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How to Survive the Zombie LIBOR Apocalypse: Saul Ewing

They're out there now, in small towns and big cities, getting ready to rise up and wreak financial havoc on unsuspecting bond issuers and borrowers. Unless they're sought out early and neutralized, the zombie LIBOR interest rates could take a big bite out of municipalities, hospitals, colleges and other institutions and borrowers with outstanding bonds, loans or swap contracts bearing interest rates tied to LIBOR.

It's already fairly well known that LIBOR, the London interbank offered rate, is being phased out as a reference rate. By the end of 2021, LIBOR will be replaced with another, as yet undetermined, reference rate or rates. Bank regulators in the United Kingdom and the United States have realized, belatedly, that LIBOR never was an efficient or fair way to set international benchmark interest rates. LIBOR is basically an average of what a small number of banks estimate on a daily basis to be their cost to borrow unsecured funds from each other in different currencies across different time periods. These unregulated self-reported estimates (or, more accurately, educated guesses based on an extremely small number of unsecured interbank lending transactions) are not based on actual transactions and, being free from governmental oversight or transparency, were ripe for inaccuracies and even manipulation.

Following some headline-grabbing charges of LIBOR-rigging by large banks, LIBOR's days were numbered, and the British authority overseeing LIBOR announced that, after 2021, it will no longer persuade or compel banks to submit estimates for the determination of LIBOR. The only question left then was what would replace LIBOR - or would a seemingly undead LIBOR continue to control interest rates as Zombie LIBOR?

Beware the Zombie LIBOR

LIBOR is now, in effect, a dead rate walking. The plan is that LIBOR will cease to exist as a benchmark interest rate at the end of 2021, but many imaginative market observers are calling it a "Zombie LIBOR", because it's not really alive now, and it may not really be dead after 2021. As mentioned above, LIBOR is no longer considered to be a reliable benchmark rate, and may become even less reliable as fewer banks provide LIBOR estimates and others move to alternate interest rates. Issuers and borrowers may begin to wonder whether their existing LIBOR-indexed bonds, notes or swap instruments actually reflect the real cost of borrowing money. Issuers and borrowers entering into new transactions may eschew LIBOR altogether in favor of another benchmark rate, without waiting for 2022 to roll around.

However, because so many currently outstanding bonds, loans and swap transactions have LIBOR baked into them, with no easy way to switch to another interest benchmark or comparable interest rate, it's possible that LIBOR may need to stay around even after 2021 in order to provide these "legacy" deals with a benchmark interest rate, no matter how unreliable. Some legacy deals with maturities extending beyond 2021 may have no other good choice but to stick with a zombified LIBOR, even as new deals and other legacy deals have switched over to another, more nimble, benchmark rate. LIBOR, kept artificially alive by a small number of reporting banks, would then go head to head with another rate, or rates, until the legacy deals all mature or find a way to provide an

alternate benchmark rate.

SOFR to the Rescue?

In the United States, a committee convened by the Federal Reserve Bank to study LIBOR replacements recommended the adoption of an alternative interest rate benchmark tied to U.S. treasuries-backed repurchase agreement market from actual market transactions. The recommended rate – called the Secured Overnight Financing Rate, or SOFR – represents rates that banks are able to fund overnight on a basis secured by U.S. government debt. The Federal Reserve Bank of New York has been publishing SOFR on a daily basis since April 3, 2018.

As a benchmark for determining interest rates, SOFR has some structural advantages over LIBOR. SOFR is an overnight secured rate based on actual Treasury transactions, changing daily, whereas LIBOR is an unsecured rate based on bankers' estimates of future rates, which means that SOFR is much less susceptible to manipulation and abuse than LIBOR. LIBOR is based on unsecured loans and, therefore, builds in a risk premium; SOFR is a secured rate, with no risk premium, so SOFR generally produces a lower rate than LIBOR and is considered less volatile than LIBOR. And who knows what could happen to LIBOR if, or when, Brexit becomes a reality? So far, it appears that SOFR is the heir apparent as the benchmark interest rate in the U.S. following LIBOR's ultimate demise, assuming LIBOR really does go away.

Who's in Harm's Way?

For decades, LIBOR has been ubiquitous in lending and swap transactions. In the public finance sector, many state, county and local issuers, school and park districts, conduit 501(c)(3) borrowers such as hospitals and colleges, and conduit private activity bond borrowers have issued bonds or entered into loan or letter of credit transactions which provide that interest is to be determined by reference to a floating LIBOR rate (of usually 30, 60 or 90 days), together with an "applicable margin" or spread expressed as a percentage or basis points. LIBOR may be used in determining a taxable rate or tax-exempt rate, or both, and borrowers may have the option to convert floating LIBOR rates into floating prime or fixed rates, and then back again.

