FEBRUARY 16, 2021

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Can't We All Just Get Along? Four Key Areas of Dispute in the Evolving Landscape of LIBOR Cessation Litigation

On November 30, 2020, parties to legacy LIBOR contracts breathed a collective sigh of relief as LIBOR's administrator Intercontinental Exchange, Inc. ("ICE") announced that US Dollar LIBOR would continue to be published until December 31, 2021 for the one-week and two-month tenors and until June 30, 2023 for the remaining, more widely used tenors.[1] As explained in our prior Client Alerts on the transition away from LIBOR, these extensions will allow time for most legacy LIBOR contracts to mature prior to the cessation of LIBOR's publication,[2] significantly reducing – or at least delaying – the potential for disputes between counterparties over the selection of an appropriate alternative reference rate. But the potential for disputes remains, particularly because the earlier-expiring one-week and two-month tenors, though less popular than those expiring in June 2023, are still prevalent in corporate lending and leasing documents according to ICE's most recent survey on LIBOR usage.[3] Now more than ever, market participants must examine their legacy LIBOR contracts and portfolios of LIBOR-linked instruments to determine which of them rely on an expiring setting, gauge the potential exposure, and negotiate a suitable fallback approach.[4]

But what if counterparties cannot agree on a mutually-acceptable replacement for LIBOR? In this Client Alert, we identify key developments shaping disputes arising from LIBOR's cessation, which will generally emerge in four key areas: (1) contract litigation between counterparties over replacement rates, (2) shareholder and investor actions against companies whose profitability may be impacted by the transition from LIBOR, (3) consumer class actions against lenders of LIBOR-based financing, and (4) regulatory enforcement actions with an emphasis on securities disclosures and consumer protection.

KEY FACTORS SHAPING DISPUTES OVER LIBOR CESSATION ISSUES

The overarching factor that will drive disputes over LIBOR cessation is the lack of any single legally-mandated or governmentally-endorsed approach to transitioning to an alternative rate. The Alternative Reference Rate Committee ("ARRC") and other regulators have undertaken extensive efforts to develop and recommend replacement protocols for counterparties to adopt, but these recommended approaches are simply that – recommendations.[5] Only one U.S. state – New York – has introduced legislation that would mandate the ARRC's proposal to adopt the Secured Overnight Financing Rate ("SOFR") as the replacement rate in legacy LIBOR contracts.[6] The enactment of that legislation is far from certain and, in any event, would apply only to instruments governed by New York law, which, though commonly designated to govern corporate contracts, is by no means the only jurisdiction whose law will be applied to decide LIBOR-related disputes.[7] The New York legislation would, however, significantly impact parties to International Swaps and Derivatives Association ("ISDA") Master Agreements that have not adopted fallback language, as New York is the default U.S. choice of law in ISDA Master Agreements.[8] Under legislation enacted in the European Union[9] and pending in the United Kingdom,[10] legacy LIBOR contracts and instruments governed by the laws of these jurisdictions will, in the absence of a negotiated replacement, default to fallback procedures selected by EU and UK regulators from a number of potential replacements.[11]

In the absence of a single mandated approach, there is ample room for dispute. Even the most widely accepted LIBOR replacement, SOFR, is historically lower than LIBOR and thus requires parties to agree on a positive "spread adjustment" (*i.e.*, rate or margin increase) to make SOFR an equivalent or workable substitute.[12] Where counterparties, such as borrowers and lenders, have conflicting financial incentives over rate adjustments, disputes over what increase constitutes a "fair" spread adjustment are bound to emerge. These disputes are fundamentally driven by concerns over the risk of "value transfer," the risk that one party will reap benefits it had not originally bargained for due to a potential mismatch between LIBOR and the selected replacement rate.

Most directly, unresolved disputes over rate adjustments will translate into contractual litigation between counterparties to legacy LIBOR contracts, leaving it up to courts to determine whether and on what terms these contracts can continue to be enforced. But LIBOR's wide usage and prevalence in both institutional and consumer finance creates myriad litigation and regulatory enforcement risks in other areas, particularly where recent events signal increased regulatory scrutiny over the LIBOR transition.

