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LIBOR Transition – Issue 5: Greenberg Traurig

Welcome to Greenberg Traurig's LIBOR Transition Newsletter, where we provide updates, analysis, and occasional commentary on the latest developments relating to the highly anticipated phasing-out of LIBOR at the end of 2021 – just 19 months from now.

Corporate Trust and Structured Finance

LIBOR is the reference rate found in many corporate trust transactions, and nearly all structured finance transactions. Floating rate notes (and swaps) in corporate and municipal bond issuances are tied to LIBOR, as are the certificates (and swaps) in residential mortgage backed securities (RMBS) and other asset-backed securitizations. What does the LIBOR transition mean for trustees and others who administer these transactions under the governing agreements for the benefit of investors?

Legacy trust agreements may pose the greatest challenge. The maturity of corporate and municipal bonds typically measures in decades. The same is true of the mortgages and other debt instruments that underlie asset-backed securitizations. Trustees are still administering deals dating back to the 2000s, or earlier, when no one contemplated the end of LIBOR. A typical trust agreement (e.g., pooling and service agreement, indenture, trust agreement) from the early-to-mid 2000s often requires the trustee to designate a new rate if LIBOR is temporarily unavailable. For example, the trustee (or securities administrator or paying agent) "shall designate an alternative index that has performed, or that the Trustee expects to perform, in a manner substantially similar to [LIBOR]." In the absence of manifest error, the trustee's designation and ensuing interest calculation "shall be final and binding."

However, making such a unilateral designation may bring litigation risk. A consensus is developing among the Alternative Reference Rates Committee (ARRC) that banks use the new Secured Overnight Financing Rate (SOFR) as an alternative to LIBOR. Investors may argue that SOFR – as a "risk free," overnight rate secured by U.S. Treasuries and calculated based on actual market transactions – inherently cannot be "substantially similar" or "comparable" to LIBOR, as may be contractually required. Even if the methodology for spread adjustments to make SOFR more comparable to LIBOR were agreed upon by all market participants, documentation signed many years ago never contemplated for the adjustment of the applicable margin. In practice, SOFR, even with a spread adjustment, may reduce interest payments to investors, to their detriment and the issuer's benefit. Litigation risk may also increase if the new reference rate would result in some classes of investors receiving comparably less under the cash flow waterfall, while others would receive more. With the agreement silent, a trustee may be put in the awkward position of exercising discretion regarding the "fairness" of applying a recommended spread adjustment methodology. Beyond that, any unilateral selection also may expose the trustee to charges of conflict of interest – for example, if the new reference rate would somehow increase the bank's compensation, or if a party questioned why the trustee in its banking capacity used one reference rate for its own deals and chose another for the trust or securitization.

For these reasons, and absent a provision delegating any such decision to an independent third party, a trustee may seek to further mitigate potential liability by putting it to the investors, or even

a court, to approve or select a new reference rate. In charging the trustee with the choice of selecting a replacement rate, the legacy trust agreements may have envisioned a short-term disruption of LIBOR, like a technology failure, but not LIBOR's permanent cessation. As a result, a trustee may need to consider other methods, potentially in combination, to administer the transition away from LIBOR. Considerations include the following:

