

Credit agreement best practice – LIBOR cessation

SEPTEMBER 16, 2020 5 MIN READ

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LIBOR, or the London Interbank Offered Rate, is the underlying reference rate for trillions of dollars of financial products, including loans, bonds and derivatives. Less than 500 days remain before the expected end of LIBOR on December 31, 2021, and there is no suggestion that the COVID-19 pandemic will delay LIBOR's end.

The secured overnight financing rate (SOFR^[1]) is expected to be the rate that succeeds U.S. dollar LIBOR for many financial products — although for loans, it is not yet clear which specific SOFR rate will be adopted. The leading contenders appear to be forward-looking term SOFR, which would have a term structure similar to LIBOR (but would require the development of a SOFR futures market), and daily simple SOFR in arrears. Other variants include SOFR compounded in advance and SOFR compounded in arrears — with the latter being the fallback rate selected by ISDA for derivatives. The transition from U.S. dollar LIBOR to SOFR will also involve a spread adjustment to equalize for basic differences in the nature of LIBOR (an unsecured, tenored rate involving interbank credit risk) and SOFR (an overnight rate for repurchase transactions secured by U.S. treasuries, so theoretically risk free).^[2]

Recent loan transactions have continued to reference LIBOR alongside amendment mechanics that contemplate the entering into of amendments in the future to implement LIBOR's eventual successor and to address the spread adjustment. These mechanics have predominantly taken the form of the Alternative Reference Rates Committee (ARRC)'s "amendment approach" or similar language. Under this approach, language is included contemplating amendments to reflect a replacement rate and spread agreed to in the future by the administrative agent and the borrower, which amendments are deemed acceptable to all lenders unless objected to by the majority lenders within a specified period of time.^[3] In the absence of provisions addressing LIBOR's replacement, an amendment to a credit agreement to replace LIBOR would normally require unanimous lender consent. Failing this, historical provisions whereby U.S. dollar LIBOR falls back to the U.S. dollar prime rate would typically be triggered. Both of these can be disadvantageous to the borrower.

There are estimated to be at least 10,000 outstanding U.S. dollar syndicated loans that reference LIBOR. It will be challenging to amend such a large number of loans to reflect U.S. dollar LIBOR's loan market successor once known — not to mention to amend new loans yet to be made that continue to reference LIBOR — all in a short window of time. For some time now, the ARRC has proposed an alternative to its "amendment approach," called the "hardwired approach." Under the "hardwired approach," language is included in the credit agreement from inception that automatically switches into LIBOR's replacement upon stated triggering events (e.g., LIBOR cessation, regulator announcement that LIBOR is no longer representative or the exercise of an early election right) without the need for amendments to the credit agreement (other than ministerial or "conforming" amendments required by the administrative agent but not requiring lender consent). However, the "hardwired" approach has to date not been widely used in credit agreements: a Covenant Review survey of 288

new-issue and amended institutional loans from January 1, 2020 through June 30, 2020 found that none of them included “hardwired” LIBOR fallback provisions.

Recently, the ARRC announced three key new best practice recommendations:^[4]

- all new *syndicated* business loans should include ARRC-recommended (or substantially similar) “hardwired” U.S. dollar LIBOR fallback language^[5] as soon as possible, but *in any event no later than September 30, 2020*;
- all new *bilateral* business loans should include ARRC-recommended (or substantially similar) “hardwired” U.S. dollar LIBOR fallback language^[6] as soon as possible, but *in any event no later than October 31, 2020*; and
- no business loans using U.S. dollar LIBOR and maturing after 2021 should be originated *after June 30, 2021*.

It bears reiterating that incorporating “hardwired” fallback language in credit agreements does not mean the relevant loans will reference SOFR from inception. Rather, such loans would continue to reference LIBOR, but would be “hardwired” to switch to LIBOR’s eventual loan market replacement (expected to be the applicable SOFR rate) upon stated triggering events, without majority lender negative consent rights or other lender consent rights.

It remains to be seen whether loan markets will adopt these best practices in the envisaged time frames. Regardless, the countdown to LIBOR’s seemingly inexorable demise continues.

[1] Additional background on SOFR, in the form of the Alternative Reference Rates Committee’s “SOFR Starter Kit,” can be found here: https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_Press_Release_SOFR_Starter_Kit.pdf. In addition, the Loan Syndications and Trading Association (LSTA) has made SOFR Concept Credit Agreements available to its members for review, reflecting SOFR compounded in arrears, daily simple SOFR and daily compounded SOFR (compound the balance). Another alternative, daily compounded SOFR (compound the rate), is expected to be addressed in a separate LSTA publication.

[2] ISDA has determined that the spread adjustment for derivatives will be based on the median over a five-year period of the historical differences between U.S. dollar LIBOR in the relevant tenor and SOFR compounded over each corresponding period. ARRC has recommended a spread adjustment methodology for business loans consistent with ISDA’s: https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_Spread_Adjustment_Methodology.pdf

[3] Credit agreements that include a Canadian Dollar Offered Rate (CDOR) interest rate option frequently include comparable “amendment approach” mechanics; although, unlike in the case of LIBOR, there is no current expectation that CDOR (which is based on transactions in the Canadian bankers’ acceptances market) will cease.

[4] <https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC-Best-Practices.pdf>.

[5] The ARRC most recently updated its “hardwired” fallback language for syndicated loans on June 30, 2020:

<https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/Updated-Final-Recommended-Language-June-30-2020.pdf>

[6] The ARRC issued refreshed “hardwired” fallback language for bilateral loans on August 27, 2020:

<https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/Updated-Final-Recommended-Bilateral-Business-Loans-Fallback-Language-August-27-2020.pdf>