AREA 1: CONTRACT LITIGATION BETWEEN COUNTERPARTIES TO LEGACY LIBOR CONTRACTS

Litigation over contract enforcement is likely to arise between counterparties who cannot agree on a suitable replacement for LIBOR. While the specific contractual language at issue will determine what claims and theories can be asserted, such litigation will likely center on disputes over whether a legacy LIBOR contract remains enforceable after relevant LIBOR tenors are no longer being published. Parties may argue for contractual rescission on a number of grounds, including that the cessation of LIBOR renders the interest rate terms of their contract ambiguous, or that it has legally frustrated the purpose of their contract such that non-performance is excused. Litigants resisting rescission of their legacy LIBOR contracts will likely focus on the foreseeability of LIBOR's cessation at the time of contract formation, arguing that these contracts cannot be voided on the basis of unilateral mistake, or at the very least should be reformed and enforced using one of several widely-accepted replacement rates.

Parties faced with anticipatory breaches by uncooperative counterparties may sue for specific performance at a judicially-sanctioned replacement rate, or alternatively terminate the contract and sue for damages incurred in securing replacement services or financing. For contract litigation filed after LIBOR has ceased publication, the availability of injunctive relief is likely to complicate these proceedings, as parties may seek an injunction to maintain the status quo while complex merits issues are resolved. This is likely to cause litigation activity and costs to materialize on an expedited basis, as courts will likely need to conduct preliminary hearings and some discovery, including expert discovery, to determine a temporary replacement.

Parties assessing their litigation risks should also be mindful of any indemnification or contribution language in their LIBOR-based contracts and instruments. A contract may, for example, contain provisions requiring one party to indemnify another party's legal costs and attorneys' fees in any litigation arising from or in connection with their contractual rights and remedies. In these situations, even where the indemnifying party's potential exposure to liability and damages on an underlying claim is relatively low, the possibility that they will required to reimburse a counterparty's litigation costs and fees may render a litigated outcome too costly to be advisable. This increased source of risk and cost for indemnifying parties is likely to become a pivotal leverage point in their negotiations with counterparties over adoption of a fallback approach and could exert additional pressure to come to a consensual resolution.

In addition to these contractual claims, parties may also pursue statutory and common law tort claims related to LIBOR cessation. Every U.S. state has some form of statutory prohibition against deceptive and unfair trade practices, which plaintiffs may use to pursue damages related to one-sided attempts to take advantage of interest rate adjustments. Claimants may also assert quasi-contractual claims and business torts, such as unjust enrichment and breach of the implied covenant of good faith and fair dealing claims. Though susceptible to a number of legal defenses that may allow for early disposition of these claims, the potential for punitive damages and awards of attorneys' fees associated with these claims must be considered in any analysis of risk.

AREA 2: SHAREHOLDER AND INVESTOR ACTIONS AGAINST COMPANIES WITH LIBOR-BASED PORTFOLIOS

Companies with LIBOR-based portfolios (and their officers and directors) also face potential litigation exposure to claims arising under federal securities law. Shareholders or investors in LIBOR-linked securities may assert securities law claims based on a company's failure to adequately disclose certain risk factors associated with LIBOR's discontinuation, including, for example, the risk of value transfer for companies with LIBOR-heavy portfolios, in securities offerings or public filings, such as the SEC's Form 10-K. This is especially true for prospectuses or filings issued after July 27, 2017 – the date on which the FCA first signaled its intention to transition away from LIBOR.[13] Since that time, regulators and institutional market groups have extensively warned of the risks associated with LIBOR cessation, and thus a company's failure to disclose those risks to shareholders or investors in light of repeated warnings from regulators would arguably meet the scienter threshold (*i.e.*, reckless or intentional) to establish such claims. Therefore, companies should be particularly careful to disclose all relevant risks related to LIBOR cessation consistent with federal disclosure regulations.

In choosing an appropriate LIBOR replacement, companies must balance the interests of shareholders and investors with the interests of consumers of LIBOR-based products. As discussed below, a replacement rate that decreases interest payments owed by borrowers resulting in lower returns on legacy LIBOR instruments could give rise to additional claims from shareholders or investors. Finally, shareholder actions may be filed against companies, and/or their officers and directors, who fail to adequately put controls and plans in place to account for the discontinuation of LIBOR. Such lawsuits could take the form of securities class actions and could be filed in multiple jurisdictions with the possibility of opt-out and tag-along actions, resulting in significant litigation costs and burdens. Thus, it is imperative for companies to act now to mitigate the risks associated with LIBOR cessation.

