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LIBOR Act Addresses Transition of USD LIBOR in Contracts Without Replacement Mechanisms

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The Consolidated Appropriations Act of 2022 (Omnibus Spending Bill)[1], signed by President Biden on March 15, contains, among other initiatives, the Adjustable Interest Rate (LIBOR) Act. The LIBOR Act solves the legal uncertainty regarding how "Tough Legacy" contracts — contracts that reference the London Interbank Offered Rate (LIBOR) as a benchmark rate and that do not contain either a specified replacement rate or a replacement mechanism — should be treated after USD LIBOR ceases publication on June 30, 2023.

Congress estimated that over $200 trillion worth of active contracts are based on LIBOR. In tackling the Tough Legacy contracts issue, Congress explicitly stated four goals. First, to establish a clear and uniform process for replacing LIBOR in Tough Legacy contracts without affecting the ability of parties to use any appropriate benchmark rates in new contracts. Second, to preclude litigation related to Tough Legacy contracts without a replacement rate. Third, to allow Tough Legacy contracts that contain a fallback replacement rate provision to use such provisions. Finally, to address LIBOR references in federal law.

Market participants holding Tough Legacy contracts may face the possibility of litigation to determine an effective replacement rate once the Intercontinental Exchange, the administrator of LIBOR, ceases to publish USD LIBOR tenors on June 30, 2023. To avoid such litigation, under the LIBOR Act, the Board of Governors of the Federal Reserve System will select the replacement rate for such contracts in the event that the contracts contain no fallback provision or if the contracts lack specificity as to the replacement benchmark rate or determining person or body. The guidelines for a replacement rate mandated by Congress include that such replacement rate should be a commercially reasonable replacement for and a commercially substantial equivalent to LIBOR, analogous to LIBOR, based on a similar methodology to LIBOR, and with similar historical fluctuations to LIBOR. The LIBOR Act directs the Board of Governors to select the Secured Overnight Financing Rate (SOFR), published by the Federal Reserve Bank of New York, as the replacement rate. Under the LIBOR Act, the LIBOR replacement date is the first London banking day after June 30, 2023, unless the Board of Governors determines a different date.

The LIBOR Act seeks to preserve continuity of Tough Legacy contracts, so the selection of a benchmark replacement rate would not be grounds to impair, discharge, terminate, void, or breach any contract that previously incorporated LIBOR and now incorporates the Board of Governors-approved benchmark replacement rate. Congress also enacted a safe harbor that provides the selection of a LIBOR replacement rate, such as SOFR, will not give rise to a cause of action in law or equity against those eligible persons with the ability to select a benchmark rate under the terms of the contract, as well as those eligible persons who implement such changes.

In addition, Congress mandated that there will be no negative interference or negative presumption regarding the enforceability of any replacement rate regardless of whether such rate is one selected by the Board of Governors. Market participants may contract freely without being restricted to replacements selected by the Board of Governors. Congress has given the Board of Governors 180 days to promulgate the necessary regulations to carry out the provisions of the LIBOR Act.

On April 5, the Financial Stability Board (FSB) — an international organization that monitors and provides recommendations regarding the global financial system — issued a statement that welcomed the transition away from LIBOR to other overnight rates, such as SOFR. FSB highlighted the need to continue LIBOR until June 2023 to support a "substantial proportion" of Tough Legacy contracts. However, FSB noted that even though LIBOR settings will continue until June 2023, market participants should stop new use of LIBOR and prepare for the complete cessation of LIBOR.

The LIBOR Act has been welcomed by market participants and other organizations as an important step in providing clarity in the face of the impending cessation of LIBOR. In the course of the next six months, the Board of Governors will release the necessary regulations associated with selecting a replacement rate, which will finalize issues surrounding LIBOR replacement in Tough Legacy contracts.

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[1] H.R.2471.

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