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LIBOR AND OPERATING LEASES

The reform of LIBOR and other global benchmark rates used in loans and other financial instruments continues, although a common alternative reference rate ("**ARR**") acceptable to banks, hedging counterparties, investors and borrowers is yet to emerge. This briefing specifically considers the impact of the potential discontinuation and replacement of LIBOR on aircraft operating leases and suggests next steps for lessors and lenders.

Background

Since the Wheatley Review in 2012, the financial markets have had to respond to (a) the replacement of the BBA, as administrator of LIBOR, with ICE; (b) the withdrawal of screen rate LIBOR for certain currencies and maturities; and (c) the announcement by the FCA's Andrew Bailey regarding the potential discontinuation of LIBOR by 2021. These developments have been discussed in various Clifford Chance briefings, including "LIBOR – the beginning of the end?", July 2017, and "Impact of LIBOR reform on contractual continuity", January 2014. Asset finance transactions are as much affected by these changes as any other funding arrangements.

The vast majority of loans, bonds and hedging agreements which use LIBOR as a reference rate will contain fall-back mechanisms (discussed further below) which attempt to provide some redress against the contractual uncertainty of a sudden discontinuation of LIBOR. Finance leases are likely to include similar provisions. However, the position with respect to operating leases is sometimes less clear-cut and this may give rise to the issues examined in this briefing.

LIBOR references - floating rate rentals

It is not uncommon for an aircraft operating lease with rentals calculated on a floating rate basis to use LIBOR as the reference rate. A sample clause might provide that rent shall be calculated as the product of the relevant LIBOR for the agreed period, e.g. three or six-month US$ LIBOR, multiplied by an agreed basic rent factor (including any rent adjustment/escalation factor).

As with syndicated loans and bonds, it is currently not feasible to draft a specific replacement reference rate for LIBOR (or any other existing market standard benchmark, e.g. EURIBOR) into any lease agreement being documented now until the market agrees on an acceptable ARR. Regulators and industry associations in different jurisdictions are debating various "risk free rates" ("**RFR**s") but there are significant challenges substituting any of these for LIBOR, not least because (a) LIBOR is a forward-looking term rate whereas such RFRs are based on backward-looking overnight rates and (b) LIBOR is not a risk-free rate (it takes account of credit risk and term risk) and therefore any RFR cannot be treated as a direct substitute, absent the introduction of some other component to preserve the anticipated economic return for a

financier or lessor. The reform process may result in different ARRs being adopted for each of the existing LIBOR quoted currencies, with individual characteristics (e.g. secured and unsecured rates); and in different markets (e.g. loans vs. bonds) electing separate ARRs.

Fall-back provisions – loans vs. operating leases

Many loans, including those based on the LMA standard form facility agreements, incorporate "fall-back" provisions should LIBOR (or other relevant benchmark for the loan interest rate) become unavailable during the term of the loan. For example, in the LMA forms, LIBOR is defined as (i) the published screen rate for the relevant currency and interest period, at the specified time, or, (ii) if such screen rate is unavailable, then one of two versions of a "waterfall of fall-backs" applies. The waterfall provides for a series of substitute rates, starting with an interpolated screen rate, then an historic rate (if the longer form waterfall is selected), then a rate provided by selected reference banks and, ultimately, if none of these is available in that order, a rate based on the individual lender's cost of funds.

While these fall-back mechanisms are undeniably helpful, in terms of the long-term transition from LIBOR, there are limitations to these provisions which are primarily designed as a temporary measure. However, they do provide contractual certainty that a rate will apply if LIBOR is not quoted; whereas not all floating rate operating leases contain such fall-backs.

Furthermore, these fall-backs may not be triggered in all circumstances. For example, if, for some reason, LIBOR continues to be published beyond the FCA's announced transition date of 2021 (and is therefore not "unavailable") but ceases to be reflective of the ARR adopted by the syndicated lending market, the parties may find themselves locked into a reference rate for the loan interest rate which is not commercially palatable. Depending on the fact pattern, such rate may also vary from any associated hedging arrangements, if the documentation for these is subsequently amended.

Market disruption

Many loans also include an express market disruption clause in favour of the lenders which broadly provides that if a lender notifies the facility agent that its cost of funding its individual loan participation exceeds LIBOR for a relevant interest period, then the loan interest rate for that period shall switch to the lender's cost of funds (plus the margin). However, this provision may be subject to specific drafting, for example, it may only be triggered by a defined "market disruption event" (e.g. an event adversely affecting the financial markets generally) and/or may require an agreed threshold of lenders to be affected. Depending on the factual circumstances of the market's transition away from LIBOR and the specific wording of the relevant agreement, a lender may not be able to avail itself of the market disruption option.