AREA 3: CONSUMER CLASS ACTIONS AGAINST LENDERS OF LIBOR-LINKED FINANCING

Approximately $1.3 trillion of consumer loans – including adjustable rate mortgages ("ARMs"), credit cards, and home equity lines of credit ("HELOCs") – involve interest rates tied to LIBOR. While this accounts for less than one percent of all LIBOR-related instruments, the plaintiffs' bar is likely to focus outsize attention on this class of assets given the heightened protections afforded to consumers under state and federal law. In particular, existing and proposed federal credit regulations require that lenders replace LIBOR with a new spread-adjusted index that is "substantially similar" to the consumer product's old LIBOR-based index. This threatens a lose-lose situation for creditors, who will face litigation from consumers if the replacement rate is perceived as overly favorable to lenders and suits from shareholders or investors if the rate is overly favorable to borrowers. Creditors must therefore walk a fine line between protecting the bargained-for profitability of their legacy LIBOR investments and abiding by consumer protection regulations.

Moreover, lenders are subject to extensive disclosure requirements under Regulation Z to transition certain open- and closed-end consumer products away from LIBOR. For example, a recently proposed section in Regulation Z (set to take effect in October 2021) requires HELOC lenders to provide notice to consumers of both the replacement index and any resulting change in the interest rate margin, even if the margin is decreased. Borrowers may assert claims against lenders who fail to provide adequate notice of such changes in a variety of consumer products. Finally, consumers may take advantage of the broad prohibitions and damages provisions in the Dodd-Frank Act, as well as various states' consumer protection statutes, to bring actions against creditors for perceived unfair, deceptive, or predatory business acts or practices.

AREA 4: REGULATORY ENFORCEMENT ACTIONS

The risks of consumer and shareholder class actions also carry parallel risks of regulatory investigations and enforcement actions. As Michael Held, general counsel and executive vice president of the New York Federal Reserve, revealed in a February 2019 speech, regulators are keenly aware of the litigation exposure caused by the transition from LIBOR: "This is a DEFCON 1 litigation event if I've ever seen one."[14] Increased regulatory focus on the LIBOR transition seems likely given President Biden's recent selection of individuals to lead his financial regulation transition teams. Gary Gensler, an early and outspoken critic of LIBOR, has been nominated to head the SEC, and is leading President Biden's team charged with staffing other financial regulators, including the Commodity Futures Trading Commission and the Federal Reserve.[15] This selection indicates the SEC will play an active role in monitoring public disclosures from companies with LIBOR-heavy portfolios to ensure that cessation risks are adequately and accurately disclosed to shareholders and investors.

In addition, state regulatory and enforcement agencies may bring actions focused on consumer protection relating to the transition away from LIBOR. The Biden administration has also selected a 10-person review team to staff the Consumer Financial Protection Bureau ("CFPB"), signaling an increased role for the CFPB in enforcement of consumer protections in the transition from LIBOR. The CFPB may scrutinize actions taken by creditors relating to the replacement of LIBOR, and creditors should therefore closely follow Regulation Z's requirements regarding consumer notification of a change to the contract terms, limits on when the index can change, and requirements for selecting an appropriate replacement index. Consumer products facing increased scrutiny under Regulation Z include ARMs, student loans, auto loans, personal installment loans, credit cards, HELOCs, overdraft lines of credit, and personal installment loans. Financial services firms with significant investment in these consumer products should carefully examine Regulation Z requirements to gauge exposure to regulatory scrutiny.

KEY TAKEAWAYS

- Discontinuation of LIBOR presents significant potential for disputes between contract counterparties who cannot agree on suitable replacement rates and fallback procedures.
- Disputes over replacing LIBOR will continue to pose litigation risks as long as the various fallback approaches recommended by regulators and industry groups remain voluntary and not mandated by government legislation or order.