1. **Investor consent.** Legacy trust agreements in the United States typically do not expressly provide for investor consent as a means to insulate the trustee from liability in exercising its authority. Still, if all investors agreed to the new reference rate beforehand, the trustee may be well-positioned to avoid liability. But, obtaining unanimous investor consent presents significant challenges. First, the potential disparate impact of a new rate on different classes of investors may preclude unanimity. Second, a consent solicitation is an up-or-down vote, often without a forum for dialogue among competing interests. Third, the logistics may prove difficult: affirmative unanimous consent may require an actual response from every investor, numbering in the hundreds or thousands. If the governing trust agreement contained a negative consent provision, the trustee might be able to use an alternative reference rate if the requisite percentage of investors did not object within an established timeframe. Without this express provision, however, a negative consent solicitation may not be enough to shield the trustee from liability, since a later-dissenting investor may allege inadequate notice or another misstep that supposedly prevented its voice from being heard. Moreover, given the competing interests among different classes of investors, there may be dissent. Finally, amendments that alter the interest rate on a note or a bond typically require affirmative consent of every affected investor.
2. **Investor direction.** By contract, a trustee typically is not be liable for any action taken by it in good faith in accordance with the direction of a specified threshold of investors. For example, a fairly typical provision in a legacy trust agreement provides: "The Trustee shall not be personally liable with respect to any action taken, suffered or omitted to be taken by it in good faith in accordance with the direction of the Certificate-holders of any Class holding Certificates which evidence, as to such Class, Percentage Interests aggregating not less than 25% as to the time, method and place of . . . exercising any trust or power conferred upon the Trustee under this Agreement."Investor direction addresses most, but not all, of the issues with a consent solicitation. It is a contractual mechanism to shield the trustee from liability, and it does not require investor unanimity, or an affirmative response from all investors. Again, however, the potentially disparate impact of a new reference rate among different classes of notes, bonds or residual interests may prevent the trustee from reaching the threshold for direction across all classes. And, like a consent solicitation, a request for direction is an up-or-down vote that may not provide a forum to resolve differences.
3. **Trust instruction proceeding.** A trust instruction proceeding (TIP) may insulate a trustee from liability in selecting or designating a new reference rate. In a TIP, the trustee asks the court to resolve a question of trust administration, but only after all interested parties receive notice and have an opportunity to be heard. The court's final order is binding on all investors. Significantly, a TIP provides that the trustee has satisfied its duties to investors and is not subject to liability if it acts in accordance with the order. The final order also may provide for payment of the trustee's related fees and expenses. Statutory provisions governing TIPs are a key part of the Uniform Trust Code, which has been enacted in 34 states as of Jan. 1, 2020. New York has not adopted the code, but it provides for a similar "special proceeding" to resolve issues of trust administration. N.Y.C.P.L.R. 7701.

> A trustee may commence a TIP to, among other things, (1) confirm or ratify its conduct, (2) resolve an ambiguity in the trust documents, or (3) resolve disagreements with, or between, investors. Designating a new reference rate to replace LIBOR implicates these

concerns. A consent solicitation or request for direction may be a prelude to a TIP, as each helps frame the issue and flesh out the competing positions. The trustee prepares a petition seeking judicial instruction or direction, and provides widespread notice to all beneficiaries and other interested persons. Any interested person who objects to the relief or wishes to be heard may appear in the TIP. If the petition is contested, the TIP proceeds as a traditional lawsuit, although ideally on a faster track, culminating in an evidentiary hearing and then a judicial decision that binds all parties and protects the trustee from liability.

Accordingly, a trustee may prefer the option of a TIP in which the court approves or otherwise designates the LIBOR replacement rate. But a TIP is not without its decision points and potential pitfalls, which a trustee should consider beforehand. For example:

- **Trustee's position.** Trustees may decide whether to take a position on the new reference rate, or simply ask that the court resolve a dispute among investors. If a trustee has a preference – for instance, a new reference rate that would best fit its own systems and operations in administering the trust for the benefit of investors – there may be little reason to remain neutral. Mechanical issues may arise when switching from a term-rate (like LIBOR), where the parties know the payment amount in advance of the interest period, to an average in-arrears rate as term SOFR may become, where the parties do not know the amount until the end of the interest period. Furthermore, the spread adjustment methodology may also lead to issues as to its sufficiency and as to its fairness in compensating for the lower SOFR rate. These types of changes may affect waterfalls and reporting obligations.
- **Consistency.** Trustees, securities administrators, and paying agents typically administer thousands of transactions. Their primary interest may be in a replacement rate that is consistent across transactions, no matter which reference rate ultimately is designated. A trustee may wish to explore structuring the TIP process across trusts to help achieve consistency and to reduce the legal fees borne by any single transaction.
- **Timing.** With LIBOR currently anticipated to end at the close of 2021, trustees may wish to move quickly. TIPs may be expedited, but recent TIPs to approve the settlements of RMBS loan repurchase actions have taken a year or more to resolve. The sheer volume of TIPs on the LIBOR transition may compound the time crunch.
- **Disclosure.** Throughout this process, a trustee should consider the disclosures it makes to investors about the process for selecting a new reference rate and transitioning from LIBOR, including anticipated steps and timing.

Recent Developments.