Issuers and borrowers have also been frequent participants in swap transactions, under which the issuer or borrower pays a fixed rate of interest to a counterparty and receives in return a floating rate as a percentage of LIBOR. In these transactions, the bonds are issued with a fixed rate, which is then exchanged with the swap counterparty for a LIBOR-based rate, so that the bondholders receive interest at a floating rate tied to some percentage of the applicable LIBOR.

Not only do issuers and borrowers need to concern themselves with the phase out of LIBOR, but banks, underwriters, placement agents, trustees, bondholders and other participants in the municipal bond marketplace will also be closely monitoring the looming battle between LIBOR and SOFR, and trying to determine which side to choose.

The Specter of a LIBOR Legacy

With 2021 staring down at them, bond issuers, conduit borrowers, banks and others are now facing LIBOR's demise from two distinct viewpoints – either those with existing, or legacy, transactions which have pegged interest rates to some fraction of LIBOR, or those entering into new deals with the full knowledge that LIBOR as we know it won't be around forever. For those entering into new floating rate transactions, being forewarned is being forearmed against Zombie LIBOR. As further discussed below, issuers, borrowers and banks can anticipate the phase out of LIBOR and draft their documents accordingly, such as by providing appropriate spread, trigger and fallback provisions.

Those with legacy contracts referencing LIBOR, however, aren't so lucky. They will need to pour over their existing documents and get a handle on what happens to their interest rates once LIBOR is history.

Issuers and borrowers with legacy agreements for LIBOR-indexed debt maturing prior to the end of 2021 have, ostensibly, no great incentive to revisit their LIBOR agreements, yet they may wish to calculate whether the LIBOR-based interest rate they are currently paying has a real relationship to the actual cost of borrowing funds. They may discover that their LIBOR is a Zombie LIBOR untethered from reality. In that case, they might want to renegotiate for a lower interest rate – through a new benchmark rate, a new applicable margin, or both – for the remaining term of their LIBOR obligations.

On the other hand, issuers and borrowers with legacy agreements for LIBOR-indexed debt maturing after the end of 2021 have a pressing incentive to revisit their LIBOR agreements – and as soon as possible. These agreements contain the seeds of a Zombie LIBOR uprising which, left unchecked, could lead to uncertainty, higher interest rates and the municipal bond market version of panic in the streets.

The trouble with many legacy LIBOR contracts is that they didn't even bother to contemplate that LIBOR may go away someday, or else they contemplated only a temporary suspension of LIBOR quotes. Those legacy contracts which were sagacious enough to address the possible unavailability of LIBOR, no matter how short-term, usually provided for "fallback" language setting out an alternate benchmark rate to be used when LIBOR was not available.

These fallback provisions have taken many forms, and have set up a variety of alternate benchmark rates, ranging from choices like prime, some sort of fixed rate, some other floating rate determined by another index listed in the financial press, or a rate picked at random by a lender or bond trustee. Issuers and borrowers will need to scrutinize the fallback language, if any, in each of their legacy LIBOR contracts with an eye towards such critical issues as:

- **What's the alternative?** Does the fallback language clearly and unambiguously identify an alternate benchmark rate? Is the alternate benchmark rate readily ascertainable in today's market, and does the alternate benchmark rate accurately reflect the cost of borrowing money? If the fallback rate is the prime rate, the issuer or borrower will be facing a rate substantially higher than LIBOR. There's no sense in replacing a Zombie LIBOR with another unreliable rate, or a rate that gives one party a distinct advantage over the other.
- **Who's in charge?** The fallback language may give the lender, a bond trustee or some other party carte blanche to determine if LIBOR is indeed unavailable and what alternate benchmark rate is to be used in LIBOR's place. Does the issuer or borrower have any say in the matter? If it doesn't like the new alternate benchmark rate or the resulting new interest rate, can the issuer or borrower refinance or redeem without getting hit with a prepayment penalty?
- **What's the spread?** The fallback language in many legacy contracts may have described an alternate benchmark rate, but probably did not provide a mechanism for adjusting the applicable margin or spread in the event LIBOR is not available. Many legacy LIBOR documents set the interest rate for a bond or loan at a multiple of LIBOR – for example, 0.75 of LIBOR for a tax-exempt bond. As mentioned above, though, LIBOR is a risk-based rate and therefore runs higher than risk-free reference rates such as SOFR (which, being based on secured short-term transactions, will generally be a lower rate than LIBOR). A higher or lower applicable margin may be required so that the actual interest rate paid under LIBOR will be roughly comparable to the actual interest rate under the alternate benchmark rate. Issuers, borrowers and lenders may need to perform mathematical gymnastics to come up with a new spread to use with the new benchmark rate, but the end result should be that the actual interest rate charged to the issuer or borrower

won't fluctuate wildly if and when an alternate benchmark rate replaces LIBOR.