- Litigation involving contract issues, shareholder and investor disclosures, consumer protection, and regulatory enforcement is likely to emerge given LIBOR's wide usage in finance and the risk of financial harm from value transfer posed by potential discrepancies between LIBOR and replacement rates.
- Market participants should carefully examine their contractual commitments and LIBOR-linked portfolios to gauge and appropriately manage their litigation risks.

[1] ICE, "ICE Benchmark Administration to Consult on Its Intention to Cease the Publication of One Week and Two Month USD LIBOR Settings at End-December 2021, and the Remaining USD LIBOR Settings at End-June 2023" (November 20, 2020), available at: https://ir.theice.com/press/news-details/2020/ICE-Benchmark-Administration-to-Consult-on-Its-Intention-to-Cease-the-Publication-of-One-Week-and-Two-Month-USD-LIBOR-Settings-at-End-December-2021-and-the-Remaining-USD-LIBOR-Settings-at-End-June-2023/default.aspx.

[2] King & Spalding LLP, "Is My Libor Back?" (December 8, 2020), available at: https://www.kslaw.com/news-and-insights/is-my-libor-back#_edn2.

[3] ICE, "Results of the IBA Survey on the Use of LIBOR" (March 2019), available at: https://www.theice.com/publicdocs/Results_of_the_IBA_Survey_on_the_use_of_LIBOR.pdf.

[4] King & Spalding LLP, "Avoiding Windfalls on LIBOR Fallback Reference Rates" (December 19, 2020), available at: https://www.kslaw.com/news-and-insights/avoiding-windfalls-on-libor-fallback-reference-rates.

[5] King & Spalding LLP, "What Happened To My Interest Rate? Agencies Confirm SOFR Not Required" (November 19, 2020), available at: https://www.kslaw.com/attachments/000/008/343/original/What_Happened_To_My_Interest_Rate_Agencies_Confirm_SOFR_Not_Required.pdf?1605890283.

[6] Senate Bill S9070, New York State 2019-2020 Legislative Session, available at: https://www.nysenate.gov/legislation/bills/2019/s9070?intent=oppose.

[7] New York law is designated as the governing law in an estimated 46% of contracts involving publicly held companies. *See* Theodore Eisenberg and Geoffrey P. Miller, "The Flight to New York: An Empirical Study of Choice of Law and Choice of Forum Clauses in Publicly-Held Companies' Contracts" (2009). Cornell Law Faculty Publications, available at: https://scholarship.law.cornell.edu/facpub/204.

[8] Since 1987, ISDA's standard governing law provisions offer a choice of law between New York law and English law. *See* 2018 ISDA Choice of Court and Governing Law Guide (February 27, 2018).

[9] Council Regulation (EU) 2021/168, 12 February 2021 (O.J. L 49/6), available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021R0168&from=EN.

[10] Financial Services Bill 2019-21, HL Bill 162, available at: https://services.parliament.uk/Bills/2019-21/financialservices/documents.html.

[11] The EU legislation, unlike the legislative fixes under consideration in New York and the UK, presents added risk because it does not provide a "safe harbor" provision that would broadly immunize parties from counterparty claims brought as a result of interest rate changes when the replacement rate is imposed.

[12] King & Spalding LLP, "Client Alert: What Happened To My Interest Rate? Planning Now To Avoid Value Transfer And Other Risks Upon The Demise Of U.S. Libor" (October 22, 2020), available at: https://www.kslaw.com/news-and-insights/what-happened-to-my-interest-rate-planning-now-to-avoid-value-transfer-and-other-risks-upon-the-demise-of-us-libor.

[13] Speech by Andrew Bailey, Chief Executive of the FCA, "The Future of Libor" (July 27, 2017), available at: https://www.fca.org.uk/news/speeches/the-future-of-Libor.

[14] Speech by Michael Held, General Counsel and Executive Vice President of the New York Federal Reserve, "SOFR and the Transition from Libor" (Feb. 26, 2019), available at: https://www.newyorkfed.org/newsevents/speeches/2019/hel190226.

[15] Amy Greer and Valerie Mirko, "What to Expect From Biden's Financial Regulation Transition" (December 18, 2020), available at: https://www.law360.com/articles/1338474/what-to-expect-from-biden-s-financial-regulation-transition.