- **ISDA publishes report summarizing the final responses to its consultation on the implementation of pre-cessation fallbacks for derivatives referencing LIBOR.** On May 14, 2020, the International Swaps and Derivatives Association (ISDA) released a report about findings of its consultation launched on Feb. 25, 2020, which indicated that the majority of respondents supported including pre-cessation triggers in the amended 2006 ISDA Definitions for LIBOR for new derivative trades and including pre-cessation triggers for existing derivative trades in an ISDA Protocol to which market participants could adhere to amend their trades. The sole pre-cessation trigger would be the unrepresentativeness of LIBOR. This issue relates to the "zombie LIBOR" issue where LIBOR ceases to be representative of the London interbank offered rate because of a lack of quotations from banks, even though LIBOR is still being published. ISDA expects to publish amendments to the 2006 ISDA Definitions to incorporate the fallbacks for new trades in July 2020, which would align the derivatives market with pre-cessation triggers that had previously been proposed by the Alternatives Reference Rates Committee (ARRC). View the ISDA report here.

- **ARRC Announces Recommendation of a Spread Adjustment Methodology for Cash Products.** On April 8, 2020, the ARRC announced that it is recommending a spread adjustment methodology for USD LIBOR-indexed products to SOFR based on "a historical median over a five-year lookback period." This methodology is consistent with the methodology expected to be applied for derivatives products, and in theory will prevent any discrepancies between the cash and the derivatives markets. Any discrepancy between the cash and derivatives market may lead to hedging issues for borrowers under loan facilities. In addition, for consumer products, the ARRC is recommending a one-year transition period to this five-year median spread adjustment methodology. View the ARRC press release here.

Parting Shot

LIBOR transition within the context of COVID-19

Amid the Coronavirus Disease 2019 (COVID-19) pandemic, "steady as she goes" seems the current position of the different regulators in charge of coordinating an orderly transition from LIBOR to alternative reference rates, in particular, after the UK's Financial Conduct Authority (FCA) confirmed on April 29, 2020, that "firms cannot rely on LIBOR being published after the end of 2021".

Notwithstanding that the FCA has extended the deadline for ending the use of the LIBOR interest rate benchmark in new loans until the end of March 2021 (from September 2020), giving more time to banks already dealing with COVID-19-related issues, the FCA has stayed course and not extended the use of LIBOR past the original deadline of end of 2021.

Meanwhile, authorities around the world are preparing for the discontinuation of LIBOR as originally announced. For example, regulators in Australia and South Korea have encouraged market participants to assess their exposure to LIBOR and begin their transition to alternative rates. In the United States, the ARRC continues to chart the course by providing its own list of objectives for 2020 and a list with recommended best practices for the cessation of U.S. dollar LIBOR, "doubling down" on its early decision to use SOFR as the alternative rate for the U.S. market after LIBOR is no longer quoted. In addition, questions persist in the United States about the viability of SOFR given recent volatility and the lack of a forward-looking term SOFR rate.

It is possible that the FCA will not further extend the use of LIBOR, and that the ARRC will not select a different rate as the recommended alternative reference rate. However, the FCA and/or ARRC may change their minds. For example, if SOFR spreads widen considerably from LIBOR during this economic crisis, as they did in a backtrack calculation during the 2008 Financial Crisis, pressure may grow from market participants to find an alternative rate. Further, some of the COVID-19 stimulus loan programs in the United States, intended to provide relief and liquidity during the crisis, are currently indexed in LIBOR (and not SOFR), because "quickly implementing new systems to issue loans based on SOFR would require diverting resources from challenges related to the pandemic." (see question G.3 in the Federal Reserve's FAQs in connection with The Main Street Lending Program).

The crisis created by COVID-19 has made market participants change priorities to address more urgent matters, and has placed transition efforts on the back-burner. As such, banks and other market participants may not be working to determine their exposure to existing contracts referencing LIBOR, outlining plans of action, changing internal models, modifying their operational systems, and further, engaging counterparties in renegotiating – when necessary – documentation that may not properly provide for a useful alternative reference rate.

COVID-19 disrupted the world as we know it. With economies around the world having to adapt to a new reality, financial institutions may wish to prioritize plans related to an orderly transition to alternative reference rates. Indeed, pre-cessation triggers may hit before 2021 if LIBOR becomes unrepresentative of London interbank offered rates. In such a case, the LIBOR disruption may occur well before it was planned by any market participant.

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