International Capital Market Services Association

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ICMSA Bulletin – The discontinuation of LIBOR/IBORS – different approaches for transition under English law trust deeds and New York law indentures

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As reported in ICSMA Bulletin 181018/44, ICMSA Bulletin – *The discontinuation of LIBOR/IBORS - implications for English-law note trustees* (the October 2018 Bulletin) in July 2017, Andrew Bailey, chief executive of the UK Financial Conduct Authority (the FCA), announced in a speech that the FCA would, from the end of 2021, no longer be persuading or compelling banks to submit quotes for LIBOR (the London Interbank Offered Rate) and that market participants should therefore not rely on LIBOR being available after 2021. Other interbank offered rates are also following suit and are heading towards being discontinued. The October 2018 Bulletin also outlined the common fallback provisions which would apply to floating rate notes with English law governed transition documents and tenors extending beyond the discontinuation of LIBOR, and considered the basis on which such transactions could be amended.

As LIBOR and other interbank offered rates (IBORs) are relevant to floating rate notes constituted by New York law governed indentures as well as under English law governed trust deeds, this bulletin is intended to compare how the transition away from IBORs could be approached under each regime.[1]

Floating Rates and Fallback Provisions

The method of determining floating rates of interest on notes is largely the same under English law governed transactions and New York law governed transactions. An agent will look at the relevant IBOR published on a page of Reuters or Bloomberg (the Screen Rate) and then add a margin to this. If the Screen Rate is not available, the fallback provisions provide that the agent first requests quotes for IBOR from a number of reference banks; if this is not available, the second fallback is for the agent instead to seek quotes from banks in the principal financial centre of the currency of the notes for the interest rate at which such banks would make a loan to another bank for the relevant IBOR period. As a last resort, the transaction documents typically provide that the interest rate for the previous interest period will continue to apply, effectively turning floating rate notes into fixed rate notes.

As explained in the October 2018 Bulletin, these fallback provisions were drafted in contemplation of the possibility of the relevant screen rate being temporarily unavailable, rather than a permanent discontinuation of the applicable benchmark. As a result, in anticipation of the permanent discontinuation the issuer may look to amend the transaction documents to replace the relevant IBOR with a new reference rate or to provide for a fallback mechanism to reflect the permanent discontinuation of the IBOR.

[1] This bulletin is intended to consider the position on legacy transactions although we note that some indentures and trust deeds drafted in the wake of the discontinuance of IBORs being announced have been drafted to try to address the permanent discontinuance of IBORs.

Amendment by the Trustee?

The issuer may first look to the trustee to consent to any amendments to the transaction documents. The extent to which trustees are empowered to consent to amendments under English law trust deeds and New York law indentures varies, although in relation to replacing reference rates and amending fallback provisions the end result may be the same.

<table>
<tr><th>English Law</th><th>New York Law</th></tr>
<tr><td> Under English law trust deeds, trustees have limited powers to modify transaction documents in their own discretion: these are the well-trodden discretionary heads of such modification being of a formal, minor or technical nature, to correct a manifest error or one which, in the opinion of the trustee, is not materially prejudicial to the interests of the noteholders. Replacing a reference rate contained in the transaction documents or amending the fallback mechanics for determining a replacement reference rate could only fall within the trustee's "not materially prejudicial" power. It is difficult to see how a trustee could ever be sufficiently comfortable to use this power to amend a reference rate or a margin. Furthermore, this power is normally removed altogether whenever the modification relates to a "reserved matter", being those categories of amendments listed in the transaction documents seen as so fundamental to the rights of noteholders that such changes ought always to be put to noteholders for their consideration (and are removed from the trustees discretionary power). A modification to the amount of interest payable or to the method of calculating the amount of interest payable is a classic (and possibly most obvious) example of a "reserved matter". </td><td> Under New York law indentures, trustees do not have discretion to make amendments, albeit indentures do typically permit amendments to be made without noteholder consent to cure ambiguities or make amendments which do not adversely affect the interests of the noteholders in any respect or any material respect. However, this typically only applies to correcting drafting mistakes or inconsistencies in the indenture relative to the notes and would not be interpreted to cover amending the fallback mechanism for a replacement IBOR. New York law indentures do not typically contemplate replacing a reference rate contained in the transaction documents that is no longer available or amending the fallback mechanics for determining such a reference rate. </td></tr>
<tr><td colspan="2">In either case, a trustee would have no discretionary power to make such amendments and noteholder consent would be needed.</td></tr>
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Amendment by the Noteholders?

As the trustee will not or is not able to exercise discretion to replace the reference rate or amend the fallback provisions, the next option for the issuer would be to seek consent from the noteholders themselves.