- **How do we fix this?** There's a good chance that your legacy LIBOR contracts will have to be amended because the fallback provisions are absent, confusing or inadequate, or because the margin is too high or too low for the new alternate benchmark rate. But it may not be so easy to amend legacy contracts. Loan agreements with banks may require the bank's consent, or the consent of all or a majority of syndicated lenders. Indentures for bond issues may require the consent of all or a majority of bondholders. Issuers and borrowers should determine what consent, if any, is needed to amend legacy documents and, if so, can the required consent be readily obtained or waived?
 - **But not so fast.** Amending legacy documents for tax-exempt bonds or loans could result in a "reissuance" for federal income tax purposes. The IRS considers a tax-exempt obligation to be reissued if there are what it deems to be "significant modifications" to the terms of the obligation so that it ceases to be the same obligation as originally issued and is essentially a new obligation, unless the terms of the bond documents themselves provide for such modifications. A reissued tax-exempt bond or loan is subject to a re-testing of the requirements for tax exemption. At a minimum, a new Form 8038 will need to be filed with the IRS, bond counsel may be required to perform additional tax due diligence, and bond counsel, issuer's counsel and/or borrower's counsel may have to give new opinions. The bottom line is that bond counsel should always be consulted prior to any amendments of legacy documents for tax-exempt obligations.
- ### **Getting Around LIBOR Before It Goes Away**

While bond issuers, conduit borrowers and banks with legacy LIBOR deals will bear most of the brunt of the LIBOR phase out, that doesn't mean that structuring and negotiating new floating rate transactions is going to be a piece of cake for anyone. Those entering into new floating rate bond or loan deals will know the perils of going forward beyond 2021, and will need to be very careful in their negotiations over issues such as:

- **A workable alternative.** New contracts tied to LIBOR should provide for a definitive alternate benchmark rate to go into effect as soon as LIBOR is no longer available. As of early 2019, SOFR seems to be the leading contender for the new benchmark rate, but there are also good arguments in favor of the Federal Funds Effective Rate, especially with respect to swap contracts. Other benchmark rates may emerge as we get closer to 2021. The key thing is to not leave it to chance but instead have a workable, fair fallback benchmark rate waiting in the wings.
- **Who's pulling the trigger?** New contracts should also clearly state who is responsible for determining when LIBOR is no longer available, and how that party will make that determination. Should the new benchmark rate kick in on January 1, 2022, or can the new benchmark rate go into effect earlier, when someone, somewhere determines that LIBOR is nothing but a hollow zombie?
- **Setting the spread.** As discussed above, the spread or margin for LIBOR may not necessarily be the appropriate spread for another benchmark rate. For new contracts, the issuer/borrower and lender should agree on an appropriate spread for when the new benchmark rate goes into effect.

Become a Zombie LIBOR Fighter

The closer we get to 2021, the more likely it is that LIBOR will become a zombie interest rate. It won't reflect real-world interest rates and may wind up costing unwary issuers and borrowers a lot of money in interest rates that are substantially higher than the market rate.

However, you can – and must – fight back against the Zombie LIBOR infestation. First, identify all of your bonds, loans, swap contracts and other financial commitments which have interest rates tied to LIBOR. Then, review the appropriate documents for each deal to see how they handle LIBOR unavailability triggers, new benchmark interest rate fallback provisions, adjustments to the margin and the other issues discussed above. If there is a fallback mechanism, try to figure out what your

new interest rate might be using the new benchmark rate multiplied by the appropriate margin (either the existing margin or a new margin corresponding to the new benchmark rate). Is the LIBOR-based rate and the currently specified margin higher or lower than the alternate benchmark rate that would replace LIBOR?

Most importantly, communicate with your lender, swap counterparty or bond trustee. You may need to renegotiate terms, restructure the debt or consider a refunding or refinancing. Also, seek the assistance of competent legal counsel, with up-to-date market experience, to help ward off Zombie LIBOR and guide you through the process of transitioning from LIBOR to the new interest rate benchmark.

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