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Pitfalls and Issues for Lenders to Consider in Connection with LIBOR to SOFR Transition

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Cessation of LIBOR:

On March 5, 2021, IBA published its LIBOR Feedback Statement on Consultation on Potential Cessation (the "Feedback Statement")[1] reporting its intent to cease publication of (i) 1 week and 2 month USD LIBOR settings immediately following the LIBOR publication on December 31, 2021, and (ii) the Overnight and 1, 3, 6 and 12 month USD LIBOR settings immediately following the LIBOR publication on June 30, 2023. The Alternative Reference Rates Committee of the New York Federal Reserve Bank (ARRC) has published recommended standard provisions with respect to the LIBOR–SOFR transition (the "ARRC Standard Language"), which have been making their way in to recent loan documentation[2], pursuant to which the Feedback Statement constitutes a "Benchmark Transition Event" as defined in the ARRC Standard Language because it is a "a public statement or publication of information by or on behalf of the administrator . . . announcing that such administrator has ceased **or will cease** to provide all [available interest periods] of such [interest rate benchmark] (or such component thereof), permanently or indefinitely. . ." (emphasis added).[3] The ARRC Standard Language has both an amendment approach, whereby parties are permitted to amend the relevant loan documentation to reflect the new benchmark after a Benchmark Transition Event, and a hardwired approach, whereby the transition occurs automatically. As a result, we expect that borrowers with loan documents that follow the amendment approach will begin to get inbounds from their lenders to start the process of reflecting the new benchmark, and borrowers with loan documentation with the hardwired approach will make the transition to SOFR automatically once the administrator indefinitely ceases to provide the applicable LIBOR rate. Finally, to the extent that loan documents lack the ARRC Standard Language but require a conversion to an "alternate base rate" if LIBOR falls away, such loan documents will shift from LIBOR to the "alternate base rate" (rather than SOFR) once LIBOR is retired (unless the loan documents are affirmatively amended).

Discrepancies Between LIBOR and SOFR "Floors":

LIBOR loan documents often include interest rate "floors" providing that, regardless of actual LIBOR at any given time, "LIBOR" shall never be deemed to fall below a certain threshold under the loan document. For example, a loan document with a 1.00 percent LIBOR floor would calculate LIBOR at 1.00 percent if LIBOR's actual value were below that threshold (and a loan document with a 0.00 percent LIBOR floor would never include negative LIBOR in the calculation of applicable interest rates). However, some LIBOR loan documents—even those with LIBOR replacement language—do not take into account that yield loss could arise from the upcoming LIBOR transition due to a “mismatch” between the LIBOR and SOFR floors. Although the NYFRB has published fallback language that includes a “spread adjustment” intended to make up the difference between LIBOR and SOFR, this adjustment may not be sufficient, from a lender’s perspective, when considered in light of the corresponding interest rate floors.

As an illustration, assume that (i) the loan documents have a 1.00 percent LIBOR floor, but no floor for SOFR or a comparable interest rate, (ii) the current applicable interest period is one-month LIBOR, (iii) the applicable margin is 3.50 percent and (iv) the loan documents include “spread adjustment provisions” with an applicable spread adjustment (as recommended by the NYFRB) of 0.20 percent. If the one-month LIBOR at the time of calculation is 0.12 percent, the applicable LIBOR interest rate would be the floor (1.00 percent) plus the applicable margin (3.50 percent) for a total yield of 4.50 percent. However, if the applicable benchmark has transitioned from LIBOR to SOFR and the one-month SOFR is 0.06 percent, the applicable SOFR interest rate at the same time would be the one-month SOFR (0.12 percent)[4] plus the applicable spread adjustment (0.20 percent) plus the applicable margin (3.50 percent) for a total yield of 3.82 percent (or 0.68 percent less than the applicable LIBOR interest rate).

Differences in interest rate floors could thus cause unexpected adverse consequences for lenders due to the LIBOR transition; accordingly, lenders should review their existing loan documentation and consider amending it to the extent a discrepancy exists between the LIBOR and SOFR floors. Lenders should also consider any necessary consents they may need to obtain from other lenders (discussed below) in order to remedy this issue, as loan documents typically require the consent of all affected lenders to amend any economic provisions (which would include the amendment of an interest rate floor).

Voting Issues:

Finally, lenders whose loan documents do not currently include transition language should consider potential inter-lender voting issues as LIBOR’s transition approaches. As discussed above, all affected lenders likely need to consent to any change in interest rate calculation, which may include adding or amending fallback provisions. Although these issues may not be present in deals with a limited number of lenders (or deals where the interests of all lenders are closely aligned), lenders participating in broadly syndicated loans should carefully consider how to address the LIBOR transition in their loan documents and what lender consents would be required to do so. The lender consent process can be time-consuming, particularly in broad syndication loans, and lenders should also recognize that third-party administrative agents may also need to consent to these changes (and may also have their own required supplemental transition language).

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[1] ICE Benchmark Administration, *ICE LIBOR Feedback Statement on Consultation on Potential Cessation* (March 5, 2021), https://www.theice.com/publicdocs/ICE_LIBOR_feedback_statement_on_consultation_on_potential_cessation.pdf.

[2] Alternative Reference Rates Committee, Federal Reserve Bank of New York, *ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Syndicated Loans* (April 25, 2019), https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Syndicated_Loan_Fallback_Language.pdf.

[3] Alternative Reference Rates Committee, Federal Reserve Bank of New York, *ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Syndicated Loans* (June 30, 2020), https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/Updated-Final-Recommended-Language-June-30-2020.pdf.

[4] SOFR rates are publicly available at the NYFRB's website: https://apps.newyorkfed.org/markets/autorates/sofr-avg-ind.

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