English Law	New York Law
Noteholders could approve replacing the reference rate or amending the fallback provisions by way of an extraordinary resolution passed at a meeting of the noteholders. The issuer will need to engage with noteholders through a consent solicitation process in order to seek their approval of the necessary modifications. However, a number of factors can make it difficult to achieve the necessary approval. The meeting will need to be quorate to pass the extraordinary resolution and, as an amendment to the interest rate or the method of calculating the interest rate will be a "reserved matter", a higher quorum than usual will be required by the trust deed, making it harder to convene quorate meetings. Additionally, with the potential difficulty of getting noteholders to engage with the process (for example, due to notes being widely held through clearing systems or the subject matter of the amendments not piquing enough interest) and different ranking classes of notes all needing to provide consent, it could be a challenge to gain enough support amongst the noteholders to authorise such amendments. It is unlikely, however in what may be a key difference to the position under New York law indentures, that any English law trust deed requires the unanimous consent of holders to make these amendments.	Replacing a reference rate or amending fallback provisions language would require the consent of noteholders. The question is whether consent of a majority, supermajority or all of the noteholders will typically be required? Typically New York law indentures require consent of a majority of noteholders to amendments, however all noteholders need to consent to amendments which reduce the rate of interest on a note or impair the right of holders to institute suits to enforce their rights to payment. Determining whether the replacement of a reference rate or amendments to the fallback mechanics would have such an effect would be a difficult task however and would need to be considered on a case-by-case basis. Whatever reference rate was chosen to replace the relevant IBOR, and any adjustments that might be made to the reference rate, either upfront or through amended fallback mechanics, would never be the same as the original IBOR all the time. The impact on noteholders could be unpredictable as it would depend on market factors varying over time. In the U.S., the Alternative Reference Rates Committee (the ARRC) has selected the Secured Overnight Financing Rate (SOFR) to replace U.S. dollar LIBOR for floating rate notes. SOFR is more liquid that LIBOR and unlike LIBOR, is a secured rate (by U.S. Treasuries). As a result, it tends to be lower than its LIBOR equivalent and, without the proper adjustment, there is a risk that interest rates payable to noteholders could be negatively impacted. In such a case consent of all noteholders would be required. This would typically require the issuer to hold a consent solicitation.

	In addition, if an indenture is qualified under the Trust Indenture Act of 1939, as amended (the TIA), or the indenture incorporates the TIA as a matter of contract law, section 316(b) of the TIA requires each noteholder to consent to any impairment of such noteholder's right to receive interest payments. Whilst the impact of a replacement of the reference rate or amendment to fallback provisions on the amount of interest received by noteholders would be hard to determine, as mentioned in the paragraph above, these changes may be seen as going to the indenture's core payment provisions, which section 316(b) is intended to protect. It may therefore be that the trustee would have no ability to agree such an amendment in relation to a TIA-qualified indenture (or an indenture that incorporates the TIA) unless the issuer has obtained the consent of all of the noteholders. This would typically require the issuer to hold a consent solicitation.

Amendment leading to U.S. tax consequences?

Concerns have been raised as to whether replacing reference rates (or amending fallback provisions to enable this) in relation to existing floating rate note transactions may lead to tax consequences for the relevant issuer and/or noteholders. In April and June of 2019 the AARC submitted documents to the U.S. Department of Treasury and the U.S. Internal Revenue Service (the IRS) identifying such potential tax consequences that may be triggered and sought guidance from the IRS on the related tax treatment of such events. The ARRC explained that substituting the reference rate would likely involve an adjustment to spreads above the reference rate and/or a one-time lump sum payment in lieu of a spread adjustment which might be considered a gain or loss or income under certain existing U.S. Federal tax rules.

On 9 October 2019 the IRS issued a proposed rule that would significantly lessen the effect of replacing a reference rate on floating rate notes. The most significant clarification that the IRS provided in the proposed rule is that replacing LIBOR with another rate or adding fallback provisions to debt instrument documents is not a "realization event" and will not result in the recognition of a gain or loss for U.S. tax purposes provided that certain conditions are met: (i) the new reference rate must be a "qualified rate" – notably, the list of qualified rates includes SOFR; (ii) the fair market value of the instrument after modification must be "substantially equivalent" to its fair market value before modification; and (iii) the new reference rate must generally be based on transactions conducted in the same currency as the rate it replaces.

The proposed rule provides issuers and noteholders with greater certainty about the impact the replacement of a reference rate may have on their floating rate notes.

The full text of the proposed rule can be found in the link below:

https://www.federalregister.gov/documents/2019/10/09/2019-22042/guidance-on-the-transition-from-interbank-offered-rates-to-other-reference-rates#h-20

Conclusion

Although the provisions under English law trust deeds and New York law indentures are different, the results may be the same when seeking to replace a reference rate or change the related fallback provisions. Whilst under a New York law indenture it may be difficult to obtain noteholder consent (as the consent of all noteholders is likely to be needed), the lower quorum requirements under English law deeds may still be difficult to achieve if there is a lack of engagement from noteholders – the problem being more acute on deals with multiple series of notes of varying rank. In any event, the English and New York regimes agree that the trustee would not be able to agree such amendments using its discretionary powers of modification.