"Hardwiring"

Accordingly, banks and borrowers are increasingly including in their loan agreements currently being documented an express option to agree on a substitute reference rate (which may be subject to majority lender or all lender consent, depending on the commercial negotiations), rather than relying solely on "fall-back" mechanisms, including any market disruption clause. The LMA, in consultation with the ACT, has recently revised its form of (optional) replacement of screen rate clause to provide greater flexibility for agreeing

amendments (e.g. with a lower consent threshold) and to accommodate a range of trigger events.

In the case of operating leases, as mentioned, there may not be any fall-back provisions drafted in the lease agreement to begin with. The limitations discussed above will also apply to those leases which do contain such provisions.

Legacy leases – post 2021

For operating leases (a) already entered into by the parties which do not include any replacement rate provisions, by way of a fall-back mechanism or otherwise, and (b) where the lease term is scheduled to expire after 2021 (including by way of any lease extension or renewal), the key question is whether the rentals calculation clause or any other payment provision reliant on a LIBOR reference rate (e.g. for any default rate applicable to late payments) will continue to be workable, from a contractual continuity perspective (assuming English law as the governing law of the agreement). Our above-mentioned January 2014 briefing analyses certain LIBOR reform scenarios in the context of English law governed syndicated loan agreements and notes that the English court may have difficulty in securing contractual continuity, save by use of contractual fall-back provisions. For operating leases without any fall-backs, the position may be even more challenging.

We have considered some additional potential scenarios for such legacy leases:

Scenario I LIBOR continues to be published but lending market adopts an ARR	While the lease agreement will continue, the parties will be "locked in" to a LIBOR based lease rate which may not be commercially desirable, particularly for the lessor where LIBOR ceases to be reflective of (or even broadly commensurate with) its financing costs. There may be payment mismatches with the lessor's financing agreements (loans, bonds and associated swaps). Note these issues may also apply if a so-called "synthetic LIBOR" or "LIBOR proxy" is published by the same provider but which diverges from any ARRs adopted by the lending and other markets, although the contractual continuity risk regarding the legacy lease would be mitigated.
Scenario II LIBOR ceases to be published entirely, lending market adopts an ARR which is appropriate for the asset finance industry	It is difficult to predict how the English court would interpret the lease agreement, using the tools of contractual interpretation and implication of terms. An operating lease is primarily a "usage" agreement, in contrast to a finance lease which may be argued to be a form of financing instrument. While an operating lessor is entitled to payment (by way of rent) for granting the possession and use

	of the asset to the lessee, a court would need to be satisfied that the parties intended all references to LIBOR to mean such ARR. In the absence of any fall-back concepts or other express terms, this could be a high threshold to meet.
Scenario III LIBOR ceases to be published entirely, lending market adopts an ARR which is not appropriate for the asset finance industry	The same challenges regarding interpretation of the lease agreement apply as in Scenario II. Even if the court concludes that references to LIBOR may be read as references to such ARR, this may not be the commercial intention of the parties.

Lease financing arrangements

Where there is any linkage between specific lease cashflows (whether in respect of a single asset or on a portfolio basis) and any financing arrangements, an operating lessor should ensure going forward that there are no payment or structural mismatches arising out of different approaches in the lease(s) and the financing documents (loans, bonds and associated swaps) to respective reference rate definitions, including any replacement rate mechanics.

Considerations

In light of these uncertainties, an operating lessor negotiating a new floating rate lease should aim for maximum flexibility to substitute another (unspecified) lease reference rate during the term. Specific triggers and conditions may be negotiated on a case-by-case basis. For example, broadly speaking, the lease could include a clause allowing the lessor to apply a replacement rate which is either the generally accepted ARR or subject to the lessee's consent (not to be unreasonably withheld). The lessor should seek the ability to amend the lease to take into account the replacement rate applicable under any financing.

For historic leases that may extend beyond 2021, lessors and lessees should be prepared to be pro-active in amending the lease agreement to include suitable replacement benchmark rate provisions as and when the position becomes clearer. Given the potential for a contractual interpretation issue to arise, doing nothing may not be an option.

Where there are linked financing arrangements, the lessor should be mindful of conforming the rate chosen for the lease with that applicable to any related financing and hedging, as well as any requirement to obtain lender consent to such lease amendments (if applicable).

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