred from the BBA to ICE Benchmark Administration Limited ("ICE") on 1 February 2014

ICE has announced that it will replace the BBA as administrator of LIBOR from 1 February 2014. Since many LIBOR definitions expressly refer to the BBA, concerns have been raised as to whether definitions which do so can now be construed to refer to LIBOR as administered by ICE.

For transactions undertaken pursuant to the currently published LMA Facility Agreement, this is not a problem, as express provision is made for a change of administrator. But there will be loan transactions with the legacy LMA definition of LIBOR which refers to the BBA and does not provide for replacement of the BBA as administrator. Will this matter? In our view it will not. We consider that the courts would regard the reference to the BBA in the definition of LIBOR as a labelling issue rather than as an inherent part of the definition itself. Provided that (a) LIBOR continues to be published on screen, (b) is based on the same methodology as before, and (c) ICE assumes the administration of the existing LIBOR processes, the English courts are likely to use Tool 1 (contractual interpretation) or Tool 2 (implication of terms) to ensure that references to BBA LIBOR are deemed to refer to ICE LIBOR. We believe that this would reflect the overriding intention of the parties that LIBOR would be based on rates available to banks lending to each other in the London markets and having the key characteristics of BBA LIBOR. In so

doing the English courts would have facilitated the smooth operation of the markets by avoiding the use of contractual fall-backs which apply when BBA LIBOR is unavailable.

Arriving at this conclusion is even easier for derivatives incorporating the 2006 ISDA Definitions where the various rate definitions linked to BBA LIBOR only refer to the BBA in their titles. In the substance of the definitions the enabling language does not, making reference instead to a rate for deposits in the relevant currency and period. So it is relatively easy to conclude that the contract points toward the rate on the same page notwithstanding the change of administrator.

Indeed it helps with this approach that ICE has stated that it does not plan to change the fundamentals of LIBOR as a quoted, interbank, offered rate.

Scenario 2 – LIBOR is discontinued and not replaced with an alternative interest rate benchmark

In this event the court's starting point would be to look at any fall-back provisions contained in the contract itself. Both the LMA Facility Agreement and the 2006 ISDA Definitions contain LIBOR alternatives which apply if LIBOR is not available (LMA) and if the relevant LIBOR does not appear on the relevant display page (ISDA). For the LMA the interest rate becomes a Reference Bank rate, or failing that a cost of funding rate. With the 2006 ISDA Definitions the rate moves to a Reference Bank rate or failing that the mean of the rates quoted by major banks selected by the Calculation Agent for loans in the relevant currency to leading European Banks.

These fall-backs are already being applied in the loan market in the case of those currencies for which BBA LIBOR has been discontinued. Either the Reference Bank rate is being used or, if this cannot be obtained, cost of funds applies. Alternatively the parties may agree something else entirely in accordance with their contract. For certain discontinued maturities (e.g. CHF, EUR, GBP, JPY and USD) the LMA and ISDA have published interpolation provisions which the parties can choose to adopt so as to avoid giving effect to the contractual fall-backs.

The question arises whether the contractual fall-backs are designed to be a short term solution only to cover temporary LIBOR glitches. This may be convenient if the fall-backs are administratively cumbersome. However we think it is difficult to construe them as limited to a short term or temporary solution. The LMA and ISDA waterfalls of fall-backs lend weight to this although with ISDA a collapse of the interbank market is not contemplated (so there is no cost of funding equivalent) which muddies the waters.

Since the fall-backs can be rather inconvenient, others have argued that the LMA provision which states that "*if the agreed page is replaced or the service ceases to be available the Agent may specify another page or service displaying the appropriate rate*" entitles the Agent to come to the rescue. In our view this needs to be read simply as a mechanical exercise in a situation where Reuters ceases to provide a published LIBOR rate when the Agent can find an alternative publisher, rather than the more radical interpretation that this leaves the Agent free to find a new benchmark altogether. A similar argument applies to the "Successor Source" concept in the 2006 ISDA Definitions. In fact since the "Successor Source" definition makes no reference to an "*appropriate rate*" it is easier to conclude with the 2006 ISDA Definitions that the mechanical interpretation is appropriate.

Scenario 3 – LIBOR is replaced by regulators or by market change

This contemplates that a new benchmark with little relationship to LIBOR comes into being. For the LMA and ISDA which have fall-back mechanics it is hard to see how a court might refuse to give effect to them unless Tool 2 (implied terms) could be employed, on the basis that had the parties thought about this eventuality it would have been clear that they would have opted for this new benchmark. We consider this a rather high hurdle to jump, unless of course the new benchmark had much in common with old LIBOR when the argument might have more chance of success.

Scenario 4 – LIBOR replacement is backed by legislation

For legislation to be effective it would have to be co-ordinated at an international level to reflect the multitude of relevant jurisdictions involved in global financial markets. This presupposes a consensus over the replacement benchmark. Of course the UK legislature could act singly so as to bind all those contracting under English law governed contracts. However this might not be recognised in the courts of the home states of the contracting

parties or the courts where the contract is to be performed and of course it would not assist contracts which are not governed by English law.

Conclusion

The appointment of ICE as the new LIBOR administrator should not of itself undermine the continued operation of the LMA and ISDA English law governed contracts which use LIBOR. Any more radical departures from the LIBOR methodology (including its discontinuance altogether) however may well present the courts with difficulty in securing contractual continuity save by the use of contractual fall-back provisions (a less than ideal solution but already playing itself out in the context of certain discontinued currencies and maturities) or by implying contractual terms, though this will be a challenge.

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