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The LIBOR Phase-Out: What Borrowers Should Know Now

The London Interbank Offered Rate ("LIBOR") is a benchmark interest rate index used in setting the interest rate for many variable-rate loans and other financial obligations. LIBOR is currently set to be phased out in stages, with the first stage scheduled to begin at the end of this year. This phase-out poses a number of risks to borrowers with outstanding LIBOR-based financial obligations. In this blog, we discuss the steps that borrowers should take now in order to mitigate those risks and to ensure a smooth transition to an alternative benchmark rate.

On November 30, 2020, the International Exchange (ICE) Benchmark Administration (the "IBA"), the administrator of LIBOR, announced its intention to cease publishing one-week and two-month LIBOR on December 31, 2021 and the remaining tenors (overnight, one-month, three-month, six-month and 12-month) on June 30, 2023. The IBA expects to finalize this plan soon. In response, the Board of Governors of the Federal Reserve System, the Office of the Controller of the Currency and the Federal Deposit Insurance Corporation (collectively, the "Agencies") have jointly recommended that banks cease entering into new contracts using LIBOR as a reference rate as soon as practicable and in any event by December 31, 2021. In addition, the Agencies advise that new contracts entered into prior to December 31, 2021 should either use a reference rate other than LIBOR or include effective fallback language with a clearly-defined alternative reference rate effective upon the discontinuation of LIBOR. With these dates and recommendations in mind, borrowers with LIBOR-based financial obligations should consider taking the following steps to address the potential risks posed by the LIBOR transition.

Borrowers should immediately begin the process of identifying their outstanding LIBOR-based financial obligations with maturity dates that extend beyond 2021, including the particular LIBOR tenor (overnight, one-week, one-month, two-month, three-month, six-month or 12-month) that is used. Such obligations may include, but are not limited to, municipal bonds, notes, bank loans and lines of credit, derivatives, leases, installment sales agreements, reimbursement agreements governing letters of credit, standby bond purchase agreements governing the purchase of bonds upon an optional or mandatory tender, other credit facilities and certain investments.

Once the outstanding LIBOR-based financial obligations have been identified, borrowers should review the underlying agreements to determine whether they include effective fallback language. For example, agreements entered into prior to 2017 may contain fallback language designed for only a temporary, rather than permanent, discontinuance of LIBOR as a reference rate. It is therefore unlikely that such language would effectively address the LIBOR transition.

If the agreements include effective fallback language, then borrowers should work with their counsel and financial advisors to consider any fundamental differences between LIBOR and the alternative reference rate that would replace LIBOR, such as: (i) potential changes in interest rate levels, profitability or costs; (ii) responses to changing market conditions; (iii) state lending law constraints; and (iv) the possible impact on financial ratios, reporting and other covenants, or accounting practices. If it is determined that the alternative reference rate could introduce unanticipated risks to, or reduce the anticipated economic return of, the financial obligation, the borrower may wish to approach the counterparty to explore a possible renegotiation of the terms.

If the agreements lack fallback language, or the fallback language is inadequate or otherwise exposes the borrower to the unintended or disadvantageous risks described above, the borrower should consider the steps necessary to amend the agreements within the timeframe anticipated for the LIBOR transition. Such amendments may extend beyond simply swapping out LIBOR for an alternative reference rate. For example, the amendments could include: (i) appropriate adjustments to the spread above the reference rate to account for anticipated differences between the alternative reference rate and LIBOR and/or (ii) a one time, lump-sum payment in lieu of a spread adjustment. In that respect, borrowers should consult with their counsel and financial advisors throughout any amendment process in order to fully evaluate the legal and economic impact of such amendments.

The LIBOR transition also poses unique tax risks to borrowers that are 501(c)(3) corporations. Under certain circumstances, 501(c)(3) corporations may borrow the proceeds of tax-exempt municipal bonds issued by a quasi-public corporation. If the bonds bear interest at a LIBOR-based rate, then the LIBOR transition and resulting amendments to the financing agreements may subject the borrower to reissuance risk and the possible termination of a qualified hedge. On October 9, 2019, the Internal Revenue Service ("IRS") published proposed regulations (which may be relied upon prior to the release of the final regulations) that would allow 501(c)(3) corporations to amend their outstanding tax-exempt financial obligations in order to replace LIBOR with an alternate reference rate without triggering such tax issues; provided, that the amendments satisfy certain conditions. Pending release of the final regulations, the IRS also issued Revenue Procedure 2020-44 ("Rev. Proc. 2020-44") on October 9, 2020. Under Rev. Proc. 2020-44, the IRS has endorsed certain amendments to financial obligations that incorporate fallback language recommended by the Alternative Reference Rates Committee and the International Swaps and Derivatives Association (ISDA). We will continue to monitor further announcements from the IRS regarding the LIBOR transition, including additional tax consequences or new safe harbors, and provide updates in future blogs.

Additionally, borrowers that are 501(c)(3) corporations should confirm their disclosure obligations with respect to the LIBOR transition. Pursuant to the Securities and Exchange Commission's Rule 15c2-12, an underwriter may not sell municipal bonds without determining that the issuer or the "obligated person" (i.e., the 501(c)(3) corporation that borrows the proceeds of the bonds) has entered into a written continuing disclosure agreement to disclose certain matters to the bondholders on an ongoing basis. Pursuant to continuing disclosure agreements entered into after February 27, 2019, such borrowers are required to file a notice with the MSRB's EMMA system of: (i) the incurrence of material financial obligations or (ii) material amendments to outstanding financial obligations, if such amendments are determined to affect existing bondholders. The borrower would be required to file the notice within ten business days of the effective date of the financial obligation or amendment. Amending the agreements underlying the borrower's financial obligations to add or change the fallback language could trigger this filing requirement.

As a preliminary matter, such borrowers should review their continuing disclosure policies and procedures, particularly the standard for assessing materiality of a financial obligation or related amendment. Then, the borrower should work with its counsel and financial advisor to confirm the specific process for: (i) evaluating LIBOR-related amendments to its financing agreements against this standard and (ii) ensuring the filing of any required notices within the necessary timeframe. For outstanding financial obligations that already contain effective fallback language, such that no amendment to the underlying agreements is necessary, borrowers may consider whether a voluntary disclosure regarding the change in the benchmark rate is appropriate.

By instituting a robust LIBOR transition protocol as soon as possible, borrowers will be well positioned to identify risks and troubleshoot undesirable outcomes in a timely manner.

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